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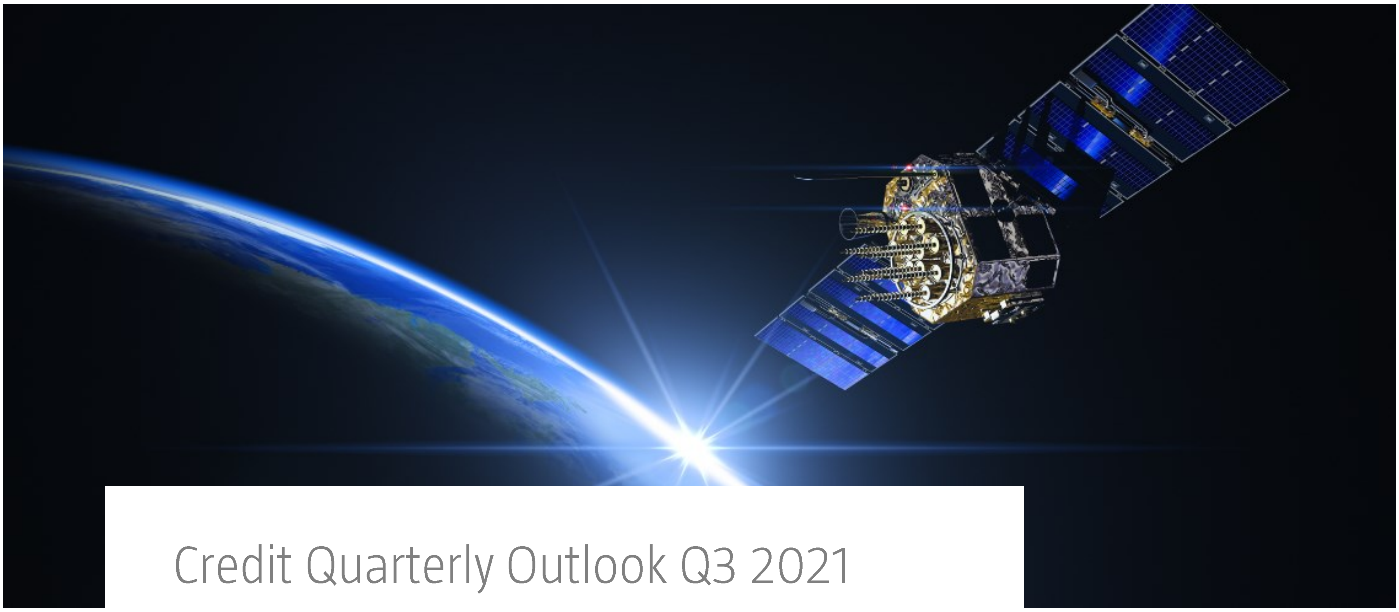

Credit Quarterly Outlook Q3 2021

Humble

- Reopening disruptions distort analysis, demanding a humble approach
- The reopening is now fully priced in by markets
- Are we seeing a shift away from neoliberalism?

The word ‘humble’ was used frequently in the Quarterly Outlook session. The degree of distortion created by the reopening of the economy is significant. Even famous economists and central bankers are changing their views and hesitating. At times like these, it is best to be humble about the unknowns and to just accept that, every now and then, it is difficult to see the forest from the trees.

A few things are clear, though. Barring accidents, the US should print a 10% nominal GDP growth number this year. That said, growth in industrial production seems to be peaking and the fiscal impulse is set to roll over first in China, then in the US. It means markets are priced for the current perfect recovery but not for future uncertainty.

We listened to some theories on super cycles. Governments have taken on extraordinary powers in the past 16 months. Might some leaders be tempted to perpetuate an era of big government post-Covid? Corporate tax rates, the scale of central planning and interference in free markets all seem more open to question after four decades of a more hands-off ‘neoliberal’ era. Some large, dominant mega-cap companies look set for a crackdown. Meanwhile, labor may take a bigger part of the GDP pie at the expense of profit and margins. We do not find evidence of this via our own analysts, but it could be a multi-year process. The

Outlook
For professional investors
June 2021

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long-term inflation outlook is uncertain, even if some consensus pro-inflation arguments look suspect. The post-Covid era, assuming eventual vaccine success, may bring substantial change in many underlying trends.

