

Stuck between a rock and a hard place

- Markets are stuck between a stubborn inflation environment and a recession
- Central banks may have to force a slowdown in order to combat inflation
- Buy-on-dips (and sell the rally) strategy remains our preferred approach

Markets have been talking about the upcoming US recession for more than a year. Over the past few quarters, we have elaborated about the increased risks of a recession, too. As of yet, a recession has not arrived. In Europe, Germany did recently slip into a technical recession after we witnessed two consecutive quarters of negative GDP growth. The decline in growth is being driven by the industrial sector. The consumer, however, does not feel this negativity as unemployment remains low.

Economic growth has been maintained by the consumer, both in the US and in Europe. The services sector has recovered to above pre-pandemic levels, thanks to strong consumer spending. This has resulted in inflation being stickier than anticipated. To alleviate inflationary pressures, the very tight labor markets need to cool off. Both the Fed and the ECB have been forced to keep their hawkish stance and hike rates further.

***“Increasing interest rates at such a fast pace always causes casualties.*”**

Increasing interest rates at such a fast pace always causes casualties. The liability-driven investment (LDI) crisis in the UK and regional banking crisis in the US are examples of collateral damage from the hiking cycle. In our last outlook, we already said this could lead to a further tightening of lending standards, and we are seeing this filter through.

Financial conditions have tightened further. Many industrial sectors are starting to feel the pain. This is especially true in Europe, where a higher percentage of loans are at the floating rate, which means the pass-through is rather quick. New loans have slowed down markedly. Capital expenditure in developed markets is not contributing to growth, despite anticipated secular support from programs like the Inflation Recovery Act or the onshoring of the tech industry.

The consensus view is that any recession would not be a balance sheet-type deep recession. And bear in mind that credit markets can be weak without a recession, and vice versa. It is more important in this case to find out where the rising interest rates will bite. In this cycle, interest rates have moved up by 4% on both sides of the Atlantic. This puts higher levered companies at risk, though the real estate sector is also in dire straits due to the higher interest rates. Knowing your assets is key to performing in such markets, as both risks and opportunities will come to the surface.

The uncertain macroeconomic outlook and inflation expectations result in higher volatility. This became evident again in March during the crisis around the US regional banks and Credit Suisse. We took the opportunity to add risk to our portfolios as financials had cheapened significantly. Since then the market has to a large extent normalized to pre-March levels, although certain pockets of value remain.

A buy-on-dips (and sell the rally) strategy from a conservative basis remains our preferred approach. Rates and recession fears are the key drivers in this cycle. And although 10-year US yields seem close to the cycle peak, volatility and uncertainty remain. Valuations are still around their long-term average, but are tighter than earlier in the

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year, while financial conditions have tightened further. For now we have taken some chips off the table.

With an outlook of either higher rates or a recession, and valuations in no-man's land, markets are between a rock and a hard place.

Fundamentals

The second quarter saw a continuation of the conditions seen in the previous one. Growth has surprised on the upside, due to strong consumer demand. But inflation remains stubbornly high, although it is gradually coming down. Rates continue to rise and lending standards continue to tighten. Industrial sectors in particular are gradually seeing the effect through lower margins. In certain sectors, pent-up demand is saving the day, keeping margins close to cyclical highs. Ultimately, they will normalize as well as the order backlog declines – they always do.

We have witnessed this in the microchip sector, which saw its best earnings years during the pandemic as consumers spent more on electronics and other goods. The chip shortage resulted in companies hoarding chips to ensure delivery of end-products. As demand normalized, inventories needed to be cleared and demand for chips and prices collapsed. Bonds of companies in this sector are now trading at recessionary levels.

We see signs of an inventory shock elsewhere too. Inventories are high and we see the first consumer goods companies cutting prices in an effort to de-stock.

Ultimately, a recession is merely the outcome of a drop in investment, production and consumption. It is more important that one looks for imbalances. Which sectors have benefitted most from the ultra-low-rate environment in the past 10 years? Where have we seen over-investment? Some margin deterioration does not necessarily change the fortunes of a company unless it is over-levered.

