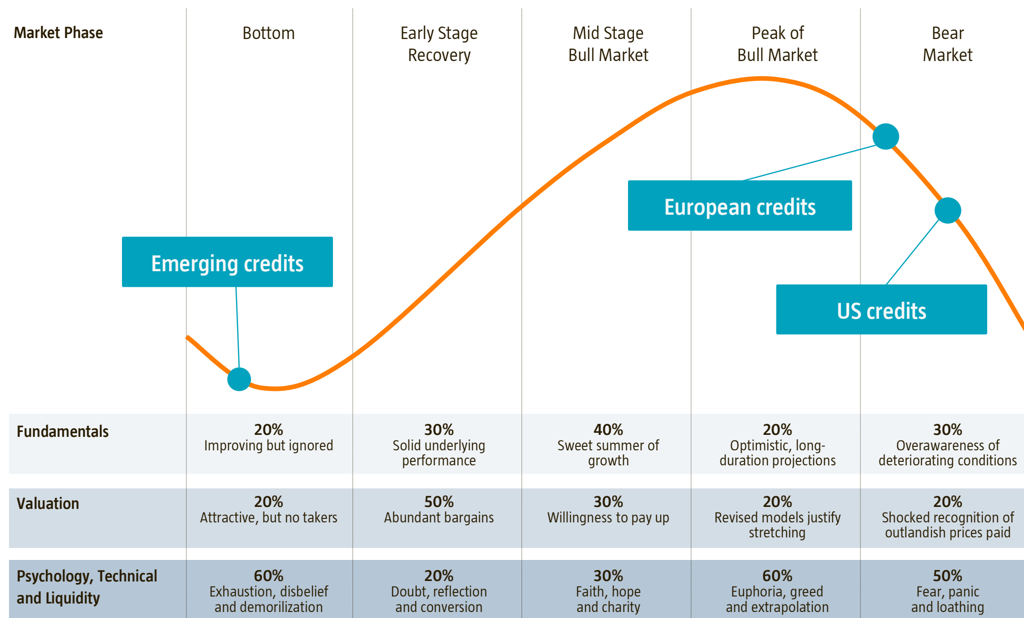
ROBECO
The Investment Engineers

Credit Quarterly Outlook: the 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%** Overawareness 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 demorilization	**20%** Doubt, reflection and conversion	**30%** Faith, hope and charity	**60%** Euphoria, greed and extrapolation	**50%** Fear, panic and loathing

Source: Robeco, Morgan Stanley, March 2016

We are on borrowed time

- The US economy is in its seventh year of expansion, this is more than the duration of an average cycle from trough to peak
- Policy makers try to stretch the cycle and prevent recessions at the expense of creating bubbles and imbalances
- Low productivity growth and adverse demographics result in very low trend growth and low interest rates
- Angry voters are attracted to populist politicians, posing a threat to stability

During our quarterly outlook meeting we tried to answer the question how much further the US business cycle can be extended. The US financial market is still by far the most important market in the world. All other markets are in fact a derivative of the US. It is therefore very relevant to have a good assessment of the US business cycle. After seven years of economic expansion, profitability and leverage data suggest that the end of this cycle is nearing. The question is whether we are on the eve of a recession or if the cycle can be stretched for a few more years. Aside the economic worries, we also see an increase of political risk, not only in emerging markets, but certainly also in developed markets. Brexit, Donald Trump, the rise of nationalist parties in Europe are all a reflection of the same thing: an angry population. As the middle class feels insecure due to high unemployment, the absence of wage growth, immigration and threat of terror, it is susceptible to populist politicians.

Sander Bus, Head of High Yield Credits
Victor Verberk, Head of Investment Grade Credits

"The future isn't as bright as it used to be"

The ECB, The PBOC, the BOJ and even the Fed have all become more dovish in the last quarter. Disappointing inflation numbers and financial market turmoil are apparently enough to trigger a strong response. Central banks seem obsessed to keep the economy growing. This is a risky obsession as it causes moral hazard. In the first place it takes away the pressure on governments to implement structural changes. Secondly, although overall capital spending levels are low, it causes overinvestment and overleverage in parts of the private sector. Debt funded excess investment in several Chinese industries but also in the US energy sector is a direct result of overly loose monetary policy. Similar to the run-up to the Global Financial Crisis in 2008 this leads to imbalances in the economy. The recession is delayed but ultimately the damage will be bigger.

