ROBECO

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Credit Quarterly Outlook Q3 2012

By Sander Bus, Head of High Yield Credits
Victor Verberk, Head of Investment Grade Credits

In this issue

Fundamentals:

- **Intra-European imbalances are adjusting**
- **Near-term US growth outlook worse than consensus due to fiscal gap**
  Global deleveraging continues and causes macro volatility

Valuation:

- **Peripheral IG credit became much more attractive, less so for core Europe**
- **US high yield expensive compared with European yigh yield**
- **Emerging markets fairly priced but risks biased to downside**

Technical:

- **Broker inventories are very light**
- **Low supply expectation is good for investment grade market, does not hold for high yield**

Crisis, Response, Improvement, Complacency; Crisis, …

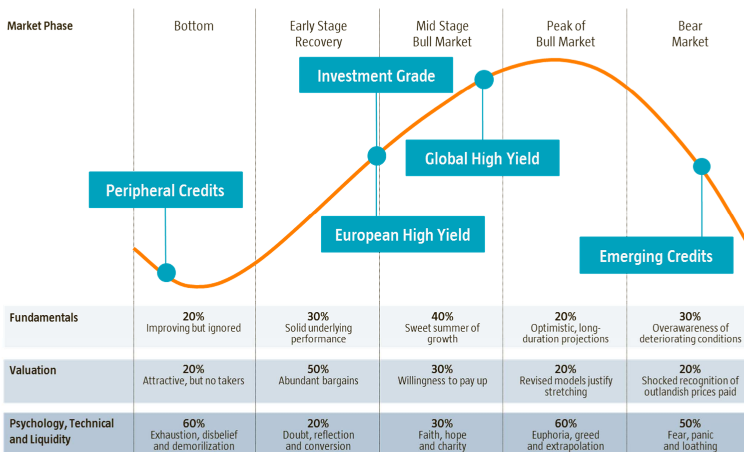
Financial markets are still coping with the unwinding of the debt super cycle. Deleveraging is a long-term positive for credit, but also increases macro volatility. Similarly to the 1930s we see short but fierce bear markets, followed by bull markets that could last 3-6 months. Dealing with the unwinding of the debt super cycle is more problematic in Europe due to a dysfunctional institutional framework. Hence, tail risks are bigger in Europe. Markets and policy makers find themselves in a so-called CRIC-cycle: Crisis -> Response -> Improvement -> Complacency. (The CRIC-cycle concept was introduced by Morgan Stanley.) Policy makers only take action when faced with an imminent crisis. The actions lead to temporary improvements and relief on financial markets, but complacency is then sowing the seeds for the next crisis. This cycle seems to unwind faster and faster. In Europe we go through this twice a year now. But each crisis gets us a step closer to the solution. We are actually starting to see improvements as current account imbalances within Europe are clearly shrinking and further fiscal and political integration is on the political agenda.

With respect to valuations we see that peripheral credits have become much more attractive. Therefore the risks of being underweight have increased. Core credit has hardly become more attractive. In high yield we see that Europe is still cheap versus the US. For emerging credit we find valuations only just fair.

Technically we see negative net supply of financials, which is a positive. For non-financials, IG supply will be modest. HY supply will be slightly higher, especially in Europe if and when markets recover.

For investment grade credit we see more spread tightening potential than for high yield and remain overweight beta of up to 25% of the maximum, while being close to neutral for the periphery. For global high yield we feel more comfortable with a neutral position, but want to be relatively overweight Europe. For emerging market credits we will run a neutral beta at best.

Mapping our view on Market Segments



Source: Robeco, Morgan Stanley

Long-term Credit Statement *

The Robeco Credit Team believes that developed countries are still struggling with the effects of the unwinding of the debt super cycle. 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, i.e. 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 expect a lot of volatility ahead of us. We see the first promising signs of a reversal of internal European (current account) imbalances. That said, the biggest risk has become capital flight and sentiment. Current account deficits of certain GIIPS countries are improving. A result of the deleveraging process is low economic growth and more macro-economic volatility with short recessions. 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 going forward. 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 in history. Drastic rebalancing between consumption and investments is necessary to keep growth sustainable.

Changes to the long-term Credit Statement

The biggest change to our long term view is that we finally see some signs of rebalancing within Europe. Strong Spanish export performance and weak domestic consumption are promising signs. On the other hand, confidence has deteriorated. This has resulted in capital outflows from peripheral Europe's private sector. The resulting funding gap is being filled by the central banks. This is illustrated by huge increases in Target2 liabilities on central bank balance sheets. Return of confidence is critical. Peripheral countries have made progress in reforming their economies. Now it is Germany's turn to restore confidence. Some form of banking and fiscal union is needed to break the negative feedback loop between sovereigns and banks.

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

Fundamentals

US growth is already leveling off. Labor markets do not show further improvements and consumer spending disappoints. The US savings rate has already come down to 3%, so there is very little room for a further decline as a source of spending growth. Low inventory levels have supported growth after the crisis, but this has reversed and the tailwind has gone. So the economic situation in the US is fragile. The fiscal cliff after the elections will not make things any better. It is our view that the US economy is not likely to grow by as much as the consensus estimate of 2-2.5% in 2013.

