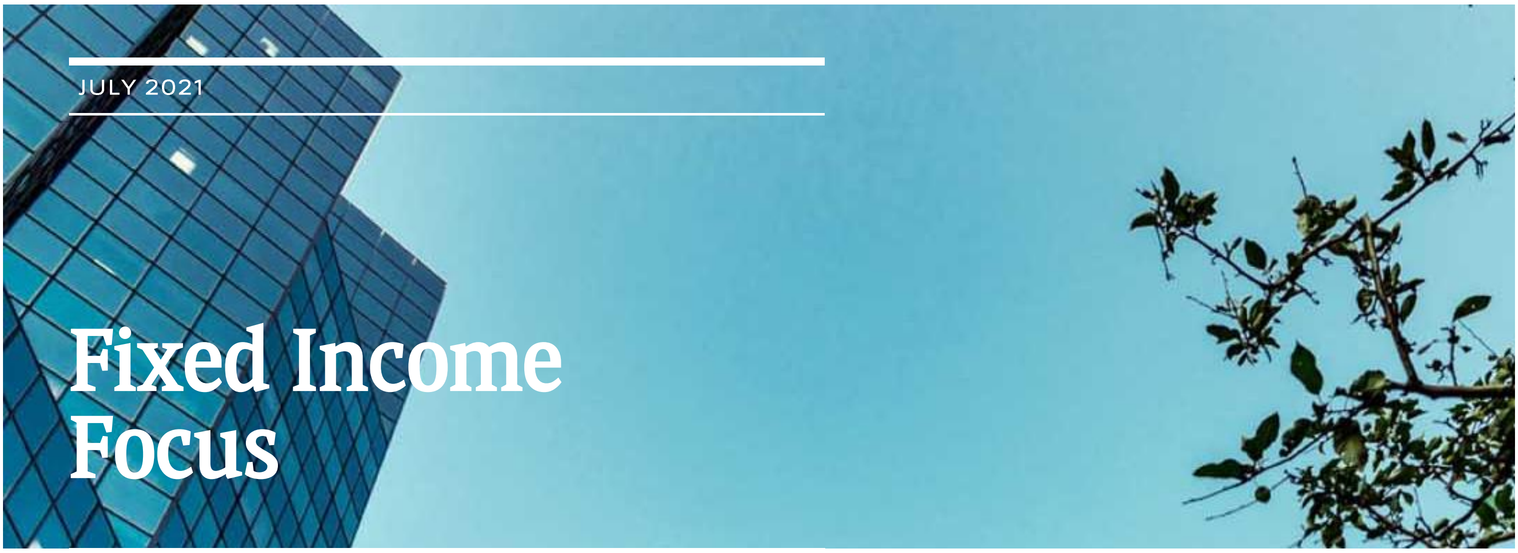


JULY 2021

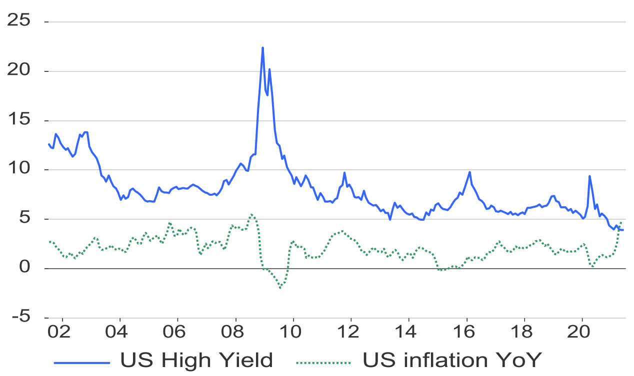
Fixed Income Focus

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.

Contents

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



Source: Refinitiv Datastream, 06/07/2021

Edouard Desbonnets

Investment Advisor, Fixed Income

BNP Paribas Wealth Management

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).

