ALL THE CAPITAL, EPISODE 2

Transcript

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Voiceover: The most consequential investment decisions rarely begin with certainty. They begin with questions, debate, and informed judgment. Here, we explore the ideas, opportunities, and tension shaping today's investment landscape through conversations with the people closest to them, revealing not just what's changing, but how we're thinking about what comes next. I am Keshav Rajagopalan and you are listening to *All the Capital*, a podcast from PGIM.

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Keshav Rajagopalan, Head of Strategic Capital Group, PGIM: Thanks for tuning into *All the Capital*. I am your host, Keshav Rajagopalan. In our inaugural episode, we tuned into infrastructure credit markets with a particular focus on Europe. There's an immense capital need there if you think about society's demands and all the aging infrastructure that needs to be replaced around the world. In today's episode, I'm excited to be joined by two of my colleagues to dive into energy markets with a particular focus on oil and gas, another vital good, but with a huge implication for the macroeconomy writ large. Joining me today is Dave Winans, our Credit Analyst in PGIM that focuses on the energy sector; and Jay Saunders, Portfolio Manager for natural resources and global power solutions on the equity side from Jennison. Welcome, Jay and David.

Jay Saunders, Research Analyst and Portfolio Manager, Jennison: Thanks, Keshav.

Dave Winans, U.S. Investment Grade Credit Research Analyst, PGIM Credit: Thanks for having me on.

Keshav: Dave, I wanted to start with you to set the stage. As we've talked about, the macroeconomic backdrop and how energy markets, which have really been roiled by geopolitics right now, really have an impact throughout the economy. So set the stage for us. What's happened with the Iran conflict, in particular, since the start of the year if you think about energy markets? And what are some of the lessons we've learned as we think about choke points, supply constraints, and some of the things now impacting pricing?

Dave: The biggest lesson is energy security still matters. When this Iran conflict kicked off, a lot of commentators and industry analysts, they not unreasonably thought that you'd see oil prices spike to 150 to 200. And the reason being 20% of the oil supply of the world goes through that Persian Gulf. And that was suddenly closed. But we avoided that. And we didn't have that kind of 1970s oil shock scenario for several reasons. The biggest reason was one country did take their energy security pretty seriously and that was China. They came into this conflict sitting on a one-billion-plus barrel inventory that they'd steadily built throughout 2025. And the Chinese, being the world's biggest oil importer, they were able to sit out the market and pull back their bid from the oil market. That, more than anything else, allowed the world to kind of avoid that $150 to 200 barrel type of move higher that we would have seen. And then you throw on to that U.S. commercial inventories, which were in a pretty good spot; there was an oil surplus in the market

coming into January; the U.S. SPR, even though it had been pulled down a lot from Russia and Ukraine, there was still some give there. And then let's not forget the U.S. Navy, which eventually they did a pretty reasonable job and able to shuttling out significant volumes through the Strait of Hormuz. All of those things put together really allowed us to avoid what would have been a really negative outcome for the global economy. Last year, it really felt like there was an oil surplus, a surplus of production in the market. And I kind of scratched my head, I felt like oil prices should be lower. The reason they weren't is the Chinese were building up this big inventory. And I think the reason oil prices aren't higher than they should be now is, once again, these Chinese inventories. So, this inventory number, you've got to think about that in terms of energy security. That's really oil off the shelf that you can take for a rainy-day fund. And it's really fortunate that the world had that going into this whole conflict. I think that really spelled the difference.

Keshav: You mentioned energy security is a theme, and you mentioned Russia, Ukraine, obviously the Iran conflict now. But, as you think about avoiding maybe the worst-case scenario, I assume there's still a bit of risk premium in pricing today because of overall supply chain vulnerability. So talk a little bit about how that's come through markets because obviously we're still up, there's a premium to this today and maybe even near term for a bit longer.

