Credit Quarterly Outlook

A brief re-Introduction; “Business as Usual”

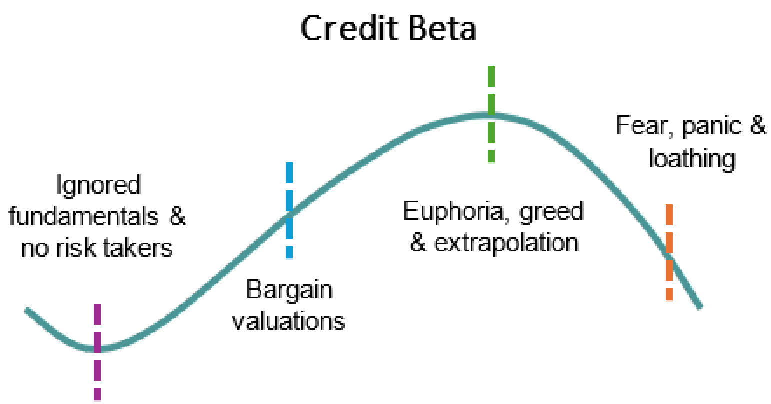
The Osmosis NL Credit Team has experienced many credit-market cycles, both upturns and downturns. Since the early 2000s, the starting point of our process has been—and will remain—a thorough review of the credit-market cycle.

We adopt a global perspective to determine which phase of the cycle we are in. This assessment forms the basis of our risk-taking, informs our market-theme positioning, and guides the selection of the right credits for the portfolio. We believe an “outside in” Credit Quarterly Outlook helps us to master structural biases within the team and, more importantly, enables us to explain to our clients why our performance is strong — or not.

Each Credit Quarterly Outlook concludes with a graphical depiction of the credit-market cycle. Every new edition may not read as the next chapter in a continuous narrative—fundamentals, valuations, and technical forces in international capital markets are powerful and can change quickly.

Factors such as carbon pricing and policy developments affect both risk-taking and valuations. Accordingly, we will start commenting on Transition positioning soon, which also drives alpha generation. Changes in sustainable-investment risk premia move our Transition Beta up or down: a higher Transition Beta indicates that we are capturing more companies making progress toward a sustainable economy, and vice versa.

Credit Quarterly Outlook:



Source: Osmosis NL

July 2025

Second edition

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Quick Read

Each quarter, we will publish our top-down view as transparently and concisely as possible.

As outlined in our book Bias, mastering the behavioral biases inherent in every team is essential.

Our Quarterly Outlook rests on four pillars: Fundamentals, Valuation, Technicals, and Transition.

Transition Beta insights help generate alpha; however, alpha will rise and fall as sustainable-investment risk premia fluctuate over time.

Canary in the Coal Mine

***Fundamentals** - Economics*

The world remains shocked by the Trump administration's unconventional policies, particularly those related to global trade and foreign affairs. The rules-based trade system is splintering into bilateral agreements, baseline—or universal—duties, and sector-specific levies. As we noted in our previous quarterly outlook, this approach has some merits, but its implementation poses significant risks. Indeed, the on-again, off-again tariffs and repeated deadline extensions are harming the global economic outlook. Tariff volatility is now the only known constant, resulting in prolonged uncertainty. We anticipate that this uncertainty will start to influence the economic cycle (it might even reinforce the already late cyclical situation). Households in the US and Europe are becoming more cautious in their spending, and corporations are growing equally wary.

Although commentators and the press emphasize the equity market's resilience following the uncertainty, the bond and currency markets have been taking notice. The US' stretched fiscal position — left largely untouched by the recent "Big Beautiful Bill" — adds to the complexity. Hence rebuilding the global trade and foreign-policy framework will not be easy. US assets remain especially vulnerable: the "Sell America" trade is still in play. Treasuries continue to struggle to rally with 30yrs even selling off, steepening the yield curve, and the dollar appears to have entered a secular bear market.

