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The Global Energy Price Surge

Our weekly view on asset allocation.

1 November 2021

Weighing up the Cyclical and Structural Drivers

After plunging to multi-decade lows in mid-2020, global energy prices have soared in recent months.

Multiple factors on both the demand and supply side have combined to drive up the price of oil, and even more dramatically gas and thermal coal prices.

Last week we suggested that a good deal of the recent surge in global inflation could be attributed to “transitory” factors linked to the global pandemic.

Read [Stagflation - Should Investors be Worried?](#)

The energy price surge also arguably contains some temporary or “one-off” influences. However, we believe the energy markets do stand apart by containing a larger component of what is likely to be “structural” upward pressure on prices. We examine the key short-term and longer drivers of the energy price surge.

Global Reopening Fuels Energy Price Rebound

Firstly, the progressive reopening of the global economy has dramatically increased energy demand after last year’s short-lived demand slump.

Industrial production has rebounded sharply with energy-intensive goods demand outstripping services demand. This has seen global trade volumes rebound sharply (see exhibit 3), as has transport activity.

Exhibit 1: The Global price of oil has made a strong recovery this year

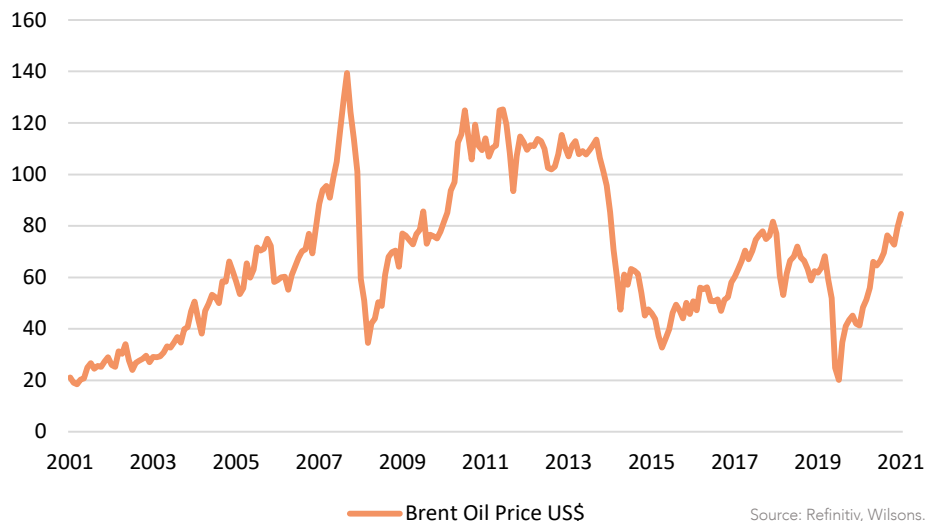
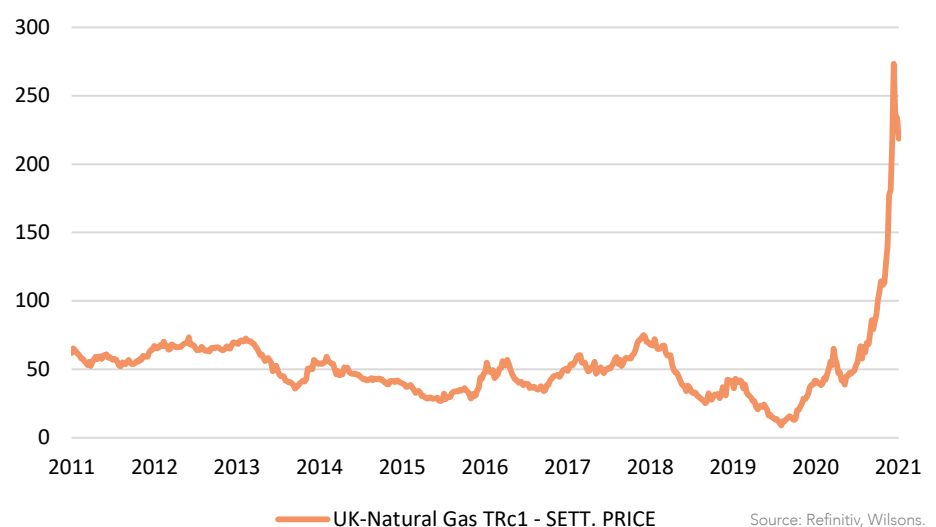


Exhibit 2: Gas prices have surged particularly in Europe



Caught Short - Bad Luck or Bad Management

A run of “bad luck” with global weather patterns has also been a major contributor to the recent tightness in energy markets. The list of weather-related problems disrupting global energy markets in recent months is staggeringly long.

