

Credit Quarterly Outlook

K's Everywhere

Fundamentals - Economics

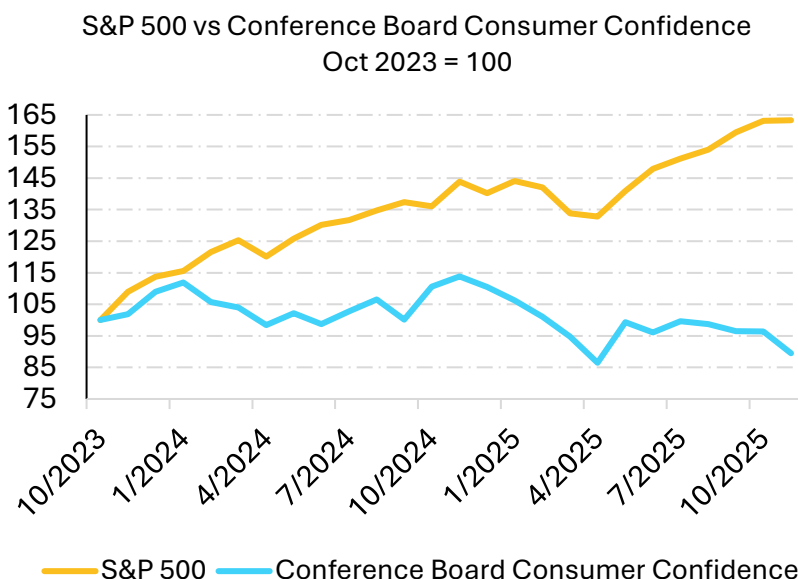
We see K-shapes everywhere - where markets and macro data move in opposite directions. A high S&P 500 contrasts with weaker consumer confidence (Graph 1), large caps keep outperforming lagging small caps, and labour's share of income erodes as corporate profitability stays elevated. The "average" economy hides widening dispersion underneath the surface. This also means that wealth and income inequality continues to rise - injecting more stress in societies around the globe.

Against this backdrop, the US economy is still doing well, defying slowdown expectations. Europe looks weakish, yet signs suggest the worst may be passing as German stimulus, higher defence outlays and some deregulation filter through. However, peripheral risks remain (France), with large fiscal deficits and no political appetite for reforms.

Expectations that China could revive global growth are misplaced. Its post-COVID rebound has faded into a structural slowdown, weighed down by a prolonged property slump and weak consumption. Import growth, a key indicator of domestic demand, remains low. Instead, China is once again leaning heavily on manufacturing and exports which is being offloaded onto global markets, harming Western manufacturers.

Chinese exports are gaining global market share, backed by state subsidies and industrial policy. This has made China dominant in many advanced manufacturing sectors, driving record trade surpluses. Rather than boosting domestic consumption, these surpluses often flow into inefficient industries or foreign assets. Meanwhile, investment as a share

Graph 1: Source: Bloomberg, Conference Board & Osmosis Calculations.
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Quick Read

K's are everywhere: S&P 500 versus weak consumer confidence; large cap outperform small caps; US exceptionalism vs Europe; etc

US economy is still doing well; Europe seems weak but worst seems behind us and China is stuck in a structural slowdown.

Corporate balance sheets look strong but stress is building at the margin in Private Credit with amend-and-extend deals and Payment-In-Kind interest notes mask underlying weaknesses, creating a shadow default environment.

Credit market valuations remain tight, with some areas appearing outright frothy. We do like super senior credit risk like covered bonds in EUR.

We're staying selective, a beta of just under 1, and overweight less cyclical companies and up in quality.

We would like to thank Dario Perkins of TS Lombard for his valuable input to our outlook.

of GDP keeps falling, making China increasingly reliant on its export engine, an unsustainable path. We're also sceptical that China can successfully revive domestic consumption. In our view, China is turning Japanese: more savings, less consumption, and a government and central bank struggling to stimulate demand.

In the U.S., inflation dynamics are shifting. Earlier disinflation was driven by easing supply chains and energy, but going forward, inflation is more demand driven. Strong consumer spending, supported by a tight labour market maintaining wages relatively high, is keeping demand-side pressures high. Meanwhile, tariffs are adding to supply-side costs, which businesses are now slowly passing on to consumers.

