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Bracing for Winter: Energy in the Spotlight

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Voiceover: Podcast Intro – Thomas Goldthorpe

Energy is in the spotlight once again, as gas prices are expected to go up and the energy crisis mounts with the EU's ban on most Russian crude-oil imports taking effect in early December.

Research analyst Thomas Goldthorpe breaks down the latest events in the energy and oil landscape. He says oil markets look to be balanced with real upside and downside risk.

Thomas also discusses the current story in Russia. He says as the December ban on Russian oil looms ahead, he describes the country as a two-way risk. The oil can be redirected, but there may be some short term, 30 to 60 days friction, as a result. In addition, countries like China, India and the Middle East will import more Russian oil as they do not believe in the embargo of Russia's product.

Thomas further expands on Europe's oil embargo, also touches on how weather plays a part in the current gas climate, and how investors should be looking at equities or their energy equities within their portfolios.

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Pamela Ritchie: We started out talking about what we saw the Bank of Canada do. It is obviously a rising rate environment... a little less than expected, though, and looks like actually oil stocks, a lot of things in the market overall have kind of responded to talks of a pivot; more talks of a pivot, I guess. Do you see it that way?

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Thomas Goldthorpe: Yes, so I think the oil markets generally view a pivot as being positive because, obviously, it's supportive for medium-term demand. As long as this pivot conversation continues it should be supportive for oil prices.

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Pamela Ritchie: We've also seen the U.S. dollar come down, so that always has its own sort of implications for commodities. I wonder if you can kind of situate us, though, in the discussion of investment for energy companies. So, energy equities, looking at them… it's been a very interesting time over the last couple of years. Are we at the end of it, are we at the beginning of it? What do you see?

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Thomas Goldthorpe: I think right now in oil markets it's a very interesting time. Markets look to be balanced with real upside and downside risk. The companies themselves are also very interesting in that they remain very cheap on strip and they're doing the right things with their capital. It feels like given… yeah, there's a lot of uncertainty in both directions that this is more of a period to focus on stock picking as opposed to making kind of large macro direction that's on the price of oil.

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Pamela Ritchie: They are, though, as you say, doing good things with the money that they're making. That broadly has meant giving it back to shareholders. Any nuance to that that you want to provide that sort of changes or is different now? Or maybe it isn't?

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Thomas Goldthorpe: This cycle is very different. Capital discipline is real. Management teams, this has been a very slow transition, so starting roughly five years before COVID through today, the companies have really transitioned from being 100% growth-focus to being more returns-focused. This is really coming from the shareholders and the shareholders badgering management teams, and now the management teams have all transferred over. Right now, we're in a world where even though oil prices are very high, gas prices are high, return on incremental investments, very high; that companies are still being very disciplined with their capital. By being very disciplined with their capital means that they're generating significant free cash flow at levels that we haven't seen historically. That free cash flow generation looks to continue at current prices and that cash is primarily being returned to shareholders and used in attractive M&A.

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Pamela Ritchie: Interesting. What is the M&A landscape? Are we sort of wrapping up? We've seen a few deals actually, recently, but what would you say broadly about the M&A front? Is consolidation sort of … have we gotten through a fair amount of that?

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Thomas Goldthorpe: We've done a lot of consolidation. There's still more to go. There's kind of two buckets. One is more kind of ESG-driven type divestitures, which offer kind of very attractive multiples for other companies to acquire within Canada. Then there's just been more broader consolidation. Yes, deals have gotten more expensive. We've gone from a world in second half of 2020 and 2021, where any deal was a homerun because there's a lot of forced sellers that just did not want to be in hydrocarbons. Deals today are getting a little more expensive. They're still attractive but they're not as attractive as they were, but there's still kind of a move towards greater consolidation. You have kind of anti-carbon type divestitures, as well as you have a lot of private equity funds you made investments 5 to 10 years ago who now… whose funds have matured and who need to kind of divest. Then there's an interest in driving further consolidation within the industry.

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Pamela Ritchie: Let's get sort of right to the heart of the risks for the global oil market right now. By now, we all know the story of Russia. We all know what's happened. We all know what happened to oil prices in response. Where are we now in this story? There are risks, there are discussions about the ongoing war and the risks that that poses. Russia also has less countries to sell to at this point. Tell us about how we should be thinking about global risks to the oil markets.

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Thomas Goldthorpe: There's two-way risk. Russia, I view as a two-way risk. First, December 5th, the European import embargoes are put in place and there's kind of some insurance bans as well. Looks like maybe those insurance bans will be a little bit weaker. It looks like all that oil can be redirected, but there may be some short term, 30-60 days, of friction as a result of that. Another risk out of Russia is linked to...

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Pamela Ritchie: Sorry, when you say redirected -just to hold you there-, what do you mean by that?

