ROBECO
The Investment Engineers

Credit Quarterly Outlook Q2 2020

'The common enemy'

- COVID-19 is causing an economic shock comparable to the GFC
- Authorities scramble to respond with fiscal and monetary stimulus
- In just 4 weeks, valuations have moved from late-cycle tights to levels seen only four times in the last 80 years

It's the end of the world as we know it. R.E.M.'s song probably describes best how many feel these days. The process of creating our 49th Credit Quarterly Outlook was largely conducted via Skype, with all our guests and most of our colleagues dialing into the meeting. What a difference one quarter can make. In December we observed an equity market bubble continuing to inflate and a sustained late-cycle search for yield in credit. Today we face a certain and severe global recession, an equity market crash and spreads that have moved from the historical tights straight to recessionary wides. We will not talk about US-Chinese trade tensions, Brexit, or tensions in the Middle East or North Korea. The world now has a common enemy. We have to join forces to beat the virus and avoid deep economic downturn. Authorities will provide fiscal and monetary support for the private sector. Governments and banks will need to work side by side to contain the fallout. The short term will be economically challenging with market pain and many market participants scrambling for cash and withdrawals. We believe, though, that we are close to the wides in spreads and that markets will try to look

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forward, through the stimulus and beyond stabilization in COVID-19 infections. It is time to buy.

Fundamentals

The longest economic expansion has ended abruptly. The end of the expansion itself is not a surprise; but the nature of the exogenous shock, its speed and the magnitude of the slowdown is. History is being made. But while COVID-19 is the proximate trigger, we firmly believe current events are not just about the virus. They have deep secular and cyclical roots.

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We discussed the debt super-cycle in a number of previous Credit Quarterly Outlooks. Many global imbalances, such as the rise in Chinese private sector debt from just USD 4.5 trillion before the global financial crisis to USD 30 trillion today, have been building for years. At minus USD 11 trillion, the US net international investment position is five times more extreme than it was before the global financial crisis. Social inequality has risen to levels not seen since the 1920s.

A build-up of imbalances emerged in this expansion, the result of 11 years of risk accumulation. Central bank policy, which was too easy at times (e.g. 2014-17), fueled an equity bubble and deterioration in lending standards, with the latter being particularly prevalent in covenant degradation and excesses in the leveraged loan market. BBB debt grew to an unprecedented size to fund trillions of share buybacks at corporates, particularly in the US. Yet, amid the financial market boom, all was not well in the real economy.

Many open economies, such as Germany and Japan, had already weakened before 2020, hurt by mercantilism and trade tensions. This unusual combination of market excesses and real economic fragility left both economies and markets vulnerable to a negative shock. No one knows ahead of time what the exogenous shocks and proximate triggers for crashes would be. If they were known, they would be priced in and there would be no crash. There is no doubt about the proximate trigger this time. A global recession is now inevitable and could be as severe as during the global financial crisis, when US GDP fell nearly 4% year on year. Credit spreads are already compensating for a deep recession.

Recession probabilities had already increased before COVID-19 dealt the final knock-out. In prior Credit Quarterly Outlooks we discussed declining corporate margins, increased leverage, the inverted yield curve and that, after the volatility of 2018, 2019 looked suspiciously like a dead cat bounce at the time. If 2008 is any guide, we could see profits decline by 20-30% on average, and by much more in the vulnerable service sectors like airlines, lodging, gaming and entertainment. The energy sector received an additional blow from the collapse in oil prices after the quarrels between Russia and Saudi Arabia. This oil supply shock, some initial false moves by several central banks and COVID-19 , were a perfect 'three strikes and out' situation for the market.

In this bear market, everything is happening at a faster speed – including the policy response from monetary and fiscal authorities. Intermeeting rate cuts and asset purchases have been followed by new measures announced almost daily, including liquidity injections and massive fiscal stimulus. As we write, the Fed have announced two new programs directly focused on the US investment grade (IG) corporate sector, going beyond their policy toolkit in 2008. These are the PMCCF (the Primary Market Corporate Credit Facility) and the SMCCF (you guessed it, the Secondary Market Corporate Credit Facility). Technically, they are not Corporate Bond QE per se, being more akin to Bank of England liquidity and lending policies during the GFC, but they involve direct buying of corporate bonds and financing of IG US companies, showing clear intent, responsiveness and the direction of travel.

