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Winter is Coming | Episode 9

Greg Sharenow, Managing Director & Portfolio Manager for Commodities and Real Assets, PIMCO

This week, we welcome Greg Sharenow into the SmarterMarkets™ studio. Greg is the Managing Director and Portfolio Manager for Commodities and Real Assets at PIMCO. SmarterMarkets™ host David Greely sits down with Greg to discuss the European energy crisis, commodity markets, inflation, and what it all means for investors.

Greg Sharenow (01s):
If you're sitting there looking at this environment and you're looking at policy uncertainty, looking at demand uncertainty, and the policy being China's COVID as well as fiscal policy, which is a really big deal in Europe right now, and it's having a big outsize impact on the market and certainly the political future of some leaders in Europe and the rising concerns that are leading to protests in the street. Like there's a lot of uncertainty. It definitely makes one have to be more nimble, but I actually think it also makes the CapEx decisions to solve some of the supply side challenges even more difficult because of all these uncertainties.

Announcer (34s):
Welcome to Smarter Markets, a weekly podcast featuring the icons and entrepreneurs of technology, commodities and finance ranting on the inadequacies of our systems and riffing on ideas for how to solve them. Together we examine the questions, are we facing a crisis of information or a crisis of trust? And will building smarter markets be the antidote?

David Greely (59s):
Welcome back to our final episode of Winner is Coming on Smarter Markets. I'm Dave Greely, Chief Economist at Abaxx Technologies. Our guest today is Greg Sharenow, Managing Director and Portfolio Manager for Commodities and Real Assets at Pimco. We'll be discussing the European energy crisis, commodity markets, inflation, and what it all means for investors. Hello Greg. Welcome to Smarter Markets. It's really great to talk with you today for our listeners, when I first got started in commodities at Goldman, it was by sitting next to Greg on the 42nd floor of 1 New York Plaza, and you helped me to better understand these markets then and ever since and there's a lot to try to understand in these markets right now. I read a piece you co-wrote at Pimco recently on the OPEC plus production cut announcement where you pointed out their short term and long term justifications that they've given for that production cut with a short term justification being that it would preempt a slowdown in demand caused by the FED tightening in response to inflation and a longer term justification that the world's under investing in oil and gas production and so supporting prices in the face of economic weaknesses serves everyone's long term economic interest and I thought that's a great way to kind of start off our discussion and I wanted to start with the short term issue. So how are you thinking about and weighing the actions of the FED versus OPEC plus when sizing up your outlook for the energy markets this winter and into next year and, you know, how does China fit into this also?

Greg Sharenow (02m 31s):
Well Dave, thank you for having me on. You know, anything I may have taught you fails in comparison to what you educated me when you joined. So it was a wonderful working relationship and definitely, you know, two way flow on, on information with regards to your question though I think it's the FED versus OPEC has really been a very challenging dynamic when you're formulating a view because it is hard to look at the actions of the FED and not say, well that is going to lead to a slowdown of economic activity. You're already seeing it in some of the data that's regarding housing and you would expect to see the actions of higher Central Bank rates, not just in the US but globally, you know, having a negative impact on real spending capability ultimately over time. Ironically though, higher rates also increases the cost of capital to the energy space, which also then reduces potential investment.

Greg Sharenow (03m 22s):
So there is a, a bullish aspect to the FED policy that will have a more impactful over a longer term horizon than a short term because investors now have more places to put their money where they're actually earning some risk adjusted return, again, after many years of, interest rates being so close to zero, which was, you know, made facilitated more money going in more places that and now is

working the other direction. I think that kind of points to one of the challenges we're facing right now is that this cycle that we've been in, higher commodity prices hasn't really been a demand side cycle. If you look at the last super cycle, the emerging market growth rate, particularly centered in China, really strained global supplies, you know, demand for many of these commodities aren't much different than where they were from 2019 and if anything, you know, they're not on the trend where they would've been, but we're seeing extreme tightness and, and very strong markets in part because of the constraints on the supply side.

