MARKET COMMENTARY

Energy Sector

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Ariel Bezalel started his career at Jupiter and has been a member of the Fixed Income team since 1998 and a fund manager since 2000. He is currently Head of Strategy, Fixed Income and manages the Jupiter Strategic Bond Fund and the Jupiter Dynamic Bond fund (SICAV).

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The listed British investment manager with boutique-like investment approach, located in London and founded in 1985, employs more than 400 employees worldwide (thereof about 35 fund managers). Today Jupiter is one of the UK's most respected asset management groups. „The Jupiter Global Fund SICAV" (a Luxembourg based UCITS structure) provides clients outside the UK access to the diverse investment capabilities through its 29 sub funds which are registered for distribution in several European countries. Jupiter's total AUMs are GBP 45.9 bn as of 30 June 2019.

The energy transition and its impact on credit markets

A sea change in energy demand and supply is underway, driven by the disruptive forces of technological changes and global efforts to move away from a reliance on fossil fuels. How will this theme impact the Jupiter Fixed Income team's credit positioning in the unconstrained bond strategy?

The energy transition is already having a profound effect on global energy markets as renewable energy and global efforts to move away from a reliance on fossil fuels affect both energy demand and supply. This long-term secular shift is gathering pace driven by the disruptive forces of new technology, concerted policy action and environmental concerns. While Jupiter's Credit Research Team primarily analyses investments on a case by case basis, we are alert to the potential impact of this long-term theme on our clients and the positioning of our sector analysts incorporates our views on energy transition and its potential impact across multiple sectors.

What is the energy transition?

Globally, the cost of renewable power generation continues to fall precipitously to the point where wind and solar can be the most cost-effective options available. Coupled with high levels of regulatory support towards renewable projects, which often benefit from government subsidies and guaranteed offtake agreements, this economic shift increases the risk that fossil fuel assets (both proven reserves and installed generation capacity) could become stranded in the coming years if renewable energy supply grows faster than previously expected.

How are we positioned for the risks and opportunities created by the energy transition?

In the power sector, the structural decline of coal versus growth in renewables is a key theme in our credit selection. We have a very negative view on thermal coal, even in emerging markets where it currently remains dominant, as we observe that the same structural issues are present albeit on a more distant timescale. In contrast, we see significant investment opportunities in emerging markets such as India, Argentina and Eastern Europe which are rolling out renewable energy programmes.

These views also shape our positioning in the mining sector, where we avoid products in structural decline, such as thermal coal, in order to minimise stranded asset risk. Growing investor aversion to thermal coal in particular is evident in the US high yield market where investor aversion on ESG grounds has significantly increased the risk that coal miners will be unable to refinance their bonds, even at the attractive valuations on offer.

In global oil markets, where road transportation represents approximately half of global consumption, increased vehicle fuel efficiency and the impact of electric vehicles have led to forecasts that global oil demand may peak earlier than previously expected, perhaps as soon as 2030. This macro view influences our credit selection approach in the oil and gas exploration and production sector, to which our exposure in our global unconstrained bond strategy is currently less than 3% of the portfolio. We currently prefer short duration instruments and have invested in bonds with maturities of less than five years which in our view reduces our exposure to energy transition risk. We select issuers with cost-advantaged operations, either through low-cost production assets or labour costs, which are likely to be more resilient in a rapid energy transition scenario.

Management quality is a crucial differentiator in the high yield space. We routinely engage with management teams both before and once invested to understand their approach to capital management. We look for companies with robust commodity price hedging programmes to reduce downside risk and management teams who favour capital preservation and balance sheet deleveraging over shareholder distributions. Management quality is especially important in an environment where the US shale boom of recent years appears to be slowing and credit quality deteriorating. In recent years, many US shale operators have lacked a disciplined approach to capital management, pursuing share buybacks even while their operations have been persistently free cash flow negative. This is changing as bondholders demand a focus on cash preservation and deleveraging.

Energy transition themes and the possibility of tougher regulatory measures also feed into our views on industrials, where we are cautious on companies with highly energy intensive business models and are very underweight 'traditional' industrials such as generic steel producers. We incorporate the impact of higher input prices into our models and consider

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risks around carbon credit costs. This is an evolving area of our research and we are currently considering potential investment ideas among industrials with more resilient business models, such as companies with upstream integration into clean power generation.

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