ROBECO
The Investment Engineers

CREDIT QUARTERLY OUTLOOK

Race to the bottom

- The credit market is priced to perfection
- Inflation uncertainty can still cause volatility
- Demand and supply of credit is robust

The ideal scenario for credit appears to be materializing, characterized by declining inflation and the likely avoidance of a recession. Credit markets have wholeheartedly embraced this narrative and are to a large extent priced for perfection. However, have market participants grown complacent, with risk appetite reaching high levels?

While we acknowledge the high probability of the consensus scenario, we remain mindful of the fragility of sentiment and the omnipresence of risks in a changing world. With current tight valuations and risk positioning, there is ample room for disappointment.

We maintain a neutral positioning in investment grade and emerging markets, focusing on generating alpha through issuer selection. Within high yield we firmly adhere to our quality bias, resulting in a beta below 1. We do not view this as the optimal time to increase beta through a derivatives overlay, as CDS is trading even tighter than cash markets.

Fundamentals

We believe it is crucial to consider economic scenarios rather than simply positioning for a single base case. Over the last year the market consensus has shifted between the three main scenarios for the US economy: hard landing, soft landing and no landing. In early 2023, a US recession was the prevailing market consensus. This shifted towards a soft landing during the summer, then to a no landing ('higher for longer') consensus by October. By the end of 2023, sentiment had firmly reverted to the soft landing scenario, which remains the predominant view in the market to date.

“ We do not view this as the optimal time to increase beta

CREDIT OUTLOOK MARCH 2024

Marketing material for professional investors, not for onward distribution

Sander Bus
High yield

Reinout Schapers
Investment grade

This soft landing scenario presents the most favorable conditions for credit, where corporate profitability can remain robust while funding costs decrease. We agree that a soft landing is likely. However, it is important to recognize the possibility of alternative scenarios, as these cannot be entirely ruled out.

When listening to sell-side strategists, it is apparent that there currently is a broad consensus suggesting that a recession is not imminent. However, there is considerably less agreement on the trajectory of inflation and central bank rates. We have encountered bold statements on both ends of the spectrum, ranging from 'no rate cuts in 2024' to 'ECB rates returning to 1% by 2026'. This indicates the significant uncertainty regarding the future path of inflation and interest rates. This uncertainty is also reflected in the ongoing elevated levels of the MOVE index, which measures implied bond market volatility. This stands in contrast to the VIX index, which measures implied equity volatility, and hovers at very low levels.

The US economy has shown remarkable resilience. One major factor for this strong performance has been fiscal stimulus that has supported households and kept consumer and government spending high. But performance of the corporate sector is mixed. While large-cap tech stocks are posting record profits, the SME sector is feeling the pressure of higher rates. When we look at a corporate EBIT proxy for the broader economy, we see that profits are actually down, including in the US. Many smaller companies no longer have the pricing power to pass on the elevated wage increases and higher funding costs.

Looking beyond the United States, the global landscape presents a starkly different picture. China is still experiencing pronounced weakness, marked by the collapsed housing market that continues to dampen sentiment. Unemployment rates are climbing, and deflationary pressures remain. The end is not in sight with money growth decelerating once again, despite efforts by the Chinese authorities to turn the tide.

The European economy has also stagnated in 2023, largely due to a faster monetary policy transmission, higher energy prices, lower fiscal impulse and more sensitivity to developments in China. This is particularly evident in German manufacturing, which is bearing the brunt of the economic strain. For a more extensive view on the macro outlook, we refer you to the outlook from Robeco's Global Macro team: Risk-on, but not gone.

We generally concur with the consensus view that there is a high probability of the Fed implementing three rate cuts, and the ECB even implementing one more. Additionally, the perceived risks of a US recession have significantly diminished. However, it's worth noting that this scenario appears to be fully accounted for in the current market prices. Consequently, credit spreads are susceptible to negative surprises which could either be of economic nature or geopolitical.

One potential source of volatility lies in the upcoming US elections. The race between Biden and Trump is closely contested, with early polls showing a slight lead for Trump. Both candidates are expected to maintain loose fiscal policies. Though, if Trump secures victory, there is additional risk of an increased US-centric approach, particularly given his past proposals for substantial tariff increases. Such actions could reignite trade tensions with China and Europe, negatively impacting market sentiment. Additionally, Trump may opt to halt military and financial support to Ukraine, which could undermine the sense of security in Europe.

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Valuations

As credit investors, we primarily assess market valuations by examining spreads, as they represent the compensation for credit risk. However, we do recognize that other market participants may focus on the all-in yield, which can drive flows into or out of fixed income assets. We judge the attractiveness of credit relative to the underlying government yields. Yield investors will look at the all-in yield of credit and its attractiveness compared to the risk-free rate.

