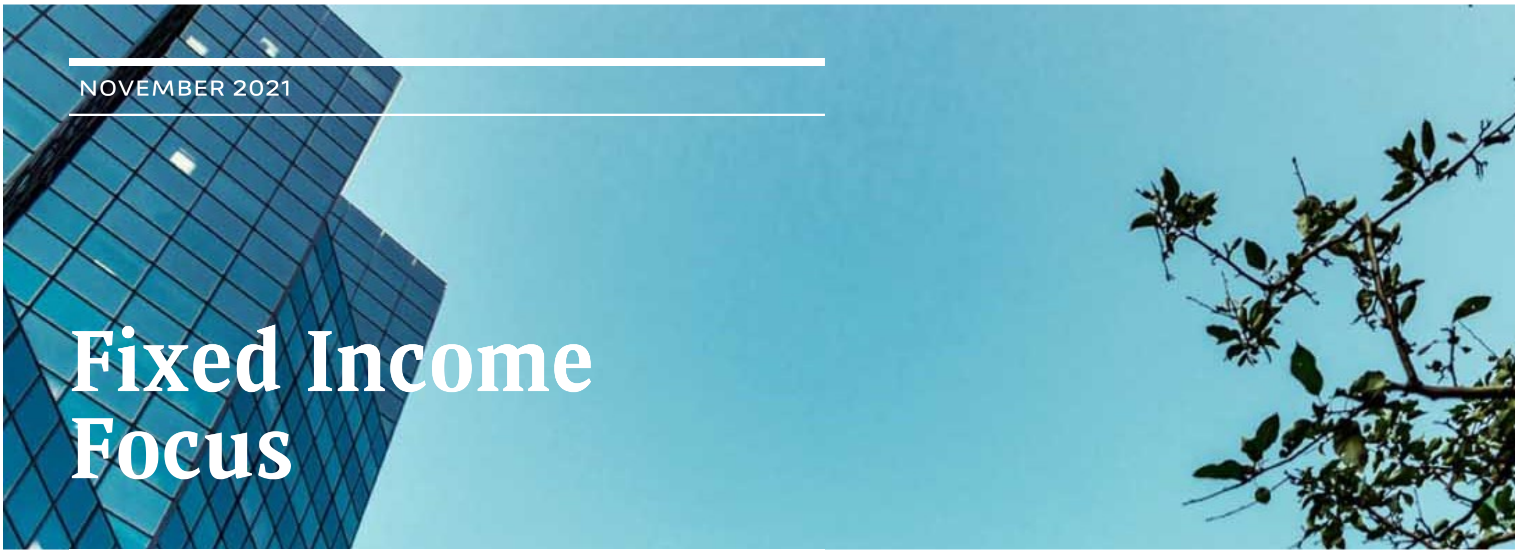


NOVEMBER 2021

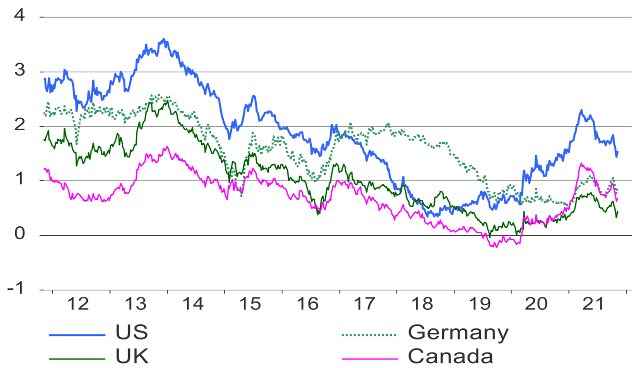
Fixed Income Focus

Summary

1. **As President Lagarde said, the main topic of the October ECB meeting was "inflation, inflation, inflation". The ECB should decide on the post Covid policy normalisation at the December meeting.** On account of recent inflation developments, we have brought forward our expectation for a deposit rate hike to H2 2023. The market pricing, with two rate hikes of the deposit rate in October 2022, seems very aggressive.
2. **The Fed normalised its policy by tapering its bond buying programme.** We expect a first rate hike in Q4 2022, along with 3 rate hikes a year in 2023 and 2024. The market anticipates the first rate hike to occur in September 2022, followed by another one in December.
3. **US and German short-term interest rates rose faster than long-term interest rates as markets repriced the policy normalisation.** We expect long-term interest rates to continue to rise. Our targets are 2% in the US and 0% in Germany in 12 months. We keep a negative view on US and German long-term Government bonds.
4. **Even though expected inflation based on market prices is a poor predictor of realised inflation, it cannot be ignored. Inflation expectations still appear anchored in the US and the eurozone.**

