

PALOS

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Weekly Commentary

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Are Soaring Natural Gas Prices a Threat to the Global Economy?

While many Canadians think of natural gas ('natgas') as a fuel used to heat our homes during our harsh winters, there is much more to the story. In Canada, natgas is also used to drive gas-powered turbines for electricity generation, fuel natgas powered vehicles, and for commercial uses including fertilizer production, heating water, cooking and cooling.

Although natgas is mostly comprised of methane, other compounds commonly referred to as Natural Gas Liquids (NGL's) include propane, ethane, butane. Canada's conventional reserves, which are extracted via traditional oil and gas drilling methods, are primarily located within porous geological formations found in the **Western Canada Sedimentary Basin (WCSB)**, specifically B.C., Alberta and Saskatchewan. Non-conventional reserves, which are found in non-porous formations like shale rock, require horizontal drilling and hydraulic fracturing (fracking) to access reserved. The **Montney Play** (Montney formation), which straddles the northwest Alberta and northeast B.C. border, is considered one of the most prolific reserves in the world.

Making headlines recently has been the sharp move higher in global natgas prices. European pricing, as reflected by futures markets, have more than doubled since July and increased five-fold since the beginning of the year. Industry analysts cite weather related issues, that are negatively impacting renewable electricity production as one of the contributing factors. There is a geopolitical twist as well. Most of mainland Europe's natgas supply comes from Russia's Gazprom. Last week, Russian President Vladimir Putin commented that he was prepared to boost shipments to stabilize European markets. Many believe higher shipments are tied to the commissioning of Gazprom's recently completed Nord Stream 2 pipeline, which links Russian supply with Germany via the Baltic Sea. Commissioning of the pipeline is facing pressure from opponents in the U.S., Ukraine, Poland, and others.

The spike, which has pushed the costs of industrial applications, power generation, and transportation higher, is raising concerns that an energy crisis may be in the making. In reaction to higher costs, some industries like fertilizer production, smelting and mining are choosing to enact temporary shutdowns until prices normalize.

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Ultimately, this likely means higher food and heating bills. The problem is not just a European one; in China, electricity shortages have the centrist government mandating rolling blackouts and the reduction of operating ours in some factories. This includes the semiconductor industry. As is already well documented, a worldwide chip shortage is having a serious impact on manufacturing, particularly in the mining, power generation and auto industries. Chip manufacturers have commented that the problem may persist well into 2021. Other countries in Asia and India are experience similar problems.

In North America, as of early October, U.S. prices at Henry Hub and Canadian prices at AECO had more than doubled in 2021. Fortunately for us, Canada has among the world's largest reserves. Our natgas industry is well integrated with the U.S due to an extensive network of pipelines and vast supplies on both sides of the border. WCSB gas is a key supplier to markets in the Western U.S. and Midwest while U.S. supply from the Northeast flows to eastern Canadian markets.

The energy sector is critically important to our economy, national security, and government revenues which in turn finance social programs and healthcare. Over the next few weeks, we will be taking a broader look at projects being developed and investment opportunities in the Canadian natgas sector.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) ¹	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$10.12	23.01%
Palos Equity Income Fund - RRSP	PAL101	\$7.77	23.04%
Palos Merchant Fund L.P. (Dec 31, 2020) ²	PAL500	\$1.35	-21.15%
Palos WP Growth Fund - RRSP	PAL213	\$25.11	57.31%
Palos-Mitchell Alpha Fund ³	PAL300	\$10.44	25.22%
S&P TSX Composite (Total Return with dividends reinvested)			22.64%
S&P 500 (Total Return with dividends reinvested)			20.38%
S&P TSX Venture (Total Return with dividends reinvested)			7.21%
Chart 2: Market Data ¹			Value
US Government 10-Year			1.57%
Canadian Government 10-Year			1.59%
Crude Oil Spot			US \$82.28
Gold Spot			US \$1767.20
US Gov't10-Year/Moody BAA Corp. Spread			182 bps
USD/CAD Exchange Rate Spot			US \$0.8088

¹ Period ending October 15, 2021. Data extracted from Bloomberg

² Fund is priced annually

³ Fund is priced weekly on Tuesdays

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