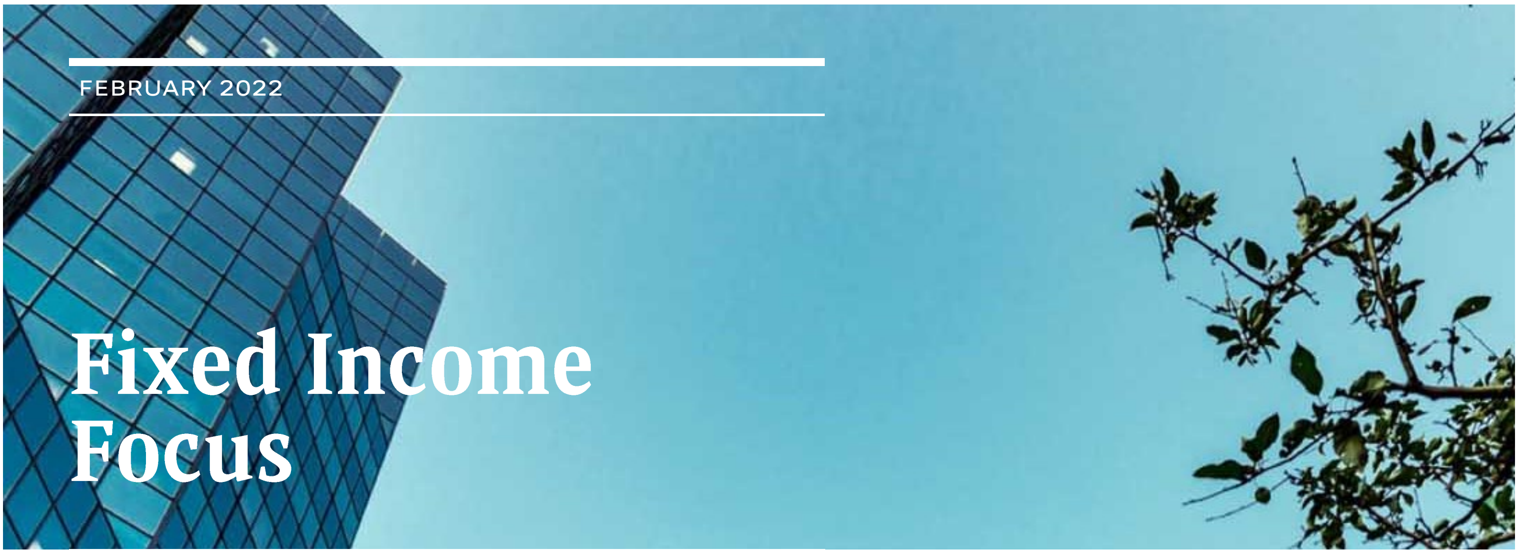


FEBRUARY 2022

Fixed Income Focus

Summary

1. **The ECB turned hawkish in the face of high inflation.** We expect a faster-than-expected end to the asset purchase programme and a first rate hike in December rather than in March.
2. **Plans to accelerate the timing of monetary policy normalisation, especially on the part of the US Federal Reserve.** The first rate hike is expected in March, followed by three additional hikes later in the year. At the same time, the Fed is set to reduce its balance sheet from July by limiting the reinvestment of maturing bonds.
3. **Bond yields rose following the announcements of Fed, the ECB, the Bank of England and the publication of a strong US jobs report.** We have raised our targets for German and UK rates. Beyond short-term volatility, the long-term upside potential for German and US rates seems limited.
4. **Consequences of the change in perception on the ECB's monetary policy: a sharp rise in bond yields, a fall in the stock of bonds with a negative yield-to-maturity and concerns over Italian debt.** We remain cautious on Italian government debt.

Contents

SHARP DROP OF THE POOL OF NEGATIVE-YIELDING BONDS IN THE WORLD (USD BN)

Source: Refinitiv Datastream, 09-02-22

Edouard Desbonnets

Senior Investment Advisor, Fixed Income
BNP Paribas Wealth Management

Central banks

The end of emergency measures

European Central Bank (ECB)

No real surprises in the press release following the last ECB meeting: inflation is worrying but should decline in the coming quarters. The economy and the labour market are improving.

But President Lagarde gave a hawkish speech and did not want to guide the markets. Mrs Lagarde wants to be as flexible as possible in conducting monetary policy in view of the very uncertain nature of inflation. This time round, Mrs Lagarde did not say that a rate hike this year was very unlikely.

