OUTLOOK
For professional investors
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ROBECO
The Investment Engineers

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Credit Quarterly Outlook Q1 2018

A love letter to economic history

- Global, synchronized growth, with more upside
- Central banks risk being caught behind the curve
- Expect less technical support, decompression and more volatility

And yet again, the global economy delivers another good quarter in terms of growth. It even seems that capital investments are finally contributing to growth. This has been the main disappointing economic variable to date in this business cycle. Moreover, it looks like the different economic blocs have synchronized their cycles. Except for China, all of them are showing an upturn. Chinese credit to GDP has reached levels last seen in crisis situations in countries such as Korea, Japan and Thailand.

Central banks falling behind?

This brings us to a topic that is in sharp contrast with the last two years: the risk of central banks falling behind the curve. The biggest question mark in this cycle is why inflation is so low. Considering the reduction of the economic output gap, one could expect some inflation scare soon at central banks. We will explain why we believe inflation might be at a secular turning point.

In any case, all central banks combined will massively reduce monetary stimulus during 2018. The only thing that would keep us from expecting increased market volatility is a scenario in which other market participants, such as commercial and retail banks, were to take over the purchasing of fixed income assets. In our view, the numbers are too large to expect such a perfect scenario. All this holds for all risky asset classes.

Once in a while, we also take a helicopter view. We try to think outside the box, outside this economic cycle with all daily noise influencing us. Guess what, that does not make us more relaxed. Ever since we abandoned the Bretton Woods system in the 1970s, we actually created fiat money, leaving it fully in the hands of central banks and politicians. This has created an ever increasing amount of financial shocks. Central banks managed by academics, overestimating themselves and the control they have on an economy, solve economic problems with lower interest rates.

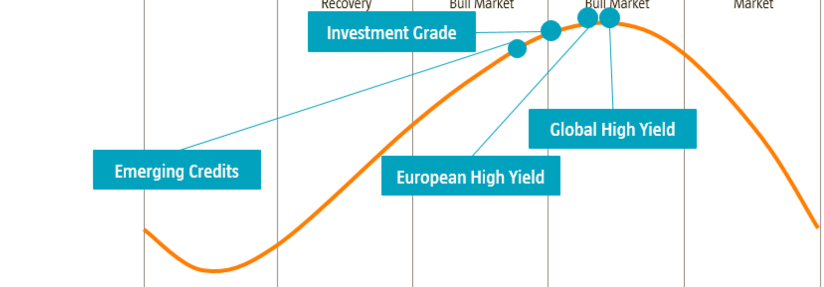
Central banks have been right for the wrong reasons in their loose monetary policies. A massive labor supply shock (over one billion Chinese entering the labor force since the 1980s) has been disinflationary. This created the debt super cycle we started writing about ten years ago. Solving debt issues with more debt will eventually create more rather than fewer financial shocks. We live in an era in which one should expect a regular cycle of crisis, releveraging, boom, excesses and bust again.

Studying economic history

Just by studying economic history and organizing this Credit Quarterly Outlook, we as a credit team have created a certain degree of understanding of the events around us. That is why we call this outlook a love letter to economic history. We keep informing our clients in an honest way about our views on the credit cycle, even when we think it is close to the end. And now risky assets are vulnerable, maybe even more so than government bonds.

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

Source: Robeco, Morgan Stanley, December 2017

Where are we in the credit cycle?

There are several indicators that the cycle is maturing. 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: economic growth and record low volatility

In this chapter we look at economic fundamentals, such as accelerating economic growth, low inflation expectations, increasing debt and the risks of an inverted US yield curve.

We are experiencing a synchronized economic upturn. This is somewhat comforting, although history shows we do not need a recession for corrections to occur. Meanwhile, debt levels keep increasing everywhere. If this cyclical upturn remains strong, central banks will have to pull the trigger. Asset prices just do not offer enough room for error.

