Key Takeaways

- Demand and supply shocks wreaked havoc on commodity markets during the first half of 2020, leaving independent energy and oil field services most exposed to the weakness.
- While oil and natural gas prices have modestly recovered since the virus-induced declines, sustained headwinds could slow or stall the price recovery.
- Default and downgrade risk remains elevated, but opportunities can be uncovered using a pragmatic research-intensive approach and disciplined security selection tactics.

Discuss the current demand and supply dynamics of the commodity markets. Are you seeing signs of stabilization?

Oil

The market is recovering from the steep drop in oil prices stemming from the concurrent demand and supply shocks created by Covid-19 and the OPEC+ price war, respectively. Producers are now cutting output to better align supply with the historically low demand, led by OPEC+, US, Canada, Brazil and Norway. US shale operators and integrated producers have shut-in wells, slashed capex budgets, and are delaying and deferring well drilling and completion activity. The risk of filling both onshore and offshore storage has now diminished, and drawdowns of record oil and product inventories could begin as soon as the third quarter.

While prices have recovered from their lows, there are still challenges in the months ahead. We believe a Covid-19 relapse, or a second wave, is the biggest threat to the demand and price recovery. Refining throughput was down 40% in early April, but has recovered to approximately 80% of normal. Gasoline demand has improved, as people return to work and favor driving over taking public transit. Jet fuel demand remains very weak however, with excess supply blended into diesel, creating an inventory overbuild. China meaningfully increased imports when prices were low, but are now slowing their buying. Refiners may slow the pace of the throughput recovery by drawing on their own large inventory stocks, as refining margins remain weak. Libya may ramp up its oil production, should civil tensions and fighting continue to ease.

Looking forward, we expect prices will continue to recover, but the pace will likely slow and could take a pause considering the above headwinds, and until global inventory draws become more apparent. Balancing higher prices with ample supply that would like to come back into the market will likely prove challenging. Shale producers are now beginning to reduce their curtailments, and could begin to increase drilling and completion activity in the $40/barrel context, though it’s unlikely the levels will be high enough to grow production unless prices reach $45-$50/barrel. OPEC compliance will also be tested by higher prices.

Our base case calls for WTI oil prices to average around $35/barrel in 2020, which is about the year-to-date average as of June 2020. We expect prices could recover modestly into year-end, toward $40 to $45/barrel. For next year, we expect prices to average $45/barrel.

Exhibit 1: Global oil supply, demand and inventory changes (in mmb/d)

**ENERGY SECTOR TURMOIL: NAVIGATING DEMAND & SUPPLY SHOCKS**

**Natural gas**
Recent commodity market and global developments have had meaningful impacts on both natural gas production and consumption, however we still expect an oversupplied market in the near term.

On the supply side, we expect US natural gas production will begin to decline from 2019 record high levels due to lower drilling and completion activity in oil rich basins, which will reduce associated gas production. Additionally, gas focused Exploration and Production (E&P) companies, particularly in the Appalachia region, have tempered future output expectations and, more recently, have curtailed production in light of lower prices.

On the demand side, Covid-19 related lockdowns and lower economic activity are expected to have meaningful impacts on industrial and commercial demand. Additionally, lower global natural gas prices have made exporting liquefied natural gas (LNG) uneconomical and the US has seen a number of cargo cancellations. As a result, we expect lower demand for gas from these facilities in the near term.

While declining gas production in the US is a meaningful reversal from prior trends, the impact won’t be felt until late 2020 and will be outpaced by lower demand from recent global developments. This net surplus position is expected to keep inventory levels above the five-year averages for 2020.

Our base case estimate is that Henry Hub natural gas prices will average $2/mmbtu for 2020, implying upward pressure in prices later in the year as production declines take hold and winter heating season begins to lift demand. In 2021, production declines are expected to be more impactful, while consumption should start to move back to more normalized levels. This will likely help draw down inventories closer to the five-year average and support higher gas prices. We would expect natural gas to average $2.75/mmbtu in 2021.

**Exhibit 2: Historical & projected natural gas storage levels**

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**How does this affect your fundamental outlook on energy companies? Which segments are most at risk?**

While oil and natural prices have modestly recovered, they are still below a level to sustain production, cover costs and deliver adequate returns on capital. Further, all segments of the energy sector are affected by the recent shocks, but independent energy and oil field services remain the most challenged.

**Independent Exploration & Production (E&P):** Prices are below the full cycle breakeven costs of many upstream producers, as they need $45-$50/barrel to be profitable. Companies are reducing spending in an effort to generate free cash flow, but this will likely lead to production declines. Investment returns have been weak in the sector, and consequently, the capital markets have closed to highly levered producers. Banks are also reducing the size of secured revolving facilities, constraining liquidity and making upcoming debt maturities more onerous. Default activity is beginning to pick up as a result. We believe companies with low-cost assets, a solid near-term hedge position, low leverage and limited near-term debt maturities are best positioned.

