CIO Viewpoint

Gasping for gas – tensions over Russian energy intensify

Investment Solutions

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Europe is facing another gas crunch, and is primed for more pain with Russian supply disruptions ahead. The energy crisis, and Western efforts to cap Russian gas and oil revenues, are fanning rising recessionary fears, and countries are seeking alternative sources. Such fears have recently taken the edge off commodity prices. In a supply-constrained market, we see little room for them to fall further.

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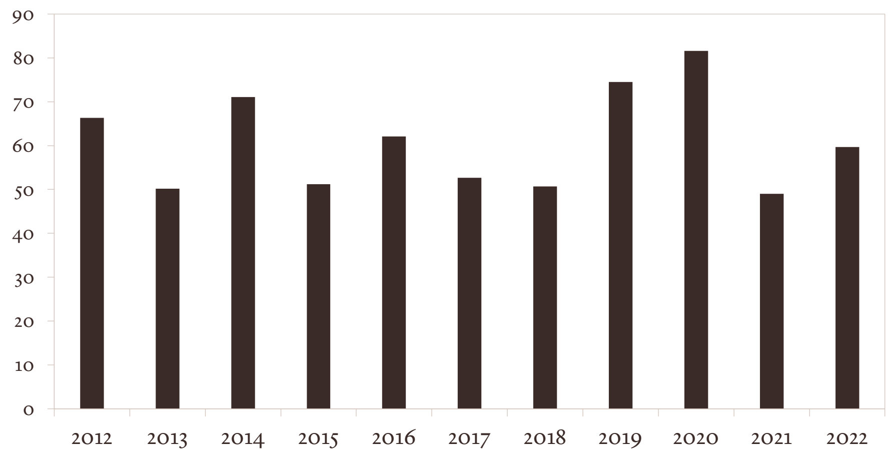
Key takeaways

- As Europe's key gas pipelines shut for maintenance, the continent fears further Russian disruptions could tip it into recession. Gas shortages would not be felt evenly across countries or industries
- Western sanctions on Russian energy have proved less effective than hoped, as supply has been diverted to other countries
- In a tight, supply-constrained market, we see oil remaining above USD100/bbl for the rest of 2022
- We remain overweight in a diversified basket of commodities, as a hedge against inflation and geopolitical risks; if the probability of a severe US recession rises we would review positioning.

Russian gas supplies to Germany fell by more than 40% in June compared with May. They are about to pause altogether. The Nord Stream 1 pipeline will undergo routine annual maintenance starting on 11 July. Germany worries that supplies will not resume as scheduled ten days later. Russian pipeline flows are needed to fill the continent's reserves over the summer months. As Moscow cuts the flow of gas piped to Europe, the continent is now receiving 53% less gas from Russia than it averaged before the start of the war, estimates JP Morgan. Supply disruptions could see the continent enter winter – when heating demand peaks – with storage levels well below the 80% it targets (see chart 1). European wholesale gas prices have more than doubled since the start of June. Rationing could be imposed. That may be enough to tip the continent into recession.

1. Storage stymied?

EU natural gas storage capacity in July for the past decade



Source: Bloomberg, AGSI+ Aggregated Gas Storage Inventory, JP Morgan

The Ukraine war is redrawing the world's energy networks. The G7 is discussing ways to cap Russian oil and gas prices. Europe wants to wean itself off Russian gas dependence and has slashed imports from 40% of total supplies, to 24%. Finding alternative supplies short-term is difficult, and building out renewable capacity takes time. Since Russia's invasion of Ukraine, the US has increased liquefied natural gas (LNG) shipments to Europe, nearly tripling its share since 2021 to 15% of total supplies in May. But US capacity was hit last month by a fire at a plant in Texas. Other sources of LNG are in hot demand, and Europe's import terminals are already working at capacity. As China's economy reopens, it will increasingly compete with Europe for shipments.

