ROBECO
The Investment Engineers

Multi-asset market outlook

High Yield – Please make me good, but not just yet

May 2023

For professional investors

Sustainable Investing Expertise by ROBECOSAM

General overview

Emerging market assets, commodities and cyclicals struggle

MULTI ASSET	1mo	3mo	YTD	1YR	3YR	5YR
Oil Index (USD)	2.0%	-3.5%	-3.5%	-12.5%	33.7%	-4.9%
MSCI World local currency	1.6%	9.2%	9.2%	-4.0%	17.4%	9.3%
MSCI World (H, EUR)	1.5%	8.5%	8.5%	-6.4%	15.6%	7.4%
Gold (USD)	1.0%	9.2%	9.2%	1.7%	6.3%	7.4%
Global real estate (UH, EUR)	0.8%	0.9%	0.9%	-17.9%	6.7%	4.1%
Global investment grade bonds (H, EUR)	0.6%	3.0%	3.0%	-7.2%	-1.8%	-0.6%
Cash (EUR)	0.2%	0.8%	0.8%	1.0%	0.0%	-0.1%
Global high yield (H, EUR)	0.2%	2.4%	2.4%	-6.2%	3.3%	-0.3%
Global Gov Bonds (H, EUR)	0.1%	2.7%	2.7%	-7.2%	-4.9%	-1.3%
MSCI World (UH, EUR)	0.1%	6.0%	6.0%	-4.7%	16.8%	10.8%
Emerging Markets (LC)	-0.7%	3.1%	3.1%	-7.3%	8.5%	1.8%
EMD hard currency (UH, EUR)	-1.0%	-0.6%	-0.6%	-4.1%	-0.6%	1.9%
Global inflation-linked bonds (H, EUR)	-1.0%	1.9%	1.9%	-15.1%	-2.4%	-0.9%
EMD local currency (UH, EUR)	-1.3%	1.6%	1.6%	-0.3%	0.9%	1.0%
GSCI Commodities (USD)	-2.3%	-8.8%	-8.8%	-10.0%	29.9%	7.1%
Emerging Markets (UH, EUR)	-2.7%	-0.6%	-0.6%	-11.0%	7.2%	1.1%

Source: Robeco, Bloomberg

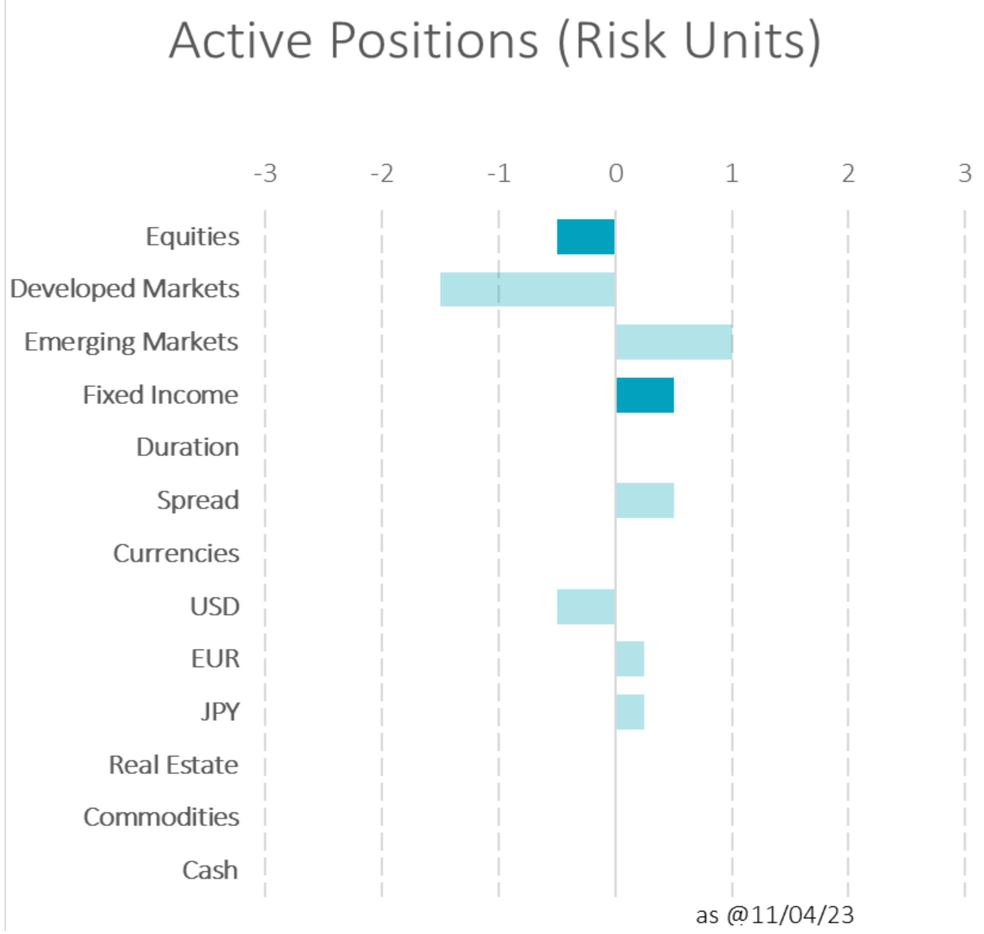
Macro signals continue to point to lower economic activity later in 2023. More indicators are joining the list and flashing warning signals to investors holding exposures in the riskier parts of the investment spectrum. Commodities are the latest asset to suffer on future demand expectations. OPEC+ announced an oil production cut at the start April because of expected weak demand and, after an initial surge in prices, the oil price settled back over the rest of the month to finish only slightly up at USD 76 per barrel (WTI spot). Equity investors took the poor economic outlook as positive news because central banks may feel compelled to cut rates soon, and by extension will reward risk taking. This development did not extend into emerging market and commodity returns as China's recent economic data disappointed bullish expectations.