We have come to a point were confidence of market participants in central banks is being hampered, which is reducing the effectiveness of monetary policy itself. The drug is losing its effect and markets respond to fundamental deterioration regardless of monetary stimulus.

We concluded that the business cycle in the US is in the mature stage. Profitability is under pressure and in order to hide that, companies are falling back to all kinds of financial engineering. We see increasing corporate leverage in the US. Debt is being raised to fund Mergers & Acquisitions and share buy-backs. These are typical characteristics of the final stage of the economic expansion.

A US recession sometime in the next three years seems unavoidable although we can be sure that monetary authorities will do anything to try to delay it as long as possible. As an investor it is important to closely monitor how much recession risk is being discounted for in credit spreads. Early February, US credit spreads had risen to levels at which a recession was fully priced in; sentiment was extremely negative and recession was the consensus expectation. We saw that as a perfect moment to increase risk in portfolios. In the last six weeks we have seen a strong reversal and spreads have tightened significantly. We believe that this was a bear market rally and that the current strong markets provide a good opportunity to clean up portfolios and reduce risk again.

We can see several exogenous risks that could disturb financial markets later this year. Brexit in Europe, elections in the US and the permanent threat of terrorism are all events that could lead to a risk-off stance in markets. With credit markets that are still fairly illiquid this can lead to violent price action, similar to what we have seen in the first quarter of this year. Central banks will also continue to be a dominant force and are prepared to intervene when markets drop to fast. We advocate a contrarian investment style. Sell when markets are positive and add risk when sentiment is at the bottom.

Fundamentals

European economic developments are the least of our worries

The European economy is slowly but surely recovering further. Consumption spending is growing in most countries on improved labor markets and a windfall from low energy prices. The fiscal drag has faded as well. Even fixed capital formation has turned positive on an aggregate level. Within Europe, not every country is enjoying the recovery at the same pace. Spain, Ireland and Portugal are leading while France and Italy still are the laggards. This is directly linked to the lack of structural reforms in these countries.

The main economic worry is the very sticky deflationary pressure. There is still so much slack in the economy that wage pressure is completely absent. That leaves the ECB with an über-loose monetary policy for the foreseeable future. We can conclude that the economic cycle has further to run in Europe. The economic threats come from outside of the region; increasing risks in the US and a further slowdown in key emerging markets, more on that below.

But let us first address one other risk that we see in Europe; the angry middle class. Big groups of voters are discouraged by the absence of wage growth, high unemployment, immigration and terrorist threats. Increasingly, populist parties are gaining popularity. Alternative für Deutschland, UKIP, Front National and the Dutch Freedom Party are no longer marginal political forces. This could be destabilizing Europe and ultimately lead to a new financial crisis. Brexit risk is another example of political risk. Economically it does not make any sense for the UK to leave Europe, but economic arguments no longer resonate with the angry man in the street. It is a complete distrust of the political and economic system that drives voters to make extreme choices.

What are the chances of a Brexit? Opinion polls suggest that the Out-camp is behind now. Bookmakers that in the past proved better forecasters suggest that it will be a very close call though. If the UK were to leave Europe, this could also lead to a break-up of the UK itself since Scotland could separate itself in order to stay in the European Union. That will lead to a lot of uncertainty which is never good for financial markets. Be prepared that Brexit is likely to dominate financial market sentiment in Europe in the coming months.

US seven years into the cycle

The big question for the US is when the next recession will hit. The current cycle has been running for seven years, which is already above the historical average duration of an economic cycle (trough to peak). We realize that historical averages do not necessarily say a lot, but they could at least provide some guidance to where we are heading. Policy makers have an incentive to extend the cycle and to push out the recession. In the short run that is positive but it comes at the expense of moral hazard and a probably deeper recession once the tide turns. This is what we have seen in 2008. Monetary stimulus did extend the cycle but at the expense of creating huge economic imbalances and bubbles that caused the financial crisis.