With spreads now near an all-time tight, a cautious positioning makes sense to us. Still, it will be a boring (most likely) or bearish year for credit. At the margin, we like emerging market credit more than other credit sub-sectors.

Fundamentals

The different opinions within the Federal Reserve (Fed) are striking. The recent Fed communication shows that there are varying opinions on timing of tapering and on the timing and magnitude of future rate hikes. Chair Powell concludes it is appropriate at this stage only to talk about talking about tapering.

It is interesting that the Fed put a lot of effort into convincing the market that it will let the economy run hot. It even changed its policy framework last year, to allow for a more symmetric inflation acceptance. Now, inflation rates are rising in the US, with a recent 5% CPI print. Having previously stated it thinks this will prove transitory, the Fed last week rowed back from this position.

> 'Markets will be very sensitive to a change in tone towards inflation acceptance'

Its statement felt a bit hawkish, given the comments on inflation. Though this is just one meeting, markets will be very sensitive to a permanent change in tone. Fed members themselves suggested they need to be humble. These are uncertain times for them, too.

And, what if inflation proves not to be transitory? Indeed, there are some potential drivers, particularly on the fiscal and labor market fronts, that could cause inflation to have some legs.

Back to reality. One could wonder why yields do not rise much more in a year of 10% nominal growth. We refer to the Global Macro Quarterly Outlook for a deeper insight in that. Economic theory, however, tells you markets are efficient. This whole reopening trade, fiscal stimulus and monetary policy guidance has been widely forecasted and well flagged. We all know that, with about 400k to 500k in new payrolls, the projected labor slack diminishes towards the end of the year. Also, the talk about the talk about when to start tapering had been expected. On top of that, we see evidence that being short duration is a very common consensus position. So, when there are fewer surprises and every piece of information is already priced into markets, it is harder to expect right-hand-tail outcomes. That, most likely, is what is going on.

The credit impulse is set to roll over in Europe, the US and China. So, the net combined fiscal and private credit impulse (year-on-year change in combined net borrowing) will become negative soon. This makes sense since one cannot expect endlessly increasing support measures. So, towards 2022, this might start to have a dampening impact on growth rates.

Let us recall what our Global Macro team reminded us happens when QE or tapering is announced. QE is reflationary so it results in higher equity markets, tighter credit spreads, lower FX, lower real yields and wider inflation breakevens. In principle, tapering, especially when it is pulled forward unexpectedly, will do the reverse. We expect taper talks will intensify over Q3. It means that plain sailing is over and that we have to be open to a reversal of events. We do not think risk premia reflect this.

These are the cyclical considerations. There are also interesting perspectives regarding secular trends. In order for inflation to move structurally higher, labor markets would need to be more powerful. The pre-World War I era was one dominated by capitalism. After World War II, there was a shift to an era of greater government involvement in the economy. However, from the early 1980s, when Reaganomics and Thatcherism ended the power of unions and hence of labor markets, an era of globalization accelerated, inequality rose and we experienced secular disinflation. Capital took a much larger share of the GDP pie and margins expanded, especially for the super companies.

It may be that we are now experiencing a subtle shift towards a new era. Although it is difficult to pinpoint, there are indications of this in the G7 talks about minimum corporate taxes, the divergent opinions on budget deficits and the potential that government's increased role may last beyond Covid. The Eurozone will even execute a common support program for the hardest-hit economies. Labor power could well make a comeback to a certain extent.

At the same time let us not hyperventilate about inflation -- as the Global Macro team has already warned us. We do not expect a return to a 1970s-style inflationary period. Ongoing technological progress, the laws of comparative advantage, unit labor cost arbitrage, the private sector profit motive, western demographics, and the curtailed power of labor relative to the 1970s are factors too dominant for that, in our opinion. We do believe, though, there is a likelihood that a new secular super cycle may have started, in which wages will rise – and maybe also productivity. It would also mean a permanent turn for value over growth in equity markets. And that has not been priced as a possibility yet.

A small anecdotal analysis from our own credit research team shows that a short-term increase in demand enables companies to implement price hikes. In the long run, it could lead to margin pressure, especially for smaller companies.

'The Fed starts talking about talking about tapering'

As for the cycle, the conclusion on fundamentals is that the current phase of the economic recovery could hardly be better. After all, we are only in the first few quarters after the recession. But, to us, the issue is that this has all been well-flagged and framed for a while. What if there is disappointment in follow through or, alternatively, what if tapering is brought forward?