**Oil Field Services (OFS):** OFS companies are in one of the more severely challenged high yield market sectors. The fundamental outlook for these companies is driven by the level of capex spending of its independent E&P customer base. When commodity prices collapsed in the first quarter of 2020, rig counts declined sharply as E&Ps halted and revised their spending plans. Along with this lower level of overall activity, OFS companies could also experience margin compression as E&P seek price concessions for cost-cutting programs. Overall, the fundamental outlook for OFS companies continues to remain extremely challenged and we expect this sub-sector to be a large contributor to the energy default rate in 2020. To that end, a number of companies have already filed for bankruptcy or have hired advisors to elevate liquidity and capital structure options.

**Midstream:** We believe the midstream sector is the best positioned in high yield energy due to lower levels of commodity price exposure, significant financial flexibility and financial results that are typically tied to production volumes and fee-based contracts. That said, this sub-segment has not been completely immune to Covid-19 related demand shocks or the secondary effects of lower commodity prices. Refined product pipelines transporting gasoline and jet fuel experienced lower throughputs due to travel restrictions and shelter in places, while supply based pipelines are expected to see lower volumes due to production curtailments in major shale basins. In response, many midstream companies
have proactively taken measures to defend balance sheets—such as deferring capital expenditures and reducing equity distributions—highlighting their significant financial flexibility. While credits metrics are expected to weaken in the near term, the midstream space should be able to weather the current environment and as a result, face significantly lower default rates relative to Independent E&Ps and oil field services.

Refining: Refiners are seeing improved demand, but margins remain weak, which can result in weak cash flow and spiking leverage metrics. Most have strong liquidity however, which should position them to weather the downturn. Operating challenges include balancing improving demand for gasoline, as driving personal vehicles is favored over public transit, with continued weak demand for jet fuel, which is causing large inventory builds for jet and diesel distillate products.

Climate change is increasingly in focus. How does this affect your long-term fundamental outlook?

Oil-focused E&Ps and refiners are the most exposed to climate change risk, but we expect the energy transition will take several decades. Having said that, companies are expected to operate with the goal of enhancing energy efficiency, to invest in more environmentally friendly production techniques and to contribute and adapt to the energy transition. Implementing strong carbon reduction targets, and ESG policies and disclosure are examples.

Flat to falling demand will likely limit upside on commodity prices assuming ample supply, so oil and natural gas producers with low-cost assets are the best positioned, including short-cycle shale producers that can scale production to prevailing commodity prices. Given their carbon emission intensity and cost structures, coal and oil sands producers are disadvantaged and face stranded asset risks. Companies also face political, regulatory and judicial risks related to their ability to operate, including stricter permitting and potential carbon taxes, all of which is increasingly a consideration for the sector.

Several large integrated producers have begun investing in the energy transition, de-emphasizing oil at the margin, by increasing investment in cleaner burning natural gas, renewable energy, alternatives, power, and new technologies. The long-term outlook for oil demand is dropping at some of these firms, as are oil price forecasts used for budgeting.

Given weak fundamentals, do you expect default and downgrade activity to persist throughout 2020 and 2021?

Defaults have increased since February as many smaller, higher-levered shale operators and oil field service companies continue to suffer. Several distressed companies have pursued discount debt exchanges of new secured debt for unsecured bonds, which, in many instances, has been resisted by bondholders.

More broadly, we expect corporate defaults will continue to increase as highly levered companies with poor access to capital markets grapple with liquidity issues. However, some of the default activity will likely be pushed out to mid-2021 and beyond, as companies have been able to shore up liquidity in the short term via rescue financing and other opportunistic capital raises.

In addition to higher defaults, the high yield market has also seen a significant rise in fallen angels. These fallen angels have increased the size of energy in the high yield market and improved the underlying asset quality, as many have low breakeven costs. Having said that, most of these companies have high leverage, face upcoming debt maturities and are not well hedged. As a result, asset sales, strong liquidity and/or access to capital markets remain important. There is potential for further downgrade activity, which largely depends on the commodity price assumptions used by rating agencies as they look out over the next few years. The recent commodity price rally should help at the margin, but we believe the risk of additional fallen angels remains elevated.

While risks remain, market dislocation also presents opportunities. The key to uncovering these opportunities, in our view, is to rely on prudent fundamental research and disciplined security selection tactics to identify opportunities and navigate turbulent markets.
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AdTrax: 3139915.1GBL
Exp Date: May 31, 2022

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