Dave: It's really hard to know what the dollar number risk premium is in the market. But one thing I have noticed is the back of the futures curve for oil. That's been moving up further and further, not just the spot price of oil, but the back end of the curve has been moving higher. Whether that's risk premium or although that's because the because the world is going to have rebuild inventories, which has now been significantly rundown here in last four months. How much of that dollar amount is amount risk premium and how much of that is, "Okay, we'll have to have future bid rebuild inventories"? That's hard for me to say, but, definitely, that back end of the curve, that market expectations for higher prices are being built more and more into the financial markets writ large.

Keshav: Maybe share a little bit about then what's happening in financial markets. So, as you think from a macro perspective, obviously higher energy prices have follow-on effects, what are some of those and some of the secondary and tertiary effects of what's going on?

Dave: The higher energy prices, the first thing that people think is gasoline, but gasoline is like 3% of CPI. It's not that big of a factor in the Federal Reserve's decisions. But, in people's minds, it's probably more like 6% or 10% because you fill your pump up every week. But, the diesel prices, that flows through into things like airline tickets and chemicals and freight and transportation. And the longer this goes on, the more that time bleeds into these inflation numbers than core inflation, and it just keeps pushing that inflation higher and higher. That has knock-on effects into the bond market, too. And I think some of that's bleeding into people's perception of what rates should be in the future and the knock-on effects in politics as well. That is the number one thing it seems like the Trump administration is focused on is getting the gasoline and the diesel prices lower. That's bleeding into inflation and it's bleeding into the bond market. And it's a big driver of politics right now.

Keshav: You've set the stage nicely. But, as we pivot towards kind of what are the big forces shaping the sector, wanted to go there and, Jay, bring you into the conversation. At a high level, what's the most misunderstood thing about energy markets today? What are people getting wrong or missing? And how are you framing you that as a force that's impacting the opportunity investment, the thesis there?

Jay: Well, I think in times like the current when you have really high prices or really low prices, in this case, there's a tendency to say demand is getting destroyed and today's comments on China. But it felt like when WTI fell below 70 on the memorandum of understanding in June, late June, early July, there was a view at that time that China was never going come back to the market. And I think a lot of the demands that we have lost, and people throw around the word "demand destruction," I think inappropriately, is this a result of not being able to get a hold of the barrels as opposed to actually the willingness to consume falling? Because oil prices as the percentage of wallet are still pretty low given inflation and the rest of these sectors. So, at times like now, I think people tend to overestimate the elasticity of demand to price. And this came through five or six years ago, just to throw it out there, on the big focus on the energy transition, as if there was a pretty one-to-one substitution of solar and wind and EVs for fossil fuels. It's just much more difficult to displace an energy system. Not to say that the complexion won't change. And a lot of this band growth. Today's point is shifting into petrochemicals. But it's just very difficult to shift off oil and gas given how ingrained it is in our economies. Number one -- numb er two I think, and this is a longer-term comment, on the supply side, the loss or the peaking of U.S. shale productions I think is going to have a big impact on supply responsiveness as we go forward. The very short cycle responsive nature of U.S. shale, and we saw this in the gas market 15 years ago in the U.S., we're going to lose a lot of that responsiveness. Hence, a lot of the new supply is going to be more fixed and longer-term oriented thing offshore platforms. And, as a result, in times like now, you will have less levers to pull to, in this case, soften high crude prices.

Keshav: Dave, you had commented on the need to build inventories back up back China up, China as an example of kind of accessing that to maybe stem some of the shock of what's happened. And then, Jay, I think you're still talking about the idea that this, although slow, you're not going to replace oil and gas overnight. There is a need to obviously offer supply that today could be constrained. So, Dave, how is that affecting credit markets? If you think about where you are in your seat as a credit analyst, what is either concerning or in general providing a healthy view to this sector?

