ROBECO
The Investment Engineers

GLOBAL FIXED INCOME MACRO OUTLOOK

The cat is out of the bag

- We've reached R**, the rates level where financial stability is hit
- Curves are beginning to steepen aggressively – a key 2023 trade for us
- Opportunities in spread product as and when recession is priced in

Summary

Markets never fail to be interesting! After an 'everything rally' in January (when yields and spreads eased), a 'taper regime' in February (when both yields and credit spreads rose), March has brought the largest banking failures since 2008 and the largest moves in the US yield curve since 1987.

To be clear, the events of March 2023 continue those of last autumn: back then, we had the near collapse of the UK derivative-based LDI market. Rates volatility, too, is hardly a new topic this year. 2022's monetary tightening is coming home to roost. The bottom line is that debt-to-GDP ratios have been rising across the public and private sector globally for four decades and that is now colliding with the sharpest rise in interest rates in 40 years.

To give a couple of examples, US corporate debt to GDP has never been higher than on the eve of a recession as it is now. US government debt to GDP is at 120%; in 2007 it stood at just 60%. This is far from a US-only issue: be it French corporate debt, Italian government debt, or Chinese SoE debt, the aggregate debt-to-GDP statistics of all of the world's major economies have risen, during decades of easy money and increased borrowing.

The bill, at least for servicing it, has now got a lot larger, and as borrowers refinance through the course of 2023, it is coming due. Monetary tightening has been a near-global theme – across developed markets, emerging markets, the US, Europe, Latam and Australasia.

In our macroeconomic forecasts, we continue to view a US recession as the base case over the next 12 months. G7 economies such as Germany and the UK are already in stagnation/contraction territory, so we think the US will merely join a slowdown which is evidentially already underway.

It is true that services and labor market strength have been surprising in their resilience, particularly in the US. The tightening in lending conditions, however, and lagged effects of monetary policy tightening, look set to overpower residual economic momentum and post-Covid structural adjustments.

For financial markets, much discussion has focused on how restrictive rates will become relative to R* (see our special edition of the Central Bank Watcher). A twist from March appears to be that rates have reached R** – the Financial (In)Stability Real Interest Rate[1] – or in layman's terms, the level at which stuff breaks. Tighter conditions affect both the real and financial arenas.

In rates, we believe US yields may have peaked, following the probable peak in UK yields last autumn. The US and German yield curves may also have troughed out and reached their

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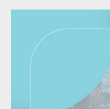

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deepest inversions, before the rapid steepening of recent weeks amid banking sector turmoil.

The volatility of recent weeks means that short-term opportunities have arisen (in EUR swap spread tighteners, for example, or in the potential for safe-haven yields to back up somewhat in the short term). We view these however as shorter-term moves. In the medium term, the recession strategies we laid out last time (see *Recession Investing)* remain our overall gameplan.

It is always interesting writing an outlook after a lot of market events – and moves – have just occurred! In the near term, in credit spreads in particular, we expect a bumpy path, with bouts of retracement and bullishness after various government banking sector rescues, and white knight takeovers of troubled institutions.

There is no particular rhyme or reason on the length of market recovery after these positive headlines: the JP Morgan rescue of Bear Stearns in March 2008 for example precipitated a four-month rally in credit; the Lloyds rescue of HBoS saw a recovery of just a few hours. The result this time may depend on the market's perception of 'who else' is out there, among troubled financial institutions and hedge funds, that may cause renewed market volatility.

Our credit colleagues advise that the European bank landscape is largely secure away from Credit Suisse. The US regional bank landscape appears a bit more complicated. In any case, it may well be that the stresses from rising rates materialize in other parts of the non-bank system (as we saw in UK LDI last October) or in structures within the shadow banking world that turn out to have mismatches in duration or liquidity.

Accidents usually follow mismatches, and be it commercial real estate or leveraged financial structures, there is plenty of scope for mismanagement to have occurred.

Ultimately, when 40 years of rising public and private sector debt meets the sharpest rise in interest rates in 12 months, the only known is that accidents are likely. Where they occur precisely, is the million-dollar question. For top-down allocations and portfolio construction, the specifics are less important than the broad themes. The implications for portfolio positioning over the medium to longer-term are clear: steeper curves, lower yields, and opportunities to pick up spread product at recessionary levels.

