



# Energy & MLP Insights: Seeking Refuge from Market Volatility in the Midstream

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*Liquid fuel prices worldwide hit a bearish tilt in the third quarter, driven by weak U.S. employment data and a long-awaited recovery for the Chinese economy that ultimately failed to materialize. Uncertainty surrounding mothballed OPEC+ production and tighter refining margins did the near-term outlook for oil few favors. However, despite the recent weakness in energy prices, the midstream segment has managed to hold its ground. In this piece, we highlight how improved fundamentals and widening growth opportunities across the broader U.S. energy complex have enhanced the resilience of this once scorned sector.*

## Key Takeaways

- Although global oil markets are forecasting a supply deficit into early 2025, bearish sentiment surrounding demand overtook supply fundamentals in Q3.
- Despite near-term weakness in energy prices, midstream equities have outperformed the broader equity market in 2024, delivering more consistent returns than their upstream and downstream counterparts.
- Midstream MLPs and corporations continue to benefit from rising energy production and constrained pipelines. Absent a prolonged downturn in global consumption, they may enhance the defensive posture of a portfolio's energy allocation.

## Bearish Sentiment Took the Wheel in the Third Quarter

For the past two years, West Texas Intermediate (WTI) crude traded within a relatively stable range of \$70-\$90, as OPEC+ effectively capped nearly 6% of global excess production capacity. However, this equilibrium breached a tenuous level in September, as crude oil prices fell below the \$70 threshold, due to a weakening demand outlook that overshadowed the energy market's tight supply fundamentals.

China and the United States are the primary factors driving demand, collectively accounting for nearly 35% of global crude oil consumption.<sup>1</sup> The annual growth in Chinese crude oil demand fell by half in September of 2024, to nearly 200,000 barrels per day (bpd) from 500,000 bpd pre-pandemic.<sup>2</sup> Meanwhile, U.S. expectations for an economic slowdown were stoked by August's higher-than-expected unemployment report.

Recent economic data out of China signaled little hope for a turnaround, after the Middle Kingdom registered its longest streak of deflation on record.<sup>3</sup> In fact, soft consumption readings have materialized across a swathe of commodities, including copper, steel, and aluminum. The nation's rising net exports were symptomatic of its falling domestic demand, with outbound industrial exports triggering bearish sentiment worldwide. Seasonal weakness in the U.S. and tightening crack spreads worldwide only served to exacerbate energy price volatility.

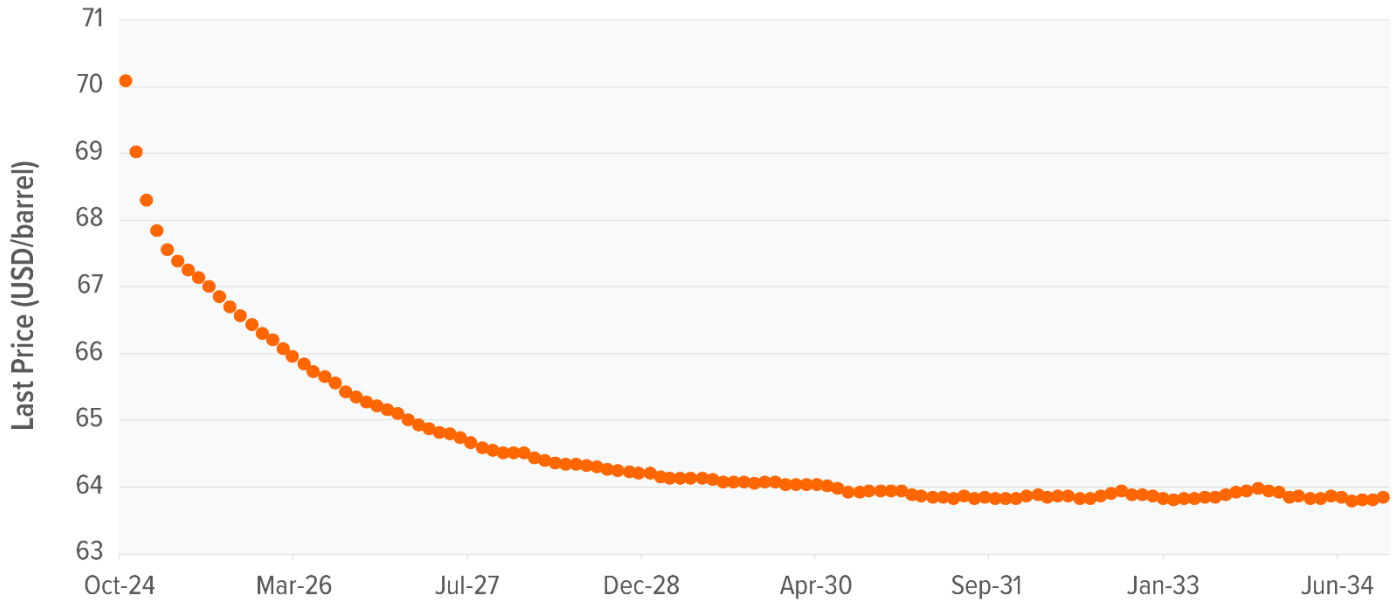
## Oil Supplies Will Likely Remains Bottlenecked Through Early 2025

