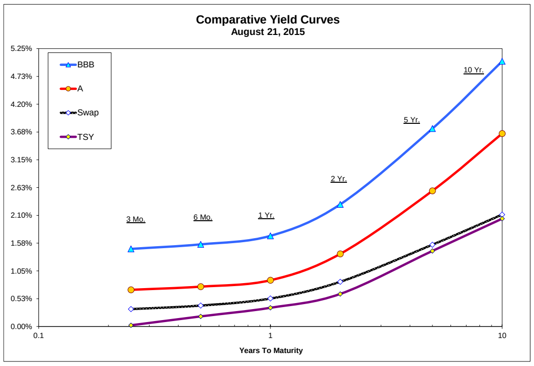
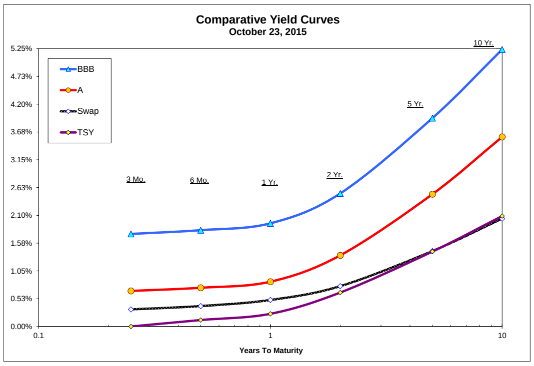
Energy Sector Investors Preferring Equities Over Debt In Short-Term

Energy yield curves have diverged along a credit dimension between August 21 and October 23, 2015 (left- and right-hand charts, respectively). While the A-rated curve has flattened bullishly, the BBB-rated spreads has steepened bearishly. What are the present indications from energy yield curve spreads and OAS levels?