US Federal Reserve (Fed)

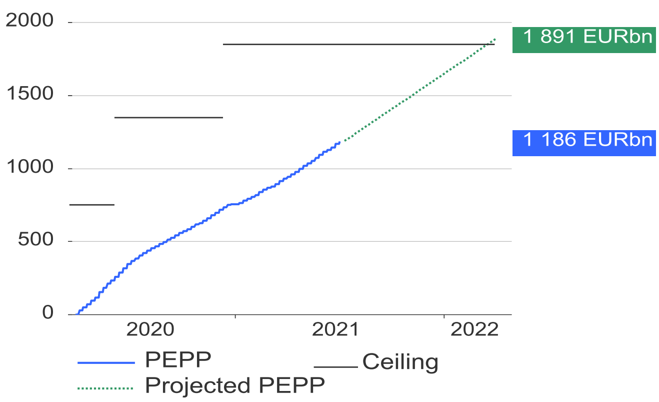
Patience has its limits. The Fed surprised the markets at the June FOMC meeting. It showed less patience to inflation as it expects two rate hikes in 2023 according to the median view of the 18 policymakers (see chart), whereas it expected none at the March FOMC meeting.

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.

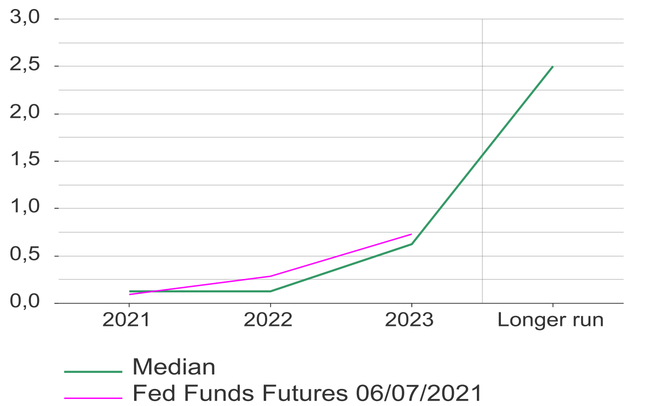
We expect the Fed to announce tapering in September and implement it in January 2022, starting with MBS. **As for the first rate hike, we have brought our expectation forward to 1Q 2023** instead of 3Q 2023, as the Fed now seems much more sensitive to inflationary risk. The Fed could favour fighting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

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



Source: Refinitiv Datastream, 02/07/2021

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



Source: Refinitiv Datastream

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

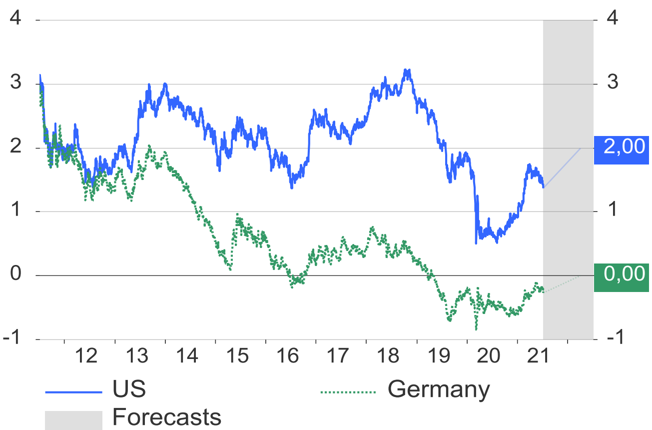
Short-term pause in a bear market

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.

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.

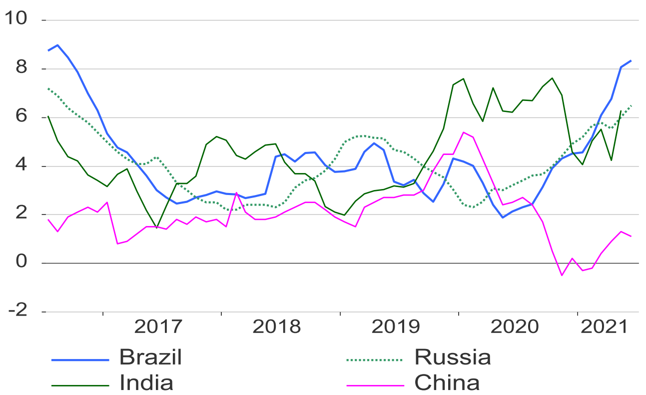
So far this year, 15 EM central banks have hiked rates, compared with only four in 2020. Brazil and Russia were the first to hike rates this year. Then Hungary and the Czech Republic followed suit. Mexico surprised with a hike, and South Korea started paving the way for hikes as well.

