Energy infrastructure

2Q 2022 QUARTERLY COMMENTARY

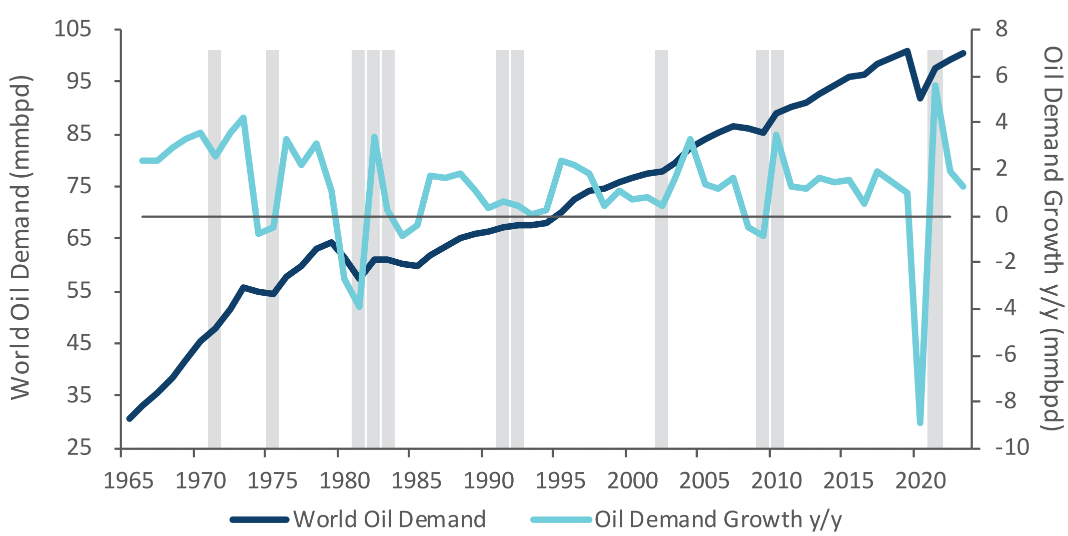
Since recent June highs, energy gave back some gains after a robust start to the year. However, with Q2 earnings nearly complete, it has been yet again another strong quarter for earnings with substantial beats and several full year guidance revisions higher.

In our opinion, we believe valuations for midstream energy stocks are extremely compelling. The sector remains undervalued, while in our view, is maintaining significant upside potential. Free cash flow for midstream energy companies is still robust and multiples are well below historical averages. Distribution growth among these companies has been surprising to the upside and excess cash is increasingly directed towards debt reduction and share buybacks.

Currently, there are five topics of concern for investors: 1) fear of a recession, 2) impact on supply of a potential Russia/Ukraine ceasefire, 3) policy changes from the Biden administration, 4) COVID concerns and 5) the impact of high fuel prices leading to fuel switching. In general, while all reasonable, we feel the path forward for energy remains open and with significant upside.

1. Our primary focus for energy demand is recession risk. In relation to crude oil, it's important to note that inventories are currently tight, with significant drainage of excess supplies and beyond from the initial build in early 2020. That coupled with an extended period of underinvestment and a lack of incremental supply coming to market to solve the imbalance. This situation is substantially different from previous recessions because we are now entering during the trough of the investment cycle, not the peak. However, it is important to note that crude oil demand has been resilient in recessionary periods. In general, demand does dip, but holds up relatively well and quickly rebounds.

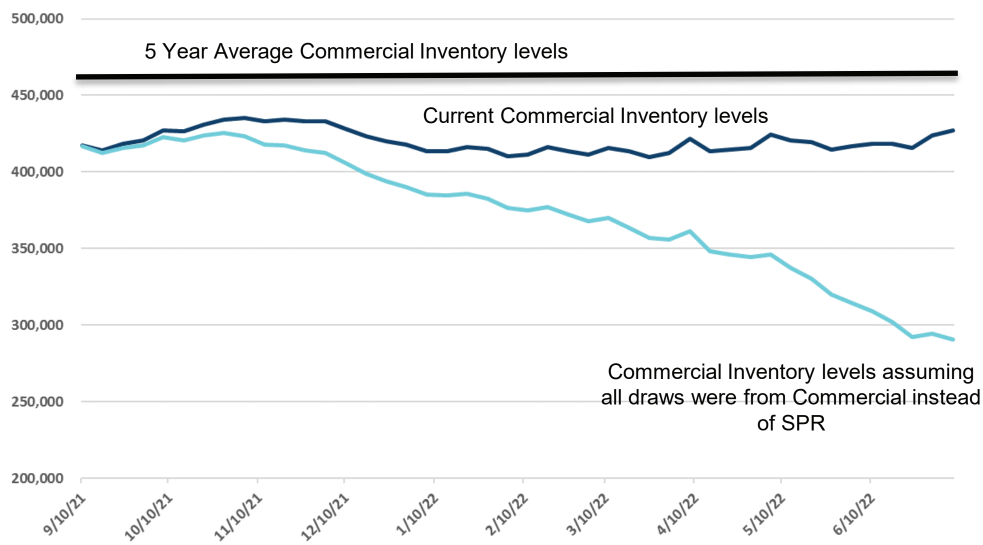
Global oil demand growth during recessions



Source: Bloomberg, TCA, RBC

2. The second concern is oil supply. Global inventory data is significantly delayed and unreliable as most nations outside the The Organisation for Economic Co-operation and Development (OECD) manage their crude oil supply hand to mouth. U.S. data, however, is very reliable, timely and accurate. We have two types of inventories in the U.S., commercial inventories and the strategic petroleum reserve (SPR). The Biden administration has started tapping the SPR to compensate for the high price of crude oil and the Russian invasion of Ukraine. This is occurring in a couple of different tranches, but the most notable is the 180 million barrel release over 180 days, which took effect on April 1 and will run through late September/early October. Knowing that the draws from the SPR will likely not end until October, further draws are plausible. This is important because it implies a double buffer in the event of a recession; either more supply or lower demand is needed to stop the existing draws and more supply or lower demand is needed to refill existing inventory back to more normalized levels.

