

# FROM THE DESK OF



**SARA SHAHRAM**  
Portfolio Manager,  
Canadian Equities  
Empire Life Investments Inc.

## INTERCONNECTED WORLD – NATURAL GAS EXAMPLE

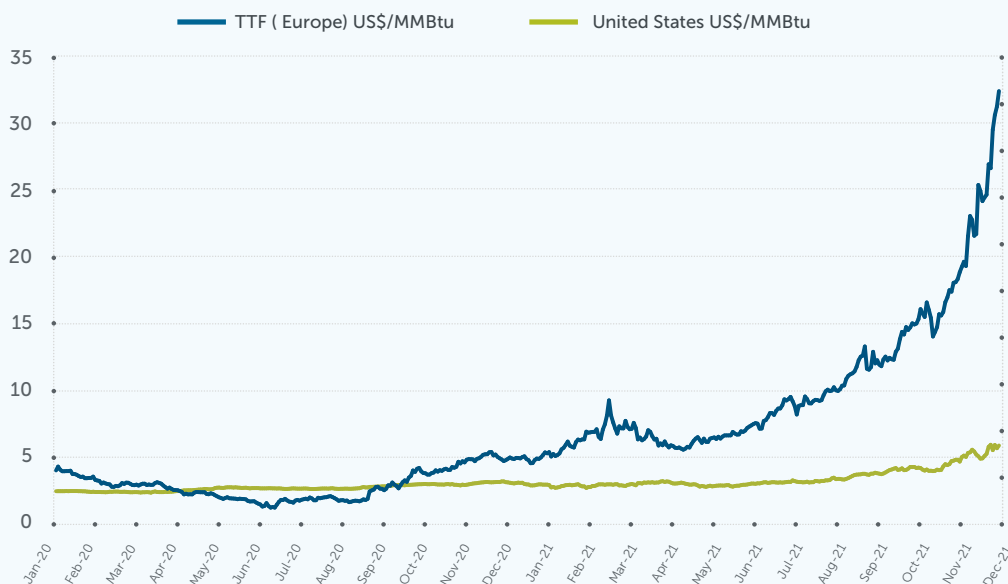
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### Summary:

- A combination of increased demand and curtailed supply has resulted in significant rally in natural gas prices globally.
- The implications of such a rally could be substantial with companies and governments making every effort to soften the impact.
- We do not believe that there is a structural change in the natural gas market. While we did selectively increase our natural gas exposure in the funds, we remain focused on our core process of investing in strong companies with pricing power above inflation.

You may have noticed the sharp rally in natural gas prices which is now approaching US\$6.00/MMBtu on the NYMEX from below US\$3.00 a year ago. The situation is even more dire in Europe with prices well above US\$30/MMBtu. In this note, we'll touch briefly on what has caused this rally, what the implications are not only for natural gas producers, but also other industries across the supply chain as well as how we use this information in our investment process.

### European and US Natural Gas Prices



Source: Bloomberg, Empire Life Investments Inc.

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## How did we get here?

### Seasonality/storage

Natural gas prices are generally seasonal. We typically see stronger prices during the winter months (demand for heating) and summer months (demand for cooling), while demand during spring and fall – often referred to as “shoulder seasons” – is generally low. Given that supply cannot keep up with demand during winter and summer months, the shoulder months are used to fill storage inventories which are then drawn during the high demand seasons.

### Europe

The natural gas market was not spared from the COVID-19 Pandemic and the many disruptions that followed it in 2020. However, entering the spring of 2021, two key events took place which had a significant impact on the natural gas market. Europe saw one of the coldest Aprils in decades and, general economic recovery as a result of reopenings post-COVID-19 was more robust than anticipated. These events resulted in an inventory draw of natural gas in Europe during the spring months versus the injection we would normally see for that time of the year.

### China

Elsewhere in the world, we had China focusing not only on its blue skies initiatives in preparation for the Winter Olympics in 2022, but also implementing strict mine safety policies. These policies resulted in a curtailment of thermal coal production which is the country’s primary source of energy. These curtailments not only increased demand for other sources of fuel (i.e. natural gas), but also caused a rally in thermal coal prices. We also had a series of cold snaps and heat waves across much of Asia.

### Renewable power

The shift towards renewable power generation also failed to provide any support to the situation. Droughts in South America and Asia substantially reduced hydropower generation, while the still air in much of Europe impacted wind power generation. The current situation has raised questions surrounding the speed of the evolution towards renewables.

These events significantly increased demand for natural gas imports globally. Natural gas is imported into these regions via tankers in the form of LNG (liquefied natural gas) or pipelines. On the LNG front a series of unplanned outages (hurricanes/fires), and delays as a result of the COVID-19 Pandemic (bottlenecks at the Panama Canal), slowed not only the production but also the transport of LNG. Delays in LNG exports delayed replenishment of the inventory levels which were now at extreme lows.

