Corporate bonds

MLP bonds: Attractive coupon "stream" update | 16 August 2017

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- MLP debt has been a strong segment of the IG market when performance is measured on a YTD basis but this segment has underperformed since we launched the theme in late February.
- MLP bond spreads remain at about the same level as when we launched the theme, while IG index spreads have compressed by 8bps. At a 50bps advantage, MLP bond spreads have only been wider than the IG index about 20% of the time over the past twenty years.
- We believe that an improvement in fundamentals and more stable oil prices should lead to better performance. We make no change to the highlighted bonds as we believe these issuers offer attractive yields and solid fundamentals.

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Theme recap

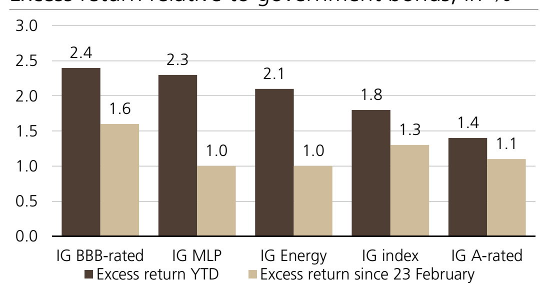
We launched the fixed income theme "MLP bonds, Attractive coupon stream" at the end of February, as we identified this sector as offering attractive coupon income in an environment where IG credit spreads are expected to trade sideways. The average credit quality of the pipeline segment is rated BBB, fitting the "down in quality bias" trend that should occur as stronger economy and pro-risk environment should favor lower rated issuers. We also viewed the fundamental profile of the MLP (midstream) sector favorably due to the fee based nature of their businesses and the fact that many issuers have been improving their balance sheets in an effort to maintain IG ratings. For example, when Plains All American (not on our list) recently announced another cut to their distribution, they cited a commitment to maintaining a strong capital structure and investment grade credit ratings.

After having been overly aggressive in the lead up to the commodity price downturn, midstream energy companies are generally employing more conservative financing policies. This includes reducing leverage and improving distribution coverage. To implement the theme, we highlight the bonds of five midstream issuers that screen well as offering both attractive yields and solid fundamentals.

Bad timing on theme launch

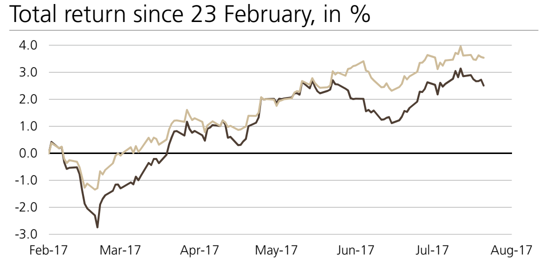
The basket of bonds that we use to measure the theme's performance has underperformed its benchmark (IG index) by 100bps since we launched the theme on 23 February. When measured from the beginning of the year, however, these bonds have outperformed the IG index by 29bps. MLP debt benefited

Fig. 1: BBB bonds outperforming YTD
Excess return relative to government bonds, in %



Source: BAML, UBS, as of 14 August 2017

Fig. 2: MLP bonds underperforming IG index since late February theme launch
Total return since 23 February, in %



Source: Bloomberg, UBS, as of 14 August 2017 from the optimism that was prevalent early in the year that Trump's policies could include an infrastructure component. Hopes have since faded that the Trump administration will be able to push through tax cuts or higher infrastructure spending anytime soon.

Another factor that contributed to the theme's relative underperformance has been the high correlation that MLP bond credit spreads have exhibited with oil prices. WTI was trading around USD 55 at the time of the theme's launch and declined to a low of USD 43 in late June. Even with the recovery, prices remain over 10% below beginning of year values. This stems from the slow pace of global inventory declines that have been witnessed along with concerns on rising US production. These are factors which CIO deems to be transitory but nonetheless the market may remain skeptical on the pace of rebalancing, which could weigh on sentiment.

