CREDIT QUARTERLY OUTLOOK Q2 2023

Buy the dip

- Economic conditions still fair but credit conditions are tightening quickly
- The November peak was a buying opportunity, as was March
- Policy intervention and banking stress present an opportunity

Over the past few quarters we have been highlighting the theme of identifying the Fed's second-to-last rate hike as a means to develop an end-of-cycle portfolio strategy. Market pricing around the Fed's end game has shown this is not an easy task – as we knew would be the case.

Rate expectations first increased late last year based on hawkish Fed comments and strong labor market numbers. Up to six additional rate hikes were priced at a certain point. Recently, this has been reduced to expectations of two rate cuts by the end of 2023. These adjustments reflect large economic imbalances in the form of very high debt-to-GDP ratios, record corporate margins and the belief that money has been free for too long.

In October last year we decided to buy the dip to a certain extent since the market was overly cautious. We increased betas to just above one for investment grade and close to neutral for high yield. Whether a bear market rally or not, it turned out to be the right choice. We reduced this position in the first quarter of 2023.

More recently, US and Swiss banking events have also had an impact on market pricing. More about that later. For now it suffices to say that we believe the financial sector has become a buying opportunity again, due to the Silicon Valley Bank and Credit Suisse debacles. We are buying the dip again.

"The market trades between the certainty of a recession and the hope of a shallow one.

The basis scenario still is that the Fed was on a hiking path. Inflation and economic data were not yet sufficiently subdued. We also know that accidents will happen in such situations. These always occur in some form or another, whether as a dot.com crisis, a subprime crisis or a UK LDI crisis. There will be black swan events at the end of a Fed hiking cycle, and certainly after such a prolonged period of free money and in the wake of such a dramatic change in course for the Fed and ECB.

The recent banking stress will have changed one thing. Bank lending standards were already tightening and this process will now accelerate. It will bring the second-to-last rate hike closer and make a recession more certain – and there may be more accidents along the way. Refinancing is the key element in a credit downturn and this is precisely what will be more difficult for some companies.

There was good reason for our focus on the second-to-last rate hike. Rates fears were the key driver in this cycle and ten-year yields historically seem to peak at that penultimate point. But it looks as though we're now back to fundamentals and we therefore have some confidence that it's time to slowly enter a buy-on-dips strategy.

Meanwhile, it seems the market trades between the certainty of a recession and the hope of a shallow one.

Fundamentals

What happened at Silicon Valley Bank and Credit Suisse? We won't go into the finer details but it starts with the rule of thumb that, at the end of the hiking cycle (certainly after such a steep rise in central bank rates), there are casualties.

ARTICLE MARCH 2023

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There always are. We just don't always know which sector or region is the most vulnerable at that point in the business cycle.

In this case, two specific bank events occurred that we consider to be idiosyncratic – and which we do not believe mark the start of a systemic series of events. These events had a catalyst in common: deposit outflows. We estimate that bank deposits totaling around USD 400 bln have flowed out of the banking system, which is another example of TINA ('there is no alternative') disappearing fast and putting stress on funding or profitability for banks. For Credit Suisse the deposit flight was obviously driven by confidence.

As a regional bank, Silicon Valley Bank operated under a flaw in the US banking regulation. Smaller banks (balance sheets below USD 250 bln) have a lighter regulatory regime than the bigger banks. They do not have to realize unrealized losses in the 'assets held for sale' portfolio, which is meant as a pool of liquidity. For Silicon Valley Bank it started when venture capital deposits, which typically are working capital rather than old-fashioned deposits, were withdrawn. Silicon Valley Bank was forced to sell liquid 'assets held for sale' and realize the losses.

It is quite possible that more US regional banks might experience issues. These could be triggered by real estate losses, commodity exposure or exposure to any other regional hotspot sector.

Importantly, the big US banks do not suffer from this regulatory flaw. Neither do European banks.

"Credit Suisse basically was the only European bank left in hospital.

