Tortoise

Halftime Analysis of the U.S. Energy Sector

As we enter the halfway point of 2019, we comment on market performance, commodity prices, fundamentals, surprises and our energy outlook for the remainder of the year.

Trade Talks Weigh on Market Performance

The stock prices of publicly-traded companies in the U.S. energy sector had a strong start to begin the year. Through the first quarter of 2019, the U.S. energy sector as represented by the S&P Energy Select Sector® Index rose by 16% outperforming the S&P 500 by nearly 3%. Energy infrastructure as represented by the Tortoise MLP Index® performed even better delivering a first quarter return of 18%. The second quarter has introduced substantial uncertainties as trade talks between the world's two largest economies have stalled resulting in the U.S. energy sector giving back some of the first quarter gains. Year-to-date, as of June 30, 2019, the U.S. energy sector has risen by 13% while the Tortoise MLP Index® is up 19%.

Energy Sub-Sector Market Assessment

Let's take a look at individual sub-sector performance across the U.S. energy value chain including oil and gas producers, oil field services, energy infrastructure and refining and utilities.

Beginning with oil and gas producers, the Tortoise North American Oil and Gas Producers Index℠ has increased by 10% year-to-date. Oil producer stock prices have outperformed natural gas producers given the directional moves in the price of the respective commodities. A major change is occurring in the oil and gas sector as producers move away from production growth and toward free cash flow generation. Oil and gas producers are looking for every opportunity to accelerate free cash flow generation to attract investors outside of the energy sector to their stocks. Time will tell but this type of change is critical and we applaud this focus.

Switching to the oil field services sector, the sector as represented by the Philadelphia Stock Exchange Oil Service Sector Index has underperformed the broader energy index, rising less than 1% in 2019. This sector continues to be challenged by underutilized equipment that has resulted in declining revenues eroding margins and earnings. Given the decline in the oil and gas rig count and current commodity prices, we believe this sector will remain challenged.

Next up is the energy infrastructure sector. This sector has been a bright spot across the energy value chain as the Tortoise MLP Index has increased by 19%. The multi-year transformation process for this sector is nearly complete. The result: better balance sheets and simpler corporate structures. A strong backlog of growth projects underpins continued cash flow growth from the sector. As U.S. oil and gas production volumes increase, the need for essential infrastructure grows. We believe this coupled with an index yield of over 8% looks attractive especially during a period when the 10-year Treasury hovers around 2%.

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Looking at the downstream portion of the energy value chain, the S&P Oil & Gas Refining & Marketing Index has increased by 4% in 2019. The uncertainty in global demand for refined products such as gasoline, diesel and jet fuel tied to a prolonged U.S. and China trade war resulted in sector returns lagging the broad energy index. In addition, concerns of rising prices for a type of crude oil typically sourced from Venezuelan and/or Canadian is causing concern over the impact this will have on U.S. refiner margins. Lastly, utilities as represented by the Dow Jones Utility Index have increased by 14% in 2019. A combination of rising uncertainty causing investors to become defensive and low interest rates have helped the utility sector maintain investor appeal.

Commodity Prices in a Tug of War

Oil prices followed a similar trajectory to the performance of U.S. energy stocks with prices rising by 32% in the first quarter of 2019 while giving back some gains with a year-to-date return of 29%. Currently, oil prices are in a tug of war between fundamental concerns that pull prices down and rising geopolitical risks that push prices higher. Fundamental concerns are tied to the potential for lower global oil demand tied to U.S. and China trade war as well as rising U.S. oil inventories. Escalating geopolitical tensions are associated with action of Iran such as attacking oil tankers near the Strait of Hormuz where approximately 20% of global oil supplies travels through. Recently, OPEC+ extended the production cut agreement through March 2020. OPEC wants to keep global oil inventories at five-year average levels. The question is the period for the five-year average. Saudi Arabia wants the baseline for global inventories to equate to the average 2010 – 2014 inventory levels. Russia suggests a higher baseline period of 2014 – 2018 as the goal. If Saudi prevails, a further cut in OPEC+ production is required to reduce global oil inventories to an average of 2.7 billion barrels. This issue along with several others will be clarified once the newly proposed Charter of Cooperation is agreed upon by OPEC+. In the meantime, OPEC+ accepts that U.S. shale production will continue to increase in the short-term even though U.S. shale may cause future adjustments to OPEC+ supply. With the 176th OPEC meeting in the rearview mirrior, our forecast for U.S. (WTI) oil prices remains $55 - $65 per barrel.

The biggest surprise for us in 2019 has been the weakness in natural gas prices. Natural gas prices have been in decline for a majority of 2019. Currently, the Henry Hub natural gas spot price has declined by 24% year-to-date. The massive potential supply of U.S. natural gas available is the primary reason for weaker 2019 prices. Inventories have become less relevant when determining natural gas prices; however, the U.S. started the year with very low natural gas inventories. We forecast natural gas prices to average $3.00 per million cubic foot over the long term.

Our View on Short-Term Fundamentals

According to the EIA, U.S. oil production is on pace for another record setting year growing by 400,000 barrels per day to 12.1 million barrels per day so far in 2019. The Permian Basin has been largest contributor to this rise with production increasing by almost 200,000 barrels per day. This rise has occurred despite an 11% decline in the U.S. oil rig count. U.S. oil inventories are 38 million barrels higher than last year. We are entering the cyclical period where oil demand exceeds supply so we expect inventories to decline over to next several months. Crude oil exports continue to rise averaging 2.8 million barrels per day in 2019 which is 1.1 million barrels per day higher than the same period in 2018. On June 26, the EIA reported the highest crude oil export in U.S. at 3.8 million barrels per day ever. The U.S. exported oil to over 25 countries with the largest amounts going to Canada, India, South Korea, Netherlands and the U.K.

