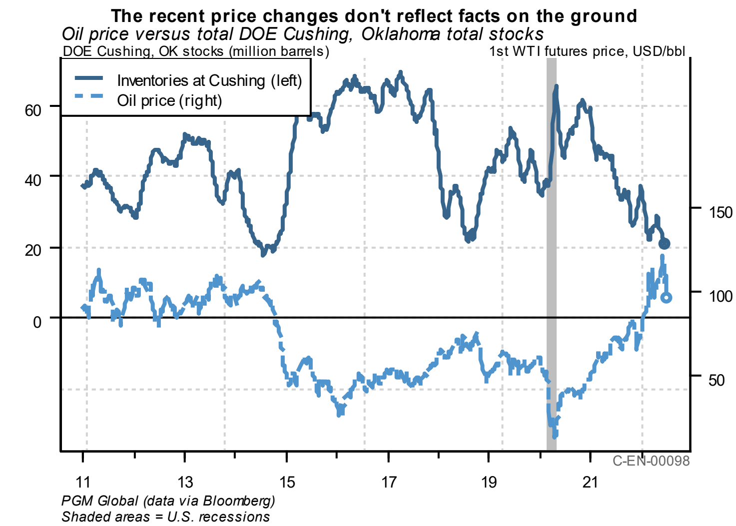
PGM GLOBAL

Inside this issue

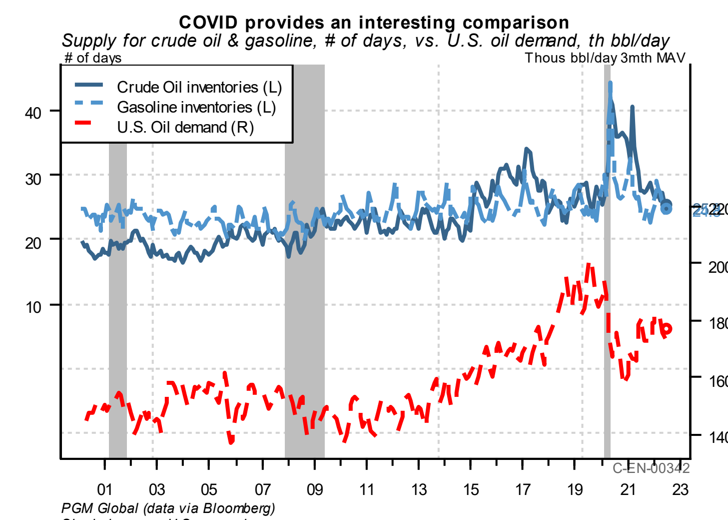
Belief is a dangerous thing: Oil prices are well off their highs. We examine possible reasons, the outlook for Energy and re-examine some of our Energy trades.

Re-examining the Energy trades

Oil prices are starting to roll over. The price decline temporarily below the psychologically important USD 100/bbl threshold reflects mounting concerns over an economic slowdown. In our view, the downturn presents a buying opportunity, as oil prices do not reflect fundamentals. This is most evident in the crude inventories at Cushing, OK, below usable thresholds. To put it bluntly, the storage tanks are functionally empty.



Oil demand is price-inelastic, resulting in volatile price swings when the market is over or under-supplied. Both oil and gas inventory levels are near their recent lows. Moreover, if we use COVID as a worst-case scenario for oil demand, it doesn't look like there is much slack in the market. While poor sentiment due to growth concerns can weigh further on oil prices, the fundamentals suggest such a decline would be a buying opportunity.



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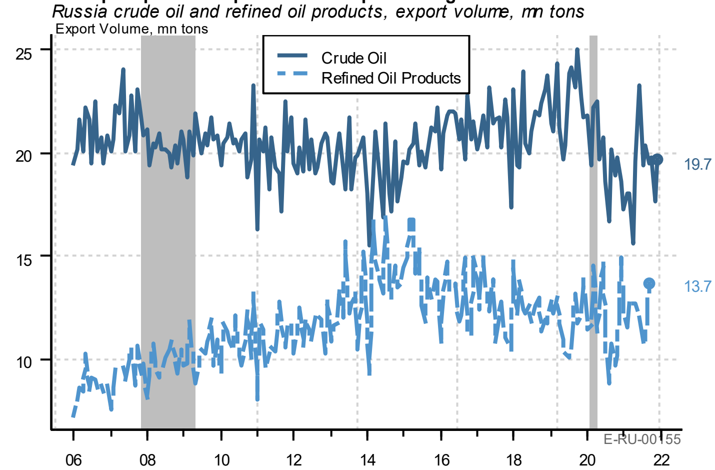
Given the fundamentals, what other reasons could there be for the recent price decline? Plans by the U.S. and Europe to cap Russian crude oil prices may be one cause. We don't think the plan will succeed, at least not without first driving oil prices significantly higher. Again, demand for oil and gas is inelastic, so Russia would need to willingly go along with the plan for it to work. If Russia were to withhold oil and gas supply—especially as winter approaches—prices would go parabolic, and Europe would freeze. This is a real risk that we think is under-appreciated.