Credits spreads continued to tighten in the first quarter and have reached levels that we consider priced for perfection in many segments of the market. US investment grade spreads, for instance, reached 90 bps. While there have been a few instances in history where spreads were tighter, these were not opportune moments for market entry. In the US investment grade credit market overall spreads are pushed down by the very low spreads in long maturity bonds. US long bond spreads are on average below intermediate maturity bond spreads, which is very rare. This has been driven by the large demand for long bonds while supply has been negligible.

Both US and European high yield, as well as emerging market debt, are trading inside the first quartile of the tightest spreads in history. The only exceptions are Euro investment grade and Euro financials, which are positioned in the second quartile of tightest spreads.

It's also noteworthy that within the high yield market, there is a clear bifurcation. Non-distressed USD high yield is at the 2nd percentile (i.e. spreads have been wider for 98% of the time since 1997). We observe exceptionally low dispersion within the BB- and B-rated bonds, whereas within CCC-rated bonds, this is the exact opposite. The primary reason for the entire high yield index not yet reaching its tightest level is the prevalence of distressed names within the CCC universe. These distressed names contribute to pushing up the yield of the CCC rating category. We classify this phenomenon as 'phantom yield' – yield that may not translate into actual returns.

So, is there still value? We would argue that while spreads are very tight, European investment grade and financials still present reasonable value relative to other markets. Although financials have tightened considerably in absolute terms, they still appear attractive when compared to corporate counterparts on a relative basis. We maintain that the long-term investment thesis for financials remains intact, given the improvements in capital ratios, liquidity, and funding since the global financial crisis. Additionally, another area of value lies within the semi-government and agencies (SSAs) segment of the market. Despite the tightening of swap spreads, these instruments continue to trade attractively and have even widened compared to swap yields.

One segment of the investment grade market that looks cheap is real estate. However, we hesitate to recommend an outright long position in this sector. Some companies within real estate are grappling with significant challenges, and not all provide the transparency necessary for market confidence. While we explore individual names as potential opportunities, we exercise caution and maintain a highly selective approach.

Regarding high yield, considering the limited variance within the BB and B universe, we believe it is prudent to focus on the highest-quality names.

> *“ We observe exceptionally low dispersion within the BB- and B-rated bonds*

Technicals

Demand for credit has been robust, as evidenced by significant inflows into credit strategies from both institutional and retail investors. We have observed this trend and have also heard anecdotal evidence of continued inflows into fixed maturity products. Additionally, there is demand for long-dated credit from insurance companies that provide bulk annuities to corporate pension schemes. However, this strong demand is met with equally strong supply in the investment grade markets. Both the European and US investment grade markets have expanded as a result.

In contrast, the high yield market has experienced contraction due to a combination of companies leaving the universe following upgrades, and refinancings outside of public markets. This disparity between demand and supply is one of the factors contributing to the outperformance of high yield. A similar narrative applies to hard currency emerging markets, where the market has also shrunk as companies found alternative funding avenues such as local currency markets.

The Robeco Risk Aversion Barometer, developed by our Global Macro team, indicates that risk appetite has shifted into ‘risk loving’ territory. This could indicate a risk of too much complacency, which typically isn’t a positive sign

for future performance. Additionally, we are becoming somewhat concerned about the emergence of 'this time is different' narratives.

The strong demand for credit is also reflected by pricing dynamics in the new issue market. Issuers can print new deals almost without any price concession while books are often multiple times oversubscribed. Central bank monetary policy can also have a significant impact on market technicals. The reduction of balance sheets is ongoing, however, the volume of fixed income instruments on the balance sheets of the Fed and ECB remains substantial. The most negative scenario for credit would be if the anticipated rate cuts were not delivered. This could happen if inflation reaccelerates.

As long as we are in an environment where rate cuts are more likely than not, we judge that the technical support from central bank policy remains constructive. However, we should not anticipate another round of spread tightening after the initial rate cut. Historical data shows that even in a soft landing environment, spreads typically do not tighten further following the first rate cut.

> *“ The strong demand for credit is also reflected by pricing dynamics in the new issue market*

Positioning

Our positioning remains broadly similar to the previous quarter. We continue to like a strategy where the overall risk of the portfolio is managed closer to neutral, while selectively taking credit risk in parts of the market where value persists. Strong issuer selection and buying quality carry offers the best value.

We remain comfortable with investment grade in general but are more cautious with the lower-rated segment of high yield. The underweight in ‘phantom’ yield results in a high yield portfolio beta below 1. We do not deem it opportune to hedge the high yield beta to 1 with credit default swaps, as these instruments trade even tighter than the cash market.

We still see value in European banks, which continue to trade cheaper compared to corporates. Our conservative positioning provides us with dry powder that we can deploy when market sentiment deteriorates.

Table 1 – Current postioning

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

Source: Robeco, March 2024

***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), Bradley Rogoff and Zoso Davies (Barclays), Barnaby Martin (BofA) and Alec Phillips (Goldman Sachs) have been taken into account in establishing our credit views.*

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