The Federal Reserve faces a delicate balancing act. Although now cutting rates and even purchasing T-bills, it remains divided on future policy. Some hope AI will boost productivity and contain inflation. But relying too early on such gains, as in the Greenspan era, risks policy mistakes. Unlike the 1990s, today's inflation and labour conditions are far tighter, leaving no room for error. If economic momentum reignites inflation, which is what we are expecting, the Fed may be forced to tighten policy again in 2026. However, markets are fully pricing in a soft landing with little economic surprises. The clock keeps ticking, tick, tock, tick, tock...

Fundamentals - Corporates

Overall, corporate balance sheets remain strong. Non-financial corporate debt levels are still below post-pandemic highs, as many firms locked in low-rate debt and have avoided re-leveraging for the bigger part. While interest coverage ratios have declined from their peak, most investment-grade companies remain well positioned. Importantly, there are no broad signs of excessive risk-taking or a credit bubble in public markets, with banks showing lending discipline and private-sector imbalances appearing modest. In fact, the largest financial excesses are now found in government spending and debt levels, not corporate activity.

However, stress is building at the margins. High-yield issuers and smaller private firms are under pressure from rising interest rates and weakening demand. U.S. bankruptcy patterns confirm an increasing trend in defaults (a.o. Chapter 11). The distress is concentrated in sectors like retail, real estate, and segments of healthcare and industry. Much of this strain lies outside the traditional banking system, particularly in private credit. Here, amend-and-extend deals and PIK interest notes mask underlying weaknesses, creating a shadow default environment. As conditions tighten, defaults could rise sharply. We note the strong fundamental divergence between the public and private credit markets here.

Regionally, U.S. corporates remain stronger than their European peers. U.S. firms benefit from higher profitability and more flexible cost structures, while European companies face energy costs, regulatory burdens, and increased competition from Chinese imports, especially in manufacturing. Again, a notable regional yet stark divergence (another K).

In the U.S., capital spending is focused on AI and tech infrastructure. Though largely funded by strong profits and cash-rich Big Tech firms, signs of speculative behavior are emerging. Circular (vendor) financing, inflated valuations, and investor hype echo the late-1990s. While not yet a bubble, the AI sector is vulnerable and feels bubbly. More broadly, we should remember that financial bubbles are often burst by central banks aggressively hiking interest rates after misreading the situation (see the earlier Greenspan reference). Still, smaller sell-offs can equally happen because of rising inflation or be policy induced (see liberation day).

Valuation

Credit market valuations remain tight, with some areas appearing outright frothy. The credit rally through 2025 has compressed spreads across most sectors to the lower end of historical ranges. Investment-grade corporate bond spreads are now in their tightest decile of the past decade, while U.S. high-yield spreads sit near post-financial crisis lows, excluding the weakest junk tiers like CCC's.

This lower rated tier of CCC's have started to trade differently or late cyclical already. Profit warnings or other disappointments with respect to leverage or cash flow are met by an unforgiving market. The disappointments or refinancing risks over the next two years is met with aggressive repricing. We have been seeing price drops of twenty points or more occurring now more frequently.

A key trend has been the strong demand for high-quality, longer-duration corporate bonds over government securities. Many investors have sought modest yield pickup and corporate balance sheet strength over the volatility of government bonds. This has driven valuations for top-tier credit to levels that suggest a benign economic path, moderate growth, declining inflation, and eventual Fed easing, with little room for negative surprises.

Currently, the market is not pricing in a recession or an inflation uptick. Any deterioration in growth or a monetary policy misstep could prompt a sharp widening of spreads, given the lack of risk premium. Break even levels are extremely low and a small spread widening wipes out the carry and/or pick-up in high yield.

Opportunities remain limited. Lower-rated credit offers slightly higher spreads, but they are only attractive if default rates remain low. Emerging Market corporates show selective value, though often with added sovereign and geopolitical risks.

