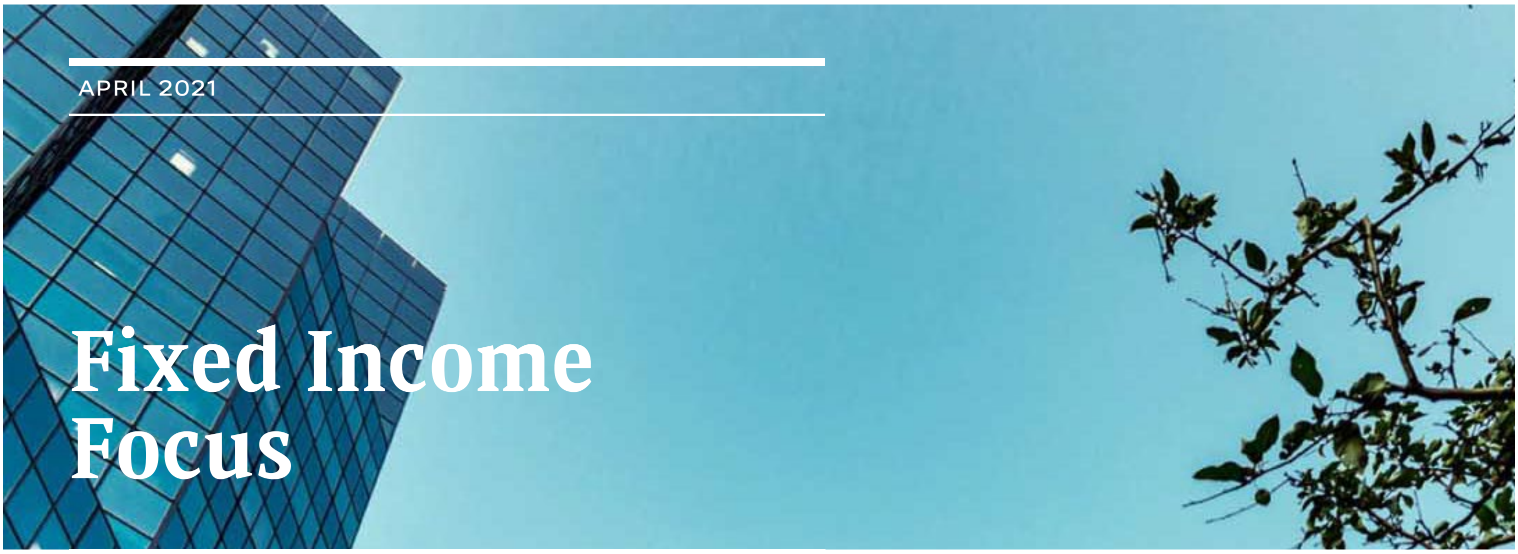


Fixed Income Focus

Summary

1. **The ECB's decision to significantly step up its bond purchases was more a compromise than a unanimous decision.** The ECB is likely to curb (but not prevent) the rise in long-term rates. Peripheral bonds' carry remains attractive, even if capital gains are compromised.

2. **Market expectations of a Fed rate hike are very high in our view.** We expect a first rate hike in Q3 2023 as opposed to the end of 2022 as the market expects. US short-term rates could fall.

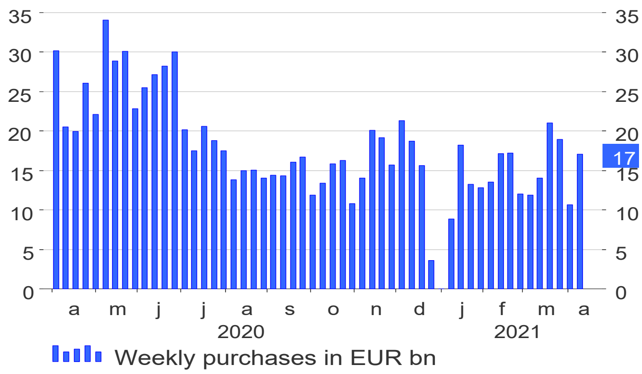
3. **Long-term rates are easing at the moment, but the backdrop remains bearish. Long-term rates are likely to resume an upward path. We have a target of 2% over 1 year for the US 10-year rate and 0% for the German bund.** Negative view on long-dated US and German bonds as a result.

4. **Credit markets are rather expensive in valuation terms.** However, there are opportunities in sub-segments, such as fallen angels and rising stars.

5. **A return of inflation in the US?** Inflation-linked bonds are already pricing in this risk in our view.

Contents

THE ECB'S PURCHASES OVER THE LAST 4 WEEKS, WHICH WERE SUPPOSED TO BE "SUBSTANTIALLY" HIGHER, ARE NOT REALLY. IS THE EASTER HOLIDAYS TO BLAME?



