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Don't Expect a Quick Resolution to the Energy Supply Shock

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Russia's energy tentacles, intertwined throughout Europe's power network, may prove difficult to excise.

Highlights

- **Historic disruption:** Increasing willingness to sanction one of the world's largest energy exporters is driving extreme volatility in commodity prices, driving inflation to a 40-year high.
- **New fuel sources:** Looking past near-term turbulence, countries are changing how they assess energy security and trade flows, laying out plans to diversify hydrocarbon supply in the transition to renewable energy.
- **Where we see value:** Global supply constraints are creating potential growth opportunities for energy, materials and agriculture companies, while incremental focus on renewables could help aluminum manufacturers and hydrogen fuel investments.

Russia's energy sector was thought too important to sanction… until it wasn't

In the early stages of Russia's assault on Ukraine, the West was careful to exempt Russia's energy sector from sweeping sanctions due to Europe's heavy reliance on the belligerent state for its energy supply. But as fighting has intensified and popular support has rallied around Ukraine, more countries have tightened the spigots on Russian exports, sparking concerns of disruptions to physical supply, infrastructure and trade flows. These actions have led to severe whiplash in global energy markets, as well as in metals and agriculture.

Where we go from here will likely have major consequences for commodity prices, supply chains, inflation and the global economy for years to come. And there aren't any easy answers.

Figure 1: Europe's dependence on Russian natural gas has been painful

US$ per MMbtu

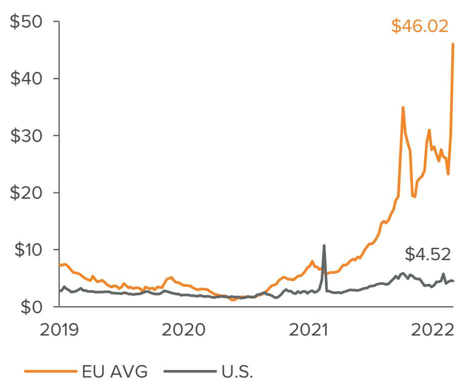
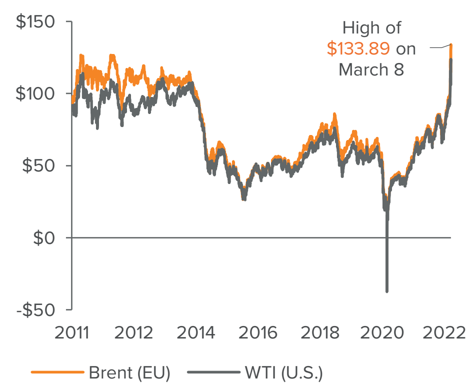


Figure 2: Local disruptions in oil supply affect prices everywhere

US$ per barrel



At March 11, 2021. Source: Bloomberg. EU natural gas price represents average of National Balancing Point (U.K.) and Zeebrugge (Belgium).

Russia is one of the world's largest producers of commodities vital to the global economy. They provide about 10% of global oil supply and are the largest exporter of natural gas, most of which is piped into Europe (Fig. 1). Since oil prices are set on the global market, disruptions in Russia drive prices higher everywhere (Fig. 2). Rising energy prices also affect input costs for other commodities, raising the production costs for other raw materials.

Russia is also a large producer and exporter of aluminum, nickel, palladium, platinum, steel, iron ore and thermal coal. These products are key raw materials in a wide range of end markets, including packaging, construction, power generation, autos, electric vehicles and semiconductors. In addition, both Russia and Ukraine are large producers and exporters of wheat, corn and fertilizer, posing a risk of significant food inflation and possibly shortages.

Europe's energy dependence on Russia means no easy way out

In the short term, the most likely path is a continuation of volatile commodity prices, higher inflation and slower economic growth, particularly in Europe. It's difficult to predict how long these conditions will last, but a protracted war could amplify the reaction in commodity prices amid panic buying and hoarding of scarce resources. In other words, the longer the roller coaster lasts, the bumpier it will get.

Certain commodity markets could face significant pain if physical supply is disrupted for months. For example, Europe depends on Russia for more than 40% of its natural gas supply. If physical flows to Europe are shut off, the EU is likely to experience fuel shortages, rolling blackouts and significant inflation, slowing the region's recovery even as the health crisis fades. A quick resolution to the conflict in Ukraine, and minimal changes to commodity trade flows, should help stabilize most commodity markets at lower levels relatively quickly.

A few other dynamics could also be significant. Some OPEC members have signaled willingness to increase oil production, and there have been talks about reviving the nuclear agreement with Iran that would pave the way for Iranian oil to return to the market. Either of these developments would help to backfill the supply shortfall from Russian exports.

As countries rethink plans for energy security, responsible sourcing of traditional energy supplies will be key to bridging the transition to renewables.

The dynamic between Russia and China also bears close attention, as an overt Sino-Russia alliance could create more havoc in global commodity markets. China has increased purchases of discounted Russian oil barrels and has begun exploring larger strategic investments in Russian energy companies. At the same time, it has largely avoided expressing support for Russia's actions, focusing on supporting a negotiated solution.

In the longer term, countries will change how they assess risks around energy security and trade flows. The supply shock in the EU has created urgency to formulate a better plan for long-term energy stability, and it has raised questions about whether it needs a more diversified regime for energy consumption as it drives toward renewable energy solutions.

The reality is there is no quick, cheap solution for Europe, and hydrocarbons are likely to play a vital role in bridging the transition. Possible solutions may include more LNG imports from the U.S. and other stable trading partners, and perhaps revisiting the use of nuclear power.

Supply constraints drive new possibilities for U.S. energy and materials businesses

As long as the war goes on, equity markets should be closely tied to energy markets (due to economic growth implications). The impact on the U.S. should be relatively modest, as most U.S. consumers are in relative strong shape to withstand temporarily high energy prices, and corporate earnings prospects haven't materially suffered. In fact, some of the opportunities in commodities and energy businesses we were tracking before the conflict have been amplified.

- North American shale producers may benefit from global supply constraints and the potential for new government incentives to increase energy independence
- Domestic materials and agricultural suppliers should benefit from higher commodity prices, re-shoring of manufacturing capacity and lower natural gas prices in the U.S. vs. abroad
- Aluminum manufacturers should benefit from secular growth in EV adoption and expansion of renewable energy
- Industrial gas businesses investing in hydrogen fuel technologies may represent a long-term opportunity to reduce greenhouse gasses over time

Conclusion

Despite the world's desire to decarbonize global fuel consumption, there is no escaping that oil remains vital to a wide range of global end markets that play a critical role in global economic growth. However, current events are prime evidence for why the clean energy transition is both difficult and necessary.

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