COMMODITIES

A RUSSIAN SPARK RISKS LIGHTING THE POWDER KEG

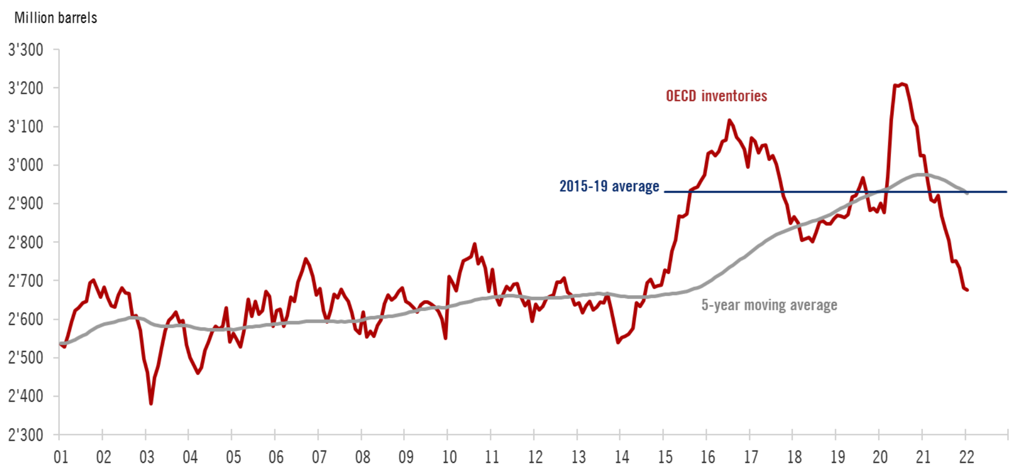
Author

JEAN-PIERRE DURANTE
jdurante@pictet.com

SUMMARY

- Russia's invasion of Ukraine has increased tensions in a commodity market that was already stretched.
- The invasion means we are moving from our core scenario towards our upside scenario that factors in heightened geopolitical tensions.
- As well as fossil fuels, Russia is a major producer of metals and wheat: the war is impacting commodities across the board.
- We are revising our oil price predictions upwards. We believe the all-time high of USD145 for Brent oil recorded in July 2008 could be tested. Once the war ends or reduces in intensity, Brent should fall back towards USD95 / bbl as economic activity and demand for oil fall back due to higher prices.
- Europe is particularly vulnerable to disruptions in energy supplies, having entered the winter with very low gas storage levels. What's more, 40% of the region's gas comes from Russia, and rapidly substituting this supply is unrealistic. Disruptions to gas and electricity supply cannot be ruled out.
- Russia accounts for 14% of global wheat exports and Ukraine 10%. Weather-related issues affecting American, European or Australian crops could therefore cause further increases in food prices.
- The impact of the surge in energy prices means higher global inflation in the short-term. The forecast peak in inflation has likely been postponed and economic activity will be hurt, although the authorities could respond with supportive fiscal policies. Europe is clearly much more exposed to these risks than the US due to its vicinity and its energy dependence.

CHART 1: OECD CRUDE OIL AND LIQUID FUELS INVENTORIES



Source: US Energy Information Administration, Pictet WM-AA&MR

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Oil inventories at very low levels

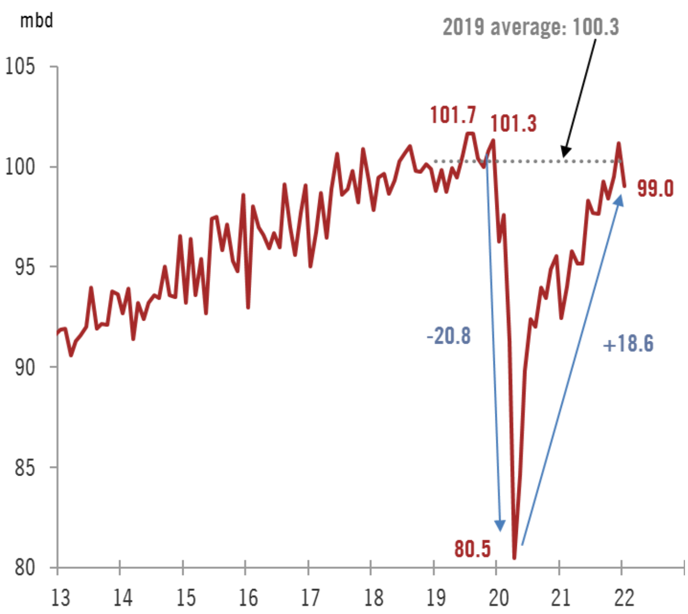
The conflict between Russia and Ukraine comes at a time when commodity markets were already very tight, with global oil inventories at their lowest level since July 2014. This is because global demand recovered rapidly after the outbreak of the pandemic, while supply has not followed suit.

