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GLOBAL ASSET MANAGEMENT

U.S. ENERGY MLP UPDATE

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Key Takeaways

- The stock market had a difficult fourth quarter as slowing global growth and rising short-term interest rates raised concerns.
- U.S. energy production growth remains robust.
- Our view remains that the disconnect between master limited partnership (MLP) stock prices and MLP cash flows will narrow over time.

Market Overview and Outlook

The U.S. stock market had a difficult fourth quarter, with the S&P 500 Index declining -13.52% as slowing global growth, exacerbated by escalating trade tensions with China, and rising short-term interest rates raised concerns. The Alerian MLP Index finished the quarter down -17.30%, and the year down -12.42%.

Revised expectations for forward U.S. economic growth created volatility across the financial markets. Yields on the 10-year U.S. Treasury fell from a high of 3.23% on November 8 to a low of 2.68% at year end. The short-end of the yield curve inverted the last week of 2018 and again the first week of 2019. The 2-year to 10-year Treasury spread narrowed to only 12 basis points in early December, the tightest since 2008. An inverted yield curve has historically proved to be a reasonably good predictor of recessions. Oil prices peaked north of US$75 in early October but cratered to the mid-US$40s by year end. Coming into the fourth quarter, oil markets had been anticipating shortages caused by new Iranian sanctions. Instead, the sanctions had little impact and weaker global economic results reduced demand expectations. The U.S. dollar increased from 1.16 euros to 1.145 during the quarter, making a new high for the year but still trading within a narrow range.

Despite fears, the U.S. economy continues to grow steadily while the labor market remains strong. The fourth-quarter market decline was broad based, with only the defensive utilities sector generating a positive return. Other defensive areas such as real estate and consumer staples were down, but performed relatively better, as long-term interest rates declined midway through the fourth quarter. The energy sector, meanwhile, was the hardest hit, as oil prices dropped to their lowest levels in a year. Information technology and consumer discretionary stocks also fell, largely on worries of global economic cooling.

While the U.S. consumer did well, manufacturing experienced some softness to close out 2018. Retail sales were strong, posting one of the best Christmas seasons in years. Car sales were steady above 17 million (seasonally adjusted annual rate), although results were boosted by high fleet sales. Housing slowed slightly but continued to grow. Unemployment claims bottomed for the cycle in September at 205,000 before rising to 231,000 by December — still a very low number. Job creation was very good in December at 312,000 and average hourly wage growth picked up to 3.2%. Employment is the best single indicator of the health of the U.S. economy but tends to lag at the onset of a recession.

> We believe the disconnect between MLP cash flow growth and valuation multiples is not sustainable.

MLP Market Outlook

U.S. energy production growth remains robust. At the end of 2018, oil production was up 20% year over year, natural gas production up 12%, and natural gas liquids production up 14%. While U.S. energy production growth rates may slow heading into 2019 due to infrastructure bottlenecks (primarily in the Permian Basin of West Texas), we expect production growth to continue. Such infrastructure bottlenecks are a clear signal from the market that growth opportunities to build new pipeline, storage and processing facilities will continue for at least the next several years. This continued growth in U.S. energy production and associated infrastructure buildout will drive increasing cash flows for energy infrastructure companies. Looking to 2019, we expect 11% cash flow growth from the MLP sector compared to 3% for the S&P 500, 4% for utility stocks, and 3% for real estate investment trust (REIT) stocks. As of year-end, the MLP index yields 8.9% compared to 2.2% for the S&P 500, 3.5% for utility stocks and 3.7% for REIT stocks. Yet, despite higher cash flow growth and higher yields, MLP stocks trade at lower EV/EBITDA (Enterprise Value to its Earnings Before Interest, Taxes, Depreciation & Amortization) multiples than the broader U.S. equity market, utility stocks and REIT stocks. We remain of the opinion that this disconnect is not sustainable in the long term.

We expect WTI (West Texas Intermediate) oil prices to trade in an intermediate to long-term range of US$50 to US$70 per barrel. In this price range, oil prices are high enough to incent drilling necessary to ensure supply growth and low enough to ensure continued demand growth. For reference, the 20-year average price for WTI oil is US$59.89 per barrel. The recent decline in oil prices has mostly been the result of OPEC (The Organization of the Petroleum Exporting Countries) (largely Saudi Arabia) increasing oil production ahead of Iran sanctions being implemented in early November. While Iran sanctions are in place, waivers have been granted to many countries allowing more Iran oil in the global market than expected — resulting in rising inventories and falling oil prices. In our view, it is likely that OPEC reduces oil production by roughly 1 million barrels per day in the coming months to bring the oil market back into balance. Such a production decline by OPEC would likely result in firming oil prices.

We expect the U.S. Federal Reserve to raise interest rates two to three more times during 2019 before pausing. In an historical context, interest rates will likely remain low and we do not expect higher interest rates to impair expected returns on new capital investment by energy infrastructure companies. MLP stocks have not typically traded with the U.S. interest rate cycle. Over the past 10 years, there have been four previous periods where 10-year U.S. Treasury yields have increased by more than 100 basis points. MLP stocks outperformed other income-oriented equities (utilities and REITs) in all four periods.

Risks: 1) A protracted trade war between China and the U.S. more significantly impacts the global economy with the resulting slump in global demand growth for oil. 2) Saudi Arabia maintains current production levels to appease President Trump for not further pursuing the assassination of journalist Jamal Khashoggi. This would likely result in an oversupplied oil market and oil prices falling below our expected intermediate to long-term range of US$50 to US$70 per barrel for a period of time. 3) Slowing U.S. corporate profit growth leads to a weakening U.S. equity market, which would likely present a headwind for MLP stock prices.

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* As of 31 December 2018.

IMPORTANT INFORMATION

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