ROBECO
The Investment Engineers

CREDIT QUARTERLY OUTLOOK

Party like it's the 1990s

- Soft landing has become the consensus as inflation comes down
- Fed pivot has led to a rally in duration
- Market is priced for a best case scenario

In our last quarterly outlook we noted consensus views had begun to shift towards a soft landing. That did not change in the last quarter as more economists and strategists abandoned their bear case views on the economy. In most cases spreads have already dropped below levels suggested by large investment banks in their 2024 outlooks.

We argue that it remains wise to stay cautious in this environment. Although markets have fully embraced a Goldilocks scenario, we think risks have not abated. History tells us that tightening cycles by central banks almost always lead to a recession. The mid-90s were an exception, as economies continued to perform well in the years that followed. The market is now pricing in a best-case scenario. Spreads have moved significantly, and parts of the US credit markets are in or shifting towards the bottom decile in valuations. We normally see this at the end of long bull markets and not in an environment like this.

Market technicals have improved in the last quarter on more stable rates markets. However, sentiment remains tenuous as we have witnessed throughout this year. Markets are priced on very high expectations and that means there is plenty of room for disappointment. It will take a more serious slowdown or recession to move markets more materially. We are comfortable holding a more neutral overall positioning while taking bottom-up risk in those parts of the market where we think risk-return is appealing. We are slightly long beta in investment grade and firmly hold our conservative positioning in high yield.

Fundamentals

For the past few quarters, we have been discussing the hiking cycle and the common wisdom that sharp hiking cycles have always resulted in a recession. Since this summer, that wisdom is being challenged and increasingly, we see economists and strategists moving to the soft-landing scenario for the US economy, and a Goldilocks scenario for markets. Soft-landing is the consensus view.

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And indeed, globally we are currently seeing inflation moving down. Economies are cooling, jobs growth has been on the decline and activity in the services sector has been slowing, whilst activity in the manufacturing and construction sectors has been dormant for a while, hovering at recessionary levels. Until recently, the consumer has kept the overall economy humming. It has also applied pressure on wages and inflation as demand for labor in these sectors remained robust. We are finally seeing that job openings in the services, retail and leisure sectors are declining, which has resulted in better inflation numbers. These are all signs that monetary policy is having its effect on the economy.

“Soft landing is the consensus view!

European economies have been slowing down for a bit longer, as fiscal support has been on the decline since the first quarter of the year. As alluded to earlier, the effects of the energy crisis and the trade connection with China have been a drag. Some economies have already seen quarters of negative growth, albeit close to zero.

The Chinese economy remains in a tough position. Recently announced support packages are seen as mere short-term relief for an economy that is deleveraging. In our opinion, this situation continues to bear a resemblance to Japan in the 1990s. In the US, fiscal support has remained outsized and has slowed down the adjustment in the economy. However, US economic data, and more importantly inflation, is finally trending lower.

In the recent meeting the Fed acknowledged they are near or at the end of the hiking cycle and hinted that lowering rates could be on the horizon. This led to a strong rally in rates on top of a very strong month for duration in November. The ECB and Bank of England remain more hawkish towards inflation, despite both economies having clearly slowed more than the US. The pivot by the Fed seems to have cemented the market view of a soft landing.

Does this mean we are out of the woods yet? The market seems to think so, but we think it is too early to declare victory. Indeed, recession odds do seem to have come down. However, signals from data are conflicting and have misled us many times in the past two years. We maintain our cautious view for now. We continue to believe the impact of a monetary cycle is difficult to predict due to the slow transmission mechanisms; historically, this has proven to be almost impossible to get right. The 1990s were the only time we saw the Fed hike rates without the economy ending in a recession.

“The 1990s were the only time we saw the Fed hike rates without the economy ending in a recession

When we look at corporate fundamentals, we are seeing margin compression in certain sectors. As inflation is coming down, pricing power seems to be on the decline as well. As wages lag, we think margin pressure could intensify going forward. Last year, sectors such as technology and heavy industrials struggled with declining margins. So far, few companies have been willing to let go of employees. Scarred by the difficulty to find staff and bolstered by the healthy buffers accumulated during Covid, companies have been willing to let margins slide over shedding labor costs. For some sectors, the luxury to retain staff may be gone.

