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COMMODITIES, FOOD & AGRI ENERGY

Little stopping the natural gas rally

Global natural gas prices have seen a remarkable rally so far this year. Prices in Europe have hit record levels, while US and Asian gas prices have also strengthened. Europe is set to enter winter with inventories well below the 5-year average, suggesting that prices will remain at elevated levels through the winter



Gas storage tank

European tightness to persist through the winter

The record low natural gas prices seen in Europe last year seem like a distant memory. Prices have hit new records on almost a daily basis recently. TTF has recently broken above EUR70/MWh, which is up around 245% since the start of the year and up from the lows of a little over EUR3.5/MWh in May last year.

There are several factors which have contributed to this significant rally in prices. Firstly, the foundation for this strong move higher started before the summer. Colder than usual weather over April and May in Europe led to a late start of the injection season. Usually gas injection starts at the end of March/early April; however, this year we did not see meaningful injections until almost mid-May.

Secondly, for much of the year there has been little incentive to send spot LNG cargoes into Europe, instead these have made their way to Asia where prices have been more attractive.

The spot Asian LNG premium over TTF has averaged a little over US\$1.50/MMBtu since the start of the year through until the end of August. Although with the more recent rally in European prices, TTF is now trading at a premium to spot Asian LNG. So, we would expect to see LNG inflows into Europe start to pick up.

Thirdly, there has been several outages over the summer. Some of these were planned maintenance, while there have also been some unplanned outages. Russian gas flows fell in July due to maintenance on both the Yamal-Europe and Nord Stream pipeline. While in August flows were disrupted after a fire at one of Gazprom's condensate treatment plants in Western Siberia. Average Russian flows via the Mallnow entry into Germany were down 40% MoM in August. Although these flows have recovered more recently. Norway has also seen a fair number of outages this summer, including at the Troll field.

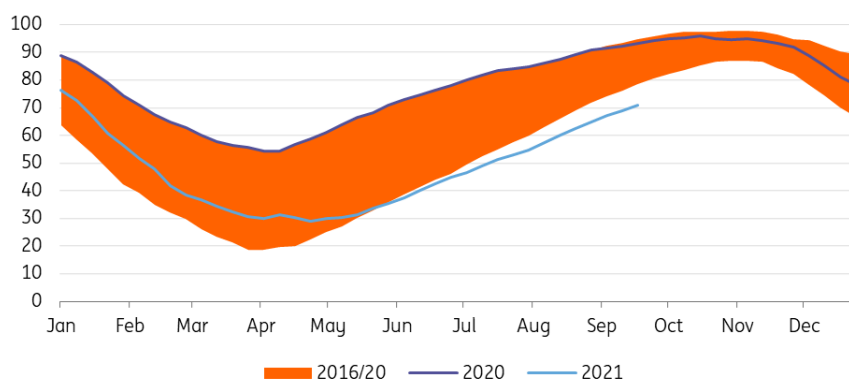
Higher EU carbon prices have also played a factor. Record carbon prices have ensured coal to gas switching. EU carbon allowances have rallied as much as 93% this year. Although, the more recent strength in gas prices has reversed this advantage. Dark spreads are more attractive than spark spreads over 4Q21. And in fact, we have seen some coal plants in the UK reopening.

A combination of a broader demand recovery, lower inflows and falling indigenous production means that European gas inventories are well below average. The official start of heating season is quickly approaching, but storage is only 71% full, compared to the 5-year average of more than 86%. Storage is at its lowest levels in at least a decade going into winter.

Therefore, we believe European prices are likely to remain at elevated levels through the winter. However, given the extreme levels the market is trading at, we would expect increased volatility.

It is also important to note that with the forward curve in Europe basically flat through until February, there is little incentive to store gas. To see that, the forward curve would need to shift to contango, a scenario which is unlikely given the current tightness.

Europe gas storage % full



Source: GIE

What could cool down the rally in European prices?

While the fundamentals for the European market are constructive, there are several catalysts which could prove to be a bit of dampener to the rally.

- There is plenty of attention on how soon the 55bcm Nord Stream 2 pipeline starts up. The sooner it does, the more it can help to alleviate tightness in Europe. The pipeline was recently completed; however, there are reports that Gazprom is hoping for flows to start on the 1 October 2021. There will be plenty of regulatory hoops to jump through before gas can start flowing. Gazprom had also previously suggested that it would send 5.6bcm through the pipeline this year. The ramp up will likely occur over 2022, so unlikely to provide a meaningful relief to the market this winter. But if we are to see a quicker than expected ramp up this could put some pressure on the market
- While spot Asian LNG prices have been trading at a premium to Europe for much of the year. This has changed given the recent rally. TTF is now trading at a premium to JKM, which suggests that we should start to see an increase in spot LNG flows to Europe. However, much will depend on Asia's appetite, particularly from the likes of China as we edge into winter.
- We will also need to keep an eye on any potential demand destruction because of the high price environment. This could be in the form of gas to coal switching and even gas to oil switching. We are already seeing the latter occur in parts of Asia.
- Finally, but very important will be the weather outlook. Much of the rally is related to the fear of tightness over the winter. However, if it turns out to be a mild winter, it will certainly help to take some of the pressure off the market.

