Infrastructure & Energy Outlook: Reflecting on Harvey & Puerto Rico

The Closed-End Fund Association (CEFA) gathered a panel of energy and infrastructure experts for a discussion about their respective market segments at large. Chris Eades, managing director and portfolio manager at ClearBridge Investments, Jim Pass, senior managing director for the municipal and infrastructure sector with Guggenheim Partners and Rob Thummel, managing director and portfolio manager at Tortoise Capital Advisors touch on what's followed the recent string of storms in our homeland and the neighboring Caribbean.

Chris Eades

Jim Pass

Rob Thummel

The following recaps the conversation that originally took place as part of CEFA's podcast series on October 5, 2017.

CEFA: Chris Eades, we hear advisors asking how the fundamental landscape of MLPs is reflected in stock prices. Can you speak to the current pricing efficiency of the market?

CE: In our view, there's been a disconnect between the underlying cash flow fundamentals of energy MLP companies and their stock prices. Cash flows and distribution growth are accelerating, on average, for MLP companies and this thriving, accelerating growth for MLP's is a result of a rebound in US energy production that we've seen thus far in 2017. Oil production actually bottomed in 2016 at around 8.5 million barrels a day, and since then has rebounded to roughly 9.5 million barrels a day. Natural gas and natural gas liquids productions are also increasing, and it's this growing production that is driving cash flow growth through the MLP companies that we invest in, not the price of oil and not the price of natural gas. Yeah, MLP stocks are down 5% roughly year-to-date, and energy stocks have probably been out of favor with energy stocks wildly underperforming the S&P500 by more than 20 percentage points year-to-date. So to some extent, MLP stocks have been painted with a broader energy brush.

Yet if cash flow and distribution growth continues as expected and balance sheet strengthening continues, our view remains that the disconnect between cash flow and fundamentals in stock prices will close in time. So as we sit today, MLP stock prices and MLP funds offer investors roughly 7-10% yields. With MLP companies experiencing accelerating cash flow growth. And our view, it's certainly not reflected in MLP prices when you look at underlying fundamentals of the assets of the companies we're investing in.

CEFA: **Now, Rob Thummel. Can you tell us how energy specific closed-end funds are performing, comparatively, and how you're seeing advisors' positioning these investments in portfolios?**

RT: So from an absolute return perspective, the large flagship, MLP-dedicated closed-end funds like our Tortoise Energy Infrastructure Fund or Chris' ClearBridge Energy MLP Fund, have delivered positive returns for investors in 2017—let's say around 1%. Now, a positive return in any stock associated with the energy sector this year is almost unheard of due to the weak investor sentiment. We think investors really underappreciate the significance of the energy sector. The energy sector is one of the few sectors in the S&P500 that can say demand has increased 32 out of the last 33 years. Energy infrastructure assets operated by MLPs are even more critical. If you look at the global energy landscape, it's changing. And at Tortoise we think the US is becoming a significant critical supplier of low-cost crude oil and natural gas and natural gas liquids to the rest of the world.

To accomplish this, the US will need MLPs to build more infrastructure. And we're beginning to see the tide turn as investors' views of energy are shifting from negative to positive. What investors like about MLP closed-end funds is the current income potential. We believe in this low-interest rate environment, investors want current income. They want current yield. So MLP closed-end funds like TYG or CEM offer investors attractive yields of 9% plus. We think these are very compelling when compared to other fixed income equity securities like REITs and utilities that have current yields of 3-4%.

CEFA: **Jim Pass, what is pricing looking like in the muni sector? Any comments on the infrastructure space?**

JP: We do, and I think one thing in the municipal space in 2017, it's been a market that's had the benefit of strong fundamentals. We've had a limited supply and very strong demand and obviously we've been able to continue a strong performance return picture throughout 2017. I think it's important to realize that even though we have distressed credits, such as Puerto Rico, and Connecticut, Illinois and others, it's important that the demand for municipal bonds in this environment has been very strong due to their income-generating capabilities. With the infrastructure space, I think it's important to realize that with the hurricanes as you mentioned in your opening remarks, really demonstrate that the need to improve infrastructure, whether it's energy related or transportation or flight control, whatever it may be, needs to be addressed sooner or later. And unfortunately the infrastructure space, just like the tax-exempt market, has a lot of political uncertainty at the moment. Whether it's energy policy out of DC, or tax reform, it is something that's hanging over the market…but it really hasn't deterred strong performance figures for 2017.

