AAM Insurance Investment Management

Energy Commodities, Geopolitical Shifts, and Fixed Income Valuations: Assessing Risks and Opportunities

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Energy commodity prices have increased in recent weeks due to geopolitical developments, particularly from the U.S., as well as unusually cold weather. These conditions have not changed fundamentals enough to warrant a change of fixed income energy valuations – we believe energy is fair relative to industrials, but there are nuances for the subsectors. Nevertheless, there have been some new issue opportunities in the energy sector that AAM has been involved in and anticipate more new issues from high-quality, low-beta companies in the upcoming year.

Recent Energy Commodity Developments

The price of oil rallied nearly 20% from early December 2024 largely due to the outgoing Biden administration's January 10, 2025 announcement of sweeping sanctions targeting the Russian energy sector, including 180 vessels and dozens of trading houses involved in the Russian energy trade, the largest Russian insurance firms providing coverage to vessels transporting Russian energy, as well as producers Gazprom Neft and Surgutneftegas[1]. Estimates are that the vessels targeted by the new sanctions transported just under two million barrels of oil per day in 2024 or 25% of Russia's exports and just under 2% of total world supply[2]. In recent days, the price of oil has given up some of the recent gains due to the Houthis announcing they will stop targeting US and UK ships and tankers in the Red Sea following the Israel-Hamas cease fire agreement.

1 RBC Global Commodity Strategy (January 2025)
2 Goldman Sachs Commodities Research (January 2025)

As we head into the new year, there are a number of supply side uncertainties for oil. Will the Trump administration maintain these new sanctions on Russian exports? Will the new administration implement sanctions on Iranian and Venezuelan exports like the last term? Will there be new 25% tariffs placed on Canadian oil imports? In aggregate, these exports represent just under nine million barrels per day in the context of a world consuming about 104 million barrels per day. We believe that the sanctions and particularly any tariffs on Canadian exports would be inflationary for U.S. consumers. Midwest refineries and consumers would be especially hard hit by tariffs on Canadian oil as they consume about three million barrels per day of Canadian exports.

In recent days, the Trump administration issued executive orders declaring a National Energy Emergency and Unleashing American Energy. We are skeptical that these orders will lead to greater domestic supply of oil. Exploration and production companies are far more disciplined in 2025 than they were in 2015/2016. Reinvestment rates (capex / cash flow from operations) for these companies have declined from an average of ~125% in 2015-19 to ~50% in 2021-24 due to executive compensation incentives. The average weighting of free cash flow (cash flow from operations less capital expenditures) has risen by >3x since 2019, while production growth targets have been de-emphasized[3].

Natural gas prices have increased 28% over the past month due to increased demand and more exports. This is the coldest January in 10 years, which has led to greater demand from residential and utility customers for heating needs. Additionally, two liquefied natural gas (LNG) facilities began operations in late 2024, which contributed to LNG exports reaching an all-time high of 15 billion cubic feet per day. Exports are expected to rise more than 15% in 2025. As expected, The Unleashing American Energy executive order will restart reviews of applications for LNG projects, which we believe will lead to greater exports in 2027-2029.

Valuations

Stable fundamentals have contributed to the fixed income Energy sector trading between 110% and 120% of Industrials over the past year. The Energy sector currently trades about 93 basis points over Treasuries compared to Industrials at 78 basis points, while having similar duration and rating characteristics. We believe Integrateds, a high-quality, low-beta subsector can offer the best relative value within Energy. Historically, this subsector has traded 30-40 basis points inside of Industrials, compared to 13 basis points currently.

Recent New Issue Activity and Expectations

Five investment grade energy issuers priced just under $6 billion of debt in the past month. We believed two of the issues could offer value to investors seeking yield. In general, new issues in the Energy sector have been well received, especially longer-dated bonds. We expect issuance to be robust from high-quality, low-beta Integrateds like Chevron, Shell, Total and Exxon Mobil in the upcoming year. These companies have meaningful refinancing needs and have already achieved debt reduction goals.

3 Morgan Stanley: Oil & Gas Exec Comp & Consolidation (June 2024)

Patrick McGeever *is a Principal and Senior Fixed Income Credit Analyst at AAM with 28 years of investment experience. He is responsible for the analysis and recommendations of investment grade and fallen angel Energy credits. Prior to joining AAM, Patrick was a Senior Vice President at Deerfield Capital Management. Patrick earned a BBA in Finance from the University of Iowa and an MBA in Finance, Economics and Accounting from the University of Chicago.*