03/28/2018

Late Cycle Mojo in Energy

Trade Alert:

Buy 1/3 S&P Oil and Gas E&P ETF (XOP)
(New addition, sold XOP shares in December at higher levels)*

Hold 3/3 Alerian MLP ETF (AMLP)
(New position from December, recently added on March 15)*

Hold 3/3 Energy Select Sector SPDR (XLE)
(Exited the position in January, at much higher levels, have been adding recently)*

Hold 2/3 U.S. Natural Gas Fund LP (UNG)
(Exited the position in December at higher prices, have been adding in Q1)*

Hold 2/3 Vaneck Vectors Oil Services (OIH)
(Exited 1/3 in Q4 of last year at higher prices. Holding 2/3)*

Hold 2/3 First Trust Natural Gas ETF (FCG)
(New position from February 9th)

**In trade alerts sent to clients*

In This Note:

- The energy sector has languished for the last six months despite a strong rally in both crude and the broader equity markets. In fact, it is one of the worst performing sectors year to date. In recent weeks we've seen the genesis of a sector rotation into energy (away from big tech), which brought relative outperformance. We believe there is more to come.

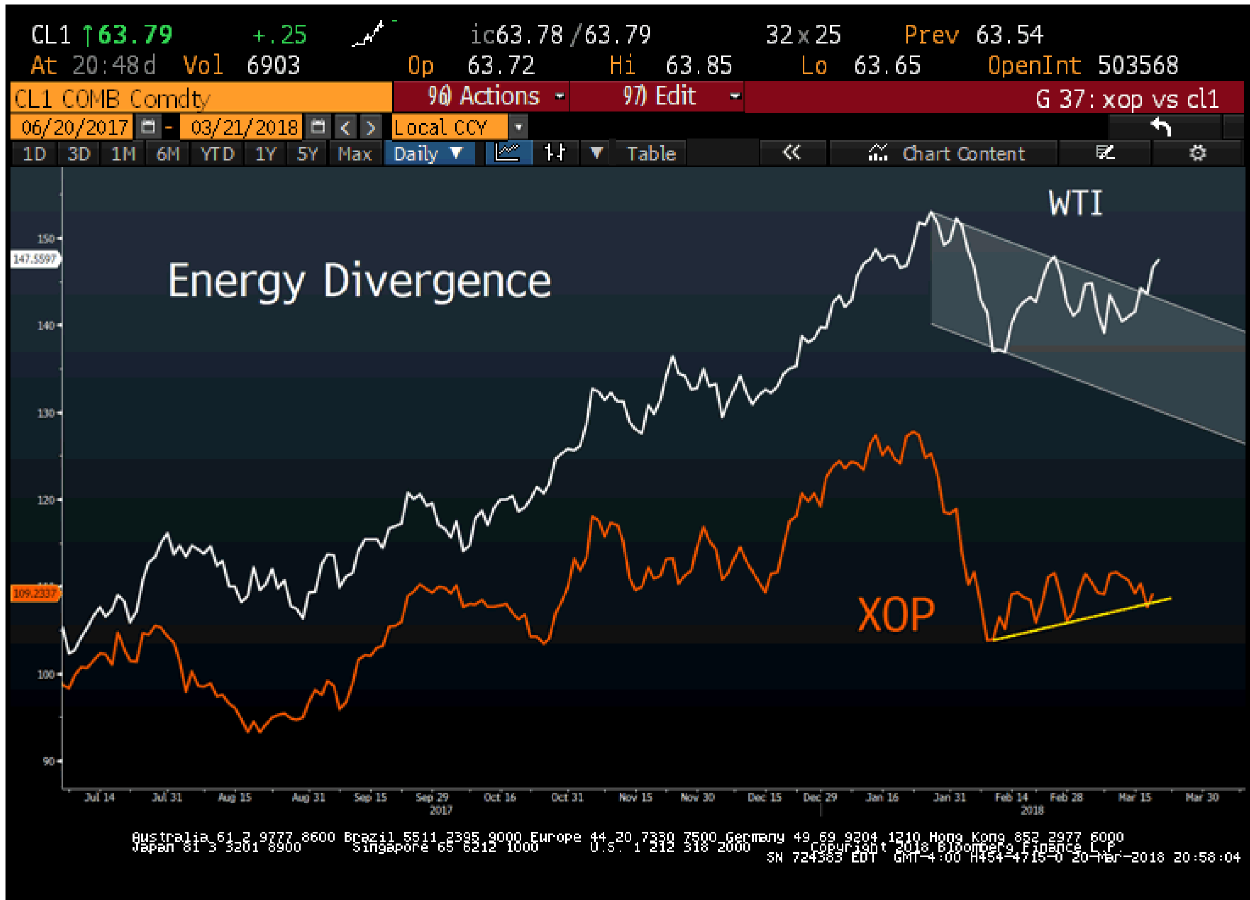
- Investors are apprehensive about the traditional energy sector because of the looming threat of the electric vehicle (EV) and government efforts to phase out the combustion engine. While this is certainly not a new concern, it is something that appears to be steadily, albeit slowly, growing. Investors also worry about the continued increase of shale production in the U.S., a perceived threat to the tight supply conditions. We attempt to address (and appease) these two fears.

- Crude prices will benefit from the seasonal rebound in refining margins, the pickup in Chinese demand, and the threat that Trump pulls out of the Iran deal. The energy sector is likely to capitalize on equity underperformance and strong spot prices by ramping up M&A activity; on a relative basis, their buyout targets appear cheap. Rather than expanding Capex for long-term reserve discovery and development, the sector wants to consolidate in the current price range while conditions are buoyant and valuations attractive. E&P companies (**ETF: XOP**), MLPs, and shale operators are the most attractive.

- Some of the underperformance in oil is explained by the backwardation in the crude futures. Backwardation is an occurrence in the futures market when the spot price (front month) trades at a premium to the contracts further out in time. For those unfamiliar with futures curves, we will give an in-depth explanation of the impact of backwardation (and contango) on the oil industry.

