Credit Quarterly Outlook Q1 2022

Imperfect information and imperfect foresight

- We expect a seasonal growth rebound after a tough Covid winter
- Valuations have cheapened a bit and corporate credit quality is good
- Technicals are weak with the Fed tapering process starting and central banks hesitating on the right policy response to inflation fears

For economic advisors, imperfect information implies imperfect forecasts, which in turn complicates the process of forecasting economic activity. This is especially true right now. With so many distorting elements at play, including severe global supply chain disruptions, we simply cannot rely on economic theory for easy answers. As we consider all the evidence around corporate pricing power, policy stimulus and consumer spending behavior, we believe that US and European fundamentals will not be the key driver of credit markets in Q1 2022.

Regarding valuations, we have seen a back up in spreads. This started in Europe, while the US lagged somewhat. We believe the US credit market will catch up, as soon as everyone realizes we are in the same global boat when it comes to Covid. There are also many risk factors that we believe are still not sufficiently priced, like geopolitical risks around Russia, the growth impact of the Chinese real estate meltdown, and emerging market volatility in general. Managing these risks with a contrarian research-driven attitude is more important than pinpointing the correct beta, if that already exists.

Outlook
For professional investors
Q1 2022

Victor Verberk & Sander Bus
Co-heads Credit team

Jamie Stuttard
Credit strategist

Technicals, and especially central bank activity and communication (the Fed's 'retiring transitory', for example) might cause a bout of risk aversion after years of increased risk taking by asset owners. Hence the technical side of our assessment provided the most ammunition for discussion and we believe it will be the main reason to stay cautious for a while longer.

Fundamentals

Humility is still the most appropriate term to use while assessing the economic prognosis. Consider the intraday volatility of equity markets as a proxy for the difficulties most of us have in assessing the current and future likely outcomes.

A few things are safe to state, though. Global manufacturing growth is solid enough despite the recent downward adjustment in growth estimations. Consumer goods demand continues to underpin growth. Actually, almost all growth has been driven by consumer demand. Capital investments and inventory build have so far hardly contributed. That might bode well for the future.

Most corporates are doing very well and profits are up. Rising input costs are increasingly a theme, but margins have held up well in general and it is clear most corporates are able to pass through rising input prices. Meanwhile, the US labor market is tightening. With vacancies difficult to fill, the significantly lower labor force participation rate than in the pre-Covid era, a trend towards early retirement and some 2.5 million lost jobs since early 2020, the overall picture is a bit blurry – but the bottom line is that labor shortages are emerging. In any case, we see labor scarcity with wages rising primarily in the lower income brackets.

A key source of concern for markets of course is inflation. Inflation prints have headed persistently higher. Despite central banks having been very firm that this would be transitory, more and more market participants no longer believe this. The Federal Reserve's communication has not helped the cause, either. The most recent comments by Chairman Powell, that we should retire the word 'transitory' or change its definition, have not been productive. Efforts in recent years to convince markets that the Federal Reserve would deliberately be behind the curve, have come to naught after a few months of high inflation.

Also, the timing of these comments was odd, given that markets were simultaneously digesting the omicron news. Equally odd was signaling that the pace of tapering would be sped up, only six weeks after its first announcement, when the Fed had previously lagged other English-speaking central banks by six months in announcing the start of tapering. It all points once again to our critical view of central bankers and the consequences of their behavior.

Markets now price nearly six rate hikes until December 2023, which would bring the federal funds rate to 1.5%, at the lower end of what we expect to be the neutral rate.

In Europe, it's too soon to talk about rate hikes. But we do have to prepare for a wind down of PEPP at some stage. We think that the ECB would want to maintain some flexibility, though, and would keep the option to reinstate PEPP whenever they feel it is needed again. In all likelihood APP might even be expanded temporarily, to offset the end of PEPP. In other words, the ECB's credit purchases will continue in some shape or form in 2022 – and the continued global portfolio rebalancing into risky assets is not over yet.

While talking about rate hikes in Europe is premature, talking about swap spreads is not. Although it is difficult to pinpoint why, the widening in European swap spreads suggests an imbalance. It could be a shortage of collateral (Bunds) or some other (leveraged) exposure being wrongly positioned. It could also just be year-end liquidity concerns that will abate in the next few weeks. We mention this because it shows that, sometimes, market drivers are not entirely clear. It's a matter of having to work with 'imperfect information'.