Our view: the ECB's economic projections (to be communicated in March) will be crucial. Its inflation projections will very likely be revised upwards in the short to medium term. This would pave the way for a slowdown in asset purchases, a faster-than-expected end to the monetary easing programme (APP) and a 0.25% hike in the deposit rate in December rather than March as previously expected. We expect 3 additional rate hikes next year, taking the deposit rate to 0.50% and the main refinancing rate to 0.75% by the end of 2023.

US Federal Reserve (Fed)

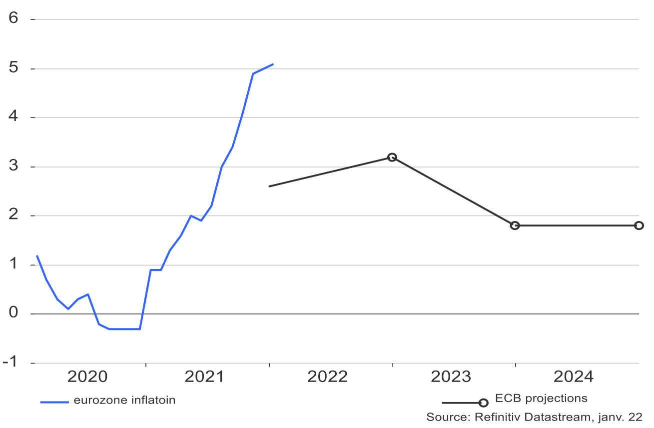
No real surprises in the press release following the last Fed meeting: the Fed will stop its asset purchase programme and start raising rates in March. After a few rate hikes, it will allow its balance sheet to shrink naturally by limiting the reinvestment of maturing bonds.

But Chairman Powell gave a hawkish speech and did not want to guide the markets.

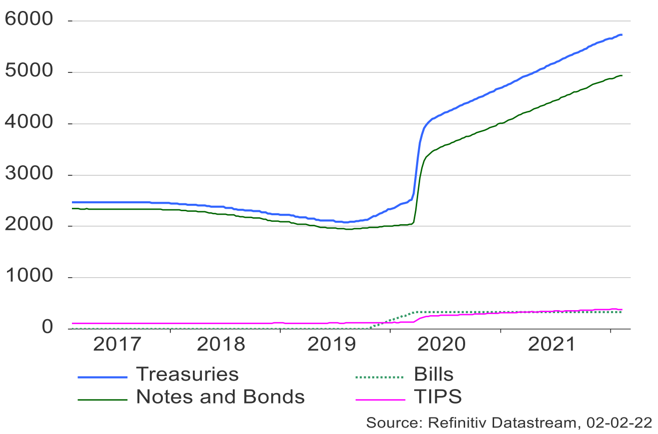
Our view: the Fed wants to be agile and allow itself to act in line with new economic data. Inflation is expected to decelerate due to base effects over the course of the year, thereby reducing political pressure on the Fed. Therefore it should not be obliged to raise its key interest rates at each meeting. We maintain our assumption of 4 rate hikes (each of 25 basis points) this year, the first one in March, and 4 more in 2023.

Balance sheet reduction should be done predictably. This could be announced in June with a view to starting the process in July.

THE ECB'S DECEMBER 2021 INFLATION PROJECTIONS COULD WELL BE REVISED UPWARDS IN MARCH



AMOUNT OF TREASURIES THE FED HOLDS (IN USD BN)



CONCLUSION

The Fed and the ECB are on the same wavelength: they both plan to put an end to emergency measures more quickly than expected in view of soaring inflation, and to provide maximum room for manoeuvre given the uncertainty over future inflation. Once the net asset purchase programmes have ended, the Fed could raise rates 4 times this year (the first one in March) and the ECB once in December.

Bond yields

Up and up

In the context of soaring inflation, central bankers have turned hawkish and the markets have reassessed the potential of policy rate hikes. Rates reacted accordingly, with a massive upward movement in all maturities, particularly short maturities, in the United States, the eurozone and the United Kingdom.

