MAY 2022

Fixed Income Focus

Summary

1. **The Fed has begun to normalise its monetary policy. The ECB is about to follow suit. Both central banks have an aggressive tone to ensure that inflation expectations do not spiral out of control.** Ultimately, they could be content with making fewer rate hikes than the market expects.

2. **The upward movement continues on rates, with high volatility. However, the momentum has changed as inflation expectations seem to have peaked while real rates continue to rise.** Our 10-year targets are 2.50% in the US and 0.75% in Germany. We are Neutral on long-term government bonds. We remain positive on short-term US government bonds for USD-based investors.

3. **Credit view: the macroeconomic environment has deteriorated but companies are, on average, in good financial health. There should therefore be no significant rise in default rates. Yet, credit spreads could widen further. Valuations have become more attractive, but not yet cheap.** We are Neutral on Corporate bonds, with a preference for the Investment Grade category.

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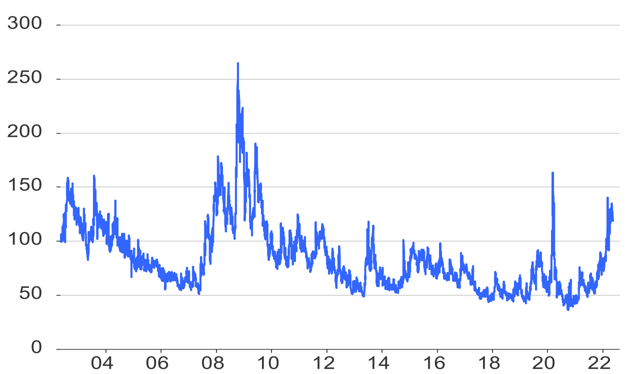
VOLATILITY IN THE US INTEREST RATE MARKET IS HIGH



Source: Refinitiv Datastream, 12-05-22

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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

Fighting inflation at all costs?

European Central Bank (ECB)

The ECB's analysis: inflation is too high and risks to growth are high.

April meeting decisions: the net asset purchase programme could end in Q3 and a rate hike could occur "some time" after.

Our view: the ECB appears hawkish in order to calm long-term inflation expectations. The risk of high inflation for longer is not insignificant in view of the Russia-Ukraine conflict. Several ECB members argue for a rate hike as early as July. However, there is no wage-price spiral in the euro area (see chart) but a wage catch-up is possible in Q3-Q4. In our view, the ECB will complete its net asset purchase programme in early Q3 and then make two rate increases later in the year (September and December). We expect 3 rate hikes next year, taking the deposit rate to 0.75% and the main refinancing rate to 1% by the end of 2023. The market is expecting a deposit rate of 1.2% at the end of 2023, which seems unlikely given the risks already weighing on growth.

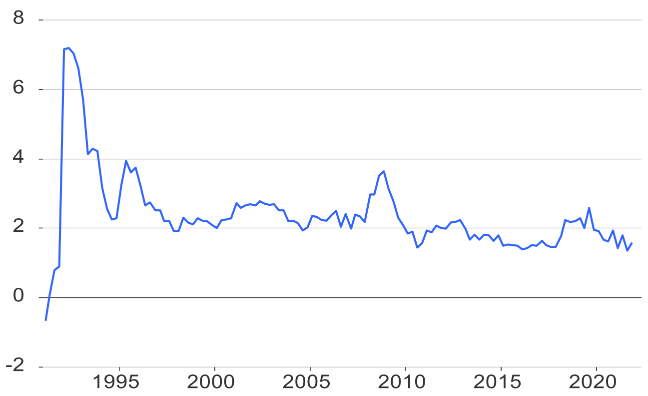
US Federal Reserve (Fed)

The Fed's analysis: inflation is far too high and the economy is strong with full employment.

May meeting decisions: the Fed will tighten monetary policy with i) a series of rate hikes (+50 bps in May, already done) and ii) a reduction in liquidity as the Fed will reduce the size of its balance sheet in a non-aggressive way (no active sales of Treasuries or MBS) from 1 June onwards (see chart).

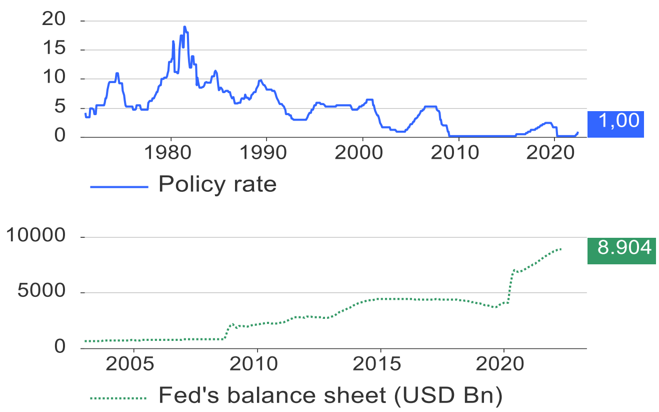
Our view: the Fed's objective is to avoid a wage-price spiral and to calm long-term inflation expectations as they are too high (2.8%). The Fed appears hawkish and is promising more rate hikes. However, inflation is expected to start slowing down in the second half of the year and economic growth is set to be less robust next year. The Fed may therefore not deliver as many rate hikes as the market expects (185 bps more by the end of the year and a Fed funds rate of 3.0% at the end of 2023). We expect 150 bps of additional rate hikes, including 50 bps in June and July and a Fed funds rate of 2.75% at the end of 2023.

