

Policy, Politics & Portfolios

IMPLICATIONS OF ENERGY POLICY FOR TODAY AND TOMORROW

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Global oil and gas output has been relatively flat this year despite the sharp rebound in energy prices, strong economic growth, and a drop in COVID-19 cases. Key drivers behind subpar production in this sector include pressure from investors and environmentalists along with government policies and discipline from OPEC+.¹

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The latest energy-price “spike” threatens to slow, not reverse, what has been a stunning recovery from the economic shock of the pandemic. As in the past, however, higher fuel costs will have a varying impact across the economy, hitting hardest at lower-income households and energy-intensive industries.

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Clean energy is a priority for the Biden administration. Yet, the transition to renewables in the U.S. has been slow. The future of energy in the U.S. may be green, but it will not be a speedy transition.

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1. The Organization of the Petroleum Exporting Countries and others such as Russia.

Constrained output in the Energy patch

Transition in the Energy sector

On the surface, the current environment has been ideal this year for U.S. energy companies to increase fossil fuel production. West Texas Intermediate (WTI) crude oil has been trading above \$80 per barrel, up 67% year-to-date, and the average price at the pump for motorists has recently spiked from \$2.25 to \$3.40. Natural gas prices have also doubled due to a freeze in Texas earlier this year, Gulf of Mexico storms, and hot summer weather.

The aforementioned scenario should be a huge incentive for U.S. energy companies to substantially increase drilling and production. Yet, U.S. oil production, which started the year at 11.1 million barrels per day (MBPD) has barely moved higher to just 11.5 MBPD. Similarly, natural gas production has risen just slightly this year despite the huge jump in price. Consistent with limited production increases, oil companies have cut U.S. capital spending to an estimated \$55.8 billion this year, compared with \$60.8 billion last year and \$108 billion in 2019. U.S. oil-field investments peaked at about \$184 billion in 2014.

The fact that energy companies are holding back on production even as oil and gas prices surge clearly indicates that the industry has changed from the growth-at-any-cost approach that occurred from 2014-2016 and ultimately led to a supply glut and plunging prices. Key factors behind the Energy sector's transition include the following:

1. **Pressure from investors** — Prior to the pandemic, whenever crude prices climbed, U.S. producers would ramp up production regardless of the impact on their bottom lines. Investors took notice as energy companies were the worst-performing sector in the S&P 500 Index by a wide margin from 2014-2020, registering a negative total return. Investors and banks are now pressuring oil companies to pay off debts from the shale boom and return extra cash to shareholders, which in turn has led to spending and production cuts. Wall Street has taken notice by rewarding energy companies as the best performing sector year-to-date.
2. **Environmental, social, and governance (ESG)** — In response to ESG concerns, investors and banks have also pressured energy companies to evaluate future ventures as related to carbon foot prints. Case in point, a large oil company is debating whether to scrap two potential projects overseas based on how they would affect the company's ability to meet pledges to reduce emissions. This follows another major oil company's decision to sell all of its assets in the Permian Basin with the goal of reducing its carbon emissions and investing in renewable energy.

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U.S. oil production, which started the year at 11 million barrels per day (MBPD), has barely moved higher to just 11.5 MBPD.

Sources: Bloomberg, Wells Fargo Investment Institute

Oil companies have cut U.S. capital spending to an estimated \$55.8 billion this year, down from a peak of about \$184 billion in 2014.

Source: Wall Street Journal, October 13, 2021, page B12, Evercore ISI

3. **Government policies** — The Biden administration has openly discouraged energy production in the U.S. Most noteworthy is the fact that President Biden has called on OPEC+ to increase oil production to relieve price pressures in the U.S. while at the same time discouraging domestic output. To date, OPEC+ has defied U.S. pressure and recently announced that it will continue its program agreed to last July of increasing oil production by 400,000 barrels per day each month.

How things could change

The restricted quantity of U.S. oil and natural gas production and OPEC+ to date could reverse quickly. First, the American consumer has become increasingly frustrated with higher gas prices and may force the Biden administration to rethink its current energy strategy.