Credit Suisse, in turn, was basically the only European bank still in hospital after Deutsche Bank had been discharged. However, when markets smell blood, trust in banks that had come by foot will leave on horseback. Credit Suisse obviously had an operating problem. A sound credit culture had been broken and the bank needed time to repair this. Unfortunately, a bank does not always get that time when confidence has been broken and capital is insufficient.

We believe the banking sector has deleveraged a lot, capital ratios have increased and balance sheet risks have been made much more conservative. The fact that there are far fewer illiquid assets on balance sheets, liquidity has improved, direct lines have been established to the central bank instead of Libor lines among the banks, means that this time around the banking sector is not the systemic risk factor.

History shows central banks always underestimate their actions. The process goes as follows: first, they blow bubbles. In this case it was by providing cheap money for too long. Second, central banks deny any negative side effects of changes in regulation or policy execution. Third and fourth, they try to solve it all with liquidity, after which they realize that is not the problem and that, instead, capital is the issue. So, the rot only stops after these weak banks get more capital.

All these policy reactions have just taken place in the space of two weeks. That is the good news and the benefit of the lessons of 2008. Policy makers react more quickly.

Our concern, rather, is with other leveraged sectors that might be rate sensitive, like CLOs, real estate or venture capital sectors. It calls for caution and a preparation for further decompression between higher-quality and lower-quality assets.

So much for banking risks. Back to economics. We'll keep this brief.

The US economy shows many signs of normalization from overheating. There is an expected increase in job cuts, hourly earnings are coming down and the number of hours worked is moderating. The main concern at the moment is that markets have become optimistic again since last October. Risky assets have rallied; for example, cyclical companies like Caterpillar and Siemens in Europe are up 50% or more.

Interestingly enough there are also early signs of an inventory shock. Inventories are high and we see examples like, most recently, Nike cutting prices in an effort to de-stock.

We would point to the fact that earnings per share drop on average 23% in a recession, which does not fit current equity market valuations. Only when risk-free yields go down significantly can some optimism return. Incidentally, with risk-free yields lower as we head into recession, growth stocks might strike back versus value stocks.

The European story is dull. The economy is in stagnation, as has been the case so many times before. Drilling down into the components, it is clear that industrial production is suffering the most. By contrast, consumer behavior is much more stable due to jobs growth, wage increases and, going forward, lower inflation. Personal income growth will actually go up a bit further.

Overall, the main theme fundamentally is that corporates will face headwinds. A big headwind is the fact that wages will rise and hence margins will compress from very high levels.

The key problem in the current situation is forecasting. Forecasting GDP or interest rates is notoriously difficult (which is why being contrarian in valuation positioning is our preferred strategy).

Here are a few timelines that we analyzed that help us to understand the cycle:

- It takes five or six quarters to see the impact of tighter lending standards on credit growth and GDP growth (recent events might detract another 0.5% GDP via tighter lending standards).
- It takes five months on average for a recession to occur after the inversion of the interest rate curve.
- Credit markets rally only after the last rate hike.

The conclusion is that we will experience a traditional recession late this year. The question is whether markets are priced for that. Sometimes they are, and sometimes not.

Valuations

The main item causing market volatility is the fact that T-Bills or risk-free rates are competing with risky assets. There is a massive gap between money market yields and deposits, and therefore TINA rests in peace. This phenomenon is causing decompression and occasionally some stress and repricing.

"R.I.P. TINA.

In general one can state that investment grade credit at current option-adjusted spreads (OAS) of 160-170 bps does reflect something of a slowdown. At around 200 OAS levels, like we noticed in October, it is a buy in normal recessionary environments.

For high yield, we notice that spread levels basically are 300 bps OAS too tight still for a recession to be reflected. We did see some decompression in, for example, CCC-rated credit versus BB credit. BB credit seems to have done better versus for example BBB too in recent months.

The stress at some US and Swiss banks has caused an aggressive repricing of bank spreads. This has been centered around the AT1 market and has even triggered questions about the functioning of the AT1 market. We note the Swiss bond indentures of the AT1 issues of Credit Suisse clearly described permanent loss absorption in a non-viable situation. Credit Suisse got into that situation due to market risk aversion and a weak credit culture. The bank was not given the time to execute restructuring like Deutsche Bank got. In that sense Credit Suisse was a victim of a credit crunch based on a lack of sufficient capital to execute the reorganization.