Valuations

It is clear that recent months have been mildly positive in terms of excess return in credit markets. In that sense we have been a bit too early in bringing down our beta. At the same time it strengthens the case that probability-weighted, future expected returns have deteriorated further. We stated it would be a bearish or boring year for credit, with boring being the most likely (and best) outcome. At current spreads the cost of running a small underweight beta is very low. Breakeven levels have come down tremendously.

Results from stock picking have been good but, to be honest, there are fewer outliers now than a few months ago. In general, the economic reopening trade has been played. Even higher-risk sectors like airlines and cruise liners or the leisure sector have all recovered to pre-Covid-19 levels. Full compression is here.

To quote an old adage: one can bag some carry for as long as the music plays. Of course, one could collect some more carry over the summer and be less contrarian. If markets become volatile, though, the carry would be wiped out via bid offers and capital losses in a matter of a few days. Credit is a risky asset and not a storage of liquidity or carry. We are wary of situations such as we saw in March last year, when liquidity disappeared. We like cash and AAA ABS in portfolios in order to be able to buy on dips. It is comforting, though, that emergency programs are already in place. The ECB in particular are set to continue buying corporate bonds well into 2022, and possibly beyond.

If we look at the annual excess returns per calendar year, it's clear that we have had a few years of volatility. Even more abundant are the incidences of intra-year volatility. Last year's trading range was spectacular, but the annual excess return was as low and as dull as this year's (to date). It shows how unusual 2020 was. As active managers, we have been spoiled in recent years with volatility. While this could well become a boring year, frequent readers know we are always expecting the unexpected. As contrarian investors, we are ready to take advantage of unexpected volatility.

Year-on-year default rates are falling, owing to base effects. At the same time, very healthy growth rates lift all boats and we hence see few defaults coming. Recovery rates are rising, as one would expect in this phase of the cycle. Still, the prevalence of covenant-lite issuance has recovered much more sharply than in the prior cycle, suggesting recoveries may be lower again in the next downturn. Nowadays, covenant protection even for B-rated credit is once again an exception. One should keep that in mind when looking at valuation in high yield markets. In Europe, default rates failed to rise last year despite a huge downdraft in growth: as a result, the stables were not cleaned out in the last recession. Extending the Herculean metaphor, the stable is still full of CCCs, zombies and weakest links.

On a positive note, upgrades-versus-downgrades ratios are still improving. We saw the peak in downgrades into the high yield universe of investment grade companies last year. Still, because ratings agencies are a lagging indicator, as soon as upgrades trump downgrades (not yet), long positions no longer make sense. Instead, it is a contra-indicator.

Emerging credit has lagged the rally a bit. We see more upside here. There are a few challenging sovereigns, like Argentina or Turkey, but the energy sector, for example, seems still attractive.

Globally, we keep finding idiosyncratic situations in corporates and financials that warrant more research and taking long positions.

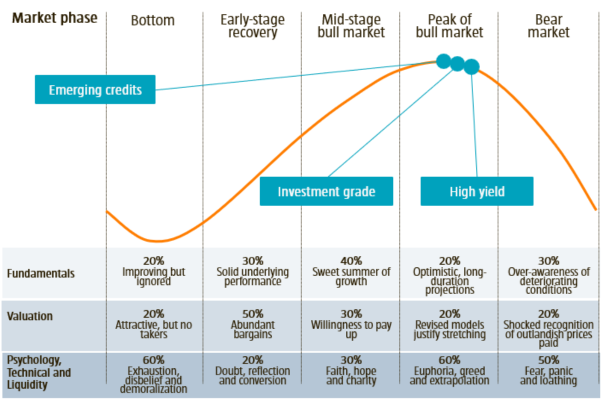
We did an interesting historic analysis. Historically, when reaching an OAS of 250, high yield no longer offers compelling returns. Maximum returns are earned by buying at 1100 OAS, a level we almost reached in March 2020. While this is rather obvious, it is not easy to do at both ends of the extremes. It tells you how contrarian one has to be.

In terms of compression, spreads have run their course and dispersion is very low. In CCC, the dispersion is now below 20%, compared to 80% last year. In investment grade, dispersion in BBB is not yet at the lows, but close.