Dave: Right now, I mean, energy has just been an outperformer in credit markets all year. The world is just short energy. And it's not just oil and the refined products is the biggest short, LNG's short, everything's short. And Jay just mentioned this whole energy transition. It's really hard to transition from one system to another, too, when aggregate demand for energy just continues to grow. And then, your traditional energy, I would argue in some cases you have a structural short. Even aside from China and the petrochemical demand there, there are plenty of people in the EM who are basically in, you know, what they call energy poverty and still cooking with things like wood and charcoal and such when they could use something like propane instead. And then you flare on top the AI demand and such, too, I think the outlook for energy is just really strong going forward.

Keshav: Jay, maybe talk a little bit about what you think are the key demand drivers, like what is it underpinning, where we are today, and where we're heading. And, Dave, we'll come back to you on data centers, in particular, and some of the energy usage there. But, Jay, curious, what do you view at a high level, what are the key demand drivers to factor in in terms of just the sectoral tailwinds here?

Jay: Demographics are a huge driver, number one, and the quality of life and standard of living for about 60% of the world is still substandard. Energy transition years ago, people kind of left out that we've got to accomplish all this while lifting billions of people out of poverty, which

means all of the above in terms of energy sources. Like you need, certainly, fossil fuels, oil and gas in particular, nuclear, geothermal. It was only four or five years ago that nuclear and natural gas were looked at as not even part of the solution, which was crazy to energy gurus because it's just such an efficient source of supply that, if we're going to accomplish all of this growth and demand, you're going to need all of the above. So it's more to the elasticity point, but I think, more directly to your question, and really what's fun about this space now, is just how diversified it's getting to be and how all these fuels compete with each other and complement each other and call on new forms of capital. A lot of people look at solar and wind as the lowest cost of electricity around, forgetting that that requires a lot of investment in grids across the world, which changes the economics. And, when thinking of natural gas, AI is a driver. You get into crazy numbers. And we're going through this process now of figuring out how that's going to happen. But, if you solely look at the big three and the amount of turbines that are coming on, you're talking about eight to 10 BCF a day of gas demand growth just in the U.S. on the base of only, like, 93 v's a day right now, something is going to have to happen there and it's not really including a lot of other sources of gas demand for power generation that are behind the meter. It's just a long way of saying energy demand is totally consistent with growing economies. And that's really the goal of everyone so it's hard to get around the growth in energy demand, not to say the complexion won't change, but these fuels are becoming complementary in many cases, not only in the application that they satisfy, but in those that are providing it.

Keshav: Dave, share a little bit your thoughts as you think about data center electrification, some of the major themes, and how you're factoring that into some of your credit analysis?

Dave: There is a huge amount of LNG demand that's being put in down around the U.S. Gulf Coast. U.S. natural gas prices are about three bucks an M. And, today, they are over 28 bucks, 27 bucks over in Europe. That's got to be arbitraged away somehow by U.S. LNG. So there's a ton of demand for U.S. gas molecules, whether it's to fire AI here at home or to fire at Europe's economy across the pond. And it's just a generational opportunity for gas infrastructure. It's tough to make a call on the U.S. gas commodity price, especially with weather and the associated gas coming out of the Permian, but you hear from a lot of companies and operators in the gas pipeline space there's just so much opportunity for gas infrastructure because most of these data centers, if you're going to have dispatchable power, the best way to get that is natural gas.

Keshav: This has quite a few tailwinds. Right? You think about the supply story and some of the constraints there. Given the geopolitical environment, the demand is there.

Dave: Demand is a huge tailwind for this gas supply. For credit, for energy investors, too, you get a five to six percent coupon, that's better than we've seen in a long time. So it's not a bad story.

Keshav: Where's the headwind emerge? What then are you looking for in terms of a signal?

Dave: The one thing I look at is the midterms because, if you talk to Democrats or you talk to Republicans, the one thing people seem to agree on is a lot of them don't want data centers in their backyard. So, maybe once the midterms come, maybe this thing gets slowed down a little bit regulatory-wise. That could be a rare place of bipartisan agreement. So maybe a little bit of cold water gets thrown on that story. That's one thing I'm looking at. And then you never know what kind of new technology, some kind of deep seek or new chip that uses less power could actually come, and maybe that could throw a monkey wrench. But that's something to keep an eye on, too, kind of your Black Swan.