R** has been breached. As for the volatility that can follow from that financial and real economic breaking point, and as the US joins the rest of the western world in slowdown, we think the cat is now out of the bag.

1 Discussion of The Financial (In)Stability Real Interest Rate, R** (newyorkfed.org)

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Macroeconomic and policy outlook

- Banking market stress to amplify lagged monetary tightening effects
- Neither China reopening nor improving real incomes are game changers
- Hard landing set to bolster market speculation about a policy reversal in 2024

Growth outlook: cracks are appearing

We've held the view that central banks would likely have to engineer a hard economic landing to get inflation sustainably back under control. And that sharp, fast monetary tightening cycles typically lead to financial accidents. Developments since our last update in December have done little to change our views. There are reasons to turn more constructive on the economic outlook, but we don't think they change the big picture.

Firstly, headline inflation in many DM and EM economies has started to trend lower, mainly owing to lower energy inflation, hence improving the outlook for consumer spending power. This, coupled with ongoing labor market resilience (albeit in the US this is probably overstated by favorable weather effects), might well keep services sector growth positive.

Secondly, notwithstanding the subdued levels of new industrial orders, supply chain disruptions are easing. This supports manufacturing production, at least in Europe, allowing companies to reduce their order backlogs (e.g. in autos). And thirdly, China's reopening is progressing faster than we had anticipated and there are signs that the property downturn is easing somewhat.

Nonetheless, these considerations do little to alter our view that a hard economic landing across many DM economies remains more likely than a 'soft' or 'no' landing. Firstly, as consumer spending power improves, other factors that have recently eased the cost-of-living crisis – including a reduction in household saving rates and fiscal support on the energy front across Europe – are likely to ebb. On savings, we find that pandemic-era excess savings in the US can provide residual support. We estimate around USD 1.5trn left in the savings reservoir, albeit distributed unevenly across income cohorts. In Europe, savings in real terms are largely depleted now.

Secondly, on China, we retain the view that reopening is much more beneficial to China's domestic services sector and some Asian tourist countries than to the global manufacturing cycle. Capex is more important than consumer spending here and, although bank lending has recently picked up, the scale of the stimulus as reflected in the overall credit impulse and backdrop appears more subdued than in prior cycles. Indeed, with land sales still in the doldrums, the property sector will remain a drag on (capex) growth. Moreover, structural weaknesses in the local government financing vehicles sector pose clear downside risks.

The third and foremost reason why we remain more cautious on growth prospects than the consensus is related to the pinch of monetary tightening (which we think still works with substantial lags). Into the recent flare-up of market nervousness, bank lending surveys and credit flows generally were already indicating that the sharp rises in policy rates of the past 12 months and tighter financing conditions were starting to have serious dampening effects on credit demand. A further tightening in lending standards due to tighter credit *supply* – especially by smaller US banks – now also beckons. We note that these banks account for a proportionately high share of lending to the commercial real estate sector, which arguably is already among the more interest-rate-sensitive parts of the economy.

Acknowledging the risk of a tightening in bank loan supply, central banks have either quickly stepped in to address specific troubled bank situations (the Fed and SNB) or turned more cautious on the future path of policy rates (ECB). However, for now central banks seem keen to separate their efforts to uphold financial stability from their fight against inflation, which goes to show that they may not be in a hurry in current circumstances to accommodate growth via drastic interest rate cuts. However, in the US, for example, markets have started to price in a reversal to a more neutral monetary policy setting by the middle of next year. This has prompted a sharp re-steepening of the still-inverted US 2s10s yield curve – which typically happens as recession draws closer.

Upside risks to the growth outlook – beyond resilient services and labor markets – would include further supply-

led disinflation and any de-escalation of the war in Ukraine. Downside risks – besides more financial accidents that typically occur after sharp Fed tightening cycles – comprise an escalation of the war in Ukraine, rising tensions between the US and China, a full-blown US debt ceiling crisis over the summer, and a renewed rise in wholesale energy prices in Europe into next winter, given the small size of the remaining Russian gas flows into the EU.

Inflation: headline leading the way?