Limited supply elasticity

Global oil demand fell by 2.2 million barrels per day (mbd) to 99.0mbd in January. However, this was only likely to be a temporary blip caused by omicron. Now that restrictive measures against covid have been relaxed in almost every Western country, global oil demand is likely to reach pre-pandemic levels soon (100.3mbd).

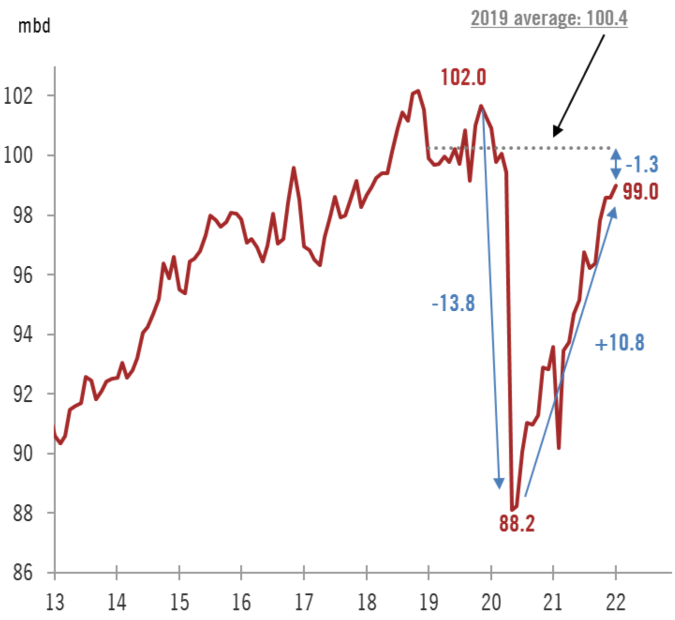
Meanwhile, global oil supply increased by 0.4mbd in January to 99.0mbd – just matching global demand. However, after six quarters of undersupply, several months of oversupply are needed to rebuild global inventories. Instead, we have a problem of limited supply elasticity. OPEC+ is not producing as much as it announced it would, while US shale oil production appears muted despite supportive prices.

CHART 2: GLOBAL OIL DEMAND



Sources: US EIA, Short-Term Energy Outlook, Pictet WM - AA&MR

CHART 3: GLOBAL OIL SUPPLY



Sources: US EIA, Short-Term Energy Outlook, Pictet WM - AA&MR

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Several OPEC+ members are unable to increase production

OPEC production is currently limited. Nigeria, Angola and Republic of Congo are unable to meet their quotas at present due to a lack of maintenance and investment in oil facilities. Excess capacity is concentrated in a few countries (Saudi Arabia (1.4mbd), UAE (1.3mbd) and Iraq (0.5mbd)), but these are barred from compensating for missed

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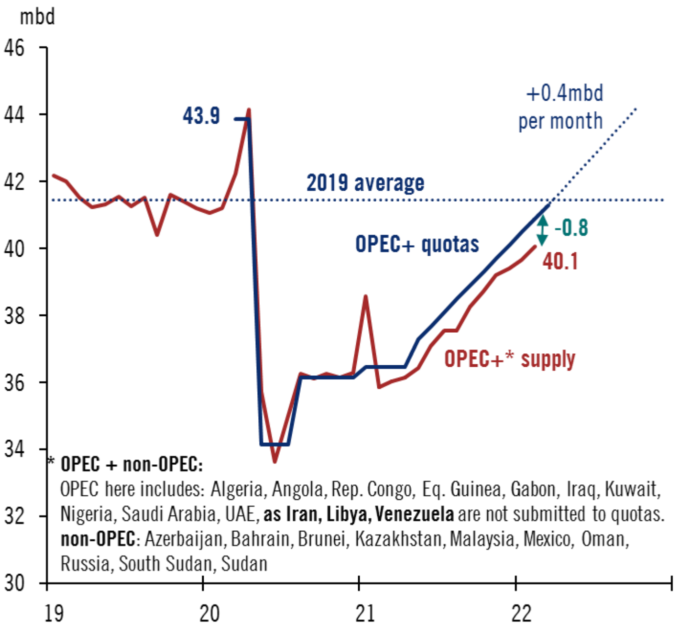
production as the other OPEC+ countries want to be able to make up for their own missed production first. Saudi Arabia is unwilling to countenance this because it fears that future production could run out of control.

