

Long Dutch TTF Nat Gas Futures

Thesis: Recent instability in Eastern Europe as a result of escalating tensions between Poland and Belarus and Ukraine and Russia will jeopardize safe transport of Russian natural gas to the EU via non-Nord pipelines. Also, depending on the outcome, even Nord flows could be significantly reduced if the EU, US, and UK become involved directly with Russia. With few alternatives to critical Russian imports, Europe's natural gas prices will be subject to increased volatility and upside pressure over the next several months of winter.



Dutch TTF Natural Gas Future for Dec21



Historical, Implied Vol of Dec21 Future

Belarussian pipelines

A migrant crisis on the Belarussian border with Poland and Lithuania has significantly escalated in the past several days. Both sides have deployed soldiers as thousands of Middle Eastern refugees remain stranded in freezing conditions along the border while they attempt to get into the EU from Belarus. Polish soldiers used tear gas against the migrants and accused Belarussian soldiers of breaking barricades on their border. In interviews of representatives from both sides, neither has discounted the risk of an escalation into military confrontation. At the same time, Russia has stood behind Belarus, continuing joint military exercises and flying nuclear-capable bombers over Belarus to show support.

The EU has taken the side of Poland and Lithuania and accused Lukashenko of fabricating the crisis by human trafficking the migrants via commercial airplanes. As a result, the EU, US, and UK are moving to impose additional sanctions on Belarus as soon as this Monday. Lukashenko has threatened to cut Russian natural gas flows to the EU through pipelines that cross Belarus. These pipelines include the major Yamal-Europe pipeline and their combined flows accounted for over a fifth of Russian natural gas exports to the EU last year.

While Putin has publicly stated that Lukashenko shouldn't proceed with this threat, public statements might not paint the most accurate picture – a cut in natural gas flows through Belarus, which deliver in Poland and Germany, strengthens the argument for more expedient German approval of the Nord 2 pipeline, which circumvents nations via the Baltic sea and delivers straight to Germany. That would be a major victory for Russia. Putin's actions (not placing pressure on Lukashenko despite several phone calls from Merkel, continuing military support) and his self-interest (Nord 2 approval, weakening EU) hint towards tacit Russian support for Lukashenko cutting gas flows.

Political leaders in both countries have strong reasons for maintaining an aggressive stance. In Poland, the ruling PiS has been very anti-migrant in the past, especially during the 2015 crisis. This stance is important to the party's popularity with its base, so they're unlikely to walk it back or show weakness on the issue. On the Belarussian side, Lukashenko runs what is effectively a dictatorship, so there is a low chance that he would walk back from the crisis since it would hurt his strength projection domestically and embolden opposition. Additionally, there could be Russian pressures motivating Lukashenko to do so in order to divide or weaken the EU, approve the Nord 2, or achieve some other goal.

Thus, it's likely that this conflict will continue to escalate, which jeopardizes natural gas flows through Belarus and aggravates the natural gas shortage in Europe, lifting prices up.



Ukrainian pipelines

The other country where there are major pipelines delivering Russian gas to the EU is Ukraine. Recently, the Russian military has been building up in Crimea and western Russia, with reports from Ukrainian officials stating that over 100k Russian troops, tanks, and other equipment of war are building up all around the country's borders. This is being done in a covert manner, at night, and with elite stealth regiments – in stark contrast to the overt moves this April and the theatrical military exercises which were used then to get a summit with Biden.

Russia wants Ukraine, so sooner or later they'll escalate the conflict again. The question is whether it makes sense for them to do so now when that could preclude Nord 2 approval. The main reasons that Putin wants the Nord 2 pipeline approved for are money and relevance: it'll bring in some good revenues while keeping Europe reliant on cheap and readily-available Russian gas over alternatives. It's a form of leverage, but one which might be fading as more and more countries have been attempting to diversify their energy imports – probably even more after this winter – as well as focusing more on continental renewable energy than the dirty fossil fuels Russia exports. In reality, the market for Russian energy commodities is shifting towards Asia, especially China, with new pipelines coming online, mutual investments in related infrastructure, and a robust, growing demand. So, if Putin can get something more valuable from intervention in Ukraine than immediate Nord 2 approval, then it seems preferable.

The trend of declining US global influence, divisive tensions within the US (politically) and the EU (Brexit, the migrant crisis, and Poland/Hungary recently), and Merkel's exit from leadership are all factors that embolden Putin towards more aggressive confrontation in the near-future. Historically, Russia's advantage is the winter. That's still true if Putin is willing to bet that an escalation in Ukraine paired with disruptions to continental pipelines will eventually bleed the EU to the negotiation table. For now, the EU can't easily get adequate alternatives to Russian natural gas because of the size of those flows and global shortage. If Putin escalates Ukraine after a hypothetical cut in Belarussian pipeline flows, then all Putin might have to do is wait until the shortage is sufficiently bad so that he can get good terms (progress on Ukraine, ex. annexation of a region, and Nord 2 approval) in a summit.

Risks: Risk is high because many events might deviate from expectations and the details remain highly uncertain. For example, what could an escalation in Ukraine look like or how might tensions between Poland and Belarus and Russia and Ukraine come together. Overall, however, I have confidence that there are significant risks of renewed disruptions in Russian-European gas flows beyond what the market is pricing in.

Conclusion: The ramifications of escalating crises between Poland and Belarus and Russia and Ukraine will spill over into the security of natural gas flows through major continental pipelines. Further tension might result in other significant cuts including via the Nord pipeline. Putin will escalate the conflict in Ukraine at the risk of Nord 2 approval, which he can hope to get back from a summit with the EU once they can't handle their natural gas shortage any longer and therefore give Putin more favourable terms for negotiation.

