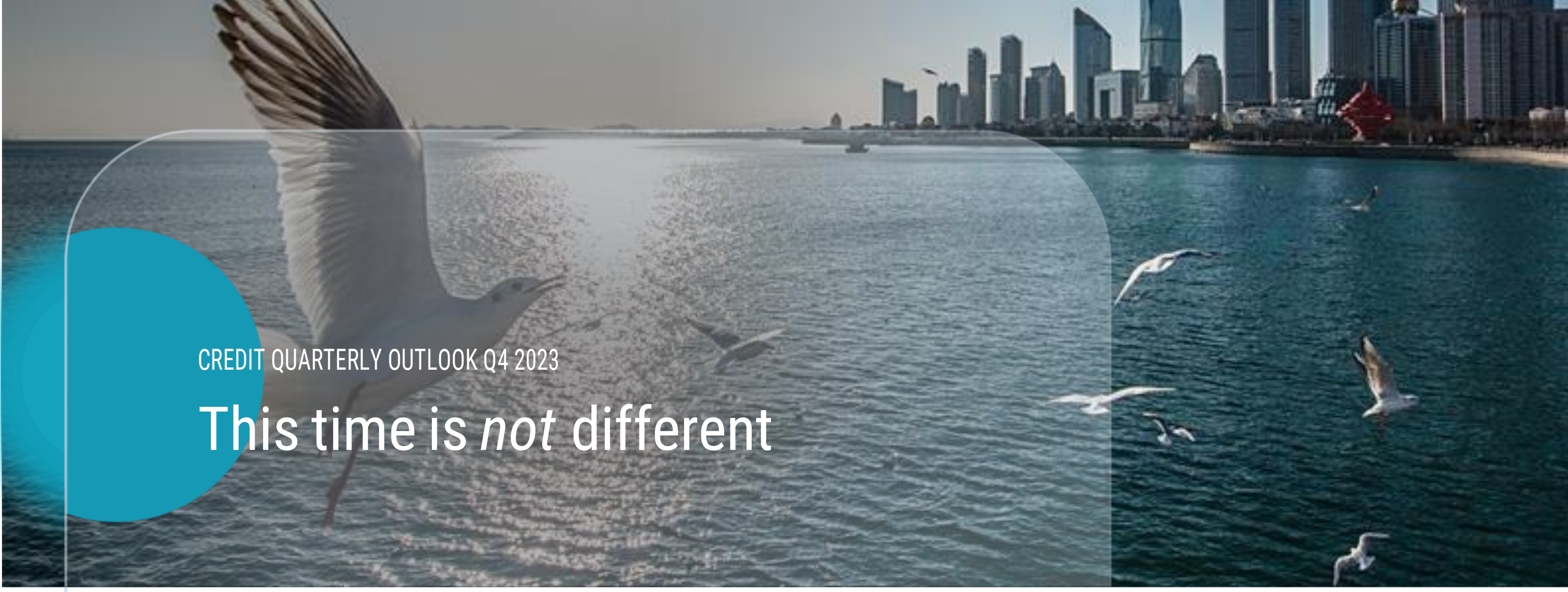

CREDIT QUARTERLY OUTLOOK Q4 2023

This time is *not* different

- Markets seem to have fully embraced a soft landing
- Monetary policy lags are longer
- Position for decompression and quality carry

Consensus views in the market have changed from a high likelihood of a recession to a most likely soft landing, at least in the US. Investor positioning has shifted accordingly over the summer. Today, cautious positioning has moved to a net-long and many sell-side strategists have lowered their end-of-year spread forecasts.

We argue that this is precisely the time to remain cautious. Economic laws have always applied, and this time should be no different. Investors should be wary when people claim the opposite. Historically, significant monetary tightening cycles have always resulted in a recession, only the time lag has differed. And this has been the sharpest rate rise in decades.

We do not have a crystal ball, however, in our assessment we believe that markets are currently too sanguine and complacent. The factors that caused the lag in monetary policy transmission have now largely played out. The savings reservoir is almost depleted, fiscal stimulus has reached its peak and the recovery of the services sector is complete.

Higher interest rates will soon start to bite the lower-rated companies and probably result in decompression between investment grade and high yield. Once central banks are finished hiking rates and rate volatility decreases, investment grade markets may well prove to be an attractive asset class compared to more risky assets. Therefore, we favor investment grade over high yield, and within high yield we strongly advocate for a quality tilt.

We are comfortably long in quality carry and positioned for decompression. Hence, we are slightly long beta in investment grade, and we stand strongly by our conservative positioning in high yield.

OUTLOOK SEPTEMBER 2023

Sander Bus
High yield

Reinout Schapers
Investment grade

Fundamentals

The US economy has been remarkably resilient despite the sharpest hiking cycle in decades. The common wisdom that sharp-hiking cycles have always resulted in a recession is now being challenged. After almost a year, the consensus view seems to have shifted away from a recession to a soft-landing scenario. Many started this year with a very cautious view on markets, as did we. At this point there has been no temptation to change our view as we begin to see confirmation that positive surprises are potentially coming to an end.