The US is not alone in its fiscal strain. France, the United Kingdom, Italy, and Japan face similar challenges, and one could argue that Spain and Canada do as well. In these markets, yield curves have steepened markedly as term premia rise, and long-end yields are moving higher. We view this repricing as a canary in the coal mine, confirming our earlier assessment that we have entered what we called the "Yield Era," a new phase of credit reckoning returns. Western economies are approaching the limits of their fiscal space in budget and debt terms while adapting to a more populist policy setting mode. Add the major defense spending around the world and the looming fiscal impulse in Europe and the result is likely to be higher neutral rates (fiscal risk premia), increased volatility, and wider term premia. Yields will become more volatile going forward. The stagflationary environment in the US will likely force the Federal Reserve (FED) to continue their wait-and-see mode while the European Central Bank (ECB) might be a bit more eager to cut rates a bit further. Higher neutral rates will limit the ability of central banks to cut rates meaningfully.

Quick Read

Tariff volatility is now the only known constant resulting in prolonged uncertainty.

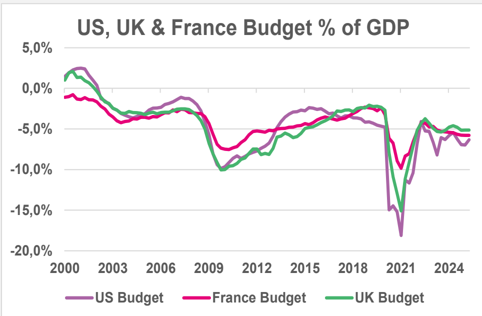
Rules based trading system as we know it is splintering into bilateral agreements.

Tariff uncertainty might reinforce the already late cyclical situation.

Risk assets continue to trade strong as evidenced by credit spreads and equity markets; US Treasury market and USD paint a bit of a different story.

Fiscal strain is a global phenomenon. Frank, UK, Italy, Japan and Canada also suffer from large debt/GDP ratios and budget deficits.

Western economies are meeting the fiscal limits – austerity will be difficult; expect more populist policy going forward.



Source: Bloomberg

Corporates

The financial health of corporate issuers in mid-2025 is generally strong. Balance sheets are healthy, and default rates are low by historical standards. However, because markets are forward-looking and spreads are already near their all-time lows, the next six months will require vigilance. Companies must adapt to a new reality: the global trading system is changing rapidly, driven not only by tariffs but also by intensifying economic competition between the United States and China and geo-political stress at several places. Shifting supply chains or reshoring production in Western economies — now facing "relative scarcity" of cheap labor and key commodity inputs such as rare earths — is not as easy as politicians would have us believe. If not enough, there are also massive investment cycles on-going to finance the Transition in some sectors. We think the market is underestimating the impact of these adjustments. Leverage for companies might rise in the intermediate term as a result, and some high-yield issuers might not survive [for example bankruptcies in the Small and Medium Entities (SME) sector are on the rise].

While public credit markets remain resilient, private equity and private credit are facing tougher conditions. Central banks cannot deliver substantial rate cuts — given higher neutral rates — so borrowing costs are squeezing highly leveraged firms. As non-bank lenders assume a larger role, concerns over opacity and liquidity in these markets have grown. Valuations are coming under pressure, exit opportunities are limited, and institutional investors may feel the strain. This corner of the capital markets is under-researched, yet the uptick in cautionary headlines, coupled with persistently high borrowing costs, makes us believe investors should tread carefully in private corporate credit. The growing difficulty of exits and the rise in defaults are, to us, another canary in the coal mine. Notable are the outlooks of KKR, Appollo and Carlyle in that respect[i].

Valuation

Credit markets continue to trade at historically tight levels with some markets getting close to all-time tights (US Investment Grade for example). The notable exception is Emerging Markets (EM), which offers an interesting spread premium vs High Yield and Investment Grade. Within structures, subordinated and perpetual bonds provide extra yield not seen in senior benchmarks. These divergences suggest investors should tread carefully – rich valuations can persist in benign conditions, but they leave less margin for error. Any shift in the macro-outlook or risk sentiment could lead to a mean-reversion in spreads from these rich levels (currently 1st decile spreads; 10bp break-even spreads only).

Quick Read

Financial health of corporate issuers generally remains strong.

The global trading system is changing rapidly and will force companies to adapt to a new reality.

We think the markets are underestimating the impact of these adjustments. Leverage might rise in the interim while some high yield issuers might not survive.

Higher interest rates are having their impact on private equity and private credit. Concerns over opacity and liquidity has risen.

Valuations in private equity and private credit are under pressure while exit opportunities are starting get more limited. Caution in these asset classes is required.

Public credit markets are at historically tight levels – close to all-time low spreads.

Some value left within structures like subordinated and perpetual bonds.