Greg Sharenow (04m 15s):
So if the FED is gonna really move rates much higher and that reduces capital availability further to up upstream investment and investment in power sector and so forth, it could actually end up having a positive long term impact. Now, OPEC action, I think you've characterized what I said pretty accurately. I think that they had some concerns about short term demand and also there is definitely an interest to support prices long term if you do from, from a consumer standpoint, if you do believe we need to get that CapEx invested that we have been shy to do up to now, but I don't think that's the only reason. I think another part of their, their view was that if you think about driving your car and you have your pedal all the way down to the metal, you're gonna start getting some vibrations and if you're OPEC and you're producing at basically your near max capacity, like if you look at Saudi, they were producing 11 million barrels per day recently.

Greg Sharenow (05m 06s):
They've never sustained that for two consecutive months. Sure their surge capacity is still higher, but we haven't really proven that they've had sustainable capacity meaningfully higher. So seeing a reduction in output from OPEC is also probably a lot to do with like creating some flexibility in the system and reducing that vibration. Now the one other piece that has happened since then is also some guidepost from SPR, which in many respects has the same sort of guidelines as what you were saying that OPEC Plus was trying to do, which is creating price stability, which over the long term is arguably going to facilitate more investment if the SPR now can commit to forward buying oil around $70 and OPEC is willing to adjust their own output, at least for right now. Like policies have changed a lot in OPEC as you know, over the last 20 some odd years.

Greg Sharenow (05m 54s):
There's, it's what the response function today is not necessarily what the response function will be tomorrow, but as of right now, SPR as well as you know, OPEC are working to kind of put a floor under our backend oil prices are probably gonna be so in our mind that leads us to having a constructive view on oil over the next 6 or 12 months or certainly that the market is discounting a lot of demand weakness that could come potentially from the FED tightening, particularly if the FED tightening leads to lower CapEx. Now your question on China, what's remarkable about these commodity markets, and I made reference to it before in the last cycle up in commodities was very much led by China and if you go back almost two years ago at Pimco in our secular forum we were talking about, it used to be that if the US sneeze is the world caught a cold and we were almost talking, we were talking more like two or three years ago about how the response function of global growth that changes in China growth is becoming like a three month lag and it all of a sudden is not just the US is now China's impulse function.

Greg Sharenow (06m 51s):
And that was even more true for commodities given their large share of not only growth but also their large share of absolute demand now given how much they've grown over the last 15, 20 years. So we've actually had incredibly tight commodity markets across the whole chain. Almost all commodities are in a state of backwardation, which is usually consistent with low inventories and type and tight fundamentals where people are willing to pay a premium for prompt delivery and you've managed to have this with China being a negative impulse. So when I look out to next year, I would love to know what exactly China's gonna grow. Like we have our view that they're still gonna grow at a slower rate than they have been and probably decelerating, but you know, if they're growing and they start changing their COVID policies, that could be a real positive catalyst. But up until, you know, they make that decision there, there are headwind to commodities and I think that's the challenge for prices and if not if we hadn't had that I don't know where prices would've been to be honest, it would've been a lot higher and a lot more painful.

David Greely (07m 49s):
Yeah, it's such a great point. You know, when you think about where would we be if China, you and I was not locking down so much of its economy over this period and there was some real demand in this market because the supply side is so tight and I wanted to ask you a bit, you know, you brought up that point of we now have these markets being managed by policy makers from so many different directions. You've got the OPEC plus trying to, you know, keep prices elevated and arguably stable. You've got the US using the SPR to try to keep prices low but then maybe agreeing that they can't be too low. You've got the FED trying to tame inflation, you've got

Chinese, you know, how are you, there just seems like there's so much more policy choices and credibility of policy makers that you must have to think about today relative to, you know, years ago you feel that way?

Greg Sharenow (08m 45s):
For sure. I mean we had the Twitter wars also for four years before and we've had COVID so there's been a lot of policy shifts and challenges I feel like since the start of COVID I like to always remark to people, you know, at one point when you and I were working together, you know, we were trying to get supply and demand down to like a couple hundred thousand barrels a day. Now our uncertainty of like all the inputs could be half a million to a million barrels a day easily. You know, like China demand, if they reaccelerate like that could be 500,000 barrels per day more demand next year. The uncertainty bands are certainly wide and I think that's part of what is also contributing to a lot of the constructive nature of the market because it really challenges CapEx you know, if you, if you're sitting there looking at this environment and you're looking at policy uncertainty, looking at demand uncertainty, you know, and the policy being China's COVID as well as fiscal policy, which in which is a really big deal in Europe right now and is having a big outsize impact on the market and certainly the political future of some of some leaders in Europe and the rising concerns that are leading to protests in the street.

