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Recent Oil Market Tumult and MLP Investments

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Oil prices have taken investors on a wild and unpleasant ride as of late. Since last August, WTI (West Texas Intermediate) Oil has dropped by just over 50% as of the time of this writing. The initial round of selling took place in the second half of 2014, rebounded significantly, only to collapse again. Oil has now retraced to the old January lows below $45 a barrel.

There are a few drivers of this turmoil. On the demand side, there are legitimate concerns about slowing in emerging market economies, which have become important buyers of commodities as they have industrialized. As the incremental buyer, emerging market demand has a significant price impact. In China, volatile equity and real estate markets in conjunction with slower economic growth has significantly worried the market. Demand from Europe and Japan remains slow, although we believe the growth outlook there is better than commonly appreciated. This leaves the U.S. as the only significant driver of demand, but growth even in the States is still slow. Equally importantly, efficiency measures have retarded energy demand growth.

On the supply side, the ongoing boom in U.S. oil production has created a notable glut of oil and gas inventories. Despite laying down a significant number of rigs, shale drillers have continued to hold up production through productivity and previously funded projects coming online. The market also is concerned about the impact of resurgent Iranian oil production, as a nuclear agreement and eventually normalized relations seems to be imminent.

We believe this altered supply picture will be a benefit for the U.S. economy overall, as consumption is an enormous part of our economy. Even at low prices the shale boom is a source of jobs and earnings in the U.S., compared to a stagnant industry before. However, the sheer size of the decline has negatively impacted U.S. energy company earnings, and thus S&P 500 Index – whereas the benefits may take longer to filter through reported earnings.

At Berman Capital, we continue to believe these events are creating investment opportunities. We would be the first to say that it's essentially impossible to predict near-term oil prices. Fortunately one doesn't have to make a direct commodity call to take advantage of dislocation. One important beneficiary may be distressed debt funds, who can step in to provide needed capital at attractive rates to borrowers in the energy patch. We think this is an attractive area, but will take time to develop.

More immediately, the collapse in oil prices has had significant impacts in the MLP (Master Limited Partnership) space. As you can see from the chart below, MLPs have declined as much as large U.S. energy companies, although far less than oil itself and energy and production companies (especially those with significant borrowing). The chart below shows the price change of the S&P (green), the energy sector (red) and the Alerian MLP Index (white) since the beginning of 2013.

