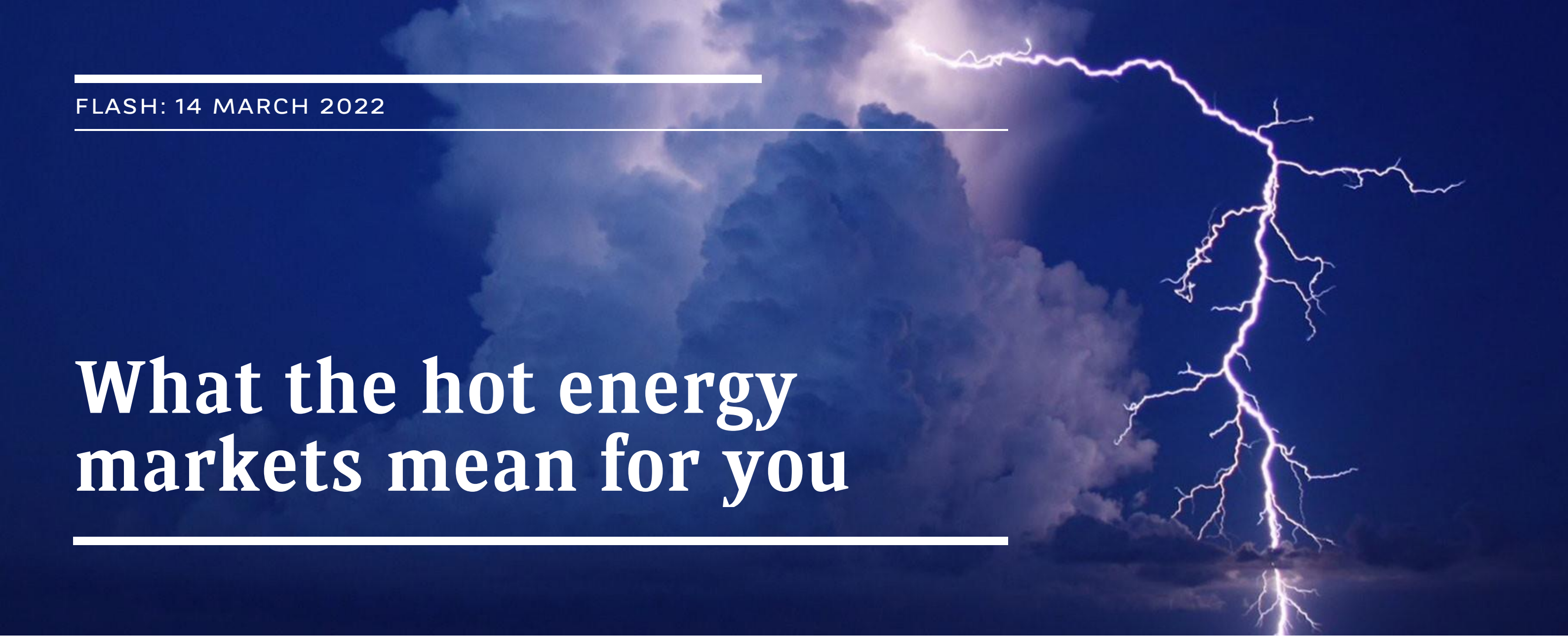


FLASH: 14 MARCH 2022

What the hot energy markets mean for you

Key Messages

Is the current conflict the sole driver of very high fossil fuel prices? No. They are clearly a contributor, but both oil and gas prices had been rising and were actually high well before the conflict started.

This rising trend in energy prices has been going on for quite a number of months due to the global increase in demand, partly because of the strength of the global economy but also the fact that Western countries have reopened post lockdowns and people are starting to travel more.

The risk of global recession has clearly risen over the last few weeks because of the damage to consumer confidence, on the one hand from worries and uncertainties over how the current conflict is impacting economic growth; and on the other hand, from very high oil and gas prices, acting like a global tax on households and companies.

Can we cope without Russia supplies, and ultimately wean ourselves off natural gas? Not in the short term. Europe has become over-reliant on historically relatively cheap gas imports from Russia, which are certainly no longer cheap today. That said, warmer spring weather will seasonally reduce European natural gas demand, while greater renewable energy electricity output should reduce gas demand for electricity generation.

Europe will accelerate investment in renewable energy (solar, wind, hydroelectric and other alternative sources) in order replace our reliance on Russian gas for electricity generation. This is a long-term, not short-term solution.