Greg Sharenow (09m 51s):
Like there's a lot of uncertainty. It definitely makes one have to be more nimble, but I actually think it also makes the CapEx decisions to solve some of the supply side challenges even more difficult because of all these uncertainties.

David Greely (10m 04s):
Yeah, and I definitely wanna dig into that point with you, but before we get there, there, just thinking about in this series we've been talking about the coming winter with a lot of it being focused on Europe and it's been interesting in that the US has been a little bit sheltered so far. You know, gasoline prices have come down and you know, in a typical tight energy market in the US we focus on gasoline, but with so much LNG going into Europe at this point, you're starting to see, you know, natural gas shortages in Southeast Asia due to LNG being diverted and now you've got the concerns around the US northeast getting enough heating fuels this winter because, you know, due to lack of pipelines, a lot of the northeast is an LNG importer as well and we'll be competing with Europe for those cargoes. I've already seen diesel prices are very high, which means high home heating oil prices in the Northeast as well and so I was curious, I mean I'm sure that'll get us policy makers engaged with high heating prices in the US with winter, but how are you thinking about some of the spillovers from the European energy markets into these broader energy markets and kind of those ripple effects across commodities right now?

Greg Sharenow (11m 10s):
Well if I can also widen that and say what is the ripple effects across the economies in the politics because it's the epicenter has been Europe, but the echo has been global and the way you see it has frankly in the real wage contraction that you're seeing that is, that is very, very sharp in Europe in particular, but elsewhere, the European energy crisis has many impacts on other commodities for example, high natural gas prices are leading to higher coal prices, higher power prices, which has the implications for creating higher coal prices elsewhere as well, which has the feed through to higher power prices. It has a substitution effect into oil. Now I'm a little less alarmist than some others on the outlook for winter in Europe. I think there's been a bit of a migration to that view recently because you've seen cash prices in Europe trading down from a high of €350 in megawatt hour.

Greg Sharenow (12m 15s):
I think this weekend traded 50 or 60. I mean that's a pretty big change now. The forward curves are still pricing a big premium. I think the challenge that we all have is figuring out what the demand response functions are when you've never seen prices in this neighborhood and if you look in the past you've seen price spikes and you kind of get a sense of how the demand responded on short term basis, but in almost all those cases, the forward curve was largely unmoved. It was viewed as a transient effect and today it is, the full forward curve is at a huge premium to what anything would've been expected historically. So the reason why I've been a little bit less alarmist is that we have so much excess consumption in our energy systems and there's a lot of actions people can do to save.

Greg Sharenow (12m 58s):
I think part of one of the ironic things we've seen this year is how weak gasoline demand may have been in the United States. It's been much better in Europe, but it's been, it's been weakish in the United States. I think part of that has to do with like, well when your real wages are contracting, you start looking at ways of saving energy. Now if you're a European energy consumer, I mean you cannot heat your whole home you can you know, maybe move back in with your parents, you can work from the office more and let the let your

firms pay your heating bills. Like there's a lot of actions that like awareness can actually lead to a material change and like, and you know that changing your thermostats by one or two degrees has a huge implication for energy consumption as well as, you know, curtailing peak power demand has a material impact on thermal generation because thermal is your marginal generation.

Greg Sharenow (13m 44s):
So I think what's gonna happen in Europe and at, if I am right, which I'm really hoping I am because it'll have meaningful implications on the fiscal stress in Europe and their ability to manage through their needed subsidies that they're planning or the planned subsidies, whether or not you can say that that's a good idea and if it's needed, but you know, as Europe consumers go, I think a lot is gonna go in the global market. You know, if we end up getting the 15% consumption out of the consumers, that'll be meaningfully lowered tax on industrial output, potentially it'll have a meaningfully lower energy prices that you could potentially expect in Europe and in Asia and elsewhere who are big energy importers who are competing with Europe. So it's sad to say but as Europe goes, like we may end up go the energy markets now oil could have its own independent issues because of Russian sanctions that are upcoming and OPEC and their decisions and you know, there's a variety of things that can make that market different, but certainly when it comes to gas and coal, I mean it's Europe can really control and hold a lot of the outcomes cause we've seen weaknesses in other places as you referenced from the high prices that are causing real strains for Asian importers in some of the lower income countries. So it's a real, you know, if you're can figure out how to contain its own demand, you know, that will be very helpful in relieving some of the pressure elsewhere.

