

OUTLOOK

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ROBECO
The Investment Engineers

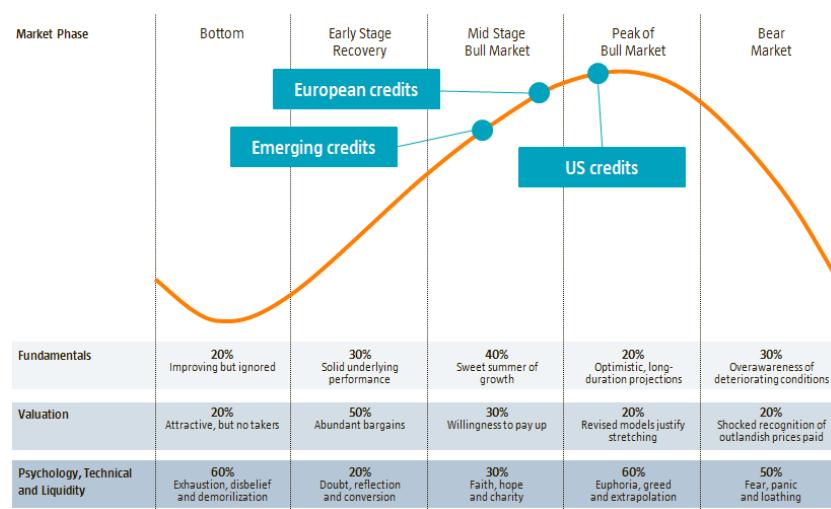
Credit Quarterly Outlook Q1 2017

Spectacularly wrong

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- Trump's election is likely to extend this business cycle. Fiscal stimulus starts right when the output gap has closed, risking overheating
- Much of this stimulus has been priced in, in the financial, construction and housing sectors
- As usual, all eyes are on the Fed and ECB. The end of ever more monetary stimulus is probably nearing...

The Market Cycle: Mapping our view on market segments



Source: Robeco, Morgan Stanley, December 2016

'Years of overestimating growth expectations may now be followed by underestimation'

Summary

For years in a row, the Federal Reserve has been wrong in its dot plot forecasts and economists have been too optimistic. The US economic recovery was below trend and disappointed every year. Now the members may all be spectacularly wrong again in their growth estimations. Trump's election, so late in the cycle, will lengthen the business cycle, overheat the US economy and might trigger the Fed to decide on more rate hikes.

In the meantime corporate credit quality keeps deteriorating, especially in the US and China. When the European Central Bank (ECB) starts tapering in earnest, and the US dollar keeps appreciating, the search for yield may become more volatile. Valuations have increased only a bit over the past three months with markets anticipating these events. Technicals remain strong; even with the ECB tapering monetary policy is still loose, but the change is becoming negative.

We need a bigger shock than Trump or an Italian referendum to derail the global credit markets. The Fed might do it in the medium term. We remain positioned close to a neutral beta while trading the ranges in the short term. We focus on stock picking and sector rotation to add alpha for now. The preference for Europe, financials and short-term credits remains.

Fundamentals

In recent years many investors, central banks and economists have been spectacularly wrong in their estimations of economic recovery since the Great Recession. By all means, the recovery has been below par and disappointing. Whether the debt loaded private sector had a debt trauma or saw no need to invest because of cheap manufacturing in China, it all meant that the closing of the output gaps went really slowly.

Now, after all these years, we are approaching unemployment levels (both in the US and increasingly in Europe) that are close to levels that one would consider full employment. At the same time we see signs of recovery in sectors like the energy sector, causing some optimism for economic growth. US household income and spending are strengthening.

How interesting is it that at this moment in time, i.e. late in the cycle, populism is increasing and someone like Trump got elected. To us this is not a coincidence as all these years of Quantitative Easing (QE) and stimulus made the rich even richer and left the middle class behind. The impact is simple too. If Trump executes at least part of his program in the near term, this will extend the business cycle with one or two years, allowing more time to let imbalances grow even further. If all that is true, the Federal Reserve might have to go back to its dot plots of a while back. If the ECB sees data confirming that the European economy keeps strengthening as well, somewhere in the summer the ECB might taper even further, pushing pressure on all trends we saw over the past five years, such as lower yields and higher equity prices. The tail risk of higher yields and more monetary tightening than the market is pricing in right now, is increasing. Everyone might be **spectacularly wrong** again and underestimating the hiking cycle!

