Eagle MLP Strategy Monthly Newsletter - December 2016

From the EGA Portfolio Management Team

A Return To Normalcy After A Wild Year

You invite some close friends together on New Year's Eve for a friendly conversation and ask, "What will you remember about 2016?" Half the table grins widely and says "Donald Trump" and the other half grimly frowns and says "Donald Trump." This unanimous conclusion masks the extraordinary nature of 2016, highlighted not only by the U.S. election but also by (1) the United Kingdom voted to Brexit the European Union, (2) OPEC decided to cut production, (3) South America hosted its first Olympics, (4) there was a once in a generation supermoon, (5) Cleveland won a sports championship in a most shocking fashion, (6) Fidel Castro finally died and (7) THE CHICAGO CUBS WON THE WORLD SERIES! So we think it's safe to say 2016 will go down as a wild year.

But it wasn't only a memorable year for the macro. For MLPs there was no January effect as commodity prices continued to crash down until mid-February when all of a sudden they finally found a bottom. After a furious rally into mid-summer, the sector paused until Election Day surprised nearly everyone. It was November 9th when humble energy advisors rubbed fog out of their sleepless eyes and took in the sunny morning. And so sets up a return to conditions where attractive valuation and improving fundamentals makes for the most interesting entry for the sector into a new year we've seen in a long time.

Our basic expectation for the new administration is a business friendly and less intrusive federal government, which when combined with a tightening global energy macro and stronger company financials, allows the oil and natural gas industry to focus on what they do best (produce!). Balance sheets are stronger, coverage ratios are higher, operating costs have been streamlined, and there is substantial upside via operating leverage for midstream companies as E&Ps increase production. There is also talk of reflation, an additional tailwind for energy infrastructure as it allows for higher tariffs on top of potentially higher volumes. However, as the saying goes, to assume anything puts the speaker at risk, and we highlight isolationism, tax reform, and rising interest rates as areas of concern. For the most part, we see the glass half full as either a catalyst for or function of a higher growth environment.

"You're Hired"...How A Trump Victory Changes Everything

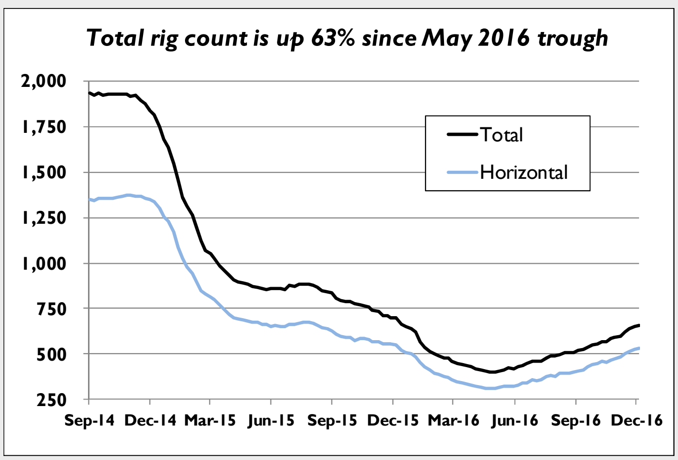
As Donald Trump's inauguration draws near we emphasize three cabinet picks we believe support our view that a Trump Administration will be pro-business and pro-energy: ex-CEO of ExxonMobil Rex Tillerson as Secretary of State, ex-Governor of Texas Rick Perry as Secretary of Energy, and Attorney General of Oklahoma Scott Pruitt as Administrator of the Environmental Protection Agency. Each has been a strong supporter of oil and natural gas development, understands the energy business and how government can be a positive force for growth.

A trending concern has been increasing regulatory oversight as the permitting process has grown longer and interactions more adversarial. The State Department's rejection of Keystone XL's Presidential Permit and Dakota Access Pipeline's (DAPL) recent interaction with the Army Corps of Engineers come to mind. We would expect federal oversight to become less political as the green lobby's influence subsides with the departure of the Obama Administration. While we don't expect an immediate explosion of growth projects as the energy industry is still working through a weak market, there is still much infrastructure needed in the United States, so when the time is right the MLP sector will have confidence in the process and regulatory consistency to get projects across the finish line.

