# Nordics – DNB Insights

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## A look at the correlation of high-yield bonds, stocks and oil prices - April 2016

The oil price is a hot topic in the financial sector. Since the financial crisis of 2008/2009 nothing seems to be the same in oil sector. The oil price experienced a massive upward movement since 2004 and has topped in prices of more than USD 140 per barrel in July 2008. At this time many have ruled out a price below USD 100 in the future, one has rather expected rates beyond 200 USD. After the collapse of Lehman Brothers and the subsequent financial crisis, oil prices plunged again to the range of 40-50 USD.

This period lasted not long, in 2009 again 80 USD were paid for a barrel of crude oil. In 2014 oil fluctuated in a range between 80 and 120 USD again. This phase of sideways movement was considered as the new normal by many analysts, the market got used to prices above 100 dollars. The fall of prices began in July 2014, the low has been marked with a little more than 26 USD in February 2016. Major market fluctuations often have one or more reasons. These reasons may not be dealt with in this article. Geopolitical risks, overcapacity, strategic production adjustments, new technologies, reduced consumption, at least in parts of the Western world, and many reasons more play an essential role. In addition to the causes of the decline in prices one should also note the consequences.

Crude oil is an essential and indispensable raw material for a consumer-oriented industry. Price fluctuations have major impacts on producers and consumers. In financial markets the price of oil plays an essential role. In this context one should remember that the price oil for several decades moved sideways until the end of the 90s and was not particularly volatile. This period was more normal in comparison to the volatile past 10 years and many investors displace this fact. What does this mean for investors? Investors allocate their capital for generating future income. In a normal environment with positive growth prospects, a normal and rising yield curve and low volatility an allocation of capital among different assets is reasonable and possible. A well-diversified portfolio protects the investor against individual risks. However, one can show that the correlation between different asset classes tends to increase in periods of very high volatility. During periods of heavy losses and sell-off scenarios all asset class prices decline. But what about today? High Yield Bonds and stocks have shown a similar performance in the past, the correlation between the two asset classes tends to be easily observed. Clearly, for high yield investors as well as for equity investors, the financial situation and the future cash flows of a company are relevant. The future cash flows are determined by the business as well as by the conditions. The different sectors within an asset class can develop in different ways. In the following I would like to explain how the price of oil had an impact on the development of different asset classes and in various sub-sectors. As described above, oil is in a downtrend since July 2014, currently a bottoming could emerge. It is interesting whether there is a correlation between the decline in oil prices and asset classes. Figure 1 shows the development of different sub-sectors of the S&P500 index and the price of oil. With the drop in oil prices from mid-2014 clearly a decline of energy and industry sub-sectors can be identified. Both sectors developed worse relative to the S&P500 index, the technology sector, for example, much better.
How developed High Yield Bonds in the same period?


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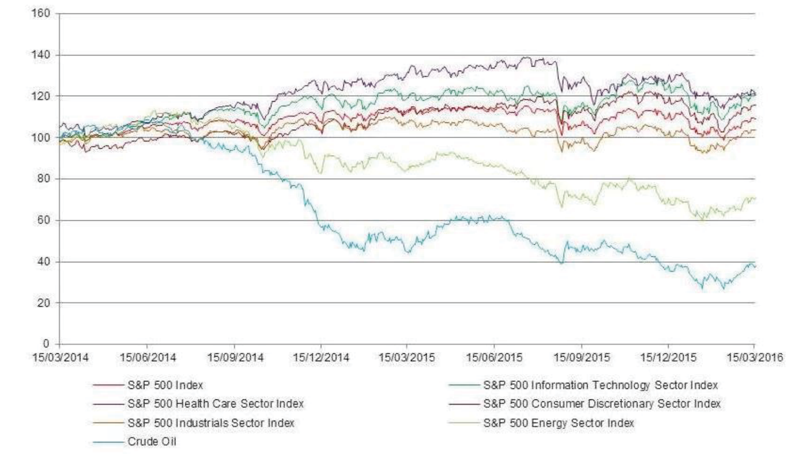


Figure 1. Source: Bloomberg 16.03.2016

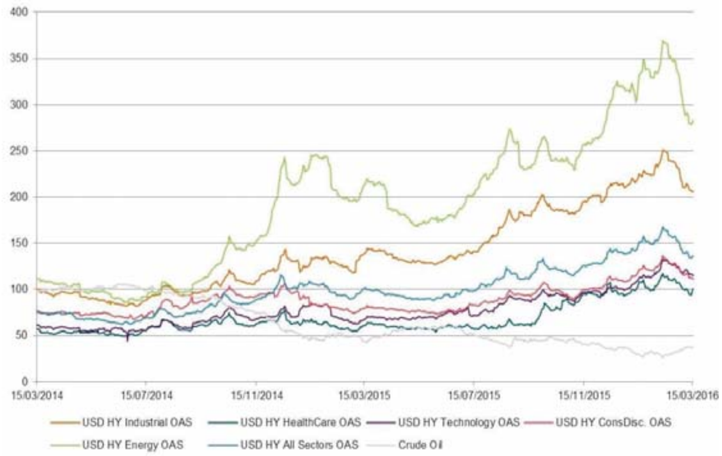


Figure 2. Source: Bloomberg 16.03.2016

The option adjusted spreads of USD high yield bonds in the subsectors energy and industry have widened since the mid of 2014. At the same time, the spreads of other selected sub-sectors have developed more or less sideways until autumn 2015, thereafter one can see a slight widening. The question of whether there is a correlation between high yield bonds and the oil price can be answered from this data as follows: Parallel with the decline of oil prices, the studied oil price-sensitive sectors of the S&P500 Index and option adjusted spreads of USD high yield bonds underperformed the overall market. However, and this is a result of the analysis, the remaining sectors had developed equally or even better than the market. The drop in oil prices so far had an impact on certain subsectors. This result was expected since a lower oil price leads to lower cash flows for oil producers, oil related firms and many industrial companies. We will see restructuring and defaults in oil-price sensitive subsectors, however, a majority of companies will arrange themselves with lower prices. Investors who see this connection and invest accordingly can speculate on a recovery of oil prices by taking advantage of the high spread levels and the underperformance of energy stocks.

Due to the massive drop in prices of oil, the market tends to overshoot. Very high spread levels and low stock prices could be a good entry point for investors. The fact that the other sectors have developed similarly to the overall market shows that the market is not overvalued or undervalued. In the oil price-sensitive environment outside the USD, quite attractive investment options can be found. The European and especially the Scandinavian High Yield markets show high spread levels in some sub-sectors. Parallel to the decline in oil prices, the Norwegian currency came under pressure. Investors who want to speculate on a recovery in oil prices should look at these markets in detail, because the equation that a low oil price is accompanied by a general spread widening of High Yield Bonds applies only conditionally.



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