ROBECO
The Investment Engineers

Credit Quarterly Outlook Q4 2021

Common prosperity

- China is changing; what does this mean for the world?
- There's no room for error priced into credit markets
- When will financial repression end?

In our previous outlook we used the word 'humble' when it came to forecasting the economy, given the degree of distortion and unpredictability created by the reopening process. Three months on, we still believe that humility is called for. Aside from the difficulty of making predictions in the current environment, one also wonders about their relevance. Do fundamentals still matter in a world of financial repression, in which monetary and fiscal policymakers set the stage? It seems that markets have for years downplayed the role of fundamentals; one scenario in which the relationship between fundamentals and markets might return is when central banks loosen their grip. The key questions for markets are therefore: when will that happen and should we be looking at central bank signaling, the stock of liquidity, the flow of liquidity or even the delta of the flow in liquidity? With valuations stretched and positioning crowded, we think that the market might be vulnerable to the *delta of the flow*.

Yet while the inflation debate is not yet settled, there are other questions to consider given that tapering is now widely anticipated. Instead, we should be prepared for some less well-flagged (and therefore more surprising) themes that could drive the normalization of risk premia in credit markets.

Outlook Q4 2021
For professional investors
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In our previous outlook we discussed the long-term possibility of developed markets turning away from neo-liberalism, which has been highly beneficial for capital at the expense of labor, and which has led to growing social inequality. In August, President Xi Jinping announced the 'common prosperity' plans that addresses exactly that point. China will shift its focus from outright growth to more balanced growth, in a way that addresses inequality and sustainability issues. The sharpening in focus is very relevant for certain sectors but, in conjunction with property sector measures and Covid restrictions, will probably also have a dampening impact on global growth.

With spreads still near an all-time tight, a cautious positioning makes sense to us. At the margin, we like financial institution credit more than other credit sub-sectors.

Fundamentals

We feel that the entire market is so focused on inflation expectations that other potentially more important market drivers might be overlooked. China has been the key engine of global growth for the last 15 years. With China now seemingly at a turning point we believe that it is probably more important than ever to monitor developments there closely. We therefore devoted additional time to discussing the economic and policy situation in China where a zero-Covid strategy, regulatory tightening in the property market and a policy reset are all contributing to increased uncertainty.

'Common prosperity [policy] will be enacted gradually. There will be a tighter grip on some sectors, but this does not mean the end of private markets in China; these are simply too important for the economy'

The zero-Covid strategy was a success in 2020 but now feels more like a double-edged sword. The virus will continue to pop up and each time that happens the harsh containment measures hurt mobility and consumption. But, given that the service sector is most sensitive to lockdowns, compared to the more immune manufacturing sector, a purely Covid-induced Chinese slowdown would not hit the global economy as badly: China's service sector is largely domestic and its products are non-tradable. However, sticking to this policy for too long will not help an economy that already has to deal with the impact of tighter regulation of its property market.

It is obvious that there is froth in the property market and that, given widespread moral hazard, tighter regulation was needed. For now, the uncertainty for the market is whether or not the authorities have overtightened and what the fall-out will be of an Evergrande restructuring. We remember all too well how a combination of froth and high leverage in a housing market can eventually result in a systemic shock. The CBIRC (the China Banking and Insurance Regulatory Commission) cannot afford a mistake here. Higher risk premia are justified to discount for this risk and do not represent an immediate buying opportunity. Let us emphasize that we do not anticipate Evergrande to be the 'Lehman' of China, as Beijing is expected to do *almost* anything in its powers to avoid a systemic crisis. But some fall-out is very likely. Indeed, to remove moral hazard, one or two headline corporate failures may be needed.

Furthermore, in a crisis there always are more interconnections than one can imagine, be it via suppliers or funding channels. Amid mixed disclosure, uncertainties around the size of local government debt, wealth management products, developer exposure and commercial paper, the precise scale and specifics are unknowable even ex ante. An engineered controlled restructuring and some further easing of monetary and fiscal policy is probable. After all, events at Evergrande (like the prior events at Huarong, Baoshang and HNA Group) are just another episode in a multi-year process of policy-driven de-leveraging following the largest nominal credit boom in history.

The last overhang in China is the policy reset where the Chinese leadership wants to shift from outright growth to balancing growth with sustainability and social equality. This policy, labeled 'common prosperity', will be enacted gradually. There will be a tighter grip on some sectors, but this does not mean the end of private markets in China; these are simply too important for the economy.

Nevertheless, the shift will have serious repercussions on certain sectors such as big tech, gaming and tutoring. It is yet to be seen what this new policy means for China's role as the world's manufacturing hub should they succeed in the policy goal to raise low-income wages further and increase labor's share in income. We note this contributes to Sustainable Development Goals (SDGs) 1, 2, 8 and especially 10. As a sustainable investment manager, we applaud the official ambition to strive for carbon neutrality by 2060.