David Greely (14m 59s):
Yeah, absolutely, so it sounds like near term it's a demand side management issue and hopefully there'll be less painful ways of handling it relative to what could potentially be more painful ways, but I wanted to get back to you to that longer term issue that, you know, over the long term it's really about investment, right and it's about getting investment in oil and gas production, other forms of energy production and I was curious, you know, from your seat, how big a problem do you see in terms of under investment and how have you experienced like the reluctance to invest in the space as a portfolio manager where you know, you're managing the portfolios for commodities and real assets at Pimco?

Greg Sharenow (15m 38s):
You know, we spend a lot of time with the corporates trying to understand their decision functions, trying to get a handle of what dollars are going back in and the reality is you know, they at one point we're spending 120% of free cash flow and an hour spending 40% or 50%. You look at the changes in oil production relative to what you would've expected at similar prices and you look at changes in investment in terms of rigs, I mean it's meaningfully lower and what I think is a very interesting stat, if you look at the international energy agencies investment outlook that was published a few months ago, you know, they were commenting also that 50% of your increase in global energy expenditures this year is all cost. So when you look at an inflation related, so when you look at companies, they really are, it's amazing how often I talk to them and they're really more concerned about their cost and cost management because of how investors view and treat their equities when they increase CapEx and have higher costs associated with it, it's very negative.

Greg Sharenow (16m 33s):
So when you look at the oil and gas side, we're investing about 15% below where we were in 2018 and 2019, despite prices about 30% higher on a real basis that's nominal on a real basis, it's like 25% below. I mean, companies are just being more disciplined now. I think it's being a function of a few things. One, investors are demanding it after a very long period of subpar returns and they want to be paid for their risk that they're taking. The second part is, is now think about anything long term CapEx related. You don't just have the demand uncertainty associated with the energy transition, you have liabilities, you know, you know that the environmental policies are gonna change. What is your carbon exposure, what is your remediation exposure. As you start expanding time, the uncertainty bounds around these policies and the demand outlook and so forth just get wider and wider and wider.

Greg Sharenow (17m 25s):
And I think that's very challenging for companies to justify and operate in that environment and that's why you see a lot of investments more likely to be green lighted in renewable diesel, which with LCFS markets down here, I mean it's gotta be really challenged, but at least they can make a justification that in the long term it's a aligned where the puck may be going. Problem is it's just a long skate between now and then and the energy markets and that's not just true in oil and gas exchange, it's also true in power and the scary thing is that while in the long term more growth in renewables, more growth in storage for renewable, you know, associated renewables are the grid is going to lead to lower prices. In our mind, the broadly deflationary as we saw for a long time, the problem is

we've done such damage to the base load generation that we've added intermittent sources that aren't able to meet the full spectrum of our needs.

Greg Sharenow (18m 17s):
So I think you're gonna end up in a situation where the next three to five years you're gonna have higher and more volatile energy prices because the CapEx decisions that have been made before and the challenges of making incremental CapEx to improve your base load capacity if it's thermal related or even nuclear in many places, even though nuclear is having a bit of a renaissance, it's still, it's definitely a two track system where some are going in the opposite direction, it's just gonna be very challenged to meet the energy needs. It certainly if the economy begins to, to grow again, you know, in a meaningful way.

