INVESTMENT STRATEGY

Europe’s policymakers were slow to address energy concerns. Even before Russia’s invasion of Ukraine, the continent was facing higher prices. Now, extended supply disruptions have pushed them even higher—reigniting fears of an impending recession in Europe. We worry that further market volatility might be unavoidable if high energy prices and geopolitical turbulence persist.

This edition of Global Insights considers Europe’s energy crisis.
The Russia-Ukraine conflict has been felt in all corners of the market. Intense selling pressure in the weeks following Russia’s invasion saw European equities, as measured by the MSCI Europe Index, underperform the S&P 500 Index significantly. What’s more, credit spreads have widened, and the euro has traded to a two-decade low against the US dollar. The effects have also reverberated across key energy commodities like natural gas, amid fears that a prolonged conflict could disrupt supplies (see Exhibit 1). In fact, since the Feb. 24 invasion, natural gas prices have risen more than most other commodities (see Exhibit 8).

Exhibit 1: The EU Depends on Russia for Much of Its Energy Needs


Europe’s policymakers have long worried that Russia could weaponize its energy supply. In our March 23 Global Insights, “Europe’s Paradigm Shift on Energy and Defense,” we highlighted the continent’s below-average emergency reserves and overreliance on a handful of exporters. Although we argued that the conflict would strengthen Europe’s resolve to diversify its energy sources, it is likely too late for Europe to avoid economic pain this winter.

First, even before Russian energy giant Gazprom reduced supply through the Nord Stream 1 pipeline last month (see Exhibit 2), Europe was struggling to store gas at levels consistent with the long-term average (see Exhibit 3). In fact, Europe’s gas storage levels did not catch up to seasonal norms until the end of July. In our opinion, the more pressing issue is the gap between the current level, at 82% of capacity, and the 90% that is typical for the end of October. Should the Nord Stream 1 pipeline remain offline permanently—or even for an extended period—storage levels could begin winter below long-term average.

Exhibit 2: Nord Stream Shutdown Could Wreak Havoc on Power Markets

![Nord Stream Russia-to-Germany Gas Flows, Cubic Meters Per Day]

Note: Flows reported by OPAL and NEL at Greifswald. Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 8, 2022

Exhibit 3: Europe Gas Storage on Track to Meet Target, but Potential for Disruptions Casts a Long Shadow

![Average Europe Gas Storage Capacity, Percent Full]

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 8, 2022

In fact, many worry that current gas storage levels may not be enough to get the continent through the winter. For example, Absolute Strategy Research notes that Germany’s 88% gas storage level would last a little more than two months without the addition of offsetting new supply.

An extended shutdown would bring new challenges. All else equal, starting the winter below trend foreshadows a lower starting point next spring, and the consequences could be dramatic. In fact, Belgium’s prime minister, Alexander De Croo, has warned that “the next five to 10 winters could be difficult” if Europe’s energy crisis persists.

Second, although we are encouraged that energy consumption in major economies like Germany is below trend (see Exhibit 4), we remind investors that the margin of supply relative to demand for energy commodities is razor-thin. If the decline in natural gas inventory were to move in line with historical averages, natural gas prices could rise sharply—contributing to inflationary pressures.
Exhibit 4: Germany Has Agreed to Cut Gas Consumption to Avoid Winter Rationing

Finally, European households may be reluctant to "do their part" to curb demand. While some cities have already pledged to dim lights and implement cooling and heating restrictions for public buildings and select businesses, an energy-saving campaign for households may prove difficult. Heating will become a priority for most households once winter arrives, especially if it’s particularly severe (see Exhibit 5).

Although investors are focused on Europe’s energy crisis and the broad implications for natural gas, it’s important to remember that inconsistent emergency policies and varying energy mixes (see Exhibit 10) all but guarantee a range of outcomes from country to country.

Exhibit 5: Energy-Saving Limits Could Face Backlash From Households in Europe

Note: Energy consumption during periods of normal climate. 

United Kingdom. The UK’s annual inflation rate touched double digits in July for its largest increase since 1982, with rising energy prices one of the main factors. In January 2019, Ofgem, the UK’s energy regulator, introduced a cap on the rate a supplier can charge in order to relieve consumers facing high energy bills. However, in October, Ofgem will raise the household price cap. As a result, the average bill is set to increase by 80% next month. The consequences of higher energy prices would be felt immediately. According to the independent UK-based think tank Resolution Foundation, removal of the price cap could slash average household income, net of energy costs, by 10% and push 3 million UK citizens into poverty.