Contents

YIELD CURVE FLATTENING: GAP BETWEEN 30-YEAR AND 2-YEAR YIELDS HAS BEEN COLLAPSING GLOBALLY AS SHORT-TERM BOND YIELD ROSE ON MONETARY POLICY REPRICING



Source: Refinitiv Datastream, 05/11/2021

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The bank
for a changing
world

Central banks

Divergence

European Central Bank (ECB)

As President Lagarde said, the main topic of the October ECB meeting was **"inflation, inflation, inflation"**. Indeed, market-based inflation expectations have been rising fast and consumer surveys also point to increased concerns.

The ECB still think that inflation is transitory, with a decrease of inflation pressure in the course of 2022, but admitted that the phase of higher inflation could last longer than expected.

The market has strongly repriced the pace of ECB rate hikes and is currently pricing two rate hikes of the deposit rate in October 2022.

On account of recent inflation developments, we have brought forward our expectation for a deposit rate hike to H2 2023.

The December meeting will be important and should formalise the end of the emergency QE programme (PEPP).

US Federal Reserve (Fed)

The market has significantly repriced the pace of the Fed tightening cycle. While no rate hike is still expected this year, the market expect two rate hikes by the end of 2022, with the first one being priced for September 2022.

This is not consistent with our expectations that inflation would peak and decline in 2022. Hence, we keep our assumption of a first rate hike in Q4 2022, along with 3 rate hikes a year in 2023 and 2024.

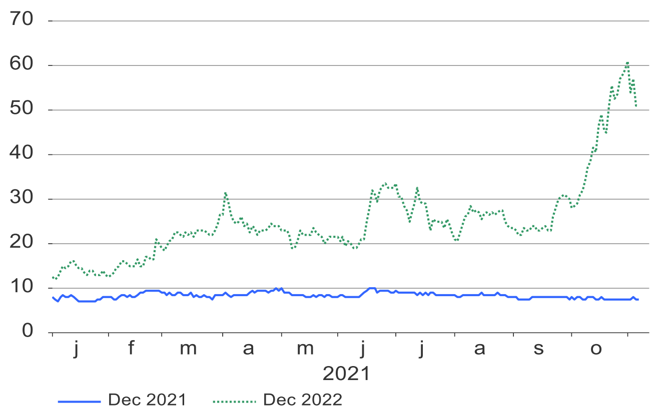
The Fed announced its tapering decision at the November meeting. The tapering process should last from December to June 2022 i.e. a $15bn monthly reduction in asset purchase every month (2/3 of Treasuries and 1/3 of Mortgage Backed Securities). They also left an option to accelerate or slow down tapering at their next meeting.

The Fed will continue reinvesting matured bonds for the next few years in our view, so its balance sheet will not shrink and financial conditions will remain easy.

THE MARKETS EXPECT TWO RISES IN THE ECB DEPOSIT RATE BY THE END OF 2022 (BASIS POINTS)

Source: Refinitiv Datastream, 03/11/2021

THE MARKETS EXPECT TWO RISES IN THE FED POLICY RATE BY THE END OF 2022 (BASIS POINTS)



Source: Refinitiv Datastream, 05/11/2021

The Fed's tapering announcement was widely expected. So is the end of the ECB's emergency programme (PEPP) in March 2022. The big question mark is the timing of the first rate hike. The market pricing is exaggerated according to us. We expect the Fed to hike rates in Q4 2022 and the ECB to follow suit in H2 2023.

Bond yields

Rising long-term rates

Long-term bond yields rose a few basis points more month-to-date in the US and Germany. The rise was fully fuelled by breakeven rates as real yields actually declined. The German 10-year real yield hit its lowest level ever.

The US and German yield curves flattened, as short-term bond yields rose faster than long-term bond yields. Inflation concerns and rising Fed/ECB rate hike expectations have been reflected in the short-end of yield curves.

