OUTLOOK
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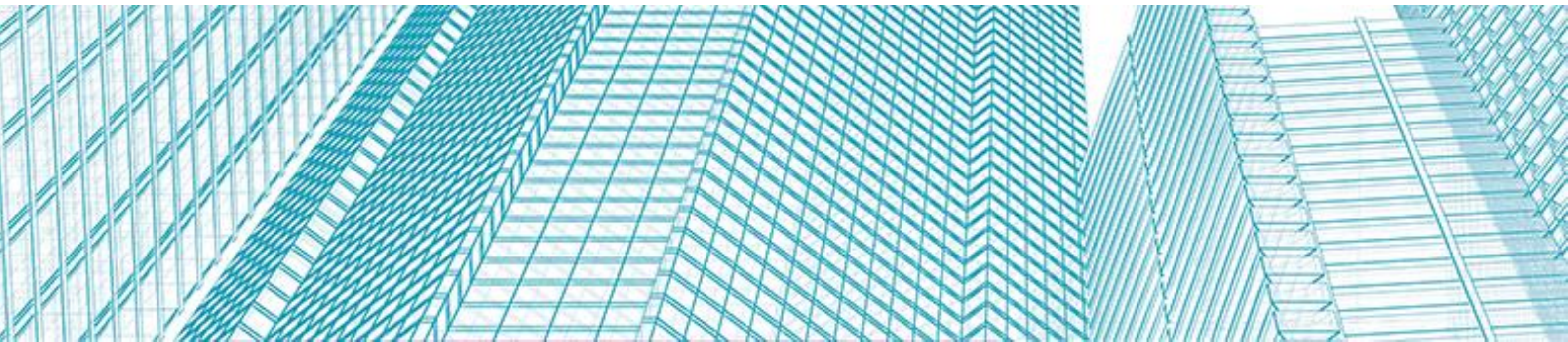

Credit Quarterly Outlook Q3 2016

Remortgaging shareholder equity

Sander Bus
Co-head Credit team
Victor Verberk
Co-head Credit team

- The US economic cycle is probably in its last inning. Corporate America is focused on raising debt to repurchase shares; US corporate balance sheets are rapidly deteriorating as a result.
- In Asia and Europe the jury is still out on whether we follow the Japan route of secular stagnation or the US route of levering up once more.
- The ECB is putting a technical floor under the European credit market with EUR 5-10 billion monthly purchases.

Central banks are trying to lengthen the recovery with ever cheaper money. Trying to stimulate corporate animal spirits for the moment primarily leads to financial engineering in the form of share repurchases. Value can primarily be found in pockets of the market like Latin American or UK banks. The market however is dominated by technicals. We are all in a deadly dance with the central banks. With ever increasing debt levels, markets are becoming more vulnerable to asset price volatility. The game central banks are playing is a very risky one, and investors have no choice but to join. We prefer being structurally more neutral in beta terms, with tactical positions taking advantage of misallocations in the market due to elevated volatility.

'Uncertainties around Brexit drive risk premia in the short run.'

In the short run, the main negative technical is the Brexit vote. It will encourage anti-European sentiment throughout the continent.

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Brexit – special edition

In this additional page we would like to share our views on the unexpected Brexit vote. In recent months the risk of a Brexit has been well flagged. Still the actual vote came as a big surprise to markets. What does it mean?

Fundamental

Most economists agree that this does not bode well for the UK and European economies. It is likely that investments and capital flows into the UK (on which it depends given its big current account deficit) will get hurt. As a result we saw a weakening of GBP which by itself could provide some relief. There are still many unknowns around the actual exit procedure. Most likely the UK will soon start this procedure. About two years later it will be effective. The negotiations for new trade agreements will probably be a tough process. Both parties have an economic incentive to come up with something productive but at the same time European politicians also have an incentive to be very tough, in order to scare off anti-European movements in other countries. This will give nasty headlines for a while. At the same time it might bring the 'remainers' closer to each other.

In general, financial markets shrug off big events like this after a few months. Remember the political turmoil around the Crimea or many 'key' elections in Europe in the last years. After a while market attention simply shifts to another topic. This time however, we are not so sure. This vote might just be the beginning of much more political turmoil and lead to uncertainty about the future of the European Union. That needs to be priced accordingly.

