Market Update from Thrivent

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The Department of Labor opened the trading day with another stunning number: 6.6 million new weekly claims for unemployment benefits, which is far higher than last week's 3.3 million. To put this in perspective, weekly claims had been tracking around 200,000. Once again, markets are very volatile but seem to be responding favorably, at least as of this writing, to news regarding oil prices. Oil prices are matching the drama of the employment numbers, surging 25% in early trading, given the optimism that China may purchase large amounts of oil to replenish its reserves and Saudi Arabia and Russia may be arriving at a truce after the very damaging price war they both were waging. However, late in the day Russia issued a cryptic statement that they may be "budgeting" oil at $20 per barrel. This may be a negotiating ploy, but it immediately pushed oil prices—and the market—generally off the highs of the day.

Well before the coronavirus problem emerged, the energy market was struggling with a glut of oil due to declining demand caused by trade friction, changing energy consumption behavior, lethargic global economies and the power struggle between Saudi Arabia and Russia. The coronavirus pandemic, and its dramatic impact on world economies, turned this weak environment into a rout practically overnight. Oil prices dropped over 60% since the beginning of the year before snapping back today. Energy company stock prices have been cut in half, if not more; a few companies have declared bankruptcy; and some energy company bonds are trading (if they trade at all) as low as pennies on the dollar. Although energy is now a relatively small percentage of the stock market, it has a much more outsized impact on the economy due to the high amount of energy related credit that is in the financial system.

The dynamics of the energy situation

The surge in oil prices after the 2001 recession helped create an entire domestic U.S. oil industry centered around fracking and horizontal drilling. Because oil drilling is very capital intensive, a significant amount of debt capital was required to build the industry infrastructure. The economics of this industry were very favorable when prices surged to as high as $140 per barrel in 2008. However, the economics became more dubious around $50 per barrel, and outright abysmal below $40—not to mention the recent $20 per barrel!

The demand destruction caused by the absolute shutdown of the global economy has been devastating to energy producers and to ancillary industries, such as service companies and midstream Master Limited Partnerships (MLPs), that are dependent on producers. Daily auto traffic maps display green, unlike any time outside of Christmas Day. The resulting sharp decline in gasoline consumption has pushed gasoline to under $2 per gallon. Air passenger volumes have dropped by 90%, decimating fuel consumption. During the 2008-2009 Great Recession, global oil demand dropped 4.5% over an 18-month period. This economic shock could result in energy demand dropping by 20% in a matter of weeks.

"The cure for low oil prices is…low oil prices"

This is an old saying in the oil industry. It basically means that such low prices will change industry behavior. Capital will not flow to the industry, new wells will not be drilled, and old wells will be shut down. Furthermore, wells shut down today might not return tomorrow, as sub-surface damage is possible after prolonged disuse. Behavior in the domestic oil industry is changing dramatically as capital budgets are slashed, employment is reduced, and a focus on servicing, if not cutting debt, becomes a priority. This industry response will probably persist until oil prices approach $40-50 per barrel. In short, the economics of supply/demand, combined with the financial demands of credit and capital allocation, will prevail.

This old saying seems to pertain with today's news regarding China, Saudi Arabia and Russia as well. The collapse of the energy market appears to be changing their behaviors as well, although time will tell the final resolution to this geopolitical struggle over oil pricing power. Today's news is encouraging for the energy sector.

Implications

Sustained oil prices in the low $20s will bankrupt dozens of producers including publicly traded firms, but paradoxically, the pain now can lead to a more sustainable industry going forward. Many companies that had funded themselves in the high yield bond market had hedged their risk at about $50, so they have bought some time. However, there are significant debt maturities that will have to be refinanced this year and through 2022. It is possible after this severe downcycle concludes, surviving companies will be far more financially disciplined and attractive to generalist investors. With energy stock and bond prices at such distressed levels, some opportunities are emerging—but it's still early.

Energy bonds of some surviving companies will provide equity-like returns for long-term investors. We are focusing on companies with no refinancing needs until 2025 and that have superior acreage positions which can be developed profitably at low breakeven oil prices. The bonds of some these possible survivors are trading at 50-60 cents on the dollar.

In the equity market, we are targeting quality companies that are well-positioned with superior returns on invested capital, line-of-sight to improved returns, and have trusted management teams. For a commodity-reliant industry, where in the long-run the low-cost provider wins, these characteristics are particularly important. Commodity price risk is inherent for energy companies. We are favorable toward companies that do not layer financial leverage on top of commodity leverage. We have taken advantage of severe price movements among energy equities to further increase allocations to the highest quality companies.

Many individual investors have used Master Limited Partnerships (MLPs) as an income generating vehicle for their portfolios. The MLP market has been negatively impacted on multiple fronts including a sharp decline in growth expectations as well as concerns about counterparty risk (customers not honoring their contracts) as a result of the weak commodity price environment. In addition, poor capital market conditions make it difficult for MLPs to refinance upcoming debt maturities and fund growth spending, increasing the likelihood of dividend cuts and/or slower than expected dividend growth. The operating outlook for larger, more diversified MLPs remains solid. Smaller MLPs with high concentrations in gathering and processing assets in 2nd tier acreage are likely to experience significant volume pressures as producers reduce drilling activity in these regions. Finally, when contracts come up for renewal, there is a risk that pricing will be negatively impacted due to a growing oversupply of capacity resulting from building new infrastructure in high growth regions, especially the Permian basin.

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