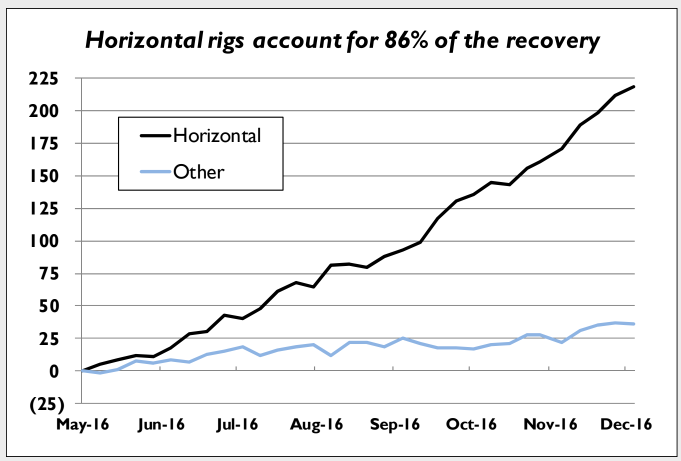
While we are positive about the potential impact a Trump Administration can have on traditional energy, we are less so regarding his isolationist rhetoric. We worry about the movement away from globalization or at a minimum a resurgence of localized isolationism and protectionism. The shale revolution has given traditional energy and general manufacturers an edge over many global competitors. Trade wars could significantly undermine this advantage, hurting the broader economy and traditional energy. We consider the nomination of Rex Tillerson as Secretary of State vitally important, his resume suggests the United States will focus on improving international trade and not jeopardize the benefits of globalization.

OPEC: Victory or Capitulation?

On November 30, OPEC agreed to cut oil production for the first six months in 2017 to help bring inventories back in line with historical norms, driving oil prices 20%-25% higher until they stabilized in the low-to-mid $50s/bbl. Some claim OPEC achieved its goal of decimating U.S. shale and are now colluding to increase pricing while others suggest OPEC capitulated and point out the lack of U.S. shale bankruptcies as proof. We highlight that U.S. shale did an outstanding job lowering its cost basis (in some cases by 50%), and has also right-sized the industry to compete in even a $40-$50/bbl price environment. Well before OPEC announced their decision, the U.S. drilling rig count began to trend higher, rising 63% since its trough in mid-May.