Like in 2008, get used to new acronyms. After misfiring initially at their scheduled ECB meeting, the ECB's EUR 750 billion PEPP (Pandemic Emergency Purchase Program) and the hints of activating the OMT (Outright Monetary Transactions), now looks to be the right sort of response for markets, hopefully preventing a 2011-type periphery sovereign crisis. Fiscal authorities have provided an extremely powerful backstop to corporates via a mixture of measures aimed at alleviating working capital, and at households aimed at smoothing the immediate financial hit.

Authorities clearly have learned from the 2008 experience and are evidently prepared to go further and faster. We will see a transfer of risk from the private sector to the public sector at the expense of huge fiscal deficits, funded by central banks amid increased asset purchase programs. Such public sector risk sharing is exactly what stopped the 2008 crisis, and is needed again. The costs will be huge, though, and the long-term question is: who will pay the bill? Will the costs fall on the public sector and translate into a special 'corona tax' in coming years or will the private sector bear the burden? It will probably differ by country, as will the inclination of governments to accept or prevent corporate failures amid the most vulnerable credits. But it is clear that the bill initially is being paid by governments and ultimately will require private sector contributions, either via the household or the corporate sector.

It is still uncertain when the global economy will be restarted. COVID-19 is still spreading rapidly and we have not yet seen the peak. Forecasts of 60% infection rates seem far off today, suggesting that there will be further deterioration first. The exception is China, where the virus seems to be under control after a complete and very strict lockdown. However, there is a risk of a second wave of infection once China tries to re-open. As long as the end of corona is not in sight, markets will probably remain extremely volatile. That said, markets will try to look through all the misery and will slowly price the right COVID-19 premium.

> 'This time, there are no bankers to blame for the crisis. In fact, they can be part of the solution'

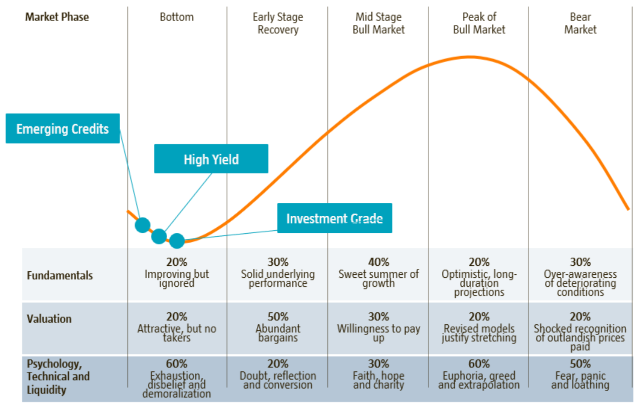
During the global financial crisis, banks were at the epicenter of the problems, generating a great deal of public anger. This time, there are no bankers to blame for the crisis. In fact, they can be part of the solution by providing relief to private companies and individuals that are badly hit by the crisis. We observe that:

- Bank balance sheets are in better shape running into this cycle than they were in the global financial crisis.
- Banks are not at the root cause of this crisis; rather, they are needed to stem the acute global liquidity crisis.
- Various forbearance measures by banking regulators will help spread NPLs (non-performing loans) and provisioning over a longer period and, more importantly, give banks room to prevent otherwise creditworthy corporates from failing due to an acute drop in economic activity.
- The decision by regulators to lower capital requirements and allow banks to temporarily operate below minimum requirements indicates that there is no immediate intention to bail in banks. Doing so would in any case not solve the pressing current need to try to cushion the immediate economic downturn.
- The longer-term impact of ECB measures may be the intertwining of sovereigns and banks once again – the so-called sovereign-bank nexus. The cost of extraordinary support today, will likely emerge tomorrow in the form of more directed lending and increased holdings of sovereign bonds.

Outside the banking sector, it is not clear what pound of flesh governments may demand for special support for affected sectors (e.g. airlines). It is clear that in some other sectors where leverage was too high (energy) or secular forces too powerful (e.g. retail), there will be defaults and restructuring. Default rates are never zero in a recession, regardless of what caused the recession, and this remains true no matter how much solidarity is generated by current events. In both financials and non-financials, individual issuer analysis now becomes more important than ever. Where one is positioned in the capital structure will matter too – amplifying returns in the consequent bull market for the winners, leading to haircuts, below-par buybacks or debt-for-equity swaps for the losers. Correlations tend towards 1 in bear markets, amid indiscriminate sell-offs, but they don't during recessions and bull markets: rather, from here, successful credit portfolios need to avoid the losers.

