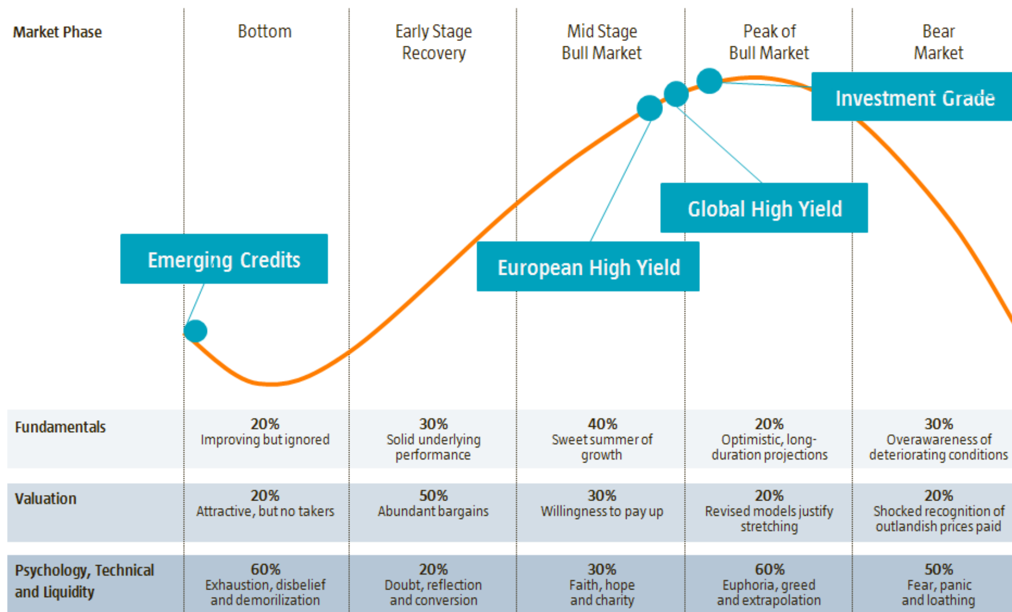
Credit Quarterly Outlook: the Market Cycle - **Mapping our view on Market Segments**



Source: Robeco, Morgan Stanley, June 2015

Dot plots and tantrums

- Financial markets are entering a new phase in the aftermath of the debt supercycle
- Financial repression by central banks cannot prevent increased volatility as the credit cycle is aging and positions are crowded
- The sweet times of easy and nice returns on financial assets are over

US growth is expected to remain at a subdued pace of 2%. The economic cycle in Europe is lagging the US cycle as usual. Growth in Europe improves, from a low base admittedly but it helps to improve the inflation outlook a bit. In emerging markets we see further conversion in growth rates with developed markets. All of these economies have to a different extent one thing in common. There is lack of aggregate demand and indigestion of debt. Policy makers around the world choose the same solution; printing money. The US might start to reverse this soon but we are not convinced it will be a smooth transition.

Two things are changing now. First, the US credit cycle is getting unfriendly. Corporate releveraging is accelerating and margins have peaked. Second, the financial repression of policy makers is now increasing market volatility in many asset classes. The market place is obsessively watching dot plots and suffers from tantrums as a consequence. Add the summer illiquidity and we conclude we are up for a less friendly period in this business cycle (for many asset classes).

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

“A new part of the business cycle”

In the last few quarterly outlook sessions we wrote about herding, investors acting like sheep and warned about complacency. Obviously one can never forecast turns in market cycles or even economic cycles. Only after many months does one realize the cycle has turned in terms of earnings, GDP or credit spreads. We discussed the simple fact that often after seven good years a bad year comes, just because that tends to happen. That does not sound very academic but earnings cycles do exist. We show that after years of normalization in the housing market, car industry and even capital expenditures to a certain extent, it is not strange to prepare for a US recession in the next two years. What would that do with investor behavior after years of great returns?

We regularly wrote about this herding behavior before since we try to understand capital flows and the reason for investors to do what they do. We always worry about consensus positioning of market participants since we believe being contrarian is best in the long term. However this will become much more important. Monetary liquidity has increased and the search for yield has been pushing up corporate bond prices and stock market valuations, thus in general causing asset price inflation. This has caused investors to herd and flows will become even more important to understand.

Animal spirits

The Fundamentals and Valuation chapters on the next pages describe two things that have changed. First, the US corporates really show animal spirits now. In other words corporate America is releveraging. Based on an ocean of almost free money, share buybacks, dividend deals and debt-fueled M&A are at cyclical peak levels. If one adds a chance that the earnings cycle is rolling over (explained under fundamentals), corporate leverage is looking stretched. On top of that the Fed is slowly moving into a tightening phase. At a measured pace or not, the whole worldwide financial market is on steroids (monetary stimulus). What would that do to investor behavior?