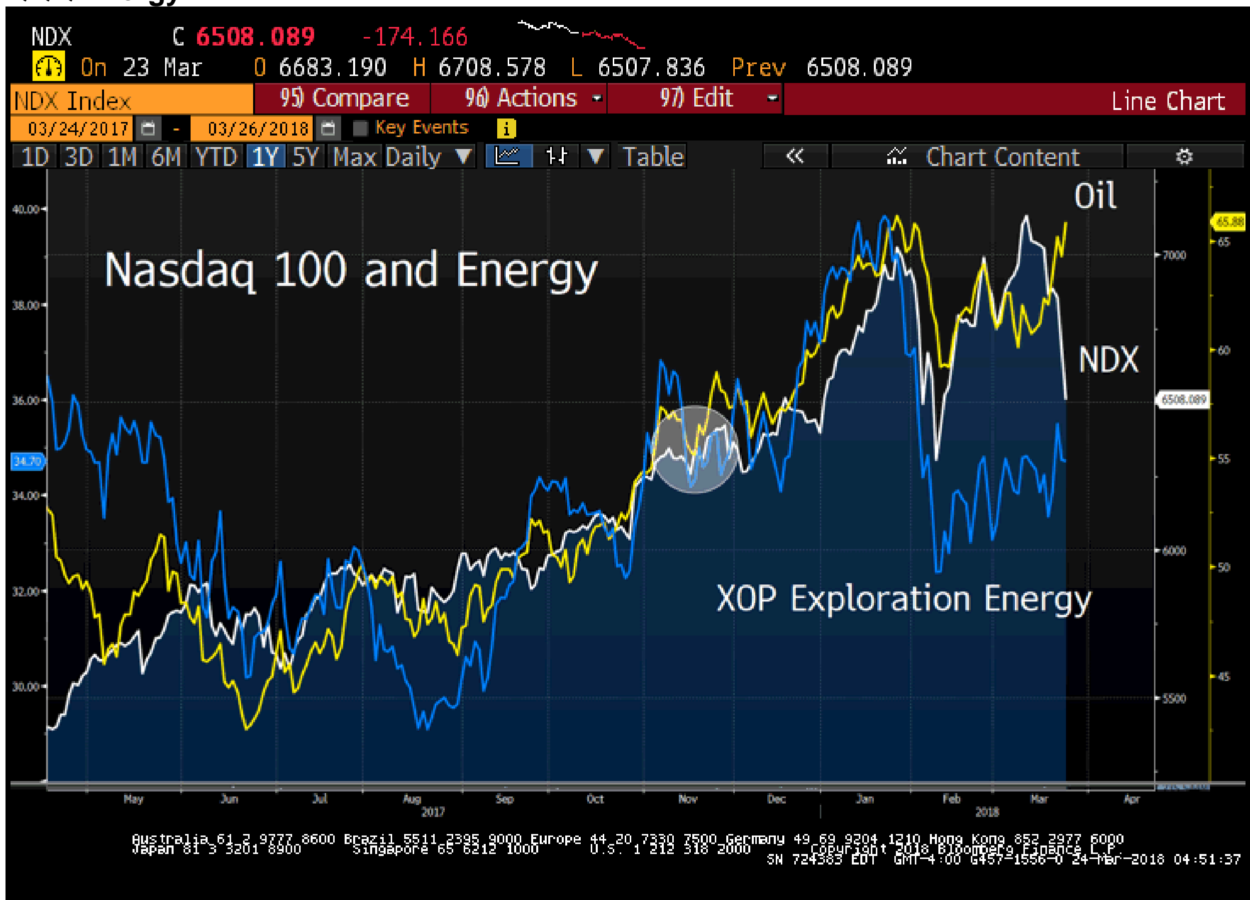
- We explore the persistent low cost of long duration capital as a primary catalyst. The proposed elimination of MLP tax benefits, combined with a period of cheap energy equities, will help trigger an M&A surge. The recent move down in long rates should provide fuel for stock buybacks and support to the MLP space. The market has mis-priced the proposed tax law changes, plain and simple. Accordingly, we look favorably upon the Alerian MLP ETF (AMLP), which has been trading as if the proposed tax law changes are going to outlaw MLPs. The capitulation in this sector sets up an extremely attractive backdrop.

WTI and XOP



The chart above depicts the recent underperformance of oil equities compared to the commodity they produce (shown here, Crude WTI 1st Generic). On a ratio basis, XOP is trading its cheapest to crude in over five years. The crude curve structure has favored underlying commodity much more than respective equities, that's about to change in our view.

QQQ Energy

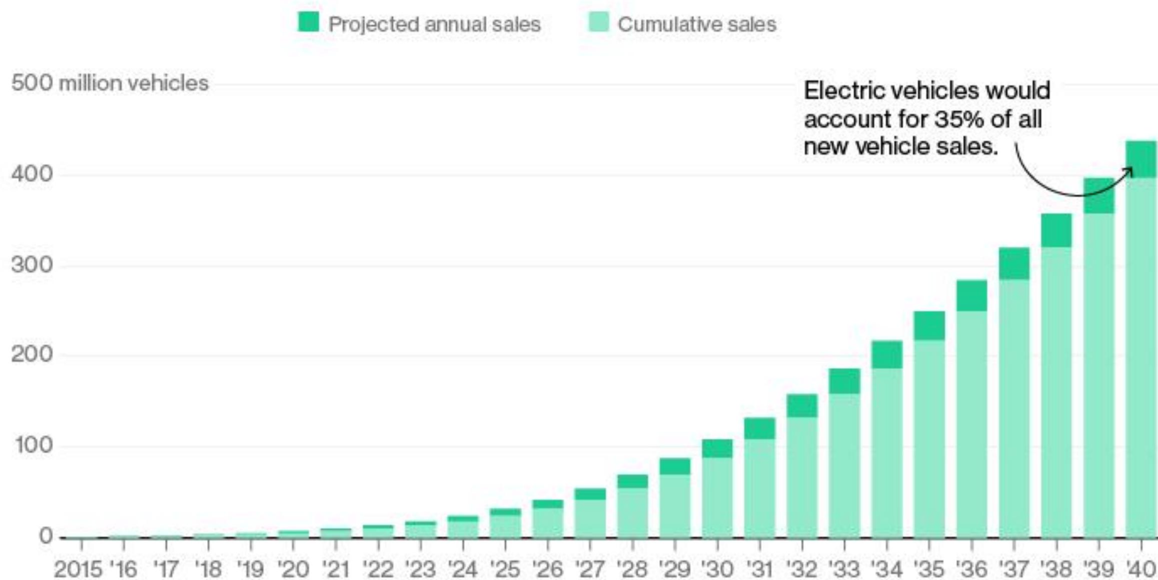


Oil has continued its march higher, in contrast to the recent selling across U.S. equities (energy included).

The EV Threat

In addition to the discount placed on the sector due to backwardation, there are other reasons behind the energy sector underperformance. Although the near-term prospects for oil prices are the strongest in at least four years, the longer-term outlook is clouded by the coming of age of the electric vehicle (EV).

EV's Bullish Trajectory



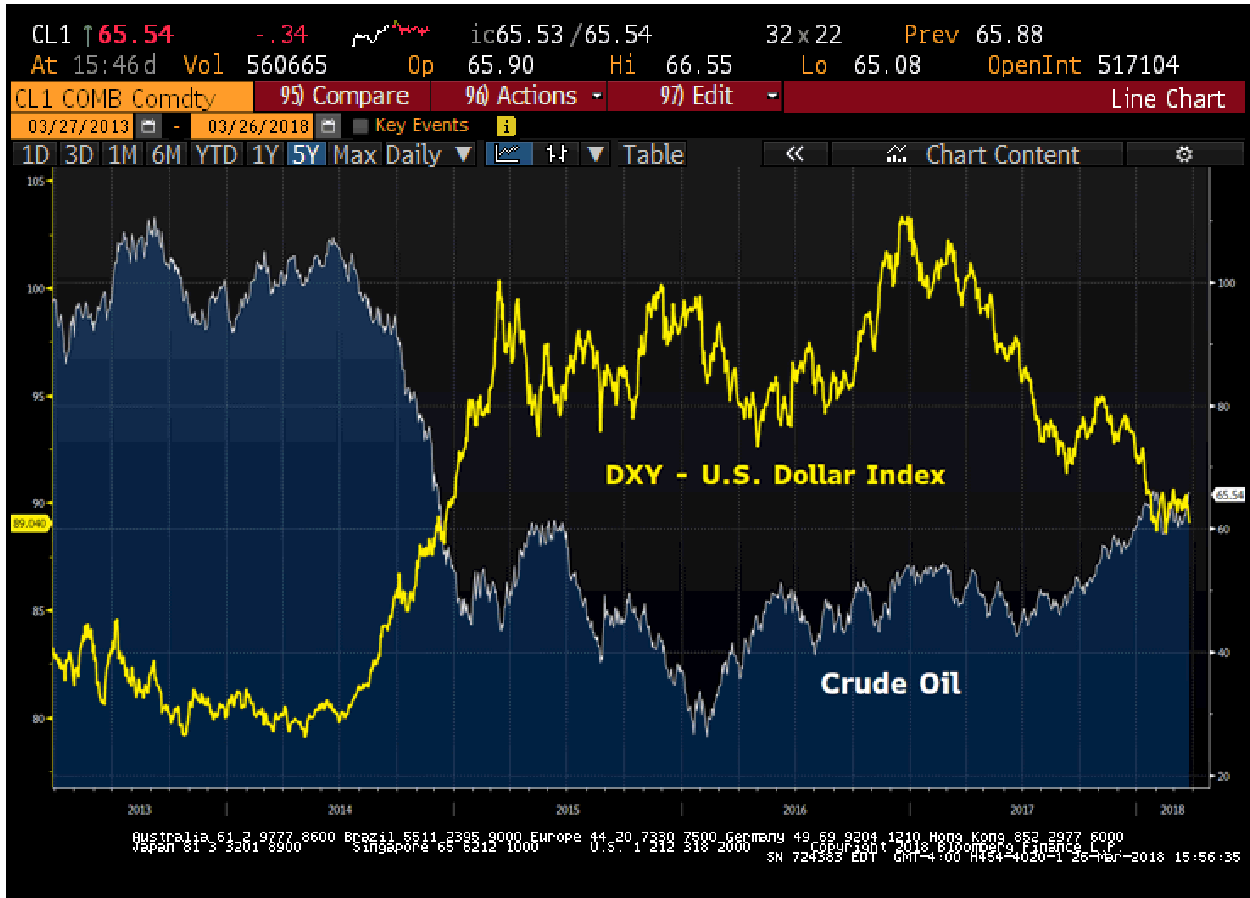
We discussed this thesis in our "China: One Hundred Years" *report from October 17, 2017 (See our note here). As we explained, EV sales are expected to grow rapidly and gain a significant market share of the total new car sales. Most developed countries, as well as China and India, are implementing strategies to reduce, or in some cases eliminate, the combustion engine vehicle altogether in the next 30 to 40 years. In the multi-government program called the Electric Vehicle Initiative, countries have set a goal for 30 percent market share for battery-powered cars, buses, trucks, and vans by 2030, according to IEA. The 10 governments in the initiative include China, France, Germany, the U.K., and the United States.*

