ROBECO

September, 2012

For professional investors only

Credit Quarterly Outlook Q4 2012

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

In this issue

Fundamentals:

- **Fundamental backdrop is weak, and hardly any improvement is expected**

Valuation:

- **Most attractive: peripheral credit , financials and some high yield sectors**
- **Emerging markets fairly priced but risks biased to downside**

Technical:

- **Financial sector is truly in buy back modus, strong tightening pressure**
- **Do not fight the Fed, ECB, MPC, nor the BOJ...**

QE squared!

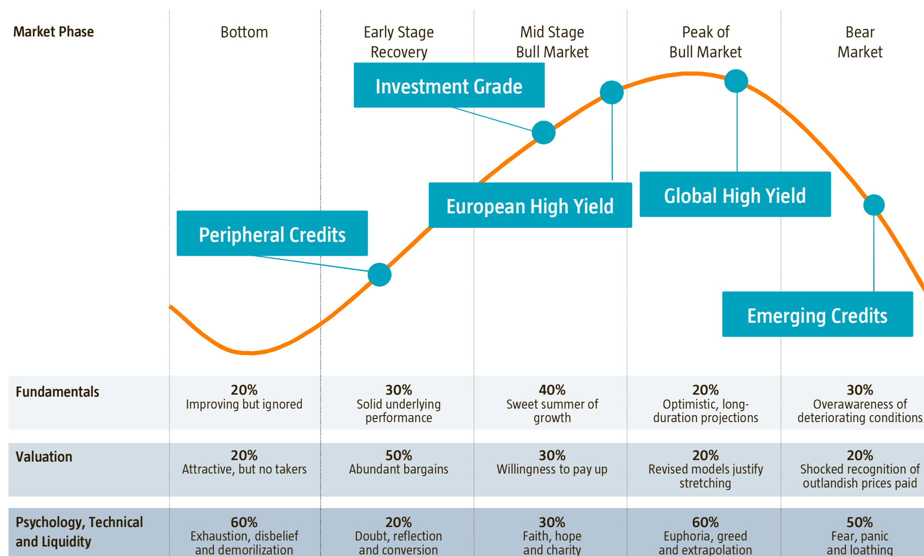
The aftermath of the burst of the debt super cycle causes low to no growth, no inflation and hardly any job growth. This makes the healing process painful since the choice is between austerity now or restructuring over time. The pressure will remain on politicians for many years to come. The CRIC-cycle (Crisis, Response, Improvement, Complacency) clearly has reached the improvement phase thanks to the ECB and the latest EU summit in which good plans were issued. The next phase is complacency though. We monitor policy makers' actions and will not be surprised to see a complacent period again. It is critical that policy makers continue the good work via a banking union and further fiscal and economic integration. Otherwise, in the long term there is no euro.

If we are correct that tail risks have become smaller, peripheral spreads and financials should trade tighter and with lower volatility. Core European (German cyclical) credit has become more expensive, especially on the long end. Steep government and credit curves make the roll down the curve effect a big contributor to total return. In high yield we overweight the European versus US market. For US high yield, investors start to "pay up for risk". For emerging credit we find valuations only just fair.

Technically we see negative net supply of financials, which is a clear positive. Tail risks have dropped since central banks around the world took the lead and keep pumping unlimited liquidity in the system, QE squared! The consequences of this will be a distant future problem. For now this supports asset price reflation.

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

Credit Quarterly Outlook: the Market Cycle - mapping our view on Market Segments



	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

Long-term Credit Statement *

Current 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. Europe shows signs of further integration with the upcoming ESM and maybe a banking union. It could well be that tail risk will be lower going forward. Still we expect a lot of volatility ahead of us driven by political disappointments and lack of growth. 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. Going forward, the remaining themes of the search for yield and client inflows are met by a shrinking (Investment Grade) market. 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 recent improvement in peripheral credit has not been driven by economic improvements. It has been the ECB that finally showed the bazooka in the form of unlimited potential bond purchases. If the politicians act responsibly, and complement this with a swift execution of the ESM and banking union, it could well be that tail risk in GIIPS risk gets lower. Capital markets have opened for GIIPS risk again, even for Irish utilities. At the same time we are wary of complacency in the political arena. Finally, the debt cycle predicts a complete lack of economic growth, putting all hopes in the hands of politicians to keep reforming for many years to come.

