ROBECO
The Investment Engineers

CREDIT QUARTERLY OUTLOOK

Plus ça change

- Credit spreads appear rich to history, but yields are higher
- The consensus economic base case may underprice the tails
- Technicals in credit are in charge, at least for now

The second quarter of 2024 might well have been consigned to history as a very dull few months for corporate bond investors, at least within investment grade. Spreads, at already historically tight levels, continued their impressive grind tighter for the majority of the period – impervious to volatility in the rates market, ongoing geopolitical tensions and elevated levels of new bond issuance.

That is, until President Macron of France unexpectedly called for snap parliamentary elections – a risky gamble which potentially gives Le Pen's right-wing party a route to government. To date, the subsequent volatility has been felt most acutely in French bank and sovereign bonds. The market's key concern appears to center not on 'Frexit' but rather the prospect of fiscal largesse, exacerbating already stretched sovereign credit metrics.

At the time of writing we cannot know the ultimate outcome of the elections, however this episode serves as a timely reminder of the potential for meaningful volatility arising from unexpected events. Clearly, this is felt more acutely when valuations are high and consensus leans heavily in the same direction.

We target a more neutral positioning in investment grade and emerging markets, focusing on generating alpha through issuer selection. Within high yield we remain committed to our quality bias, resulting in a beta below the benchmark.

Fundamentals

Economic data in the US has continued to paint a picture of a resilient economy. Indeed, most commentators have abandoned the view that the economy must ultimately break or fall off a cliff owing to the sharpest hiking cycle in recent years. A 'Goldilocks' scenario of softer growth, cooling inflation and the prospect of imminent rate cuts remains the broad market consensus. If realized, this should provide a solid fundamental tailwind to fixed income investing, both in rates and credit.

OUTLOOK JUNE 2024

Marketing material for professional investors, not for onward distribution

Sander Bus
High yield

Reinout Schapers
Investment grade

Matthew Jackson
Investment grade

Yet we cannot dismiss entirely the prospect of meaningful deviation from this base case. In considering the downside, or hard-landing, scenario we note increasing evidence that consumers are feeling the pinch from higher rates. The recent deterioration in the University of Michigan consumer confidence survey illustrates this point, combined with increasing anecdotal evidence from corporate earnings calls. Similarly, we note a continued lack of optimism from small businesses – estimated to account for around 40% of employment. In the event of a sharper deterioration in growth than the market expects, this is unlikely to be positive for credit spreads, even as more aggressive rate cuts probably follow. On the other hand, sticky inflation clearly complicates matters for the Fed and the recent spike in freight rates is an unwelcome development. If the market truly begins to consider that rate cuts may be even further out, or even contemplate further hikes, we would again consider this an unfriendly scenario for risk assets.

In Europe, the debate is more nuanced. Earlier this month, the first interest rate cut was duly delivered although European Central Bank President Lagarde stressed future moves would be data dependent. While growth expectations have improved throughout the year and consumer confidence has visibly increased, the recent political (and ongoing geopolitical) turmoil makes the future somewhat harder to predict.

The strength of the USD will continue to pressure EM currencies and constrain interest rate cuts. China being a case in point, despite the very subdued economic outlook, the weaker Yuan is a concern for authorities. Geopolitics continues to hit the headlines with India, Mexico, and South Africa surprising the markets, yet corporate fundamentals have remained relatively stable supporting spreads to reach historically tight levels.

Corporate fundamentals appear solid overall. Within investment grade, the aggressive terming out of debt maturities at very low yields post Covid has clearly insulated many borrowers from rising interest rates. Leverage in both the investment grade and high yield markets has ticked up a little from recent lows but hardly appears a major cause for concern. Likewise, interest cover ratios have declined but reside at healthy levels. In aggregate, margins and liquidity stay robust. Default rates within high yield have picked up in recent quarters but remain at relatively low levels. Maturity walls in high yield, at least for the remainder of this year and the next, appear manageable. While a higher cost of debt could prove painful for some, it may also provide a strong incentive to deleverage.

We keep our eyes wide open for potential sources of volatility as we enter the second half of the year. Worries about the fiscal health of many large economies, renewed trade tensions and election outcomes represent just a few such concerns. The results of elections in several countries has already triggered substantial volatility locally this year. The US election may well prove no different.

For a more extensive view on the macro outlook we refer to the outlook from Robeco's Global Macro team: Fiscal hurricane season.

> *“ Corporate fundamentals appear solid overall*

Valuations

As credit investors, our primary metric for assessing value in the market is to look at spreads. By examining 20 years of history we can see that US investment grade spreads currently look very skinny. This is particularly true of industrials, which currently sit at around the 4th percentile of historical observations. The Euro market doesn't appear quite so rich by comparison, with spreads at or around the 50th percentile over the same period. In both cases, financials would seemingly offer superior relative value against non-financials.

