ClearBridge Investments

Are Midstream Stocks Poised to Rally?

August 27, 2019

Key Takeaways

- Midstream stocks have a history of relative outperformance versus equities when their yield spread relative to U.S. Treasury bonds is as wide as it is today.
- Performance of midstream stocks following yield curve inversions has also been strong, especially when they are cheap relative to U.S. Treasurys.
- The yield spread between midstream stocks and high yield bonds is also at a record level.

Similar Periods of Yield Advantage Have Augured Well

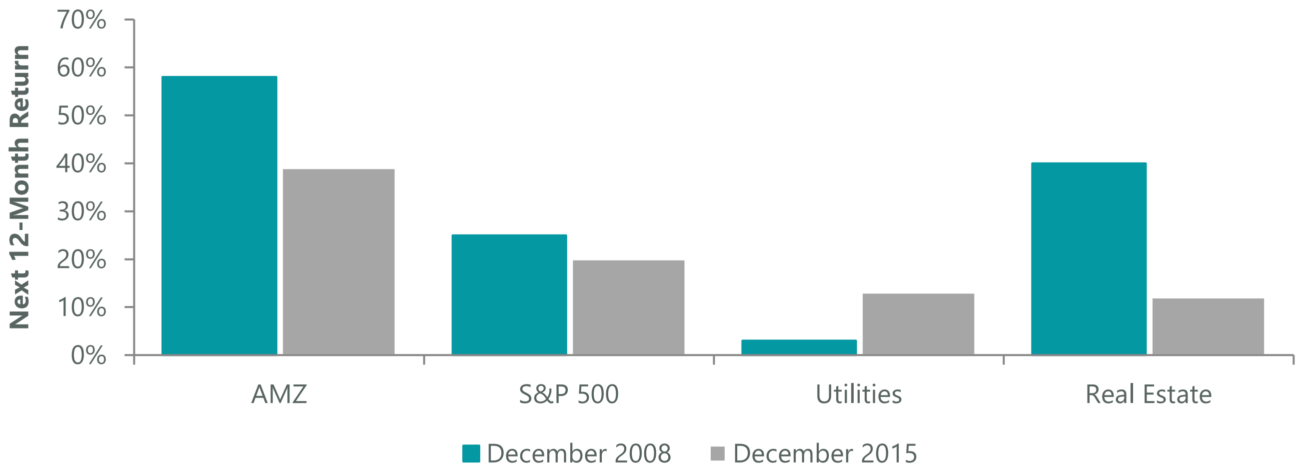
Current low U.S. Treasury yields and the inversion of the 2-year/10-year Treasury yield curve earlier this month should remind energy midstream investors that the spread between midstream stocks and Treasurys is an anomaly — one that has boded well for midstream companies in the past. As of August 15, the yield spread between the Alerian MLP Index (AMZ) and 10-Year Treasurys stood at 717 basis points, nearly 90% higher than the 20-year average yield spread of 381 bps. Moreover, the current spread is 2.2 standard deviations above the mean, and this does not happen very often. Including this August, only three times in the last 20 years has the yield spread blown out to more than two standard deviations from the mean. What do the other two occasions have to tell us?

Exhibit 1: Yield Advantage of Midstream Companies Ticking Up

Source: ClearBridge Investments, Bloomberg LP. As of August 15, 2019.

In December 2008, the yield spread increased beyond two standard deviations, and over the next 12 months the Alerian MLP Index returned 58%. This more than doubled the 25% return of the S&P 500 Index over the same period and beat utilities (+3%) and real estate (+40%) stocks as well. When the spread grew past two standard deviations in December 2015, the Alerian MLP Index returned 39%, compared to the S&P 500's 20%, utilities' 13% and real estate's 12% gains over the next 12 months (Exhibit 2).

Exhibit 2: Midstream Outperformed After Yield Spread Increases



Source: ClearBridge Investments. Next 12-month return periods follow increases of Alerian MLP Index and 10-year U.S. Treasury yield spread greater than two standard deviations beyond 20-year average of 381 bps.

One major difference between those two periods and today is the yield curve. In December 2008 the 2-year/10-year Treasury yield curve was positively sloped by 95 bps; in December 2015 it was positively sloped by 194 bps. As of August 21, it was positively sloped by only three basis points.