> ‘On valuation, the room for error has become smaller again’

The conclusion on valuation is that the room for error has become smaller again. The Fed’s May financial stability report highlighted that valuations in many markets are now vulnerable to any deterioration in risk appetite. Here, again, is a reminder of the importance of always expecting the unexpected: that’s how markets work. This is also when the skeletons in the closet are exposed. A recent investor survey suggests the top four concerns range from an inflation surge, to rising real yields, vaccine-resistant variants, and US-China trade tensions.

Market cycle | Mapping our view on market segments



Source: Robeco, June 2021

We are happy to have a small underweight beta. It is small enough to ensure that via stock picking we can deliver a decent return and some outperformance. In terms of composition in DTS (Robeco; ‘riskpoints’), in several idiosyncratic cases but also on portfolio aggregate level, we prefer a short in spread duration (close to 2 years) in investment grade credit. This is compensated for in a higher-risk profile. The net result is a yield that is flat or slightly higher than the index, but short beta. Probability weighted, the odds are best with the current position, hence we opt for a small reduction in beta while maximizing alpha via stock picking.

Technicals

After so many months of positive excess returns, it is human to start extrapolating the series and expecting a continuation. It’s tempting to confirm current trends and valuations with today’s strong fundamentals. And confirmation biases indeed play a role: it is increasingly hard to justify and explain the end of such a long streak of winning excess returns. It is a time in which debates within the team heat up. It is also a time to be humble and accept the many unknowns that lie ahead.

The fact is that fundamentals do not always play the most important role. Nevertheless, we believe a change in monetary policy, or the sheer thought of it, remains a clear candidate to change market risk premia. An example might be inflation breakevens, which are often positively correlated with credit, and where the recent FOMC meeting has upended the consensus pro-inflation trade.

Something related to this potential change in the Fed regime is correlation between equity and bonds. We have mentioned it before. If a reflation trend occurs and yields rise while equity drops (positive return correlation), bonds lose their hedge to equity in a multi-asset context. Bonds therefore need to receive a higher risk premium.

We spent some time discussing positioning. The recent drop in yields suggests a consensus positioning for higher yields. Regression analysis and checking fact sheets confirms this positioning. The yield drop may have coincided with a lengthening in some speculative long credit positions. It is important for credit markets since, as long as TINA (‘There Is No Alternative’) sings, credit is relatively safe. Rising yields would change that and put total returns deeper into negative territory.

We believe that the technical between the European market and the US credit market is improving in favor of the former. The ECB umbrella is there, because even once the PEPP program is wound down, the APP program (which is where the CSPP program lies) is set to remain. There are no signs whatsoever that the ECB might stop buying what is in effect 20% of the European gross supply. It really means downside risks have become smaller in Europe versus the US, which is much more of a free market. Notably, both central banks have adopted political agendas, with more inclusive employment measures for the Fed and political union and greening the QE program at the ECB.

'Confirmation biases are dangerous in today's markets'

The only threat we see for European markets is, as is usually the case, politics. This year, German elections might go to the Greens, Italy might see a change in Prime Minister early in 2022 amidst a potential tapering plan, and Macron might not be so certain about being re-elected versus Le Pen, which could cause some pre-election nervousness.

The bottom line is that technicals are still strong. It is the change we are concerned about. Together with the fundamental and technical situation being so well flagged, we do not think June 2021 is a buying opportunity. Talking about buying opportunities, the last 13 years supplied us with five big buying opportunities. This is one every 2.6 years, on average. Just a fun fact for a very contrarian active credit team.

Positioning

Most likely, the credit market will at best deliver a coupon excess return. A boring year, in other words. We think it is better to be positioned on the cautious side. 'All signs on green' has become the widely shared view for credit. This is a market that no longer compensates for tail risks and which is vulnerable to negative surprises. Confirmation biases rule.

We are not running huge underweight betas, though; our positioning is just below one. Given the very low dispersion in markets, it no longer pays to reach out for the riskier names. Nevertheless, we still find opportunities in banks, Covid-recovery trades and some idiosyncratic cases. Our positioning is consistent across all credit categories.

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

Source: Robeco, June 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), Max Kettner (HSBC), Nikos Panigirtzoglou *(JP Morgan) and* Dario Perkins *(TS Lombard) 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.