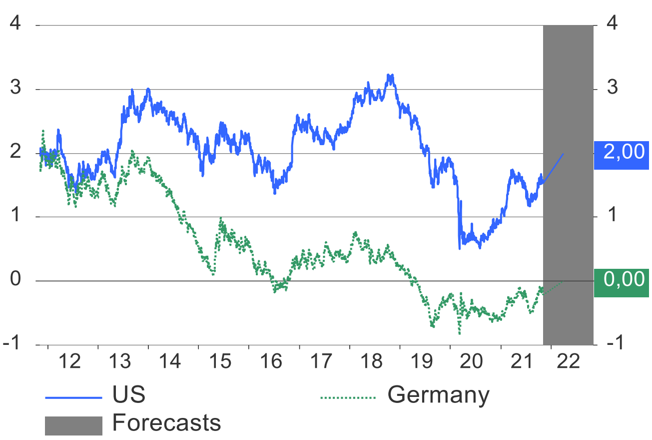
We expect long-term bond yields to continue to move higher given inflation worries and central banks' moving away from the Covid-19 emergency measures.

The flood of liquidity, the obligation for insurers/pension funds to buy safe assets, the ECB and the Bunds scarcity may limit how much bond yields can rise.

	Maturity (in years)	28/10/2021	12-month targets
United States	2	0.50	0.60
	5	1.19	1.25
	10	1.57	2
	30	1.96	2.60
Germany	2	-0.63	-0.50
	5	-0.45	-0.30
	10	-0.15	0
	30	0.16	0.50
United Kingdom	2	0.64	0.60
	5	0.76	0.80
	10	1.01	1.20
	30	1.11	1.50

Source: Refinitiv Datastream, BNP Paribas WM

10-YEAR RATES



Source: Refinitiv Datastream, 05/11/2021

Bond yields have been rising and are likely to continue doing so. Our 12-month targets for 10-year rates are 2% in the US and 0% in Germany.

Theme in Focus

Inflation, obviously

Higher inflation, globally: Realised inflation, market-based measures of inflation expectations (see chart), inflation surveys, all have been rising.

Different reactions: Emerging central banks have been quick to raise policy rates to combat inflation and avoid currency depreciation. Some central banks in the developed world have changed their views, like the Bank of Canada, which took the markets by surprise by revising its inflation projections significantly upwards and immediately accelerating its policy normalisation.

But inflation is hard to predict: Inflation is one of the most difficult data to forecast as it involves estimating energy prices –which are volatile by nature– and anticipating consumer behaviour when prices change.

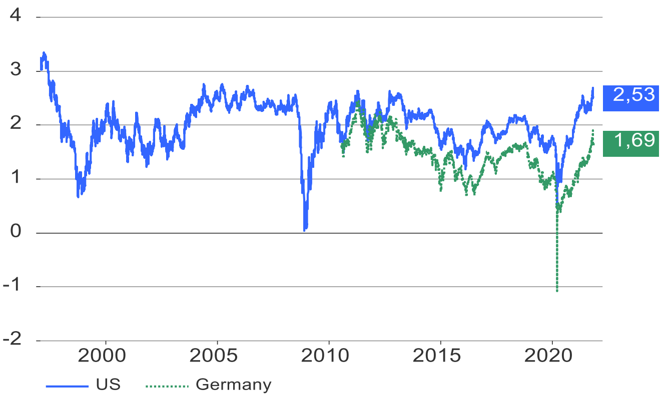
Market-based measures of inflation expectations poorly predict realised inflation: Granted, the series do not have a long history, but they show that market-based measures of inflation expectations have overshoot and undershoot realised inflation, sometimes by as much as 1% in the eurozone (see chart). Same phenomenon with US data.

The fear: Markets are concerned that the ECB and the Fed could suddenly switch their view on inflation and accelerate their monetary policy normalisation. However, this is less certain given that inflation expectations in the eurozone and the US still appear anchored, even if the relationship has weakened lately i.e. lately market-based measures of longer-term inflation expectations have been more responsive to short-term news.

Our base case: Inflation is currently peaking in the eurozone and in the US but it will remain higher than in the past. Ten-year breakeven rates in the US and eurozone - a bond market gauge for consumer price expectations over the next decade – are elevated. They may have room to climb higher but will fail to move substantially higher without a wage-price spiral, that we don't see happening.

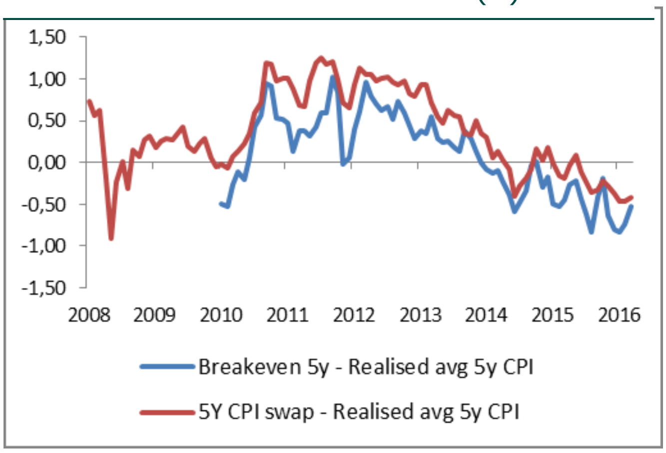
Best long-term inflation hedge: Commodities, gold, REITs, equities with companies that have a pricing power, inflation-linked bonds with duration hedge (or short duration).

