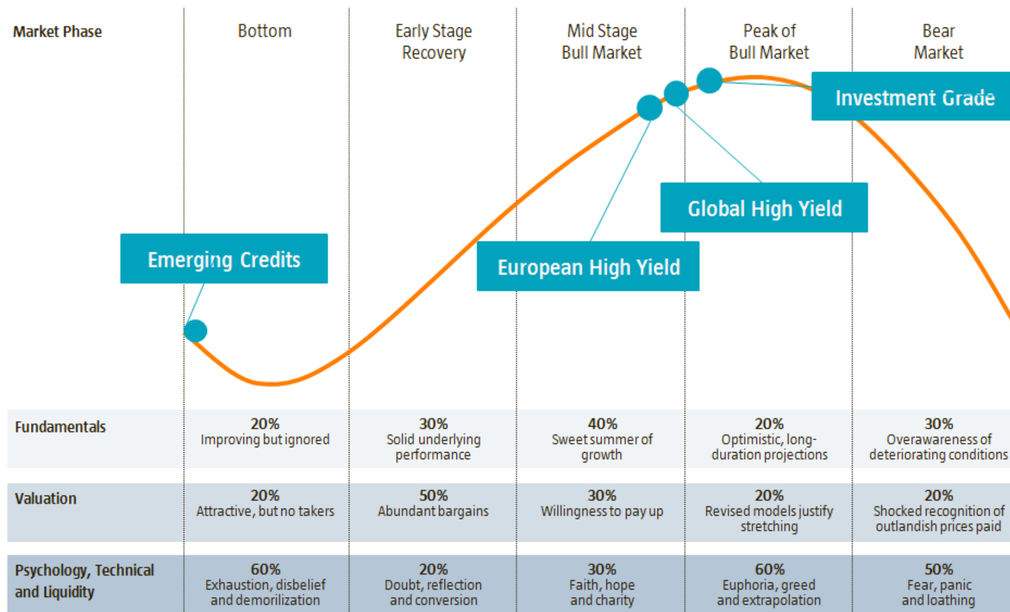

Source: Robeco, Morgan Stanley, March 2015

Herd behavior rewarded?

- History tells us that herd behavior usually ends in tears
- Central Banks push investors into risky assets like a flock of sheep
- We hold small long positions except for emerging credit

There are finally some rays of light for the European economy. Even before the ECB started its QE program, consumer data surprised on the upside helped by a cautious recovery in labor markets and lower oil prices. The negative surprises this time come from the US, where producer data has disappointed and more weakness could be inflicted by the strong dollar. For markets this was just another reason to rally, especially in equity, as the first Fed rate hike has been pushed out further.

Emerging markets are still having a difficult time facing a strong US dollar (or weak emerging currencies), having large external private debt to finance and facing a few tail risks in China and Russia. Valuations have become tighter in investment grade. European non-financial investment grade looks outright expensive compared with high yield and US credit, but that can be justified by the search for yield in an environment where 40% of European government bonds trade with negative yields. Emerging markets spreads have widened and Brazil starts to look appealing on a valuation basis. For Asian credit we have not seen enough widening in the light of the expected further economic slowdown. All in all we still are comfortable with a small long positioning in high yield and investment grade while being a touch more cautious on emerging credit.

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

“Year of the Sheep”

Our previous quarterly outlook was entitled “Year of the sheep”, which we believe is still an adequate description of the year we are in. Investors are herding like a flock of sheep with the central bank in the role of shepherd. Being in the middle of the flock feels safe as the dangers are not visible, but we all know that herd behavior usually ends in tears in financial markets. 2015 is the Chinese Year of the sheep. To many Chinese, the sheep has a negative connotation. The number of newborns is significantly lower this year as people see the sheep as a bad omen and sheep babies could end up with a miserable life. Will the sheep bring bad news to financial markets as well? Probably, but not yet.

We realize that we are part of the flock with our overweight beta exposure. That does not feel very comfortable as we know that contrarian strategies usually work better. Therefore we keep the long position limited and implement it in a way that should offer us better protection when the market turns. We are cautious with the highest risk positions, such as CCC, Cocos and emerging credit, which have attracted opportunistic investors (tourists).

