NOVEMBER 2022

Fixed Income Focus

Summary

1. **ECB: a dovish guidance does not mean rate hikes are over.** We expect further policy rate hikes and a terminal rate of 2.75% in Q1 2023 for the deposit rate..
2. **Fed: no pivot yet, no pause yet, but a slowdown in policy rate hikes is likely in December or February.** Given the evolution of core inflation, we revised our scenario to add a last rate hike of 50bps in February 2023, leading to a terminal rate of 5% (vs 4.5% previously).
3. **The UK crisis did not spill over. The mini-budget U-turn and the change of Prime Minister has put an end to market tensions. Bond yields have fully retraced the rise.** We take the opportunity to end our Positive view and take a Neutral view on short-term UK government bonds.
4. **US long-term bond yields are likely to be lower in 12 months while its German peer could grind modestly higher.** We expect 10-year yields to reach 3.5% in the US and 2.5% in Germany in 12 months. We are Positive on US government bonds for USD-based investors. We stay Neutral on German government bonds.
5. **Corporate bonds in the eurozone:** we maintain a Neutral view on eurozone HY corporate bonds. We prefer IG corporates over HY. Within HY, we prefer high quality (BB-rated bonds) as they remain at record cheap levels relative to other rating cohorts and they face less refinancing risk.

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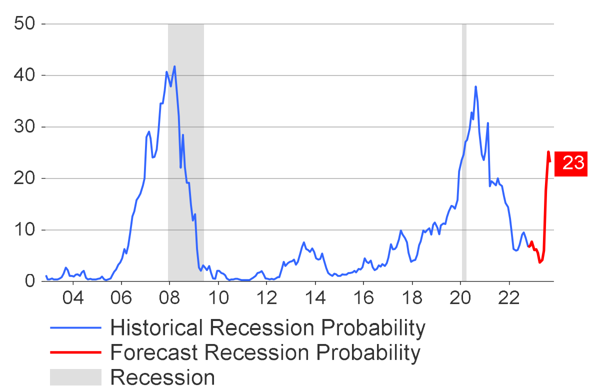
PROBABILITY OF US RECESSION PREDICTED BY TREASURY SPREAD (NY FED)



Source: Refinitiv Datastream, oct. 22

Edouard Desbonnets

Senior Investment Advisor, Fixed Income
BNP Paribas Wealth Management

BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

No pivot but a slowdown before a pause

European Central Bank (ECB)

Rates are approaching neutral: the ECB raised rates by 75bps at its October meeting as widely expected but the guidance was more dovish than expected.

Dovish guidance: the ECB removed a reference to "several" further hikes and said "substantial progress" had been made. The market got carried away in our view and pared back its expectations strongly (see chart).

Smaller steps from now on: with current deposit rate at 1.5%, the ECB may continue with smaller hikes going forward as it approaches restrictive territory, in a context of recession. ECB members seem to anticipate that the recession will have an impact on the inflation outlook.

Our view: we maintain our expectations for a 50bps rate hike in December. We envisage two rate hikes in 1Q23 totaling 75bps and leading to a terminal rate of 2.75% for the deposit rate.

US Federal Reserve (Fed)

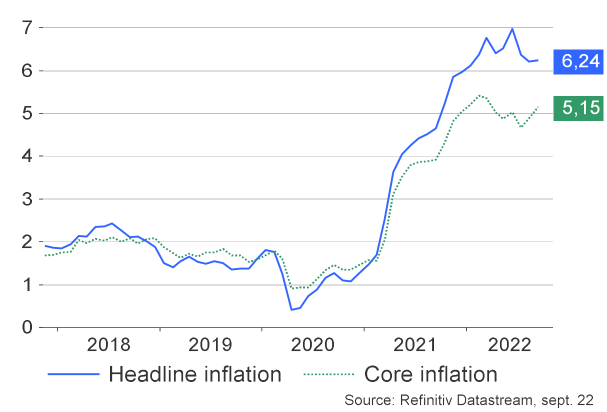
Headline inflation trending lower: the Fed's rate hike cycle depends on the inflation outlook. Many indicators are pointing to a deceleration in headline inflation next year.

Core inflation trending higher: core CPI inflation is stickier. Core CPI has accelerated in the past two months (see chart) due to the lag of shelter prices. Some Fed policymakers have acknowledged the drawbacks of how rent inflation is measured in CPI.

Our view: At the November meeting, the Fed suggested the need to hike more even if possibly at a smaller pace. We expect a deceleration to 50bps rate hike in December as the Fed funds rate will become restrictive, which require more cautious steps. In previous cycles, the Fed rate peaks before inflation comes down. Given the evolution of core inflation, we revised our scenario to add a last rate hike of 50bps in February 2023, leading to a terminal rate of 5% (vs 4.5% previously).