CEFA: **We've talked a lot about the pricing of these vehicles. So let's go ahead and shift that focus to discussion around their performance as income-generating investment vehicles. Due to their tax advantages and regular cash distribution, investors often look to municipal bonds, master limited partnerships, and closed-end funds for income generation. With many of these investments being tied to the infrastructure and energy market, are storm risks taken into consideration when evaluating investment opportunities?**

Rob, Thummel, with Hurricane Harvey hitting Houston's energy production, refining and distribution infrastructure in the area, has this changed how you evaluate energy investments going forward? Further, do you consider the effectiveness of local governments when you're considering opportunities in an impacted area?

RT: So Harvey was devastating, and our thoughts really continue to be with the people that were impacted. Since our inception at Tortoise, we've invested in energy companies that are both geographically diversified as well as diversified across commodities. We believe that this reduces the risk of events like a Hurricane Harvey having a material impact on a company's results. So Hurricane Harvey had the biggest impact on the US refining sector. With over 20% of US refining capacity effectively halting the production of gasoline, diesel, and jet fuel for several days. Gasoline prices initially spiked, but now are coming back down. Refineries are returning back to full operation, but in general, consumer energy prices have remained relatively low.

In our view, it's been the people that are working in the energy sector, not the government, that really deserve all the credit for keeping low energy prices and the rapid recovery of the asset. It's the people that operate these critical assets that protect and prepare these energy assets for events like Harvey. The other thing is advances in technology have played a critical role as well. Let me give you an example. Technology actually allowed many oil and gas producers to halt production from oil and gas wells basically from their cell phones in advance of Harvey. Producers were also able to turn production back on in a similar manner. Previously, it would've taken a lot more time and required a significant amount of resources to manually turn off and turn on this oil and gas production that was in the path of the hurricane.

CEFA: Jim Pass, you're responsible for Project Finance. Let's go ahead and turn things over to you.

JP: Probably similar to the comments we heard, I think it's important to realize that when you're looking at an equity position or a debt position in the infrastructure space or buying municipal bonds... whether it's tornado alley or the hurricane area or even earthquakes, it's a factor that goes into the analysis. But it's one of the factors, not the driving factor. It's important to realize that when you're putting together an infrastructure portfolio or bond portfolio, diversification is important as well as different sectors. Whether you're buying a power plant, or investing in flood control, or hospitals and so forth, storms have different impacts on different sectors. I think it is something that the market has adapted to following Katrina and other storms that have occurred in recent memory.

It's also important to realize that volatility is rather significant...both from a spread point of view, when storms do hit (unlike a tornado) hurricanes take a long time to materialize, and we usually get a lot of good research information where they may hit. I think that does allow investors as well as my team to really understand what is the impact and what we should be looking for. Like we've seen in Katrina and others, defaults are rare and really the volatility is much more in the rating agency perspective because the initial reaction is quite negative. All in all, I think it's a factor but there are many other factors we consider as well.

CEFA: Thanks, Jim. Chris Eades, you notice that despite record winds and rainfall during Hurricane Harvey, energy infrastructure companies reported minimal to no damage to their assets along the Texas gulf coast. Do incidents like this affect your evaluation of MLP investment options and will it going forward?

CE: First off, and foremost, we're long term investors. We're not looking to trade these sort of events on any sort of volatility. We're very much focused on what the intrinsic value is of the assets that an MLP owns. That being said, given that the storm as you mentioned did little damage to energy infrastructure assets, our view of the underlying value of an MLP asset or even an MLP company certainly did not change based on Hurricane Harvey. As a result of that, we didn't alter the composition of our portfolios based on the short term impacts of the storm, and if anything, we were looking for opportunities to put some more money to work, once it was apparent that the damage was minimal. Looking forward, storms (whether it's a hurricane, tornado or earthquake) are certainly part of the landscape for investing in these types of assets, but again, so long as the long-term value of a specific asset is not impaired by that sort of an event, it's not the sort of thing that plays a critical role in our investment process or in our construction of the portfolios.

