Big Oil's terrible day: Bond market (lack of) reactions

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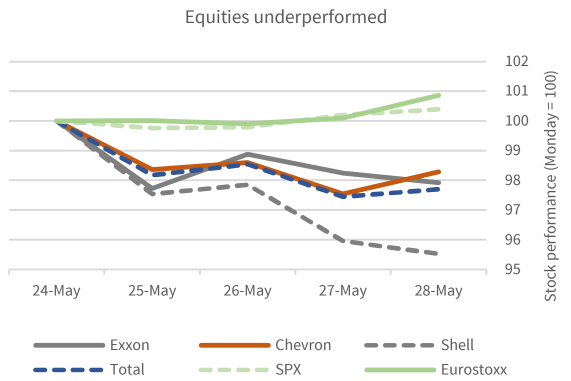
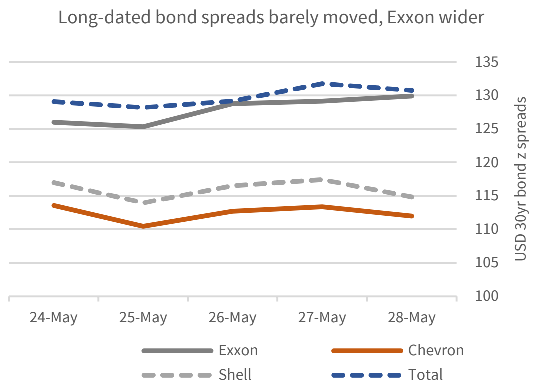
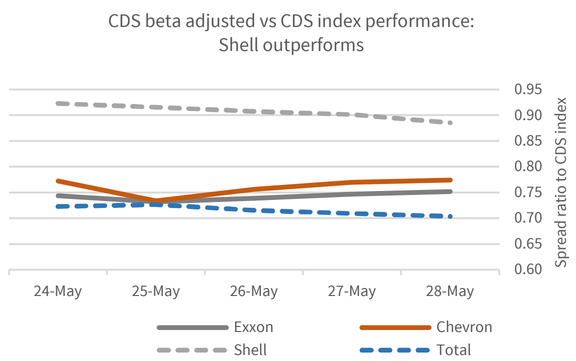
The Financial Times Energy Source newsletter called it "Big Oil's Terrible, Horrible, No Good, Very Bad Day." The core events of May 25th were a successful challenge to Exxon management to place more climate aligned representatives on the board, Shell losing a court case in the Netherlands and forced toward sharp CO2 reduction targets, Chevron's board losing out versus a climate activist proposal, and Total seeing off another climate proposal. Market observations:

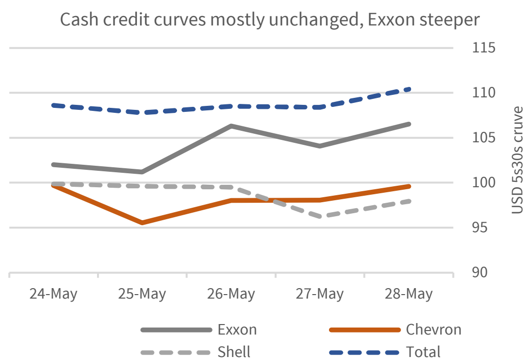
- The companies' equities underperformed by 2-4.5% versus indexes. Most noticeable was Shell with the main underperformance after the Wednesday court ruling.
- Fixed income did almost nothing, in terms of outright spreads as well as curve shapes. If we really trust the data – a clear if – we can say that Shell outperformed in CDS, ca. -2.5bp over the week, and -2bp on 30yr cash bonds. Exxon 30y bonds widened +4bp and its 5s30s curve steepened roughly the same amount.

We find the relatively small reactions – they border on statistical noise - in bond space intriguing. For actionable ideas, we opine that investors should underweight Shell long-dated USD bonds.