Part of this negative economic outlook has been the centered-on China's reopening from COVID restrictions, which has been perceived as underwhelming. Although the GDP and consumer data releases were slightly ahead of expectations, as in the US, manufacturing data was softer, hence the lack of demand for commodities narrative.

Earnings season has been pretty good so far, the companies that have pushed equity indices higher continue to deliver against bottom line expectations. The high-end luxury consumer goods segment is seeing high demand and low inventories from the US to China, although some indications from other consumer stocks suggest that price rises are not being accepted blindly.

Robeco Multi-Asset views

Sustainable Multi-Asset Solutions views



Source: Refinitiv Datastream, Robeco

Our central investment roadmap is for a global economic slowdown later in the year as the rapid rate hikes to fight inflation crimp nominal and real GDP. This will increase the variability of corporate earnings this year, especially the high levels of corporate margins, and reduce the scope for financial engineering (debt for equity swap on balance sheets). Q1 earnings season has surprised as 2023 index winners (mega tech) rewarded their shareholders with better than expected earnings, taking on the bullish baton from windfall energy earnings in 2022. One other bright spot was demand from US and China consumers, which gave the luxury goods sector a massive bump in margins as supply could not keep up.

In April, we moved portfolios to an underweight equity position for several reasons; the small number of stocks driving equity market performance, the gloomier economic outlook, our lower conviction that earnings can support valuations and the defensive sector leadership. We have not added to the preference for emerging equities within the equity sleeve.

We remain long high yield as the risk premium compared to equities is still favourable. We increased the euro long against the US dollar, as the valuations and technicals remain positive.

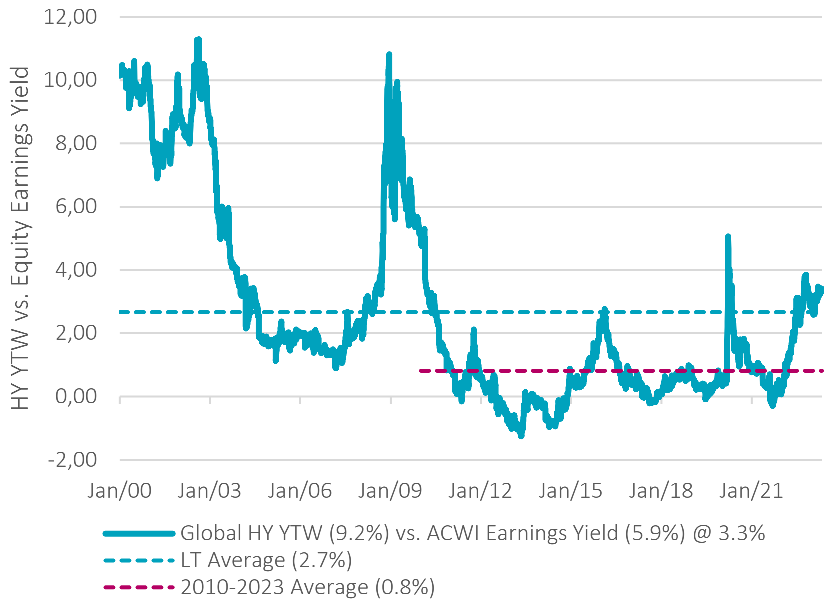
Overall, we positioned more defensively as the risks rise around earnings, the economic outlook worsens, US regional banks' liquidity drops, and the monetary policy outlook becomes even more muddy.