Firstly, in recent months a lack of wind reduced the energy production coming from European wind farms, leading to a shift toward natural gas and coal for power generation. Wind power represented about a quarter of the power used by the UK last year.

Importantly, natural gas inventories have been extremely low in Europe recently, leaving Europe vulnerable to any disruption in energy supply. This low level of inventories is unusual for this time of year because the heating season has not begun. There has been a lower production of natural gas in Europe due in part to EU taxes on carbon emissions to discourage the use of fossil fuels.

As natural gas production has slowed, Europe has grown increasingly reliant on imports from the US and Russia. Russia currently supplies about 40% of Europe's natural gas.

This has led a number of commentators to ponder whether we may be now witnessing the unexpected consequences of the EU's push to aggressively cut greenhouse emissions. In short, less natural gas is being produced in Europe and a greater dependency on wind power and gas imports has proved to be a somewhat unreliable combination.

On the other side of the globe a hot summer in North Asia raised electricity demand, while flooding in China and Indonesia significantly curbed coal output.

While there has been considerable discussion around China's recent GDP growth slowdown, the picture is actually more nuanced. A boom in the China export sector has driven strong growth in manufacturing which is relatively energy-intensive. The combination of hot weather and China's strong manufacturing export production has caused electricity consumption to surge. This has led to elevated energy demand for both gas and coal.

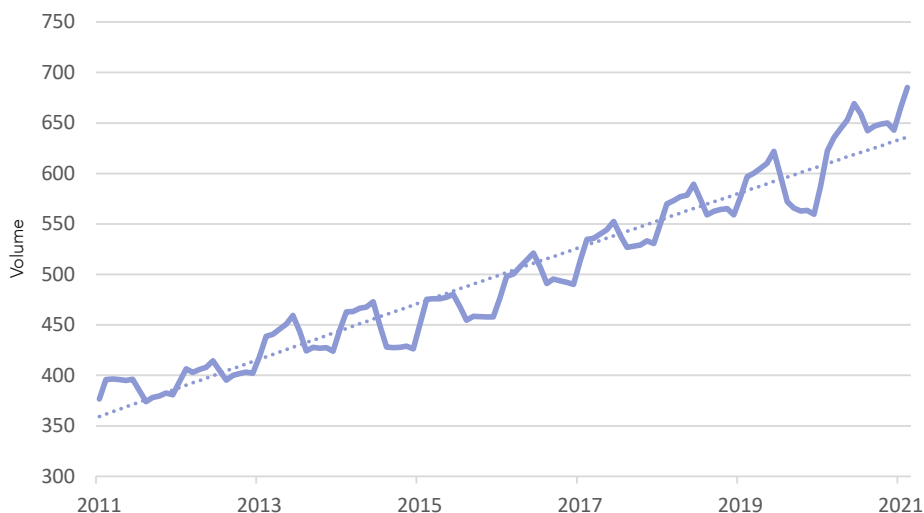
As well as Europe's green energy policy shift, policy developments in China have also contributed to the recent dislocations in energy markets.

Exhibit 3: A sharp global trade rebound has lifted global energy demand (value index)



Source: Refinitiv, Wilsons.

Exhibit 4: Surging global trade has lifted Chinese electricity production and thus energy demand above trend



Source: Refinitiv, Wilsons.

China has been trying to reduce its consumption of coal as it attempts its own enormously daunting energy pivot. Coal still accounted for just over 60% of China's electricity generation in 2020. China has been trying to gradually curb domestic coal production. To fill the energy shortfall caused by a combination of hot weather, elevated electricity demand from the manufacturing (export) sector and its policy-driven constraints on coal production, China has been forced to step up purchases of natural gas in global markets at the same time Europe has also been clamouring for supply.