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Thomas Goldthorpe: Effectively the oil... places like China, India and even the Middle East will import more Russian oil as they do not believe in the embargo of Russian product. And then, oil that those countries were previously importing from places like the Middle East will be redirected to Europe. There is enough infrastructure to make it all happen, but there's a lot of rewiring that needs to occur to make sure that the Russian oil gets to where it needs to be, and the non-Russian oil gets to where it needs to be. Speaking of Russia, there's short-term kind of transactional risk around rerouting of those barrels. There's also the potential of a unilateral cut by Russia so, similar to how Russia cut natural gas supply into Europe, there's a chance that they also cut global oil prices to increase oil prices and put more pressure on Europe to sue for peace in Ukraine.

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On the flip side with Russia, there's also some upside supply risk on -let's call it 6-to-12-month basis- because it appears that on the ground Russia is... is losing ground in Ukraine. If this situation persists and Ukraine continues to push back Russia, there's a chance of Russian peace and a more normalized Russian oil supply environment. Shorter-term, there is potential of real disruption. I think in the medium- to longer-term, there's upside risks to what a lot of people believe out of Russia just due to potential Russian peace.

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There's that bucket, there's economic risk. It does appear that a recession will occur next year and there's a reasonable probability that is a deeper recession and deeper recessions will impact demand, so that's a risk. There is uncertainty around OPEC as well. OPEC has cut into the end of the year to help offset some of the demand headwinds from places like China due to zero-COVID, and Europe as well has had weak demand. There is debate about how aggressively they're going to defend pricing, both on the downside... and, also, now they have more spare capacity, so they could increase production on the upside. All this is to say is that there is a lot of uncertainty out there. There's upside and downside risks.

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Pamela Ritchie: This was something that we discussed a while ago and it's hard to know really what's going on. There's so many different pieces. There is an argument that the Chinese Congress will happen and then they will magically lift lockdowns. That hasn't happened, but there have been incremental… it looks like some version of vaccines happening in China. Different kinds, that kind of thing. What if China opened-up reasonably quickly? What would that do to oil demand globally?

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Thomas Goldthorpe: It would clearly be a positive for oil demand and should lead to higher prices. Part of that could potentially be offset by increased OPEC production. I think OPEC doesn't want prices to go too high, but they also don't want prices to go too low. There is a potential offset there; and now OPEC has the spare capacity -due to the recent cuts- to buffer the market a little bit more. But ultimately, it would be a positive for the market.

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Pamela Ritchie: There's a lot of voices coming out of Saudi Arabia right now because they're having a big conference; you're hearing a lot of sorts of quotes here and there. We heard the oil minister, Mr. Nasser, say that they're interested in blue hydrogen. The world is looking at alternative energies. Let's turn attention to this a little bit. I think the quote from the oil minister was along the lines of blue hydrogen is where we'd like to go -super expensive to produce it right now, in the neighbourhood of $300 for barrel of oil- sort of that type of area. It needs to come down with a catalyst, a big client, a big deal being signed. What do you make of all this? Is this really something that's going to move? Is it going to move quickly? How do you react to those discussions?

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Thomas Goldthorpe: Some idea of hydrogen, it's still relatively early stages. The technology is there. It's just, as you said; it's very expensive. My opinion of hydrogen; it's one of … for all energy transition I don't think there's one single solution. It's you do a lot of solutions and maybe 20 to 30 different things. They're all small in isolation, but when you add them all up, they are all helpful. I think there is room for blue hydrogen, and it will play a role in the transition, but it won't be massively transformative. It will be interesting to see how Saudi's investment in the space progresses because the interesting thing with Saudi is now, with higher oil prices, they have more excess savings, which they can use to invest in more of these energy-transition projects.

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Pamela Ritchie: Right. Interesting. Right. So, it's nice for the oil price to be high for a little while until they can invest in some of those options for the future. Is that fair?

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Thomas Goldthorpe: Absolutely. It just gives them more money, so they can invest in more future technology.

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Pamela Ritchie: So interesting. Let's go to a few questions. There's a number of things that are rolling in here. Are we back to a long-term kind of secular bull market for commodities? There have been lots of questions about this. Lots of talk about recession, too. How do you square that?

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Thomas Goldthorpe: There's a lot of moving parts to that question. Let's say, in terms of energy, I wouldn't necessarily say we're in a secular bull argument and energy prices can only go up from here. What I would say, though, is that the next five years will likely look better than the last five years as markets are a little tighter and they're a little more susceptible to unexpected events. There's a little more upside skew kind of in that risk-return, risk-reward trade-off.

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Pamela Ritchie: This question came in. I think you pointed to it earlier; it's sort of the key question for Russia. With Europe's oil embargo, which you were mentioning before, who will Russia sell oil to? India, China, you mentioned those. You also mentioned the Middle East, which I think might be Turkey. Just talk a little bit more about either how serious that concern would be for Russia or if it's getting, I guess, managed. You said there's sort of a reorganization of things.

