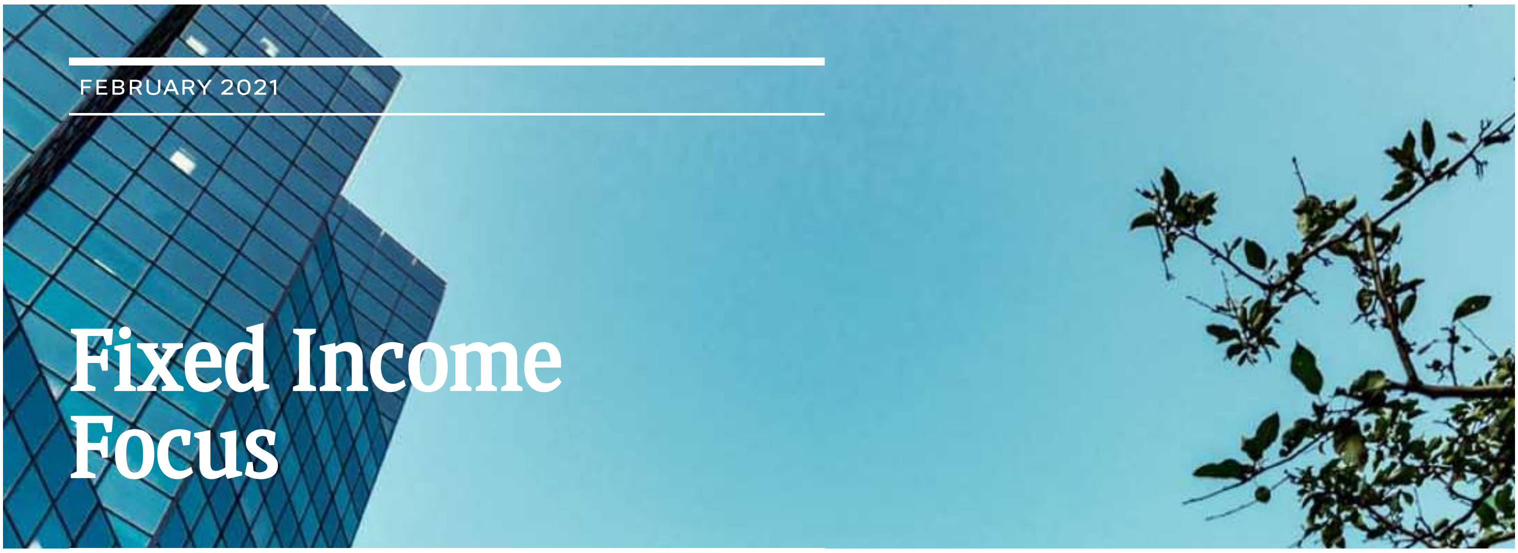


FEBRUARY 2021

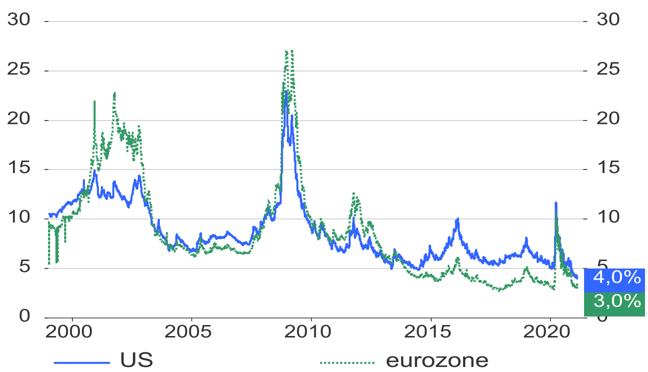
Fixed Income Focus

Summary

1. **The ECB will stay very accommodative this year and ignore the spectacular -and likely temporary- rise in inflation in January.** A safety net for peripheral bonds as well as Investment Grade corporate bonds.
2. **The Fed will also continue its lax policy and ignore the repeated calls by some members for a reduction in asset purchases.** Expect volatility in US rates as soon as economic data improve.
3. **The first central bank in the world gearing up for less monetary laxity is the Bank of England...!** Avoid long-term UK sovereign bonds.
4. **We expect long-term rates to continue to rise in the US and Germany via higher inflation expectations.** The gap between long and short rates will increase further.
5. **Italian sovereign bonds have delivered stunning performances. Long-term Italian rates are at their historic lows.** Take profits or keep positions to receive higher coupons than in other eurozone countries.
6. **The average yield on High Yield bonds is at an all-time low in the US and close to eurozone lows.** Favour Fallen Angel bonds because the risk/return ratio is more attractive.

