

Credit Quarterly Outlook Q2 2021

Running the economy hot

- US policymakers, both fiscal and monetary, will run the economy red hot
- TINA is still singing, but the amplifier is unplugged
- Risky assets discount a flawless reopening of the economy

Investing is not about making a point forecast. Rather, our view is that it entails assessing the probability of various scenarios and determining what's been discounted by markets. This is especially relevant as we present our latest quarterly outlook: we agree with the consensus forecast of strong economic growth – but not with the view that a long position in credit is always justified under these conditions.

It seems obvious that the global economy will in 2021 experience its strongest growth in decades. Ultra-loose monetary policy, aggressive fiscal stimulus and the unleashing of pent-up demand as the economy eventually reopens fully, are expected to pave the way for high single-digit economic growth. Some forecasters even suggest that the US could experience double-digit nominal GDP growth.

The Fed and the ECB have made it very clear that they will keep rates low for a long time. The Fed has signaled that

it will deliberately be behind the curve, and that it will accept higher bond yields as long as these are driven by higher inflation expectations.

Today's fiscal and monetary policies are unprecedented. In fact, one could argue that they are a giant dual

Outlook

For professional investors
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experiment. When you are experimenting, unexpected outcomes are always a possibility.

Credit markets traditionally perform well in the first year after a recession. What's more, spreads have been negatively correlated with rates most of the time in the last two decades. So, why are we advocating a defensive positioning? The short answer is that the market is priced for perfection, which means that you don't get paid for potential tail risks.

'While it is possible that credits could keep rallying, the margin for error is extremely limited'

While it is possible that credits could keep rallying, the margin for error is extremely limited. The opportunity costs of being defensive are therefore low. We believe it very likely that better entry points to increase credit risk will arise in the next six months.

Fundamentals

With an expected acceleration in the roll-out of vaccines in Q2, the prospects of a full economic reopening are improving rapidly – starting in the US and followed by the UK and Europe. On top of that, base effects will result in spectacular year-on-year GDP growth. The OECD is now forecasting that developed markets will have recovered most of their economic losses by the fourth quarter of this year. In its latest projections, US GDP growth will even outpace the pre-pandemic growth trajectory.

The health crisis triggered a powerful fiscal solution of an unimaginable scale, and we have probably not seen the end of it yet. A new infrastructure bill is already in the making in the US. The projected fiscal stimulus for 2021 is up on 2020, despite last year's two large programs. Fiscal stimulus in Europe, albeit not as outrageous as in the US, is set to continue for at least another year. This is very different compared to the aftermath of the global financial crisis, when fiscal austerity dampened the recovery.

By protecting household incomes during the pandemic and simultaneously restricting spending opportunities, governments encouraged the build-up of a substantial stock of excess savings. When the pandemic ends, households might run down part of this buffer, producing a powerful economic boom that – according to estimates – could easily add an additional 2% of GDP.

The big question is whether we're watching the unfolding of a dual policy mistake, with excessive stimulus leading to overheating. On the other hand, coordinated fiscal and monetary easing has the power to disrupt the secular decline in growth: we know we'll need a great deal of stimulus for a long time to overcome the deflationary impact of the debt supercycle.

In considering the inflation outlook, it is instructive to frame it over three distinct horizons: tactical (the next three months), cyclical and secular. The question of whether there will be a secular regime breakout in inflation won't be settled over the coming quarter; the jury is still out on that. However, as markets watch the recovery in inflation over the next three months (owing to the reopening), and over the ongoing recovery phase of the cycle (owing to fiscal help), they may start to worry about the longer term. While a secular breakout is not our base case, it nevertheless is a scenario that needs to be considered. In any case, given the fiscal boost over the cyclical horizon, for us it is particularly important to understand how credit spreads will behave in such an environment.

The consensus view is that credit spreads and rates are negatively correlated, i.e., when rates move up, credit spreads tighten. This sounds intuitive since the common driver is stronger economic growth. We dare to challenge this conventional wisdom, though. It is true that the relationship worked this way over the last two decades, but if we look back to periods during the great moderation and before, we see that there have been times when the correlation was positive. Even more recently, in periods of aggressive quant easing, we saw rates and spreads moving lower in tandem, and indeed higher together during episodic tantrums, during what we might call the era of QE dependency.

We think that the market is too relaxed about higher rates. Higher nominal rates are not a problem as long as inflation rises at the same pace and hence real yields stay low. But as soon as real yields rise, we expect it will start to bite. Even though we subscribe to the view that most central banks would prefer to keep real yields low, this is not fully in their control. With the US economy set to steam ahead, the Fed will probably start discussing tapering at some point from this quarter onwards. That could trigger a further increase in real yields, either through rising nominal yields or a drop in inflation breakevens.

Inflation was often seen as positive for corporates over the past decade, as it was a sign of growth and pricing power. Corporate margins improved, with wage inflation lagging earnings growth. The ratio of capital to income

improved at the expense of labor's share. Over time, fiscal dominance and a willingness to run economies hot can result in a restoration of the balance of power between capital and labor, and hence in lower company margins as wages grow, particularly should top-down wage and income redistribution policies become more progressive. It is too early to draw firm conclusions, but we will monitor this theme closely.