Non-OPEC members of OPEC+ such as Mexico, Azerbaijan and Malaysia are also facing difficulties fulfilling their quotas. Overall OPEC+ production was 0.8mbd below its planned level in January. Since February 2021, supply has, on average, been 0.6mbd below announced levels. Barring an exceptional hike in the demand for oil, we expect OPEC+ to announce regular 0.4mbd per month increases in supply to respect the quota agreement reached in July 2021 even if effective production does not increase by this amount.

Russia is a special case. It is the second-biggest oil producer in the world and has the capacity to increase its production. What’s more, after the severe set of international sanctions that have been imposed, it will be in dire need of revenues. But we believe it could use its influential position within OPEC+ to weaponise oil production.

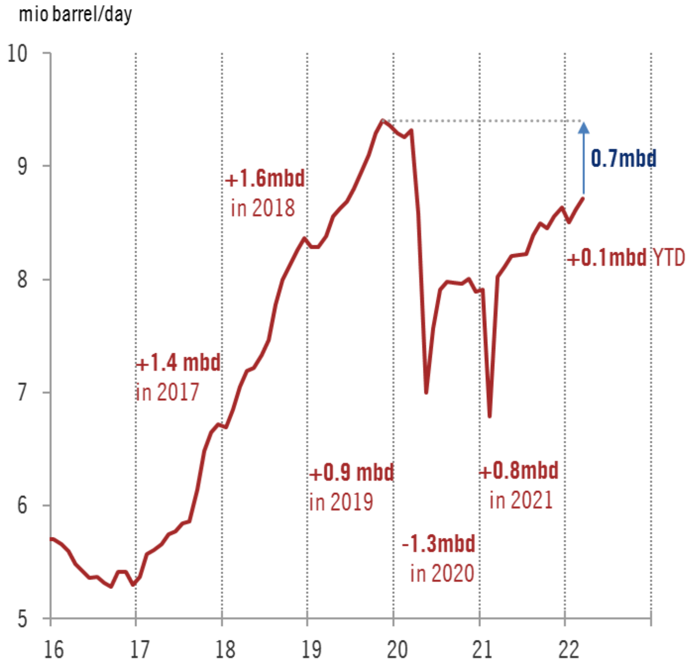
The restart of nuclear negotiations with Iran could result in 1.3mbd of missing Iranian oil soon hitting the market. However, Moscow could disrupt the negotiations and prevent an agreement. Iranian oil would certainly help smooth price tensions but is unlikely to be enough to completely restore the global supply-demand balance.

CHART 4: OPEC+ OIL SUPPLY



Source: PWM-AA&MR, OPEC, Rystad Energy, Bloomberg

CHART 5: US SHALE OIL PRODUCTION



Source: Rystad Energy, Bloomberg, Pictet WM- AA&MR

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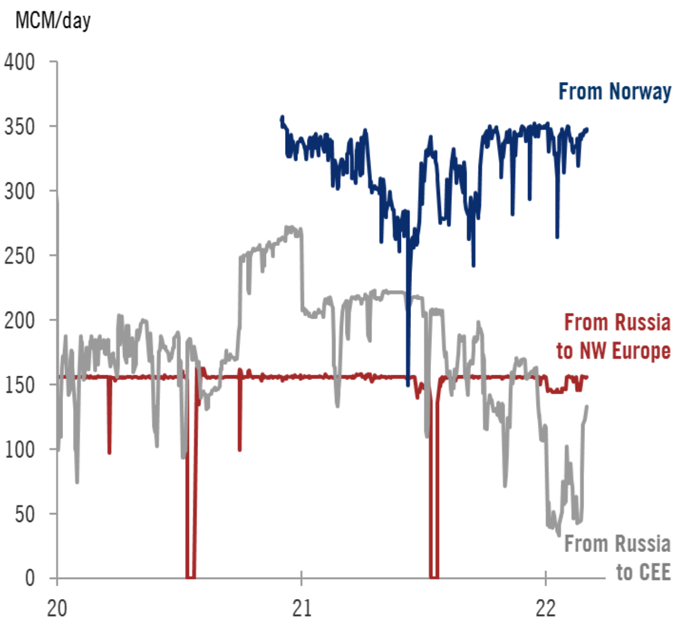
The US is no longer the swing oil producer