While a much narrower slope today may disrupt the pattern of midstream outperformance when yield spreads have increased, performance following yield curve inversions — such as the one on August 14 — has been strong. In the last 20 years, the yield curve has inverted two other times: in December 1999 and December 2005. Twelve months following the December 1999 inversion, the Alerian MLP Index was up 33%, while the S&P 500 was down 9%. Three years later, the Alerian MLP Index was up 61%, while the S&P 500 was down 38%.

One year after the December 2005 inversion, the Alerian MLP Index had risen 27%, beating the S&P 500's gain of 16%. Three years later, the Alerian MLP Index was down 10%, while the S&P 500 had fallen 23%.

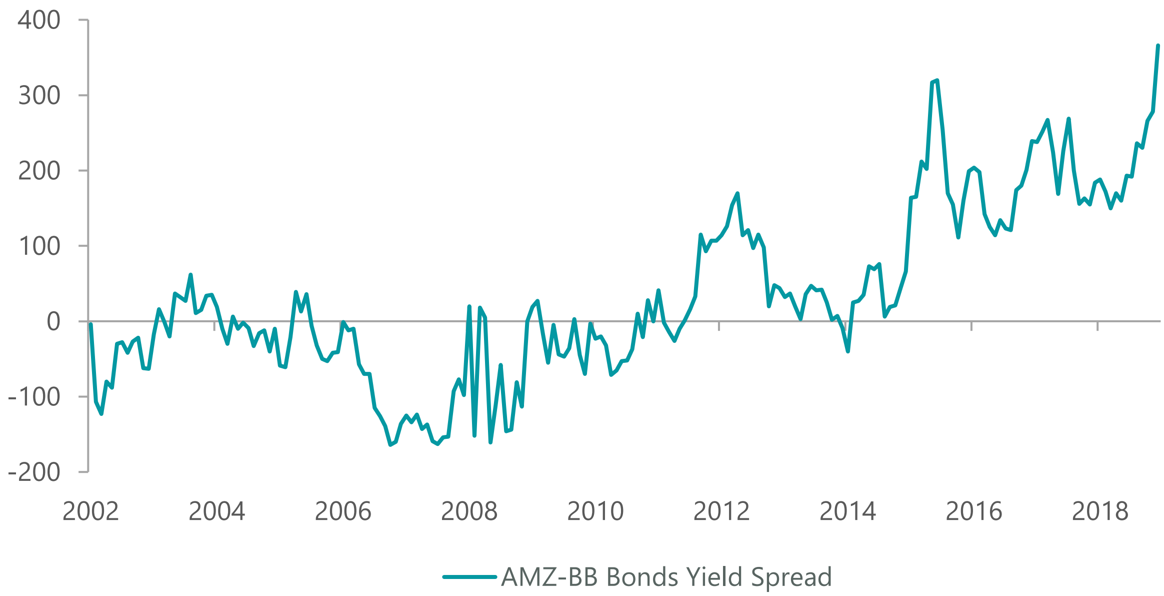
One difference between the December 1999 and December 2005 inversions was that in 1999 the yield spread between the Alerian MLP Index and 10-Year Treasurys was historically high at 446 bps. In December 2005, this spread was historically low, at 258 bps. This might explain why midstream stocks performed better following the 1999 inversion than after the 2005 inversion — they were more expensive relative to 10-year Treasurys in late 2005 than in late 1999. In late 1999, midstream stocks were historically cheap relative to 10-year bonds, though not as cheap as they are today.

Midstream stocks look attractive compared to the high yield bond market as well. At the close of trading August 15, the yield spread between the Alerian MLP Index and BB bonds stood at 366 bps — a record spread, well beyond the average of 34 bps and 2.9 standard deviations above the mean (Exhibit 3).[1] Investors looking for

[1] Since the inception of the Bloomberg Fair Value USD Composite (BB) 10-Year Index.

income as the Fed weighs further rate cuts and bond yields remain depressed may find midstream stocks an attractive place to be.

Exhibit 3: Midstream–High Yield Spread at Record Highs



Source: ClearBridge Investments, Bloomberg LP. As of August 15, 2019.

About the Author

Chris Eades
Managing Director, Portfolio Manager

- 27 years of investment industry experience
- Joined ClearBridge Investments in 2007
- BA from Vanderbilt University