Strong growth will help companies in 2021 to grow their EBITDA and improve leverage ratios from a very high base. Markets respond to the change in leverage and not to the absolute levels, so the elevated debt levels are not an immediate worry – even though the longer-term vulnerability is clear. We do acknowledge there are sectors and companies that will truly enjoy a recovery of earnings on the back of reopening.

It is worth spending a few words on China since the policy response there may unfold differently compared to the US and Europe. China turbo charged the global economic recovery with massive fiscal spending after the global financial crisis. It obviously managed the Covid-19 crisis much better and, having been the first major economy to require fiscal stimulus, may not feel the urge for more. Instead, China is more focused now on financial stability. Without the benefit of the positive base effects and the fiscal support, it will not be the world's growth engine this year.

Chinese growth is also tied to overall emerging market performance. There are some opposing forces here. Strong global growth can benefit emerging markets as well, especially the exporting countries and those in the US economy's orbit. On the other hand, vaccination in most emerging markets is lagging, so reopening could take longer and social pressures could mount. As this sector is not a homogenous group, we look at it on a country, growth model and issuer-specific basis.

'We are concerned that markets are ahead of fundamentals'

All in all, we are concerned that markets are ahead of fundamentals. Should there be any unexpected combination of negative surprises on rates volatility, policy errors or geo-political tensions, conditions could turn more bearish.

Valuations

An improving macroeconomy and the absence of monetary tightening usually are great for risky assets. But these factors are so clear that they are widely recognized. And credit markets played the full recovery in 2020. In a normal economic recovery, spreads usually start at much higher levels as there is always doubt in the early days about the sustainability of the recovery. Remember people talking about green shoots? This time the slump was the result of a pandemic and the solution was colossal policy support, followed by a vaccine. We are therefore at a place of such broad agreement about the recovery that it has been fully priced in even before it has started. That explains the massive bull market in the midst of the worst recession ever. We should therefore not be surprised to see spreads struggling to tighten further in the strongest recovery ever. Barely discussed these days, there are still virus mutation risks. One challenge this time around is that the post-recessionary price action in credit and rates has not been synchronous: the credit rally came first, which means there is now no cushion to total returns from the rise in yields. This could have a variety of implications – for fund flows as well as for equity discount factors on the negative side, and – on the positive side – improving funding ratios for pension funds.

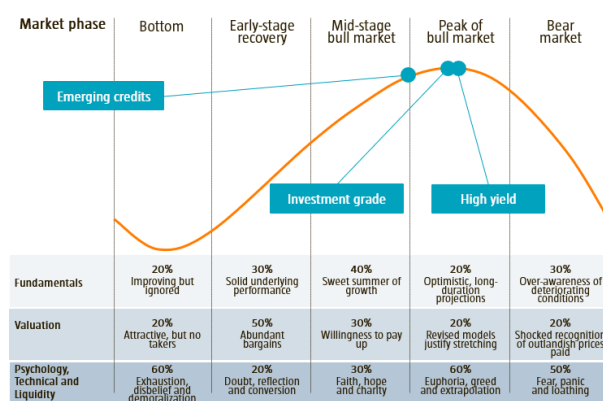
Generally speaking, credit markets are back to or better than pre-pandemic levels. All categories are well below the bottom quartile spread levels, with some even approaching their all-time tights. When we adjust for changes in the composition of the benchmark, the picture doesn't look any better. The IG index quality has deteriorated, with longer average duration and a higher weight of BBB-rated assets. For high yield, the benchmark quality has improved, with an increased weight of BB. Although the benchmark duration looks low, there is a caveat here: the vast majority of bonds trade to their call price. These calls are valuable for the issuer but not for the investor. The flipside of the low duration in callable bonds is the negative convexity. That means that when rates move higher, the duration can rapidly move up as issuers will not refinance their low coupon debt at the first call date.

The best environment for carry is usually the boring periods with modest economic growth and inflation. Recessions are the worst, while periods of very high growth are also undesirable, due to the unleashing of animal spirits, risk taking and exuberance on the corporate leverage side, and the risk of extreme swings in policy and interest rates to cool any resultant overheating.

On a relative basis, there are two pockets of the market that still offer some value: financials and emerging market corporates. These are also tight versus their median spread, but less so than the other categories. Financials are also the least duration-sensitive sector as both insurance as well as banks can benefit from higher inflation and steeper rates curves. For emerging markets, sector and country selection remain key, with commodity-related names benefiting from reflation in the near-term, while commodity importers suffer.

All considered, the starting point for valuations for the coming period gives us a sense of unease. There is very little room for error.

Market cycle | Mapping our view on market segments



Source: Robeco, March 2021

Technicals

The Fed's new approach of flexible average inflation targeting (FAIT) means that it will not be in any rush to increase rates even as inflation – and inflation expectations – start to rise. This will be quite a break from recent history. Intuitively, this is positive for risk assets but we should also acknowledge that this episode is in fact one big experiment. We are in uncharted territory. Shouldn't that deserve slightly higher risk premia?