The other unfortunate policy decision from a Chinese perspective has been the ban on Australian thermal coal. Australian coal imports have traditionally been an important residual source of supply to supplement domestic coal production.

These Australian imports disappeared last year following a diplomatic row between the two nations. China has attempted to source more coal from Mongolia and Indonesia, but supply has disappointed. The recent super spike in thermal coal prices has led to speculation that China is set to lift the ban on Australian imports.

Lack of Investment in Oil and Gas Laid the Foundation for Higher Prices

While adverse weather patterns alongside government policy decisions (both climate-related and otherwise) have been key contributors to the recent surge in energy prices, the foundations for higher energy prices were arguably laid some years ago.

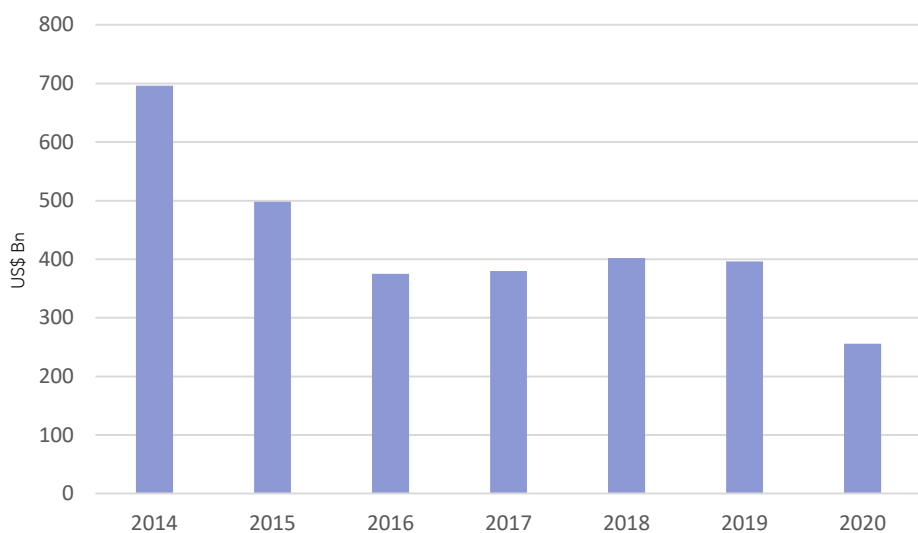
Years of subdued investment in the oil and gas sector is likely contributing to the current market tightness. More importantly, this will likely set energy markets up for more protracted tightness over the next 5-10 years, even in the face of the ongoing shift to renewable energy.

Energy producers have not been investing much in new capacity for a good seven years now. Globally, oil and gas capex is down 60% since 2014. This is important from the perspective that global (traditional) energy supply degrades a few percent each year in the absence of sufficient replacement capex.

The genesis for this capex decline was the collapse in the global oil price in late 2014 as the surge in US shale oil production overwhelmed the global supply-demand balance. A combination of the global pandemic and the intensification of the green energy pivot have seemingly intensified this capex drought of late.

Longer-term, the International Energy Agency's (IEA) estimates suggest oil demand is set to grow for another 10 years at least, while gas demand is likely to continue to grow for well in excess of 20 years. So, even with the progressive shift to renewable energy, the world would appear to be facing a tighter supply-demand balance in respect of traditional energy sources. This would suggest higher trend prices and an energy system more prone to periodic spikes in prices.

Exhibit 5: Global Oil and Gas Capital Expenditure has Collapsed



Source: IEA

Are Energy Prices a Threat to the Inflation and Growth Outlook?

Could the surge in energy prices either reignite a more permanent shift in inflation or bring the global growth cycle undone? Could we potentially find ourselves in a worst-case scenario of stagflation (high inflation, low growth) as we did in the 1970s?

It is quite possible that stubbornly high energy prices contribute a discernible and durable increase in inflationary pressures, but the likelihood of either an energy-induced regime shift to high inflation or an energy-induced growth recession is much lower than in the 1970s or 1980s.

