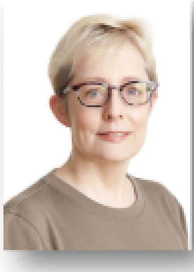
Forbes



Pamela Rosenau

VIEW FROM ABOVE

Cast Adrift – The Tide Is Coming In For MLPs

Apr 23 2018 – 01:50 pm

Over the past four years, the price of crude oil has been on a wild roller coaster ride. From a high of over $100 per barrel in the summer of 2014, West Texas Intermediate crude declined (more than 70%!) to $30/barrel less than two years later. Now approaching $70/barrel, the commodity has been recovering from its own bear market. In fact, crude oil was the best performing asset class in the first quarter of the year amid the broader stock market turbulence.

While crude has performed well, energy master limited partnerships (i.e. MLPs – the infrastructure that transports, processes and stores the commodity) have dramatically lagged. The energy MLP sector has seen its market capitalization decline since 2014 from over $500 billion to approximately $350 billion despite vastly improved fundamentals over the past year. Many MLPs have stabilized their balance sheets, plan to invest in new projects to meet increasing demand, and expect to retain more capital to create a self-financing business model. The attractive valuations, coupled with tax-efficient current yields above 8%, have not been enough to swing investor sentiment more favorably yet. This is beginning to change, especially given the current macro backdrop.

I have always carefully and cautiously followed the mantra, “Don’t fight the Fed.” The Fed’s view that inflation will hit its 2% target is unusually unanimous among its members. The Fed is no longer fighting deflation, which had previously led them to establish their unprecedented large-scale bond purchase programs that led to near zero interest rates. Those days have ended and I expect short-term rates will continue to climb. Just look at the 2-year US Treasury note, which now yields close to 2.50% (a rate that has doubled over the past seven months!). As market strategist Dave Rosenberg has written, if the Fed raises short-term rates above long-term rates, “they are really pushing above what economic fundamentals suggest is sustainable,” which inevitably leads to an economic slowdown. Unfortunately many investors follow a “group-think” mentality and are often caught looking in the rear view mirror. Here’s a reality check – when the Fed tightens, asset bubbles begin to pop. If you are looking in the rearview mirror, you won’t see that big boulder sitting right in front of you.

One renowned bank CEO was recently quoted as saying, “Many people underestimate the possibility of higher inflation and wages” which means that the Fed may “have to take more drastic action than they currently anticipate.” Recently, interest rates have been climbing on days when the equity markets have sold off. This is the biggest indication of rising inflationary pressure as bonds have not been acting as a hedge for stocks – a relationship that had been consistent for most of the past 20 years.

I believe this will eventually lead to a shift in equity market leadership from what’s popular (like the highly-valued tech sector) to undervalued asset classes. I am zeroing in on energy MLPs which offer an attractive total return supported by an underlying growth story (i.e. U.S. energy production.) This current period is analogous to the late 1990s, when MLPs had underperformed a ballooning tech sector, just prior to the Fed raising interest rates and popping the unforgettable tech bubble. The consistent total return of MLPs was part of a shift in market leadership in 2000. A similar shift is now occurring underneath the surface. In this market environment, I would argue that one should buy what is under-owned and undervalued. Remember that dividends will likely play a larger role in the market’s overall total return as inflation rises and multiples peak as they have historically, according to Strategas Research.

In 2001, Bob Farrell said it best, “Change of a long-term or secular nature is usually gradual enough that it is obscured by the noise caused by short-term volatility….Moreover, in a shift of secular or long-term significance, the markets will be adapting to a new set of rules while most market participants will be playing by the old rules.” Those words are very relevant today.