Keshav: Jay, what about you? What do you look for from a potential headwind perspective in terms of the growth story being dented a bit here?

Jay: I would put a wrinkle on what Dave just said about the data center effort. There's a lot of similarities there. When you think back to the shale industry 15 years ago or so, you can remember things like what are coming out of the faucet and fire. These hyperscalers, almost by definition, these data centers have been real secretive. They're in the very early stages of interacting with communities and figuring out ways to show how important the infrastructure is certainly on a geopolitical basis, but also just for these communities. The view is that they consume a lot of water and they don't provide that many jobs. And these things are so massive, these workforces in many cases per gigawatt campuses are permanent. Like they're going to be phase after phase. And that provides a lot of jobs in certain areas. And, just like the fracking industry, sharing that with the community and being upfront on the risks, it gave you the recipe for all the chemicals within their frack jobs. Various localities came up with severance taxes in many cases where the money came back to the communities. You may not say that people fully got on board, but some religions recognized the benefits of that activity and fully endorsed it. And I think that's the process we're going through now with data centers. And the stocks have sold off as if the story is over, like these things aren't going to be developed. I think, as we go through that process, we're going to have investment opportunities as this story is told in a more constructive way. And, in reality, yeah, they use a lot of water, but it's very minor compared to a golf course, for instance. And, as I said earlier, the jobs, these things really can inject capital into communities. So you're already seeing areas that you might expect, Louisiana, parts of the Rockies, parts of the Upper Midwest, and West Texas, that are embracing data centers. And I think, as we get these regions there regulatory and on a community basis, that will make for a smoother growth phase for data centers.

Keshav: Let me ask you one follow-up question before we pivot a little bit to deployment of capital. Are you both still bullish on demand prospects in the energy sector ex-data centers? And what do you view as kind of the demand potential if you kind of take that out or mute it?

Dave: I mean, ex-data centers, I think the demand is still bright. I mean, you have the whole LNG trade. That's not going away. That's ex-data center. All the macro drivers overseas and the supply constraints. The Middle East doesn't seem to be as quite as a reliable supplier of LNG to the world as it used to be. So I think ex-data centers I think you've still got a good outcome for energy.

Keshav: Jay, your thoughts?

Jay: Just from the consumption basis with all the reshoring and electrification, generally EVs, maybe not so much in this country, but certainly in Europe. My assumptions on the longer-term demand forecast for natural gas in the U.S. really don't hinge on a lot of data center growth since the continual electrification of the economy really that drives that, and you don't have to be heroic given the amount of gas that's going to be exported that Dave just mentioned, to have these markets really tighten up, I'm talking about U.S. gas, later in this decade.

Keshav: Well, actually, let's pivot there. Let's go now to more specific capital deployment opportunities. Let's get to the meat of this a little bit more. Jay, start with you. What specific areas are you focused on? I think electrification has come up. What are you thinking about in terms of

actual capital deployment in this space as you think about just the needs there from a infrastructure perspective, but then an overall sectoral perspective? And what excites you?

Jay: Behind the meter solutions are really important in terms of speed to market, but also the efficiencies that you get from them. I think there's been an underestimated view on the efficiencies are much better than you might think.

Keshav: Behind the meter, can you explain what that is?