### Russia

To add insult to injury, Russia, who is the largest exporter of natural gas to Europe, had reduced its export of natural gas. Gazprom – the state-owned natural gas company in Russia – is currently completing Nord Stream 2 which is a controversial pipeline meant to increase natural gas export capacity from Russia to Germany. While the pipeline is very close to mechanical completion, it is currently undergoing regulatory approval in the EU. The controversy surrounding the pipeline is around its route – it bypasses Ukraine which relies on transit fees – but also in the fact that it increases Russian imports at a time when Germany/Europe have been attempting to reduce their reliance on the country and its potential political pressures. Some argue that Russia’s reduction of gas exports to the region is meant to put pressure on power costs, strengthening its negotiating position.

### North America

Europe’s woes are keeping demand for LNG exports out of the US strong. Given the attractive spreads between LNG exports and domestic natural gas, producers are currently fully utilizing the LNG export facilities, tightening the domestic natural gas market, and pushing prices to the US\$6.00 level. Despite this robust pricing, producers have generally remained disciplined – i.e. we’re not seeing aggressive increases in supply. Although we are seeing a bigger supply response out of Western Canada and higher imports into the US, the supply/demand fundamentals in the US remain relatively robust.

## Implications of higher natural gas prices

The above is a brief background on how we got here; robust demand coupled with constrained supply generally always leads to strong commodity prices. The implications of higher natural gas prices could be significant in the near-term. Extremely low inventory levels have increased demand for not only natural gas but all sources of fuels such as thermal coal and crude oil, as countries struggle to replenish their stockpile ahead of the winter season. Today we are seeing record prices in both natural gas and thermal coal which in turn has resulted in record power prices in Europe and Asia.

### Industry

Higher prices have resulted in companies taking action. As an example, CF Industries announced halting of its nitrogen plants in the UK given high natural gas prices. CF Industries is a global manufacturer of fertilizer (nitrogen) products which use natural gas as its feedstock. During the nitrogen production process, CO<sub>2</sub> is produced in the form of a by-product. The curtailment of the UK plant caused a shortage of CO<sub>2</sub> in the region, raising concerns about food inflation as CO<sub>2</sub> is used in meat packaging, food transport, carbonation of water, greenhouse plants such as cucumber and stunning of animals before slaughter. It has been reported that the UK government has agreed to subsidize the increased cost, allowing CF to restart its facilities to avoid a disruption to the UK food supply.

### Government

Governments are more concerned about the availability of power particularly as we approach the winter months. In China we are seeing government mandated curtailment of power intensive industries such as industrials, chemicals and materials. Despite these power rationing measures, the country saw blackouts in several regions and has now ordered its power producers to secure fuel at any cost. Not surprisingly, this has further increased prices for all hydrocarbons.

### Consumer

We are witnessing soaring power costs in many parts of Europe. Government interventions and subsidies will be required to minimize the impact to consumers at a time when they are hoping to recover from COVID-19.

In UK panic buying of gasoline has depleted the supply at many gas pumps. Although unclear whether the shortage of gasoline is the result of domestic logistical bottlenecks (shortage of truck drivers) or limited imports, it does demonstrate the extent of the crisis.

While the situation is not quite as dire in North America, increased demand for all sources of fuel (including crude oil) will keep gasoline prices elevated.

### Global growth

The current power crisis will likely impact global growth in the near-term. Curtailments of production not only directly impact growth, but also cause additional bottlenecks to an already stressed supply-chain. The inflationary pressures from the events noted above, could also negatively impact demand as we look to recover from COVID-19. As the situation is very fluid, this is an area we will be monitoring closely.

You may have heard the phrase “the cure for high prices is higher prices”. This refers to demand destruction and/or supply response as prices for a commodity remain elevated – in this case well above marginal cost of production. There are levers which could ease the current extreme situation, but the timing remains unclear. These levers include higher volumes from Russia, restart of curtailed coal production in China, higher LNG exports, or a mild winter.

While we expect moderation of natural gas prices from current levels, it does appear increasingly more likely that prices will stay above historical levels at least into the next shoulder season of Spring of 2022 as storage is brought back to normal levels.

## Our funds

We increased our natural gas exposure through select equities such as Tourmaline Oil. As the largest natural gas producer in Western Canada, TOU will benefit from higher prices. We have been long-term shareholders of TOU not for its commodity exposure but for its consolidation strategy in Western Canada and its strong free cash flow generation. While outside of other E&P companies such as Canadian Natural Resources (CNQ), and Topaz Energy (royalty and infrastructure company), our direct exposure is limited, we would note that higher natural gas prices could lead to higher power prices which are often inflationary in nature.

In general, we do have a strong preference for companies with unique product/service offerings with pricing power. In that respect, we are investors in the rail as well as the waste management sectors through both CP and CN as well as GFL and Waste Connections who have demonstrated a history of pricing power above inflation.

We thank you for your continued support.

**Sara Shahram**

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### **The Empire Life Insurance Company**

259 King Street East, Kingston, ON K7L 3A8

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[empire.ca](http://empire.ca) [investment@empire.ca](mailto:investment@empire.ca) 1 877 548-1881

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