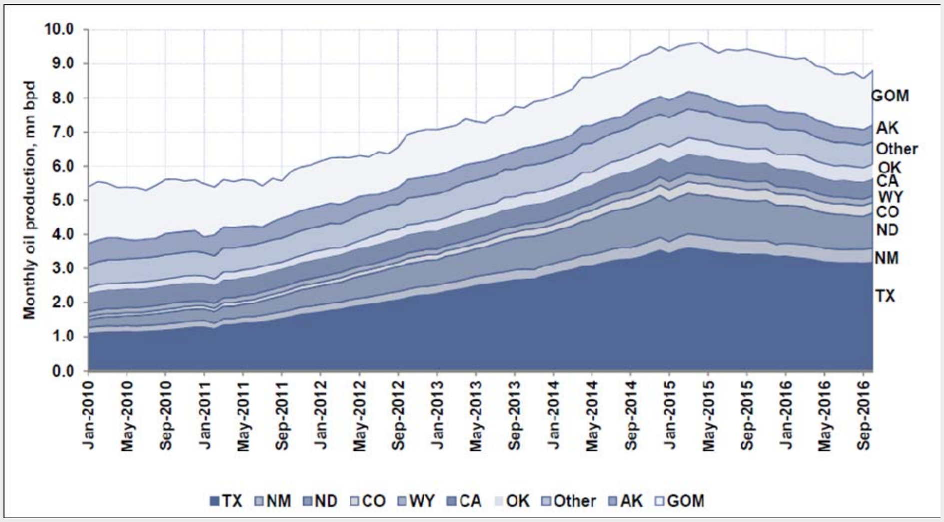
Source: Baker Hughes



Source: Baker Hughes

In the end, what we focus on is that North American oil volumes are stabilizing, a necessary step before the MLP sector can return to growth. We see consensus calling for growth to return in the second half of 2017, though we're starting to hear chatter about growth returning as early as the late first half of 2017. The Permian, DJ Basin, and STACK/SCOOP are highly active areas right now, while other fields like Eagle Ford and Bakken are seeing enough green shoots to encourage optimism.

Monthly U.S. Oil Production by Area, Million Barrels Per Day



Source: Goldman Sachs, EIA

Rig Count Analysis Shows Growth Not Only in the Permian

Field	12/27/13	"peak" 9/19/14	12/26/14	12/31/15	"trough" 5/27/16	9/30/16	12/30/16	From "trough" abs.	From "trough" %
Ardmore Woodford	10	5	6	2	1	0	1	0	0%
Arkoma Woodford	5	8	5	8	3	4	4	1	33%
Barnett	33	25	24	7	2	1	3	1	50%
Cana Woodford	36	38	48	38	28	35	37	9	32%
DJ-Niobrara	49	63	60	23	13	17	25	12	92%
Eagle Ford	228	205	204	76	29	36	46	17	59%
Fayetteville	9	9	9	1	0	1	1	1	--
Granite Wash	53	66	52	15	6	10	15	9	150%
Haynesville	41	46	40	25	15	13	27	12	80%
Marcellus	85	81	78	41	26	32	39	13	50%
Mississippian	79	78	72	12	3	3	3	0	0%
Permian	469	560	536	217	137	204	264	127	93%
Utica	38	44	50	15	11	15	20	9	82%
Williston	183	198	179	53	22	30	33	11	50%
Others	439	505	477	165	108	121	140	32	30%
Total US Rig Count	**1,757**	**1,931**	**1,840**	**698**	**404**	**522**	**658**	**254**	**63%**

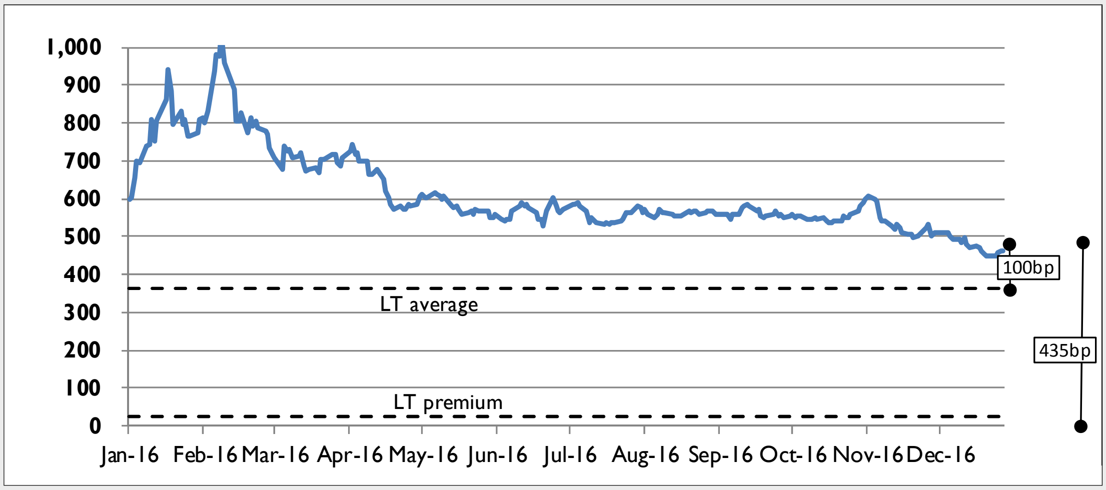
Source: Baker Hughes

Glass Half Full: Interest Rates and Tax Reform

The most common questions we've received from investors over the past few months relates to interest rates and tax reform. We fully recognize that both can be headwinds for the MLP sector, but believe we are on solid footing when we say the glass is half full.