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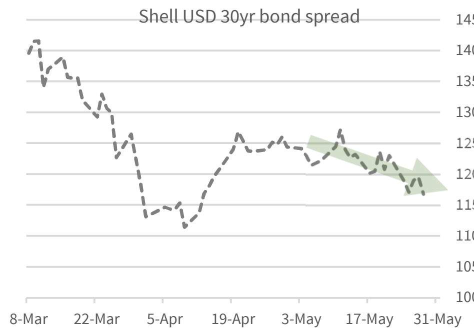
Further comments

We see a couple of different potential arguments for the (lack of) action in credit relative to equities around last week, in general and for the Shell bonds specifically.



- **Fixed income had already repriced** following the IEA report the week prior, or through other means. However, a closer look at the data does not support this. E.g. 30yr Shell paper[1] tightened from around 120-125bp to 117bp in a fairly linear trend over the month of May.
- **Fixed income investors do not believe these new company trajectories are credible, and/or will not affect credit quality even in the long-run**. But it is hard to see why Shell equity would sell off and why it would not affect credit valuations on the very long end.
- **Fixed income investors might buy Shell bonds on the back of "oil bond of last resort."** This argument goes as follows: given the exogenous constraints on CO2 emissions thrust upon Shell, it may be the only investable oil major for climate aligned investors out there. Hence, the company could see an inflow of investors. But the question arises why the equity market should not see the same dynamic? The equity sell-off and the Shell tightening does seem counterintuitive in this context.
- **Fixed income investors are not aware, or care, about these new developments.** When reviewing the top holders of the long dated Shell benchmark 30yr paper, the traditional investors such as PIMCO, Vanguard, Wamco, BlackRock, AXA Life Insurance, Capital Group, Manulife, conglomerates of US Insurance companies and Fidelity form a core group owning more than 20% of the outstanding bonds.[2] It is not, according to AFII's experience, completely improbable that these investors are ignoring the Dutch court ruling right now.

Is this a trading opportunity?

The court ruling "against" Shell superficially increases long-term risks for the company, as reflected in the negative move on the equity side. We believe, however, it is a credit supportive factor for the company in the longer run as it will be forced to start with a proper energy transition strategy ahead of others. But in the short term, this is likely to be swamped by negative valuation implications, for example by rating downgrades due to deteriorating credit metrics when rebuilding the business model.[3] **Hence, we believe benchmarked investors should consider underweighting long-dated Shell bonds in their portfolios as this revaluation plays out.** Please contact the AFII team for further ideas in that capital structure.

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[1] We have used the RDSALN $3.25 04/50 bond (ISIN: US822582CH36) as "Shell 30yr" benchmark.

[2] This refers to the RDSALN $3.25 04/50 but a similar ownership structure is also present in other long-date bonds such as the RDSALN $3.125 11/49. There is also a long-dated GBP bond RDSALN £1.75 09/52 which widened marginally during the week.

[3] Few business models can be as strong as the traditional oil major model, where private revenues are generated from extraction and the negative externalities from emissions are socialised. We believe it is unlikely that any renewable energy model can ever become as beneficial as there are much less of negative externalities to implicitly profit from.

We note that there is fairly strong historical relationships between equity momentum and credit spreads that can be used for positioning purposes, cf. "Alpha generation in volatile times"[4]. If the negative momentum around oil names vs the markets holds up, this would suggest a potential for bond spread catch-up in the intermediate term.

References

"Defeats for Big Oil mark 'sea change' in climate battle", Financial Times, 27 May 2021.
"ExxonMobil and Chevron suffer shareholder rebellions over climate", The Guardian, 26 May 2021.
"Total secures shareholder backing for controversial climate strategy", Environmental Finance, 28 May 2021.

[4] Erlandsson and Rennison, Barclays Capital Research (2008). Further details on the model available upon request. A downloadable example is available in p. 128ff. in the "CDS Curve Trading Handbook", Rennison et al., Barclays Capital Research, 2008, where the Dynamic Indicator of Equity Momentum (DIEM) model is applied.

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