Theme of the month

High Yield – Please make me good, but not just yet

We are navigating a very uncertain economic environment where opportunities to add alpha or diversification are increasingly dependent on the pricing of assets vis a vis where we are in this cycle. This is making it increasingly challenging for investors to choose the right assets to generate positive risk adjusted returns this year. So far risky assets have fared well with High Yield, an asset investors shunned in 2022, delivering similar returns per unit of risk as global equities. However, it's not all good news, as recent performance means that high yield bonds are now priced to perfection, leaving less room to generate future returns through spread tightening, let alone compensating investors for the risk of a potential recession. Nevertheless, high yield still offers a more attractive valuation proposition relative to equities, as seen in the above long term average differential of the global high yield index yield versus the global equity earnings yield. (see chart)

Global High Yield vs. Equities Yield



Source: Bloomberg, @28 Apr 2023

At this juncture markets are pricing in different scenarios as return expectations and correlations between risky and "riskless" assets are painting either a picture of complacency or that of an imminent recession. As one of the steepest and fastest hiking cycles is approaching an end, one would expect markets to start reflecting a clearer picture of the timing and nature of an upcoming recession. However, the rangebound market environment since the beginning of the year has provided scant guidance.

For what it's worth, policy rate expectations point towards rate cuts starting during the third quarter of the year, suggesting that a recession is not far off. On the other hand, equity and credit markets are yet to price in a meaningful probability of recession within 2023, with current spreads consistent with default rates close to historic averages and global equity multiples suggesting earnings remain supportive and above levels expected ahead of an upcoming recession.

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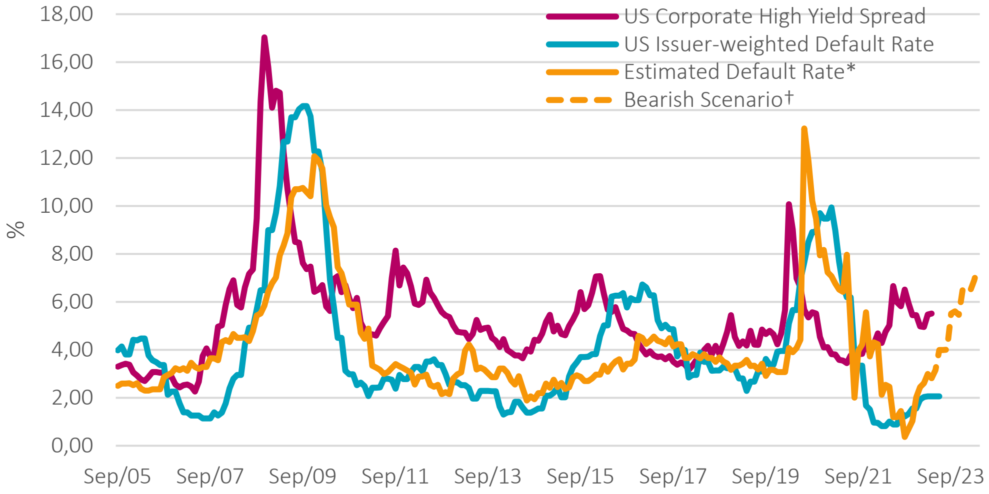
Theme of the month

US High Yield Spreads vs. Default rates



Source: Bloomberg, BoFA, Robeco @28 Apr 2023

* The estimated default rate is based on the regression of US 12m default rate with Tightening Standards of C&I Loans for Large and Medium firms (1Y lag) and 1Y Change in unemployment rate (1Q lag)
† Estimated Default Rate assuming US Unemployment rate increases to 6% in the next 12 months

Is it too late for high yield in this cycle?

