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## Energy MLP Strategy

### Key Takeaways

- ▶ Strong performance for midstream came on the back of strong execution, an improving natural gas price outlook and growing acknowledgment midstream infrastructure plays a key role to back up renewable power as AI demand grows.
- ▶ The trajectory of oil prices over the next year or so will likely be dictated by demand factors — not supply.
- ▶ The intermediate- to long-term outlook for natural gas prices remains positive — driven by continued increases in demand for natural gas in U.S. electricity generation and increasing U.S. liquefied natural gas export capacity.

### Market Overview

Midstream energy stocks stood out from the energy sector in the second quarter, with the Alerian MLP Index advancing 3.35%, more than 500 basis points ahead of the S&P 500 Index's energy sector, which fell 2.42%. Strong performance came on the back of strong execution, an improving natural gas price outlook and growing acknowledgment that midstream infrastructure plays a key role to back up renewable power as AI demand grows. Natural gas prices rose 47.5% to finish the quarter at \$2.60 per mmbtu, while extensions of OPEC+ supply cuts well into 2025 helped crude oil prices recover from a steep decline mid-quarter to end down 2.0% at \$81.54 per barrel of WTI Crude.

Our outlook for the MLP market remains constructive. Global economies continue to face multiple headwinds, led by a combination of stubbornly high (although recently moderating) inflation, elevated geopolitical uncertainty and lingering supply chain and policy impacts from the COVID-19 pandemic. In the U.S., we have begun to see the dampening effects on the economy of tighter monetary conditions. During 2022, equity markets began pricing in a reasonable chance of recession, both in the U.S. and abroad. In 2023, global equity markets generally recovered the losses incurred in 2022, and expectations are that developed economies should avert a recession in 2024.

Crude oil prices fell from more than \$120 per barrel in June 2022 to ~\$70 per barrel at year-end 2023. Recession concerns left oil market traders fearful of global demand downdrafts for crude oil in 2023 much like those witnessed during the Global Financial Crisis (GFC). A stronger U.S. dollar and large-scale releases of crude oil from the U.S. Strategic Petroleum Reserve (SPR) further pressured oil prices. On the

other hand, demand fear was partially offset by some optimism for a rebound in China demand with the lifting of COVID-19 restrictions. The surprise OPEC+ supply cut of 1.1 million barrels per day at the end of March 2023, and again in November, have also likely put a floor on oil prices over the near term.

The trajectory of oil prices over the next year or so will likely be dictated by demand factors — not supply. Most oil economists forecast a roughly 1.0-1.5 million barrel per day increase in global oil demand to ~103 million barrels per day in 2024. Essentially all of this demand growth is expected in developing nations, rather than OECD nations. We would argue that oil prices of roughly \$70 per barrel at the end of December 2023 discounted that oil demand growth will not approach levels expected by oil economists in 2024. Said differently, oil traders seemed to expect a material contraction in global oil demand growth rates compared to oil economists. A final twist to oil demand analysis remains the timing of the U.S. refilling its vastly depleted Strategic Petroleum Reserve (SPR). After depleting the SPR by roughly 275 million barrels (or ~45%) in the 18 months prior to June 2023, the U.S. government has slowly begun refilling it. Thus, what has been a meaningful source of supply in the crude oil markets is becoming a source of demand. Since the start of 2024, the SPR inventories have increased by 12.5 million barrels, and 18 million more are expected by October.

If global oil demand growth does approach roughly 1.0-1.5 million barrels per day in 2024, we see upside in oil prices in 2024. The supply side of the global oil market will meaningfully struggle to meet that kind of demand growth. We would also argue that the incremental barrel of oil supply in such a scenario will almost have to be a barrel of U.S. oil — continuing to drive visibility in continued growth in U.S. oil production to the benefit of U.S. midstream companies.

Looking at natural gas, the short-term outlook is negative while the intermediate- to long-term outlook remains robust. Fairly mild winter weather (demand) and increasing associated natural gas production from oil wells (supply) has resulted in spot natural gas prices falling from above \$3 per mmbtu in December to \$2.60 per mmbtu at the end of June. The intermediate- to long-term outlook for natural gas prices remains positive — driven by continued increases in demand for natural gas in U.S. electricity generation and increasing U.S. liquefied natural gas (LNG) export capacity to international markets in 2024-2027.

Valuations for U.S. midstream companies remain well below the levels seen before the pandemic. Entering 2020, enterprise value to EBITDA (EV/EBITDA) multiples stood at roughly 10.5x. Despite the rebound the sector has experienced since the March 2020 lows, the sector today trades at 9.1x — despite what we view as a vastly better business model. Dividend/distribution coverage has moved from 1.1x to more than 2.0x. The sector has moved from being free cash flow negative to free cash flow positive (increasingly so in 2023) and

balance sheet leverage (debt/EBITDA) has moved from more than 5.0x to below 3.5x. With no need for midstream companies to access capital markets for the foreseeable future, we increasingly expect excess cash flow (above and beyond capital spending and dividends/distributions) to be used for increasing share buybacks and further increasing dividends/distributions.

With improving financial metrics and continued low valuations, we still see solid upside potential for the U.S. midstream sector despite strong performance in 2022 and 2023.

### Portfolio Highlights

The ClearBridge Energy MLP Strategy outperformed its Alerian MLP Index benchmark during the second quarter. In terms of absolute performance, three of four subsectors in which the Strategy is invested made positive contributions, with the diversified energy infrastructure subsector the main contributor.

On a relative basis, the Strategy outperformed due to sector allocation effects and stock selection. Stock selection in the diversified energy infrastructure and liquids transportation & storage subsectors as well as an overweight to the gathering/processing subsector contributed the most to relative results, while stock selection in the gathering/processing subsector detracted.

In terms of individual holdings, Targa Resources, Western Midstream Partners LP, Genesis Energy LP, Williams Companies and DT Midstream were the main contributors. The sole individual detractors were TC Energy, NuStar Energy LP and Enbridge, while EnLink Midstream and Sunoco LP also lagged.

During the quarter holding Sunoco LP completed its acquisition of holding NuStar Energy LP.

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Performance source: Internal. Benchmark source: Alerian MLP Index.

Performance source: Internal. Benchmark source: Standard & Poor's.