On fundamentals, our biggest concern is still on China. With 25% of GDP and 40% of domestic lending related to real estate, one cannot afford to be too easygoing about China's property sector. There might be some fall-out into European banks, too. A full-blown crisis after a secular credit boom tends to follow a sequential pattern and, when serious enough, can lead to a Minsky moment and very turbulent risk premia adjustments. Initially, market participants underestimate the wider implications of a seemingly idiosyncratic event. Then it becomes apparent that there are broader sector issues, following years of system-wide debt accumulation. In time, unforeseen contagion elements cause market participants to worry about liquidity, and they eventually panic due to outflows. While policymakers can mitigate the forces of contagion, resolution of the underlying imbalances can take years.

The conclusion is that, for a western developed market credit investor, the fundamentals will probably be fine. Despite the difficulties in estimating growth, and barring a major policy mistake from the Fed or a downward acceleration in China, fundamentals will probably not be the long-term driver for credit spreads beyond a tough winter. Most likely is that we get a further healthy medium-term recovery. Inflation and central bank behavior and communication will determine sentiment and might drive

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short-term risk cycles. Our Global Macro team expects European inflation to peak in Q4 2021 and US CPI to peak in H1 2022, after which inflation is expected to moderate to just above central bank targets by the end of next year.

More than ever before, we are now investing in a world of imperfect information and imperfect foresight. This will drive market volatility and hence create opportunities for active managers.

Valuations

Valuations have very recently eased a bit, as we have been expecting for some time. US and European credit spreads on average widened by 25 bps for investment grade and by 50 bps for high yield, while Europe underperformed slightly. For example, with European spreads at 108 bps at the time of writing, the historical median spread of 122 bps is still some way off – let alone the historical third-quartile OAS level of 173. In short, markets certainly are not cheap yet.

On the other hand, it does offer some opportunities for stock picking and it is good for Robeco's current cautious positioning. We still believe that risk factors have not been sufficiently priced. Geopolitical risks (Russia and Ukraine), inflation concerns, the China growth scare, energy prices or just general moves of nominal yields (in both directions, given H2 2021's curve pivot), all suggest that current spreads are not justified.

Rising yields in general are good for credit spreads. When one digs a bit deeper, a gently steepening rate curve is even better for credit. When inflation expectations rise, like we're seeing now, real yields can fall and that generally is accompanied by positive credit excess returns. However, as we've written before, rising real yields reflect a different situation: they are typically accompanied by wider spreads. For now, real yields are still at rock bottom.

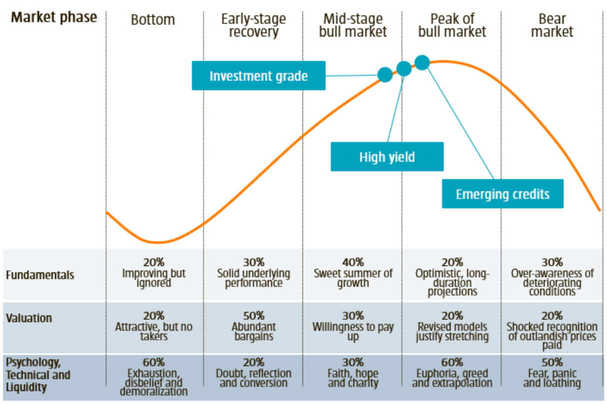
Valuations are well underpinned by corporate health. Margins are generally strong, pricing power seems to be mostly in order and cash balances are high. In fact, most credit strategists expect rising stars to heavily outnumber fallen angels. Corporates are managing leverage in a way which is credit friendly and the default rate has fallen back to close to all-time lows.

A special note on Chinese credit is fitting. We are very cautious here, given our base case of an extended slowdown and our assessment that the high yield market in China is almost uninvestable, given opaque disclosure. Furthermore, the Asian credit landscape is still too reliant on implicit government guarantees. Spreads in some cases are very cheap but one needs thorough credit research to make choices and assess the difference between 'cheap' and 'value'. There is a lack of market-wide rigor in bottom-up research.

In developed market credit, we like BB-rated credits and prefer the higher spreads in European high yield over US high yield. Higher-rated European credits have been driven wider by the correlation with swap spreads that had widened in Europe. We allocate more to covered bonds and quality credit. We also think higher yields and inflation should bode well for financials.