If anything positive can be said about Brexit it is that the uncertainty might reinforce the conservative attitude in balance sheet management we have seen in European companies. On top of that, these events have also increased chances that monetary support will only get stronger. Both the Bank of England and the ECB will not hesitate to take action when needed.

Portfolios

In our credit portfolios that allow for it, we have implemented an overweight position in (UK) financials. After the weak performance at the start of 2016, and the weak performance of the negative deposit rates announced in 2015, especially UK financials have never really recovered. UK banks trade 150/200 bp wide to comparable European banks in lower tier II (plain vanilla subordinated bonds) and AT1 bonds carry a yield of up to 9-10%. We consider that a sufficient compensation to justify an overweight position, despite recent underperformance due to the events discussed.

In the non-financials part of the market, including plain vanilla senior high yield or investment grade corporate hybrids, events have not really dented confidence that much yet.

'Adding weight to the political mega risk.'

Conclusion

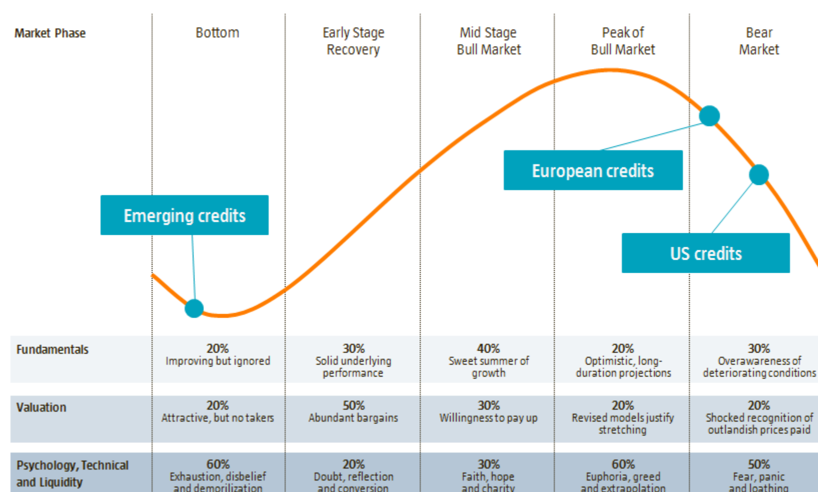
We do not want to underestimate recent events. It reinforces the tension between weakening fundamentals and political risks on the one hand and central bank support on the other hand. At the same time, the alternative often is zero or negative yield....

Fundamentals

In this quarterly outlook we revisit our long standing statement that we are in a period that can be described as 'the aftermath of the debt supercycle'. We started writing about this years ago. The idea is that after decades of increasing debt levels the private sector has a debt trauma. High unemployment, high inequality and just rolling over the mountains of debt make the private sector more cautious. This has been driven by decades of ever cheaper money. Inflation is low and over-confident central bankers have been willing to massage away recessions with ever cheaper money. In the meantime, China is in the midst of blowing its own debt bubble. Our mantra of being in the aftermath of the debt supercycle always helped us to expect lower rates and more search for yield, and therefore helped us to manage the beta of our funds.

> 'The aftermath of the debt supercycle.'

The Market Cycle: Mapping our view on market segments



Market Phase	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, Morgan Stanly, June 2016

Within the context of this long-term trend, we also see that the US is experiencing a much more normal credit cycle. Therefore it is worthwhile to test the hypothesis, and determine which countries are still suffering from the aftermath of the debt supercycle. Animal spirits, excess risk taking and rising leverage are traditional late cyclical behavior.

We believe that policy makers underestimate the side effects of the stimulative monetary policies. Pension funds and life insurers are getting squeezed, zombie companies are kept alive, markets are being repressed and misallocation of capital is a real risk. Real estate is a way of making money again. When did we see that before? Markets have become very vulnerable to asset price volatility in the future, as assets are being mortgaged with loads of debt. This policy could ultimately even result in more deflationary pressure.

Life after debt in the US

At a certain moment in time, asset price volatility, in combination with large debt loads, will cause financial losses and recessions. Policy makers' ability to combat a debt bubble by pushing for even more debt is in the end limited.

So, how bad is it? Actually it is pretty bad! We are experiencing the fastest rise in debt levels in peace time (during war time governments tend to finance exceptional government expenditures with additional money printing and debt issuance). Let's focus on the US first.