Demand Side Dynamics

Based on current trends, global gasoline demand will peak in the next 12 to 14 years. UK-based Wood Mackenzie believes the expected demand for electric vehicles will cut gasoline demand significantly, particularly beyond 2025 as the battery-powered cars go mainstream. With car manufacturers being forced by regulations to produce models that run further on the same amount of oil, a new report by analysts suggests global gasoline demand is likely to peak by 2030. In the current global oil production of 97 million barrels per day (mbd), 60 to 62 million are used for transport, which Wood Mackenzie predicts will stall by 2030. Mass adoption of EVs will, therefore, have significant consequences for the global oil market. If EVs control a 25% market share in 2040, it equates to 29 mbd less in demand for crude than in a world without EVs. In other words, without EVs, global crude demand would be 12% higher than where it is estimated to be in 2040.

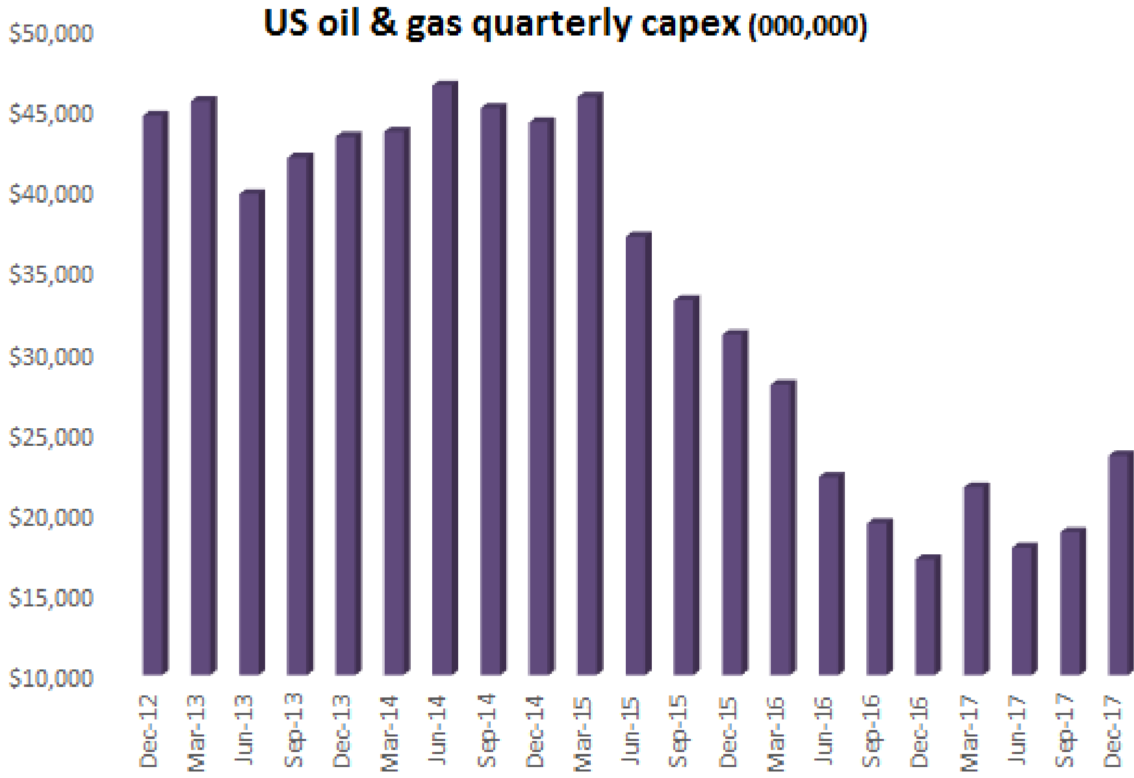
The oil industry will eventually try to combat this structural decline in demand by lowering the price of crude to a level that undermines the economics of EVs. A combustion engine car is much more attractive at $1.50 per gallon than at the U.S. average of $2.50 per gallon. Investing in an oil company is, in large part, a call on the future oil production that this company can sell at a profit. It takes between 5-10 years from discovery to field production and the EV threat is making investors reluctant to deploy capital in such long-life business. To that end, energy companies that have prioritized capital return (dividends/buybacks) over Capex growth have outperformed in recent months.

Crude Oil and the USD



Oil's previous headwinds are turning into tailwinds at a very advantageous time in the economic cycle. Inventory levels are dropping, global production growth is no longer in a race to the bottom (as we've seen with OPEC, the opposite is true). Global economic growth is, at the very least, no longer overwhelmingly sluggish. Another key variable is the U.S. dollar, which was a big headwind for oil. Supply factors, a broadening of demand growth, and a softer dollar should continue to fuel oil. The shale side does continue to be a worry but given future depletion rates and other extraction related factors, EIA and IEA may be paying a bit too much attention to it, especially as other global factors on the supply side are clearly positive.