The conclusion on valuations is that we think credit spreads are still expensive. The limited widening that we have seen might deliver some stock-pick opportunities, for example in Covid-recovery companies, financials and high yield, given the better duration protection.

Market cycle | Mapping our view on market segments



Source: Robeco, December 2021

Technicals

We have referred to our concerns about central bank policy mistakes and communication errors. We leave it at that. In their defense, though, central bankers also face a world of imperfect information and imperfect foresight. Looking at economic sectors in aggregate terms is easy but it can be misleading. For example, one has to disaggregate consumers' savings and wealth trends into different income and wealth brackets to assess the potential implications of savings dynamics for future spending. Also, the ECB, as always, has to set policy for Northern as well as Southern Europe using a single policy rate.

It could well be that some supply bottlenecks are here to stay for a good while yet, even if there have been incipient signs of easing. Longer term, Covid might become part of life, but its economic impact should dwindle over time. It

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does mean that corporates will have to adjust their view on just-in-time delivery, governments have to execute more fiscal transfers and market-risk cycles might be more frequent. We mention this under 'technical', since a potential permanent impact on inflation remains a big question and the uncertainty premium on central bank behavior could be bigger. It also increases the chance of policy mistakes and market reactions to these mistakes.

Among the many variables we monitor is the USD. The greenback is appreciating on a trade-weighted basis and that might cause stress in the medium term. After all, the USD is still the world's reserve currency. About 50% of all cross-border lending, 80% of all FX transactions, 50% of all international trade and 80% of all import and export for emerging markets are denominated in USD. A more expensive USD makes global debt service costs more expensive for borrowers reliant on external financing like Turkish corporates or Chinese real estate developers.

Another topic is the geopolitical risks in Europe versus the US. Europe faces a range of issues along its eastern frontier, from Polish-EU relations, Russian-Ukraine tensions, events in Belarus and increased financial market volatility in Turkey. On their own, none of these may matter. Yet in combination, these events could coalesce into a more bearish tone. In the US, the near-term sees a calendar-based risk in the debt ceiling, once again. While eventual resolution is likely, brinkmanship before a deal is often observed, too. The latter would be particularly relevant for risk if it occurred in more seasonally illiquid holiday markets into year end.

A final topic which has become more relevant is LBO risks. We have not written much about this in recent quarters, but the barbarians are back at the gate. There is a lot of as yet undeployed dry powder at private equity firms and deal values are drifting up (think, for example, of the telecom sector).

The conclusion is that technicals look weak. There are too many risk premia that are not well priced. This combined with the clear central bank hesitation in discerning the most appropriate path forward for policy, might prompt flows out of risky assets.

Positioning

We have written about 2021 playing out as either a boring or bearish year. It turned out to be boring, with year-to-date EUR investment grade excess returns at 0%. That said, at the tail-end of the year it looks as though economic uncertainty is increasing, driven by unease around inflation. In our case, we would need to be convinced that we're at the beginning of something bigger in order to justify increasing betas from the current underweight.

We do see the opportunities opening up in selected emerging markets ex-China, as well as in financials, BB-rated credit, Euro swap spreads or Covid-recovery plays. We remain overweight EUR over US credit, given where valuations are. We would adjust this on any back up in the US credit market.

The strategy will also be about managing risk factors in a portfolio context. For example, if one owns a great deal of callability risk via hybrids or holds a set of higher-risk idiosyncratic positions in a portfolio, the beta should be lower to manage extension risks or a general sell off. Similarly, where we are long Europe over the US, we should be careful about Italy risks and manage the composition of the overweight with care.

Overall, it is important that, whatever we own, the risk should be reflected in the spread in this phase of the credit cycle. And, looking for less-correlated positions makes sense.

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

Source: Robeco, December 2021

Guests:

We would like to thank the guests who contributed to this quarterly outlook with their valuable presentations and discussions. The views of Rikkert Scholten, Martin van Vliet and Jamie Stuttard (Robeco), Winifred Cisar (CreditSights), Robert McAdie *(BNPP) and* Marco Valli *(UniCredit) have been taken into account in establishing our credit views.*

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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 subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.
Additional Information for investors with residence or seat in Uruguay
The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except under circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

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