The good news is that in most sectors there has been no over-investment of any kind. Companies have mostly been focusing on optimizing profitability. This means in many cases we should only see lower top-line growth and a manageable deterioration of margins, which is already visible in cyclical industries like chemicals.

However, we have seen leverage rising in the past 10 years. In the high yield and leveraged loan market, companies have

been building up debt as peak margins and low interest bills allowed for that. Debt to EBITDA or interest coverage may still look fine for now, but debt to total capitalization already screens high. As interest rates move up and margins move down, balance sheets need to be adjusted.

The real estate sector has been playing the same game by revaluing portfolios to allow for more debt, leaving many companies now with a debt burden that their assets can no longer sustain. That means we are likely to see a further pick-up in defaults and restructurings.

Services sectors are in contrast in good shape as consumers started spending on services after the pandemic. Low unemployment, higher house prices and governments eager to support the consumer to get them through the pandemic and later energy crisis in Europe have helped. Services, however, have already reached levels above pre-pandemic trend growth, leaving little upside from here. House prices have peaked and are moving lower.

***“China has just gone through a real estate and an extended Covid crisis.*”**

Emerging markets are at a different point in the cycle. To counter inflation, emerging countries have been much more aggressive in hiking rates. As inflation comes down now, they have more room to cut rates going forward. In Brazil, real yields are currently near 5%, which is historically very high.

China has just gone through a real estate and an extended Covid crisis. Youth unemployment is high and consumer confidence low. As a result, China is lowering reserve requirements to prop up its economy. Will China save the day for the rest of the world as it did in previous cycles? We don't think it will. In previous cycles, China heavily invested in infrastructure and real estate to boost economic growth, and the rest of the world benefitted. Even if China was able to do this again, there seems to be little appetite to start a new investment cycle. China is focusing more on the consumer and high tech industries and is reducing its reliance on foreign trade.

The latter is bad news for European industry, and more profoundly in Germany, which has benefitted greatly from trade with China and a better competitive position that lower energy prices in Europe had brought. Europe no longer receives cheap natural gas from Russia. Gas prices may

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have come down due to an extremely mild winter, but are still very high compared to levels before the Ukraine war. As such we are slightly more cautious towards European corporates.

We remain comfortable about European banks where the general thesis still stands. We believe the banking sector has deleveraged a lot, capital ratios have been increased and balance sheets have become much more conservative. Interest rate-induced losses as witnessed at US banks are not an issue for European banks, thanks to tighter regulation.

Economically, things remain the same. The US economy seemingly continues to normalize after overheating. However, data is moving up and down. Volatility in rates markets has been high. A month ago, markets were pricing in rate cuts towards year end. In the last few weeks, they were priced out after disappointing inflation prints. Speeches by Fed chairman Jerome Powell remain hawkish. European economies remain vulnerable, with the ECB also vigorously trying to bring down Europe's sticky inflation.

“In the last quarter we buried TINA (‘there is no alternative’) for good.

All in all, macroeconomic indicators are pointing towards a recession later in the year. This has been the case for a while and is why this is the longest anticipated recession in recent history. However, both in the US and Europe, the consumer and the services sector are keeping economic growth positive for the time being, but industrial sectors are already suffering.

All we can conclude is that markets continue to be caught between recession fears and rate fears. To stop rates from moving higher, inflation needs to come down, and for inflation to come down, we almost need a recession. Credit markets are not fully pricing this in.

Valuations

Risk-free rates have moved up further over the last quarter and now compete with risky assets. This means markets will remain more volatile going forward as investors move from risky assets into risk-free, and vice-versa. In the last quarter, we buried TINA (‘there is no alternative’) for good.

We entered the past quarter at higher spreads after the banking crisis-induced March sell-off. Since then, markets have tightened considerably. Investment grade credit

spreads at current option-adjusted spreads (OAS) of around 145 bps are still around the longer-term median levels.

