SEI New ways. New answers.®

Oil Slump Casts Shadow on AK, LA, MT, NM Munis

NOVEMBER 2017

Pete Bednarek
Senior Portfolio Manager
SEI Fixed Income Portfolio Management

SEI Fixed Income Portfolio Management (FIPM) manages fixed-income strategies for SEI's Managed Account Solutions (MAS).

Snapshot

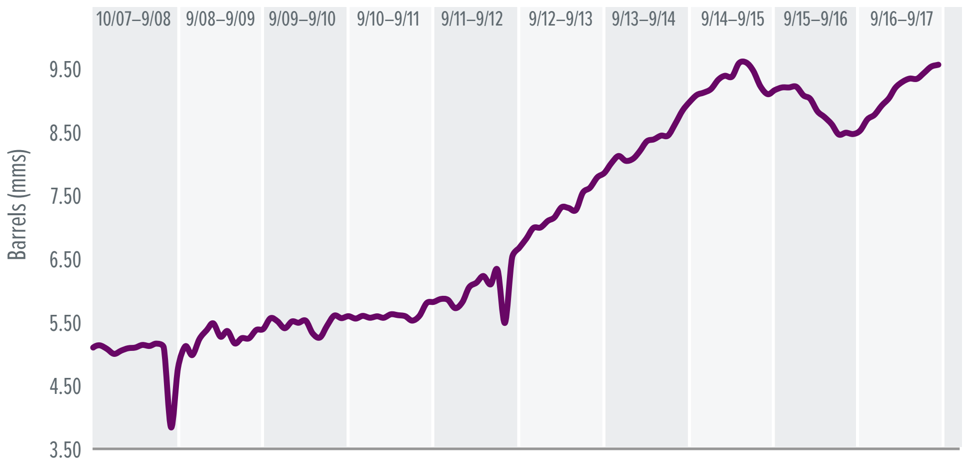
- Despite finding a level of support in 2017, oil prices remain well below their 2012 levels.
- The decline in oil prices has negatively affected oil-related revenues for oil-producing states, including Alaska, Louisiana, Montana, New Mexico, North Dakota, Oklahoma, Texas and Wyoming.
- While SEI FIPM feels there is not a lot of potential for default on general obligation bonds in these states, we anticipate the potential for future volatility.

When oil prices decline, as we have seen during the past two-and-a-half years, consumers of gasoline, diesel fuel and heating oil stand to benefit. States not reliant on oil production also benefit as consumers are able to spend more of their income on other goods and services. The decline in prices, however, negatively affects revenues for oil-producing states. This has a knock-on effect for municipal markets in these states. Alaska, Louisiana, Oklahoma and New Mexico are examples of this, as they have seen their state general obligation (GO) bond credit ratings cut within the past two years.

Too Much Supply

The challenges all stem from the basic economic idea of too much supply and not enough demand. On the supply side, we have seen growth in North American production almost double since 2007 (Exhibit 1).

Exhibit 1: U.S. Oil Production



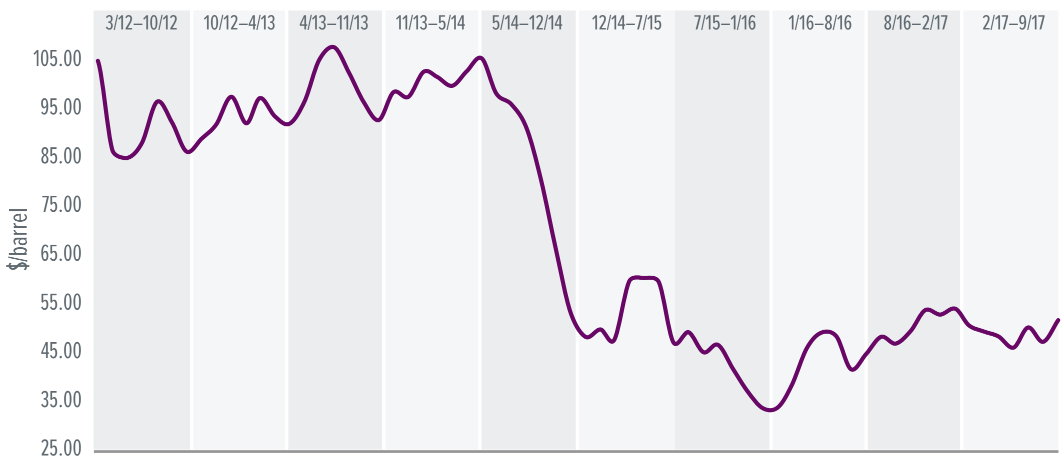
SOURCE: Bloomberg, EIA.

According to the EIA, about 9.5 million barrels per day of oil was produced in the U.S. in September 2017, about half of which was produced directly from shale oil resources. As technology has improved, the growth in shale oil production has added to supply.

