ClearBridge Investments
A Legg Mason Company

Energy MLP commentary

Executive summary

- Energy MLP companies were relatively flat during the second quarter, and they underperformed the broad U.S. equity market.
- In ClearBridge's view, the potential for multiple revaluation, increased merger and acquisition and private equity activity, and more aggressive share buybacks are creating a positive outlook for MLPs and midstream energy companies.
- Risks to ClearBridge's outlook include protracted U.S.-China trade negotiations imposing a negative effect on global growth, coupled with slowing U.S. corporate profit growth, leading to a weakening U.S. equity market.

Market review

The U.S. equity market continued to generate solid returns in the second quarter, with the broad S&P 500 Index gaining 4.30%, led by the financials sector. Reflecting concerns that slowing global growth and trade tensions would curb energy demand, the energy sector was the only broad market sector in the red for the quarter. The Alerian MLP Index returned 0.12%, led by the refining and liquids transportation and storage subsectors.

Oil prices edged down from $60 per barrel of WTI crude at the end of March to $58.50 to finish the quarter. This was largely driven by rising U.S. crude oil inventories and worries that an escalation in the U.S.-China trade dispute would further slow sluggish global economic growth. Prices hit as low as $51, but they rebounded in June, when tensions between the U.S. and Iran, an OPEC consensus on extended production cuts, and lower-than-expected U.S. inventories kept supply in check. Meanwhile, reported progress in U.S.-China trade talks helped improve the demand picture.

MLP stocks also paused, after a very strong first quarter, to register modest losses in April and May before rising again in June. This turnaround occurred as investors were cheered by hints of a more accommodative policy turn by the Federal Reserve Board ("Fed") and trade optimism. MLP stocks remain up almost 17% through the first half of the year. Slowing global growth remained a concern throughout the quarter. In particular, China's gross domestic product (GDP) growth declined, the eurozone economy is losing momentum and trade tensions are dampening business confidence. Reflecting a more pessimistic outlook, 10-year U.S. Treasury yields dropped to 2.00% and the yield curve inverted during the second quarter.

U.S. energy production growth remains robust. As of April 2019, oil production was up 16% year over year, natural gas production was up 11%, and natural gas liquids production was up 12%. Infrastructure bottlenecks are beginning to clear, as midstream projects are adding new takeaway capacity, primarily in the Permian Basin of West Texas, where crude production is estimated to double, to eight million barrels per day over the next four years.

We see continued evidence that growth opportunities to build new pipeline, storage and processing facilities will continue for at least the next several years. In our view, continued growth in U.S. energy production and the associated infrastructure buildout will drive increasing cash flows for energy infrastructure companies. Looking ahead, we expect 11% cash flow growth from the MLP sector, compared with 3% for the S&P 500 Index, 4% for utility stocks and 3% for real estate investment trust (REIT) stocks.

Outlook

As of the end of the second quarter, the MLP index yielded 7.8%, compared with 1.9% for the S&P 500, 3.3% for utility stocks and 4.1% for REIT stocks. Yet, despite higher cash flow growth and higher yields, MLP stocks trade at lower EV/EBITDA multiples than those of 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.

In recent months we have also seen merger and acquisition (M&A) activity and notable interest from private equity buyers. Typically, private market deals are transacted at lower multiples than public market valuations. For midstream, however, the opposite has been true. Public valuations are cheaper than private market assets, which has led to private equity buying select assets in the public midstream space. This is a clear indicator of how inexpensive public market midstream assets are.

In our view, risks to the sector include protracted U.S.-China trade negotiations imposing a negative effect on global GDP, coupled with slowing U.S. corporate profit growth, leading to a weakening U.S. equity market. This scenario, in turn, would likely present a headwind for midstream stock prices. Against these possible outcomes, we view the potential for multiple revaluation,

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increased M&A and private equity activity, and more aggressive share buybacks to create a positive outlook for MLPs and midstream energy companies. We expect WTI oil prices to trade in an intermediate to long-term range of $50 to $70 per barrel. In this price range, oil prices are high enough to incentivize the drilling necessary to ensure supply growth and low enough to ensure continued demand growth.

Note: Any oil, gas and energy data referenced are sourced from the U.S. Department of Energy. Distributions and distribution growth rates are subject to change and are not guaranteed.

Investment risks

All investments are subject to risks, including the possible loss of principal. Investments in MLP securities are subject to unique risks.

MLP cash distributions are generally tax-deferred. Non-cash expenses, such as depreciation or depletion, usually offset income derived from an MLP's operations. To the extent that these expenses exceed income, cash distributions are considered return of capital under tax law. As such, they are not taxed when received. Instead, the distribution, in the form of return of capital, reduces a unit holder's cost basis. This adjusted cost basis, in turn, results in a higher capital gain or lower capital loss when the units are sold. Of course, there can be no assurances that distributions from an MLP will be tax-deferred. Distributions are not guaranteed and are subject to change.

Glossary

Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

The **Alerian MLP Index** is a composite of the 50 most prominent energy master limited partnerships, and it’s calculated using a float-adjusted, capitalization-weighted methodology.

U.S. Treasurys are direct debt obligations issued by the U.S. government and backed by its “full faith and credit.” The U.S. government guarantees the principal and interest payments on U.S. Treasurys when the securities are held to maturity.

S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

EV/EBITDA represents Enterprise Value/Earnings Before Interest, Tax, Depreciation and Amortization.

Past performance is no guarantee of future results. The views expressed are those of ClearBridge Investments as of July 22, 2019 and are subject to change based on markets and other conditions. These views may differ from those of other portfolio managers or the firm as a whole, and they are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Discussions of individual securities are intended to inform shareholders as to the basis (in whole or in part) for previously made decisions by a portfolio manager to buy, sell or hold a security in a portfolio. References to specific securities are not intended and should not be relied upon as the basis for anyone to buy, sell or hold any security. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional. Forecasts are inherently limited and should not be relied upon as an indication of actual or future performance.

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