JUNE 2022

Fixed Income Focus

Summary

1. **The Fed and the ECB want to tighten policy rates to combat inflation. The ECB is now more aggressive than the Fed.** We believe market expectations are too high. The ECB is set to tighten its key interest rate as of July, with the aim of exiting negative rates in September. The Fed could reduce its pace of monetary tightening from autumn onwards if inflation decelerates sufficiently.

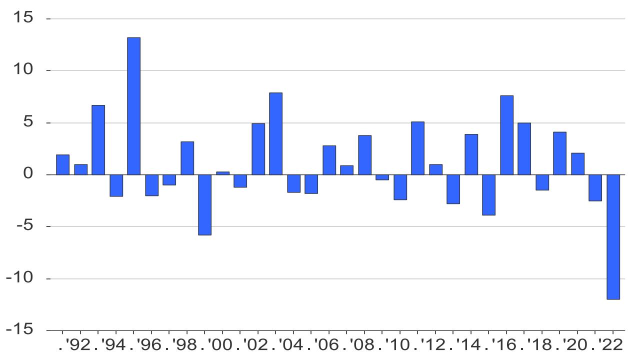
2. **Interest rates continue to rise, but this time more in Germany than in the US. Volatility remains high and liquidity is deteriorating.** We have revised our rate target to 1% for the German Bund in 12 months and to 2.75% for the 10-year Treasury bond. We expect a flat US yield curve in 12 months. Neutral view on long-term government bonds and Positive on short-term US government bonds for dollar-based investors.

3. **Italian sovereign bonds: valuations are adjusting to a new era of no net ECB purchases. Reinvestments of maturing bonds made by the ECB will limit risks, without eliminating them.** The Italian spread could continue to widen. Italian sovereign bonds should underperform German government bonds. We prefer short-dated government bonds.

Contents

CALAMITOUS START TO THE YEAR: PERFORMANCE FROM 1 JANUARY TO 8 JUNE IN EACH YEAR (%)

Bloomberg Global Aggregate USD index (developed and emerging markets, government and corporate bonds)



Source: Refinitiv Datastream, 08-06-22

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Central banks

Fighting inflation at all costs?

European Central Bank (ECB)

Gradual but sustained normalisation: unsurprisingly, the ECB has decided to stop its net bond purchases on 1 July and to raise rates thereafter, in July (25bps), in September (25bps or more) and probably beyond.

Our view: the ECB will keep its commitment due to the strength of inflation (see chart), the weakness of the euro and economic projections that see inflation above the 2% target (2.1%) in 2024. Our initial scenario of a 1% deposit rate at the end of 2023 will be revised upwards.

Market expectation: the market expects an aggressive monetary tightening, with a deposit rate close to 2% at the end of 2023.

Risk: the risk of eurozone fragmentation, i.e. a widening of spreads in the eurozone not justified by fundamentals, is real. To avoid this, the ECB insists on its flexibility to allocate bond reinvestments to countries where spreads have widened the most. Moreover, it is working on a new tool to achieve this goal.

US Federal Reserve (Fed)

The Fed must do more: inflation expectations have eased only slightly (see chart). Monetary conditions have eased over the past month. Inflation is decelerating too slowly.

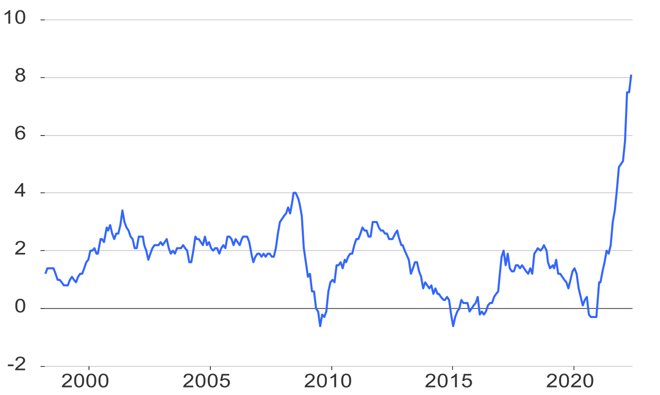
Consequence: The minutes of the last monetary policy meeting revealed that its members were in favour of bold rate hikes now in order to have more flexibility later.

Our view: our scenario is supported by the Fed's minutes. We expect a rate hike of 50bps at the next two Fed meetings (in June and July) and then smaller hikes of 25bps as inflation should decelerate and risks to growth should increase. We see a terminal rate of 2.75% at the end of 2023.

Market anticipation: expectations have been revised downwards. The terminal rate has fallen to 3%.

Balance sheet management: the Fed began reducing its balance sheet in June by ceasing to reinvest a portion of its maturing bonds.