Second, despite the aforementioned pressures from investors and environmentalists, producers will soon need to ramp up drilling activity. To be sure, post-pandemic growth has come predominantly from completions of drilled but uncompleted wells (DUCs). But these wells for the most part have been exhausted, and many companies will need to restart more drilling rigs just to keep production flat.

Finally, OPEC+ has displayed remarkable discipline by maintaining predetermined production levels despite the sharp rise in oil prices and pressure from the Biden administration to increase output. This could change, however, if U.S. producers exhibit signs of ramping up production.

Key takeaways

- Constrained oil and gas output amid rising demand has led to higher energy costs with stronger profits and equity-share prices within the industry.
- The current environment for the Energy sector as it pertains to output could quickly change, triggering increased production and drilling — affecting prices; profits; and environmental, social, and corporate governance (ESG) policies.

Flame out? Gauging the economic impact of rising fuel costs

Will energy sink the growth cycle?

Rising fuel prices have joined supply shortages, the risk of a resurgent pandemic, rising interest rates, and reduced fiscal stimulus on the list of potential headwinds to satisfactory growth in 2022. However, we view rising energy costs as more of a threat to the strength of economic growth than to the expansion itself for the following reasons:

- Rising fuel costs this year aren't unprecedented, having been exceeded in decades past.
- Inflation-adjusted fuel costs (a better measure of their "bite" on economic activity), though elevated, aren't inordinately high by historic standards.
- Energy conservation and the shift in spending and activity toward less fuel-intensive services have reduced our vulnerability to periodic spikes in fuel costs.
- Increased energy independence, propelled by rising oil and natural gas output, has further reduced the net impact of higher fuel costs on the U.S. economy.

Energy's impact on U.S. inflation this year is apparent from its 30% year-over-year increase in October, a multiple of the 4.6% rise in the "core" Consumer Price Index (CPI) excluding food and energy. The full impact of higher energy prices will continue to be felt in coming months as input-cost increases in an array of seemingly unrelated goods and services industries. However, recent increases in inflation-adjusted oil and natural gas prices have still left them below previous peaks in 2014 and short of what was typical prior to the emergence of the U.S. fracking industry.

In fact, the combination of conservation and a secular shift in household spending patterns toward services has kept energy's share of the household budget at a historically low level. As of September 2021, energy expenses were 3.6% of disposable income, still much lower than the average 4.4% of the past decade. This gap represents \$143 billion in total savings to consumers, or an annual \$1,125 per household. True, energy's relatively small share of the household budget normally doesn't prevent adjustment in spending patterns as fuel costs rise. However, we believe that adjustment is being cushioned now by sizable household savings boosted, in part, by direct government stimulus. By one estimate, for example, cumulative household savings from February 2020 to September 2021 amounted to \$2.3 trillion, allowing households, as a group, to accommodate higher fuel costs without an abrupt pullback in other spending.²

2. Peak bottleneck, then peak inflation, November 2, 2021, Strategas

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The tilt away from energy-intensive goods production is underscored by the rising share of private-sector services activity in gross domestic product (GDP) to over 66% last year from 42% at the time of the first oil crisis in 1974.

Source: U.S. Commerce Department, Gross Output by Industry, September 2021

Energy expenses were 3.6% of disposable income as of September 2021, still below the average 4.4% of the past decade despite recent increases. Fuel's lower share of the budget translated to annualized savings of \$1,125 per household.

We think the hardest hit, however, will be lower-income groups, whose fuel costs take up a relatively large share of their budget and whose saving rates historically have been well below the overall average of more than 7%. By one estimate, the saving rate of the lowest three quintile groups is negative (partly — but not solely — due to retirees and unemployed included in this group), compared to 12% for the top income quintile group.³

Higher energy costs permeate the economy. However, the full impact is cushioned by an ongoing shift from energy-intensive goods production to less energy-intensive services activity. In the private sector alone, services currently account for two-thirds of activity compared to little more than 42% when the first oil crisis hit the economy in 1974.⁴

Lastly, the U.S. has become more energy independent. Fracking has provided a material boost to the U.S. energy industry, a sector of the economy benefiting, of course, from higher fuel prices. The U.S. Commerce Department estimates that output of the oil and gas extraction industry climbed to a prepandemic peak of \$409 billion in 2018 from an average of less than \$170 billion a year prior to the full development of the fracking industry in 2000-2006.

