Oil & Gas Crisis of 2022
Credit Risk Impact is High

The Latest, Catalysts

G7 ministers Friday agreed on a price cap for Russian oil and oil products. Under this plan, countries that have not imposed outright import bans on Russian oil can continue to import the barrels if it is priced at or below a predetermined price. The cap is expected to be enforced via limits on European freight insurance and U.S. finance for Russian oil cargoes.

The G7 is expected to want a cap of around $60 p/b, a $20 discount to the current Ural grade. This price cap kicks in on **December 5th, the same day as the EU is scheduled to fully embargo Russian oil and oil products.** This plan does not replace that embargo.

This idea from the G7 came in reaction to the almost full recovery of Russian export volumes, despite a near ban -on paper- on Russian oil and products by the E.U. and the U.S. As a result, Russia has enjoyed a juicy surging trade surplus and the G7 now wants to minimize the oil revenues Russia receives without disrupting the flow of oil. While oil continues to flow under the price-cap, any country not part of the price cap scheme would incur much higher costs for importing Russian oil.

The plan is very likely to backfire, making oil more expensive while Russia's trade surplus might even increase. In this note, we will discuss how this is likely to play out.

German inventories were 85% full at the start of September, a month ahead of target. The goal is to achieve 95% by early November - the heating demand surge zone. Street reports say this will probably be achieved through alternative imports, especially from Norway, and by accessing liquefied natural gas (LNG) cargoes imported into Belgium and the Netherlands.

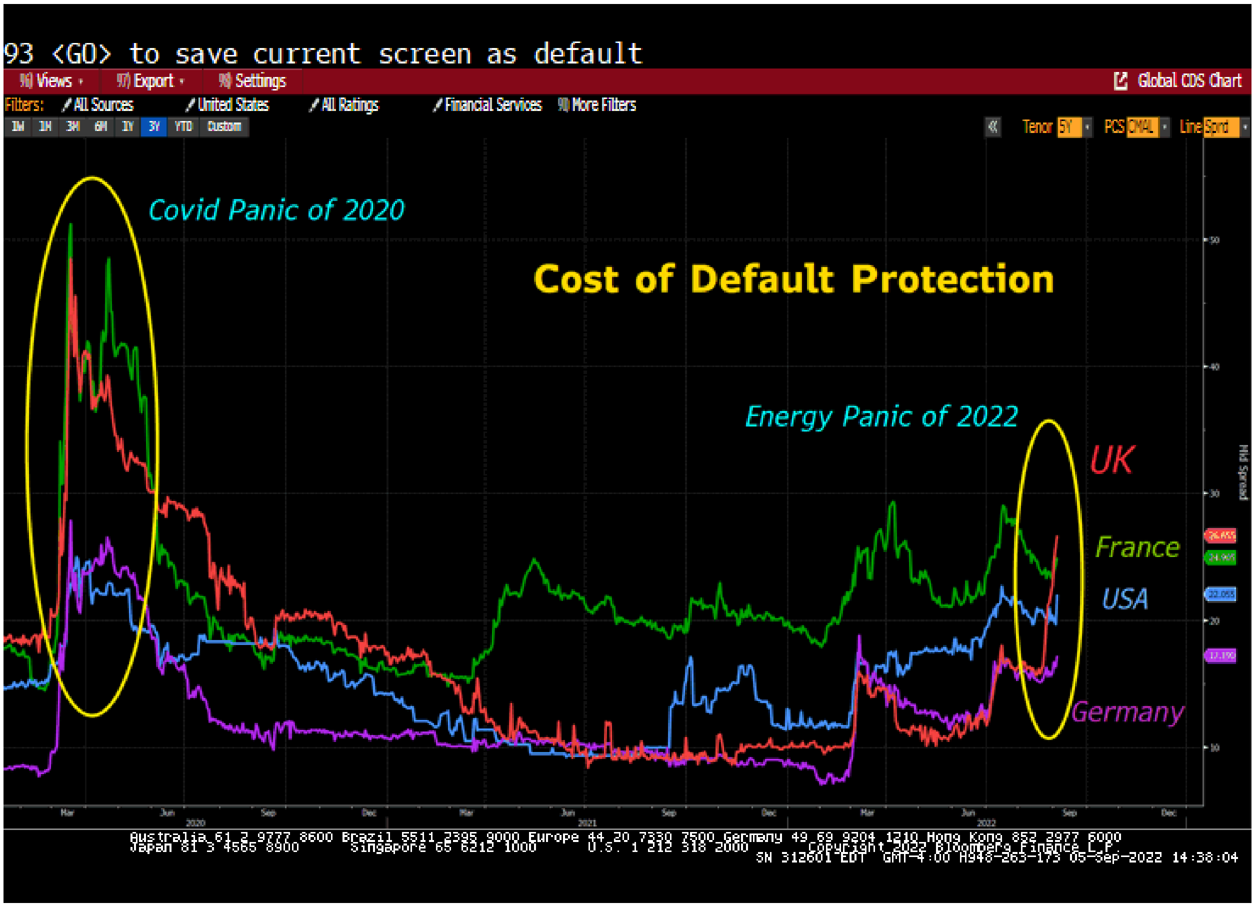
Looking Forward

September 8: ECB rate decision
September 9: EU emergency energy meeting
September 13: US CPI
September 15: BoE
September 16: UMich prelim
September 21: FOMC
September 24: Italian Elections
October 2: Brazil Elections

On September 9th (Friday), the EU nations will hold an emergency energy meeting which has the potential to ease some concerns by addressing the pricing mechanism for electricity in the EU among possible tools. ***Then Putin responds to that move, much fun.***

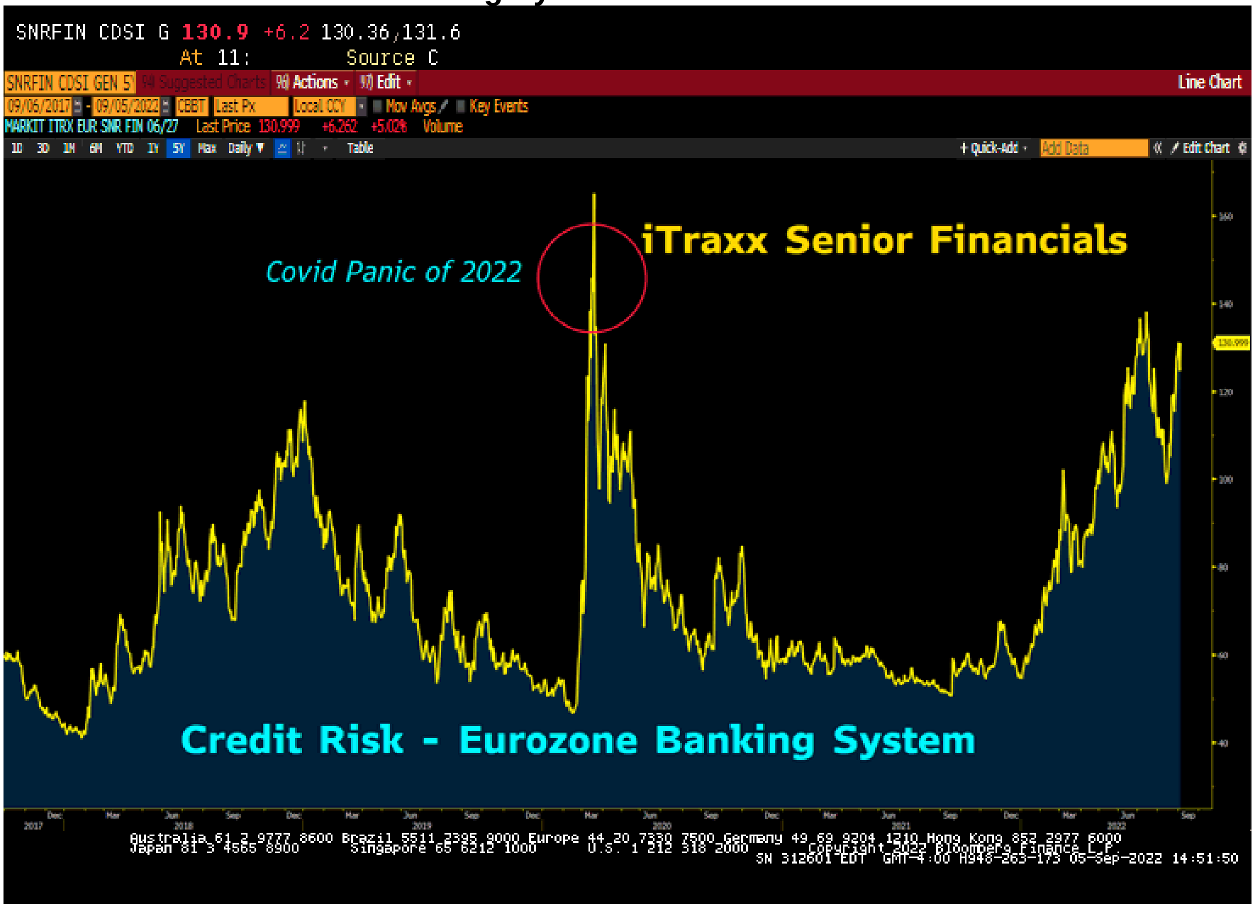
KREMLIN ON NORD STREAM SHUTDOWN: "GAS TRANSPORTATION PROBLEMS AROSE BECAUSE OF SANCTIONS INTRODUCED BY WESTERN COUNTRIES" - ON OIL PRICE CAP: THERE CAN ONLY BE RETALIATORY MEASURES" - AP

Credit Risk on the Rise



With the cost of credit default protection on the rise in the UK and Europe. The IMF urged the EU to revamp its fiscal framework amid high debt and rising interest rates, saying the reforms are ***critical to avoid debt crises that "could put the EU itself at risk.*** *October wholesale gas prices at the European trading hub in the Netherlands jumped nearly 35% on Monday, to around EUR 275 ($273) per megawatt-hour (MWh), though that was still below the record of almost EUR 350 per MWh seen in August.* ***This risk is passed from consumers to businesses and utilities - all the way up to the sovereign (government) credit risk.***

Putin´s Threat to the EU Banking System is Real



The last time credit risk looking over the EU banking system was this high - ***the Federal Reserve was CUTTING rates****, NOT kicking off a $1T, twelve-month balance sheet reduction plan. Clearly, the Russian announcement of a reduction in Nord Stream One flows is a meaningful escalation - the reduction in flows itself is not all that large, but it´s a direct retaliation for the G7 agreement for a price cap on Russian oil.* ***Putin is CLEARLY weaponizing the gas supply - bank credit risk in Europe has taken notice.*** *Street estimates see increased risk to the flows via Turkstream and the Brotherhood network, which are running at ~31-35bcm annualized (versus around 120-123bcm capacity), per energy sector investors in our live chat.* ***Clueless economists are myopically focused on backward-looking U.S. jobs data - NOT credit risk ripping higher.***

"Every day that goes by, it´s clear - ***Vladimir Putin is holding a gun to the head of the European banking system****. Balance sheets were already ravaged by the Covid lockdown hit – now the size and scale of energy liabilities to consumers and businesses are colossal. No one is doing the math – but the waiter has the bill and he´s walking this way."* - **Bear Traps Turning Point, September 4, 2022**

Summary

Several important events this September-October may form the catalyst for a further rally in oil prices. Exxon XOM was recently 24% above the July lows (now 18%), while service king Schlumberger SLB surged 34% (now 24% off the Summer´s lows). Needless to say, a lot of good news is priced in. **We are using this opportunity to lighten our exposure - but the 12-18 month picture is bright.**

1) The U.S. will phase out emergency releases from the Strategic Petroleum Reserve in October.