Looking for cues in the latest macro data, one cannot overlook the observed 'conundrum' between the level of US unemployment and cyclical indicators. Historically, the US ISM manufacturing index below 50, pointing to a contraction, would typically coincide with an unemployment rate of at least 6%, and a rising risk of recession. However, we are yet to see an unemployment rate higher than 3.7%, even though the ISM has been sub-50 since November 2022.

The strength of the labour market has supported a more benign economic environment where default rates for companies have stayed below historic averages, even though financing costs have markedly increased as central banks continue to tighten monetary policies.

Less favourable credit conditions for commercial and Industrial loans to large and medium sized firms in the US, a leading indicator of default rates, suggest that the likelihood of higher a higher default rate is increasing. To put that into perspective, and assuming the unemployment rate increases to 6% over the next 12 months, we could expect default rates to rise to 8% and spreads to widen to levels between 800-1000 bps. This does not bode well for high yield credit, and current spreads of 550 bps (for global high yield) are not deemed recession proof. Conversely, leverage remains low and interest coverage high in the US high yield space, suggesting a healthy credit fundamentals, still supportive of the lower default rate environment.

Love it or hate it, high yield is offering a better alternative relative to equities on valuation grounds, but the asymmetric risk of holding this asset during the late cycle phase, has increased the opportunity cost for Multi-Asset investors. The recent narrative is favouring a shift to a more cautious approach, with focus on the higher quality spectrum of the high yield space and the deployment of active management to mitigate downside risks through credit selection.

Economy (I)

Stagnation continues to be the theme, but a global recession has so far been forestalled. The brightest spots are to be found in Asia where China's Q1 GDP grew by 4.5% on an annual basis with the IMF now expecting China's economy will expand by 5.2% in 2023. The US showed subdued growth at 1.5% in Q1 with the Euro area managing to escape recession posting a 0.1% q-o-q growth rate. Leading global manufacturing indices for April didn't divert from signaling a contraction in global activity. That trend has been in place since Q3 2022 and South Korea, a country that typically leads the global manufacturing cycle, is experiencing its longest slump in 6 years as the April purchasing managers index remained at 48.1, signaling continued contraction. New orders have also dropped, showing continued weakness in global demand on the back of ongoing monetary tightening. Banks in the Euro area reported a substantial net tightening in credit standards for loans to firms and house purchases in April. Treasury Secretary Yellen suggested the Fed April/May Loan officer survey will signal the same trend in the US, potentially substituting for further rate hikes by the Fed. Following the banking turmoil in March, small to mid-sized US banks are clearly not out of the woods, evidenced by another collapse in April, this time the First Republic Bank. The decline in (capital goods) new orders and a nascent credit contraction will likely keep manufacturing data subdued in the near term.

Subdued manufacturing activity across DM continues

Manufacturing PMIs (Seasonally Adjusted)

	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23
Global	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	N/A
US	59.2	57.0	52.7	52.2	51.5	52.0	50.4	47.7	46.2	46.9	47.3	49.2	50.2
Euro Area	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5	47.3	45.8
Germany	54.6	54.8	52.0	49.3	49.1	47.8	45.1	46.2	47.1	47.3	46.3	44.7	44.5
France	55.7	54.6	51.4	49.5	50.6	47.7	47.2	48.3	49.2	50.5	47.4	47.3	45.6
Italy	54.5	51.9	50.9	48.5	48.0	48.3	46.5	48.4	48.5	50.4	52.0	51.1	46.8
Spain	53.3	53.8	52.6	48.7	49.9	49.0	44.7	45.7	46.4	48.4	50.7	51.3	49.0
Greece	54.8	53.8	51.1	49.1	48.8	49.7	48.1	48.4	47.2	49.2	51.7	52.8	52.4
UK	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3	47.9	47.8
Australia	58.8	55.7	56.2	55.7	53.8	53.5	52.7	51.3	50.2	50.0	50.5	49.1	48.0
Japan	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0	48.9	48.9	47.7	49.2	49.5

