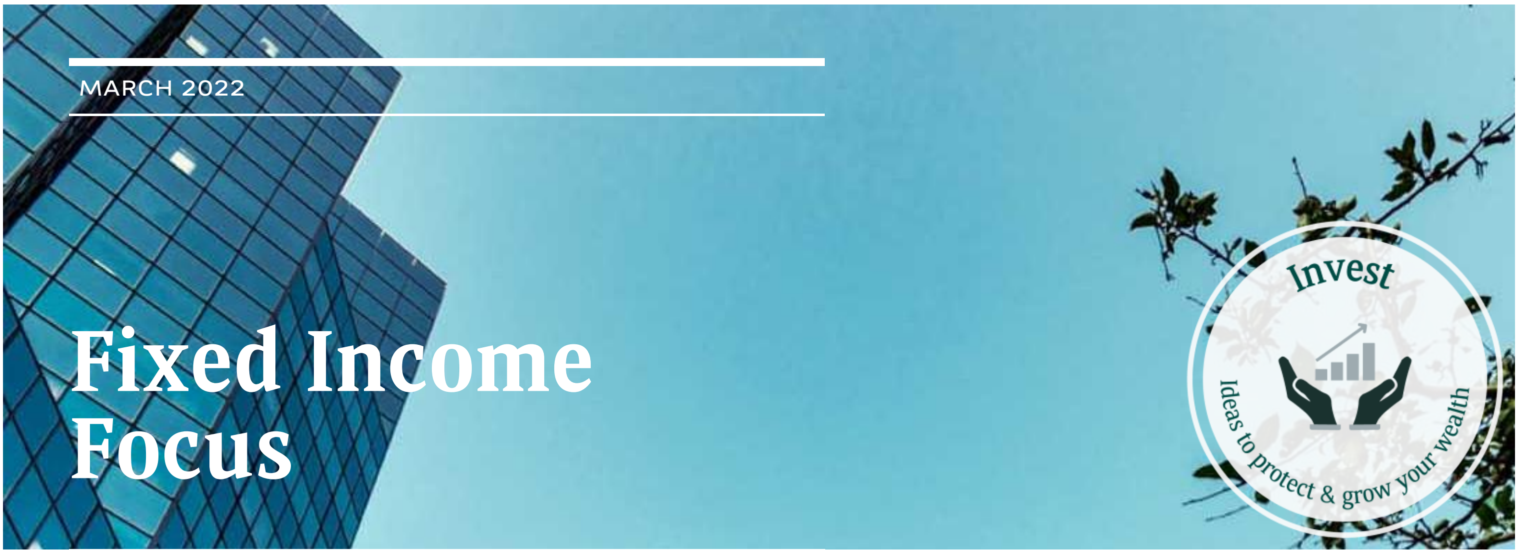

MARCH 2022

Fixed Income Focus

Summary

1. **The normalisation of monetary policies by the Fed and the ECB should only be marginally affected by geopolitical uncertainty, as central banks are more concerned about inflation being too high.** We are maintaining our already cautious scenario of 4 rate hikes this year for the Fed and only 1 in December for the ECB.

2. **US and German long-term interest rates, which had dropped sharply with risk aversion, have already returned to their pre-military conflict levels. They are expected to rise further as inflation will remain higher for longer.** We remain negative on US and German long bond yields. We have been positive on US short-term bonds as they serve as a safe haven in the event of geopolitical tensions.

3. **In this period of geopolitical uncertainty and the beginning of the normalisation of monetary policies of the major central banks in the developed world,** we believe that US short-term government bonds, bonds with indexed coupons, corporate bonds and emerging bonds offer opportunities.

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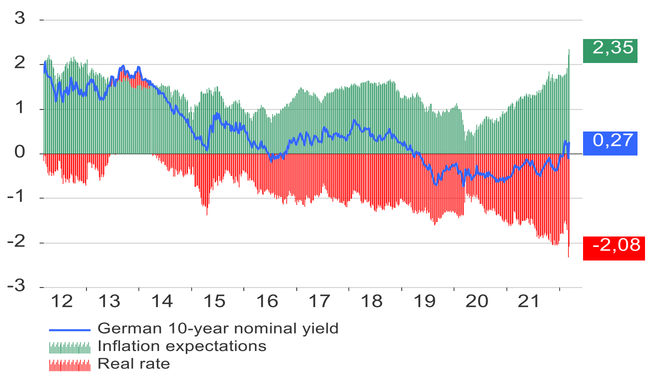
THE BREAKDOWN OF THE GERMAN 10-YEAR NOMINAL RATE SHOWS A SURGE IN INFLATION EXPECTATIONS AND A REAL RATE AT AN ALL-TIME LOW



Source: Refinitiv Datastream, 11-03-22

Edouard Desbonnets

Senior Investment Advisor, Fixed Income

BNP Paribas Wealth Management

Central banks

Towards a flexible normalisation

European Central Bank (ECB)

Inflation: The ECB revised its inflation forecast sharply upwards for 2022 and slightly upwards for 2023 and 2024. The medium-term inflation forecast is very close to the 2% target.

