Credit Quarterly Outlook

Tick, tock, tick, tock.....

***Fundamentals -** Economics*

The last quarter made one thing clear: the divergence between the US and Europe is deepening. The US economy remains surprisingly resilient, despite the noise surrounding the Trump administration. Europe, by contrast, continues to stagnate. Growth is tepid, unemployment rising, and every geopolitical urgency is met with bureaucratic paralysis.

China won't be the solution. Once expected to reignite global momentum, it remains stuck in structural slowdown, dragged down by a deflated real estate bubble and chronic overcapacity with the latter also exported to the rest of the world (think cars, steel for example).

In the US, most disinflation is already behind us. Goods and energy provided temporary relief, but new tariffs and fading base effects are reversing that trend. Services inflation is now central, and the signals aren't encouraging. Sticky components remain elevated, while AI-driven demand keeps pushing up utility costs. In Europe, inflation is drifting lower, but for all the wrong reasons.

The US labor market is showing late-cycle cracks. The quits rate keeps grinding lower, and payroll growth now sits near levels that often precede job losses and Fed cuts. Rate cuts are priced in, but risks remain. If jobs roll over faster than expected, the soft-landing narrative gets tested. Payrolls move quickly—we'll know the outcome soon.

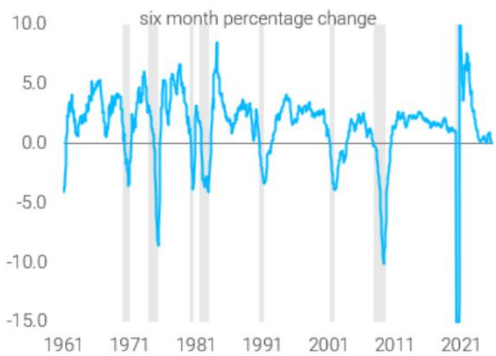

Chart 1. US Employment Growth. Source: TS Lombard. As of 29 September 2025

Monetary policy is shifting. The Fed calls its stance restrictive, yet credit growth is recovering in line with nominal GDP. That's not what restriction looks like. We think cuts are coming, pressured by labour, and politics. Implies a rising probability of a policy mistake! The ECB, stuck in stagnation, will follow, optics aside.

Sovereign debt is becoming unhinged. Deficits keep rising, political will is absent, and markets are starting to care. Long-dated yields are rising, fiscal credibility evaporating. Long live the Yield Era! Populism dominates, and any hint of fiscal consolidation is still taboo. Italy's upgrade? Absurd. Defense spending adds pressure, even if it's needed. Sovereign debt keeps growing. Tick, tock, tick, tock.....

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Quick Read

Economic divergence between the US and Europe is deepening

US labour market is showing late-cycle cracks with lower quits rates and payroll growth at levels that often precede further job losses and Fed cuts.

Corporate credit remains a pillar of stability with debt-to-GDP ratios continuing to fall since the pandemic.

Private markets are different. Valuations are stretched and debt structures are opaque. Not systemic yet, but risks are building.

We hold a neutral beta across credit strategies. The risk-reward balance is broken. Valuations are rich, dispersion low, and late-cycle signals are appearing.

Fundamentals – *Corporates*

Corporate credit remains a pillar of stability. Non-financial debt-to-GDP ratios have fallen steadily since the pandemic. There are no signs of stress or excess lending in the banking system. Spreads—both investment-grade and high-yield—are near multi-decade lows. That reflects solid balance sheets and an absence of major private-sector imbalances. In our view, the real excess lies with governments. Private assets are a separate story.

Regionally, US corporates still lead. Profitability is strong, and balance-sheet discipline remains intact. Europe and the UK continue to lag—think de-industrialization, overregulation, and weak productivity. Uneven tariffs are starting to bite. The global auto sector is a case in point: production cuts, furloughs, and Chinese overcapacity are squeezing margins. In more cyclical areas, credit quality may soon be tested, even if the broader picture stays stable.

Private markets are different. Valuations are stretched, debt structures are opaque, suffer from high interest rates and exits are narrowing. Not systemic—yet—but risks are building under the surface.

AI-related capex dominates budgets. Chip and datacenter spending (~1% of US GDP) has surged. But discipline prevails: profits are holding up, leverage is contained, and resource constraints may cap overheating. Still, exuberance and financial engineering are back. Tech firms lending to or investing in one another just to buy each other's goods and services is troubling. Not a bubble—not yet. Feels more like 1996 than 1999.

Valuation

Credit markets continued their steady grind tighter this quarter. Spreads compressed across ratings and regions, with European investment grade again outperforming US IG. US high yield delivered stronger relative returns than its European counterpart. Most IG sectors now trade near the bottom of their historical spread ranges—often in the first decile—leaving little room for error.

Outliers remain in CCC-rated credit and select EM corporates, where spreads in both the US and Europe remain elevated and far from prior tights. EM remains tricky. The sovereign nexus is deeply embedded; selection is everything. Subordinated debt—AT1s and hybrids—looked attractive last quarter but has since rallied hard. These now trade at or near all-time tights.

The US long end still stands out. Investors continue to favour high-quality, long-duration corporates over Treasuries, pushing spreads even tighter. With sovereign credibility under pressure, the tilt toward balance sheet strength and stable cash flows feels increasingly justified.

Dispersion tells the usual late-cycle story. AAA–BBB spreads are compressed across markets, offering little incentive to move down in quality. High yield is more nuanced: BB–CCC spreads remain wide, isolating CCCs. That's where residual value may sit—but also where volatility likely returns.

In Europe, distortions persist. IG spreads are tight, yet French and Italian corporates trade absurdly tight to Bunds and their own sovereigns.

