SCALING IMPACT OF OIL PRICE FALL

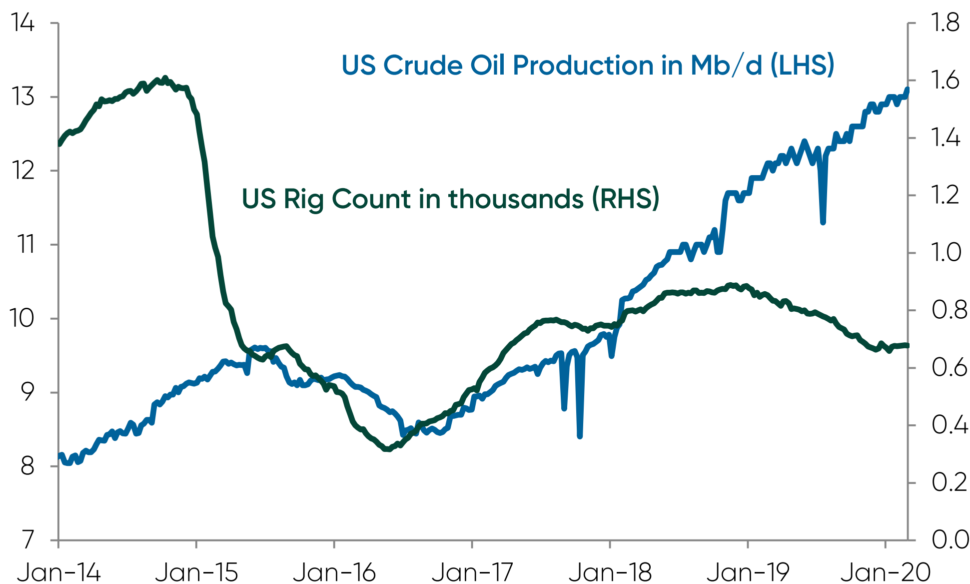
Impacts to the real economy from reductions in capex and employment were manageable from 2014-2016 and likely remain so in the current environment. In terms of country-level winners and losers, the vast majority of countries by market cap and GDP are net importers. Banks remain modestly exposed to Energy loans, and most lending to the sector remains in the form of corporate debt.

For the oil producers, the weakness is primarily among the US small-cap upstream firms. We have modest exposure to that space in US equity strategies, but are generally underweight as we have preferred to focus on quality. The large-cap producers—both integrated and larger exploration and production companies (E&Ps)—generally have much stronger balance sheets. Here, the concern is less about bankruptcy and more about sustainability of dividends. It is worth noting that these firms represent a large percentage of the Energy sector in public markets.

CAPITAL EXPENDITURES

As a percent of non-residential capex, oil, gas, and mining is already near current cycle lows, though the category will likely fall further if oil prices stay depressed. For context, in the first iteration of the price war from late-2014 to early-2016, oil, gas, and mining capex fell from 14% of non-residential capex to 9%. The associated dollar fall in oil & gas capex during that period was -$135 billion, or 38%, though aggregate non-residential capex fell only -$20 billion. However, oil companies have already curtailed capex, doing more with less, which is seen most easily in the falling rig count. (Exhibit 1)

Exhibit 1: Rig Count Trending Lower Since Late 2018



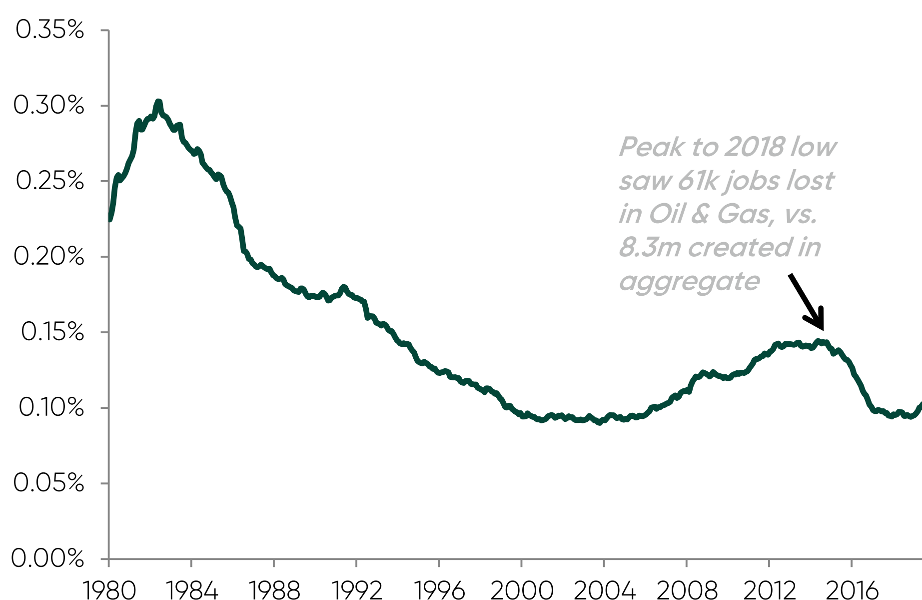
Source: US EIA, Baker Hughes as of 28/2/2020.