David Greely (18m 49s):
Yeah, it seems like such an intractable issue. Like I've heard from a number of guests now this point of, you know, a lot of the infrastructure that needs to get billed is something that, you know, you'd want it to have a 20, 30 year lifespan and people look at it and go, Susan Sakmar talking about LNG said, you know, when people are thinking about an LNG investment, it's like, oh fine, that's great, we need LNG now, but what if in 10 years we're not allowed to use gas anymore, can this be converted for hydrogen and you know, what you were saying made me think of that a little bit too of you know, with the clean diesel of you know, okay, can you, can you take this investment and convert it into something in five years or 10 years that's gonna continue to generate returns and that seems like a very hard plan, a high bar for corporate to try to meet in making an investment. Is this pretty widespread?

Greg Sharenow (19m 36s):
Yeah, I think the policy uncertainty is what you're referencing there and the fact that if you look at clean diesel for example, I mean it relies on policy incentives and if you look at some of the other investments, it's really very policy and if the policy is going to change with different political wins, it does make the challenges harder and certainly consumers and governments are willing to look at the next three and five years and make that decision, but as you reference, it's harder to make that decision over a 20 year, 30 year period. Now we're definitely moving into a peer with higher LNG FIDs gonna be made. I even if it's the lesser of all the evils, it's one that markets are paying for. So I think you're gonna see more LNG projects but when you start looking at some of the other projects that would otherwise go, I think you can easily say that some of the challenges are real.

Greg Sharenow (20m 25s):
Now my, my real concern about LNG is that everyone might want to build an LNG import terminal and lots of builders in the US want to be l LNG export terminals. We have to accompany that with upstream. Now if you're in East Africa, they are paired and there's some other areas of the world where they're gonna be paired like in Qatar, but in places like the US I mean we have to be able to invest to keep up with the LNG export capacity that could come down the line and you know, permitting is a big portion of the challenges in doing so.

David Greely (20:55):
Yeah, we don't want to start paying European prices for natural gas in the US if we build all the export terminals, but not the upstream production facilities.

Greg Sharenow (21m 02s):
Unless they're both at six, then

David Greely (21m 03s):
You're then it's okay, but I imagine that's not your forecast.

Greg Sharenow (21m 08s):
No, that's not but I definitely you would expect that over time you're gonna see compression in the ERBS because the incentives are there just like dollars will flow through the highest margin. It's not a grand philosophical statement of like insight. I'm more just saying like, investors go or returns are LNG, ERBS are high, we should invest to rectify that.

David Greely (21m 30s):
Right, right. Well I want to follow the investment dollars upstream with you for a moment in that, you know, if you look US inflation's the highest it's been in 40 years the strength of the dollar against other currencies means, you know, commodity prices are much more

painful outside the US The conventional 60-40 equity bond portfolio I think just had its worst year in a century. So I'm curious, how are investors, you know, who ultimately will finance projects through, you know, investments in companies and more directly in commodities are investors, you know, responding to the situation and is the attitude towards investments in commodities and real assets changing at this point?

Greg Sharenow (22m 13s):
Yes, but it's fairly nuanced. So I think if you look at the 60-40 portfolio, there's a period of time which has a large historical sample where the correlations aren't negative between fixed income and equities and usually in that environment tends to be associated with inflationary environments and you've seen that in the past year where inflation is really picked up its head, you know, growth rates are coming down, nominal rates are going up and it creates a real problematic time for investors. So owning inflation assets are more important than maybe other periods where growth is a dominant factor when inflation's a dominant, you know, inflation related assets are in higher demand for portfolio diversification. So there's definitely a lot of clients who are interested in hedging their inflation risk to their portfolio. The thing is, is that there are a lot of scars, particularly in the United States from long periods of poor commodity returns and low inflation where it wasn't the best use of dollar.

Greg Sharenow (23m 22s):
Now the problem is, is it's when we have the regime shifts that like you had it have had the investment and while there's definitely some regret from a lot of the US investor base who weren't really actively engaged like they may have been 10 or 15 years ago, I think the challenges that many are debating now is like, can you buy commodities today if the forward economic ALEC is lower. So there's a tug of war between those who can get over that hump and view it from a portfolio diversification standpoint versus those who are like will say, well in a bad economic outlook, do I want to own commodities and you know, they're at a higher nominal price than they've been and as a result like I should not be interested. So there's, it's a two way conversation and the other part of that is that for those who were invested because your 60-40 went down so much and commodities are up, if you had a 3% allocation now you might be at 4.5% or 5% today.