Investment implications

Rising energy costs will continue to pose a headwind to consumer-spending growth in the coming year, but we don't expect the increases to have an overriding effect on what we believe will be above-average strength for the economy through the middle of next year. The growth outlook supports our favorable view of economically sensitive industrials.

At the same time, higher fuel costs can hurt defensive sectors of the stock market in two ways. First, several defensive sectors also carry relatively high dividends, most sensitive to higher interest rates propelled by energy-led increases in inflation. Second, spending on brand-name essentials, or consumer staples, could be hurt by the disproportionate impact of higher fuel costs on lower-income groups, risking cuts or a rotation toward cheaper private-label and other discounted brands.

Taking the longer view, we don't expect a quick return to low-cost energy prevalent during the heyday of fracking, one reason why we think that the economic impact of elevated fuel costs may play out over an extended period. The U.S. fracking industry, expected to be the swing producer during periods of energy-market volatility, has been restrained by increased discipline imposed by investors. Moreover, uncertainty over peak demand for fossil fuels, aggravated by the growth of renewables activity, appears to be restraining investment in deep water and other traditional exploration projects with a longer gestation period.

Key takeaways

- Higher energy costs have a real but limited impact on consumer budgets and would be unlikely to impede the economic growth trajectory. We favor equities over fixed income.
- Rising energy costs could continue to pressure nominal consumer budgets but won't be large enough, we believe, to derail consumer spending before the holiday season. That's one reason why we favor cyclically sensitive Industrials over defensive sectors of the market.

3. U.S. Economic Analyst, Goldman Sachs, February 2020

4. Survey of Current Business, Bureau of Economic Analysis, September 31, 2021. Data as of December 31, 2020.

Renewables and the Biden administration

A greener future?

Earlier this month, President Biden announced new actions to reduce greenhouse gas emissions and invest in clean energy initiatives at the Conference of Parties (COP26) United Nations Climate Change Conference in Glasgow, Scotland. The move away from fossil fuels and toward renewables in the U.S. has been slow but remains a priority for the White House. Today, fossil fuel usage remains 80% of U.S. energy consumption, but nonfossil fuel sources like wind and solar are gaining share gradually (see chart below). And support for green energy appears bipartisan (see sidebar 1). Yet, with the prices of oil and natural gas rising of late, voters may become frustrated with paying more at the pump and for heating their homes this winter. Such sentiment may impede the adoption of renewable sources of energy but would be unlikely to derail the transition to a greener U.S. energy future, in our view. Readers should note, it will not be a speedy transition.

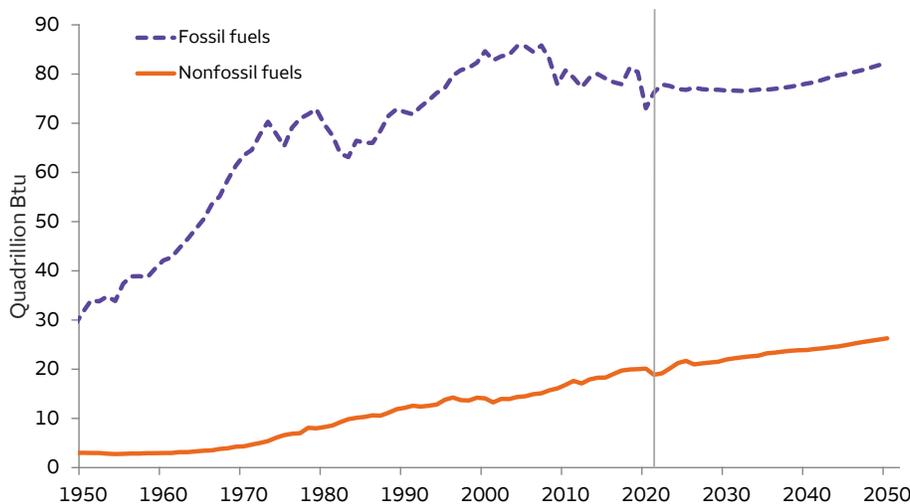
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77% of Americans say it's more important for the U.S. to develop alternative energy sources like solar and wind than produce more fossil fuels.

