

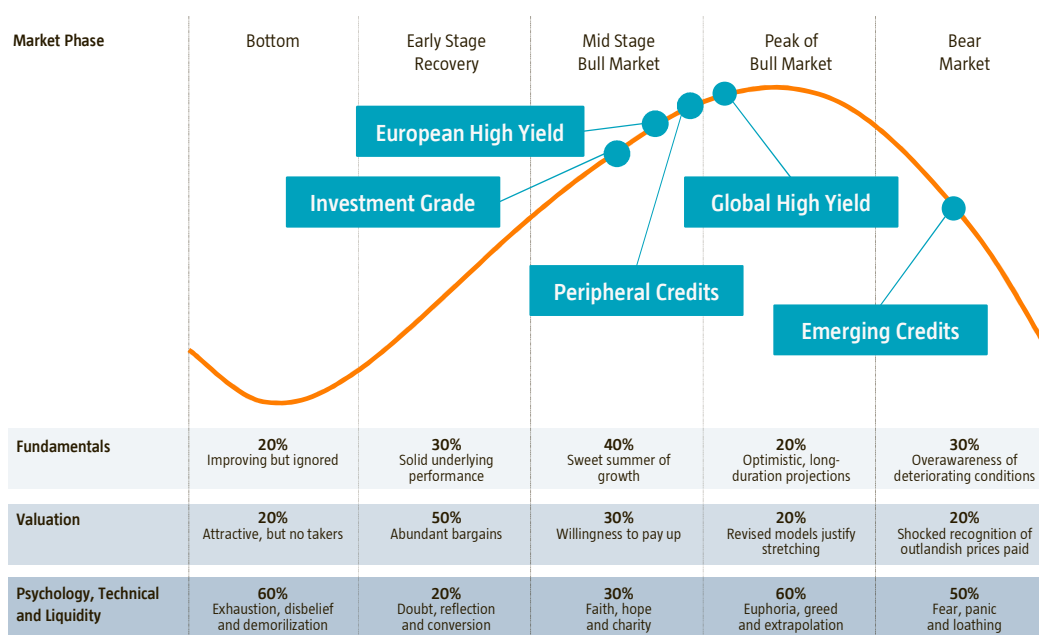
# Credit Quarterly Outlook Q3 2013

Tourist investors

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Credit Quarterly Outlook: the market cycle



Source: Robeco, Morgan Stanley, June 2013

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# Tourist investors

Fundamentally things have not improved since our last quarterly outlook. Economic growth is stable at best. While the US outperforms, the rest of the world is still struggling with the great recession.

Europe clearly is in dire straits. Even German growth has slowed and might even be hurt more if emerging market growth slows and the yen weakens. The periphery is still fighting the balance sheet recession, especially Spain. A big internal devaluation is necessary to deal with negative growth but total nominal debt claims might be too high to service. Chinese leadership might have accepted short term pain for long term reforms but it remains to be seen how the market reacts to potentially much lower growth than expected.

Valuations have remained the same or have become a bit more attractive since the last quarterly outlook. Emerging credit is somewhat the exception, having widened more (+25%). The issue we have here is that corporate fundamentals are deteriorating. Corporate balance sheets are re-leveraging while earnings are deteriorating slowly. Driven by liquidity, credit spreads are deviating from fundamentals further.

That brings us to the key topic: liquidity. Central banks around the world have been adding liquidity to the market. This has repressed fixed income assets and in the end pushed even equities and commodities higher. This has caused many investors to buy risky assets they did not want in the first place; tourist investors were born. When these investors exit the market, they will be met by record low risk appetite and trading inventory at banks.

The positioning of the portfolios will not change. High yield will be as close to neutral as possible without buying unsustainable businesses (e.g. CCC). For investment grade we remain neutral while being underweight periphery. Emerging markets remains short as we expect more spread widening. In general we think risks are more balanced now between fairly attractive spreads and a number of tail risks in the global economy.