Headline inflation has moderated from 9% y/y to 6% in the US, and by more modest amounts elsewhere. Still, it's hard to argue just yet that central banks are decisively winning the war against inflation. For sure, the arrival of supply-led (goods) disinflation and lower energy price inflation is welcome, and headline inflation seems set for further (sharp) falls over the coming 6 to 9 months. But core inflation (excluding food and energy) remains sticky, to say the least.

> *"Headline inflation has moderated. Still, it's hard to argue just yet that central banks are decisively winning the war against inflation.*

In the US one can argue that this is in large part due to still-elevated rental price inflation, which is very likely to turn south soon – if new rental agreements are anything to go by. And in Europe, for which the war in Ukraine constituted a much larger inflationary shock, the spillover from energy prices into core prices is also likely to ease soon – given the sharp drop in wholesale gas and electricity prices.

But a sustained easing in core inflation pressures, especially on the services side, most probably also requires slower wage growth. The latter has started to come down in the US, albeit still running noticeably above levels consistent with sustained on-target inflation. We remain in the camp that a significant weakening of labor demand and rising unemployment is needed to achieve this.

In other markets such as Japan and the Eurozone, where wage pressures have lagged (rather than coincided with) the rise in headline inflation, wage growth measures generally remain on a rising trend. However, tentative signs of a possible slowdown are emerging in the Eurozone, including a weakening in the rate of growth in wages advertised in job postings and a relapse in consumers' short and long-term inflation expectations.

In China and parts of Asia, inflation pressures have generally remained much more subdued, due to a smaller price impact from supply-chain disruptions, government price intervention and cyclical reasons. But in China, a recovery in consumer spending should start to lift core inflation, which at just 0.6% y/y in February, remains far below the levels seen elsewhere across the globe.

All in all, while core inflation is likely to remain sticky across many economies in coming months, keeping many central banks on a tightening bias, the prospective further descent in headline inflation as well as increased economic (and possibly further financial) weakness should pave the way for lower core CPI prints in 2H as well. Sufficient progress in underlying inflation dynamics to settle the secular debate on inflation, however, is unlikely to be made before the turn of the year.

Fiscal and monetary policy: focus on the banks channel

Less fiscally friendly

While US fiscal policy is expected to act as a drag on US economic growth in 2023, the drag should be much smaller than in 2022, when pandemic support was withdrawn or ended. This contrasts with the Eurozone where fiscal policy remains highly supportive for now due to the energy-related measures and EU recovery fund payments. But the Eurozone fiscal stance looks set to become incrementally less supportive, if energy prices avoid a further spike. Meanwhile, in China, the stance of fiscal policy also remains expansionary, but as shown by one of the speakers at our *Quarterly*, less so than in 2022 if one includes local government bond issuance and other off-budget measures.

In any case, providing fresh fiscal stimulus on a grand scale to boost growth seems more challenging in a world where central banks are still fighting inflation and implementing *Quantitative Tightening*. The bar for resorting to new *Quantitative Easing* hence seems rather high. At the moment, however, fiscal authorities – certainly those in the US and Switzerland – seem more preoccupied with tackling issues surrounding the banking system.

Monetary policy reluctant to succumb to 'bank dominance'

Market pricing of rate expectations is moving fast! Market turmoil associated with the banking sector has prompted investors to price in an imminent end to DM policy rate tightening cycles. This sharply reverses the market's direction of travel in February when rate hike cycles were being extended out in time. Across EM, central banks in Latam and CEE were already either done or on the verge of pausing.

We suspect that most DM central banks including the Fed (but barring the BoC, which already seems in pausing mode) are still inclined to deliver at least one more 25 bps rate hike, if only to give the impression that they will not succumb to 'financial dominance' over monetary policy. If the likes of the Fed and ECB instead tighten much further, as markets priced in as recently as early March, this would reinforce our belief that a significant reversal of tight monetary policy is in store for 2024 (as further tightening would amplify the economic damage and disinflation pressure that's already in the pipeline). In Japan, as in China, a rate hike seems unlikely, although it is still possible that the BoJ will further modify its yield-curve control (YCC) policy in coming months.

As for QT across DM space, our central scenario assumes a continuation until at least the end of Q3. But certainly in current market circumstances we think neither the Fed nor the ECB will resort to the active QT seen in the UK, Sweden, and New Zealand. Note that the ECB will still continue to fully reinvest maturing bonds held under PEPP this year– with some flexibility in the latter to support EGB spreads.