Facing an economic crisis, the UK’s new prime minister, Liz Truss, unveiled a £100 billion energy initiative. It proposes: 1) lifting a ban on fracking, 2) pursuing nuclear projects and 3) licensing oil and gas projects in the North Sea. Importantly, in order to help consumers in the short term, Truss announced plans to freeze the average annual energy bill for households at £2,500—below the average £3,548 per year they would have paid without the intervention (see Exhibit 6). Notably, businesses will also get a partial reprieve, but only for the six months beginning in October.

Exhibit 6: Caps That Protect Citizens From Higher Energy Prices Could Have Long-Term Consequences

Source: Bloomberg, Morgan Stanley Research, Office of Gas and Electricity Markets (Ofgem), Morgan Stanley Wealth Management Global Investment Office as of Sept. 9, 2022

Lower energy bills could cut inflation in the short term. According to estimates from Morgan Stanley & Co.’s UK economists, with price caps in place headline inflation would come in at 8.9% in full-year 2022 and 6.6% in 2023, which compares to an estimated 9.5% and 8.9%, respectively, over the same periods without a freeze. While a cap on energy bills could help UK households avoid more serious consequences in the short term, there are questions regarding the proposal’s longer-term impact on the UK economy.

France. So far, France has fared better than its neighbors. First, it derives more than 75% of its electricity from nuclear energy, compared to 10% for Germany. Given its relative independence from Russian fossil fuels—especially natural gas—France could see a better outcome if all its state-owned reactors are running. While only half of France’s reactors are running at the moment, the country’s energy minister plans to have them fully opened ahead of the winter freeze.

Second, the country’s energy infrastructure makes it far less...
vulnerable to price swings. For example, in the first 100 days following Russia’s invasion of Ukraine, France spent approximately $5 billion on Russian fuel, with pipeline gas only accounting for less than $500 million. That compares to Germany, which, according to the Center for Research on Energy and Clean Air, imported nearly $12.5 billion, primarily through pipelines.

Finally, because France is less dependent on natural gas, consumer price pressures have been more modest. This has resulted in lower inflation than the rest of Europe (see Exhibit 7). We expect this trend to continue, as further supply shocks could widen the spread between France and other European economies.

Investment Implications

European equities look cheap relative to the US, but there is a risk that valuations could fall further. Rising inflation, the potential for further aggressive monetary policy and increased risk of recession present near-term headwinds for European equities.

Once these headwinds recede, investors in European equities could see a more favorable entry point given compelling valuations versus the US. In the meantime, we recommend staying overweight defensives and underweight cyclicals until economic and policy uncertainties normalize.
Charts You Can't Miss

Exhibit 8: Not All Commodity Prices Show Signs of Easing

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dutch TTF Natural Gas</td>
<td>132</td>
</tr>
<tr>
<td>Henry Hub Natural Gas</td>
<td>79</td>
</tr>
<tr>
<td>Corn</td>
<td>1</td>
</tr>
<tr>
<td>FAO Food Price Index</td>
<td>-2</td>
</tr>
<tr>
<td>Wheat</td>
<td>-2</td>
</tr>
<tr>
<td>WTI Crude</td>
<td>-5</td>
</tr>
<tr>
<td>RBOB Gasoline</td>
<td>-9</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 9, 2022

Exhibit 9: Euro Drops to a 20-Year Low as Euro Area Plunges Deeper Into Crisis

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 9, 2022

Exhibit 10: Countries Less Dependent on Russian Imports Could See Better Outcomes

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 9, 2022

Exhibit 11: Price Cap Regulation Could Pressure European Utilities

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 8, 2022
Exhibit 12: Falling Real Wages Drive UK Consumer Confidence to Record Low

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

Like other parts of Europe, the UK has grappled with high inflation driven by rapidly rising natural gas and heating prices. While wholesale natural gas prices have fallen since the end of August, they remain approximately double what they were a year ago, inhibiting consumer discretionary spending and putting a large dent in consumer confidence. With consumer spending accounting for 61% of UK GDP, the latter should suffer as consumers allocate more toward energy and less toward nonessentials. Political, economic and geopolitical uncertainties, on top of falling real wages, have driven consumer confidence to a record low and should signal caution to UK equity investors. - Brad Fulton

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022
Investors should consult with their tax advisor before implementing such a strategy. The criteria in their investment strategy. There can be no guarantee that a client's account will be managed as described herein. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The returns on a portfolio consisting primarily of commodity investments may be especially volatile. Risks applicable to companies in the energy and natural resources sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile. Risks applicable to companies in the energy and natural resources sector investments include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. Health care sector stocks are subject to government regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

The returns on a portfolio consisting primarily of environmental, social, and governance-aware investments (ESG) may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, hold or sell any securities or investment products. They are intended to demonstrate the approaches taken by managers who focus on ESG criteria in their investment strategy. There can be no guarantee that a client's account will be managed as described herein.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy. The indices are unmanaged. An investor cannot invest...
directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

The indices selected by Morgan Stanley Wealth Management to measure performance are representative of broad asset classes. Morgan Stanley Wealth Management retains the right to change representative indices at any time.

