Energy Sector Yield Curve Spreads

While the high-yield segment of the energy sector is grabbing all of the attention, and understandably so, we should be paying attention to the much larger investment-grade segment as well. What we see is rising credit stress creeping up from lower-rated to higher-rated bonds.

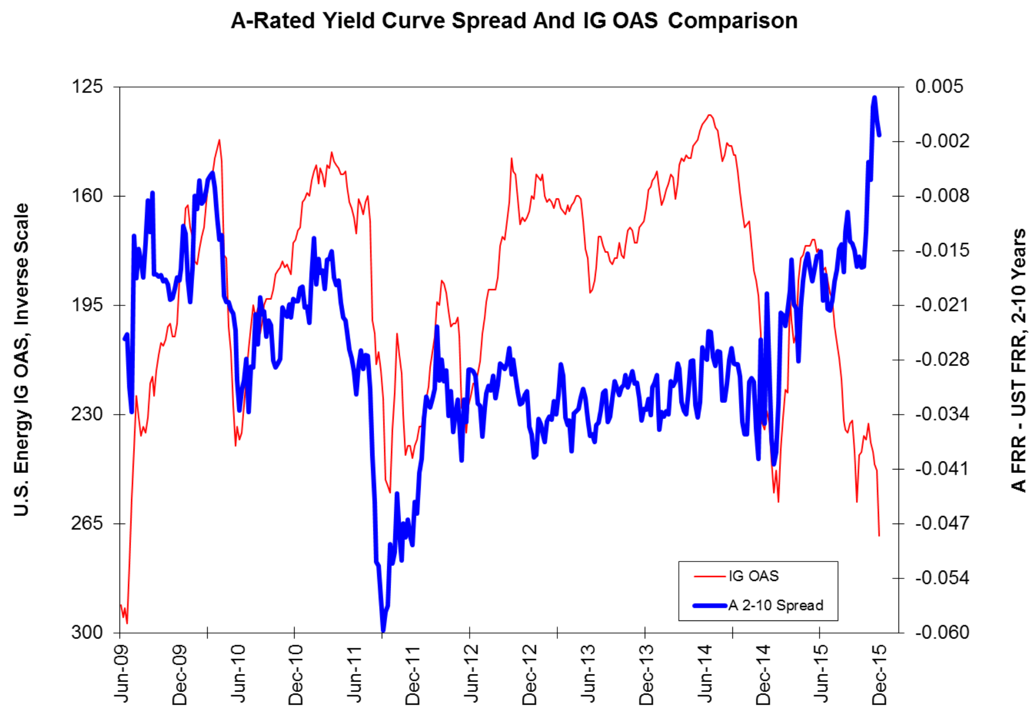
If I could write in a stage whisper, which I cannot do, I would ask *sotto voce* why we still rely on credit ratings so many years after they proved bogus in the structured mortgage market.

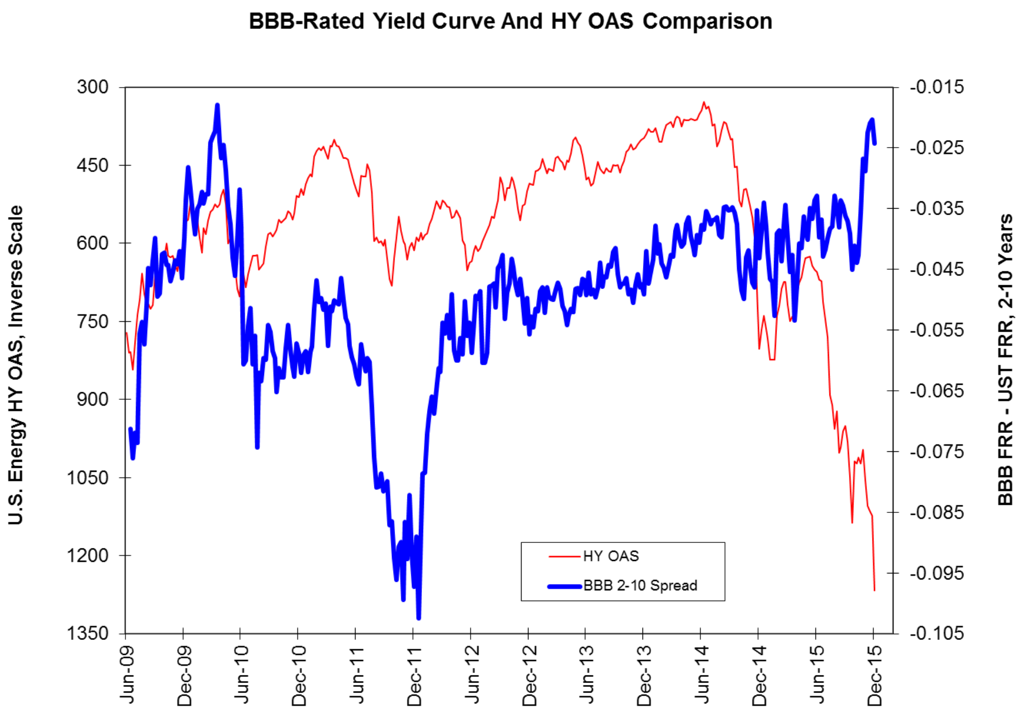
Yield Curve Spreads

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 ($FRR_{2,10}$). This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The steeper the yield curve, the more this ratio exceeds 1.00.