CUMULATED ECB RATE INCREASES PRICED IN (BPS)

US PCE INFLATION (%)



INVESTMENT CONCLUSION

The rapid part of the monetary tightening cycle is likely over for the Fed and ECB, but central banks are not done yet. We expect more modest rate hikes before a long pause after Q1 2023. We see the Fed stopping its tightening cycle with a policy rate at 5% (vs 4.5% previously) in Q1 2023 and the ECB pushing the deposit rate to 2.75%, also in Q1 2023. We do not expect rate cuts in the next 12 months.

Bond yields

Massive moves

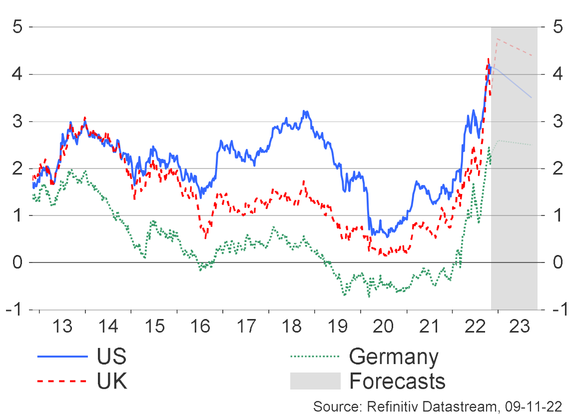
Interest rates volatility has remained very elevated. Daily moves are huge.

Liquidity has deteriorated due to the high inflation and interest rate volatility and the Fed's quantitative tightening.

UK rates have collapsed after the UK's mini-budget U-turn, the resignation of former Prime Minister Truss and the nomination of Sunak instead. We are taking the opportunity to end our Positive view and turn Neutral on UK short-term gilts given the lack of new catalyst and potential rise in the 2-year yield as the bank of England faces inflation of 10.1%.

US 10-year government bond yields are above the 4% mark while the German yield is around 2,30% respectively. Most of the rise in now behind us. As discussed, inflation is expected to cool down gradually (especially in the US) and central banks could raise rates more cautiously. We are Positive on US government bonds for USD-based investors. We stay Neutral on German government bonds.

10-YEAR RATES



	Maturity (in years)	27/10/2022	12-month targets
United States	2	4.32	4
	5	4.09	3.75
	10	3.94	3.5
	30	4.09	3.5
Germany	2	1.80	2.25
	5	1.84	2.35
	10	1.98	2.50
	30	2.03	2.60

Source: Refinitiv Datastream, BNP Paribas WM

INVESTMENT CONCLUSION

We ended our Positive view and turn Neutral on UK short-term gilts given the lack of new catalyst and potential rise in the 2-year yield. We are Positive on US government bonds for USD-based investors as we anticipate lower long-term yields in 12 months, and we expect the dollar to weaken. We stay Neutral on German government bonds due to a possible modest further increase in long term rates in 12 months. We are Positive on US IG corporate bonds. We are Neutral on EUR IG corporate bonds, with an up-in-quality bias.

Theme in Focus

High Yield corporate bonds in the eurozone:

A tough year so far: High Yield corporate bonds in the eurozone (EUR HY) are down around 14% since the beginning of the year, broadly in line with Investment Grade (IG) bonds and slightly better than government bonds (-16%). This terrible performance is linked to the surge in bond yields coupled with the dramatic rise in risk premiums (credit spreads).

Attractive yield: yields are at decade highs. The EUR HY average yield-to-worst is around 8%. This is above historical average.

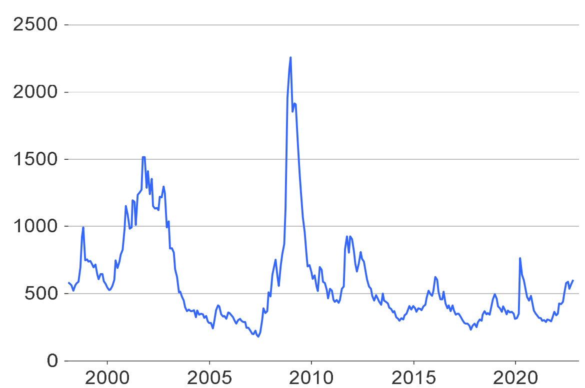
Cheap valuation: with the deterioration of the economic outlook, geopolitical tensions between Russia and Ukraine, the HY spread has doubled since the beginning of the year to reach 601bps as of 27 October. This is extremely cheap compared to the last decade, but overall, in line with historical average. The current level of spread is far from the peak seen during past crises: 966bps during the Covid crisis, 983bps during the Greek crisis, and 2291bps during the Great Financial Crisis.

Higher fundamental risks: credit spreads are at risk of further widening driven by weaker fundamental and recession risks. Balance sheet liquidity has deteriorated moderately from pandemic highs. Interest coverage is close to all time highs and likely to deteriorate. Leverage will likely start to increase in 4Q 2022 driven by margin compression.

Rising supply risk: corporates have issued very few bonds since the beginning of the year. High rate volatility has limited market access. As a result, the share of debt that matures within less than two years is rising and now close to all-time highs. Many companies will be forced to tap the market in 2023.