We continue to hold the view that economic laws apply and that this hiking cycle will have similar consequences to those in the past. The only difference is that the policy lag is a bit longer. The longer lag can be explained by the imbalance that the world had to cope with after Covid: a high savings reservoir, catch-up demand for services and large order backlogs in for example the auto sector. Additionally, fiscal support, especially in the US, has supported growth and employment. So, why do we think that the market is too complacent about the prospects of a soft landing? We believe the previously mentioned effects seem to have run their course.

Firstly, the US has benefited from outsized fiscal stimulus, however, from now on the fiscal impulse will be negative. Secondly, there is no additional upside from a further recovery in the services sector, and the service PMI's dipping below 50 also indicates this. Thirdly, the consumer has depleted their excess savings and the very high perceived job security can only come down from this point. In other words, it is difficult to see continued strength in consumer spending, making it harder for companies to pass on input cost inflation moving forward. To be clear, by no means does this suggest we expect a deep recession. We have not seen an overinvestment cycle; hence, we do not expect a decline in capex, which is usually symptomatic of deep recessions. Yet, we could see some collateral damage down the road, similar to what we witnessed in March this year during the US regional banking crisis.

> *" We continue to hold the view that economic laws apply and that this hiking cycle will have similar consequences as those in the past*

The European economy has not been as strong as the US. Europe has not enjoyed the same fiscal impulse, and as a more open economy has also not been immune to weakness in China, a key trading partner. Another big difference between the US and Europe is that Europe is a net importer of energy. With a lag, we are beginning to see the first consequences of monetary tightening, evidenced by the rising number of bankruptcies (from a very low level). It is possible that we may have already seen the last rate hike in Europe with the first cut being priced in for next year.

The Chinese economy has exhibited outright signs of weakness for over a year now. In the short term, the Chinese economy may receive some support through fiscal and monetary policy easing. Although so far, the level of support has been underwhelming, and it raises questions about whether there will be enough to sustain a recovery. Looking ahead China faces some serious challenges that resemble the Japan experience after 1990. For too long the country relied on investment spending to keep its economy growing, resulting in high debt levels and overcapacity. High debt and deflation are not great combinations. Trade tensions with western trading partners and an aging population add to the negative sentiment. Over the summer we saw the cracks intensifying as liquidity issues occurred in several Local Government Funding Vehicles (LGFV's). The construction sector is still in the doldrums with major developers' sales more than halving this year, and many have defaulted in the past year. So far, given this is not yet considered an event that threatens global financial stability, there has been little market contagion outside China. However, it is clear that Europe, especially Germany, is most at risk from the Chinese economic struggles.

Elsewhere in emerging markets we note some positive developments. Various Asian countries could benefit from the tension between China and the west as they are well-positioned to take over the role of China as an outsourcing hub. We also see divergence in monetary policy amongst emerging economies with some countries now cutting rates as inflation outlooks start to improve. In Latin America we see some positive benefits from America's near-shoring efforts.

Bottom-up, company fundamentals were strong when we started the rate hike cycle. Earnings surprised to the upside this year against very downbeat expectations. However, on a year-on-year basis, earnings are now declining across the global corporate sector. As many companies locked in low rates during the Covid era, for the average company, there is a lag between rate hikes and an actual increase in interest expense. This is particularly true of investment grade companies, who tend to have very long-average maturities, meaning the average coupon has hardly increased. In terms of high yield, maturities are shorter, and we see that higher rates are starting to already bite, especially for those companies that have a lot of floating rate loans in their funding mix. A sizable portion of low single-B and CCC-rated companies will see interest coverage ratio's decline to stressed levels once a significant part of their debt gets refinanced at current market yields.

Valuations

Risk-free rates continued to move higher during the quarter, while credit spreads held in well or even tightened. Year to date, in high yield we saw compression across ratings with lower rated credit outperforming higher ratings. This reflects recession risk being priced out. We expect credit markets to start decompressing in the coming months as we believe that the market is currently underpricing the risk of a recession. We favor quality carry positions that still look attractive on a historical basis, and we would rather keep clear of the riskiest section of the markets that trade rich by historical measures.

Valuations in investment grade are better. Within investment grade markets we still see banks offering the best value. Banks benefit from the higher rates environment via improved interest margins. Senior banking paper continues to trade wider than historical averages and as a result of the Credit Suisse problems in March, this is equally true of banking AT1 paper.

" Within investment grade markets we still see banks offering the best value

European credit spreads are trading wider than their US counterparts. This holds for both Investment grade and high yield on a ratings and maturity adjusted basis. For dual currency issuers we still see a pick-up in euro bonds, even when we adjust for the wider swap spreads in the Euro market. We appreciate the fact that slightly higher-risk premia are warranted for companies that have elevated exposure to the euro market, given the more elevated geo-political risk in Europe. We remain comfortable with maintaining an overweight exposure to Europe because the extra spread sufficiently compensates for the additional risks.

In high yield portfolios, the regional bias towards Europe is partly a consequence of our strong preference to be underweight highly levered CCC's and weak single B's. This is a segment that is overrepresented in the US high yield market. In investment grade portfolios, the underweight in the US can be mostly attributed to an underweight in the very expensive long-dated (15+ year) part of the market.

