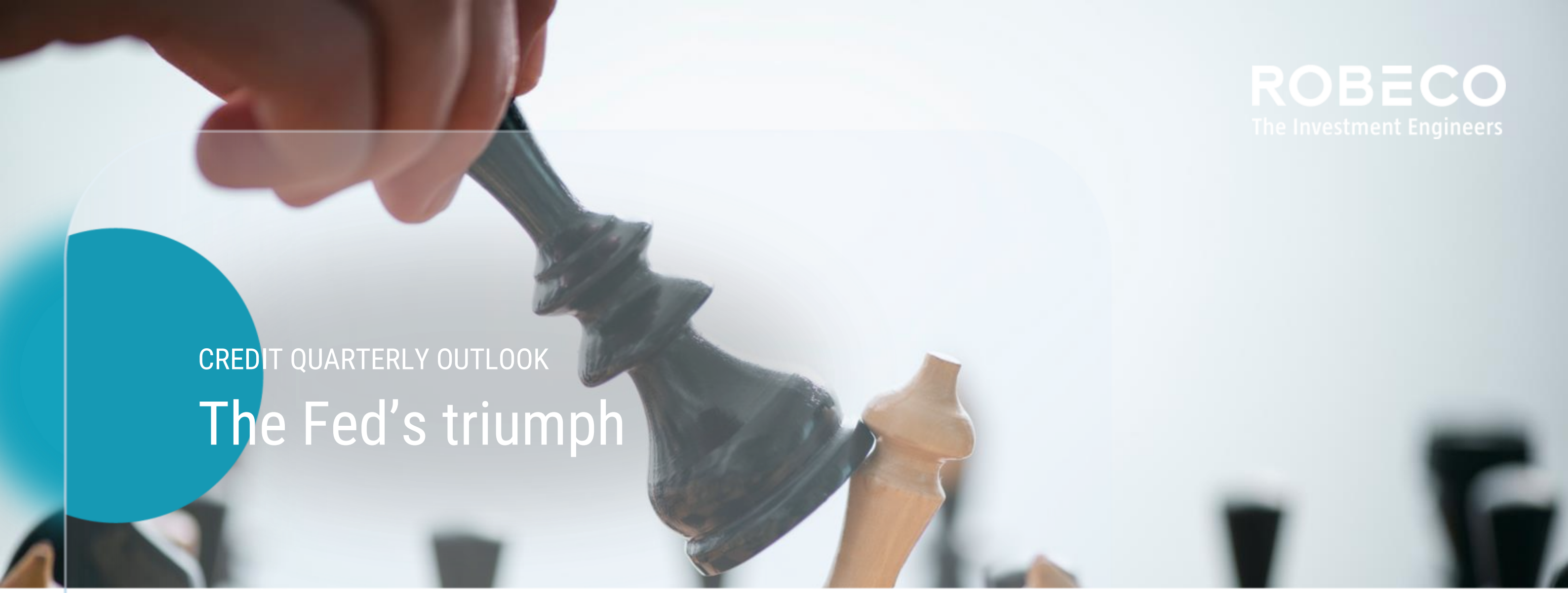


CREDIT QUARTERLY OUTLOOK

The Fed’s triumph

- The market remains confident in the Fed's ability to achieve its goals
- China's economic challenges do not significantly impact global markets
- Strong technicals continue to provide robust support for the credit market

The die is cast. The Fed has lowered interest rates by a significant 50 basis points, officially declaring victory in the battle against inflation. With this rate cut, the Fed is signaling its intention to stay ahead of the curve, aiming to prevent the economy from suffering excessive damage due to tight monetary policy. During the last quarter, the labor market weakened further, and leading indicators point to a slowdown in the US economy.

The prevailing market consensus is that the Fed will succeed in achieving a soft landing, balancing the labor market without triggering a sharp rise in unemployment. While we agree with this consensus, we do not see this as the moment to increase portfolio betas. The margin for error is small, and as we saw in early August, the market can pivot quickly if the consensus shifts, even slightly, in the opposite direction.

Predicting financial markets is not about forecasting recessions; it’s about predicting the direction of change in the consensus. In 2022, the consensus leaned toward a recession that ultimately never materialized — at least not in the US. However, the mere fear of a recession was enough to cause a significant bear market. In 2023, the consensus shifted, and the market rallied in response.

Fundamentals

The US economy appeared resilient to the series of rate hikes for a long time. The reasons are well known: expansive fiscal policy, ample fixed-rate corporate funding, and pent-up demand after Covid all played a role. Toward the end of the hiking cycle the market became increasingly convinced that a recession would be avoided. However, there was a brief moment of uncertainty when the Sahm rule was triggered following the July unemployment figures. The weakness in risk assets was short-lived, though, as the market seemed to have no doubt that the Fed would succeed in its mission.

OUTLOOK SEPTEMBER 2024


Sander Bus
High yield


Reinout Schapers
Investment grade


Matthew Jackson
Investment grade

The combination of tight credit spreads and steep rate cut expectations reflects high confidence in the Fed's ability to achieve a soft landing. However, the moment complacency sets in is the time to be careful. Research from the Fed itself shows there are few examples where a pre-emptive rate cut has ultimately been successful in achieving a soft landing.