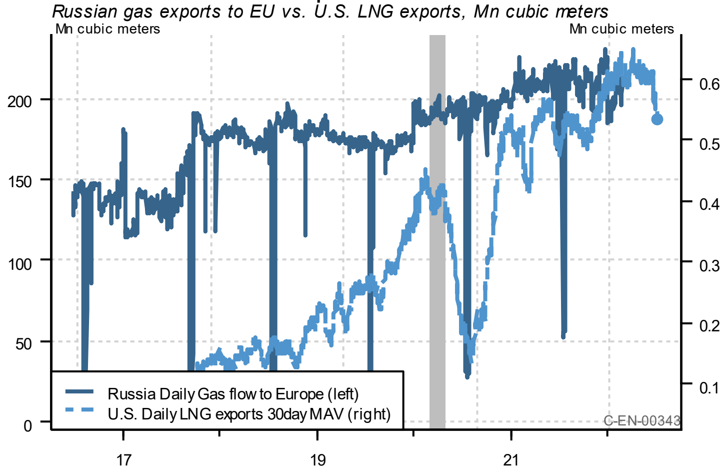
Europe's plan to cap Russian oil prices might be economic harakiri
Russia crude oil and refined oil products, export volume, mn tons



PGM Global (Federal Service State Statistics data via Bloomberg)
Shaded areas = U.S. recessions

America produces natural gas, but its gas exports are a fraction of what Russia exports to Europe. While President Biden has promised the Europeans more gas, this promise isn't workable. Even if the U.S. could produce all the gas Europe needs, the U.S. lacks both the export terminals and the LNG tankers to move LNG in size. Europe can source it elsewhere, like Qatar, but this increases competition for Qatari gas. In short, since demand for Russian oil, and especially gas, is inelastic, if Russia reduces its exports to Europe, prices will go parabolic. Europe's plan for a price cap appears unlikely to work and is one reason we think prices rise.

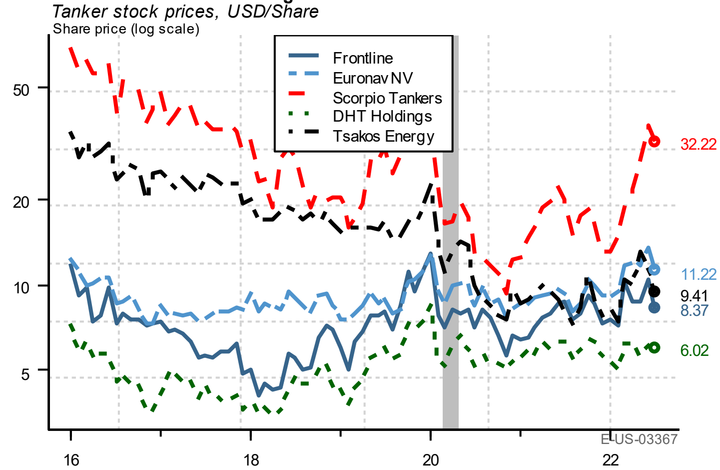
America lacks the export terminals and and tankers
Russian gas exports to EU vs. U.S. LNG exports, Mn cubic meters



PGM Global (Gazprom, Bloomberg Energy data via Bloomberg)
Shaded areas = U.S. recessions

As a brief aside, expectations that the West enforce a price cap on Russian crude and prohibit the insurance of tankers that carry Russian crude may lead to a near-term pullback in the tanker stocks. There are obvious ways around the European measures (like ship-to-ship oil transfers and transponders 'temporarily' turning off). So, while we still like the tanker stocks, we are up more than 50% on some names since we 'went long' in April (see: *"Unexploited Energy opportunities"*, April 20). It is time to take some profit and look for another re-entry.