Capex Surge

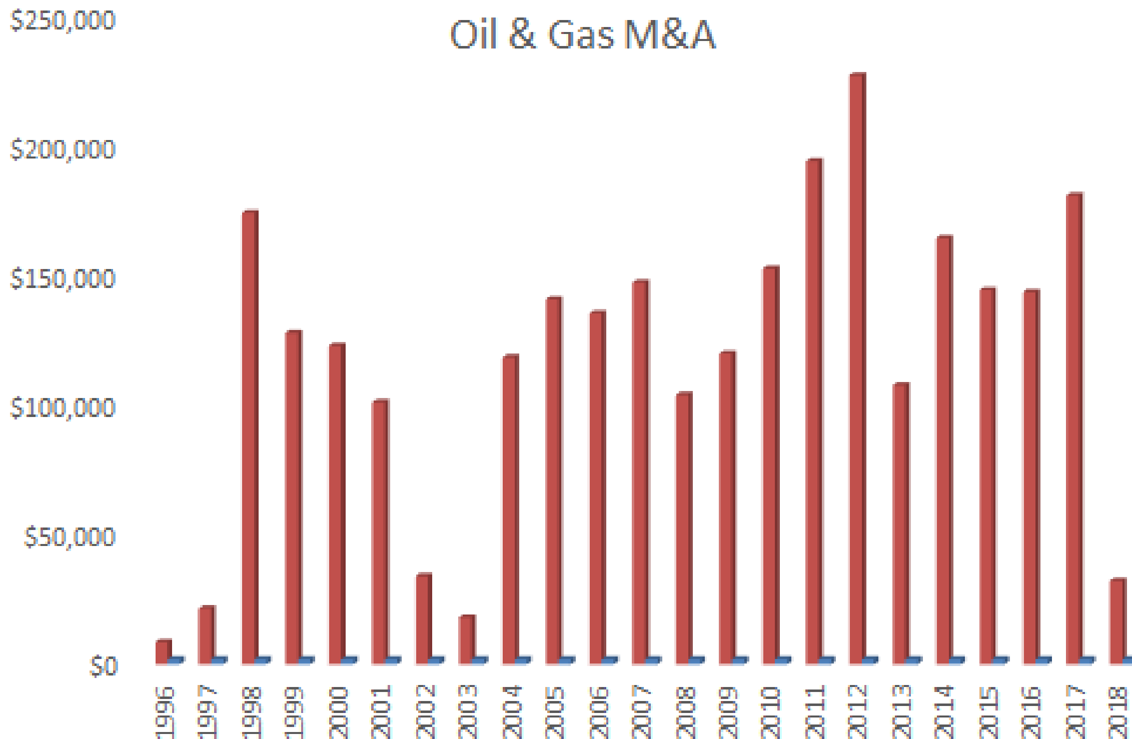


While crude prices have taken back more than half of what they lost in the 2014-2016 bear market, the U.S. oil & gas sector is still investing as if WTI were at $26 a barrel. The industry reluctance to expand Capex is partially rooted in the uncertainty about the long-term sustainability of high oil prices in the face of the threat from EVs and alternative energy. Ironically, the lack of Capex assures that oil prices remain elevated in the medium term, due to a lack of exploration and development activity, i.e. future production growth.

M&A to the Rescue

The lack of a Capex response to the price improvement in the last half year is related to the EV threat, but also the fear of getting caught in a downdraft if the OPEC agreement disintegrates. However, one way that oil companies may try to maximize their returns on higher oil prices is to acquire other oil companies. Rather than invest in a ten-year project with an uncertain payoff, acquiring a smaller oil producer gives access to developed carbon reserves and **more immediate monetization**.

Deal Flow



M&A activity in the U.S. and European oil & gas sector has remained relatively robust, despite the slump in oil prices from the end of 2014 until the middle of 2016. The ability of oil companies to buy proven reserves at attractive levels, given the underperformance of the sector, gives them access to immediate cash flows and production to capture current high oil prices.

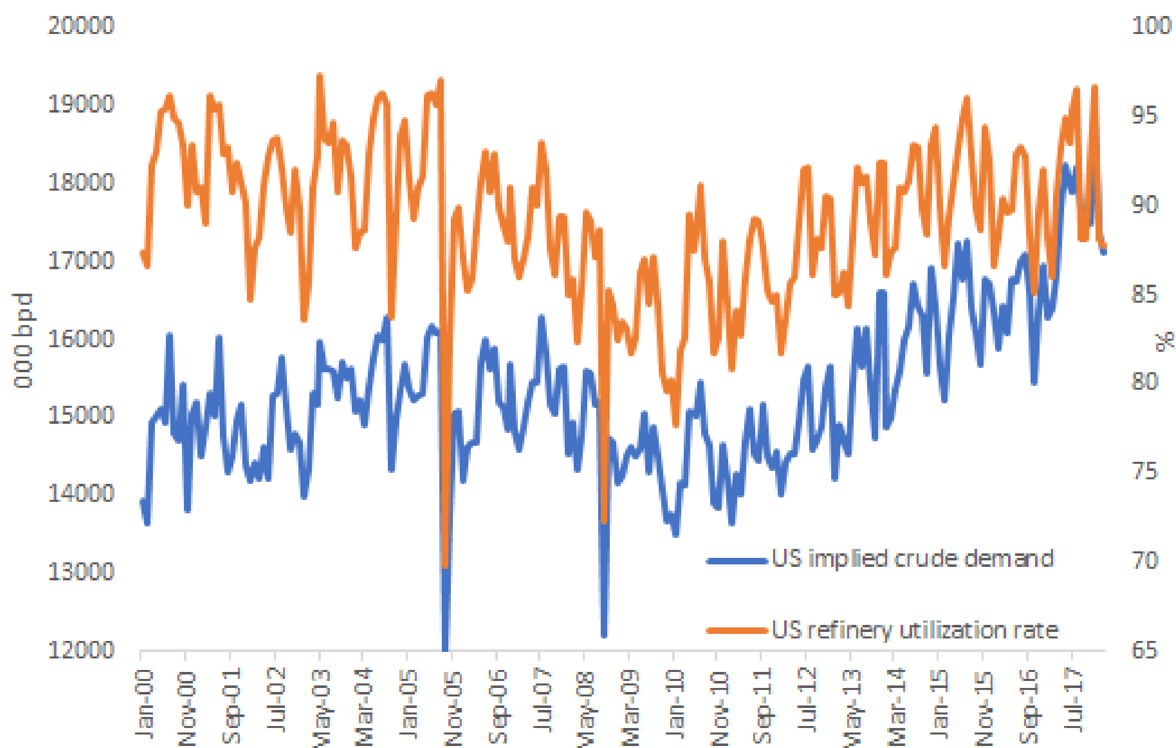
Catalysts for Higher Oil

As the EV threat is overshadowing the oil industry, the near-term demand picture is extremely robust, helped by the first period of global synchronized growth since 2010. The industry discipline, outside of shale, as well as supply shortfalls in Venezuela, Nigeria, and Mexico have helped support crude prices and push the curve into backwardation.

In the coming months, we expect oil prices to be helped by developments in the U.S. and China. First, the rebound of refinery utilization rates after the seasonal maintenance will boost the demand for crude. Second, China had a week-long Lunar New Year at the end of February,

which dampened economic activity temporarily. This may explain why some of the leading economic indicators from China have softened in recent weeks; the week-long holiday caused a brief lull in economic activity. Now, with this holiday period behind us, economic activity is ramping up again and demand for crude will bounce back as well.

