JANUARY 2022

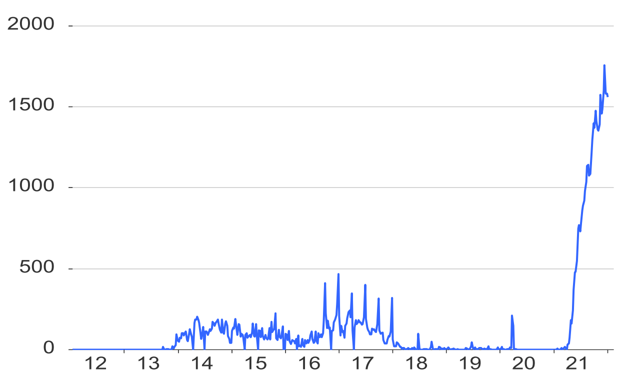
Fixed Income Focus

Summary

1. **Developed countries will follow the lead of Emerging Markets and normalise their monetary policies in 2022.**
2. **The Fed is expected to accelerate its normalisation schedule due to high inflation and the labour market at full employment.** We now expect 4 rate hikes in 2022 rather than 3, the first in March rather than June. Parallel to the rise in rates, the Fed could start reducing its balance sheet in August in order to tighten financial conditions.
3. **The ECB, on the other hand, is not in a hurry. Inflationary pressures are lower and relate to more transitory factors than in the US.** The ECB will continue its bond purchases throughout 2022, clearly to a much lesser extent than in 2021. We do not expect a rate hike before June 2023.
4. **Long-term rates have risen in the US and in the eurozone.** A pause is possible in the short term but the underlying trend remains a moderate rise.
5. **Five key figures about bonds to put 2022 into perspective.**

Contents

FED REVERSE REPO VOLUMES SHOW EXCESS LIQUIDITY IN THE US FINANCIAL SYSTEM



Source: Refinitiv Datastream, 07/01/2022

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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

The end of emergency measures

European Central Bank (ECB)

Slow normalisation: the ECB will stop its emergency asset purchase programme or PEPP (implemented at the start of the pandemic) in March 2022 as planned. However, it will continue to reinvest maturing bonds until the end of 2024, i.e. for one more year than previously agreed.

Immortal APP? The ECB will temporarily increase its traditional asset purchase programme (APP) in Q2 and Q3 2022 to limit the potential market turbulence associated with the end of the PEPP. In total, net asset purchases are expected to be around EUR 480bn in 2022, a reduction of just over 50% compared with 2021. The APP does not officially have an end date.

Our view: the relatively low inflation projections (1.8% in 2024 according to the ECB), combined with the extension of quantitative easing, make it unlikely that the ECB will raise rates in 2022. The first rate increase, +0.1% on the deposit rate, could occur in June 2023.

US Federal Reserve (Fed)

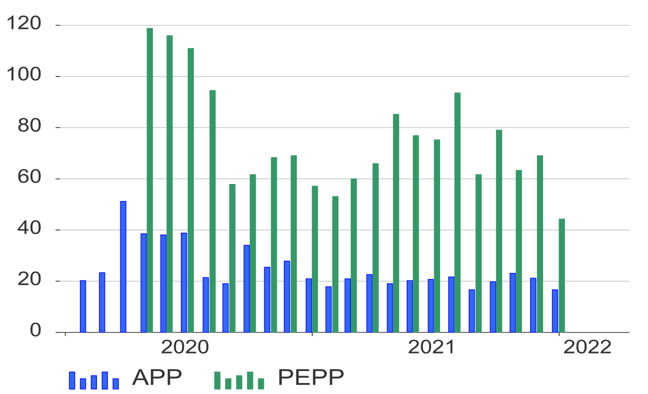
Acceleration of the normalisation calendar: the speed of change in the Fed's monetary policy scenario in just one month is impressive: the faster-than-expected reduction of asset purchases, the resolve to hike rates more rapidly, and already an extensive discussion of balance sheet reduction.

Conditions met: with CPI inflation at 7%, unemployment rate at 3.9% and wage inflation pressures, all the conditions are in place for the Fed to normalise its monetary policy.

End of quantitative easing in around mid-March.

Our view: we no longer expect 3 but 4 rate hikes this year. The first rate hike could take place at the time of the March meeting, three month earlier than previously expected. In addition, the Fed could start reducing its balance sheet in August, via less reinvestments of maturing bonds, to allow long-term rates to rise. The aim would be to avoid an inverted yield curve, which often heralds an economic recession. Fed funds rate should rise to 2.25% by December 2023.

ASSET PURCHASE PROGRAMMES - MONTHLY NET PURCHASES IN EUR BILLION



Source: Refinitiv Datastream, déc. 21

FED BALANCE SHEET (IN USD BILLION)

Source: Refinitiv Datastream, 12/01/2022

CONCLUSION

The Fed and the ECB are putting an end to the emergency measures implemented at the start of the pandemic. The Fed is expected to accelerate its monetary policy normalisation schedule due to high inflation and full employment. The ECB, on the other hand, is not in the same mind as inflation in the euro area is mainly linked to the temporary rise in energy prices.

