Revisiting MLP Performance as Interest Rates Rise

November 2018

With the 10-year Treasury yield touching levels in 2H18 that have not been seen for years, it seems like an opportune time to revisit MLP performance in a rising interest rate environment. We discussed this topic in detail in a 2015 white paper, which provides historical context going back to the mid-1990s. This piece focuses on how MLPs have performed in rising rate environments since 2013 and key differences with the current environment that could have a bearing on MLP performance as rates increase.

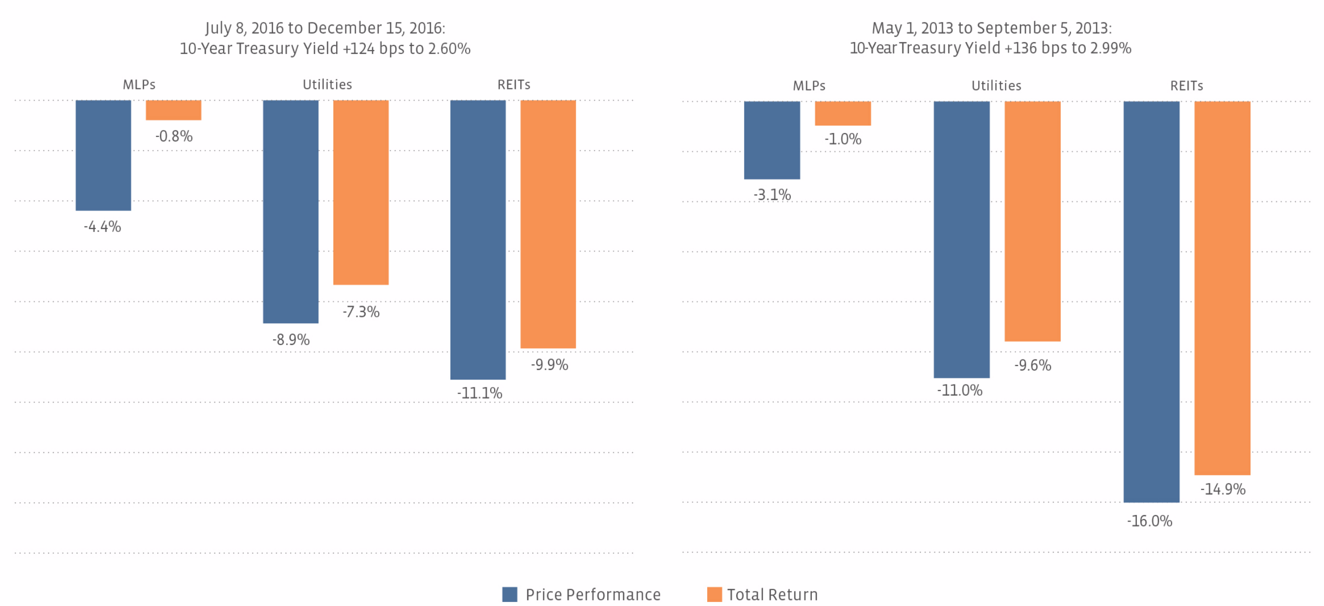
For MLPs, rising interest rates can be a headwind in two ways: 1) fixed income investments become more attractive, increasing competition for investor dollars among yield vehicles, and 2) borrowing costs rise. There are several factors that have historically allowed MLPs to mitigate the negative effects of rising interest rates, particularly in comparison to other yield vehicles such as REITs and utilities. We discuss those factors as well as other tailwinds for the MLP space that may help offset any negative impact from rising rates.

What can we learn from history?

MLPs have historically demonstrated a low correlation with Treasury yields. Using the Alerian MLP Index (AMZ) as a benchmark, the weekly correlation for the past ten years between MLPs and the 10-year Treasury yield is 0.2 as of October 2018, and the 15-year correlation is even lower. Given historically low interest rate levels over the preceding decade of less than 4.0%, the long-term correlation between the AMZ and 10-year Treasury yield may be less meaningful than if we had experienced more volatility at higher interest rate levels over the time period.

As an alternative, it's informative to look at MLP price performance during periods of rising rates. As shown below, MLPs significantly outperformed REITs and utilities during both the taper tantrum in 2013, and when rates nearly doubled in the second half of 2016.

