Tortoise

Tortoise QuickTake Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise will provide a timely update on trending topics in the market.

Ed Russell: Hello, I'm Ed Russell, senior managing director at Tortoise. Thank you for joining us for this special QuickTake podcast. I'm joined today by Tortoise portfolio manager and managing director Rob Thummel. Let's start by talking about what you think is behind the selloff in the energy sector. This year, the energy sector is the weakest performing sector in the S&P 500®. Through May 8, 2017, the S&P Energy Select Sector® Index has declined by 11% year-to-date while the S&P 500® is up 7% year-to-date.

Rob Thummel: The sharp decline in oil prices this year has been a headwind for the energy sector. Oil prices have declined by 11% and are currently lower than they were when OPEC held its last meeting in November of last year. Sentiment towards the energy sector has turned negative resulting in weak stock performance across the energy sector except for energy infrastructure which has held steady.

Ed Russell: So, obviously OPEC thought that they would be able to get a different result from their production cut. In your opinion, why are oil prices falling?

Rob Thummel: Initially, traders were skeptical of OPEC's compliance with its production cut agreement. However, OPEC compliance has been a very good 99%, as of April 30th, 2017. I think the biggest factor right now is U.S. crude oil inventories. In the first quarter, U.S crude oil inventories increased 12 out of 13 weeks including one of the largest crude oil inventory increases in U.S. history that occurred in February. Traders want evidence that oil inventories are declining and U.S. inventory numbers that come out weekly are the most readily available information. The increases in U.S. oil inventories are not a surprise to us as the first quarter is a seasonal period when inventories typically rise.

Ed Russell: So what about U.S. oil production? We're seeing a lot of evidence about rig increases, and you generally think that would be good for energy as a whole. What do you think is contributing to it being a weakness in crude prices?

Rob Thummel: Yes, we do think that higher U.S. production is having an impact as well. U.S. crude oil production is rising, with most of the increase coming from shale production. But think about this, U.S. shale oil production represents less than 5% of the total global oil supply. Yes, U.S. shale production is economic at $50 per barrel and in some basins U.S. shale oil is economic with oil in the $40s. However, we estimate that oil production from U.S. shale will likely increase by 300,000-500,000 barrels per day in 2017. Don't forget that global oil demand is forecasted to increase by approximately 1.4 million barrels per day in 2017.

Ed Russell: So I think this is confusing for investors. You've got OPEC doing what people think is the right thing in cutting production and you've got U.S. increasing production. How do you find middle ground? What is the market really looking for?

Rob Thummel: I think this is a common misconception in the oil markets right now. Traders want to create a boxing match pitting U.S. shale versus OPEC in a battle for global market share. In my opinion, this is simply not going to happen, as the global oil markets are going to need both U.S. shale and OPEC to increase oil production for two reasons. First, global oil demand is growing by over 1 million barrels per day and the U.S. and OPEC are two of the lowest costs suppliers of crude oil. Second, we have only spent time so far talking about approximately 32 million barrels of production from OPEC and 9 million barrels per day of U.S. production, throw in Russia and we have only accounted for approximately half of the global oil supply. Very few are talking about what is happening with the other half of the global oil supply. Capital investment related to the other half of the global oil supply which represents say 40-50 million barrels per day of production is expected to decline for the third consecutive year. Reservoir engineering and geology 101 tells us that oil production declines every year. I think this is an important point. If capital investment is insufficient to offset natural production declines then production volumes will fall. We believe the lack of capital investment in almost half of the global oil supply will result in declines in oil production, and that U.S. shale and OPEC will fill the gap created by the production shortfall associated with these declines in the years to come.

Ed Russell: Alright Rob, so with that we just saw oil break that $50 barrier that we thought was so important and is trading this week in the mid-$40s. Where do you think we go from here? Do we test new lows or do we get back up in the $50-$60 range?

Rob Thummel: We believe help is on the way for oil prices. What do we mean? We mean higher oil prices. First, we think OPEC's production cut agreement is likely to be extended at the bi-annual OPEC meeting on May 25th. All signals coming from the major players such as Russia and Saudi Arabia point to an extension of the agreement. While the production cut agreement would be likely be extended through the end of the year, some recent news organizations have reported that an extension of the cuts into 2018 is being discussed. This would be great news for oil prices. Regardless, the OPEC meeting should remove significant uncertainty from the global oil markets. Second, we expect to see a consistent reduction in U.S. crude oil inventories very soon. We are entering the seasonal period when U.S. oil inventories decline most weeks. What is most encouraging to us, is what has happened over the last six weeks in U.S. crude inventories. In five out of the last six weeks, the change in U.S. oil inventories was at or below the low end of the 5-year range. If this trend continues, there will be some substantial declines in U.S. inventories in the weeks to come. Look what happened today! Another larger than expected inventory decline, helped move oil prices up a little over 3%. So in general, we still believe that oil prices will range between $50 and $60 per barrel in 2017.

Ed Russell: Thanks. Let me bring you back to oil demand because I think that's important. And also, your last comment where inventories levels jumped crude prices. It seems to me to me that inventory levels and rig counts are getting all the headlines. But if you go back, I do remember a time when there was concern about global demand and that was getting headlines but right now, no one is talking about global demand. Can you enlighten us on where we're at compared to historical numbers?

Rob Thummel: Sure, good point Ed. So the forecasts for global oil demand growth in 2017 range between 1.3-1.5 million barrels per day. This range is 30% - 50% higher than historical averages. There is seasonality in the numbers as the lowest growth occurs in the first quarter while the highest growth happens in the second or third quarters. As global oil demand growth accelerates and oil supply falls, global inventories should approach normal levels which will be supportive for oil prices.

Ed Russell: Alright Rob, any concluding thoughts?

Rob Thummel: The U.S. energy sector serves a basic need and is critical to every sector. We are moving into a new era of low cost energy that could significantly boost global economic growth. The global energy landscape is changing. We believe shale oil and gas is here to stay. The U.S. is becoming a significant supplier of low cost energy to the rest of the world due to technology. A recent report by McKinsey labeled shale oil and gas as a disruptive technology. We agree. The U.S. energy sector is in transition requiring energy companies to be agile moving forward.

Ed Russell: Rob thanks for that, but I want to come back with one more thing. You've just outlined some things that show that the outlook for U.S. energy is very exciting. Yet, we have seen some volatility in the midstream area, particularly. Now, we're not at the levels where we were last year where people are doubting the business model of MLPs and some pipeline companies. But there has been some volatility there. Can you tell us specifically what this energy sector outlook can mean to the midstream space?

Rob Thummel: Sure Ed. I think probably the biggest factor impacting the entire energy sector right now is oil prices. And spent a lot of time talking about why we think oil prices are going higher. But when you have to think about the energy sector and MLPs and midstream in general you have to think about more than just oil. You've got oil pipelines, natural gas pipelines and natural gas liquids pipelines, you've got other types of assets. They are steady, fee-based driven assets that are a bit agnostic to what oil prices and natural gas prices actually end up being. Their cash flow and revenues and growth is more derived off of volumes. What we tried to layout over the last few minutes or so is a case that the U.S. energy sector is going to become a really critical long-term player in really supporting global energy demand growth. As a result of that we expect U.S. volume growth to occur in both oil and natural gas and MLPs will play an absolute critical role in serving a really important need which is providing critical infrastructure that connects areas of crude oil and natural gas supply to areas of crude oil and natural gas demand.

Ed Russell: Perfect Rob! Well thank you. No more follow-ons from me and I want to thank everyone else for joining us for here for our special QuickTake podcast.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.

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