Rates strategy

- Recent market turmoil clarifies the debate on peak rates
- Boxes getting ticked for a turn to a constructive cyclical outlook for duration
- Opportunities for significant curve steepening

Medium-term outlook more constructive

It should by now be clear to all that, at current levels, official interest rates are indeed tightening credit conditions. That is an important conclusion for rates markets from the recent banking stress. This matters because it narrows down the path of possible outcomes for terminal central bank rates in this cycle. Recent market turmoil has also revitalized the debate on when to expect the first cuts. Rates have fallen a lot since early March, which creates room for some temporary short-term upward re-adjustment.

Still, any such move will be regarded differently than just a few weeks ago: markets will probably judge a rise in rates as a technical correction, rather than a resumption of the upward trend that dominated 2022. This should limit the extent of any upside moves in yield, while the medium to longer-term scope for yields to decline has probably grown.

The increased clarity on terminal rates has implications for yield curves. Front-end rates have been the main drivers of the shape of curves across western markets. Uncertainty on the level of terminal rates that was needed to curb inflation resulted in sizeable inversions of yield curves. In the US for example, the recent daily closing trough at -107 bps in the US 2s10s curve was the deepest inversion since 1981. With increased clarity on the end point of tightening cycles, front-end rates will probably settle and medium-term risks for these are no longer tilted to the upside. This makes it more likely that we have seen peak inversion for most curves.

In previous editions of this publication we have discussed three markers for guidance on whether the time has come to become constructive on duration. We now review each.

2s10s inversion is the first marker. Historical data for the US suggest 10-year yields typically peak within seven months from inversion. As 2022 progressed, more and more DMs and EMs saw the 2s10s inversion box ticked, with even German Bunds reaching this point in November. For comparison, Mexico reached that marker right back in March 2022. There are exceptions, though. The Australian and Japanese 2s10s curves are still in positive territory.

The second marker is inversion of 2-year yields versus central bank rates. At the time of our December outlook most curves were still in positive territory on this front-end metric. Things have progressed. The German curve saw its 2-year Schatz rate dive below the depo rate in March. The US Treasuries, Canadian government bonds and UK Gilts curve first experienced this in December, followed by a stronger move in March. Mexico showed a similar pattern. Even Australia has ticked this box.

The third pointer, one carrying quite some weight within our team debates, is the timing of the second-to-last rate hike. The recent banking stress episode has increased the likelihood that the last hike for the Fed and ECB will take place within the next three months. Some central banks, such as the BoC, may already be done hiking. This suggests that the meeting that delivers the penultimate rate hike is either very close, or has already passed for most western DM central banks.

We have investigated whether the second-to-last hike signal could also be relevant for a turn in yield curve trends. Here the historical data is less convincing. The last hike, rather than the penultimate one, seems a more relevant signal for 2s10s steepening, based on US Treasuries data since 1970, though we do find that 10s30s starts to re-steepen earlier.

Evaluating these three metrics together, we can conclude that the medium-term outlook has become more constructive for duration. This should not be a surprise to our regular readers, and we have been modestly long duration in portfolios since autumn 2022. The central bank battle against high inflation has not finished yet and some temporary correction upward in yields can be expected after the fierce drops amid the flight to quality (FTQ) in recent days. Still, that should be viewed in the context of a shifting trend in yields, and should give opportunities to add to long positions either outright, or cross market versus for instance Japanese or South Korean government bonds.

We have actively traded yield curves in recent days, for instance adding to steepeners in Canada and Sweden and closing a flattener in Australia, but the dominant theme at the total portfolio level in Q1 has been adding to steepeners as curves became more inverted. The more constructive rates market dynamic suggests peak inversion has likely passed for most markets. We would thus regard any sizeable new inversion moves as an opportunity to add to steepeners. Japan, as is often the case, remains the exception, and we continue to run flatteners in JGBs.

Fixed income asset allocation

- Tightening in lending conditions indicates the medium-term trend
- Credit spreads twist and turn as the rolling bear market continues
- When spread products are priced for recession, we buy them

Credit markets – recession pricing getting closer

We have been cautious in broad terms on credit markets since 2021, as the evolving global slowdown, tightening of monetary conditions and expensive valuations conspire to send spreads wider. Since October 2021, US IG spreads have nearly doubled from an OAS of +87 bps to +162. US High Yield has widened over 200 bps from +312 bps to well over +500 bps. But the path since then has not been a straight line.