EURO AREA NEGOCIATED WAGES, YEAR-ON-YEAR CHANGE (%)



Source: Refinitiv Datastream, Q4 21

THE FED IS TIGHTENING MONETARY POLICY VIA TWO TOOLS



Source: Refinitiv Datastream, mai 22

CONCLUSION

The Fed and the ECB want to fight inflation and calm long-term inflation expectations. The market is anticipating an aggressive upward move in policy rates. However, it is likely that central banks will be able to settle for fewer rate hikes than expected as inflation is set to decelerate from the second half of the year and growth should slow down next year.

Bond yields

Massive moves

Interest rate volatility is high, close to levels seen at the beginning of the pandemic.

Nominal 10-year rates continued to tighten in the US and the euro area (see chart), driven by real rates. Inflation expectations, on the other hand, have fallen, suggesting that central banks are credible in their fight against inflation.

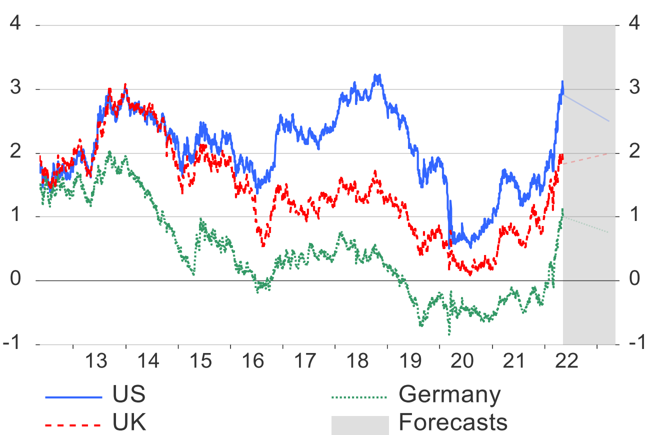
Our 10-year targets in 12 months are 2.50% in the US and 0.75% in Germany. We believe rates could tighten further as inflation will remain high and financial conditions are not yet restrictive. That said, inflation is expected to decelerate in the second half of the year due to base effects and growth may show signs of weakness. As a result, long-term rates are likely to fall from current levels over the next 12 months.

We are Neutral on long-term bonds and Positive on short-term Treasury bonds for dollar-based investors.

	Maturity (in years)	11/04/2022	12-month targets
United States	2	2.63	2.25
	5	2.88	2.40
	10	2.92	2.50
	30	3.04	2.60
Germany	2	0.15	0.25
	5	0.67	0.50
	10	1.00	0.75
	30	1.16	0.85
United Kingdom	2	1.30	1.60
	5	1.45	1.75
	10	1.83	2.00
	30	2.07	2.40

Source: Refinitiv Datastream, BNP Paribas WM

10-YEAR RATES



Source: Refinitiv Datastream, 12-05-22

CONCLUSION

The upward movement continues on rates, with high volatility. However, the momentum has changed as inflation expectations seem to have peaked while real rates continue to rise following the monetary tightening initiated by central banks. Our 10-year targets are 2.50% in the US and 0.75% in Germany.

Theme in Focus

Credit view

The credit cycle is in an advanced stage. The recovery phase is behind us and we are entering the late cycle expansion phase. This is generally associated with negative returns and greater volatility.

Strong fundamentals. On average, companies have strong balance sheets thanks to economic growth and good results achieved last year (see chart), as well as lower debt. In addition, companies massively refinanced themselves at extremely low rates last year.

Deteriorating technicals. The bond supply is expected to remain strong for Investment Grade issuers but lower for High Yield issuers. Demand should fall in line with central bank withdrawals (end of the ECB's net purchases, and the start of the Fed's quantitative tightening).

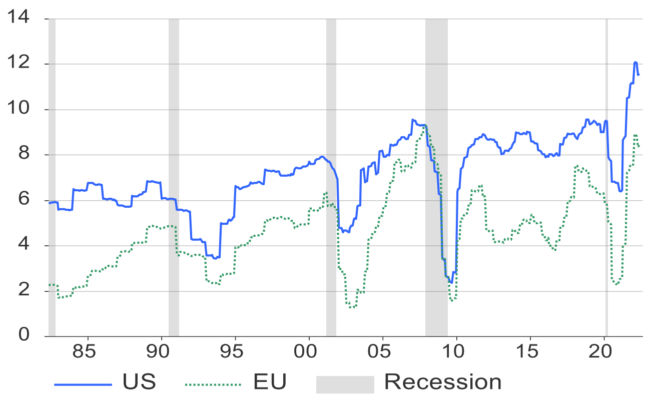
Deteriorating macroeconomic environment. The geopolitical risk has increased. Financial conditions are less favourable than before. Higher production costs should weigh on margins over time.