Second, the excessive financial repression caused a new phenomenon; negative yields. This exacerbated the search for yield but also herd behavior. It is the explanation for increased volatility on FX markets, bond markets and stock markets. We are all excessively watching the Fed dots and whenever we fear changes (or dots up) we enter a tantrum causing one-way selling in an ever more illiquid market. By the way policy makers have changed and adapted their forecasts for growth and inflation so many times, one can wonder why the market has so much faith in them.

So, with US corporate behavior becoming typically late-cyclical and financial repression entering a phase in which it actually cannot prevent volatility anymore, we are changing the way we are looking at markets. A separate topic is that the economic cycle is aging too and recessions are still a normal phenomenon. From now on one will probably see a much more neutral positioning in terms of beta.

We remain positioned in the first quartile of our beta budget. However, regularly we will see a completely neutral beta. For emerging markets we make an exception. We strive for a neutral beta but our more strict underwriting criteria will probably cause us to end up with an underweight position. The main reason for not being underweight is the fact that markets have repriced a bit wider and there simply is not enough tangible evidence for defaults or recessions in the time horizon of the quarterly outlook.

Fundamentals

Europe extends improving trend

In Europe it's not difficult to become happy in terms of growth. The recent Italian figures were pathetic in an international context but did help to drive away deflationary fears a bit. It is all about your reference point. However it is clear that the initial improvements in economic activity are continuing. Labor market data are improving and the cheaper euro helped boost exports with 8% yoy. Especially the periphery is showing signs of improvements. Not only the cheap euro but also a relaxation of austerity measures in the periphery is helping growth rates.

In Europe the divergence between the various economies is often large. While this time the periphery improves a bit, with Ireland a clear winner, Finland and France are disappointing. For example, French and Finnish employment growth is in negative territory. In Europe we are far away from any signs of wage growth.

The ECB just started with quant easing. At the very least it has improved funding costs and together with all other measures, it seems to have caused credit growth to be positive again. Historically money supply is a good leading indicator of PMIs. If that holds in the future we expect economic activity to pick up further. We believe we are far away from any tapering in Europe though.

We have often written about the CRIC cycle. It still is relevant as the Greek saga shows. Whenever we experience a crisis (C) policy makers respond (R), markets calm down and improve (I) until they become complacent (C) again. We all know that the Greek population cannot pay back the debt load it has to handle. It is probably fair to say the rest of Europe has to think about that. Too much German medicine might drive social unrest and consumes political support for our EMU project. If the Greek situation gets resolved (the stakes are very high to do so on both sides), it will be a mid-night solution full of compromises.

Let's not forget that Spain and Italy are doing well partly because these countries postponed further austerity. These countries experience better growth rates at the expense of a growing debt load. For now that is not a market theme. Depending on how the CRIC cycle is played out, we hope it may remain so.

Business cycle reaching a mature phase in the US

We always ponder on the theme that many countries suffer from the aftermath of the debt supercycle. The same is true for the US. We are in the seventh year of the expansion and the US economy never surprised to the upside. Again, this year the first quarter showed the economy is having a difficult start. Reasons differ through time. This time an oil shock caused a sudden cutback in investments, and households increased savings based on the additional income from lower oil. The next headwind will be the strong US dollar. If the Fed causes further USD strength, this will become a new drag on the economy.

The list of indications that the US economy is normalizing is also growing though. The labor market continues to improve. At a very regular pace the underemployment situation is improving. On top of that demographics are much more favorable than in other developed countries. This has become a real driver of growth differences between countries nowadays.

The banking sector has healed and the willingness to lend is there. Indicators of the 'availability of loans' all show that credit growth is positive and will stay like that for a while. If one takes the debt service burden into account (as a percentage of disposable income), things look even better for households.

The vast amount of spare labor caused wage growth to be absent in recent years. This might change too. Compensation is increasing and one can regularly read about different firms warning for wage pressure. Therefore in the US it is easier to say that deflationary pressures have eased. Add the fact that the base effect of the drop in oil prices will fade towards the end of the year, and even headline inflation might surprise to the upside.

