Bond Market Perspectives

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High-Yield Bonds & Oil Prices

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Highlights

We find it premature to draw conclusions regarding oil prices and the performance of the broad high-yield bond market.

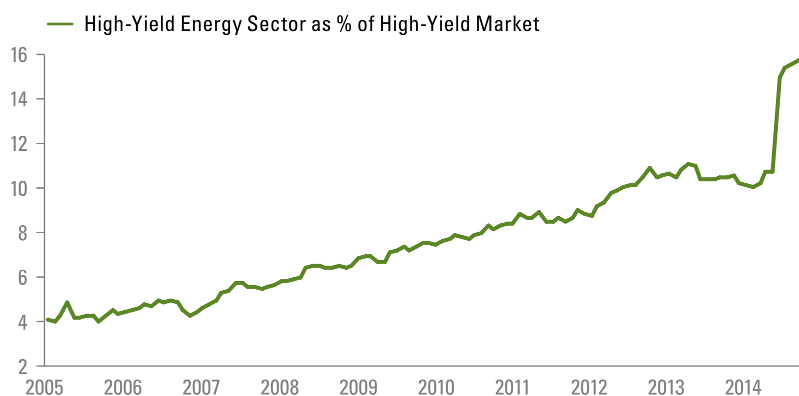
Default rates, the pace of economic growth, and the strength of credit quality metrics among high-yield issuers—not oil prices—will be the primary drivers of high-yield bond market returns.

The decline in oil prices and its impact on the high-yield market has been cited as a concern for investors. This week we stay on the topic of high-yield bonds and take a closer look at the potential impact of oil prices on the high-yield bond market and whether recent concerns are justified.

Energy's Growing Presence

Within the high-yield bond market, the energy sector has become a growing component and now comprises slightly more than 15% of the overall Barclays High Yield Bond Index [Figure 1]. Energy is the second largest subsector within the high-yield index and its influence on the broader high-yield market has increased. However, it is one of four sectors that comprise more than 10% of the broader high-yield index—and one reason why energy's impact should not be overstated.

1 The Energy Sector Has Steadily Increased Within the High-Yield Bond Market



Source: LPL Financial Research, Barclays Index data 11/10/14

Past performance is not indicative of future results.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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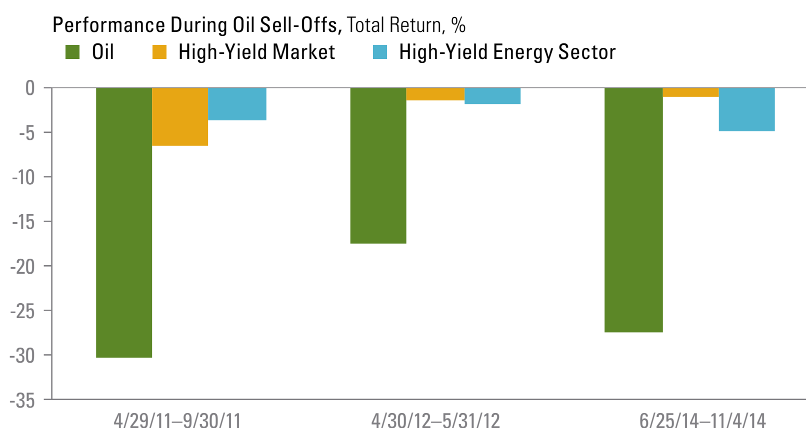
Prior Oil Declines

A look back at prior periods of sharp oil price declines shows that they coincide with pullbacks in the high-yield bond market [Figure 2]. A simple glance at Figure 2 would seemingly lead to the conclusion that falling oil prices lead to high-yield bond market declines. But declines in oil prices have come with growth scares, where investors fear that global economic growth may be slowing dramatically, possibly flirting with recession, and that demand for oil will be reduced. All three periods shown in Figure 2 have coincided with growth scares, and Europe has been the focal driver of each.

2 Only Recently Has High-Yield Energy Performed Notably Weaker than the Broad High-Yield Market



Source: LPL Financial Research, Barclays Index data, Bloomberg 11/07/14

We would argue the cause of weakness in these cases has primarily been economic concerns with lower oil prices a result of growth fears and not necessarily a driver. As an example, the energy subsector proved more resilient than the broader high-yield market in 2011, suggesting oil price declines were not a concern even though oil fell to just under $80/barrel, very close to current levels.