2) The hurricane season will peak in September. With ocean surface temperatures already above average, this creates the risk of a debilitating hurricane hitting the U.S. oil and gas infrastructure.

3) The Italian election in late September is an incentive for Putin to minimize gas flows into Europe, as the energy crisis is the single largest driver for the surge in right-wing support.

4) Demand season for natural gas starts in Europe in September and Russia is already limiting supplies. This could lead to about 1ml barrels of extra oil demand from gas-to-oil switching.

5) US midterms may flip the House and possibly the Senate to Republican control, to the dismay of Biden. Higher oil prices have been a big driver for the high disapproval ratings for Congress and Biden and another reason for Putin to prop up energy prices.

6) Brazil's elections in October will likely return the presidency to left-wing Lula. He's signaled a partial renationalization of Petrobras and for the oil company to lower gasoline prices and buy back refineries. These events will likely deter Petrobras from increasing oil production.

7) Europe has a self-imposed deadline of Dec. 5 to fully ban the import of seaborne Russian oil and ban Russian oil through pipelines.

8) As we have discussed numerous times over the past 12 months, Saudi has much stronger control over the price of oil relative to recent years. This was on display in recent days after Prince Abdulaziz's comments pushed oil back higher.

Follow the Money

Russia's oil exports have completely recovered as Russia sent barrels that previously went to Europe and the U.S. to the Asian market instead. With much higher prices for oil and refined products, Russia's current account surplus has reached record highs. Russia has continued to export oil despite the U.S. and European (partial) embargo on Russian crude. As the chart above shows, Russian exports have completely recovered the blip right after the Ukraine invasion and Russian oil production has also rebounded to 10ml bpd. The G7 now tries to deprive Russia of the oil revenues to fund its war by imposing this price cap scheme. In reaction to this plan, Russia already said that it will not deliver oil to any buyer that imposes price caps on their oil and that it will sell to other markets.

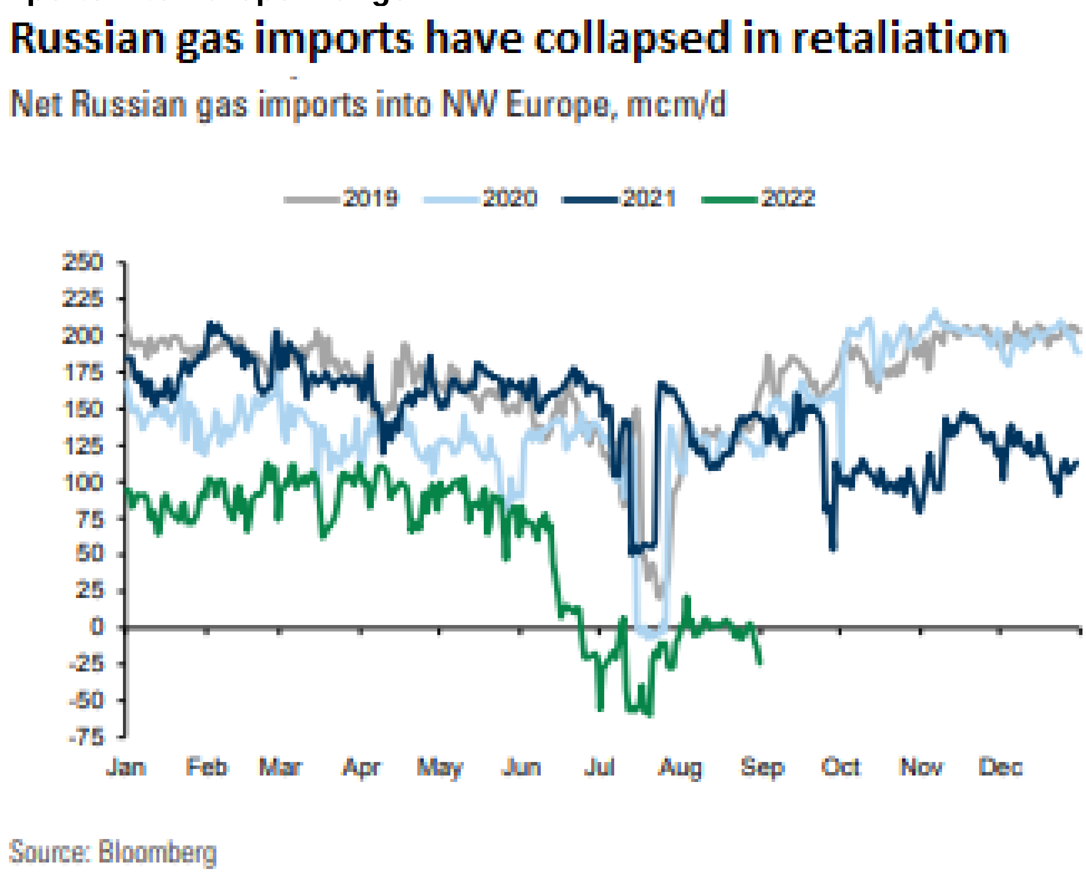
It is also highly unlikely that big buyers of Russian oil such as China, India, and other Asian countries will agree to this price cap regime. They can avoid this by using a newly introduced Russian insurance program or Indian and possibly Chinese government insurers to ship oil to buyers. The G7 plan also ignores the ability of Russia to influence global crude prices. Russia is very likely to retaliate by cutting Europe and other NATO buyers off and shutting in its own production. Russia's fiscal position is strong, and it could easily cut 3ml bpd from its 10bpd production to avoid selling under the capped price program and to spite the West.

"Under normal conditions, gas prices are cheap during the low demand summer to allow gas to be stored for winter. Utilities only tap into the costly winter spot market if they need additional supply. In the current situation, Russia's cuts have driven spot prices above those for winter delivery, so there is no commercial incentive to buy gas and hold it for sale in winter. Instead,

authorities (e.g. in Germany) had to introduce state purchase mandates under which gas is bought and stored irrespective of the price and trading signals, meaning that the market as such is currently not functioning." - **Eurasia Group**

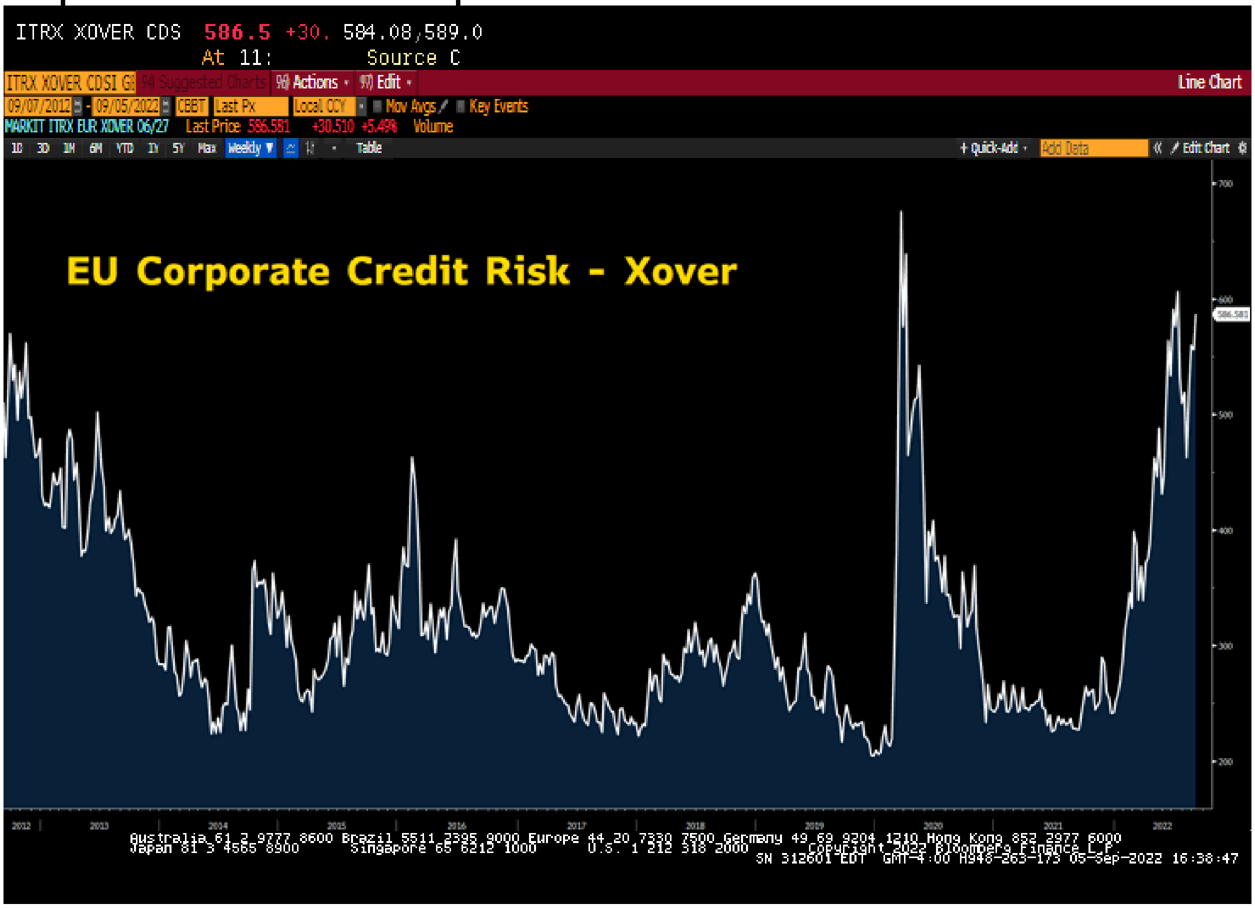
OPEC has struggled to reach its self-imposed quotas and is currently producing more than 1.5ml bpd below its quotas. As such, this gives Russia even more power to influence global oil prices. Would Russia be willing to inflict such economic pain on itself? We have seen that Russia quickly retaliated against EU's military support to Ukraine by drastically reducing gas flows into Europe. Russia is currently flaring $10ml of gas daily that otherwise would have gone to Europe. And yet, Russia's current account surplus is at record levels as higher prices have more than compensated for lost volumes.

Imports into Europe Plunge



Russian gas supplies to Northwestern Europe have turned negative, as pipeline flows have dropped to a trickle. This has led to a full-blown energy crisis in Europe as gas and electricity prices went up 10-fold in a matter of months.

