ConnText Podcast

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TRANSCRIPT

Energy Markets Review with Marcus McGregor, Director and Head of Commodities (Energy and Basics) Research Team

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

[OPENING MUSIC]

SEGMENT 1 – OPENING

[Rich Sega (RS)]

It's the first quarter of a new year and so, we present the first of a new set of Conning ConnText podcasts for 2023.

Last year was a very disappointing one for the markets. As investors try to shake it off and look ahead, we see many of the same challenges we just left behind in 2022: inflationary fires still burning, confusing data and confused central banks, political discontent around the world.

I'm Rich Sega, and in Conning's Hartford offices today is my long-time colleague and head of our commodities research team, Marcus McGregor. We'll take a look at the energy sector which has profound impact upon, and is profoundly affected by, the whole global economy.

[FADE TO MUSIC]

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS]

First, let's take a quick look at the year ended a month ago, closing out a spell when markets - both debt and equity - were tattered, thanks to the combination of a coordinated central bank effort to tighten monetary policy across the globe, geopolitical conflict with war and threats of war, and China's zero-covid policy lasting far longer than expected. Entering 2023, the question was how significant a downturn might the economy experience and what, if any of it, is priced into valuations?

Inflation has been an overriding topic of concern ever since we came out of lockdown, and rightly so. But as Milton Friedman pointed out, monetary policy operates with lags that are long and variable. Money supply is down hard and has been dropping for almost a solid year; the effects are only now beginning to be felt. Will policy continue to pull the economy down even as prior policy tightening is taking hold?

At this point, we believe that the FOMC most likely will raise rates 25 basis points at both upcoming February and

March meetings. If the data come in very strong, the next move could be 50 basis points; conversely, a steep drop in reported inflation could call the March move into question. Based on current and expected inflation trends, a pause after that March meeting is likely in the cards - a pause, but no pivot. The odds of a recession have been increasing over the last several quarters and now sit between 65 and 70%.

[FADE TO MUSIC]

SEGMENT 3 – ENERGY MARKETS DISCUSSION WITH MARCUS MCGREGOR

[RS]

The world is still trying to recover from the devastating lockdown years while fighting to get past the subsequent stubborn inflation. We need the production side of the economy revving up to meet the demand created by the release from pandemic restrictions and the huge government policy stimuli, both monetary and fiscal. And we need energy to do that. Cheap energy would be best, the cheaper the better. There's no macroeconomic model on earth that wouldn't just love free energy - hugely positive for growth. The farther we get from free, the slower we can expect to grow, and the more inflation we can expect for any given level of monetary accommodation.

There are today so many forces, mostly political, working against fossil fuel production while simultaneously pumping up demand. We have production and price caps, President Biden giving a tongue-lashing on war-profiteering to the companies, cancelled pipelines, environmental requirements, and taxes - so-called "windfall profits" taxes - export levies, all manner of additional costs that the production and distribution processes have to bear. At the same, another $1.7 trillion of fiscal stimulus passed by the lame duck Congress will continue to fire up demand. These things increase energy prices and reduce growth; neither are good policy objectives for investors. So let me turn now to Marcus to help sort it all out.

Marcus - though down from their highs last spring, crude oil prices have risen over 30% in five years. How does that contribute to the recent recession fears, and, if we actually have a recession, how might declining recessionary demand affect the price in 2023?

[Marcus McGregor (MM)]

Hello Rich. Thanks for having me on the podcast to talk about our views on crude and energy prices.

Well, luckily, the price for West Texas Intermediate crude, the oil benchmark known as WTI, is down nearly 18% over the past six months to roughly $76 a barrel, and this is also well within Conning's own near-term target range of $60 to $90 a barrel. This recent softening is largely due to several reasons, the first of which is relatively warm winters we are experiencing across the U.S. and Europe, healthy inventories of both oil and natural gas in those regions, and to some extent the rise in COVID cases in China in the later part of last year. It's also worth noting that January is off to the warmest start in 15 years. We certainly believe that if this softness were to continue, it would lower the impact of energy costs on both food and core inflation. However, we must be cognizant about the future of energy prices in lieu of Russian sanctions and the impact on the oil and refined-product markets, which includes diesel as well, and the possibility of some demand recovery. However, we see the average price of WTI over the next two years staying within our $60 to $90 per barrel range, barring a better-than-expected reopening of China's economy, which could of course push prices to the upside.

[RS]

Yes, so let's look a little deeper into production. We are seeing pressure on companies to align with the aims of an activist ESG movement and a Biden Administration that seems openly hostile to the industry. As a result, capex is

down to about a quarter from its peak in 2016; companies seem to be preferring to pay dividends and buy back stock over spending on exploration and production. That's great returns for investors of late, but what's our outlook for supply trends? And how about those price caps on Russian exports: what do they mean for the whole picture?

[MM]

Sure, I could spend some time chatting about this, Rich, but let me first note that our expectation is that North American capex for oil and gas development will continue to trend higher in 2023 and over the next several years barring any significant destruction to global oil demand. This view is also supported by a recent Dallas Fed Energy Survey of 97 exploration and production companies, which projects an increase in capex spending this year versus last year.