Greg Sharenow (24m 11s):
So just you know, portfolio rebalancing, take the cash from here to finance other ills in your portfolio, but the interesting part, and this is unexpected to me to be honest, is that the global investor, particularly in Asia, Latin America, places that historically have had a high leverage to EM growth and as a result would've felt more insulated in an inflationary cycle, a commodity cycle than they have been this time. Never had that EM virtual demand growth and never had the EM growth story kind of what I mentioned before about China. You never had the growth but you still got the commodity, you know, inflation because of the supplies exchange. All of a sudden they're finding themselves very subject to changes in inflation globally, changes in the US FED policy and have found themself on the tail end of the inflation cycle and have become more and more interested in hedging their inflation.

Greg Sharenow (25m 02s):
So while US, what our perception is, the US investors are very much split and there's some who are reducing for various reasons or some who have just missed it and they're now concerned because of a demand. The global investor has been much more interested than they have been in past cycles in part because of the nature of this, you know, rise in prices have been much more on the supply rather than the virtuous economic boom EM led cycle that we had before. So everyone is having a different experience right now in terms of how, or rather everyone's having a shared experience and have wrong different conclusions on how to manage going. There's no rock you can hide on that's big enough, you know?

David Greely (25m 39s):
Yeah, no it's great cause it is like you look at it and say okay, we've got an energy crisis, high inflation, central banks tightening equity markets, falling bond markets not diversifying, which often seems like that classic environment for commodities, but you know, as you said there's a long history of investors who that did not go well for them and it takes time to change that attitude and look back at the diversification. I'm curious from your perspective though, like where do you see as some of the bigger investment opportunities and commodities and real assets over the medium term?

Greg Sharenow (26m 14s):
You know, so I think probably the part of the commodity complex where we think has the best medium term outlook is the oil space in part because of the real limitations that we think are happening on the growth and the production side. When I look at other commodities such as agriculture, while the environment is very tight right now and we've had two years of some fairly unfavorable

weather conditions, ultimately every year this volatility on the supply side is meaningfully higher than the volatility on the demand side. So if you have good growing conditions, you can start seeing a rebuilding of stock. So it's hard to, harder to have like a strong view that these prices are sustainable in agriculture without knowing the weather. Now we do know that there's been higher inflationary pressures that will likely limit the ability to bring in additional marginal acreage.

Greg Sharenow (27m 05s):
We've seen some, what we believe is some plateauing or definite slowing of the ability of places like Brazil to bring in additional acreage. So we do think that there is inflationary potential in the agro space, but I would describe it more as we have a more much like power and gas, like we have a much more brittle system. So as if you do believe that the climate is becoming less stable, more volatile, AG potentially gonna have a higher likelihood to see price spikes than you would've seen maybe 10 or 15 years ago. If you think that this is like a real structural change and we had a speaker in from Nassau who was talking to us about this and I think the way you conclude from that is you would expect higher average prices, but definitely higher vol than you would've expected before.

Greg Sharenow (27m 46s):
So our starting point on the AG market still on the near term is on a constructive side because of where inventories are and where the harvest has been, but at least the worst has been avoided in the US for corn and soya but it still was not a great year and then when I look at metals, I think a lot of it has to do with as China goes, the metals markets will go, we are seeing some reductions in CapEx in the metal side as prices have come down and amazing they're doing it at higher price levels than you would may have expect in the past, but again, related to inflationary pressures, but China still is the biggest mover. So yes, the energy transition has positives for the metal space, but it's hard to offset the size and scale of China growth to their implications for that to the metals markets. Does that answer your question or?

David Greely (28m 29s):
Oh yeah, absolutely. So sounds like the oil sector is the one that you're favorable on in the medium term and probably on the upstream.

