Credit Quarterly Outlook Q1 2023

From rates to ratings fears

- The market focus will shift from inflation to growth
- Spreads have not yet peaked (except for EUR swap spreads)
- We're long quality as dispersion is set to increase

As our Global Macro team explained in their September 2022 outlook, 'Twin Peaks', in a hiking cycle that ultimately ends in recession, rates typically peak before credit spreads do. In particular, rates usually peak around the second-to-last Fed hike. We believe we are now in the valley between the two peaks. Rates have started to come down and may have peaked in some markets, while inflation is now easing. Credit spreads have also rallied a lot since mid-October but are set to rewiden when markets start anticipating a recession that would hit corporate health.

As the probability of a recession rises and becomes part of the consensus view, market dispersion will increase. The lower-quality end of the credit spectrum is likely to see an increased default rate while the higher end of the market could benefit from lower rates and a flight to quality. Once recession is fully priced in and spreads reach their own peak, that would be the time to go outright long, even in high yield. Typically, that point is reached well before default rates have peaked.

With increased supply of European government bonds we expect Euro swap spreads to tighten further. Since swap spreads are a large part of the total credit spread for Euro investment grade, we are comfortable with a modest long position in Euro investment grade markets while being

Outlook
For professional investors
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much more cautious towards other markets that are trading tight, given where we are in the cycle.

Fundamentals

Most of the markets we cover did not exist in their current form the last time developed market economies were grappling with inflation. There was no market in assets originally issued as high yield, and investment grade corporates still funded themselves largely through the banking channel. Still, we believe it makes sense to look at historical cycles to give us clues about the future.

Our base case is that the US as well as Europe will experience recession in 2023. Although we expect the recessions to play out in the same year and to be mutually reinforcing, the root cause will be different. The US is likely to experience a classic boom-bust cycle, whereas the European recession will be driven largely by an energy supply shock.

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There are multiple signals pointing to a looming recession. We are in the midst of the fiercest hiking cycle in 40 years, and we know that most central bank hiking cycles ultimately result in a recession. The 3-month-versus-10-year yield curve has firmly inverted, which is another strong indicator of what lies ahead. On top of that, several leading indicators – such as those reflecting consumer and producer sentiment – are firmly in the red. What's more, our bottom-up sector analysts have flagged signals of a nearing recession. These include:

- a pick-up in cancelation rates for US homebuilders, to 30% of their order book;
- a slump in sales in the semiconductor industry, and
- rising delinquencies in subprime auto loans.

But at the same time there still are sectors that show healthy revenues. The services sector, especially holiday related, is still benefiting from catch-up demand after Covid. The auto and truck sectors are working their way through a healthy backlog now that supply chain constraints have eased. Revenue growth is still healthy so far, but we also note that new orders are slumping.

A positive feature of the current cycle is that for most corporate sectors there has not been much of a fixed investment boom. That means that capex probably would not need to go down much and that there is limited risk of overcapacity in most sectors in western economies. We therefore think a recession will be driven by lower consumption rather than cuts in capex.

We sometimes hear the argument that a high-inflation environment is good for highly indebted companies. While there is some truth to this, in that inflation helps to reduce real debt levels, we would argue that credit investors should not draw too much comfort from high inflation. High inflation coincides with high macro volatility, which is an environment that creates winners and losers.

Sure, commodity producers do benefit from high inflation. But there are also many companies whose input costs rise and who are unable to pass these on to the consumer in a recessionary environment. Credit is an asymmetrical asset class, which means that the pain from losers in this market hurts more than the gain from the winners. Credit markets need stability above all else.

The Fed and the ECB are determined to keep monetary policy tight until they see confirmation that inflation will reach their target. The good news is that inflation has started to moderate, which means the end of the hiking cycle is in sight. But that does not mean the Fed is anywhere close to *cutting* rates. They will keep an eye on the labor market in particular, wanting to see signs that wages are coming down to more normal levels and that are consistent with the inflation target. That might only be possible if unemployment were to rise, which in turn requires a recession.

China is in a different phase. It has just abandoned its zero-Covid policy. Counterintuitively, the reopening can in the short run lead to less economic activity as the virus will spread rapidly and consumers will self-impose reduced mobility. But a recovery of the Chinese economy is likely within a couple of months.

Can China regain its role as the locomotive that prevents the rest of the world from going into recession? We doubt it. The fiscal impulse in that market is simply not strong enough and China's fiscal situation prevents it from ramping up spending the way it did in the past when the economy needed a boost.

We also believe that the effects of a reopening of the Chinese economy could be ambiguous for the rest of the world, and especially Europe. On the one hand it would be positive for a former global growth engine to be back in business, but on the other hand it can be inflationary as demand for commodities will go up. Competition for LNG could become especially problematic for Europe.