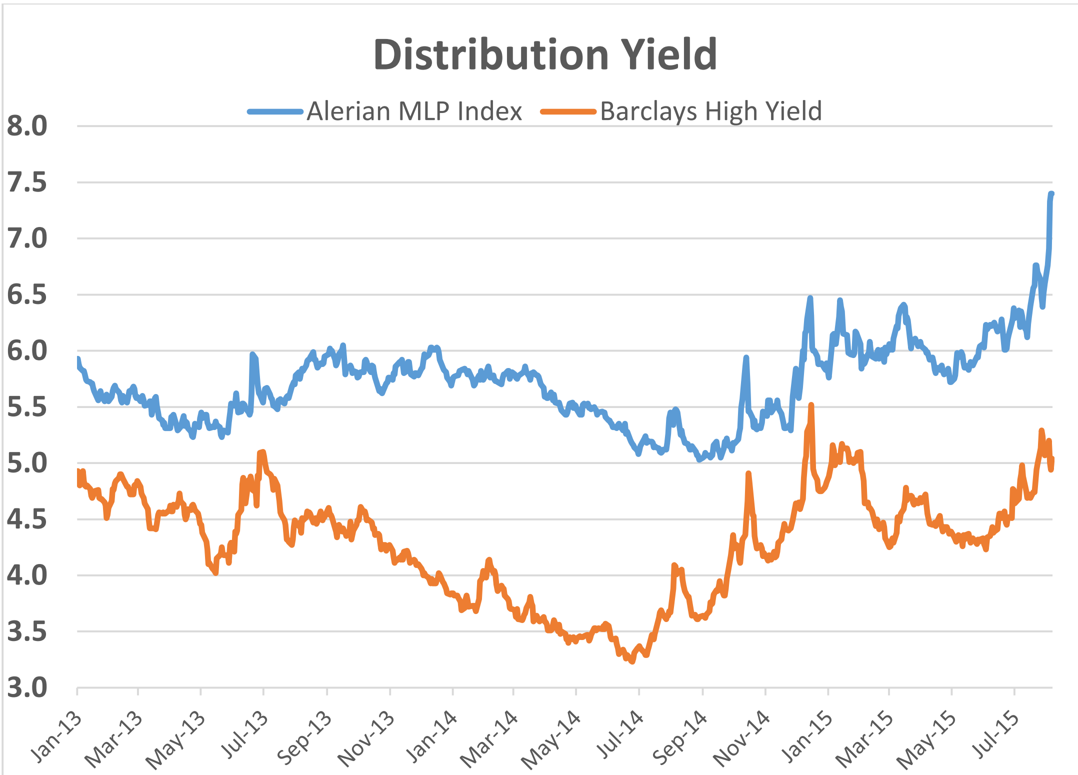
Source: Bloomberg LLC

Investing in MLPs

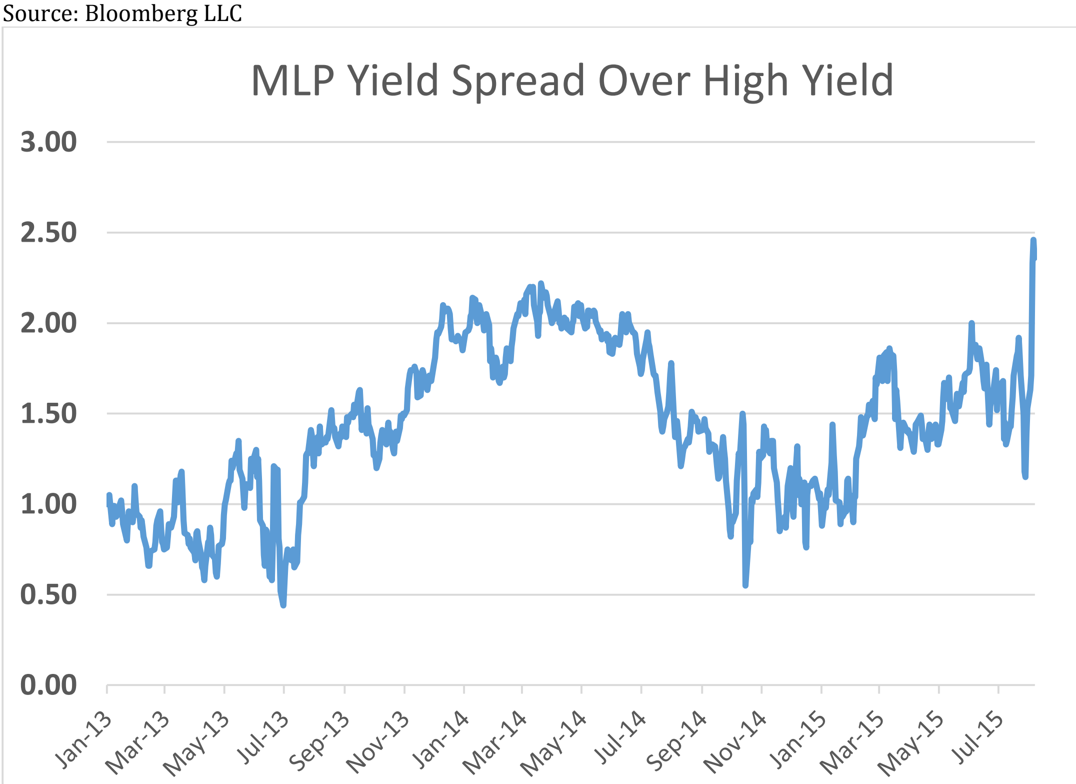
MLPs are tax advantaged vehicles principally used to invest in energy infrastructure. MLPs have attracted a lot of investor interest in recent years for two main reasons: their tax treatment encourages them to offer high yields, and the critical need for transport infrastructure has created significant growth, generating strong stock performance.

The primary thesis behind MLPs is the U.S. shale oil and gas boom. The advent of horizontal drilling and “fracking” has resulted in an enormous and large unexpected growth in U.S. energy production. This production has occurred across several basins in different parts of the country, many of them far from existing oil and gas infrastructure. After the oil comes up out of the well, it must be transported to a refinery, optimally by pipeline. The current lack of infrastructure has resulted in expensive rail and truck transport to fill the gap. Midstream MLPs that build and own gathering, storage and transport pipelines have been filling this need.

Based on valuation versus history, this may be a good time to get invested, or to stay the course with existing investments. MLPs are trading at wide spreads to their historical relationship with Treasury bonds, making their yields attractive. They are even trading wide of high yield bonds, which have also sold off as fear has risen.



Source: Bloomberg LLC



Source: Bloomberg LLC

Infrastructure versus Non-Infrastructure MLPs.

