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Credit Quarterly Outlook Q4 2011

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In this issue

Fundamentals:

- **Risk of a recession has increased**
- **We are still in the aftermath of the debt supercycle, resulting in below trend growth for a prolonged period of time**

Valuation

- **Credit markets price in a recession, investment grade credit the** most

Technical:

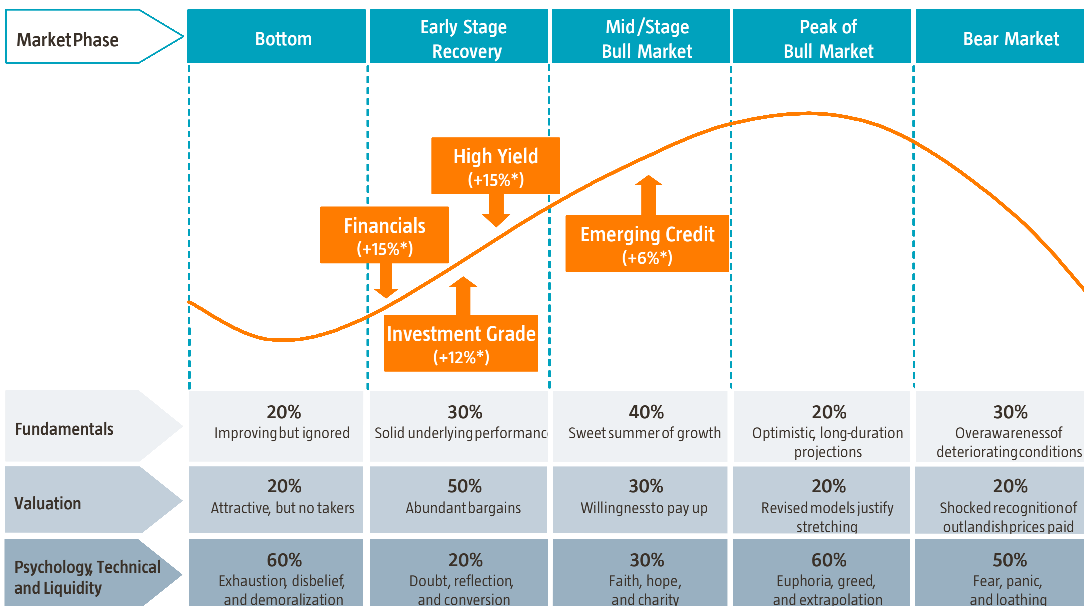
- **Clearly, political risks are the most pressing. Division among politicians and possible policy mistakes are depressing investor confidence**
- **Market liquidity is likely to stay low, causing huge swings in spreads, and being contrarian is more important then ever**

Division leads to inaction *– The current slow down in economic activity fits in our long-term view of a prolonged period of below trend growth in a deleveraging world. With central banks and governments now having exhausted most policy measures, the outlook for growth is grim. Austerity hurts, but balance sheet repair and financial conservatism is the name of the game for some time to come for the private sector as well as governments.*
On a more positive note, corporations and banks are in a much healthier position now than in 2008. Margins, cash balances and debt profiles are as healthy as ever. On top of that, CFOs behave very conservatively: the average CFO behaves like a bondholder.

The investment grade market reflects a full blown recession. High yield is cheap too, and less exposed to peripheral risk. With respect to emerging markets, we are not so certain about their 'safe haven' status. It is a very crowded, long-risk position.

Technically, we share the markets' fear that policy makers continue to make mistakes .They have been behind the curve all the time and only seem to act when markets panic.. However, we believe that this crisis will in the end be solved by fiscal adjustment (in multiple small steps). Politicians can no longer afford to continue to be as divided as they are now and international pressure is mounting. As market expectations are already very negative, almost any solution is an improvement to the current deadlock..

For both investment grade and high yield markets returns that exceed 10% on a 1-year horizon are feasible. We will be overweight beta with a beta-usage from 25% up to 50% of the maximum. For emerging market credits, we fear the crowded positioning and perceived low-beta character. We remain beta-neutral at best.



Source: Morgan Stanley, Robeco

* The percentages in the graph are expected returns over a 12-month period, based upon a normalization of currently elevated spreads back to their respective historical third-quartile spreads, and unchanged government bond yields.