Until the pandemic, the US was the swing oil producer thanks to the boom in the country's shale oil industry. But this is no longer the case as the industry's restructuring after the oil price collapse of April 2020 and the need for capital discipline to pay dividends has completely changed the industry's reaction function. That said, US share oil producers are progressively rebuilding capacity: 350 oil rigs have been added since August 2020 (although the 522 there are today is still well below the peak of 888 in November 2018). Nonetheless, there should be a progressive increase in US shale oil production during the year: we expect US shale oil production to increase by 0.7mbd in 2022, reaching 9.4mbd (close to its all-time high) by the end of the year.

Limited potential supply from outside the US and OPEC+

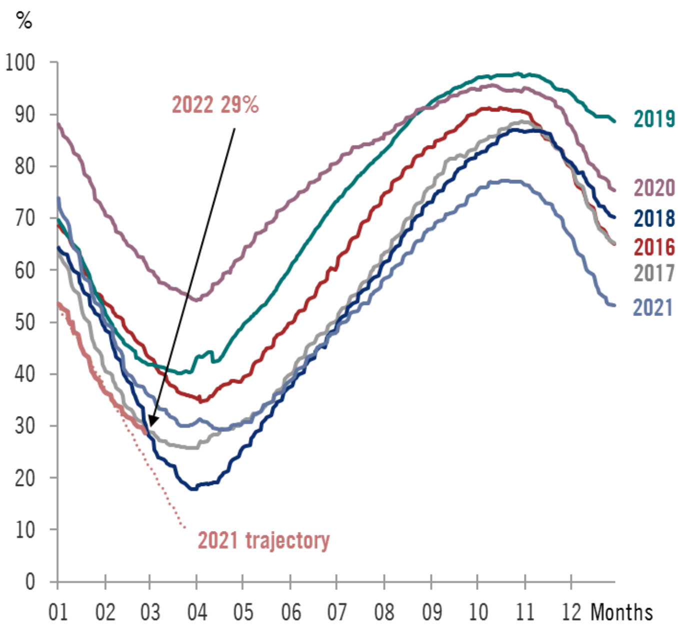
Other suppliers, such as Canada, Brazil and Norway, are likely to be encouraged by higher prices to ramp up their production. However, production in Canada and Brazil has already risen. Production in Canada is already 0.4mbd above its 2019 average, and it is 0.3mbd above in Brazil, so the potential for further significant increases in the short term appears limited.

CHART 6: GAS FLOWS TO EUROPE



Sources: NEL, OPAL, Gassco, Bloomberg, PWM AA&MR

CHART 7: EUROPEAN GAS STORAGE



Sources: AGSI, Bloomberg, PWM AA&MR

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Overall global supply elasticity appears constrained as the biggest producers – the US, Russia and OPEC – all face limitations. This, combined with very low inventories, means the Russian invasion has led to a spike in oil prices.

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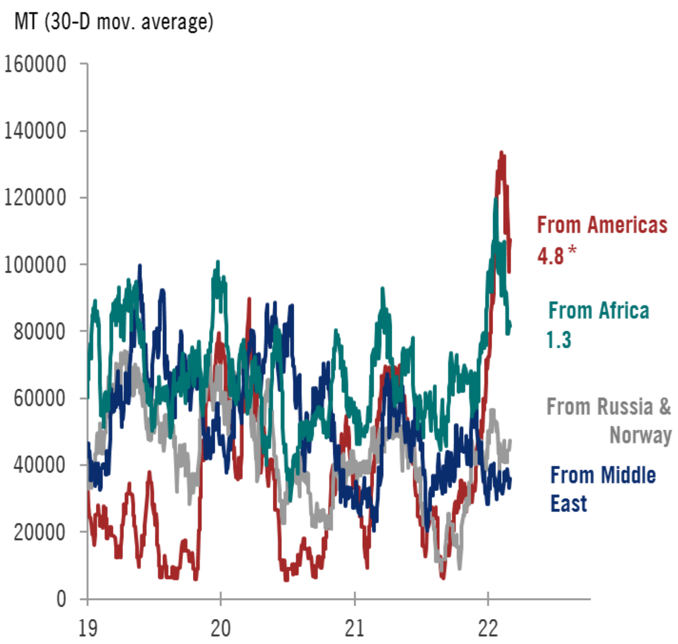
European gas: a critical situation

Even before the Russian attack, Europe was in a critical situation when it came to gas supplies. The region entered the winter with low storage (67% of capacity in early December, well below the average of 84% between 2016 and 2020). This was due to low flows from Russia. Even though Russia has honoured its long-term contracts, when European countries asked for extra supply Russia did not respond with increased gas flows.

