LPL RESEARCH
BOND MARKET PERSPECTIVES

June 27 2017

HIGH YIELD: THE RETURN OF OIL SENSITIVITY

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

Oil's recent weakness has led to a challenging month for the high-yield energy sector, as the sector's sensitivity to oil has returned after decoupling for much of the year.

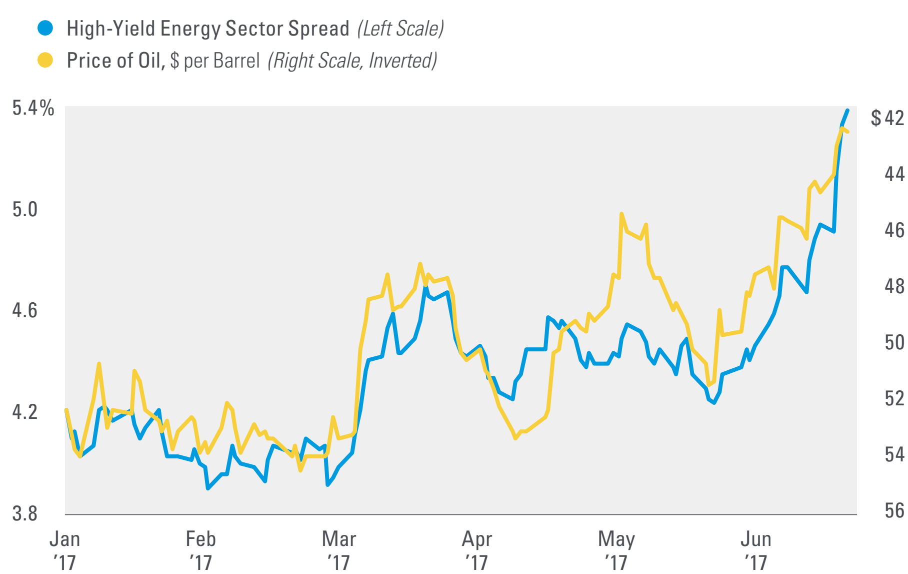
Thus far, the spillover to other sectors has been limited, but the situation has put some pressure on high yield overall.

Fundamentals for high yield remain positive, but the situation must be monitored for deterioration going forward.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The month of June has not been good for oil with signs of concern emerging in the high-yield energy sector. The situation remains relatively well contained to the sector and spillover has been limited, but requires close watch for ongoing deterioration. High yield and high-yield energy remained relatively resistant to oil's move lower in early May, but recent weakness below the $45 per barrel level has brought the high-yield energy sector along for the ride. High-yield energy bonds' spread over comparable Treasuries widened on mounting concerns about sector weakness, given lower oil prices [Figure 1]. Oil's decline over the last month from $51 on May 22, to $43 on June 22, has led to a -3.8% total return for high-yield energy over the same period based on Bloomberg Barclays High Yield Energy Total Return Index performance. That is the sector's largest month-over-month decline since the end of oil's initial decline in February 2016.

1 OIL'S DECLINE HAS PUSHED HIGH-YIELD ENERGY SPREADS HIGHER



Source: LPL Research, Bloomberg 06/26/17

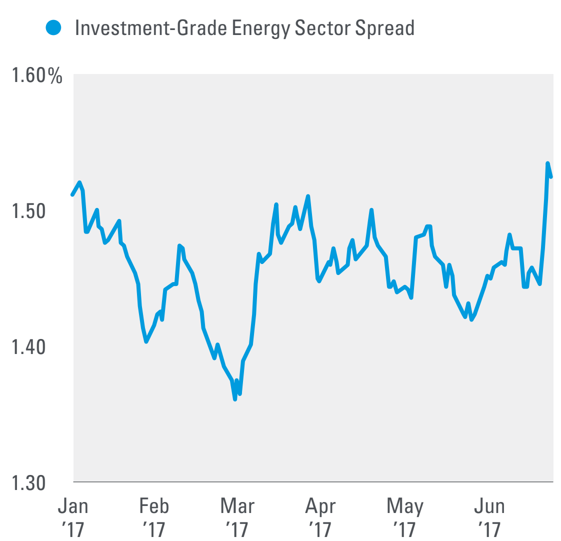
Spread represents the Bloomberg Barclays High Yield Energy Average Option-Adjusted Spread over comparable Treasuries. Past performance is no guarantee of future results.

Member FINRA/SIPC
LPL Financial

HOW BIG IS THE PROBLEM?