We will continue to closely monitor the labor market to ensure it doesn't weaken to a point where reflexivity could trigger a self-reinforcing downward spiral. While this is not our base case, it remains a risk scenario for which the market is currently offering little compensation.

The situation in the rest of the world is not comparable to that of the US. China remains deeply entrenched in economic troubles, with no signs of recovery. There is significant overcapacity in the manufacturing sector, and large fiscal stimulus used in the past to boost investment is likely to be counterproductive. This overcapacity has triggered a deflationary spiral that is proving difficult to reverse.

Expectations from the Chinese consumer are muted. The collapse of the housing market has dealt a severe blow to consumer confidence. In the past, China's strategy was to export its way out of trouble, but this time it will be more challenging. Western nations are likely to impose tariffs to prevent cheap Chinese goods from causing unfair competition as witnessed in the automative sector.

The likelihood of steep import tariffs rises significantly if Trump wins the US presidential election. Retaliation from affected nations would then be on the horizon, with potentially negative consequences for the global economy.

At first sight, it is surprising to see that China's economic malaise has, so far, barely impacted financial markets globally. While Germany's industrial sector is facing challenges, the broader effects have remained relatively contained. The deflationary pressure from China is currently a blessing for Western economies that have been struggling with high inflation. We also observe the weak Chinese economy reflected in lower commodity prices, but this has not yet caused problems for mining companies, which remain well-capitalized and resilient. The same holds true on a broader scale for the economies of the US, Europe and larger emerging economies — there are no glaring macroeconomic imbalances at present.

“ China's economic malaise has, so far, barely impacted financial markets

Looking at companies in the credit universe, we see positive trends within the investment grade segment. Leverage (debt/EBITDA) is decreasing as profitability improves, though interest coverage is deteriorating due to rising interest costs, as low-coupon debt is being refinanced at higher rates. However, this poses no significant issue for most investment grade companies. In the high yield segment, there is more bifurcation. Higher-rated companies show both the ability and willingness to reduce debt, but the weakest high yield firms are struggling. These companies will likely need to reduce their debt through restructurings, where creditors may face partial write-downs.

In the long term, we must recognize the higher likelihood of entering a new regime characterized by higher fiscal spending, deglobalization, and structurally higher inflation along with higher interest rates. For many years, 2% inflation was considered the upper bound, but it's not unreasonable to expect that 2% may now become the lower bound. For credit spreads, this may not be a negative development, although we cannot rule out that higher macroeconomic volatility could be reflected in slightly higher term premiums.

For a more extensive view on the macro outlook, we refer to the outlook from Robeco's Global Macro team: Season finale.

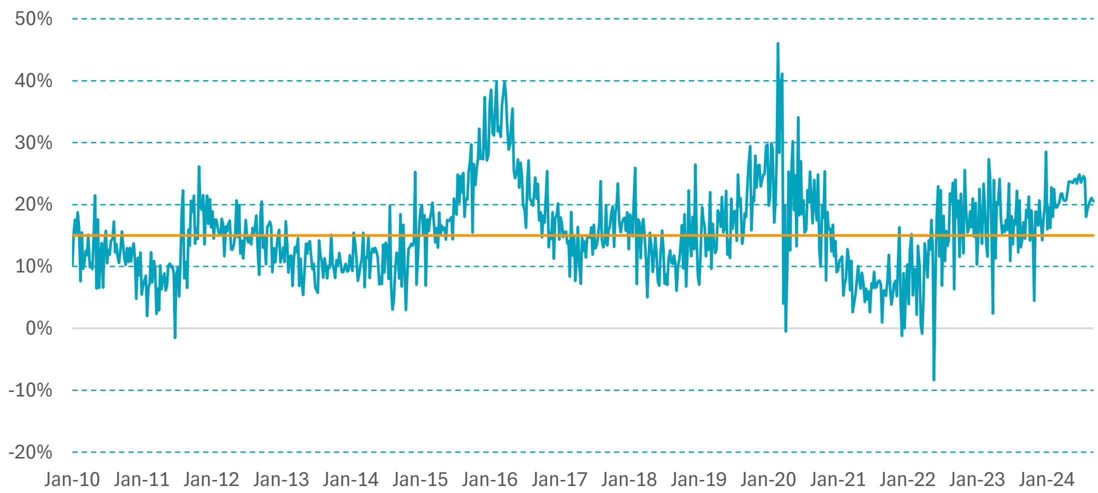
Valuations

As credit investors, our primary metric for assessing value in the market is to look at spreads. When examining 20 years of historical spread data, we observe that spreads across all segments of the credit market are relatively low. US investment grade credit, in particular, stands out with exceptionally tight spreads. In contrast, Euro investment grade credit appears more attractive relative to the US, as spreads hover just below the 20-year median. Within US investment grade, the long end of the curve is particularly expensive. Additionally, the spread compression between A-rated and BBB-rated bonds is near all-time lows in both Europe and the US. Given this backdrop, we favor up-in-quality trades but recognize that rigorous issuer screening is essential. Financials have outperformed non-financials, and we believe there is still room for further outperformance in this segment.

