Rising Energy Sector Credit Risk Is Real

While buying low and selling high is alleged to be beneficial to your financial well-being, timing is still important. One of the more predictable head-scratchers of the crude oil price collapse underway since June 20, 2014 is how quickly it brought out the serial bottom-pickers. The bear market in crude oil and the damage it will cause the upstream side of the energy market will take a long time to reverse itself for the simple reason it is cheaper to sell crude oil at a lower price and get cash to cover fixed costs than it is to leave it in the ground and incur the opportunity costs while watching your competitors benefit from lower overall production levels.

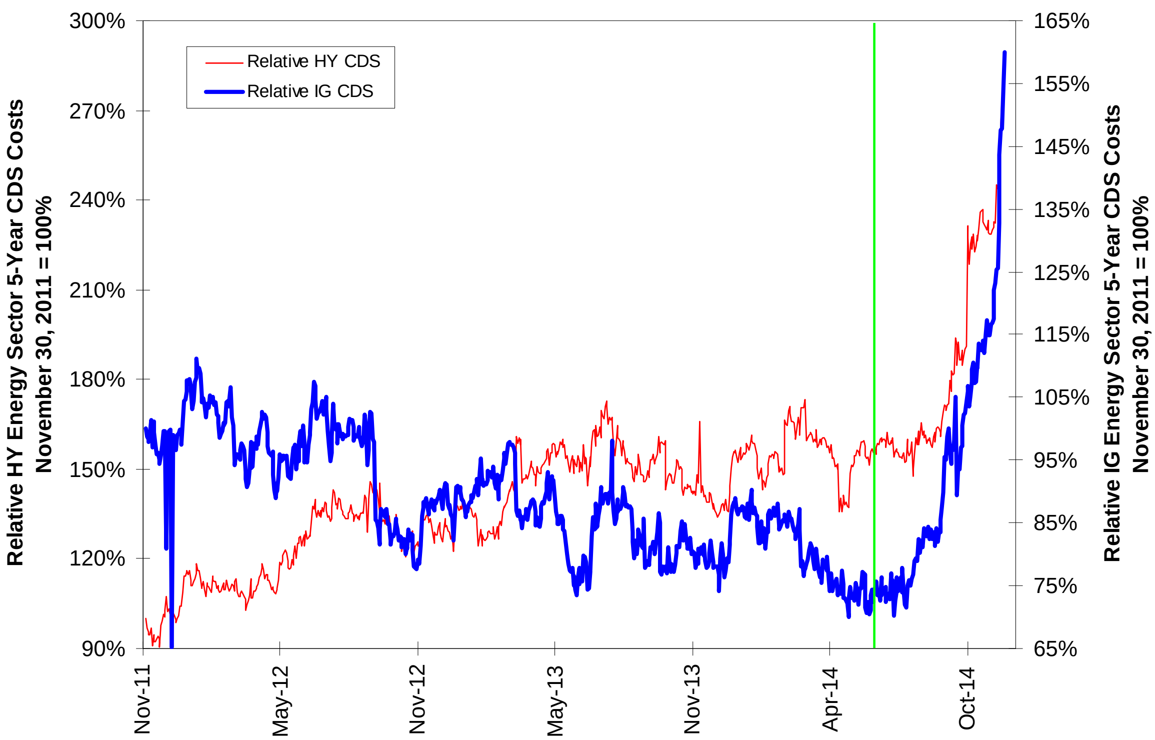
Memo to energy sector bottom-pickers: Take a page out of the Obama foreign policy playbook and try not to do stupid [stuff].

Relative Credit Risk

One of the distortions created by six years of artificially low interest rates and ongoing distortions created by the tax code has been a very rational preference for debt over equity. Firms, including Apple, borrowed vast sums in lieu of repatriating overseas cash and used it to pay dividends. Not so incidentally, strategies such as this work out very nicely for corporate managers who get paid based on stock performance. Leverage is so much fun on the way up, is it not?

However, as most of us have found out the hard way at least once, leverage is not so much fun on the way down, especially if you are saddled with a boatload of debt and your oilfield customers are canceling orders left and right. Let's take a look at the relative costs of five-year energy sector CDS vis-à-vis the iBOXX investment-grade and high-yield CDS indices. I started the comparison at the November 2011 date when global currency swap lines were expanded and marked the date of crude oil's price break with a green vertical line.

Crude Oil Price Break Significant For Energy Sector CDS



The relative CDS costs have increased as an exponential function of lower crude oil prices. As things get bad for crude oil, they get much worse for the sector's credit risk.

Sector Return

If we move from the relative CDS costs of the sector to the option-adjusted spreads of these bonds, we find a very strong and contemporaneous relationship, especially for the OAS of high-yield energy bonds. Once again, the relationship is more than linear; since June 20, 2019, high-yield OAS levels in the energy sector have increased 32.2% while the total return on the S&P 500 energy sector has declined 8.9%.

The temptation is to say the energy sector's loss is everyone else's gain, but the economy is not a zero-sum affair. We should have learned about sector contagion in the housing debacle, but what good is making a mistake if you cannot make it twice? As corporate bond investors, especially in the high-yield sector, retreat from energy-related bonds, they will find out just how illiquid these markets have become after the Volcker rule and Dodd-Frank restricted banks' ability to hold positions.

Moreover, in a market downturn, you do not always sell what you should, you sell what you can. This means investment-grade bonds will suffer as well and funds will flow into already expensive Treasury debt. Those who have been short Treasuries and have paid for their folly before will get to do so again.

All that is missing is for Ben Bernanke, Tim Geithner and Hank Paulson to make return appearances proclaiming the energy-bond selloff is "well-contained." When that happens, run.