# ENERGY MLP UPDATE

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### Key Takeaways

- Energy was — by far — the best performing sector in the second quarter.
- The master limited partnership (MLP) sector was supported by energy sector outperformance and firming commodities prices in the second quarter.
- Strong MLP performance is potentially signaling a shift in investor sentiment after first-quarter volatility weighed on returns.

## Market Overview and Outlook

The stock market overcame trade frictions to rise 3.4% during the second quarter of 2018, as measured by the S&P 500 Index. Energy was — by far — the best performing sector in the second quarter. Technology and consumer discretionary stocks, driven by strong earnings, also generated healthy returns. Trade concerns and the previously mentioned impact on Treasury yields resulted in considerable performance lags among financial, industrial and consumer staples stocks. Utility and real estate stocks — which had lagged earlier in 2018 and all of 2017 as interest rates rose — outperformed.

The Alerian MLP Index led the broad market in the second quarter, finishing in the period up 11.8%, ahead of the S&P 500 Index and both growth and value subsets of major large and small cap indexes. Oil prices rose to a five-year high owing to a multitude of factors, including strong demand, threats of U.S. sanctions against buyers of Iranian oil, outages in Venezuela and Libya and transportation constraints in the Permian Basin.

The U.S. looks strong on both the consumer and industrial sides of the economy. After dipping to a weather-constrained 2% in the first quarter, U.S. Gross Domestic Products (GDP) growth accelerated to over 4% in the second quarter, according to estimates. The unemployment rate fell to 3.8% in May, the lowest in 18 years, and jobless claims ended June at a multiyear low of 231,000. Debt service, while off the 2013 bottom, is only about 10.5% of disposable income, compared with a peak of over 13% in 2009. Auto sales jumped in June to a seasonally adjusted annual rate of 17.4 million, after several months in the high 16 million range. Housing permits grew 23% in April, the most important month of the year. While permit growth slowed in May to 8%, performance was consistent with increases seen over the past year. Personal Consumption Expenditures (PCE) inflation is slowly accelerating and finally hit the Federal Reserve's 2% target in June, while wage growth was 2.7%. The June ISM Manufacturing Index hit a near cycle high of 60.2. The only economic yellow flags we see are the flattening of the yield curve and a high level of corporate indebtedness.

Despite sustained healthy U.S. economic performance, including a modest acceleration in inflation, concerns that trade would reduce U.S. growth held back increases in U.S. Treasury yields (up in the second quarter to 2.86% from 2.74%).

> Takeaway issues in the Permian are a positive for MLPs, who should find oil producers eager to sign up for capacity.

## MLP Market Outlook

Our outlook for MLP stocks remains positive over the balance of 2018 and into 2019. As of the end of the second quarter, the Alerian MLP Index is up 11% from its bottom in March and almost 12% in the second quarter despite roll ups of Enbridge and Spectra and a distribution cut from TC PipeLines. The sector is supported by energy sector outperformance and firming commodities prices in the second quarter, but also potentially signaling a shift in investor sentiment, which was rattled by volatility earlier in the year. Sector fundamentals remain strong, and MLP companies are delivering growth — first-quarter 2018 distributions were up on average 5.5% year-over-year. In time, our expectation remains that MLP stock prices will reflect solid and improving cash flow fundamentals.

We are starting to see signs oil producers in the Permian Basin are unable to facilitate growth. Oil is selling at a deep discount in the Permian compared to the West Texas Intermediate (WTI) benchmark, as producers are having a hard time getting oil and gas out of the area; the region is running out of pipeline quicker than expected. This is a positive for MLPs, who should find oil producers eager to sign up for capacity.

MLP stocks should also benefit from several tailwinds that include rising U.S. energy production, decreased equity capital market needs, growing cash flows and record-low valuations.

U.S. oil production should continue making new all-time highs over the balance of 2018. Global demand growth is outstripping global supply growth — reducing inventories and requiring more U.S. oil in the global market to avoid a significantly undersupplied market.

U.S. natural gas production will likely continue to increase — driven by visible demand growth over the coming years. Demand growth for natural gas will likely continue to increase with market share gains in power generation, increasing contracted exports of Liquefied Natural Gas (LNG) and greenfield construction of 12 petrochemical plants.

MLP balance sheets remain on average in good shape, and MLP companies continue to enjoy ready access to capital markets. Capital expenditures, however, should fall in 2018 and 2019 from recent elevated levels and require less equity issuance, and new projects coming into service will drive cash flow growth in 2018 and again in 2019. We think this is a critical component to why MLP stocks are well-positioned for a rebound over the remainder of 2018. These positives, combined with MLP stock valuations at record lows, could set the stage for a further rebound in MLP stock prices.

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| Brandywine Global<br>Clarion Partners<br>**ClearBridge Investments**<br>EnTrustPermal<br>Martin Currie<br>QS Investors<br>RARE Infrastructure<br>Royce & Associates<br>Western Asset Management | Legg Mason is a leading global investment company committed to helping clients reach their financial goals through long term, actively managed investment strategies.<br>• Over US$752 billion* in assets invested worldwide in a broad mix of equities, fixed income, alternatives and cash strategies<br>• A diverse family of specialized investment managers, each with its own independent approach to research and analysis<br>• Over a century of experience in identifying opportunities and delivering astute investment solutions to clients<br>* As of 31 August 2018. |