Fixed Income Focus

Summary

1. **Looking for the pivot of central banks: although growth is showing signs of weakness, the world's main central banks will continue to raise their key rates to stamp out inflation.** We expect an end of cycle rate of 4.50% at the end of the year for the Fed, 2.75% in Q1 2023 for the ECB and 5% in Q1 2023 for the Bank of England.
2. **The rise in long-term rates should come to an end: historically, US Treasury and German 10-year yields have peaked at 1 to 2 months before the central bank's last rate hike.** We have raised our 10-year bond yield target to 3.5% in the US, 2.5% in Germany and 4.5% in the UK.
3. **Change of recommendation on US and UK government bonds:** we have moved to Positive from Neutral on US government bonds for dollar-based investors as the 10-year US bond yield is close to 4%. We believe that short-dated UK government bonds are attractive, with a 2-year yield of around 4.5% and sterling at an all-time low.
4. **Change of recommendation on US Investment Grade corporate bonds:** following the rise in rates and widening of spreads, we have moved to Positive from Neutral on US Investment Grade corporate bonds for dollar-based investors. The average yield-to-maturity is 5.7%. We remain Neutral on Investment Grade corporate bonds in EUR, with a preference for quality issuers. In addition, we increase the recommended duration to that of the benchmark in the US (7 years) and to 3-5 years in the eurozone.

Contents

SHARP MOVEMENTS ON THE 30-YEAR REAL RATE IN THE UK

Source: Refinitiv Datastream, 10/17/2022

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Central banks

Fighting inflation at all costs?

The pivot: as the global economy is showing signs of weakness and inflation seems to have peaked in several parts of the world, investors are impatiently waiting for the central bank pivot, in other words the end of the rise in key rates.

Hope came from Australia where the central bank raised rates by only 25 basis points (bps) versus 50bps expected. The start of this pivot was justified by the rapid slowdown in global growth as well as the impact of rising interest rates on consumer confidence and the real estate market.

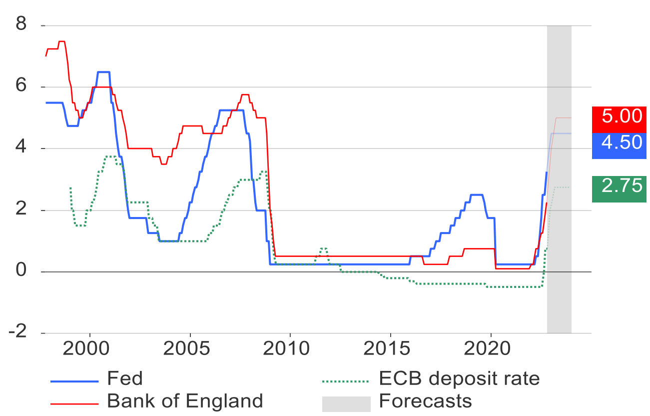
Financial stability is also often cited by investors as a way of persuading central banks to raise key interest rates more cautiously. The UK is a perfect example. The sharp rise in policy rates would have led to a collapse in pension funds without the intervention of the central bank. However, its temporary intervention (via purchases of long-term government bonds) must not be confused with the end of a restrictive monetary policy.

In this case, we believe that the Bank of England will raise its rates to 4% by the end of the year and then to 5% in Q1 2023 (end of cycle rate).

No imminent pivot for the Fed: we have revised up our forecasts based on the latest publication of inflation figures and the strength of the job market. We expect policy rate hikes of 75bps and 50bps to be announced at the next two meetings. The Fed policy rate will then be 4.5% at the end of the year (versus 4% in our previous scenario), which should be the end of cycle rate.

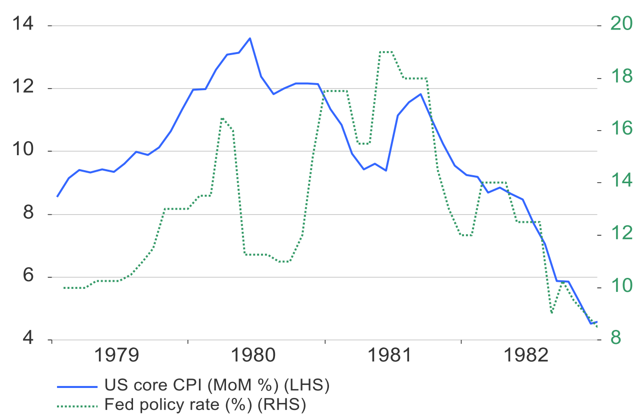
No imminent pivot for the ECB: inflation is too high, and euro weakness is not helping things along. Some ECB committee members are concerned about a possible wage-price spiral. The ECB could revise up its medium-term inflation projections following the overly optimistic assumptions about Russian gas flows. We expect a series of rate hikes at the next 4 meetings, starting with 75bps on 27 October, to reach an end of cycle rate of 2.75% (versus 2.25% previously) in Q1 2023.

