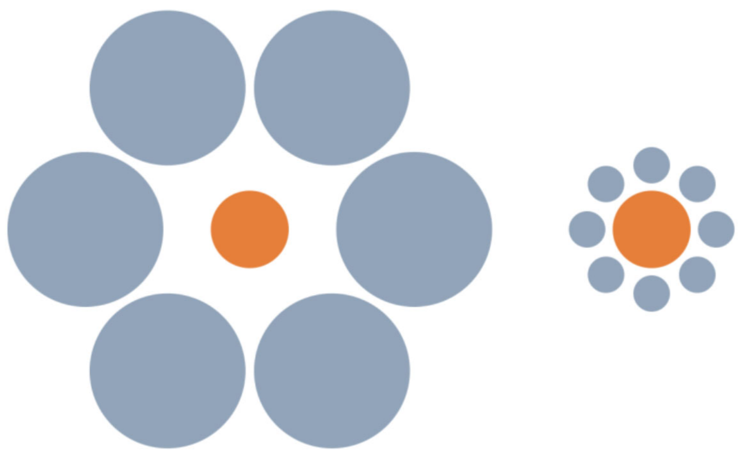
Quarterly Commentary
Q3 2020

EGA Energy Infrastructure

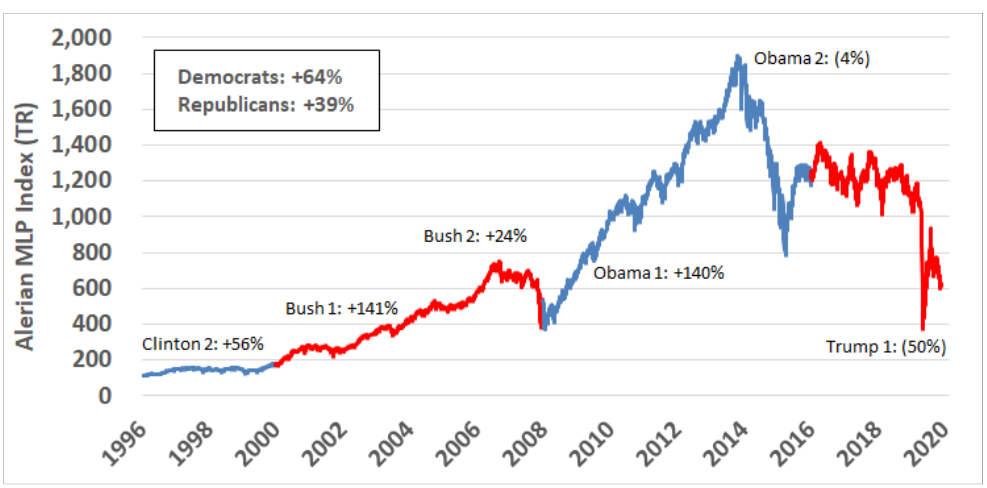
From the EGA Portfolio Management Team

Is Midstream's Concern Of A Biden Presidency An Illusion?

The Ebbinghaus illusion shown below is an optical illusion of relative size perception. A casual glance would make the viewer believe the orange circle on the right is larger than the orange circle on the left, when in reality they are the same size. As we approach the 2020 Presidential Election there are concerns a Joe Biden administration would weigh further on traditional energy valuations, but are these concerns an optical illusion? Below we look at the statistics and how we believe Midstream management teams may strategically respond to potential pressure applied by a Biden administration.



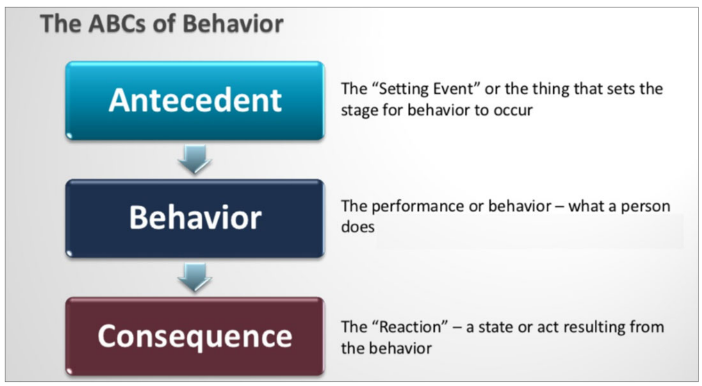
Before we get into the fundamental and strategic implications of a shift to a Democratic administration it may help to first analyze performance data. Total returns for the Alerian MLP Index since the mid-1990s show in aggregate Midstream performed better during Democratic administrations (+64%) than Republican administrations (+39%). Since the mid-1990s each presidential term saw absolute levels of growth until the second Obama administration, which ended with the first OPEC supply shock that started what has been a six-year bear market for Midstream. At face value, stock price performance during Democratic administrations has been more supportive of Midstream than during Republican administrations and provides one reason why investors shouldn't concern themselves too much with a Democratic administration.



