WHAT'S HOT – GEOPOLITICAL TENSIONS LEND A TAILWIND TO NATURAL GAS PRICES

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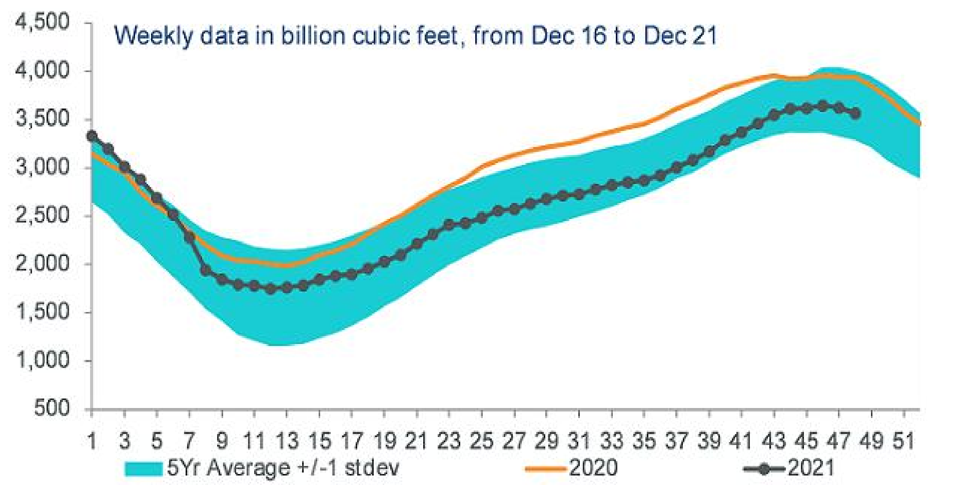
Natural gas prices have declined sharply by 32.8%[1] over the prior month. As we discussed here, market price action had run ahead of its underlying fundamentals. A combination of expectations of a warmer than usual winter period in North America[2] coupled with the implied reduction in natural gas demand resulted in the recent sell-off in US natural gas prices. There has been little evidence of net physical tightening as storage levels have risen seasonally in a normal fashion, as illustrated below. Net speculative positioning in natural gas futures is below the 5-year average and approaching the 1-standard deviation mark underscoring weak sentiment.

Figure 1 – US Henry Hub Natural gas inventory



Source: Department of Energy, WisdomTree as of 3 December 2021

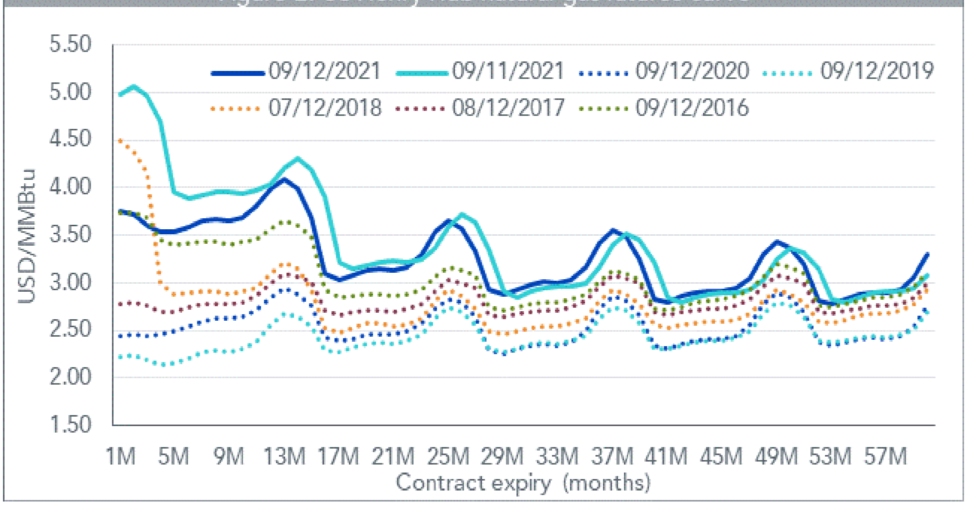
Geopolitical tensions escalate over the Russia/Ukraine border