≥ 60   50   ≤ 30

All market data to 28 April 2023 unless mentioned otherwise

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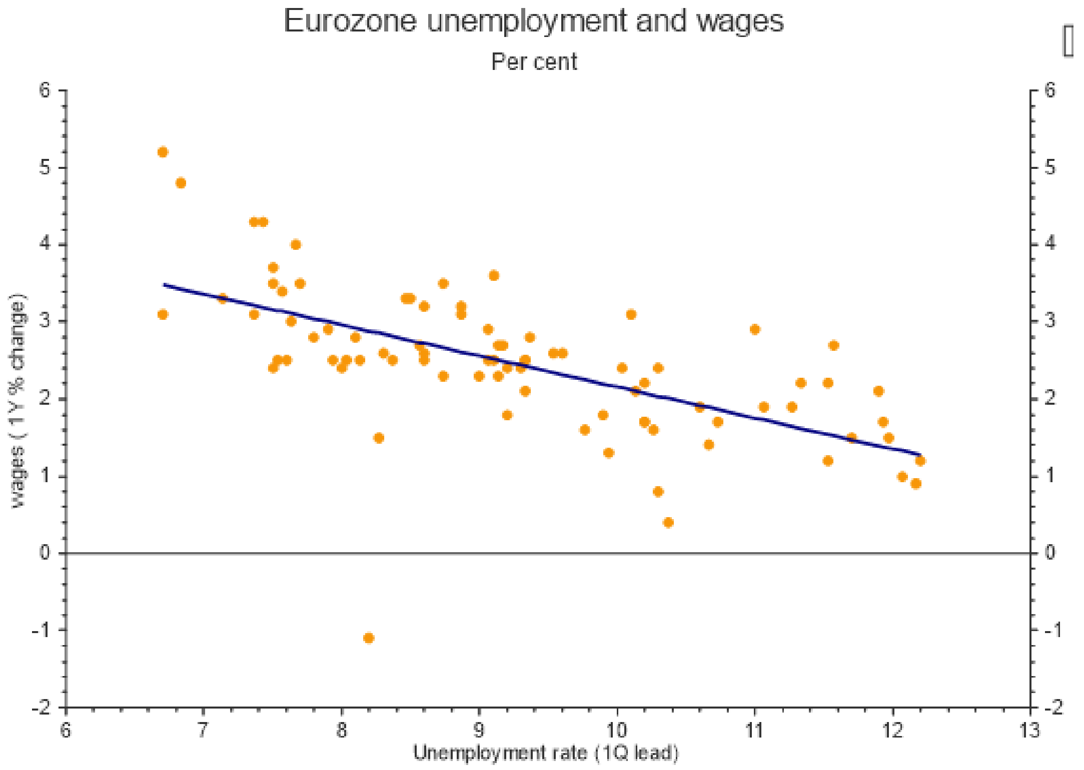
Economy (II)

In addition, it is interesting to note that the announced OPEC production cut production by 1 million barrels per day last month only caused a temporary spike in the oil price, with Brent prices now back at pre-announcement levels. This price action indicates the concerns over demand weakness signaled by sluggish manufacturing activity data are outweighing the impact of supply cuts. Yet, the pace of contraction in manufacturing seems to be slowing somewhat. In Germany with German corporates getting less downbeat about the future, and US ISM manufacturers confidence also perking up.

The sting of this developed markets central bank tightening cycle will eventually be in its tail, and largely depends on the consumer throwing in the towel. Services activity is still in expansion though decelerating as well. In China, the pace of expansion in services slowed with the non-manufacturing PMI declining to 56.4 in April. Yet, the capitulation of the consumer does not look imminent, especially in Asia. With global demand for labor still resilient, real wage growth has started to improve in the US as the decline in inflation has outpaced the slowdown in wage growth recently. The US employment cost index peaked in Q2 2022 but is still averaging 5.0% as of Q1 2023. In Europe, nominal wage growth is accelerating.