Corporate Credit Risk in Europe



"Negative technicals and fundamentals to dominate for now but valuations are attractive. Negative technicals (heavy supply, heavier positioning, seasonality) and weak fundamentals (max CB hawkishness, energy crisis, Italian elections) should continue to weigh on investment grade cash spreads in the near term but we struggle to get too bearish given that valuations are attractive (we are wider than the peaks of the previous large cyclical sell-offs in 2018, 2015-16 and 2000-03). We keep overall risk close to home, avoiding names with refi risk and looking for opportunities to pick up cheap risk in primary. We like adding longs in recent high-quality underperformers (BBB+ or higher, non-cyclicals), some of which trade significantly through COVID wides. We are neutral on spread duration now as curves steepened significantly in August on the back of the rates sell off. EUR cash remains relatively compressed (as cheap to BBBs, BBBs cheap to BBs) and we would continue to position for decompression. We would sell REITs given they outperformed despite the significant move-up in real rates. Italian corps continue to trade with a significant risk premium and we view the election later in September as a potential catalyst for some compression. UK-focused corps trade with limited risk premium and we would be sellers given the particularly weak economic outlook. The CDS-cash basis collapsed to neutral levels last week as macro indices outperformed on the NFP print, but with Main/Xover opening +6 / +30 Monday morning we see another opportunity to sell basis." - ***Jefferies***

Putin´s Next Move

The surge in export revenues has created a different challenge for Russia as the Ruble has soared in value and Russia faces an uncomfortable imbalance in its external accounts (too many dollars and euros). Due to previously imposed sanctions, Russia's central bank can no longer accumulate large sums of foreign reserves. It can now only buy gold from local producers, which is relatively small; Russia produces gold worth $2bl per annum. Russia has been buying assets in friendly EM to recycle these dollars and euros, but this has been slow and it lacks scale. As such, Russia might welcome a decline in its record current account surplus that would cause the Ruble to decline in value. This allows the Russian government to reduce pressure on its fiscal budget which is predominantly funded by $-linked revenues while expenditures are in (now expensive) Ruble. In other words, Russia's government might actually have an incentive to lower oil volumes. Russia's oil production is already starting to come down, as the summer drilling season comes to an end.

Even if Russia does not retaliate further, the **loss of oil barrels would still amount to about 1ml bpd due to the incomplete redirection to non-Western buyers.** This is due to shipping constraints, as illustrated by the spike in crude shipping costs, as well as refining slate limitations in Asia and competing for market share with core OPEC members.

Crude On the High Seas

More than 40m barrels of oil are stuck on the water, which is subtracted from available commercial stocks. *It has also caused a surge in oil freight rates as the lack of available tankers drives up the price of shipping. Overall, the loss of crude from these sanctions* ***could be as much as 1ml to 3ml barrels per day.*** *We DO NOT know when*

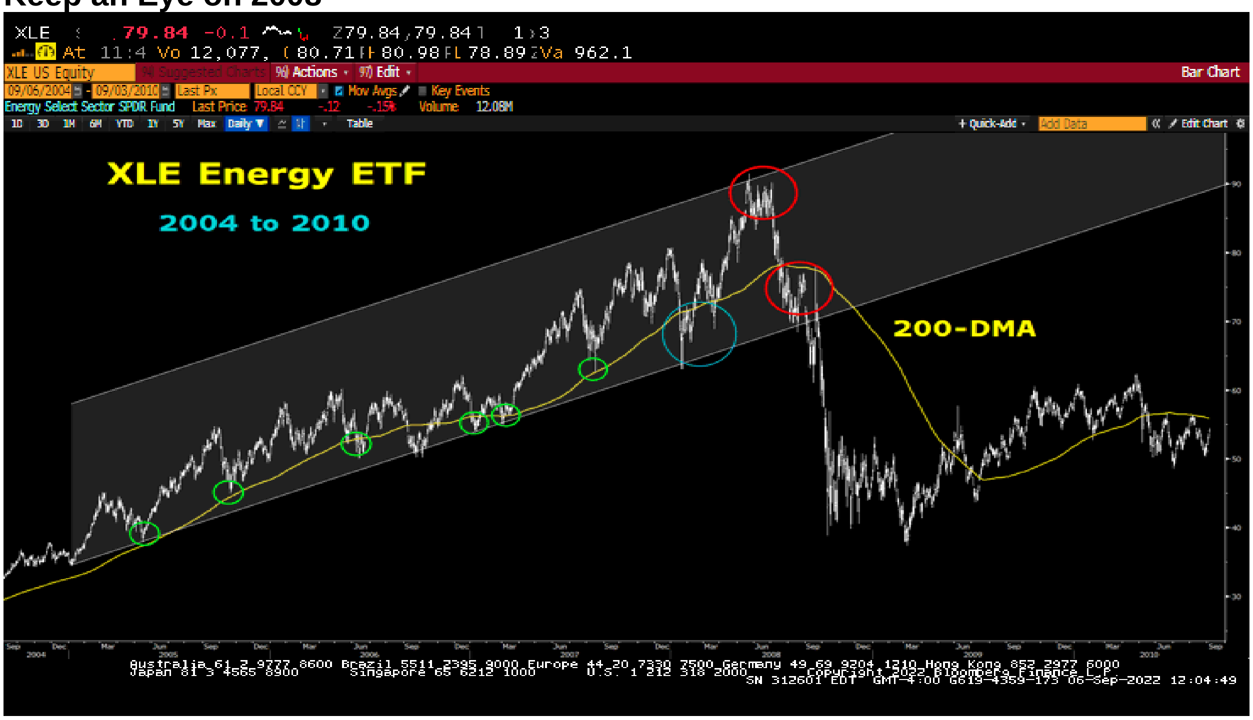
*Russia plans to retaliate, but the price-cap plan goes into effect on December 5th. Such a shortfall could lead to **extreme tightness** in the physical oil market (JP Morgan estimates **$190 brent** in a worst-case scenario). This would come on top of loss of 1ml bpd in SPR supplies after October and an estimated 1ml demand from gas-to-oil switching this winter.*

Putin´s Cash Cow

	Russia	USA
Government budget	-1%	-5%
Gross sovereign debt	15%	130%
Exports	16%	-5%

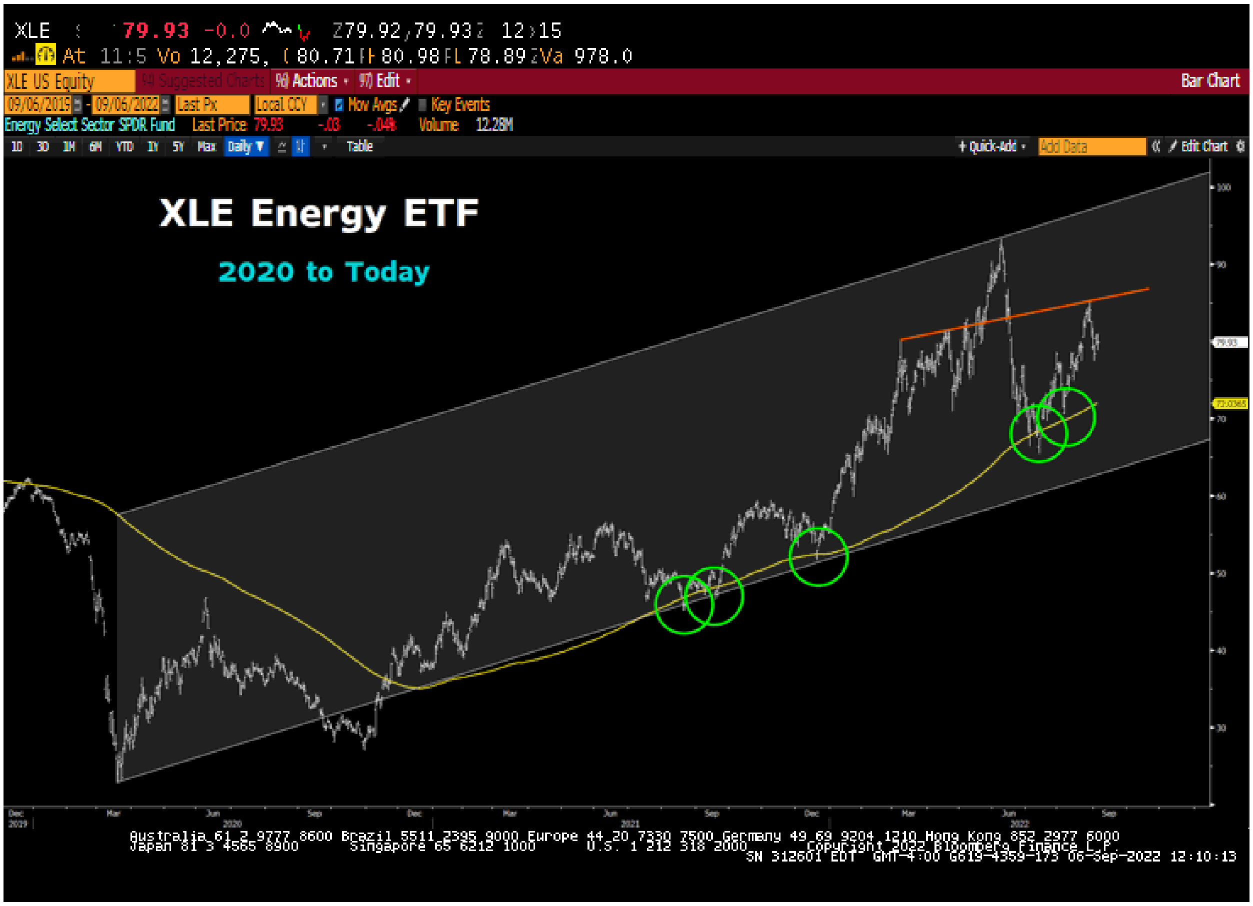
*Russia's financial position is extremely strong at the moment. **He has the dry powder to withstand a production hit and inflict a lot of pain on the West.** In addition to a trade surplus and an almost balance budget, Russia's sovereign wealth fund (the National Wellbeing Fund) has $2T in assets and Russia's Central Bank has cash balances of $85B.*

Keep an Eye on 2008



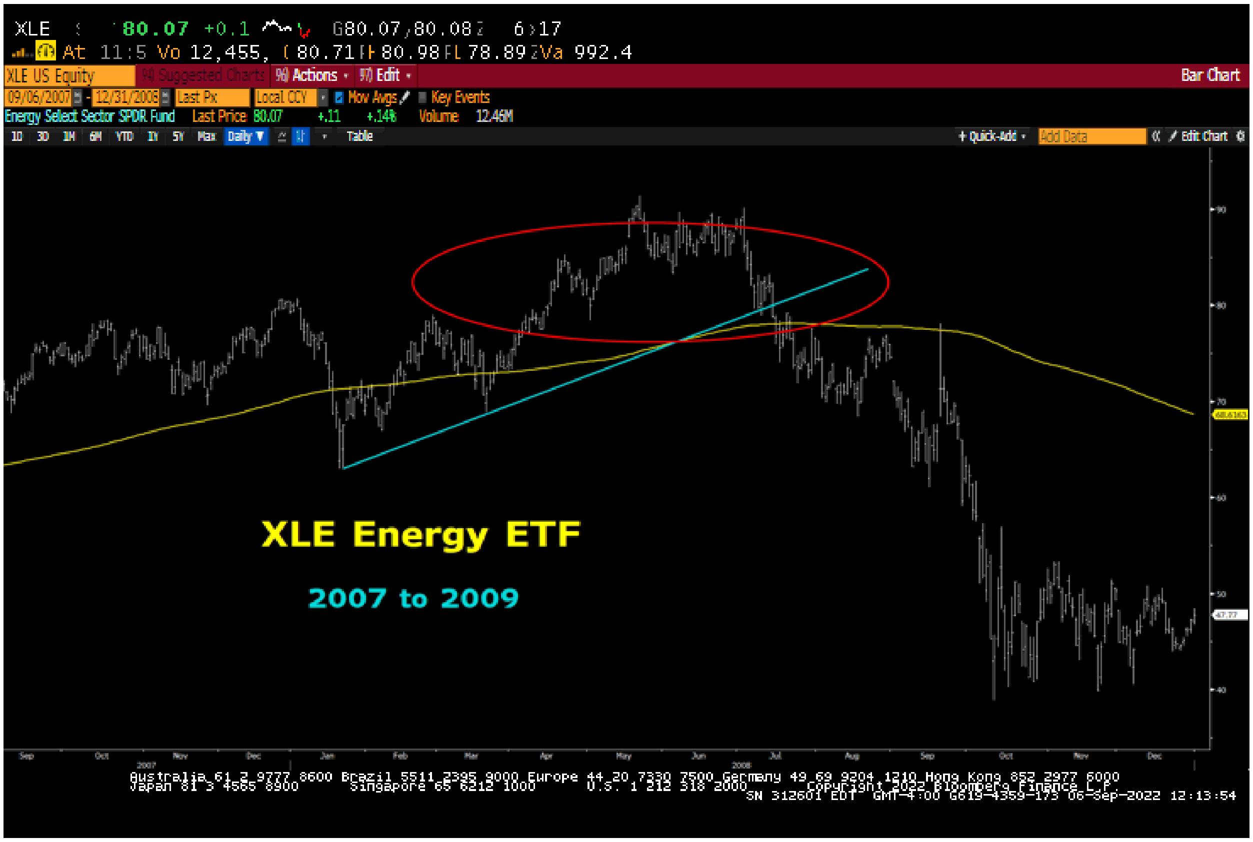
All recessions come with a demand shock for oil prices - some more than others, ala 2008. We want to make something VERY clear. The probability of a demand panic is extremely high. Similar to the Nasdaq in recent years - for all of 2004 - 2008, the 200-day moving average was - key firm support for the XLE Energy equities, once that gave way we had the "flush."