Performance of Yield-Oriented Equity Investments During Recent Periods of Rising Interest Rates

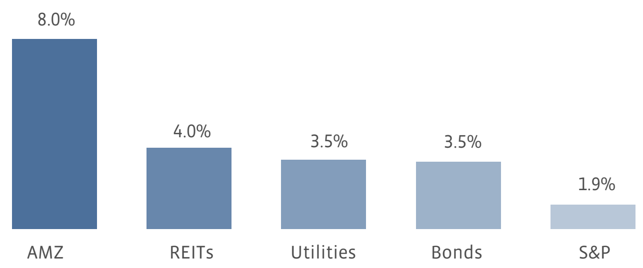


Source: Bloomberg
Note: MLPs represented by the Alerian MLP Index. Utilities represented by the S&P 500 Utilities Index. REITs represented by the Real Estate 50 Index.

How is today's environment different?

It's important to point out that each scenario of rising interest rates will have its own nuances. Relative to the periods shown above, the 10-year Treasury yield in October 2018 of more than 3.0% is at a higher absolute level, creating more potential competition for yield. On the other hand, MLP yields are also at higher levels in 2018 than they were for the time periods in 2013 (5.8%) and 2016 (7.3%). MLPs' higher yield may help insulate them from the impact of rising rates. MLPs also boast a more attractive yield than Utilities and REITs as shown below.

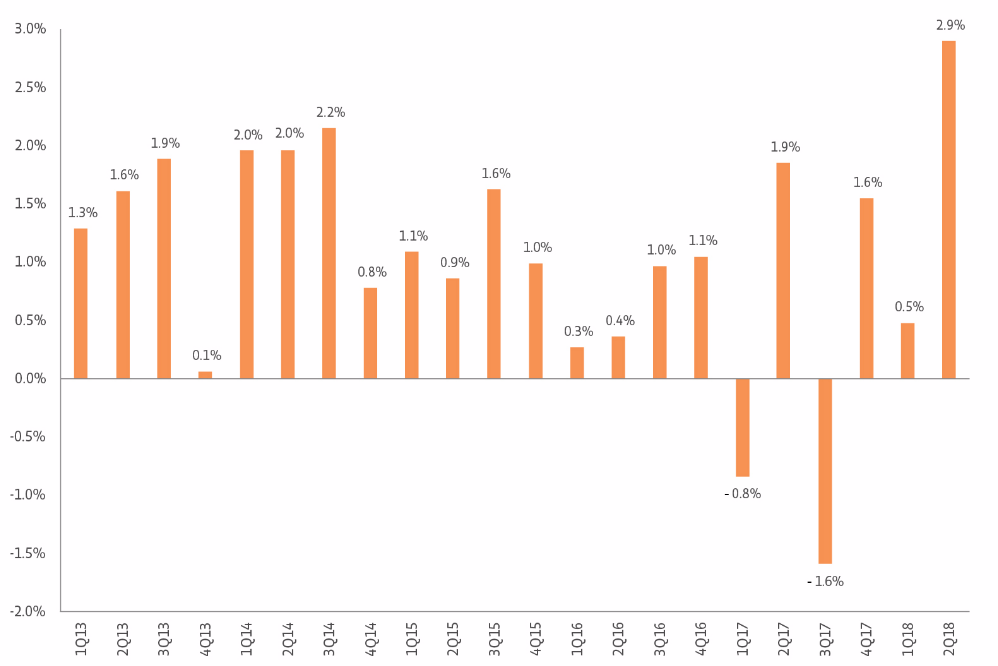
MLPs Offer More Attractive Yields Than Utilities and REITs



Source: Alerian, Bloomberg
Note: As of September 28, 2018

Another contributing factor that helps MLPs offset the impact of rising rates is MLP distribution growth. The MLP space is generally leaving behind the old convention of 6-8% annual distribution growth in favor of more sustainable distribution growth and stronger balance sheets. Despite the fact that growth has generally moderated since 2013 as shown below[1], most AMZ constituents grew their 2Q18 distributions, and more than 80% of AMZ constituents grew or maintained their distributions relative to 2Q17 (read more). The significant increase for 2Q18 was largely driven by a 233.3% sequential increase in the distribution of Hi-Crush Partners (HCLP), which accounted for half of the 2.9% increase.

AMZ Quarterly Weighted Distribution Growth



Source: Alerian

1 // Quarterly weighted distribution growth is calculated by taking constituent-level growth rates and then multiplying by each constituent's weight in the index and summing the values. The distribution growth rate for 2Q18 reflects the distributions announced and paid in 3Q18 related to 2Q18 performance.

