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The Curious Case of the WTI Brent Spread

By Matthew Krupski (March 17)

There are two grades of crude oil futures that are actively traded: West Texas Intermediate (WTI), and Brent Crude. WTI crude accounts for the majority of crude produced in the U.S., and is considered to be a better grade than Brent, as it is easier to refine. Brent crude is found in the North Sea and is most similar to the crude produced by the OPEC countries. Because it is easier to refine and has no import costs associated with it, WTI has historically traded at a premium to Brent. However, a domestic production boom has reversed this trend, and in recent history, WTI has traded at a discount to Brent. Since November of 2016, this spread has increased dramatically. The question is, how wide can it go?

The difference between front month (May) Brent futures and front month (April) WTI futures reached a new high of 3.20 this week (Brent trading at a $3.20/barrel premium to crude). This expanded from a $1.60 premium in November of 2016. Much of the expansion can be attributed to two things: The OPEC announcement of production cuts in November and the composition of Donald Trump's administration, which is friendlier to U.S. production. The OPEC production cuts reduced Brent supplies, and the energy friendly administration has helped grow domestic supply and increased the perception that supplies will continue to grow in the future.

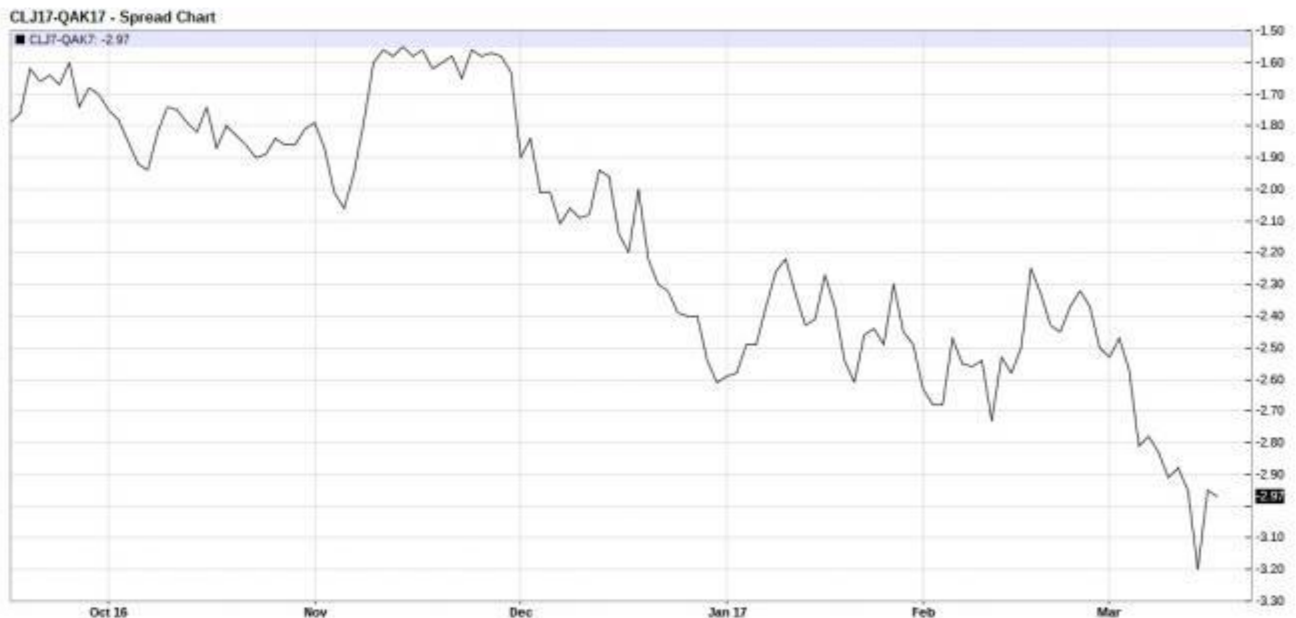

Chart from Barchart.com

However, as the spread widens, the economics of oil production may help bring it back in line. There have recently been rumblings about OPEC countries cheating and increasing production despite their agreement to cut. If OPEC's agreement fails, new Brent supply should pressure Brent prices. Additionally, the U.S. has removed restrictions on exporting domestic oil. If WTI continues to trade at a large discount to Brent, it becomes more economical for overseas refiners to import crude from the U.S. (despite transportation costs) rather than use the more expensive Brent. In fact, we have already seen U.S. oil exports surging this year. Any implementation of a border tax would further stoke demand for domestically produced WTI and hamper demand for Brent, causing a narrowing of the spread. Finally, U.S. consumer and business confidence is strengthening, which may be a precursor to a domestic demand surge. Any surge in demand could quickly eat into our burgeoning supplies and support WTI prices. Traders looking to benefit from a narrowing of the spread should consider buying WTI crude and selling Brent.

Matt strives to offer a steady, informed perspective, helping clients to limit emotional trading and execute a clear trading plan. You can reach him at 312-242-7978 or matthew.krupski@archerfinancials.com.

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