Utilization Rates



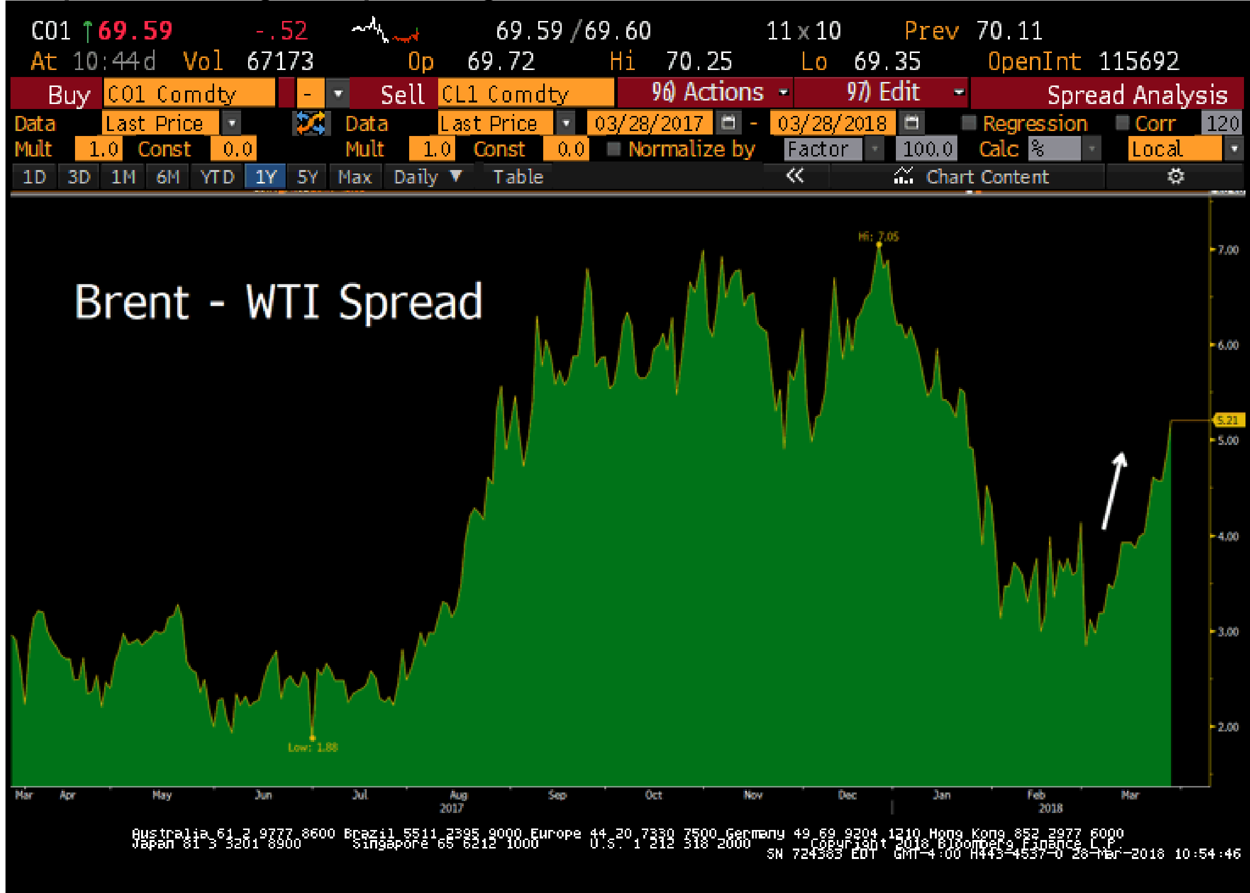
Demand in the U.S. is driven by refiners. Therefore, there is a strong relationship between refiner utilization rates and the demand for crude oil. Twice a year refiners take some capacity offline for maintenance and prepare for seasonal changes in a gasoline blend. This typically happens in February and October. With less capacity operating, refiners take off less crude to turn into product. Once the capacity is back to normal, crude demand also rebounds, as refiners replenish inventories. U.S. inventories have been drawn down to the lowest levels in five years, and we expect the industry to replenish some of these crude inventories, which is another tailwind for crude prices.

Geopolitical Risk is Oil Positive

Geopolitical risk continues to be a real concern for risk assets, and a plus for oil markets. Just a few days ago there were missile intercepts over Riyadh from the Iran-backed Houthi group in Yemen, which has tried to strike Aramco related targets. In the United States, there is a diminishing probability that the Iran deal is re-certified given the personnel changes in the White House. The addition of Bolton and loss of McMaster and Tillerson as voices in Trump's ear lead us to believe that the President will adhere to his campaign promises and cancel the Iran nuclear deal. President Trump is facing another deadline (May 12th), at which point he will have to decide to extend or terminate the deal. The European partners to the deal already fear Trump may pull out, and have offered a series of extra sanctions to encourage Trump not to terminate.

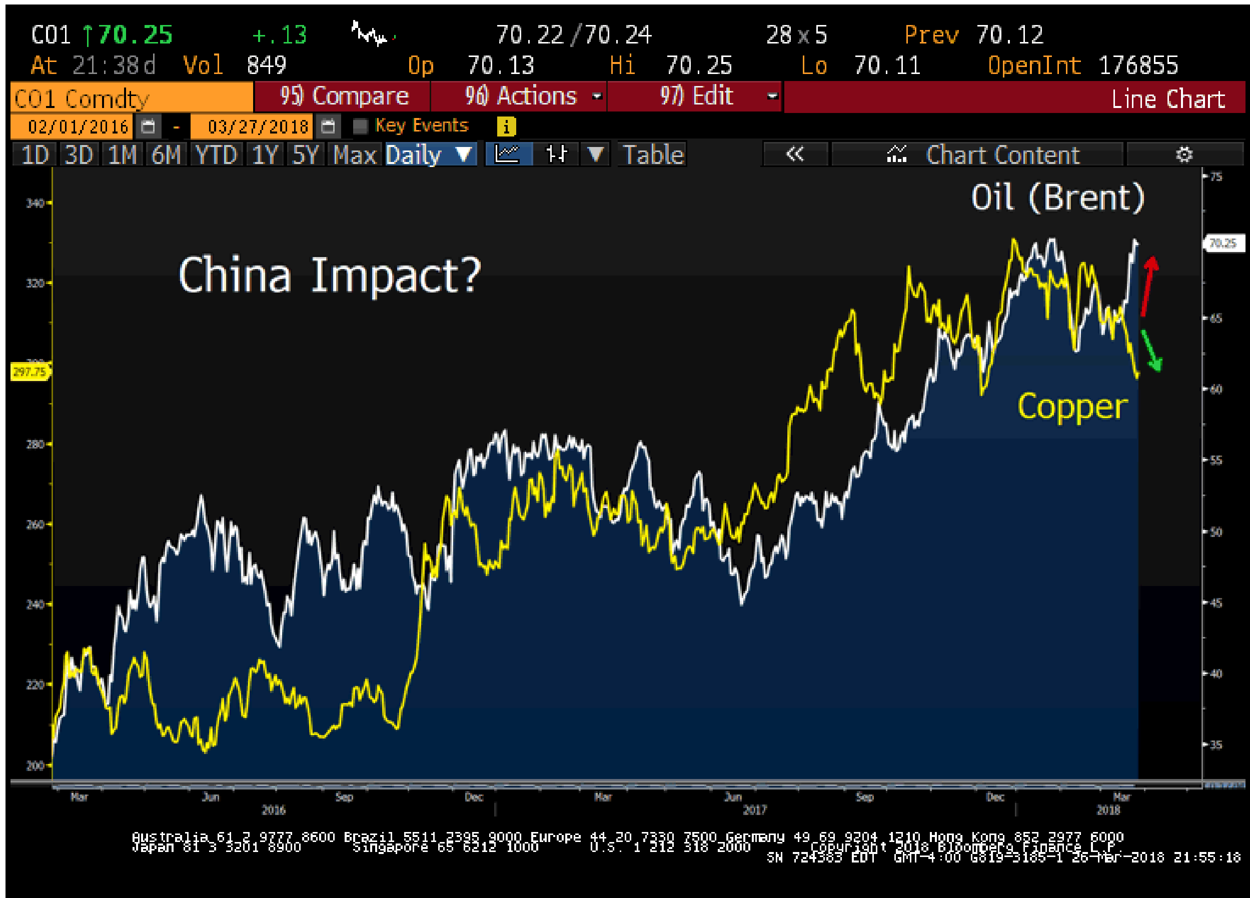
There is no way to know what he may decide, but either the sanctions are bolstered to prevent a pull-out, or Trump terminates the deal. Either way, it's an upside catalyst for crude prices.

Geopolitics Driving this Spread Higher



The (above) spread between WTI and Brent continues to widen, focused on the two-sided energy barbell. On one side, a global GDP surge fueled by a weak dollar and levered-up emerging market economies (to the tune of an additional $10T of dollar-denominated debt issued globally over the last ten years). Now, let us throw in a surge in geopolitical risk. Both point to demand upside, and supply downside risk for Brent. On the other side, the over-levered shale production treadmill is speeding up with higher WTI prices, they "have to pay those coupons you know." Both high yield credit and equities in the energy patch are far more focused on the U.S. risks than hot geopolitical developments. Additionally, Turkey also recently announced that their operations on the Syrian border will continue. The tides in the Middle East continue to point to real oil risk, all at a time when OPEC has actually been effective in getting inventory levels down and keeping member country production levels close to their respective quotas.

China Driven Another Market?