This is an uncomfortable position for the ECB, with current inflation well above its 2% target on the one hand, and growth weakened by geopolitical uncertainty and the consequences of sanctions against Russia on the other. Faced with this dilemma, the ECB has chosen to prioritise the fight against inflation.

Flexible normalisation: the normalisation of monetary policy is underway. The ECB will stop the net purchases of the pandemic asset purchase programme PEPP in March, accelerate the taper of the APP programme and, in principle, stop net purchases in Q3 and raise its policy rates some time afterwards.

Rate hike: September is not ruled out, but December seems more plausible given that it is only towards the end of the year that we should see inflation translate into wage increases.

US Federal Reserve (Fed)

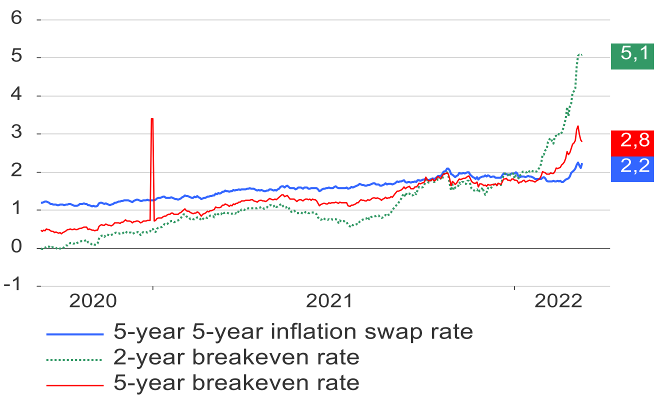
More caution but no backtracking: the Fed should maintain its roadmap to normalise its monetary policy while showing that is agile and cautious given the uncertain geopolitical context and the mild tensions in the money market.

Our view: we are maintaining our cautious scenario of a 0.25% rise in policy rates in March, a total of 4 rate hikes this year and 4 next year. The reduction of the balance sheet is expected to be announced in June and should start in July.

Enthusiasm disappears: The probability of a 0.50% rate hike in March has fallen from around 100% to 0% following the military conflict. However, the number of rate hikes expected by the market has dropped from 7 to 5, before returning to 7 with the release of February inflation (7.9%).

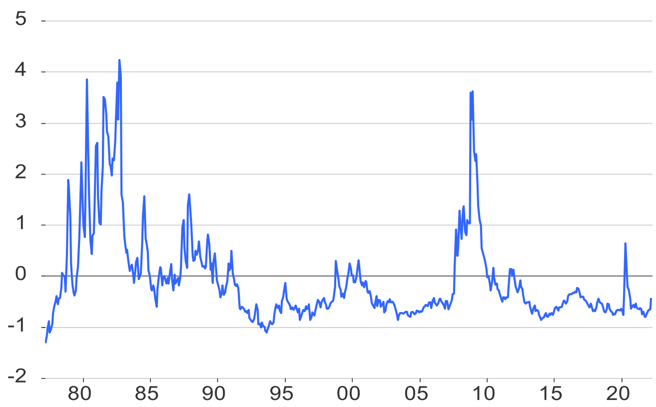
Financial conditions have already begun to tighten with the widening of credit spreads and the fall in equity markets, while the Fed has not yet raised its policy rate or stopped purchasing bonds.

MEDIUM-TERM INFLATION BASED ON MARKET PRICES IS ABOVE THE ECB'S TARGET



Source: Refinitiv Datastream, 11-03-22

FINANCIAL CONDITIONS ARE TIGHTENING (CHICAGO FED)



Source: Refinitiv Datastream, 04-03-22

CONCLUSION

The normalisation of monetary policies by the Fed and the ECB should only be marginally affected by geopolitical uncertainty, as central banks are more concerned about inflation being too high. We maintain our cautious scenario of four rate hikes this year for the Fed and one in December for the ECB.