We should not forget that recessions are helpful in the way that they are a source of creative destruction. Zombie companies with uneconomic business models and too much debt disappear and new businesses start. Also they force companies and governments to implement restructurings that strengthen the foundation of an economy. Avoiding a recession can hurt long-term economic growth. There are several signals that the US is in the final phase of its economic expansion. Declining profits and rising corporate leverage are red flags.

There are economists who point to the oil dividend for consumers and the lower fiscal drag that could support the US economy, and extend the cycle a bit more. This is indeed a scenario that is not unlikely. However, the corporate sector is slowing down if we look at corporate profitability.

Historically recessions have always been preceded by profit declines, but not all profit declines have immediately led to a recession. Policy makers have occasionally been successful in interfering and preventing a recession.

It is good to realize that as portfolio managers we also ought to be risk managers. That means not simply implementing the scenario that is most likely (policy makers successfully extending the cycle) but explicitly taking into account the tail risks. If a recession will hit, it will be risk-off in the months preceding that recession. Equity returns have on average been -35% in these periods. It goes without saying that credit spreads will also widen significantly in such an environment.

So let us be humble and admit that we simply do not know if the recession is around the corner or if this cycle can be extended a bit more. But what we do know is that this is not the time to be aggressively long and that we should very closely monitor what is priced into markets. Early February, at the wides in spreads, a recession was fully priced into credit markets. That is no longer the case, so reducing exposure back towards neutral is warranted.

Is corporate leverage a problem?

Some strategists claim that US corporate leverage is very manageable. Arguments that are used are low interest rates (servicing costs) and low debt as a percentage of net worth. Also, looking solely at S&P 500 companies, leverage looks very manageable. But that is actually misleading. Companies with a huge equity market cap have a higher weight in the equity index and these are by definition the companies with lower leverage. When you look at the bond universe, the average leverage looks much higher. US investment grade leverage has even risen above the peak that is usually seen during a recession when EBITDA bottom.

We believe that high leverage is a risk even though it is true that due to low interest costs debt servicing is currently very manageable. The problem with high leverage is that when a recession hits and enterprise values come down, companies could find themselves cut out of credit. Let's assume a 4x levered company with 400 million debt at 100 million EBITDA and 600 million total enterprise value. This is perfectly manageable in a normal situation. But when a recession hits and EBITDA drops to 80 million and enterprise value decreases to a multiple of 5x (400 million) you can see that the equity cushion gets wiped out and that this company probably gets a hard time refinancing its debt. So leverage does make companies vulnerable during a negative economic environment and can cause companies to spiral down.

Aggressive corporate behavior and financial engineering are back in US boardrooms. Debt funded M&A and share buy backs are as high as they have ever been. Another signal is the increasing gap between GAAP earnings and pro-forma earnings (or adjusted earnings). Pro-forma earnings are adjusted by management discretion and are not complying with accounting rules. Companies can massage their pro-forma numbers and hide the contraction that is visible in GAAP numbers.

Political risks are on the rise

Very similarly to developments that we see in Europe, political extremism is also back in the US. Donald Trump attracts the angry voter in the US. His anti-globalization and immigration agenda could mean another blow to economic growth and could also cause rising geopolitical tensions. It is hard to imagine that Donald Trump will be able to make it to the White House, but the mere risk that this could happen will be enough to disturb financial markets.

Emerging markets; China does it again

In previous quarterly outlooks we have written extensively about the debt bubble that has been building in China. Years of loose monetary and fiscal policies have resulted in huge credit growth and overinvestment in several sectors of the economy. The oversupply has resulted in deflation and falling profits.

On March 5, Premier Li presented the economic plans to the National People's Congress. It is clear that social stability is the key priority for Chinese leaders and economic growth is a prerequisite to accomplish that. They have set a growth target of 6.5%. In order to reach that goal the government seems to have decided on renewed adoption of an expansionary monetary and fiscal policy. The bad news is that imbalances will grow further as a result.

