

# MyConsultant

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## Consultant

Domien is a Consultant and a member of the Fixed Interest and Portfolio Construction Research Teams.

Prior to joining JANA in 2010, he worked as an assistant portfolio manager at Vanguard Investments. His responsibilities during this time covered both domestic and international equities.

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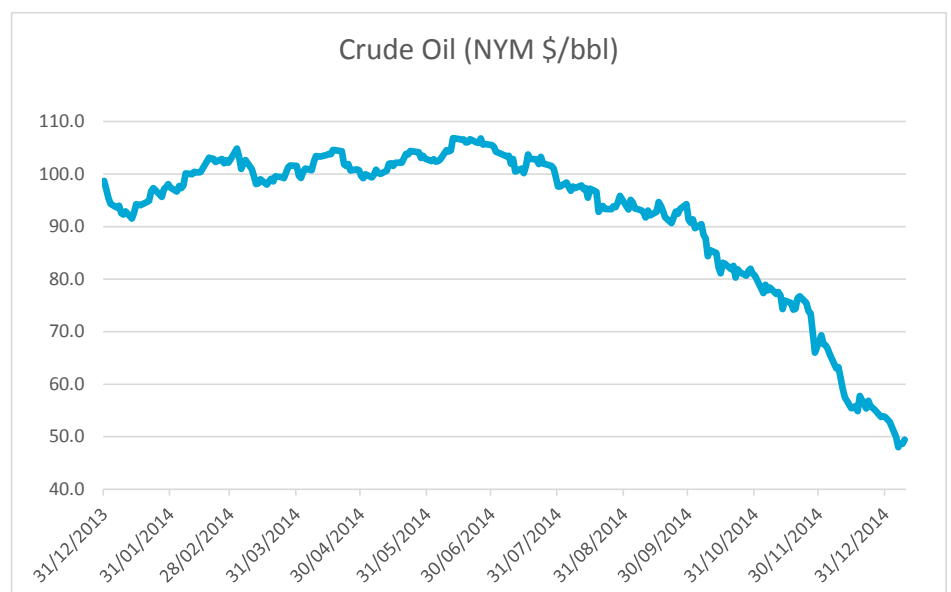


## Oil and credit markets

The August edition of MyConsultant, 'The US Shale Gas Revolution – An Infrastructure and Political Opportunity', reviewed the shale gas revolution currently taking place in the United States and the potential opportunity this might create for the infrastructure asset class. Since this article was written a lot has changed in the energy market - in particular, the price of crude oil has fallen significantly: from \$105/barrel at the middle of the year down to \$54/barrel at year end and subsequently to below \$50/barrel in early January (see Figure 1).

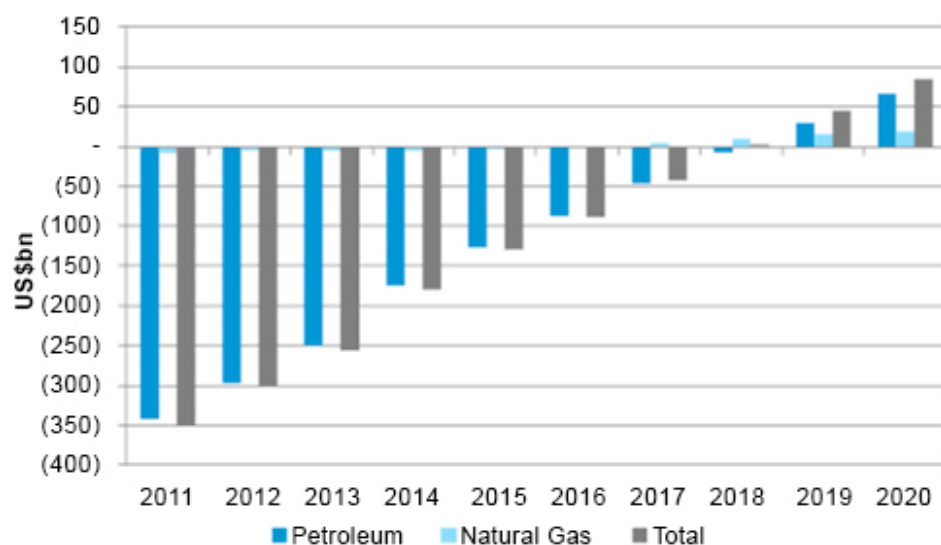
The impact of a falling oil price for the US economy is not as clear cut as it once used to be. Historically, the US relied on a significant level of oil imports. However, the shale gas revolution has meant that the US has become less reliant on imports and is predicted to be a net exporter of gas and oil over the next few years, as is illustrated in Figure 2.