Disclosures

Morgan Stanley Wealth Management is the trade name of Morgan Stanley Smith Barney LLC, a registered broker-dealer in the United States. This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Past performance is not necessarily a guide to future performance. The author(s) (if any authors are noted) principally responsible for the preparation of this material receive compensation based upon various factors, including quality and accuracy of their work, firm revenues (including trading and capital markets revenues), client feedback and competitive factors. Morgan Stanley Wealth Management is involved in many businesses that may relate to companies, securities or instruments mentioned in this material.

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security/instrument, or to participate in any trading strategy. Any such offer would be made only after a prospective investor had completed its own independent investigation of the securities, instruments or transactions, and received all information it required to make its own investment decision, including, where applicable, a review of any offering circular or memorandum describing such security or instrument. That information would contain material information not contained herein and to which prospective participants are referred. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We make no representation or warranty with respect to the accuracy or completeness of this material. Morgan Stanley Wealth Management has no obligation to provide updated information on the securities/instruments mentioned herein.

The securities/instruments discussed in this material may not be appropriate for all investors. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives. Morgan Stanley Wealth Management recommends that investors independently evaluate specific investments and strategies, and encourages investors to seek the advice of a financial advisor. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies and other issuers or other factors. Estimates of future performance are based on assumptions that may not be realized. Actual events may differ from those assumed and changes to any assumptions may have a material impact on any projections or estimates. Other events not taken into account may occur and may significantly affect the projections or estimates. Certain assumptions may have been made for modeling purposes only to simplify the presentation and/or calculation of any projections or estimates, and Morgan Stanley Wealth Management does not represent that any such assumptions will reflect actual future events. Accordingly, there can be no assurance that estimated returns or projections will be realized or that actual returns or performance results will not materially differ from those estimated herein.

This material should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. This information is not intended to, and should not, form a primary basis for any investment decisions that you may make. Morgan Stanley Wealth Management is not acting as a fiduciary under either the Employee Retirement Income Security Act of 1974, as amended or under section 4975 of the Internal Revenue Code of 1986 as amended in providing this material except as otherwise provided in writing by Morgan Stanley and/or as described at www.morganstanley.com/disclosures/dol.

Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley Financial Advisors do not provide legal or tax advice. Each client should always consult his/her personal tax and/or legal advisor for information concerning his/her individual situation and to learn about any potential tax or other implications that may result from acting on a particular recommendation.

This material is disseminated in Australia to "retail clients” within the meaning of the Australian Corporations Act by Morgan Stanley Wealth Management Australia Pty Ltd (A.B.N 19 009 145 555, holder of Australian financial services license No. 240813). Morgan Stanley Wealth Management is not incorporated under the People’s Republic of China (“PRC”) law and the material in relation to this report is conducted outside the PRC. This report will be distributed only upon request of a specific recipient. This report does not constitute an offer to sell or the solicitation of an offer to buy any securities in the PRC. PRC investors must have the relevant qualifications to invest in such securities outside the PRC. This report will be distributed only upon request of a specific recipient. This report does not constitute an offer to sell or the solicitation of an offer to buy any securities in the PRC. PRC investors must have the relevant qualifications to invest in such securities and must be responsible for obtaining all relevant approvals, licenses, verifications and or registrations from PRC’s relevant governmental authorities.

If your financial adviser is based in Australia, Switzerland or the United Kingdom, then please be aware that this report is being distributed by the Morgan Stanley entity where your financial adviser is located, as follows: Australia: Morgan Stanley Wealth Management Australia Pty Ltd (ABN 19 009 145 555, AFSL No. 240813), Switzerland: Morgan Stanley (Switzerland) AG regulated by the Swiss Financial Market Supervisory Authority; or United Kingdom: Morgan Stanley Private Wealth Management Ltd, authorized and regulated by the Financial Conduct Authority, approves for the purposes of section 21 of the Financial Services and Markets Act 2000 this material for distribution in the United Kingdom. Morgan Stanley Wealth Management is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule") and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule.

This material is disseminated in the United States of America by Morgan Stanley Wealth Management. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

This material, or any portion thereof, may not be reprinted, sold or redistributed without the written consent of Morgan Stanley Smith Barney LLC.

© 2022 Morgan Stanley Smith Barney LLC. Member SIPC.

RS166313449501 09/2022