> *" From a high yield perspective, we see value in corporate hybrids and subordinated bank debt*

The high yield market also appears expensive, particularly when factoring in the phantom spread, which reflects distressed bonds with a high probability of restructuring — spreads that investors are unlikely to ever fully monetize. When excluding these distressed bonds, performing high yield spreads are still hovering around all-time lows. These valuations could be justified if the soft-landing scenario plays out, but if the landing turns out to be less smooth, this market is vulnerable. From a high yield perspective, we also see value in corporate hybrids and subordinated bank debt, both of which still offer attractive spreads.

Figure 1 – Phantom spread as % of high yield index spread



Source: Bloomberg, Robeco September 2024

We've also compared the spread differences between cash bonds and synthetics (CDS) and concluded that it is currently not advantageous to take long positions via CDS indices.

Emerging markets credit has performed well, even outpacing its developed market peers. Most companies in this segment seem unaffected by the spillover effects from China's economic slowdown. The Chinese credit market itself remains in poor shape, however, we do not yet see this as an entry point. In other emerging markets we see that corporate balance sheets are strong with relatively low leverage as emerging market companies have been deleveraging over the past eight years. This justifies the current valuations.

We are aware that many investors assess the credit market through an all-in-yield lens rather than a spread lens. From that perspective, the market appears more attractive, leading to inflows, particularly from annuity products that are in vogue. However, following the substantial rally in government bonds, we now see the forward curve pricing in a terminal rate of 2.8% in the US and 2% in Europe, lowering the attractiveness of the credit market from an all-in-yield perspective. A further decline in government bond yields would likely only occur if the soft landing proves not to be so soft, in which case widening spreads would offset any gains for all-in-yield investors.

Technicals

It is evident that the technical factor has been the primary driver of credit performance this year. Strong demand for credit led to substantial inflows into investment grade strategies. One major reason for these positive flows was the attractive all-in yield, which spurred high demand for annuity products in the US. We also observed significant inflows from target date funds. Although demand for high yield products was comparatively lower, this market still benefited from a strong technical.

High yield continues to experience a reduction in issuers due to upgrades to investment grade, known as rising stars. Furthermore, new issuance in the high yield space has been relatively subdued. While limited supply is supporting the strong technical in high yield, the opposite is true for investment grade credit, where robust demand remains the dominant force. Issuers are taking advantage of the favorable environment, with a flood of new deals coming to market, even during the typically quiet month of August. These new issues were easily absorbed, with little need for concessions on the new issue premium (NIP). We do not rule out the possibility that many issuers are locking in funding ahead of potential volatility following the US elections. If issuance slows after the elections, we could see an unwaveringly strong technical continue through the final months of the year.

“ In summary, the technicals remain robust, but prudence is advised

The demand for fixed income is not driven solely by retail investors; pension funds are also making their way into the market. Corporate pension schemes have seen their funding ratios improve, supported by rising equity markets (boosting assets) and higher yields (which reduce liabilities through higher discount rates). This dynamic creates a meaningful tailwind for high-quality fixed income, as pension funds shift toward derisking to mitigate potential asset/liability mismatches.

The high yield market has remained relatively calm. However, with the onset of interest rate cuts, the leveraged loan market may become less attractive to yield-seeking investors. This could result in flows from leveraged loans into high yield bonds. On the supply side, we expect the high yield market to become more active. Lower all-in yields make leveraged buyouts (LBOs) more appealing to private equity sponsors, who are likely to tap into the high yield market to finance these deals.

In summary, the technicals remain robust, but prudence is advised. Historical patterns demonstrate that this factor can reverse abruptly, as seen during the initial period of August.

Positioning

Our positioning remains largely unchanged from the previous quarter. In investment grade credit, we continue to feel comfortable with a beta slightly above 1. For now, we see no change in the strong technicals, and if spreads do widen, we have ample room to increase beta accordingly. In a period of economic and political change not all companies will thrive and credit selection is the key driver of alpha.

The overweight positions in banks and corporate hybrids still offer attractive opportunities, so we are maintaining those exposures. In global portfolios, we remain overweight in European credit, both in investment grade and high yield segments.

Within high yield and emerging markets, we continue to hold an underweight position in the distressed part of the market. This keeps the betas of these strategies below 1, which aligns with our inherent quality bias.

We intend on maintaining an up-in-quality 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 overly confident with the idea that low volatility and unattractive valuation can persist indefinitely. They rarely do. By adopting a patient and disciplined approach, we position ourselves to capitalize on more compelling opportunities as they emerge.

Table 1 – Current postioning

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

Source: Robeco, September 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, Lauren Mariano, Martin van Vliet, Rogier Hoogeveen (Robeco), Viktor Hjort (BNP Paribas) Dario Perkins (TS Lombard Street), and Michael Anderson (Citigroup) have been taken into account in establishing our credit views.

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