Greg Sharenow (28m 37s):
Yes and I think that also is gonna ultimately drive a lot of what happens in other commodities. Yeah. Like for example, if oil has and the investment, the cost of investing in other upstream, you know, production, whether it be in metals or agriculture becomes more less challenging you know, high fertilizer prices and ammonia prices as a result of what's happen in Europe. Like if that reverses, that certainly reduces some of the pressures in the system. But I do think oil is the one that has the greatest constraints. Certainly natural gas is, is been very tight, but the ability of Russia to shock Europe now has gone, you know, there were 400 million cubic meters a day 40% they're now 40 into Northwest Europe. I mean there's always zero and, and that wouldn't be easy adjustment but like in the oil market their built, their potential drop in exports alone can dramatically keep, you know, can keep this market really tight for a very long time. So we think oil health's a better outlook right now.

David Greely (29m 36s):
Yeah, and you gave us a great tour of, you know, kind of the, the current commodity landscape, but I wanted to ask you, cause our next podcast series is gonna be on financing the energy transition and of course the energy transition as it's conceptualized requires moving, you know, a pretty big change in the commodities landscape. You know, we're gonna go into pricing carbon, decreased use of fossil fuels, increase use of metals and minerals like copper, nickel, lithium, cobalt for electric vehicles and renew renewable power generation. You know, when we talk about commodity markets, I don't know whether it's in five years or 10 years or longer, it might be a different set of markets that we're focused on and I'm curious, how are you thinking about that from an investing standpoint, like investing in traditional commodity sectors versus the commodity sectors that, you know, the world's increasingly committed to transitioning toward and you know, is that space even investible at this point?

Greg Sharenow (30m 36s):
So I think we're not gonna see a phase out or retirement of trading and investing opportunities in traditional energy because we have yet to prove that the world can move off of any, We've seen lower shares over time for different commodities, but we, our wood consumption and you know, coal and, and you name it, like we've just largely been by, we've just, we're always at adding because the global energy market. So I think it's our expectation in five years is that, you know, we are, our invest in space is still gonna be very similar to today with additional opportunities. Carbon for example, you mentioned I think is an area of growing interest now talk about a market that has a big policy driven views, right, you know, Europe going for 50-55 had a meaningful impact on the forward supply of

European emissions allowances and US California policy is another market that is potentially gonna change given the new carbon neutrality goal by 2045.

Greg Sharenow (31m 33s):
That was just brought into law, but you know, these markets are gonna be very interesting because one of the ways in which the globe is gonna try to make that transition is through bringing in carbon prices and carbon is like letting the market try to solve is hopefully the way forward, but some places will be more command and control, some places will be carbon taxes and just assume that they know the right place to get the outcome they want, but you know, it's definitely gonna be an area where you'll have greater opportunities for investing. Now if I think more broad across asset classes, I think it argues for a very flexible approach because you are gonna have periods of time where different areas are gonna have higher rates of return and just being in any one sector just energy transition and not investing in the old line energy markets could leave pretty big gaps in in one's portfolio.

Greg Sharenow (32m 18s):
Particularly if you're really thinking about this area as part of your inflation hedging basket. So like it's not just a return center but it's a return and inflation, then you kind of need to have what drives inflation and right now oil is still and food in the emerging markets and elsewhere still the biggest contributors to the volatility inflation. Now core inflation has really had its own year and a half right now where volatility there is certainly picked up, but if you want to hedge and have your view about that as inflation related, you can't ignore the old line commodities and in terms of being investible, there's definitely the capital markets are ignoring some of the challenges very recently with the higher rates and reduction ability for the market IPO and new technology, technology sector's kind of the epicenter of some of those challenges, it's gonna continue to grow and there's opportunities in companies that are going to be able to take advantage of some of some of the growth industries.

Greg Sharenow (33m 14s):
The challenge that I have and Dave and I have seen this over and over again, like if I want to invest in a company that's gonna build batteries, for example, for the grid, they're all gonna target the same hour or two or three a day. So you always have to be very careful with like how much you expect current margins to sustain. That's just like, I'm throwing that out there is like, I mean I can't you, you can't tell you how many times you're like, oh look at the rate return you can get from hours 16 and 17, which used to be hours 13, 14, 15, you know, and everyone's gonna invest into that and next thing you know that isn't the hour and all of a sudden it's some other hour. So you have to be pretty careful. So I think knowing the history of the challenges and investing in solar globally, investing in wind investing in some of these technologies is gonna be really important for investors to take those lessons and learn them because you don't want to put money behind an investment theme and you're relying on something that is very challenging.