Shale Oil Profitability

The sharp drop in oil prices since the end of June 2014 has sparked profitability fears for companies involved in the shale oil boom. At near $80/barrel, the price of oil is viewed as a potential threat to shale oil producers, whose costs to extract oil are much higher compared with traditional oil drillers. But trying to assess an accurate “break-even” price for oil at which shale oil producers are profitable is complicated. Extraction costs vary from area to area and well to well. Shale companies have nonetheless witnessed their costs decline as drilling techniques and technology improve. Monthly drilling reports available from the U.S. Energy Information Administration (EIA) reveal production per oil rig is up 30%, or more, in most areas over the

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past year. Greater efficiency means a lower break-even point. Additionally, oil rig counts have increased monthly, suggesting the drop in oil prices has yet to have an impact.

Fretting over oil company profitability seems premature at this stage. In addition to productivity gains, many oil projects are long-term in nature and price fluctuations are anticipated. Companies with a longer-term view may even hedge against the risk of oil prices dropping too far via oil futures.

Low Correlation

Weaker oil prices may be a headwind for the high-yield bond market but not a major risk.

Our analysis reveals that the longer-term codependency of oil prices and high-yield bonds is limited. Over the past 10 years, the correlation between high-yield bond returns and oil prices is 43%, a relatively weak reading and lower than the 50% correlation of high-yield bonds and the stock market, as measured by the broad S&P 500 Index. This correlation suggests that weaker oil prices may be a headwind for the high-yield bond market but not a major risk, and much of that impact may be simply due to growth scares rather than true profitability challenges to oil companies.

Default rates, the pace of economic growth, and the strength of credit quality metrics among high-yield issuers—not oil prices—will be the primary drivers of high-yield bond market returns. It is no surprise that the high-yield energy subsector maintains the highest correlation with the broader high-yield market. The path of the broader high-yield market best explains fluctuations in the high-yield energy subsector and not the other way around.

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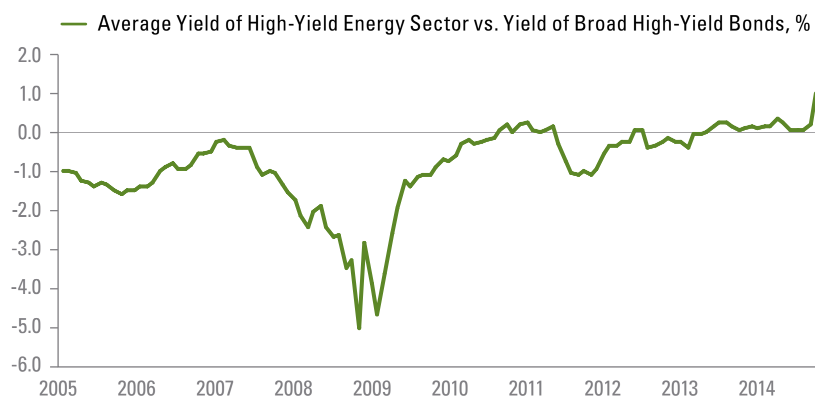
Recent high-yield energy sector underperformance has led to wider yield differentials [Figure 3]. The average yield of the high-yield energy sector is roughly 1% greater than that of the broad high-yield market. The yield disparity contrasts sharply to the yield deficit at the peak of the financial crisis, when the energy sector was more resilient and yields increased much less than the broad market. The price of oil dropped to $40 barrel in late 2008—a time when the shale oil industry was less efficient—yet

3 Yield of High-Yield Energy at a Record Advantage Relative to the Broad Market



Source: LPL Financial Research, Barclays Index data 11/07/14

profitability concerns were not an issue for market participants. To be sure, 2008 presented different risks, but the inconsistent behavior suggests the market may be overreacting to the price of oil on the ability of high-yield energy companies to service debt obligations.

Despite all the fears of lower oil prices, the broad high-yield bond market still returned 1.2% in October 2014 as global growth fears subsided, in contrast to an 11.7% drop in oil prices. We believe it is premature to view the drop in oil prices as a threat to the broad high-yield bond market. The high-yield divergence continued last week as stocks made new record highs while high-yield bonds were down slightly (please see *Bond Market Perspectives*, "High-Yield Divergence," November 4, 2014). A seasonal surge in new issuance, the winding down of earnings reporting season, and the postponement of early October issuance have all been factors weighing on the high-yield bond market. The issuance surge, rather than the price of oil, has been a primary influence of high-yield bond performance over the past two weeks. We find it premature to draw conclusions about oil prices and the performance of the broad high-yield bond market. ■

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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