OUTLOOK
For professional investors
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ROBECO
The Investment Engineers

Credit Quarterly Outlook Q4 2017

Addicted to short-term performance

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- The global economy is enjoying solid, synchronized growth, while the credit cycle is maturing
- Credit spreads are close to all-time tights
- A decade of unprecedented central bank balance sheet expansion is about to come to an end

Key take-aways

We are in the eighth year of economic expansion in the US and markets are enjoying one of the longest uninterrupted bull markets. Still we are growing increasingly uncomfortable.

Too much money has been chasing too few assets as central banks have been crowding out investors. Volatility and credit spreads, which are both measures of risk, have declined to historic lows. This is an indication of risk fatigue: investors no longer dare to take risk scenarios into account as that has been hurting them (Brexit, for instance). The central bank has forced people to follow the flow and close their eyes for risk. The bear has been killed.

It is important to keep the longer perspective into account. That tells us that we are getting close to the end of central bank buying, the Fed is in a hiking cycle and the credit cycle is maturing. Corporate leverage in the US is high. This makes markets vulnerable.

'This is no longer the time to stick your neck out and take risk'

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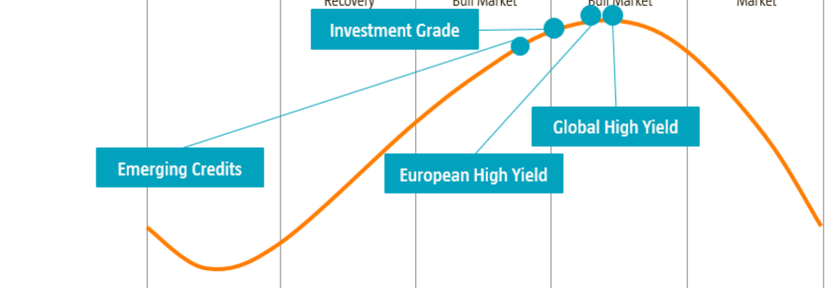
Risks are not being priced in

We do not know how much more time there is for this cycle. It does not make sense to spend too much time trying to predict a recession, it is enough to conclude that risks are not being priced in at all. This is no longer the time to stick your neck out and take risk. With central banks backtracking, investors are less likely to buy on dips. We are not moving aggressively underweight, but we position our portfolios cautiously in terms of beta. That means a beta of around or slightly below 1. We do however see plenty of opportunities for active issuer selection. As a result of compressed spreads, it will probably pay to focus on conservative credits, which will outperform the market once decompression kicks in.

Many investors feel the need to be fully invested. Negative yields on cash are a punishment for being conservative and therefore people are pushed into uncomfortably long positions. Although it is easier said than done, we advocate not taking too much beta risk in this environment and avoid being addicted to short-term performance.

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 demoralization	20% Doubt, reflection and conversion	30% Faith, hope and charity	60% Euphoria, greed and extrapolation	50% Fear, panic and loathing

Source: Robeco, Morgan Stanley, September 2017

Where are we in the credit cycle?

There are several indicators that the cycle is maturing, at least in the US. As mentioned above, it is hard to predict the exact turn of the cycle, but, as the market cycle graph shows, all segments of the market are close.

Fundamentals

In this chapter we look at economic fundamentals, such as economic growth, the maturing credit cycle, the absence of wage inflation and China's high debt levels.

Everything looks fine fundamentally. Global growth is firing on all cylinders, while inflation is still largely subdued. People justify tight valuations with an often used argument that they do not see a catalyst for things to change. Well, let's remember that a catalyst for change is mostly only seen with hindsight. The forest is dry, you do not need to know which match in the matchbox will set it on fire. It is enough to conclude that markets are not discounting any negative surprise and that the cycle is in its mature phase. Reason enough to be cautious.

The global economy is enjoying solid, synchronized growth. The big question is: how long can this cycle last? For the time being, everything looks fine. The labor market and housing markets are solid both in Europe and in the US and this supports consumer spending and confidence. Also, there are no signs of big asset bubbles in financial markets, at least in developed markets.

The cycle is maturing

As we have written before, there are several indicators that the cycle is in its mature phase, at least in the US. We see peak leverage for US companies, and we see a tightening of monetary policy. Corporate leverage ratios usually spike during recessions due to a drop in the denominator (Earnings before interest, taxes, depreciation and amortization, or EBITDA), but we are now already well beyond the historical peak. US growth could be boosted further if the Trump administration manages to get its tax reform approved, resulting in a lower corporate tax rate. The flipside is that it will probably trigger the Fed to become more hawkish as well, a scenario that is not priced in by the market.