EUROZONE INFLATION, YEAR-ON-YEAR CHANGE (%)



Source: Refinitiv Datastream, mai 22

EXPECTED INFLATION: 5-YEAR 5-YEAR INFLATION SWAP RATE (%)

Source: Refinitiv Datastream, 09-06-22

CONCLUSION

The Fed and the ECB want to tighten policy rates to combat inflation. However, the momentum is changing as it is now the ECB that is more aggressive than the Fed. The ECB is expected to tighten its key rate as of July, with the aim of exiting negative rates in September. The Fed could reduce the pace of monetary tightening from the autumn if inflation decelerates sufficiently.

Bond yields

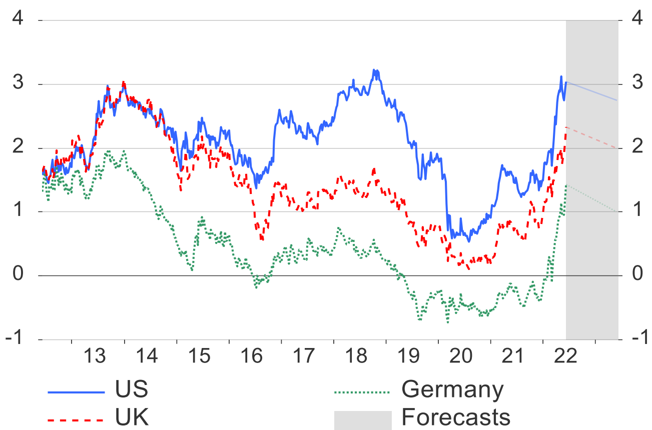
Massive movements

Change in momentum: rates have continued to rise recently, but this time much more so in Germany than in the US, due to the hawkish rhetoric of European central bankers and because inflation has surprised on the upside.

Interest rate targets: we have raised our targets for German rates to 0.5% for the 2-year rate and 1% for the 10-year rate in 12 months. Current rates are above our targets and should remain so for a few months as inflation could continue to surprise to the upside until the autumn. In the US, we expect rates to be lower than today in 12 months' time as inflation is expected to slow down, which will encourage the Fed to be less aggressive in its monetary tightening cycle, especially as growth is expected to slow down. We see a flat yield curve, at 2.75% in 12 months.

Our view: we are Neutral on long-term bonds, and Positive on short-term US Treasury bonds for dollar-based investors.

10-YEAR RATES



Source: Refinitiv Datastream, 10-06-22

	Maturity (in years)	08/06/2022	12-month targets
United States	2	2.77	2.75
	5	3.03	2.75
	10	3.03	2.75
	30	3.18	2.75
Germany	2	0.70	0.50
	5	1.08	0.75
	10	1.35	1.00
	30	1.59	1.30
United Kingdom	2	1.78	1.60
	5	1.88	1.75
	10	2.25	2.00
	30	2.46	2.40

Source: Refinitiv Datastream, BNP Paribas WM

CONCLUSION

Interest rates continue to rise, but this time more in Germany than in the US. Volatility remains high and liquidity is deteriorating. We have revised our rate target to 1% for the German Bund in 12 months and to 2.75% for the 10-year Treasury bond. We expect a flat US yield curve in 12 months.

Theme in Focus

Italy back in the spotlight

Sovereign bonds in peripheral eurozone countries (Italy, Greece, Spain, Portugal) have been suffering since the beginning of the year (see chart). With interest rate pressures and widening risk premiums, Italy, a large issuer in the eurozone, has returned to the forefront.

> 200 bps: risk perception has increased. The Italian spread (spread between the yield on the Italian 10-year bond and the German 10-year bond) has exceeded the symbolic bar of 200 bps (see chart).

> 3%: The yield on the Italian 10-year bond has increased to 3.2%. The elevated yield is justified by the existing risks.

ECB risk: the ECB will stop its net bond purchases by 1 July. Its share will have to be absorbed by investors.

Refinancing risk: the ECB's withdrawal comes at a time when Italy has substantial refinancing needs (EUR 500 bn in the next 18 months), in a context in which interest rates are higher with Italy facing weak growth and high inflation and the risk of a recession hanging over the eurozone. Fear of debt sustainability could return.

Election risk: even though the elections are scheduled to take place before 1 June 2023, talks will begin after the budget is approved in October/November.

ECB relative support: maturing bonds will be reinvested. The ECB could in theory redirect all PEPP reinvestments to those countries whose spreads have widened the most to avoid a fragmentation of the euro area.