CEFA: **Now that we're up to speed about where we are pricing and performance-wise, let's talk about the outlook for these market segments. Jim Pass, with your focus on muni bonds, I'm especially interested in your thoughts around the Puerto Rico muni market. It's no secret that Puerto Rico has long been a favorite for investment vehicles, and commonly owned in national municipal bond products. But with Puerto Rico in financial difficulty, long before the aftermath of the hurricane, where does this leave existing positions, and Puerto Rico's access to the market?**

JP: Puerto Rico is part of the municipal market and it's not the market. I think it's important to realize that yes, there's a debt problem, there's a governance problem, as well as there's a lot of political undercurrents that are going on. I think it's important, when you look at that, it's hard to separate the financial economy from the political economy following the hurricane in Puerto Rico. Just yesterday, obviously, the president had significant impact on prices and it may be that crystallizing moment when people start making decisions rather than continuing on. From Guggenheim's point of view, we have very limited exposure in some of our institutional accounts. We have been reviewing opportunities where municipal bonds are insured by some of the remaining monolines that have investment-grade credit and we do our own research and like those stories.

I think Puerto Rico is an area where time will tell, and it's a very opportunistic area. But also, due to the political uncertainty and really the fluid nature of decision making, because you have the courts, you have the politics, and the exodus from the population—that just doesn't paint a very pretty picture. But at the end of the day it is part of the United States, they are US citizens, and I think the role of the federal government as well as the capital market needs to be considered. Ultimately, your most important comment was regarding access to capital. We have seen in municipal bankruptcies before that access does return, issuers can issue bonds such as Stockton in California, Orange County, Detroit, and so forth, but here, being a territory and a lot of these undercurrents ... we'll have to see what the resolution is and what the recoveries will be, whether they're general obligation bonds, or COFINA bonds or purely revenue bonds.

It's a complicated story and it's not something that will go away anytime soon, but I think it's important for the listeners to really acknowledge that the rest of the municipal market has performed extremely well, and even during this time it will continue to perform well, at least in my opinion, from what is the ultimate solution down in Puerto Rico.

CEFA: **Chris Eades, do you see residual Harvey aftermath impacting third quarter volumes for MLPs? What's the broader space as a whole looking like as we move forward?**

CE: There will be volume impacts from Harvey on third quarter results. Production was shut in, refineries shut down, NGL fractioning plants were shut down. All of these shut ins or shut downs will impact third quarter numbers, but I think the market has correctly looked through the short-term impacts of the storm and has been more focused on the minimal to no long-term impacts. As I said before, the ultimate value of the assets owned by MLP companies have not been impaired by the storm. But if there had been destruction of these assets, the dialog would obviously be very different. But again, there was very limited, to no lasting impacts of the storm on MLP companies. As I look at the space moving forward, I mentioned it in the earlier question ... Investors need to be focusing not on the price of oil, or the price of natural gas, but rather focusing on the volume trajectories of crude oil, natural gas, and natural gas liquids. If the trend continues up, and that's certainly our expectation as we look over the balance of 2017 and into 2018, you should expect cash flow growth from the MLP companies, and as I mentioned before, I don't think that landscape, which is positive, is being reflected in MLP stock prices where they currently trade today.

CEFA: **Lastly, Rob. Can you share your forecast for the energy space for Q4, moving into 2018?**

RT: Sure, let's start with oil prices. So at Tortoise we believe that US oil prices will remain range bound between $50 and $60 per barrel through the end of 2018. In our opinion, stable oil prices are the key allowing the management teams that operate the most critical energy assets to differentiate themselves. We do see the potential for some near-term events that could cause a spike in oil prices, such as an OPEC production cut agreement being extended through the end of 2018. Or a reimplementation of sanctions on Iran, or even more sanctions on Venezuela. Nevertheless we do believe that if oil prices remain stable, then the environment is constructive for investors to return to the energy sector. At Tortoise we have been calling for a second half of 2017 comeback for the energy sector. And the energy sector outperformed all sectors except for tech in the third quarter of '17. The energy sector was the top performing sector during the month of September. So we think the tide has turned and investors will begin to recognize the value in the energy sector and associated stocks.

Oil and gas producers are potentially shifting their focus towards returns and away from absolute production growth. This will allow the lowest-cost producers and the lowest-cost producing regions to shine. For the energy infrastructure sector, including MLPs, cash flow growth will drive value. And we see multiple energy infrastructure companies well-positioned to grow dividends and distributions supported by a strong backlog of growth projects.

Disclosure

Closed-end funds trade on exchanges at prices that may be more or less than their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. CEFs often use leverage, which increases a fund's risk or volatility. The actual amount of distributions may vary with fund performance and market conditions. Past performance is no guarantee for future results.