What are our favourite investment solutions in the energy space? One area we really like is renewable energy storage infrastructure (e.g. industrial batteries), as we will still need electricity when the wind does not blow and the sun does not shine. Listed and unlisted funds in this space can offer attractive income yields, often in the 5-6% range.

Why are energy prices so high?

Any car owner cannot escape the ugly truth that the price of the pump has soared in recent weeks at the time of publishing this paper. Indeed Brent crude oil was around $110 a barrel and gas prices too have hit record highs.

The big question is, can we pin these rises on the conflict or are there more, fundamental reasons behind this rise?

Summarising the current energy markets

Energy markets are obviously very tight and very expensive. They are a clear motor behind the very high inflation rates we are seeing across the world today.

Is the current conflict the sole driver of very high fossil fuel prices? No. While clearly a contributor to today's multi-year high oil & gas prices, these prices had been rising quickly well before the conflict started.

This rising trend in energy prices has been going on for quite a number of months, driven largely by a global increased in demand. This is partly due to the strength of the global economy and the re-openings of domestic economies post lockdowns, we are now travelling more once again.

In addition, the ability of oil-producing nations, such as the OPEC+ group of nations, to supply more oil has been relatively constrained. It always comes back to a question of supply and demand.

In conclusion, demand has been growing robustly up until recently, and supply has struggled to keep up.

Edmund Shing, PhD

Global CIO

BNP Paribas Wealth Management

Previous oil price shocks resulted in economic recession. Do we see recession ahead today?

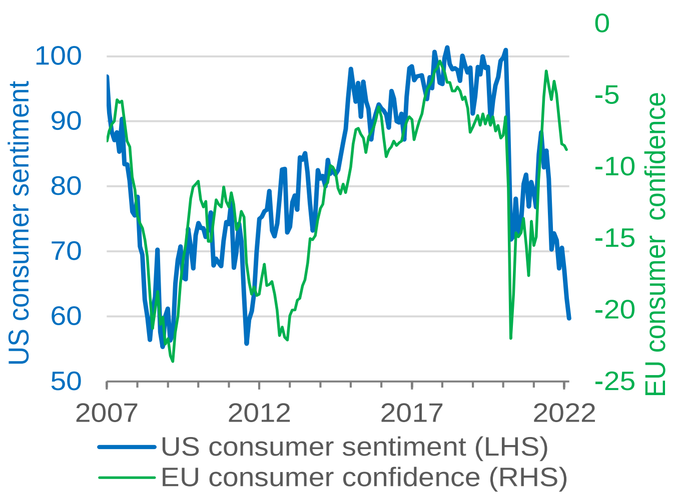
The risk of global recession has clearly risen sharply over the last few weeks because of the damage to consumer confidence, firstly from worries and uncertainties over what the conflict means for economic growth.

Secondly, very high oil and gas prices have also depressed consumer sentiment. Elevated energy prices act like a global tax on the economy, transferring wealth and money from countries that import and consume energy to oil & gas-producing nations.

The beneficiaries today are the OPEC+ member nations, for instance, in the Middle East. The rest of us are paying the cost via a higher energy "tax", which inevitably means that we tend to consume a less of everything else because energy for transport and heating is an essential cost. Heating and travel tend to be relatively inelastic. So, we tend to adapt as households by consuming less elsewhere. This has a negative knock-on effect on economic growth.

Thus, the risk of recession has certainly increased. It is by no means certain, because what caused a recession in the past was not just the fact that oil and gas prices were very high, but also that that they then stayed very high for some considerable time, at least three to six months. This is what we need to watch for. If oil and gas prices stay at their current levels for at least the next three to six months, then yes, we could be looking at an economic recession thereafter. At this point, that outcome is by no means certain.

US, EU CONSUMER SENTIMENT HEAVILY IMPACTED BY HIGH OIL & GAS PRICES



Source: BNP Paribas Wealth Management, Bloomberg

If we were to strip Russia out of global oil exports, can other sources compensate to supply more oil?

For Europe, the situation is even worse than a potential lack of crude oil, it is rather a massive shortfall in natural gas supply. The impact is much greater on Europe than on other economies such as the US, because the US actually today the largest producer of oil in the world. They are largely self-sufficient, whereas in Europe we certainly are not, particularly in terms of our natural gas needs.