Technicals

One of the more telling features of today's credit markets is the structural investor preference for investment-grade (IG) corporate bonds over sovereign debt. Government issuance is surging, central banks are constrained, and IG credit, scarce and offering a yield premium, looks like the obvious explanation for further spread tightening. IG issuance is still growing but now lags nominal GDP, a clear sign corporates are deleveraging rather than releveraging, creating relative scarcity.

The same story plays out in the primary market. New-issue premiums are near non-existent, order books massively oversubscribed, and that's despite already expensive valuations. High yield still separates strong from weak issuers. The former are printing solid deals with limited concessions.

Positioning remains firm, firmer since Liberation Day. Investors are already overweight credit across positioning indicators and not rushing to change. We've seen bleak economic data and geopolitical drama, yet tiny spread peaks have simply been used to add to credit.

Future rate cuts may be welcomed as bullish, but if they are driven by collapsing payrolls or policy mistakes from the Fed or a Trump administration, they could just as easily trigger wider spreads.

Transition

In previous updates, we promised to explain how we integrate our transition approach into our strategies. That starts here. Transition is a key part of our credit selection process, measured through six transition pathways. One of them is carbon deleveraging. Rather than focusing solely on a company's current emissions, we assess whether there is a credible future investment plan to reduce them over time. Then, we assess whether the company has the financial means to make the Transition. Ultimately, it comes down to one question: is the transition realistic? Is the technology available and can companies finance it?

At the end of the quarter, our High Yield (HY) and Investment Grade (IG) strategies showed lower carbon intensity than their benchmarks **with minus 37% and minus 17% respectively. That's important, but not the full story. Within our framework, our strategies may invest in companies with high emissions today, as long as they have a clear and measurable plan to reduce them in combination with outperformance potential. Think steel, chemicals, and automotive. No plan, action or unrealistic financial planning? Then our strategies do not invest. If there is a plan, our strategies still need to able to justify the footprint via increased spread premia. If the premia is gone, our strategies sell again. For actual examples please engage.

Conclusion

We hold a neutral beta across credit portfolios. The risk-reward balance is broken. Valuations are rich, dispersion low, and late-cycle signals are appearing. Too many risks. No real compensation.

Caution isn't just about tight spreads, it's about fundamentals. Sovereign debt imbalances are structural. Inflation in the US isn't gone; it's shifting.

Services, sticky components, and rising utility costs are quietly re-pricing expectations. Europe, meanwhile, is stagnating. Rate cuts may come, but inflation may linger. Not a great setup for credit, even with solid corporate fundamentals.

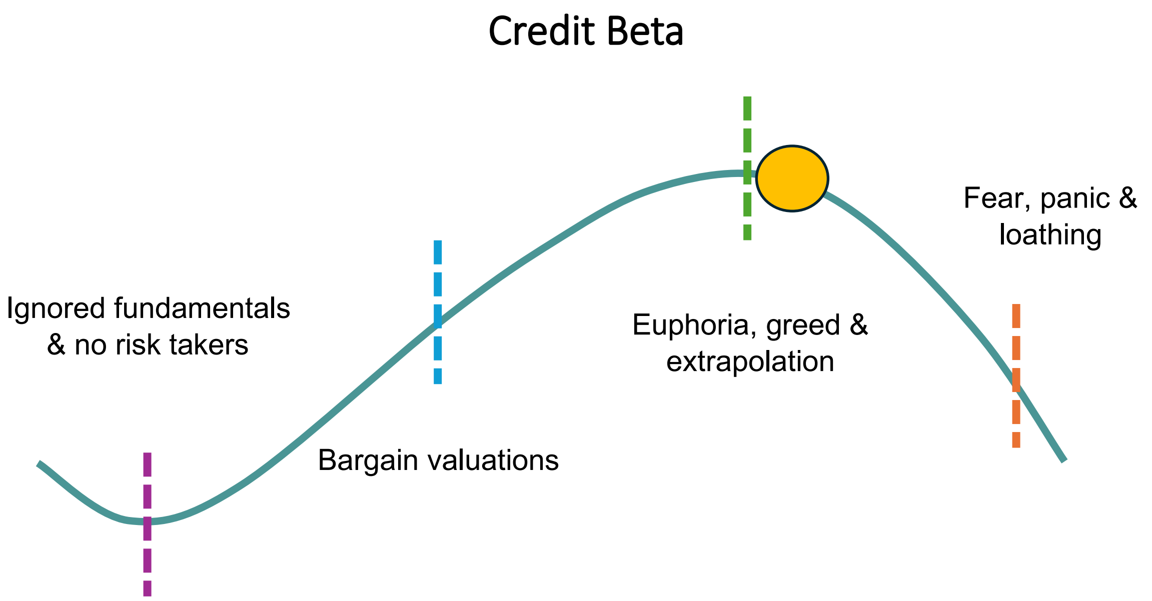
In IG, we favor selective recovery plays in BB and BBB names, autos, media, food and banking. These are balanced with Euro covered bonds from core markets, which tend to outperform corporates in sell-offs. France and Italy? We have moved to an underweight position. Spreads do not reflect the risks.

In HY, we continue to like BBs over the index, alongside a handful of special situations in telcos, utilities and media. CCCs might look cheap, but viable names are scarce—and require surgical precision.

We win by not losing. That hasn't changed. Chasing spreads in expensive markets, or leaning on technicals built on complacency, isn't a strategy. It's hope. We do realize markets can be expensive for years though.

This is about discipline. Cautious beta coupled with rigorous stock selection. Avoiding drawdowns. This is the Yield Era. Focus on quality yield/income. The cycle is aging. Spreads don't care yet. But time does. Tick, tock, tick, tock....

Credit Quarterly Outlook: Where are we in the Cycle



Source: Osmosis NL

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Investment strategies mentioned in this communication are not available to US investors.