In a vacuum, rising interest rates are negative for yield-oriented investments. However, there are numerous other independent variables that play a meaningful role in how a stock trades. For us, an important variable is whether the MLP sector is cheap in the first place. The MLP yield's spread over the 10-year Treasury yield shows the sector currently trades at a discount to historical averages, implying a "buffer" exists to protect against rising interest rates. Assuming MLP yields stay constant suggests 10-year Treasury rates can rise 100 bps before hitting its long-term average of 435 bps. That said, we believe the rise in interest rates has hung over the MLP sector over the last few months, resulting in lost performance relative to other sectors that are not yield-oriented. Ultimately we believe the inexpensiveness of the MLP sector will allow both a rise in interest rates and MLP stock prices. As a final point, we believe an underlying driver of rising interest rates is a stronger domestic economy, which when combined with potentially pro-business and pro-energy policies of the Trump Administration implies higher growth going forward. We do not believe this is yet reflected in MLP valuations, which should further offset the impact of rising interest rates.

Yield Spread Analysis Implies MLPs Are Still Inexpensive



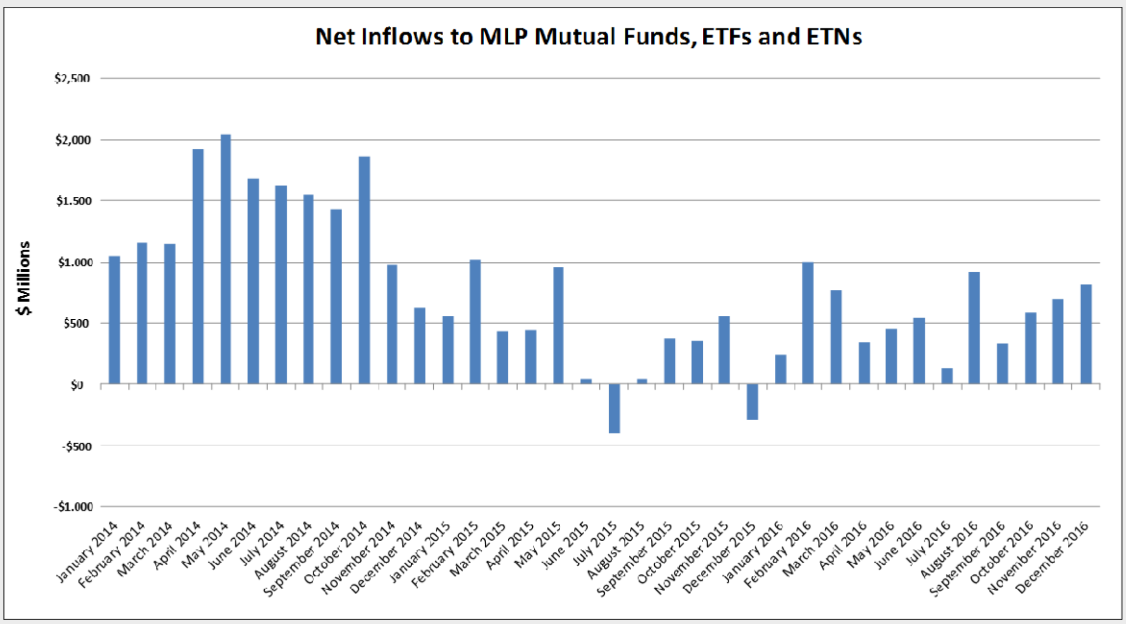
Source: Alerian MLP Index, Factset

Tax reform is trickier, because as of now the correct response is "nobody really knows" since the end result on tax reform will follow intense negotiation at the Congressional level. But generally we assume corporate and personal tax rates will be lower by some amount. We also see minimal risk that the outcome will eliminate MLPs as an asset class; a Trump Administration pro-business and pro-energy position puts MLP in good standing, a view we share with industry insiders. The potential impact of tax reform on the MLP sector will come down to the relative changes on corporate, personal, and dividend tax rates. There are, however, a few conclusions we can draw: (1) Lower personal tax rates reduce individuals tax on MLP K-1 income, and also the liability on the reduced cost basis recapture, reducing the punitive nature of selling long-held MLPs, (2) Lower corporate tax rates should reduce some of the cost of capital advantages that MLPs have over corporations, but unless the corporate or dividend tax rates are reduced to 0% (quite unlikely, in our view), some advantage will remain, and (3) MLP management teams have shown a willingness to adjust their structure to reduce investor tax burden and maximize their distribution payout, including the creation of the up-C structure (PAGP) or a collapse of the GP / LP structure to monetarize imbedded tax losses (SEMG, TRGP) while at the same time reducing long-term cost of capital through the elimination of the IDR burden. Whatever the outcome of any potential reform is, it will certainly be an interesting process to watch and we will be diligent in making sure your MLP portfolio is best positioned to benefit from those changes.

Corporate Actions, Capital Raises and Fund Flows