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Is the Fed put still there? We moved from monetary dominance to fiscal dominance. That also implies a shift in focus from Wall Street to Main Street. Policymakers prefer to see wages go up instead of equities. Indeed, corporate tax rates may now start to head higher in the US and the UK, having fallen for several decades. The Fed

put might be further away than is generally thought, especially if a risk sell-off is driven by inflation fears.

Given the uncertainty entailed by these new policies, we would not be surprised to see higher volatility in rates and equity markets. Our research shows us that rates volatility and credit spreads are almost the same thing. The case for wider credit spreads might be difficult to make in the current environment, but the case for higher volatility in rates markets (and probably growth equity markets as well) does make sense.

Why is volatility important for credit spreads? Remember the 1974 Merton framework for credit risk. The distance to default is derived from the equity cushion and the risk that you burn through that equity cushion. Merton's framework for equity applies to credit more on the high yield and the bottom-up side, so the higher the volatility of the assets the higher the default risk. For top-down IG credit strategy, historical analysis shows it is rate volatility that matters more. It therefore makes sense that spreads move in tandem with broader volatility measures. Equity volatility, while elevated versus pre-pandemic levels, has not trended higher this year; however, rate volatility clearly bottomed in H2 2020 and has accelerated higher over the year to date. This is an indicator that we should monitor closely.

We also discussed the rotation from growth to value that we see in equity markets and what that means for credit spreads. The conclusion is that value equity is more important for credit than growth equity. Still, the burst of a growth bubble would probably cause collateral damage for credit markets. While we are humble about our ability to identify equity market bubbles, we recognize some elements that imply a degree of market frothiness, such as a surge in IPOs, a retail option frenzy and larger insider selling volume, and a ninth consecutive calendar year of equity all-time highs which, while less than the protracted 1990s tech boom, is still substantially more than that seen in the roaring 20s.

The bear market of 2020 was very atypical. Not only was it extremely short lived, it also did not solve legacy imbalances that always build up after a long expansion phase. The default cycle was very shallow as monetary and fiscal policy helped avert a larger-scale bondholder default loss in 2020. This was at the cost of leaving plenty of weak issuer debt overhang and excess in the system from the previous expansion. We also did not see the improvement in bondholder protection that is typical in bear markets. Instead, covenants worsened and call structures in high yield became even more favorable for issuers. This matters, as it enables issuers to prime existing bondholders and it even allows them to put

pressure on bondholders to accept unfavorable and coercive bond exchanges.

All considered, it seems that the usual full cyclical reset of default, covenant and psychological cycles that traditionally play out in bull and bear markets, and which in the past two downturns took years to play out, has been shortened.

With last year's spread recovery, the strong technical that credit markets experienced on the back of the search for yield and a firm macro outlook has lowered the distress ratio and resulted in massive compression. High tide lifts all boats. The extra spread that you get on CCC compared to BB is minimal.

'Usually, fund flows follow returns. We have not yet seen that this year'

Usually, fund flows follow returns. We have not yet seen that this year: amid negative total returns for the asset class, inflows into US IG mutual funds are continuing. With rising US rates, the demand for credit is still intact. TINA ('There is no alternative') is still singing, but the amplifier is unplugged.

We cannot be too negative on the technicals, though. Savings are massive and monetary policy is still accommodative – for now. Flows are still positive, too. However, Fed asset purchases will not continue forever, particularly if 2021's superlative growth forecasts play out: we can see markets temporarily widen on the first sniff of tapering talk from the Fed. Our Global Macro team would not be surprised to see tapering being mentioned in the FOMC minutes any time from May onwards.

The bottom line is that technicals are still strong. However, we look forward to bumper growth in the second and third quarters. We are not so certain that central banks will still be in control under these conditions. Risk premia might rise, despite a solid growth outlook...

Positioning

There is still a good chance that this will be a boring year, in which the fireworks are in treasuries and growth equity markets, while credits just deliver their carry with spread remaining range bound at current low levels.

Still, we think that it is better to be positioned on the cautious side. 'All signs on green' has become the widely shared view for credit. Even some of the perma bears on the sell side have now turned bullish. Yet, the market no longer compensates for tail risks. The consensus long makes the market vulnerable to negative surprises – be it policy errors, Covid setbacks or geo-political tensions.

We are not running huge underweight betas. We are positioned just below one by focusing on the higher-quality names in the universe. Given the very low dispersion in markets, it does not pay to reach out for the riskier names. Our positioning is consistent for all credit categories.

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

Source: Robeco, March 2021

Fundamentals have clearly improved and the recovery is broadening. The appeal of valuations has deteriorated a great deal and technicals are now neutral.

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), Jim Reid (Deutsche Bank), Andrew Sheets (Morgan Stanley) and Hans Lorenzen (Citibank) 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 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 in 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.