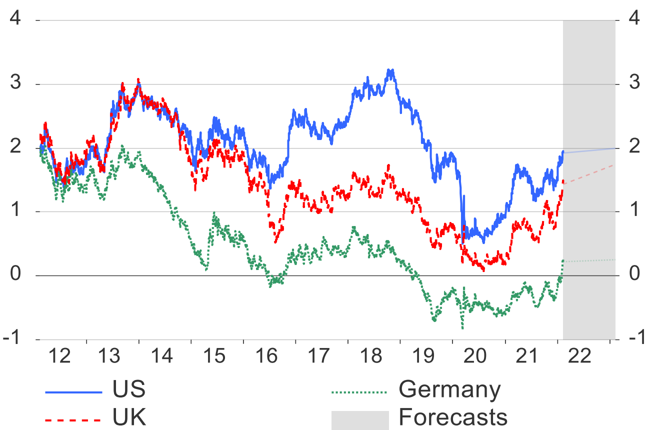
The Bank of England's decision to sell its corporate bonds, accumulated during the pandemic, has paved the way for a slight possibility of it doing the same thing with its government bonds.

The reduction in the Fed's balance sheet is likely to take US rates a little higher via a higher term premium. Moreover, historical observations suggest that the 10-year yield tends to peak towards the end of the cycle, usually just before the last rate hike.

We adjusted our German rate targets after the last ECB meeting. An earlier-than-expected rate hike and a faster-than-expected end to asset purchases should put upward pressure on rates.

We also adjusted higher our UK bond yields targets after the hawkish Bank of England meeting.

10-YEAR RATES



Source: Refinitiv Datastream, 10-02-22

	Maturity (in years)	08/02/2022	12-month targets
United States	2	1.34	1.50
	5	1.81	1.75
	10	1.96	2
	30	2.25	2.60
Germany	2	-0.30	0
	5	0.03	0.10
	10	0.26	0.25
	30	0.46	0.50
United Kingdom	2	1.33	1.50
	5	1.38	1.60
	10	1.49	1.75
	30	1.60	2.10

Source: Refinitiv Datastream, BNP Paribas WM

CONCLUSION

Rates rose rapidly as central bankers turned hawkish. The upward movement is likely to continue, probably in fits and starts, depending on central bank statements and potential inflation surprises, but to a lesser extent than the movement observed thus far.

Theme in Focus

Market impact following the ECB

Rising rates. Given the persistently high levels of inflation, the ECB raised its tone at its last monetary policy meeting. It could exit its loose monetary policy sooner than expected, by ending its net asset purchase programme and by raising its policy rates this year. Market expectations were rapidly adjusted and rates rose.

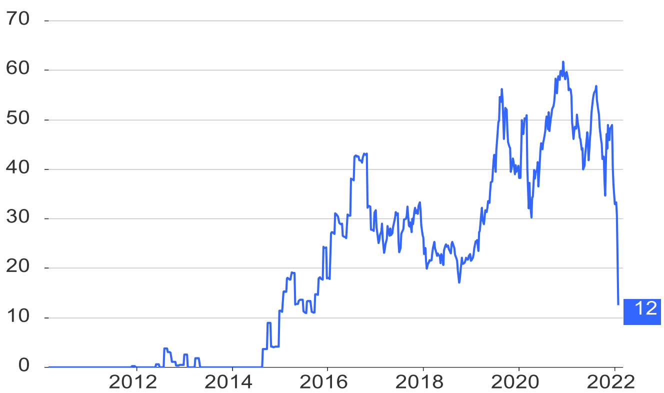
As a result, **the pool of negative-yielding bonds has melted like snow in the sun.** At the end of 2020, when the ECB was buying huge quantities of bonds via its asset purchase programmes, 62% of eurozone bonds were trading at negative yields at maturity. At the end of January, there were only 12% of negative-yielding bonds in the eurozone.

Refinancing costs are growing with the rise in rates and are once again putting **the most fragile countries in the spotlight,** particularly Italy due to its high level of indebtedness. Italy was one of the main beneficiaries of the ECB's asset purchasing programmes.

In 2020 and 2021 the ECB purchased more than Italy's total net debt issuance. In 2022, the ECB is expected to buy around 60% of Italy's net supply and then nothing in 2023. Italy will have to be content with the ECB's reinvestments. As a result, the Italian risk premium has increased. The spread between the Italian 10-year bond and the German *bund* widened by 25 basis points to 155bps within a few days. The Italian 10-year yield rose to 1.85%. We cannot rule out the possibility that Italian rates will continue to rise when the ECB confirms the end of its accommodative monetary policy.

However, the risk of a credit rating downgrade for Italy is small. According to the rating agency Standard and Poor's, the country is still protected from rising bond yields thanks to the low refinancing cost of its debt. The market estimates that the sustainability of Italian debt is at risk if Italy's 10-year yield exceeds 2.5%. We remain cautious on Italian government debt.