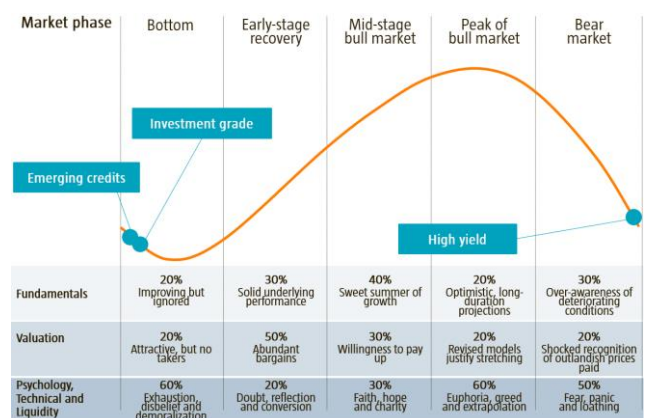
European spreads are slightly higher, although this is fully explained by a higher than normal swap spread. The average spread on AAA-rated bonds in Europe still trades close to historically high levels. This makes high-quality assets like covered bonds and agencies attractive investments for a portfolio.

An OAS of 200 bps is seen by the market as the appropriate level in a normal recessionary environment. We see spreads towards that level as a good entry-point at which to increase risk in an investment grade portfolio. In many cases, the market as whole may not reach such levels, but parts of the market will, as they did in March.

For most banks, additional tier 1 bonds (AT1s) recovered during the quarter, when prices moved up in May and June, and the larger banks in core-Europe performed particularly well.

High yield spreads have moved from an OAS of 450 bps to 400 bps. We still believe these spreads do not price in the uncertain economic outlook and higher interest rate environment. We believe that, even without a recession, corporate defaults in high yield will pick up. Over the last quarter, spreads between CCC-rated and BB-rated bonds even compressed.

Figure 1 - The market cycle



Source: Robeco, June 2023

Looking at our valuation sheets, a difference can still be discerned between financials and corporates, albeit a smaller one. Corporate investment grade corporate spreads remain just above average, while US spreads have dipped below it.

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Bank bonds remain firmly above their historical average despite their performance over the past few months.

High yields spreads are below average both in Europe and the US, with the US slightly more expensive than Europe. Emerging market corporate bonds have moved below their long-term average as well, although dispersion is high in this market.

We remain cautious about buying CCC-rated and low single B-rated credit, or corporate hybrids. We have also reduced our long position in AT1 bonds in response to the performance in that space.

We prefer a quality portfolio with some exposure to financials, stable corporates or idiosyncratic opportunities. We remain cautious about real estate, retail and cyclical sectors. Retail and other cyclical sectors in particular are not priced for potential margin declines.

Technicals

Technicals remain tough for the period to come. The Fed and ECB continue to be hawkish as inflation remains higher than desired. Both central banks are continuing their quant tightening programs, which is taking liquidity out of the market. Given the size of their balance sheets, one could argue that it still leaves a lot of liquidity in the market. In our opinion, it is more important to look at the change of purchasing by central Banks, which has become negative.

At its last meeting, the Fed surprised markets by clearly signaling the possibility of further rate hikes, and so the expected Fed fund rates for 2023 moved up. The market is now pricing in two additional rate hikes of 25 bps each, as growth and inflation expectations have been raised.

In previous statements, Powell had explained that recent events in the US banking system would probably contribute to further tightening of bank lending standards. But this time, he opened the door to a less hawkish stance, as recent inflation data has forced his hand.

All in all, the technical picture is not improving. Central banks are taking liquidity out of the market, while higher rates are drawing money away from risky assets. With flows towards credit becoming more neutral, it is hard for markets to find a clear direction.

As long as data keeps whipsawing and there is no clear direction of travel, volatility will remain high. This volatility needs to be reflected in higher spreads. Spreads will continue to move up and down with short-term rallies and sell-offs in the market. In the backdrop of such markets, we will continue to be contrarian, moving in and out of them.