It is not so interesting to time exactly when this economic cycle will mature. We do not care about GDP growth forecasts or pinpointing five-year inflation rates five years forward. We do care if there is room for surprises or policy errors. Or which market segments are complacent. We manage a risky asset class with fat tail risk and want to be positioned in a contrarian way.

Economic projections are improving and ever more globally synchronized. Some regions are already growing at full capacity but let's not worry about that. For the first time ever, the amount of job openings is equal to the amount of unemployed persons in the US. We start questioning the very low inflation expectations. We do not want to start an academic debate on a steep or flat Phillips curve. Fact is that the markets are not expecting any inflation volatility, while US payroll numbers continue to point to ever lower unemployment in the near future (180,000 on average, while only 120,000 is necessary for stable employment).

'Somewhere in 2018, the Fed will most likely create an inverse curve'

What do the leading indicators tell us, if anything?

We have discussed some leading indicators on future economic activity and market returns. Financial conditions indices do not tell a lot. They are normally very loose, until they are not. That means it is a useless, lagging indicator. Also the debate on unemployment is hugely ineffective, since it is also very much a lagging indicator. Very soon after unemployment has reached the bottom (we think we are close), the credit and economic cycles will turn.

A third indicator is the yield curve. One of the most followed and reliable indicators of the next recession. Somewhere in 2018, the Fed will most likely create an inverse curve. Most interesting is the 2-year Fed Funds rate curve. If that inverts, and it makes foreign buying of US credit unattractive on a hedged basis, we could experience a large outflow of (US) credit markets. We question the liquidity available, the role of ETFs and the size of this flow and wonder if the transition will be smooth. The estimates of foreign buying into the US are staggering and have actually accelerated recently. This could well be one of those unexpected events surprising market participants.

It is fair to state that there are a few indicators that have become less negative. Merger &Acquisition activity seems to ease a bit. Also, corporate leverage in the US is reducing a little. Despite companies doing massive share buybacks and paying dividends instead of investing, corporate health is stabilizing and that moderates our immediate concerns.

Valuation: tightening - again

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

Credit spread have tightened yet again, but that doesn't necessarily worry us. Spreads can remain low for a very long time. Moreover, as dispersion is growing, we are focusing on stock picking. Financials will offer a safe haven in the next financial crisis.

'Spreads can remain low for years'

Credit spreads have tightened another 9% this quarter. With the exception of European high yield, all categories are tighter again. Emerging credit is the winner, tightening even more basis points than high yield. We have reached a point at which swap spreads in Europe are wider than the credit spreads over swaps. Corporate spreads have become expensive. On average, the market is trading between the tenth and twentieth percentile. Please remember that this is not uncommon for credit markets. Spreads can remain low for years.

Is this all bad and should we run for the exit? Not necessarily. First of all, we are stepping up our stock picking activity. This year we have already realized good results, as dispersion is growing. Differences between high yield and investment grade are increasing, for example. Second, these levels can be sustainable for years. It can just as easily be '2005' as '2007'.

European credit still more attractive than US credit

US credit is further advanced in the credit cycle. Corporates are managing their balance sheets much more aggressively. On the margin though, European corporates have started to leverage a bit more and US corporates a bit less. It makes the valuation gap less pronounced. We still prefer European credit to US credit.

Some sectors face more stress than others. We are careful on auto loans (delinquencies are still rising), pharma and retail. Avoiding these sectors keeps us out of a lot of potential problems. Some companies have taken on massive debt via Mergers & Acquisitions (USD 50-100 billion). All this needs to be refinanced, also in periods with more volatility.

Our trading strategy will also differ a bit from now on. Not every sell-off or period of underperformance will automatically be seen as a buying opportunity. We will scrutinize this case by case, just like we do for single name credit. We also think that the next downturn will be centered around corporate profitability and leverage. Therefore we believe financials will offer safe haven status in the next financial crisis. We like segments where we can still find value or where we are paid for risk: shorter dated credit, European swap spreads, insurance, 5-7 year maturity, Additional Tier 1 and special situations in high yield.