The $FRR_{2,10}$ spreads for A- and BBB-rated issues in the energy sector both have narrowed bearishly over the past month as the Treasury curve flattened as a function of higher two-year rates. The combination of a steeper yield curve for energy sector bonds and a flatter UST yield curve led to an observed high for A-rated yield curve spreads during the last week of November and the highest level since April 2010 for the BBB-rated yield curve spread in the first week of December.

Let's add the OAS of broader energy sector investment-grade and high-yield indices to these yield curve spreads. OAS levels for investment-grade issues, plotted inversely, are at their highest levels since the recession's end in mid-2009. High-yield OAS levels are at their highest observed levels, and by a very wide margin.

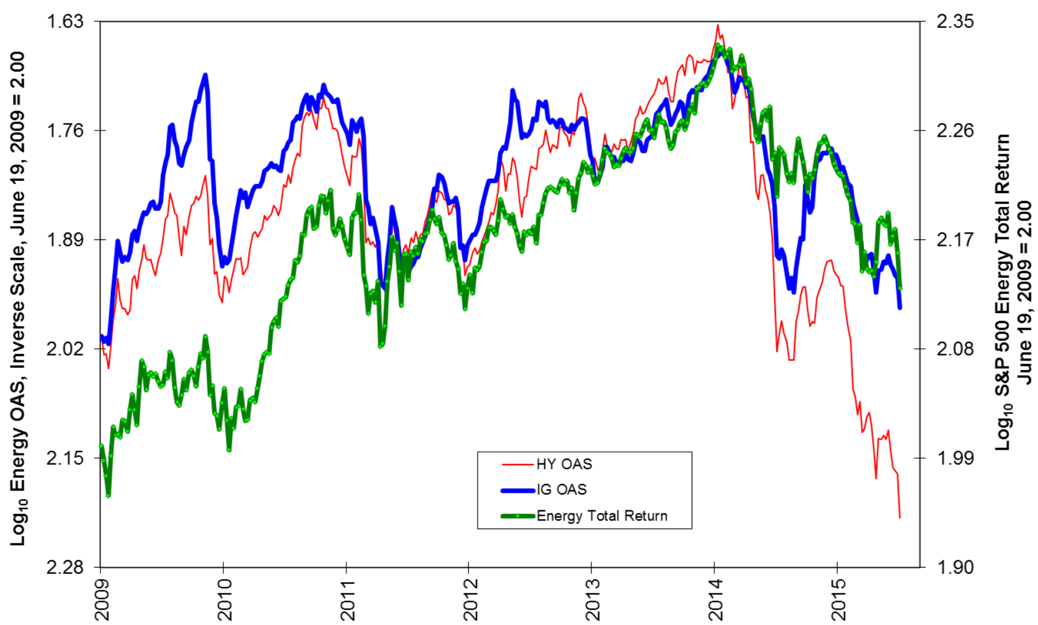




Stock Market Overlay

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 how investment-grade OAS has joined high-yield OAS in a strong linkage to energy sector equity returns. Indeed, since the beginning of crude oil's downturn at the end of June 2014, the r-squared or percentage of variance explained between OAS levels and the total return of the energy sector have been 0.76 for high-yield and 0.75 for investment-grade bonds.

Energy Stocks And Sector OAS



The rising convergence of energy sector investment-grade OAS and equity returns suggests the financial stresses of leveraged upstream players has spread throughout the broader energy sector. As fixed-income liquidity is disappearing as demand for it is increasing, energy sector investors are doing what investors everywhere do during risk-off periods: They are selling what they can as opposed to selling what they should. This means stranded investments in energy sector bonds will be hedged, very imperfectly, via short equity positions.

The sector remains trapped in a vicious cycle right now, with lower crude oil and natural gas prices contributing to higher credit stresses and higher credit stresses demanding production be maintained in a vain attempt to service debt and cover fixed costs. The end game will be bankruptcy and consolidation, along with some good entry points for the inevitable upturn. But not now: Remember, the early bird gets the worm, but the second mouse gets the cheese.