In short, the fundamentals are clearly weak. A deep recession and lots of uncertainty will be with us for some time. But it is evident that we are in the phase of fear, panic and loathing (see our cycle chart). Regarding policies to soften the blow, expect fiscal support of over USD 1 trillion in each major economic region.

The Market Cycle - Mapping our view on market segments



Source: Robeco, March 2020

Valuations

Spreads moved from late bull market tights to recessionary levels in both IG and high yield (HY) within just 4 weeks. Federal Reserve data for the period from the Great Crash in 1929 to April 1931 shows that the process of credit spread widening to current levels took 19 months. So, the speed of the sell-off has been 19 times faster than in the early phase of the Great Depression. We live in truly historic times.

Current spread levels have been seen only three times since the 1930s: October 2008 to June 2009, October 2002, and the early 1980s. Otherwise you need to go back to 1937-8. With hindsight, if you were prepared to withstand near-term volatility, these were all great entry levels into credit, setting up returns for the next 12 months, 5 years and even decades after.

In the near term, markets are clearly dysfunctional. Liquidity is poor and it is challenging to assess where market prices really are. During the third week of March we saw that actual trading levels were often well below screen levels. Only by execution can one find out where individual bonds trade, and often the size available is small.

We have seen true capitulation in the market in the last week, with massive outflows across the market from ETFs and mutual funds. Investment banks were at times unable to provide balance sheet, and credit gapped wider as a result. An indication of the poor liquidity and dislocations are the huge discounts versus NAV for several ETFs. Even in the highest-quality parts of fixed income, the spreads between on-the-run and off-the-run US Treasuries, and the levels for AAA assets versus swaps, show how challenged physical-funded assets have become.

'Going back to first principles, credit spreads should over time compensate for default risk, downgrade risk and liquidity risk'

Going back to first principles, credit spreads should over time compensate for default risk, downgrade risk and liquidity risk. We believe spreads already compensate for huge illiquidity premia and recession. A severe default scenario can get you to annual default rates in the HY market of 10% or higher, with recovery rates that could drop to as low as 20%, translating into a default loss of 8% in any given year. A 1000bps spread on an index with a maturity of 5 years does generously compensate for such a harsh scenario. The immediate questions are just how far default rates will rise – a function of the depth of recession – and of the degree of ongoing and escalating policymaker support.

The conclusion is that valuations are clearly cheap now. It is rare to see these spreads in any credit category. Spreads are cheap for a reason, a big recession will be with us and credit losses will be there, but there is plenty of liquidity premium left. Time to buy.

Technicals

Why has this bear market happened so fast? The rapid spread of the virus is obvious. But behind that, if one peers more closely into the structure of the market, we think that investor positioning has played a big role. Amid negative rates in many current-account-surplus countries, and after years of 'search for yield', investors had moved down the rating curve in order to get some yield. We also heard anecdotal evidence that short-dated bonds were often seen as a proxy for cash. Last, but not least, there was leverage in the system. This is not so much in the investment products themselves, although CLOs (collateralized loan obligations) and some private banks had their fair share, but rather in many of the underlying corporate issuers, particularly in leveraged loans. Leveraged investors have accelerated the sell-off as positions need to be unwound in order to meet margin requirements. Yet there is more to it than that.

As central bankers and strategists have warned, the key problem in this cycle, unlike 2007-08, was liquidity rather than leverage. We warned only last quarter of the interconnection between assets, amplified by products such as Multi Asset Credit Funds, highlighting what we termed 'Big Mac' risk at the time. Credit problems in one sector can flow to creditworthy securities in another. (The HY energy sector might be fundamentally vulnerable, but Single A and higher consumer products makers are not. Yet interconnections drag both down.) Added to a diminished sell-side market-making capability, which has had its wings clipped by regulators since 2008, particularly in terms of balance sheet, risk appetite and trade size, these themes have coalesced into a massive spike in volatility and the biggest VAR shock since the Lehman crisis.