The correlation between MLP credit spreads and oil has been high but this stems largely from the indirect exposure that midstream partnerships have to commodity producers. When compared to IG energy producers, MLP bonds exhibited lower sensitivity to oil prices during the peak of the oil stress from late 2014 to early 2016. Many of the contracts that midstream partnerships engage in are fee based but lower oil prices can raise concerns over the ability of counterparties to meet the terms of their contracts. To the extent that midstream companies continue to strengthen their balance sheets to be better prepared for a downside scenario, this should help lessen the correlation that MLP bonds have with oil prices, in our view.

Theme drivers still hold

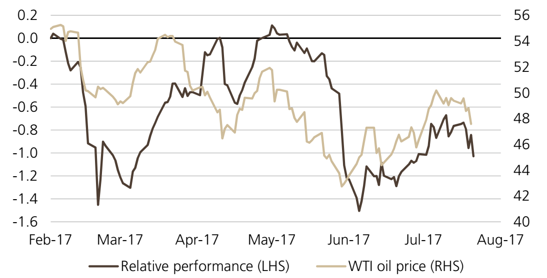
Midstream issuers as a whole have been improving their credit profiles by reducing leverage and improving distribution coverage with strong incentive to maintain investment grade ratings. These more conservative financial policies are being adopted at a time when business conditions for midstream companies are improving. Increasing crude oil and natural gas production activity, particularly in the Permian and the Marcellus shale formations, as well as growing demand for natural gas and natural gas liquids in the US, will likely drive the need for additional energy infrastructure expansion over the next several years.

From a valuation standpoint, IG MLP bond spreads are currently at 166bps, which is roughly the same level as when the theme was launched. IG index spreads have tightened 8bps since late February, which has increased the spread advantage that IG MLP bonds have over the IG index to 50bps. MLP bond spreads have only been wider than the IG index about 20% of the time over the past twenty years.

When compared to oil & gas companies (147bps), IG MLP bonds remain about 20bps wider which is the same differential as when we launched the theme and this in line with historical averages. Combining the improving fundamentals and the attractive credit spreads leaves MLPs well-positioned looking forward, in our view. In addition, without much policy success being priced into MLP debt, this leaves room for upside should progress on the infrastructure side of the agenda gain momentum next year. CIO's outlook on oil prices also remains constructive as the rebalancing in the global oil markets should support higher oil prices.

Fig. 3: Theme's relative performance has been correlated with oil prices

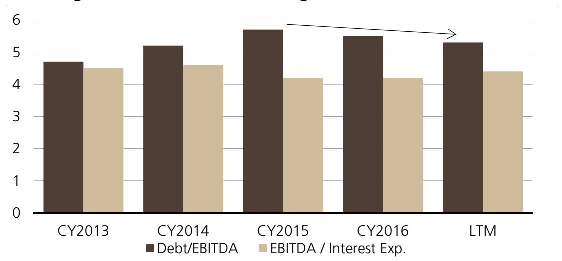
Relative return (LHS), in % and WTI oil price (RHS), in USD



Source: Bloomberg, UBS, as of 14 August 2017

Fig. 4: Fundamentals for MLP debt issuers are improving

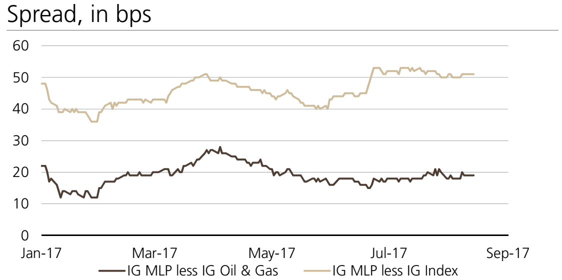
Leverage and interest coverage ratios



Source: S&P Capital IQ, UBS, as of 2Q17 LTM. Chart shows aggregated metrics from thirteen IG MLP issuers with the most debt outstanding

Fig. 5: MLP bond spreads have widened vs. the IG index

Spread, in bps



Source: BAML, UBS, as of 14 August 2017

Appendix

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