Appleton Partners, Inc.

Energy & the Corporate Credit Markets

March 9, 2020

A Supply Shock Hits the Markets

Due to a collapse in Russia and OPEC's supply limitation alliance, a development compounded by global Coronavirus ramifications, already weak global energy markets were driven into a tailspin over the weekend of March 7-8th and in March 9th trading.

West Texas Crude futures fell 25% to $30.89 to open the week, down from as high as $51.90 as recently as March 1st. The last time such a shock occurred was during the Gulf War in early 1991. Unlike that period, Monday's price declines were seemingly much more a function of a supply surge driven by attempts to protect and gain market share rather than weakening demand. That suggests a greater likelihood of price stabilization and modest recovery.

Energy and the Bond Markets

As is typically the case in flight to quality environments, high yield spreads have widened much more than investment grade, the former by nearly 219 bps since the start of the year vs. 49 bps for the investment grade sector.

Energy is a major component of the US high yield market, accounting for 10.82% of the Bloomberg Barclays US High Yield Index at the end of February. Although Appleton's strategies do not invest in high yield bonds, the asset class still demands our attention given its influence on broader credit markets.

The impact of energy sector turbulence has been somewhat muted by an extreme downward move in US Treasuries. Although energy bonds are underperforming on a relative basis, 10Yr UST yields have fallen by nearly 100 bps since the end of January to only 0.55% as of March 9th. While there is variation within the sector, IG energy names have mostly seen positive performance YTD, although returns have lagged the broader fixed income rally.

Appleton's Exposure

Our High Grade Intermediate Government/Credit strategy (HGIGC) has an average credit quality of AA-, and as of March 6th, 5.64% of composite assets were held in the energy sector.

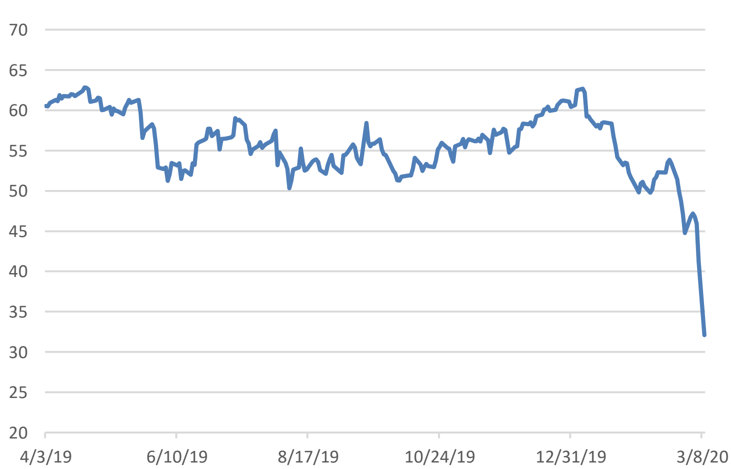
Consistent with our investment process, the energy names we own are predominately very large firms with strong balance sheets and diversified revenue sources. This reflects a longstanding belief that these companies are better positioned to withstand unfavorable market conditions than "single stream" revenue firms and weaker credits.

Additionally, a relatively widespread use of commodity hedging in the exploration and production sub-sector should mute the immediate impact of the sharp fall in oil prices.

Our View on Corporate Credit

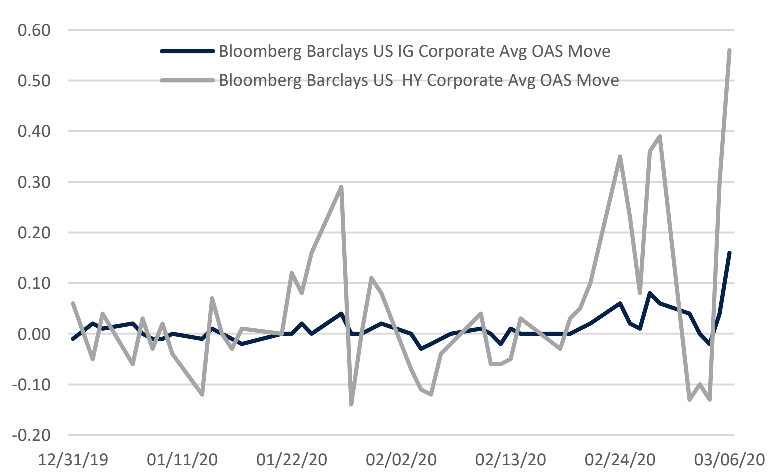
At Appleton, our focus has always been on high quality, liquid, actively traded corporate bonds, with holdings well diversified by sector and risk factor. This will not change. While the energy sector faces considerable challenges, the recent spread widening in investment grade energy bonds appears to be in sympathy with the sector's high yield issues. Investment grade price movement may not necessarily be reflective of the credit strength of larger, more diversified companies. These events highlight the importance of fundamental credit research and prudent diversification within an active, long-term investment strategy.

New York Mercantile WTI Crude Futures ($)



Source: Bloomberg

Investment Grade & High Yield Credit: YTD OAS (%)



Source: Bloomberg