

Credit Quarterly Outlook Q2 2022

**'If I have to make a tackle,
I've already made a mistake'**

(Paolo Maldini)

- Fundamentals have deteriorated; the range of outcomes has broadened
- Valuations never stay at average levels, but they do reflect some risk now
- Technicals are weak since central banks (the Fed) need to tackle inflation; they are behind the curve and have to correct quickly

Making an economic assessment had been difficult even before the escalation of the Russia-Ukraine crisis, given the distortion in many data series after two years of Covid. This was why we entitled our previous Credit Quarterly Outlook 'Imperfect information and imperfect foresight'. With the Ukrainian conflict, higher oil prices and further supply chain disruptions, it is clear that an even wider set of possibilities has to be assessed for fundamentals. If anything, downside risks to the economy have risen materially and recession risk is now openly debated. Although a recession might still be one or two years away, markets might anticipate such an event to materialize within the next 12 months.

Regarding valuations, markets have cheapened up significantly since our Outlook in early December. Drilling down, we conclude that the compensation for liquidity risk has risen a lot, as is also reflected by wider European swap

spreads. This is true to a lesser extent for the compensation for true credit risk, as reflected in default premia.

Outlook

For professional investors
Q2 2022

Victor Verberk & Sander Bus
Co-heads Credit team

Jamie Stuttard
Credit strategist

Technically, the main worry we have is that developed market central banks are behind the curve. We think the Fed made a clear policy mistake by starting this tightening cycle too late. The key risks here are higher-than-anticipated hikes in the coming months, and inflation that not only lasts longer but peaks out at higher levels. As one of our speakers, Dario Perkins, put it, this situation is akin to the Italian football player Paolo Maldini stating that when your defensive tactics don't anticipate future risks ahead of time, you have to take an emergency measure (that is, tackle).

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All in all, we are accepting betas that are a touch higher for investment grade credit. We do not mind if betas are just above one, while we remain in the first quartile of our risk budget. For high yield, the US market in particular has already started reflecting some optimism again, and trades too tight in our opinion. This means we like to stick to our underweight beta positioning overall, despite the fact that European high yield credit spreads have cheapened up in recent months.

Fundamentals

Let us first express our sympathy to all victims of the unjustified war in Ukraine. A humanitarian disaster is unfolding that far exceeds any relevance that our regular Credit Quarterly Outlook might have. This is our job, though, and we will therefore focus as usual on a cold financial assessment of the situation, in order to be positioned correctly on behalf of our clients.

The European economy will be hit hard by this crisis. Europe faces supply chain issues and is of course highly dependent on energy from Russia, besides agricultural commodities from Ukraine. Europe is a net importer of oil and gas, and will remain dependent for its energy supply for many years to come. A sudden loss of access to Russian gas, even stricter sanctions or the previously unthinkable scenario of a nuclear escalation are not in our base case assumptions, although we note growing pressure on the timescale for a full phase out of Russian gas.

The US economy, despite being less than two years into a recovery, is already in overheating territory. The labor market has largely healed and this part of the Fed's job is

done. Most of the workers who abruptly left the labor force during the Covid period have returned and the US unemployment rate is almost back to the pre-Covid lows, particularly in the 25-54 age cohort. Wage growth has started to broaden out. It seems that the key question for everyone in the policy and market community is the inflation trajectory.

A few words on China are warranted, too. We have been worried about the sustainability of this debt-fueled economic growth 'miracle' for some time. It is clear to us that this economic miracle has come to an end. More debt will not help in meeting the 5.5% growth target without simultaneously compromising Beijing's macroprudential concerns. The demise of the real estate sector is a symptom of capital misallocation and of a system which is overleveraged. Because social stability remains the overarching objective for Beijing, stimulus will likely come in some shape or form.

The slowdown in China will also increase pressure on South-East Asian growth rates due to intra-regional trade channels. A small bridge to other emerging regions is easily made. Oil imports are starting to hurt in some places, of course, but we now also face food price inflation. This is important for a few of the poorest countries in the emerging market segment: food and energy inflation has historically been typical initial conditions for social unrest. This is not per se a rosy fundamental outlook for many commodity-importing emerging fundamentals. At the opposite end, countries like Brazil are benefiting.

So, what is the impact of the higher oil and gas prices? By some estimates, sharply higher oil prices can cost about 3% of GDP growth over a multi-year period. So, the energy shock is clearly a tax on growth, besides its inflationary effects on headline inflation. This puts central banks in an awkward position. Inflation simply is too high to ignore (CPI inflation might creep up to close to 10% in the US) and the Fed has to react, given their mandate target for PCE inflation of 2%. Therefore, a quick series of rate hikes is likely to occur in a short period of time, with balance sheet tightening thrown in for good measure, potentially hurting economic growth. This is why the Global Macro team titled their Quarterly Outlook '[Czech mate](#)', referring to a growing number of inverted yield curves globally, beginning in Czechia, which point to rising risks of an economic downturn after a sharp series of rate hikes.