Bond yields

Volatile

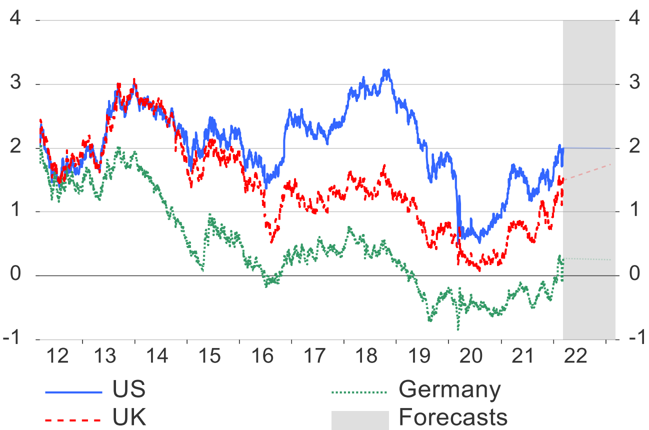
The military conflict triggered a strong risk aversion movement at the end of February, with long-term interest rates falling sharply. Yet, the move was fairly short-lived. Nominal rates have now returned to their pre-conflict levels. However, the internal dynamics have changed as real rates have collapsed while inflation expectations have soared, as wars are generally inflationary.

As a result, we have increased our German 12-month and US long-term yield targets by 0.25% to reflect the fact that inflation will stay higher for longer. We expect bond yields to continue to rise as monetary policy normalisation takes place. We are negative on long-dated US and German government bonds.

During this troubled period, short-dated US government bonds can be seen as an alternative. We have turned positive on this segment. Note that there is a currency risk for investors who are not based in dollars.

Volatility on rates remains very high.

10-YEAR RATES



Source: Refinitiv Datastream, 11-03-22

	Maturity (in years)	10/03/2022	12-month targets
United States	2	1.72	1.50
	5	1.94	1.75
	10	2.01	2.25
	30	2.39	2.60
Germany	2	-0.40	0
	5	0.00	0.25
	10	0.27	0.50
	30	0.45	0.60
United Kingdom	2	1.35	1.50
	5	1.30	1.60
	10	1.52	1.75
	30	1.70	2.10

Source: Refinitiv Datastream, BNP Paribas WM

CONCLUSION

Government bonds have been playing their safe-haven role in the wake of the military conflict. Interest rates have fallen sharply. They should rise again as inflation will remain higher for longer. During this troubled period, short-dated US government bonds can be seen as an alternative.

Theme in Focus

Investment ideas during this troubled period

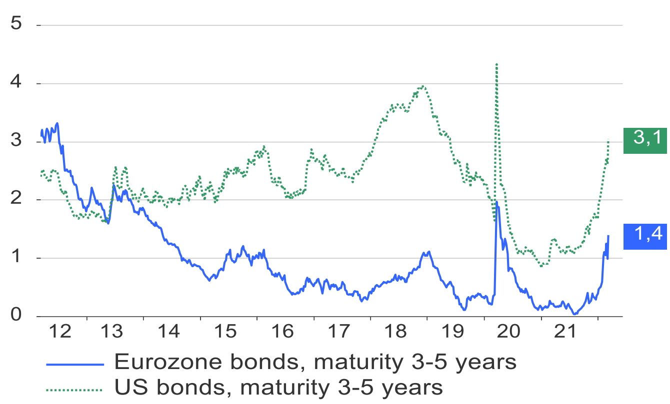
We have turned positive on **US government bonds in the short term.** They are a safe haven against geopolitical tensions due to their characteristics: safe, liquid and short term. They offer a yield of 1.7%. We see limited interest rate risk as the market anticipates an aggressive Fed rate hike cycle despite the highly uncertain geopolitical environment. Investors whose base currency is not the US dollar are exposed to currency risk.

We also like **bonds with indexed coupons**, such as **inflation-indexed coupons** in countries where inflation risk is particularly high and the labour market is tight, as in the United States and the United Kingdom. Alternatively US **floating-rate bonds** for defensive investors, as prices are generally very stable and the coupon adjusts to reflect short-term interest rate increases.

Turning to **corporate bonds**, the expected normalisation of monetary policy had already led to a widening of credit spreads at the end of last year. This movement has since intensified with the geopolitical tensions. Corporate bond yields are now attractive, even for short maturities (see chart). However, this is more tactical than strategic as the credit cycle is already well advanced.

