APRIL 2022

Fixed Income Focus

Summary

1. **Inflation has become the only priority and the Fed is determined to act. However, while it can calm inflation due to excess demand, it can do little against inflation driven by supply disruptions.** We except 150bps of additional rate hikes in the US and 25bps in the eurozone. Our view is more cautious than that of the market.

2. **Government bonds ended Q1 2022 with the worst performance in their history.** We have raised our 10-year yield targets to 2.50% in the US and 0.75% in Germany. We are moving to Neutral from Negative on long-term government bonds as bond yields have surged, with a preference for the US over the eurozone. We remain Positive on short-term US government bonds.

3. **In the US, past recessions have been preceded by an inversion of the yield curve: long-term rates have become lower than short-term rates. As of 31 March, the 2-10 year curve was close to inversion.** However, two other yield curves are still very steep and suggest a negligible risk of recession in one year. This view is supported by two other indicators: the share of inverted segments in the yield curve and the fact that real policy rates are well below potential US GDP.

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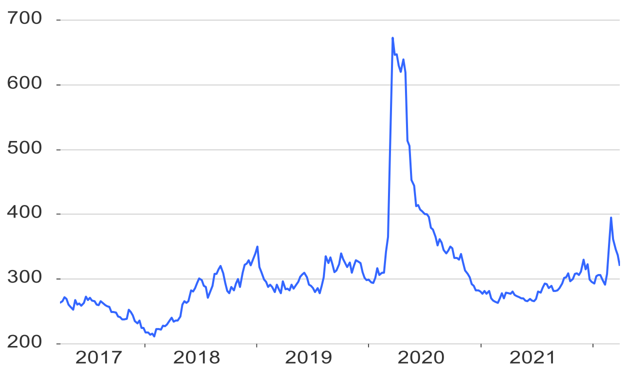
THE SPREAD OF EMERGING MARKETS HARD CURRENCY BONDS HAS RETURNED TO ITS PRE-RUSSIA-UKRAINE CONFLICT LEVELS



Source: Refinitiv Datastream, 31-03-22

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BNP Paribas Wealth Management

BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

Fighting inflation at all costs?

European Central Bank (ECB)

Hawkish: The tone at the March ECB meeting was hawkish. The ECB announced a faster taper of the APP bond buying programme and -as expected- the end of the PEPP bond buying programme on 31/03 (see chart), despite the Russia-Ukraine conflict and its impact on energy prices and eurozone growth.

Market view: The market has revised its expectations sharply upwards following the publication of inflation figures. It expects 55bps of rate hikes by the end of the year, including 15bp by July.

Our view: There is little the ECB can do about rising energy prices. The ECB's guidance support our assumption that it will end net purchases of the APP in Q3 and raise the deposit rate for the first time by 25bps in December by 25bps. Indeed, it is at the end of the year that the impact of inflation should be visible on wages. We expect 3 rate hikes in 2023, bringing the deposit rate to 0.50% and the main refinancing rate to 0.75% by December 2023.

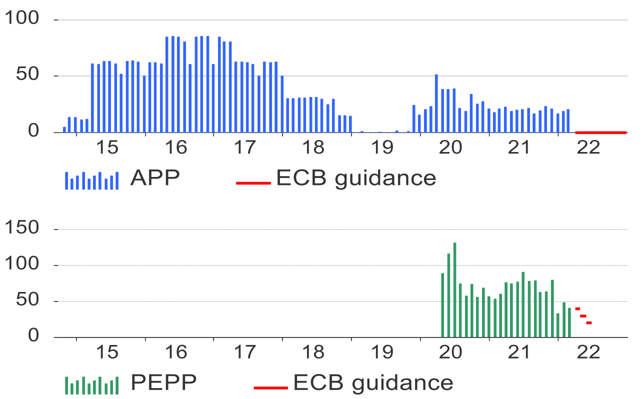
US Federal Reserve (Fed)

Very hawkish: The Fed hiked rates by 25bps as widely expected at the March FOMC meeting and turned decidedly hawkish.

Fed officials revised their rate forecast significantly upwards, now pointing to 6 additional 25bps rate hikes until the end of the year i.e. one at each meeting. The key rate is expected to peak at 2.75% from 2023 and to be maintained in 2024. That level is higher than the expected long-term rate (2.38%), suggesting that the Fed has moved from wanting to remove excess liquidity in the system (see chart) to tightening financial conditions.

