



Conclusion: E&P subsector – maintain Underweight

Keeping all of the preceding in mind, we believe investors should be underweight the DB HY Energy E&P Index, and maintain this recommendation. Last year, the DB HY Energy E&P Index was the worst performing sub-sector in high yield. HY Energy was down ~6% for the year, which compares to overall HY being up ~3.5%. In particular, we see little room for E&P subsector outperformance as these smaller HY credits can't really continue their aggressive growth strategies of the past as they try to make a path to neutral FCF. In short, we believe these credits can stay in and around FCF neutral but with little opportunity to expand the asset base and delever. We expect the best they can do is survive and reach the other side of this commodity and credit cycle. In particular, we see more value in the "higher quality" B/CCC credits like Halcon (HKUS, BUY-rated) and EXCO Resources (XCO, BUY rated). Given this lower-quality bucket has led the way down in energy, we believe upside/downside is more positively skewed there. We understand the natural tendency is for accounts to reach for quality in the BB area. Our concern with this strategy is that these names have outperformed thus far. We worry that if HY energy credits take a step down due to seasonally weak oil in 1H 15 that these names will take a disproportional hit. Therefore, we suggest that accounts stay in the BB-rated credits with upwards trajectory related to possible M&A like Cimarex (XEC, BUY-rated) and to development of new higher margin plays like Newfield (NFX, BUY-rated) in the SCOOP/STACK. We believe both of these credits still also have IG upgrade potential even in this market. Lastly, one of the most important reasons why we are maintaining our underweight stance is driven by our suspicions that early 2015 fundamental weakness in oil will mean that investors won't "miss the trade." Despite positive data points around slashed capital budgets from many HY issuers and even selective capital infusions (LINE/BX), we are moving back towards the energy sector wides seen in December. More specifically, looking at LINE bonds, which were the direct benefactor of an effective capital infusion from BX, they are trading at pre-funding announcement levels. In our minds that means the market isn't giving much credit to that increased liquidity either because there's a perception that more capital is needed or on a macro basis, that we just aren't there yet.