Ultimately, corporate fundamentals are key to being able to refinance debt, especially in high yield. Does this mean we are extremely pessimistic? No. Many companies started this cycle in a healthy state and can withstand some headwinds. We do expect dispersion to grow, not just in high yield but in investment grade too. If we look at the rating agencies, we see them placing negative outlooks on an increasing number of companies, yet they also maintain many positive outlooks.

The pressure from higher rates is still present. Although interest rates may have come down a lot in the last month or so, they remain at the same level as the start of 2023, meaning financing costs for companies will rise materially. The effect of this is not yet that visible in public bond markets as companies have fixed rate debt. Looking at small and mid-sized companies or (high yield) companies that finance themselves using floating rate bank loans, we are seeing the effect of higher rates as the transmission is faster. It is not surprising that within these companies, defaults are surpassing those of the bond market. Only a portion of the higher quality high yield companies refinanced in 2023, taking on higher rates.

> *“ The banking sector globally remains relatively cheap*

As more companies in the bond market need to refinance in 2024, these effects will soon become more visible. For high-leveraged companies, higher rates will have a material impact on a company’s financials. For investment grade companies the effects will, in most cases, be small. However, here we are seeing companies in need of capital allocation adjustments as well. For example, infrastructure companies like telecom towers and renewable energy need to adjust their balance sheets for higher rates. There are clearly winners and losers in this environment.

Valuations

Duration rallied considerably in November and December. Risk-free rates peaked in October with the US 10-year rates almost reaching 5%, now set to rally back to below 4% in December. European rates peaked already in early October at almost 3%, to retrace to almost 2% in December. The peak in rates drastically changed sentiment in the credit market as risk-free had previously been the key driver of volatility and returns. As demand for credit swelled, spreads moved down aggressively in a period of limited liquidity. US markets are now priced for a Goldilocks scenario. Looking at the various 2024 credit outlooks published by large investment banks, we are seeing that current market spreads are already below year end 2024 targets. With that in mind, we think the US market is underpricing risk and is now completely disregarding the odds of a recession or slow-down.

We do see a lot of variation between markets. The US is clearly ahead of other markets in terms of valuation. Spreads in parts of the US market are already in the bottom decile. This is visible in for example the industrial and consumer sector and US BB-rated companies. European markets are still above the long-term median, although European high yield is currently well below the median. Emerging markets have also lagged the performance of US markets, trading just above the long-term median. Dispersion is clearly visible here as well. In emerging markets, investment grade is trading below the median while high yield remains above. This is especially true in Asia where investment grade spreads have moved into the bottom quartile.

> *“ We have already seen a shift with more money flowing into credit*

The banking sector globally remains relatively cheap. In particular, senior bank bonds have generally lagged the market and can still be considered on the cheap side. AT1 bonds have performed quite well and are now below median levels, albeit still higher than pre-March. However, the market seems to have left the debacle of SVB and Credit Suisse almost fully behind.

CCC-rated bonds have underperformed in the last few months and have decompressed versus single-B and BB-rated bonds. This does not mean it is time to add to this part of the market. Many CCC-rated companies are trading cheap for a reason. A number of those companies are witnessing severe margin pressure, or have too much leverage, and as result are finding it difficult to refinance at these higher interest rates. This part of the market is about idiosyncratic risk and cannot be approached from a top-down point of view.

With many companies experiencing margin pressure or debt burdens too high for the current rate environment, we expect to see companies migrate in rating, or in the case of high yield, even default. We believe current markets are about issuer selection, balancing fundamentals and valuations.

Technicals

With lower inflation expectations and the peak in interest rates behind us, overall market sentiment has changed. Flows into credit markets were very modest this year, and it seems many investors have remained underweight in this asset class following the negative returns that haunted the market from 2022 until the third quarter this year. We argued previously that credit at current yields is providing an attractive value proposition for total return investors, but that it was difficult for credit to perform if risk-free rates remained volatile. This has now changed. We have already seen a shift with more money flowing into credit, especially investment grade credit.