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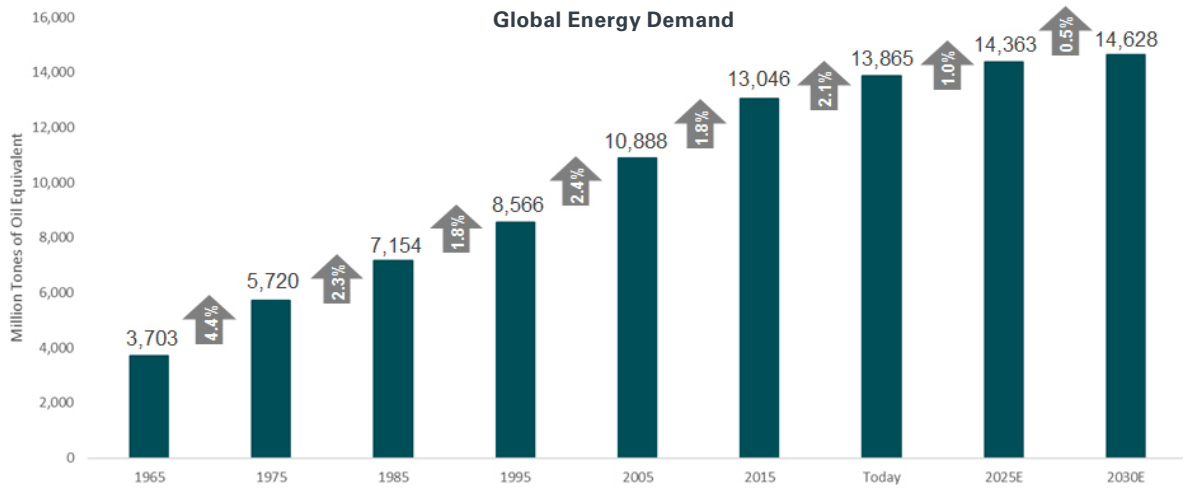
U.S. natural gas production has remained flat around 89 bcf/d throughout 2019. Natural gas inventories began the year approximately 20% below historical averages. According to the 2019 BP Statistical Review of World Energy, today's inventories remain approximately 8% below average levels. Exports of U.S. produced liquefied natural gas or LNG is an emerging theme in the U.S. energy sector. Global carbon dioxide emissions need to decline. Using natural gas to displace coal in the generation of electricity is an effective way of reducing carbon dioxide emissions. The EIA reports that currently, China and India are heavy users of coal with 67% and 75% of electricity generation coming from coal. LNG exports are on the rise in 2019 increasing to 5.5 billion cubic feet per day (bcf) from 3.3 bcf per day this time last year. LNG export capacity is forecasted to reach 8.9 bcf per day by the end of 2019, making it the third largest in the world behind Australia and Qatar. The U.S. exports LNG to almost 20 countries with the largest shipments going to France, South Korea, Spain, Mexico, and Japan.

U.S. Taking the Wheel as Net Energy Exporter

At Tortoise, we view the energy sector as an essential asset. Global energy demand has increased in 35 out of the last 36 years. We expect energy demand to continue to increase as populations grow and global GDP expands. We forecast significant changes in the supply sources to fill global demand.

Energy An Essential Asset – Global Energy Consumption Is Growing

- Global energy sector fuels over 1 billion autos every day
- Global energy sectors provides electricity to 6.4 billion people around the world
- Energy demand has grown 35 out of the last 36 years



Source: BP Statistical Review of World Energy (2019) and Tortoise estimates

Natural gas and renewables will displace coal and nuclear as the supply source used to generate electricity. Oil will remain relevant but becomes a less significant supply source over a longer period time as electrification gains prominence in the transportation sector. Currently, the U.S. is months away from becoming a net exporter of energy. The U.S. role as a global supplier of low cost energy to the rest of the world is expected to accelerate as the U.S. steadily grows its production of natural gas, crude oil and natural gas liquids.

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Rising Cash Flow Driving Value for the Remainder of 2019

All of this leads us to the final question of where do we go from here? At Tortoise, we believe the U.S. energy sector is a compelling investment opportunity for all investors. The fundamental backdrop for the sector is strongly supported by several emerging themes such as rising U.S. energy exports. We believe this backdrop can deliver cash flow growth and cash flow growth will drive value. The energy sector is in the beginning stages of building a mountain of free cash flow over the next several years. As cash flow increases, we believe companies operating in the energy sector will be well positioned to increase dividends, buyback shares and/or reduce debt. Given an outlook for a stable commodity price environment for the remainder of the year, we expect investors will begin to reap the rewards tied a basic fundamental premise that has driven the stock market for years - rising cash flow.

The S&P 500® Index is a market-value weighted index of equity securities.

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.

The Philadelphia Stock Exchange Oil Service Sector Index is a modified market weighted index composed of companies involved in the oil services sector.

The S&P Oil & Gas Refining & Marketing Index The S&P Oil & Gas Exploration & Production Select Industry Index represents the oil and gas exploration and production segment of the S&P Total Market Index. The S&P Total Market Index is designed to track the broad U.S. equity market. The oil and gas exploration and production segment of the S&P Total Market Index comprises the following sub-industries: Integrated Oil & Gas, Oil & Gas Exploration & Production, and Oil & Gas Refining & Marketing. The Oil & Gas Refining & Marketing sub-industry contains companies engaged in the refining and marketing of oil, gas and/or refined products that do not necessarily find or extract the oil, gas and/or refined products.

Dow Jones Utility Index is a stock index from Dow Jones Indexes that keeps track of the performance of 15 prominent utility companies.

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® is a float-adjusted, capitalization weighted index of energy master limited partnerships (MLPs). 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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