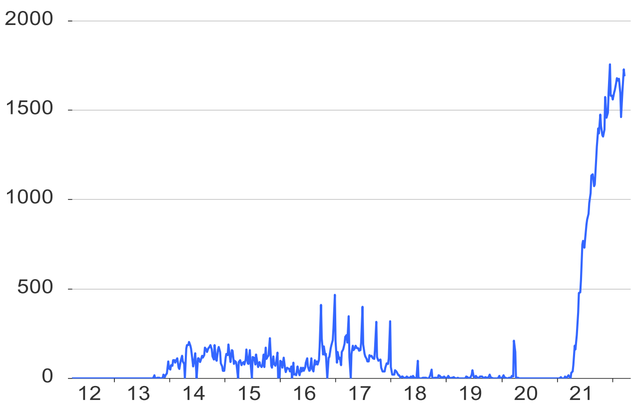
Our view: The Fed is likely to front-load the rate hikes given the high inflation. We thus expect a 50bps rate hike in May rather than 25bps, as well as the start of the balance sheet reduction. We envisage the policy rate to reach 2% by the end of the year, i.e. a further 150 basis points. For 2023, we now anticipates a 75bps increase rather than 100bps. Our Fed funds rate target for the end of 2023 remains unchanged at 2.75%.

ECB'S TWO ASSET PURCHASE PROGRAMMES (MONTHLY NET PURCHASES IN EUR BN)



Source: Refinitiv Datastream, févr. 22

EXCESS LIQUIDITY IN THE SYSTEM PROXIED BY THE FED OVERNIGHT REVERSE REPO FACILITY (USD BN)



Source: Refinitiv Datastream, 30-03-22

CONCLUSION

Inflation has become the only priority and the Fed is determined to act. However, while it can calm inflation due to excess demand, it can do little against inflation driven by supply disruptions. We except 150bps of additional rate hikes in the US and 25bps in the eurozone. Our view is more cautious than that of the market.

Bond yields

Massive moves

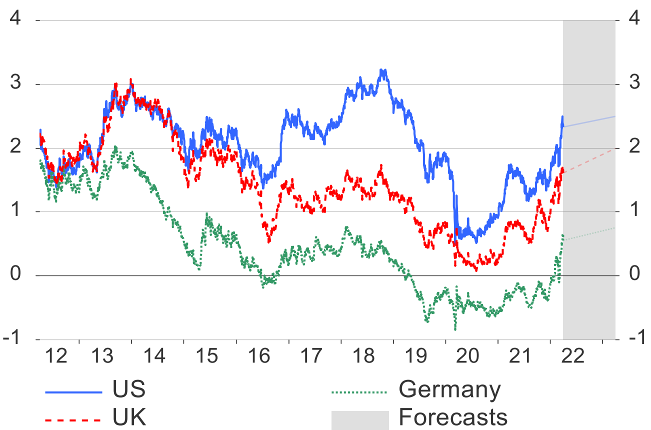
Markets participants have significantly reassessed the pace of policy rate hikes in the US and the eurozone as inflation due to rising inflation. As a result, bond yields have jumped amidst high volatility and government bonds ended Q1 2022 with the worst performance in their history.

In the wake of the sharp rise in bond yields, we have increased our 12-month targets by 25bps, to 2.50% for the 10-year Treasury yield and to 0.75% for its German counterpart.

We turn Neutral from Negative on long-term government bonds with a preference for the US over the eurozone given the absolute level of yield. With the US 10-year yield at 2.50%, upside risk is limited, unless –not our main scenario– the Fed decides to actively sell its bond portfolio as part of its balance sheet reduction strategy.

We remain Positive on US government bonds up to the 3-year maturity.