KEY INTEREST RATES (%)



Source: Refinitiv Datastream, Sep 22

THE FED WILL KEEP RATES HIGH TO PREVENT INFLATION FROM RISING AGAIN, AS SEEN IN THE '80S



Source: Refinitiv Datastream, Jan 83

Investment Conclusion

The end of the policy rate hike is not imminent in our view, even though we are seeing growing risks to economic activity and to the real estate market. The Fed, ECB and Bank of England should continue to raise their key interest rates aggressively at the next 2-3 meetings. We expect an end of cycle rate of 4.50% at the end of the year for the Fed, 2.75% in Q1 2023 for the ECB and 5% in Q1 2023 for the Bank of England.

Bond yields

Massive moves

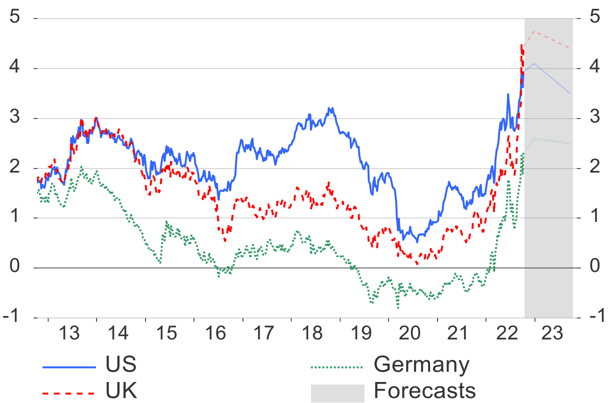
Apart from one or two exceptions, the world's main central banks are sticking to an offensive tone, making the fight against inflation their top priority, regardless of the impact on growth. Pressure on short-term rates should therefore persist for a few months.

In 12 months' time, it is highly likely that inflation will have returned to more acceptable levels and that its trajectory will encourage central banks to relax their restrictive monetary policies in a bid to avoid a recession, especially in the US. The 10-year Treasury bond yield could fall to 3.5% in 12 months, in our view.

On the other hand, long-term German and UK bond yields could rise further due to more persistent inflation in these countries. Our 12-month targets are 2.5% and 4.5% for German and UK bond yields respectively.

We have turned Positive on US government bonds for dollar-based investors, as well as on short-term UK government bonds.

10-YEAR RATES



Source: Refinitiv Datastream, 10/17/2022

	Maturity (in years)	10/10/2022	12-month targets
United States	2	4.31	4
	5	4.14	3.75
	10	3.89	3.5
	30	3.84	3.5
Germany	2	1.89	2.25
	5	2.12	2.35
	10	2.32	2.50
	30	2.31	2.60
United Kingdom	2	4.35	4.50
	5	4.65	4.50
	10	4.47	4.50
	30	4.71	4.60

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

We have moved to Positive from Neutral on US government bonds for dollar-based investors as the 10-year US bond yield is close to 4%. We believe that short-dated UK government bonds are attractive, with a 2-year yield of around 4.5% and sterling at an all-time low. We remain neutral on German government bonds.

Theme in Focus

Changes in recommendation:

Long bond rates should soon peak: historically, US and German 10-year yields have peaked 1 to 2 months before the central bank's last rate hike. Thus, the US yield could peak within a few weeks, and in a few months for its German counterpart. Higher rates in the very short term are possible, boosted by central bank rhetoric and higher-than-expected inflation.

We raise our opinion to Positive from Neutral on US government bonds for USD investors. The yield on 10-year US Treasuries is close to 4% in a context of high volatility. This level was last observed in 2010! Treasury bonds are attractive to dollar-based investors, but not necessarily to investors based in other currencies because they are exposed to potentially significant currency risk.

We see a **buy opportunity for short-dated UK government bonds** for EUR and USD investors (see chart).

