

Market Commentary

Spike in gas prices puts central banks in an uneasy position

Author: Paolo Zanghieri

October 7, 2021

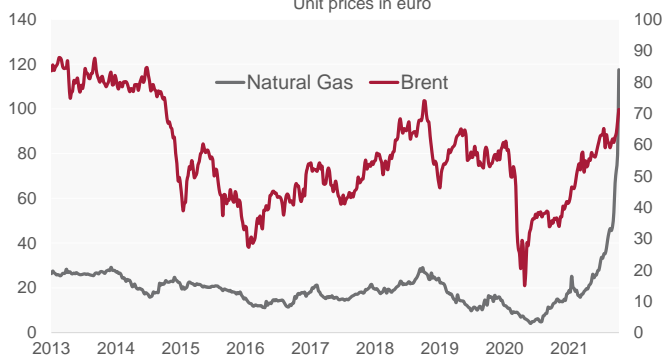
- The surge in gas prices has added to the hurdles of a recovery in advanced economies. Several factors lie behind the 350% surge in European gas prices since June, including lower inventories, past underinvestment (aggravated by the shift of capital to greener fuels), geopolitical issues and weather-related ones like the lack of wind limiting European renewables' output. Some of them may not be resolved quickly, increasing the risk of persistently high gas prices.
- This not only has a direct impact on consumer prices, but also on the costs of several gas-intensive manufacturing sectors, leading to a more protracted fallout on prices. The result would add to the upward pressure from high non-energy commodity prices, spurred by undersupply.
- Switching from gas to oil can only help marginally, but would further put upward pressure on oil prices, on top of the impact of the recent decision by OPEC and Russia not to step up production above scheduled despite stronger demand. The role of US shale producer to rebalance supply has been weakened by tougher regulation and stretched balance sheets.
- The prospects of higher inflation and risks to growth leave central banks in a bind. A few have already cited higher inflation as a reason to tighten policy earlier than expected; however, a more fragile growth path may also induce caution. This difficult trade-off could spill over into higher inflation risk premia. Moreover, the risk of higher inflation and weaker growth is detrimental for both stock and bond prices, leading to a higher correlation, low diversification benefits and higher risk premia

The path toward a full economic recovery from the pandemic has found another stumbling block in the unprecedented surge in gas prices seen since the summer. While this may not ultimately derail growth, also given the still strong monetary support and the expansionary bias of the euro area fiscal policy, it is a big problem for central banks as they seek to start exiting QE and may lead to choppier financial markets.

European Gas prices have increased more than threefold since January, as a combination of temporary and structural factors. Starting from the short-term ones, the recovery in activity and weather conditions (a long winter followed by heatwaves in the summer) triggered a quick and sizeable increase in power demand. Output from wind and hydropower (which account for respectively 12% and 13% of power generation in 2019) failed to catch behind due to droughts in part of the region and lack of wind in Northern Europe. Moreover, import demand from Asian countries surged in the early month of the year. The impact of China was particularly strong, as its ban on Australian coal on political grounds led to switch part of its energy demand to gas. On the supply side, Russia has so far decided against increasing deliveries to Europe. This owes in part to higher demand, domestically and elsewhere, but also to the willingness to secure the full approval of the new Nord Stream 2 pipeline, actually pending behind the German regulator. The European Union found itself unprepared for this crunch. Inventories have remained significantly below the historical norms, especially since the summer, when they should ramp up to face the winter demand peak. Secondly, the lack of unified EU purchases resulted in individual countries having a very limited bargain power against suppliers (in particular Russia). Diversifying supply sources is difficult in the short run and is currently limited by the low capacity of US shale producers (see below). The demand/supply imbalance increases the risk of shortage in the winter months; this risk is priced by markets adding to the upward pressure.