In Europe, distortions persist. IG spreads are tight, yet French and Italian corporates trade absurdly tight to Bunds and their own sovereigns. Hence, we continue to run maximum underweights in peripheral markets. We do like super senior credit risk like covered bonds in EUR. These trade at only a small give up in spread versus investment grade credit. Ideal to own this liquidity and exchange into lower rated credit when the opportunity is there.

We also like bank debt higher in the capital structure. Senior preferred debt of Polish banks for example or senior bank debt in general is preferred. We do not invest in so-called Business Development Corporations (BDCs) as the balance sheet holdings are opaque and a lot of PIK notes and companies with an interest coverage of 1 or lower are on it. This is where the default cycle will start.

We do not like the technology sector which is growing fast in the benchmark. The sector appears expensive with spreads frequently trading below the historical average. Also, we question the circular investments among them and the increasing usage of debt and primarily off-balance sheet debt, SPV funding vehicles and operating leases. Risks slowly rise while not offering compensation.

Finally, we also see opportunities in special situations. Since more corporates have been met by an unforgiving market or actual restructurings, a growing number of companies also emerging from restructurings. These examples plus a few corporate actions or M&A opportunities make the number of special situations available rise fast.

One could state that parts of the market are still expensive (the biggest part), parts of the markets are suffering (Chemicals or Automotive) and part of the market in a special situation (smallest part). Hence, an increasing divergence among credits and (slowly) an increasing set of opportunities for alpha generation.

Technicals

A notable dynamic in today's credit environment is the structural tilt of investors toward investment-grade (IG) corporate bonds over government securities. With sovereign issuance accelerating and central banks operating with limited flexibility, IG credit, still relatively scarce while offering a yield pickup, remains an appealing alternative. Although IG supply continues to rise, it trails nominal GDP growth, signaling that companies are prioritising balance sheet strength over new leverage, adding to the scarcity effect.

This trend is also evident in the primary market. New bond deals are being met with overwhelming demand, often pricing with little to no new-issue premium despite elevated valuations. In the high-yield space, credit quality still

matters, stronger issuers are securing favorable terms, while weaker names face tougher conditions and some are even pushed to the private credit market.

Investor positioning in credit remains resilient, and in fact has grown more entrenched post-Liberation Day. Most portfolios are already overweight corporate credit, and few appear inclined to reduce exposure. Despite weak macro data and geopolitical tensions, investors have viewed minor spread widening as a buying opportunity.

Looking ahead, potential rate cuts might support sentiment, unless they stem from deteriorating growth or policy missteps, which could just as easily trigger a risk-off move. Similarly, renewed inflation or economic acceleration could have a comparable effect on spreads. This shows that adverse economic or inflation outcomes are not materially priced. Equally, the link between credit spreads and central bank liquidity seems broken. Central banks have reduced their balance sheets quite materially in the past few years while also hiking interest rates creating tighter liquidity conditions. Still spreads tightened which is at odds with the prevailing view that liquidity drives excess returns and tighter spreads. While this framework may have been useful during the QE era the subsequent reversal via QT certainly did not unfold as expected, QT should lead to less liquidity and wider spreads. So no, liquidity did not necessarily drive markets!

Transition

Transition investing remains central to our investment strategy. As outlined in earlier updates, we incorporate a “transition-focused” framework into credit selection, based on six defined pathways. Among these, carbon deleveraging, tracking a company’s emissions reduction over time, is especially critical. Instead of automatically excluding high-emission issuers, we evaluate whether they have credible, actionable plans to lower their carbon footprint and the financial capacity to follow through. The key questions are: Is the company’s transition plan feasible? Does the necessary technology exist, and can they fund the required changes? A company’s current emissions are just a starting point, its direction of travel and commitment to progress are what truly matter.

This approach allows us to hold bonds from traditionally high-emission sectors such as steel, cement, chemicals, or automotive, but only when issuers demonstrate clear, measurable decarbonisation strategies and spreads offer sufficient compensation for the environmental risk. We continuously evaluate whether the additional yield from such bonds justifies their climate exposure. If not, we avoid or exit the position. As a result of this disciplined process, the carbon intensity of our portfolios is significantly lower than their respective benchmarks, currently 20% lower in High Yield and 21% lower in Investment Grade, reflecting our targeted and selective exposure. For actual examples please engage.