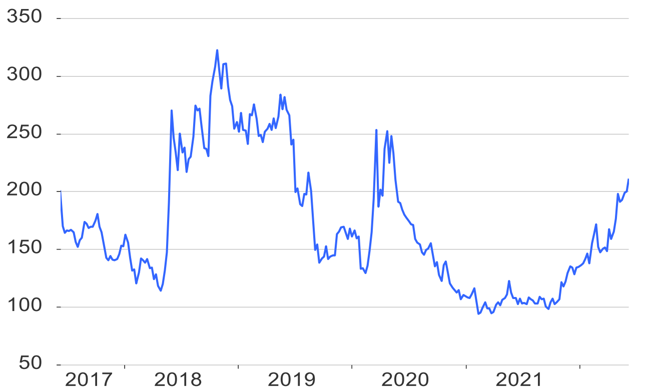
Long-term EU support: raising common debt (NextGen and Repower EU programmes) is a major step towards more integration and transfers within the euro area in the long term.

Conclusion: we are Neutral on Italian government bonds. Spreads could widen further. When the ECB stopped its net purchases in January-July 2019, spreads moved between 250 and 275 bps. We prefer short-dated bonds.

YEAR-TO-DATE PERFORMANCE OF ITALIAN DEBT (%)

Source: Refinitiv Datastream, 08-06-22

THE ITALIAN SPREAD (BPS)



Source: Refinitiv Datastream, 08-06-22

CONCLUSION

Peripheral bond valuations are adjusting to a new era of no net ECB purchases. Reinvestments of maturing bonds made by the ECB will limit risks, without eliminating them. The Italian spread could continue to widen. Italian sovereign bonds should underperform German government bonds. We prefer short-dated bonds.

Our Investment Recommendations

Asset classes	Zone	Our opinion	
Government bonds	Germany	=	We are Neutral on German sovereign bonds.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United States	+ =	• Positive on US short-term Governement bonds for USD-based investors. • We are 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	3.03	---	
Germany	1.35	---	
France	1.87	52	0
Italy	3.46	211	11
Spain	2.48	113	2
Portugal	2.51	116	1
Greece	3.99	264	24

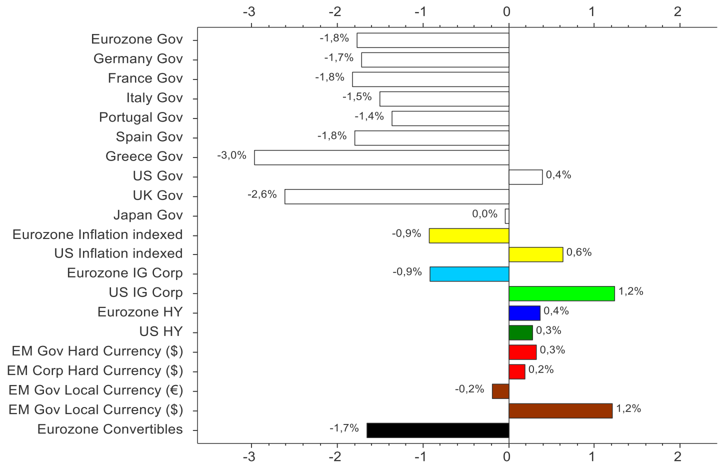
08/06/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	2.77	49	0
Corporate bonds IG EUR	2.63	162	1
Corporate bonds IG USD	4.40	130	-4
Corporate bonds HY EUR	5.81	461	-22
Corporate bonds HY USD	7.41	420	18
Emerging government bonds in hard currency	7.16	405	8
Emerging corporate bonds in hard currency	6.77	377	-17
Emerging government bonds in local currency	4.39	136	4

08/06/2022
Source: Refinitiv Datastream, Bloomberg

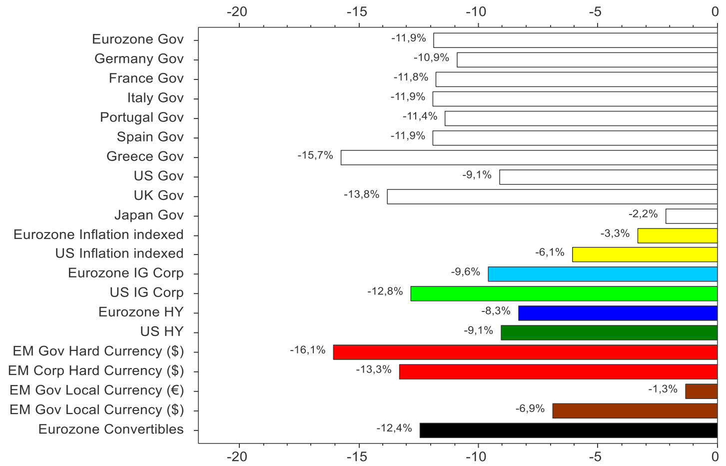
Returns

OVER ONE MONTH



Source: Refinitiv Datastream, 08-06-22 Source: Bloomberg Barclays indices exept Convertibles (Exane)

SINCE THE BEGINNING OF THE YEAR



Source: Refinitiv Datastream, 08-06-22 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

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