



Credit Quarterly Outlook Q4 2022

Trade and trust

- At an inflection point around monetary, fiscal and geopolitical policies
- The credit and business cycles still need to unwind a bit further
- Central banks are driving markets like never before

The Robeco Multi-Asset team has just issued its latest 5-year Expected Returns publication, entitled 'The Age of Confusion'. The report reflects on the many cyclical, secular and geopolitical inflection points we need to juggle as market participants. The Credit team agrees.

One example is the fact that global supply chains only work in peace time. 'Eurussia' no longer works, and Chimerica, the largest bilateral relationship in the world, needs watching carefully. The theory of trade expectations tells us that trade works if there is trust. We are now entering a phase of deglobalization or – as the Global Macro team prefers to phrase it – *re-globalization* along the lines of emerging military alliances.

These secular trends overlay cyclical trends in which central banks continue their own war: a war on inflation. For now we take them at face value, and hence discount the dual mandates these might have, that inflicting pain on the economy is needed to bring inflation (expectations) back in

line. This means more recession pain is to come in terms of earnings, investments, defaults in leveraged loans and market volatility in general. Valuations have cheapened but this has not been broad-based enough.

We do acknowledge that the corporate sector is healthier at the start of this recession compared to similar points in

Outlook

For professional investors
Q4 2022

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previous cycles, and that earnings are actually very resilient. But we need more proof that a full-blown recession is priced. Technically, central banks will hike more and in many cases QT still has to start. All in all, we push out our forecast of the bottom of the cycle slightly, to later this year.

Fundamentals

The last decade or so policy makers have been horribly wrong in forecasting growth or inflation trends. We experienced a decade of almost no inflation and QE, which resulted in asset price inflation. We were then told that inflation was supposed to be transitory. Yet we have now entered a phase in which central banks worry about inflation becoming entrenched in the economy via wages and corporate pricing power. It tells you how inherently difficult inflation forecasting is, as well as the process of managing it. There is no textbook for central banks. This means that policy mistakes have to be expected.

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Central banks believe they have to inflict pain on the economy, on the demand side, to bring down inflation expectations. For now, do not count on the Fed’s dual mandate to manage the employment side of their objective. In fact, expect the opposite. The Fed will only stop hiking when one of three conditions is satisfied: inflation comes down, the economy slows significantly or financial conditions have tightened a lot more. That is why we have pushed out our forecast for the bottom of this cycle a bit further into the future.

We have done some historical analysis to get guidance on what the nature of this pain could be and what we can learn about the timing and potentially the depth of the upcoming recession. Let us give a few examples.

First, history shows us that as the ISM falls from 60 to 50, spreads tend to widen. Only once recession is acknowledged, typically when ISMs and PMIs fall below the 47-48 region, is the downturn usually priced in. If the ISM or PMIs are good indications this time again, we are not there yet. By the way an average recession shaves off 5% of GDP and is a good number to watch.

Second, payrolls growth on average decelerates to under 200k at the end of the tightening cycle. The US economy is still way above that.

Third, median financial conditions in recessions were historically much tighter than at present. The impact on rates, oil and equity has further to run on this metric.

Fourth, sticky inflation like rents is still trending up. Also, the Atlanta Fed wage tracker does not show meaningful moderation yet.

Fifth, the housing market does show some deceleration driven by higher mortgage rates. At this stage this is more visible in home sales than in prices, but it will have a corresponding impact on durable goods spending.

These are just a few of many examples we’ve looked at. The overall conclusion is that, in terms of the economic cycle, we are not there yet by most metrics.

Then there is the market cycle. Historically, credit bear markets associated with recession last for at least 1.5 years. We have so far reached only nine months. Furthermore, the magnitude of the spread widening is typically at least 150 bps, while we’ve seen less than half of that move to date. On a more optimistic note, carry has increased, and spread peaks are often temporary, meaning that at some stage one can expect positive excess returns over a 12-month horizon.

We also must point out that central banks have a habit, shown time and again throughout history, to overtighten and then to have to undo most of it. It is impossible to know precisely when we are approaching the end of the tightening cycle, but once conditions are restrictive versus estimated neutral rates, we know we are in an overtightening zone.

We do know that interest rates historically peak before credit spreads. We also know that interest rates peak, on average, around the time of the second-to-last rate hike. Based on this framework, our conclusion is that we might get there somewhere in November or December this year. If we are wrong about this, it is likely because the peak turns out to be later rather than earlier. Markets tell us Q1 2023 will give us the peak in rates.

Corporate balance sheets, as we mention in the introduction, seem generally healthy. Of course, we know that earnings drop around 20% to 30% in a downturn. It is remarkable, though, that the last few weeks’ earnings revisions recovered from the much lower levels of the previous period.