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We have witnessed three large bounces in the meantime, from temporary OAS peaks in March, July and September 2022. Each one saw a market rally lasting a few weeks to a few months, but each was interrupted by a new bearish event. In 2022, these events were predominantly related to monetary policy and inflation (Powell's hawkish Jackson Hole speech, for example).

A new development in 2023 is the end of the latest bear market bounce due to bank failures in both the US and Europe. That changes the nature of the bearish newsflow quite dramatically for credit, in line with the Credit Quarterly Outlook from December 2022, *From rates to ratings* fears.

From here, looking beyond the near term and the dramas in US and Swiss banks, we think credit and growth-related developments will be key – and not monetary and inflation news. In fact, if anything, the best hope for credit markets lies in a disinflationary narrative, whereby household real incomes are restored and falling yields attract total-return momentum-chasing buyers to IG credit. Unfortunately, as outlined above, we think a soft landing is a low-probability outcome compared to our base case of US recession.

As a result, we remain cautious on credit overall, even though sharp moves and high market volatility mean there is room for tactical changes in portfolio credit exposure. For example, the 40% widening in the iTraxx Main index from early to mid-March created an opportunity to take profits on buy-protection positions. Events are moving fast and we retain a valuation focus in the short term.

It is important, though, to distinguish between the tactical and the strategic. It is normal for markets to try to time strategic bottoms most of the way down in bear markets. That seems to have occurred at several junctures since late 2021. The brevity of the credit bear market and recession in 2020 (just eight weeks for both!) may have added recency bias into the psychological mix.

Unless the BoE's action in October were a cyclical turning point for the global credit cycle, this bear market looks like a longer one than 2020, in the manner of 2000-02. We do not think the UK has the policy clout to drive global spreads (that probably ended in around 1916!). In any case, for the medium term, with US recession still ahead as our base case, we recommend strategic caution as our analysis suggests it's more likely than not that the ultimate OAS peaks lie ahead of us.

Fundamentals – bear market processes just beginning

The single best guide to the fundamental direction of credit spreads are the Federal Reserve and ECB's quarterly bank lending surveys. Whereas markets twist and turn (as illustrated by the start and end of three bear market rallies already this cycle) and at times give conflicting readings of events, the trends in lending surveys have been cyclically much more persistent (and ultimately reliable) over prior cycles.

Default rates have just started to rise, from a cyclical low of 0.8% to 2%.[2] However, the process has only just begun. As we highlighted in our last quarterly, *Recession Investing,* our analysis shows that while default rates usually tend to peak after credit spreads have peaked, default rates typically have to rise to a 4-5% level before longs can profitably be established. Further, the entire recessionary corporate earnings contraction seems ahead of us.

On the top-down side, the unemployment rate is yet to rise meaningfully, and our analysis shows that a rise of around 2 ppts is often typical in recessions. Again, spreads tend to peak a good while before the peak in the unemployment rate, but we are so early on in the process of labor market adjustment, that it arguably hasn't yet even begun.

One metric we analyzed this quarter was the performance of credit spreads once the NBER has called recession. While the official dating committee often only opines several months after the recession has started, and there is a degree of variability around the precise time from when credit markets actually recover, we have found this is not a bad metric for timing the start of a credit bull market. This indicator, too, seems quarters away.

Market factors

We think many market factors in credit strategy can be analyzed to help understand the backdrop and near-term future for credit. One area where we continue to be philosophically skeptical, however, is in the power of recent performance (flows, excess returns etc.) in determining future returns. So it has been in 2023. While January started with a buoyant credit market mood, not only did that stall in February, but it sharply reversed in early March. A surface-level analysis is incomplete too: even in the early-year euphoria, CCC-rated high yield companies were struggling to regain market access after 2022's primary market travails. This suggests rising defaults down the road.

This quarter we also analyzed the seasonal track record of credit markets and the potential for reversals in excess return as the year progresses. In no fewer than 14 years between 1997 and 2015, a good start to the year (either a strong January or a strong Q1 for credit) ended up in a mixed to negative excess return year. In some years, this was dramatic (e.g. 2007 and 2011); in others, it was more modest but still a defining characteristic of the year (2014 or 2015).