We have become over-reliant strategically on relatively cheap gas imports from Russia, which are certainly not at all cheap today, but which in the past have been cheap. I believe that Europe has systematically underinvested in its own energy production and energy infrastructure over the last few decades.

Of course, we are moving to renewable energy sources, but this transition has not been quick enough. I think that we have compounded this issue by trying to phase nuclear power generation of electricity out in many countries such as Germany, which has left us even more reliant as a result on gas to supply our everyday electricity needs.

Shell forecasts a shortfall in global gas supply by mid-2022. Can we cope without Russia supplies, and ultimately wean ourselves off natural gas?

The obvious answer for certain countries is no, because if you take Western countries such as Germany or Austria or even some of the Central European countries like Poland, the vast majority of their gas supply comes directly from Russia. It would be very difficult for them to substitute that with anywhere else because simply there just is not enough supply either, via liquefied natural gas from the US or from Qatar or from anywhere else. There just is not the supply available. There are not the pipelines in place to do that on the scale necessary for these countries.

However, bear in mind that, seasonally speaking, our gas demand in Europe will go down simply because the weather is improving. We are exiting winter, we are entering springtime and temperatures rise. Our heating demand therefore falls and the bulk of our gas demand actually comes from heating.

Some of that gas demand should fall and that should start to ease the pressures, other things being equal. But, certainly in the short term, we cannot do completely without Russian gas, which is exactly why Europe has not put sanctions on imports of gas and oil from Russia for that reason, because we are just as dependent as they are, they need to export what we absolutely need to import long term.

The European Union nations are getting together in Versailles in the very near term and are going to certainly agree to accelerate investment in renewable energy, solar, wind, hydroelectric and other non-fossil fuel energy sources in order reduce/eliminate our reliance on Russian gas for electricity generation in the long term. But that is going to take a number of years. That will not be a solution tomorrow, at least not sufficiently within the European Union.

Will EU member countries struggle to meet their climate change targets, if politicians decided to wean the EU off Russian energy?

We observe a clear tension between the three goals that the European Union has in terms of energy policy:

1. Climate change, as in moving towards a low or zero carbon economy
2. Cost, keeping the economic costs down to something that is affordable for companies and for households, and
3. Energy security - this idea of energy independence within the European Union.

In our view, energy security had been relegated in favour of the first two policy goals. Of late, the third point has become so much more important. Thus, there is a risk that one of the other two will have to give way. Either it is going to cost us a lot of money to put in place the energy infrastructure necessary, or we are going to have to compromise on our low or zero carbon objectives.

Ultimately, I do think that we will probably have to compromise on the cost. We will have to put up with the fact that energy costs in general will be higher for longer in Europe, because of the need to invest in this alternative energy production and infrastructure going forward.

What are our favourite investment solutions in the energy space today?

If we look firstly at the US, there are certainly two areas I like, oil exploration & production companies, and energy infrastructure funds.

US oil exploration and production companies are predominantly focused on land-based shale oil production and gas production. We expect the US to produce 900,000 more barrels of oil per day between now and the next six to twelve months.

You are thus going to see a lot more production and higher profitability given the very high US West Texas Intermediate (WTI) crude oil prices, which are still over USD100/barrel. These companies can be extremely profitable given that the break-even costs for these shale producers may be as low today as USD50/barrel, once you consider the revenues they can also generate from shale gas, which they tend to produce at the same time.

Secondly, US energy infrastructure pipelines that carry this oil and gas from the shale fields in Texas to where they are needed or to ports to be shipped as, for instance, liquefied natural gas or crude exports. Those companies are Master Limited Partnerships (MLPs), which you can buy in the form of funds or ETFs.

In Europe, one area I really like is renewable energy infrastructure because we need both to generate renewable energy, but more importantly also to then store it because we still will need electricity when the wind does not blow and the sun does not shine.

We therefore need solutions such as large-scale industrial batteries or other forms of electricity storage such as via gravity solutions or via, for instance, hydroelectric dams where you pump the water up the hill using surplus electricity. When you have it and when you need it, you allow the water to flow back downhill and drive turbines to generate the electricity, using water as an enormous natural battery.

These types of renewable energy infrastructure fund exist; and one can invest in either fund or ETF format. They typically offer a yield around 5% or even 6% – a very attractive yield at a time when cash and bond yields are so low.

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