Our discussions included a debate on the nominal economy versus the real economy. We observe that real yields, as measured by US TIPS, are rising rather fast. In general, this sucks money out of risky assets like housing, equity, credit and commodities. So, that is a negative signal from an investment perspective. On the other hand, we must be open to the fact that corporates as well as governments might have their revenues linked more to the nominal economy. When earnings inflate via higher price levels and tax revenues, corporate earnings and government proceeds rise relative to the outstanding nominal debt stock.

Another simple explanation for the current level of corporate health is the fact that corporates simply have not yet had the time since the Covid crisis to engage in the typical bull market re-leveraging of their balance sheets. That probably is why rising stars still outweigh fallen angels, although we do not attach a lot of value to this lagging indicator.

‘It is evident that we should not expect the old locomotive of the global economy to do its job again this time’

We spent little time on China this quarter. It is evident that we should not expect the old locomotive of the global economy to do its job again this time. We seriously worry about growth expectations, debt levels and very high youth unemployment, for example. Economically restrictive Covid policies are also not helping.

The conclusion is that we do not want to sound too bearish but at the same time we need to be somewhat more patient about entering the last phase of the credit cycle. We are wary of the fact that a credit team might have a behavioral bias of being a touch too bearish, may tend to extrapolate Fed policies too far or lean towards being too confident based on historical analysis that might not tell us which is the right future path.

There are a few positive tail risks that might change the base case. First, an unexpected end to the Ukrainian war or the recession itself might cause oil to drop a lot further. This would have benign implications for inflation and growth and might give the Fed a reason to pause. Second, maybe corporate pricing power will be better than expected, which in turn is good for corporate health. All considered, we do not think we have seen all phases of the bear market yet but we are slowly getting there.

Valuations

On an optimistic note, the very painful positive correlation between credit, government bonds and equity so far in 2022 has led to much better valuations. A typical 60/40 balanced fund has lost 18% and bond markets have experienced the worst sell-off in total return terms for years. The flipside of the coin is that pricing has started to move towards more attractive levels. We describe a few parts of the market separately since the composition of corporate yields has become rather complex.

Starting at the lowest risk part of the spectrum, we are very constructive on European swap spreads. Cross-sectional relative value shows that is the cheapest part of the market on a risk-adjusted basis compared to its own history. This is driven by Bund scarcity and very tight repo markets, which in turn is one of the many side effects of QE. It means that European credit spreads have become cheaper than US credit spreads if the investor has government bonds as a reference benchmark. It has made high-quality investment grade credit like covered bonds or agencies very cheap. On an ASW or spread-over-swaps metric, credit spreads do not look cheap yet. A reversal of Bund scarcity could be triggered by some kind of QT program by the ECB in the coming months.

Another element in European markets are Italian spreads. Given where Italy is headed politically and given the financial health of its government, we do not think Italian spreads reflect the right risk premium. Despite the potential for the ECB to limit the pain in Italian spreads after a certain threshold, we remain cautious on Italian corporate exposure.

For US high yield, the average OAS has historically been 540 bps. We are close to that now, but recessions often see spreads twice that level. Current spreads do not reflect a premium for rising default rates or other unexpected risk premia. Still, as markets weaken, we are likely to enter the phase in which excess returns on a 12-month horizon become positive.

US investment grade spreads tend to widen to over 200 bps in a recession. We are not there yet, with current spreads around 150 bps. In Europe, spreads have widened a bit further due to the swap spread, but basically the risk premium for credit risk rather than liquidity risk is not there yet to justify a long beta position on an index basis. Here too, there are pockets of the market that have repriced a lot, like banks or cyclicals, which might warrant a long position already. And here too, there are scenarios where the excess return on a 12-month horizon is becoming positive.

Dispersion metrics such as for spreads between BBB and AAA, or within CCCs, suggest that dispersion still has some more to go before one can call the credit market cheap. BBB spreads for example can easily reach 400 bps OAS, compared to current levels of only 200 bps.

Derivative credit spreads as reflected by iTraxx or CDX series seem to be further along in their journey to peak historic spread levels. The basis remains positive since we have not yet observed forced selling in cash credit markets. In any case, a lot of hedging seems to have been done and derivatives appear to us to be the first choice of instrument to go long beta.

‘The European market is cheap versus the US market. It does make sense if one considers that most of the more severe fundamental risks are impacting the European continent’

The European market is cheap versus the US market. It does make sense if one considers that most of the more severe fundamental risks are impacting the European continent. Whether it is political risk, behind-the-curve central bank policy or the Ukrainian conflict, it all has a far greater impact on Europe than the US. However, these are all known risk factors. Markets move based on incremental risk or new risk factors. We do believe Europe should be overweight versus the US. European-denominated bonds in global capital structures trade cheap.