# Fundamentals

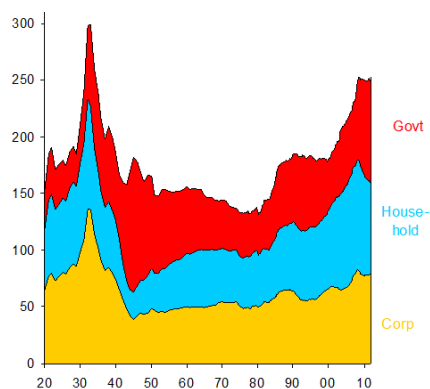
The macro-economic situation has not changed. The US outperforms the rest of the world and seems to have found the best answer to this great recession for now. The budget balance has even started to improve too, driven by profit distribution of the US agencies and the automatic federal budget cuts (sequestration). Like Bernanke stated, downside risks to the economy are slowly decreasing. This might bring the Fed from 'mega exceptional stimulating' to just 'exceptional stimulating' in the next quarters by tapering quant easing. However, let's not forget that the Fed expects a minimum amount of quantitative easing (QE) over the next 12 months as big as the total of QE 2. On top of that the Fed does not rule out that any weakness might be countered by restarting quant easing in full force at any time. Therefore, we are not so worried yet about monetary tightening.

On a more cautious note, the US is fighting a debt bubble with more debt and somewhere in the future this needs to be reversed. GDP growth still is below trend, inflation is at a multi decade low and unemployment is only slowly improving.

In Europe things are different. Economic weakness is spreading throughout Europe. Even Germany has been infected. Germany is at risk due to its big export sector. When global growth, and especially the periphery and emerging markets, continue to disappoint, Germany will feel the pain too. On top of that the weakening of the JPY might hurt too, as Germany's export mix competes with the Japanese.

## No aggregate deleveraging here

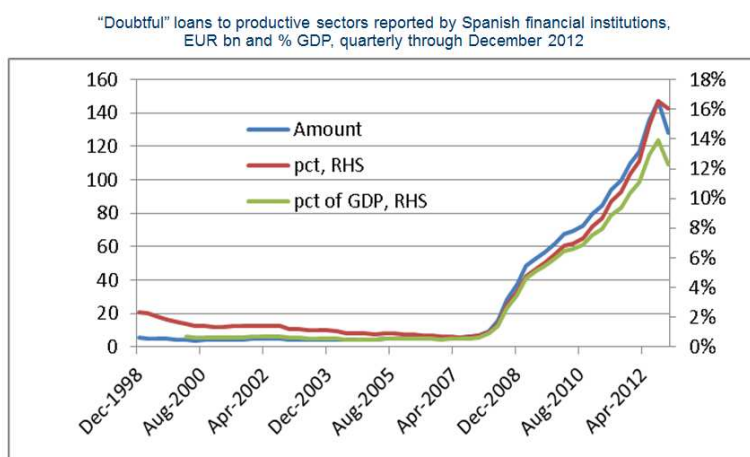
US non-financial debt by sector, % GDP



Source: Federal Reserve Flow of Funds, Haver Analytics, Yield Book

The positive news in Europe is that more monetary stimulus can be started. It seems that hard core austerity is off the table and is being replaced with different plans for different countries. The ECB has some options left too and might have become more trigger-happy considering the continued disappointments in economic growth. The ECB could go for lower rates but also negative deposit rates, more LTROs and even fixed-rate long-term LTROs, effectively guaranteeing low rates for longer.

This time we want to dedicate a few comments on Spain. We have been both cautious and optimistic in the past depending on the government's progress in reforms. We now move towards a somewhat more cautious stance again. The problem is total debt to GDP. Both the private sector and the public sector are indebted.



Source: Credit Suisse, Banco de Espana

Spain risks a vicious cycle in which investments go down, private savings go up, growth does not recover (note that most people expect positive growth in 2014 again), inflation collapses and bad debt keeps increasing and finally brings banks new problems. The positive news about exports is helpful but as a percentage of GDP too small to make the difference. In the end Spain needs a big internal devaluation (e.g. lower wages, etc.), will face lower economic activity (having already lost 7% of GDP since 2007), while facing and servicing nominal debt claims at a 2007 level.