With EZ unemployment rate at 6.6%, upward wage pressures persist



Source: Refinitiv Datastream, Robeco

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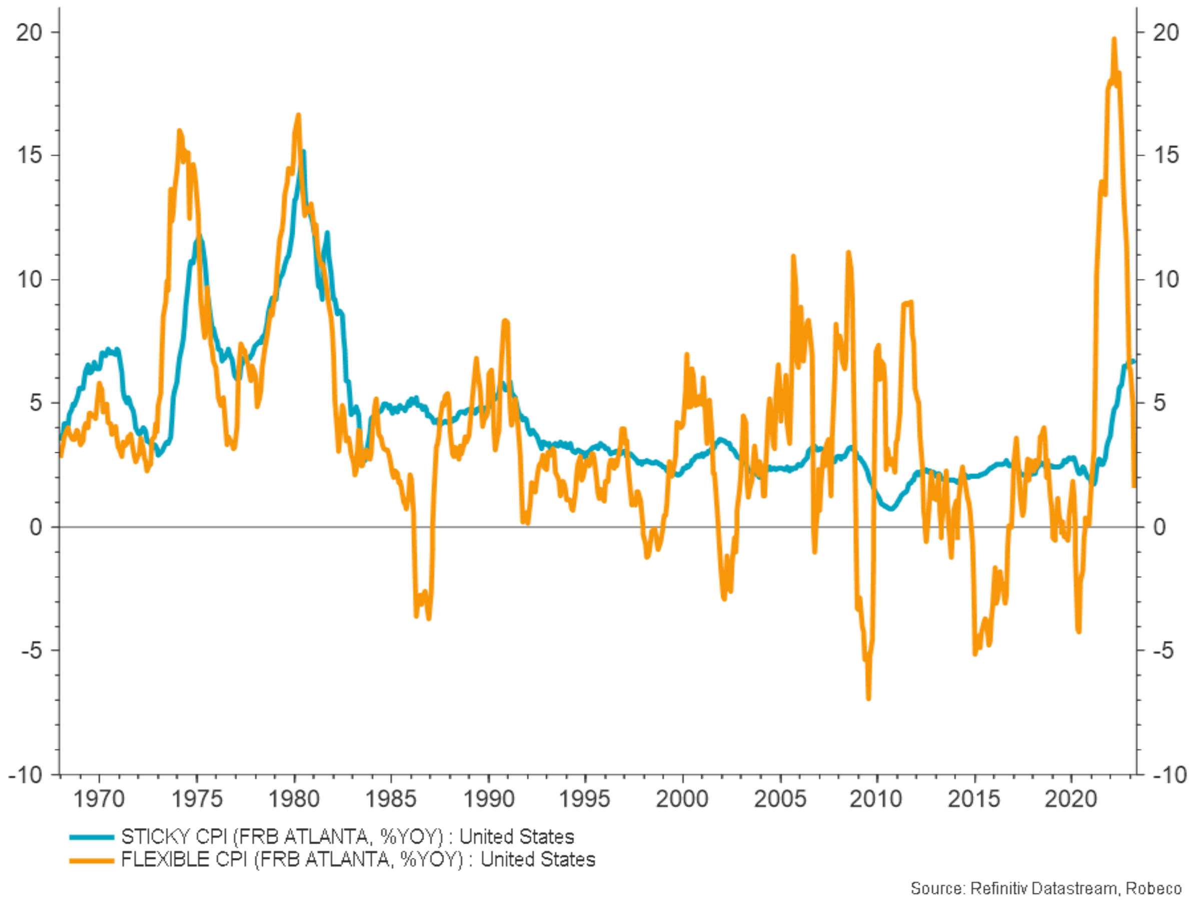
Economy (III)