China is a concern for the oil market, as Q1 economic data has pointed to some slowing on the industrial side. These data releases led to a correction in hard metals (like copper), which have a tremendous beta to the Chinese economy. While oil remains sensitive to the Chinese economy, in a demand-side context, it is a bit more diverse than the hard metals. This makes us think outperformance should continue. Specifically, China makes up less than 20% of global oil consumption, while it makes up half of the demand for copper. In other words, economic growth in the U.S. is above trend and supply dynamics led by OPEC have proven to be effective. This puts oil at a relative advantage to many hard metal peers, like copper.

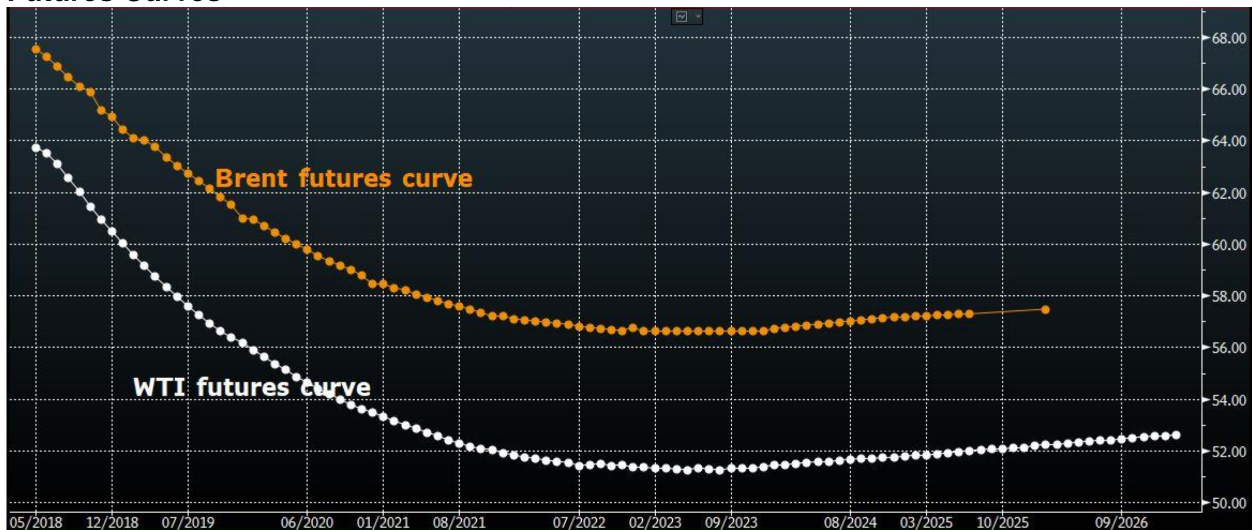
The Virtue of Backwardation

Backwardation in the futures market is when the spot price trades at a premium to the future, it eliminates the profitability of the crude carry trade. Traditionally, a profitable business has been to sell the forward and drill the oil. In backwardation, there is a net drag on the operational financing. As a result of backwardation, producers have limited or no opportunity to capture the high(er) spot prices, and has a led to a process of inventory de-stocking.

Companies with crude storage capacity make money when the opposite occurs; the futures trade at a premium to the spot price (contango). They buy crude in the spot market and store it for delivery at a later time against the future that they sold at a premium. This (relatively low-risk) arbitrage fosters the building of crude inventories when crude futures are in a steep contango. This is exactly what happened after crude prices collapsed in H2-2014, and the world ended up drowning in inventories. OPEC realized this problem and the supply agreement helped clear a lot of that excess inventory.

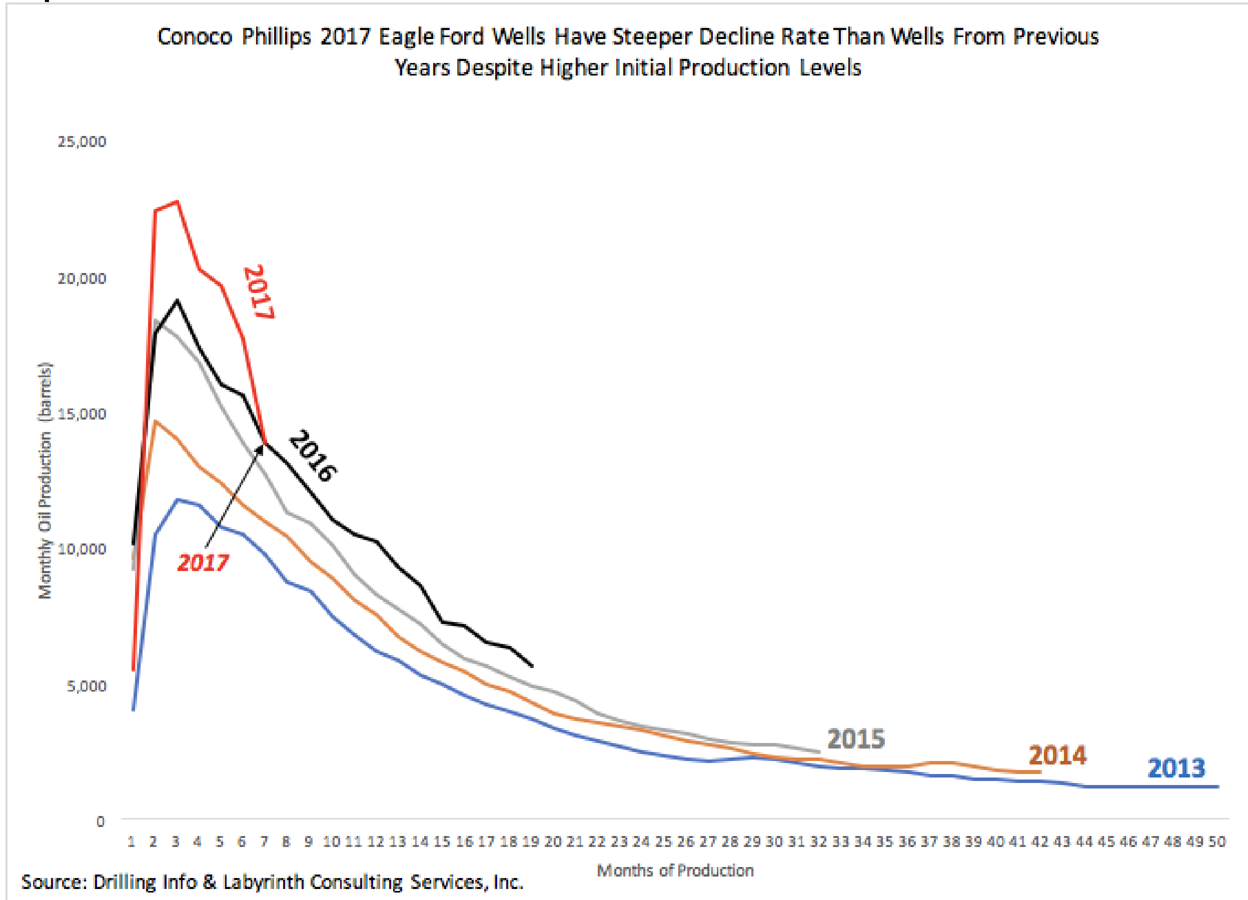
The acceleration of global growth in the second half of 2017 started to boost crude demand. Next came the hurricanes that hit U.S. oil infrastructure in September 2017. This was the final straw, pushing the curve into backwardation and leading to inventory de-stocking. U.S. Domestic crude and product inventories have now returned to average levels, which makes the market more vulnerable to any upside demand and downside supply shocks.

Futures Curves



Backwardation in the crude futures is caused by a robust demand for physical crude, which forces the industry to take crude out of inventory to meet the immediate demand. The OPEC supply agreement, combined with a synchronized global growth, formed the foundation for these conditions, while the hurricanes last summer were the final straw. Ever since the September 2017 hurricanes, both Brent and WTI have spent a lot of time backwardation. While this is generally bullish for spot prices (short-term supply shortages), it reduces the ability for the oil industry to hedge future production at a premium. This makes the sector more volatile and risky for long-term.