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Thomas Goldthorpe: Two things, [indecipherable] Middle East there actually is some signs that even Saudi Arabia is importing some Russian crude and they're exporting more Saudi Arabian product. I think ultimately the world we're in right now outside of Europe, outside of the U.S. and outside of maybe Japan and South Korea, the rest of the world has determined that they'd rather buy cheap Russian energy than not buy it. What we're seeing is there's a greater receptivity in these countries to import the products. Africa could be a big importer; even South America to a lesser extent and, basically, Asia. So, basically, all these countries, effectively outside of those ones I just mentioned, have shown a willingness to buy the product.

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It's really hard to go to these countries and say "Hey, the economy is slow, things are tough on the ground right now and, hey, don't buy Russian product even though it's a lot cheaper". I think there's a way and also there's a lot of kind of backdoor stuff going on that you're effectively importing Russian crude, but you blend it, or you use other ways to… there's other clever ways to kind of get around these sanctions. We've seen historically that in oil markets especially, there's ways around these sanctions that are kind of difficult to monitor.

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Pamela Ritchie: It's like the reason for Dubai is to sell Iranian goods. No, that's not quite true, but it certainly is where a lot of Iranian goods … I mean, there are limits to how things work. Let me just ask you this, does Russian oil… if it were to get to Africa, does it need to go through the Suez Canal?

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Thomas Goldthorpe: It depends. It depends where the oil is going. I think in Eastern Africa it'll go through Suez but on Western Africa, it doesn't have to go through the Suez.

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Pamela Ritchie: It can just go out through the Mediterranean. Fascinating how all these lines are rerouting. Speaking of lines rerouting, let's look at Canada a little bit. You mentioned earlier that, because Europe kind of has to find other ways, they are finding other ways or there's a faster move on that front, and that has a lot to do with ESG and alternatives and so on. But in Canada, the question mark surrounding getting some pipelines built -gas pipelines built-, we actually spoke on this program to the ambassador to the UN for Canada, Bob Rae, last week and he said that he was seeing more movement, actually, with First Nations, with discussions about getting more pipelines across this country to sell abroad, to get to other Canadians. I mean, some movement on this front. Is that what you see from your analysis?

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Thomas Goldthorpe: I think what I'm seeing today is there's a lot of talk of a more supportive environment for energy infrastructure. But when push comes to shove there still hasn't been a lot of action. I think what you'll find in a lot of these cases is you can find people are very supportive of these actions. You can find First Nations and everybody else, but once you go down the path of permitting, there's going to be groups that are very opposed to it and very publicly opposed to it. That will hold up the processes and, when push comes to shove, it still doesn't appear that we have the political will to get the stuff built.

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Pamela Ritchie: That's with all levels of government? It's tricky [crosstalk].

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Thomas Goldthorpe: I think as we get closer to on the ground there's a little more support, especially in Alberta. But ultimately, I think, especially at the federal level there's not just the political will to get these projects completed. If there is kind of strong minority pushback on the projects. That's kind of the frustrating thing; you can have these situations where the majority of people support it but if 5, 10, 15% of people are opposed to it, then that can ultimately cancel these projects.

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Pamela Ritchie: Just coming back to sort of strategically how investors need to be looking at equities -oil equities, energy equities- within their portfolios. We certainly saw energy be a winning group for a long time. Year-to-date we've seen some incredible moves. Sometimes that means something different for the year after. How do you look at that? How do you respond to that?

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Thomas Goldthorpe: I think it's a fair question. There's been a big outperformance this year, a big outperformance last year. The normalized energy prices these stocks are pricing in are significantly higher than they were, but also the set-up, I think, has improved. Stuff has changed, fundamentals have changed, companies have proved that they are a little more disciplined. As always, I don't necessarily look at past performance to try to predict future performance. I think in this case that holds true. Maybe they're not as screaming cheap as they were, but it also doesn't appear that they're incredibly expensive either.

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Pamela Ritchie: How important is the weather? I'm asking a fellow Canadian. But actually, for this winter how much on a knife's edge is sort of how things could really spiral out of control in terms of having enough energy in certain parts of the world? Is it just dependent on how cold a winter it is?

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Thomas Goldthorpe: Weather is important, especially in Europe with their current gas situation. Also, you always have to remember that weather is a two-way risk. If we have a really cold winter, Europe should be fine, but energy prices are going to go higher and potentially significantly higher. But if we get normal weather or warm weather -and, remember, in the last 10 years you've generally had warmer rather colder weather- it could put real downside pressure on European gas prices. It's the same set-up in North America in that a lot of people want to talk about what happens in a winter scenario when things get tight and how high prices can go, but a lot of that risk is also balanced by if you don't have cold weather then, yeah, there could be significant downside risk to pricing. I think in this environment, given where inventories are and everything else, there's just greater range of outcomes that could occur. Versus history, a cold winter probably does make prices go higher than they would historically, but you could actually see prices actually go down more than we normally would if we have a warm winter.

