FIXED INCOME FOCUS

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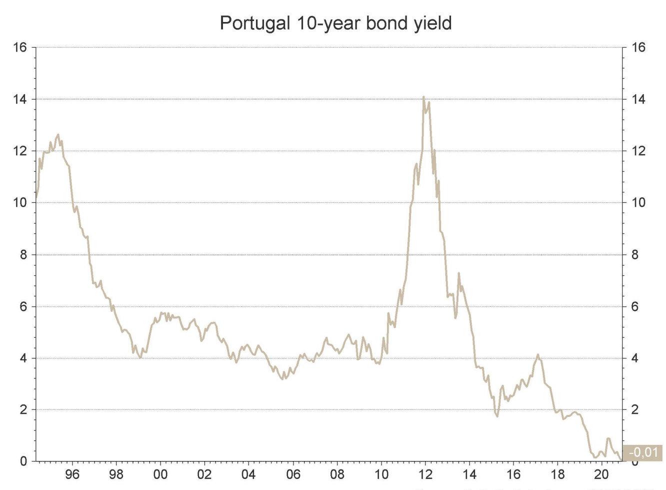
Fallen angels and emerging bonds

Lower rates in the peripheral countries of the eurozone. Opportunities exist: we are turning positive on fallen angel bonds and emerging bonds in hard currency.

Chart of the month: Portugal in the spotlight

This month, Portugal, Spain, Italy and Greece saw their 10-year bond yields hit an all-time low. Spain's is just above zero. Portugal's has gone negative! The efforts of the European Central Bank and the prospects of the European recovery plan are reassuring investors.



Central banks:

- **US Federal Reserve:**
  - The Fed does not want to tighten the financing conditions. It should therefore remain very accommodating.
  - Even if the debate has already been launched, tapering (slowing down bond purchases) is not on the agenda. The subject will take on greater importance next year. The Fed, remembering its bad experience in 2013 (taper tantrum: when rates rose sharply and quickly), will carefully communicate to the markets.
  - The Fed should continue its bond purchases at the same pace and extend the maturity of its purchases (operation twist) as the US Treasury will issue longer bonds in 2021. It could also reduce its purchases of Mortgage Backed Securities as it holds nearly a third of the market and increase its purchases of Treasury bills in return.
  - Policy rates are expected to remain low, in the current 0-0.25% range, for several quarters.

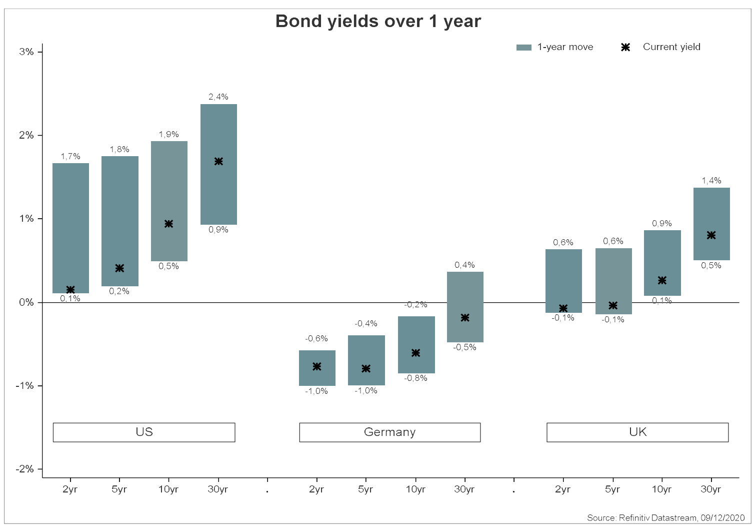
- **European Central Bank:**
  - The ECB increased its support for the economy as its December meeting, but did the bare minimum.
  - It increased the PEPP (bond purchase programme to support the countries most affected by the pandemic) by €500 billion and extended it until March 2022, slightly more than expected. The ECB's objective is therefore to keep bond yields low for a long time.
  - It has also added 3 TLTROs that will allow banks to borrow at rates of up to -1% until June 2022, under conditions of lending to the real economy (companies, households).
  - The ECB's new projections show core inflation (excluding volatile energy and food prices) at 1.2% in 2023, which is far from its objection of 2%. More stimulus can therefore be expected in 2021.
  - We do not envisage a cut in policy rates.

Bond yield targets

- We have lowered our 12-month target for the German 10-year yield (bund) to -0.25% from 0%. The ECB is determined to keep yields low through its bond purchases (Quantitative Easing, QE). The ECB has the capacity to buy more than the total volume of debt that will be issued by the eurozone countries next year, which implies persistent downward pressure on long-term rates. Moreover, the ECB seems to want to keep the GDP-weighted 10-year yield of eurozone countries below 0%. This means that the yield of the German bund will remain negative, even if the spreads of other countries vis-à-vis Germany tighten sharply.

- Conversely, we have revised upwards our 10-year bond yield target for US Treasury bonds to 1.40% from 1.25% due to a stronger-than-expected economic rebound that will raise inflation expectations and the term premium. However, the Fed will probably not tolerate too high yields (1.50% seems to be a symbolic barrier).

- Short-term bond yields are expected to remain close to current levels in the US and the eurozone. Central banks are not planning to raise their policy rates and the market does not anticipate this either.