Once again leaders shy away from short-term pain in order to reach long-term gain. In fact, they do exactly the opposite. The impact was immediately visible in rising commodity prices and emerging market assets. Deleverage and de-risking the economy should be the priority, but instead credit growth is once again stimulated. This will only make things worse in the long run. So even though in the short run this policy supports markets, it makes us more bearish in the long run.

The government does acknowledge that it needs to deal with overcapacity in several 'old' industries. It would be a positive if capacity is really taken out in sectors as steel and mining. Plans look promising, but when it comes to execution of painful measures the practice can prove to be difficult in China.

With the renewed focus on economic growth and releverage, the risk of renminbi devaluation has come down, at least in the short run. So that deflationary threat to the rest of the world is not imminent. However, given the genuine long-term doubts that one could have about the effectiveness of Chinese economic policies, we find it likely that there will be continued pressure on the capital account as citizens try to move their private wealth oversees. So in the long run we still do not rule out renminbi devaluation.

Brazil

A note on Brazil is warranted as well. The country is in total economic and political disarray. Even an impeachment of the president has become likely. Brazil does have a little bit of time left but otherwise a classical crisis might occur, maybe even with IMF involvement. The market has reached a phase where it is responding positively to bad news as it increases hopes that the current political leaders are being replaced sooner rather than later.

Conclusion

From an economic point of view, Europe looks the best place to be. The cycle in Europe has only run for about four years (since the end of the sovereign crisis in 2012) so there has not been much of a debt build-up in Europe. That is different in the US where corporates have increased balance sheet leverage by issuing debt to fund share buy-backs and M&A. All major central banks are still running very accommodative monetary policies. In the short run this might help to fend off a new recession, but in the longer run this is at the expense of new imbalances and keeping zombie companies alive. Emerging economies are a diverse group. Brazil is already in an advanced stage of the bear market. China is still in the phase of debt build-up and delaying the pain.

Valuations

Back to square one

Credit markets have had a bumpy ride since our last quarterly outlook in mid-December. Markets started the year on a very weak note. US high yield widened by about 200 bp to 864bp in early February. We saw a similar move in investment grade, widening by about 50bp to a high of 215bp. Emerging corporates also saw a similar move. As quickly as markets sank in the first six weeks, did they recover in the following six weeks. For the market as a whole, we are back to the levels of three months ago. This does not mean that spreads are tight. On the contrary, there are still several pockets of the market that carry a very decent spread.

US markets wider than European markets

US credit underperformed Europe by a wide margin in 2015 and still trades much wider. We believe this is justified since the US is in a much more advanced stage of the economic cycle. Europe is only in its fourth year since the end of the sovereign crisis in 2012. The US has already had seven years of expansion. Europe has not had a credit boom similar to the US, so it is unlikely to have a credit bust. Having said that, we think a complete decoupling in spreads between Europe and the US is unlikely. The US financial markets are still dominant and other regional markets more or less trade as a derivative of the US.

US investment grade does trade significantly wider than its European counterpart. For high yield this also looks to be the case at first sight. However if we adjust for the lower credit quality and sector skew, we actually reach a different conclusion. Euro denominated bonds still trade wider than the USD denominated bonds of the same issuer in many cases. Also, the European market is more skewed to sectors that are less vulnerable to low commodity prices.

European banks underperformed

European bank spreads did underperform since our previous outlook as losses in the first half of the first quarter were not recouped in the second half. We see two reasons for the underperformance. Firstly, there is increasing concern that negative interest rates hurt profitability since banks are unable to fully pass on negative rates to retail deposits. Negative ECB deposit rates work in a certain way as an additional tax for banks, although the LTRO at negative rates that was announced by the ECB should mitigate this somewhat. A second reason for the underperformance was probably linked to Brexit fears. London's hegemony as a financial center could be at risk if a Brexit were to happen. Relocation costs could hurt bank profitability in that scenario. That this is not just theoretical risk was illustrated by the announcement of HSBC that it would relocate 1,000 people from London to the continent if the UK were to leave the EU. We still see value in the higher quality banks in the stronger European economies, but stay away from the weaker banks.

