Middle East Ceasefire: What Has Changed for Energy Fundamentals and What Hasn't

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On April 7, 2026, the U.S. and Iran agreed to a cease-fire for two weeks, subject to a number of conditions, including the complete opening of the Strait of Hormuz. As a result of the announcement, oil prices have declined by 15%, and European natural gas prices by 14%.

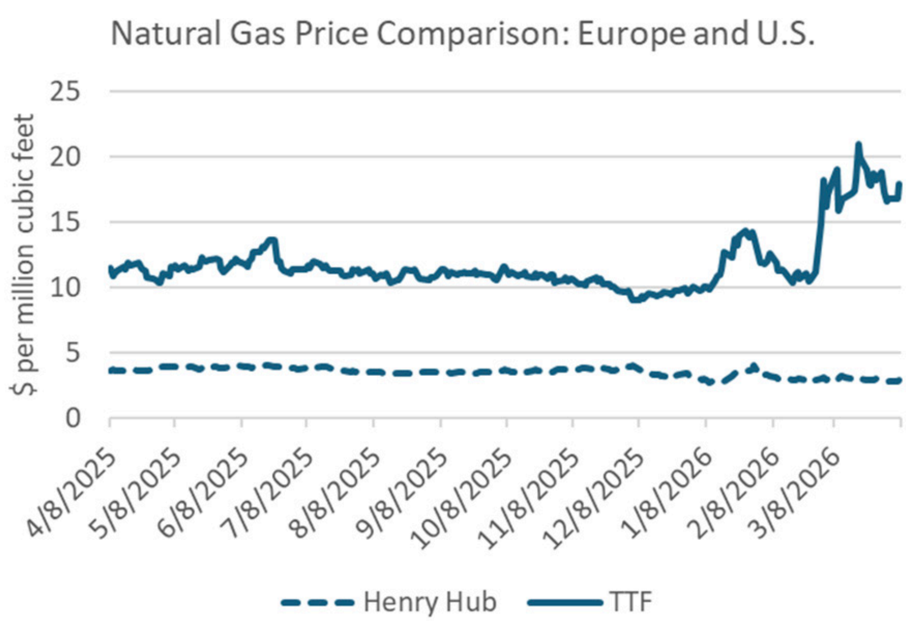
We believe the agreement is fragile and are skeptical that it will last the full two weeks. In the 24 hours since the agreement was announced, Saudi Arabia's East-West Pipeline was hit by a drone attack, Kuwait's air defense has intercepted 28 drones targeting energy infrastructure, and Israel has continued its attacks on Lebanon, which resulted in Iran halting oil tanker traffic through the Strait.

Regardless of whether we are correct about the duration of the cease-fire, three significant changes have taken place for energy fundamentals that are likely to result in higher prices than experienced over the past three years. First, we estimate that petroleum reserves have declined by about 150 million barrels (3% of total) since the beginning of the conflict. Each day that passes without normal flows through the Strait results in an additional 5-10 million barrels removed from inventory that will have to be rebuilt in the future, probably more than recent high-level marks due to real worries that the Strait can be closed.

Secondly, there is damaged infrastructure throughout the Gulf Coast countries, including Qatar, Kuwait, Saudi Arabia, the United Arab Emirates and Iran, that will require quarters or years to reestablish normalcy. Moreover, according to Kuwait Oil Company, even producing wells that were not attacked but were taken offline due to a lack of takeaway capacity will take more than several quarters to reestablish pre-conflict levels.

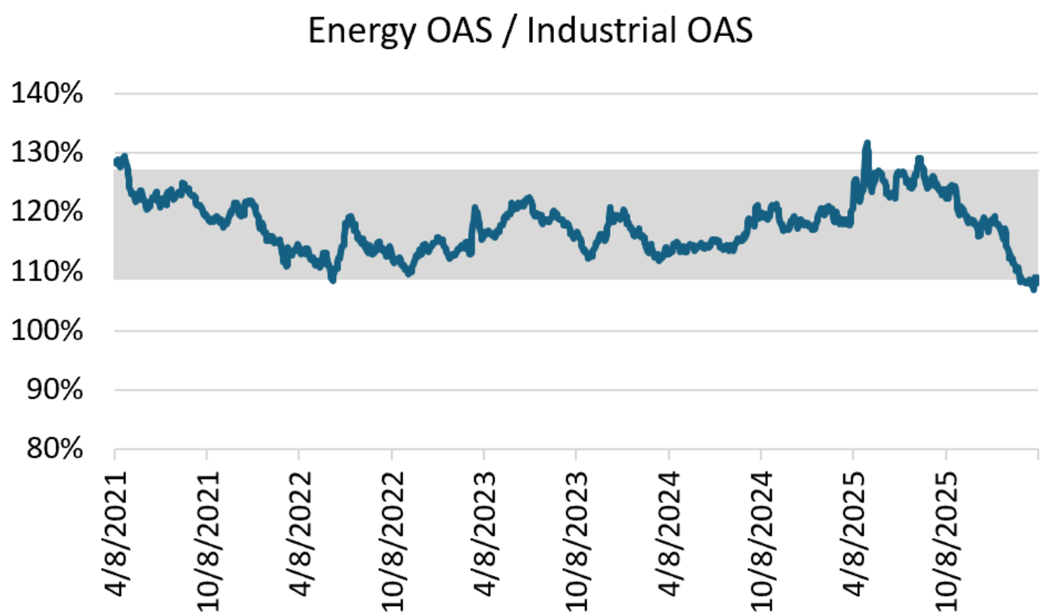
Thirdly, the spare capacity security blanket that had existed for the past 5 years is no longer. One item keeping oil prices low in recent years was ample spare capacity of about 4-5 million barrels per day from OPEC, specifically Saudi Arabia. Until normal supplies are reestablished and petroleum reserves are rebuilt, we will have almost no spare capacity. We believe this will take multiple quarters.

In this highly volatile environment, we are taking advantage of items in which we have a high degree of confidence. We are confident that natural gas prices will be higher in regions that depend on natural gas imports, such as Europe and Asia. Qatar Energy reported that an attack on its Ras Laffan facility (joint venture with Exxon Mobil) has taken 17% of its liquefied natural gas capacity offline for the next 3-5 years. As a result, the liquefied natural gas market has gone from modestly oversupplied to significantly undersupplied. This secular change is positive for companies that can sell natural gas into those importing regions. For example, independents and integrated companies that produce natural gas from the Norwegian Continental Shelf and sell into the EU, where realized natural gas prices are at a 2x-4x premium to its U.S. counterparts.



Source: Bloomberg, AAM; Henry Hub is U.S. benchmark; TTF is the Netherlands Title Transfer Facility

While fundamentals for energy companies will benefit from the supply shock of this conflict, valuations are unattractive. Over the past five years, the premium of the Energy sector's option-adjusted spread (OAS) relative to Industrials has averaged 18%. Today, that premium is only 8%, or 2 standard deviations more expensive than average.



Source: Bloomberg, AAM; gray shading represents +/- 2 standard deviations

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