July 2021 High Yield Market Insights

Summary:

- Historically, as the HY energy sector goes, so goes the broad HY market. The post COVID world is no different.
- Despite a modest weighting, the energy sector has a disproportionate influence on the broad HY market.
- Economic activity and the corresponding effect on the price of oil heavily influence the profitability of energy companies.
- The monetary and fiscal policies that have supported the post-COVID recovery have lowered energy default rates.
- Given its momentum, look for energy to continue to perform well as part of a "rising stars" wave.

Within the high yield market, the energy sector has always garnered disproportionate interest among investors. The interest is disproportionate because the market weight of the sector isn't particularly large, yet its performance tends to correlate highly with the performance of the broad high yield market. Since the end of 2005, despite possessing an average market weighting of just 12.5%, the energy sector has an R^2 of 69.5%.

The interest of investors in the energy sector reflects its connection to the broad economy. After all, crude oil and its derivatives are the elixirs that fuel the economy. The price of oil, however, is volatile. A sudden change directly affects the profitability of energy companies and often presages a recession or recovery in the broader economy.

Figure 1a shows the WTI price per barrel over the last decade. Figure 1 tracks the rolling 12m change in total debt and EBITDA for the energy sector.

Figure 1: US HY Energy Sector LTM Change in Total Debt and EBITDA

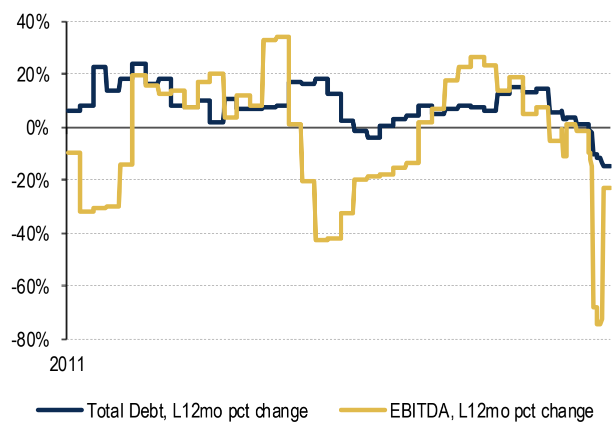


Figure 1a: WTI Price per Barrel

Source: BofA, Concise Capital

By late 2014, the price of crude had begun to come off its historically high trading range of \$100 - \$115 per barrel. By the time crude reached \$50 per barrel in late Q1 2015, EBITDA growth momentum had started to wane. According to the BofA data, the LTM change in EBITDA dropped from 34% in Q1 2015 to -43% by the end of November 2015.

The drop in EBITDA momentum corresponded to a ramp-up in the default rate, which peaked at 23% by the end of 2016 (see Figure 1). At the same time that EBITDA momentum was fading, total debt rose, which fueled the default cycle that followed.

Figure 2: BofA US HY Energy Sector

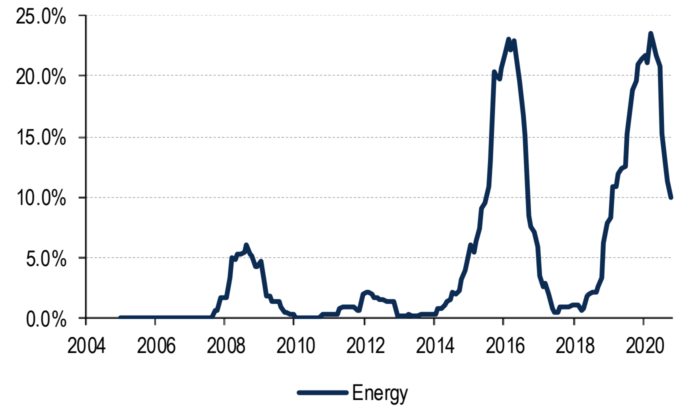
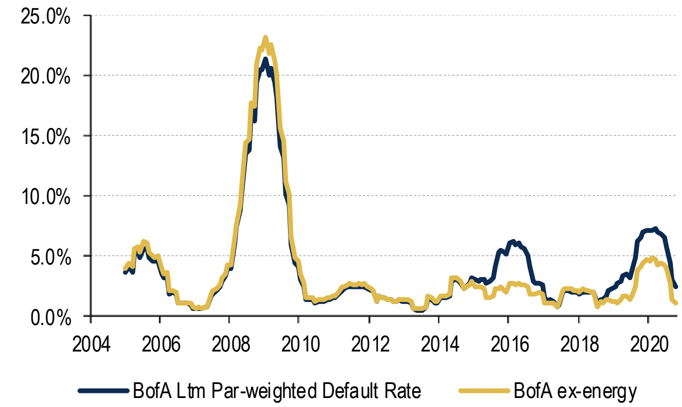


