

OUTLOOK

For professional investors

March 2017



Credit Quarterly Outlook Q2 2017

Boom & Bust

Sander Bus

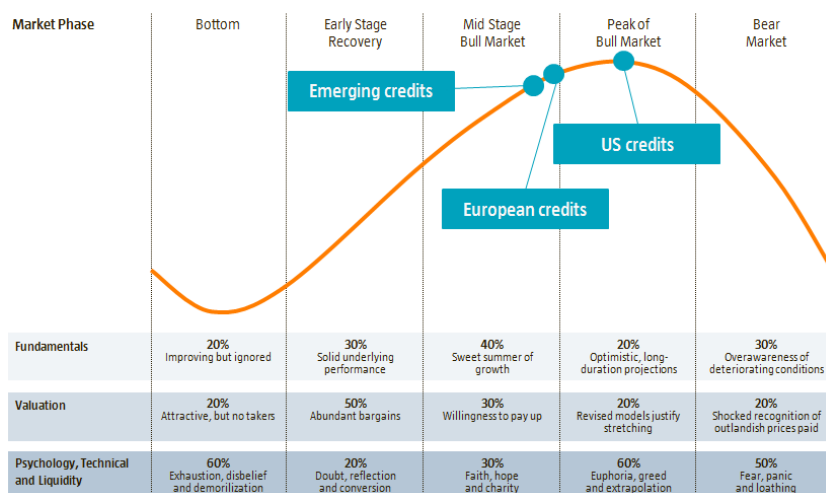
Co-head Credit team

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Co-head Credit team

- Economic expansion being above potential while output gaps are closing is causing inflation to rise. Central Banks will respond.
- Increasingly populist politics lead to de-globalization.
- The US credit cycle is mature. Credit spreads do not have much tightening potential and could widen a lot once the cycle ends.
- European credit is more midcycle with European balance sheets in better shape.

The Market Cycle: Mapping our view on market segments



Source: Robeco, Morgan Stanley, March 2017

Summary

The end of monetary easing has arrived with the Fed in a rate hike cycle, the European Central Bank (ECB) being expected to start tapering Quantitative Easing (QE) and the People's Bank of China (PBOC) tightening monetary conditions as well. Credit spreads offer only limited room for further tightening, especially when we consider that the cycle is mature and corporate credit quality keeps deteriorating, particularly in the US and China.

Economic growth in itself is a positive for credit, but wage growth and higher rates can put pressure on profits. Volatility has been suppressed by central bank liquidity for years. A reversal of monetary policy will probably lead to higher volatility and more dispersion between individual companies and segments of the market. That is good news for active managers like ourselves. In the coming period we should be able to prove our added value by avoiding losers and identifying segments of the market that can still perform well in this environment.

Fundamentals

We see broad-based strengthening of economic data across the globe. In the US, the consumer is still going strong and corporate profitability is recovering. In Europe, unemployment is steadily declining and industrial production and exports are up, even in Italy. In the meantime, the Chinese economy is still steaming ahead.

Unsurprisingly, inflation is a theme that is definitely back on investors' minds. After many years of underwhelming inflation numbers, the data have recently surprised to the upside. The key question is, have we reached the point where further growth will be inflationary? We believe that this is indeed the case. The global output gap, which has kept inflation low for so long, seems to have finally closed. That means that economic growth above the natural growth rate will result in inflation. This might sound logical for the US, where unemployment has dropped to well below 5%, but even for Europe with still over 9% unemployment, wage pressures have started to emerge. German unemployment has reached the lowest level since 1980 and as a result labor has strong bargaining power. Even in southern Europe, there is probably less slack left than high unemployment numbers suggest. There is anecdotal evidence of a thriving black economy that is not visible in the numbers and as the structural rate of unemployment is higher, NAIRU – the level of unemployment below which inflation rises, is also higher.

We have not seen strong wage growth yet, but there are indications that this is about to change. A CFO survey of US companies by Duke University shows that CFOs expect an acceleration of wage increases in 2017 for their respective companies. Also a growing number of job openings point to this direction. Further adding to inflationary pressures are the fiscal stimulus plans of the Trump administration and, in the longer term, a reversal of globalization. We also see that China now is a source of global inflation as illustrated by a rising PPI. A classical boom-bust scenario seems to be in the making. The only unknown is the timing of the bust...

