ROBECO
The Investment Engineers

CREDIT QUARTERLY OUTLOOK

Can credit spreads ever widen again?

- Credit spreads reside at optically tight levels versus history
- However, higher total yields have generated an abundance of demand
- Trump's second term is a likely source of volatility in 2025

***Spoiler alert: Yes, of course they can.* As we close the books on 2024 and look forward to the future, it's worth reflecting briefly on the past year and the lessons learnt.**

Suffice it to say, credit has been remarkably firm of late despite a host of potential obstacles. Political turmoil in Europe, extreme rate volatility, geopolitical escalations, and the US Presidential election (to name just a few) might reasonably have been expected to trigger material uncertainty and risk aversion. However, any such episodes were typically short-lived and 'buying the dip' was the correct response every time.

With hindsight, we've been a little too cautious this year. Our base case of slowing growth, ongoing disinflation and easier monetary policy supporting credit has indeed played out. But, given the plethora of risks on the horizon, we didn't quite imagine spreads would end the year at, or close to, the tights of the century.

So what did we miss? The power of yield!

While credit investors typically assess value from a spread perspective, it has become increasingly obvious that total yield is a far bigger driver for many market participants. This gives rise to something of a 'valuation conundrum' where tight spreads meet attractive yields. For now at least, the lure of higher yields trumps compressed spread valuations and demand for credit remains relentless.

This brings us back to the very 'clickbait' title of this piece. Yes, spreads can still widen, but exactly when and why remains uncertain. While we struggle to get excited about spreads at current levels, we also find it difficult to be too negative given the overwhelming demand in the market. Fortunately, as global credit investors, simply being long or short risk is not the only game in town. We expect to derive our alpha from other levers in the near term, while maintaining ample 'dry powder' to exploit any volatility in coming months.

OUTLOOK DECEMBER 2024

Marketing material for professional investors, not for onward distribution

Matthew Jackson
Investment grade

Sander Bus
High yield

Reinout Schapers
Investment grade

Fundamentals

On a macro level, US exceptionalism continues to be evident. Despite aggressive monetary tightening in 2022/23 the economy failed to collapse as many had predicted. Huge fiscal stimulus, pent-up demand post-Covid and longer-duration debt obligations have all helped to shield households and businesses alike. When we study the multitude of 2025 investment outlooks the consensus is clear: while US growth is expected to slow, there is little concern over a potential US recession. Nor is there much concern over a possible resurgence in inflation, with widespread belief that further rate cuts are coming as the labor market cools.

In Europe, and Germany in particular, it has been a different story altogether, with the region hammered by higher energy prices following the loss of Russian gas, poor consumer sentiment, weak investment, and economic woes in China. While growth is expected to remain sluggish, the risk of 'too low' inflation gives the ECB ample room to ease policy further. The potential for German fiscal easing and meaningful China stimulus may also benefit the region.

In 2025, the Presidency of Donald Trump and the Republican clean sweep introduces a fresh layer of uncertainty, both domestically and abroad. Will bold tax cuts upset the bond market (and the Federal Reserve?) Likewise, will trade wars and mass deportations reignite inflation and damage global growth? Or are these fears, as many suggest, overblown and Trump is simply using these threats as a bargaining tool to promote US interests? One defining feature of Trump's first term was frequent boasting via X about the strength in US stock markets. We'd therefore suggest the new administration will exercise restraint with anything that potentially causes major disruption in financial markets. Indeed, Trump's apparent resolve to diffuse the conflicts in Ukraine and the Middle East could serve as positive events for the markets.

A new trade war would present growth and inflation challenges for many emerging market (EM) economies given the trade linkages with China and the US. However, EM corporate fundamentals are on a better footing than at the start of the 2018 trade war. On average, the asset class is higher rated than in 2018 and net leverage ratios are well below those of developed market (DM) peers, especially for investment grade (IG) companies. There remains much skepticism that China can engineer a 'quick fix' to stabilize the economy. With weak consumer demand at home and the risk of significant tariffs from the US, China has indicated more fiscal and monetary stimulus is likely in 2025. The urgency of easing has clearly increased for policymakers, but how this support will be implemented is still unclear. We expect it to be incremental, and the timing reactive rather than proactive to the scale and scope of Trump's tariffs.

In aggregate, corporate fundamentals continue to look stable and robust with typical measures such as net leverage and interest coverage suggesting no cause for concern. However, aggregate fundamentals may not tell the full story and recently we have seen problems in US retail, UK water and the automotive sector to name just a few. Additionally, we might reasonably expect a meaningful pickup in M&A activity in coming quarters given the combination of high 'animal spirits' currently in markets, combined with the prospect of looser regulation under Trump.