Waiting for another moonshot
Tanker stock prices, USD/Share



PGM Global (data via Bloomberg)
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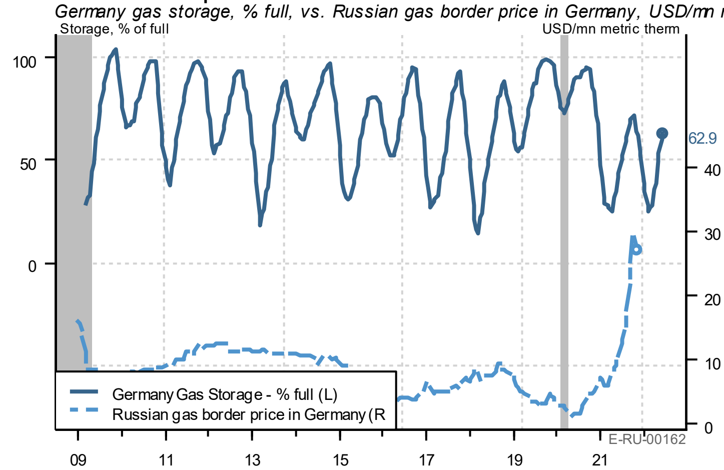
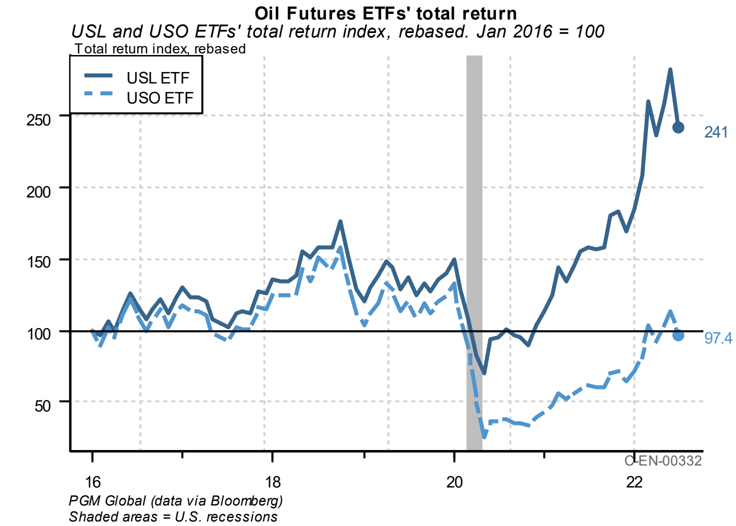
German gas supplies are also quite low, so it doesn't look like abundant energy supplies in Europe are behind the energy price decline. As we have also mentioned in previous notes and presentations to clients, diesel inventories in Europe, the U.S., and Asia are at decade lows. Not to belabor the point, but the recent downtrend in oil prices appears unsupported by fundamentals.

A lump of coal for Christmas would be welcome
Germany gas storage, % full, vs. Russian gas border price in Germany, USD/mn metric the



PGM Global (ICE data via Bloomberg)
Shaded areas = U.S. recessions

Interestingly, while oil prices have declined, the front-ends of both the WTI and Brent curves are more backwardated today than they were a month ago when oil prices were in the USD 120/bbl range. Steeper backwardation implies greater shortages of crude oil. It also suggests that the total return of the USL ETF should improve. The roll-yield between the 13th and 1st WTI contracts is $20, or 24.6%! The USL ETF contains futures going out one year and should benefit from both the roll yield and any increase in oil prices.



Bottom line: Oil prices are well off their highs, as concerns about a growth slowdown and hopes that Europe can cap Russian energy prices become mainstream. We aren't so sure. Inventories of WTI at Cushing are below functionally useful levels. Global distillate inventories are at decade lows, and Europe's plan to cap Russian oil prices has a low chance of success. We advise clients to use any pullback in oil prices as an opportunity to add exposure. The roll-yield on the WTI futures curve generates 25% over the next year. The USL ETF is one way to play this. After a roughly 50% gain on the tanker stocks since April, we are taking profit here and looking for another re-entry point.