



Credit Quarterly Outlook Q3 2022

The mess after the largesse

- Inflationary pressure has accelerated and risks to growth are increasing
- A horrendous start to the year has resulted in much improved valuations
- Debt levels have never been higher and the safety net has been removed

US Treasuries this year had their worst January-to-April period since 1788. On top of that, credit spreads widened. By all standards, we have seen a very significant repricing of fixed income. The world looks grim and it would be easy to extrapolate the bear market. But panic and volatility can also provide opportunities. We already see a few pockets of the market that are starting to look attractive. Investment grade looks cheap at these levels and investors able to withstand the volatility and who are prepared to take a longer investment horizon could start buying. High yield is not there yet, although we believe that the quality names in high yield already look attractive. Weak single-B and CCC credit still looks vulnerable and has the potential to underperform much more with the increasing likelihood of a recession.

How did the world get into this mess? The policy response to Covid-19 seemed like a great cure during the health crisis, but the combination of massive fiscal and monetary stimulus now turns out to have been an over-extension of

an era of largesse that is one of the key ingredients for the disease called inflation.

Fundamentals

While many parts of the economy are still red-hot, leading indicators are increasingly pointing to recession risk.

Outlook

For professional investors
Q3 2022

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Consumer confidence, producer confidence, inverted yield curves and housing affordability all indicate that trouble is coming. This should not be a surprise given the aggressive monetary tightening that we are now seeing in response to raging inflation.

'Central banks have no option than to tighten financial conditions further to slow their economies and restore the demand-supply balance'

Central banks currently have no option other than to tighten financial conditions further in order to slow their economies and restore the demand-supply balance. Clear evidence of inflation coming down is needed before they can stop tightening. The longer inflation persists, therefore, the more painful it will be for markets. The chances that inflation pressures would somehow simply disappear of their own accord are slim. That had been what policymakers hoped for when they still used the word 'transitory' in 2021. But the 't' word has been long canceled. If history since 1955 is a guide, we have to conclude, as Larry Summers and Alex Domash first posited, that from current levels of inflation and labor market overheating, Fed tightening has always resulted in a recession.

Inflation is overshooting in the US and in Europe, while it remains a bit more moderate in China. In the US, it is most clear that the key trigger was excess fiscal stimulus at a time when the output gap had already closed. In Europe, there is also an element of too much fiscal spending, and on top of that a food and energy crisis on the back of the war in Ukraine, together with imported inflation via the foreign exchange channel.

Inflation has caused a shock to real incomes not seen in the US since the 1970s. This, coupled with the sharp tightening in financial conditions, with the fragile China macro backdrop to boot, implies a real risk of recession in our view. There are more parallels to the 1970s episode. Policymakers at that time also argued that inflation was transitory since it was initially triggered by external shocks. Even though they were all temporary shocks, together they caused individuals to expect higher inflation, entrenching the inflationary dynamics further and contributing to a self-reinforcing spiral of wage-price inflation. We do not see inflation spiraling out of control yet, but it is a scenario that central banks are desperate to avoid, given this type of inflation can be very difficult to fight.

With the consensus now shifting towards a higher probability of recession, we are also starting to see some commodity prices coming down. Lumber prices for instance have more than halved since early March, in a sign that the US housing market is feeling the brunt of a doubling of 30-year mortgage rates from 3% to 6%. We also see that several other commodities, even oil for instance, seem to have started to slip away from their upward trajectories. This can be seen as an encouraging sign that the monetary tightening that is currently discounted by markets might be enough to sufficiently cool the economy. On the other hand, we also see that wage pressures keep rising and that inflation expectations are still moving higher.

Corporate profit margins are at cyclical highs, which is not uncommon on the eve of an economic slowdown. Corporates enjoyed strong pricing power in 2020 and 2021, with supply constraints and government support helping to lift margins. Earnings are 20-40% above 2019 levels in all key regions. The positive spin on this is that companies have a strong base going into the rough period ahead of us. The negative spin is that things can only get worse from here. One important element to judge corporate health is to look at companies' interest rate sensitivity. This is a function of total debt to capital and of the maturity profile. Companies that have high gearing and a lot of floating-rate debt on the balance sheet are clearly more vulnerable. These can mainly be found in the LBO names that populate the single-B and CCC universe and that have used the leveraged loan market to fund their buyouts. Investment grade companies look healthier on this metric since most of them have locked in low coupons for an extended period, but there are exceptions, such as real estate and retail, that are vulnerable within the investment grade universe.