Robust LNG demand growth from China

Asian LNG demand this year has also been strong, which has been key to the lower volumes

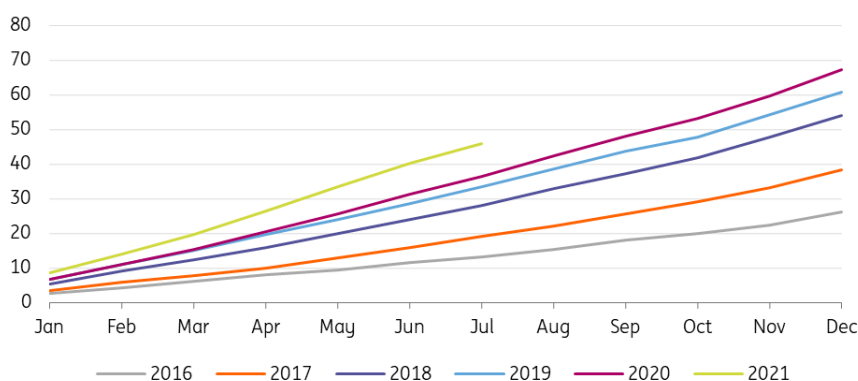
arriving in Europe. This growth has predominantly been driven by China. Chinese power generation over the summer hit record levels, which has been supportive for both coal and gas demand. LNG imports over the first seven months of the year totaled 45.8mt, up 26% YoY. While if we compare to the same period over 2019, imports are up 37%.

China has made a real push to tackle emissions this year, which has been supportive for LNG. In addition, domestic coal prices in China have rallied significantly this year due to a combination of import restrictions and the temporary closure of some coal mines earlier in the year.

It is difficult to see a slowdown in China's appetite, as the government will want to ensure adequate supply particularly over the winter months.

Although given the strength in both the gas and coal market, there is the potential to see an increase in fuel oil used for power generation in other parts of Asia. There have already been reports of Pakistan and Bangladesh switching to fuel oil, given the high LNG price environment.

China cumulative LNG imports (m tonnes)



Source: China Customs

High global prices a boon for US LNG exporters

Strong prices in Europe and Asia would be welcome news to US LNG exporters, particularly after the weakness seen last year, which led to a significant amount of cargo cancellations. However, this year there has been little risk of that with the spot Asian LNG premium over Henry Hub averaging almost US\$8/MMBtu so far this year. While the spread is currently closer to US\$14/MMBtu.

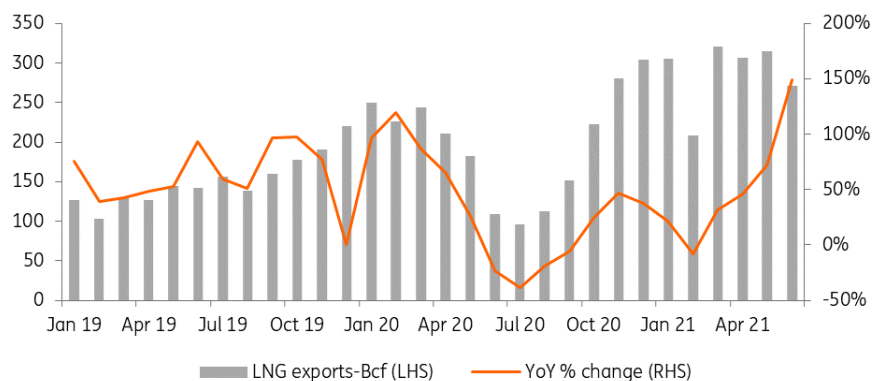
As a result of this, US LNG exports have hit record levels this year. US LNG exports over the first six months of the year are up 41% YoY, while exports in March hit a monthly record high of 321Bcf. At current netbacks, strong flows are likely to continue, assuming no disruptions to LNG export facilities. In addition to stronger LNG exports, pipeline exports have also hit record

levels with increased flows to Mexico.

Domestic demand in the US has also been robust. The latest available EIA data shows that demand from power generators in June increased by 3.5% YoY, and almost 9% higher than the same month in 2019.

Stronger export volumes and robust domestic demand has meant that US inventory injections this year have been slower than usual. Total US natural gas inventories are 2.9Tcf compared to the 5-year average of closer to 3.2Tcf. To reach the 5-year average by November, we would need to see injections of more than 800Bcf between now and November. While the average build between now and November is in the region of 550Bcf. The tighter environment going into winter suggests that Henry Hub will likely remain well supported over the coming months.

Monthly US LNG exports



Source: EIA

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