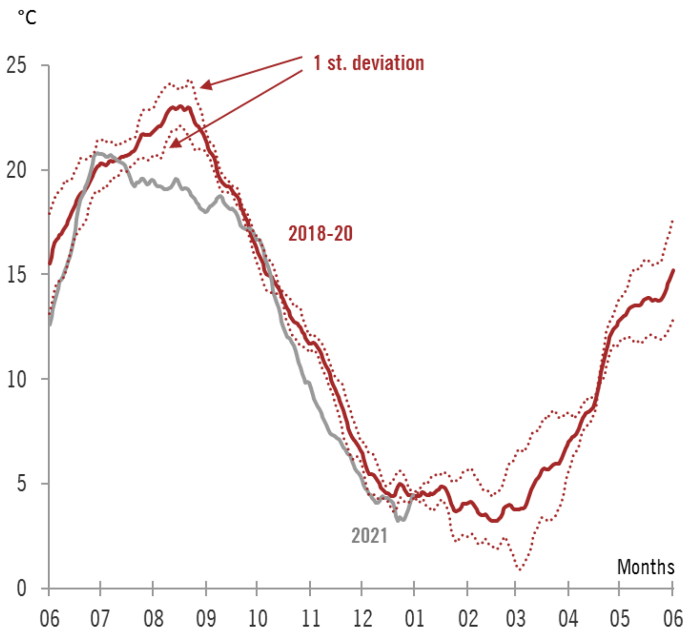
As a result, storage levels have plummeted to 29% of total capacity. The fall has slowed recently thanks to increased imports of liquefied natural gas (LNG) and relatively mild temperatures. However, there is a significant risk that European storage levels end the winter below 10% of capacity.

CHART 8: LNG IMPORTS FROM NORTHERN EUROPE



* Current level / 2017 - 2019 average Sources: Bloomberg Energy, PWM AA&MR

CHART 9: TEMPERATURES IN EUROPE (FRANKFURT AIRPORT)



Sources: MeteoStat, Frankfurt airport, PWM AA&MR

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A rapid substitute for Russian gas supplies is impossible

What are the alternatives to Russian gas? Of the 380bn cubic metres (bcm) of gas that the EU consumes in a year, around 40% (150bcm) comes from Russia. Increased imports of LNG could compensate in part: by the end of last year, imports to Europe from the Americas and Africa had increased significantly (by 4.8 and 1.3 times their 2017–19 averages respectively). On paper, there is room to increase imports further. According to a recent report by European think tank Bruegel, the EU only imported 75bcm of LNG in total, well below the 194bcm it has the capacity to handle. When it comes to pipelines, the EU had unused import capacity of 67bcm, notably 20bcm from Norway, 10bcm from

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North Africa and 5bcm from Azerbaijan. All in all, the extra 186bcm of gas that Europe could source exceeds the amount of gas that arrives from Russia.

All this sounds good in theory, but there could be considerable hurdles in practice. For a number of technical, legal and intra-EU reasons, a rapid shift from Russian gas towards liquefied natural gas imports appears unrealistic. It could be achieved, but it is likely to take several years.

TABLE 1: EU GAS NEEDS

	Current consumption	Unused capacities
	Bcm	Bcm
EU annual consumption	**380**	
Of which 40% from Russia	**150**	
LNG imports		119
Pipelines:		
- Norway		20
- North Africa		10
- Azerbaijan		5
- Other		32
Total		**186**

source: Williams, Sgaravatti, Tagliapietra, and Zachmann (2022) 'Can Europe survive painlessly without Russian gas?', Bruegel Blog, 27 January

What's more, it is not difficult to envisage a range of scenarios, including retaliation from Russia, that could reduce Europe's gas supply and, as a result, leave it exposed to power shortages. The consequences of this sort of scenario on economic activity would be severe. A recent ECB study[1] suggests that a 10% reduction in gas and electricity supply would result in a 70bps shock to real GDP.