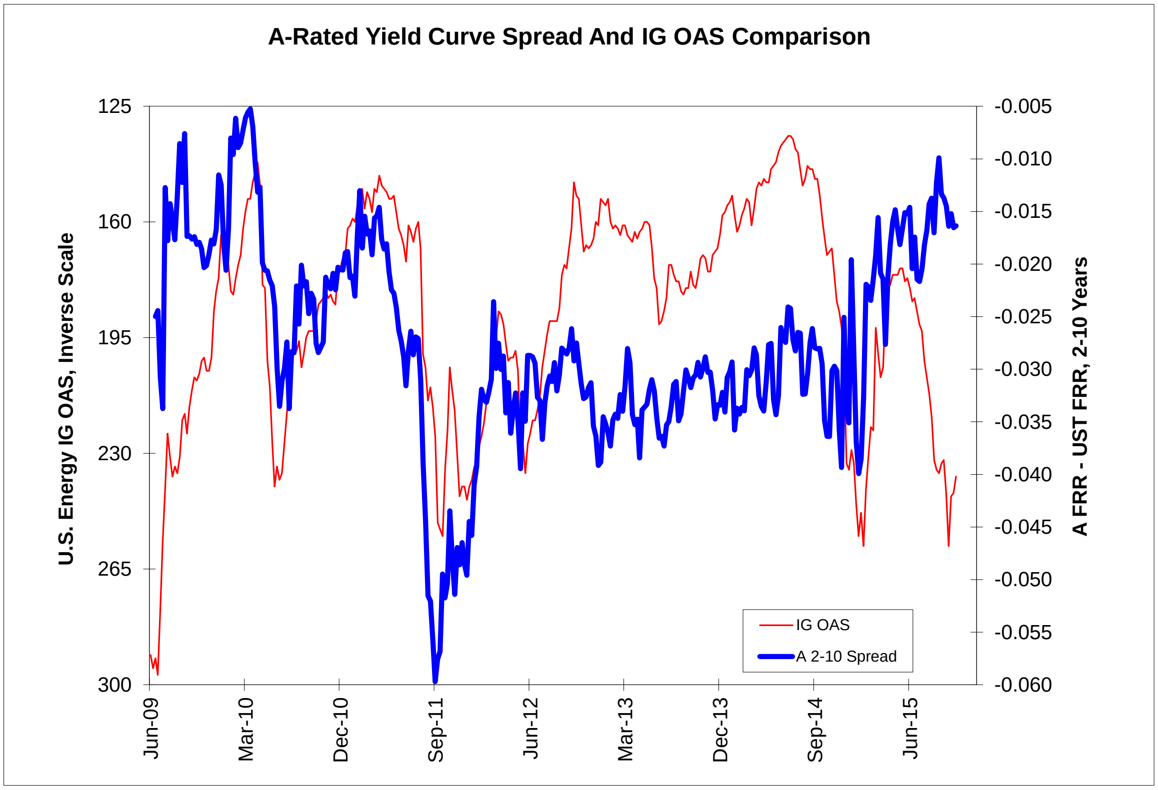


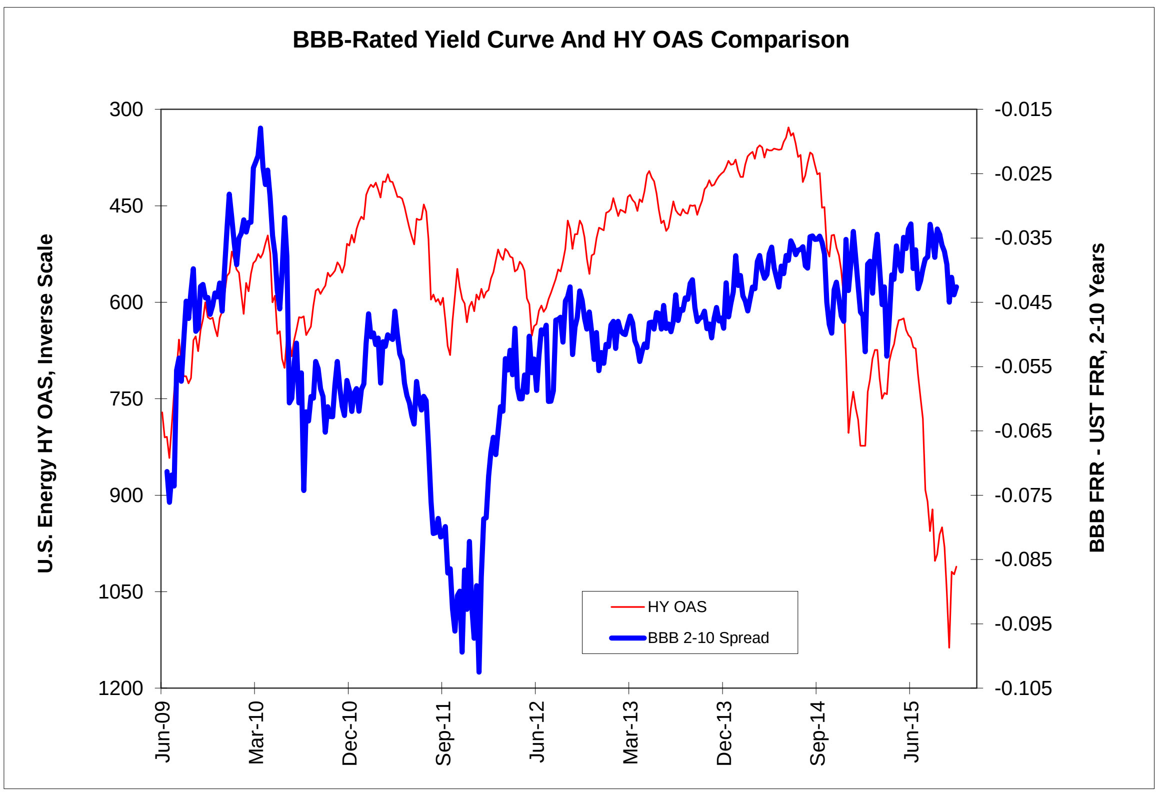
Yield Curve Spreads

We can compare the relative steepness of two yield curves by comparing their forward rate ratios across a segment of the yield curve, in this case the 2-10 year segment.

The $FRR_{2,10}$ spreads for A- and BBB-rated issues both have narrowed bearishly over the past month as the UST curve widened as a function of lower two-year rates. However, the A-rated yield curve spread has not narrowed beyond the level it was in late May, a time when crude oil prices were still in their second quarter rebound. The BBB-rated yield curve spread has been in a consolidation since late April.

OAS levels for investment-grade issues, plotted inversely, tested their late-January lows successfully at the start of October and have narrowed slightly. High-yield OAS levels continued to expand into early October and remain well over levels reached during the August equity selloff. This remains the strongest indicator of deteriorating credit quality within the energy sector.


A-Rated Yield Curve Spread And IG OAS Comparison
U.S. Energy IG OAS, Inverse Scale
125
160
195
230
265
300
-0.005
-0.010
-0.015
-0.020
-0.025
-0.030
-0.035
-0.040
-0.045
-0.050
-0.055
-0.060
A FRR - UST FRR, 2-10 Years
IG OAS
A 2-10 Spread
Jun-09
Mar-10
Dec-10
Sep-11
Jun-12
Mar-13
Dec-13
Sep-14
Jun-15


BBB-Rated Yield Curve And HY OAS Comparison
U.S. Energy HY OAS, Inverse Scale
300
450
600
750
900
1050
1200
-0.015
-0.025
-0.035
-0.045
-0.055
-0.065
-0.075
-0.085
-0.095
-0.105
BBB FRR - UST FRR, 2-10 Years
HY OAS
BBB 2-10 Spread
Jun-09
Mar-10
Dec-10
Sep-11
Jun-12
Mar-13
Dec-13
Sep-14
Jun-15

Stock Market Overlay

If we map the sector's investment-grade and high-yield OAS levels against the total return for the S&P 500 energy sector, all values reindexed to the start of the data in June 2009 and displayed on a common logarithmic scale, we see a strong relationship for high-yield OAS. Indeed, since the beginning of crude oil's downturn at the end of June 2014, the r^2 between high-yield OAS and the total return of the energy sector has been 0.92 as compared to 0.71 for investment-grade OAS.

The relationship appears to have changed in the very short and statistically meaningless period since U.S. equities tested their August lows successfully at the end of September. The total return of the energy sector has been 14.69%; this compares to OAS contractions of 7.78% and 9.32% for investment-grade and high-yield energy sector bonds, respectively. Such a risk-seeking preference for equities suggests a great deal of short-covering apart from fundamental improvement is underway in the energy sector.