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Pamela Ritchie: Just on sort of the inventories, the spare capacity discussion. We saw the U.S., for a variety of different reasons, release their special purpose, their extra inventories, essentially. What do we need to know on that front about whether replenishments going forward sort of from political inflationary discussion need to happen? What do investors need to watch on that front?

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Thomas Goldthorpe: I think SPR looks like they will finish up their initial program by the end of this year. There's some congressionally-mandated sales to come as well. I think they talk about refilling, so that's another one where we will see how serious they are about refilling. They talked around $70 [crosstalk]...

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Pamela Ritchie: Do they have to? Is it necessary?

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Thomas Goldthorpe: No, they don't necessarily have to. The thing you have to remember with the U.S. is the U.S. is effectively balanced. Their oil supply is balanced and, if you include Canadian imports, are actually a large exporter of oil, so generally, countries that are balanced to exporters of oil don't actually need SPRs primarily. The most famous one is... Russia doesn't have big inventories because they're generally a big exporter, whereas countries that are short ... so, traditionally, U.S., if you look at it pre shale, was a big importer of energy, so the SPR was more important. The refill question is interesting in that the question is if prices do go down to their target price and the economy's a lot worse, will politicians ultimately decide to spend money on replenishing the SPR or do they want to spend it on kind of other programs. Famously, in 2020, the President wanted to fill up the SPR at $24 oil and the Congress said no. There's a lot of talk of refilling and doing all this, but I think when we actually get to it it'll be interesting to see what actually happens.

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Pamela Ritchie: I have a couple more questions for you. I'm curious, what are we missing here? What's one of the sorts of big stories that you feel is either coming down the pike or is a piece of the energy transition story that maybe we're talking about less, or maybe we're talking about something too much, I don't know. What's around the corner?

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Thomas Goldthorpe: I think two things to notice. We talked about natural gas; it's just a two-way risk. Everyone wants to talk about what happens if you have a cold winter, but I think about that; there is some downside risk if we have a warm winter or regular weather. Another topic, I think, is of interest is Iran. You're having kind of big protests there. There are questions of whether or not that either accelerates the nuclear agreement or accelerates regime change in the country, which could kind of bring a lot of additional supply back on the market. I think on Russia, the chance of Russian peace… they're all in this mindset that this Russian war will go on forever and Russia's supply will never improve, but I do think the current situation on the ground feels unsustainable because, ultimately, U.S. is supplying weapons to the Ukrainians at a faster pace than the Russians can and Russia is having a tough time replacing that inventory, so they're slowly losing on the battlefield.

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That looks like an unsustainable situation and that looks like a situation that could be resolved in a years' time. There is a lot of Russian risk around what happens over the next three months, but give it a year, give it two years; Russia could be back to normal and that changes everything. I think the big takeaway is there is two-way risk. Everyone wants to talk about the tightness and how high things can go, but there are stuff that could go the other way as well. I think oftentimes that stuff is not given the same type of airtime that the more bullish narrative is given.

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Pamela Ritchie: That's very interesting. There was a point at which, there were questions… it's not possible for the Fed to chase the oil price. We know that, but there was sort of a question of whether the Fed was trying to chase the oil price to try and crush inflation. Give us just a little bit of a sense of how things are working with rates rising. Some signs that inflation is coming down, but we still have high oil prices. Where does this all fit? We understand the core and the separation, but I'm just sort of curious in this rising rate environment where the inflation story with oil fits.

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Thomas Goldthorpe: I think there's a bit of chicken and egg. If they cut rates or they don't increase rates enough, then oil prices go much higher. That creates more inflation. That prevents them from actually, truly pivoting. So, in the short term, oil prices will, I think, hurt the ability for the Fed to cut. The second thing with that is over the medium term, if Fed keeps rates too high for too long, that could create a recession which could create a demand destruction. I think going in that conversation is also OPEC's decision to cut, which does lead to higher oil prices, which ultimately puts more pressure on the Fed to keep rates higher for longer and could ultimately lead to kind of greater demand destruction at the other side of this. It is interesting that there is a bit of a governor on the Fed's ability to pivot in that, if they pivot too quickly, you get higher oil prices and then higher inflation and then, forced to kind of either re-increase interest rates or stick to their original plan.

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Pamela Ritchie: Thank you so much, Thomas Goldthorpe, for laying out the field of upside-downside risk and ultimately where the story of oil goes from here. We're very grateful you could join us.

Ending: [00:27:34]

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