Although being in the flock might be risky, fundamentally, we avoid tail risk positions as much as possible, for instance by being underweight periphery and Asia in our investment grade (IG) portfolios.

Fundamentals

Finally some positive surprises in Europe

After years of misery there is finally a bit of good news out of Europe where several economic indicators have surprised on the upside, especially on the consumer side. The improvement in consumption takes place on the back of somewhat better labor market data. Most large economies are participating, with the exception of France. Consumer sentiment is further supported by lower fuel prices, recovery in housing markets and no further austerity. On the producer side there is not much improvement yet, although EUR weakness should start to have a positive impact on exporters in the coming months.

It is worth noting that the small improvements already happened before the ECB actually started its Quantitative Easing program. QE by the ECB so far has had a phenomenal impact on financial markets, it almost worked too well. But it is doubtful if it will also work for the real economy. The big difference with the US is that quant easing in the US was implemented simultaneously with fiscal stimulus and debt write-offs. In addition the transfer mechanism to get capital to the SMEs does not work smoothly in Europe as these smaller companies do not have access to the abundant amounts of money that are seeking a home in capital markets.

Monetary policy alone cannot solve structural imbalances. Policy makers need to implement structural changes in order to sustainably reach a higher economic growth potential. For Europe this means, among other things, implementing a system of fiscal transfers or the ability for countries to restructure debt. We still do not see any progress on this front as the political and popular support for these changes are absent in the core of Europe. Therefore QE in Europe will probably not do much to the structural strength of the European economy other than giving it a temporary boost through low exchange rates. But for markets it is definitely positive.

Business cycle reaching a mature phase in the US

The business cycle has reached a more mature phase in which profits do not seem to be growing anymore and companies increasingly depend on financial engineering to grow earnings per share. Corporate sector releveraging will lead to more volatility in equity and credit markets. The corporate credit cycle has definitely turned less friendly for bondholders. This does hold much more for the US than for Europe. In that respect, the cycles are still desynchronized. What should also give comfort is that we still do not see the same amount of excessive risk-taking by investors as in previous late-cycle markets. In that light, we think that this cycle probably has a bit further to run before it turns into a bear market. Credit excess returns can still be positive but will be fairly limited in this environment. Phrased differently, portfolio managers need to work a bit harder to find the attractive opportunities that are still there.

The US creates a new OPEC country each year

Some words on oil are warranted in this edition of our quarterly outlook. Oil prices have continued their march lower so far in 2015, reaching a low of USD 45 per barrel of WTI. This is not only relevant for the Exploration & Production companies that are well represented in the US high yield market, but also for consumers. In addition there is a large wealth transfer from oil exporting to oil importing countries. Forecasting oil prices is not our expertise and we have no ambition in that area. Still it is important to understand why prices have fallen as much as they did and who the beneficiaries are.

The collapse of the oil price was predominantly a supply-side phenomenon. Global production has been growing, mainly as a result of strong growth in US shale production. According to a Goldman Sachs report, US growth alone has been 1.2 million barrels per day which is the size of a small OPEC country. In fact the US was creating a new OPEC country every year, thereby marginalizing OPEC's ability to steer pricing. The abundance of shale oil and the falling costs of production will probably

mean that oil prices are very likely not to return to their highs. They will return to a level where the marginal producer is making a decent return over its cost of capital. This level is estimated at around USD 65 by oil watchers.

For our high yield portfolios it means that we should avoid companies that need higher prices in order to generate sufficient cash flow to repay their debt. We rather stick to the low cost producers with a healthy capital structure and stay away from the very high yielding part of this sector. In investment grade, we even see long opportunities as these companies are in general well diversified and low cost producers.

For emerging markets we take into account that low oil prices do represent a tail wind for the oil importing economies.

US growth disappoints

US economic data have disappointed on the producer side recently but have been resilient on the consumer side. Producers suffer from an expensive dollar, whereas consumers benefit from better labor markets and lower oil prices.