We also looked at earnings and equity valuations as a reference. This was the part of the day when we realized the dangers of going too far in extrapolating weak trends. A few facts here. First, 50% of the NASDAQ constituents are down over 50%. Second, global fintech stocks on a price-to-sales ratio are arguably at oversold levels. Third, FAANG stocks (with real cash flow and business models) are down 30% to 70% from peak to current. Finally, European cyclicals/value stocks are at an all-time oversold level versus defensives. Clearly, long-duration assets got hammered and a recession to a certain extent has been priced in.

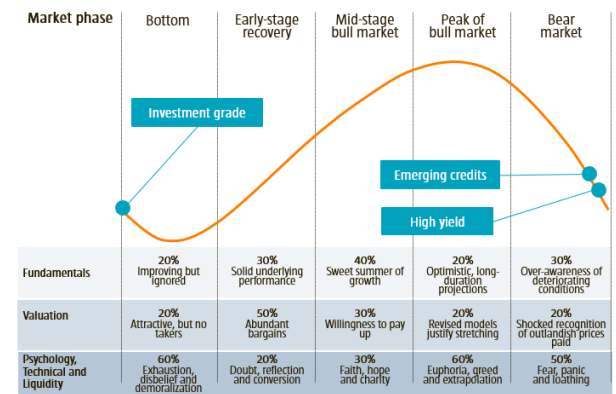
There is one observation to be made about a special part of the credit market. The leveraged loan market in the US is over USD 1 trn in size (of which a whopping 80% is rated B/CCC). This has become largely covenant lite since the massive demand over prior years, driven by CLOs. High yield bond issuance volumes have therefore been disappointing. Given the very weak B-rated credit in these structures, forced selling (deleveraging) might be on the cards if downgrades hit the CCC bucket.

This market is less visible to most market participants but it is the segment where overleveraged balance sheets are. There is a fundamental impact on loan borrowers, too: we should expect accidents here, driven by higher yields, since higher interest costs will be priced one-for-one into lower earnings for borrowers with floating-rate debt structures, as rates ratchet higher every three months as the reference borrowing benchmarks reset.

The conclusion is that valuations have become more attractive. We are wary about fierce bear market rallies, which have occurred in recent months. We will be slowly adjusting from neutral positions into long positions over the coming months.

Figure 1 | The market cycle

Mapping our view on market segments



Source: Robeco, September 2022

Technicals

Whether one is long or short, the conclusion on technicals would be the same: technicals drive markets nowadays. Central bank liquidity withdrawal is still the driving factor, as we forecast at the December 2021 Credit Quarterly Outlook. Equity and credit returns continue to correlate with the changes in the aggregate balance sheets of the world’s major central banks. A move from QE to QT means a lot of deflation in asset prices. It is the reversal of the last decade.

Given the very clear message from central banks that bringing inflation in line remains their key priority, we do not expect a QE program any time soon to save the market. Instead, we should expect more volatility. One blessing in disguise is that creating new bubbles will be much more difficult.

As Richard Koo has written for many years, reversing QE at the same time that one has to hike rates is very difficult. Excess reserves have to be mopped up and one could even expect political debates around central bank subsidies to commercial banks, by reimbursing higher yields on excess reserves.

These policies have important ramifications in our markets. The sheer size of central banks in bond markets over recent years means that secondary market liquidity has dried up significantly in 2022. The market has, at times, become a one-way street. The withdrawal of central banks means the market will have to find a new equilibrium on its own. In the interim, the lack of a volatility cushion means there is a greater vulnerability to larger shocks.

The conclusion on technicals is that we respect the old adage: do not fight the Fed or any other central bank for that matter. For now, we are still a few months away from the second-to-last rate hike and even once rates have stabilized, history suggests we may first undergo a period of falling yields and rising spreads.

Conclusion

The age of confusion has started. Inflection points in the business cycle, the monetary cycle as well as some secular cycles around demographics (are we headed for permanent labor shortages?) and geopolitics make the current period confusing to analyze.

For now, we believe that if history teaches us any lessons, it is that the business cycle has to unwind a little further, there is a risk that central banks will overreact and the market in general is not yet priced for a full-blown recession. We are aware of wider spreads, and in some pockets of the market we have started to buy, but a bit more patience is prudent before making a long beta call.

Positioning

We prefer European spreads over US spreads. This is driven purely by the risk factors mentioned above, which has resulted in Europe becoming cheap versus the US markets.

We like swap spreads and hence higher-quality European credits.

We also like the banking sector, primarily banks with simple 'loaned up' balance sheets that will benefit from rising yields. Senior and senior unsecured spreads are very attractive.

In high yield we prefer to have a continued focus on quality. Here, too, we are overweight Europe and still favor more stable non-cyclical companies. Portfolio credit betas have been moved to less underweight and we are watching derivatives before taking the next step.

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

Source: Robeco, September 2022

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), Kamil Amin (UBS), Mislav Matejka (JPMorgan) and Matt King (Citi) have been taken into account in establishing our credit views.

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