Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

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Global Fixed Income | High Yield | Volatility

Ramifications on high yield from the plunge in oil

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Boston - Monday's headline plunge in the May contract for West Texas Intermediate (WTI) oil — from $18 to an unprecedented low of *negative* $37 — was triggered by investors needing to sell at any price. With this US benchmark contract expiring today, these investors would be unable to take delivery given the lack of storage capacity.

The next longer contract for June WTI was also weak, but far less so, moving down approximately $5 to $16. International benchmark Brent crude sold off, too, though not as much as the June WTI contract.

Estimates of demand are falling as the hope for a "V" shaped global economic recovery fades and anxiety over the possibility of a protracted recession — or even depression — builds. The most recent agreement regarding production cuts was insufficient to assuage concern of a supply glut based on demand shortfalls.

The recent price action will likely prompt countries such as the US, Saudi Arabia and Russia back to the bargaining table to negotiate further supply cuts. For example, the Saudis recently cut daily production from 12 million to 8.5 million barrels/day, but they could limit output even more. One option being discussed is a 20% production cut across partnering countries. There is also speculation that the US Congress may attempt to intervene.

The weakness in the price of oil has wreaked havoc on the energy sector of the US high yield market. We expect oil will rebound from current levels, but that it will remain depressed for a protracted period and improve slowly as global economic activity recovers.

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Bottom line: The energy sector has been the largest contributor to the increase in default volume in US high yield over the last several months, and we expect further increases. In our view, now is not the time to bet on distressed producers. It is the time to sharpen the pencil on producers with the highest quality acreage and prudent management teams who have the greatest relative liquidity and optionality.

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