

The Fed in serial hiking mode



Summary

- The Fed increased its policy rate as expected at the March meeting but now intends to hike rates faster and harder in this rate hike cycle.
- The Fed moved from a desire to remove excess liquidity to a decision to tighten financial conditions given the high level of inflation.
- We now expect 5 additional rate hikes this year instead of 3. We maintain our forecast of 4 rate hikes in 2023. We have raised our target for the US 2-year rate to 2% and we have a positive recommendation on US short-term Treasuries.
- The Fed risks a recession if the US economy proves less resilient than it thinks. For now, the risk of recession in one year is low.
- The ECB was also hawkish at its March meeting given high inflation. The eurozone economy faces risk to growth due to the conflict in Eastern Europe.

Hawkish Fed

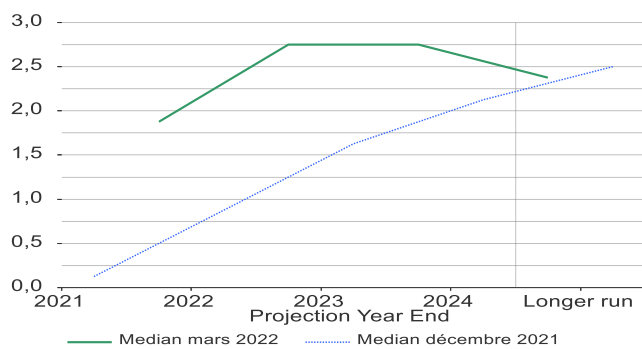
The Fed hiked rates by 25 basis points (bps) yesterday, to 0.50% as inflation is soaring. It raised its inflation forecast for this year and the next two years. It also revised down its growth forecast, but only for this year. All this was expected.

The surprise came from the Fed's projections for rate hikes. It changed its forecasts substantially from the December projections. The Fed now expects a steeper and shorter rate hike cycle with 6 additional rate hikes this year, i.e. one at each meeting. It expects the policy rate to peak at 2.75% as

early as 2023 and to be maintained over 2024. That level is higher than the expected long-term rate (2.38%), suggesting that the Fed has moved from wanting to remove excess liquidity in the system to actually tightening financial conditions. The Fed is convinced that the economy can take it. It seems that the Fed is now focusing solely on fighting inflation, ignoring the labour market, at the risk of causing a recession.

FEDERAL OPEN MARKET COMMITTEE PROJECTIONS

Implied Fed Funds Target Rate



Source: Refinitiv Datastream, N/A

Source: BNP Paribas Wealth Management

Edouard Desbonnets

Senior Investment Advisor, Fixed Income
BNP Paribas Wealth Management

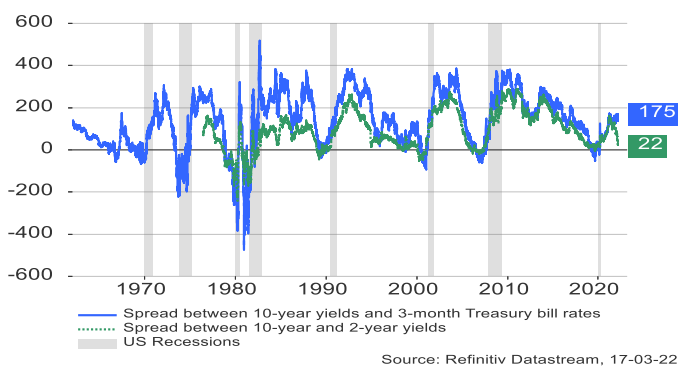


Risks of recession

In the US, past recessions have usually been preceded by an inversion of the yield curve (long-term rates becoming lower than short-term rates). This inversion triggered a recession 12 to 16 months later. Currently, the differential between the 10-year rate and the 3-month rate, which is the yield curve used by the Fed in its recession model, is 175bps, indicating a very low risk of recession in one year (5%). The market focuses more on the difference between the 10-year rate and the 2-year rate. It is currently 22bps, which suggests a non-negligible risk of recession in one year (25%), as in the past recessions have occurred on average when this probability was above 30%.

US YIELD CURVE

Spread between long-term and short-term yields, in bps

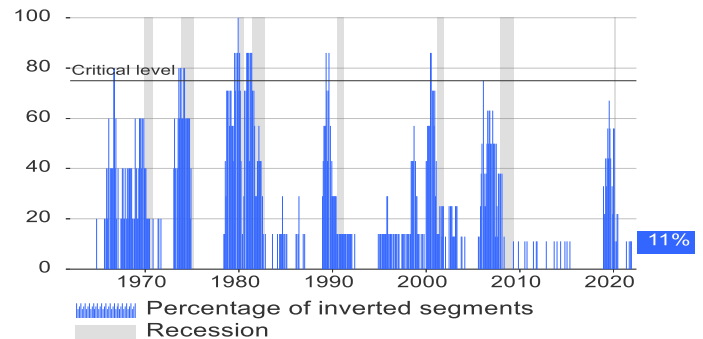


Source: BNP Paribas Wealth Management

In addition, we look at the number of inverted segments of the yield curve to better assess the risk of recession. Currently, although the yield curve is quite flat, there is only 1 inverted segment (the 7-year rate is higher than the 10-year) out of 9. The risk of a recession is therefore low for the moment. However, if the Fed continue to raise rates as planned, the yield curve will flatten further and the number of inverted segments in the yield curve will increase. The Quantitative Tightening (QT) could help then. Indeed, the Fed plans to reduce the size of its balance sheet by slowing down reinvestments of matured assets. This will take away some buying pressure on medium and long-term Treasuries, thus removing some pressure on the yield curve flattening. More details on QT should be announced in May and QT may start soon after.

US YIELD CURVE

Percentage of segments inverted



Source: BNP Paribas Wealth Management

Change in our scenario

We have revised our scenario given the hawkish Fed, its determination to return to price stability and its willingness to tighten monetary policy faster and harder than originally expected. We now expect the Fed to raise rates 5 more times this year instead of 3. We maintain our assumption of 4 rate hikes next year. It means that we are raising our 12-month target for the US 2-year rate from 1.5% to 2%. As the 2-year rate is currently very close to this target, we have a positive stance on US short-term government bonds, especially in light of current geopolitical events as these assets are considered as safe havens as they are safe and liquid.

Our 12-month targets for long-term rates are 2.25% for the US 10-year rate and 0.50% for its German peer. We see rates rising moderately as monetary policy normalisation takes place.

Hawkish ECB

For the ECB, inflation is also a concern. At the March meeting it 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. The ECB is in an uncomfortable position, 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. The normalisation of monetary pol-

icy is therefore 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 the net purchases of the APP in Q3 and raise its policy rates some time afterwards. We expect the first rate hike to come in December given that it is only towards the end of the year that we should see inflation translate into wage increases.

THE INVESTMENT STRATEGY TEAM



FRANCE

Edmund SHING

Global Chief Investment Officer

ASIA

Prashant BHAYANI

Chief Investment Officer

Grace TAM

Chief Investment Advisor



BELGIUM

Philippe GIJSELS

Chief Investment Advisor

Alain GERARD

Senior Investment Advisor, Equities

Xavier TIMMERMANS

Senior Investment Strategy, PRB



LUXEMBOURG

Guy ERTZ

Chief Investment Advisor

Edouard DESBONNETS

Senior Investment Advisor, Fixed Income



BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world

CONNECT WITH US



[wealthmanagement.bnpparibas](https://www.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 2022. All rights reserved.

Pictures from Getty Images.



BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world