We have upgraded our opinion to Positive from Neutral on US Investment Grade corporate bonds for USD investors. We are more comfortable with this risk-taking now that the US Treasury yield is close to 4% and that risk premiums (credit spreads) have widened considerably. The average yield offered on the asset class is around 5.7% (see chart). The current level of spreads implies that a mild recession has already been priced in. The default rate is expected to remain low, probably at around 0.9%. Valuations across asset classes suggest a preference for Investment Grade bonds over High Yield bonds.

European investors should remain more cautious in view of the energy crisis and a potential recession. We recommend short-term Investment Grade corporate bonds, denominated in EUR. We also like quality issuers, such as 3-5 year A-rated bonds, offering a yield-to-worst of 4%.

UK 2-YEAR POLICY RATE SOARS (%)

Source: Refinitiv Datastream, 10/11/2022

US INVESTMENT GRADE CORPORATE BONDS AVERAGE YIELD

Source: Refinitiv Datastream, 10/17/2022

INVESTMENT CONCLUSION

This month, we are upgrading our opinion from Neutral to Positive on US government bonds and US Investment Grade corporate bonds for dollar-based investors. We remain Neutral on Investment Grade corporate bonds in EUR, with a preference for quality issuers. In addition, we increase the recommended duration to that of the benchmark in the US (7 years) and 3-5 years in the eurozone.

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	3.89	---	
Germany	2.32	---	
France	2.90	57	0
Italy	4.63	231	0
Spain	3.48	116	0
Portugal	3.39	107	0
Greece	4.90	258	3

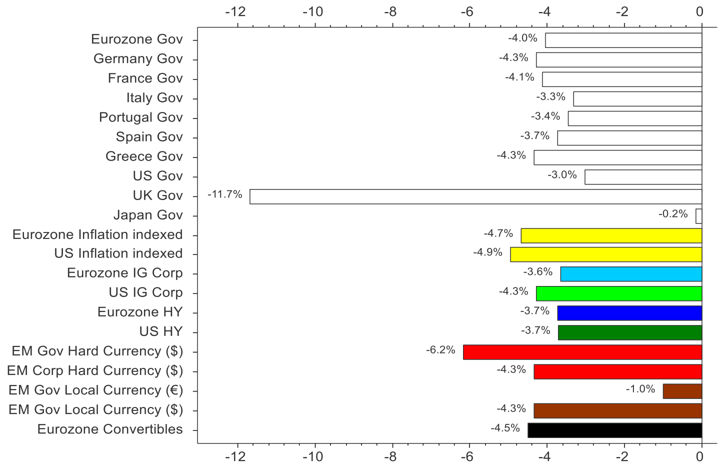
10/10/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	3.79	61	6
Corporate bonds IG EUR	4.39	223	26
Corporate bonds IG USD	5.70	154	13
Corporate bonds HY EUR	8.78	615	69
Corporate bonds HY USD	9.28	498	49
Emerging government bonds in hard currency	8.74	463	47
Emerging corporate bonds in hard currency	8.83	456	52
Emerging government bonds in local currency	4.50	36	-42

10/10/2022
Source: Refinitiv Datastream, Bloomberg

Returns

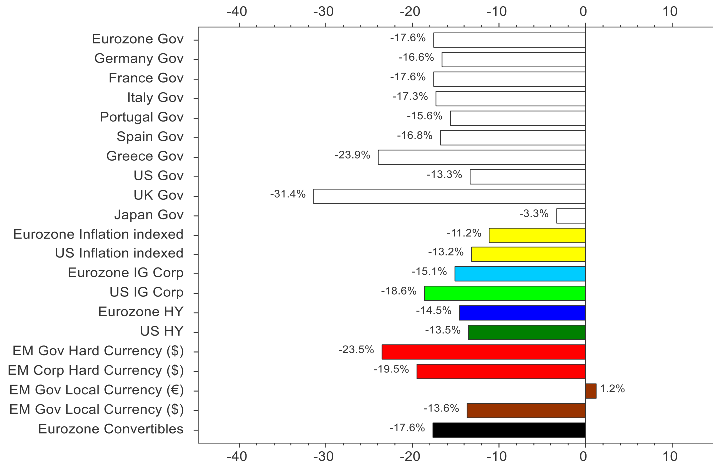
OVER ONE MONTH



Source: Refinitiv Datastream, 10/10/2022 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

SINCE THE BEGINNING OF THE YEAR



Source: Refinitiv Datastream, 10/10/2022 Source: Bloomberg Barclays indices exept Convertibles (Exane)

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