

The Record High Diesel Prices

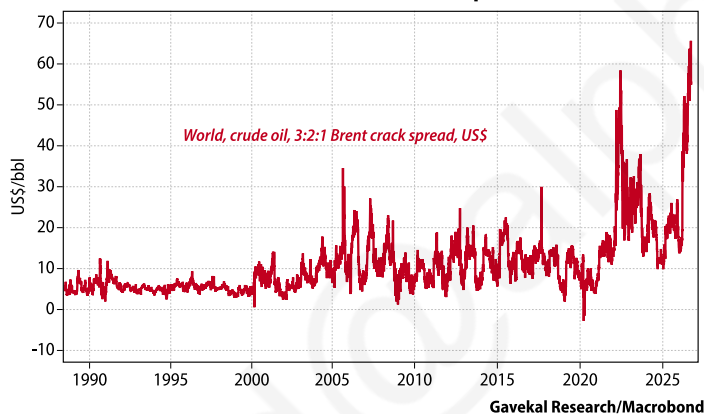
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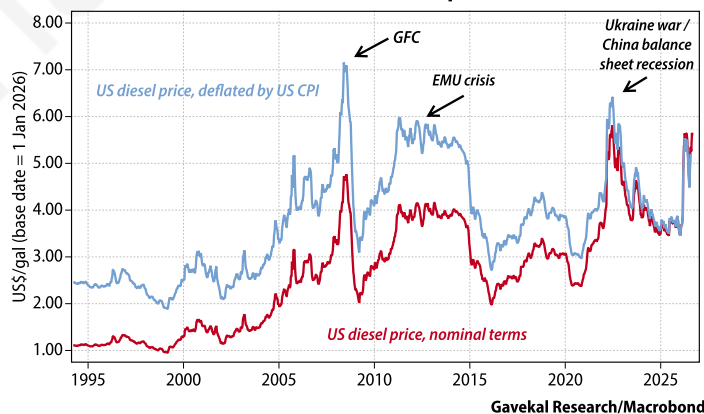
Because of soaring crack spreads, diesel prices everywhere around the world are making new all-time highs, at least in nominal terms. In real terms, diesel prices are still far below the levels reached in 2008 (when the Sichuan-Gansu earthquake, and consequent mobilizing of the Chinese rail system to bring rescuers and supplies into Western China meant that coal could no longer travel around the country, thereby pushing Chinese factories to rely on diesel generators), or in late 2011/early 2012 (when the Fukushima tsunami pushed Japan and Germany to shut down their nuclear plants). In real terms, the diesel price is still lower than the 2022 spike that followed the start of the Ukraine war.

But even in “real terms,” the US diesel price is now over US\$5/gallon (it is higher than that across most of the OECD). And above US\$5/gallon, few good things happen. Trucking goods around becomes expensive, as does farming, shipping, mining, construction etc... As we never tire of pointing out, “*economic activity is energy transformed*,” and large parts of the economy find it much easier to generate activity, and profits, when the price of diesel is low than when it is high.