Credit spreads could widen further due to supply/demand dynamics and the more challenging macroeconomic environment, which could lead to some payment defaults among the most fragile companies. On the other hand, the good financial health of companies on average should prevent a significant wave of defaults and therefore a massive widening of credit spreads.

Valuations have become more attractive, but are not yet cheap (see chart), following the rise in bond yields and the widening of credit spreads.

We have a Neutral view on credit. We are rather defensive in this more challenging environment and favour Investment Grade over High Yield.

NET PROFIT MARGINS IN THE US AND IN THE EUROZONE (%)



Source: Refinitiv Datastream, 11-05-22

GLOBAL CORPORATE BOND VALUATIONS RETURN TO THEIR HISTORICAL AVERAGE

Source: Refinitiv Datastream, 11-05-22

CONCLUSION

The macroeconomic environment has deteriorated but companies are, on average, in good financial health. There should therefore be no significant rise in default rates. Yet, credit spreads could widen further. Valuations have become more attractive, but not yet cheap. We are Neutral on corporate bonds, with a preference for Investment Grade 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	2.92	---	
Germany	1.00	---	
France	1.55	54	4
Italy	2.91	191	27
Spain	2.11	111	17
Portugal	2.11	111	21
Greece	3.52	252	46

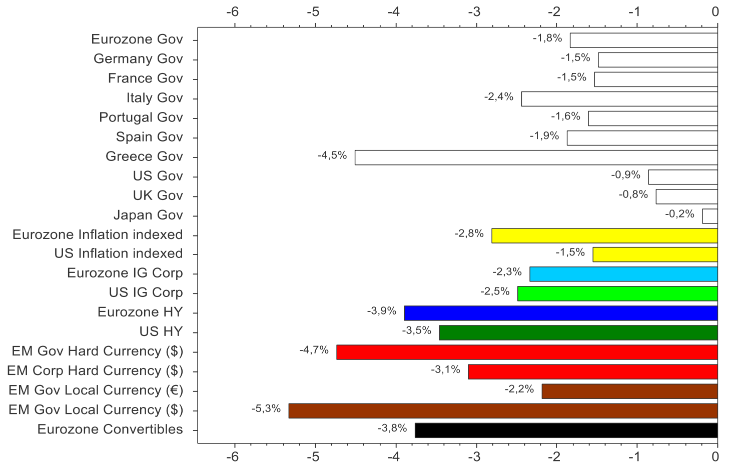
11/04/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	2.60	50	7
Corporate bonds IG EUR	2.31	169	39
Corporate bonds IG USD	4.34	139	20
Corporate bonds HY EUR	6.78	496	111
Corporate bonds HY USD	7.51	441	89
Emerging government bonds in hard currency	7.17	422	59
Emerging corporate bonds in hard currency	6.92	406	46
Emerging government bonds in local currency	4.37	149	9

11/04/2022
Source: Refinitiv Datastream, Bloomberg Barclays

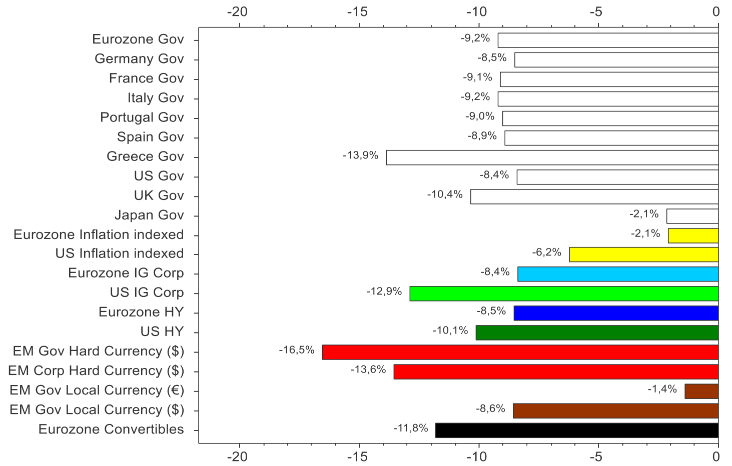
Returns

OVER ONE MONTH



Source: Refinitiv Datastream, 11-05-22 Source: Bloomberg Barclays indices exept Convertibles (Exane)

SINCE THE BEGINNING OF THE YEAR



Source: Refinitiv Datastream, 11-05-22 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

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