What's Hot: Supply alleviation should cool the natural gas rally

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Natural gas prices have been on a tear in 2021. Natural gas has been heralded as a bridge fuel to a low carbon future. It is the cleanest burning fossil fuel that emits nearly 50% less CO2 compared to coal. Emerging from the depths of the COVID pandemic, a broad global demand recovery in sync with the energy transition has led to the recent surge in natural gas prices. At the same global supply outages have lent a further tailwind to the price recovery. However, as governments have not yet committed clearly enough to a low-carbon future, we expect the switch back from gas to coal for power generation to alleviate the tightness in the natural gas market and cap further upside.

Figure 1: Natural gas prices soar in 2021

Source: Bloomberg, WisdomTree as of 17 September 2021. Please Note: Henry Hub is the key benchmark for US natural gas; Netherland's Title Transfer Facility (TTF) is the key benchmark for European natural gas and Asia Japan/Korea Marker JKM Swap Futures is the key benchmark for Asian natural gas. MMBtU is Metric Million British Thermal Unit. MWh is Megawatt-hour.

Historical performance is not an indication of future performance and any investments may go down in value.

Rising demand amidst tight supply

The narrative behind higher natural gas prices in Europe began before the summer owing to a much colder winter over April and May, which caused a delay in the injection season (end March/early April). Liquified Natural Gas (LNG) exports have fast become a major influence on the US natural gas market dynamics, and consequently, the global market is increasingly impacted by LNG exported from the US. The US is shipping increasing volumes of shale gas, making it one of the world's biggest players in the LNG market. On its own, US natural gas accounted for a trade surplus of $26 billion last year1. The two main destinations for US LNG exports are Asia and Europe. Asian LNG demand accounts for 70% of the global LNG market2. For a large part of this year, LNG cargoes were being directed to Asia due to its higher price advantage over Europe, leading to lower volumes arriving in Europe. Asian demand led by China has also been a major driver of growth in LNG demand as China seeks to reduce its dependency on coal. Chinese LNG imports grew by 26% from the previous year.

While China generates a fifth of its electricity from hydropower, a drought this year led to lower hydropower generation. A similar trend was witnessed in Latin America, which derives half its power from hydro, doubled its demand for gas over the past year, owing to the drought. The US also faced the hottest

June on record resulting in higher demand for natural gas in the electric power sector. Unplanned supply disruption caused by Hurricane Ida resulted in more than 90% of natural gas production in the Gulf of Mexico remaining offline. There have also been outages over the summer in Europe owing to planned maintenance on the Yamal-Europe and Nord Stream pipeline. Norway's output has also been in its fourth year of decline, with heavy maintenance affecting flows this summer.

Supply situation expected to alleviate

European gas inventories are only 71% full compared to the 5-year average of more than 86% as we approach the heating season. A cold winter could leave the continent short of sufficient natural gas supply. With the probability of a La Niña weather pattern rising, this is a non-negligible risk3. However, there appears to be some respite as Norway (Europe's second-largest gas supplier) is expected to allow state-controlled Equinor and its partners to increase gas exports from two offshore fields over the next 12 months (according to government reports. The highly anticipated Nord Steam 2 pipeline has now been completed, and Gazprom is hoping for flows to start before the end of this year. The International Energy Agency (IEA) has also called on Russia (accounts for 40% of EU gas imports) to supply more natural gas to Europe to help alleviate soaring energy prices. The high price environment also opens the door to potential demand destruction in the form of gas to coal switching. Europe is burning more coal than this time last year, evident from the rising EU carbon prices. The US Department of Energy expects a 21% rise in coal generation for 2021. When natural gas prices are high, generators typically switch from natural gas to coal, which is a lower cost source for power generation. Illustrated in the chart below, gas inventories in the US are sharply lower than a year ago and at the lower end of the 5-year average. While the US gas market is trending tighter on a seasonally adjusted basis, it is not yet as tight as prices were this high. The current US natural gas price is trading at US$5.07 per MMBtU (Metric Million British Thermal Unit) as as high as the level seen in February 2014, but storage is only the tightest for this time of year since 2018. The market is not tight enough to support prices at the current level. The downside risk appears higher at this point, while there could be room for further upside contingent on a colder winter, the ongoing price surge looks unsustainable.

Figure 2: US Natural Gas Inventory (Weekly data in billion cubic feet)

Source: Bloomberg, Department of Energy (DOE), WisdomTree from 22 September 2016 to 22 September 2021.

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1 Bloomberg

2 Wood Mackenzie

3 https://www.severe-weather.eu/global-weather/enso-la-nina-watch-autumn-winter-2021-2022-usa-europe-fa/

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