World, crude oil, 3:2:1 Brent crack spread, US\$



Real and nominal diesel prices

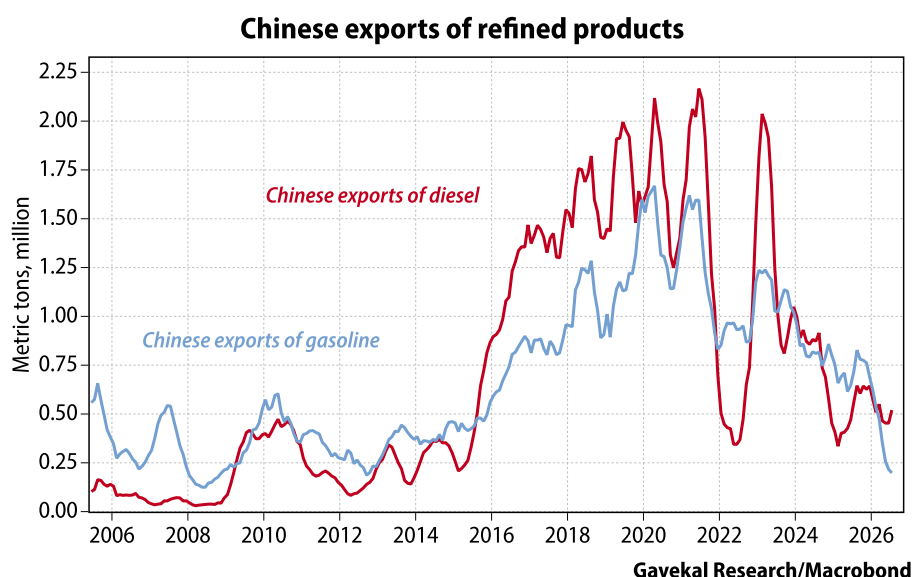


Just as success has many fathers, there are a number of factors contributing to today’s record high crack spreads (see the left-hand chart above). The most obvious ones are that:

- Over the past 30 years, most of the OECD has been happy to outsource the building of refineries to the broader emerging markets, first in Korea, then in China, and then across the Middle East and Africa. Of course, this assumed that the US Navy would always control the world’s major sea lanes and that refined products would easily flow from point A to point B. This assumption has, so far this year, come under heavy scrutiny (see [Shattered Assumptions And The Energy Quandary](#)).

With China's teapots no longer getting cheap Iranian crude, China's exports of refined products have fallen

- The war in Iran has seen a number of large refineries targeted by Iran (in Bahrain, in Israel, in Kuwait), by the Houthis (in Saudi Arabia), and by the US and Israel (in Iran).
- The war in Ukraine has seen the top 10 refineries in Russia come under attack by Ukrainian drones, while every single major Ukrainian refinery has by now been destroyed by Russian attacks.
- The uncertainty around the global energy situation and the inability of Shandong's "teapot" refiners to get access to deeply discounted Iranian crude have meant that China's ability to export refined products has collapsed. The below chart shows a six-month moving average, but in recent months, China's gasoline exports were almost nil (though July did see a little bit of a pick-up).



Refiners elsewhere have used their profit windfalls to buy back shares

This last point brings us back to another Gavekal trope, the idea that *“when China enters a room, profits walk out.”* As it turns out, the reverse is also true, namely that *“when China exits a room, profits surge”*, or at least, this has been the case for refiners around the world who, this year, have been making money hand over fist, and have typically used their outsized profits to buy back shares (thereby further boosting earnings per share) rather than expand capacity. Unsurprisingly, pure-play refiners have had a very impressive five years (see the chart overleaf), outperforming the S&P Energy index (which itself has outperformed the S&P 500 over the past five years).

So can refiners continue to generate outsized profits? In spite of record margins, there seems to be little excess capacity coming on stream anytime soon. So the bearish argument for refiners is obvious enough: at some point, when the Strait of Hormuz crisis ends, Iranian oil will once again flow to China, be refined, and products will then be reexported to the rest of the world.

Major US & Canada refiners & US energy stocks



In principle, this sounds great. In practice however, in 2025 before the Iran war, China exported an average 1.2mn barrels per day of refined products. Not nearly enough to make up for all the disruptions in Ukraine, Russia, Bahrain, Qatar, Kuwait etc...

If shipping disruptions persist, refined product shortages are likely to get worse

And then, of course, there is the counter-argument. Namely that shipping across the Strait of Hormuz remains disrupted for months to come. Or, worse yet, that on the other side of the US midterms, a President Trump who no longer has to face the US public in elections actually decides to dramatically ramp up air attacks on Iran, taking out the country's energy infrastructure, thereby unleashing more chaos across the Middle East, and the energy markets. A course of action that would see China (and possibly everyone else!) further tighten its own meager exports.

All this to say that diesel prices are starting to become uncomfortably high and it is not obvious what will bring them back down. Sure, diesel costs are not yet high enough to push the US, or global, economies into recessions. But the current trend is no one's friend (well, aside from the refiners!), and a reversal of the trend will require either some kind of resolution in Ukraine or for Iranian oil to once again start flowing to China. As of right now, neither seems to be on the cards?