This is largely due to a contraction in capex from 2014 to 2020 where spending fell by 55% in North American for E&P spending. And this is due to two significant events. The first was the oil price destruction caused by the Saudis in late 2014, who pumped huge amounts of oil to drive down oil prices, knock out their competitors and gain market share. The second major event happened in 2020, when of course the COVID-19 lockdowns greatly impacted global demand causing a significant decline in capex and supply trends.

And despite a continued, and sometimes contentious, rise in ESG-focused investing and negative political rhetoric around the oil and gas industry here in the United States, oil production is expected to hit record levels this year. According to the U.S. Energy Information Administration, production will average 12.4 million barrels a day this year. That surpasses the record of 12.3 million barrels a day set in 2019 and is a significant increase from the 11.8 million barrels recorded last year. So we expect production to actually trend higher over the next couple of years.

And as you note, the recent $60 per barrel cap on Russian oil exports were implemented and designed primarily to accomplish three things. The first was to maintain the flow of supply from Russia; the second was to limit the revenue Russia can receive from exporting energy; and lastly, to help keep global prices in check. It's also our understanding, Rich, that the G7 and EU countries also intend to duplicate this price cap system on petroleum exports from Russia at a later date. So as a result of these recent sanctions, India and China have really become the largest buyers of Russian oil.

[RS]

So supply looks in pretty good shape. On to the demand side. A slow but inevitable recovery in China that you've already noticed, a steady, three-decade-long rate of increase in global consumption, and a restocking of the (Strategic Petroleum Reserve) here in the U.S. Sounds like pretty good price support for me. Would you agree?

[MM]

We would, Rich, but, given that we're starting out with a relatively warm winter here in more than 15 years, rising stockpiles and a weak macroeconomic backdrop, we would expect prices here to remain range-bound in the near term and within our $60 - $90 per barrel price-target range. However, should the recovery in China be more pronounced and the global economic picture become more promising, we could see oil prices certainly head north of $100 a barrel this year.

[RS]

On that last point Marcus, I asked about the Strategic Petroleum Reserve - ostensibly created for strategic national crises but often used for political maneuvering - it's been cut nearly in half in the last year. That tactic has been

effective in lowering retail prices at the pump, but what's the longer-term impact, and will it be felt this year in '23?

[MM]

Our view is that the SPR is a very short-term solution to an energy crisis here in the United States. Even at its peak of roughly 700 million barrels, that represents only about a month of supply for the United States. And as you note Rich, current SPR reserves are half of their normalized levels, and it is my understanding that the Biden administration is expected to start refilling the SPR in February. However, the administration has set up a process to refill the SPR at a price of $67 to $72 per barrel, noting that when the administration thinks the price is within a range that is good for taxpayers and good for the market, they will buy the replacement barrels, but Rich this could take months or years to accomplish.

[RS]

Gasoline prices – they've fallen nationally, but the price of diesel has been sticky high. Diesel and diesel exhaust fluid power the trucks and trains that are key to restoring the once frozen industrial supply chains. Can we expect any relief?

[MM]

Yes. I'll take a step back and just note that one of the primary drivers to high diesel prices, that we were certainly seeing last year, relates to the nation's shutdown of roughly 1 million barrels of daily refining capacity, which occurred during the pandemic. This represents about 4.5% of all capacity in the United States. It is also difficult to restart refining when there is a jump in demand, which occurred when Russia invaded Ukraine last February. It's also an issue that diesel is scarce worldwide. However, diesel prices here in the U.S. are expected to fall about 16% this year to an average of $4.20 a gallon, according to a recent EIA report. This results from additional refining capacity being brought online this year coupled with lower oil costs. So we are expecting some relief in diesel prices this year.

[RS]

Marcus. My understanding is we haven't opened a new refinery in this country in a generation. How is that working out in places where we try to refine product - New Jersey, Louisiana and Oklahoma? Are we getting crimped? What's the outlook for refining capacity?

[MM]

So Rich, I would go back to 2020 where refining capacity was roughly 19 million barrels a day here in the U.S., and as we were just discussing, during COVID roughly 4.5% of that refining capacity was taken offline. The expectation is that we'll get back to pre-COVID levels sometime this year which should help with some of the costs we're seeing at the pump. However, with the events that happened last year, with the sudden impact to supply with the Russian invasion of Ukraine, that really did a number on spot prices and that's where you saw a lot of record prices for refined products around the February timeframe last year. Our expectation is that, slowly, capacity will come back online, diesel prices should soften in here, but again largely this depends on a second-half recovery this year, but in the near term we expect some relief for refined products.

SEGMENT 4 – CLOSE

[RS]

Marcus - thanks. The world runs on energy, and we appreciate your enlightened perspective on it.

We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

We at Conning thank you for joining us, and we wish you all a happy and prosperous 2023.

[FADE TO MUSIC]

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