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Fighting climate change has rapidly become an important topic in capital markets, anyway. The International Energy Agency estimates that achieving net zero emissions will require annual investments of around USD 5 trillion. Some economists see these large investments as a way out of secular stagnation, as growth and inflation are lifted. Also, on a micro level, we see that climate policies are playing an increasingly important role in companies' strategies.

'The immediate Covid crisis seems to be over, but the virus still has the potential to derail the recovery, perhaps via further disruption to supply chains'

Besides the potential slowdown in China, there are many other sources of uncertainty globally. First and foremost, we are still not out of the woods on Covid-19. Forecasters seem to be relaxed about the virus and the narrative continues to be that we will be back to normal in three months' time. But why would delta be the last economically impactful mutation of the Covid era? Maybe it will be, maybe not. The immediate Covid crisis seems to be over, but the virus still has the potential to derail the recovery, perhaps via further disruption to supply chains (in which case central banks will continue to stimulate and credit markets might not budge). Labor supply is still tighter than pre-Covid, which could support higher wages.

Inflation has been the main focus for markets and is extensively discussed in the Global Macro team's quarterly outlook. All we want to say here is that the inflation debate will not be resolved in the coming months and will cause heated discussions from time to time. It has the potential to cause some volatility, given the evident two-way risks. A key metric to watch is wage inflation, as this might give an indication on the persistence of inflation and tightness in labor markets. This holds for Europe as well as the US. Indications of more structural wage inflation would be important signals for the Fed and the ECB that it is time to speed up tightening plans. On the other hand, the role of elevated energy prices as a 'tax' on spending, and institutional memories of the ECB's policy mistakes by way of rate hikes in the summer of 2008 and 2011 – when oil prices were respectively at USD 150 and USD 100 – no doubt still linger.

Closely related to the inflation debate are the supply chain constraints plaguing many sectors. It started with semiconductors for the automotive industry but there are now shortages of many other inputs, such as containers, truck drivers, electricity and even raw materials for matrasses. Each has its own explanation, but the bottom line is that supply is falling short of demand. The majority of companies that are faced with higher input costs are able to pass on these higher costs as demand is robust across the board. Our sector analysts confirm that corporate profitability is strong and that margins are well protected. It is unclear if we have seen the peak in raw material price increases, as we get mixed signals from commodity markets (lumber plunging, gas skyrocketing). We have to watch this closely as idiosyncratic risk will probably increase on the back of the swings in input prices.

Valuations

Spread markets have moved in a very narrow range during the last quarter. The exception is China high yield, where spreads have widened substantially on the back of the Evergrande issues and signs of weakness in the Chinese economy. Although we must admit that we were too early with our underweight beta position, we still feel comfortable holding on to this position. At current spreads the cost of running a small underweight beta is low.

The search for yield has resulted in very compressed markets where even troubled credits have performed well. This is not the easiest environment for a bottom-up manager that invests according to the adage 'winning by not losing'. Still, we take comfort from our belief that our credit work will pay off when markets turn and start to distinguish between the good and the bad. Meanwhile, results from stock picking have been good for most portfolios.

Although it is conceivable that the current low-spread environment could last for longer, it is our fiduciary duty to also evaluate tail risks: it is very clear to us that the current spreads do not discount any of these risks, i.e. there is no room for error. We have been in this situation before, where tight spreads seemed to last forever – until the music suddenly stopped. The trigger is often hard to pinpoint in advance, but easy with hindsight. For us it is enough to conclude that markets do not offer adequate compensation in a world that is full of potential sources of turbulence.

There are always opportunities on a relative basis. Within European credit, we still see value in financial institutions. Massive fiscal support from the EU into the periphery has reduced systemic risk, which supports domestic banks. At the same time banks should be better shielded against a potentially more inflationary environment.

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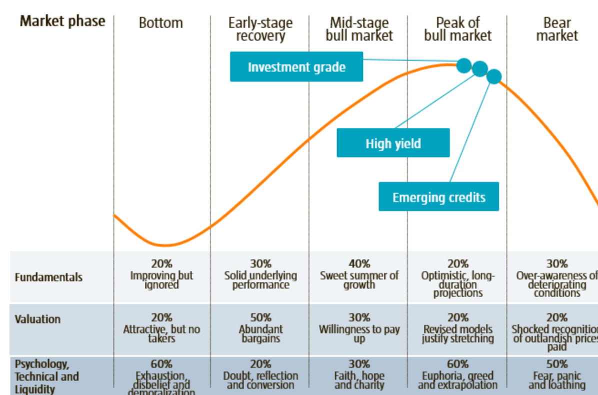
Within corporates we see value in rising stars where the upgrade to investment grade (IG) is not fully reflected in valuations yet. We play this theme both in the IG as well as in the high yield portfolios.