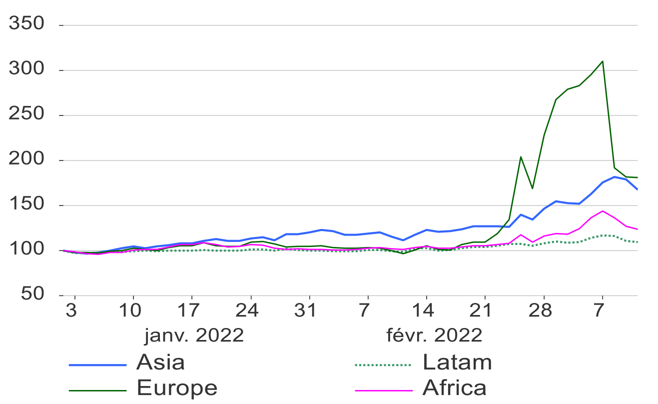
For investors able to withstand volatility, **emerging market bonds** were already discounted before the military conflict and are even more so now. Russian bonds have lost nearly 90% of their value since the beginning of the year and are the biggest contributor to the poor performance of emerging market indices. However, there is only limited contagion to other emerging market bonds (see chart). Meanwhile fund/ETF flows are not showing any panic movements. Most emerging markets will benefit from the boom in commodity prices.

INVESTMENT GRADE CORPORATE BOND YIELD (%)



Source: Refinitiv Datastream, 11-03-22

LIMITED CONTAGION: EM SOVEREIGN SPREAD BY REGION, REBASED TO 100



Source: Refinitiv Datastream, 10-03-22

CONCLUSION

In this period of risk aversion and the beginning of a normalisation of monetary policies by major central banks in developed countries, we believe that short-term US government bonds, bonds with indexed coupons, corporate bonds and emerging market bonds offer opportunities.

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).
	United States	+ -	• We moved to Positive from Negative on US short-term Govenement 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 below benchmark for EUR (5 years) and US (8 years) bonds. • We have moved from Positive to 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	2.01	---	
Germany	0.27	---	
France	0.75	48	2
Italy	1.92	165	1
Spain	1.28	101	10
Portugal	1.15	87	3
Greece	2.54	226	0

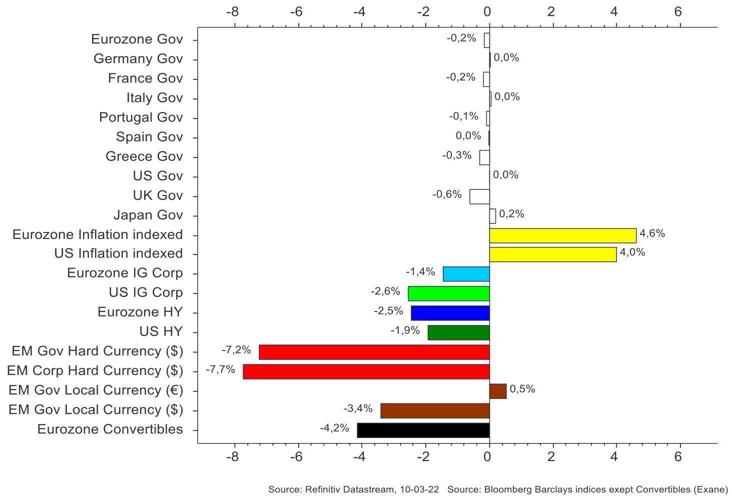
10/03/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	1.91	48	8
Corporate bonds IG EUR	1.46	152	35
Corporate bonds IG USD	3.47	141	35
Corporate bonds HY EUR	5.43	456	84
Corporate bonds HY USD	6.13	389	54
Emerging government bonds in hard currency	6.17	408	77
Emerging corporate bonds in hard currency	6.28	433	107
Emerging government bonds in local currency	3.98	204	14

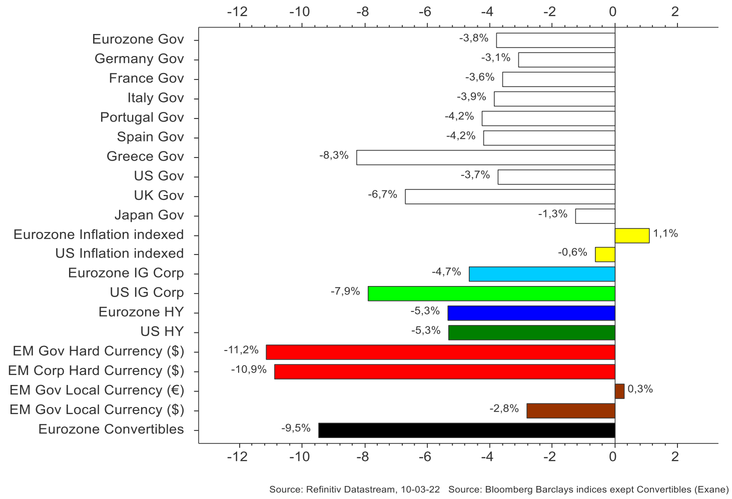
10/03/2022
Source: Refinitiv Datastream, Bloomberg Barclays

Returns

OVER ONE MONTH



SINCE THE BEGINNING OF THE YEAR



EM = Emerging Markets

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