Opinion **Markets Insight**

The energy sector dilemma for high-yield debt investors

Are extreme price swings part of a longer-term trend in the transition towards a greener future?

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Junk investors are uniquely positioned to point out that this energy cycle is far from over © REUTERS

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The high-yield bond market has just experienced an extreme cycle of bust and boom in the debt of energy companies.

Or, depending on your time horizon, the price swings of the last year were just part of a series of sharp pricing roundtrips in a much longer cycle as much of the energy sector shrinks towards obsolescence. The market history books are still being written.

For the uninitiated, companies become high yield (or less charitably but more accurately, "junk") in one of two ways. They issue bonds which are junk-rated or their debt is downgraded from investment grade to high yield because they hit a rough patch, becoming what is known as fallen angels.

Although students walk out of Finance 101 knowing that debt-laden balance sheets should not coexist with volatile commodity prices, the high-yield market underwrote this cash-burning industry for years before oil and gas prices started sliding in 2014.

Junk exploration and production bonds delivered a negative return of 30 per cent in 2014-2015, an era that saw the bankruptcy of more than 20 per cent of the high-yield energy sector.

When pundits showed the returns of the high-yield index "ex-energy" in 2015, it had nothing to do with environmental, social and governance issues. Rather, it was to demonstrate the underlying health of the rest of the market.

It was no wonder the energy sector industry saw so many defaults after the underwriting binge, investors said after the dust settled in 2016. "We won't make that mistake again" was the refrain.

But sometimes high-yield investors are asked to clean up others' mistakes. We were not consulted about the original financing of, say, Occidental Petroleum. But it became 2020's second-largest fallen angel and the largest junk energy issuer by a factor of four in March of last year.

Suddenly, as a result, here came $40bn in very cheap bonds into high-yield territory for us to analyse. A meaningful part of high-yield performance as an investor depended on getting that right.

Junk energy has returned 82 per cent since the pandemic trough, versus 28 per cent for the Bloomberg US Corporate High-Yield Bond Index. As one of high-yield's largest industries, with a 13 per cent weighting in the sector benchmark, a portfolio manager ignores it at their peril. For comparison, energy is 8 per cent of the investment grade corporate market and about 3 per cent of the S&P 500 index. You might say that the high-yield market is where energy companies go to die.

Or, to resurrect themselves. As risk appetite improved, high-yield investors lent $10bn to Occidental in 2020 at successively lower coupons, enabling it to refinance its debt with 2021-2022 maturities. Occidental's 3.5 per cent 2029 bond now trades at a spread of 2 percentage points or less over US Treasuries — not far from an investment grade valuation.

Blink once and you might miss this high-yield issuer, along with several other fallen angels. The upgrade cycle will leave a big, dry well in our market. In retrospect, a relevant history lesson was the banking downgrade cycle of 2008, which saw billions of bank hybrid bonds barrel into the junk index at cents on the dollar — and in some cases, rebound with returns of 10 times.

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Now when clients, reasonably, ask for an energy thesis, none of the answers are satisfying. Divest, and give up the incremental yield of about 0.6 of a percentage point offered by the industry over the market's benchmark index? Hold, for the last bit of appreciation as the fallen angels go back to investment grade? Hope for an ESG fund management mandate which takes the decision away from you?

A harder question is: Will high-yield energy matter five years from now? Or will we see a massive fallen angel cycle as the world gets serious about fighting climate change that makes Occidental look like a dress rehearsal? Recall that the big three US automakers and US department stores had "A" credit ratings once upon a time.

Based on our experience in various industries that downgraded their way into our world, junk investors are uniquely positioned to point out that this energy cycle is far from over. There will be money to be made along the non-linear transition to a greener world (some are already making it).

Don't reassign your high-yield energy analysts' new coverage just yet. They may have a few dry years, but the likelihood of striking oil as this cycle grinds on is high.

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