US non financials are spending too much. Companies spend 35% more than operating cash flow. This is the biggest financing gap in 20 years. These companies issue debt to buy back their stock. At the current pace, US companies buy back USD 400 billion, or 2.5% of market capitalization. Based on average leverage, debt levels have been rising very fast across sectors. Like stated before, this is much more the remortgaging of shareholder equity than anything else.

Besides that, cheap money fuels misallocation of capital. Doing business is about finding opportunities to invest, it should not be about the cost of debt. We have seen in Japan what happens to an economy when you create zombie companies, driven by overinvestments and dwindling returns on assets. China is making the same mistake and the western world is creating the same problem too with artificially cheap funding.

So why has economic growth not collapsed yet?

Imbalances can continue to build for a long time, especially when central banks allow (or even stimulate) this to happen. Ultimately we will reach the limits, but it is very difficult to exactly predict that moment. We try to understand these trends and fine-tune our investment policy and portfolio construction accordingly. One should also not underestimate central bank behavior and creativity to make the marginal cost of debt ever lower, boosting the incentive to take on even more debt.

The US profit cycle is turning

The profit cycle in the US is turning. There are a few reasons for this: productivity is low, labor is slowly taking a bigger part of the economic pie and demand from emerging markets has been under pressure . A further contraction of corporate profitability might trigger the asset price volatility we fear. In the wake of lower profits, many US companies have increased debt levels in order to optically keep earnings per share growth. This increases the vulnerability to further margin pressure. Investment grade companies that have increased leverage the most could end up with leverage statistics that would qualify them as high yield when margins decline even further. In the end, when margins go from 12% back to 10%, a serious 20% drop in earnings will hurt a company. If the starting point then is an investment grade company which is three times leveraged, it will end up with a high yield leverage.

The higher corporate leverage has not really helped to grow GDP as investment spending never took off; all it did was inflate asset prices. Therefore, it does look like a normal economic cycle but the caveat is that trend growth has turned lower.

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We conclude again that the US credit cycle is in the last inning. Animal spirits are very aggressive, the employment leading indicators are weakening and especially the earnings cycle keeps rolling over. Combined with high asset price valuations, we have become cautious. It does look like a normal credit cycle in the US within the context of structurally lower growth and inflation .

Europe

How different can it be in Europe. The average CFO has been much more cautious and actually data shows that leverage might have decreased on the private side. Let us do a few tests whether our hypothesis of the aftermath of the debt supercycle still holds for Europe. Maybe we are following the Japan scenario in Europe? We identify a few warning signs that indicate a Japan scenario is still not unlikely.

Firstly, European households extended the initial deleveraging cycle that normally occurs after a recession (2008). Household leverage as a percentage of GDP continues to shrink. This is a drag on growth. Secondly, due to demographics the European labor force is shrinking just like it did in Japan. Thirdly, both in the US and Europe we experience a slowdown in productivity. And finally, the investment cycle has still not recovered.

To conclude, while the US follows a more normal credit and economic cycle, for Europe the jury is still out. This partly explains the aggressive policy measures of the ECB.

Emerging markets

This time we write less about emerging markets. Still, things have not become better. The Brazilian economy has ended up in much lower trend growth and with respect to China, we still have to learn what the new trend growth is going to be. At least much lower than most people think. Based on a lot of debt, and generally a high gearing to a weak US dollar, the country's vulnerability is high. Cheap credit has weakened productivity by misallocation of capital in China. This has reduced supply side reforms and keeps zombie companies alive (see the parallel in the US). Debt service ratios, the combination of interest costs and refinancing needs, are very high.

We also studied a model that shows China's economic vulnerability through time. Key things to watch are a) private credit to non financials, b) the real effective exchange rate, c) debt service ratio and d) property prices. If one looks at these variables in 2007/8 the western world looked vulnerable. At the moment these variables point to high levels of alert for Emerging Asia and first of all China. We have much more often written about the Chinese growth 'miracle' but we would like to warn once again; our concerns are far from over.

Japan

Years ago, just after the Global Financial Crisis, we wrote about the chances that the debt supercycle would bring a Japanese style recovery. Back then we circled it as a minority chance. As we just explained, Europe still risks that kind of scenario and even China might

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follow that path. Therefore, watching and studying Japan makes sense to forecast events in the West. At least it helps us to understand policy makers' behavior.