That brings us to another less positive trend. Many years in a row corporates have been able to shed labor (costs) and increased their profits. Actually, profit as percentage of GDP is at record high levels. Margins have expanded for years and are at levels we have not seen since the 1950s. However it seems that profit as a percentage of GDP is not a very stable factor. It is either moving up or down. It never stabilizes for long. Again, this is not a very academic reasoning but it is true. Here we can explain that slowly but certainly the labor force is demanding a bigger share of income. This will happen at the expense of corporate profitability.

Related to this is that car sales, the housing market or investment cycles all contributed a lot to the recovery over the last seven years. It is very unlikely that these factors will contribute another time. We need other factors (like more government spending or consumption via more employment) to keep the expansion going.

Currently corporate cash flow is increasingly spent on share buybacks, M&A activity and dividends and less so on capital expenditure (especially in a historical context). Corporate leverage in the US has increased to close to 2007 peak levels. If one reconsiders the chance of a cyclical recession at some point, EBITDA growth (yoy) can drop 10% or more. If that happens, corporate leverage suddenly looks high.

An interesting thing we learned from Japan is that interest coverage ratios are still going up due to refinancing of expensive debt (high coupon). So while leverage (debt to EBITDA) rises, servicing that debt becomes easier. It makes corporate America more vulnerable to yield rises but we realize this can be the case for extended periods of time.

A short note on European corporates since the trend is very different here. Cash balances are very high and debt levels have yet to rise. European corporate releveraging is lagging the US just like the economy is. Obviously this more conservative behavior is driven by totally different economic prospects. This time we write much more about the US since we believe the behavior we see now will in a few quarters also been seen in Europe.

Emerging markets, too early to enter

With respect to emerging markets this time we limit ourselves to the most important one, China. It is very simple, all economic indicators point south. Real estate investments go down, house prices have dropped and railway freight traffic is negative.

China is really pushing for reforms and trying to rebalance the economy from investments to consumption. However, this brings stress too. Deflationary pressures are huge. Debt levels (domestically funded but still) are really high. Policy makers though have a firmer grip on the economy in some respects. Whenever the economic growth slows down to fast, mini stimuli are announced.

In the long run China's contribution to growth has come down. This is having an impact on commodity prices too. The amount of structural imbalances is still huge and policy mistakes loom here as well. An example is that cement consumption per capita per year is higher than the peak levels of Spain or Ireland in 2006. And we know that were real bubbles. Historically, cement consumption levels like that drop 80% after the peak. Just a nice fact to now….

Conclusion: US credit cycle is aging

The first big change in this cycle is that corporate America is now fully in animal spirits mode. Not via investments in future growth (capital expenditures) but via distributions to shareholders. Leverage is rising and the profit cycle seems to have peaked. Therefore we have entered a new phase of managing credit. Buying debt of a company that just releveraged via an M&A transaction is fine, but getting hit by an LBO just after you bought is a different thing. The financing gap is negative, meaning that bond supply in the US market is high.

A potential slowdown in growth for whatever reason will become more painful then. Car sales are showing a cyclical peak, the housing market has contributed a lot to the expansion and capex has recovered nicely. This all means these events are unlikely to occur another time. The business cycle is aging and corporate leverage is higher. We are becoming more cautious.

Valuations

Investment grade credit cheaper
For a while credit markets did not react at all to the increases in government yields and more importantly the increases in rate volatility. However at the beginning of June they finally did. Markets repriced moderately. European IG indices have widened 18 basis points or close to 20% since the former quarterly outlook. More extreme has been the widening of a few high beta sectors like corporate hybrids (55 bp or 25%) and the insurance sector (+70 bp or 29%). Also the Greek tensions finally made an end to the ever tightening trend of the periphery. The periphery widened 31% in the last three months. The exceptions have been emerging markets and US high yield, which have been fairly resilient.

We have been surprised by the outperformance of emerging credit. The ratio of EM credit versus developed tightened, meaning that, adjusted for risk, EM credit outperformed. We still struggle to find enough relative value within EM credit versus developed credit. Especially since one considers country risks and governance issues.

Value in high yield
The high yield market is known for its resilience to rate rises. This time again it proved this to be true. It does make the asset class a bit less attractive now since other segments sold off more in spread terms. However, we believe high yield levels are still compensating for risks. We still see no default cycle looming and high yield can occasionally benefit from IG rated companies buying HY rated companies.

US versus Europe
We withdraw our preference for the US credit market. Animal spirit behavior is increasing and is just as important as the more political risks we see in Europe. Therefore we have a neutral view on both regions. In the end credit quality is better and within high yield covenants too. Therefore the small spread premium in the US market might turn out to be a value trap in the medium term. On top of that, if one corrects for maturity mismatches (the US market has a longer duration) and the basis swap, spread differences are not that high.

