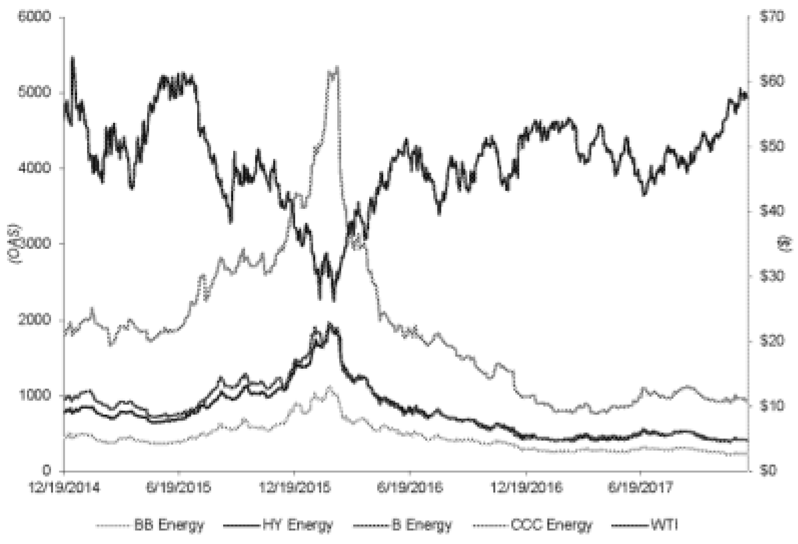
With high quality tight, selective value in lower quality and mid-quality

In our outlook report a year ago, we talked about sticking to Higher Quality oily names given how little extra return was offered for moving out the risk spectrum. As shown below, the Higher Quality names on average have tightened by 61 bps (OAS) while the Mid Quality names have tightened by only 12 bps. This is only partly attributable to outperformance of better quality credits in the broader HY market – the single-B index underperformed the double-B Index by only 26 bps during the period. The HY Energy single-B index has widened only 28 bps vs. the HY Energy double-B index, largely in-line with performance of the broader HY market. The underperformance of the Lower Quality oily names has been starker with the spread gap between the two groups widening by nearly 500 bps. Even excluding EPE (which widened by ~1,500 bps), the underperformance would still be ~280 bps. In comparison, the CCC Index has tightened about 100 bps vs. the double-B index during the last one year. The HY Energy CCC Index also has underperformed, with spreads staying largely flat vs. the HY Energy double-B index.

At current trading levels, we see a positive risk-return payoff for the Lower Quality oily group – besides BBG, all other names offer OAS of between ~800 to ~2,400 bps. First, while downside risks to oil markets continue to be meaningful, the risk of the disaster scenario has come down considerably over the last year (while spreads have widened sharply) as we move one year closer to market rebalancing. Second, we think market is underappreciating the fact most of these names can deliver a stable cash flow model (neutral FCF at maintenance mode) at or below low-$50s oil. Many names have also significantly improved capex efficiency during the year. Third, given the 2018 oil strip has moved close to 2-year highs even as this group has significantly underperformed, there is upside in a tactical sense around the oil-beta credits. We are selectively positive on the Mid Quality names. We like names like WPX and OAS which show superior growth-FCF equations compared to their peers. We acknowledge the top quality core assets of Higher Quality Oily names - but except Parsley (OAS: 248 bps), the other names (OAS: 179-213 bps) already trade inside the broader-BB index and it is therefore difficult to see much further upside.

Figure 5: Historical spread levels: HY Energy, BB Energy, B Energy and CCC Energy vs WTI price movements



Source: Deutsche Bank, Bloomberg Finance LP