Depletion Rates

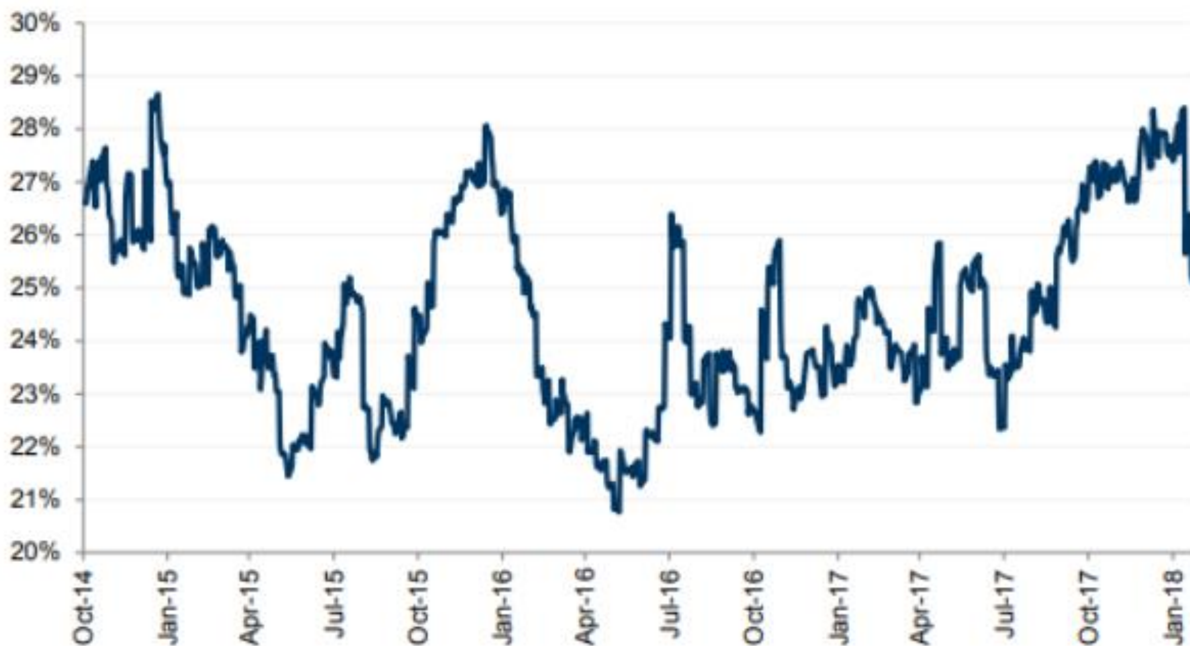


Depletion rates are getting more severe, and it looks like the industry-wide answer is to just keep drilling. In the long run, the highly concentrated fracking in the Permian basin (and the steeper depletion rates) will lead to frack interference (and then higher production costs), ultimately hurting U.S. shale. That is not a near term concern.

February Crude Sell-Off

While crude has been able to cling on to gains, the sell off a few weeks ago was both abrupt and forceful. Little crude negative news flow preceded this selloff. As we saw with equities, trend following institutional investors such as CTAs (and quantitative algorithm-based Artificial Intelligence (AI) funds), have the propensity to exacerbate a pullback. Both trend-following investors were caught in the dramatic equity market sell-off in early February, and the indiscriminate selling by them is likely to have spilled over into energy. CTAs started the year heavy long energy. In fact, non-commercial net long positioning in crude futures, both Brent and WTI, reached historical highs at the start of this year.

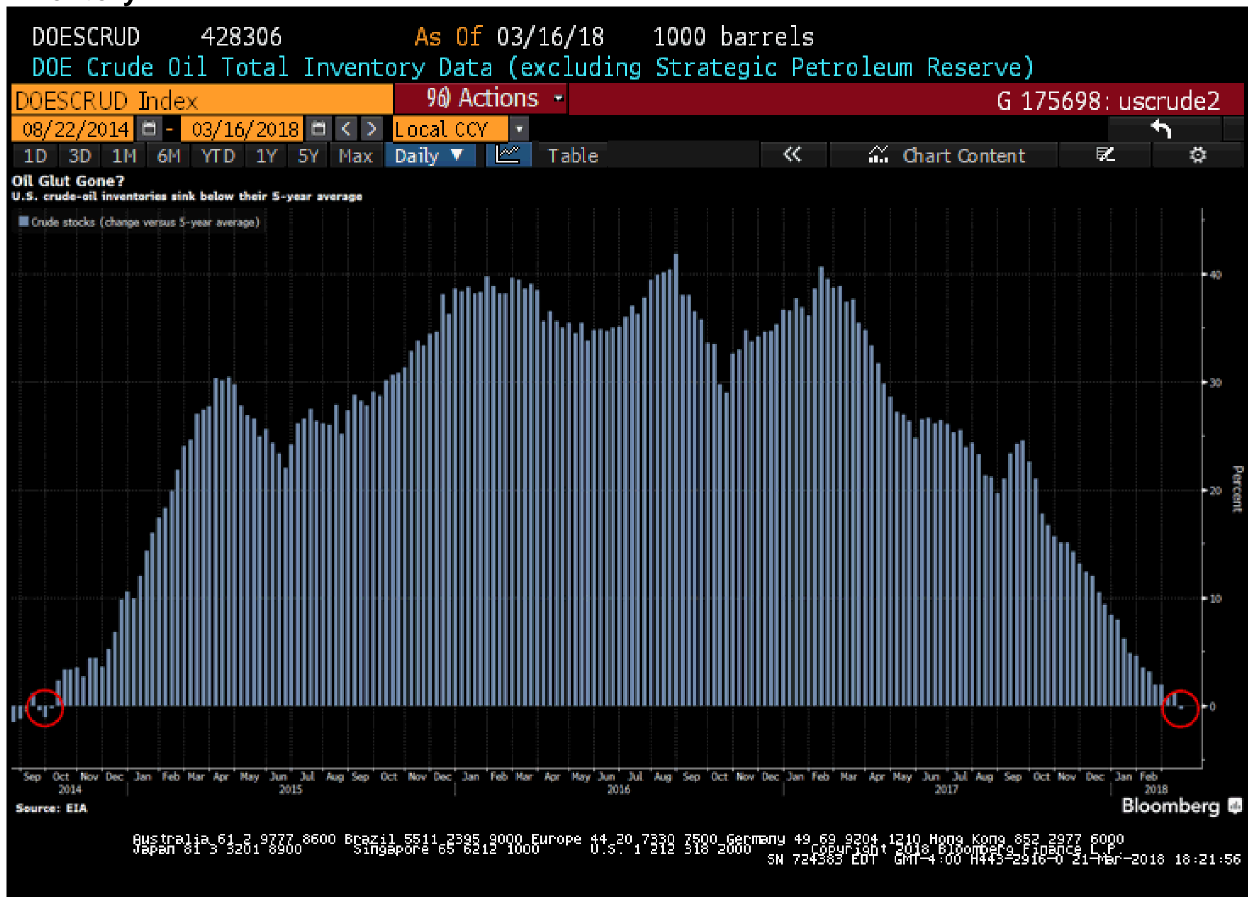
Positioning



Source: CFTC, Bloomberg

Market positioning in the oil and product futures and options has been extremely bullish until the recent sell-off. Non-commercial net longs were at extreme levels but the recent sell-off has shaken a lot of these speculators, which include CTAs, out of the market. With fewer weak hands long oil, some of our previously expressed immediate concerns about excessive bullish positioning have been alleviated.

