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Energy Following G20 and OPEC Meetings

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Two critical meetings took place in the first week of December that were expected to influence both demand and supply of crude oil in the upcoming year. The G20 meeting in Argentina and, more specifically, the Saturday night dinner between U.S. and Chinese leaders addressed the threat of trade disputes between the two largest economies in the world, and thus oil demand. The meeting between Presidents Trump and Xi ended with an agreement that the US would postpone a planned escalation of tariffs to March 1 and China agreed to resume purchases of agricultural and other goods. This “pause” in a trade war should result in very limited change in oil demand from either country, at least until March 1, 2019, when the two countries evaluate any progress made.

The second meeting of great importance to the oil industry was the semi-annual OPEC meeting. On December 7th, the 14 members of OPEC and Russia decided to reduce production 1.2 million barrels per day from October levels. As a result of this cut in production, Canada’s recent announcement of a short-term 0.3 million barrel per day cut, and the actual implementation of Iranian sanctions in 2Q19, we believe supply and demand should be better balanced in 2019 than in the last quarter of 4Q18, and we should not have a repeat of 2016. In short, the two meetings worked out reasonably well and better than many observers expected.

Fundamentals should not change much in the energy sector

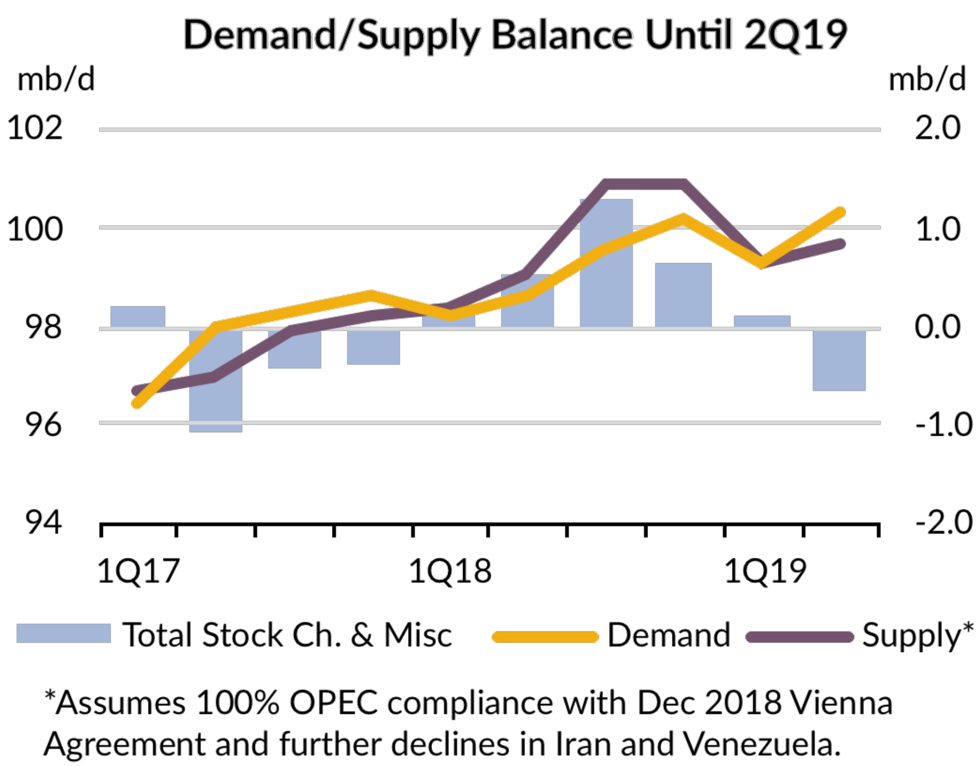
Given the IMF’s current worldwide economic outlook of around 3.7% growth and a suppressed crude supply outlook, oil prices are expected to be in the $50 (WTI) -$60 (Brent) per barrel range in 2019. This commodity price outlook combined with increased capital spending discipline, should contribute to stable fundamentals in the energy sector, particularly for independents, integrateds, refiners and midstream companies.

However, we have little conviction that the fundamentals will remain as they are. The outcome of the U.S./China trade dispute will affect oil consumption or, at the very least, the market's perception of expected consumption. Equally challenging is attempting to forecast how political decisions will influence crude supply in the coming year – actions made by US/Saudi Arabia/Russia/Iran will have as big an influence on supply and short-term crude prices as the trade dispute will have on demand and long-term crude prices.

Energy constituents are better prepared to withstand commodity volatility

Because of our less than high conviction of future fundamentals, it is worthwhile to review the creditworthiness of the energy sector in the face of what we believe will be a volatile year in terms of both crude supply and demand. In short, we believe that the energy sector is in a stronger position to withstand commodity price volatility than it was in 2016.