Even though the consumer looks strong on average, it is important to realize that not everyone is benefiting. Younger generations and low income groups have hardly seen improvement in their financial situation and struggle to service their debt levels. This is visible in rising non-performing loan (NPL) levels in subprime car loans and student loans. These are also the groups that often cannot afford to buy a house and have been exposed to stiff rent inflation. The unequal distribution is a risk for growth and stability in the US.

Corporate leverage is much more contained in Europe, were companies have not embraced the same animal spirits. European consumer spending and sentiment is strong, with Italy being the only exception. Exports are still going strong as well, but are no longer the sole driver of economic growth. It really is domestic consumption that is propelling growth. This makes the economy more resilient and less vulnerable to the stronger euro.

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No wage inflation

One of the most discussed topics amongst economists these days is the absence of wage inflation in an environment of tight labor markets. In our quarterly outlook discussions, we had the debate as well, without reaching an unanimous conclusion. There is one camp that believes that structural changes in the labor market (non-unionized temporary workers) and technological changes (automation) have weakened the bargaining power of workers permanently and hence the Philips curve, which shows an inverse relationship between unemployment and inflation, is dead. The other camp believes that wage inflation is actually in the pipeline and points to indicators such as 'vacancies hard to fill' and the 'quits rate'.

'One of the most discussed topics is the absence of wage inflation'

Wage increases have been very moderate so far, but with unemployment at very low levels in several countries, unions have regained negotiation power and they have been vocal about wage increases (e.g. in Germany and the Netherlands). It remains an open question if we will see any wage inflation anytime soon, but we would flag it as a risk that is not been priced by the market. For the longer term, it is relevant to also look at China in order to understand Advanced Economy inflation dynamics. The Bank for International Settlements (BIS) published a working paper on this topic (http://www.bis.org/publ/work656.htm) that predicts the end of a three-decade long stagnation in wages due to a shift in demographic trends in China.

High debt in China

China in the meantime is also showing healthy but decelerating growth. The Producer Price Index is still high and wages are rising. We have seen imports of commodities slowing down, which is not necessarily bad as the country is making a move from investment spending to consumption. We once more repeat our concern that debt levels are unsustainably high in China, but with the global economy doing fine and policymakers willing to inflate debt even more, there is no imminent risk that the debt bubble is about to burst. It's just one of these tail risks that is hanging around.

Valuation

In this section we look at the valuations in the market – where do we see risks and where are the opportunities?

Spread products have performed strongly this year. For most credit categories we are close to the all-time tights on a risk-adjusted basis. Corporate hybrids and financials still offer value in investment grade. For high yield and emerging markets, we stay as high quality as possible without compromising too much on the beta.

Valuation is becoming even more expensive. Credit spreads have tightened further and are now in the bottom quartile in all credit markets. When we properly adjust investment grade spreads for differences in index composition, the historical comparison becomes even worse. Both in Europe and the US, the percentage of BBB in the investment grade indices has steadily moved at the expensive of A and AA ratings. On top of that, average durations have increased substantially. When looking at risk-adjusted spread measures (spread per turn of leverage, spread per unit of duration) there can only be one conclusion: credit has rarely been richer.

'Credit has rarely been richer'

All-time tights in high yield

For high yield, we also see that spreads are very close to all-time tights. In this market, we have not seen a deterioration in average credit quality nor an increase in duration. Still, the same conclusion can be drawn as for investment grade. Apart from tight valuations, we have seen that abundant liquidity has had another negative effect on high yield. We have seen a massive rise in the issuance of covenant-light structures. This has been a trend in the booming leveraged loan market as well. Covenant-light issuance in loans and bonds provides more flexibility for issuers, but will eat into recovery values once the cycle turns and default rates start to rise.

For emerging and Asian credit we cannot draw other conclusions. These markets have even outperformed developed market credit this year and often suffer from weaker governance and bond structures. Spread compensation is insufficient.