Source: Refinitiv Datastream, 09/04/2021

Edouard Desbonnets

Investment Advisor, Fixed Income
BNP Paribas Wealth Management

Central banks

Agreements and disagreements

European Central Bank (ECB)

The ECB decided to substantially increase the Pandemic Emergency Purchase Programme (PEPP) to counter the rise in long-term rates. This is the result of a compromise between its members.

Agreement: ECB members agree that the rise in long-term rates needs to be substantial and persistent to have a significant impact on financial conditions.

Disagreement: some members think that too much intervention via asset purchases gives the impression that the ECB wants to control the yield curve.

Compromise: the substantial increase in asset purchases was passed, on condition that the total amount is not challenged and the pace of purchases can be reduced in the future.

Our view is that growth should pick up from Q2 as vaccination accelerates. The ECB will not extend the PEPP beyond March 2022, but will remain accommodative as inflation is still a long way off the target.

US Federal Reserve (Fed)

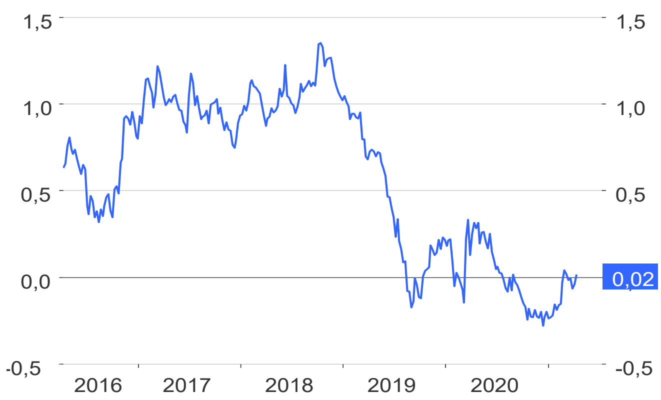
Agreement: the Fed and the markets believe growth will be strong this year.

Disagreement: some members want to slow asset purchases (tapering) at the earliest opportunity due to strong growth, falling unemployment and inflation risks.

The Fed, as a whole, thinks that inflationary pressure will be transitory and that it will not have to raise policy rates either this year, in 2022 or in 2023. The market does not believe this and expects a first rate hike from December 2022.

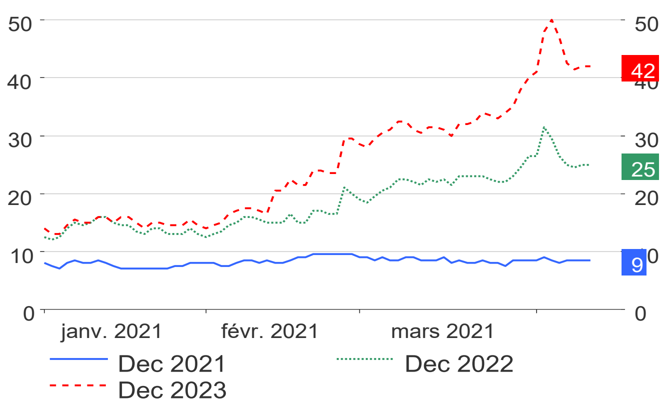
Our view: given the strength of the recovery, the Fed's two objectives (i.e. inflation above 2% and maximum employment for all categories of the population) should be well on track to prompt the Fed to announce tapering at the end of the year, with implementation in Q2 2022. We expect a first hike in policy rates once the effects of the pandemic dissipate, in Q3 2023.

EUROZONE 10-YEAR SOVEREIGN YIELD (WEIGHTED BY EACH COUNTRY'S GDP)



Source: Refinitiv Datastream, 12/04/2021

MARKET EXPECTATIONS FOR FED RATE HIKES (IN BASIS POINTS)



Source: Refinitiv Datastream, 12/04/2021

CONCLUSION

Differences of opinion are beginning to emerge, both at the ECB and at the Fed, with regard to managing the exit of the crisis. There is no doubt, however, that monetary policies will remain accommodative. We do not expect any rate hikes in the eurozone or any rate hikes before 2023 in the US.