We have also conducted an assessment of the current economic state of affairs compared to the 1970s. The speed of rising energy prices in 2022 is already comparable in magnitude to 1973-4 as well as 1978-9, when looking at real commodity price time series data. The impact on the US economy needs consideration since, despite a lower

energy sensitivity now versus the 1970s, real prices are twice as high as in the 1970s. On the plus side, the absence of unionized workers and global competition are major contextual differences.

All in all, we are aware that both the rate cycle and the oil shock can trigger a recession. We think the likelihood is reasonably large, and it has certainly increased.

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Fortunately, prevailing corporate balance sheet health is pretty good, particularly given the current high corporate margins and short-term liquidity buffers. The good interest coverage situation will continue despite rising yields, since many corporates termed out their debt profile. This time around there is not really a standout sector with a bloated aggregate balance sheet facing restructurings (except China real estate) or painful adjustment processes, in the manner of TMT in the late 1990s or the US housing and financial sectors into 2007.

One last paragraph on the distant future. Despite all uncertainties in the short term, it looks feasible that we may finally exit the low-growth, low-inflation era we experienced in the last decade. The European response to the Global Financial Crisis and the European sovereign crisis was fully driven by central banks that were very supportive. Governments did not spend significantly, which is a reason why QE was less effective in supporting economic growth. The response to the pandemic was different, with governments willing to run large deficits. We expect that this new fiscal environment can continue for longer, with European governments collectively likely to spend more on defense and energy. This should have a positive impact on economic growth, but it will likely also lead to higher inflation than we have seen over the past decade. Be aware that that does not mean better asset returns per se, since more volatility and uncertainties could weigh on asset price valuations.

The conclusion for the coming quarters is that – as US economists Larry Summers and Alex Domash pointed out – when inflation is above 4 or 5% and unemployment also below 5%, in a large majority of cases historically, the business cycle ends in a hard landing. Central banks will put on the brakes: they have few good choices and risk putting themselves in 'Czech mate'. Imperfect information and imperfect foresight are as relevant today as they were last quarter. Fundamentally speaking, though, it is clear that the market outlook has deteriorated.

Valuations

We spent a lot of time digesting the relative value of current credit markets. At first glance, credit markets have cheapened considerably and in some cases, such as European investment grade or high yield, and even US investment grade, spread levels are around median levels again. Digging a bit deeper shows some remarkable differences, though.

It seems that the recent spread widening, in Europe at least, is driven more by the liquidity premium than anything else. Euro swap spreads have widened due to German government bonds having become increasingly scarce (due to the ECB buying up a large share of Bunds and not making these available in the repo market). That means that, of the total option-adjusted spread widening, a significant portion has been due to swap-spread widening, and a smaller part due to wider credit spreads over swaps. It means that default risk has not been priced into markets yet. Another reference is the outperformance of the CCC rating category in high yield.

In the US, swap spreads have been more stable and hence the option-adjusted spread widening is almost entirely due to more compensation for real credit risk. When we position for risk taking, we prefer taking collateralized risk like European swaps over default risk that has arguably not been priced enough.

In the past quarter the market quickly adapted to the idea that the Fed would need to act fast this year. At the start of 2022, only three rate hikes were expected by the market – and by the Fed themselves. That number is now close to eight. In our analysis, the end of QE and the expectation of the start of QT in the coming months is now reflected in market prices and in credit spreads. We refer to this as the '2018' scenario. But there are also a few scenarios that have not been priced yet.

First, 1970s-style inflationary and recessionary consequences from the current oil price shock might not materialize, but the comparability of the supply-driven oil shock currently unfolding makes us alert to the possibility of a bigger slowdown and spread reaction. Still, compared to the 1970s, there are many differences in the structural economic landscape, geographic distribution of oil production and potential longer-term mitigants.