For Europe, the situation is even more challenging given the gas squeeze and terms of trade developments that have lifted gas and electricity prices in euro terms to very elevated levels. Putin is now clearly using the gas market to put pressure on Europe. Each time Moscow reduces deliveries, market prices respond. The result is that Europe is paying more to Russia and receiving less. This is inflicting pain on European corporates, especially those in Italy and Germany, that see their competitive position weakening. Reducing dependency on Russia is absolutely critical and requires accelerated investment in alternative sources and renewables. The overhang of the energy crisis is negative for Europe but at the same time will constrain the ECB from lifting rates as aggressively as the Fed.

Since we have overweight positions in European banks and many clients have the global financial crisis still top of mind, we think we should make some remarks about this segment. During Covid, a substantial amount of SME credit

risk was shifted from bank balance sheets to government entities via the use of state-backed loans. This tool was used mainly in southern Europe, with Italy now having more than 10% of GDP in state-backed loans. This means that when defaults increase, banks are partly shielded as some losses will end up at the government. We conclude that healthy capital positions and probably lower credit losses compared to earlier episodes of economic stress should help banks to weather the storm. We feel comfortable that banks will not be the epicenter of stress in the next recession.

'Healthy capital positions and probably lower credit losses compared to earlier episodes of economic stress should help banks to weather the storm'

The economic environment in China is different from that in the US and Europe. Inflation is somewhat more subdued and this enables the Chinese government to do some more fiscal stimulus in order to ease the pain from its zero-Covid policy and ongoing real estate travails. The credit impulse in China has turned positive, which could be an early signal of better times ahead.

Valuations

US Treasuries had their worst start of a calendar year since 1788. On top of that, credit spreads widened. Correlations in rates and risk markets have clearly been positive in this regime of financial tightening, taking away the benefits of diversification. Uncertainty about the needed magnitude of monetary tightening is lifting rates volatility, and that in turn contributes to wider spreads.

Spreads on all segments of the credit market are now undoubtedly above median spreads. Euro investment grade and Euro high yield have even reached top quartile. Could spreads go wider in a full-blown recession scenario? Yes, they can. Should we run full underweight positions until we see those highs? No, we don't believe that would be prudent to do. Even though we acknowledge that recession risks are elevated, there is never a 100% certainty that this scenario will play out. Given that markets are rapidly repricing, it is sensible to start buying some credit risk now.

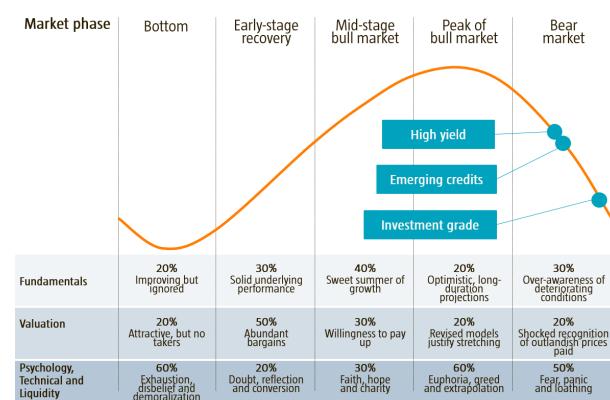
For investment grade, we have reached levels where we feel comfortable running portfolio betas just above 1. EUR investment grade looks particularly cheap versus German bunds. This is to a large extent caused by wide swap

spreads. Sophisticated investors who are able to separate swap spread and credit spread should prefer exposure to the swap-spread component, either via positions in swaps or SSAs.

For high yield and emerging debt portfolios we have reduced the underweight beta as well, but are not yet in positive territory for all portfolios. Especially for portfolios that are managed against a benchmark with a lot of 'phantom yield', it is more difficult to get the beta above 1. (Phantom yield is defined as observed yield from distressed companies that will probably never result in real credit income because these companies are on the verge of default. This holds for Chinese property names but also for some US CCC-rated companies.)

We are more cautious on high yield than on investment grade. The ratio between high yield and investment grade spreads is tight by historical standards, which leaves room for underperformance of high yield on a risk-adjusted basis. We believe that the lower end of the credit spectrum is particularly vulnerable. A recession will increase idiosyncratic risk and dispersion in this segment. This is still insufficiently priced. Default rates of 10% per annum are not uncommon in a normal recession. Let us reiterate that default rates are a lagging indicator. Therefore, once defaults start to hit, you should already be long the market.