Summer of 2022 Brent Drawdown



We already had a significant "tremor" during Summer 2022 (Brent 25% drawdown June to July), with a quake potentially nearby. ***Structural forces in the market - all described in this note - point to any such drawdown as a buying opportunity.*** *After all the drama - Brent is still unched since February. Once again, the 200-day is a key buy-zone - in client trade alerts 2020-2022 - we have been buyers there.*

A Closer Look at 2008



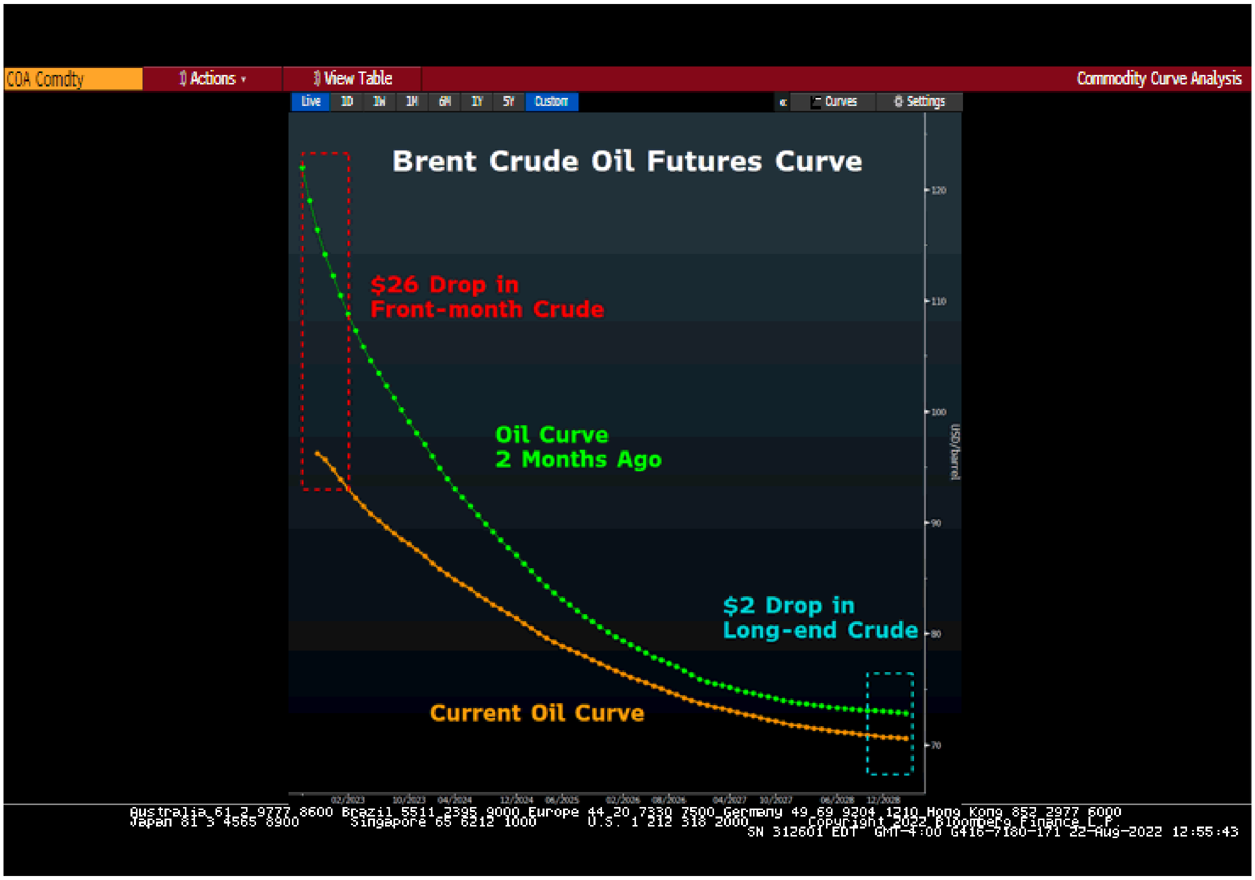
The Summer of 2008 looks similar to the Summer of 2022 with a large consolidation area - a bull vs. bear battleground.

Above all - secular forces in the global natural gas and oil market are fueling certainty around a sustained inflation regime. Thanks to LNG, nat gas markets globally are now fungible, meaning that skyrocketing gas prices in Europe drive up US nat gas prices as well. This in turn has led to a surge in wholesale electricity prices in the US, which can be very inflationary. Both directly (Bund yields) and indirectly (nat gas surge) the European energy crisis is pushing up Treasury yields, which has become a real headwind for equities.

Altogether, Europe will be about 2 million barrels per day (bpd) short by the end of 2022 from the seaborne crude ban. In addition, the gas-to-oil switching and the phase-out of SPR emergency releases will lead to at least 2ml bpd supply shortfall in Q4. Now that OPEC is back to pre-corona quotas, it will no longer increase production quotas at every meeting. In other words, the world could face a 4ml supply shortfall in H2 with little offset. All this leads to a further supply/demand imbalance and a depletion of commercial inventories. We think brent crude oil prices could end 2022 at around $110 per barrel based on our estimate of year-end inventories.

"Witnessing this recent harmful volatility disturb the basic functions of the market and undermine the stability of oil markets will only strengthen our resolve." - **Prince Abdulaziz**

Crude Oil Futures Curve: Shift in Past 2 Months



Oil has seen a strong rebound higher since the comments from the Saudi Prince. What led to the comments? Over the last 2 months, the short-end of the crude curve has dropped dramatically relative to the long-end. This has created a disconnect between price and fundamentals to which the Saudis object - unsurprisingly they want higher prices. What's interesting is the timing - just weeks after a meeting with Biden and his team... Back in late June the sell-side was talking-up oil going to $50 in a recession. We bought the energy dip with a basket of trade alerts near the lows in late June and early July as our best oil guys were saying the oil drop would likely stop near $80 in a recession scenario with a large factor being the control the U.S. had given Saudi Arabia over the price of oil.

"The Saudis have FAR FAR FAR more control over prices without the shale boogieman, the U.S. rig count is still 33% below 2018 levels and 63% below 2014 the US capex overdose levels. - If demand destruction is occurring now and the energy sector is the leading indicator, then it is pricing in a recession none of us have ever seen before. The scope of destruction required to alter the physical market's lack of supply is way out of wack here to where the broader market is trading." - ***Bear Traps, July 7th, 2022***

"OPEC knows the Biden White House's conservative posture on U.S. production; they have far more control over global oil prices now. Bullish Exxon, Chevron and company." - ***Bear Traps Report, March 2021***

Saudi's Oil Price Control

After COVID hit, we saw a severe drop in both production and growth potential in North America. This set the stage to have OPEC+ in control of the market again back in roughly June 2020. That is when OPEC announced pricing for their crude, effectively challenging the market for control. The Saudi minister warned traders in oil not to play with oil when OPEC is in control. For the most part the volatility finally subsided after a decade+ of OPEC not being in control.

Remember early this year we saw the oil price begin to elevate volatility in conjunction with the Ukraine war. It was that bump in demand that took the global oil demand up through the current supply and more importantly, OPEC excess supply was clearly shown to NOT be there anymore. Since then, the deficit in what they say they are producing and what they actually are producing ramped up to a deficit of 2.8 mil b\d. Why do we continue to sit on pins and needles every time we hear about OPEC new adds and they can't keep up with their old adds?

OPEC loses control if they have to give production to the market - they gain more control if they are taking barrels out of the market. Having inventory is better to control the market than the current situation where they can't even keep up with their current allocations. Another way to think about it is that OPEC gained control as demand dropped below supply in 2020 leaving OPEC excess supply as the swing or balancing producer. However today you could say that demand is swinging in front of supply now as OPEC excess supply is gone leaving the market in a more volatile state because speculators are back seeing blood. These speculators are annoying the Saudis, MBS.

Saudi along with pretty much every major producer in the world has stated that the physical market is very tight and the lack of spending on the sector helps to foresee an abysmal future for supply. The only way out of this elevated price situation is either a global and unprecedented economic meltdown which would tilt demand to the downside or allow industry to grow supply which will need at least 2 years of lead time for the production to even begin to hit the market.

Bottom Line - Neither look likely so OPEC is in the enviable position of cutting production to regain credibility again as they have clearly lost control of the market after the Ukraine war began. Hey if the market wants to take oil prices lower and make assumptions that are simply too far-fetched, Saudi is basically saying they will cut production to keep it up and hurt the speculators that are shorting it on fictitious events and far-fetched assumptions. Then they get prices higher, they get rid of speculators, and they gain control with more production in their pocket. Cha ching! - with Energy Focused CIO in Canada

XOP vs XLE Returns

Last 6 Months:
XOP +37% vs XLE +21%

Last 12 Months:
XOP +100% vs XLE +80%

Last 5 Years:
XOP +32% vs XLE +62%

XOP Oil E&P ETF vs. XLE Energy ETF

Alert: XOP E&P ETF breakout vs. XLE Energy (oil majors). From 2014-2019 – the exploration and production bear market was on the heels of a large-scale capex overdose, shale pain. From 2020-2022 capital retention era with the upside for exploration - ESG - green new deal threats - trillions of investment in green alternatives viewed as a fatal 2028-2038 threat to (XOP long term upside capped) exploration. People are waking up to how much control over price the Saudis have - thus - the long-term upside of XOP names is getting priced back in.