Services firms are in a tough spot because they benefit from upstream capex. It is too early for comprehensive estimates, but early estimates from industry analysts expect a fall in capex of ~20%.

EMPLOYMENT

Employment in oil & gas extraction as percent of non-farm payrolls is similarly near cycle lows. During the 2014-2016 period, employment in the space fell by 14,000 jobs. The low point was February 2018, in which 61,000 jobs were lost with in a 2 year period. In the same span, 8.3 million jobs for all other industries were created in aggregate. If the gains since the February 2018 lows were reversed from here, it would result in 16,000 jobs lost in oil & gas extraction. As seen in exhibit 2, the percentage of Oil & Gas jobs has been trending lower since late 2018.

Exhibit 2: Oil & Gas Extraction, % of Non-Farm Payroll



Source: US Department of Labour as of 28/2/2020.

IMPACT TO BANKS

Most banks have relatively small percentages of loans to the Energy sector. Of the money centre banks, JPM is highest at 2.8%; including mining, all are below 5%. Additionally, most large banks have significantly fewer Energy loans outstanding now vs. 2016, the last time this was a common concern.

Exhibit 3: US Money Centre Bank Energy Exposure

	JP Morgan	Bank of America	Wells Fargo	Citibank
Energy Loans as % of Total Loans	2.8%	1.7%	1.4%	-
Energy + Mining Loans as % of Total Loans	3.8%	4.4%	3.1%	4.5%
Common Equity Tier 1 Ratio	12.4%	11.2%	11.1%	11.8%
Nonperforming Loan Ratio	0.33%	0.61%	0.65%	0.57%

Source: Company Financials as of 31/12/2019, JPM and HSBC figures are estimates based on adjusted wholesale loan exposures

IMPACT ON BROADER CREDIT MARKETS

The majority of global Energy company debt is in the form of corporate bonds, both investment-grade and high-yield. Loans make up an estimated 23% of outstanding debt, however, this figure accounts only for loans that trade on a secondary market and thus is not inclusive of all loans on a bank balance sheet, some of which are not easily traceable. By rating, many current investment-grade (IG) bonds are likely on the verge of being downgraded to high-yield (HY) status. $260 billion in IG debt is rated Baa1 to Baa3, and could see downgrades, which would tip the distribution to be majority high-yield.

Exhibit 4: Global Energy Debt

	Outstanding	Distribution
IG Bonds	$422	57%
HY Bonds	$149	20%
Loans	$169	23%
Total	$741	100%

Source: FactSet Universal Screener, 09/03/2020, includes loans trading on a secondary market only.

By maturity, a minimal amount of Energy bonds are due in the next few years.

Exhibit 5: Energy Bond by Maturity Year ($M)

	Loans	IG Bonds	HY Bonds
2020	11.4	16.3	7.5
2021	29.5	23.3	6.8
2022	28.3	35.5	15.7
2023	29.8	30.1	15.4
2024	25.6	31.9	16.0
2025	11.4	27.5	25.3
>2025	33.5	262.6	67.2

Source: FactSet Universal Screener, 09/03/2020, includes loans trading on a secondary market only.

With low money centre bank exposure to Energy loans, most energy debt being corporate bonds, and a benign maturity schedule over the next two years, systemic risk seems manageable and not meaningfully worse than in 2016. From a macro perspective, there is no reason to believe the financial weakness of US Energy firms poses a larger risk to US oil output—the most strained producers account for a modest percent of US production.

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