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When 5% goes poof

Evan Lorenz writes:

The humble Treasury bill was a port in the August storm that ended almost as soon as it began (Aug. 5 was the date, in case you missed it). As highfliers like Nvidia Corp. gapped down, investors turned to the risk-free paper that yielded an inflation-beating 5%-plus. Some $88.2 billion coursed into money-market mutual funds over the next two weeks.

But today's heroes could become tomorrow's goats if, as the futures markets expect, the Fed is going to slash 225 basis points off the funds rate by the close of 2025 (though T-bills will remain indispensable just the same; see *Grant's*, July 5). Where, then, to find attractive yields without absorbing excessive risks?

In preview, *Grant's* is bullish on pipeline owner MPLX LP (MPLX on the New York Stock Exchange), on select high-yield bonds and on the Simplify MBS ETF (MTBA on the NYSE Arca).

A master limited partnership, MPLX was incorporated in 2012 as a spin-out from Marathon Petroleum Corp.'s midstream energy assets. No Johnny-come-lately, our first yield candidate traces its origins to the 1887 founding of the Ohio Oil Co., a predecessor company to the Standard Oil Trust.

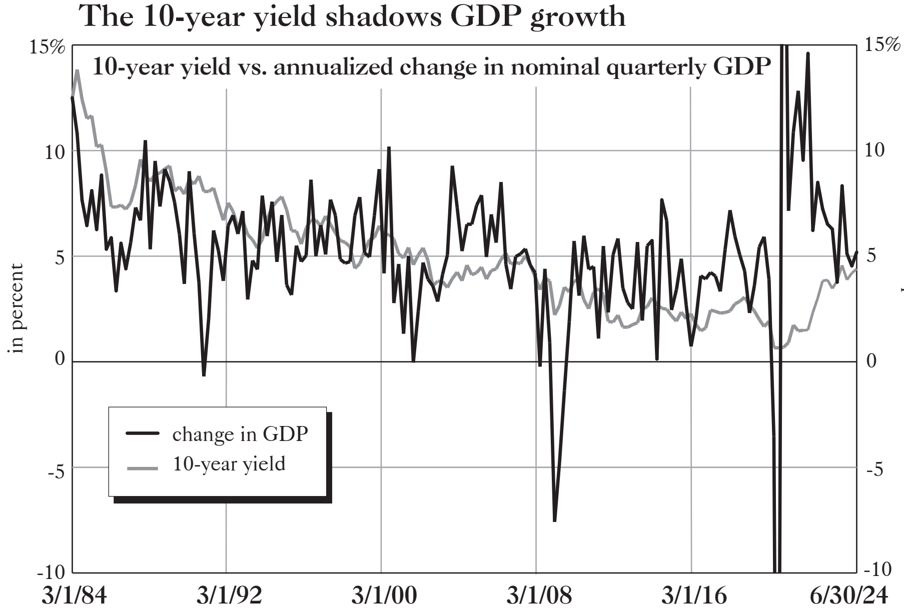
MPLX owns, or holds interests in, 16,000 miles of pipelines; 132 million barrels of refining logistics and tank farm storage capacity; 35.1 million barrels of terminal storage capacity; 12 billion cubic feet of natural-gas processing capacity and 334 vessels and barges. It divides its business into two parts: logistics and storage (68% of trailing Ebitda), which transports and stores oil, refined products and renewable fuels; and gathering and processing (32%), which, as the name implies, aggregates, transports and stores natural gas and natural-gas liquids.

The stock is priced to an 8% dividend yield, which the company's distributable cash flow (Ebitda less maintenance capital expenditures and other adjustments) covered in the second quarter by 1.6 times. Notably, in the first half of the year, MPLX repurchased $150 million's worth of shares, no big outlay in relation to a $43.2 billion stock market capitalization but notable just the same; ordinarily, MLPs are not the buying-back kind.

Between 2020 and 2023, Ebitda and dividends per share grew at annual rates of 6.4% and 5.7%, respectively. In the crucible of the lockdown year 2020, when West Texas Intermediate crude traded as low as negative $37.63 per barrel, both Ebitda and dividends rose by 2%.

In the three years through 2026, the Street expects distributions to grow at a 7.9% annual rate. If so, it will be investments in projects like the Blackcomb Pipeline, which is slated to come online in the second half of 2026 and will transport natural gas from West Texas to the Gulf Coast, that will make it happen. The need is clear enough. As the highly productive Permian Basin churns out more gas than current takeaway capacity can handle, the price of natural gas in West Texas is quoted at negative $2.05 per thousand cubic feet (mcf). Compare and contrast the posi-

The 10-year yield shadows GDP growth



sources: U.S. Bureau of Economic Analysis, the Bloomberg tive $1.91 per mcf price tag for gas at Henry Hub, La.; MPLX holds a 34% interest in the Blackcomb project.