Bond yields

Up and up

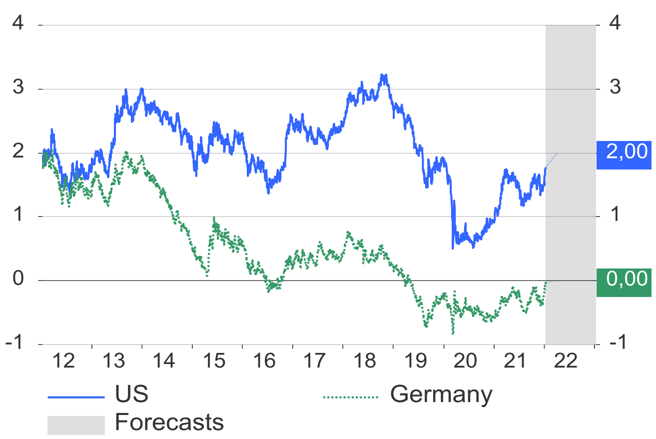
Bond yields have been rising since mid-December: +30 basis points for the 10-year rates in the US and Germany. The US 10-year rate has thus reached its highest level since the pandemic, at 1.75%, and its German equivalent is now close to the symbolic 0% mark.

Real rates are driving the rise. After hitting all-time lows, 10-year real rates are rising in the US and the eurozone, driven by the decision of central banks to normalise their monetary policies.

Outlook for US rates: our expectations of Fed rate hikes imply higher short-term rates. We increased our 2-year yield target by 0.25%. The trend on long-term rates remains upwards. The Fed's shrinking balance sheet will reduce buying pressure on long-term Treasuries.

Outlook for German rates: they could tighten in the wake of US rates, but to a lesser extent. Indeed, the ECB's purchasing programme will still be active and net issuance will remain negative in Germany in 2022

10-YEAR RATES



Source: Refinitiv Datastream, 11-01-22

	Maturity (in years)	10/01/2022	12-month targets
United States	2	0.90	1.50
	5	1.54	1.75
	10	1.78	2
	30	2.11	2.60
Germany	2	-0.59	-0.50
	5	-0.37	-0.30
	10	-0.04	0
	30	0.29	0.50
United Kingdom	2	0.84	1.10
	5	1.01	1.25
	10	1.19	1.45
	30	1.31	1.75

Source: Refinitiv Datastream, BNP Paribas WM

CONCLUSION

Following the rapid rise in long-term rates in the US and Germany, a pause (or fall) is possible in the coming days/weeks. However, in 12 months' time, long-term rates are likely to be moderately higher than they are today, mainly driven by central banks, while the economy is expected to remain strong.

Theme in Focus

Five highlights for 2022

113: the number of policy rate hikes worldwide in 2021. The vast majority took place in Emerging Markets. While there was a clear downward trend in rates in 2020 to support economies hurt by the crisis (207 cuts and 9 hikes), central banks backtracked in 2021 to fight inflationary pressures, with 113 rate hikes and 13 cuts.

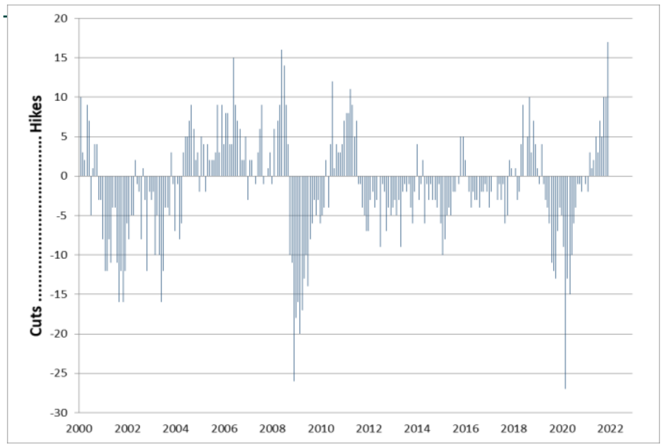
3: the number of vacancies on the Fed's Board of Governors. President Biden will have the opportunity to appoint 3 of the 7 members of the highest body of the Monetary Policy Committee, subject to validation by the Senate, thus indirectly giving him the power to influence the hawkish/dovish balance of the institution (advocates of a strict/accommodative monetary policy).

11%: the share of Investment Grade Corporate bonds in the eurozone that trade at negative yields at maturity. This proportion could fall this year due to the rise in bond yields.