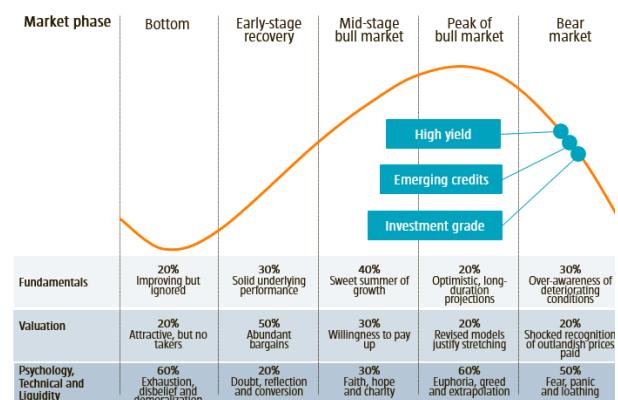
Second, we are not so certain that a Russian default, which would in nominal terms be one of the biggest in history, could be dismissed as being fully priced in risk premia.

Third, 5.5% economic growth in China, which is the stated government target, looks increasingly unlikely to us.

Without massive stimulus China will not achieve that. Given that China has provided over 50% of the marginal contribution to global GDP growth in the past decade, this scenario might also cause disappointment.

The conclusion for valuations is that spreads are around median levels again, which is wider than at any time in the past seven quarters. That said, the range of tail-risk events is broad enough that it is not wise to take a long beta position over the medium term. We want to see more evidence of the consequences of the large drop in real purchasing power of consumers, and the economic point at which rate hikes begin to bite, given the higher debt loads today compared to the 1970s. (We think there ought to be more emphasis on the higher *interest rate intensity* in today's developed market economies....) We no longer want to be short risk, as we had been in recent quarters, but we need a bigger risk premium to take a long risk position. We focus on stock picking, sector choices and regional differences in the composition of spreads.

Market cycle | Mapping our view on market segments



Source: Robeco, March 2022

Technicals

The technicals debate in our Quarterly Outlook session was one of the most interesting in years. We talked about the fear of much more front-loaded central bank action, the signals of an inverted curve and many geopolitical events. But we did even more than that. We tested some trading rules.

The Global Macro team has done work on fund flows. For bond markets, fund flows have been rather negative year to date. However, we found there is very little correlation with flows and consecutive excess returns in the weeks thereafter – they are more of a contemporaneous quantification of the conditions of the very recent past. However, after three months of 2-sigma outflows, returns

for the next three months do move into positive territory, indicating that market instability tends to be followed in turn by stability, after a while.

Another hypothesis we tested is what happens to excess returns after a widening of at least 40 bps in option-adjusted spreads, as markets have just experienced. The result is that after a few weeks of sell-off, the market is likely to continue to trend wider. However, after a longer sell-off of ten to twelve weeks, the odds of a turn in the market and positive excess returns for the median outcome become likely. However, the skew in the size of losses on the downside, in the event of a continued sell-off, is large so one cannot rely on spread mean reversion based on time alone.

Finally, we looked at the expected returns after 100 bps of rate hikes are priced. We found that since 1982 (the start of the current secular cycle of globalization, disinflation and financial repression), markets have tended to price in more rate hikes than those that are actually delivered. By contrast, we found the opposite result pre-1982 (markets underestimated how many rate hikes are required) and hence it looks like markets do not appreciate secular cycles in inflation and interest rates. In the current cycle, we think spreads should peak within 12 months. However, at what level this happens depends very much on fundamental conditions. We conclude that time is, perhaps unsurprisingly, not the only factor in a forward-looking strategic assessment. Integrating the fundamentals is vital, given that they tend to determine whether or not markets will experience more significant left-hand tail outcomes following a quarter of sell-off.

In other words, a simple trading rule will not work!

We go back to basics, instead. In principle, QT must deliver the opposite financial market result of QE, as St Louis Fed President James Bullard has previously posited. That means higher real yields, lower inflation break-evens, lower equities, wider spreads and a stronger currency, all else equal (i.e. if the Fed would be the only central bank reducing its balance sheet). This series of events is almost exactly what transpired in the first six weeks of the year. Now, following the shock to break-evens from the oil price spike, it is far from clear if we are fully done yet. The reason is that oil shocks tend to be met with a tighter central bank policy response, and that oil shocks as well as sustained rate tightening cycles historically precede recessions. The risks to growth are especially acute when oil shocks are exogenous supply-side events (like now) instead of demand-side shocks: the odds are not looking very good.

Still, there is also positive news. We do see a lot of soft evidence that positioning is cautious. Fixed income asset

allocations, beta positioning and credit weights seem to be at the low end. (There are harder pieces of evidence too, with a notable shift towards buy-protection positions in CDS indices in the DTCC data, for instance.) We could well therefore experience some kind of a bear market rally in the near term. This is an important reason for us to reduce underweight risks now. Another positive element is the return of the new issue premium. Recent new bond issuance is significantly cheaper than secondary bonds. That is a nice way of harvesting some additional excess return. When the new issue pipeline reopens, the reliquification of the primary market can give a positive performance impetus to the broader market, even if the idiosyncratic secondary curves of the issuer in question cheapen up.