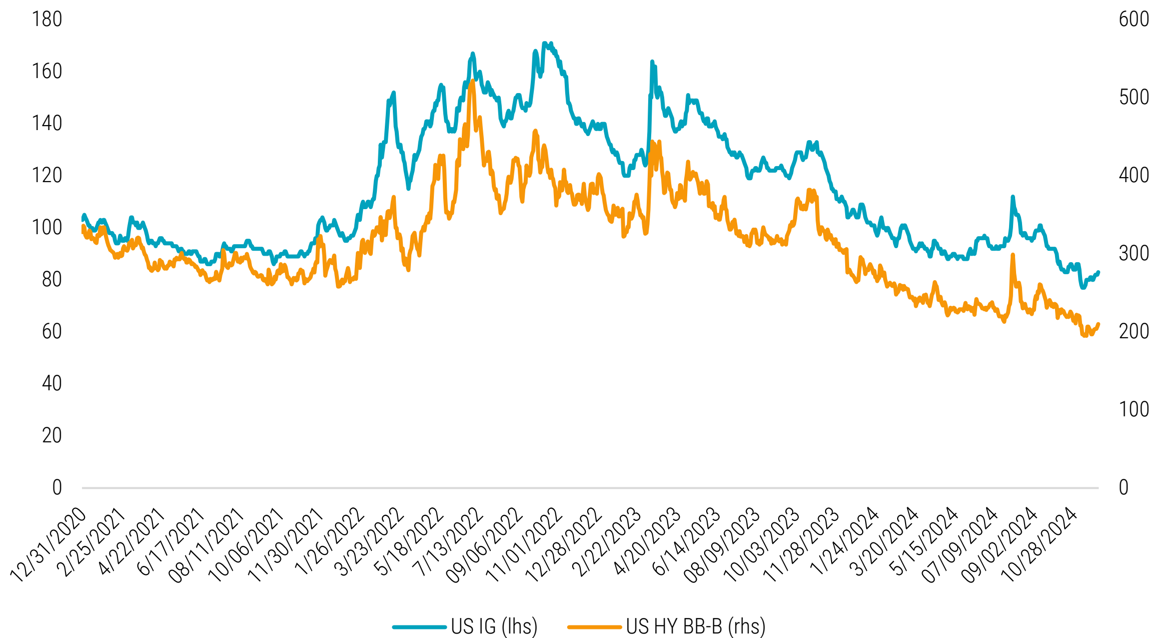
For a more extensive view on the macro outlook, we refer you to the December outlook from Robeco's Global Macro team: Made in the USA.

Valuations

Our favored metric for assessing value in credit markets is to reference the excess yield of corporate bonds over equivalent maturity government bonds. Through this lens, there can be little argument that credit spreads look fairly rich in comparison to history in many parts of the market. US IG stands out in particular, with the aggregate spread at the tightest percentile of the past twenty years. This richness is evident across all sectors, maturity buckets and rating categories. European IG valuation looks somewhat less stretched in comparison, with spreads hovering around the 30th percentile of the past two decades. It's indeed a very similar picture when looking at the

high yield (HY) market and even EM corporate spreads currently sit near all-time tights, despite potential vulnerabilities from trade war escalation.

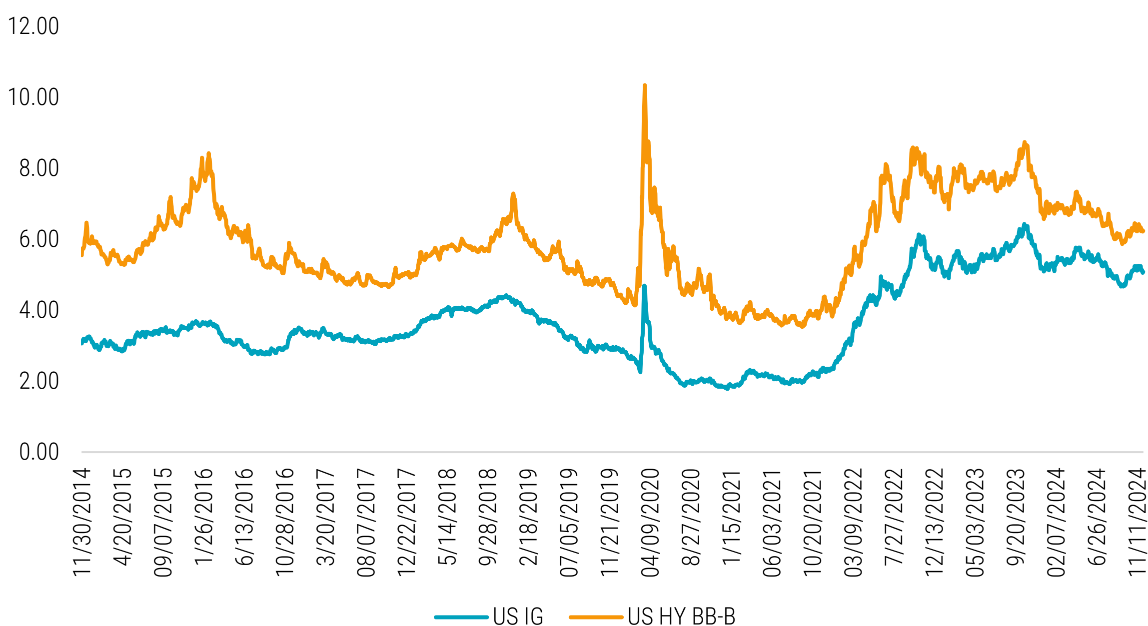
Figure 1 – Investment grade and high yield spreads vs. governments (bps)



Source: ICE, Robeco, December 2024

However 2024 has shown that, for many investors, all in yield might be more important than credit spreads. And viewed in terms of total yield, the market looks considerably better. This is particularly true for the IG market, although the argument becomes somewhat less powerful when looking at HY.