Conversely, for EM debt and subordinated credit which are still somewhat cheap, there may be some room for outperformance if global liquidity and fundamentals remain supportive versus senior IG and HY for example. As always, maintaining selectivity (by region, sector, and seniority) is key when valuations are stretched. The current landscape rewards those who can identify where spreads truly compensate for risk – and right now, that appears to be more in EM and lower in the capital structure, rather than in the ultra-tight core (senior) IG/HY markets of the US and Europe.

Technicals

Year to date, technical conditions have remained favorable for credit. Robust investor demand has readily absorbed heavy new issuance, even as some central banks have continued withdrawing net liquidity. Fund-flow data also point to a clear "risk-on" bias, with many managers preferring carry- and income-focused strategies.

Another positive technical that has emerged is investors' preference for spread products over government bonds to obtain duration. The sharp tightening of long-dated, high-grade US issues illustrates this trend: some names now trade at spreads in the low 30 basis-point range versus Treasuries (Apple, for example). Increasingly, investors are starting to recognize that, on fundamental grounds, high-grade corporates often offer a better risk–reward profile than their respective sovereign markets. As noted in the fundamentals section, many governments face large deficits and elevated debt burdens, leading investors to conclude that exposure to solid corporate balance sheets is preferable to holding riskier government debt. The question whether one should watch total yield or spreads in credit markets is the most important one going forward.

Conclusion

Our view this quarter is that caution and patience should outweigh carry and income by a wide margin as break-even spreads show hardly any cushion left. The fundamentals suggest we are in a late-cycle economy facing heightened sovereign and geopolitical risks. We have identified several canaries in the coal mine we consider important, while remaining mindful of other potential dark horses and black swans out there. With spreads near all-time tights, we have chosen a neutral-beta stance as a result. We prefer selective stock-picking and are willing to wait for some spread widening. Every calendar year, unexpected events in the global economy affect credit spreads. Liberation day was such an example. More moments like this will happen; it's worth the wait!

Quick Read

Emerging markets seem to offer some spread compared to IG corporates next to subordinated paper.

Technicals remains strong for credit. Investor demand is quite robust with new issuance absorbed rather easily despite central banks continuing to withdraw liquidity.

We see investors preferring corporate spread product over their respective sovereign bond markets.

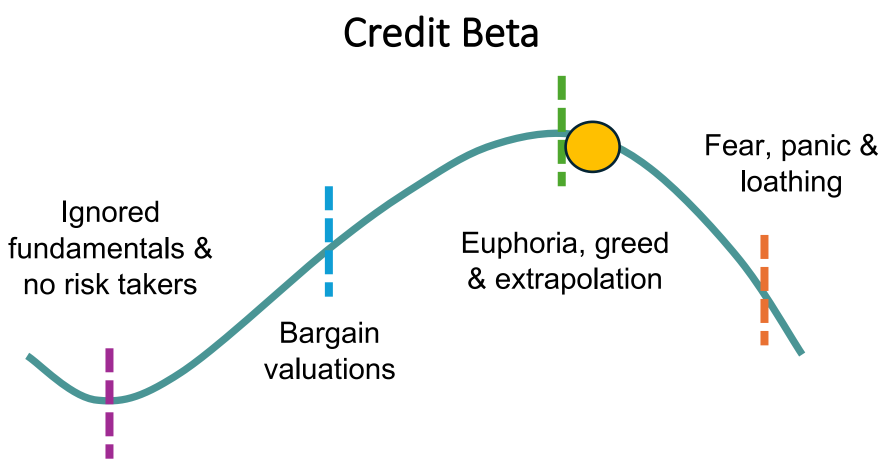
We are living now in the Yield Era – most important question going forward is whether on should watch total yield or spreads in credit markets.

Neutral rates are on the rise. The deflationary super cycle has ended!

Late cycle economy facing heightened sovereign and geopolitical risks.

Spreads are near all-time tights with break-evens hardly existing. Conclusion is therefore a neutral beta.

Credit Quarterly Outlook: our new graphic



Source: Osmosis NL

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[i] https://www.kkr.com/insights/mid-year-uHH LMHpdate-2025; https://www.apolloacademy.com/mid-year-outlook-at-the-crossroads-of-stagflationwhats-next/; https://www.carlyle.com/global-insights/research/2025-credit-outlook