Exhibit 1



Source: International Energy Agency

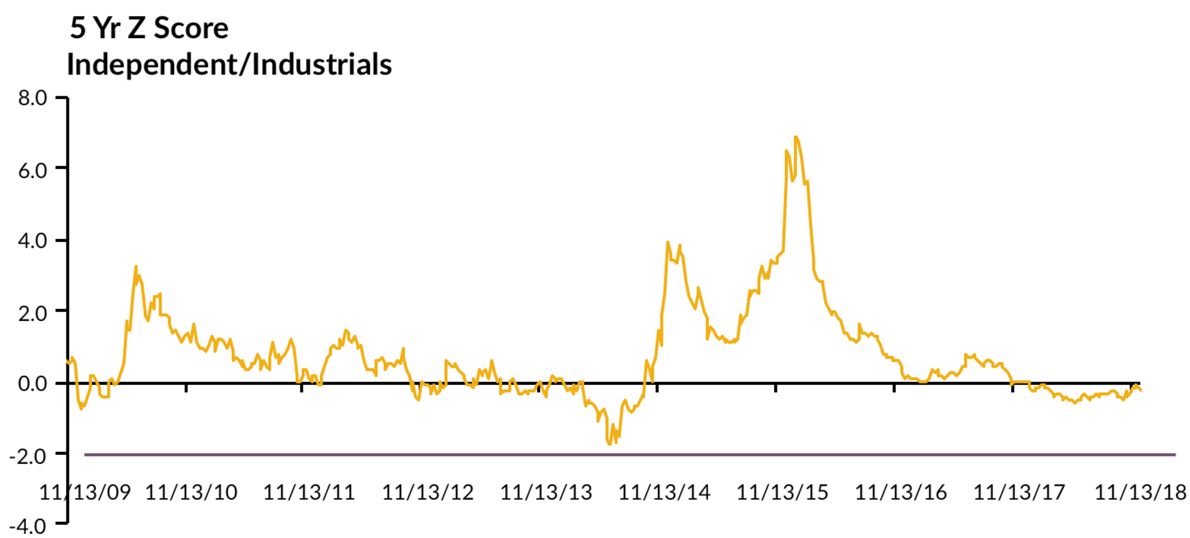
The credit profile of the Upstream (independents and integrateds) is healthy. The median debt/LTM EBITDA of 1.6x is nearly a full turn better than it was prior to oil's collapse in 2016. The sector is also carrying about 10% less debt relative to production than it was two years ago. Midstream leverage is below 4.2x compared to 4.5x several years ago.

More importantly, many constituents have simplified their corporate structure, reigned in distributions, reduced reliance on external funding and are increasingly focusing on reducing the cost of capital. Refiners are as healthy as they have ever been, but make up a very small component of the index. The one subsector that has yet to fully recover from 2016 is the oil field service group as its customers, the Upstream, have been very disciplined in how it spends money. Similar to the refiners though, the oil field service sector makes up a small portion of the investment grade market, and its constituents are financially healthy.

Valuations are better but not yet attractive

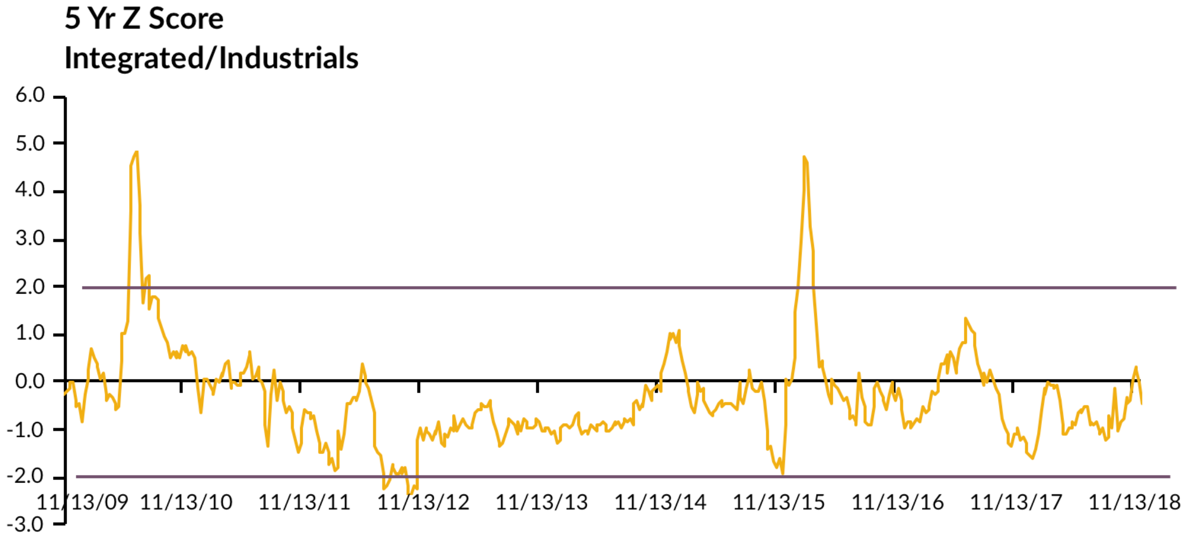
The weakness in oil prices and general risk-off mentality over the past quarter has contributed to the energy sector widening out by 50 bps, which compares with investment grade non-financials ("Industrials") widening by 40 bps. Despite greater income opportunities for investors, we do not believe valuations are compelling enough to add to our existing exposure. As the charts below show, the relationships between the major energy subsectors and Industrials are all within 2 standard deviations of their long term mean. These values combined with low conviction on stable fundamentals demand that we exercise substantial caution when changing our energy exposure.

