Why Midstream Investors Should Look Past Oil Volatility

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Summary

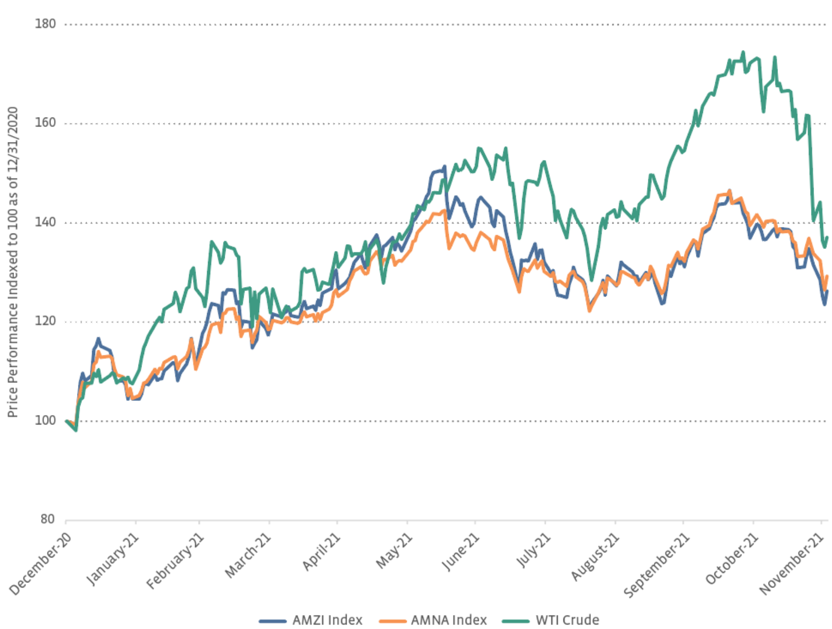
- Despite the significant pullback in oil prices lately and uncertainty posed by the Omicron variant, midstream performance has been largely resilient.
- Multiple factors arguably exacerbated the recent downward move in oil prices, and oil market fundamentals have likely changed less than price action would suggest.
- Even with the recent volatility in oil prices, the outlook for midstream cash flows and volumes remains largely unchanged. Midstream companies are expected to generate significant free cash flow, which will be used for reducing debt and returning cash to shareholders via buybacks and dividends.

Midstream investors often lament that equities do not rise with oil when it rallies but get penalized when oil prices fall. For fee-based businesses that generate stable cash flows, oil movements often seem to drive midstream equities more than they should. With oil prices under pressure lately and the potential for continued volatility, today's note discusses midstream performance and the outlook for midstream in the context of oil prices. Specifically, this note explains why midstream investors should continue to look past the noise in oil prices – just as recent midstream equity performance has largely shrugged off oil's volatility.

Midstream lagged oil's rally but also did not get severely punished in oil's sell off.

Despite the significant pullback in oil prices lately and uncertainty posed by the Omicron variant, midstream performance has been largely resilient. West Texas Intermediate (WTI) oil prices fell more than 15% from November 24 to December 2 on concerns surrounding the Omicron variant. Over the same timeframe, the Alerian MLP Infrastructure Index (AMZI) fell 6.4% and the broad Alerian Midstream Energy Index (AMNA) was off just 5.6%, while the S&P 500 was down 2.7%. Given midstream's resilience, the year-to-date performance gap between oil prices and midstream has narrowed markedly over the last week or so as shown in the relative price performance chart below. WTI crude rallied this fall, hitting $86 per barrel (bbl) in late October, before taking a dive in November. Midstream/MLPs followed oil's direction but with significantly less volatility to both the upside and downside. As noted in the past when discussing midstream equity performance in relation to oil prices, the commodity has unique drivers relative to the equities, including the impact of traders and speculators, which likely exacerbated oil's downward move since Thanksgiving.

Oil's Sell-Off Closes the Gap Between Oil and Midstream Performance YTD



Source: Bloomberg as of December 2, 2021

Oil fundamentals have not changed as much as the sell-off since November 24 would suggest.

Oil's rally this fall was perhaps a bit too much, too fast in retrospect, and the emergence of the Omicron variant provided a swift check on prices as new uncertainty clouded the outlook for oil demand. Multiple factors likely exacerbated the recent downward move in oil prices, headlined by the 11.5% decline on November 26. Driven by profit-taking after a strong run and concerns around the potential for strategic oil releases, selling was already underway before the strategic oil release was announced and news of the Omicron variant emerged. For traders and speculators, the Omicron variant provided added reason to sell out of existing oil positions while potential buyers were likely sidelined. The November 26 decline was likely made worse by lightly-staffed trading desks in the US given the Thanksgiving holiday.

Despite the volatility in oil, fundamentals have probably not changed all that much. The demand impact from the Omicron variant is still uncertain and will be better understood as time passes. In the interim, OPEC+ has decided to proceed as planned with the 400,000 barrel per day output hike in January suggesting little reason for concern at this point, although the group left open the potential to adjust plans if needed. While the Omicron variant certainly adds uncertainty, the sell-off in oil, particularly on November 26, seems like a "shoot first, ask questions later" scenario exacerbated by oil's notable run-up prior to the news and the trading dynamics discussed above.

Midstream outlook remains constructive.

Even with the recent volatility in oil prices, the outlook for midstream remains largely unchanged. Whether WTI is $78/bbl or $68/bbl, midstream companies are expected to generate significant free cash flow thanks to the stability of their fee-based businesses. That free cash flow will be used for reducing debt and returning cash to shareholders via buybacks and dividends. Given public producer discipline, the outlook for production growth is likely little changed despite oil prices being approximately $10/bbl lower than they were prior to Thanksgiving. Furthermore, midstream remains well positioned for today's inflationary environment given contracts with built-in inflation adjustments.

While the price response from midstream has been moderate in oil's latest pullback, it bears noting that the AMNA Index is down 11.7% on a price-return basis from October 20 to December 2. With many midstream companies having opportunistic buyback authorizations in place, the recent price pressure may entice management teams to be more active with buybacks, which could provide support for equity prices. Perhaps, that has even contributed to the more muted declines for midstream.

Bottom line

Oil is likely to remain volatile as market observers learn more about the Omicron variant and watch to see how OPEC+ responds. Just as midstream equities largely shrugged off the recent oil selloff, midstream investors should look past the noise from oil and focus on the constructive outlook for midstream into 2022.

AMNA is the underlying index for the ETRACS Alerian Midstream Energy Index ETN (AMNA). AMZI is the underlying index for the Alerian MLP ETF (AMLP) and the ETRACS Alerian MLP Infrastructure Index ETN Series B (AMUB).

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