Gas and oil prices

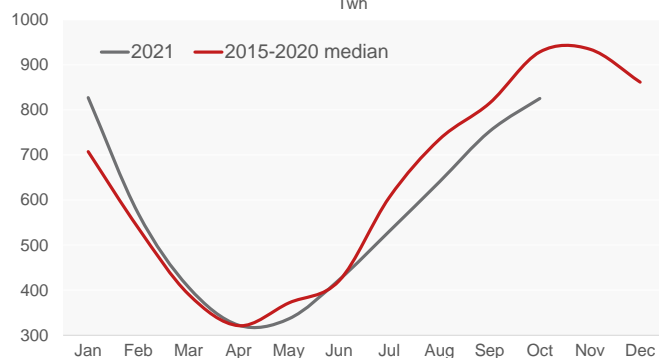
Unit prices in euro



Source:Refinitiv

Total EU gas inventories

Twh

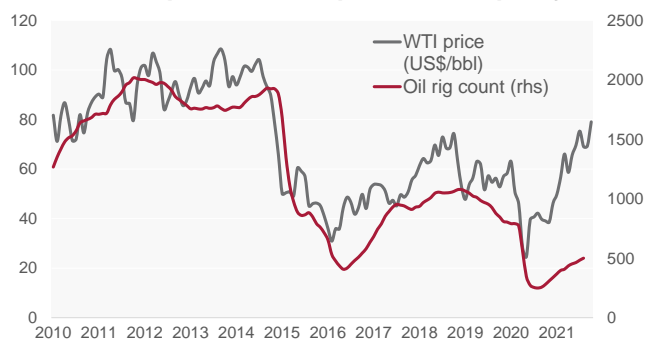


Source:Refinitiv

Some of these causes may abate in the short term, and indeed, the recent opening by Russian president Putin to higher supply has clipped a bit prices and a mild winter would reduce the risk premium, but most of them are longer term. First, while a coordination among EU countries' purchasing policies would help stabilise prices, supply diversification may be more effective. But this cannot happen overnight: it takes around five years to build a terminal for liquified gas shipped by sea. The environmental transition is playing an important role too. First, the ESG push is shifting capital away from fossil fuels toward greener sources. As building up capacity takes time, greener energy sources may not be capable of compensating short-term undersupply. Second, temporary shifts to more polluting sources like coal, are made more difficult by regulation, in particular by the rising price of emission permits.

Shifting to oil as a short term is likely to have a relatively small impact: in the US less than 20% of gas usage for electricity can be shifted to oil: moreover, tight environmental regulation in Europe acts as a strong disincentive. This occurs when the oil market itself has tightened considerably, and the recent decision by OPEC and Russia to keep the current slow pace of supply extension is not helping. Even though the upward pressure to demand from switch from gas proves limited, the impact of prices can be sizeable, as arbitrage may induce producer to increase gas supply at the expense of oil. Contrary to past episodes, the US shale sector is not contributing to offset undersupply, quite the opposite. Higher oil prices are not proving enough to ramp up production, as years of underinvestment have limited capacity and stretched balance sheets make most producers reluctant to prioritise production over margins. The prospects of tougher environmental regulation in the US and globally will add a further constraint to capex in the sector. The widening disconnect between oil prices and oil producers' stocks testifies these troubles and poses a significant limitation not capex expansion in the sector. We expect Brent to reach 85 US\$/bbl by year-end and to remain above 75 US\$ until mid-2022, but the recent development add a substantial upside risk.

