

The United States Energy Renaissance

The goal of MAI Insights is to provide you with our views on the most pressing issues and opportunities in the current investment environment. Lost in the clouds overhanging the global economy has been the quiet emergence of a new energy renaissance in the United States. Until just recently, it had long been assumed that the U.S. was "over the hill" in terms of energy production and that we would need to increasingly rely on foreign sources in the future. Over the past three years, however, the U.S. has contributed more incremental oil supply than any other country in the world and has gained a huge competitive advantage in the production of natural gas. If it continues at the current pace, this major reversal in our energy outlook has far-reaching implications for the economy and markets. In this month's MAInsights, we will discuss the drivers behind this surge in energy supply, the implications for the U.S. economy, and how we seek to participate in this theme.

Where is the new supply coming from?

Thanks to increasing demand from emerging markets, a weakening dollar, and geopolitical tension in the Middle East, oil prices have averaged \$90-95 per barrel for the past couple of years - a level that has made new exploration and production very profitable for U.S. oil companies. In addition, new technologies such as hydraulic fracturing or "fracking" (which uses pressurized water to break shale rock and cause oil and gas to flow freely) and horizontal drilling (which enables drillers to access more energy supply by drilling horizontally into the rock instead of just vertically) have combined to cause a dramatic acceleration in production. For evidence of this, one needs to look no further than the Bakken Shale in North Dakota which has seen crude oil production explode from a just few barrels per day in 2006 to more than 594,000 barrels per day in June 2012.¹ The Bakken is expected to ramp up to 1 million barrels per day within the next few years and represent 10-15% of the total U.S. oil output.² And this is not an isolated situation! Amazingly, there are more than twenty shale/tight oil formations like the Bakken in the United States that are still virtually untapped³, leading many forecasters to now project the U.S. to be a net exporter of oil by 2020.⁴ In addition to the oil renaissance, these same technologies have caused an even stronger boom in natural gas production in the U.S.; so much so that excess supply has driven the price of Henry Hub natural gas down from close to \$14/mmBtu in 2008 to under

\$3/mmBtu today. At these levels, the U.S. now has a distinct price advantage in the global natural gas market, creating a significant export opportunity and giving new life to a manufacturing sector that had looked all but doomed. While the main risk to this theme appears to be concern over the impact of this new technology (particularly "fracking") on the environment; in our view, the need for greater regulation would only help to ensure environmental safety rather than derail the industry's strong prospects.

What does this mean for the economy?

Over the next decade, the energy renaissance appears to be one of the few visible bright spots for the U.S. economy. According to a Citigroup report, new oil and gas production and associated activity could potentially add 2-3% to real GDP and 2.7 - 3.6 million net new jobs to the economy by 2020. Given that oil and gas extraction remains a very small part of our economy today (roughly 1% of GDP)⁵, the expectations and multiplier effects of this movement appear very robust. In fact, it has been estimated that for every job added in oil and gas extraction, three additional jobs are added in ancillary industries to support the production growth (manufacturing, steel, machinery, etc.) and cater to the new wealth created in the process (retail, housing, banking, etc.). In addition to employment gains, higher supplies of oil and natural gas should keep a lid on energy costs for our domestic economy going forward. This means more money in the pockets of consumers to spend on discretionary items and a competitive advantage for U.S. manufacturers and chemical producers who will benefit from lower input costs. The last major positive for our economy is the opportunity to export liquefied natural gas to other countries where the price of gas is, in many cases, 4-6 times higher than our prices in the U.S. For example, while natural gas is currently selling for under \$3/mmBtu in the U.S., European natural gas is selling for \$12-14/mmBtu and in parts of Asia it is selling for over \$17/mmBtu. Thus, the arbitrage opportunity for North American producers appears very rich and we would expect a sizeable export business to emerge soon.

How are we participating in this theme?

While surging oil and gas supplies is a major positive for our economic future, investing into this theme successfully will likely require betting on higher volumes rather than higher prices. For this reason, our preferred way to play this theme is through our investment in energy midstream master limited partnerships

("MLPs"). Midstream MLPs provide the infrastructure necessary to process, transport, and store natural gas, natural gas liquids, crude oil, and other related products. We liken MLPs to toll-road operators who make money simply based on the number of cars on the road. In the same way, MLPs lock into long-term volume commitments with producers and end users to provide the essential service of getting fuel to the market. Their focus on volume results in very stable cash flow streams and very little exposure to commodity price movements. An added consideration of owning MLPs is the largely tax-deferred yield of 4-7% annually which looks especially attractive with the 10-year treasury below 2%. Combining this yield with the 6-8% distribution growth rate that we expect from continued infrastructure build out, we believe MLPs provide a very competitive total return opportunity in today's low interest rate, slow growth economy. For owners of individual MLP securities, the preferred tax status of an MLP does create some tax complexity as the majority of its distribution is taxed as return of capital, but we believe the added complexity is more than offset by the total return potential of the asset class.

Sources:

- ¹ Barclays, August 20, 2012
- ² U.S. Energy Information Agency (www.eia.gov); Crude Oil Production Data
- ³ Magueri, Leonardo. Oil: The Next Revolution. Harvard Kennedy School: Belfer Center for Science and International Affairs. June 2012.
- ⁴ Raymond James & Associates, April 2, 2012.
- ⁵ Loder, Asjlynn. "America's Energy Seen Adding 3.6 million Jobs Along with 3% GDP" Bloomberg, August 13, 2012.

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