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Energy Market Outlook

October 10, 2018—Jennison Associates portfolio managers Jay Saunders and Stephen Maresca, CFA, shared their views on recent developments in the energy sector, their outlook, and attractive opportunities.

Energy market update

- **Overall market:** After trade-war demand concerns and increased Saudi/Russian production in anticipation of Iranian sanctions weighed on oil prices through the summer, Brent prices rose near four-year highs on the back of strong demand and increasingly tighter inventories and spare capacity. The team expects WTI crude oil prices to end the year in the $65 to $85 per barrel range with the upper end more probable, especially if there are unanticipated outages in Libya, Iraq, and/or Nigeria. Although not a likely scenario, the team believes that prices could temporarily drop near the lower end of the range if the Trump administration decides to use the U.S. Strategic Petroleum Reserves (SPR).
- **Tighter supply:** The increasing premium on Brent Crude futures price reflects a supply squeeze, likely due to falling Iranian exports. While U.S. exports are rising to fill the void, basin constraints and the West Texas supply bottleneck make it increasingly clear that the U.S. alone can't fill supply gaps.
- **Healthy demand:** Demand growth has shown a consistent elasticity to prices. Coming off of a weak 1Q17, global demand started to exceed expectations again with both India and China rebounding after early-year weakness. European demand had been strong throughout the year and U.S. demand picked up as the year wore on. Into 2018, the rest of Asia continued to reflect sound economic growth absent some short-term domestic policy-driven lags in China and India.
- **Signs of life in global offshore drilling:** $80 Brent seems to be renewing interest in offshore activity. Offshore rig rates seem to have bottomed and deepwater drilling is showing signs of recovery with increased capex spending getting approved for larger scale exploration projects. As a result, service companies have been preparing to upgrade idle rigs for more stringent requirements from operators and associated capital equipment.
- **Better capital discipline:** While 2Q capex rose for most U.S. exploration & production companies (E&Ps), it was largely due to a combination of non-oil field service cost inflation (e.g. steel, labor) and accelerated drilling in the first half of the year. Judging by valuations, the market seems to be skeptical concerning austerity, but commentary from select company management teams continues to reflect the mantra of keeping spending within a returns/free cash-flow-focused framework. Not every E&P is exercising capital discipline but those that are show better prospects for free cash-flow generation.

*Does not include Prudential Day One Funds.

MLP/Midstream market update

- **Robust fundamental tailwinds:** Fundamentals continue to strengthen which was confirmed by the strong 2Q earnings we saw back in late July and August. The team expects another stellar earnings season for 3Q, given the tailwinds listed below that continue to blow strongly.
- **More solid financial footing:** Evidence of fundamental improvement in the energy markets is making its way into improving midstream financial metrics. Cash flow per share is up ~15% over levels from 3Q17. Balance sheets continue to get healthier and overall debt/EBITDA leverage ratios have declined materially.
- **Healthy end-user demand and exports:** Indications of this healthy demand have been evident in the price action and demand growth for natural gas (up 10% year-over-year) and natural gas liquids (22% in ethane demand year-over-year). This end-user demand and increase in exports are not only contributing to volume growth, but are also driving utilization on current pipeline, processing, and fractionation assets higher (in many cases 90% or more), fueling the need to build new infrastructure to bring growing production to market. Additionally, commodity price differentials help to highlight the tremendous value of midstream with lower prices in key basins showcasing the need to de-bottleneck the transportation.
- **Continued corporate governance enhancements:** The improvement in corporate governance and the evolution towards a more simplified corporate structure is a tailwind that should have material long-term benefits. The elimination of general partner (GP) payments materially reduces the cost of capital and forces management teams to focus on return of investment capital over just dividend growth, which should benefit shareholders. Consolidation of uneconomic MLPs, removing GP payments, and self-funded financing are expected to continue and overall sets the foundation for the entire sector to do well over the longer term.

Positioning

- The team has shifted positioning towards offshore-oriented oil field service providers, lagging E&Ps, and international producers. Additionally, they've also reduced exposure to service companies prone to a slowdown from West Texas bottlenecks, while still maintaining a heavy weight to Permian producers, as bottlenecks should prove temporary.
- For the midstream sector, the team continues to favor the reformed companies (e.g., companies that have reduced leverage, have solid corporate governance, etc.) and firms with exposure to the natural gas liquid (NGL), liquified natural gas (LNG), and natural gas demand and export themes, along with companies that have integrated business models – offering the lowest cost infrastructure from the well-head to the burner tip – by providing gathering and processing, transportation, and the storage and delivery of hydrocarbons to end-users and to export markets.

[1] Stephen was named #1 MLP Analyst for three consecutive years in a row (2011–2013), as well as the #1 Natural Gas Analyst for 2013 in *Institutional Investor*'s buy-side client poll. The 2011, 2012, and 2013 All-America Research Team annual client poll reflects the opinions of more than 3,300 individuals from nearly 990 buy-side firms that collectively manage an estimated $10.5 trillion in equity assets.

Brent Crude is a classification of sweet light crude oil that serves as a major benchmark price for purchases of oil worldwide. **West Texas Intermediate (WTI)**, also known as Texas light sweet, is a grade of crude oil used as a benchmark for oil pricing. **EBITDA** is earnings before interest, tax, depreciation, and amortization.

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