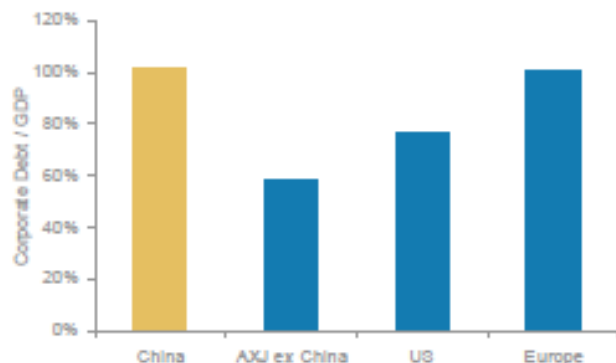
The reason we come back on Spain is that, simply stated, it is the first country big enough (unlike Greece, Cyprus or Ireland) to shake up EMU. In principle Italy shares a lot of Spain's problems. Spain accounts for 10% of eurozone GDP. On top of that the umbrella of Mr. Draghi protects all peripheral countries the same way. Therefore all policy makers risk falling back to complacency. That could mean the CRIC pattern returns (Crisis, Response, Improvement, Complacency).

Despite all positive policy reactions we have seen, LTROs and OMT primarily, some very important and basically crucial decisions still have to be made. In the end Germany and the rest of the core of Europe (does it include France?) need to decide on a banking union, deposit guarantee system, blue bonds and direct recapitalization of banks without government interference. These are critical decisions. We have made progress, but much more needs to be done too. It's a matter of seeing the glass half empty or half full. In all cases these are important decisions to be made in the long run to keep the eurozone together.

We have a final fundamental comment on China. We have been negative for a while on this 'growth miracle' but still believe most people do not fully appreciate the real issue. We think China has a debt problem too. With an objective to get as many people out of poverty as possible, the authorities waited too long to adjust the imbalances. That is assuming the government is in control. Let's assume it is for now.

The majority of debt in China is corporate debt. State-owned enterprises are heavily indebted. The problem is that these companies often are not efficient and hardly profitable. Due to vested interests and guided lending too much of debt growth has taken place at these SOEs. A major misallocation of capital.

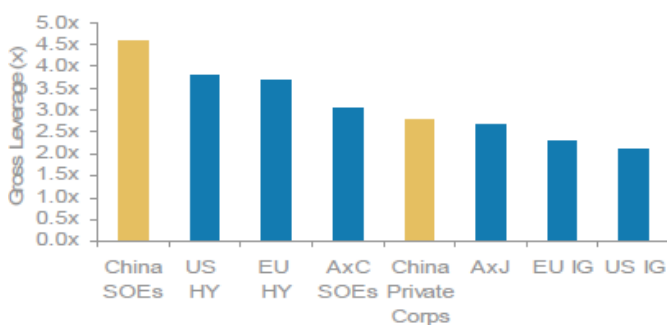
**Most of China's Debt Is Corporate and Most Corporate Debt Is SOE**  
Corporate debt / GDP



Source: Factset, Bloomberg, Morgan Stanley Research

**Putting China's Leverage in Perspective**

Gross leverage



Note: Leverage data for HK-listed China SOEs and Chinese private corporates are part of the MSCI China universe. SOEs are defined as those corporates having more than 30% government ownership. Source: FactSet, Bloomberg, Morgan Stanley Research

If one thing has become clear, it is that total social financing (a term for total corporate lending including bank and non-bank lending) is increasing while doing nothing for growth. It seems that China needs ever more debt/ credit to sustain its growth levels. All in all our concern is that when the government is going to face the bill (not if but when), the debt problem will have become much bigger than in 2008 and therefore markets will become more concerned about this debt bubble.

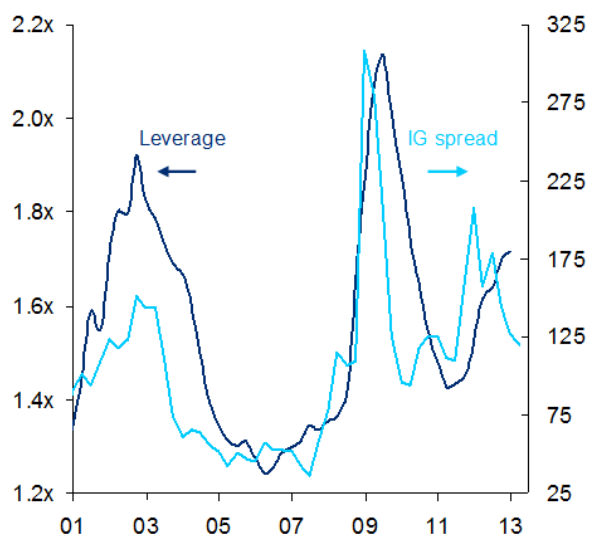
# Valuation

We will be brief on valuation this time, as technicals have been driving the market in the last few years and will continue to do so in the years to come. Since the last quarterly outlook spreads have been stable or have widened marginally. Emerging markets are the exception with more than 20% widening. At the time of writing markets are widening too.