Of course nobody knows for sure what will happen and we can easily end up in another year of a search for yield and endless monetary stimulus. Something that has changed versus last quarter though, is that we see a small recovery in US profitability as well. This somewhat undermines the profit recession we talked about last time. What still stands is a meagre 0.5% productivity growth and accelerating wage growth causing pressures on margins.

Under normal conditions it is true that the longer a business cycle lasts, the bigger the imbalances become. We also see this now. Corporate credit quality keeps deteriorating, especially in the US and China. It is not rare to see a big US corporate issuing cheaply in euros to fund M&A activities in the US, financed by the ECB!

We disagree with the often mentioned comparison with Reaganomics. The debt to GDP starting point for Reagan was 40% and now we are closer to 80%. The room for maneuver is much more limited.

We do not spend too many words on Europe. As is often the case it seems likely that Europe is following the US at a 9-month distance. Unemployment is higher but so is the natural or structural level of unemployment. This means that while the labor market is strengthening

here as well, and especially the Spanish economy is doing very well, the ECB will have an increasingly difficult time not to taper even more. The only major worry we have in Europe is Italy. This country desperately needs reforms, a banking sector clean-up and hopefully it will not be downgraded to junk too soon...

A final word on emerging markets is warranted. We attach a higher probability to an overheating US economy and thus higher yields and Fed action. Especially emerging markets are in the line of fire. In the long term, currency devaluations will help stabilize emerging markets as they regain competitiveness, but in the short term a strong US dollar and capital flows will hurt a lot more. With Trump we might enter a new era of protectionism. But within emerging markets the famous capital controls will become in vogue again. If this higher Fed level and strong US dollar work out, some currency pegs will come under pressure and capital flight will hurt current account deficit countries. Recent data from China shows that capital flight is accelerating. The same might become true for countries like Turkey. Higher yields to keep money in, currency interventions depleting, inflation rising and low economic growth do not go well together. We remain cautious.

Conclusion: the QE tigers are leaving and the wolves are coming

Our conclusion is simple. It is likely that the Trump election extends the business cycle and gives the healing process more time. Central banks might have to react. At the same time it will aggravate corporate deleveraging and postpone the inevitable, an even more painful slowdown. Debt levels are still rising and the world desperately needs higher inflation. It is just a possibility that one might not expect this anymore, just when it becomes real. Central bank QE tigers will then withdraw and the wolves will be coming.

Valuation

Valuations eased a little bit last quarter. Investment grade spreads widened about 17% with the US outperforming. Peripheral spreads underperformed with 28% widening. Emerging markets spreads have been very resilient, certainly compared with the volatility we noticed in the local currency markets. High yield did well with a 10% tightening, benefiting most from the search for yield.

These spread moves are not large enough to change our views. Most of the investment grade credit markets are trading around the historical mean or at average levels. For high yield, valuations have dropped to 0.8 times the median. In both cases this is not tight enough to start positioning with an underweight beta. Credit markets can trade at very tight levels for years in a row and then suddenly widen aggressively. It would be too costly to be short risk at these levels.

We continue to prefer European credits to US credits. We weigh the risk of higher Fed activity impacting markets more than potential political events in Europe for now. As one can see from the Italian referendum, politics often do not matter enough. We remain wary though on European politics because the 2017 election calendar is fully packed in Europe. We may become more concerned about European credits if the ECB starts moving more clearly towards further tapering.

Last but not least we will continue to implement a quality bias in our portfolios. In high yield will remain underweight Leveraged Buyouts, private equity sponsored credits and CCC ratings. In investment grade we remain underweight the periphery and focus on more stable sectors like beverage or pharma and financials. A special note on financials: we believe insurance companies are trading too cheaply and expect some more recovery from financials versus corporates in general.

