January 2023

A review of midstream equities and interest rates

Brian Watson, CFA
Senior Portfolio Manager

1 Historically, midstream equities have outperformed other yielding equity sectors during periods of rising interest rates

2 MLP equities have provided positive returns over five of the seven periods examined of rising rates

3 Despite macro and company fundamental improvements, midstream equities still trade at historically low valuations

With inflation running high, investor anxiety over the potential impact of rising interest rates has begun to intensify. For midstream companies in particular, investors often wonder if the sector's relatively high distribution or dividend yields tend to help or hurt performance during periods of rising rates. In summary, while there have been short-term periods of weakness in response to dramatic rate moves, we find that over long-term periods, midstream equities, specifically MLPs, have not demonstrated meaningful correlation to interest-rate changes.

Over the past fifteen years, there have now been seven periods over which interest rates have increased by at least 100 basis points (bps):

- In the wake of the 2008 financial crisis, the yield on the 10-year U.S Treasury increased by 190 bps. Over this period, MLP equities, as measured by the AMZ index, appreciated 29% while utilities[1] and real estate investment trusts (REITs)[2] declined 5% and 3%, respectively.[3] Utilities and REITs are often cited as yielding equity-sector comparisons.
- From late 2010 to February 2011, the 10-year yield increased by 134 bps. Over this period, the AMZ appreciated 8% while utilities and REITs increased 3% and 8%, respectively.[3]
- From June 2012 until September 2013, the 10-year yield increased by 154 bps. Over this period, the AMZ appreciated 10% while utilities and REITs each fell 2%.[3]
- From July 2016 through the end of January 2017, the 10-year yield increased by 123 bps. Over this period, the AMZ declined 3% while utilities and REITs declined by 8% and 9%, respectively.[3]
- From September 2017 through October 2018 the 10-year yield increased by 118 bps. Over this period, the AMZ declined 1% while utilities and REITs declined 1% and 5%, respectively.[3]
- From August 2020 to March 2021 the 10-year yield increased 122 basis points while the AMZ was up 27% while utilities rose 6% and REITs increased 15%.[3]
- And finally, from January 2022 to October 2022 the 10-year yield increased 273 basis points while the AMZ was up 22% while utilities lost 11% and REITs fell 31%.[3]

Period		10 Year Yield	AMZ	Utilities	REITs
Dec-08	**Jun-09**	+190 bps	28.5%	-5.3%	-3.4%
Oct-10	**Feb-11**	+134 bps	7.5%	3.0%	8.2%
Jul-12	**Sep-13**	+154 bps	10.3%	-2.4%	-2.2%
Jul-16	**Dec-16**	+123 bps	-3.3%	-8.3%	-8.6%
Sep-17	**Oct-18**	+118 bps	-0.5%	-1.4%	-5.1%
Aug-20	**Mar-21**	+122 bps	26.5%	5.7%	15.2%
Dec-21	**Oct-22**	+273 bps	22.3%	-11.1%	-30.5%

Source: Bloomberg L.P., United States Treasury and Invesco SteelPath as of 12/31/2022. Past performance does not guarantee future results. An investment cannot be made into an index.

While the proclivity to compare interest rates and MLPs is natural given the yield component of each, we believe history reveals that MLP price performance over these periods is not necessarily dictated by the rate change. In fact, as demonstrated in the examples above, midstream equities have often performed well suggesting that the interplay between rate changes and the midstream sector is fairly weak or fleeting. In fact, MLP equities actually provided positive returns over five of the seven periods examined. Interestingly, though utilities and REITs are often assumed to exhibit particular interest rate sensitivity, both sectors also exhibited price appreciation over some, though fewer, of the periods examined and delivered 2.8% and 3.8% losses on average over these periods respectively.

Though, we do caution that within some of these periods, there were short-lived stretches of broad market, as well as high-yield, equity price weakness. Overall, however, we believe this historical performance suggest yielding equities in general, and midstream equities in particular, may carry less interest rate sensitivity than often assumed.

Market trading trends aside, it is also worth noting that many midstream contracts include annual rate adjustments linked to inflation indexes such as the Producer Price Index (PPI) or the Consumer Price Index (CPI) which provide a direct and timely cash flow adjustment to changes in inflationary environments. Using the FERC Oil Pipeline Index as a proxy, which is linked to the Producer Price Index for Finished Goods, FERC liquids pipelines were able to increase tariffs by 8.7% in July 2022 and, according to the analysts at Wolfe Research, the preliminary data suggests FERC liquids pipelines are on track to affect a 13.7% rate increase in July 2023.[4]

Historically, then, we believe there is little evidence to suggest rising interest rates pose a particular headwind to long-term midstream equity price performance. Further, we believe the greatest drivers of midstream sector performance in recent years have been energy market macro factors and individual company growth or balance sheet concerns. Importantly, we believe both of these influencing factors may be more stable than in years past.

Outlook

The commodity price backdrop today is very supportive of producer drilling activity while the current era of producer financial discipline is resulting in a relatively muted uptick in drilling activity. While producer discipline means US production growth is likely to be modest relative to today's prices, we believe producer drilling and production plans will also remain fairly stable even if pricing were to move lower. We believe this energy macro backdrop is healthy for midstream companies.

Further, over the past several years, many energy midstream companies have been able to grow cash flows, reduce leverage, and are beginning to resume distribution growth.[5] According to Wells Fargo, midstream free cash flow yields are set to reach 9.2% in 2023, compared to -1.5% back in 2018, and exceed 12% by 2027. Distribution coverage for 2023 is expected to average approximately 1.8x compared to 1.5x in 2018, while Debt-to-Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) multiples are expected to have fallen to 3.9x in 2023 from 4.4x in 2018.[5]

Despite these macro and company fundamental improvements, midstream equities still trade at valuations substantially below the five- and ten-year averages. Therefore, we continue to believe the sector may provide investors an attractive yield and total return experience over the coming years.

Important information

1. Utilities are represented by the Dow Jones Utilities Index which keeps track of the performance of 15 prominent utility companies
2. Real Estate Investment Trusts (REITs) are represented by the FTSE Nareit Equity REITS Index and are securities that sell like a stock on the major exchangesand invest directly in real estate.
3. Bloomberg L.P. as of 12/31/2022.
4. Wolfe Research, The Fleishman Daily, December 12, 2022
5. Wells Fargo Securities, Midstream Monthly Outlook: January 2023.

The Alerian MLP Index is a float-adjusted, capitalization-weighted index measuring master limited partnerships, whose constituents represent approximately 85% of total float-adjusted market capitalization.

A basis point is one hundredth of a percentage point.

Producer Price Index (PPI) is a measures the average change over time in the selling prices received by domestic producers for their output.

Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods andservices.

FERC Oil Pipeline Index is an index used by pipelines to adjust their annual rates each year for service. It is based on the Producer Price Index for Finished Goods(PPI-FG) with some adjustment to reflect industry cost changes.

EBITDA or earnings before interest, taxes, depreciation, and amortization, is a measure of a company's overall financial performance and is used as an alternativeto net income in some circumstances.

10-Year Treasury is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance.