

# Fixed Income Focus

## Summary

1. **The Fed surprised the markets with a hawkish pivot at the June FOMC meeting. Several members expect earlier-than-expected rate hikes, i.e. in 2023, as inflation is high. So we have brought forward our expectation for the first rate hike to Q1 2023.**
2. **The ECB remains very dovish. We expect the pace of purchases to return to normal in September. Peripheral spreads should remain tight in the meantime.**
3. **We have slightly raised our 12-month target for US short-term bond yields since the FOMC meeting. As a consequence, we have turned Neutral (from Positive) on US short-term Government bonds.**
4. **Long-term bond yields have fallen recently, particularly in the US. Investors revised down their inflation risk assessment after the FOMC meeting. The move was amplified by an unwinding of short positions by hedged funds in a context of the summer lull. We do not see that as the beginning of a new trend. We expect long-term bond yields to resume their upward movement after the summer. We are keeping our target of 2% for the US 10-year yield and 0% target for the German 10-year yield in 12 months.**
5. **Emerging Markets' central banks are hiking policy rates. We remain positive on EM local bonds.**

Edouard Desbonnets

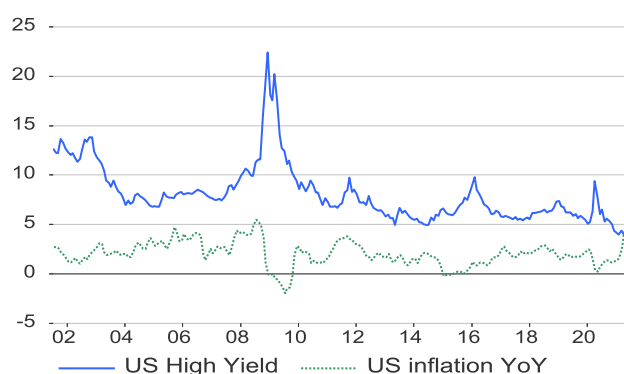
Investment Advisor, Fixed Income  
BNP Paribas Wealth Management



## Contents

Central banks	2
Bond yields	3
Theme in focus: Inflation and EM local bonds	4
Recommendations & Data	5
Returns & Strategy Team	6
Disclaimer	7

### THE AVERAGE YIELD ON US CORPORATE HIGH YIELD BONDS HAS DROPPED BELOW INFLATION



**BNP PARIBAS**  
WEALTH MANAGEMENT

The bank  
for a changing  
world

## Central banks

### Reducing emergency measures in September?

#### European Central Bank (ECB)

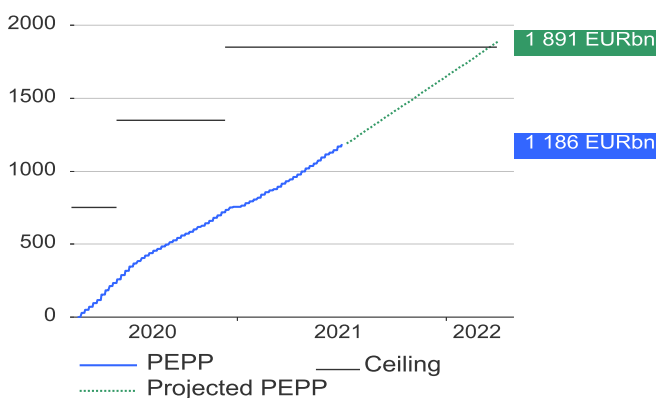
The ECB renewed in June the high pace of asset purchases made in March, given that it wants to keep a very accommodative monetary policy.

In practice, purchases will certainly be reduced during the summer as they depend on market conditions.

The ECB has published the **conclusions of its strategic review**. In a nutshell, it will integrate climate change considerations into its monetary policy and will be more tolerant of rising inflation. This paves the way for a prolonged period of accommodation.

The next important meeting will be on **9 September**, when the ECB could announce a **return to a normal (i.e. not "substantially higher") pace of asset purchases for the emergency pandemic programme, or PEPP**. This would not call into question the very accommodating nature of the policy and would allow the PEPP to be carried out until its planned end date (end of March 2022) without the risk of exceeding the envelope (see graph).

#### THE PEPP ENVELOPE WILL BE EXCEEDED IN MARCH 2022 IF THE HIGH PACE OF PURCHASE IS MAINTAINED



#### US Federal Reserve (Fed)

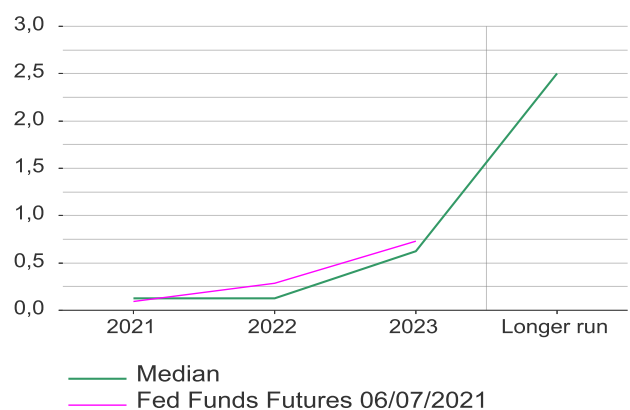
**Patience has its limits.** The Fed surprised the markets at the June FOMC meeting. It showed less patience to inflation as it expects two rate hikes in 2023 according to the median view of the 18 policymakers (see chart), whereas it expected none at the March FOMC meeting.

**The tapering debate is officially underway**, but Powell puts it into perspective by saying that it will take several more meetings to reach a conclusion.

**The June meeting was a success** as the Fed signalled tapering plus rate hikes earlier than expected, and financial conditions barely changed.

We expect the Fed to announce tapering in September and implement it in January 2022, starting with MBS. **As for the first rate hike, we have brought our expectation forward to 1Q 2023** instead of 3Q 2023, as the Fed now seems much more sensitive to inflationary risk. The Fed could favour fighting inflation over supporting employment if it must choose between its dual mandate.

#### THE FED SUGGESTS TWO RATE HIKES IN 2023. THE MARKETS SEE A RATE HIKE AS EARLY AS THE END OF 2022



### CONCLUSION

The Fed and the ECB are more optimistic, but are unwilling to withdraw emergency support measures for the time being. The Fed should be the first to take the plunge. It should announce tapering in September, implement it in January 2022 and increase policy rates in 1Q 2023, in our view.



## Bond yields

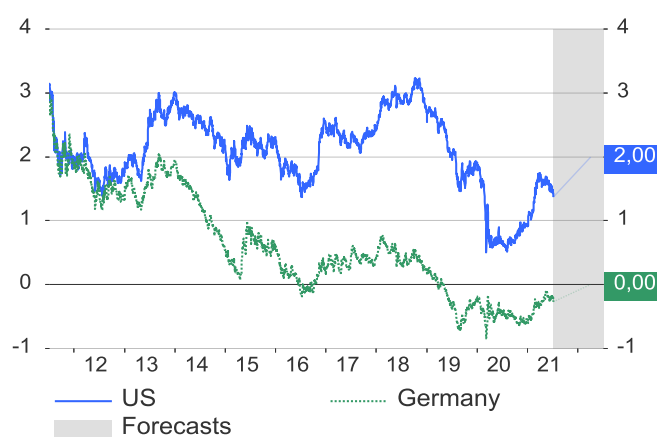
### Short-term pause in a bear market

We have raised our 2- and 5-year year bond yield forecasts after the Fed hawkish pivot. **We thus turn Neutral (from Positive) on US short-term government bonds.** The risk of zero expected returns on that asset class has increased, especially since current short-term yields are close to zero.

**Long-term bond yields have fallen sharply, particularly in the US.** Markets focused on the second derivative, namely that the US economy continues to grow, but at a decreasing pace. In addition, some investors repriced the inflation risk lower after the FOMC meeting. The downward move in bond yields was exacerbated by investors covering their short positions during thin summer markets.

**Does this justify a 10-year Treasury yield of 1.3%?** In our view, the fundamental situation remains strong and the latest economic data do not justify such a reassessment of growth and inflation expectations. Longer-term bond yields should rise, but a catalyst is needed first. This could come from a strong job report, the Fed's tapering or an increase in bond issuance, for example.

#### 10-YEAR RATES



Source: Refinitiv Datastream, 07/07/2021

	Maturity (in years)	06/07/2021	12-month targets
United States	2	0.22	0.60
	5	0.81	1.25
	10	1.37	2
	30	2.00	2.60
Germany	2	-0.67	-0.50
	5	-0.62	-0.30
	10	-0.27	0
	30	0.22	0.50
United Kingdom	2	0.05	0.30
	5	0.28	0.60
	10	0.64	1.20
	30	1.17	1.50

Source: Refinitiv Datastream, BNP Paribas WM

## CONCLUSION

We turn Neutral from Positive on US short-dated government bonds as short-term bond yields are now less anchored by the Fed.

The bear market should continue after the summer. The reopening of activity, the expected Fed tapering and the flood of Government bond issues should push bond yields higher. We are negative on US and German long-term Government bonds.



**BNP PARIBAS**  
WEALTH MANAGEMENT

The bank  
for a changing  
world

## Theme in Focus

### Inflation and EM local bonds

Inflation has accelerated worldwide in recent months, in both developed and Emerging Markets (see chart). While developed markets' central banks sat on their hands, EM central banks were prompted to react.

Rising policy rates in EM are not ideal as they weigh on growth prospects at a time when growth has only just started to pick up in some countries, while other countries are still struggling to cope with the pandemic. But EM countries cannot afford for inflation to spiral out of control as they need to continue to attract inflows, maintain financial stability and avoid currency depreciation.

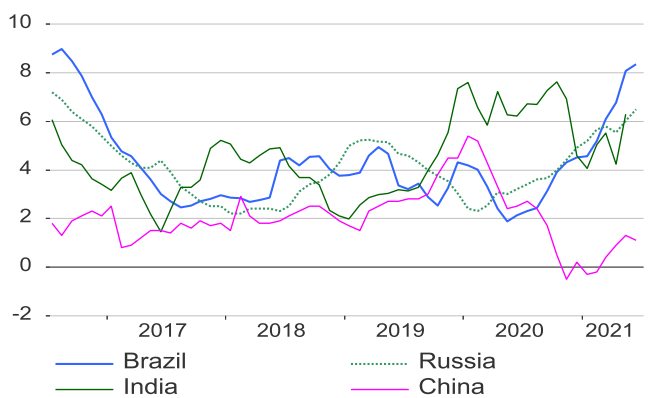
So far this year, 15 EM central banks have hiked rates, compared with only four in 2020. Brazil and Russia were the first to hike rates this year. Then Hungary and the Czech Republic followed suit. Mexico surprised with a hike, and South Korea started paving the way for hikes as well.

The markets reacted positively to countries whose central banks are getting ahead of inflation (see chart), as it somewhat protected them from the impact of higher short-term US yields and the stronger dollar. Indeed, the Brazilian real and the Russian ruble were among the best-performing currencies against the euro in June. Currency movements traditionally account for a significant part of local currency sovereign bond returns.

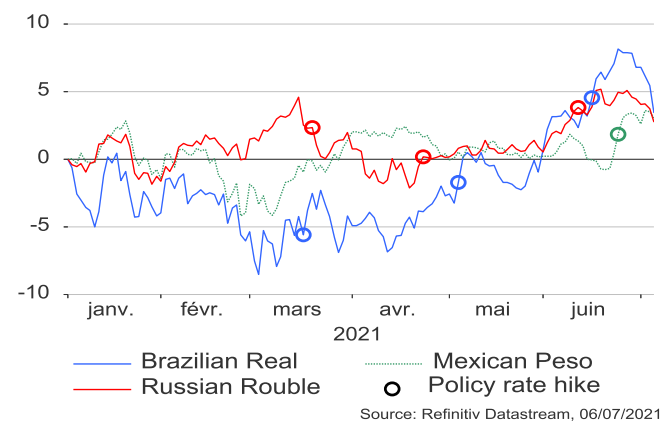
Moreover, it seems to us that expected inflation is already well priced in and we believe that EM central banks on average may tighten policies less than the markets have already priced in. This is a tailwind for EM local bonds.

As such, we remain positive on EM local bonds, especially in the current environment of ample liquidity, expectations of a weaker dollar and high commodity prices. Not to mention that growth will eventually catch up in EM once the pandemic calms down, and EM offer attractive real yields compared with developed markets.

#### INFLATION IS RISING IN EM (TWELVE-MONTH PERCENTAGE CHANGE)



#### EMERGING CURRENCIES APPRECIATED WHEN CENTRAL BANK HIKE RATES



### CONCLUSION

Several central banks in Emerging Market countries hiked policy rates in the wake of high inflation and the hawkish Fed pivot. Their currencies appreciated as a result, which improved local bond returns. We remain positive on EM local bonds. The environment is supportive and the markets are already discounting high inflation and policy rate hikes.



## 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	= -	<ul style="list-style-type: none"> <li>We turned Neutral from Positive on short-term Government bonds.</li> <li>Negative on long-term debt.</li> </ul>
Corporate bonds Investment Grade	Eurozone	=	<ul style="list-style-type: none"> <li>We prefer corporate bonds to sovereign bonds.</li> <li>We favour EUR and US bonds with a similar duration to the benchmark (5 and 9 years respectively).</li> <li>Positive on convertible bonds in the eurozone.</li> </ul>
	United States	+	
Corporate bonds High Yield	Eurozone and United States	=	<ul style="list-style-type: none"> <li>Neutral on HY bonds.</li> <li>Positive on <i>fallen angel</i> and <i>rising stars</i>.</li> </ul>
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	1.37	- - -	
Germany	-0.27	- - -	
France	0.06	33	-4
Italy	0.75	102	-7
Spain	0.35	61	-5
Portugal	0.32	58	-8
Greece	0.77	104	+1

06/07/2021  
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	1.08	33	0
Corporate bonds IG EUR	0.30	83	-2
Corporate bonds IG USD	1.99	82	-3
Corporate bonds HY EUR	2.83	287	+1
Corporate bonds HY USD	3.53	262	- 35
Emerging government bonds in hard currency	4.30	301	+13
Emerging corporate bonds in hard currency	3.92	312	+14
Emerging government bonds in local currency	3.62	282	+3

06/07/2021  
Source: Refinitiv Datastream, Bloomberg Barclays

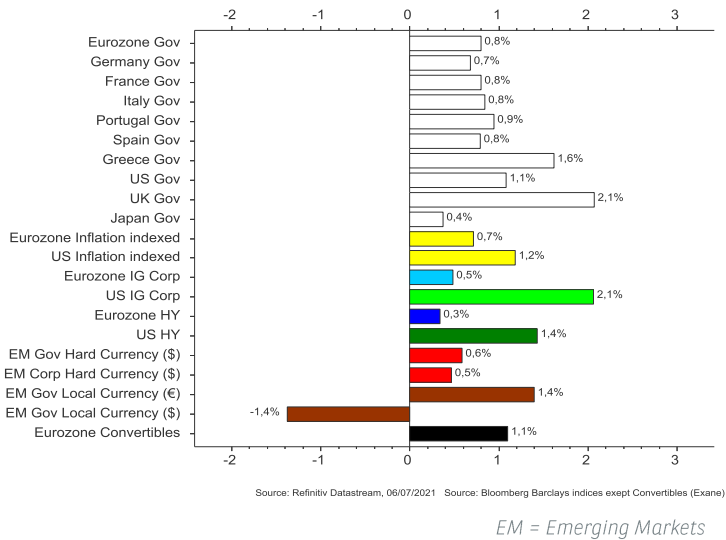


**BNP PARIBAS**  
WEALTH MANAGEMENT

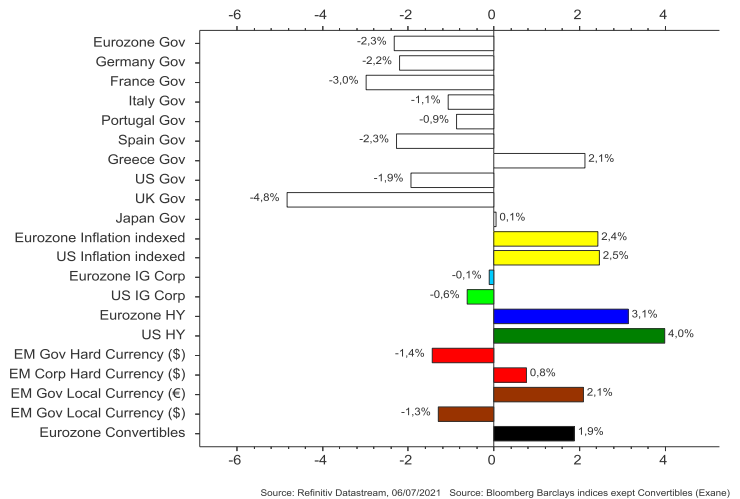
The bank  
for a changing  
world

## Returns

### OVER ONE MONTH



### SINCE 01/01/2021



## 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

Investment Advisor, Fixed Income



**BNP PARIBAS**  
WEALTH MANAGEMENT

The bank  
for a changing  
world



# CONNECT WITH US

---



[wealthmanagement.bnpparibas](https://wealthmanagement.bnpparibas)

---

## DISCLAIMER

---

This marketing document is communicated by the Wealth Management Métier of BNP Paribas, a French Société Anonyme, Head Office 16 boulevard des Italiens, 75009 Paris, France, registered under number 662 042 449 RCS Paris, registered in France as a bank with the French Autorité de Contrôle Prudentiel et de résolution (ACPR) and regulated by the French Autorité des Marchés Financiers (AMF). As marketing material, it has not been prepared in accordance with legal and regulatory requirements aimed at ensuring the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination. It has not been submitted to the AMF or any other market authority.

This document is confidential and intended solely for the use of BNP Paribas SA, BNP Paribas Wealth Management SA or their affiliates ("BNP Paribas") and the persons to whom this document has been delivered. It may not be distributed, published, reproduced or disclosed by any recipient to any other person, nor may it be quoted or referred to in any document, without the prior consent of BNP Paribas.

This document is provided solely for information and shall not constitute an offer or solicitation in any state or jurisdiction in which such an offer or solicitation is not authorized, or to any person to whom it is unlawful to make such offer, solicitation or sale. It is not, and under no circumstances is it to be construed as, a prospectus.

Although the information provided herein may have been obtained from published or unpublished sources considered to be reliable and while all reasonable care has been taken in the preparation of this document, BNP Paribas does not make any representation or warranty, express or implied, as to its accuracy or completeness and does not accept responsibility for any inaccuracy, error or omission. BNP Paribas gives no warranty, guarantee or representation as to the expected or projected success, profitability, return, performance, result, effect, consequence or benefit (either legal, regulatory, tax, financial, accounting or otherwise) of any product or transaction. Investors should not place undue reliance on any theoretical historical information regarding such theoretical historical performance. This document may contain or refer to past performance; past performance is no guarantee for future performance.

The information contained in this document has been drafted without prior knowledge of your personal circumstances, including your financial position, risk profile and investment objectives.

Prior to entering into a transaction each investor should fully understand the financial risks, including any market risk associated with the issuer, the merits and the suitability of investing in any product and consult with his or her own legal, tax, financial and accounting advisors before making his or her investment. Investors should be in a position to fully understand the features of the transaction and, in the absence of any provision to the contrary, be financially able to bear a loss of their investment and willing to accept such risk. Investors should always keep in mind that the value of investments and any income from them may go down as well as up and that past performance should not be seen as an indication of future performance. Any investment in a product described herein is subject to the prior reading and understanding of the legal documentation concerning the product, and in particular the one which describes in details the rights and obligations of investors as well as the risks inherent to an investment in the product. Save as otherwise expressly agreed in writing, BNP Paribas is not acting as financial adviser or fiduciary of the investor in any transaction. The information, opinions and projections expressed herein reflect the opinion of their author at the time of writing; they are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by anyone, and are subject to change without notice. Neither BNP Paribas nor any BNP Paribas Group entity accepts any liability whatsoever for any consequences that may arise from the use of information, opinions or projections contained herein.

As distributor of the products described herein, BNP Paribas may receive distribution fees on which you can obtain more information upon specific request. BNP Paribas, their employees or administrators may hold positions in these products or have dealings with their issuers.

By accepting this document, you agree to be bound by the foregoing limitations.

© BNP Paribas (2021). All rights reserved.

Pictures from Getty Images.



**BNP PARIBAS**  
**WEALTH MANAGEMENT**

The bank  
for a changing  
world