Oil, metal and food prices could also flare up

Russia is also a big producer of metals such as palladium (it accounts for 38% of global total traded volume), nickel (13%), gold (10%), platinum (10%) and aluminium (9%). Russia and Ukraine are important producers of wheat (accounting for 14% and 10% of global wheat exports respectively). With reduced supply from these two countries, weather-related issues afflicting North American, European or Australian crops could see food prices rise further.

[1] ECB, Economic Bulletin, Issue 1/2022, pp. 46-51

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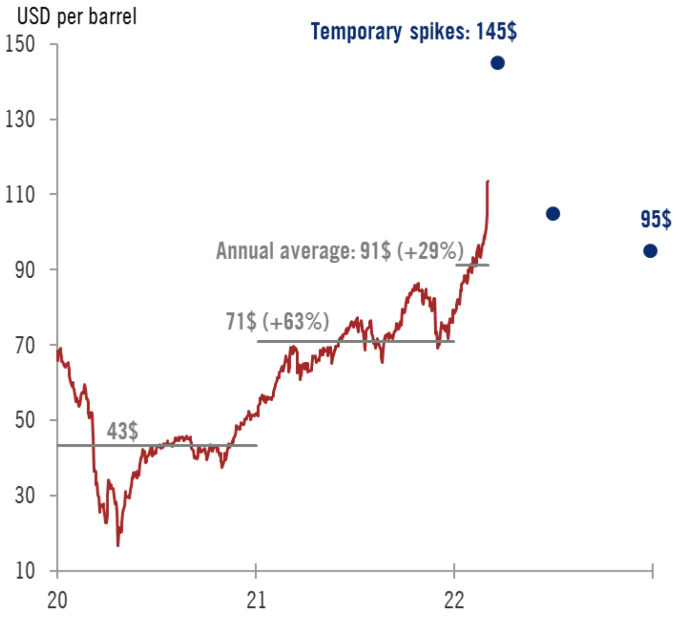
Potentially severe economic consequences

Meanwhile, gas supply difficulties and higher gas prices would boost demand for oil to produce electricity. Conditional to the developments on the ground in Ukraine, so there is a strong possibility that oil prices will continue to flare in the short term. We think that Brent could test its all-time of USD145 per barrel in the short term. But the ongoing energy crisis is likely to progressively impact economic activity, so oil demand should fall back. As a result, we expect the price of oil to fall towards a lower equilibrium. Our forecast remains unchanged that Brent will settle at USD95 / bbl by the end of the year.

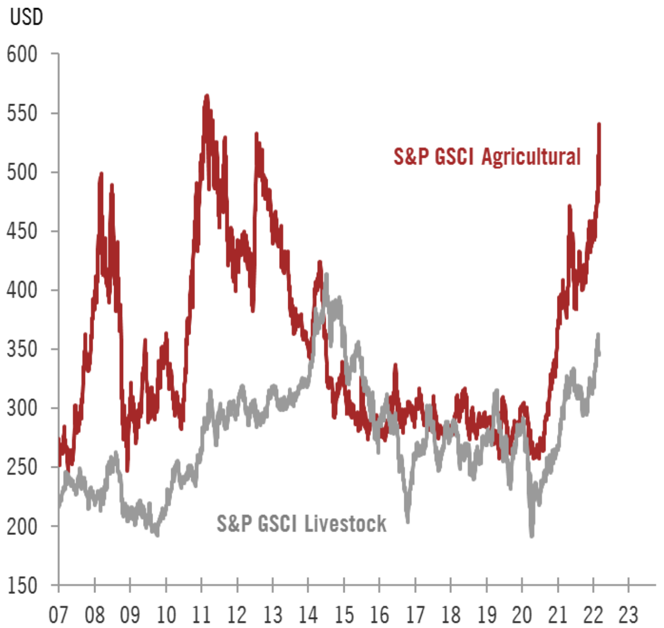
The impact of increased inflation brought on by the energy crisis risks being severe. Hopes that inflation would peak over the summer are having to be revised. The latest sharp rise in energy prices will further dent households' purchasing power and companies' margins, potentially triggering precautionary saving behaviour. The authorities could react by introducing additional supportive fiscal policies. Europe is clearly much more exposed to stagflation than the US due to its vicinity to Ukraine and its energy dependence on Russia.

CHART 10: BRENT PRICES FORECASTS



Sources: Pictet WM - AA&MR, Refinitiv

CHART 11: SOFT COMMODITY PRICES



Sources: S&P, Refinitiv, PWM AA&MR

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