10-YEAR RATES



Source: Refinitiv Datastream, 01-04-22

	Maturity (in years)	31/03/2022	12-month targets
United States	2	2.28	2.25
	5	2.42	2.40
	10	2.33	2.50
	30	2.45	2.60
Germany	2	-0.07	0.25
	5	0.38	0.50
	10	0.55	0.75
	30	0.67	0.85
United Kingdom	2	1.36	1.60
	5	1.41	1.75
	10	1.61	2.00
	30	1.77	2.40

Source: Refinitiv Datastream, BNP Paribas WM

CONCLUSION

Government bonds ended Q1 2022 with the worst performance in their history. We have raised our 10-year yield targets to 2.50% in the US and 0.75% in Germany. We are moving to Neutral from Negative on long-term government bonds as bond yields have surged, with a preference for the US over the eurozone. We remain Positive on short-term US government bonds.

Theme in Focus

The spectre of the inverted US yield curve

In normal times the yield curve is steep: long-term rates are higher than short-term rates because investors prefer short-term liquidity and therefore demand an extra return for investing over the long term.

As of 31 March, the US yield curve was flat and very close to inversion, judging by the 10-year rate (2.33%), which was barely above the 2-year rate (2.28%).

An inversion almost always heralds a recession: long-term rates become lower than short-term rates, causing banks to reduce or even stop lending to businesses, which in turn is squeezing activity, that potentially could lead to a recession.

The spread between short-term and long-term rates makes it possible to calculate the probability of a recession in 12 months using statistical models. **But which pair of rates to choose?** (see chart)

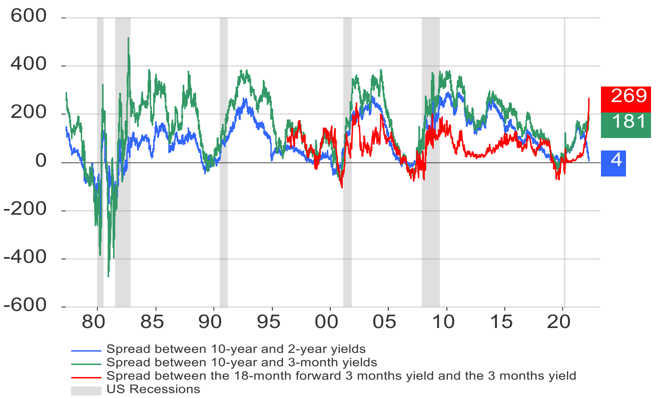
Market participants traditionally look at the 2-10 year curve. Critics will say that the signal sent by this curve is blurred because the Fed has bought a lot of bonds and has therefore manipulated the rate levels. Nevertheless, it signals a high risk of recession in a year's time (29%).

The New York Fed uses the 3-month-10-year curve. The spread between these rates, 181 basis points, suggests a very low risk of recession in one year (5%).

The Fed President, on the other hand, prefers the spread between the 3-month rate in 18 months and the 3-month rate today. Here the spread is 269 basis points, which means that the risk of recession in one year's time is close to zero (1%).

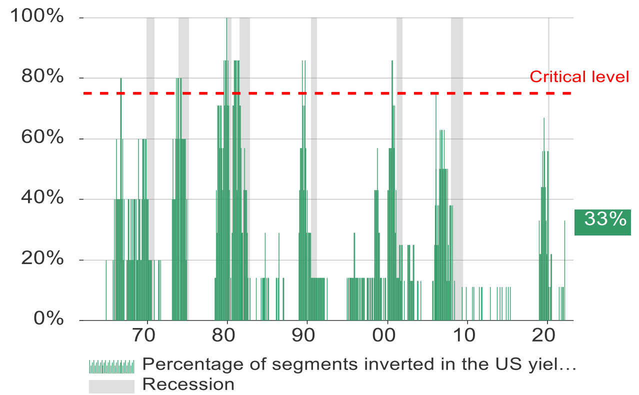
Other indicators to watch: Past recessions have been preceded by the inversion of almost all segments that make up the yield curve (see chart). Today, only 33% of the segments in the yield curve are inverted. Moreover, past recessions occurred when the Fed pushed its policy rate (in real terms) above the potential growth rate of the economy. Today, real policy rates are very negative and far below potential GDP.

SPREAD BETWEEN LONG AND SHORT RATES. WHICH YIELD CURVE TO CHOOSE?