Financial markets often design their own volatility. This time around we are experiencing 'vol shocks' and 'VAR shocks' almost on a weekly basis. Commodity price moves, one-day moves in equity or frenetic moves in Chinese markets are the story of the market. Since central banks have provided vast amounts of liquidity, one should not be surprised that the withdrawal of liquidity leads to more volatility. Trading liquidity, high valuations and one-sided positioning causes markets to dysfunction and are a legacy of the QE era. The ECB, for example, has conducted QE for over 90% of the time elapsed since 2014. This is a very awkward time for central banks to be withdrawing liquidity, but inflation once again leaves them with little alternative.

'The shock of the deterioration in the growth-inflation mix might result in outright stagflation. We will soon find out whether it indeed does'

The conclusion is that the shock of the deterioration in the growth-inflation mix might result in outright stagflation. We will soon find out whether or not this is the case. We do know that the tail risks involved would cause spreads to widen significantly – to around 200 bps for US investment grade – and this is not yet priced.

Conclusion

All in all, valuations suggest a somewhat more constructive stance to credit markets. However, as Paolo Maldini once said, "if you have to make a tackle, you have already made a mistake". Geopolitical outcomes were far from priced in just a few weeks ago, yet central banks are needing to

apply the brakes. We do not fight the Fed. Given that a 2018-style environment has been priced, it makes a lot more valuation sense to allocate to credit again. We still are a touch cautious in managing these allocations, though, since tail risks are around the corner and the full extent of the oil shock remains to be seen.

Positioning

During the last quarter we had already adjusted portfolio positions. We added risk from late February, after spreads had backed up significantly. That said, liquidity risk premia have risen, evidenced by the moves in swap spreads, but to a lesser extent by movements in default premia.

Investment grade credit has therefore become a natural allocation again for clients. We experience institutional demand and that fits with our much more neutral to slightly positive stance. For high yield, we remain underweight risk.

We prefer European risk over US risk, on account of the Ukraine premium. Also, the Fed fear might become more prevalent in the US market. Nevertheless, in investment grade we are decreasing this regional position a bit given the real default/credit premium that is more apparent in the USD market.

We focus on sector rotations. Covid-recovery beneficiaries are still there and energy is a safe haven. We are more cautious on labor-intensive sectors and smaller companies that deliver into the automotive industry.

	Constructive	Neutral	Cautious
Fundamentals			✓
Valuations		✓	
Technicals			✓
IG credit	✓		
HY credit			✓
Financials	✓		
Non-financials		✓	
Emerging			✓

Source: Robeco, March 2022

Guests:

We would like to thank the guests who contributed to this quarterly outlook with their valuable presentations and discussions. The views of Rikkert Scholten, Martin van Vliet and Jamie Stuttard (Robeco), Viktor Hjort (BNP Paribas), Nikolaos Panigirtzoglou (JPMorgan) and Dario Perkins (TS Lombard) have been taken into account in establishing our credit views.

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Robeco Institutional Asset Management B.V., Sucursal en España with identification number W0032687F and having its registered office in Madrid at Calle Serrano 47-14º, is registered with the Spanish Commercial Registry in Madrid, in volume 19.957, page 190, section 8, sheet M-351927 and with the National Securities Market Commission (CNMV) in the Official Register of branches of European investment services companies, under number 24. The investment funds or SICAV mentioned in this document are regulated by the corresponding authorities of their country of origin and are registered in the Special Registry of the CNMV of Foreign Collective Investment Institutions marketed in Spain.

Additional Information for investors with residence or seat in South Africa

Robeco Institutional Asset Management B.V. is registered and regulated by the Financial Sector Conduct Authority in South Africa.

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Additional Information relating to RobecoSAM-branded funds/services

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Additional Information for investors with residence or seat in Thailand

The Prospectus has not been approved by the Securities and Exchange Commission which takes no responsibility for its contents. No offer to the public to purchase the Shares will be made in Thailand and the Prospectus is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Additional Information for investors with residence or seat in the United Arab Emirates

Some Funds referred to in this marketing material have been registered with the UAE Securities and Commodities Authority (the Authority). Details of all Registered Funds can be found on the Authority's website. The Authority assumes no liability for the accuracy of the information set out in this material/document, nor for the failure of any persons engaged in the investment Fund in performing their duties and responsibilities.

Additional Information for investors with residence or seat in the United Kingdom

Robeco is subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

Additional Information for investors with residence or seat in Uruguay

The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except under circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.