Fundamentals

The private sector has now really started its deleveraging process. In the US, debt levels are falling. We reiterate that this will be a long-term process. Many years of policy mistakes by smoothing recessions with ever lower yields never brought the recession needed to wash out excesses. Every upturn started with more leverage. On top of that, the era of low inflation driven by cheap labor in Asia made consumers highly confident, resulting in too much consumer debt. These times are behind us now, the debt super cycle has burst.
In the aftermath of this cycle there is less room to spend, capping consumer spending growth effectively to income growth. This in turn depends on labor market improvements. This situation is going to take many years and will cause multiple 'soft patches' or even short recessions along the way. Markets will keep reacting violently to these cycles, because growth matters a lot in an indebted situation. It looks like Japan but…

Compared with Japan's lost decade, there are some important differences that bode well for the US. Demographic trends are much better. There is a better trend in dependency ratios. Also, the cleaning up of bank balance sheets has been done faster, hence preventing the existence of the notorious Japan-style zombie banks. Another positive for the US is that the residential construction recession is already equal in size to the sector's pre-bubble overinvestment boom. However, the issue is with the situation of zombie mortgages. People in a negative equity situation find it difficult to refinance and thus move. On the other hand, any recovery of the housing sector will immediately cause additional growth considering the extremely low level of construction activity currently.

In Europe, the economy looks worse than in the US. Multiple austerity packages push the economy down even further. Other European countries need to become more competitive relative to Germany in order to remove structural imbalances. This means painful wage reductions and structural reforms. This process has successfully started in Spain and Ireland. Greece and Portugal are taking painful measures too, but have started too late. Italy is one of the better positioned GIIPS countries despite an increasing current account deficit. It already runs a primary surplus and tries to have a balanced budget in 2013. However, it lacks a credible government. All in all, in Europe the economic situation is more vulnerable than in the US.

The result of the balance sheet recession is reflected in balance sheets of US banks. Like the Japanese, US banks are very wiling to lend, but there is hardly any demand for credit! This is the main difference with a normal recession. US banks are very liquid. While European banks have recapitalized, more work has to be done on the funding side. Like our US counterparts, in Europe we need much lower loan-to-deposit ratios and thus smaller banks and bigger capital markets. This process has started and will now be accelerated by the French banks.

With respect to Greece, the most likely outcome is a debt restructuring with Greece remaining within the euro zone. Processes of defaulting sovereigns are likely to be messy. We point out that market prices already reflect restructuring. Also, there are signs that countries such as Spain and Ireland will not suffer from the level of contagion the market fears. A well organized plan regarding Greece, plus some ring-fencing of the other countries could very well be a success story. We at least believe that the current muddling through is worse for capital markets. By the way, Greece exiting the euro zone would be a mistake. It would cause too much uncertainty for the EMU, and for Greece it would not solve its lack of competitive powers due to the likely high inflation levels that result from a weak currency.

One of the main reasons why we believe the downturn will be less deep than 2008 is corporate leverage. For example, high-yield leverage is at only 3.2 times (net debt to EBITDA), which is the lowest point in 15 years. Even some expected reduction in profitability does not change this picture. Even better, corporate CFOs are still behaving very conservatively, which is beneficial to bondholders. A strict focus on the term structure of the debt profile, reluctant dividend increases and cheap labor bode well for the default cycle. Even banks have increased their cash holdings dramatically in anticipation of Basel III. Basically, Basle III has already done its work pushing the big banks for more liquidity and capital long before January 2013. Be aware that no capitalization is high enough to be able to bear a binary sovereign default.

In the meantime, another fire sits simmering on the back-burner. It may not drive markets tomorrow, but demographic trends start to hurt. The huge investments in production capacity of the last decades were caused by a growing working-age population in Asia. This population trend has now played out for many countries like for China, although India is the exception. With emerging markets experiencing a growth of the middle classes, these countries are now becoming a source of global demand. A more inflationary period is ahead of us, with upward pressures on commodity and food prices. In the meantime the developed world is busy deleveraging.