There is a similar picture in high yield. The US market appears expensive in comparison to the EUR market, although, at around the 23rd percentile, it is hard to see compelling value in the EUR market in isolation. The notable exception here is the CCC-rated bucket where the more distressed cohort resides. We often refer to much of this as 'phantom yield/spread' as it is unlikely to be realized.

It has typically been the case that the Euro denominated credit market trades at a tighter spread than the USD market, primarily due to the shorter duration of the former. We accept that with the emergence of fresh political risks, closer proximity to geopolitical instability and a higher sensitivity to China this traditional relationship may not reassert itself anytime soon.

One thing that stands out as quite remarkable is the difference in spread dispersion within the IG universe compared to high yield. Put simply, for investment grade it is at or close to post-GFC lows, while for high yield it is at or close to the highs. Within high yield this dispersion is evident within the distressed part of the market, but higher-quality high yield mirrors investment grade in terms of low dispersion. In combination with tight overall spreads, we can conclude that the primary focus of credit investors today should be on avoiding problems.

In emerging markets credit, the valuation picture is similarly stretched. For example, the JP Morgan Asia IG index currently trades at an OAS of just 85 bps, against a median level of 133 bps since 2010. The broader EM index, the CEMBI IG index, today sits at 125 bps, versus a longer-term median of 174 bps since 2001.

Technicals

In the final quarter of 2023, credit appeared to cheer the prospect of significant policy rate cuts over the course of 2024 and beyond, alleviating contemporaneous fears of recession. Yet the defining feature of 2024 thus far has been the unwinding of these expectations, both in regard to the timing and magnitude of policy loosening.
It may therefore seem somewhat counterintuitive that credit spreads have continued to tighten as the probability of 'higher for longer' interest rates has increased. So why does demand for credit continue to be so strong, at even tighter spreads levels and facing a glut of supply?

The answer, we believe, lies in the 'all-in yield', with spreads potentially of secondary importance for many investors. As described in greater detail already, suffice it to say that credit spreads appear far from cheap at current levels. Yet, when viewed through the lens of 'all-in yields' a different picture emerges. Looking back over the past decade, yields across most global credit cohorts currently sit in the 80+% percentile of historical observations.

EPFR data continues to show strong inflows into credit, both investment grade and high yield, as investors seek to lock in today's juicy yields. LIMRA data recently showed that US annuity sales posted the highest Q1 outcome on record since they began tracking in the 1980s. The funding ratios of corporate pension schemes have continued to improve thanks to higher equity markets (benefiting assets) and higher yields (discount rates) serving to reduce liabilities. This represents a meaningful tailwind for high quality fixed income as schemes move to derisk potential asset/liability mismatches.

> *"EPFR data continues to show strong inflows into credit, both investment grade and high yield*

Perhaps contrary to expectations given high hedging costs and improved relative valuations in local markets, overseas demand for US credit appears to have remained firm. Evidence seems to support investors reducing or abandoning currency hedges and/or going down the quality spectrum for yield.

Corporates have responded to a very receptive market with very strong issuance. There has, however, been evidence of diminishing demand as new deals have typically offered increasingly small concessions. One theme of note has been high volumes of 'Reverse Yankee' issuance in the Euro market (US issuers printing in EUR). The market has to date welcomed non-European name diversification and some longer duration supply. It is widely considered that much of the year's issuance will be 'front-loaded' and subside to a large extent as we encounter the summer lull and get ever closer to the US elections.

While we must seek to understand and respect the technicals at all times, experience also tells us that they can change very quickly. An unbalanced supply and demand picture can cause spreads to trade far richer, or cheaper, than fundamentals might otherwise imply, and this can persist for long periods of time.

Positioning

Our positioning remains largely similar to the previous quarter. For investment grade portfolios this means we target a close to neutral position in terms of risk relative to the benchmark. We continue to target an overweight to the banking sector given strong fundamentals combined with superior relative valuation. We note that problems may not be over in US commercial real estate, and therefore the regional banks, and thus limit our exposure to the 'big 6' within the US for now. Recent developments in Europe may well lead to underperformance in the French banks in the near term, but we see little reason for this to ultimately evolve into something truly systemic. We maintain an underweight to USD credit in light of unattractive valuations. High yield portfolios currently target a beta of below 1 owing to a meaningful underweight to CCCs.

For both strategies, we believe we will derive outperformance from deep research-driven name selection opportunities in the near term, as opposed to beta management.

We intend on maintaining a conservative stance regarding overall risk in portfolios. Recency bias is a powerful thing and we have seen numerous episodes in the past 20 years where investors become too comfortable with the idea that low volatility and unattractive valuation can persist indefinitely. It rarely does. By employing a patient and disciplined approach, we will be in a strong position to capture more compelling opportunities as they arise.

Table 1 – Current postioning

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

Source: Robeco, June 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, Martin van Vliet, Daniel Ender and Rogier Hoogeveen (Robeco), Steve Caprio (Deutsche Bank), Sherif Hamid (Jefferies) and Robert Sockin (Citi) have been taken into account in establishing our credit views.*

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