In Europe, economic growth is completely absent, but that is not the main market concern. People are desperately waiting for policy makers' next steps. What is needed is a credible roadmap towards further European integration, starting with some form of banking union. Joint European banking supervision is the most logical next step. A joint deposit guarantee scheme is less likely in the short run. At least sovereigns should be immunized from banking problems to avoid the Irish example where the sovereign was dragged down by banking sector problems. It is unrealistic to expect a full all-in solution anytime soon. We will move from crisis to crisis and slowly move towards a final solution. We believe that this solution will ultimately take place simply because the cost of failure is too high. As the private sector in core Europe has reduced exposure to southern Europe, the central banks are at the other side of the equation. Target 2 liabilities which measure the claims of central banks on each other are spiraling higher. Finland, the Netherlands and Germany now have Target2 liabilities worth close to 30% of GDP. It is clearly in the interest of the core to help the periphery.

It is very relevant to realize that this European struggle happens against the background of a deleveraging process. Balance sheet repair is the name of the game and it is a positive for credit. Corporate profits as a share of GDP are at an all-time high.

In our previous quarterly outlook we described our worries about imbalances in the Chinese economy. These worries have not gone away. We have seen a further slowdown of economic activity in China, but there are no signs that the slowdown is getting out of control. As credit investors we prefer to avoid companies that depend too much on China. Emerging markets in general are not able to decouple from economic weakness in the developed world.

To conclude, we have become more concerned about a synchronized recession in all major economic blocs in 2013. For the periphery, adjustments in current account imbalances have started to reverse but a capital flight is the biggest concern now.

Valuation

Spreads have widened during the past three months, although there was a huge dispersion within the market. The entire underperformance of European investment grade spreads compared with the US was caused by peripheral credits. Core European credits, which widened by 11%, even marginally outperformed US credits whose spreads widened by 18%. Peripheral credit was the underperformer. Spreads widened by 69% in the last three months.

A breakup of the euro zone is absolutely not our central scenario, but if that were to happen the core of Europe would suffer as much as the periphery. We therefore believe that the huge valuation difference between core and peripheral credits no longer warrants an underweight position in the periphery on the condition that we find enough companies that pass our underwriting requirements.

Within high yield we still believe that European high yield offers great value. The average credit quality in Europe is better and still spreads are higher. In Europe we also see more conservative behavior by management teams as they are keen to have business plans fully funded against the backdrop of the large political uncertainties.

Emerging market corporate spreads have widened in line with high yield in the last three months. We see emerging market valuations as fair at the moment. They are still not cheap. So, for emerging market debt we are as cautious as we were last time. We construct a more solid portfolio with countries and companies slightly safer than the universe.

Technicals

Market technicals have not changed that much. An important dynamic is the negative net issuance of senior unsecured banking paper. Banks are funding themselves through other means such as covered bonds, the ECB, shrinking balance sheets and preferably via deposits. Investors do not have much appetite for senior unsecured bank debt either. The prospect of potential burden sharing for bonds with maturities later than 2018 is not enticing investors. Shrinking bank balance sheets also mean that companies will be increasingly forced to tap the capital markets. For IG companies most of the funding is already carried out via the capital markets so there will not be a big change. Smaller high yield companies will need to tap capital markets more often. In the longer run, this will result in growth of the European high yield market.

Investor sentiment seems to be relatively negative. We view this as a contra-indicator. It is not a bold statement to say that most international investors are probably underweight peripheral credit by now. The marginal seller has gone and the market could see a short-squeeze if and when policy makers would surprise to the upside.

Another technical that is here to stay is the relatively low market liquidity. The main reason is the lessened ability of the broker community to warehouse and transfer risk due to a more stringent regulatory environment. This is illustrated by broker inventories that have dropped by 79% post-Lehman. Lower liquidity means higher volatility as the street is unable to cushion price swings. On a more positive note, the lower broker activity also offers opportunities for investors. Illiquidity also results in relative value opportunities.

Last but not least we want to reiterate the fact that record low risk-free yields will lead to a strong search for yield. We have seen evidence of investors switching from government bonds into credit. It is also noteworthy that we have hardly seen any outflows in credit in the last three months despite the negative market tone.

Conclusions

In our view, the biggest driver of financial markets continues to be the unfolding of the European sovereign crisis. This crisis will keep coming back and we will probably need to go through the CRIC-cycle many more times before we will have reached a sustainable solution. A bigger than anticipated slowdown of the US economy post elections is a new risk that will probably get more market attention in the coming months. Emerging markets are not able to decouple from developed markets and are not the safe havens some investors think they are. So, there are several uncertainties. The biggest positive is the fact that corporates are still doing fine. Balance sheets are healthy, management teams behave conservatively (mainly in Europe). Deleveraging is good news for credit investors and leads to a secular bull market. For our portfolios we wish to stay relatively close to home with betas close to 1 for high yield and emerging debt and slightly above 1 for investment grade. For the first time, we no longer advocate an underweight position in peripheral credits.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Erik Nielsen (UniCredit), Roberto Henriques (J.P. Morgan), Neil McLeish (Morgan Stanley) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

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