As investors we should not only consider a base case scenario but also look at probabilities of tail events that could move markets. When spreads are tight, we typically identify potential negative tail risks. When spreads are wide, we should do the opposite. A recession is our base case. Events to which we assign a low probability but that have the potential to move markets tighter if they were to happen are:

- an early end to the war in Ukraine (and Russia normalizing its economic relationship with the rest of Europe);
- a smoother than expected emergence of China out of Covid;
- inflation declining while a recession is avoided.

The conclusion is that we have no reason yet to be positive about fundamentals.

Valuations

To start on a positive note, the all-in nominal yield has greatly improved this year as a result of the simultaneous sell-off in rates and spreads. Income-oriented investors now have plenty of opportunity in fixed income markets after years of very low or even negative yields.

The era of TINA ('there is no alternative') is definitely behind us. Even short-dated T-bills now provide a 4% yield, a level that a year ago could only be found in high yield markets. To judge the relative attractiveness of credit we prefer to look at option-adjusted spreads rather than the all-in yield. These have widened too, but for most markets are still close to median levels after the rally that started in mid-October.

The most attractive valuations can be found in European investment grade and especially in financials. This market offers spreads that are above median levels and it also trades cheap versus its US equivalent.

European swap spreads are still at elevated levels with 5-year spreads at 70 bps. Swap spreads even briefly reached 100 bps amid bund scarcity. With increased issuance of sovereign paper and the prospect of quantitative tightening (QT) next year, we expect a further normalization of swap spreads towards long-term average levels of 40 bps. This is helpful for Euro investment grade since swap spreads are a large component of the total spread versus governments.

Within Euro investment grade, financials screen relatively cheap. In past cycles, financials were often seen as high beta since they are a leveraged bet on the economy. This time around we see banks as less vulnerable since capital buffers have greatly improved and banks are unlikely to run into liquidity issues, thanks to central bank support. There will always be exceptions at individual weak banks, but by and large we do not expect banks to be a source of systemic risk in this cycle.

With a recession in developed markets being the base case, the key question is: what will recession do to the riskier parts of the credit market? When are spreads high enough to start buying? We know from the past that spreads typically peak before default rates peak. Our study shows that, historically, high yield spreads were at their wides when we were at about two-thirds of the way through the default cycle. In the coming cycle, that would correspond with a default rate of around 5%, given that we expect the peak to be around 7.5%.

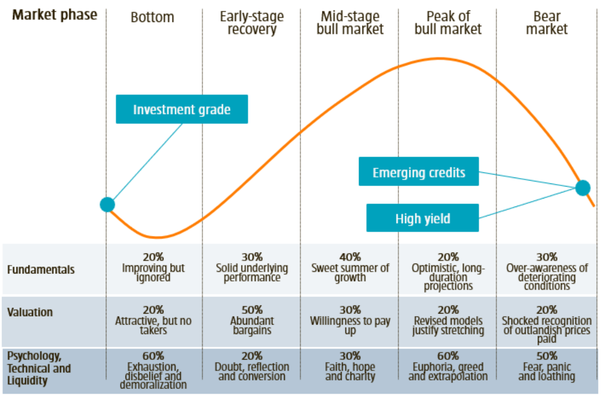
Defaults rates have barely started their bearish phase, so it seems too early to start aggressively buying into high yield. High yield spreads are well below the 1000 bps level where they usually peak in recessionary environments.

Bear in mind that these peaks are always heavily influenced by 'phantom spread' in the distressed part of the market. Remember that when market spreads are at 1000 bps you would have a difficult time finding bonds that trade at a spread of 1000 bps, since the market is bifurcated between quality names at say 500 bps and default candidates at say 5000 bps spread.

With a higher-quality high yield market today, the default rate will probably end up being lower and hence the market spread will probably have a lower peak.

Figure 1 | The market cycle

Mapping our view on market segments



Source: Robeco, December 2022

Markets are very volatile and the valuation assessment can change quickly. In the middle of October there were more markets that looked attractive, but after the strong bear-market rally of the past six weeks our conclusion is that we had to lower our assessment of this pillar, with the exception of Euro investment grade.

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Technicals

What are the most vulnerable markets in the current environment of high interest rates and low growth? Clearly these are the pockets where profitability is low and leverage is high. We see fragilities in the lower-quality end of the high yield market and to a much larger extent in the leveraged loan markets.

Prudent corporates termed out maturities during the easy money years, and while higher rates are a longer-term concern for fundamentals, the vast majority of corporates will have only minor increases in interest expense in 2023, providing a cushion during the likely slower growth period.