Marathon Petroleum retains a 63.4% stake in MPLX, contributed 50% of its 2023 revenues and continues to dominate its management. The risk of divided loyalties is obvious; is the parent not tempted to fatten its bottom line by underpaying for the use of its former subsidiary's assets?

But Marathon stands shoulder-to-shoulder with MPLX's stockholders in the matter of the MLPX dividend. All parties want a bigger one, as an exchange on the Aug. 6 earnings call helps to underscore.

UBS Group A.G. analyst Manav Gupta had an observation to share. If, he said, the MPLX dividend could grow over the next two years at the same rate it logged over the previous two, the income that Marathon Petroleum would receive from MPLX would jump to over $2.7 billion. "At that point," Gupta went on, "it's covering your full capex [budget] and full dividends. So, technically, you are a recession-proof refiner."

"Thanks, Manav," Maryann Mannen, the CEO of both Marathon Petroleum and MPLX, replied. "I think you said it well. . . . We've talked about targeting mid-single-digit growth [for MPLX's dividend] . . . that will fully cover [Marathon's] dividend and largely cover the capital that heretofore [Marathon] has been putting to work. So, again, we think that strategic relationship becomes incredibly more important as we are able to increase MPLX's distribution going forward."

As of June 30, Baa2/triple-B-rated MPLX showed $19.6 billion in net debt, which equaled three times trailing Ebitda. In the second quarter, operating income covered interest expense by 6.1 times.

Ten of the 16 analysts on the case call the shares a buy. Perhaps the hefty dividend serves as bear repellant, as short interest sums to just 2.4% of the equity float. Over the past 12 months, insiders have neither bought nor sold a share.

"Underpinned by a diverse asset footprint and meaningful refinery logistics stability, MPLX continues to demonstrate strong operational performance, including asset and cost optimization," Jeremy Tonet, who rates MPLX a buy for JPMorgan Chase & Co., summed up the bull case in an Aug. 9 note. "Moreover, delivering sizable return of capital increases stands out versus the peer group."

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At a glance, today's speculative-bond market is a dry hole. Double-B-rated bonds are priced to deliver an average yield of 5.6%, a 1.8% spread over Treasurys. It's a pickup closer to what investors have historically earned on investment-grade-rated bonds (1.6% over the past quarter century) than on top-rated junk paper (3.7% over the same span).

What the value-seeking investor needs is a catalyst. "We're really focused on event-driven debt," Kirk Whitney, an assistant portfolio manager and bond manager at CrossingBridge Advisors, LLC, tells me. Changes in corporate control can lead to the retirement of a certain issue before maturity at an attractive call price.

For example, consider the Ziff Davis, Inc. senior unsecured 4⅝s of 2030, quoted at $92.35 to yield 6.1%. The issuer, a digital publisher, manages websites and apps including PCMag, IGN and Everyday Health. A tough advertising market left its calling card on second-quarter results, with revenues down by 1.6% and adjusted Ebitda off by 9.8% (both on a year-over-year basis).

However, Ziff Davis's financial position is arguably stronger than its Ba3/double-B-rated balance sheet implies. As of June 30, net debt amounted to $323 million, or 0.7 times trailing Ebitda. In the second quarter, operating income covered interest expense by 15.8 times.

David Sherman, the founder of CrossingBridge, asks me, "Why do we like this?" He then answers: "First of all, the company has bought back debt in the past so the balance sheet is improving, even with the decline in cash flows. . . . We think ultimately the company will likely get upgraded, or it may get acquired. It may not happen, but the point is if you can put together a portfolio of a bunch of Ziff Davises, then some of these events are going to occur. So on a blended basis, you have this embedded call option."

Fatter yields are available farther afield. Europe's mutual funds, dubbed UCITS, for "undertaking for collective investment in transferable securities," are generally prohibited from investing in corporate loans. To circumvent that restriction, Nordic banks sell leveraged loan-like securities in bond wrappers.

"Typically these are issues that have a three-to-five-year maturity," Sherman explains. "They're floating-rate, and they're secured. They also have covenants. They typically have debt-incurrence tests, and they may have additional covenants, like maintenance tests and various other tests. Something like 96% to 97% of the market is listed on an exchange. . . . Typically they yield 100 to 200 basis points more than the U.S. market and have one to two turns [of Ebitda] less leverage.

"The typically sized bond issued in the Nordics is, in dollar terms, $50 million to $350 million," Sherman goes on. "Okay, that's a small market. Well, in the U.S. nobody underwrites those anymore, right? Jefferies got too big. DLJ is out of business. Bear Stearns is out of business. Credit Suisse is out of business. So, who has taken up that vacuum in the U.S.? Direct lending. We believe the Nordics are potentially the only platform that exists today that, both from a cost structure and a legitimacy structure, can compete with direct lending but with public debt."

To capitalize, CrossingBridge is launching a fund to invest in the Nordic high-yield market.