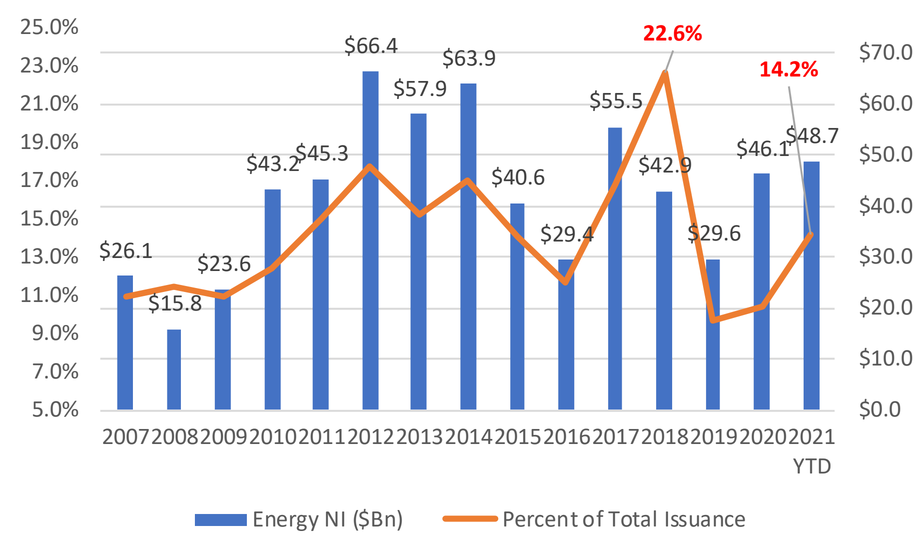
Figure 2a: Broad HY Par-Weighted Default Rates



Source: BofA, Concise Capital

During this period, aggregate spreads surged higher, from 380 basis points (bp) at the end of 2014 to a cyclic high of nearly 2,000 bp by February of 2016, which coincided with the cyclic low in crude prices of $28 per barrel. As a result of this shock, which served to drag down the broad high yield market, energy companies recapitalized their balance sheets, shut in production, and scaled back capital expenditures. Consequently, energy companies were able to refinance their debt in 2017 and 2018. As illustrated in Figure 3, in 2017, with HY new issue proceeds totaling $55.5 billion, the energy sector represented 16.8% of new issues. In 2018, with total proceeds totaling $42.9 billion, the energy sector represented 22.6%. The refinancing wave contributed to the precipitous drop in defaults between 2015 and 2017.

Figure 3: Energy Sector Contribution to US HY Primary Issuance



Source: Bloomberg, Concise Capital

The COVID crisis shocked the energy sector. The collapse in the global economy caused the price of oil to plummet, even leading to the price of WTI futures falling into negative territory (low: $-37.63) in April 2020.

The collapse in crude prices turned EBITDA growth severely negative (Figure 1), causing bond spreads in the energy sector to explode beyond the 2016 highs, peaking at 2,267 bp on 3/23/20. The default cycle that followed matched the level of severity during the 2016 period with the LTM default rate peaking at 24% in November 2020.

The rebound from the COVID-led collapse has been much different than that of previous economic cycles. A combination of monetary and fiscal policies that delivered trillions of dollars in financial aid rescued the economy and corporate balance sheets. The largess from the Federal Reserve and Congress has been a key driver in opening up the high yield primary market, which has allowed many otherwise distressed energy companies to either retire or term out their balance sheets. The energy sector's participation in the primary market has been trending higher after bottoming out at 9.6% of primary activity in late 2019 with the current run rate at 14.2% through July 2021.

With corporate coffers flush with cash, default rates have dropped precipitously. As highlighted in Figure 2a, as of June, the HY market's LTM default rate sat at 2.5%. Excluding energy, which has accounted for two-thirds of total corporate defaults, the rate fell to 1.1%. Both measures are well below the long-term averages of 4.1% and 3.8%. Even the default rate of the energy sector is quickly improving from its current LTM level of 9.8% (see Figure 2) towards its long-term average of 5.6%.

The dramatic recovery has shown up in absolute and relative performance. While it lost some ground in July (-0.16%), energy is the best performing sector YTD, advancing +9.71% vs +4.01% for the broad high yield market. With oil prices expected to hover around the current $70 per barrel, the energy sector should continue its leadership within high yield.

The energy sector may even experience a shift from "fallen angels" to "rising stars". The COVID-led collapse in oil prices in March 2020 led credit rating agencies to downgrade energy companies, especially within the exploration and production (E&P) sub-group. Currently, fallen angels comprise over 50% of the HY E&P sub-group. The recovery in energy prices should push rating agencies to upgrade the credit ratings of many of these companies.

A reevaluation of the energy sector by the rating agencies within the current economic environment could see a sizeable rising stars event. According to a report by research firm CreditSights, nearly 37% or $77 billion of energy bonds could be upgraded to investment grade. With these candidates still 80-100 bp wide of their investment grade brethren, the sector could see a boost in performance as these spreads narrow ahead of any official upgrade.

These trends bode well for the energy market, and due to the sector's high correlation, for the broad HY market, during the second half of 2021 and into 2022. The tightening in credit spreads should offset the expected increase in nominal bond yields, which is the basis for our overweight in short-duration HY bonds.

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