It's stock picking time

We stay up in quality and keep buying into credits that have widened or just changed their strategy into deleveraging mode. We stay away from the mega companies with EUR 50 billion debt or more on their balance sheets to refinance. It is stock picking time again.

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Technicals: a major shift in Quantitative Easing

In this chapter we discuss technical factors, such as Central Banks shifting from net buying to net selling and concerns about foreign ownership of US credits.

The technical part of our Credit Quarterly Outlook has become more negative this time. Timing is difficult, but the market is not expecting enough turbulence. Markets across asset classes have seen the low in volatility we believe. It will offer opportunities for active managers like us. Idiosyncratic risks are rising due to refinancing worries and together with decompression between credit categories, this provides alpha opportunities. In terms of beta, we are more careful.

On technicals there is a lot to tell. We are facing the first months of a major shift in the Quantitative Easing (QE) programs. During 2018, we will approach the moment at which the US rate curves will invert and private markets need to replace the central banks with EUR 1 trillion or more of buying fixed income assets. This may well happen. The stock of liquidity is huge. If the flow of stimulus turns out to be most important, more volatility is in the cards. In terms of timing, we foresee that the combined net buying of the Fed and the ECB will become negative in May 2018 already

An important item here is the debate on government yields. It is common to state that these are too low. If one takes inflation expectations for real, this remains to be seen. It is likely that the asset classes that benefited most from QE, i.e. risky assets such as equities and credit, will face most increases in risk premiums. Do not be surprised there.

One of our biggest concerns, and we have not written a lot about it yet, is foreign ownership of US credit markets. Quietly and almost in stealth mode, every year foreign investors massively bought US credits,, hedged back into their base currencies (short USD to domestic currency). Japanese and European capital account outflows have been huge, for example. There are estimates that 30-45% of US credit is owned by foreigners. If the hedging costs keep rising (i.e. the Fed keeps hiking a few more times), and short-term interest rate differences increase, there is no spread premium or yield premium left. A reversal of this flow, triggered by a tightening mode which accelerates due to the strong economy, will have major implications for credit spreads. This is another reason why we are more constructive on European credit.

‘Asset classes that benefited most from QE, are likely to face most increases in risk premiums’

Conclusion & positioning

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

Beta: careful

Despite the fact that fundamentals are improving in economic terms, we are becoming more careful. Asset price corrections do not always require a recession. There are some extreme things we worry about. When five FAANG stocks drive up the S&P 500 index by over 20%, when inflation is so low even though unemployment tells you different and when credit markets face a net selling system of central banks, beta positioning should be careful. Then we are well positioned to benefit from the volatility that is to come. The opportunity loss of not owning enough beta exposure is just too low.

Tail risks: studying history makes us less comfortable

It is darkest before dawn but all looks bright before darkness too. Remember 2007. Since then debt levels and dependence on low interest rates have increased ever more. We just need some kind of shock (remember, do not try to figure out which one) to reprice risky assets. It has happened so many times before, and it will again. This is the lesson history teaches us. We live in an era of financial shocks based on too much debt and overconfident central bankers.

Opportunities: stay up in quality

We like companies that just relevered or changed their strategy into deleveraging. We also like the roll down the curve of 5-7 year credit or credit that just offers good yield like short dated high yield or the AT I paper of the good banks.

Otherwise we prefer safety and stay up in quality to benefit from further decompression and higher risk premiums. A correction is not the end of the world, it will not necessarily be like it was in 2008.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Jamie Stuttard (HSBC), Nikolaos Panigirtzoglou (JPM), Jim Reid (DB) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

The Robeco Global Credit Team wishes everyone all the best for this festive season. We hope that you have enjoyed reading this 40th Credit Quarterly Outlook. This year, we have celebrated ten years of Credit Quarterly Outlooks. We are looking forward to the next ten years!

Robeco's Global Credit Team

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