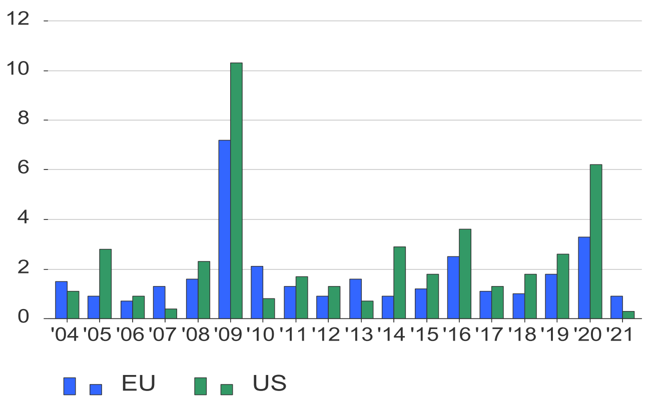
0.9%: the default rate of High Yield Corporate bonds in the eurozone in 2021 (6 issuers), half the historical average. In addition, the recovery rate was 84%, which is twice the historical average. In the US, this is just as impressive because the default rate fell to 0.3% (8 issuers), an all-time low, with a recovery rate of 47%. These figures highlight the strength of companies' fundamentals, thanks in particular to economic growth, extremely low refinancing rates and easy access to capital markets.

EUR 379 billion: the estimated volume of new bond issues in euro area countries net of redemptions for 2022. By way of comparison, euro area countries raised EUR 527 billion in debt net of redemptions in 2021. Adjusted for the ECB's purchases, the supply of bonds in Germany and the Netherlands should be negative, while that of France and Spain should be positive.

DIFFERENCE BETWEEN INTEREST RATE HIKES AND CUTS FOR THE 38 MAIN CENTRAL BANKS



HIGH YIELD CORPORATE DEFAULT RATE (%)



Source: Refinitiv Datastream, JPM, Moody's 10-01-22

CONCLUSION

Five key figures show in particular that central banks are committed to monetary tightening, that the rise in rates in the eurozone has reduced the share of negative-yielding Investment Grade Corporate bonds at maturity and finally that High Yield Corporate default rates are extremely low thanks to solid fundamentals.

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	1.78	---	
Germany	-0.04	---	
France	0.29	32	-2
Italy	1.28	132	+1
Spain	0.65	69	-2
Portugal	0.59	62	-4
Greece	1.57	160	-13

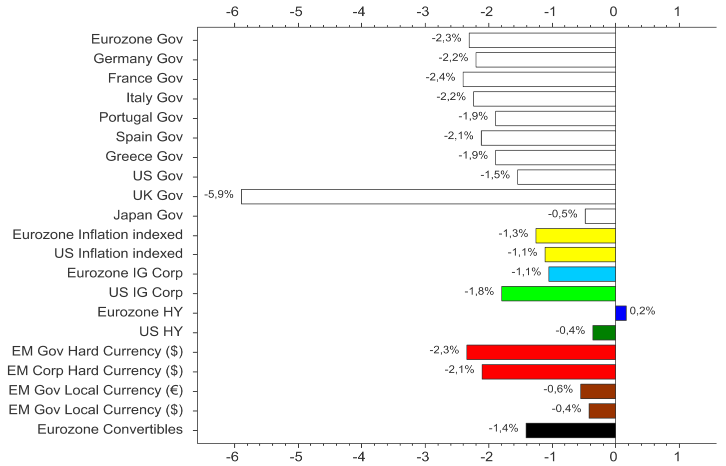
10/01/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	1.46	36	-1
Corporate bonds IG EUR	0.60	95	-2
Corporate bonds IG USD	2.58	94	-2
Corporate bonds HY EUR	3.53	303	-18
Corporate bonds HY USD	4.68	302	0
Emerging government bonds in hard currency	5.08	336	3
Emerging corporate bonds in hard currency	4.89	346	-59
Emerging government bonds in local currency	3.85	231	-25

10/01/2022
Source: Refinitiv Datastream, Bloomberg Barclays

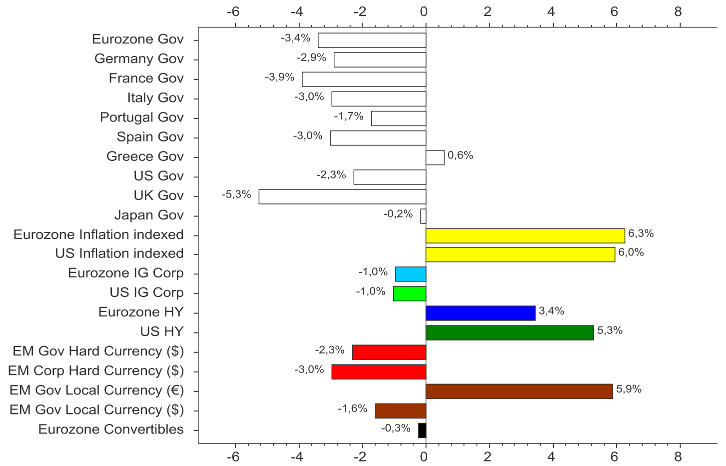
Returns

OVER ONE MONTH



Source: Refinitiv Datastream, 10-01-22 Source: Bloomberg Barclays indices exept Convertibles (Exane)

IN 2021



Source: Refinitiv Datastream, 31-12-21 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

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