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.

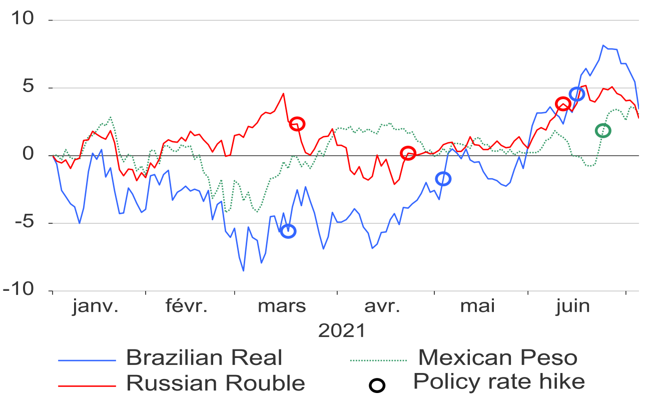
As such, we remain positive on EM local bonds, especially in the current environment of ample liquidity, expectations of a weaker dollar and high commodity prices. Not to mention that growth will eventually catch up in EM once the pandemic calms down, and EM offer attractive real yields compared with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

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



Source: Refinitiv Datastream, juin 21

EMERGING CURRENCIES APPRECIATED WHEN CENTRAL BANK HIKED RATES



Source: Refinitiv Datastream, 06/07/2021

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	= -	• We turned Neutral from Positive on short-term Governement bonds. • Negative on long-term debt.
Corporate bonds Investment Grade	Eurozone 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* 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	1.37	- - -	
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

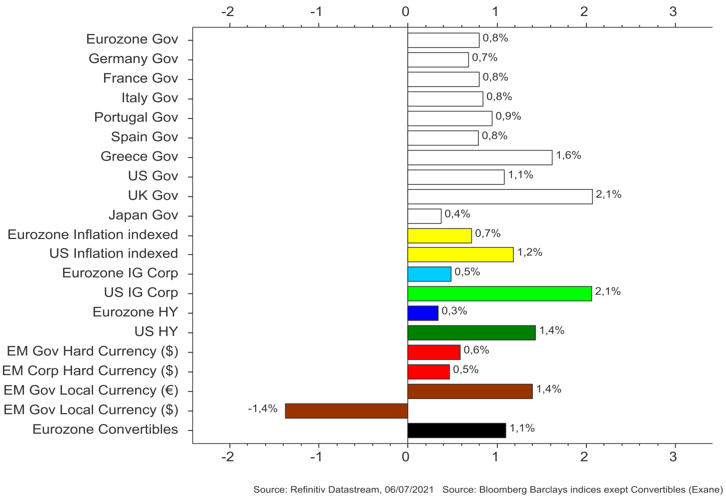
06/07/2021
Source: Refinitiv Datastream

	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

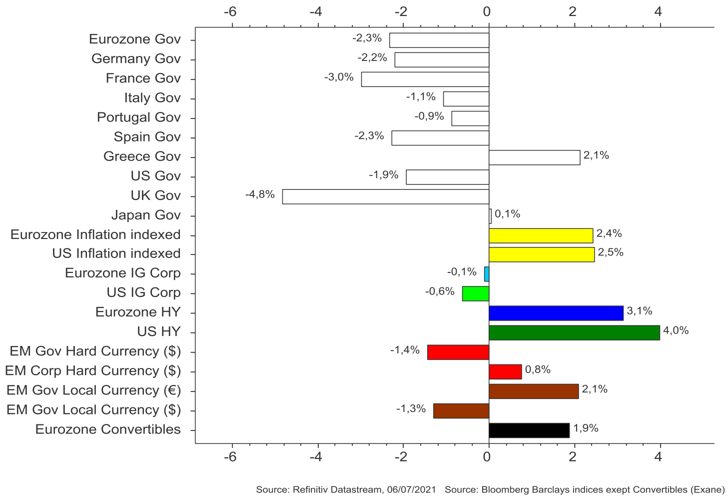
Returns

OVER ONE MONTH



EM = Emerging Markets

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

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