With respect to Abenomics one can be clear. In many aspects it has aggravated Japan's problems. The power of corporations, the vested interests of these companies, the lack of creative destruction and therefore the hoarding of cash at corporations, at the expense of households, have become worse. Due to the Bank of Japan (BOJ)'s aggressive Quantitative Easing (QE) policies, yields dropped, but the economy did not recover. Private sector savings remained too high. However, a new phenomenon will pop up soon. Somewhere in the next 12 months, the BOJ will not be able to buy Japanese government bonds from the banking sector anymore. Simply because there are not any more left in their sheets. It means the BOJ will need to abandon QE (with devastating consequences) or come up with something very creative and set new boundaries to central bank expectations.....

Conclusion

To conclude, this all does not sound optimistic. However, for a financial crisis one needs more. First, one needs a major misallocation of capital to non-productive assets financed with debt. An overbuild in housing stock pre-2008, or maybe a Chinese investment bubble are decent examples. Second, one needs a systemic or very large and relevant economy to bear this. Third, it needs to be a major concern in investor portfolios. One can judge for him or herself whether a debt bubble in corporate America fulfills these requirements already, but we believe not all three conditions are met here .

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Valuations

Uncomfortable carry

Credit markets have done well. Spreads are tighter and the ECB's Corporate Sector Purchase P (CSPP) pushed spreads even tighter. Overall spreads are at average levels, though. Sometimes looking back makes things look expensive but actually high yield and investment grade credit spreads trade around average levels. Not bad as a starting point. Obviously, all in all yield levels are very low.

The reason we write about uncomfortable carry is that now the Federal Reserve is done hiking, and other central banks will start stimulating more, a window of carry opens. However, fundamentals increasingly look horrible. The window the Fed is giving us (6 months?), combined with these fundamentals and actually investing based on technicals (ECB intervention etc), makes it uncomfortable and upside is limited in beta terms.

US markets wider than European markets

The US credit market looks cheaper at first sight. If one corrects for maturity and quality mismatches, the wider spread is equal to the basis swap difference (the swap one has to execute to hedge floating USD exposure into floating EUR exposure). The much more aggressive stance of corporate America in the cycle make us hold on to our preference for EUR denominated debt.

Another interesting topic is home market biases. Yankee bonds (European companies issuing in USD) are trading cheap to domestic US bonds. The same is true for the increasing reverse Yankee bonds (US corporates issuing in EUR). In our portfolios, we benefit from our global coverage list and are able to buy the cheap bonds on both sides of the Atlantic.

A new phenomenon will be the screening of elible bonds (in the CSPP program) versus non eligible bonds. The eligible bonds outperformed in the first days of the CSPP execution (which runs at EUR 5-10 billion a month it seems). However sometimes the pick-up in non eligible bonds or reverse Yankees is big (up to 50 bp). In that case we prefer the non eligible bonds.

Emerging markets valuations not reflecting the full risk

Within emerging markets we remain cautious on Asian credit and the potential consequences of financial stress in the region. However, Latin America has cheapened enough to warrant a closer to neutral position overall, certainly when the Fed seems to be more dovish than we thought three months ago.

Conclusion: fair value

After a wild ride, we are still at fair value at index level. The exception is China, where we believe spreads do not sufficiently compensate for the risks. That said, we actively look for tactical positions to benefit from temporary bouts of stress. If we like a risk factor, and believe the window of opportunity is long enough we take long risk positions. In recent history we have been successful with long or short risk factors like commodities or geo-political stress.

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Technicals

CSPP is perverse

In this part we exclusively write about the CSPP program and its consequences. The ECB has done something that the longer one thinks about it, the more remarkable it becomes. We are in the perverse situation in which a US company could issue bonds in EUR at 0% yield, and finance share buybacks and dividends for its shareholders. How perverse is that!

It has nothing to do with the credit transmission system or inflation we believe. It will do nothing about that but might impact the euro currency. After the announcement of negative rates in 2015, portfolio flows became negative and spreads widened. In other words, investors acted differently to what Draghi thought and bought more government bonds instead of lower rated credit. This clearly was not expected.So instead, the ECB set up a major financial repression program, the CSPP.

Given the relaxed guidelines it basically is a credit QE to the world. One only needs a European entity to issue from. In itself a very smart side-effect is that the reverse Yankee bonds issue in EUR and swap that probably into USD, generating capital flows pushing the EUR weaker versus the USD.