Take, for instance, the Norske Skog A.S. senior unsecureds of 2029. With $133 million outstanding, the unrated, pint-sized bond pays a coupon set at 450 basis points above the three-month Norway Interbank Offered Rate, now quoted at 4.74%. At a price of NOK 101.56, that works out to an 8.8% yield to maturity.

Norske Skog, a Norwegian paper and packaging manufacturer headquartered in Oslo, owns four paper mills in Europe and one in Australia. On June 30, its balance sheet recorded net debt of $283 million, a sum equal to 2.2 times trailing Ebitda. In the second quarter, operating income covered interest expense by 12.6 times.

Like the Skog issue, the unrated Azerion Group N.V. secureds of 2026 are small in size—just $240 million are outstanding—but large in yield. With a coupon set at 675 basis points over the three-month Euro InterBank Offered Rate (3.5%) and quoted at a price of €102.75, they deliver 8.8% to maturity.

Based in Schiphol-Rijk in the Netherlands, Azerion manages a digital-advertising platform that connects more than 400,000 advertisers with around 300,000 publishers. It runs e-commerce sites and sells video games. As of March

31, Azerion's balance sheet showed a net-debt balance of $177 million, or 2.2 times trailing Ebitda. The first quarter delivered an operating loss of $6.3 million versus an interest expense of $5 million. Despite that blotch of red ink, the company generated $1.9 million in cash flow from operations after interest payment.

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If the Fed does wind up cutting the funds rate by a cumulative 225 basis points over the next 16 months, the yield on T-bills will fall by a like amount. "Where are 10-year rates going?" asks Harley Bassman, bond quant extraordinaire and managing partner at Simplify Asset Management, Inc., before answering, "Look to nominal GDP. GDP is sort of the 'income' of the U.S. (profit, revenue, whatever), while the 10-year rate is its 'cost of capital.'"

If, Bassman proceeds, rates are set too far below nominal GDP growth, "there should be massive demand for money that will lead to inflation and the Fed hiking rates, or something along those lines. And if rates are too far above GDP growth, there will be little demand for money, and we likely will have a recession."

Over the past 40 years, except for the decade or so incorporating ZIRP and Covid, the 10-year yield has roughly tracked changes in nominal GDP. The 10-year note is currently priced to yield 3.8% while, in the second quarter, the U.S. economy grew at an annualized rate of 5.2%.

Suppose, Bassman proposes, the Fed were successful in bringing the inflation rate down to 2%, and assume that it fixed the funds rate at 2½%. Recall that the 2-year Treasury typically changes hands 50 basis points higher than the funds rate and that the 10-year note trades at about 100 basis points over the 2-year. Such an alignment would give the 10-year note a yield of 4%, or 20 basis points over the yield you see in your newspaper. In any case, says Bassman, "the back end of the curve is running out of gas, but the front end can come down a lot."

The purchase of a residential mortgage-backed security involves what amounts to a simultaneous purchase *and* sale. What you buy is a Treasury bond (or its facsimile: Fannie Mae and Freddie Mac paper is implicitly guaranteed by the U.S. government). What you sell is the option that American mortgagors hold to prepay what they owe whenever the spirit moves them.

Valuing the bond is straightforward enough. As for options valuation, investors estimate a forward rate based on today's spot rates. It's this calculation, and the analytical dust it often kicks up, that helps to account for what Bassman contends is the systematic mispricing of residential MBS.

An example: If the 1-year bill rate were 3% and the 2-year note rate were 4%, the estimated 1-year bill rate one year hence would be 5%. Why 5%? It's not a prediction, but rather the rate that today's investor in the 3% 1-year bill would need to earn to get the same return available on the 4% 2-year note over its 24-month maturity. That is, 3% plus 5% equals 4% plus 4%.

When the curve is inverted, as it is today with 3-month bills outyielding the 10-year note by 1.3 percentage points, the models calculate a forward rate that's below current spot rates. Of course, mortgagors are more likely to refinance when rates are low, and it's for this reason that investors are assigning a high price to options to refinance. The price of current coupon MBS are accordingly weaker than the prices of lower-coupon models, and it is this fact which explains the big spreads between the current mortgage rate (6.85%) and the 10-year yield (3.8%).

If the Fed reduces short-term rates as the market expects, the value of that option should decline and the value of the current coupon MBS that the Simplify ETF owns should appreciate. Meanwhile, the fund is paying a 5.8% dividend yield.

Risks to the ETF are symmetrical: Rates could rise, which would lower the value of the mortgage bonds it holds; or rates could fall, which would send mortgagors scrambling to refinance their obligations at 100 cents on the dollar. The fund would suffer losses on bonds quoted above 100 cents.

"My goal is to keep the average price of MBSs in MTBA between 97 and 101," Bassman tells me. "I want to stay near that current coupon. If rates go down enough, I will sell my Fannie Mae 6s and will buy Fannie 4.5s. I will roll down. You won't lose the money you've made by capital appreciation. What will happen is that I will lower the dividend."

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