Still, while these seasonals played a notable role 10-25 years ago, they have been less prevalent in more recent years. An analysis of peer group performance suggests that an over-emphasis of (fleeting) strategy factors such as fund flows and performance has sucked the consensus into long credit positions. That set-up would prove fine in the event of a soft landing and sustained disinflation. But in the event of a harder outcome, these initial conditions suggest the potential for a washout at some stage.

A more reliable cyclical market-factor indicator is money supply. Here, US M1 is contracting at -4%y/y, with real money supply contracting at a -10% rate, a sharper fall than at any rate in the past 60 years. The monetary excess of the 2020 Covid response now seems a distant memory.

The rise in rates volatility has been a defining feature of the past six quarters of credit bear market. In March 2023, though the mathematical hurdle was already high, rates volatility reached new levels. For credit strategy, we think rising rates have a three-way effect. First, there is the causality of recession, as highlighted by Milton Friedman and Anna Schwartz in their seminal Nobel Prize-winning article in 1963. Sixty years on, their thesis remains as intact and relevant as ever, having stood the test of time.

Second, rates volatility has a market effect: we have highlighted the close correlation between rate vol and IG credit spreads in prior Quarterlies. Third, rates have an asset allocation impact: for domestic US investors, for example, a 3-month T-Bill with a close to 5% yield offers a compelling alternative to the US IG index yield at just 5.3%. Why take seven years of credit and duration risk for just 30 bps additional compensation? Indeed, the gap between yields and cash is an ominous forward-looking signal. In the past 40 years, the gap was only thinner ahead of 2008 and 1990, and it reached similar levels ahead of the 2000 Dotcom bust. The corporate yield to T-Bill gap is in the territory of busts and crises.

For international investors, this gap represents the actual FX hedging cost. For Japanese investors, for instance, hedged US IG corporate yields in JPY are now even lower than pre-2007-08: corporate yields have risen, but front-end yields have risen by more. A similar level was reached in late 2019, removing an important pillar of US new issue demand. (The silver lining for Japanese investors is that EUR IG credit offers relatively higher returns in JPY, but the global strategy implication, given the US tends to set the tone, is bearish.) All in, cash at nearly 5% shows we have moved from a world of TINA (There is No Alternative), to an alternative that not only provides competition, but is risk free. (One has to elicit a

2 LTM Issuer-weighted, US High Yield

half-smile describing US T-Bills as risk free ahead of another summer of potential debt ceiling drama, but hopefully the point is clear…).

Finally, on rates, it has become painfully clear in recent weeks that bank business models (borrow short and lend long) are vulnerable with inverted curves. First of all, there is the potential duration mismatch and mark-to-market question if duration risk hedging is incomplete (e.g. at US regional banks), but second, borrowing at 5% to lend at 4%, and doing so in levered size, does not add up. The upshot is that either curves need to resteepen (see the Rates section), or the weakest banks left in the system will continue to attract short sellers and headlines. Given events at Silicon Valley Bank, Signature and Credit Suisse, this is not a case of one isolated institution or geography globally.

Moving to equities, our analysis shows US equities tend to peak 5-8 months before the start of recessions and start to decline hard around three months before. While the S&P500 index has already declined over 18% from its peak six quarters ago, a recession potentially beginning in H2 2023 means investors should think now about when equity markets might anticipate it. The extraordinary rise in cyclically adjusted PE valuations in the prior bull market showed pattern similarities to the late 1990s, so it could be argued the degree of fall this time round has parallels to the 2000-02 era, too. This suggests a longer and large magnitude period of adjustment.

To be sure, the twists and turns in credit spreads do not make for a straightforward investing environment. There were six bounces in the credit bear market of 2000-02. While the historic almanac doesn't parameterize future outcomes, it would not be unprecedented to see at least another three bear market bounces to come before this bear market is over.

To balance out the argument a little, one positive signal has emerged. The rise in rates volatility to new highs – and the rise in credit and equity vol this has brought about – means that our proprietary global risk aversion barometers have now just entered the risk-averse zone. While historically they can occupy this zone for some time, we do view this as a contrarian indicator (even temporarily) and this is one input (of many) that we consider in our allocation to spread products.