Exhibit 2



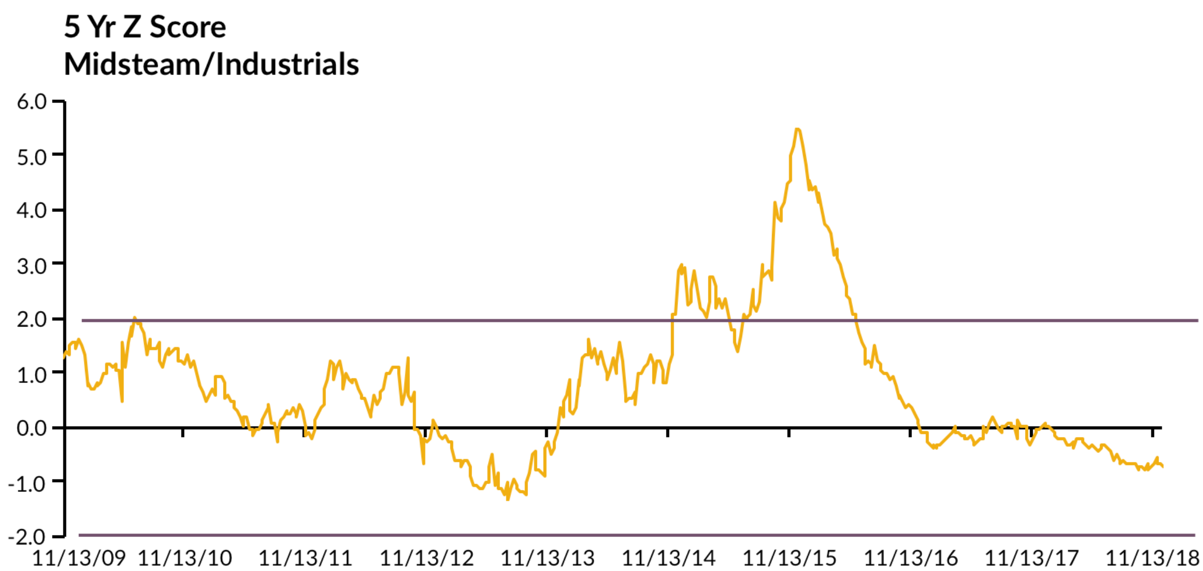
Source: AAM, Bloomberg Barclays

Exhibit 3



Source: AAM, Bloomberg Barclays

Exhibit 4



Source: AAM, Bloomberg Barclays

Looking ahead

In the upcoming quarter, we will monitor several items, which could change our views on fundamentals and valuations:

1. Compliance within OPEC and Russia on the announced 1.2 million barrel per day production cut.

2. Any deviations in negotiations between China and U.S. regarding 5G, intellectual property, tariffs and/or trade flows (automobiles, liquefied natural gas, soybeans).

3. Acceleration in M&A (enterprise values to 2019 EBITDA should further stimulate an already active market).

Patrick J. McGeever *is a Principal and Corporate Credit Senior Analyst at AAM with 24 years of investment experience. Prior to joining AAM, Pat was a Senior Vice President at Deerfield Capital Management. He was responsible for approximately $600 million of leveraged loan investments in the Energy, Utility, and Metal & Mining industries. Prior to Deerfield Capital, Pat was Director of the Oil & Gas Sector at Fitch Ratings. Prior to that, Pat was a Vice President of High Yield Research for ABN AMRO Incorporated covering the Oil Service and Exploration and Production Sectors and was an Associate of High Yield Research for TD Securities (USA), Inc. covering the Energy Sector. Pat earned a BBA in Finance from the University of Iowa and an MBA in Finance, Economics and Accounting from the University of Chicago.*

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