Fundamentals on the supply side remain largely intact. As of mid-September, OPEC+ extended its production cuts into November, reaffirming its commitment to maintaining the price stability of global oil markets.<sup>4</sup> Recent reports from the perennially opposed U.S. EIA, IEA, and OPEC+ all point to a global oil market deficit, with most forecasts expecting oil prices to rise into the end of 2024.<sup>5</sup> Meanwhile the WTI oil futures curve remains in backwardation, a strong indication of continued supply tightness, as contracts for near-term delivery remain significantly more expensive than longer dated contracts.



## BACKWARDATION IN THE GLOBAL CRUDE FUTURES CURVE INDICATES TIGHT SUPPLY

Sources: Global X ETFs with information derived from Bloomberg. US Crude WTI Futures Curve as of 9/16/2024.



We think falling commodity prices may translate into softer inflationary pressures within U.S. markets. This could have a stimulatory impact on consumption domestically and abroad. Although hiring has slowed within the U.S., layoffs seem to be contained. According to the U.S. Fed, the recent rise in unemployment figures likely reflects an increase in labor supply rather than an increase in layoffs.<sup>6</sup> We think this belies the point that at least some latent strength remains within the U.S. economy, which has repeatedly outpaced forecasts in 2024.<sup>7</sup> Additionally, unresolved geopolitical tensions overseas may well impact risk premiums.

We believe that the Fed’s monetary easing cycle will ultimately be supportive for U.S. oil & gas. Rate cuts may weaken the U.S. dollar, which would likely stimulate investment activity in emerging markets and abroad, particularly within nations that historically see their economic performance track inversely to the U.S. dollar. Regarding the upcoming U.S. election, we note that neither party has expressed a willingness to moderate fiscal policy nor adopt an outwardly hostile stance against the U.S. oil & gas industry. With consensus forecasts for monetary easing and fiscal policy likely to remain stimulatory over the near term, we think these trends could support valuations across energy equities well into 2025.