The hiking cycle will most likely bring to surface a few more problems that are difficult to predict. We simply know that each hiking cycle historically has caused collateral damage in sectors of the economy that are not able to sustain a rising rates environment.

***“The Fed surprised markets by clearly signaling the possibility of further rate hikes.*”**

In recent weeks we have seen positive sentiment in credit markets fade. We are entering the season that is known for reduced liquidity, raising the risk of negative returns. “Sell in May” is seen as a strong law in financial markets. In the last few years, that law was often challenged as there was no alternative. With risk-free rates up significantly, investors can move into risk-free assets during market uncertainty.

Conclusion

We are in a period that marks the end of a 15-year experiment of low and negative interest rates. This has ended in an overheated situation where central banks were forced to act aggressively.

Markets are stuck between a stubborn inflation environment and a pending recession. These are interconnected. To kill the inflation monster, central banks almost have to force the economy into a recession to cool off labor markets. The time-lags between central bank action and impact make it virtually impossible to avoid over- or undershooting.

Ultimately, a mild recession itself is not the biggest problem. One needs to look for those parts of the market that are vulnerable to these much higher rates. Luckily we have not seen a capex cycle that has created over-supply situations. Banks have been held in check after the Global Financial Crisis. Yet, we think accidents are likely to happen, and have seen this already.

Our strategy in the current phase of the business cycle remains to buy the dips. We added risk in October last year and March this year because spreads moved significantly wider, creating value. We then reduced risk each time markets normalized.

Positioning

We have been buying the dips every time an opportunity revealed itself over the past few quarters. In October last year, we saw a broad sell-off in markets after the LDI crisis. In November, Asian credits offered new opportunities, and in March, value appeared in the financial sector.

Moving contrarian into positions during a period in the cycle when risks are elevated, also requires the discipline to take some risk off the table.

So, we have lowered the beta of the investment grade portfolios, although not yet to a neutral position, as we still see pockets of value. We had taken on risk via the financial sector, and as positions mean reverted back to pre-March levels, we also took profits. Our AT1 position in the global portfolios has been reduced back towards 3%. We do however still like financials, and banks in particular, where there is plenty of value to be found.

We decided to take out the swap spread position that we had increased in February. The thesis was that the arrival of quantitative tightening would further reduce swap spreads. It did, although not to the extent we had hoped. With no immediate catalyst on the horizon, we decided to close the position. We still like the level of swap spreads in Europe, but from here we prefer to play this via AAA-rated bonds like agencies and covered bonds.

For our high yield portfolios, we remain conservative. Within the CCC and low-rated B's space, we see many companies that are unable to sustain higher rates and an economic slowdown. Defaults will rise at the low end of the high yield market, and it is our strategy to avoid these losers. That results in an up-in-quality portfolio with a beta that is below 1. This also gives us room to increase the beta when we see opportunities arise on the back of volatility.

For our investment grade credit portfolios, we brought betas back to around 1.1, whereas the betas of our high yield strategies moved below 1. We continue to like financials and also see value in sectors such as technology, in particular in chip makers, which have repriced to recessionary levels. In

general, corporate exposure is not yet cheap enough to add, and cyclical sectors are rich, in our opinion.

We are still overweight Europe as a result of our positions in the banking sector. On European corporates, we are somewhat more cautious. We believe the risk of rising energy prices and China's economic recovery are insufficiently priced in.

The US seems to be closer to the end of the hiking cycle, is energy independent, and is less dependent on a recovery in China. On the other hand, leverage is higher, particularly in the high yield space, and we are mindful of potential value traps. Being underweight CCC-rated and low B-rated companies is the result of this.

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

Source: Robeco, June 2023

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 and Martin van Vliet (Robeco), Dario Perkins (Lombard Street), Robert McAdie (BNP Paribas) and Stephen Caprio (Deutsche Bank) have been taken into account in establishing our credit views.