Emerging markets valuations not reflecting the full risk

Emerging market corporates also experienced a very volatile ride. Global slowdown fears in the beginning of the first quarter did hit commodity related companies and countries that are well represented in emerging markets. The political crisis in Brazil also added to the negative sentiment. We used the weakness in emerging markets to add exposure to our EM credit portfolios. Emerging markets also rallied significantly in the last six weeks. Spreads do not fully reflect all the risks that we still see for this category. So we use the recent strength to reduce risk again. It is fair to say that there is more value in Brazil and less so in China.

Conclusion: fair value

In our previous quarterly outlook we concluded that valuations were at fair value. Since we are back to the same levels, after a wild ride, we are still at fair value. The exception is emerging markets and more specifically China, where we believe spreads do not sufficiently compensate for the risks.

Technicals

ECB corporate bond buying surprised markets

The ECB surprised markets with its announcement to include corporate bonds in its Quantitative Easing program. It caused a strong initial market reaction but the rally faded after a few trading sessions already. Details about the corporate bond buying are still unknown. We fear that the execution could lead to disappointment, similarly to what we saw with the ABS buying program. ABS spreads initially tightened on the announcement but started to widen when the ECB started its actual buying. A typical example of buy the rumor, sell the fact. The ECB will probably have a hard time to buy sufficient bonds in the light of the limited market liquidity. Moreover, there is no clarity on how low in credit quality they can go.

Central banks are a source of volatility

For a while central bank actions helped ease volatility. That is no longer the case. Central bank policies are pushing investors into crowded trades and add to imbalances in global financial markets. The increase in corporate leverage that we have seen in the US, but also in certain emerging markets, is the result of globally very loose monetary policies. In general we see that central banks have lost credibility and that market response to monetary stimulus has become more short-lived as worries about the health of the economy are not taken away.

Search for yield continues

With such a big part of the fixed income market trading at negative yields, the strong technical for higher yielding assets is still prevalent. Holding on to cash for a longer period of time is not an alternative with deposit rates in negative territory.

Poor liquidity adds to volatility

Liquidity conditions in bond markets are still well below the levels of before the Global Financial Crisis. Only a small fraction of corporate bonds trade on a daily basis. For managers of mutual funds it is essential to have liquidity policies in place. It is also important to have a contrarian investment style in order to minimize trading costs and enhance returns. In the first six weeks of this year market sentiment was very negative and it was very difficult to find a buyer for credit. Thiscompletely reversed after mid-February when it became very difficult to buy bonds. The lesson is that as a credit investor you cannot afford to go with the flow. The only way to move in this market is to sell when others are buying and buy when others are selling.

Supply to pick up in 2Q16

Supply of new issues has come down in the first quarter of 2016 after the very high supply in 2015. This was a result of the weak start of credit markets in the first weeks of the year. The demand for new issues was simply not there. With markets recovering in March, supply has also picked up, especially in the US market where several mega transactions priced that are related to M&A. With low euro yields and strong markets we expect US issuers to increasingly issue new bonds in the euro market. These bonds are called reverse Yankees.

Petro dollars

The investment funds of oil producing nations were steady buyers of developed market financial assets for years. With the low oil prices, these buyers have now disappeared and even turned into net sellers. It is difficult to find out how big this force exactly is, but given the still very low oil price we think that this technical should not be ignored. The Norwegian oil fund was in the news with reports that it would for the first time withdraw funds this year. Saudi Arabia is even considering to re-establish its debt agency in order to be able to tap capital markets to fund its fiscal deficit.

VIX index back to the low

There is a strong positive correlation between volatility as measured by the VIX index and credit spreads. Low levels in the VIX index mean that implied volatility in equity options is low, the market price for hedging tail risks is low. That is often seen in bullish markets. Low VIX can be an indication of complacency. The VIX index has come down from a level of 28 in February to around 14 in the end of March. Spreads also tightened, but not to the same extent. One could argue that spreads have more room to tighten given the low VIX, but it is probably more likely that we will see a higher VIX.

Conclusion: more volatility is in the cards

We stick with the view that all asset classes and certainly credit markets will experience more volatility. The credit cycle has become a lot less friendly, liquidity is poor and investors are stuck between a rock and a hard place.