Energy Transfer once again dominated headlines at a company specific level thanks to its announced merger of ETP/SXL, two MLPs underneath ETE's umbrella that makes it an all-in-the-family transaction. We consider the merger slightly negative for SXL, neutral to moderately positive for ETP, and great for ETE. This largely validates our theory (and positioning) that investing with management is usually the best bet. At a sector level, the ETP/SXL merger is the latest in a year of structural re-organizations we see as driven by a desire for cleaner/simpler MLPs, stronger balance sheets, and more diverse cash flows. This was the major theme of 2016, though at this point we believe the simplification trend has mostly run its course. On the other hand, we think third party acquisitions could become the story of 2017 but stress upside exists only in thoughtful transactions. Merger math is getting more difficult as upside risk to EBITDA guidance increases and the potential for management to overpay becomes very real.

Equity markets continue to be open in the fourth quarter though there was a modest slowdown in the number of overnight follow-on offerings. We believe this slowdown is partially driven by high activity earlier in the year and proof that investors and rating agencies are currently comfortable with the sector's financial health. Importantly, of the four common equity follow-ons offered in the fourth quarter, three closed higher than deal price the next trading day and all had outperformed the Alerian MLP Index by December 31. We highlight Dominion Midstream (DM) in particular as the stock outperformed the AMZ by 27% from the deal date. Separately, there has been much discussion about the absence of the retail investor. Several sell-side analysts have mentioned this point, as a lion's share of 2016 capital raises was bought by institutions, implying a return of the retail investor to the sector could generate a strong technical tailwind.



As of 12/31/16; Source: US Capital Advisors

Finally, fund flows into the sector ended the year on a positive note as the fourth quarter inflow of $2.1 billion was a high for the year, topping the $2.0 billion inflow in the first quarter of 2016. Also worth noting is that 2016 inflows of $6.8 billion were 67% above the prior year. While this remains below the pace of inflows seen during 2014 (see chart above), the improvement of sector and macro fundamentals is a positive sign that investor participation will continue advancing into 2017.

MLP Team Update

There were two significant team related news items this quarter. We are happy to announce that in addition to their analyst roles, both Michael Cerasoli and Alex Meier have been promoted to Portfolio Manager of MLP Strategies. Over the past few years their responsibilities have expanded substantially to warrant the new designation, and we expect their contributions to the firm will continue to grow in the years to come. Separately, we announce the departure of Kunal Nainani who left the firm to pursue other opportunities. We are actively looking to add an analyst to the MLP Research Team.

We thank you for your continued patronage of Eagle Global Advisors. We believe the long-term return outlook for MLPs remains attractive, and we look forward to communicating the results of your investment in an Eagle managed MLP account next quarter.

- The Eagle MLP Team