In our previous quarterly outlook we wrote that for years central banks and investors have been wrong in overestimating growth and a return of inflation. Inflation remained absent for much longer than anticipated and rates kept declining for much longer than most investors could imagine. We fear that the market is now underestimating a reversal of that trend. The cycle could shift from mature to seriously overheated and inflationary. While growth in itself is a positive for credit markets, a reversal of monetary easing certainly is not. Also, an increased bargaining power for labor could put pressure on corporate margins. That means that a higher topline might not necessarily result in higher earnings.

In our previous quarterly outlooks we have always talked about big differences in corporate behavior between the US and Europe. That theme is still unchanged. We see that US corporate leverage is at peak levels after years of share buy-backs and debt-funded acquisitions. This is very different in Europe, where corporate balance sheets still look

healthy. You can almost conclude that, compared with their US peers, European companies are under-levered.

In our discussions we spent a lot of time on political risk. In most developed nations we have seen a collapse of the political center in favor of alternative political parties that often have in common that they want to retake sovereignty and reform democratic representation. This trend has been going on for two decades and has coincided with the globalization trend. Donald Trump and the Brexit vote are exponents of this trend. A likely consequence of the popularity of these alternative political parties is a reversal of globalization.

Globalization has resulted in high growth and low inflation, but has also caused stagnant middle class incomes in the developed world. A reversal of globalization will cause exactly the opposite; lower growth and higher inflation and a shift of power from capital to labor. Higher wages for the middle class, which have a higher propensity to spend, can lead to a lower savings rate. A lower savings rate in turn will result in higher interest rates. These are interesting topics but it is good to bear in mind that it will only slowly play out over the long run.

A final word on emerging markets is warranted. We attach a higher probability to an overheating US economy and thus higher yields and Fed action. Especially emerging markets are in the line of fire. In the long term, currency devaluations will help stabilize emerging markets and regain competitiveness, but in the short term a strong US dollar and capital flows will hurt a lot more.

Protectionist policies from the US will not help emerging markets either. Currency pegs could come under pressure and capital flight will hurt current account deficit countries. For China, preventing capital flight is particularly important. Domestic debt levels are unsustainably high and money has been deployed uneconomically. This has been financed by high domestic savings. The Chinese have been lending to themselves, so a debt bubble can be solved domestically as long as the savings do not flow out of the country. Still, it is not a question if but how the Chinese debt bubble will deflate or burst. We remain cautious.

Conclusion: moving from mature to overheating

Output gaps are closing with the economy growing above its potential. Inflation will pick up and central banks will have to respond. Growth in itself is good for credit, but the credit cycle is mature, especially in the US. Wage inflation may eat into profit margins.

Valuation

On balance, spreads have tightened in all credit categories over the last three months. Valuations have therefore become more expensive.

In European investment grade credit, we believe that corporate bonds that are eligible for the ECB program are trading rich and are vulnerable for a tapering of quant easing. We still find European banks and insurance companies attractively priced but we prefer to avoid institutions from Italy due to the strong link with sovereign risk.

European and US high yield spreads are well below their historical averages. The two markets also trade at very similar outright levels, but when you adjust for the higher quality of the European market and the more benign corporate behavior, we find euro denominated high yield more attractively priced.

In the past, we have seen that credit markets can trade at very tight levels for an extended period of time and then suddenly widen aggressively. It is always very difficult to exactly time that moment, but it is fair to say that many parts of the market are more or less priced for perfection and there is limited room for error. That means that we do no longer pursue a strategy of buying on dips. That would be too risky as the end of the credit cycle is nearing.

We remain conservatively positioned with a preference for Europe, and within Europe a preference for financials. Even after the recent outperformance, we still believe that insurance companies trade too cheap and expect a bit more recovery from financials versus corporates in general. We are most cautious on emerging debt and US high yield. Within high yield, we stick to our underweight in the lowest credit quality.

Volatility has been subdued for a pretty long time due to the predictability of central banks. This has also reduced the dispersion in markets, which made it more difficult for active management to make a difference. With monetary conditions now tightening we should expect more dispersion and less predictable correlations. That is good news for active managers like ourselves. In the coming period we should be able to prove our added value by avoiding losers and identifying segments of the market that can still perform well in this environment.

Technicals

Monetary policy has turned into a negative technical for credit markets. Although the aggregate size of central bank balance sheets is still rising due to the buying programs of the ECB and the Bank of Japan (BOJ), momentum has certainly shifted.