Gas shortages will not be felt evenly across the continent. Germany, Italy and Finland are among the most dependent on Russian imports; the Netherlands, Romania and Ireland are less affected (see chart 2). Germany has no domestic LNG terminals. It plans to build two facilities and is also being forced to halt coal-fired power station closures. Belgium has postponed a plan to phase out nuclear energy. Gas trade between countries has helped cushion past shocks. Now there are fears nationalism could triumph: the UK speaks of cutting off supplies to Europe in an emergency. Fertiliser, chemical, steel and aluminium makers are worried; authorities plan to prioritise supply to households, hospitals and schools in an emergency.

Bad news on inflation, again

The gas supply squeeze could increase inflationary pressures. Consumer prices in the eurozone rose by a record 8.1% in May, compared with a year earlier, and are expected to have reached 8.6% in June, according to the European Commission. It calculates that energy prices will account for almost 42% of the increase.

High energy prices are already starting to temper demand, even in the US. We estimate that the prolonged war in Ukraine and related supply disruptions will shave 1% off global growth this year, although eurozone growth could remain a solid 2.5%, following a post-pandemic rebound. Should supply from Nord Stream 1 fail to restart, it would certainly inflict further grave economic damage. Here, it is worth noting, however, that Russia has few replacement buyers for its piped gas, albeit some capacity to increase Chinese flow, since its pipelines mostly point west.

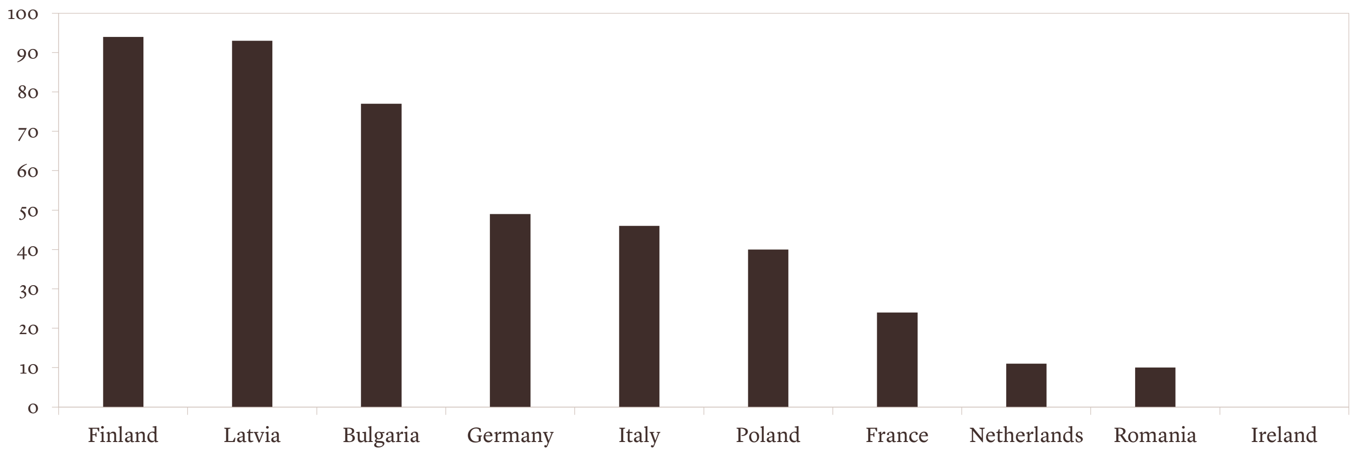
Essential oil

Oil prices – a bellwether of global growth – have fallen 15% since an 8 June peak, as markets increasingly price in the risk of a US and European recession in 2023. What will happen in coming months? Supply looks constrained. Strategic reserve releases are helping short-term but should fade in the third quarter. Although historically, the Organization of Petroleum Exporting Countries (OPEC) has managed demand and a series of supply shocks well, today it has limited capacity to expand production. Many of its members are hard-pressed to meet current output targets. US shale is unlikely to make up the shortfall. The industry has still not returned to pre-Covid production levels and refining facilities are struggling.