Positioning

Issuer selection more important than beta policy

The credit cycle is in an unfriendly phase for investors. Valuations partly reflect this, as we are above median levels in most markets. When are we at the bottom of the bear market? Let's take a look at the market cycle on the front page. The bottom of the bear market is characterized by a mental state of exhaustion, disbelief and demoralization. We can vividly remember this phase from 2008. We have not seen this yet, although we got close in January/February. Another thing that we need to see in order to conclude that we have seen the bottom: improving fundamentals that are being ignored. For the US, which is still the dominant financial market, we cannot draw that conclusion yet. If anything, fundamentals are still getting worse. So our conclusion is that February represented a nice entry point, but did not mark the bottom of the bear market. We did grab the opportunity though to increase exposure for most credit portfolios by buying very cheap credits.

What followed was a typical bear market rally. Market participants that were positioned for an extended bear market were badly hurt and squeezed back into the market. That shows how risky it is to be too outspoken on bearish positioning when spreads are already wide. We see the current strength as a nice opportunity to lower risk in the portfolios again to neutral/ first-quartile long. We use strength to clean up the portfolio and sell bonds that we probably won't be able to sell when the market turns negative. We do not have a crystal ball and recognize how difficult it is to rightly position on the waves of this volatile market. We feel much more comfortable to allocate our risk budgets to issuer selection. This is a market where dispersion between issuers can be big. Stock-picking, or actually bond picking in our case, can generate serious alpha and returns. In our bond picking we take country and sector risks into account.

Betas close to 1 in developed markets

In developed markets we only use 0% - 25% of our beta risk budget. This holds for both investment grade and High Yield. For investment grade we had moved to the range of 25%-50% that we implemented during the selloff in the first quarter. We are prepared for a continuation of volatile markets in the coming quarters and will continue to invest with a contrarian style. That means that we will tactically add risk during risk-off periods, but if spreads are tightening further to below median levels we will be net sellers of credit risk. From a fundamental point of view we have a preference for Europe over the US, given the better credit environment, but are also cognizant of the fact that the US investment grade market does offer attractive valuations. Also, tail risks could be a bit higher in Europe. All in all, for investment grade there is no strong preference for either Europe or the US.

For high yield this is different. We are more constructive on Europe than on the US. The US market has a high exposure to energy (about 20% of the market measured by Duration-Times-Spread risk). As we continue to be underweight energy and CCC, we also have an underweight exposure to US high yield on a regional basis. The difficulty in high yield now is that the market is basically split into two parts: a distressed part and a part that still is on the expensive side. For global high yield the portfolio beta will be around 1. For European high yield strategies, the beta will be slightly higher but stay well within 25% of the risk budget

Emerging beta below 1

Unsurprisingly, we re-implement our conservative positioning in the emerging credit portfolio, with a beta below 1. Temporarily we had moved our beta to just above 1 during the violent sell-off in the beginning of this year. However, valuations have tightened again and we believe that there are still a lot of vulnerabilities in emerging markets. Key is a repricing of the Asian credit markets. That will be the trigger for us to call the bottom of the bear market. In our merging market credit portfolio we still like developed companies with exposure to emerging markets. We benefit from a similar risk premium but with much better governance.

Long financials

European financials underperformed in the first quarter after a strong outperformance in 2015. We believe that banks are still a nice place to be, at least for a fixed income investor. Financials are still in de-risking mode, pushed by regulators. That bodes well for outperformance of financials. On top of that financials are now a safe haven in a very aggressive credit market. Brexit fears will cause volatility in this space and probably present opportunities to add risk from time to time.

Conclusion

As research-driven stock-pickers we like this market. We do not want to use too much risk budget for beta policy, although we do use volatility to tactically move the beta within a tight range using a contrarian style. We have probably not seen the bottom of this market cycle yet. We still see a deterioration of credit quality in the US and we see risks building in emerging markets. At the same time, central banks are determined to extend the cycle and keep rates low. That provides for a strong 'search-for-yield' technical. Good reasons not to be too outspoken on beta. We focus on credit selection for now.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Jan Loeys (JP Morgan), Neil McLeish (Morgan Stanley), Jamie Stuttard (HSBC) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

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