Tortoise QuickTake Podcast

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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.

Welcome to the holiday season. For energy investors, presents came early, with a Trump presidential victory and an OPEC production cut. Now cold weather is leading to a nice bump in natural gas prices as well, closing near a two year high on Friday. With news over the weekend of a coordinated cut in non-OPEC, non-U.S. production, we believe the stage is set for a rebalance to occur in 2017.

Sentiment has clearly shifted to the positive side of the ledger, yet many details remain to be determined related to the new administration and the crude oil production cuts.

Let's start with a quick look at market performance this past week. On the commodity front, crude oil was down marginally, about 35 basis points, while natural gas was up big as mentioned, plus 9% for the week on colder weather. Shifting to equities, the broader S&P Energy Select Sector Index® finished higher, rising 2.3%. Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠, increased as well, up 1.9%. And finally MLPs were solid, as the Tortoise MLP Index® finished up 1.2%.

It was a busy week with two different industry conferences. We sent a team to New York for a major investment bank's annual midstream, MLP and utility conference. The key takeaways were consistent with what we have been hearing for the last several weeks; better sentiment on an improved regulatory outlook and OPEC cuts, but cautious management teams on still undecided 2017 E&P budgets, as well as a hot merger environment.

We also attended a conference focused exclusively on the various resource plays within North America. As expected, the key takeaways centered on the positive outlooks for the Permian Basin in West Texas and New Mexico, the SCOOP/Stack in Oklahoma and the Marcellus Shale in the Northeast. Interestingly one of the key stats noted was the approximation that it would take only 100-150 incremental rigs to increase production 500,000 barrels per day, per year. That's below the 1 million barrels per day we were adding annually pre-oil price collapse, but still very strong considering the large decline in the rig count.

Speaking of rigs, North America added 57 rigs in the latest week, including 27 by the U.S., which is the most U.S. rigs added in a single week since April of 2014.

Finally, I would like to touch on the impact of rising rates on energy investments. Most notably, we receive this question related to midstream and MLP investments. From our view, we evaluate the impact of rising rates from both a direct and indirect basis on MLPs. So first, from a direct standpoint, there is an impact to the extent that a company has floating rate leverage. The key mitigating factor is that midstream MLPs are approximately 80% fixed rate debt, so this impact is very minimal on cash flow. Second, from an indirect standpoint, we look to assess the impact on the weighted average cost of capital and returns over and above that cost of capital. While you could see some increases in the cost of debt and equity, there are several mitigating factors in our view that help lessen the impact of the higher rates and ultimately allow companies to continue growing their distributions.

A few of those mitigating factors are:

1) excess coverage,

2) internal versus external growth; and

3) the ability to pass thru inflation via either higher rates or volumes.

The next point simply looks at what history has shown us. What we have seen historically is that when rates have increased by 50 basis points or more, the return of MLPs has actually been quite positive and similar to what you see in the S&P 500. In fact, MLPs have averaged a 6.4% return based on the 12 different time periods that we have noted. This compares favorably to the S&P 500 average return of 6.7% for the same time periods.

Finally, I would point out two more important data points. First, we evaluated the spread of MLPs to the 10-year Treasury for 2 different scenarios. The first is when the 10 year is above 4%. In those instances, the average spread to MLPs is roughly 266 basis points. The second is when the 10 year is below 4%. In those instances, the average spread to MLPs is roughly 450 basis points.

The key takeaway is that as the 10 year moves higher, the spread is historically not a linear function, but rather will compress, hence MLPs don't have to trade off simply because the 10 year is moving higher.

Second, we ran correlation data for the 10-year Treasury to MLPs and confirmed that traditionally over essentially all time periods, including 1, 3, 5 and 10 years, the correlation is exceptionally low and actually is lower for the more recent time periods. One more indication of our view that MLPs trade more as equities as opposed to fixed income due to the growth component

In summary, while you may see some near term impact on MLPs from rate moves, we feel the data points to a more positive story and history has shown that to be the case as well.

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@tortoiseadvisors.com.

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The S&P Energy Select Sector® Index is a capitalization-weighted index of S&P 500® Index companies in the energy sector involved in the development or production of energy products.

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.

The Tortoise MLP Index®
The Tortoise MLP Index® is a float-adjusted, capitalization-weighted index of energy master limited partnerships. The index is comprised of publicly traded companies organized in the form of limited partnerships or limited liability companies engaged in transportation, production, processing and/or storage of energy commodities.

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