The ECB announcement, in late 2016, to reduce the monthly purchase program is a precursor of more tapering, as European inflation is rising. The market will prepare for this in the coming months. At the same time, the Fed will continue to tighten its policy. Three rate hikes in 2017 are the consensus expectation but depending on Trump's fiscal stimulus plans we could see an even more aggressive Fed. In addition, Chinese policy has also shifted gear away from a growth focus to a focus on financial stability. China tries to make the financial system safer without hurting access to credit for its corporates, which is easier said than done. So we are likely to see a simultaneous tightening of monetary conditions from all major central banks as inflation picks up. For years, the search for yield has been a major driver of credit market flows. That technical is likely to disappear.

Several fixed income strategists are making a comparison with the hiking cycle in 1994. Even though the hikes were well flagged, it still caused a lot of turmoil in fixed income markets as leveraged investors were squeezed out of their positions when margin calls were hit. In the Global Financial Crisis we also saw that the down market was aggravated by forced selling by leveraged investors. So, the question is, can that happen again?

At first sight, it seems that investors do not use a lot of leverage in their investments, at least in Europe and the US. Anecdotally we know that that is different in Asia, where private banks provide their clients with substantial leverage on their investment portfolios. So we could see some forced selling from that part of the world when the cycle ends. But overall we should conclude that leveraged investment portfolios are not the biggest risk.

What we do see as a risk though are investors that have developed a high appetite for risk due to the perceived low volatility. Risk models that use implied volatility or current spreads as an input are typically pro-cyclical in nature. When markets turn, risks go up and investors might be forced out of their risky positions. We have seen huge flows into credit mutual funds over recent years, often from investors that can be classified as tourists. Low rates have pushed these investors out of money markets into higher yielding, higher risk categories.

A last technical that we would like to discuss is the potential impact of abolishing tax deductibility as part of the US tax reform. There are still many unknowns, but if this were to happen, the impact would probably be mixed. For US investment grade credit it is probably a net positive. The tax shield is not that important and the overall tax bill goes down. Issuance of US corporate bonds will probably go down as companies do not have a tax incentive to lever up their balance sheets. In addition, the repatriation of money back to the US also takes away the need to issue debt. So that is a positive for US corporate bonds. For high yield debt

it is not that clear cut. Highly leveraged high yield companies greatly benefit from their tax shield. It is likely that existing debt will be grandfathered but once bonds need to be refinanced the tax shield falls away. For the most levered companies that could lead to inability to refinance and ultimately a default. In the long run though, high yield companies will feel an incentive to reduce debt levels, which is good for credit quality. On a relative basis, we therefore think that these measures will be beneficial for higher quality high yield companies and negative for highly levered CCCs.

Conclusion: boom 2017, bust 2018?

The global economy is strong. The output gap is closing, which means that further growth could result in accelerating inflation. Fiscal stimulus is not what is needed at this point in the cycle, but it is exactly what Donald Trump is planning to do. The Fed will respond and rates have much more room to rise. Economic growth is positive for credit, but the strong technical will disappear when the ECB reduces its QE program.

Valuations are not compelling, although we still see some pockets of value. The credit cycle is mature and that means that upside is limited. Credit can remain at these tight levels for a while, but once the cycle ends, spread widening can be aggressive. We remain cautiously positioned with betas close to or just below 1 and focus on stock picking.

Positioning

Beta

We remain cautiously positioned with betas close to or just below 1 and focus on stock picking. In the past years, we have always advocated to add risk on weakness as we knew that the strong technical on the back of central bank buying was supporting the markets. That has changed now and as a result we have become less courageous.

Regional

We stick to our preference for European over US credit. The US credit cycle is much more mature as illustrated by weak corporate balance sheets. The markets are upbeat on the outlook for growth, but if growth were not to materialize for whatever reason, US credits are vulnerable. Looking at Europe in isolation, a long position would be justified, but when the US cycle turns we know that Europe will be dragged along. Therefore we rather express our preference for Europe as a relative value trade instead of an outright long position.

Emerging

We nurture our short beta position and quality bias. This year, that has not been the best position and emerging markets volatility occurred primarily in the local markets. However, we are approaching the moment at which less monetary stimulus will also affect emerging credit markets.

Long financials/ long the consumer

We prefer financials and more domestic consumer-related sectors. We are hesitant to invest in companies with a high exposure to global trade or the capital spending cycle. European financials still offer value and are the sector that is actually still derisking as opposed to the non-financial sectors. However, we do avoid financial institutions in Italy due to the strong link with sovereign risk. Within non-financials, we prefer sectors that are not cyclical and linked to domestic consumer spending.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Marvin Barth (Barclays), Robert McAdie (BNP Paribas), Neil McLeish (Morgan Stanley) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

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