Valuation

Valuations have become much more attractive. In the second quarter we reduced our beta, but if anything we have underestimated two things last time. First of all, the reaction of financial markets to the current economic slowdown has been much more aggressive than we anticipated. Second, the tragic disagreement of policy makers in Europe and the US (remember the debt ceiling debate) caused spreads to move dramatically wider. In the mean time spreads have increased so much, that we feel that the risk of being underweight has become bigger than the risk of being long. Within most asset classes or sectors we find bargains and elements of demoralization or disbelief. This all points to a positioning a lot lower on our market cycle curve for the different sector blocks. We believe its time to be long risk and we believe corporate fundamentals are actually diverging from valuations. When credit spreads move back to around third quartile historic spreads over the next 12 months, return over 10% are feasible.

To us it is obvious that investment grade credit is cheap, especially for core Europe. With senior financials above the 2009 levels and corporates a long way to these levels, we do not want to be neutral. For high yield the picture looks a bit less compelling at first sight, but there is more. The current European high yield market is of a much better quality and diversification than in 2008 and 2002 (TMT bubble). The average quality is also above US high yield. Therefore we think both European and US high yield are very attractive now. With respect to emerging markets we see more drawbacks. It probably is the most crowded fixed income position to be long emerging (credit)debt. We have a low conviction that emerging markets can successfully decouple from developed markets. Finally, last months we noticed a stream of corporate governance issues (fraud) in emerging markets that make credit investing more risky than the current spreads imply.

Despite the US economy having less downside, we prefer European assets since valuations are so compelling.

We remain cautious on the periphery. We think more proof is needed for our old thesis that Spain and Italy really are a different case compared with Greece. Our long beta positioning for investment grade credit is centered in the North of Europe.

Technicals

We quote the Bank Credit Analyst by saying that ‘vicious circles of debt crises, policy paralysis and a sickening banking system are intertwining with the bleak secular trend of debt, deficit and growth stagnation’ to create complacency and despair. This is exactly what we are experiencing. Clients move into safer assets, risk managers are all around and confidence in counterparties is gone. On top of all this, Basle III regulation, even though it is improving bank solvency, it diminishes trading books at the brokers. This means that liquidity is even worse than it otherwise would have been. Trading costs are high and one really needs to be contrarian. This policy paralysis is the market’s biggest enemy now, even more so than the looming recession. It is yet another reason that makes the future path a bit more binary. We have seen signs of fatigue and demoralization in the market. This is often a sign that we have seen the bottom. It feels like early 2009 when the markets were tired of policy inertia, but started to turn for the better after a string of policy measures that had been ignored earlier.

Another risk is the ECB. We do not doubt its ability to buy treasury debt. The pockets of a central bank are very deep and not restricted to their capital base. It is clear though that even within the ECB there is no unanimity about the willingness to support bond markets. The much discussed potential use of leverage to increase the effective capacity of EFSF will need ECB approval as they are the intended leverage providers. It remains to be seen how the ECB feels about that (what about the Germans?).

There are positive trends going on too. The solid liquidity position of corporates and even many banks make net supply very low to negative. Actually, the financing gap is very positive. Corporates generate enough cash after investments. This time, the corporate sector is ready for some headwinds, while it was surprised in 2008. That is the biggest difference with 2008, and risks are well flagged and, in our opinion, mostly priced in for risky assets.
Robeco’s sector credit analysts do not foresee a widespread risk of a big recession from their bottom-up analyses. The outlooks given by car manufacturers remain positive. The lodging sector also still sees a healthy order book for conference bookings, which is a good sign. Electricity usage is still growing, although at a low level, supporting the growth regime we forecast.

The trend of pension funds allocating away from equities into bonds (whether forced by regulators or not) seems to continue. Demographic trends support this. This is a long term positive. We believe that the search for yield will resume once the worst political stress abates, and investors will once again acknowledge the fundamental strength of corporate credit.

Conclusions

We are in a crisis of confidence. A surprising economic slowdown and quarreling European policy makers made things far worse than expected. In the mean time, corporate fundamentals continued to improve. Any limitation to the sovereign contagion will cause risk premiums to move lower. We think we are at, or close to the bottom of this very short credit cycle.

Guests

We would like to thank our guests who contributed with valuable presentations and discussions to this new quarterly outlook. The views of Véronique Riches-Flores (Société Générale), Matt King (Citi), Nikolaos Panigirtzoglou (JP Morgan) and Rikkert Scholten (Robeco) have been taken into account establishing our central view.

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