The collapse in oil from a high of over $107 per barrel on June 20, 2014 to just over $26 on February 11, 2016 prompted an industry shakeup in the domestic oil market. Many weaker producers, those less capitalized or those with higher marginal costs of production, were forced into default. This caused pain in the market, and weakness and losses in high yield overall, but the silver lining was a stronger industry with more resilient producers. High-yield energy's weight within high yield was 14.9% in June 2014, immediately prior to oil's large price decline. That weight bottomed with the price of oil to 9.7% of the market in mid-February 2016, and has since recovered to 12.9% as of June 23, 2017. That resiliency is being tested as of late, with high-yield energy sector weakness pronounced enough to create caution in the overall high-yield market. In fact, the caution is strong enough to create concern even in the investment-grade energy sector, with spreads now at a year-to-date high [Figure 2].

2 INVESTMENT-GRADE ENERGY HAS SHOWN WEAKNESS TOO



Source: LPL Research, Bloomberg 06/26/17

Spread represents the Bloomberg Barclays Investment Grade Energy Average Option-Adjusted Spread over comparable Treasuries. Past performance is no guarantee of future results.

THE GOOD NEWS...

Since reaching a low in early 2016, the recovery of oil prices has given many energy firms the ability to refinance their debt or issue new debt throughout 2017 at historically low borrowing costs. Many of these companies can now go years without tapping debt markets again, allowing them to withstand temporary weakness in the price of oil as they may not have been able to do just two years ago as oil slid. As is common across commodity production industries, many firms have hedged themselves and effectively locked in the price that they will receive for some of their future production.

...AND THE RELATED BAD NEWS

Regardless of whether firms are hedged or not, one thing remains true: domestic producers will continue to produce oil, as they need the revenue to pay the interest payments on existing debt. There are other factors that encourage production as well, like the costs associated with starting and stopping production on existing wells. So even if a producer is taking a marginal loss on each barrel produced, they will continue to do so out of necessity. One negative effect of this is that as a now important oil producer in the global market, our domestic producers' commitment to production will result in continued supply, making it difficult for the price of oil to recover through supply and demand dynamics alone. Therefore, regardless of whether the Organization of Petroleum Exporting Countries can continue to cut output to try to limit supply and raise prices, our freshly capitalized domestic oil industry makes it much more difficult to achieve than before the U.S. shale revolution over the last five years.

GOING FORWARD

As we have reiterated in *Bond Market Perspectives* pieces throughout the year, high yield remains fundamentally sound, but expensive valuations warrant caution, as the market remains susceptible

Member FINRA/SIPC

LPL Financial

to pullbacks in equity and/or oil. Despite high yield's decoupling with oil in late 2016 and early 2017, we maintained our belief that oil remains an important driver of high-yield markets. The recent events in the market help to explain why. While some fluctuation in the price of oil is natural and expected by markets without major flow through to spread levels, a decline below certain levels or a perceived change in supply and demand characteristics can have sudden and profound effects on the market. Despite the solid fundamentals we saw in terms of lending standards (outlined in our recent *Bond Market Perspectives*), the market was "priced for perfection," with the decline in defaults expected in 2017 already fully priced into the market.

CONCLUSION

Price action in oil and its effect on high-yield energy spreads and returns indicates that despite decoupling over certain periods, the two remain correlated. Investors should be aware of the ongoing risks to high-yield energy, and perhaps the spillover into the broader high-yield market. Even considering recent weakness, we still judge the high-yield market to be slightly richly valued. Spreads at current levels may not compensate investors for future risks. Balancing this with lending standards data providing fundamental support for the market, and the problem not yet spilling over into high-yield ex-energy, we remain neutral on the asset class overall. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The fast price swings in commodities will result in significant volatility in an investor's holdings.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

INDEX DEFINITION

The Bloomberg Barclays High-Yield Bond Index is an unmanaged index of corporate bonds rated below investment grade by Moody's, S&P or Fitch Investor Service. The index also includes bonds not rated by the ratings agencies.

Bloomberg Barclays High Yield Energy Total Return Index is composed of futures contracts on crude oil, heating oil, unleaded gasoline and natural gas. It reflects the return of underlying commodity futures price movements only and is quoted in USD.

This research material has been prepared by LPL Financial LLC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial LLC is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 5965 0617 | Tracking #1-621060 (Exp. 06/18)

Member FINRA/SIPC

LPL Financial