Key Private Bank

Key Questions February 22, 2021

What Does the Crisis in Texas say About Energy Markets?

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Prices are likely to be headed higher still.

In our November 30, 2020 edition of Key Questions titled "What Surprises Might 2021 Have for Us?", we said the following:

"Crude oil exits 2021 above $60 per barrel, and Energy is the best performing sector in the S&P 500 Index. With the global economy set to rebound sharply once vaccines become available, it becomes apparent to market participants just how much damage was done to US upstream production capabilities. Demand increases significantly, and the slow reaction function of producers causes prices to rise more than the consensus expects. Equity investors who have shunned the Energy sector are forced to chase performance, further driving rotation into Cyclicals."

Now, nearly two months into 2021, this "surprise" is looking directionally correct at the very least, with crude oil trading up from $45.34 per barrel at the end of November to nearly $60 per barrel. Energy stocks have lagged the move in the commodity's price, potentially creating an opportunity for investors, and structural issues appear poised to continue to support outperformance.

Unprecedented cold weather in the central United States has frozen wells and pipelines, closed refineries and factories, and left millions without power due to outages impacting both conventional and renewable energy sources. While the focus of market participants has been on the bullish implication of lost oil production for the energy supply, the hit to oil demand is likely to be large as well.

This leaves only a small and transitory impact on the overall global oil supply-demand balance. Clearly, while the polar vortex will result in tighter product relative to crude balances, this is a near-term issue that will fade quickly.

We believe this situation is directly comparable to what we usually see during a typical Gulf Coast (USGC) hurricane, as the recovery of refinery runs tends to be slower than that of well production. Currently, we believe that a recovery profile like that following hurricanes should occur; however, it is also clear that refineries on the USGC are less prepared for uniquely cold weather than for seasonal storms, just like the power generation infrastructure. On a very short-term basis, this could skew risk to the downside for the commodity, and we would not be surprised to see crude oil prices pull back.

Asking our crystal ball to look a little further into the future than the next two weeks, we continue to see an environment that is very favorable for both energy commodities and energy stocks. The situation in Texas that developed into a humanitarian crisis highlights several different things. First, conventional sources of energy such as natural gas are likely to be around for a lot longer than some policy makers may like. While the transition to renewables has been favored by regulators, the mix between intermittent sources of energy and more reliable providers of baseload capacity needs to be reexamined. We believe that one of the clearest messages coming out of Texas will be that so-called dirty energy is not going away, providing yet another structural tailwind behind energy commodity prices over the intermediate and long terms. There is more upside to come, in our view.

Second, while it is true that wind turbines and solar panels have had issues with the polar vortex, so did conventional energy generation facilities such as natural gas and coal-fired power plants. It is not as simple as the windmills froze and solar panels had icicles hanging on them. Most conventional generation plants in Texas, which has its own power grid, were not winterized in a fashion that would allow them to continue to function in the harsh and frozen winter conditions we are used to in the northern tier of the country. This was an infrastructure failure of massive proportions.

One could make the case that companies were responding to poor regulatory incentives by failing to prepare for a worst-case scenario, but this lets corporate executives off the hook for their part in the process. A clear takeaway from this is that large-scale investments will be needed in power generation and transmission infrastructure. Whether this merely takes the form of winterization and more wind turbines or expands into things such as lengthening the licensing period for existing nuclear generation facilities is yet to be determined. However, the landscape has changed due to the frozen fish tanks we have all witnessed. It seems that nothing is off the table now. And with politicians in a mood to dole out large sums of money to help the post-COVID recovery, we can think of worse things to spend money on than an all-of-the above approach to improving our antiquated power grid and generation infrastructure.

Many are asking why this could occur, and both the red team and the blue team are throwing bricks at each other and trying to assign blame. It is what they do. In our view, there is plenty of blame to go around on both sides of the political spectrum as well as in the industry itself. Game of Thrones fans will be familiar with our view of these machinations, “Shame! Shame! Shame!”

We prefer to focus on the potential response to the situation and what it means for investors. Conventional energy sources will continue to play a major role in meeting our energy needs, which will provide a tailwind for energy commodity-levered companies. Large-scale infrastructure spending will create opportunities for companies that make the products and the engineering and construction firms that implement them. Finally, energy sources like nuclear that were written off are likely to get another look, bringing a completely different supply chain into investor consciousness. Needless to say, in somewhat counterintuitive fashion, we believe that all of this is bullish for energy and energy-levered stocks.

For more information, please contact your Key Private Bank Advisor.

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