Short GBP/USD

Thesis: While the UK diverges from the EU as a consequence of Brexit last year, geopolitical tensions are going to continue emerging. Disputes are incentivised by the sluggish domestic economy and Boris' shifting of blame towards the EU. The most pressing of these is the anticipation of Boris' decision on keeping or discarding the North Ireland protocol. Such disputes will bring back the uncertainty of the earlier Brexit period and drive the pound lower. Interest rate hike risks are also concentrated to the downside because the market is already pricing in fairly aggressive hikes.

Tensions with France

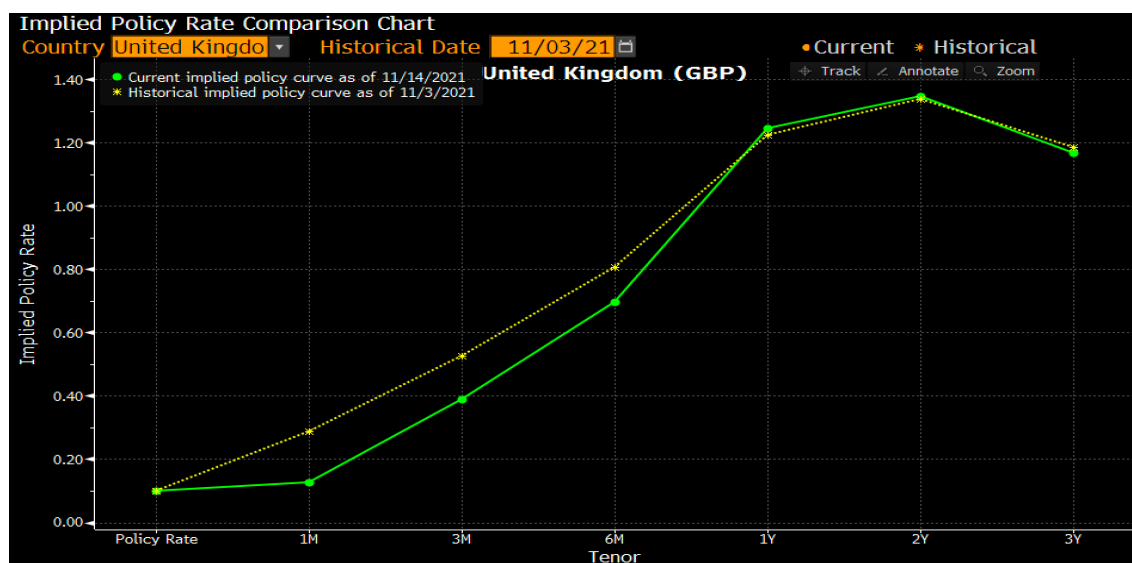
The UK and France have been diverging since the UK's exit from the EU last year. Instead, the UK has been aligning itself with the US and Australia, and the US nuclear submarine deal with Australia within AUKUS drew aggressive criticism from France. Recently, disputes have arisen over the extent of fishing rights of British and French fishermen in the British Channel due to differing interpretations of the new post-Brexit trade agreement over fishing activity. As a result of Boris denying some French boats access to fishing around the Channel Islands, Macron threatened retaliatory measures including stricter checks on trucks and fishing boats crossing into France, though they were postponed amid talks. Domestically, Macron is facing strong nationalist opposition from Éric Zemmour in the upcoming presidential elections, so his adoption of a strict stance could carry him politically. Meanwhile, Boris faces both economic and political motives for taking a more combative stance on trade and other post-Brexit agreements, because of the UK's sluggish recovery and fragile economy; he can shift blame onto unfavourable Brexit agreements. While the fishing issue in particular might not be too significant, the dynamics pushing the confrontation are more broad-based so they're likely to continue finding expression elsewhere.

North Ireland disputes

One such example is the more important disagreement between Boris and Brussels over how North Ireland should be treated. Boris disagrees with the deal previously agreed to with the EU over customs, where the region belongs both to the UK and the EU's single market and the European Court of Justice retains a significant role as an arbiter of trade disputes. Boris has threatened to trigger Article 16 and go back on the agreed North Ireland protocol, which would inflame tensions much in the same way that the fishing disputes occurred. However, this would be much more significant and the likelihood of a new multilateral agreement would be very low. Instead, the uncertainty that characterised the earlier Brexit period could return. Paired with domestic economic weakness, this would drive the pound sharply lower.

Aggressive hikes priced in

Similar to how the market priced in aggressive rate hikes which failed to materialise earlier this month, the market has returned to implying a relatively aggressive hiking cycle with the only adjustment being the pace of the hikes, but the same terminal values. While this does seem more appropriate, the risk is still concentrated to the downside when you compare the pretty dovish statements of other major central banks like the Fed and ECB, as well as the weak economy which has fallen behind its comparables in the G7.



MIPR now vs the day before last policy rate announcement

Risks: As mentioned before, the trade depends immediately on Boris' decision on whether to go back on the North Ireland protocol, but also represents a bigger-picture pressure for confrontation between the UK and EU, driven by geopolitical divergences and domestic economic and political incentives. One risk would be an extraneous factor coming into play that has enough force to pressure the UK and EU towards work together – something like that could happen if Russia escalates the war in Ukraine significantly. Also, because of the uncertainty surrounding central bank policies right now, the hiking cycles for BoE and the Fed could become one important risk to keep track of.

Conclusion: Due to points of conflict between the UK and the EU on existing Brexit agreements, the sterling will weaken. The trade's risk is minimised by a sluggish economy and aggressive rate hikes already priced in by the market, but is still exposed to some geopolitical (ex. Russia) and central bank uncertainty in the US and UK.