Valuations

For all of the fundamental and market factor analysis above, the single most important question for allocating to spread products in this environment is: what market is pricing in recession? In 2022, we successfully added an allocation to GBP IG credit in October, once the OAS had reached +250. At this level, our analysis concluded that recession was priced in. Spreads soon peaked and tightened a full 100 bps into Q1 2023.

While we took profits on this position in January and February, the salient point is that when spreads price in recession, compensation is sufficient. Similarly, EUR swap spreads reached spreads of +100-110 bps amid financial market volatility in autumn 2022. While we were early in implementing the trade, recessionary levels here also proved a good entry point for an asset class that also has some mean-reverting characteristics.

For now, the only market that is close to pricing in recession across our universe is (once again) EUR swap spreads. Having reached tights amid calm markets in early March of around 60 bps, 5-year swap spreads reached over 50% wider to trade in the 90-95 bps zone amid the concerns over Credit Suisse, before its forced takeover by UBS had been fully appreciated by markets. That gave us an opportunity to re-add (we had previously dialed back swap spread exposure during the calmer earlier days of 2023).

Elsewhere, we view levels of +200 in the US OAS or +650 in HY indices as the sorts of levels that begin to compensate for recession. We are not there yet. However, we note that with US IG trading back up in the 160s OAS (from just +120 earlier in Q1) and EUR IG in the 190s (up from +140), we are getting there. The latter in particular is appealing at these levels, albeit the greater relative value is (like most of 2022) in the swap spread rather than the credit spread.

A final point to make on expected peak OAS levels is that there are different kinds of credit bear markets. For 2023, our base case is a garden variety recession, leading to an OAS peak at the milder end of the range. We could be wrong however and it's possible that a broadening of financial institution concerns leads to financial crisis. That might sound outlandish to some, but we have already witnessed the forced takeover of an entity not much smaller than Lehman Brothers and the failure of a US bank almost twice the nominal balance sheet size of Northern Rock. Further, there is precedent and a framework for the idea of financial cycles occurring once every 15-20 years, from the BIS.[3] While

3 https://www.bis.org/publ/work395.pdf BIS Working Papers No 395, The financial cycle and macroeconomics: What have we learnt?

this remains a minority risk in our view, we think it would be unwise to dismiss it. As Claudio Borio asks: what indeed have we learned?

Peripheral bonds: so far not bad

Peripheral government bonds have held up relatively well during the recent market turmoil. Nonetheless we believe that valuations of peripheral spreads remain vulnerable. Financial linkages between European banks and their sovereigns are still significant. In particular, countries with a more vulnerable banking system and high debt ratios could face risks of contagion should market stress that surrounds banks escalate. Despite the market turbulence, the ECB still hiked the deposit rate by 50 bps to 3.0% in March. As past ECB rate hikes increasingly feed through to the economy, growth is likely to continue to struggle, potentially raising concerns about the scope for fiscal deficits to tighten.

Furthermore, ECB QE support is waning. As of March, the ECB has reduced the amount of monthly APP re-investments, leading to lower government bond purchases at a time when supply pressures are still significant. Even as the ECB has committed to provide backstops (PEPP re-investments and the TPI tool), these backstops will only be triggered retro-actively (that is, after spreads have widened significantly). Therefore we continue to take a cautious approach with regard to bonds from Italy, Portugal and Spain. Their valuations look particularly stretched still versus high-rated SSAs.

EM debt: bulk of price adjustment made

As in DM, global rate-hiking cycles have now become sufficiently pronounced that signs of weakness in the global financial system are becoming more frequent. As global financial conditions tighten, it is only natural to see a rise in EM government debt defaults in hard-currency markets. This is likely to continue, albeit it is not an 'unknown unknown'. Markets spent much of last year re-pricing EM sovereign default probabilities higher and recovery rates much lower with many distressed bonds repricing 1500 bps wider.

> *“Global rate-hiking cycles have now become sufficiently pronounced that signs of weakness in the global financial system are becoming more frequent.*

While worries about additional defaults and the need for IMF bailouts are likely to increase as financing conditions worsen further, driving risk aversion and leading to still wider hard currency spreads, we suspect the bulk of the adjustment has been made. Moreover, given the scrutiny already on this market, the chances for further surprises appear relatively slim. In fact, many distressed countries have already sought assistance, evidenced by an increasing number of IMF program announcements. All of this should help limit the extent of further spread widening but does not mean EM escapes the global market environment.