10-YEAR BREAKEVEN INFLATION RATES (%)



Source: Refinitiv Datastream, 05/11/2021

MARKET-BASED MEASURES OF INFLATION EXPECTATIONS POORLY PREDICT REALISED INFLATION – EUROZONE (%)



Inflation has been rising globally, as is expected inflation. Even though expected inflation based on market prices is a poor predictor of realised inflation, it cannot be ignored because it influences the behavior of economic agents. Some central banks have already raised their policy rates in response, others have not, arguing that inflation is transitory and that inflation expectations still appear anchored.

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) with a "buy on dips" strategy.
	United States	= -	• Neutral on short-term Governement 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 at benchmark for EUR bonds (5 years) and lower than benchmark for US bonds (less than 9 years). • Positive 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	1.57	---	
Germany	-0.15	---	
France	0.20	35	-1
Italy	0.98	114	+7
Spain	0.51	66	0
Portugal	0.41	56	-1
Greece	1.06	121	+17

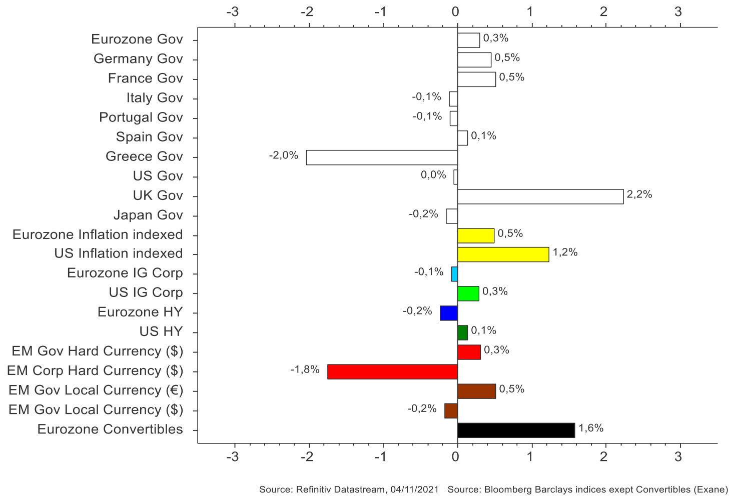
28/10/2021
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	1.27	33	0
Corporate bonds IG EUR	0.45	87	+3
Corporate bonds IG USD	2.22	85	+1
Corporate bonds HY EUR	3.31	306	+11
Corporate bonds HY USD	4.23	286	-3
Emerging government bonds in hard currency	4.61	315	-8
Emerging corporate bonds in hard currency	4.98	389	+9
Emerging government bonds in local currency	3.95	276	+6

28/10/2021
Source: Refinitiv Datastream, Bloomberg Barclays

Returns

OVER ONE MONTH



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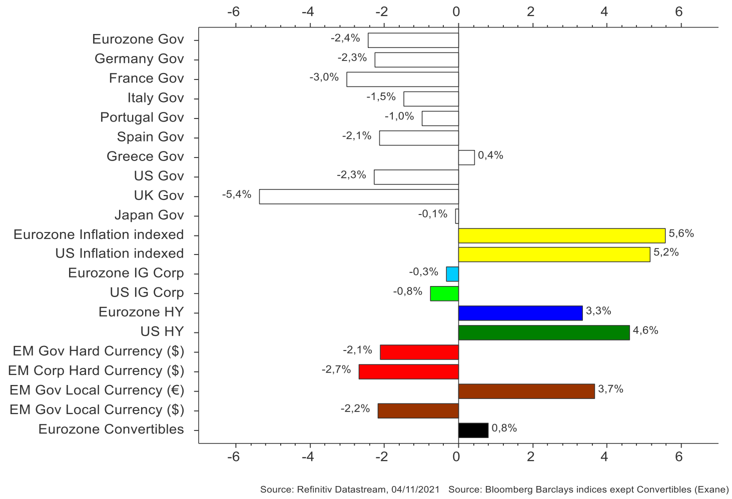

EM = Emerging Markets

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