Inflation has come down sharply and has even dipped below 0.0%. Deflation fears are not justified though, as the drop can be fully explained by the lower oil prices. This is ‘good’ deflation and above all it is transitionary. Once oil has stabilized, the impact on CPI will disappear. A strong dollar, low inflation, and some weakness on the producer side was enough ammunition for the Fed to relax its stance a bit. The first rate hike has been pushed out further and the Fed dots have moved more in line with what the market was already pricing in. We can even envision a scenario where there will not be any Fed hike this year.

Grexit is still a tail risk

At the time of writing the Greek Saga is reaching a new climax. European and Greek politicians are clashing once again in a way that does not appear to be very constructive. A debt crisis in a country usually gets solved by a mix of the 3Ds; Devaluation, Default and Deflation of demand. Since Devaluation is not possible and Default is not allowed, the exclusive focus has been on demand deflation. This has been detrimental to the Greek economy and resulted in social unrest and poverty. How will this end? Grexit is not in anyone’s interest, so the likelihood of that happening is not very large. In the end there will be a compromise which includes some debt forgiveness and implementation of more structural reforms, but accidents on the road to that compromise are very likely. This will cause bouts of market volatility and short lived spread widening. Later this year we could see more peripheral related volatility as Spain will have its elections.

Emerging markets, too early to enter

Of course it is always dangerous to talk about emerging markets as if it is a homogeneous group. There are large differences between China, Russia and Brazil, and each faces its own specific problems. Our biggest worries for China are the consequences of the significant debt build-up that we have seen in recent years post the global financial crisis. Debt did grow as policymakers actively tried to mitigate the effect of economic downturns by fiscal adjustment and encouraging lending. Higher levels of debt imply greater susceptibility of the economy to shocks, and higher growth rates of debt suggest that spending (demand) is vulnerable to a correction. History tells us that economic growth will slow down significantly after the debt build-up ends. The Chinese so far have managed the economic slowdown well, but debt levels have only gone up further. When credit grows that fast, it is almost a certainty that misallocations of capital have taken place. China, and some other emerging countries that faced similar increases in debt, could very well be the place of the third episode of the global financial crisis after the US and Europe.

For Brazil problems are more related to weak commodity markets and political uncertainty. Companies that have high levels of dollar debt without the revenue stream in dollars are suffering. The economy as a whole will ultimately benefit from a weaker real. Central Banks in emerging markets are often forced to act in a more pro-cyclical way. Instead of lowering interest rates when the economy turns down they are forced to hike in order to fight the inflationary impact of a weak currency.

Conclusion: the search for yield is still on

Fundamentally the situation has not changed a lot. The US is in a fine growth corridor heading for just over 2% growth again. Monetary tightening will be very limited in the US and we can even imagine a scenario of no rate hikes this year. Europe is finally looking a bit less vulnerable but the recovery is by far not strong enough to stop QE. That means that interest rates will continue to be depressed and that search for yield is still the central theme in financial markets. The trends of the last few years will continue. The combined central bank balance sheets keep growing. The net supply of fixed income products remains low (even negative for European government bonds)

More bears on the road

That said, the amount of bears on the road is increasing. Complacency is the biggest risk in this phase of the cycle. Investors have learnt not to fight the central bank and that mentality has caused herd behavior which is a risk in itself. With fundamental analysis we try to identify tail risks and avoid them in our portfolios. Within that framework we stick to a small long credit risk position.

Valuations

Euro IG is tight

European non-financial investment grade spreads have compressed the most, being the biggest beneficiary of the search for yield. Within this universe, the decompression that we saw in 2014 has partly reversed as the search for yield filtered through to the lower ratings and the tightest names reached a kind of spread floor. Within European investment grade we still see relative value in corporate hybrids and we prefer subordinate bank debt to Cocos.

Favor US over Europe

Historically, the European market has been a high beta market compared with the US market. Issues on banking health, emerging market exposures, the Russian crisis and Greece all point to Europe as the high beta market. Since we are becoming a bit more cautious in this aging cycle, we prefer US spread markets to euro markets. The US market is also cheap versus the European market. Within US investment grade we have seen underperformance of the long end. Curves have steepened which can provide additional return from roll-down.

Value in high yield

In high yield we also see that Europe has continued to outperform the US. The US is now more attractive on a valuation-only basis, but the composition of the market is very different. We judge each credit on its own merits but expect to gradually move more assets to the US. US high yield spreads are wider than a year ago, even when we take out the energy sector.