Figure 2 – Investment grade and high yield historical yields (%)



Source: ICE, Robeco, December 2024

Others point to spreads over swaps as a potentially cleaner way to look at valuations and again, on this metric, things don't look so extreme. The general theory is that high government borrowing and perhaps therefore some concerns about sovereign debt sustainability means corporates can trade much closer to their government counterparts. We're a little bit skeptical here, as negative swap spreads are nothing new – particularly in the US and UK — and consider this more a function of heavy demand for liability-hedging from pension funds meeting constrained dealer balance sheets.

We are often asked what we see as the main risks on the horizon for spreads. The default response generally includes some mention of tariffs, inflation, debt sustainability, bubbles in asset markets and geopolitics. And yet, the biggest risk is usually what we don't see. The excellent Jim Reid at Deutsche Bank sums it up nicely:
"In 2020 the pandemic meant the year-ahead outlooks were redundant by the end of Q1, in 2021 a surge in inflation surprised virtually everyone, in 2022 markets were caught off guard by the most aggressive rate-hiking cycle since the 1980s, in 2023, the consensus wrongly expected a US recession and in 2024, no-one expected an S&P 500 return that could hit 30% YTD in the days ahead."

Perhaps then the biggest risk out there is valuations themselves. With spreads at current levels, there is very little cushion for any kind of negative development. Yet, we are frequently reminded that spreads can remain tight for extended periods, as seen during the 1990s and 2000s, when US IG spreads sat below 100 bps and HY below 350 bps for several years.

Technicals

Very healthy demand for credit has been the major theme for 2024. The apparent imbalance between demand and supply is even more impressive when one considers that the supply of corporate bonds has also been elevated. The fact that new issue concessions have been negligible or non-existent in recent months highlights the depth of investor appetite.

The demand for corporates continues from multiple sources. Indeed, one rarely discussed but powerful factor is simply coupon reinvestment flows. In a higher rate environment, coupons on newly-issued bonds have been going up in recent years. Evidence points to continuing strong foreign demand for USD corporates, despite high currency hedging costs and more attractive domestic alternatives. There is some evidence that overseas investors may be abandoning currency hedges or going lower in quality to preserve yield. Data from LIMRA continues to show the surge in sales of US annuity products in the past few years, with IG credit an obvious beneficiary. Likewise, funding ratios for pension schemes have greatly improved alongside the rise in yields and the strong performance of equity markets. This creates huge incentive for pension schemes to derisk via liability hedging which again favors corporate bonds.

Long-duration instruments appear particularly in favor. An interesting anecdote is that several corporate hybrids have issued bonds with a 10-year call date (likely maturity) at a lower yield then their hybrids with a shorter 5-year call. One potential conclusion from this is that investors do not believe these juicy all-in yields will be around forever, and they should be locked in for as long as possible.

Positioning

The great thing about managing credit is that you have many thousands of issues and issuers in multiple currencies – we have multiple routes to alpha and there is always something to do. The 'beta call' is just one lever we can employ – being long risk when credit is cheap, expecting spread compression and/or high carry or being short risk in anticipation of a material widening in spreads. At current valuations, we de-emphasize the beta call and target overall risk broadly in line with benchmarks. If not for the overwhelmingly positive demand technical, we might be even more conservative. However, we see no obvious reasons why this technical should change materially or reverse any time soon (but must acknowledge that it can!).

Our cross currency positioning in both IG and HY reflects our highest conviction top-down view: EUR credit is relatively more attractive than the USD market. On a sectoral level, we have recently begun to add selectively in the unloved European automotive sector. We maintain a positive view on the banking sector given strong fundamentals and attractive valuations relative to non-financials. That said, we stay cautious on French banks as valuations offer limited compensation for the ongoing political risk, combined with the prospect of heavy issuance as we enter 2025. Within HY and EM strategies specifically, we maintain an underweight to the distressed part of the market.

More M&A activity can present both an opportunity and a threat. Through rigorous bottom-up research our clear aim is to avoid companies we believe may engage in significantly leveraging transactions. However, the bond issuance that typically follows, with a clear path to deleveraging thereafter, can present an attractive entry point.

Table 1 – Current postioning

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

Source: Robeco, December 2024

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On behalf of Robeco's credit team, we wish you and your loved ones happy holidays and the very best for 2025.

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