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

Fundamentals

The economy is in dire straits. It does not matter where one looks. Europe is in a recession. The southern part of the eurozone is in a real slump with unemployment still rising. On top of that Germany clearly shows signs of moderating growth. This means the locomotive of the European economy is showing signs of weakness too.

In the meantime the ECB put a temporary floor under the market with the potential unlimited purchases of peripheral government bonds. This has given the politicians some more time to continue rebuilding the European house. Building new institutions like the ESM and central oversight on banks is critical. A banking union and some kind of deposit guarantee system needs to be drafted. We fear that the politicians need another crisis before they will be urged to finish the draft of a banking union.

In the meantime some countries need deep reforms of their economy. We think lowering pension ages, increasing taxes and skipping labor market reforms, like is happening in France (although for a small selected amount of people) is NOT the correct way forward. It sets a wrong example to the Southern part of Europe.

Other problems are on the horizon in the US. A lower participation rate in the labor market hides a standstill in total employed American workers. A fiscal cliff is coming in sight. The US really needs to start to get their public finances under control. It can cost the US economy more than 1% potential output if it succeeds, but potentially even more if it does not succeed to reach a sustainable debt level.

In the US, there are also some positive signs to be mentioned. The inventory cycle is marginally better. That makes the quality of growth a bit better. The housing market has really started to recover. If house prices keep rising that is good news for banks and potentially for the construction sector. More good news for the financial sector comes from the drop in delinquencies and foreclosures.

Debt forbearance has lowered household debt-to-GDP. This deleveraging trend has caused US household debt levels to look more sustainable (and back to trend). This might cause a surprisingly strong US consumer. We have had a long debate about the upward trend in leverage for the US economy since the 1980s. Many economists question this upward trend to be sustainable. In any case we believe total debt levels will have to come down.

The situation for emerging markets has not improved either. The Chinese construction sector threatens to cool down too much, pushing China into a new and much lower growth era. In the meantime there are geopolitical tensions with Japan and a switch of political powers that seems not to go smoothly. The trade balance (exports) of its Asian trading partners is worsening, a clear sign of slowing growth in China. There are also geopolitical risks around Israel/Iran and Syria that might be overlooked.

The conclusion on fundamentals is not positive. Hardly any growth, the risk of deflation and questionable outcomes of central bank interventions are not things to be excited about. However, it seems that technical factors matter more now and these are very supportive.

Valuation

In general credit markets have rallied and spreads have compressed by 30% over the last three months. Clearly this makes credit less attractive. The US high yield market is even entering the phase we call "paying up for risk". The bright spots are peripheral credit and financial credit.

We follow the peripheral to non-peripheral spread ratio to estimate value. This ratio has traded up from 1.6 to 2.6 in the last 12 months and is currently back at 2.1. If we are correct that volatility stays a bit lower for now, this market should benefit more. With respect to financials, spreads are still cheap, fundamentals continue to improve, capital levels increase and funding gets better. Return on capital is currently low, but we are in business for return of capital and that is getting more certain every day.

Another topic we would like to address is credit curves. Government, swap but also credit spread curves are very steep, making break-even levels high. This means that the roll down the curve effect is a big part of total return on a 1-year horizon. Several 5- year corporate bonds generate returns from rolling down the curve as high as their yield-to-maturity. On the other side we notice expensive cyclical core (German) European issuers taking advantage of strong markets to issue longer term (10-year) debt. At current tight spreads one is vulnerable for even just a small spread widening. Of course this all assumes that curves remain unchanged for the next 12 months.

For high yield it is worth noting that he leveraged loan market now trades at a wider spread than the public market. The biggest part of US high yield now trades above par prices. Also, 70% of the market trades to the call price. This means upside is limited. There are strong signals that high yield issuance is getting more covenant-lite. Within covenant-lite there is a trend to more issuance of the really weak covenant packages. If this trend continues, it is a negative sign.

The conclusion for valuation is that it clearly got less attractive. We favor financials, Europe and peripheral risk for a bit longer, but with less outspoken positions. We are fully aware that if we end up in a complete Japanese situation spreads can go much tighter. It is just a scenario we take into account and makes us wary to put on short positions.