Our analysis also suggests it would take a major US recession to offset the loss of Russian supply. As long as we remain in a mild US recession scenario (our base case for 2023), demand should not fall enough to seriously affect the oil market balance. China's reopening will help boost demand. EU travel has now returned to pre-pandemic levels and China's is taking off, although mobility indicators in the US and Europe have softened in recent weeks. As long as we avoid a severe recession, we expect oil to continue to trade above USD 100 per barrel for the rest of 2022 before gradually falling in 2023.

2. Reliant on Russia ?

% share of gas supply from Russia, selected EU countries



Sources: European Union Agency for the Cooperation of Energy Regulators

What effects will Western efforts to cut Russia's oil revenues have? European leaders have already agreed to end Russian oil imports, worth USD 69 billion in 2021 according to the World Bank, by the end of this year. The G7's mooted price cap on Russian oil exports would be difficult to enforce. Unlike gas markets, it is easier for oil producers and buyers to find alternative clients, sources and distribution routes.

The impact of US and EU sanctions has so far been disappointing. Russian supply has instead been diverted to other countries, including China, India, and Turkey. A hypothetical price cap at around USD50 a barrel might look attractive in theory. Banning maritime insurance for shipments is one way to try to stop Russian oil moving, but Iran's experience shows that there are always routes around embargoes. Russia's own insurers, and those of buyer nations including India, are already covering tankers.

Commodities outlook

Even after recent falls, commodity prices, as measured by the S&P GSCI commodities index, are still up 22% year-to-date. Since the start of the Ukraine war, we have invested in a broad basket of commodities including energy, industrial metals and gold. We maintain this overweight as a hedge against inflation and geopolitical risks, including the risk that Russian retaliation to any new Western measures leads oil prices to spike.

Industrial metals have structural growth drivers despite cyclical growth concerns: infrastructure projects and battery production in the context of the energy transition. Tight, supply-constrained markets and low inventories make us more positive on oil, gold and copper prices this year than consensus forecasts. Of course, commodities prices have historically fallen in downturns, and if the probability of a severe US recession rises – and we ascribe this a sizeable 30% risk – we would review our positioning. This might include replacing broad commodity exposure for gold, a traditional haven asset, once interest rates are closer to their peak.

See page 4 to discover our ***Recession scenarios – oil, gold and industrial metals prices***

3. Recession scenarios – oil, gold and industrial metals prices

	Base case			Alternative scenario
	Mild recession	**Mild recession**	**Mild recession**	**Severe Recession**
	Prolonged supply disruptions on energy markets	**Ceasefire/end to war. Gradual EU energy independence**	**War intensifies, max level of sanctions/ Russian retaliation**	**... due to ultra-restrictive US Federal Reserve**
Oil	+ USD 120/bbl 2 mbd Russian production removed from global oil markets partly offset by OPEC/shale	- USD 100/bbl Sustained geopolitical premium adds to tight fundamentals	+++ then -- USD 150/bbl, then back to below USD 70/bbl 4-5 mbd Russian production removed from global oil markets but demand destruction (recession needed to rebalance)	=/- Below USD 100/bbl: demand collapse, decline in prices depends on supply scarcity
Industrial metals (copper)	++ USD 10000/mT Chinese demand accelerates European Union's REPowerEU plan	+++ >USD 11000/mT European Union's REPowerEU plan	=/- USD 7 000/mT Further de-risking from financial investors weighs on non-energy commodities	- USD 7000/mT Further de-risking from financial investors
Gold	+ USD 1900/oz	- USD 1800/oz Sustained geopolitical premium but gradual return to Fed overtightening fears	+ then ++ > USD 2000/oz Collapse of economic activity	- then ++ Gold below USD 1700/oz as market prices in additional rate hikes and gold suffers from portfolio de-risking
Global commodities	++	=/+	+++ then =	-- then OW gold

Source: Lombard Odier calculations
mbd= million barrels per day, mT= metric ton, OW= overweight

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