Tortoise QuickTake Podcast with James Mick

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

Thanks for joining us today on the Tortoise Quick Take Podcast. I'm James Mick, managing director and Portfolio Manager with Tortoise Capital.

I'm sure many of you spent last night as I did, watching football with family and friends. Fresh off Super Bowl Sunday, it will be a long wait until the next football season kicks off. However, we don't seem to have to wait long for volatility in energy markets these days. Last week was similar to a long play being called back by a penalty as crude markets rallied on news leaks of a potential coordinated cut between OPEC and Russia, only to be brought back to reality with denials all around.

As for last week's performance,

- On the commodity front, crude oil was down 8.1%, while
- Natural gas was also lower for the week, down 10.2%, primarily due to weather
- Shifting to equities, the broader S&P energy index was down 3.3%
- Exploration and production companies were down 5.2%
- And MLPs finished down 4.8% for last week

This week has started off rough with two pieces of news to quickly address. First, the Williams Companies and the Energy Transfer family are likely feeling pressure as a result of a potential bankruptcy at upstream producer Chesapeake. Second, a negative article in Barrons' regarding MLPs ran over the weekend, yet simply rehashed old arguments we have addressed many times. Additionally, it should be noted that the cover of Barrons actually called for higher crude prices by year-end, to the tune of $55. So if the correlation of MLPs and crude continues, that should bode well for MLP returns as $55 is dramatically above the current $30 price.

Given the volatility and the strong correlation between crude oil prices and all energy securities, including both debt and equity, we felt it would be helpful to walk through our fundamental outlook for crude oil for 2016 and 2017.

I'll preface this by stating this is our best estimate at this time, utilizing data from multiple reporting agencies, independent 3rd party research providers and company estimates. That being said, as a Nobel laureate once quipped, "Prediction is very difficult, especially if it's about the future."

With those caveats out of the way, let's address our view of supply and demand.

Currently, we believe the global market is approximately 1.3 million barrels per day oversupplied for crude. Evaluating first the supply situation, we estimate that OPEC will produce an incremental 1.1 million bpd in 2016 compared to last year's production of approximately 31.3 million bpd. US production is expected to decline by an estimated 700,000 bpd compared to last year's average of 9.4 million bpd. Finally, the rest of the world would face declines of approximately 400,000 bpd in 2016 as well. All told, we anticipate net supply to be essentially flat with OPEC growth offsetting declines elsewhere.

On the demand side of the equation, we anticipate approximately 1.4 million bpd of incremental demand world-wide compared to last year.

Assuming those numbers are correct and our starting point of 1.3 million bpd of oversupply is accurate, the net zero supply increase and the 1.4 million bpd demand increase moves the overhang to a slight undersupply situation of roughly 100,000 bpd. This implies the world will draw on crude inventories in 2016.

Importantly, our forecast is seasonally driven. We believe that inventories will build in the first quarter, stabilize in the second quarter and then begin to draw in the 3rd and 4th quarters. Inventory draws should setup a positive feedback loop for crude oil as a more balanced market paves the way for better prices moving forward.

Let's take a quick look at the key risks to the equation.

First, OPEC could outpace our estimates. We believe we are being conservative with estimates of incremental supply of 500,000 bpd from Iran, 400,000 bpd from Saudi Arabia and 200,000 bpd from Libya, all in 2016. Obviously this has been extremely difficult to predict and it does pose a serious risk to the forecast.

Second is worldwide demand. We utilized an average of multiple groups to arrive at our 1.4 million bpd estimate, including the IEA, OPEC, EIA, independent research providers and energy companies. The range was a high of 2.0 million bpd all the way down to 1.2 million bpd. The punchline is that our 1.4 million bpd estimate sits squarely in the range of historical demand growth for the last 2+ decades of approximately 1.0 to 1.5 million bpd per year. A global recession clearly impacts this assumption, but that's not our base case.

U.S. supply is also a risk as production has certainly proven more resilient than many expected. The 700,000 bpd decline is in-line with EIA forecasts, but could prove high if companies continue to lower break-evens and generally obtain financing for capex.

2017 shapes up to be an even better year if our estimates prove correct as we anticipate an additional 1.4 million bpd of demand more than offsetting an incremental 500,000 bpd of OPEC growth. In short, 2017 would require inventory draws of approximately 1 million bpd, or more likely increased US production to meet the estimated demand.

So where does that leave us? We believe the U.S. can be the swing producer of crude oil for the world.

Natural declines and yearly demand increases put pressure on the global system to replace and grow production. However, issues persist to meet those challenges. Global exploration and production capex spending is expected to be down dramatically for the 2nd straight year. The result is likely a deferral of new projects to next decade and a lack of visibility on new production. Additionally, OPEC spare capacity is not what it used to be and provides little relief in our view.

Enter the U.S. and shale drilling. The short-cycle nature of shale sets up well to respond to supply needs.

The bottom line, it is our belief that the fundamentals point to the world needing increasing amounts of US crude in 2017 and beyond.

Thanks for listening and we look forward to speaking with you next week.

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@tortoiseadvisors.com