Jay: That's like an islanded situation where you're actually usually gas driven reciprocating engines or gas turbines to generate dedicated power for, in this case, data center application. That gets you around the view that data centers are stealing power from the grid and, therefore, raising the rate base, among other things like using your own water and recycling it within that islanded scenario. There's all different kinds of ways to play that from the natural gas side to the developer side certainly to the equipment side as I was mentioning these engines. And there's certain regions of the country. West Texas is getting more popular largely because of the obvious really abundant gas and water, but also the regulatory environment within [inaudible]. There are other parts of the Rockies, say, where cooler temperatures are helpful in this regard for cooling data centers. It's hard, for me at least, to be more positive right now on the refining situation tailing to the diesel tightness, meaning it's difficult for me to put extra capital there because markets tend to fix markets that is tightness, but it's difficult to see what really reverses that near term, even the tightness of capacity to demand right now, unless there's some miracle like detente between Russia and Ukraine. And the situation in the Middle East is like some of these plants are going to take a while to bring back. And, finally, I think oil, there's always going to be opportunities in oil for a lot of the reasons we mentioned earlier. I think those stocks are now discounting a price that is still lower than where we're going to settle out. I don't think $105 right now in WTI basis is sustainable, but, coming into this conflict, people are generally thinking 60; at best, 65.

Keshav: Dave, talk to us a little bit about CapEx spend now. What are you seeing in terms of issuance and where different energy companies are looking to spend and deploy capital? Like what's exciting you from an overall credit perspective?

Dave: The pipeline guys have definitely stepped-up CapEx this year, I mean, maybe roughly out of the order of 25 to 50% depending on the company. So that makes sense given the infrastructure needs. We haven't seen a really big production response from the producers yet or a CapEx upcycle from them. Maybe a little bit at the margin. But these guys are going through their budget cycles right now, this is about the time when they put together their drilling plans for next year, so my gut says you're going to see a little bit of a uptick, maybe 10 - 15%, a response. But I don't think you're going to see these guys just explode and go after it on the CapEx because the resource base is fairly finite, them drilling into any kind of rally is going to be perceived as self-defeating, and they've been under a lot of pressure for a lot of years to return capital to shareholders and not just drill into any kind of oil rally. So I'd be hesitant to say that there's going to be a big upstream CapEx spike. Maybe some exceptions here with smaller companies here and there. But I'm ready to be kind of a little bit underwhelmed on the production side. Infrastructure-wise, I think that's probably going to keep growing. It's been a big move up and I think you're going to see maybe even some more moves up.

Keshav: And then what about downstream? What's the outlook there? If you think about kind of refineries and as we talked about diesel earlier, how does that play through the market?

Dave: Refining is in a bad place right now. You are really short refined products, especially diesel. Like I said, that's what's bleeding into the CPI, and then the gasoline numbers. And, just like Jay said, I don't see how that gets solved near term. Some of these facilities in the Middle East took some pretty heavy damage. My understanding is two of the biggest ones that were damaged are supposed to come back online here any day, if they haven't already, so maybe you start seeing a little bit of a relief there. That's the bulk of the problem. And then maybe about another 25% of the problem is Russia and Ukraine. The Ukrainians continue to target Russian refineries. I don't know how that gets ended or if it gets ended. And then, finally, we had some refinery shutdowns last year, too. Europe has shut down some in the recent past and California has shut down some, too. But I don't see how refining loosens up near term and we get some relief right away, barring some world peace breaks out. And, even then, these facilities are going to take some time to get repaired.

Keshav: To the U.S. market, I think we talked about shale a little bit earlier, so, Jay, can you talk a little bit about kind of the outlook for shale, capital deployment there, and what you view as the opportunity set when you look here in the United States at least?

Jay: Every year, the haves and the have nots in shale continue to consolidate just as a function of the maturity of shale. It's not like we're looking at maps anymore to figure out where the best locations are. It's pretty well-known transaction values keep going up reflecting the scarcity of the best locations. So I think what you'll see is just a further consolidation reflecting that maturity and less growth. I mean, the more you produce, the shorter your inventory is, which is valuation destructive, so to speak. The name of the game will be to have really clean balance sheets to be proactive when sellers come out of the woodwork as commodity prices fall. And you're even seeing transactions happen in this environment, which is a little bit against the grain. Typically, nobody wants to do anything at high prices like we have now. But it's just reflective where the EP industry is at. I should say as well, efficiencies continue to surprise like cost basis despite inflation generally throughout the supply chain. Cost bases aren't inflating like you would expect given steel and chemicals in some cases. These companies are just really innovative, do a great job of keeping their cost base down. So I think the name of the game will be not to be repetitive, but keep your costs in check, and there's only virtues to slowing down as opposed to putting capital into an inflated market, and be ready when commodity prices come off so that you can be opportunistic to reload the inventories as sellers come to the market.