Energy Supply / Demand

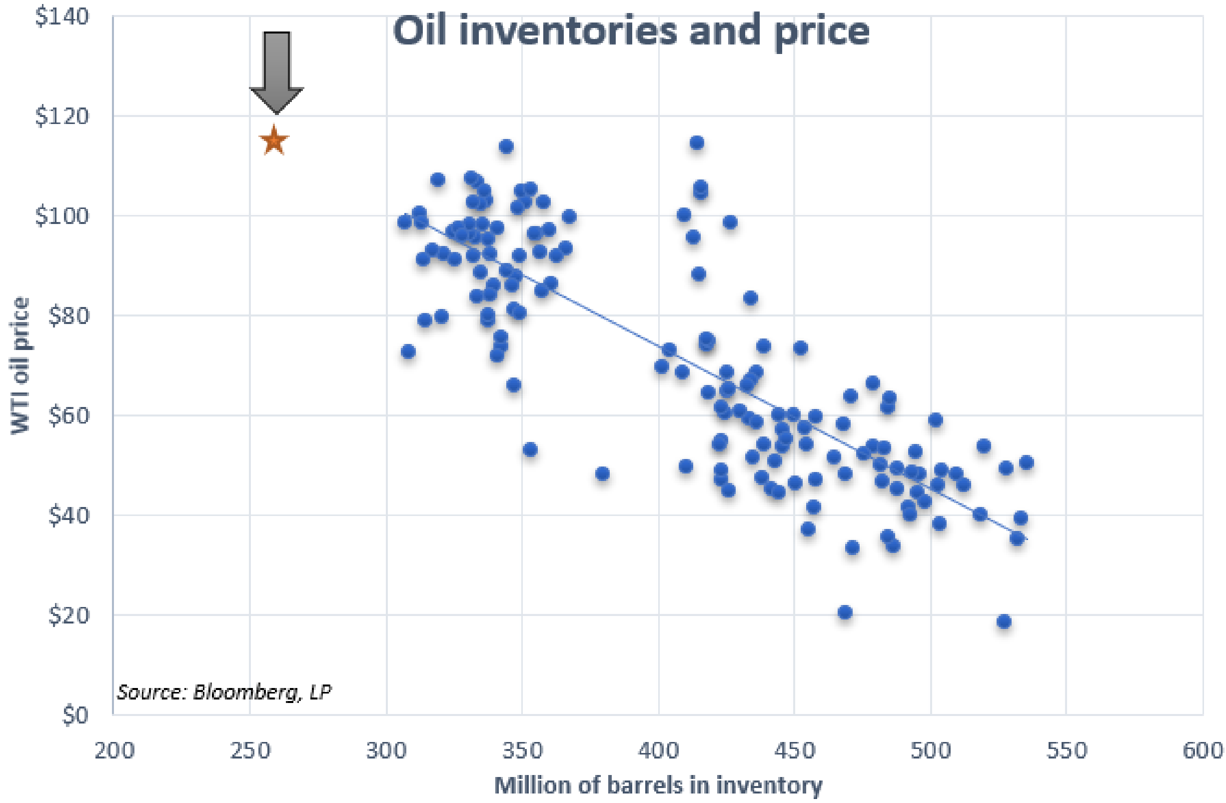
Supply has surprised to the upside recently with the return of Libya and Russian supply recovering the entirety of the losses from the war. Thus, the oil market is building and the physical market continues to move towards contango to support further builds in onshore OECD, This should be a 4-8 month phenomenon and the market will need $100+ henceforth to balance both prompt S/D and also encourage future investment. Many markets less widely followed are in contango - and have been for 2 months. The lighter ends of the oil market have been very weak due to weaker manufacturing trends. And distillate is pricing max margin. Crude seasonally builds onshore into November - seasonality would tilt the odds towards contango through November. But there is a lot of changing elements on supply side... If you lose Libya or Russia then we are back above $100. - with an Energy CIO in Canada

"Demand is coming in weaker right now given the weakening economic indicators but still remains on an upward trend this decade. Forward prices do not incentive future investment necessary to prevent future supply/demand imbalances. Backwardation spreads (front-months higher than back months) are back to YTD lows. Either oil is a big buying opportunity or it's gonna break down lower. It's at make or break levels. I think the former - oil storage counts are near the lows, so overall demand is still okay." - ***Oil Sector Portfolio Manager***

Brent Crude Oil - On Key Support

Brent crude oil recently bounced off support and is now unched since late February. Since reversing on the Saudi Princes' comments, oil is nearing the recent downtrend. We expect a breakout to the upside in the near-term.

Oil Inventories and Price



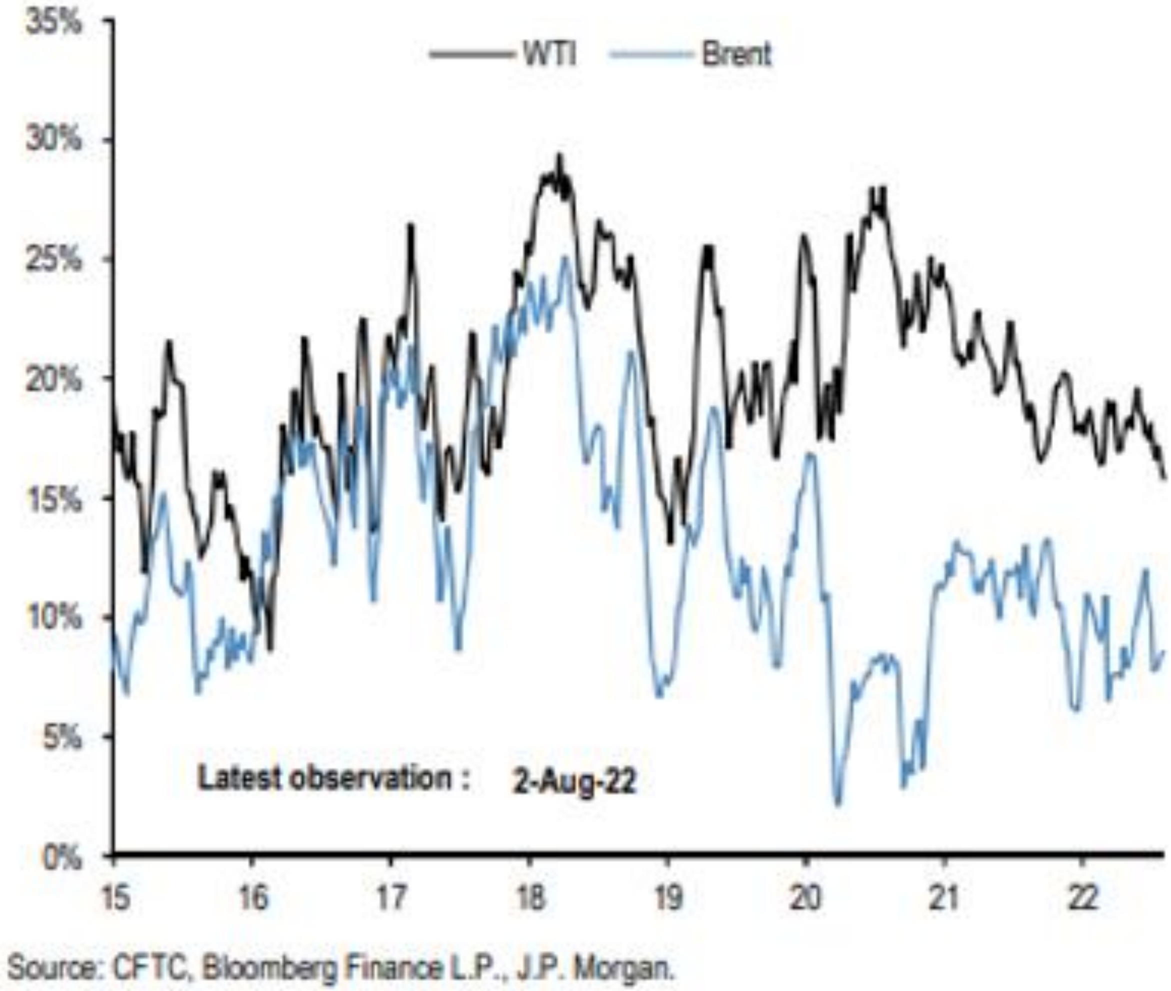
The chart shows the relationship between commercial inventories and the price of crude. Given current demand supply trends and the looming absence of SPR releases, oil inventories could decline from 425ml to 300ml barrels by year end, which equated to a $110 oil price.

As of mid-August, the U.S. government has sold a total of 135ml barrels from the Strategic Petroleum Reserve (SPR). The U.S. is not alone with dumping oil on the market out of emergency inventories. America and its allies have released 240ml barrels of oil on the market since the start of the war in the Ukraine to avert an even bigger energy crisis. Thanks to the massive release of emergency stocks, commercial OECD crude inventories have rebounded by 72ml barrels since March. However, SPR releases are scheduled to stop in October of this year. This means that, from November on, there will be at least 1.2ml barrels per day less supplied daily to the market. Besides the U.S., other EIA members (Europe, Japan) have also released emergency stockpiles simultaneously, so when the U.S. completes its emergency releases, other EIA members may likely complete their sales as well.

Domestic oil inventories are now almost 20% below historical norms. Commercial inventories have recovered a bit thanks to the aggressive oil selling from the government's emergency inventories. By the end of November, the SPR will have declined to ~400ml barrels, from 620ml just before the crisis started. The October timing is opportune as it is right before the midterms on November 8th. Once these midterms are out of the way, there is less political motivation to lower the price of oil. Still, the

White House has said it will not begin to replenish these emergency stockpiles until sometime in 2023. This potential massive buy program should keep a significant premium in the oil market while the more than 1ml bpd decline in supplies from U.S. and other EIA member emergency stockpiles should drive spot prices higher.

WTI and Brent Positioning

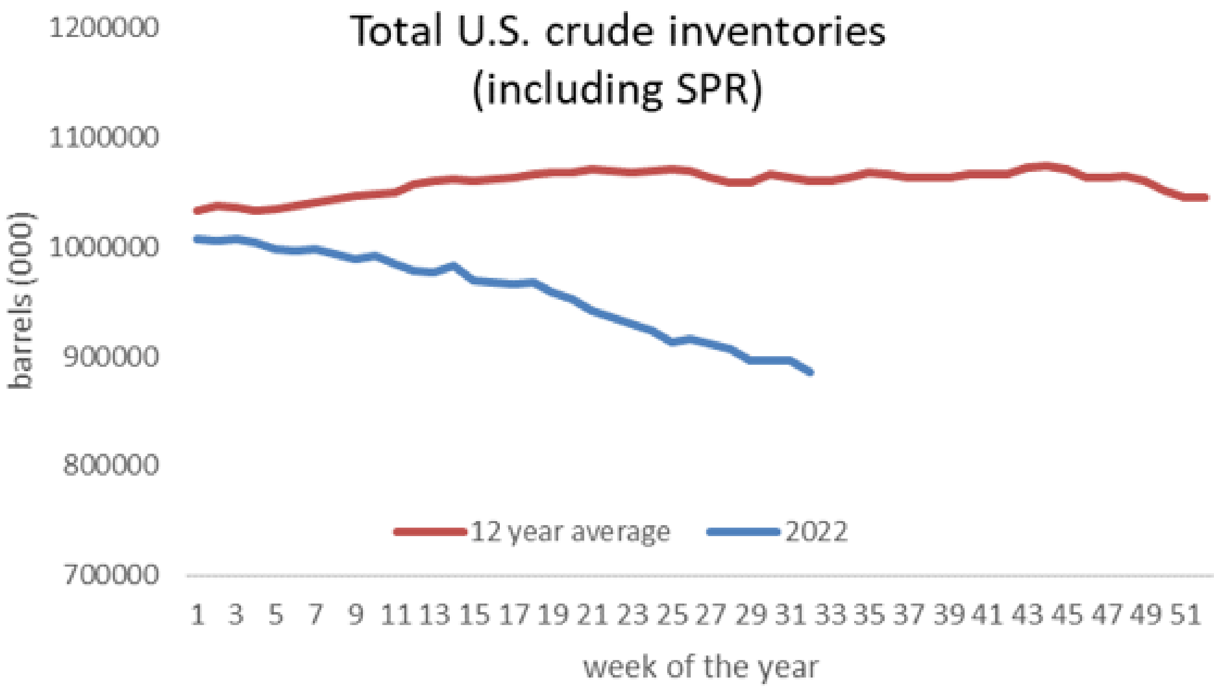


Net speculative positions as a percentage of open interest shows that speculators are far from overextended in crude. In fact, net long positions in WTI are at their lowest level since 2019. This means that speculators are not particularly bullish on oil prices yet.