### Midstream Firms Have Outperformed Equity Markets in 2024 Despite Market Volatility

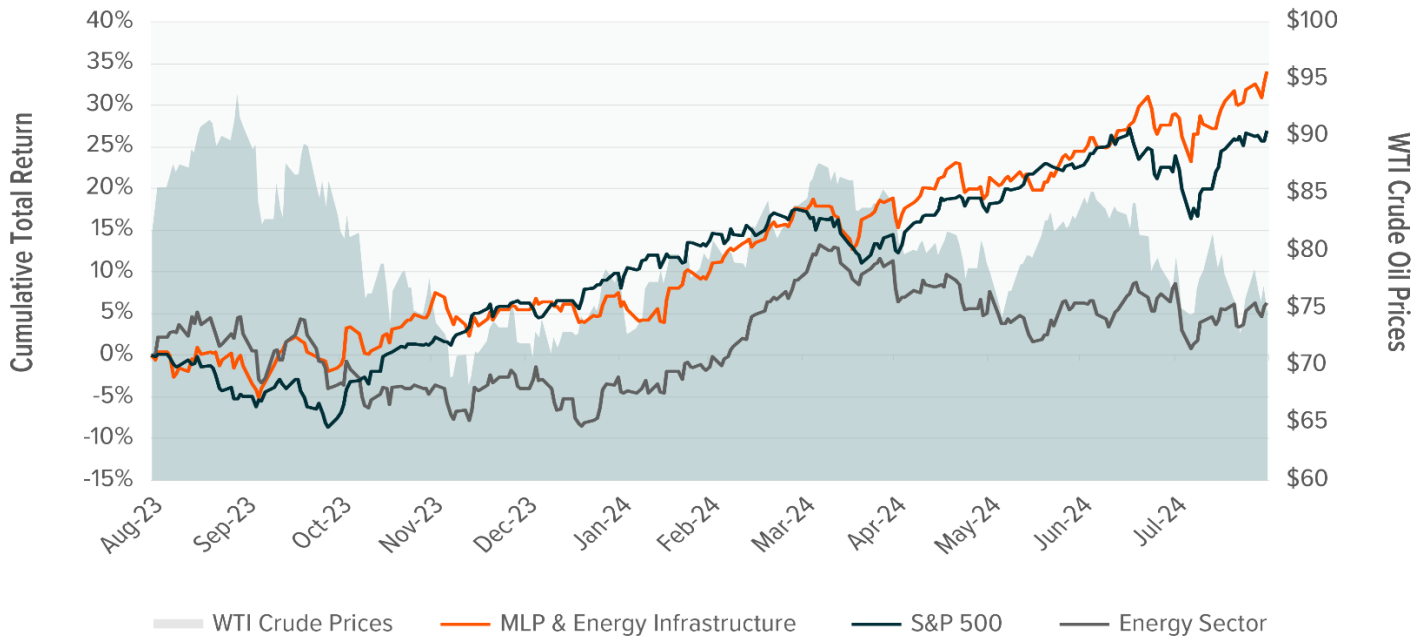
Intuitively, when people think about companies in the energy sector, tight ties between commodity prices and equity performances are often inferred. Recent resilience of the midstream energy sector, however, underscores its reliance on production volumes and pipeline capacity, rather than energy prices. In fact, the five-year correlation between the Solactive MLP & Energy Infrastructure Index (the “Midstream Index”) and oil prices registered a moderate 0.525; this relationship was even weaker when viewed over the last six months, where that correlation halved to 0.270. Weaker still was the six-month correlation between the Midstream Index and natural gas prices, which flipped into negative territory at -0.113, thus highlighting a weaker link between commodity prices and midstream performance than many might anticipate.

When evaluating performance, midstream corporations and MLPs have largely held onto positive gains throughout 2024, even as market volatility negatively impacted shares of refiners and producers. When comparing one-year performance, the Midstream Index not only managed to outperform the broader energy sector (as represented by the Energy Select Sector Total Return Index), but also surpassed the S&P 500 Index. Despite market volatility affecting large-cap equities in July and a general downtrend in oil prices during Q3, midstream firms continued to perform strongly through September.



## STRONG TRANSPORT VOLUMES HAVE SUSTAINED MIDSTREAM PERFORMANCE

Sources: Global X ETFs with information derived from Bloomberg. Cumulative One-year Total Return data ending August 31, 2024.



### Oil Prices Are Under Pressure, But Midstream Continues to Benefit from Rising Production

Record production volumes from U.S. oil producers have kept utilization rates on midstream pipelines high. Even with global energy markets in flux, output of both oil and natural gas continues to trend near record levels. In 2024, U.S. field production of crude oil reached as high as 13.249 million barrels per day,<sup>8</sup> while U.S. natural gas production also hit record levels, with total production nearing 115.5 billion cubic feet per day (bcf).<sup>9</sup> These prodigious volumes have continued to support fee-based revenues on transport pipelines for oil and natural gas.

While oil prices have trended down in 2024, we think that low breakeven prices and constrained pipeline capacity may continue to support strong transportation volumes for midstream firms. According to a survey from the Federal Reserve Bank of Dallas (the “Dallas Fed”), breakeven prices for existing wells among U.S. oil producers averaged from \$31 to \$45. While we note that breakeven prices for new wells were substantially higher at \$59 to \$70, many producers have shifted to tapping more productive existing wells rather than drilling new capacity.<sup>10</sup> This largely supported increasing production volumes, even as oil prices fell beneath \$70.

### PRODUCTIVE DRILLED WELLS AND LOW BREAKEVEN COSTS SUPPORT OIL OUTPUT

Sources: The Federal Reserve Bank of Dallas. First Quarter Dallas Energy Survey, Special Questions 1 and 2. Average WTI price necessary to cover operating expenses. Existing wells and new wells, March 27, 2024





## The Opportunity for the Midstream Sector Lays in Addressing Backlogs and Growing Exports

High utilization rates for U.S. oil and gas pipelines continue to support midstream revenues. One of the key constraints for U.S. energy markets is the lack of egress from highly productive regions like the Permian Basin, which has led to localized backlogs that can drive natural gas prices to negative levels at accumulation points such as the Waha Hub in West Texas.<sup>11</sup> In these regions, some U.S. producers have resorted to paying buyers of last resort as much as \$3 to \$4 per million Btu to offload associated natural gas, using the substantial profits from crude oil production to offset the incremental losses from associated gas sales.