Sticky CPI in US still close to 7%



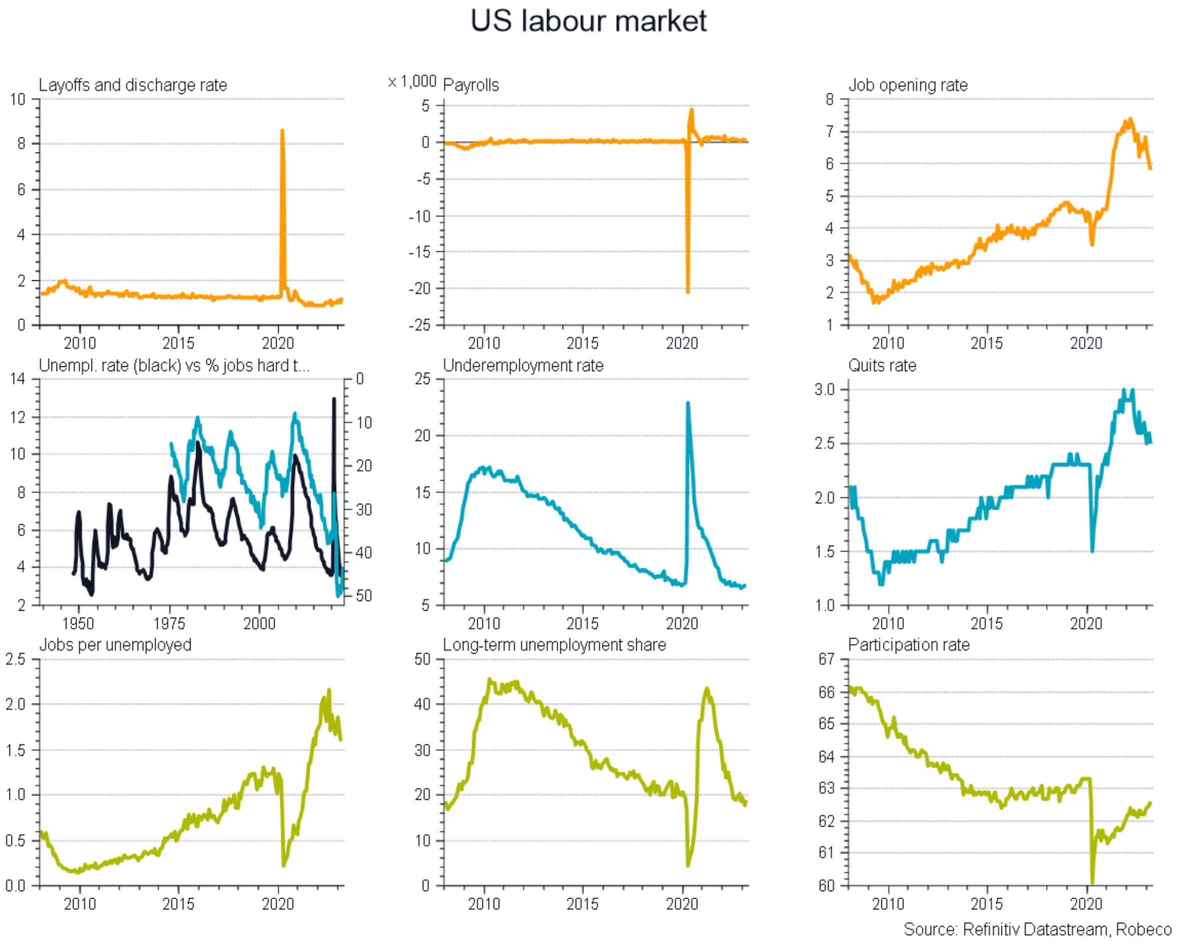
Source: Refinitiv, Robeco

The declining wealth effect as a result of the recent housing recession has dented consumer confidence but only to a degree. After the recent global housing market price drop, households still hold a significant cushion from past house price appreciation. Also, the vulnerability to rising rates for US households is much lower compared to the 2008/2009 financial crisis. For instance, only 1.3% of current outstanding mortgage-backed securities are adjustable-rate. Yet, the rising US savings rate shows the US consumer is getting more cautious with some income cohorts looking stretched as US credit card debt reached new highs in April.

Rising spreads between short and longer dated US T-bills shows that markets have started to pay more attention to the US debt ceiling debate as a summer showdown in Congress looms. Tax revenues in April have not disappointed and push out the so-called X-date where the Treasury runs out of money. Yet, while the Fed pays attention to a lifting of the debt ceiling as it would amount to a tightening market liquidity, the central bank's primary focus remains on labor market resilience and its potential inflationary impact. The number of job vacancies per unemployed is still 1.6, too high for comfort for the Fed which is still facing a 4.9% inflation rate. Therefore, the risks to current market expectations of an imminent Fed pause and subsequent Fed cutting cycle this summer, are tilted to the downside.

Economy (IV)

US labor market.. signs of easing but still tight



Source: Refinitiv, Robeco

Likewise, the hawks within the ECB governing council might hold their ground, pointing at accelerating nominal wage growth while the flash CPI is still 7%, miles away from the 2% inflation target. The largest waves are perhaps to be made by the BOJ where new governor Ueda still sees inflationary risks tilted to the downside but the statement on monetary policy tellingly saw the long-standing easing bias removed. Japan's core inflation stood at 3.8% in March.

Looking ahead, the tension between persistent inflation pressures on the one hand and weakening macro momentum, joining financial stability concerns on the other, has tilted towards inflationary pressures gaining ground in April. This could leave central banks to postpone any considerations about switching to an easing bias. Given the absence of global spillovers from the US local banking crisis and increasing macro instability (i.e. rapid job losses and/ or broadening banking distress) the market could have excessively pre-empted near term Fed cuts at this juncture.

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