Inventory



While the extended long positioning in crude is something to worry about, the shadow of shale has blinded everybody's (IEA, EIA) vision about supply/demand dynamics. The U.S. has reached over 10mbd in production, yes, but the structure of the oil curve continues to say "glut" is a misstatement. The other 90% of global production is just not keeping up with the robust move in demand. The U.S. makes up a fifth of global consumption and demand is at the highest its been since 2011, as freight indexes reach multi-year highs. Despite this, the assumption is that oil's right tail is unlikely (with shale growth effectively capping prices). We think there is a real chance that understated U.S. demand and continued reduction in global inventories may mean another leg higher in crude, as we usually see at this late stage of the economic cycle.

Trouble in Master Limited Paradise

The Federal Energy Regulatory Committee (FERC) ruled last week that it will revise its 2005 Policy Statement for Recovery of Income Tax Costs and no longer allow master limited partnership (MLP) interstate natural gas and oil pipelines to recover an income tax allowance in the cost of service rates. The news triggered a dramatic sell-off in the MLPs out of fears of a considerable hit to their operating profit.

MLPain

MLPs are pass-through entities, which distribute almost all pre-tax income to unitholders, who then are responsible for paying the taxes on it according to their individual situations. As such, they benefit from a very advantageous (almost 0%) tax treatment, while regular "C" corporations pay a 21% statutory tax rate (35% prior to tax reform). Since 2005 MLPs have been able, in the FERC's words, "to recover an income tax allowance in their cost of service" -- effectively boosting the amount of pre-tax income to be passed through. This "double recovery" of income tax costs that MLPs enjoyed is now disallowed.

Impact of FERC (Federal Energy Regulatory Commission)

With the recent developments since the FERC rate policy change, the stocks most impacted were those with higher exposure to the cost of servicing pipelines. Given the weakness in EEP and TCP, which are also financing vehicles for C-Corps, we could see difficulties in executing drop downs, a way energy companies monetize the midstream part of their operations. Most of the other MLP names are not as exposed to this recent FERC-related negative impact on the share price, as their drop downs look ok to us.

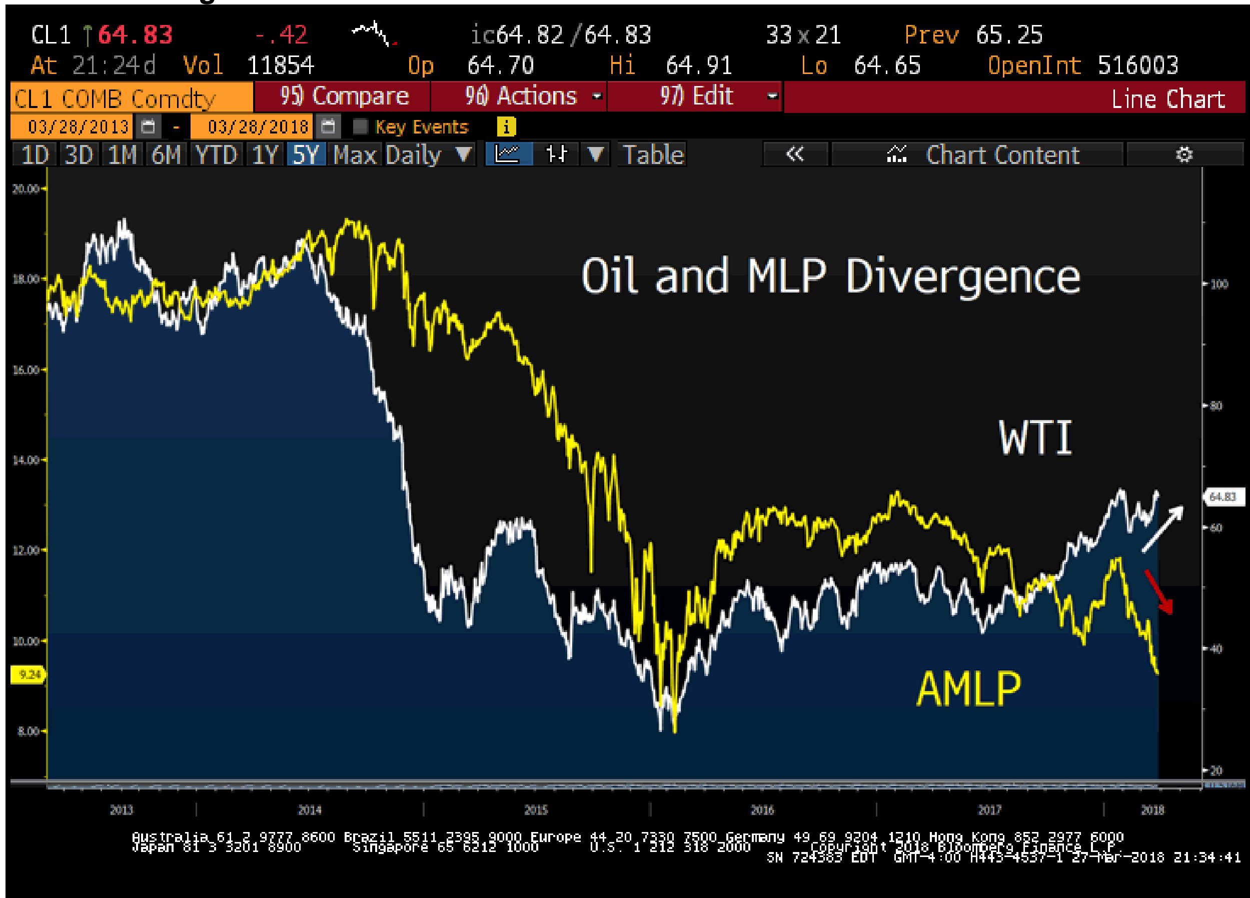
The most impacted pipelines under this ruling are those that have legacy costs of service rates, and those that are earning at their maximum rate. However, the FERC ruling applies only to interstate pipeline assets and not to those that originate and terminate within the same state. Furthermore, the rule is not expected to go into effect until 2020.

In cases where the MLP holds the pipeline asset but a C corporation ultimately owns the MLP, the FERC rule applies. In a reverse case, where the C corporation owns the pipeline within an MLP, the asset would not be subject to the ruling. As a result, we could see strategic reviews and acquisitions within the MLP sector to circumvent the income tax order. Examples of these would be refining companies buying back assets currently held in MLPs (*see our M&A section above*). The ruling does not apply to, for example, Kinder Morgan (KMI), which acquired its MLP some years back. But in the case of Williams Co. (WMB), it might be collaborating with Williams Partners to create a new corporate structure to hold long-haul assets like its Transco gas pipeline. This is a big opportunity that is certainly worth watching.

The takeaway here: there is a period of time (between today and the enactment of this tax code restriction), where corporations have the opportunity to buy (and therefore secure) a tax-advantage that they previously saw more value in divesting. They were wrong, and they now have the chance to fix it.

Ultimately, only a few MLPs will see a meaningful impact on their earnings from the FERC ruling. On the other hand, we could see strategic reviews leading to some buybacks of MLPs that were spun off in the past. Refiners have spun out their pipeline assets into MLPs in prior years, but may now want to buy them back to circumvent the new ruling.

MLPs in Rising Rates



It is true that in rising rate environments the relative performance of MLPs to the S&P 500 is lower, but relative to other known rates-like sectors (such as utilities and REITs), MLPs tend to outperform. This makes sense as oil prices are the key driver, and oil often goes up in hiking cycles. As oil prices continue to rise we expect MLP performance to turn higher as oil becomes the marginal driver. Over the past decade, MLP correlation to crude prices has remained quite high. Against the rate backdrop it is important to notice that in credit spread terms, MLP yield valuation are getting very attractive again, especially given these oil price levels and their trends. The average spread of Alerian MLP (AMLP) to the Ten year treasury yield since 2000 has been around 350bps, and is currently over 600. The yield valuation is there while AMLP yields over 8%.

Best Regards,

The Bear Traps Report Team

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