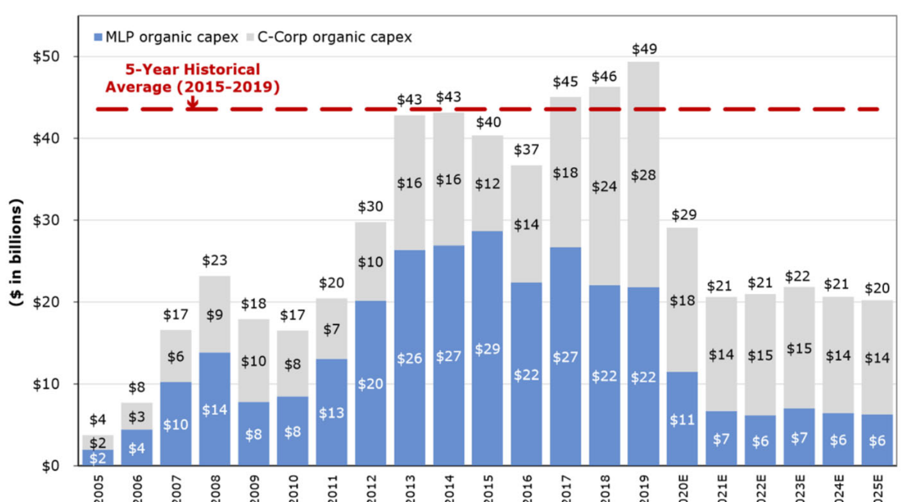
Source: Bloomberg

Of course, fundamentals drive stock price performance and not intangibles like political leanings or which league won the World Series last year. As an example, it was the fracking revolution's lowering of natural gas prices that "killed coal" and not President Obama, and it is similarly impossible for President Trump to "save coal". However, the federal government can have a psychological impact on how management teams approach different markets. It is certainly possible that a friendly, pro-business government may nudge a company to pursue projects they're on the fence about building. If management is wrong about market conditions the decision to move forward on these projects can exacerbate the severity of a downturn, especially if other management teams came to a similar conclusion about competing projects. On the other hand, a less friendly government may have nudged the same management teams to reject these same projects, and potentially reduce the severity of a future downturn. It's worth highlighting that a more restrictive development regime would drive up premiums for those companies that already have steel (infrastructure) in the ground. So not only would they be harvesting cash flow, but the assets they own would also be worth more.

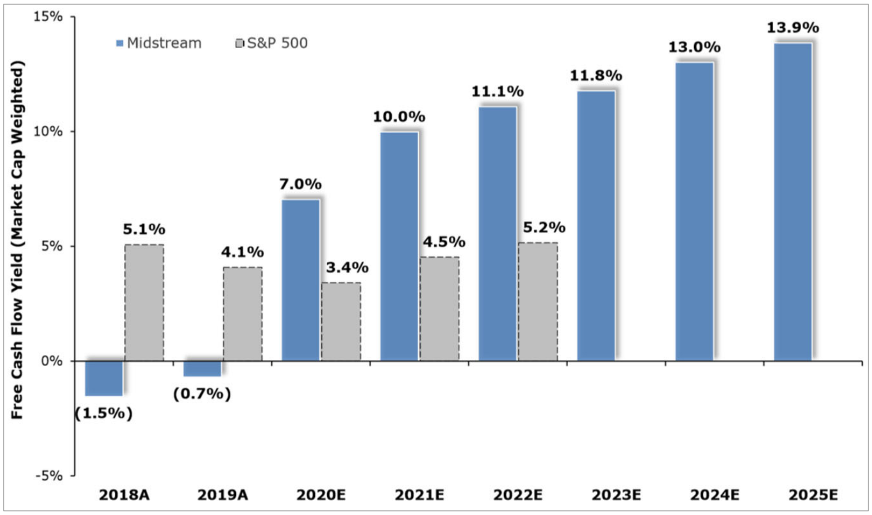
An argument could also be made about regulatory scrutiny. A less business friendly government tends to more closely scrutinize development, on sociological and environmental grounds. The fact is people tend to be more careful and detail oriented when they're under the watchful eye of parents than their "cool" Uncle or Aunt. This is basic human nature, and the main focus of Behavioral Science as applied to management.



Looking forward the question remains: Would a Biden presidency be bad for Midstream investors? If it means more oversight that leads to sector consolidation, additional balance sheet improvement, more cost cutting and less profligate spending, then it could possibly be good. This all matters because free cash flow metrics and financial strength are resonating with generalist investors, as we've heard from a variety of sources. Perhaps the only thing holding back a Midstream recovery are concerns of repeating the same mistakes, and a Democratic administration may help management teams avoid this.