> *“From a demand point of view, technicals look very good*

With overall yields in investment grade credit still at attractive levels and with good return prospects, the asset class can compete with many other more risky classes. From a demand point of view, technicals look very good. On the negative side we will continue to see quant tightening from central banks. The Fed, ECB and BoE have all indicated they will continue to reduce their balance sheets. The ECB, in particular, holds a considerable position in corporate bonds that ultimately needs to be unwound over the medium term.

With the recent rally in credit markets and rates, we believe demand for credit will be met with new issuance. In the high yield market there is a maturity wall that needs to be dealt with. With yields now almost 2% lower than two months ago, we believe many issuers could start to address upcoming maturities. Although, several companies will still struggle to refinance due to high leverage. In investment grade, where companies have less financing needs due to long average maturity profiles, companies could come to the market to issue debt. Investment grade companies have been very reluctant to issue longer-dated paper in the last 12 months as a result of the high-rate environment.

In emerging markets the picture is rather different. We are already witnessing that companies, where possible, are choosing to refinance their offshore debt in the local market. Especially in Asia, where local interest rates are much more attractive than their USD equivalent. As a result, the hard currency EM market has been gradually shrinking and we expect this to continue into next year.

> *“It will take a more serious slowdown or a recession to push markets materially wider*

Although ignored by the market, the hiking cycle could bring to the surface more problems that are difficult to predict. And we do see that market sentiment is still rather volatile and liquidity is thin. With expectations currently high, it would not take much to push markets wider from time to time. However, we should not ignore that market technicals have improved materially and we believe it will take a more serious slowdown or a recession to push markets materially wider.

Conclusion

We have reached the end of one of the sharpest hiking cycles in modern history. Economies in Europe and the US have so far moved through it without being derailed. Markets have declared victory and fully embraced a soft-landing. However, we remain cautious, as it is likely we have not fully seen the impact of the tightening cycle. Central banks are gradually pivoting, but rate cuts are still a few months away it seems.

Markets have performed quite a bit better than many would have thought, and short risk was a costly position to be in. We continue to see sectors struggle to maintain pricing power, especially with inflation coming down. The market overall has moved a lot and in many parts valuations are outright rich. Does this mean that spreads cannot continue to tighten from here? No! We often see markets overshoot in a positive sentiment environment. We believe selection will be key, not all companies are equal, so it is important to remain vigilant and invest in those companies where risk return is properly balanced.

Technicals have improved considerably now that we seem to have reached the end of the hiking cycle and this may put a floor under markets. This does not mean we should expect nothing to happen next year. High expectations are priced in. The market is partying like it's the 1990s. This also means there is room for disappointment, and in such case spreads could move wider. However, we will need a more severe slowdown or recession to move markets more materially. We think the odds on this are still considerable, given the slow transmission of the tightening cycle.

Positioning

We continue to like a strategy where the overall risk of the portfolio is managed closer to neutral, while taking credit risk in those parts of the market where there is still value. Strong issuer selection and buying quality carry offers the best value. We remain comfortable with investment grade in general, and more cautious on high yield, especially in the lower-rated part.

For Investment grade portfolios, we continue to see value in banks that still trade cheaper on average. Europe has further room to tighten compared to the US credit market. Given the rally that we have witnessed, we are currently targeting our betas for investment grade portfolios to just above 1. We see this as a conservative positioning for this category. Given the improved technical picture, we deem it too early to go underweight risk. And this leaves ample room to increase risk if volatility returns.

For high yield we remain underweight risk with an overweight in longer duration in BB-rated companies and crossover names, for example in banking. We expect lower-rated companies to continue to decompress as they struggle to refinance or risk default. CCC-rated companies are already underperforming and given their leverage, this is likely to continue. In high yield we also remain overweight Europe versus the US on valuation grounds.

Table 1 – Current postioning

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

Source: Robeco, December 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), Song Jin Lee (HSBC), Andrew Sheets (Morgan Stanley) and Lotfi Karoui (Goldman Sachs) have been taken into account in establishing our credit views.

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