Keshav: Dave, are you seeing a similar theme if you look at the credit side of the equation and how these companies are playing capital structure? Is it a similar theme? In terms of the U.S. shale players, how are they looking at their balance sheet in terms of cleaning them up and being opportunistic in the future?

Dave: Well, I agree with Jay with one caveat. He was saying they want to have a clean balance sheet and they're cleaning it up. I think they have already cleaned it up so it's hard for me to think anybody who's really over their skis in terms of leverage. So there's a lot of capacity for them to do deals. There's a couple maybe that are bringing debt down a little bit, but the whole debt reduction game in the upstream space is kind of over.

Keshav: So maybe we will end with a question on just the structural nature of this. We started the conversation with geopolitics and obviously that's presenting a supply challenge. How do you see that play out?

Dave: Before I started this job, I was an intelligence officer for the U.S. military and I've watched this whole Iran War play out with, you know, a lot of interest. And it seems to me that the situation right now, where oil is sneaking out through the strait and the Iranians continue to lob missiles and disrupt maritime traffic, it's just long-term untenable. We're either going to have to go one way and get some kind of diplomatic solution or I think the more likely course is, given Iran's stated intentions and their behavior thus far, we'd probably get some kind of escalation either from the Iranians or the United States in the near term. And that is just going to throw more cold water on the idea that the Middle East is a safe haven and that they can be the energy supplier to the rest of the world. It's going to make U.S. and OECD assets just more attractive. So I think a secular infrastructure story for the U.S. to assume more and more market share globally, especially in the gas trade, I think that makes some sense. And we have to look and see about where we can start building some more refining capacity in the world, too, aside from the Middle East.

Keshav: Jay, your thoughts?

Jay: Even before this conflict in the Middle East, a lot of the resource-rich countries, particularly the Middle East, but also in North Africa, were already sweetening terms in trying to attract capital into those countries unlike really they had done in a couple of decades. And now there's this region, the Middle East, that's much more fragile than we thought it was previously. So I think, overall, in combination with this peaking in a few years of U.S. shale production, the supply complexion is going to be much more geopolitically sensitive and, therefore, feeding into that notion that, "Hey, you may have a higher base oil price than you did previously, but you asked about a war premium earlier." I don't think a lot of people think about that as like a bunch of speculative conjecture that inflates the oil price. But, in reality, I've always looked at it as a very physical thing. And it's coming through in spades right now. The only reason we're lightering tankers is because the big tankers don't want to go into this really risky region or at least the heart of it. So I feel like that's going to all feed into the risk profile of the supply base that, until recently, had been viewed as somewhat stable and reliable. And so the workarounds in the Middle East that will ultimately result from this episode are being capitalized right now. That will be helpful, but it's going to be difficult I think overall, particularly given the steadfastness of the IRGC. There's going to be a sustaining and higher level of risk with what has traditionally been a really reliable supply base for the oil market.

Keshav: Jay and Dave, a really fascinating conversation. It's fun when you weave in obviously an investment thesis around energy, but then talk geopolitics, macroeconomics, and structural changes. I think what stands out to me from our conversation is there's some tailwinds here and I think there are twin effects. One is on the supply side, the energy security theme we started with, there's some real structural changes that have occurred because of geopolitics and just politics in general and how people are thinking about it that presents interesting investment opportunities. And then, on the demand side, I like, Jay, how you framed it as energy expansion; the opportunity set is wide and vast. It's obviously a complicated space, you both make it sound easy, but there's a lot to untangle here. Thanks so much for a great conversation, really enjoyed it.

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Keshav: This has been *All the Capital*, a podcast from PGIM. Thanks for joining the conversation. Until next time.

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