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Energy Crisis or Energy Tightness? An Opportunity Either Way

A culmination of energy issues has emerged since the start of the pandemic, which has been exacerbated by a lack of investment/reinvestment in traditional major energy sources. The big question today is, "are we in an energy crisis"? Environmental, Social and Governance (ESG) proposals took center stage over the past year. One cannot underestimate the impact this has had on individual nations' energy policies. We can all agree, environmental matters and climate change are serious imminent issues that need to be dealt with. Where there seems to be differences of opinion, is with regards to the pace at which global leaders address these issues. Are we looking before we leap? Is there a plan on how to achieve our environmental goals without disrupting everyday life or escalating energy costs?

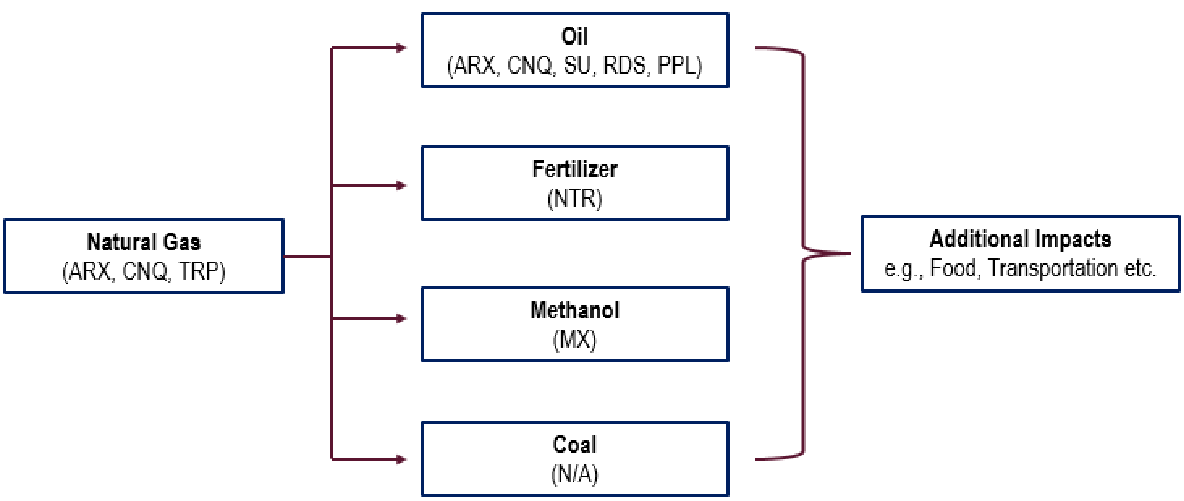
Since the beginning of 2021, we have witnessed numerous events causing tightened energy supplies: a freeze-off in Texas led to a spike in natural gas prices; California's drought drew down hydro electrical reserves; and Hurricane Ida forced the shutdown of various oil and gas fields. These events are not isolated to North America: we are seeing hydro shortages in South America; a shortfall in replenishing natural gas inventories across Asia; Europe and the UK spiking prices to over $30 mmcfe (equivalent of ~$180 oil); and escalating global oil prices to ~$80/bbl – all leading to a tightening of traditional energy supplies.

The pace of global energy transition and lack of reinvestment in traditional energy sources fuels a knock-on effect beyond the energy sector – impacting industries in ways not anticipated by political leaders. Lower emission energy sources, such as wind and solar, are funded and preferred these days but their intermittent nature requires natural gas to fill in energy supply gaps – leading to an increase in demand for natural gas. Meanwhile, higher emission sources such as oil and gas, are starved of capital reinvestment and diminished supply. As Asia/Europe/UK become short of natural gas this year, the substitutes available become coal and oil, forcing prices higher across these commodities. Natural gas has many uses: heating homes, an input into fertilizer production and methanol and other various by-products used in numerous industrial processes. As natural gas prices spiked, it became uneconomic to produce nitrogen/urea (essential nutrients for crop growth) across parts of Europe with ~40% of production being shut in. This lack of production prompted a warning of an industrial CO2 shortage in the UK (essential for meat processing and food security), until the government stepped in with subsidies/incentives. China followed with an export ban on phosphate, another essential food crop nutrient, until June 2022. China and India face shortages of coal, which dominate the base loads of their electrical grids, so have been enduring brown/blackouts to conserve inventories going into the winter season. Global methanol prices rose since the main feedstocks include natural gas and coal. There are other numerous examples, but the point is clear – the knock-on impacts were unanticipated by global leaders and led to higher prices.

As illustrated on the following page, North American natural gas prices have not increased as dramatically as their Asian or European counterparts; however, the knock-on impact is clear as reflected in the pricing of coal to fertilizer inputs.

Source: Bloomberg. Scotiabank.

Moving over to our portfolios here at Sionna and how it impacts your bottom-line. The diagram below identifies some of our investments in a variety of our strategies that have benefited from rising energy prices. As you can see, these investments are inter-related, but at the same time different.



Many of our investments into these names were made well before last-year's events began to unfold – some were certainly contrarian and neglected by investors because of perception issues. Our bottom-up investment focus at Sionna is key to understanding how these quality businesses may benefit from these types of events and helps us identify when stocks are 'on sale' in the market. But. Patience is required.

So then, are we in an energy crisis? To us, it feels more like a tightening of supply rather than a crisis. That said, environmental issues will continue to be important over the decades to come. Analyzing ESG issues has long been part of Sionna's investment process, so this focus on environmental impacts is not new to us. It is imperative that global leaders get this energy transition right, but it must be done with the help of the industry – there is no better place to start than in Canada. Many Canadian companies have led in the environmental space but have done so quietly. We hope their voices become louder in the near future, so we all benefit from this transition globally. A watchful eye is required and must be focused upon the pace of energy transition. We are likely at the beginning of a 30-40+ year journey, and nobody wants a preventable energy crisis to emerge.

Aleksy Wojcik, CFA
Portfolio Manager
Sionna Investment Managers