Tight credit markets always bear the risk that investors will reach out to the highest yields that are available. This is not the right tactic, as these bonds tend to be the most overbought in bull markets and are therefore prone to underperformance over the cycle (known as the low-risk anomaly in academic literature). We rather focus on credits that are still relatively attractive on a risk-adjusted basis. Within investment grade, we still see value in European financials and corporate hybrids. In high yield we still find relative value in cross-currency opportunities (euro denominated debt of US issuers) and in the more stable higher rated companies in sectors that can benefit from consumer spending growth.

Technicals

In this chapter we discuss technical factors, such as central bank support – or the end of it – supply & demand, and market volatility.

Technicals will turn for the worse and will no longer provide support to credit spreads. Balance sheet expansion, which has been the main supportive factor for the last decade, is coming to an end.

Central banks: the end of an era

A decade of unprecedented central bank balance sheet expansion is about to come to an end. Since the financial crisis started ten years ago, the major central banks have increased their balance sheets by more than 400%, largely on account of asset purchases. With the global economic recovery becoming more synchronized and deflation risks receding, it is obvious that balance sheet expansion will be coming to an end. The Fed has announced to start shrinking its balance sheet in October and the European Central Bank (ECB) will taper its bond buying. The ECB will reduce not only its government bond buying program but also corporate bond buying. Most ECB watchers expect ECB quantitative buying to end by late 2018 or early 2019.

Research suggests that the impact of quantitative easing on financial markets was related to the flow effect rather than the stock effect . In other words, it is the change that matters. With the ECB reducing buying and the Fed reducing its balance sheet, , this means that the supportive technical is going into reverse. In the last decade, investors have been crowded out of government bonds into alternative investments. This is no longer the case.

Supply & demand

When looking at supply & demand balances, we should really take a global perspective. Asian investors have been the largest contributors of inflow into the US credit market. This is now slowing down and with the Fed likely to hike rates further, the flow will probably slow further if not reverse. Higher US short-term rates are increasing hedging costs. In addition, a steeper yield curve in Europe and Asia than in the US alters the investment decision for many investors that can now pick up more attractive yields in non-US assets.

When looking at technicals, we should not only look at demand but also at supply. If Trump succeeds in getting his tax plans approved, this could potentially result in much lower supply of corporate bonds in the US. Repatriation of money from US multinationals is one reason for this (which could partly be used to redeem debt). The other reason is the elimination of the tax shield if interest cost deductibility is eliminated. That would remove the tax incentive for companies to maximize the use of debt in their capital structures. A lower supply of corporate bonds would obviously be very bullish for credit markets in the long run.

Another market that has seen shrinking supply is high yield. Both in the US and in Europe the market size has declined over the last two years. The main reason for this is competition from the loan market. We have seen many companies refinance their public high yield bonds with private loans. Discipline in the loan market has disappeared and companies have access to almost unlimited funding without having to give covenant protection or early redemption fees.

'Investors have given up betting on down markets'

Low volatility

A last technical is the ultra-low (implied) volatility in financial markets. A hypothesis is that volatility is suppressed by central bank buying. Every blip wider in credit is being absorbed by demand. At the same time, investors have burnt their fingers so often with bearish positions that they have simply given up betting on down markets. That means that potential risks are hardly priced in. We currently see a rather unique combination of low volatility but relatively high skew. This tells us that risks are hardly priced in for the broad market, but if individual companies disappoint, they are punished by markets.

Positioning

How will we be positioning our credit portfolios in the coming quarter?

Beta

We run almost all portfolios with a beta close to one. For high yield and emerging markets, this means that it might end up just under one, since we want to avoid the cyclical companies. For investment grade, it is easier to reach a neutral beta as we can still find attractive yield in financials.

Regional

For a long time we had a preference for European over US credit. For high yield that is still the case, as we continue to find better spreads in Europe on a risk-adjusted basis. For investment grade the conviction to be overweight Europe has disappeared. European investment grade valuations have compressed due to ECB buying and are vulnerable to a reduction of purchases, so we advocate a more neutral regional allocation. For European portfolios we skew the portfolio to bonds that are non-eligible for ECB buying.

Sectors

We prefer companies in more stable sectors that are less exposed to an eventual turn of the cycle. We are in general underweight commodities and like banks. In our issuer research, we stress-test the financial models for the companies we invest in for higher interest rates and recession scenarios.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Matt King (Citibank), Barnaby Martin (BAML), Anatoli Annenkov (Société Générale) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

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