Not Enough Demand

On the demand side, European economies are still relatively weak, China's growth has slowed and motor vehicles are becoming more energy-efficient. In the U.S, demand continues to rebound from a two-decade low in 2013. Prices have moved lower with the decrease in demand. Despite finding a level of support in 2017, oil prices remain well below the $100 per barrel level seen in 2012 (Exhibit 2). Oil prices are expected to stay in a $48 to $51 a barrel range barring an unforeseen geopolitical event that drives prices higher.

Exhibit 2: WTI Cushing Crude



SOURCE: Bloomberg.

Low Prices Drill States

When oil prices rise, municipal bond markets in oil-producing states like Alaska, Louisiana, New Mexico, North Dakota, Oklahoma and Texas benefit because employment and tax revenues also rise. Higher prices mean more activity in the oil fields, which helps local service businesses, construction firms, small hotels and car and truck dealerships. There is a positive effect on local governments as well. The reverse is true when prices fall.

State Updates

SEI Fixed Income Portfolio Management holds bonds in Alaska, Louisiana New Mexico and Oklahoma. An overview of how the oil price decline has affected the bonds in these states follows.

Louisiana

The state's GO bonds were downgraded by S&P in March because of the decrease in personal and corporate tax revenue from the oil and gas industry slowdown. The state also experienced a decline in reserves over the last few years which created a budget gap. While the Louisiana economy somewhat stabilized in 2017 as the unemployment rate dropped to 5.3%, the governor and the legislature have been at odds as to how to address the oil-decline-driven deficit and failed to agree on a plan during the 2017 legislative period. Eventually, a compromise will need to be made.

Oklahoma

Driven by weaker oil and gas industry revenues, Fitch downgraded Oklahoma's GO bonds in July from AA to AA-. Fitch indicated that "the state has been unable to address its fiscal challenges with structural and recurring measures and revenue collections continue to reflect subdued energy prices." On a positive note, Oklahoma's unemployment rate dropped to 4.4% last year, and it has a low amount of outstanding debt. Also, its pension liabilities are lower than Louisiana, Alaska and New Mexico.

Alaska

In July, both Moody's and S&P downgraded Alaska's GO bonds. Alaska was forced to draw on its reserves the last few years and it now has a $2.5 billion budget deficit that it must close. The governor and state legislatures have yet to agree on a plan to address the structural imbalance. A few years ago, oil revenues accounted for 90% of state revenue; for the 2016 fiscal year, oil revenue made up just 70% of all revenue for the state.

New Mexico

New Mexico saw a drop in tax revenue in 2016 and 2017. GO bonds were downgraded because of the depletion of general fund reserves. New Mexico's economy has a higher-than-average concentration of oil and gas production. The unemployment rate is at 6.3%, an improvement from 6.7% in 2016. The slow recovery in the oil sector should continue to provide job and revenue growth, but oil is not expected to appreciate to its 2014 levels soon, and another public- or private-sector industry will need to help fill the gap from lost revenue.

Our View

Despite the recent downgrades and negative headlines in oil-producing states, we do not expect further downgrades in the near term. Over the last few years, spreads on GO bonds in Alaska and Louisiana showed significant widening against the Bloomberg Barclays Municipal Bond AAA Index by as much as 50 basis points in early 2017. Driven by strong technicals within the municipal market, GO bond spreads for both Alaska and Louisiana have tightened considerably and are currently trading about 26 basis points above the Bloomberg Barclays Municipal Bond AAA Index.

Despite stability in the price of oil over the last few months, we still expect spreads for oil-producing states to remain volatile in the near term and do not expect much potential for improvement.

While we feel there is not a lot of potential for default, we anticipate the potential for volatility with these bonds in the future.

SEI Fixed Income Portfolio Management also owns and buys local municipality bonds in these oil-related states, including City of Anchorage (AK), Oklahoma City (OK), Borough of Fairbanks (AK) and the City of Tulsa (OK).

Definitions

Basis point: One basis point equals 0.01%.

Bloomberg Barclays Municipal Bond AAA Index: The Bloomberg Barclays Municipal Bond AAA Index is a market-value-weighted index that tracks general obligation bonds, revenue bonds, insured bonds and prerefunded municipal bonds rated AAA.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. Bonds and bond funds will decrease in value as interest rates rise. Because the portfolio may invest in a particular state's securities, it may be more volatile and susceptible to a single adverse economic or regulatory occurrence affecting those obligations.

Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

SEI Fixed Income Portfolio Management is a team within SEI Investments Management Corporation (SIMC).

Information provided by SEI Investments Management Corporation, a wholly owned subsidiary of SEI Investments Company. Neither SEI nor its subsidiaries are affiliated with your financial advisor.

176064-IMU 66642 (10/17)