Hurricane Risk

The 2022 hurricane season started last month and will last until early October. While no meaningful storm has formed yet, there is a risk of a significant hurricane hitting the oil and gas or refining infrastructure in the Gulf between now and late September. Water surface temperatures in some parts of the Gulf of Mexico are already above 90 degrees vs 88 average for August. Warm water functions as an accelerator for hurricane speeds and above seasonal temperatures in both the Gulf and the Atlantic Ocean mean above average risk of a destructive hurricane. If such a hurricane forms and enters the Gulf, the oil and gas industry will evacuate offshore platforms and oil and gas production will decline. Production from the U.S. waters of the Gulf is still 13% of total U.S. oil and 15% of U.S. natural gas production. Even more important is the refining industry. 47% of total petroleum refining is located along the Gulf coast, primarily around New Orleans, Houston, and Corpus Christi. Should a hurricane pass over the Atlantic into the Gulf, markets will anticipate risk to output and refining capacity. Oil and gas prices could spike higher, and refining (crack) spreads would widen further. Last year, Ida was the largest hurricane hitting the Gulf coast when it made landfall on August 26th. It crossed into the Gulf from the Caribbean Sea and almost directly hit New Orleans when it made landfall. The oil and gas producers in the Gulf evacuated most of their personnel from the offshore rigs and in total, the US had a 23ml barrel production shortfall due to the hurricane. Oil prices rallied $15 per barrel in the aftermath of the hurricane and the production shortfall.

Total Crude Inventories

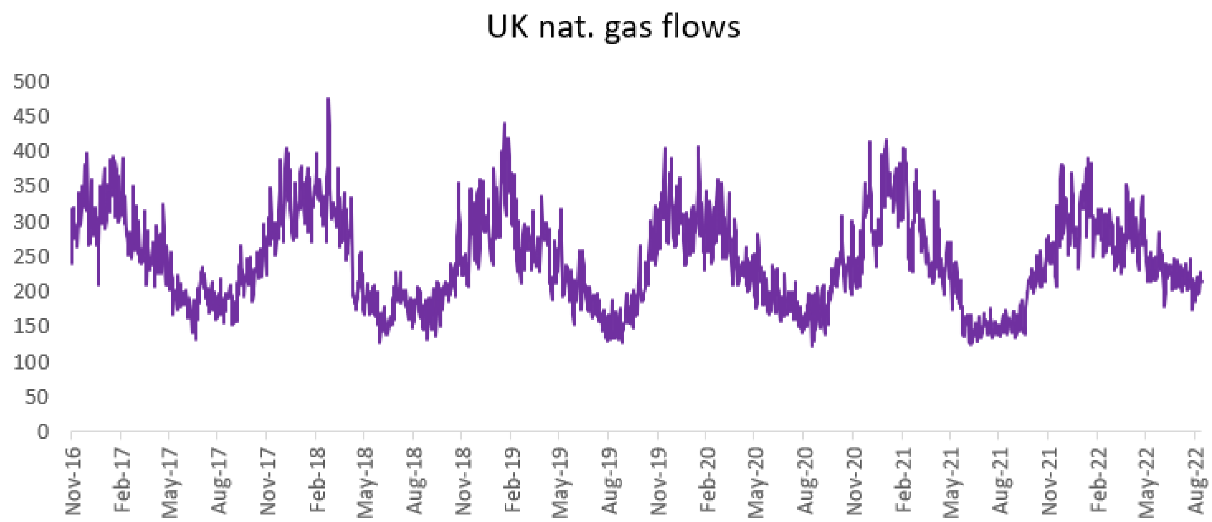


US total oil inventories are well below the average over the last 12 years. The main culprit is the Strategic Petroleum Reserve, which has dumped 135ml barrels of oil on the market so far this year. Global oil inventories are also below average, as OECD countries have joined the U.S. in releasing emerging inventories. Eventually these emergency stocks will need to be replenished which means a looming demand for 250ml barrels of oil. This should keep oil trading at a premium for the coming months.

Heating Season in Europe

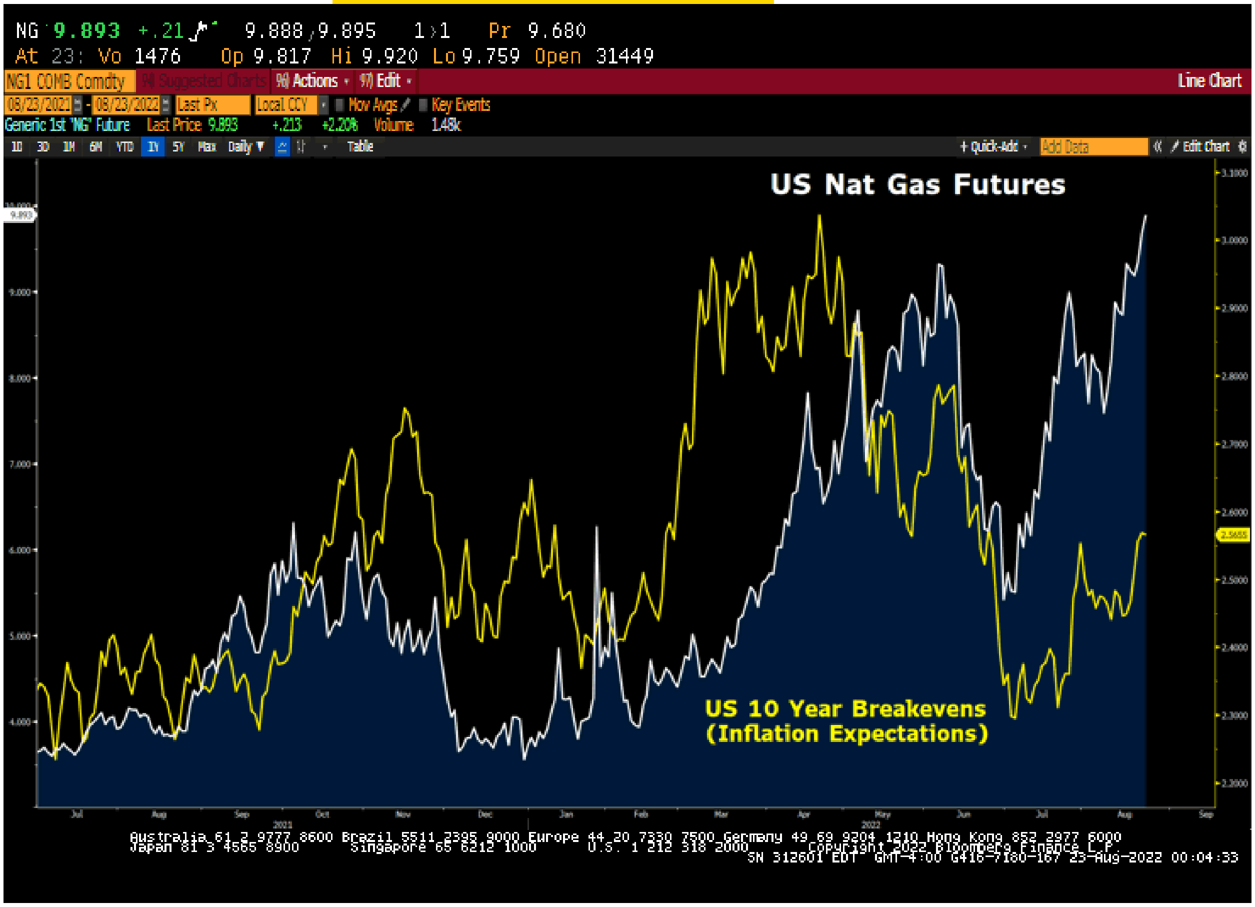
Now that it's September - the heating season is starting in northern Europe. This means that natural gas demand will increase as northern Europe starts burning gas to heat their homes. Germany already warned that it must cut its gas use by 20% to avoid a crippling shortage this winter. According to Goldman Sachs, gas-to-oil switching could add 900K barrels per day to demand and 1.85ml bpd if winter is extreme. Gas flows from Russia are still just 20% of normal and Putin may want to continue restricting flows, with an eye on the Italian elections and the U.S. Midterms. **On December 5, the EU will officially ban all seaborne crude imports from Russia.** That could mean a 2ml barrels shortfall in supply, although Europe has already partially reduced its imports of Russian oil substantially since the war started. Germany and Poland will also eschew Russian oil imports via pipelines at that moment. The shortfall in Russian barrels will further tilt the supply/demand balance in the seaborne crude market, as these barrels will need to be replaced with oil from OPEC or the U.S.

UK Nat Gas Flows



The data from the UK's National Grid shows how demand for natural gas quickly increases each fall, as temperatures drop and demand for heating surges. Use of air conditioning in Northern Europe is only a fraction of the U.S. where demand for natural gas remains high in the summer due to cooling demand. In other words, if Russia decides to continue only limited amounts of natural gas flows into Europe, natural gas and electricity prices may go parabolic this fall.

US Nat Gas Futures - Point to Sustainable Inflation

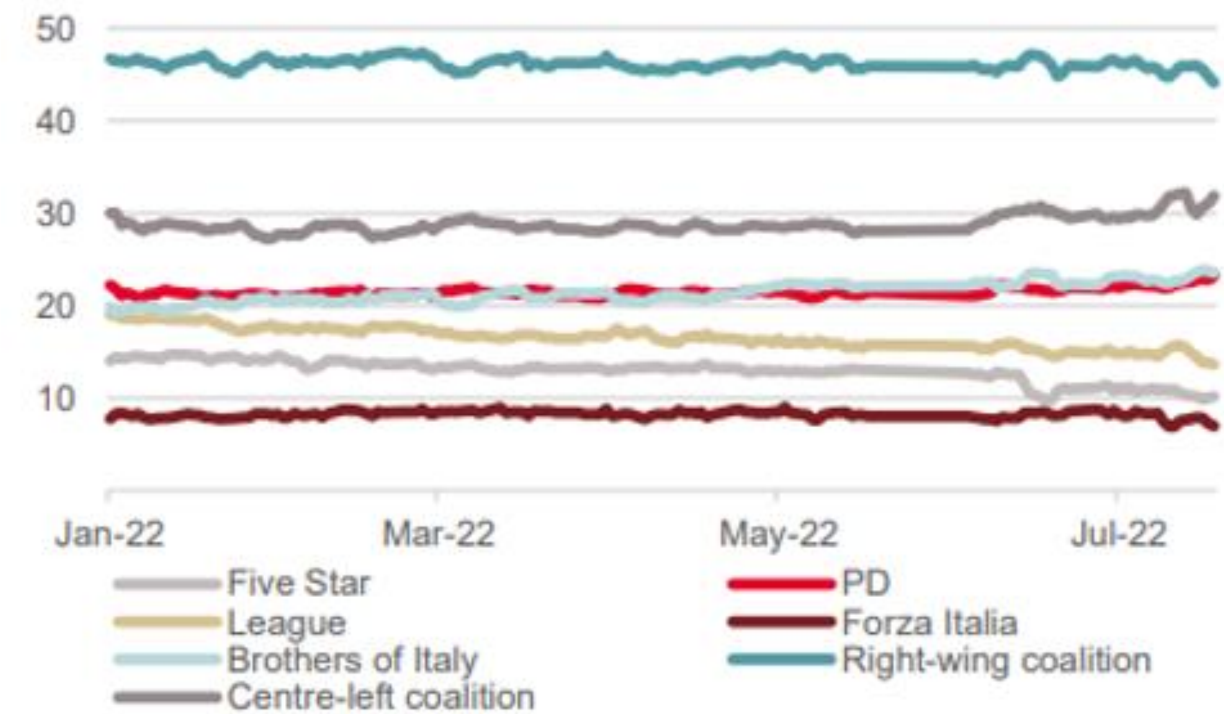


US 10-year breakevens (inflation expectations) have gone from near 2.30% in early July back to 2.5% largely driven by the combination of slightly improving economic data and surging nat gas prices. Keep in mind, the last time inflation expectations were here in June, nat gas was nearly 50% lower.