Within the set of larger countries, Hungary remains a vulnerable candidate given its problematic mix of high inflation, weak external resilience and too loose monetary policy.

For EM local-currency markets, we expect central banks to respond to weakening growth and inflation risks by utilizing FX as the primary adjustment channel, with lower yielding currencies facing the greatest pressure. Markets such as Brazil and Mexico, where central banks were proactive, offer attractive real yields that should see these currencies outperform.

FX: Bullish on the yen

The rollercoaster of news over the past two weeks has left the USD virtually unchanged. This may come as a surprise as such headlines might trigger a stronger USD environment. But we think it is justifiable for a number of reasons. Perhaps the most relevant for FX in the current environment is USD funding stress, especially in the cross-currency swap markets. While USD funding via cross-currency has tightened recently, it is far from historically stressed levels especially at the very front end. This one will be key to watch over the next few weeks. Secondly, high-beta EM has been very resilient so far but we note the considerable divergence across currencies.

Indeed, Latam looks a prospective outperformer as shorts are expensive given the high level of real interest rates: this sets the hurdle painfully high to make money on those shorts, which is a different dynamic this cycle compared to prior years. Indeed, this time around, many EM central banks, front ran the Fed's tightening cycle by raising rates to levels not seen since the 2000s. As EM inflation is cooling substantially faster than, say, US inflation, the real rate complex is in favor of EM. That does not mean that EM high beta FX is about to rally – our point is more about its inability to sell off materially.

A key nuance to be made here is that EM is not a homogenous asset class; large differences exist. We believe that Latam and parts of Eastern Europe are better positioned

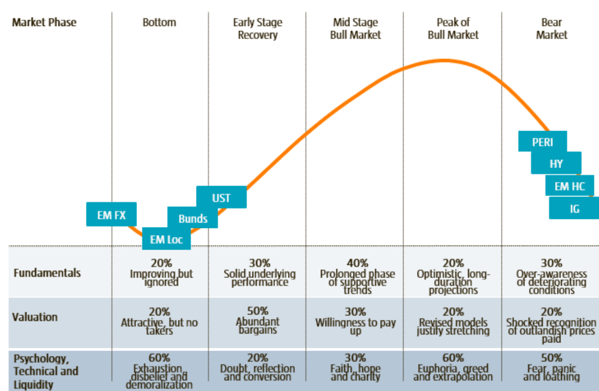
with relatively high rates, while Asia and Africa remain vulnerable given the lag in their pace of monetary tightening.

We believe the JPY remains a powerful bullish proposition as the BoJ pivots away from strict YCC policy to a policy that will allow rates to drift higher amid higher inflation and wage pressures. We expect the BoJ to start adjusting their policy settings, with April as the earliest opportunity. We expect the YCC policy to be adjusted in such a way that 10yr JGB yields can rise up to the 0.9% area. As we think the US is heading for recession and the Fed is close to being done on their tightening cycle, we also expect the JPY to get a boost from that angle as USD yields will be trading lower heading into a recession.

Finally, in flight-to-quality markets where the USD trades weak and front-end UST yields rally, the JPY works as a safe-haven trade. Overall, we are overweight JPY while being underweight cyclical FX such as the KRW, AUD, TWD and SGD.

Asset class positioning

Figure 1 | The market cycle



Market Phase	Bottom	Early Stage Recovery	Mid Stage Bull Market	Peak of Bull Market	Bear Market
Fundamentals	20% Improving but ignored	30% Solid underlying performance	40% Prolonged phase of supportive trends	20% Optimistic, long-duration projections	30% Over-awareness of deteriorating conditions
Valuation	20% Attractive, but no takers	50% Abundant bargains	30% Willingness to pay up	20% Revised models justify stretching	20% Shocked recognition of outlandish prices paid
Psychology, Technical and Liquidity	60% Exhaustion, disbelief and demoralization	20% Doubt, reflection and conversion	30% Faith, hope and charity	60% Euphoria, greed and extrapolation	50% Fear, panic and loathing

Source: Robeco, March 2023

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