Bond yields	Maturity (years)	09/12/2020	New 12-month targets	Previous 12-month targets
US	2	0.15	0.25	0.25
	5	0.41	0.50	0.50
	10	0.94	1.40	1.25
	30	1.69	1.90	1.75
Germany	2	-0.77	-0.50	-0.50
	5	-0.79	-0.40	-0.25
	10	-0.61	-0.25	0
	30	-0.18	0.30	0.25
UK	2	-0.07	0.25	0.25
	5	-0.04	0.25	0.25
	10	0.26	0.60	0.50
	30	0.81	1.20	1.00

Sources: Refinitiv Datastream, BNP Paribas WM

Positive view on Fallen angels credit:

- These are Investment Grade rated bonds that are downgraded to the High Yield category.
- Typically, the yield spreads with the benchmark rate widen sharply when suspicions of downgrades intensify as some fund managers rush to get rid of these bonds. Once downgraded by the rating agencies, the bond then enters the High Yield category with a higher spread than bonds rated BBs (best High Yield category). On average, one or two months later, the spread normalises. These are therefore opportunities. The average spread for eurozone fallen angels is 280bps (or 2.80%) compared to 256bps for BB-rated bonds. In the US, the average spread is 322bps versus 276bps for BBs.
- The average yield in this segment is 2.3% in the euro zone and 3.9% in the US, which is higher than the average yield of the highest rated bonds in the High Yield category (2.2% and 3.3% respectively).
- The highest rated High Yield bonds are sought after by so-called "Investment Grade tourists". These are Investment Grade portfolio managers who venture into the High Yield market in order to increase the average yield of their portfolios. The number of such managers has increased since interest rates remain at extremely low levels in the eurozone.
- Unlike the ECB, the Fed is directly supporting fallen angel bonds through its emergency asset purchase programme in both the primary and secondary markets. This programme will be terminated by the end of the year following a unilateral decision by the US Treasury, but no doubt it will be reinstated in the event of further tensions in the debt markets.

Shift to positive from neutral on emerging bonds in hard currency

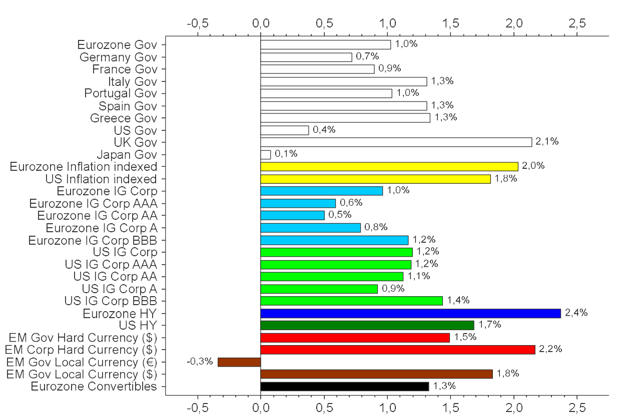
- Leading indicators show that growth is returning, particularly in China.
- Some 15 Asia Pacific countries signed a trade agreement in November. It creates the world's largest free trade zone. Emerging companies will benefit as their profits are closely linked to world trade.
- The political environment is also changing. Biden's victory in the US elections signals, not an end to trade tensions between China and the US, but an improvement. As a result, the global risk premium on emerging assets will be reduced.
- Low interest rates in the US and the expected weakness of the dollar are both tailwinds for emerging bonds in hard currency. Both are synonymous with capital flows to emerging countries.
- Valuations are a bit expensive in absolute terms. Spreads have already almost retraced their year-to-date wides. However, they are relatively cheap and less volatile than US high yield bonds.
- The average yield is high, around 4.5%, in a world where interest rates are at or near zero.

Our views

GOVIES	-/= +	• We are positive on the front-end of the US yield curve for USD-based investors as short-term yields have a limited upside. • We are negative on long-term US govies and German govies, whatever the maturity. • We stay positive on periphery debt (Portugal, Italy, Spain, Greece) on a buy on weakness strategy.
INVESTMENT GRADE	+	• We prefer corporate bonds over government bonds. • We like EUR and US IG bonds with a duration at benchmark (5 and 8 years, respectively). • We are positive on eurozone convertible bonds.
HIGH YIELD	=	• We are neutral on eurozone and US HY bonds. We favour fallen angels.
EMERGING	+	• We turned positive from neutral **on EM hard currency bonds (sovereigns and corporates).** • We are positive on EM local currency bonds, for both USD and EUR based investors.

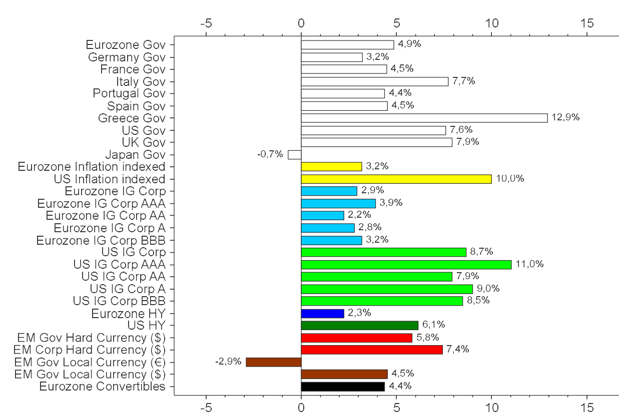
Fixed Income returns

Over the last 30 days



Source: Refinitiv Datastream, 09/12/2020. Source: Bloomberg Barclays indices exept Convertibles (Exane)

Since 31 December 2019



Source: Refinitiv Datastream, 09/12/2020. Source: Bloomberg Barclays indices exept Convertibles (Exane)

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