Our opinion: We maintain a Neutral view on EUR HY corporate bonds. We prefer IG corporates over HY. Within HY, we prefer high quality (BB-rated bonds) as they remain at record cheap levels relative to other rating cohorts and they face less refinancing risk.

THE EUR HY SPREAD (BPS) IS BROADLY IN LINE WITH HISTORICAL AVERAGE



Source: Refinitiv Datastream, 09-11-22

FAVOUR IG OVER HY WHEN THE HY-TO-IG BREAKEVEN RATIO IS LOW

Source: Refinitiv Datastream, 08-11-22

Investment Conclusion

We maintain a Neutral view on EUR HY corporate bonds. We prefer IG corporates over HY. Within HY, we prefer high quality (BB-rated bonds) as they remain at record cheap levels relative to other rating cohorts and they face less refinancing risk.

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.
Corporate bonds Investment Grade	Eurozone United States	= +	• Eurozone: Focus on short-term and quality corporate bonds. • US: Positive opinion for dollar-based investors. Prefer a duration similar to that of the benchmark (7 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	3.94	---	
Germany	1.98	---	
France	2.49	51	-10
Italy	4.04	206	-45
Spain	3.02	104	-16
Portugal	2.96	98	-13
Greece	4.53	255	-5

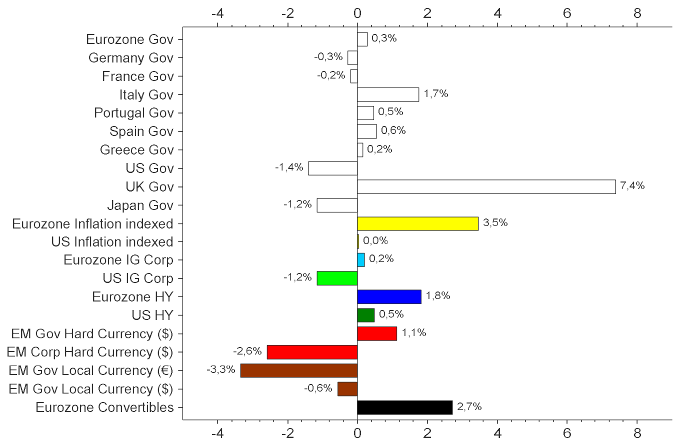
27/10/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	3.72	62	3
Corporate bonds IG EUR	4.23	225	17
Corporate bonds IG USD	5.82	161	6
Corporate bonds HY EUR	8.62	612	38
Corporate bonds HY USD	9.12	478	-48
Emerging government bonds in hard currency	8.77	461	14
Emerging corporate bonds in hard currency	9.52	520	89
Emerging government bonds in local currency	4.54	45	22

27/10/2022
Source: Refinitiv Datastream, Bloomberg

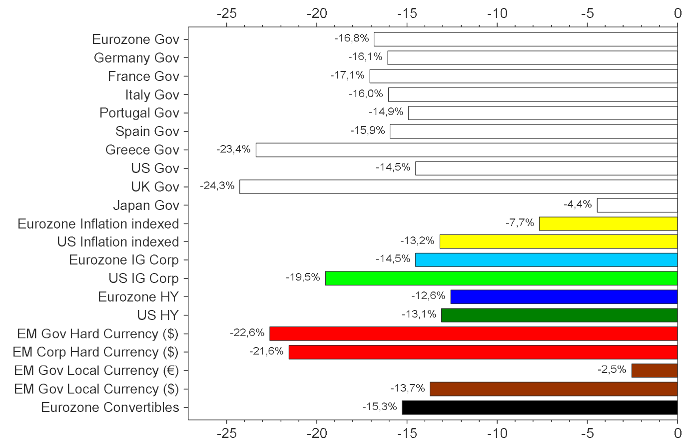
Returns

OVER ONE MONTH



Source: Refinitiv Datastream, 08-11-22 Source: Bloomberg Barclays indices exept Convertibles (Exane)

SINCE THE BEGINNING OF THE YEAR



Source: Refinitiv Datastream, 08-11-22 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

THE INVESTMENT STRATEGY TEAM

FRANCE

Edmund SHING
Global Chief Investment Officer

Jean-Roland DESSARD
Chief Investment Advisor

Isabelle ENOS
Investment Advisor

ITALY

Luca IANDIMARINO
Chief Investment Advisor

BELGIUM

Philippe GIJSELS
Chief Investment Advisor

Alain GERARD
Senior Investment Advisor, Equities

Xavier TIMMERMANS
Senior Investment Strategist, PRB

GERMANY

Stephan KEMPER
Investment Strategist

Stefan MALY

LUXEMBOURG

Guy ERTZ
Chief Investment Advisor

Edouard DESBONNETS
Senior Investment Advisor, Fixed Income

ASIA

Prashant BHAYANI
Chief Investment Officer, Asia

Grace TAM
Chief Investment Advisor, Asia

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