At the same time corporate fundamentals have started to deteriorate. Corporate leverage is increasing (more so for the US) while spreads are tightening driven by ever more market liquidity. Therefore the dispersion between fundamentals and valuation is increasing. One can plot a similar graph for the relation between unemployment and equities. All in all it means financial markets are repressed by central banks.

## Rising debt, falling spreads

EU nonfin spreads to Treasuries vs leverage, bp



Source: Citi Research, Bloomberg, Markit.

By the way, we believe that government yields are even more repressed by central banks than credit markets. Globally, the government bond market has been the central bank target to repress yields. Although technicals could become an issue for credit markets, government yields (together with emerging markets) are most vulnerable to a reversion to 'normal exceptional stimulus'.

The central banks have caused a search for yield and therefore many investors have been 'forced' to buy risky assets that they would otherwise not have considered. Many of these tourist investors will withdraw when yields rise or monetary easing starts to reverse. This could cause a very uncomfortable situation as shown under technicals.

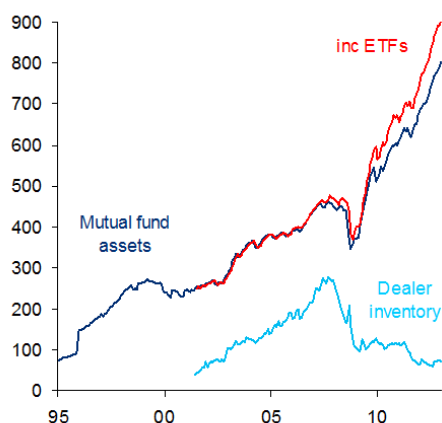
# Technicals

In the last few years, the single most important driver for credit markets, but basically for all risky assets, has been excess liquidity. The above-mentioned search for yield caused an imbalance between fundamentals and valuations. In the long run more debt to solve a debt problem is not the solution. However, that is a concern for much later.

Our biggest concern for the intermediate period is related to the picture opposite. The search for yield has driven ever more nontraditional investors into credit products. At the same time banks have been forced to deleverage and bring down trading capacity. Effectively investment banks have become brokers matching sellers and buyers without being risk takers or sellers themselves. This will cause much more volatility and can also be very unexpected. This is a new phenomenon compared with the pre-2008 period.

## Entrance with no exit

US credit mutual fund assets vs dealer inventory  
(\$bn, IG+HY)



Source: ICI, NY Fed, Bloomberg, Haver Analytics, Citi Research.

A few years ago, it took 50% of mutual fund outflows to cause broker inventory to double, now it only takes 5% to do that. On top of that broker risk appetite is much lower too. Some investors will experience that the exit will be costly, if there is one after all. What happened to gold can happen to credit.

Another more positive phenomenon is the net supply balance in fixed income markets. People spend a lot of time looking at demand but one should realize that net supply - which is gross supply minus central bank buying of treasuries - has become very low. This is a positive technical of course given the fund inflows we have seen. Another positive supply factor is the net negative bank debt issuance (gross supply minus redemptions) for this sector.

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## Conclusion

All in all we support the case that liquidity is driving markets, not only credit markets. This has caused many unstable equilibriums despite markets telling us that volatility is basically dead. It will return and we are in an environment in which volatility can come from many different sides. Whether it is German elections, Italian politics, Fed tapering, Chinese growth or maybe even Abenomics, all in all one should realize that markets and economies have been driven by ever more liquidity and debt. Many more difficult decisions have to be taken in the future and that will be accompanied or even only made possible by more crises and debt forgiveness.

For now we will trade much more from a neutral stance for investment grade and from a small underweight in high yield. We will react to severe market moves with a bias to add risk rather than taking a long-term bullish view. With respect to emerging markets, we think some more expected short-term volatility will justify a short beta position.

### Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Matt King (Citi), William Porter (Credit-Suisse), Viktor Hjort (Morgan Stanley) and Olaf Penninga (Robeco) have been taken into account when establishing our credit views.



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