Greg Sharenow (34:08):
Kind of like I made a comment before about renewable diesel, look at the LCFS market, like we looked at a bunch of projects two years ago and it's funny, we got called to sell puts to hedgers because they all needed to have 125 or 120 to generate a good return for their investment and we're trading 65 or 70 now. I mean it's challenging because the growth in projects that we're looking oh 200, this is great, commodity markets are really volatile. So I really suggest having a very broad approach and having a very flexible approach because you have to appreciate just how volatile they are.

David Greely (34m 42s):
And with that volatility in mind, I was curious, you know, from your perspective, what would be the most helpful in helping us finance the transition into some of these newer forms of energy, is it better risk management, is it better education, what do you see from your end?

Greg Sharenow (35m 00s):
I think policy certainty and clarity would all be very helpful, but that I optimistic we get there. If you look at Europe, if you look at the United States, the western world is really struggling with that. China probably has like a slightly greater ease in imposing policy certainty, but even there we've seen changes in the way in which they've approached their heavy emitting industries. So I think the big challenge is to deal with that. I think the other challenge is to deal with a lot of the efforts in deglobalization and some of the challenges that a lot of countries don't want to rely on energy or mineral suppliers from other countries and view it as a zero sum game and I think that also threatens to reduce the available amount of money that will float to the upstream you know, supply of energy. When I say upstream, I'm not just meaning oil and gas in that standpoint.

Greg Sharenow (35m 51s):
So I think the energy transition is going to require a massive amount of capital and some of these hurdles are just a real challenge at the very least one would say we can control policy a little bit better than we have and put some good policy in place and if you look at the political outcomes you're seeing in Europe with people in the streets and the, and the pressure and rising populism, like you can see the imperative of doing so. I'm just afraid that these events cause bad outcomes as a short term and political imperative, which again reduces the incentive and ability to invest. The other thing also is hedging is really hard as you go into less liquid commodities and a lot of the banks face different tiering on their capital. So if you trade something that's highly ill liquid or something really long dated, they have to have higher capital charges and greater reserves against it, which is probably good for the overall finance stability of the system, but also makes hedging very challenging. So there's a bit of a dearth of capital out there dedicated to helping facilitate that. I think that's an opportunity for investors, but it's definitely an obstacle to growth of that CapEx.

David Greely (37m 01s):
Thanks again to Greg Sharenow, Managing Director and Portfolio Manager for Commodities and Real Assets at Pimco. We hope you enjoyed the episode. This concludes our series, Winter is Coming on Smarter Markets. Next week we begin our new series financing the energy transition in which we'll talk with the investors, financiers and project developers who are working to finance the energy transition and to use carbon financing to fund carbon reduction projects. We'll be discussing the current state of the energy transition, ESG and carbon finance, and what is needed to invest in the energy transition and carbon reduction at scale. We hope you'll join us.

Announcer (37m 39s):
This episode was brought to you in part by Abaxx Exchange Market. Participants need the confidence and ability to secure funding for resource development, production processing, refining and transportation of commodities across the globe with markets for LNG, battery metals and emissions offsets at the core of the transition to sustainability, Abaxx Exchange is building solutions to manage risk in these rapidly changing global markets, facilitating futures and adoptions contracts designed to offer market participants clear price signals and hedging capabilities in those markets, essential to our sustainable energy transition. Abaxx Exchange, bringing you better benchmarks, better technology, and better tools for risk management. That concludes this week's episode of Smarter Markets by Abaxx. For episode transcripts and additional episode information, including research, editorial and video content, please visit smartermarkets.media. Please help more people discover the podcast by leaving a review on Apple Podcast. Spotify, YouTube, or your favorite podcast platform. Smarter Markets is presented for informational and entertainment purposes only. The information presented on Smarter Markets should not be construed as investment advice. Always consult a licensed investment professional before making investment decisions. The views and opinions expressed on Smarter Markets are those of the participants and do not necessarily reflect those of the show's hosts or producer. Smarter Markets, it's hosts, guests, employees, and producer Abaxx Technologies shall not be held liable for losses resulting from investment decisions based on informational viewpoints presented on Smarter Markets. Thank you for listening and please join us again next week.