ROBECO

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Credit Quarterly Outlook Q2 2012

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In this issue

Fundamentals:

- **Weak growth outlook for all regions of the world**
- **Deleveraging cycle not even close to an end**

Valuation:

- **Valuations in investment grade credit still cheap due to banking sector**
- **High yield valuations fair at the moment, Europe has better credit quality**

Technical:

- **Lower tail risks for banking sector and GIIPS countries due to LTRO**
- **Low supply expectation good for investment grade market; this does not hold for high yield**

Addicted to China

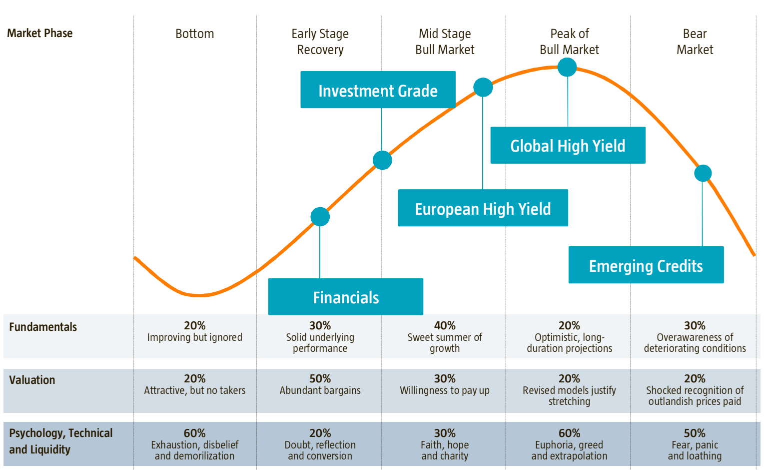
Fundamentally, the world is full of imbalances. The most famous one is the trade imbalance of the US with China (and many more trading partners by the way). A second one concerns the differences in competitiveness within Europe (North versus South). A somewhat less known imbalance we want to point out is the investment and debt bubble in Emerging Markets and China in particular. The Chinese need to invest less and consume more to keep the economy growing on a more sustainable basis. In the meantime several other emerging markets have become addicted to the Chinese growth engine (imports of commodities). Finally, countries such as Sweden and Germany are also highly geared to China, and the rest of Europe to Germany. We believe risky assets will suffer when the Chinese economic miracle starts to show growing pains in the next couple of quarters. This means that the big deleveraging cycle we are in might become more painful when the biggest growth engine of the world has to cope with its own debt bubble.

As for valuation, we still prefer euro assets to dollar assets, albeit to a lesser extent than three months ago. We have become much more conservative towards core European cyclical companies such as German automotives because of Emerging Market concerns. In addition, GIIPS credits have become a lot more expensive and there is no need to chase them any longer.

Technically, we believe risks have come down significantly. We do not want to underestimate the ECB's LTRO impact. Supply for the financial sector will be negative on a net basis and inflows continue. This means tail risks are much lower despite a very sluggish growth outlook.

For investment grade credit we see more spread tightening potential and maintain our beta overweight of up to 25% of the maximum. The overweight is concentrated in the financial sector. For high yield we feel more comfortable with a defensive position as the upside is capped. For emerging market credits and high yield we will be underweight beta with a beta usage of -25% to 0%.

Mapping our view on Market Segments



Source: Robeco, Morgan Stanley

Long-term view*

The Robeco Credit Team believes developed countries have entered a balance sheet recession (a recession with at the same time a debt burden problem) like Japan. This means the private sector has to digest the debt pile taken on over the last 20 years. At the same time an important cause of this debt driven cycle, the (competitive) imbalances between countries relating to balance of payment imbalances, needs to be solved. For some countries it means households should start saving and in other countries it is the corporate sector. Recently, after assuming a big part of the private debt, many governments have started to (try to) reduce debt too. Our central case is that Europe will integrate further but we still expect a lot of volatility and disappointments in the decisiveness of policy makers ahead of us. This is part of the deleveraging cycle just like in the more frequent shallow recessions. We expect capital expenditure and GDP growth to disappoint too. The banking system will become smaller and inflation will remain low. Central banks are virtually powerless to stimulate growth via traditional interest rate policy. This deleveraging trend is good for credit and risky assets but the accompanied repression of real yields by central banks will end in tears. The search for yield and client inflows will be dominant themes. Finally, we believe the same kind of debt bubble has been built in emerging markets. It seems increasingly likely that China is at a crossroads of history. Drastic rebalancing between consumption and investments is necessary to keep growth sustainable.

Changes to the long-term view

We strongly believe we are still experiencing the aftermath of a balance sheet recession. In fact, many problems such as current account imbalances and the sheer size of debt levels in the private and public sector have even deteriorated. The biggest change in our view is our concern about emerging markets. On a more positive note, debt service levels are decreasing fast in the US suggesting private leverage is no longer problematic. Driven by lower yields and debt forbearance, households have deleveraged more than we had expected. Accompanied with faster employment growth, the US might surprise us on the growth front.

* Apart from our outlook for the quarter, for the first time we present separately our Long-term view in the CQO, including any changes to it, since the previous quarter.