One important consideration, at least in terms of the 1-2 year outlook, is that The Organization of the Petroleum Exporting Countries (OPEC) still has a good deal of spare capacity. About 7 million barrels per day in a close to 100 (mbpd) market. While OPEC has been sitting on its hands over the past few months, it has the capacity to respond to a further significant spike in the price of oil in the near-term.

The \$100 a barrel level (perhaps if the European winter proves particularly cold) has been discussed as a level where OPEC may well be willing to release significant reserves into the global system. The United States is also a huge swing producer, and the US rig count is now rising again. We judge that the risk of a significant additional surge in oil prices in coming months is fairly low. However, while this may provide some short-term comfort, the risk of the supply-demand equation tightening up on a medium term (3-5 year) view is quite real.

The global economy is much less dependent on oil than in the 1970s so the world can cope with higher trend oil prices – the pass-through to core prices and wages is less likely than in the 1970s and 80s.

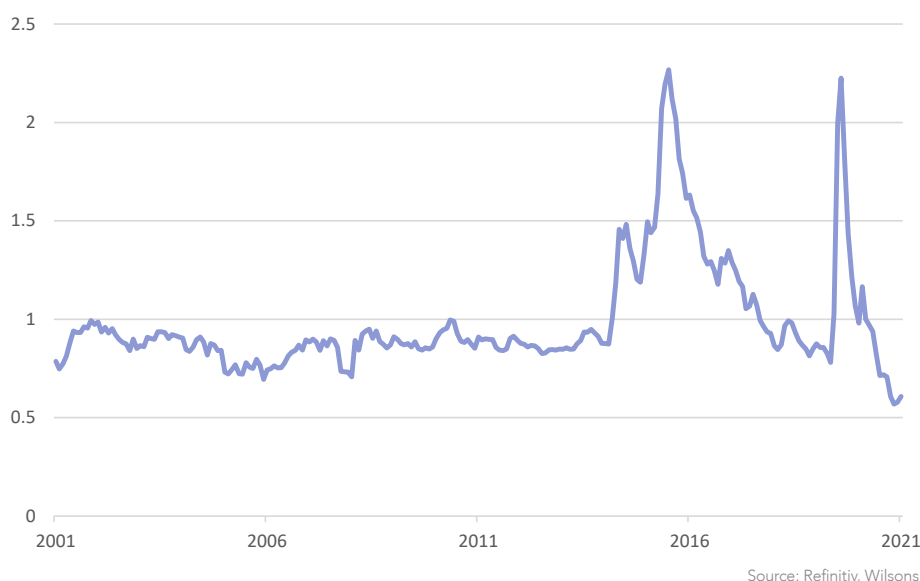
In the past 20 years global equities have tended to be positively correlated with oil prices. This is likely because high oil prices have tended to coincide with strong growth periods for the global economy. Nevertheless, structurally high energy prices will likely add some inflationary pressure at the margin.

The labour market holds the key to the medium-term inflation outlook, but a combination of tight energy markets and tight labour markets would suggest the inflation environment may not be as benign in the coming 5-10 years as the last 5-10.

Exhibit 6: Global energy sector versus global equities - relative performance



Exhibit 7: Global energy sector versus global equities - relative PE



Markets Look too Complacent on Energy Outlook

Markets continue to bet that energy prices will come down. Futures curves are in backwardation with investors expecting oil, gas, and coal prices to decline over the coming year. This seems like a reasonable expectation for gas and coal given the surges seen in these markets. We are less sure on oil. In part, this is because the price rise has not been as significant. We see trend prices (for oil and gas) as having scope to move higher over the medium-term (with more risk of spikes) as the supply-demand balance tightens over the medium-term.

We continue to see good prospects in the Australian and global energy sectors. To the extent that energy markets add at least some moderate inflationary pressures in coming years, it is yet another reason to be cautious toward fixed interest (we prefer floating rate credit) and another reason to think the "value stock" comeback has some longer-term legs.

Read [The Australian Energy Sector - A Premature Rush for the Exit?](#)

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