Oil has dogged high yield bonds for much of the last 24 months, but its recent stability combined with the industry’s drive to reduce costs has lifted the yoke oil prices once held on the asset class.

- Markit iBoxx $ Liquid High Yield Index spreads have fallen to a third of their crisis highs
- High yield oil bonds have delivered returns of over 30% this year to date
- Current spread premium required to hold high yield oil & gas bonds is now half the level seen when Western Texas Intermediate (WTI) last traded in the $40-50 range

No factor has shaped the high yield bond market more over the last 24 months than the vagrancies of energy prices. The commodity’s plunge from the historically high $100 per barrel to less than $30 during February’s lows saw the spreads of the Markit iBoxx USD Liquid High Yield Oil & Gas Index jump from around 300bps to as high as 1,674bps in February as investors worried about oil & gas issuers’ ability to repay bond commitments made during rosier times. This price driven slump not only made oil bonds the riskiest portion of the high yield universe by far, it also weighed down high yield bonds as an asset class, as bonds issued by oil & gas firms represented 15% of the wider Markit iBoxx USD Liquid High Yield Index prior to the beginning of oil’s fall from grace in October 2014.

However, the last nine months have seen a remarkable turnaround as oil prices bounced back to the $40-50 range which has in turn rekindled the market’s appetite for high yield oil & gas bonds. This resurging appetite has been evidenced by the fact that current spreads...
stand at less than a third of the levels required at their highs in February. This strong rebound has removed oil & gas bonds from their perch as the riskiest segment of the high yield bond universe - a title which they relinquished in the days immediately following OPEC’s September 26th decision to cut output for the first time in eight years.

The comeback witnessed in oil bonds has also translated into very strong returns for investors willing to hold them, as the Markit iBoxx USD Liquid High Yield Oil & Gas Index has delivered an asset class-beating 32.8% year to date on a total return basis. These provided outsized contributions to the 12% returns of the wider Markit iBoxx USD Liquid High Yield Index.

While much noise has been made over the last two years about the link between high yield bonds and oil prices, bond investors have been coming to terms with the new normal in oil price.”

While much noise has been made over the last two years about the link between high yield bonds and oil prices, bond investors have been coming to terms with the new normal in oil price. The current extra spread required by investors to hold high yield bonds issued by oil & gas producers over other non-investment grade universe has fallen to as low as 45bps in the
weeks since the OPEC meeting. The current extra yield required is less than half the extra spread required 12 months ago when West Texas Intermediate (WTI) oil last traded in the $40-50 range.

This increasing willingness to hold high yield oil & gas bonds reflects not only the cost cutting and deleveraging undertaken by the industry in the wake of the commodity slump, but also a growing feeling among investors that while oil will probably not command $100 in the foreseeable future, the prospect of a return to the lows set back in February is dwindling. This consensus is likely to only get stronger in the wake of recent supply reduction steps taken by oil producing countries.

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