Source: Refinitiv Datastream, 01-04-22

SHARE OF INVERTED SEGMENTS IN THE US YIELD CURVE



Source: Refinitiv Datastream, 31-03-22

CONCLUSION

In the US, past recessions have been preceded by an inversion of the yield curve: long-term rates have become lower than short-term rates. As of 31 March, the 2-10 year curve was close to inversion. However, two other yield curves are still very steep and suggest a negligible risk of recession in one year. This view is supported by two other indicators.

Our Investment Recommendations

Asset classes	Zone	Our opinion	
Government bonds	Germany	=	We moved from Negative to Neutral on German sovereign bonds.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United States	+ =	• Positive on US short-term Governement bonds. • We moved from Negative to Neutral on long-term debt.
Corporate bonds Investment Grade	Eurozone United States	=	• We prefer corporate bonds to sovereign bonds. • Neutral view on corporate bonds. Focus on duration below benchmark for EUR bonds (5 years). We increase duration to benchmark in the US (8 years). • Neutral on convertible bonds in the eurozone.
Corporate bonds High Yield	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angel* and *rising stars.*
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	2.33	---	
Germany	0.55	---	
France	0.99	43	-5
Italy	2.04	149	-11
Spain	1.45	89	-10
Portugal	1.37	82	-6
Greece	2.67	212	-27

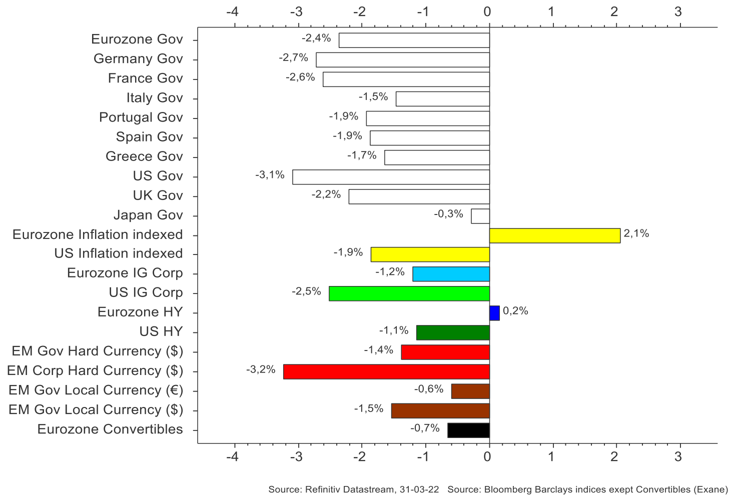
31/03/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	2.15	42	-4
Corporate bonds IG EUR	1.55	129	-15
Corporate bonds IG USD	3.60	116	-6
Corporate bonds HY EUR	5.05	391	-40
Corporate bonds HY USD	6.01	325	-34
Emerging government bonds in hard currency	6.05	362	-66
Emerging corporate bonds in hard currency	6.14	374	-78
Emerging government bonds in local currency	4.05	163	-57

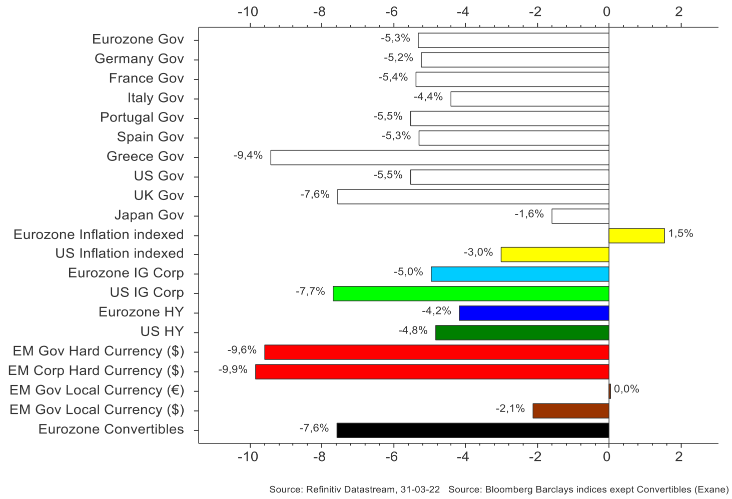
31/03/2022
Source: Refinitiv Datastream, Bloomberg Barclays

Returns

OVER ONE MONTH



SINCE THE BEGINNING OF THE YEAR



EM = Emerging Markets

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