Unprecedented Italian Elections

The Italian government fell in July, because of a crisis among the coalition partners. It is not uncommon for Italian governments to fall, but what is unusual is the timing of the snap elections. For the first time since 1919 elections will be held in the Fall. On September 25th Italians will vote and the timing may lead to low turnout and a shortened election campaign. This will likely help the right-wing coalition as their voters are the most motivated to go to the polls. The right-wing has formed a broad coalition between the Brothers of Italy (FdI), Lega, Forza Italia (Berlusconi) and the smaller Noi Moderati (NM). The coalition on the left is fractured as PD leader Enrico Letta ruled out a coalition with 5-star immediately after the government fell. The two parties were in the previous coalition but the recent government crisis had caused an irreversible break between PD and 5-Star. On top of that, the Italian left (SI) and Greens (EV) announced they would form a separate coalition. This has left the major center-left PD with few parties to form a coalition. As a result, the right-wing coalition has a chance to win an outright victory (50%) in Parliament. Given the changes in the election law that were instituted in 2018, they may even be able to win a 2/3 majority, which would be an unprecedented event in Italian history. The electoral law that instituted these changes combines a proportional and a first past the post system. Changes were made because it was almost impossible for parties to form a coalition because of differences in the way the lower and upper house allocated votes. This made Italy almost ungovernable. Under the new law, 3/8th of the seats are allocated on a majority system, and the remainder on a proportional basis. Such a large majority would allow them to change laws. One of the coalition goals is to give the -now largely ceremonial- President more authority which would require a change in the law.

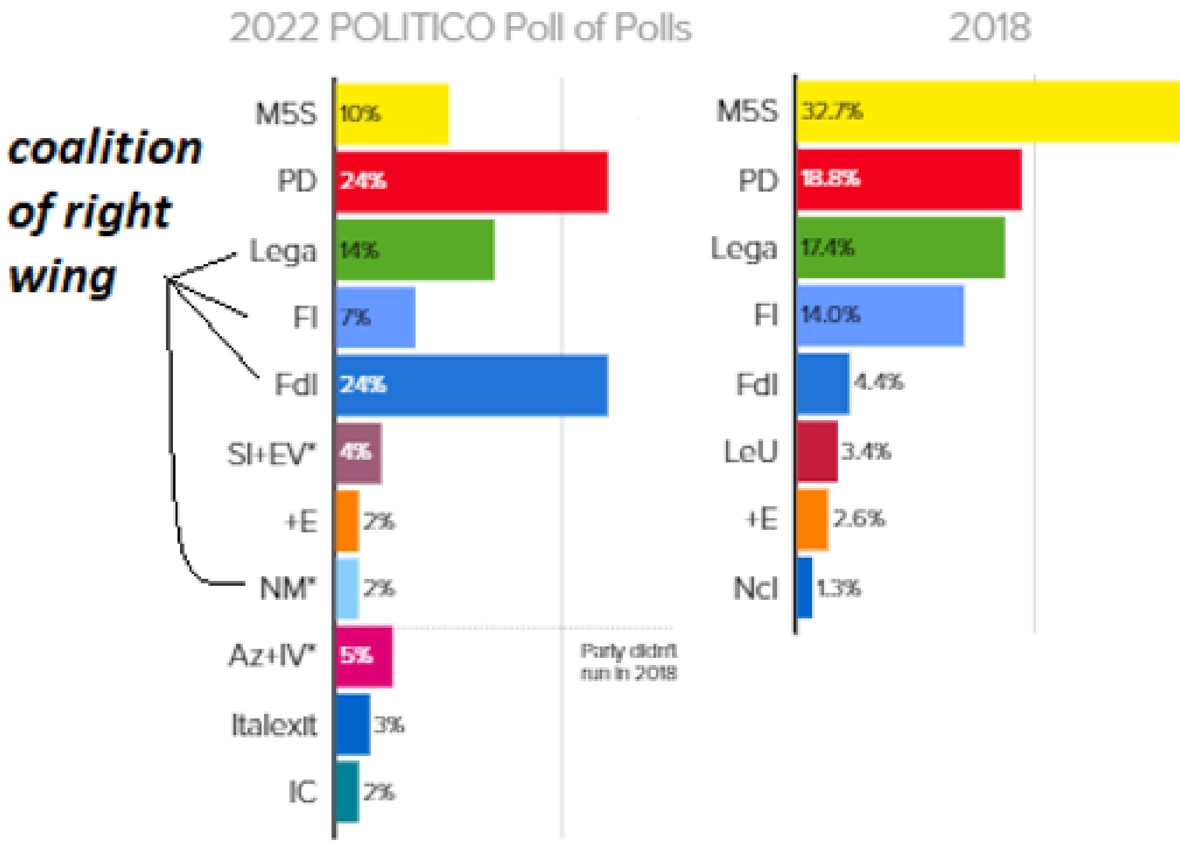
Italian Election Polls



The chart shows the average of the opinion polls for the different parties and coalitions. Clearly, the right-wing coalition has maintained a consistent sizeable lead over the other parties and coalitions.

Putin would benefit from a right-wing government in Italy. The right in Italy is less antagonistic towards Russia than a center-left government would be. Also, a right-wing coalition could lead to more fractures within the core of the Eurozone, as France and Italy are now governed by center-left parties. More fractures play into Putin's hands as it means a less cohesive political block to punish Putin for the war in Ukraine. So how can Putin influence the Italian elections? One of the biggest drivers of support for the right-wing parties in Italy is the unbearable surge in the cost of living. Food and energy have been a big source of discontent among Italian voters. Italy is one of the hardest hit countries in Europe by the current crisis because of its high reliance on natural gas. The leader of Brothers of Italy, Giorgia Meloni noted on the Russian gas embargo that "it would be suicidal for us, the economic cost is too high." While she has said to support current EU policy towards Russia, once in power she and especially her coalition partner Lega will try to water down the sanctions to give Italian citizens relief on their utility and gasoline bills. It would serve Putin to maximize energy prices in Europe this fall as it would drive more votes to the far-right. It's no coincidence that Gazprom announced that it will completely shut off gas flows into Europe for the end of August. Restricting the flows once the demand season starts in September could lead to parabolic price increases in natural gas and electricity.

Italian Political Shift Since 2018



According to the polls, the right-wing coalition now has around 47% of the vote. Italy is a parliamentary democracy where coalitions of parties vie for the majority in parliament and the winning coalition forms a government. The parties on the left are fractures with two separate coalitions (AZ+IV and SI+EV) and the center left PD has no major coalition partners. 5-Star, which was the largest party in 2018, has been reduced to about 10% support.

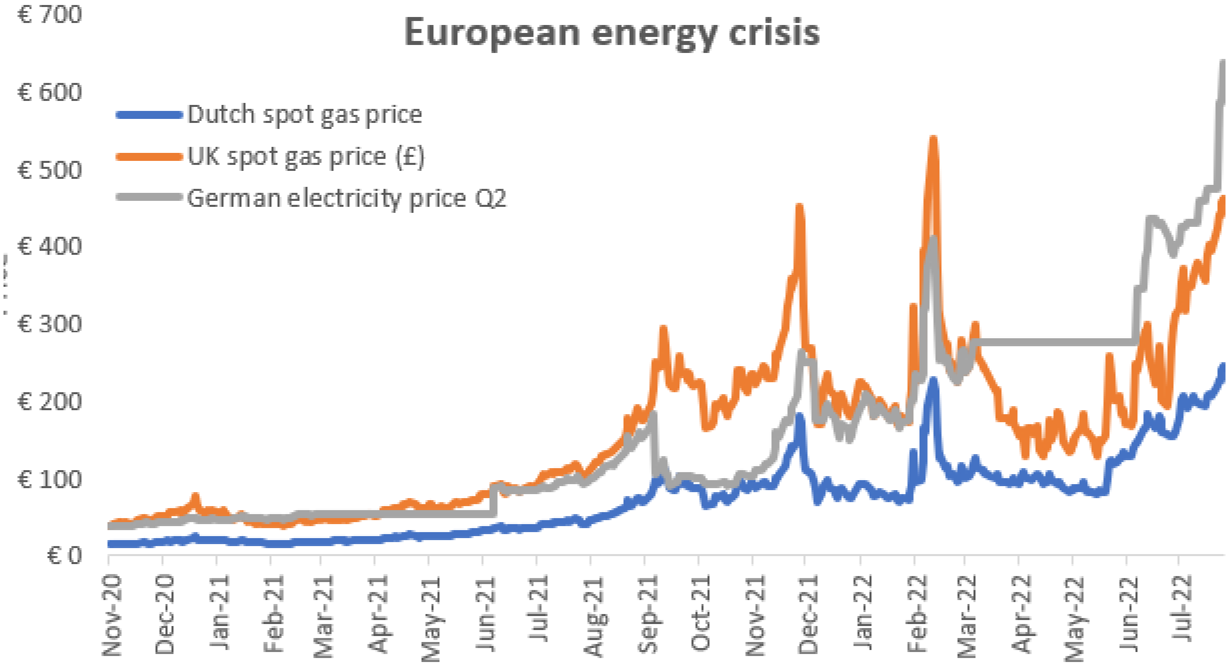
Italy 10 Year Yields Less USA 10 Year Yields

The spread between Italian and US 10-year yields is right back near its 2022 wides. Keep in mind, this was also the widest hit in 2018 and 2019. Sovereign risk is on the rise in Europe. Italy is going to have to bail-out its population getting crushed by energy prices. The market is saying there's going to have to be another big installment...

Natural Gas Move in Europe: Implications for the Italian Election

The recent gas move in Europe will impact the coming Italian elections. Some believe this speaks to Putin trying to help the far-right. Yes, Meloni, the candidate who is leading the far-right party Brothers of Italy, is extremely anti-Putin and has been very supportive of NATO throughout the Ukraine conflict. However, it's not about Meloni being pro-Putin. Salvini, her coalition partner is very pro-Putin and they are obviously trying to down play the whole Russian position during the campaign to avoid being called Russia shills. But Meloni is running on an Italy first program, that puts the interest of Italy above that of the EU. Since energy is the number one issue, Meloni and the coalition will try to bring down energy prices, which inevitably means a less antagonistic position vis-a-vis Russia or at the very least a fracture between Italy and the German-France axis.