Another angle on the natural gas market is the rise of geopolitical tensions, which could tell a more compelling story. Storage levels in the European gas markets are below the seasonal trend at a time when tensions are rising over the build-up of Russian military on the Russian/Ukrainian border. The US is expected to urge Germany to agree to stop the contested Nord Stream 2 gas pipeline if Russian President Vladimir Putin invades Ukraine. President Biden’s intentions were made clear at an important video call between the US and Russia on 7 December 2021. Nord Stream 2 is important both for President Putin, as a route to sell more gas into Europe, and for Germany, which relies on supplies from Russia. This has led to further uncertainty on Russian pipeline supply pertaining to the approval process for the Nord Stream 2 pipeline. At the start of December, European gas in storage was at 67.5% of capacity, compared with a 5-year average of 84% for this time of year, according to Oxford Economics. Additional Russian natural gas supply via the Nord Stream 2 pipeline was expected to gain approval by early January, but the German regulator BNetzA suspended the certification procedure in mid-November. The intentions on the Russian side also remain unclear. The latest Gazprom supply auction suggests that the October and November flows are likely to be mirrored in the December flows, which will do little to counteract the extremely low inventory levels. Added to that, natural gas shipments from Norway are expected to slump by nearly 13% after the Troll field suffered an unplanned outage, according to the Network operator Gassco AS. There are further signs that other sources of sustainable energy from nuclear power are unlikely to be made available in the coming months due to maintenance work being carried out in France’s nuclear power stations.

Natural gas futures curve heads back to seasonal norms

In November 2021, the front end of the futures curve was very elevated (see 09/11/2021 line in Figure 2). Excluding the very front-month seasonal contango[3], the curve was extremely negatively sloped for the following 4 months (backwardation), indicating market tightness at the time. Today (see 09/12/2021 line in Figure 2), the front end of the curve has dropped and is more in line with what is seasonally normal (see previous year curves around this time of year). This indicates abnormal tightness has largely dissipated for the US.

Figure 2: US Henry Hub natural gas futures curve



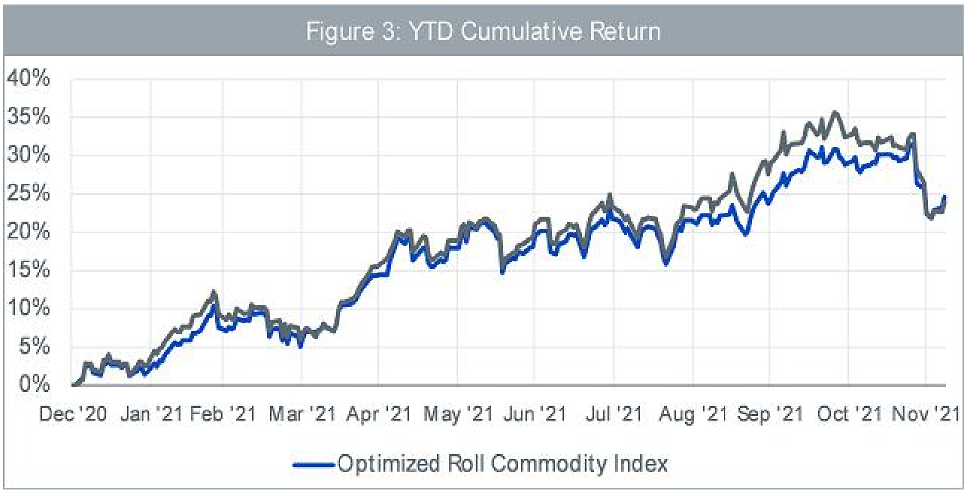
Source: Bloomberg, WisdomTree. Data from 09/12/2016 to 09/12/2021

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

The outperformance of front-month tracking broad commodity strategies relative to optimised strategies (that tend to invest further out on the curve observed last month has now largely evaporated with the drop in the front end of the natural gas futures.