Technicals

We had an in-depth discussion on the consequences of a Greek exit. Although this event might have been pushed to the background for now, it is a very interesting technical case to study tail risks. The word tail risk must have been the most used word in our recent session anyhow. In summary, a Greek exit would have the following consequences; imploding exports due to lack of export credit, failing banks, a further falling apart of public tax collection and institutions, deposit flight, introduction of IOUs ('I owe you'), social unrest and maybe even geopolitical risks when Russia or other countries take up financing Greece. In the end it might cause a humanitarian disaster. In that case Europe needs to help after all. So, whether one likes it or not, in all likelihood Europe keeps paying for Greece for much longer. The chances of a second Lehman-type event are just too big to take. In this situation, contagion and potential capital controls for Spain and Italy would complete the created mess. This discussion is almost a theoretical exercise, but we do hope the politicians will not take this route. Primarily, we would fear an unknown technical contagion.

The biggest beneficiary of lower tail risks will be the financial sector. The sector is already enjoying a 9-quarter strike of solid earnings in the US. More tailwind is coming from lower provisioning, better and cheaper funding and maybe a bit better demand for loans (in US). Last years the Northern-European banks have offloaded peripheral exposure a lot (to central bank funding). Already we see a continued trend of buybacks of wholesale debt (both senior and subordinated). This will further enhance scarcities of investment opportunities and decent yields for investors.

In many aspects, the last months have shown that an investor needs to be contrarian and be very aware of positioning and flow of funds. Opposite to expectations, European credit outperformed US credit, the basis got positive, French government bonds rallied and credit market reactions to sovereign stress seem to soften. The market's pain trade is a continued tightening for peripheral credit driven by the market's underweight positioning. We are wary of that and therefore do not want to be short. However, we do search for signals that the consensus has turned and shorts have been covered.

Finally, if one takes a helicopter view, it is clear that most central banks are flooding the system with liquidity. It takes on different forms (direct quant easing or LTRO) but the result is a huge expansion of central bank balance sheets. The Federal Reserve, MPC, ECB and BOJ all try to reflate financial assets. Bernanke, in what could be seen as a historical comment, even explicitly said that a 1930s deflationary scenario needs to be circumvented. This enormous execution of quant easing and interest repression is supporting financial assets in all forms; this is quant easing squared.

The conclusion for technicals is that while our central case for now is more fiscal integration and at least a less volatile period, there are enough potential tail events remaining. Chinese imbalances, the US fiscal cliff, European leaders disappointing, German recession or geopolitical stress all have the ability to scare markets.

Conclusions

The next chapter in the saga of the debt super cycle is more of the same. Around the world, the economy is weak or weakening. Labor participation is dropping and all kinds of bearish scenarios are possible (fiscal cliff, China and peripheral recessions). Still it does not matter for now. The market is in a delicate equilibrium between fundamentals and technicals. The Fed, ECB, MPC and BOJ are really pushing liquidity in the system to generate asset price inflation, quant easing squared. For now this works, negative consequences are a concern for later. Tail risks have come down a bit in Europe but complacency looms around the corner. In the near future further recovery in peripheral and financial spreads will lead indices tighter.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Jan Loeys (J.P. Morgan), Michala Marcussen & Dirk Hoffmann-Becking (SocGen), Hans Lorenzen (Citi) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

Important information

This document has been carefully prepared by Robeco Institutional Asset Management B.V. (Robeco). It is intended to provide readers with information on Robeco's specific capabilities, but does not constitute a recommendation to buy or sell certain securities or investment products.

The information contained in this document is solely intended for professional investors within the meaning of the Dutch Act on the Financial Supervision (Wet financieel toezicht) or persons which are authorized to receive such information under any other applicable laws.

The information contained in this publication is not intended for users from other countries, such as US citizens and residents, where the offering of foreign financial services is not permitted, or where Robeco's services are not available.

Investment decisions should only be based on the relevant prospectus and on thorough financial, fiscal and legal advice. The prospectuses are available on request and free of charge from www.robeco.com.

The content of this document is based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness. This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Historical returns are provided for illustrative purposes only and do not necessarily reflect Robeco's expectations for the future. The value of your investments may fluctuate. Results obtained in the past are no guarantee for the future.

All copyrights, patents and other property rights in the information contained in this document are held by Robeco. No rights whatsoever are licensed or assigned or shall otherwise pass to persons accessing this information.

Robeco Institutional Asset Management B.V., Rotterdam (Trade Register no. 24123167) is registered with the Netherlands Authority for the Financial Markets in Amsterdam.