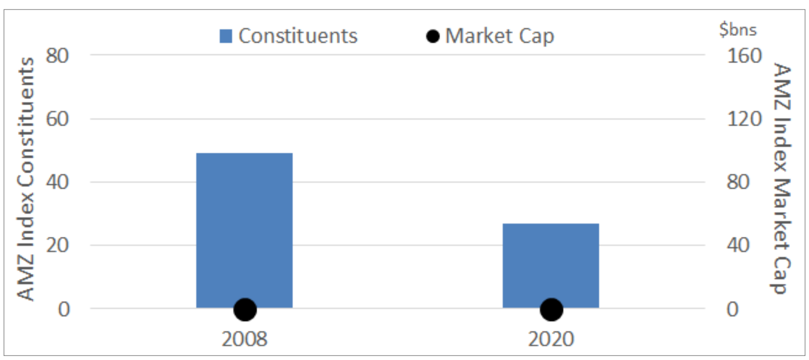


Source: Wells Fargo



Source: Wells Fargo

We also want to address the possibility a Democratic administration may decide to eliminate the MLP structure in its entirety, even if to date this issue has not been raised. To state the obvious this would be negative for those MLPs that remain, though such a move would have been more impactful if this was 2008 and not 2020. In 2020 many companies have already converted to C-corps (see below chart), have right-sized balance sheets and distributions during this multi-year downturn, and have guided to further declines in operating costs and capital expenditures in 2021. As our portfolios remain focused on quality we would expect only minimal disruption to current operations and, in the absence of a distribution cut, perhaps a slower rate of deleveraging and share buybacks over the long-term to account for the inevitability of federal taxation.

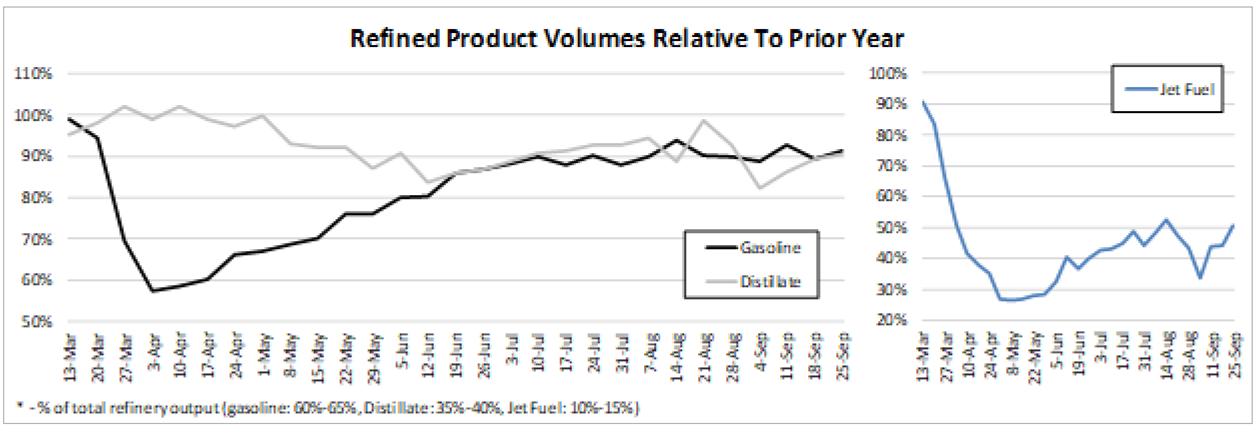


Source: Bloomberg

Finally, we highlight a portion of Candidate Biden's revenue proposal that calls for an increase in corporate tax rates. An increase makes the MLP tax structure more attractive for those that remain, and this could in theory help close or reverse the well documented underperformance of MLP Midstream companies versus their C-corp Midstream brethren.

Refined Product Volume Recovery Slows; Recovery In Air Travel Will Take Time

The good news is refined product demand modestly grew in the third quarter relative to the second quarter. This was driven especially by improvements in gasoline demand where it averaged 90% of last year's volumes compared to the June rate of 83%. Similarly, distillate demand improved to an average of 91% of last year's volume compared to the June rate of 87%. However, a similar improvement in jet fuel demand masks what is still a terribly depressed air travel market. Yes, it's true jet fuel demand improved to 45% of last year's volumes compared to the June rate of 37%, though at 45% the implication is air travel demand is still a ways off from full recovery. What may not be fully appreciated is the impact weak jet fuel demand is having on refining economics, where excess jet fuel supply is rejected back into the distillate pool as a result of weak demand. This negatively impacts refining economics and puts enormous strain on refiners' balance sheets that may reverberate down the infrastructure chain if the situation goes past the point of no return (i.e., bankruptcy, refinery shutdowns). However, there is a view that a jet fuel recovery to 70%-80% of last year's level would be enough to help refiners get past these unprecedented times, and subsequently remove the overhang associated with Midstream companies tied to refineries.



Source: Department of Energy

We remain cautiously optimistic about the economic recovery and believe its fragility is intertwined with the country's ability to safely push past this pandemic. It's for this reason we continue to focus on quality for our Midstream strategies, as we believe these companies are best positioned to not only make it through the downturn but also perhaps add significant fundamental and shareholder value on their way through.

Energy Infrastructure Team Update

There were no significant team related news items to highlight this quarter. We continue to focus on the research and portfolio execution effort and are in constant dialogue with industry experts and management teams. We continue to believe oil and natural gas will play a major and increasing role in the global economy, and owing to healthier balance sheets, higher coverage, and heightened discipline are optimistic about the long-term viability of Midstream as a sector for investors who prioritize income.

We look forward to communicating the results of your investment next quarter and thank you for your continued patronage and confidence in Eagle Global Advisors.

- The Eagle Energy Infrastructure Team