Source: Pew Research Center, January 15, 2020

Chart 1. U.S. fossil fuel and nonfossil fuel consumption (projections to 2050)



Sources: U.S. Energy Information Administration (EIA) and Wells Fargo Investment Institute, November 15, 2021. Yearly data: 1950-2050. Fossil fuels include coal, natural gas, and petroleum and other liquids. Nonfossil fuels include wind, solar, hydropower, biomass, geothermal, and nuclear.

Today 80% of total energy use in the U.S. is fossil, a dip of only 3% over the past decade.

Green energy is a priority for the Biden administration

Like President Obama’s clean energy policies, renewables and green energy are a priority for the Biden administration. During the first weeks in office, the current administration halted completion of a major pipeline, rejoined the Paris Climate Accord, and suspended oil and gas permitting on federal land and waters. Although coal usage has dropped by over 50% since 2008 in the U.S., total fossil fuel use (which also includes crude oil and natural gas) has remained stubbornly high. Looking ahead, the political winds could continue to shift in favor of green energy as the U.S. electorate adds younger voters and

the environment becomes a dominant political issue for some. Yet, replacing fossil fuels with renewable energy sources will not be a simple endeavor in our view. Lawmakers must balance the environmental benefits of an energy transition away from fossil fuels with the economic costs for their constituents, particularly lower-income families.

The costs and competitiveness of renewable power generation have improved dramatically over the past decade and oftentimes are more competitively priced than traditional fossil fuels. In fact, over two-thirds of the world's new capacity builds are wind or solar.⁵ Yet, issues remain, such as intermittency (renewable energy sources cannot consistently produce energy at all hours of the day), storage, and location (some areas are not viable candidates for renewable power). On demand power sources like fossil fuels and nuclear will likely remain a vital part of the world's energy mix for decades to come.

Investment implications

Investors should prepare for a green future but should also recognize that the transition is a process and not an overnight conversion. Under the current administration, we anticipate more government-led green initiatives that could impact the Energy sector. We currently hold a neutral outlook on Energy as fundamentals support the sector with strong earnings prospects, improving revisions, and reasonable valuations. But these positive attributes are offset by potential regulatory risks, sensitivity to slowing global growth, and near-term cost and political headwinds from green-energy initiatives. The sector also faces secular challenges as the world continues to shift to cleaner energy and its high debt levels are vulnerable to rising rates.

Although the private sector has been moving to develop renewable energy for many years now, it seems that momentum is finally in green energy's corner as companies and countries are falling over themselves to set ambitious renewable energy and carbon-neutral goals. And investor money is following suit as fund flows into renewables investment vehicles (exchange-traded funds and mutual funds) have surged from roughly \$800 million at the end of December 2019 to over \$16 billion as of October 2021.⁶ We expect this trend to continue as environmental, social, and corporate governance (ESG) investing continues to gain popularity. Meanwhile, we also expect demand for energy commodities to rebound further into 2022 as the global recovery continues, travel restrictions ease, and the pandemic fades. We currently favor commodities and expect near-term performance to be bolstered by demand for oil and gasoline.

Key takeaways

- President Biden announced new actions to cut greenhouse gas pollution and invest in clean energy at the Conference of Parties (COP26) summit earlier this month.
- The move away from fossil fuels and toward renewables in the U.S. has been slow.
- Under the current administration, we expect more government-led green initiatives that could impact the Energy sector. We currently hold a neutral outlook on Energy.

5. Bloomberg NEF, November 12, 2021

6. Morningstar, November 12, 2021

Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. There is no guarantee dividend-paying stocks will return more than the overall market. **Dividends** are not guaranteed and are subject to change or elimination. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

An investment's social policy could cause it to forego opportunities to gain exposure to certain industries, companies, sectors or regions of the economy which could cause it to underperform similar investments that do not operate under a social policy. Risks associated with investing in ESG-related strategies can also include a lack of consistency in approach and a lack of transparency in manager methodologies. A socially responsible investing style may shift in and out of favor.

Definitions

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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