Beware of downgrades from BBB to BB. Leverage in BBBs has gone up in recent years due to M&A and debt-funded share buy-backs, particularly in the US. In normal economic conditions IG companies can reduce leverage quickly, but in a recession that is more difficult, with demand for and valuations of asset sales being one example. Rating agencies will probably start downgrading overleveraged BBBs with reduced scope for debt reduction. In EUR, downgrades to HY means that these bonds will no longer be eligible for ECB buying.

So, it is clear that the 'search for yield' era has come to an abrupt halt. February and March 2020 have shown a pronounced 'flight to quality' mode. But spread peaks tend to be very spiky. The first phase of bull markets tends to be just as sharp as the last phase of bears. Eventually, when markets stabilize, people will again reach out for yield in their fixed income portfolios. Large IG corporates now offer a great yield and should be an easy target for yield-starved investors. Life insurance companies with stable capital and deep pockets, and who are now facing a lack of yield in government markets, are already showing demand in primary markets, leading to low new issue allocations and deals performing well on the break.

Credit curves have inverted: spreads on the short end have widened more than longer-dated bonds as short-dated credit was often used as a proxy for cash. Since investors needed cash to meet redemptions or to buy opportunities in longer-dated credits, they have sold the short end. While the new Fed PMCCF and SMCCF programs can help, this technical would otherwise stay negative for short-maturity bonds. We highlighted only in December that the Single-B curve had already inverted – a cyclical early warning signal. Now those inversions have flown up the credit quality spectrum, through Double BBs and into Triple BBBs.

In a bull market, the pricing power lies with the issuers, which in this cycle translated into very loose bond documentation, aggressive pricing and the creative use of adjusted EBITDAs. In today's market we will most likely see a restoration of sensible covenants, accounting conservatism and new issue premia – in sum, 'good vintage' market practices. It still requires active vigilance, however; we have been disappointed to see call features in IG bond new issues, and large revisions to new issue price talk – in the midst of the market turmoil. Perhaps some behaviors never change.

'As policy responses ultimately counter fear-driven flows, market technicals will improve'

All in all, be prepared for more policy stimulus and disappointments, and having to fix these again. Most governments and central banks will join forces to fight this common enemy. It means that, in the short run, there might be more search for liquidity, but as policy responses ultimately counter fear-driven flows, market technicals will improve.

Positioning

We are known not only for our conservative investment style, but also for our value-based, contrarian approach. Our view is that one should trim risk when the skies are clear, and buy risk when the storm has begun and markets panic. And, we believe that we have now reached the moment to reduce the underweight exposure to HY markets and to implement a long position in IG. This is the big sell-off that we have been waiting for – for years. We have moved the beta of our HY funds up to 1 and for investment grade to above 1. Once we see HY spreads well above 1000bps, we may consider adding more risk. We recommend that clients with a strategic horizon adopt a contrarian stance, as well, and that they add risk. We remind you of the fact that illiquidity works both ways: investing in a bull market will show disappointing trading results too.

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

Current spread levels equate to those of late September 2008 – a few weeks after the Lehman failure. If you bought back then, you had to endure negative mark-to-market volatility for 2-3 quarters, but then made returns of 16% in IG and 60% in HY in 2009, with further large cumulative returns during the long, subsequent expansion. In the early 1980s you had a few months to buy at these levels and in 2002 just one – and that was after all of the 9/11 shock, the dot-com bust with its 78% Nasdaq drop and corporate frauds. In all, just 19 months in the last 80 years have seen valuations at or better than current levels. We do not know whether we will trade at or wider than these levels for nine months, or less than one. The near-term looks set to confirm a deep recession and severe market pain in some quarters. We appreciate that it does feel like the worst time to add risk, but that is usually the best time to do so.

It is the end of one cycle as we know it. But that sows the seeds for a new one.

Guests:
We would like to thank the guests who contributed to this quarterly outlook with their valuable presentations and discussions. The views of Shobhit Gupta (Barclays), Nikolaos Panigirtzoglou (J.P.Morgan), Jim Reid (Deutsche Bank) and Rikkert Scholten (Robeco) have been taken into account in establishing our credit views.

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Additional Information concerning RobecoSAM Collective Investment Schemes

The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub-Funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website www.robecosam.com.