This does not hold for the leveraged loan market where, by definition, higher rates immediately translate into higher funding costs for companies. In the past, leveraged loans represented the most senior part of the capital structure for highly levered companies, with junior tranches being funded by the high yield market. That has dramatically changed over the last decade.

The majority of leveraged loans are now issued by companies that are loan only, i.e. there is nothing below you except for a thin equity tranche from an often aggressive financial sponsor. Many companies that issued loans would not have been able to issue high yield debt because they would not have passed the scrutiny of high yield buy-side analysts.

The bar for issuing leveraged loans has been much lower since financial engineering overtook fundamental research in the pursuit of maximizing profits for the CLO machine. The leveraged loan market is now dominated by weak single-B companies with maximum leverage for their ratings and very poor documentation. Rating migration is already negative and recession has not even started.

There is good news in this for the high yield bond market, which now has much better quality compared to earlier cycles, since the worst companies ended up in the loan market. As the high yield primary market features fewer frothy companies, default rates will probably peak at lower levels than in the past. The bad news is that there can be contagion from a leveraged loan market in trouble when investors who are active in both markets become forced sellers of their good assets.

Lending conditions are tightening, according to the Federal Reserve senior loan officer survey. This means that access to credit is becoming more difficult for lower-quality borrowers. We see a similar picture from the European bank lending surveys.

We also think that it is important to discuss correlations between rates and credit markets. 2022 was an exceptional year where we saw positive correlations between almost all asset classes as inflation was the dominant theme. Higher inflation meant higher rates and higher spreads.

However, longer term, the correlation between the two is usually negative, where higher rates are a reflection of a solid economy where corporates do well and spreads tighten. The opposite applies when the economy slows down: spreads typically widen and rates decline. We expect negative correlations to return to the market in 2023. Rates markets could do well in anticipation of the first rate cuts, while credit markets might suffer periodically from disappointing economic data.

While the rates tightening cycle may be close to an end, the quantitative tightening cycle has only just begun. The Fed, the ECB and the BoE have started shrinking their balance sheets. The ECB has already received an early repayment of EUR 744bn in TLTROs and another repayment will follow in 2023. The ECB will also start reducing asset purchase program (APP) reinvestments by EUR 15bn per month from March 2023. At the same time, net government bond issuance will go up.

The effect of QT in the US will likely be indirect, as credit competes with the higher Treasury supply. In Europe, through the Corporate Bond Purchase Scheme (CBPS), the BoE has bought 5% of the sterling investment grade market, while the ECB owns 15% of Euro investment grade through the Corporate Sector Purchase Program (CSPP). With that demand gone, and now going into reverse, new buyers are urgently needed for credit products.

But keep in mind that central banks could always come back if the market really becomes dysfunctional, particularly under their financial stability mandates rather than their monetary policy mandates. This became clear when the BoE temporarily bought bonds when rates spiked in the LDI sell-off. Central bank puts are still in place, but they are far out of the money.

A mitigating positive is the defensive positioning which seems to be consensus amongst credit investors, and the high cash balances in many investment portfolios.

The conclusion on technicals is that central banks are still driving markets. As long as central banks are still withdrawing liquidity from our market, the only conclusion we can draw is a cautious one.

Conclusion

We are now in the valley between the rates peak and the spread peak. That means we expect wider spreads in the next three to six months for most markets, with the exception of Euro investment grade that can benefit from tightening swap spreads and a more attractive historical valuation.

As the probability of a recession is increasing, more dispersion is likely in markets. The lower end of the credit spectrum could experience an increased default rate, while the higher end of the market could in due course benefit from lower rates and a flight to quality. We advocate up-in-quality strategies.

Once the recession is fully priced in and spreads reach their peak, it would be time to go outright long, even in high yield. Typically, that point is reached well before default rates have peaked. So, we believe we have seen the peak in rates fears and rates volatility, but credit volatility will linger, with a high likelihood of better entry moments in 2023. We just need to be patient…

Positioning

We are constructive on European investment grade credit and feel comfortable with small long-beta positions. This is driven by attractive valuation in this category and the expectation of further swap spread tightening.

In high yield we stay focused on quality. We favor the more stable non-cyclical companies. Portfolio credit betas in high yield have been brought back to below one after having briefly reached a level of one in the middle of October, when valuations had justified a more constructive positioning.

For emerging markets it really depends on the particular investment universe. It is a very dispersed market with high benchmark spreads due to a large percentage of distressed issuers. This market has pockets of opportunity and we believe that issuer selection is more important than beta policy.

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

Source: Robeco, December 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), Andrew Sheets (Morgan Stanley), Viktor Hjort (BNP Paribas) and Michael Anderson (Citi) have been taken into account in establishing our credit views.

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