

What's Hot: Feeling the Heat

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While oil may be grabbing all the headlines today, Henry Hub natural gas prices are trading at a six-year (seasonal) high. The price of the energy source is up more than 25% over the year and 21% over the month¹, outpacing the moves in oil markets, and we could see more increases to come. There are two main drivers (1) a heatwave in the US has driven up the demand for air-conditioning and hence the natural gas for power generation; (2) demand for US natural gas exports has increased.

Heatwave Summer 2021 breaking all known records

A record-breaking heatwave has inflicted western Canada and the US Northwest². That comes a week after a heatwave broke records across the Southwest and northern Mountain West. Needless to say, demand for air-conditioning is rocketing and thus the electricity to power these cooling devices. 40% of electricity in the US is made using natural gas (US Energy Information Administration estimate, February 2021). More than 35% of natural gas consumed in the US goes into electric power, which is the largest source of natural gas demand by sector (US Energy Information Administration). In 2020 electricity was the only sector to have increased its demand for natural gas.

Severe drought conditions in the West have also reduced the ability to generate electricity through hydropower, thus increasing reliance on natural gas.

Above-average temperatures are predicted for the coming week and the whole month of July across the Pacific West and Eastern seaboard by the National Oceanic and Atmospheric Administration (NOAA)³. That is likely to keep demand for natural gas elevated.

Exports booming

US natural gas exports are also at an all-time high (Figure 1). There is strong demand for this 'transition fuel' from countries with an energy deficit. We often think of natural gas as a transition fuel as it is a hydrocarbon and thus combusting it contributes to the carbon emissions, but it has lower emissions than coal or oil. Therefore, it is useful in the path to lower emissions. As more countries sharpen their focus on meeting their obligations under the Paris Agreement to limit global temperature increases to just 2° above pre-industrialised levels, we believe the demand for US natural gas exports will rise.

Figure 1: US Natural Gas Exports

Source: US Department of Energy, Release date: 30th June 2021, Jan 2000 to April 2021 Historical performance is not an indication of future performance and any investments may go down in value.

Droughts aren't unique to the US. Brazil is experiencing its worst drought in almost a century⁴. The Energy Minister has called for reduced use of electricity as hydroelectric dams struggle. The President has signed a temporary executive order to create a 'Chamber of Exceptional Rules for Hydro-energy Management' that could limit power use. As a result of this struggle, Brazil's imports of Liquefied Natural Gas ("LNG") have risen to an all-time high in June 2021, according to data and analytics firm Kpler. We believe Brazilian demand for US LNG could remain elevated as the drought persists.

Curve backwardation

The natural gas futures curve is very seasonal – flipping from contango to backwardation by season⁵. The front end of the natural gas futures curve is currently in backwardation, providing an investor with a positive roll return.

Working natural gas in storage stood at 2,558 billion cubic feet (Bcf) on June 25th 2021⁶, which is 5.3% below the 5-year average of 2,701 for this time of year. This reduction in stocks could help keep the seasonal backwardation more pronounced than in past years.

Conclusions

Natural gas prices have been boosted by a heatwave in the US. Although strong gains have already been had, and a heatwave may pass, demand for exports are likely to maintain a tailwind for the energy commodity.

1 Source: Bloomberg, WisdomTree. As of 30th June. Using the Bloomberg Commodity Natural Gas Total Return Subindex in USD

2 <https://climate.gov/news-features/event-tracker/astounding-heat-obliterates-all-time-records-across-pacific-northwest>

3 <https://www.cpc.ncep.noaa.gov/>

4 <https://earthobservatory.nasa.gov/images/148468/brazil-battered-by-drought>

5 See Commodity ETPs Are Exposed To Futures Contracts Not The Physical Spot. Why Does It Matter?, May 2020 for more on contango, backwardation and roll yields

6 <https://ir.eia.gov/ngs/ngs.html>, released on July 1st 2021

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