Bond Yields

Short-term pause in a bear market

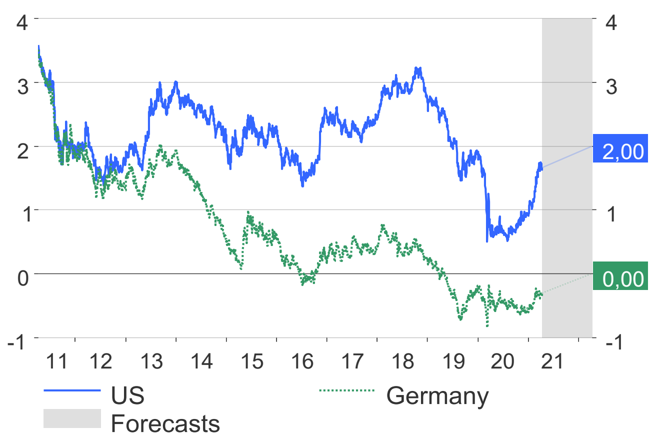
Long-term rates are stabilising for the moment. Interest rate volatility has lessened and Treasury issuance is expected to be reduced in Q2 relative to Q1. Currency-hedged US long-term rates are attractive for international investors. The US 10-year bond is trading at 0.9%, protected from the EUR/USD currency risk, which is the equivalent of the Greek 10-year rate (0.87%). The advantage is even more striking for Japanese investors: 1.3% vs. 0.1%.

Rising long-term rates within the next year. Strong expected growth and rising inflation are likely to push long-term rates higher, especially as central banks will intensify discussions on ending pandemic-related asset purchases in the second half of the year.

Negative view on long-dated, US and German sovereign bonds.

Positive view on short-dated US sovereign bonds. The market is pricing in a series of rate hikes that is too aggressive in our view.

10-YEAR SOVEREIGN YIELDS



Source: Refinitiv Datastream, 12/04/2021

	Maturity (in years)	09/04/2021	12-month targets
United States	2	0,16	0,40
	5	0,87	1
	10	1,67	2
	30	2,34	2,60
Germany	2	-0,70	-0,50
	5	-0,63	-0,30
	10	0,30	0
	30	0,25	0,50
United Kingdom	2	0,05	0,30
	5	0,33	0,60
	10	0,76	1,20
	30	1,29	1,50

Source: Refinitiv Datastream, BNP Paribas WM

CONCLUSION

Long-term rates are stabilising for now. However, the backdrop remains conducive to a continued rise in rates, but probably at a slower and more gradual pace than before. We have raised our rate targets to 2% for the US 10 year-rate and 0% for the German bund in one year.

Theme in Focus

Fallen angels and rising stars

As a direct result of the pandemic, 2020 was marked by a record number of fallen angels, i.e. Investment Grade corporate bonds that were downgraded to High Yield. We counted 25 European companies in the region of €70 billion and 37 American companies in the region of $220 billion.

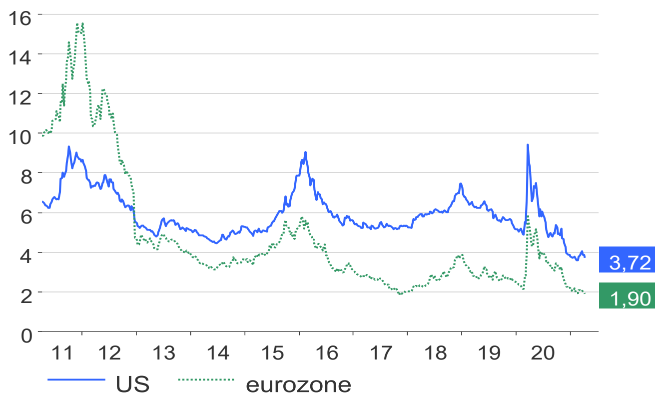
These events should be seen as opportunities for investors as they are causing credit spreads to widen. Historically, spreads start to widen 12 months before the downgrade as Investment Grade managers gradually reduce their exposure. The bond then joins the High Yield category with a higher spread than the best High Yield bonds (BB-rated). It is only about a month after the spread adjusts, as High Yield managers incorporate these new bonds into their portfolios.

Following the rally in credit markets, additional yield compensation on fallen angel bonds versus BB-rated bonds are currently small: barely 0.10% for bonds in the eurozone and 0.25% for US bonds.

This year, the economic rebound has led to the emergence of some rising stars (High Yield bonds upgraded to the Investment Grade category). We forecast €29 billion in rising stars in the eurozone and $82 billion in the US this year.

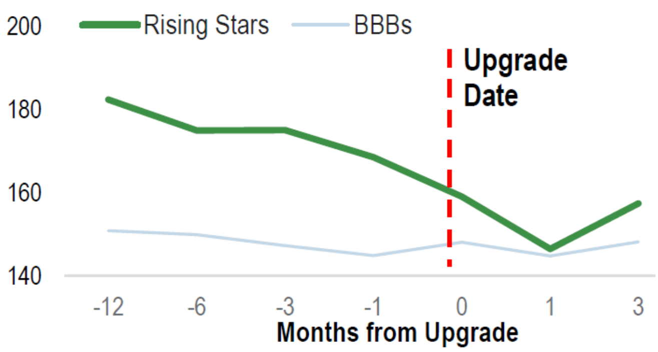
Again, the historical behaviour of their spreads is attractive. They outperform BBB-rated bonds by 0.20-0.25% in the year of their upgrade. Half of this outperformance occurs within 3 months before the upgrade. Then, once upgraded, they continue to outperform BBBs, with an additional gain of around 0.05-0.10% 3 months later as Investment Grade investors readjust their portfolios.

