TortoiseEcofin QuickTake Podcast

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Thanks for joining us today on the Quick Take Podcast. I'm James Mick, Managing Director and Senior Portfolio Manager with TortoiseEcofin.

We have officially hit the dog days of summer. It's hot, vacations are rampant and sports are in that weird spot before football starts with only baseball taking place. That said, it's been anything but dull in energy markets, with the government recently adding spice to an already active recipe. OPEC had their monthly meeting, bringing even more questions to the crude oil markets. Oh, we also had the busiest week of earnings for the quarter. We'll get to all of that and more shortly.

Let's start things off with performance for the week that was:

- On the commodity front, crude oil was down sharply, with futures dropping 9.7%, while
- Natural gas was also negative, falling 2% on futures pricing,
- Shifting to equities, the broader S&P Energy Select Sector Index® followed the commodities, declining 6.8%
- Exploration and production companies, as measured by the S&P Oil & Gas Exploration and Production Select Sector Index also moved lower, down 5.8%
- Utilities, per the Dow Jones Utility Index, held in better, yet still fell 1%
- And finally MLPs, as represented by the Tortoise MLP Index® displayed lower beta than broad energy, but still declined 2.7% for the week

Given the performance and my mention of a heavy earnings week, you would probably expect that earnings were terrible, companies guided down and the outlook is bleak. Well that would be massively wrong. There were too many earnings to recap individually, but just as an example, on the midstream side we had 16 companies report, with over half raising full year guidance, several doing so for the second time in as many quarters. In addition, of the 16, half repurchased stock for a total of $930M for the second quarter. I would note, we anticipated the entire midstream sector to repurchase about $750M for the quarter to keep us on pace for the $3B we forecasted. Just including this past week we are now well ahead of that pace. Distribution growth continues as well, with double-digit bumps out of various companies, including 15% from heavyweight Energy Transfer. DCP Midstream grew 10%, it's first distribution growth since 2014.

Needless to say, it has been yet another robust quarter for midstream.

Upstream has had a mixed bag with several companies reporting excellent results, but most have suffered a bit from inflationary pressures with several raising capex to compensate for those increased costs. That said, as Rob mentioned last week, buybacks continue to be very strong on the upstream side as well.

Of course, not be outdone, refiner Marathon Petroleum reported as well this week and all they did was set a quarterly record as their EBITDA generated for the 2nd quarter was the equivalent of the company's best yearly result in 2019. Yes, one quarter represented almost the same as the entire year of 2019. And to top it off, they repurchased about $4 billion of stock in the quarter with plans to buy back an incremental $8B, bringing the total to $20B of buybacks.

So that begs the question, what the heck happened and why were the stocks down? To answer that we have to dive into crude oil. As mentioned at the outset, crude oil was down almost 10% for the week and is now trading just shy of $90. To put

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that in perspective, the last time we were at these levels was February 10th, a couple of days before the U.S. government warned of a possible invasion of Ukraine by Russia and two weeks prior to the actual event taking place. In the meantime, we have seen inventories decline and OPEC bring back theoretical production to pre-pandemic levels.

At odds between bulls and bears is the glaring issue of demand and the impacts of a potential recession. We are officially in the good news is bad news part of the cycle. For instance, a solid jobs report on Friday led many to believe the Fed will need to do more to slow the economy, hence the broad market fades on fears of additional rate increases and a longer time period before rates start to decline.

Back to crude, where weekly gasoline demand numbers have been all over the board for the U.S. In fact, since the EIA had data issues in late June and had to delay reporting of several data sets, we have seen wild swings in implied gasoline. Notice I said implied gasoline because the data is based on surveys and calculations, not actual demand data. That comes much later due to timing, hence the revisions we often see. Despite all this, we have seen implied gasoline demand up and down over 8% on a week-to-week basis. This is for a segment of the value chain that is relatively inelastic and usually does not fluctuate nearly that much.

So let's go to what we do know, inventories. In the U.S. inventories are reported weekly and they are both timely and pretty darn accurate. Here is what we know:

- Gasoline inventories are down 3% since the beginning of the year, 4% below the 5 year average and 3.4% below the average from 2015 to 2019
- More alarmingly, distillate inventories, i.e. diesel are down 14% since the beginning of the year, 19% versus the 5 year average and a whopping 22% below the average from 2015 to 2019

Let's shift to crude oil, one of the biggest misunderstandings in my view. In the U.S. we have two types of crude oil in storage, commercial stocks that are utilized all the time and the Strategic Petroleum Reserve, or SPR, that is utilized in emergencies. President Biden has tapped the SPR a few times since he became president. The result has been very interesting.

- Commercial stocks are 2% above the beginning of year numbers, 5% below the 5 year average and 6% below the average from 2015 to 2019
  - Overall, not great, but not bad
- However, where it gets interesting is the SPR
  - The SPR is 21% below the beginning of year numbers, 26% below the 5 year average and 30% below the average from 2015 to 2019

In other words, we are borrowing from the SPR to keep commercial inventories essentially flat. What this translates to is for total U.S. crude oil inventories, we have drawn 24 of the last 30 weeks and 64 of the last 83 weeks going back to the beginning of 2021. In other words, we have an issue. At some point we will need to refill the SPR and we will stop drawing from it in October.

In the event of a recession, we have what we have referred to as a double buffer. First, we have to stop drawing inventories. Then, we need to refill the existing inventories that are well below average when incorporating the SPR. That means we can withstand a dip in demand and still be just fine. In fact, with all the wonky data over the last 4 weeks for implied demand, we have still drawn 27 million barrels of crude oil.

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One other thing I'll note, OPEC plus just met this past week and raised production by a meager 100,000 bpd. The premise, they have to leave the very thin spare capacity they do have for real challenges that may present. The official communique stated, "severely limited availability of excess spare capacity necessitates utilizing it with great caution".

To be clear, crude at $90 feels pretty good to us. Not too high and not too low. Midstream loves to avoid the extremes of the price spectrum. However, it just feels like signs are pointing to higher prices and the move lower feels unjustified in my view. Just a word of warning for future price moves.

With that, 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 episode. Have topics you want covered or other feedback to share? Write us at info@tortoiseecofin.com.

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