In relation to emerging markets, we see a lot of dispersion between countries, sectors, and ratings. We continue our cautious stance on the riskiest countries including China and therefore have a quality tilt in this portfolio and a neutral beta view.

Technicals

Whilst technicals remain tough there are some positive indicators that suggest opportunities for investment grade bonds. With the end of the hiking cycle now in sight we are likely to see a period with lower rate volatility. A decrease in volatility paves the way for carry trades and investment grade would be the beneficiary. This environment also creates prospects for lower government bond yields which will benefit the total returns of investment grade. However, for high yield this leads to a different scenario, as high yield tends to underperform in a falling rate environment, usually coinciding with a weaker economy and rising defaults.

It would have been nothing short of a miracle if monetary policy makers would have been able to set rates exactly right and engineer a soft landing, thus avoiding inflation and maintaining positive economic growth. There are simply too many uncertainties around the lags in monetary policy transmission for this to happen. With inflation materially above target levels, it is likely that central banks will err on the side of caution. This means with hindsight, we can probably conclude that central banks left rates too high for too long, however, given the uncertainty of today, their response makes all the sense in the world. In today's credit markets the risk of a recession is probably higher than the market discounts for.

Supply technicals are another factor that positively support investment grade bonds. On average companies have fairly long-maturity profiles and as they have enough free cash flow to sufficiently service debt they do not need to come to the market. Consequently, we witnessed an underwhelming new issue calendar. Given large capital structures, company refinancing will have a limited impact on average debt costs in the medium-term. For high yield this is different, as maturities are shorter and cashflow generation is lower. High yield companies have also been delaying refinancing in the bond market, but they cannot continue to do this as the maturity wall (2025/2026) slowly approaches.

" We are probably close to the end of this cycle, but it is likely we have not yet seen the full impact

Detracting from this is the fact that the ECB still has large positions in corporate bonds that need to be unwound. This results in a negative overhang. In the case of Europe we have the overhang of potentially negative geopolitical developments, with the war against Ukraine continuing to rage. In this environment the potential for unexpected negative events is simply elevated and we would consider this as a negative technical factor.

In our outlook we also discussed the implications of the lending surveys, that are clearly pointing to the tightening of lending standards by banks. Additionally, the demand for loans has been low and the credit impulse, defined as the change in lending growth, is now clearly negative. Historically, this would have resulted in a sharp reduction in economic activity. Some market participants claim that things are different this time around, but we choose to stick to economic laws and support the notion that it is merely a result of longer lags that we are yet to realize.

The hiking cycle will most likely surface a few more problems that are difficult to predict. We have seen this unpredictability over the last few years with the LDI crisis in 2022 and the regional banking problems in the US earlier this year. We simply know that historically each hiking cycle has caused collateral damage in sectors of the economy that are unable to sustain a rising rate environment.

Overall, our conclusion is that technicals are still difficult, especially for high yield markets.

Conclusion

We have witnessed the sharpest hiking cycle in the past 40 years as a measure to combat very high inflation. We are probably close to the end of this cycle, but it is likely we have not yet seen the full impact. The exact implementation lag is unclear, and it is unlikely that central banks did exactly enough to maneuver the economy towards a soft landing

It is more likely that they erred on the side of caution and hiked too much in order to be sure that we are not left with a price-wage spiral. We believe that more pain on the real economy is in the pipeline.

Many market participants seem to have embraced the soft-landing scenario and given up on their recession forecast. We believe this change in view was mainly triggered by markets that did not react in the way that was previously anticipated. Yes, a cautious position was painful this year, especially in high yield, but that is not reason enough for us to diverge from our view. With market positioning having turned more bullish, we think this is all the more reason to remain cautious on the riskiest part of credit markets and favor the higher-quality aspects of the market. Investment grade companies can probably fare reasonably well in this environment if the recession isn't too deep.

Positioning

We advocate a strategy of buying quality carry and positioning for dispersion. This means we are comfortable with high quality bonds such as high-rated corporates, banks, agencies and covered bonds.

For investment grade portfolios we believe value remains in banks that have not yet reverted back to early 2023 levels. After the rally we witnessed over the summer, for now we are targeting our betas for IG portfolios to just above 1, as spreads have moved considerably since our last outlook. We see this as a conservative position for this category as it also allows us the option to increase risk if volatility re-emerges.

For high yield we remain more conservative. In a decompression scenario, which is our base case, we expect to see underperformance of weak single B's and CCC's. Now more than ever, we think this is the time to run a strong quality tilt in high yield by being overweight BB versus the lower rating categories, and to take credit exposure via the banking sector and crossover names.

We are still overweight Europe in the IG portfolio, which is partly a result of being overweight in the European banking sector and underweight long duration assets. In our high yield strategy, the overweight Europe is a reflection of our quality bias on the basis that lower quality credit is overrepresented in the US market.

Figure 1 – Current positioning

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

Source: Robeco, September 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), Stephen Dulake (JP Morgan),Viktor Hjort (BNP Paribas) and Zhipeng Cai (Morgan Stanley) have been taken into account in establishing our credit views.