‘Steering away from the losing companies is likely to pay off in this environment’

Within emerging markets, spreads have widened for good reason. Here we look for opportunities in names that saw their spreads widen in sympathy, without this being justified by their fundamentals. We expect to see more opportunities if unrelated sectors start to widen on the back of the Evergrande denouement. That said, ‘winning by not losing’ will be an important strategy here, too, as volatility could very well rise further. Steering away from the losing companies is likely to pay off in this environment.

Within high yield, the CCC-rated segment is outrageously expensive. Average bond prices are now above par. Why do we look at bond prices for this category? Default risk is very high for CCC (five-year cumulative average default rates are close to 50%), so downside risk for any given bond is substantial. That is fine as long as the market also offers opportunities for price appreciation in the credits that survive. That potential upside is absent with prices above par and bonds being call constrained. In other words, the convexity is very negative.

Market cycle | Mapping our view on market segments



Market phase	Bottom	Early-stage recovery	Mid-stage bull market	Peak of bull market	Bear market
Fundamentals	20% Improving but ignored	30% Solid underlying performance	40% Sweet summer of growth	20% Optimistic, long-duration projections	30% Over-awareness of deteriorating conditions
Valuation	20% Attractive, but no takers	50% Abundant bargains	30% Willingness to pay up	20% Revised models justify stretching	20% Shocked recognition of outlandish prices paid
Psychology, Technical and Liquidity	60% Exhaustion, disbelief and demoralization	20% Doubt, reflection and conversion	30% Faith, hope and charity	60% Euphoria, greed and extrapolation	50% Fear, panic and loathing

Source: Robeco, September 2021

Technicals

Central bank policies have for years been the driving force in credit markets and dwarfed all else. And where fundamentals have mattered, they have done so in a counterintuitive way: the worse they got, the better it ultimately was for credit, due to the policy response. It is only human to extrapolate these recent experiences into perpetuity and assume that central banks will continue to support us. We had a lively debate again on the question of what exactly to look for in central banks’ asset purchase programs. Is it simply the sheer size of the central bank balance sheet (stock) that drives the market? Or is it the amount of purchases (flows) that are more important. Or could it even be the delta in the flow? This could be seen as a rather theoretical discussion but, given the tight valuations and the seemingly crowded long positions in credit, it is not inconceivable that even a slight change in central bank policy could disturb markets.

Separate from the stock, flow or delta discussion we should also consider the announcement effect of policy changes. Our Global Macro colleagues meticulously scrutinize every statement by the Fed and the ECB to find clues of potential policy changes. It is clear that the Fed is further ahead on the way to normalization with the groundwork for tapering already being prepared. 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 corporate supply.

So even though it is very clear that central banks will not stop buying bonds in the near future, we still believe it is warranted to call the technical factor neutral instead of strong. The marginal change in policy is negative. We are moving from extremely accommodative policies to very accommodative policies.

Although any other technical factor is dwarfed by what the Fed and ECB are doing, we believe it is still worth looking at other potential market drivers. This is not least because, as the initial Covid shock demonstrated, if a left-hand tail surprise is big enough, spreads can still widen materially in the short run – even when QE is already in operation.

The weakness in Asian credit markets has so far not led to any global contagion. That is somewhat surprising given the importance of Asian flows for US and European markets, trade linkages and China’s outsized contribution to marginal global GDP growth. With the Evergrande story now rapidly approaching its climax, we are closely monitoring potential transmission of risks via unforeseen

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interconnections. We have spoken before about the private debt boom in China. History shows us that there are few examples of unsustainable private debt booms that have unwound smoothly. Chinese private debt is at elevated levels and, with Evergrande and Huarong, larger cracks have appeared. Higher risk premia for Chinese credit are justified and we should not rule out a spill-over into other regions.

The bottom line is that we no longer call technicals strong. It is the change we are concerned about.

Positioning

Most likely, the credit market will at best deliver a coupon excess return – in other words, a boring or bearish year as we forecast in December 2020. We still think it is better to be positioned on the cautious side, even if that means that we lose some carry. 'All signs on green' has become the widely shared view for credit, and as a contrarian investor that is a red flag to us. This is a market that no longer compensates for tail risks and which is vulnerable to negative surprises.

Even though optically the beta position for some portfolios looks very low in terms of risk points (Duration Times Spread or 'DTS') the underweights are not excessive. A 100 risk-point underweight in a low-spread environment gives you a much larger beta deviation than in a high-spread environment, while the tracking error contribution is identical.

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, rising stars 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, September 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), Robin Xing (Morgan Stanley), Matt King *(Citigroup) and* Michael Anderson *(Citigroup) have been taken into account in establishing our credit views.*

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