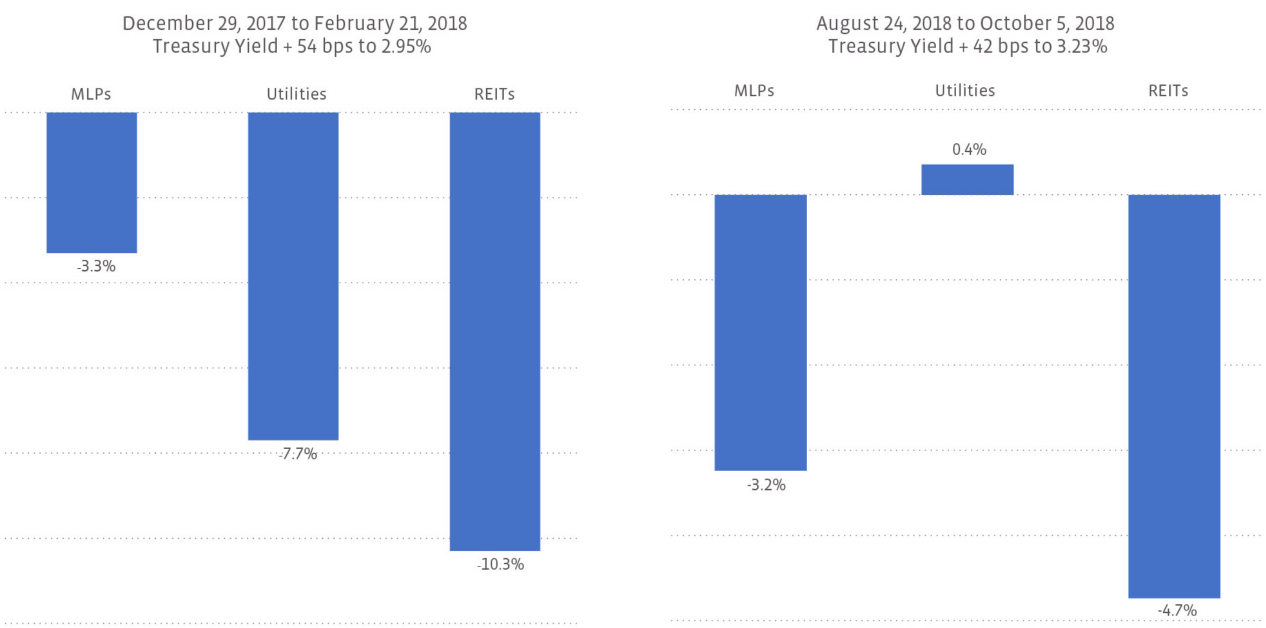
In the wake of the oil downturn that began in 2014 and saw WTI crude prices bottom in February 2016 at $26 per barrel, many MLPs have taken steps to improve their positioning. MLPs have reduced their leverage, and balance sheet positions have generally improved. Stronger balance sheet positions should help mute the negative impact of rising interest rates on borrowing costs for MLPs.

From a fundamental standpoint, MLPs are also in a better position today with US oil and natural gas production at record highs. As volume-driven businesses, higher energy production supports high utilization of existing pipeline and infrastructure assets and creates growth opportunities. MLP growth projects are built with customer commitments largely in place under long-term contracts and clear visibility to fee-based cash flows. Often, contracts will also include inflation adjustments, further protecting MLP cash flows.

How have MLPs performed as rates have risen recently?

As rates have risen in 2018, performance among yield-oriented investments has been mixed. As shown below, MLPs outperformed REITs and Utilities as the 10-year Treasury yield gained 54 basis points (bps) at the start of 2018. However, when rates increased in the fall, Utilities provided better performance. Utilities were up slightly as the 10-year Treasury yield increased by 42 bps from August 24 to October 5, 2018, while MLPs and REITs traded lower. It's worth noting that Utilities outperformed even before the flight-to-safety trade kicked in with the broader market pullback on October 10th and 11th when the Dow Jones Industrial Average fell by nearly 1,400 points over two days. Utilities have been perceived to be more defensive and may hold up better in an environment of rising rates if the market embraces a risk-off trade (read more).

Price Performance As Rates Increased in 2018 is More Mixed Among Yield-Oriented Equity Investments



Source: Alerian, Bloomberg
Note: MLPs represented by the Alerian MLP Index. Utilities represented by the S&P 500 Utilities Index. REITs represented by the Real Estate 50 Index.

Bottom Line

Admittedly, past performance is only so helpful in evaluating how MLPs will perform as rates rise, and rates are reaching levels not seen in years. Balancing the higher level of interest rates with the advantages MLPs enjoy today, including a strong fundamental backdrop with record high US oil and natural gas production, improved balance sheets, higher yields than in past scenarios of rising rates, and distribution growth at a more sustainable pace, the tailwinds seem to outweigh the headwind of rising rates. These advantages may also support better relative performance for MLPs as rates rise compared to other yield-oriented investments.

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