ClearBridge Investments

Energy MLP Strategy

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Key Takeaways

- Midstream energy stocks bounced back in the second quarter as energy prices stabilized and the world succeeded in slowing the spread of COVID-19.
- COVID-19 reducing global oil demand by about 25% has left the short-term outlook exceedingly cloudy.
- Beyond 2020, the lack of spending on oil drilling as a result of the price collapse could set the stage for a healthy recovery if global oil demand normalizes.

Market Overview and Outlook

Midstream energy stocks bounced back in the second quarter as energy prices stabilized and the world succeeded in slowing the spread of COVID-19, in many areas reopening economies and creating optimism for renewed energy demand.

Energy prices rose steadily after dipping into negative territory in April when supply and demand imbalances peaked. Higher oil prices were supported by signs of renewed oil demand as well as an at least temporary cohesion between OPEC and its allied countries, which agreed to extend a production cut through July. A barrel of WTI Crude oil began the quarter at $20.48 and finished at $39.64.

The U.S. economy showed signs of improvement in the quarter. A surprisingly upbeat jobs report that saw 2.5 million jobs added in May was accompanied by positive consumer spending news. The economy then added another 4.8 million jobs in June, while the unemployment rate fell to 11.1% from 13.3% in May. Similarly, manufacturing activity picked up, with the ISM Manufacturing PMI for the U.S. rising from 41.5 in April to 43.1 in May to 52.6 in June — over 50 and in expansionary territory. At the same time, surges in the number of COVID-19 infection cases, both abroad and in parts of the U.S., continued to loom over economic reopening.

The benchmark Alerian MLP Index (+50%) recovered strongly in what was largely a mirror image of its selloff in the first quarter when oil prices plummeted and economies shut down. The gathering/processing subsector, leading the index down with a -72% return in the first quarter, advanced 87% in the second quarter and led the index. Liquids transportation & storage was also second in line in both quarters, falling -55% in the March quarter and gaining 46% in the June quarter.

Diversified energy infrastructure returned -53% and 43% and natural gas transportation & storage garnered -33% and 22% in the first and second quarters, respectively.

The lack of spending on oil drilling as a result of the price collapse could set the stage for a healthy recovery if global oil demand normalizes.

Entering 2020, midstream investors had a good reason to be optimistic. U.S. energy production growth would likely continue to drive midstream cash flows. Balance sheet deleveraging had reached a level where share buybacks were likely to be in play during the second half of the year. Dividend/distribution coverage was estimated to approach 1.5x. M&A activity was expected to be robust with publicly traded midstream stocks trading substantially below cash flow multiples seen in private market transactions. In short, the outlook was positive heading into the year.

However, COVID-19 reducing global oil demand by about 25% has left the short-term outlook exceedingly cloudy. A renewed OPEC+ agreement reached in early April reduced global oil supplies by roughly 10 million barrels per day. However, global oil demand collapsed by over 25 million barrels per day due to global coronavirus shutdowns. The question as the second quarter concludes is at what pace global oil demand will recover and the resultant duration and magnitude of the oil market's oversupply. If demand recovers enough to limit global inventory builds, oil prices will likely hover between cash operating costs ($15–$20 per barrel) and the price where new oil drilling is economical ($35–$40 per barrel). If demand does not recover quickly enough and inventories are again filling rapidly, oil prices will have to fall below $15 per barrel to incentivize producers to shut in existing production. If the latter becomes reality, it will likely be short lived. Yet, it would bring into question midstream cash flows in 2020 and into 2021 as U.S. oil production would move lower.

Beyond 2020, the lack of spending on oil drilling as a result of the price collapse could set the stage for a healthy recovery if global oil demand normalizes. If global oil demand returns to levels seen in early 2020, the lack of capital spending on oil wells could result in a shortage of oil. In such a scenario, the global market would need more U.S. oil production — setting the stage for shale drilling to again be a growth driver for midstream companies.

Portfolio Highlights

On an absolute basis, the Strategy had a positive return for the second quarter, underperforming its benchmark. In terms of absolute performance, the Strategy had gains in all four subsectors in which it was invested. In a reversal of first-quarter performance, the diversified energy infrastructure subsector was the strongest contributor, while the natural gas transportation & storage subsector was the main laggard.

On a relative basis, the Strategy underperformed due to stock selection and sector allocation effects. In particular, stock selection in the liquids transportation & storage and gathering/processing subsectors detracted from relative returns; the Strategy's cash position also weighed on relative performance. Conversely, stock selection in the diversified energy infrastructure subsector and an underweight to the natural gas transportation & storage subsector proved beneficial.

In terms of individual contributors, Energy Transfer LP, ONEOK, Enterprise Products Partners LP, Williams Companies and MPLX LP contributed the most to absolute performance. CNX Midstream Partners LP and Equitrans Midstream were the sole detractors.

During the quarter, Equitrans Midstream Corporation (ETRN) completed its acquisition of all outstanding common units representing limited partner interests in portfolio holding EQM Midstream Partners LP (EQM). The Strategy received and retained shares of Equitrans Midstream.