

Pairs Trade: Bullish Energy Sector & Bearish Financial Sector

March 21, 2018

by Steven Vannelli
 of Knowledge Leaders Capital

As of this writing, WTI crude oil is back above \$65/barrel, closing in on the recent \$66.33 high on January 26. While oil and US equities have been in a “wedge” formation where, hemmed in by the January 26 high and the February 90 low, crude oil has broken out from its wedge.

WTI Crude Oil



Source: Knowledge Leaders Capital

CL1 Comdty (Generic 1st 'CL' Future) WTI Crude Oil Daily 21MAR2017-21MAR2018

Copyright© 2018 Bloomberg Finance L.P.

21-Mar-2018 11:20:24

This is good news for US energy sector investment grade credit. The move up in oil corresponds with an expected 20bps contraction in spreads to around 100bps.

US Energy Sector Investment Grade OAS Compared to Oil Prices



Source: Knowledge Leaders Capital
USOAIGEN Index (USD IG Energy OAS) US IG Energy & Oil Daily 21MAR2017-21MAR2018 Copyright© 2018 Bloomberg Finance L.P. 21-Mar-2018 11:07:41

If US energy investment grade spreads retreat to 100bps based on oil prices, it is possible we could see a 15% move higher in energy shares.

US Energy Sector Investment Grade OAS Compared to S&P 500 Energy Sector



Source: Knowledge Leaders Capital
USOAIGEN Index (USD IG Energy OAS) US IG Energy & SPS Energy Daily 21MAR2017-21M Copyright© 2018 Bloomberg Finance L.P. 21-Mar-2018 11:32:04

At the same time, the LIBOR-OIS spread is widening, which is a leading indicator for a widening in US financial sector investment grade credit spreads. At current LIBOR-OIS levels, financials spreads should widen by roughly 15bps. If funding pressures continue to push the LIBOR-OIS spread higher, financial spreads will possibly widen even more.

LIBOR-OIS Spread (USD) Compared to US Investment Grade Financial Sector OAS



Source: Knowledge Leaders Capital
BICLOIS5 Index (US Libor OIS Spread) LIBOR-OIS & Fin. IG OAS Daily 21MAR2017-20 Copyright© 2018 Bloomberg Finance L.P. 21-Mar-2018 11:16:33

Widening financial credit spreads are a leading indicator for the performance of S&P 500 financial stocks. The widening already experienced could correspond to a 10% correction in the financial sector.

US Financial Sector Investment Grade Credit Spread Compared to S&P 500 Financial Sector



Source: Knowledge Leaders Capital
 S5FINL Index (S&P 500 Financials Sector GICS Level 1 Index) US IG Fin. & SP5 Fin Copyright© 2018 Bloomberg Finance L.P. 21-Mar-2018 11:09:11

Distilled, this is a basic pairs trade long energy and short financials.

S&P 500 Energy Sector Relative to Financial Sector



Source: Knowledge Leaders Capital
 S5ENRS Index (S&P 500 Energy Sector GICS Level 1 Index) S&P 500 Energy Rel. Fin. Copyright© 2018 Bloomberg Finance L.P. 21-Mar-2018 11:36:58

© Knowledge Leaders Capital