European Energy Crisis

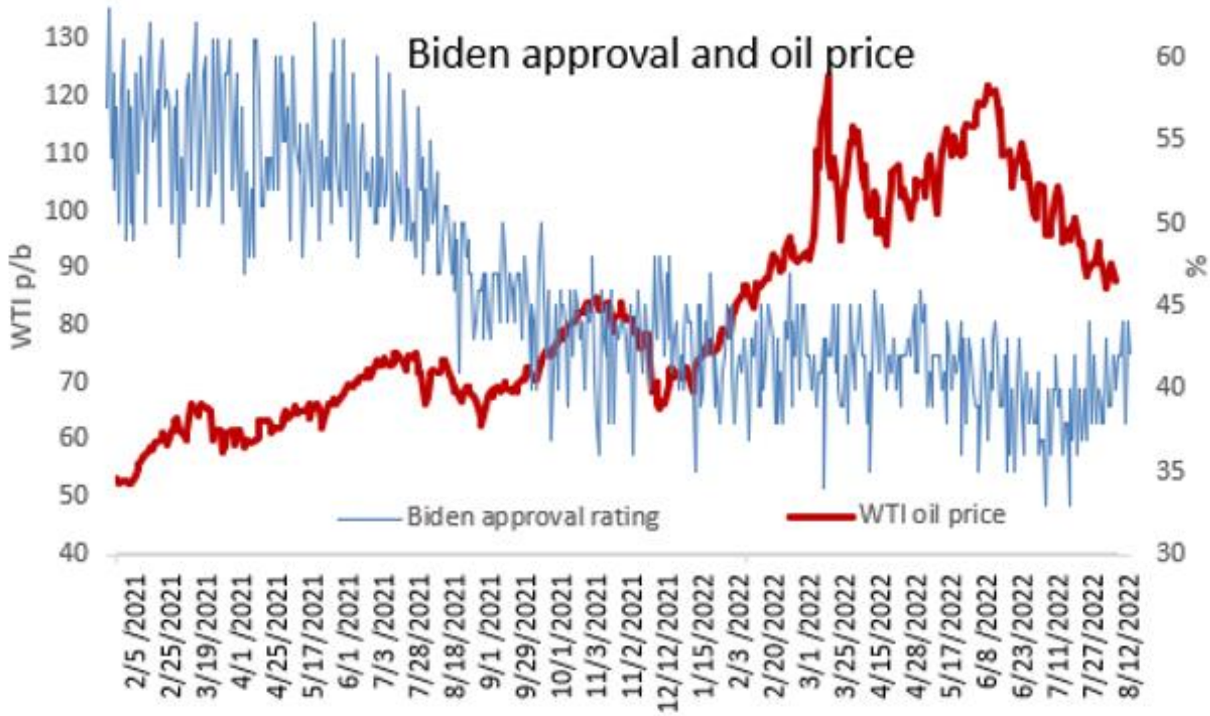


Natural gas and electricity prices have surged this year on the war in the Ukraine, and prior to that, a reduction in flows from Russia and shortfalls in renewable production last fall. The recent run-up in energy prices is ahead of the demand season, which starts in September.

More Elections This Fall

The U.S. has midterm elections on the 8th of November, where voters elect a new Congress. All members of the House and 63% of the Senate is up for reelection. Election odds now show 75% chance that the Republicans will win the House and about even odds that the Republicans control the Senate after the elections. If Congress flips, even if it's just the House, it will significantly diminish the power of Biden's White House. Congress has the power of the purse, meaning that spending is determined by the legislative branch, primarily the House. Without control over both chambers, there will be little to no extra fiscal spending the White House can deploy for its political priorities. Equally important, the Republicans have vowed to start several Congressional investigations. Some Republicans have also signaled they will try to impeach Biden. This primarily to take revenge on the Democrats who twice impeached Trump when they controlled the House. As with Trump, the impeachment will die in the Senate where a ⅔ majority is needed to convict a President. Nevertheless, all these investigations and impeachment efforts will haunt Biden, to the benefit of Putin.

Biden Approval Rating vs. Oil Price

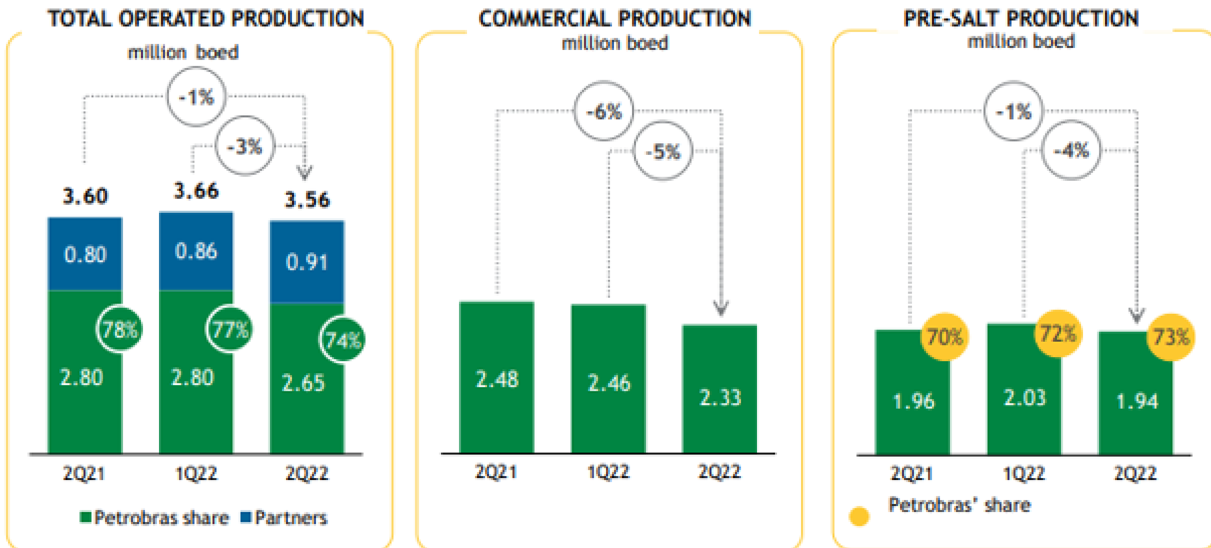


The low approval ratings for Biden and Congress is in part due to the gasoline price surge. As such, a higher oil price would make the midterms more difficult for the Democrats and this is another reason for Putin to try and prop up the price of oil.

Brazil Elections

Brazil's elections look like a shoe in for Lula. He is running against an unpopular incumbent Bolsonaro and is well ahead in the polls. As many countries, Brazil has suffered immensely from high inflation and the energy crisis and Lula has positioned himself as the candidate who will reduce energy prices. He has proposed to stop the privatization program of Petrobras and for the oil company to buy back the refineries it has sold or is in the process of selling. Some Lula advisors even suggested to develop a state-owned energy company, possibly by merging Petrobras with the privatized Electrobras. Lula's advisors want to regain control over Petrobras so politicians and unions to get seats on the councils. For Petrobras to repurchase the refiners, lower petroleum prices for Brazilian citizens and to appease political stakeholders would mean less focus on exploration and production. Petrobras has already struggled to maintain production in recent years, and such a reallocation of capital will likely further reduce their output.

Petrobras Oil Production



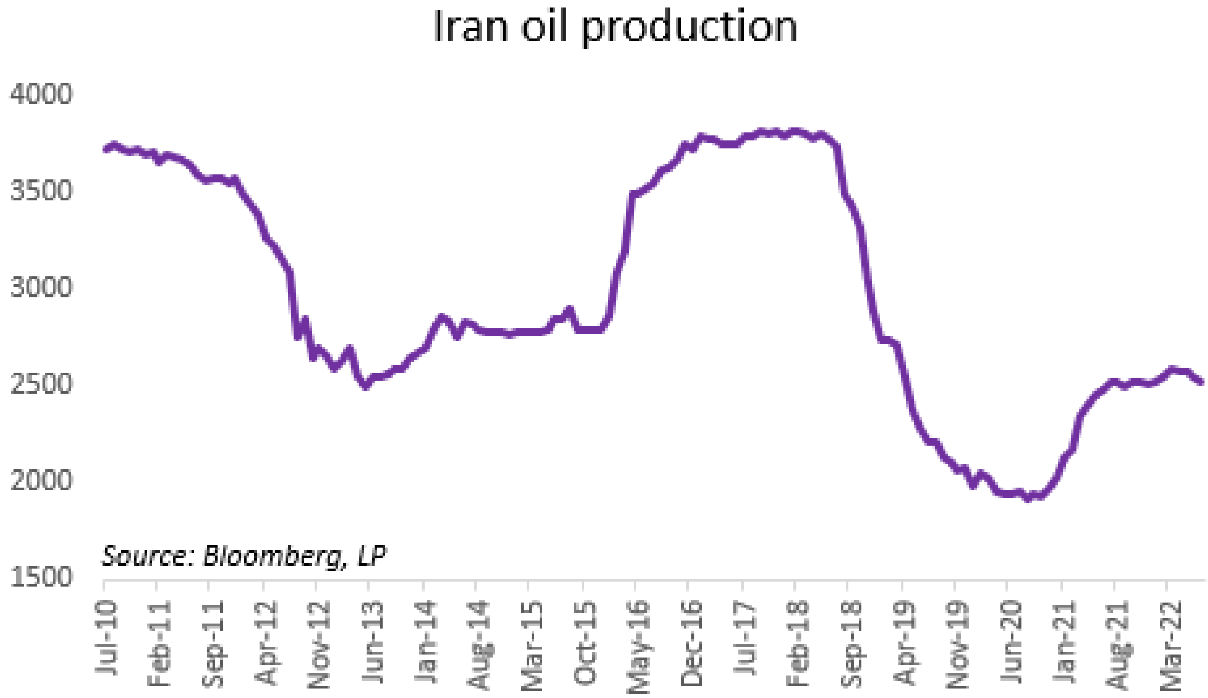
Petrobras' oil production has declined in the last few quarters despite a modestly rising capex budget. If Petrobras would be forced to lower petroleum prices for Brazil citizens and redirect capital to repurchase refineries it sold in the last few years, they E&P budget will suffer and production as well.

Chances of Iran deal

Oil languished in August because of a looming deadline on negotiations for the revival of the '15 nuclear agreement with Iran. Multiple deadlines have passed but Iran's demands make it very hard to reach a deal. However, both the U.S. and Europe are extremely incentivized to forge a deal with Iran. The U.S. wants oil prices down before the election and Europe is facing a self-imposed deadline to phase out Russian sea-borne crude. Iran on the other hand might be less eager to strike a deal. In the new multipolar world, Iran is closer aligned with Russia and China, and may find alternative ways to export its crude without forfeiting its nuclear program.

We don't know whether an agreement will be struck or not, but the impact on production is likely to be modest at first. Iran already produces 2.5ml barrels per day, of which it exports about 1ml. The remainder is for their own consumption. Prior to the rescinding of the 2015 nuclear deal, Iranian production was at 3.8ml, which means that -at best- Iran might be able to increase production by 1.3ml barrels per day. What will have an impact is the oil that Iran has in inventories. According to Kpler Iran has about 90ml of oil in floating storage and 50ml barrels in onshore storage. As such, if a deal is struck, we expect the curve to become even more backwardated, meaning that spot will trade at a premium to futures, as markets price in near term shortages but supply increases further out as oil comes out of inventories. Saudi Arabia and OPEC have signaled they would cut supplies if the Iran nuclear deal is reinstated and Iran oil returns to the global markets. It's unclear if OPEC just cuts quotas or actual production, since OPEC currently undershoots official quotas by 1.3ml bpd.

Iran Oil Production



Iran oil production rose to 3.8ml barrels per day after the 2015 nuclear deal was struck. When the U.S. pulled out of the deal, oil production declined as exports were cut to 100K bpd. Currently, exports are back around 1ml barrels per day. If Iran returns to the deal, exports could increase to 2.5ml bpd.

Best Regards,

The Bear Traps Report Team

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