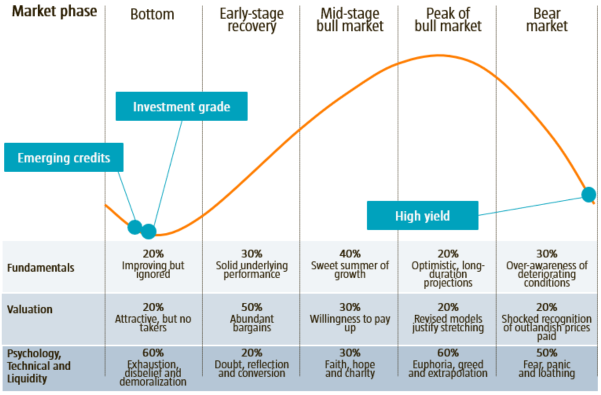
Robeco Fixed Income did not hold Credit Suisse's AT1 bonds – nor those of Silicon Valley Bank or other Californian banks.

The reason we like AT1 now is that these events have increased massively the risk premia on them. At above 8% yield, let alone at current much wider levels, we normally like these bonds. Equity-like returns are possible in these AT1 bonds. It also shows that equity-like risks are involved in a very adverse, scarce and idiosyncratic situation. AT1 has protected senior bond holders and therefore did exactly what it was supposed to do: absorb losses in a perfect storm. The fact that equity should preferably have lost 100% of its value instead of 95% does not matter too much to us.

Looking at our valuation sheets there is a clear difference between financials and corporates. Both in high yield and investment grade, the corporate sectors are a touch cheap but no longer recession-proof as in October.

We will remain a bit constrained still in buying CCC-rated credit, peripheral (financial) bonds or corporate hybrids. We prefer a quality portfolio with some exposure to financials. We are most cautious on real estate, retail and other rate or recession-sensitive sectors.

Figure 1 - The market cycle



Source: Robeco, March 2023

An interesting anecdote is that for a brief period T-Bills traded at a higher yield than US investment grade credit. It once again tells you that risky assets will have to compete for risk-free (real) yields. With the second-to-last rate hike here, we know spreads might still have to peak.

Technicals

Let us start with Mr. Powell's press conference that took place the day before our Credit Quarterly Outlook meeting. There was a clear statement that the Fed was on a path of some more tightening in the months ahead. Strong labor numbers were the main reason for this, since these would keep the still too-high inflation rate higher for even longer.

Then Powell explained that the recent events in the US banking system would probably contribute to further tightening of bank lending standards. These therefore need to be taken into account, although it will take time to assess the fall-out of these events.

> *"This period of the cycle is known for all kinds of flash crashes, corrections and convulsions.*

Compared to previous meetings, there is a slight change of tone in the Fed's press release: it now states that some more rate hikes may be appropriate, depending on data and the assessment of the banking stress and potential contagion. It means a more balanced rate outlook from the Fed. We mention this in the 'Technicals' section since we still are in the phase of the business cycle where the Fed is not your friend. Technicals are still against us.

The active exploring by markets of where we are in the cycle and when the recession will start has caused a very particular market behavior. Data shows we constantly slip into a risk-on-risk-off kind of environment. It means yields drop and spreads widen, and vice versa. In this beta-on or beta-off environment we try to steer beta contrarian to market moves.

This period of the cycle is known for all kinds of flash crashes, corrections and convulsions. Last week we noticed a record three-day spread widening followed by one of the strongest ever one-day recoveries. Also it seems the correlation between spreads and rates has become negative again. It means markets are not driven by rate fears anymore.

Central banks are not yet our friend. Risk-free rates will remain high for longer and might even be pushed a bit higher. In that sense there is a policy error of too much tightening in the making.