YIELDS OF FALLEN ANGELS (%)



Source: Refinitiv Datastream, 12/04/2021

SPREAD BEHAVIOUR OF RISING STARS IN EUROPE



Source: BNP Paribas Global Markets

CONCLUSION

Credit markets are rather expensive in valuation terms. However, there are opportunities in sub-segments, such as fallen angels and rising stars. On average, the latter offer additional yield compensation.

Our Investment Recommendations

Asset classes	Zone	Our opinion	
Government bonds	Germany	-	Negative on German sovereign bonds, irrespective of their maturity.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece) with a "buy on dips" strategy.
	United States	=	• Positive on short-term debt for dollar-based investors. • Negative on long-term debt.
Corporate bonds Investment Grade	Eurozone and United States	+	• We prefer corporate bonds to sovereign bonds. • We favour EUR and US bonds with a similar duration to the benchmark (5 and 9 years respectively). • Positive on convertible bonds in the eurozone.
Corporate bonds High Yield	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angel* bonds.
Emerging bonds	In hard currency	+	Positive on EM hard currency bonds (sovereign and corporate).
	In local currency	+	Positive on local currency government bonds.

Market data

	10-year rate (%)	Spread (bps)	Spread change 1 month (bps)
United States	1.67	- - -	
Germany	-0.30	- - -	
France	-0.04	26	1
Italy	0.74	104	+3
Spain	0.39	68	0
Portugal	0.29	58	1
Greece	0.87	117	4

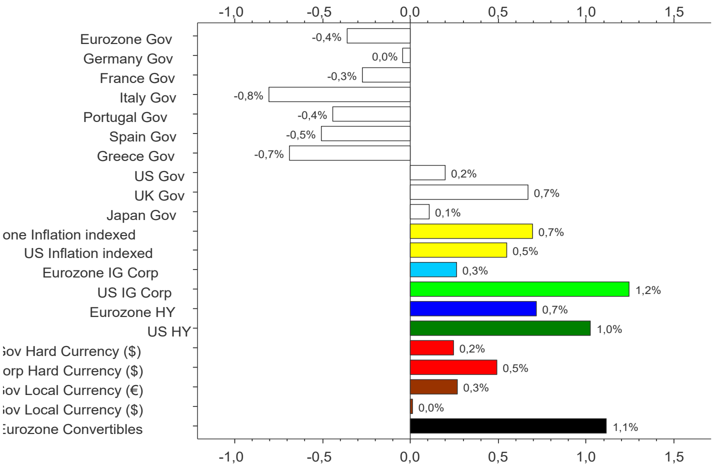
09/04/2021
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	1.13	33	-1
Corporate bonds IG EUR	0.32	87	-2
Corporate bonds IG USD	2.21	89	-11
Corporate bonds HY EUR	2.91	296	-19
Corporate bonds HY USD	4.02	292	-42
Emerging government bonds in hard currency	4.87	320	-22
Emerging corporate bonds in hard currency	4.83	325	-7
Emerging government bonds in local currency	4.91	404	-2

09/04/2021
Source: Refinitiv Datastream, Bloomberg Barclays and JPM indices

Returns

OVER ONE MONTH



Source: Refinitiv Datastream, 12/04/2021 Source: Bloomberg Barclays indices exept Convertibles (Exane)

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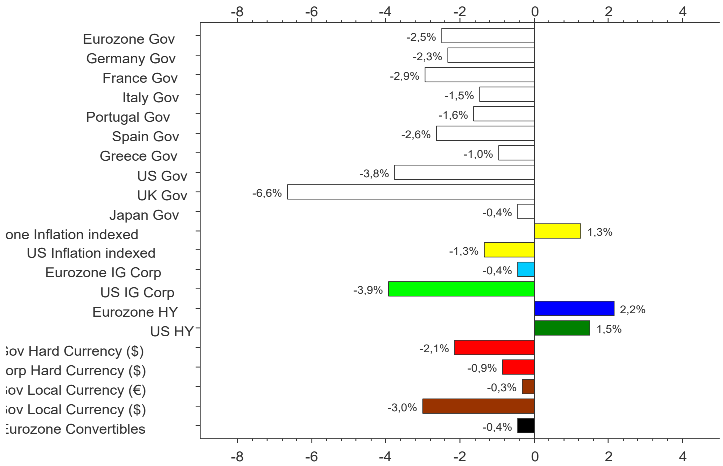

Source: Refinitiv Datastream, 12/04/2021 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

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