U.S. Crude Oil – Commercial Inventory



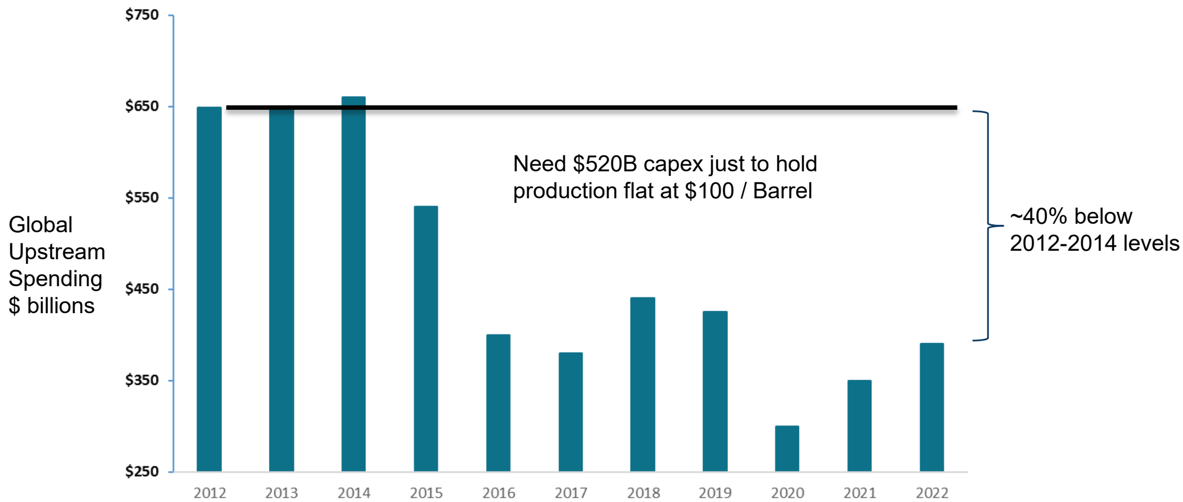
Source: Bloomberg, TCA, RBC

3. The next issue to consider is U.S. energy policy. The administration doesn't have many levers to pull to solve the problem of high prices that are currently impacting the economy. The most difficult aspect is that while crude oil prices are high, gasoline prices are higher as refining capacity is limited and cannot be fixed in any short timeframe. The largest concern has been a ban of exports, yet doing so at this point would hurt our allies in Europe and elsewhere, as we export a significant amount of product, including crude oil, gasoline, diesel and liquefied natural gas (LNG) to those countries and our prices domestically for products such as natural gas are a fraction of those in Europe.

4. The impact to demand in early 2020 was due to COVID. In 2022, whenever news breaks of China and a potential lockdown of a city, the price of crude oil has dipped lower due to fears of reduced demand. Clearly, this is a risk, yet the world is learning to deal with the impacts and we see no desire for large-scale lockdowns in Western countries, especially if hospitalizations and deaths remain lower.

5. The last issue is the risk of high prices. In some cases, high fossil fuels prices incentivize a switch to renewables and electric vehicles. Historically the switch was from coal to natural gas, move to more coal if gas prices go higher, or vice versa. Yet given low stockpiles of coal and high international prices incentivizing exports, coal prices have surged past natural gas prices. For crude oil, we review inflation-adjusted numbers, including the corresponding crude oil price and the percentage of personal consumption expenditures (PCE) allocated for a family to gasoline. Despite high prices, we are nowhere near early 80's levels, nor '07/'08 prices on an inflation adjusted basis. In addition, prices at the pump have been declining for the last month after hitting a high in mid-June. In short, it is hard to replace natural gas and crude oil, especially in such a short period of time, therefore, fuel switching is not a an option at this point.

We believe that the current market environment presents a strategic opportunity to invest in the energy sector. The sector has experienced underinvestment globally for almost a decade which may likely lead to higher commodity prices for an extended period of time. Midstream energy stocks can offer inflation protection in the form of escalators tied to the Producer Price Index (PPI). While carbon reduction is still a global concern and a focus for energy companies, energy security has become a top priority, underscoring the need for affordable and available energy worldwide. All of these factors can lead to a compelling opportunity, both tactically and strategically for midstream investors.



Source: Energy Aspects

Concluding thoughts

We believe the value of energy has been affirmed and the need for energy security will remain, providing a great fundamental backdrop to invest. In our view, the sector is cheap and has significant upside potential. We believe the underlying risks to the energy sector are not only manageable, but are also in much better shape than in previous periods. In fact, we think energy will outperform for the next decade, with several tailwinds present to work as catalysts. All of these factors can lead to energy as both a tactical and strategic opportunity.

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It is not possible to invest directly in an index.