Tortoise QuickTake Podcast

June 19, 2017

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Thanks for joining us today on the Tortoise Quick Take Podcast. I'm James Mick, Managing Director and Portfolio Manager with Tortoise Capital Advisors.

As we field investor calls about the malaise in the energy space, I find myself consistently stating sentiment in energy is clearly negative. I'm half expecting someone to tell me, "Thank you Captain Obvious." And yet the next question is the one that is harder to answer, but more important, "What will turn this ship around and get energy markets heading in the right direction?" As Henry Ford said, "Don't find fault, find a remedy."

Before we get to that answer, let's kick things off with a recap of market performance:

- On the commodity front, crude oil continued its weakness, declining 2.4%, while
- Natural gas was essentially flat, down 7 basis points
- Shifting to equities, the broader S&P Energy Select Sector Index® finished higher, up 52 basis points. And for the record, I did double check that number 3 times!
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠, were down, falling 2%
- And finally MLPs were also under pressure, as the Tortoise MLP Index® also fell 2%

Obviously energy stocks continue to be under pressure and sentiment is negative. Insert the aforementioned thank you Captain Obvious comment. Sentiment is being driven by crude oil prices which are lower primarily due to concerns about stubbornly elevated inventory balances, increasing U.S. production in 2017 and expectations for that to continue in 2018, the stronger and earlier than expected return of Libyan and Nigerian barrels, concerns regarding slowing demand and the expectation of increasing OPEC barrels hitting the market when the current production cut agreement expires in 1Q 2018. That's a long list…

Additionally, OPEC only executed on half of their equation to start the year. While production has been cut and compliance has been strong, exports have remained much higher than anticipated, with some reports of only 400,000 bpd cuts versus the 1.2 million bpd production cuts. In effect, OPEC has yet to take crude off the market in the volumes they stated they would. This has to change. We anticipate that it is now a priority, but for the first five months or so of 2017, it appears to be a bit of a head fake.

Enough about why we are here, let's figure out some ways to get out of the doldrums.

From a macro perspective, here are a few things that we think would likely give the market a boost:

- OPEC could deepen the production cuts
  - – This isn't out of the question and was at least discussed in May
- Exports out of OPEC countries fall to levels of production
  - – This must happen, but the data is delayed, so we may not know for awhile
- Libya and Nigeria could be brought under the production cut agreement to eliminate the continued surge in their production
- U.S. producers could announce lower than anticipated capex budgets for the back half of 2017
- The U.S. rig count could stop increasing every single week
  - – Obviously this would coincide with lower capex spending just noted
- All of this would ultimately bring down inventory balances

In past years, we would have said a geopolitical event that caused a disruption in supply could also impact prices positively, but with sentiment so poor, even those have been taken negatively.

From a sector level view:

Upstream companies would likely benefit from a slowdown in drilling and capex spend in the back-half of 2017. That would alleviate some of the concern about surging U.S. production simply overwhelming OPEC production cuts. Note, as we have discussed before, we believe this concern is overblown and 2018 production, while moving higher, is not likely to increase at levels many expect.

Midstream companies would perversely be helped as well by the slowdown in drilling. It's interesting that midstream companies have performed so poorly when a big concern in the market has been surging volumes from U.S. producers. Yet the slowdown in drilling would likely benefit sentiment. Additionally, announcing distributions and solid earnings would go a long way to getting over the hump for midstream companies. Finally, in our view more open equity capital markets or alternative sources of funding would be hugely beneficial to relieve pressure on stock prices of those companies with capital needs or visible growth requiring equity market access.

Downstream companies would benefit from an uptick in demand markers. Demand for crude oil typically builds by quarter throughout the year. For the most part, agencies such as the EIA and IEA have kept their 2017 full year demand numbers intact, but builds in product stocks in the U.S. specifically have some market watchers a bit worried.

At a company level, we feel energy executives must work to control what they can and execute on plans they have laid out to investors. Healthy balance sheets are likely to be rewarded as avoiding the pitfalls of the most recent downturn will prove beneficial for relative outperformance.

With all that, we feel the numbers dictate we will see draws in inventory for crude oil in the back half of the year. OPEC needs to get exports in line with production and reiterate to the market what they intend to do at the end of the production cut period.

Given we provide weekly podcasts, it can be easy to get narrowly focused on the next week, month or quarter, but it's always good to step back and see the bigger picture as well.

Over the next five years, we see crude oil, natural gas and natural gas liquids production in the U.S. increasing meaningfully. Additionally, we believe exports will play a vital role as the U.S. continues its march to being a major global player in energy on the supply side. There are always bumps in the road in any transition and this is a significant transition we are in, brought about by the exploitation of shale resources.

The market is currently weak and presents a great opportunity for long-term buyers. The rebound will come and when it does, we believe investors are very likely to be handsomely rewarded for their patience.

That will do it for today. Have a great week and we look forward to speaking with you again soon.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.

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Tortoise North American Oil & Gas Producers Index℠ The Tortoise North American Oil & Gas Producers Index℠ is a float-adjusted, capitalization weighted index of North American energy companies primarily engaged in the production of crude oil, condensate, natural gas or natural gas liquids (NGLs). The index includes exploration and production companies structured as corporations, limited liability companies and master limited partnerships but excludes United States royalty trusts.

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