Figure 1



Source: Factset, JANA

Figure 2



Source: EIA, Citi Research

### What are the implications for credit markets of the sudden and sharp fall in the price of oil?

The impact of the recent fall in the oil price is different for every asset class, and the focus for this article is on the impact on the US leveraged (bank) loan and high yield markets. As a reminder, these markets comprise sub-investment grade (i.e. rated below BBB-) debt issuers. Bank loans are floating rate debt whilst high yield bonds are fixed rate. Many JANA-advised investors have invested into the US bank loan market over the last six years.

Sub-investment grade credit has performed very well as credit spreads have fallen significantly from the highs of December 2008 down close to longer term averages (5.2% for US loans and 4.8% for the US high yield market at the end of October 2014) (see Figure 3).

The size of the energy sector within both the Credit Suisse Leveraged Loan and Credit Suisse High Yield indices has increased over the last few years, as shown in Figure 4.

The growth of debt issuance has mostly occurred within the high yield bond

market over the last 10 years, compared to the exposure within the loan market which has been relatively static. The Oil and Production Services sub-sector is the most sensitive to lower oil prices and makes up roughly half of the overall Energy sector within the US high yield bond market.

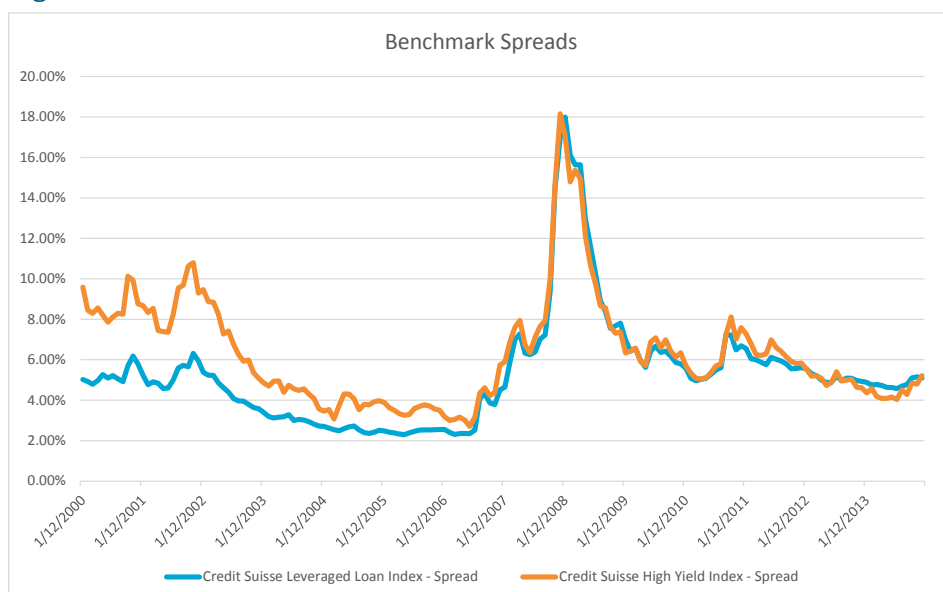
According to Thomson Reuters, Energy producers have issued US\$65.8 billion in the calendar year up to early December,

or roughly 22% of the US\$301 billion of high yield bonds that have come to market this year.

Over the last few months, the falling oil prices have impacted the debt valuations of speculative oil and gas firms and as a result the energy sector has underperformed the broader loan and high yield markets (see Figure 5).