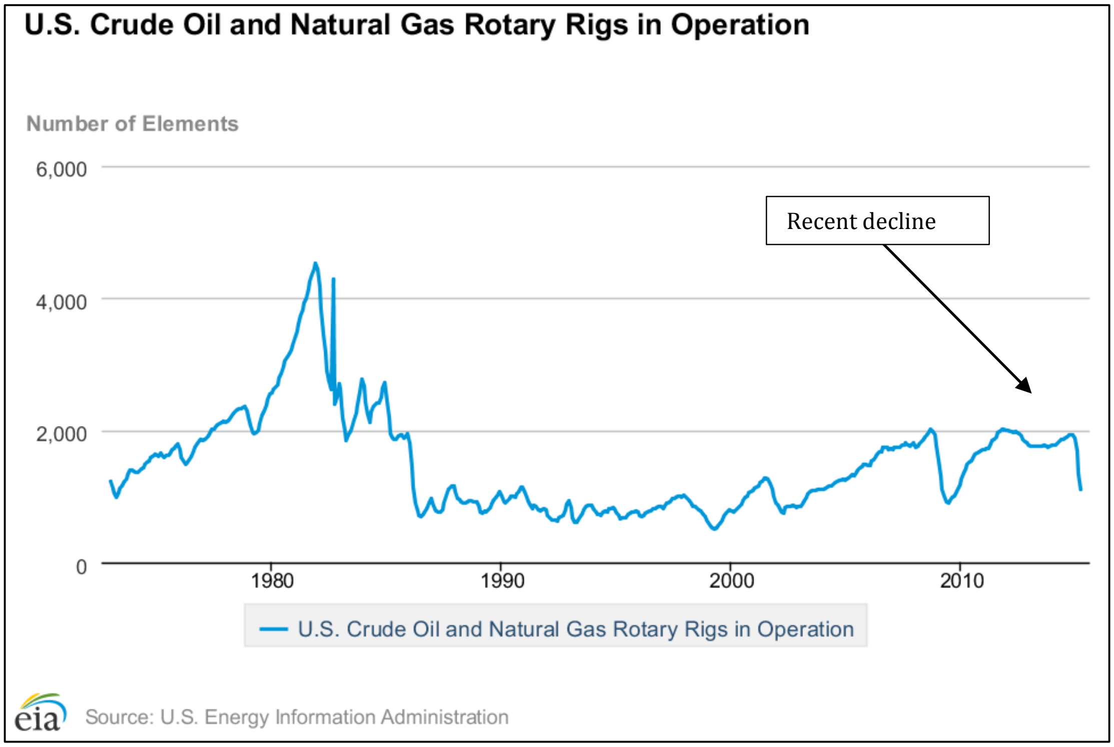
These MLPs typically operate under long term contracts and are not exposed to commodity price risk. Investors have sold their shares due to worries that production growth will slow, eventually resulting in lower demand for infrastructure, and that financing projects will be more expensive. We believe the selloff has been generally overdone, and the underlying demand for infrastructure is robust. The current price drop may be a good buying opportunity for the right type of MLPs.

There is a huge difference between "midstream" infrastructure MLPs – the pipeline companies – and those focused on commodity exposed businesses such as energy exploration and production. Unsurprisingly, these MLPs have been the worst in the current downturn. Yet we believe the selloff has wrongly depressed many high quality pipeline companies as well.

We think the best way to approach MLP investing is through an active manager who can focus on MLPs with low capital costs and strong balance sheets. The sharp selloff in recent weeks has given investors the opportunity to buy blue chip MLPs at discount prices, at least relative to their historical yield spread versus other high yielding investments.

Headline risk is likely to continue, because some non-infrastructure MLPs are highly indebted and could file for bankruptcy before this down cycle is over. This may continue to frighten investors and prompt selling pressure transmitted through ETFs and mutual fund redemptions.

While we don't have a strong view on the direction of oil prices, the market may come back into balance in the second half of this year or first half of 2016. The rig count has declined 60% since the peak, and the pipeline of legacy projects coming online should dry up. Momentum is building to remove the oil export ban, which could also help balance the market. While Iran should increase its production following the nuclear deal with the U.S., many OPEC countries have far less excess capacity than in previous cycles. The bottom line is that oil itself may rebound, which could help sentiment.



Investors have also been concerned about rising interest rates and their impact on MLPs. Historically, MLPs have performed well during rising rate periods because they are not fixed-coupon bonds, but rather can raise distributions as the economy grows. Even if financing for some marginal projects becomes unattractive, the underlying demand for distribution, and the ability of pipeline companies to pass through costs, should still be strong. Relative to the credit risk, we think quality MLPs are a good way to get yield in today's low interest rate environment. With the downturn in oil, producers are cutting costs and being innovative, lowering breakeven costs in shale plays. Long term this should be positive for hydrocarbon volumes and thus midstream MLPs.

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