Conclusion

Central banks have been experimenting with monetary policy for years – and have invented a lot of new monetary instruments and strategies along the way. The result has been low or negative yields for way too long. The economic system created debt in all corners of society. We can also mention economic idiocy like NFTs, SPACs or what have you. Typical end-of-cycle inventions. A fast and aggressive hiking cycle will for sure reveal many problems. Which ones that will be we don't know, but a few real estate and banking accidents would all make sense.

All time series show the recession could start somewhere toward the end of the year – and we believe central banks will definitely cause one. The main addition to our views in our previous Credit Quarterly Outlook is the fact that bank lending standards will tighten in an accelerated fashion. The next Credit Quarterly Outlook will probably shine more light on the recession.

Our strategy in the current phase of the business cycle is to buy on dips. Spread markets reflect recession every now and then, driven by yield peaks (we might revisit 4% in US 10-year

Treasuries), financial stress like that of recent weeks or via an old-fashioned corporate credit crunch.

The Fed is not our friend yet, and rate cuts are too optimistic an expectation for now. Be prepared for risk-free rates being very credible alternatives to other asset classes for longer. It is payback time for years of negative yields and manufactured bubbles.

Positioning

We are far enough into the business cycle and rate cycle that when markets become too bearish, like in October, or when banking events like those of recent weeks drive spreads wider, buying opportunities occur. That is why we buy the dip in specific segments of the market. Last time it was swaps and high-quality credit, this time it is AT1 and subordinated financials where excessive risk premiums are offered.

The rest of the market, in broad terms, is just not yet fully at recession levels. We therefore limit ourselves in the consumption of the beta budget using 25% of our risk budget.

We have increased the beta of the investment grade portfolios via the financial sector. Our view that the banking stress was idiosyncratic rather than systematic gave us the conviction to increase the overweight in European banks. These somewhat higher-beta European banks have given us this opportunity a few times over the last 10 years. We have bought AT1 based on a much larger risk premium driven by the Credit Suisse stress. We might have up to 5% exposure in global accounts. The rest of the purchases have been in plain vanilla senior or lower tier two bonds.

On top of that we increased the long swap spread position a bit after having halved it in February. This is the best way to have exposure to high-quality agencies-like exposure which all trades from swaps.

In high yield we have closed some overlay hedges in XO and CDX derivatives, which are much easier to transact. It drove the beta up closer to neutral and with some financial purchases a touch long beta even. Given the cautious outlook of lower-rated assets we are a little more careful in high yield.

We will revisit cyclical companies after the strong performance since October.

For our investment grade credit portfolios we are using roughly 25% of our risk budget, pushing betas to around 1.2-1.3x, whereas the betas of our high yield strategies are slightly above 1. This is targeted specifically through the financial sector exposure and swaps. Corporate exposure is not yet cheap enough to add – or at least we prefer the much wider financial spreads for now.

The consequence of all this has been that the European overweight has been increased versus the US region. It is more the long European banks that cause the position. For high yield it is the underweight of CCC-rated bonds, among others, that causes the European overweight. With the recession still to start, we expect some more underperformance in this rating spectrum.

We do believe risks are more skewed to the US market this time. Fed action is much more front loaded, regional banks have a hedging problem on treasury holdings and other exposures are also more concerning, like covenant-lite leveraged loans and CLOs.

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

Source: Robeco, March 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, Martin van Vliet and Rogier Hoogeveen (Robeco), Max Kettner (HSBC), Barnaby Martin (BofA Securities) and Mislav Matejka (JPM) 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 47-14º, is registered with the Spanish Commercial Registry in Madrid, in volume 19.957, page 190, section 8, sheet M-351927 and with the National Securities Market Commission (CNMV) in the Official Register of branches of European investment services companies, under number 24. The investment funds or SICAV mentioned in this document are regulated by the corresponding authorities of their country of origin and are registered in the Special Registry of the CNMV of Foreign Collective Investment Institutions marketed in Spain.

Additional information for investors with residence or seat in South Africa

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

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 Zürich, 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. 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 27 September 1996, as amended.