We strongly disagree with the ECB premise that it does not distort markets. Actually, who in the world thinks it does not? There is now a price-insensitive buyer of last resort in the market that may buy 10-20% of the market (depending on supply). It will put extra pressure on the before-mentioned capital misallocation, creating zombie companies and broken business models. By the way, we constantly invest in more and better research for our clients but this new 'asset manager' does not, and takes negative selection risk for granted.

Another side-effect is that the European credit market probably will see a strong growth rate, just like the US market experienced during its QE periods. That in itself is good, since it increases diversity and depth of the market. More disintermediation would be good for banks too. However, if it just activates animal spirits, we will experience more pain in the future.

All in all it is the biggest incentive to start releveraging of all time. Time will tell whether the Brexit event will prevent European companies from doing this.

Mega risks

As credit investors we are said to always be pointing the finger at risks and to be afraid of the downside risks. To a certain extent this is true, but in our global high yield, investment grade and emerging portfolios we actively position for all these risks, long and short. Maybe it is good to show three mega risks that will be with us for the foreseeable future.

The first one is the extreme policy by central bankers. In every issue of this quarterly outlook over the last few years we have been writing about policy measures we never thought would become real only a few quarters ago. This time, start thinking about helicopter money

already! Whatever form it takes (writing down governments bonds the central bank owns or actual giving away spending vouchers), it will set new boundaries to central bank behavior. Second is leverage. As long as the cost of leverage continues to go down, financial engineering will be the preferred way to invest instead of real investing in assets. We try to combat a debt problem with more debt. Third, populistic politicians will cause CRIC (Crisis-Response-Improvement-Complacency) cycles and stress. Whether it is right wing or left wing or a referendum, the population's trust in current mainstream politicians is low. This can seriously derail financial markets every now and then (think about Brexit).

Conclusion

The conclusion is that the technical support for credit markets is huge with central banks expanding their mandate again and again. One has to understand fundamentals, but the technicals are driving markets now.

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Positioning

Guerrilla

At this point in the cycle, we believe it is not the time to be long beta permanently. We therefore execute a beta strategy that our CIO Edith Siermann once called a guerrilla strategy. We take a more neutral starting point and execute tactical positions into regions (Brazil), sectors (oil), segments (reverse Yankees) or other factors (Brexit factor) where value occurs due to excessive fear. When this factor has recovered we quickly move back to a more conservative profile. This time we start with a higher beta primarily driven by the Brexit spread premium. Obviously, the majority of our return remains driven by issue selection based on thorough company research.

Beta

We move to neutral betas as a starting point for all portfolios. There is too much value in certain pockets of the market and technicals are too strong for short positions. However, whenever we see pockets of value (like the current positioning in UK banks but also Brazilian corporates or certain energy names) we actively pursue these opportunities. If these opportunities temporarily cause the beta to be above 1, we accept that.

Regional

We slightly prefer European to US credit. The US credit cycle is too aggressive. We need more spread compensation, maybe driven by the fear of recession, to go overweight the US.

Emerging

Within emerging markets we continue to dislike the expensive Asian market. A combination of governance, legal structures and valuation do not even warrant a neutral position. Nowhere are debt levels increasing so fast as in China. The probability of a crisis is not priced at all and is therefore an easy short. This is offset by an improving situation in Brazil.

Long financials

Driven by Brexit fears, financials are cheap. Recent events made UK financials very cheap with a 150 bp spread premium for subordinated bonds over European banks. It remains the only delesector that deleverages. A special case is made for the subordinated financials of recovering banks, where there are still many opportunities . Top on our list is solid UK bank AT I trading at 10% yield or more. This time there is no asset quality issue so their balance sheets should remain clean. Of course, lower real estate prices or slower GDP growth might hit earnings.

Conclusion

We focus on doing research on all the regions, sectors and individual bonds that have the potential to deliver alpha or total return. There still are many of them. The entire long beta position consists of UK/ Brexit risk premia. Corrected for that, portfolio construction is conservative in terms of quality underwriting, cyclical sectors, etc.

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Guests

We would like to thank our guests who contributed to this new quarterly outlook with valuable presentations and discussions. The views of Barnaby Martin (BOA), George Bory (Wells Fargo), Kevin Gaynor (Nomura) and Rikkert Scholten (Robeco) have been taken into account when establishing our credit views.

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