SHARE OF BONDS WITH A NEGATIVE YIELD AT MATURITY IN THE EUROZONE (%)



Source: Refinitiv Datastream, 09-02-22

ITALIAN 10-YEAR RATE (BPS)

Source: Refinitiv Datastream, 10-02-22

CONCLUSION

The end of the ECB's lax policy has led to a sharp rise in bond yields. As a result, the supply of bonds with a negative yield-to-maturity has dwindled dramatically. Moreover, the rise in refinancing costs has put the most fragile countries in the spotlight, particularly Italy. We remain cautious on Italian government debt.

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	-	• We moved to Negative from Neutral on US short-term Governement bonds. • Negative 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 at benchmark for EUR bonds (5 years) and lower than benchmark for US bonds (less than 9 years). • Positive 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	1.96	---	
Germany	0.26	---	
France	0.72	46	13
Italy	1.85	159	23
Spain	1.13	87	18
Portugal	1.02	76	12
Greece	2.56	229	74

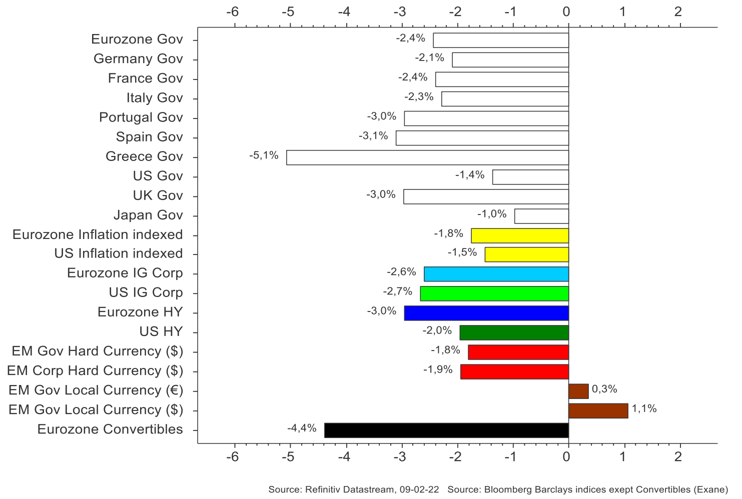
08/02/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	1.73	39	4
Corporate bonds IG EUR	1.16	118	24
Corporate bonds IG USD	2.96	107	15
Corporate bonds HY EUR	4.53	379	79
Corporate bonds HY USD	5.45	343	45
Emerging government bonds in hard currency	5.37	342	10
Emerging corporate bonds in hard currency	5.15	341	0
Emerging government bonds in local currency	3.83	202	-31

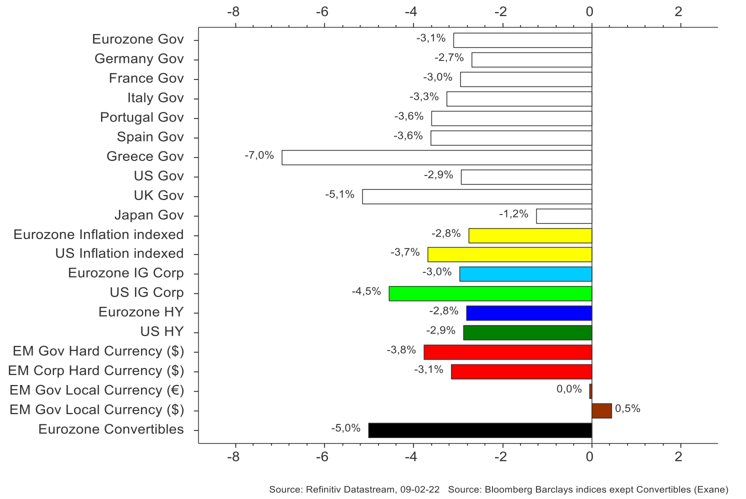
08/02/2022
Source: Refinitiv Datastream, Bloomberg Barclays

Returns

OVER ONE MONTH



SINCE THE BEGINNING OF THE YEAR



EM = Emerging Markets

THE INVESTMENT STRATEGY TEAM

FRANCE

Edmund SHING
Global Chief Investment Officer

ASIA

Prashant BHAYANI
Chief Investment Officer, Asia

Grace TAM
Chief Investment Advisor, Asia

BELGIUM

Philippe GIJSELS
Chief Investment Advisor

Alain GERARD
Senior Investment Advisor, Equities

Xavier TIMMERMANS
Senior Investment Strategist, PRB

LUXEMBOURG

Guy ERTZ
Chief Investment Advisor

Edouard DESBONNETS
Senior Investment Advisor, Fixed Income

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