Fundamentals

In the US, growth seems to stabilize at a low level. We already fear the fiscal adjustments that will need to be implemented after the elections. Growth might become vulnerable by that time. On the other hand, this will be a 2013 event. The US employment situation is slowly improving. There are side-effects such as a vast amount of discouraged workers leaving the labor market and an ageing population decreasing the labor pool. This makes the employment recovery a little less bright. On the investment side there appear to have been small increases in capital expenditure recently.

Company leverage is still falling. However, in the margin we see a little more capital expenditure putting some pressure on free cash flow. The record high profit margins are stabilizing as well. If the stock of capital starts to increase for real, return on capital will have peaked.

For Europe, things are a bit different. Economic recovery is basically absent. The only healthy man in Europe is Germany. Differences within Europe are big. Most concerns are related to Southern Europe. Austerity hurts and more austerity is still necessary. It remains to be seen whether policy makers will continue to feel the pressure to keep pushing for economic reforms. Nevertheless, many governments in these countries are at least stable now.
The ECB's LTRO scheme helped reduce tail risks a lot. Basically, it is hard to see that by now a bank could still get in problems due to funding issues. Further deleveraging can happen via the natural attrition rate of the loan book. There will be no forced selling of assets and profitability (and thus capital) will be boosted.

The biggest change compared with last time is our concern about emerging markets. It starts with an investment boom in China that on all measures looks stretched to say the least. Just to keep GDP growth stable, China needs an ever bigger contribution from construction and investments. As construction and investments already account for around 50% of GDP this is a challenge. On top of that, several emerging markets have become addicted to shipping commodities into China. This makes these countries vulnerable. The investment boom has been accompanied by a sharp increase in debt levels. Whether looking at bank assets as percentage of GDP or at official plus unofficial estimates of government debt, China also seems to have excessive debt levels.

Solving these imbalances will not be easy for China. Savings rates (as a percentage of GDP) seem to increase even further. The complexity of the situation is increasing. China suffers from excessive credit growth, and a monetary system that is not ready for a modern economy. For instance, state-owned enterprises have privileges and banks suffer from guided lending. Furthermore, the labor market is getting closer to the 'Lewis turning point' (a situation in which the supply of cheap labor becomes too small to prevent labor cost inflation). There is a complex interference of a property bubble, too low real yields and local governments that seem to be out of control. Time will tell whether this has been the biggest misallocation of capital.

Valuation

Senior unsecured bank spreads are still historically narrow. In the crisis of the past three years they have traded above industrial spreads but recently they have started trading closer to industrials. We expect a reversal to historical standards, which means they will trade below industrial spreads. Within industrials there is a lot of dispersion. We have started to reduce holdings in cyclical core European companies. They have become too expensive and in some cases they are even back to pre-crisis levels. Therefore we overweight financials versus industrials.

The huge rally in GIIPS credit makes us a bit more careful too. We will be cautious with GIIPS exposure since there are better opportunities elsewhere such as regulated utilities or financials. That said, we still like good companies in non-cyclical sectors in GIIPS countries.

With respect to high yield we believe spreads have tightened a great deal already. US high yield is considered fairly valued to slightly expensive. More than 50% of the market trades close to its call price and therefore capital appreciation is limited. As the upside is capped, we prefer to be positioned conservatively in order to be able to increase positions when new supply hits the market. In European high yield there is a risk premium to be captured. On top of that, the average credit quality in Europe is higher than that of equivalent bonds in the US market.

For emerging market debt, we are as cautious as we were last time. We are constructing a more solid portfolio with countries and companies that are slightly safer than the universe. The above-mentioned concerns about China and the addiction to China make emerging markets vulnerable. Valuations are not even our biggest concern for now. This also means that our integrated team of portfolio managers will reduce emerging market holdings in the investment grade portfolios. This includes Western companies that have a link to emerging markets.

Technicals

We do not underestimate the impact of LTRO. The biggest impact will be felt on the supply side of bank paper. Many banks will keep issuing from a reputational standpoint but in principle supply is expected to become heavily negative. This is supported by further deleveraging (shedding assets) due to Basel III regulations. On top of that banks can now safely redeem bonds that are callable if they want and even buy back bonds. We have even seen buybacks of covered bonds already. This drives spreads tighter. We expect stronger supply on the corporate side, especially as bank disintermediation drives these companies to capital markets for funding.

In some countries an increasing amount of (local currency) emerging market bonds is owned by foreign investors. While European banks are resisting lending more to emerging markets, bond investors pile in ever more into emerging markets. The risk is that many investors want out of these markets at the same time.

Last but not least, we want to point to the record low real yields. If we are right the current financial repression (governments pushing yields down via purchasing programs causing negative real yields) might well lead to an incredibly strong search for yield. We even expect trades from government bonds into credit just for yield pickup reasons. This is entirely normal in the first period of solving a balance sheet crisis. Later we can worry about the unintended consequences…

Conclusions

The biggest driver of risk premia in the last quarters was the tail risk that European policy makers could not solve the sovereign crisis. There is news: they have still not done this! This crisis will keep coming back until total debt levels really start falling. For the moment however, the introduction of the LTRO and some other policy measures have cut tail risks dramatically and have therefore bought time. This justifies credit spreads trading tighter and in general the presence of more upside. A new risk that will become more prominent over the next quarters will be the debt cycle in emerging markets and the large trade relations between Western economies and emerging markets.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Kevin Gaynor (Nomura), David Lubin (Citi) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.