Market cycle | Mapping our view on market segments



Source: Robeco, June 2022

Technicals

Central bank policy is clearly the dominant driver of asset prices this year. There is much uncertainty about the amount of monetary tightening required to achieve price stability and a return of inflation rates back down to mandated targets, without overshooting into deflation. This uncertainty is creating very high volatility in fixed

income markets, and that is translating into high risk premia, i.e. credit spreads.

Markets have to unlearn the behavior of the last decade where it was smart to buy the dips in anticipation of forthcoming QE. That is no longer a smart strategy since the Fed put has disappeared and there is no longer any CSPP in Europe. But there is one exception. The ECB has been very vocal about fragmentation risk in the Euro area and they are now designing a new tool to counter fragmentation in markets. It is likely that they will come up with an instrument that enables them to interfere when sovereign spreads exceed the level that is considered acceptable by the ECB. So, there is potentially a new central bank put in the making for European sovereign risk.

One of our guests suggested that a next step could be that the ECB would come up with a new tool to cap credit spreads. We would not ascribe a high probability to that, but if it happens it would be very bullish for European credit. For now, the ECB has ended its buying of European credit, which is one of the reasons for the weak performance of European investment grade.

'Markets are fragile. There is financial stability risk, with more debt than ever in developed markets and central banks that are no longer supportive'

During the sell-off this year we saw days that reminded us of March 2020 and September 2008, with very poor liquidity conditions. It is also a reminder that investment bank balance sheets are not the same as before the GFC. More regulation, more stringent risk management and a lower appetite for physical inventory means investment banks are unable to act as a shock absorber. This is why we see liquidity rapidly deteriorating in markets where everyone is looking for the exit. It once again stresses the importance of being contrarian in these markets. Do not run for the exit on days when everyone is doing the same. Markets are fragile. There is financial stability risk, with more debt than ever in developed markets and central banks that are no longer supportive.

Mutual fund flows have been negative, which is not surprising given that these flows almost always follow returns. This should therefore not be seen as a leading indicator. The same is true for new issuance, which has been low. This should certainly not be considered as a good sign. Low supply is merely the consequence of low demand for credit.

The only conclusion we can draw is that technicals are still weak with central banks rapidly tightening financial conditions. This will only change when there is some visibility on a moderation of inflationary pressures.

Conclusion

All in all, valuations suggest a somewhat more constructive stance to credit markets, but at the same time fundamentals and technicals are still weak. During QE we learnt not to fight the Fed – and the same holds this time around during tightening. The Fed is combatting inflation, and market weakness is collateral damage that they are accepting. Spreads could very well widen even more, at which point we will consider increasing the beta further. Recession risk has increased and the market has moved towards that scenario as well. Nevertheless, we are not yet in the phase of capitulation and unjustified cheapness. These opportunities might very well occur in the next three to six months.

Positioning

We added some risk during the last quarter in investment grade as well as high yield portfolios. For investment grade, we see that spreads have now reached levels that historically were followed by strong positive returns. That does not mean that spreads cannot move even wider, but we believe that the much more balanced upside versus downside justifies at least a neutral positioning in developed market investment grade.

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

Source: Robeco, June 2022

For high yield and emerging markets, we see more pockets of the market that are vulnerable in a recessionary environment. We think that spreads in these pockets will widen more in order to price in a higher default rate that could follow in six to 12 months.

For our emerging market portfolio we see opportunities to buy some beta via developed market investment grade that

trades relatively more attractively. We remain underweight core emerging market credit.

For high yield we have proven that it is possible to outperform markets through the cycle by focusing on quality in the portfolio. We will hold on to that and will use derivatives to increase the beta when we believe that the moment is there. So, the portfolio betas for high yield are now just below 1.

We hold overweight positions in European banks since we are confident that this sector will not be the epicenter of the bear market in this cycle. Banks are shielded to a certain extent by state-backed lending programs for SMEs that were instituted during the Covid crisis.

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), Jim Reid (Deutsche Bank), Mislav Matejka (JPMorgan) and Barnaby Martin (BAML) have been taken into account in establishing our credit views.

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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 temporarily deemed authorized and regulated by the Financial Conduct Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorization, are available on the Financial Conduct Authority's website.

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.