We think that the completion of new pipelines, storage units, processing facilities, and export terminals can help alleviate supply bottlenecks at existing hubs, potentially increasing the flow of both oil & natural gas while helping to mitigate regional price swings. One key project is the Matterhorn Express Pipeline, a 580-mile joint pipeline venture involving MPLX and Enlink Midstream, scheduled to become operational in the fourth quarter. This pipeline is designed to transport up to 2.5 billion cubic feet of natural gas per day from the Permian Basin to the Houston area and may alleviate some of the pricing pressures that have plagued natural gas hubs.<sup>12</sup>

Simultaneously, we think energy exports represent another key growth opportunity for the midstream sector. In April, Enterprise Product Partners received its deepwater port license for the Sea Port Oil Terminal (“SPOT”), allowing it to proceed with the construction of its offshore oil export terminal. Set to go live by 2026, the SPOT terminal is expected to increase oil export capacity by as much as 2 million barrels per day (bpd), a nearly 50% increase from current levels (~4 million bpd).<sup>13</sup> We believe that projects like the SPOT terminal, as well as the Matterhorn Express Pipeline, highlight the promising future of the United States as a major energy exporter.

### Conclusion: Energy Market Volatility Highlights Midstream Energy’s Defensive Profile

While the outlook for energy prices remains uncertain, we see the U.S. midstream sector as a bright spot within the broader oil & gas industry. The U.S. energy sector in 2024 contrasts sharply with the growth-at-any-cost industry of the 2010s. Today, low leverage, strong cashflows, and a favorable growth outlook underpin earnings. We think these solid fundamentals, along with the midstream industry’s reliance on production volumes, underscore its defensive nature relative to its upstream and downstream peers. Midstream equities may help diversify holdings across broader energy indices and help mitigate potential declines in energy prices, provided there isn’t a protracted downturn in global demand.

#### Footnotes

1. U.S. Energy Information Administration. (2024, April 11). International Energy Statistics, Total oil (petroleum and other liquids) consumption.
2. Reuters. (2024, September 9). APPEC-Transition to cleaner fuels seen dragging on China’s oil demand growth.
3. Bloomberg. (2024, September 9). China’s Deflationary Spiral is Now Entering Dangerous New Stage.
4. Organization of the Petroleum Exporting Countries (2024, September 5). Saudia Arabia, Russia, Iran, the United Arab Emirates, Kuwait, Kazakhstan, Algeria, and Oman extend voluntary cuts.
5. International Energy Agency. (2024, August). Oil Market Report – August 2024.
6. The New York Times. (2024, September 16). The Fed is Still Banking on a Labor Market Miracle.
7. The White House. (2024, September 17). Beating the Forecasts: How the US Economy Defied Expectations.
8. U.S. Energy Information Administration. (Accessed on September 16, 2024). U.S. Field Production of Crude Oil.
9. U.S. Energy Information Administration. (2024, September). Short-Term Energy Outlook, U.S. Marketed Natural Gas Production.
10. Federal Reserve Bank of Dallas. (2024, March 27). Dallas Fed Energy Survey.
11. S&P Global. (2024, August 21). Negative Permian gas prices set record stretch as Matterhorn startup looms.
12. Matterhorn Express. (Accessed on September 16, 2024). What product is the pipeline transporting?
13. Enterprise Product Partners L.P. (2024, April 9). Press Release: Enterprise Receives Deepwater Port License for Spot Project.

#### Glossary

**Crack Spread:** The margin between crude oil and refined petroleum products.

**MLP:** Master Limited Partnership, A publicly traded partnership that engages in the exploration, development, processing, or transportation of natural resources.

**Midstream:** The segment of the value chain involved in the transportation, processing, and storage of natural resources.

**US EIA:** U.S. Energy Information Administration.

**IEA:** International Energy Agency.

**OPEC+:** The Organization of the Petroleum Exporting Countries and non-OPEC participants.

**Backwardation:** A market price relationship where the current price of a commodity exceeds its prices for future delivery.

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