

Oil Shock and Coronavirus – Full Discretion Team



FIXED INCOME UPDATE

Over the weekend, Saudi Arabian state oil firm Aramco announced that it has planned to cut prices, sending futures on the commodity lower by ~20% with Brent crude at a four-year low of \$33 per barrel. Included below are the thoughts of Matt Eagan, EVP and Portfolio Manager of Loomis Sayles, on the recent developments with the energy markets as well as the coronavirus and how the full discretion portfolios are positioned:

Oil Price Fall

It seems like Saudi is playing a game of chicken with Russia, who has not co-operated with OPEC in efforts to cut production in response to COVID. If Russia doesn't blink, oil prices will remain in the tank. Let's see how Russia responds. The last time Saudi started a price war in 2014, they ended up losing. Their target back then was US shale. But US shale production kept growing anyway and the Saudis capitulated as their economy took a hit. Saudi really needs \$70+ oil from a budgetary perspective, though it has huge currency reserves and lots of borrowing capacity to fight a long price war if they choose to do so.

But this time the US oil business is more vulnerable. The US oil industry was already under a lot of pressure to rein in capex and focus on improving profits. Stock prices and bond prices of these companies have been in the dumps. Capital was already being severely rationed even before the recent Saudi actions. Many of the weak shale companies will fail if a price war remains in place this year. Many were questioning the ability of the shale industry to grow production this year. Now, it is very likely that oil production will fall in the US. Natural gas prices may actually benefit from a rollover in shale oil production because gas prices have suffered from low-priced associated gas from shale oil in the Permian Basin.

The US oil and gas industry contributes about 8% to US GDP and accounts for about 10.3 million jobs. It has been a big success story for the US economy. In an extended price war, the oil industry will be a drag on economic growth. Not sure by how much, but it could be noticeable. Economists will be talking about this over the next few days.

At a macro level, the portfolios are very well positioned for the current environment. There are ample reserves and a relatively low level of credit exposure by typical full discretion standards. It's true there is some oil exposure, but it's not concerning. The names that are at risk have already been trading at very distressed levels. The most notable distressed names are California Resources, Whiting, and Chesapeake. They are now small exposures based on current prices. These issues weighed on our past performance, but won't be big contributors in the future. There will be negative price action on other issuers in the portfolio, but there is no longer a large exposure collectively compared to the past. Also, the team will be ready to pick up any cheap offerings in this space. It's possible the opportunities may come in very high quality E&P credits and in the midstream segment (pipelines).

Coronavirus Impact

View on the credit markets

- There has been a slight erosion of credit quality even with the decent economic activity before coronavirus hit
 - If the economy falters from coronavirus, we will see more credit events

- However, there don't appear to be signs of overt distress just yet, which may be why credit has held up better as equity markets fell
 - Risk-free rate has collapsed (10-year is down about 80 bps)
 - Even though spreads have widened a bit, dollar price of credit (especially within investment grade) has gone up because the Treasury curve has moved so much lower
- With a backdrop of weakening credit fundamentals on the margin before the virus hit, the team thinks the market is going from over-valued to better valued
 - Specific opportunities in cyclical area and those directly affected by Covid-19 (leisure and gaming)

View on the Fed

- Fed officials have effectively 300 bps of easing with existing tools, even though fed funds rate is low from a historical perspective
 - Relaxing their 2% inflation target
 - Buying longer dated Treasuries as part of liquidity injection (2-year maturities)
- The Fed will do whatever it takes to help markets and try to prevent short circuiting
 - Reaction to 50 bps cut showed how the market is struggling to price in a pandemic, and the uncertainty that relates to length and depth of impact

Positioning

- The team has ample reserves (short US Treasuries) that can be deployed, but they haven't seen a large buying signal just yet. As such, there have been no major positioning changes.
- While the option-adjusted spreads have widened, the significant move lower of the Treasury curve results in total yields that are not much more attractive than recent periods. So despite the volatility, bond prices have remain fairly unchanged. Hence why the team thinks prices have gone from over-valued to better valued.
- Additionally, there is uncertainty regarding how hard this virus will impact the US economy. The team expects that data coming out over the next few weeks will begin to shed light on what type of impact is to be expected.
 - Risk premium models look more attractive, but there is not a clear signal just yet to add credit risk in a meaningful way

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