Technicals

We believe there is a good chance that the December announcement of a reduction in the monthly QE purchase program is a precursor of more tapering. The reason is that the European economy is recovering and the European output gap is closing fast.

This means that somewhere in late 2017 (and possibly only in 2018 for real), total worldwide monthly QE purchases will start to decline. For the first time in five years, the next policy announcement may be a tightening announcement. This just changes the game plan.

Up until now central banks have added almost USD 200 billion a month (!) to the monetary base. The Fed has stopped and basically the BOJ as well, since it switched to yield curve targeting, which will probably cause them to buy fewer Japanese government bonds. The UK will announce a hard QE stop soon as inflation is too high. That leaves us with the ECB. One should not underestimate the impact of the ECB. Many tourist investors have been pushed into US investment grade and high yield markets. As soon as the ECB starts to taper further, these kinds of flows will reverse.

So while the short-term risks are centered around Trump, the US economy and consequently the Fed reaction, in the medium term the same risks arise around the ECB and Europe.

Emerging markets flows have been volatile. Recent data from China shows an accelerated outflow and subsequently an attempt to reverse capital account liberalization. For other countries like Turkey or Brazil constitutional worries are rising. At the same time inflation in these countries is high, capital flows are negative and the vulnerability of foreign exchange reserves is coming to the forefront. If all this continues, and Trump's plans for the US economy play out, do not be surprised if the words 'capital controls' appear on the front pages of the financial press. This cannot be good for risk appetite.

In the medium term, many emerging countries will experience higher competitiveness as their currencies weaken and their economies bottom out. Short-term capital flows determine returns and we are concerned.

Conclusion: boom 2017, bust 2018?

The election of Trump will extend the credit and economic cycles. It will cause more years of increasing imbalances, including corporates that are re-leveraging like never before. It means a recession that will be deeper but later than expected. To the extent it causes more Fed action than anticipated by the market, it will cause volatility. Certainly if Europe follows suit in six to nine months' time.

Higher growth will reduce default rates in the near term, creating a moment of opportunity for high yield. Valuations have improved a bit in investment grade and tapering has been partly priced in.

Technically, the amount of additional stimulus is still huge but will become incrementally less so. The jury is out on what the market impact will be. We stick to last quarter's positioning, with the beta around neutral and a focus on stock picking.

The main risk that the market is spectacularly wrong again in its expectations needs to be reflected in our portfolios. For years economists have been too optimistic, and now they may be too relaxed. Expect more volatility and thus opportunities for an active fundamental team like the Robeco Global Credit Team.

Positioning

Beta

We stick to neutral betas as a starting point for all portfolios. The technical support for the markets as a result of central bank policies is simply too strong to ignore. However, we realize that market sentiment can turn quickly for the negative as many market participants are very much aware that they are uncomfortably long. These bouts of unrest can temporarily provide opportunities and dislocations. We will not hesitate to capture these and accept an increase in portfolio beta but from now on with the knowledge that in the near term monetary stimulus will decline. We focus on sector and region rotation.

Regional

We also stick to our preference for European over US credit. The US credit cycle is too far advanced and more vulnerable to a turn for the negative in global growth. We need more spread compensation, maybe driven by the fear of the Fed, to go overweight the US.

Emerging

We nurture our short beta position and quality bias. This year that has not been the best position and emerging market volatility occurred primarily in the local markets. However, we are approaching the moment when less monetary stimulus will also affect emerging credit markets.

Long financials and long the consumer

We prefer financials and more domestic consumer related sectors. We are hesitant to invest in companies with a high exposure to global trade or the capital spending cycle. European financials still offer value and are actually still derisking unlike the non-financial sectors. Within non-financials, we prefer sectors that are not cyclical and linked to domestic consumer spending. A special mention for the insurance sector: this may be a great hedge versus rising yields should this occur.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Jamie Stuttard (HSBC), Torsten Slok (DB), Charles Dumas (Lombard Street Research) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

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