Equity markets
We have looked at equity market valuations too to determine whether these are telling a different story or not. It is a fact that US valuations are close to TMT bubble period levels. In addition, returns on equity in the US market are at a 40-year high difference versus Europe. If one believes a little bit in mean reversion of developed economies, the US looks vulnerable. If one looks at forward P/E ratios, Europe looks expensive. If European money supply growth continues, European equities seem to have more upside.

In any case US corporate profitability is at long highs. This typically does not stay like that for long. We have indications that share buybacks are driving earnings per share growth already.

Conclusion: a bit cheaper
The conclusion is that we experienced a moderate sell-off. Some segments have cheapened significantly. Especially corporate hybrids and insurance bonds are cheap again. High yield remained resilient and emerging credit is still too expensive. A special note on the periphery is warranted. This market segment is priced for perfection with on index level a meager 20 bp pick-up versus core Europe.

Technicals

Central bank buying is the main driver of asset returns

Let us start with the second big change we acknowledge in this quarterly outlook. Up until now volatility levels were low in basically all asset classes. However, since the ECB QE and Fed tightening talks things have changed. FX volatility is severely up, equity markets are correcting and credit spreads have started to widen. How is this possible when the ECB just started buying EUR 60 billion a month?

The answer is simply that financial repression does not mean volatility repression. Market participants forget sometimes that for years we have been pushed (like sheep) into one direction. Taking more risk. So, the moment an economic cycle turns, or the Fed might tighten or Greece might spoil the party, we all move into a certain tantrum. We hope that nothing will change in order to justify our consensus positions built in the last years of expansion and herding behavior. We are consensus long in carry trades, long equity risk or FX trends. The very light capacity of broker dealers to shift around risk does not improve the situation.

Despite QE, we will see more volatility driven by consensus positioning and an aging credit cycle. This might reprice assets along the way.

The basic principle has not changed much. In the long run we see an unprecedented amount of negatively yielding assets. Despite the recent Bund yield rises, the search for yield remains. It remains to be seen how retail investors react to negative total returns though. We fear that if outflows come through, weak markets can extend for a few months.

The negative yield environment is supported by an increase (not decrease) in central bank rate cuts. The pace of rate cuts is at or above that in the 2008 period. Admittedly, many emerging markets are reversing trend after a defense of their currencies but still many countries in the world are in easing modus.

Supply

A special note is warranted on corporate supply. Supply is up for the year. Remarkably however is the behavior of US corporates. Not only are these more actively increasing leverage, they are also issuing massively in the EUR market. This will increase the synchronizing of market cycles in the future. We only need EUR 10 billion more of issuance of reverse Yankee bonds, or cowboy bonds, and these become the second biggest country of the European credit market.

A nice phenomenon in the European market is that corporates are shortening the balance sheet. What happens? The negative yields on many credits or government bonds drive CFOs to use the corporate cash balances, which are very high. Instead of share buybacks we are experiencing a record bond buyback situation. This is positive for bond credit markets.

Conclusion: more volatility is in the cards

In the last few years technicals have been very important to explain low volatility and asset price inflation. This has not changed in the sense that the search for yield stays the same. However, excessive financial repression and maybe very convincing policy makers all caused us to do the same; take more risk. When the economic cycle matures, and the Fed might tighten, and the credit cycle and rate cycle might turn, more volatility is in the cards, not less.

Positioning

First quartile of beta budget

We already had a flat beta earlier in this quarter. However, after the recent sell-off we selectively added in the segments that now show value. This situation might not change. We will be moving from a very small overweight back to neutral regularly. We are not convinced that a default cycle or EM stress or surprise Fed actions are in the cards. Therefore short positions are premature for developed markets.

Both the aging credit cycle in the US and the expected increase in volatility make us more cautious than last time. Excessively watching dot plots to justify positions and fearing tantrums will become ever more important. The easy part of this expansion and asset price inflation is done.

Regional versus sectoral

We do not prefer US or European credit markets. We will use our vast research resources more than ever to balance the portfolio with various good value positions in different instruments, sectors or regions.

Solvency in the financial sector is still improving. If rates rise a bit, that's even good for shareholders since there is a good correlation with net interest margins and yield levels.

Emerging markets remain too expensive. Especially after the recent rally, we expect them to reprice a bit versus developed markets. We are less concerned about the Fed hiking cycle than last time.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Srikanth Sankaran (MS), Barnaby Martin (BOA), Mislav Matejka (JP Morgan) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

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