Emerging markets have become more attractive

Emerging market spreads have underperformed developed market credit. This widening is justified as several emerging countries suffer from weak commodity prices and companies have sizable amounts of USD denominated debt. With local currencies under pressure, the debt burden weighs heavily, especially on companies that do not have a natural hedge. Brazil spreads have widened significantly on the back of lower oil prices and corruption cases at Petrobras. Spreads are now reaching territories where most of the negative news is priced in. That does not hold yet for Asian credit. We believe that spreads need to widen more in order to account for a further slowdown of the Chinese economy. We stick to our underweight stance for emerging debt.

Technicals

Central bank buying is the main driver of asset returns

The central thesis of the Robeco Credit Team continues to be that combined central bank buying causes a shortage in fixed income supply. Over 40% of sovereign bonds in Europe trade with a negative yield now. The ECB's quant easing program results in a shrinking market, while at the same time excess savings in Europe, Japan and China are looking for a home. This combination will be a very strong support for fixed income assets, not just in Europe, but across the globe including the dollar market.

Savings glut further supporting asset prices

The global savings glut continues to push asset prices higher. The increase in savings boils down to insufficient aggregate demand globally. China, Japan and Europe have all been sources of excess savings. That money is finding its way into financial markets which is supportive for asset prices. Money has flown to the US and supported the USD as well. The strong dollar is a headwind for the US economy and that helps to keep the Fed on hold for longer.

Corporate issuance going strong

Corporate bond issuance has been very strong in 2014, especially in the US, as a result of corporate releveraging, and is set to continue at a strong pace in 2015. The supply of new bonds has been one of the reasons for the lagging performance of US credit against Europe.

In Europe we have seen increased issuance from US and Asian corporates that opportunistically tap the euro market to benefit from the abundant availability of capital. However, the basis swap (which reflects the cost relative to Libor when swapping from one currency into another) has moved decisively more negative. This makes it more expensive for foreign issuers to issue in the EUR market.

AT1 issuance from banks to stay at elevated levels

Another area where we will see more issuance is AT1 capital from European banks. Estimates are that hundreds of billions still need to be raised in the next few years. As these bonds are not eligible in all fixed income benchmarks this could mean a weaker technical for this particular segment.

Positioning

Long beta for investment grade and high yield

We stick to the long beta positions for our investment grade and high yield portfolios. We are however very much aware that this is a crowded trade and that the credit cycle is progressing with a likely increase in volatility. Therefore we only use a maximum of 25% of our beta risk budget and construct portfolios with a focus on companies with viable businesses. For high yield we continue to be underweight CCC and for investment grade underweight in GIIPS as these segments do not offer sufficient compensation for the tail risks.

Prefer US to Europe

US spreads have widened vis-à-vis European spreads. Business cycles have decoupled. Maybe there is more to come but we start to prefer US credit. For global mandates we can often buy the same credit risk (issuer and seniority) cheaper in the US market.

Neutral beta in emerging markets

Within emerging markets we construct portfolios with a beta that is just below 1. This is due to underweighting the un-investable situations driven by country risks or governance issues. We avoid Chinese real estate and are cautious with Russian credits.

Within our developed investment grade and high yield products we very selectively take off-benchmark positions in emerging markets. We select companies that we believe have seen a spread widening in sympathy with EM weakness but that is unjustified by the company-specific fundamentals.

Financials are attractive

We still like to invest in European and US banks. The banking sector keeps deleveraging and net issuance is negative, with the exception of the AT1 (hybrid) segment. Banks are in a multi-year deleveraging process. The sector is slowly becoming lower beta relative to the broader market (like it used to be). We are overweight financials in our investment grade portfolios but are cautious on AT1. In the high yield universe, we are more hesitant to buy into banks as the weakest banks are found here, such as the Austrian banks. So for high yield portfolios that can invest in financials we rather buy the subordinate bonds from investment grade banks.

Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Alberto Gallo (RBS), Kevin Gaynor (Nomura), Jason Gilbert (Goldman Sachs) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

Important information

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