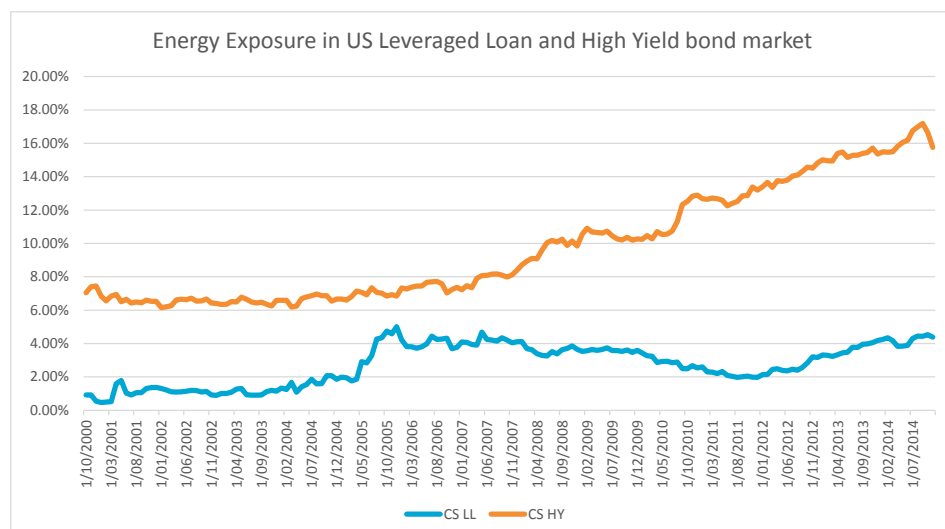
It is clear that if oil prices remain at these low levels for a sustained period then the profitability of some of the more speculative energy issuers will come under pressure and ultimately lead to an increase in default rates. According to Standard & Poor's, energy issuers make up 52 of the 180 bonds considered distressed within the Merrill Lynch High Yield Index. A research piece by Deutsche Bank has stated recently that the default rate for the Energy sector within the high yield bond market could reach as high as 15% if the oil price fell and remained below \$60/bbl. At this price, the debt-to-enterprise value for issuers within the sector would rise above 65%, a level that historically has seen a significant increase in defaults.

Figure 3



Source: FactSet, JANA

Figure 4



Source: FactSet, JANA

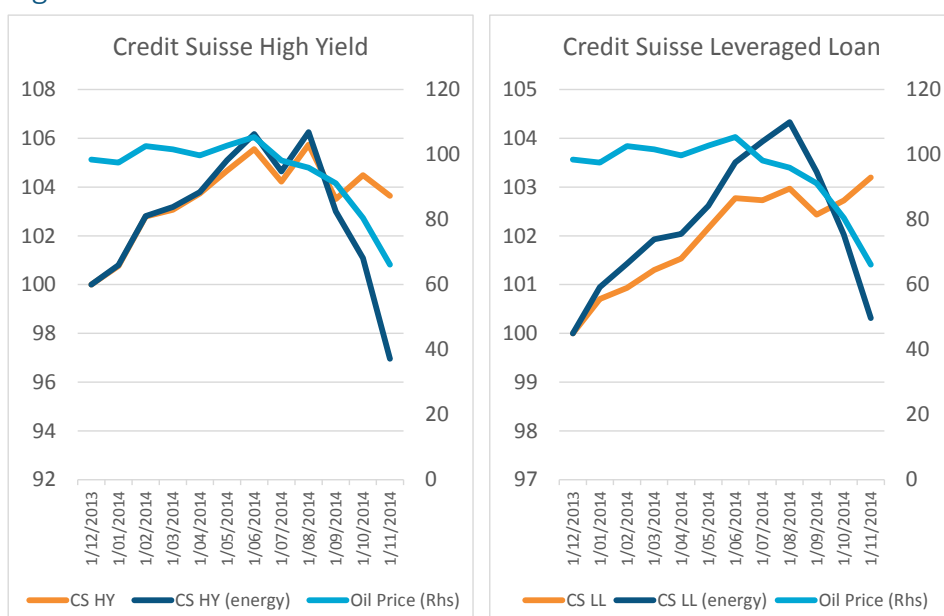
However, the impact of a dramatic fall in the oil price is not uniform within the Energy sector. Whereas the oil producers are the most heavily hit, other Energy sub-sectors such as Pipelines for example have experienced little impact. And even within the oil producing sector, different companies have different level of production costs that lead to different profitability break even oil prices.

A lower oil price is thus not all bad news and in fact has a substantial benefit to other sectors, such as household consumption and the manufacturing industry. Consumer confidence levels

in the US have recently jumped to a 7-year high and should be an indicator of increased consumer expenditure which should boost economic growth. For most manufacturers, energy is a large part of the production cost, and the lower oil and gas prices have a significant positive financial effect.

Various factors, both on the demand and supply side, come into play that determine what the oil price might be in the immediate future. Regardless of the outcome, the last couple of months have shown us that significant oil price movements have a flow-on effect on the valuation of sub-investment grade debt valuations, in particular within the high yield bond market. JANA's view on the medium term default risk within the US loan market remains positive, and despite increased risk within the Energy sector, the default risk within the overall high yield market remains benign.

Figure 5



Source: FactSet, JANA

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