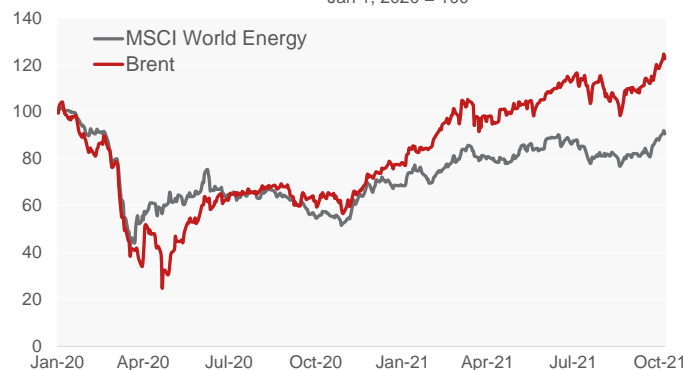
Oil prices and US productive capacity



Source:Refinitiv

Oil prices and producers equity price

Jan 1, 2020 = 100

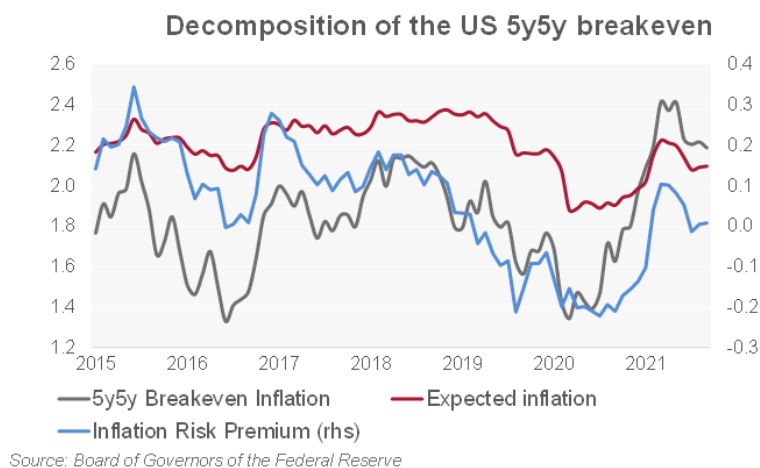
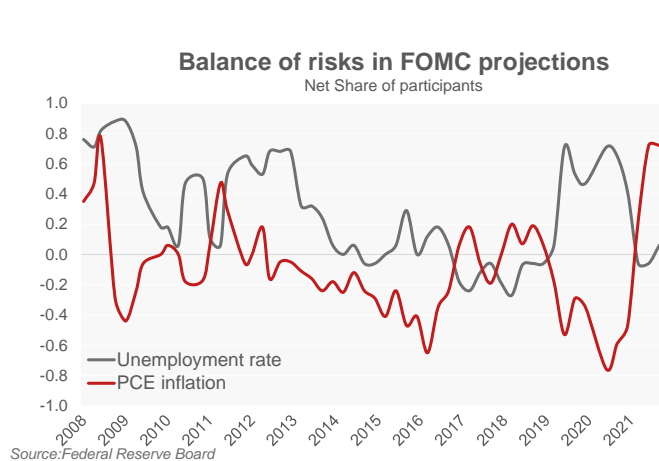


Source:Refinitiv

The first impact of high oil prices will be on consumer prices, and governments are trying to minimise the damages by, for example, temporary reduce taxation or apply a windfall tax on utility providers to be rebated to households. Second-round effects, however, can be longer lasting and more damaging. Several relevant manufacturing sectors like steel and paper are highly reliant on gas; while power outages forcing production to be scaled back remain a tail risk for the moment, production price inflation will accelerate. Robust demand may allow retailers to pass through a relevant part of it to consumers. This would happen on top of the already high inflation caused by supply chain bottlenecks, whose easing is proving slower than many expected only a few months ago. This may significantly reduce the expected slowdown in inflation. We see US headline inflation to remain around 5% by year end and to drop below 3% only during the summer 2022.

Consumer surveys in the US are already showing that high prices for certain items are negatively affecting confidence. Slower consumption would limit the offset the private sector is expected to provide amid a fading fiscal stimulus in advanced economy in the coming months. This would slow growth and employment creation.

This puts central banks in advanced economies in a very difficult position, as monetary policy is not particularly useful to stem negative supply shocks. Higher inflation mechanically calls for a monetary tightening and is behind the decision by a few central banks (among which New Zealand and Norway) to already lift rates. However, prolonged supply disruptions and high commodity prices are harming growth and this requires more caution. Both the Fed and the ECB have recently insisted on the temporary nature of the inflation spike and mostly resisted calls for an early withdrawal of accommodation, even though concerns on prices in part motivate the fact that one half of FOMC members now expect the first rate rise by the end of 2022. The occurrence of a positive shock to inflation and the on the headwinds to growth may push central banks to even more tolerance towards inflation, and this would start being priced in the inflation risk component of bond yields. On top of the uncertainty it creates, continued adverse supply shocks the economy will affect financial markets. The resulting positive bond/stock price correlation may reduce diversification opportunities at a time when the economic outlook become more uncertain, raising risk premia.



This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio has obtained from sources within and outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. The information, opinions estimates and forecasts expressed in this document are as of the date of this publication and represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. It shall not be considered as an explicit or implicit recommendation of investment strategy or as investment advice. Before subscribing an offer of investment services, each potential client shall be given every document provided by the regulations in force from time to time, documents to be carefully read by the client before making any investment choice. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio may have taken or, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein provided. Generali Insurance Asset Management S.p. A. Società di gestione del risparmio relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible damages or losses related to the improper use of the information herein provided. It is recommended to look over the regulation, available on our website www.generali-investments.com. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..