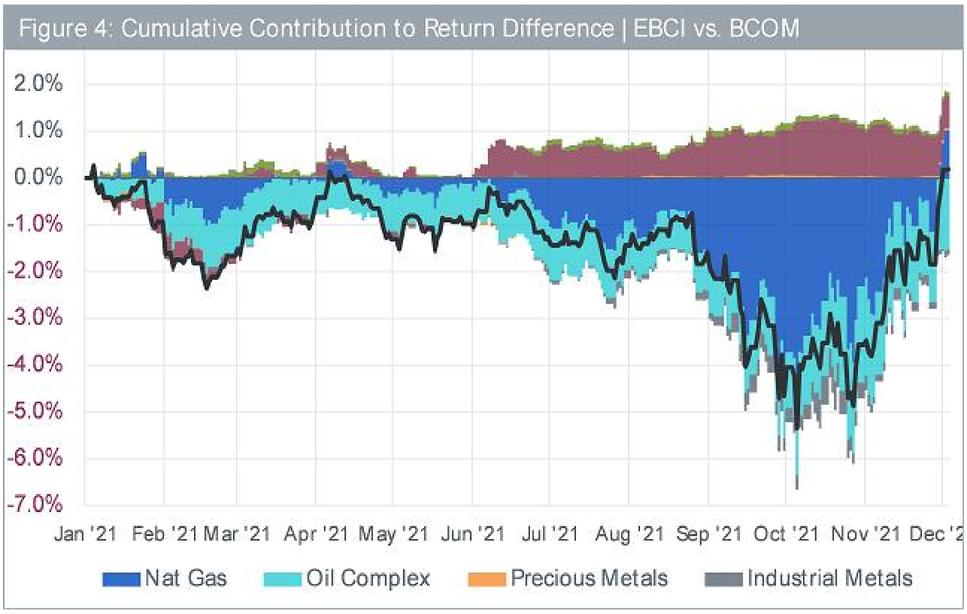
As an example, let’s look at the Optimised Roll Commodity Index (EBCIWTT), which invests using the same weights as the Bloomberg Commodity Index (BCOMTR) at yearly rebalance in January but, typically, invests further on the curve on contangoed commodities. Over virtually the whole year, it was invested in the April 2022 contract, which led it to underperform as the front end of the curve rose by a much larger extent.

This quickly reverted when the gap between the front contracts and the April 2022 contract started to close (see Figure 2), helping the optimised index catch up with BCOM performance and eventually start outperforming from the beginning of December 2021.



Source: Bloomberg, WisdomTree. From 31 December 2020 to 07 December 2021.
EBCI: Optimized Roll Commodity Index. BCOM: Bloomberg Commodity Index. **Historical performance is not an indication of future performance and any investments may go down in value.**

This is particularly striking when decomposing the return difference between these two indices. In Figure 4, we decompose it by sector, splitting Energy between Natural Gas and the Oil Complex. See how Natural Gas represented much of the underperformance when the front end of the curve was extremely steep. That negative contribution quickly shrank from November this year, eventually turning positive in December.



Source: Bloomberg, BNP, WisdomTree. From 31 December 2020 to 07 December 2021.

EBCI: Optimized Roll Commodity Index. BCOM: Bloomberg Commodity Index. Historical performance is not an indication of future performance and any investments may go down in value.

Conclusion

US natural gas prices have fallen with supply and inventory conditions returning to normal in the country. However, tightness in Europe could once again translate to higher demand for US exports. Amidst the depth of the European winter, as heating demand grows, low stockpiles in Europe would mean elevated demand to replenish them when the summer season arrives. This is likely to translate into higher demand for US natural gas at a time of higher uncertainty of supply from neighbouring countries such as Russia and Norway. However, in the absence of renewed tightness in US natural gas stemming from the higher European demand, US natural gas futures curves could maintain their current structure. That could leave prime conditions for optimised commodity strategies to outperform front-month tracking strategies.

Sources

[1] Bloomberg – Henry Hub US Natural gas prices as of 7 December 2021

[2] NOAA – National Oceanic and Atmospheric Administration

[3] See "Commodity ETPs are exposed to futures contracts not the physical spot. Why does it matter?" for a description of contango, backwardation and why these are important concepts in commodity market futures investing.

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