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This document has not been registered with the Monetary Authority of Singapore ("MAS"). Accordingly, this document may not be circulated or distributed directly or indirectly to persons in Singapore other than (i) to an institutional investor under Section 304 of the SFA, (ii) to a relevant person pursuant to Section 305(1), or any person pursuant to Section 305(2), and in accordance with the conditions specified in Section 305, of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. The contents of this document have not been reviewed by the MAS. Any decision to participate in the Fund should be made only after reviewing the sections regarding investment considerations, conflicts of interest, risk factors and the relevant Singapore selling restrictions (as described in the section entitled "Important information for Singapore Investors") contained in the prospectus. Investors should consult their professional adviser if you are in doubt about the stringent restrictions applicable to the use of this document, regulatory status of the Fund, applicable regulatory protection, associated risks and suitability of the Fund to your objectives. Investors should note that only the Sub-Funds listed in the appendix to the section entitled "Important information for Singapore Investors" of the prospectus ("Sub-Funds") are available to Singapore investors. The Sub-Funds are notified as restricted foreign schemes under the Securities and Futures Act, Chapter 289 of Singapore ("SFA") and invoke the exemptions from compliance with prospectus registration requirements pursuant to the exemptions under Section 304 and Section 305 of the SFA. The Sub-Funds are not authorized or recognized by the MAS and shares in the Sub-Funds are not allowed to be offered to the retail public in Singapore. The prospectus of the Fund is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply. The Sub-Funds may only be promoted exclusively to persons who are sufficiently experienced and sophisticated to understand the risks involved in investing in such schemes, and who satisfy certain other criteria provided under Section 304, Section 305 or any other applicable provision of the SFA and the subsidiary legislation enacted thereunder. You should consider carefully whether the investment is suitable for you. Robeco Singapore Private Limited holds a capital markets services license for fund management issued by the MAS and is subject to certain clientele restrictions under such license.

Additional information for investors with residence or seat in Spain

Robeco Institutional Asset Management B.V., Sucursal en España with identification number W0032687F and having its registered office in Madrid at Calle Serrano 47-14^º, 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.

Additional information for investors with residence or seat in Switzerland

The Fund(s) are domiciled in Luxembourg. This document is exclusively distributed in Switzerland to qualified investors as defined in the Swiss Collective Investment Schemes Act (CISA). This material is distributed by Robeco Switzerland Ltd, postal address: Josefstrasse 218, 8005 Zurich. ACOLIN Fund Services AG, postal address: Leutschenbachstrasse 50, 8050 Zurich, acts as the Swiss representative of the Fund(s). UBS Switzerland AG, Bahnhofstrasse 45, 8001 Zurich, postal address: Europastrasse 2, P.O. Box, CH-8152 Opfikon, acts as the Swiss paying agent. The prospectus, the Key Information Documents (PRIIP), the articles of association, the annual and semi-annual reports of the Fund(s), as well as the list of the purchases and sales which the Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, at the office of the Swiss representative ACOLIN Fund Services AG. The prospectuses are also available via the website.

Additional information relating to RobecoSAM-branded funds/services

Robeco Switzerland Ltd, postal address Josefstrasse 218, 8005 Zurich, Switzerland has a license as asset manager of collective assets from the Swiss Financial Market Supervisory Authority FINMA. The RobecoSAM brand is a registered trademark of Robeco Holding B.V. The brand RobecoSAM is used to market services and products which entail Robeco's expertise on Sustainable Investing (SI). The brand RobecoSAM is not to be considered as a separate legal entity.

Additional information for investors with residence or seat in Taiwan

The contents of this document have not been reviewed by any regulatory authority in Hong Kong. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. This document has been distributed by Robeco Hong Kong Limited ("Robeco"). Robeco is regulated by the Securities and Futures Commission in Hong Kong.

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 deemed authorized and regulated by the Financial Conduct Authority.

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 27 September 1996, as amended.