Conclusion

We remain defensively positioned, yet practical in our approach. Our beta is neutral; we’re not making aggressive directional calls at this stage of the cycle. Instead, we’re focused on high-quality credit, strong liquidity, and staying nimble amid a complex and shifting backdrop. The current environment is full of competing signals and potential surprises, requiring both caution and flexibility.

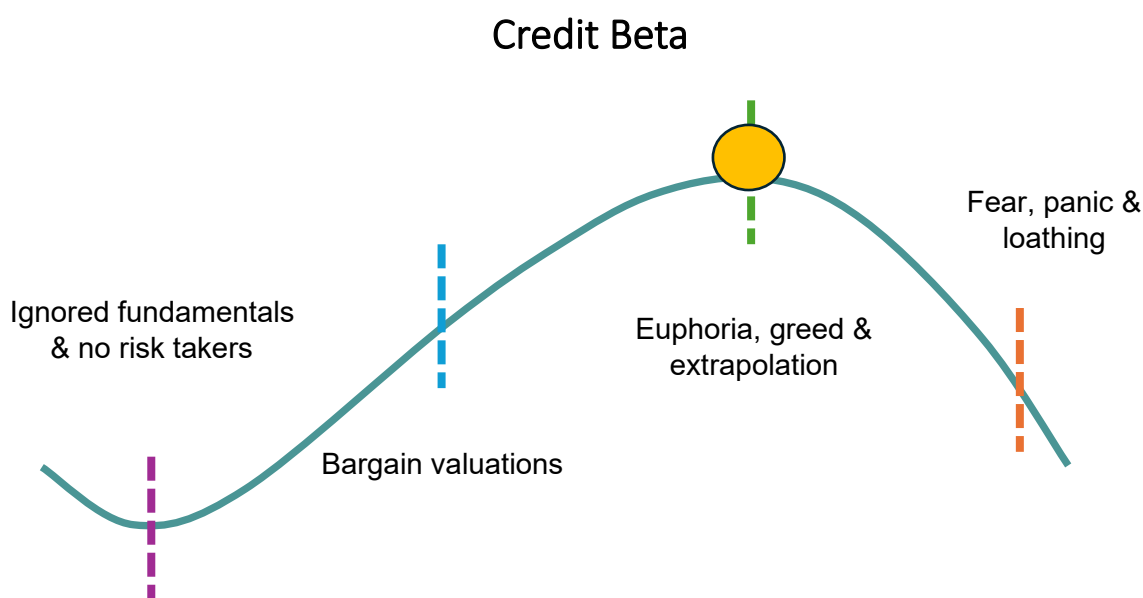
We see a lot of divergence which is quite unusual. Public and private markets are flashing different kinds of fundamentals and risks. Large cap companies are very profitable while small cap companies struggle (40% of Russell 2000 companies are not making profits currently). Higher income households are doing pretty well while lower income households’ struggle. It’s the K-shaped economy and we currently see a lot of K’s...

Markets continue to price in a soft landing, with credit spreads and equity valuations reflecting a scenario of steady growth and cooling inflation. We don’t see signs of a broad credit bubble, corporate and household leverage is contained, and banks remain in solid shape. Risks appear more localised in areas like private credit and leverage-driven strategies, with any stress likely emerging gradually through isolated defaults rather than a sharp systemic break.

Ironically, strong economic data may pose a bigger threat to credit than weak data. A sudden burst of growth or inflation could force central banks to tighten further or delay rate cuts. In a market priced for perfection, even modest policy errors, whether dovish or hawkish, could trigger sharp repricing across assets.

We also remain cautious on the AI-driven rally. While we're constructive long-term on its economic impact, short- and near-term froth and extreme capex suggest bubble-like dynamics. A reversal here could impact sentiment broadly, even if credit remains less exposed than equities. In summary, we're staying selective, a beta of just under 1, and overweight less cyclical companies and up in quality. We have included the first couple of special situations to the portfolios. With valuations stretched and risks finely balanced, discipline is paramount. We aim to preserve capital now to be positioned for better opportunities later.

Credit Quarterly Outlook: Where are we in the Cycle



Source: Osmosis NL

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