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Energy Market Weakness Pressuring Fixed Income Credit Quality

Persistent weakness in energy markets has had significant impacts on credit quality across fixed income markets. The sharp decline in oil and natural gas prices since the Fall of 2014 has eroded the financial performance of companies in the sector. Declining prices have also impacted the revenues of states and municipalities that depend on taxes and fees related to energy production.

Corporate Bonds

The worst impacts to date of energy price declines have been in high-yield corporate bonds, where rapidly increasing default rates in the energy sector have driven a sharp sell-off in high-yield bonds since mid-2015. While the recent rise in oil above \$40 per barrel has stoked some recovery in energy sector equity and bond prices, many small and mid-sized energy sector companies remain under extreme pressure. According to Bloomberg data, approximately 50 oil and gas producers have filed for bankruptcy since January 2015, and the pace of defaults is increasing rapidly. While the dollar volume of defaulted high-yield bonds topped \$37 billion in 2015, a five-year high, the total volume of high-yield defaults year-to-date 2016 has already eclipsed last year's total.

The damage is not limited to junk bonds, however. The high grade corporate market has also been affected. Even the strongest oil and gas companies have now either been downgraded or been placed under review for downgrade. As the rating agencies continue to revise their estimates for energy prices in 2016 and 2017, they will closely monitor company earnings, free cash flows, balance sheet leverage, and debt coverage metrics.

While we believe that there may be value opportunities in the out-of-favor energy sector, Ascent only holds bonds issued by companies that we are confident can maintain strong investment-grade ratings. We believe that income investors are best served by picking strong companies with solid balance sheets that have proven they can successfully manage through commodity price cycles. In addition, bonds from such companies generally remain highly liquid regardless of short-term energy price moves. We also believe that investors can limit risk by focusing on relatively short maturities, which helps to limit both price risk and the risk of material credit erosion should low oil and gas prices persist beyond the 2017-to-2018 timeframe that most analysts currently forecast.

The table below outlines the changes in credit quality over the past 16 months of some of the most widely held energy sector corporate bonds. Notably, many have received multi-notch downgrades. Additionally, all of these companies currently have a negative rating outlook from at least one rating agency or have their rating under review for downgrade.

Senior Unsecured Credit Ratings

| Company | January 2015 | Present |
|----------------------------|--------------|-----------|
| Exxon Mobil | Aaa/AAA | Aaa/AA+ |
| Chevron | Aa1/AA | Aa2/AA- |
| Royal Dutch Shell | Aa1/AA | Aa2/A+ |
| Total | Aa1/AA- | Aa3/A+ |
| Schlumberger | Aa3/AA- | Aa3/AA- |
| Halliburton | A2/A | A2/A |
| BP | A2/A | A2/A- |
| Occidental Petroleum | A2/A | A3/A |
| ConocoPhillips | A1/A | Baa2/A |
| Canadian Natural Resources | Baa1/BBB+ | Baa3/BBB+ |
| Marathon Oil | Baa1/BBB | Ba1/BBB- |
| Anadarko Petroleum | Baa2/BBB | Ba1/BBB |
| Devon Energy | Baa1/BBB+ | Ba2/BBB |
| Transocean | Baa3/BBB- | B2/BB+ |

Sources: Bloomberg, Moody's, S&P

Municipal Bonds

In the municipal market, the effects of low energy prices have been slower to manifest. Due in part to the nature of municipal budgeting and financial reporting, municipal credit ratings have been slower to react to low energy prices than have corporate ratings. Additionally, states and local governments generally have somewhat diverse revenue streams that help mitigate the impact of declines in energy-related revenues. As we noted in our January 2015 comments ("Oil Price Drop Will Have Varying Impacts on Municipals," January 16, 2015), the material impacts on state and local governments from low oil and gas prices vary widely, depending on the specific characteristics of the issuers.

Not surprisingly, the states that have the greatest concentration of revenues generated by energy-sector activities – Alaska and Louisiana – have felt the most significant pain and will continue to feel pressure on revenues from low oil and gas prices. However, we do not believe that there is a significant risk of substantial credit deterioration for any state in the near term. State general obligation bonds and bonds issued through state agencies and backed by legislative appropriations generally have maintained their high credit quality. In fact, such bonds can offer value to investors in the current market environment if investors overestimate the negative impact of low energy prices and yields rise significantly.

The table below outlines changes in credit quality over the past 16 months for states with a significant energy sector presence. Unlike energy sector corporations, rating changes for the states have been limited. Like their corporate counterparts, however, many carry negative rating outlooks, though none are currently under review for downgrade.

General Obligation Bond Ratings

| State | January 2015 | Present |
|---------------|--------------|---------|
| Alaska | Aaa/AAA | Aa1/AA+ |
| Louisiana | Aa2/AA | Aa3/AA |
| New Mexico | Aaa/AA+ | Aaa/AA+ |
| North Dakota | Aa1/AAA | Aa1/AA+ |
| Oklahoma | Aa2/AA+ | Aa2/AA+ |
| Texas | Aaa/AAA | Aaa/AAA |
| West Virginia | Aa1/AA | Aa1/AA- |

Sources: Bloomberg, Moody's, S&P

Local issuer impacts have been more muted to date, though that is beginning to change as well. In March, Moody's placed its ratings on 15 cities and local municipal issuers in Texas under review for downgrade. Because local issuers often rely heavily on property taxes for revenue generation, negative impacts from declining mineral values or corporate and utility property values may take one or two years to begin to be reflected in the tax base and reduce tax levy collections. Those communities that depend more heavily on economic activity – employment, manufacturing, sales and use taxes, etc. – typically are being hit harder and sooner.

Our overall approach to investing in municipal bonds from energy-heavy states remains unchanged. Ascent believes that these states are generally well positioned to weather the storm of oil price volatility. Even with a sustained period of low oil prices, few states are so dependent on the industry that we expect their ratings or pricing to significantly decline relative to the general market. Alaska and Louisiana are likely the most at risk for additional credit downgrades, though we expect both to maintain solid double-A category ratings. West Virginia has been hurt by the extreme weakness of the coal industry, which continues to weigh heavily on that state's economic performance. In contrast, Texas' economy has shown resilience in the face of weak energy prices, with no material deterioration of the state's credit quality.

In contrast to the states, we view local issuers as being at much greater risk for significant credit impacts and pricing declines. Even so, we do not expect rating downgrades or bond defaults to be widespread. While the diversity of local issuers makes it very hard to generalize, those in Texas, New Mexico and North Dakota are most exposed to the effects of the oil boom/bust cycle. We expect that the worst credit effects are likely to be felt in small cities and school districts in Texas, as well as a scattering of municipalities with concentrated local economies and tax bases.

Ascent's research-driven approach to fixed-income investment helps insulate investors from the risks of energy sector-driven portfolio impacts. Because we take a long-term, buy-and-hold approach, we avoid holding bonds that may be exposed to significant negative impacts from persistent weak energy prices.



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