Contents

AVERAGE YIELD OF HIGH YIELD BONDS



Source: Refinitiv Datastream, 12/02/2021

Edouard Desbonnets

Investment Advisor, Fixed Income
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BNP PARIBAS
WEALTH MANAGEMENT

The bank for a changing world

Central banks

Dovish, and for a long time

European Central Bank (ECB)

The President of the ECB emphasised the importance of **maintaining favourable financial conditions** at least until the end of 2022. Accordingly, it will therefore give itself leeway to adjust its asset purchasing programme so that lending rates for households and businesses will remain low.

The **spectacular rise in core inflation** in January (from 0.2% to 1.4%) is mainly linked to technical factors: a postponement of the Sales, a change in the weight of the components of the consumer price index, a rise in VAT in Germany, etc. These factors are temporary by nature and therefore not enough to justify a change in money policy.

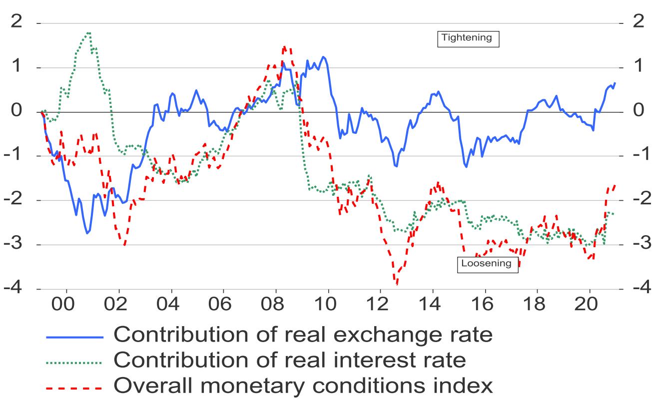
Some ECB members **advocate a cut in the deposit rate in a bid to curb the euro's rise. We do not think this will happen**. The deposit rate is already extremely negative (-0.50%). Lowering it would further weaken banks, potentially hampering their capacity to lend households and businesses.

US Federal Reserve (Fed)

At the January monetary policy meeting, the Fed chairman was clear: **the tapering debate is premature.** Experience from previous crises shows that it is better to maintain an accommodative policy over a long period, even if it means creating "too much" inflation. The Fed will successfully manage this issue.

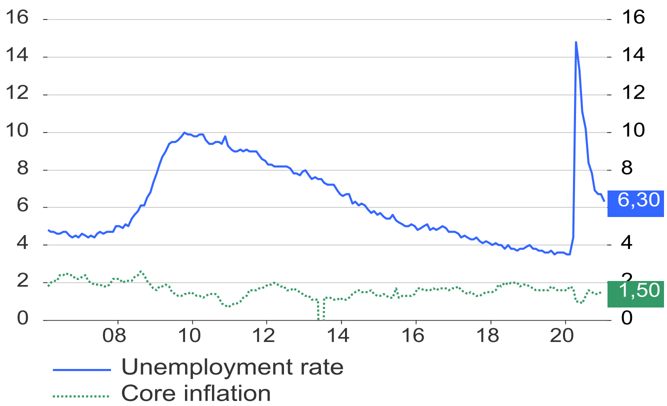
The Fed chairman will find it increasingly **difficult to convince some of the Fed's voting members** to keep monetary policy extremely accommodative in the middle or at the end of the year as economic data are expected to improve significantly. That said, we believe the Fed will therefore continue purchasing at the current pace this year. We expect tapering in 2023, when inflation will have remained above 2% for a year and the job market will have improved substantially. The Fed is then expected to make an initial rate hike in 2024.

PANDEMIC EMERGENCY PURCHASE PROGRAMME (PEPP)



Source: Refinitiv Datastream, déc. 20

FED MANDATE: INFLATION AND EMPLOYMENT



Source: Refinitiv Datastream, janv. 21

CONCLUSION

Central banks still need to support reflation. The ECB will remain very accommodative. The Fed will come under internal pressure, but is also likely to remain very lax in our view. The aim of central banks is to support economic stimulus by preventing a tightening of monetary conditions.

Bond Yields

Slight uptick anticipated

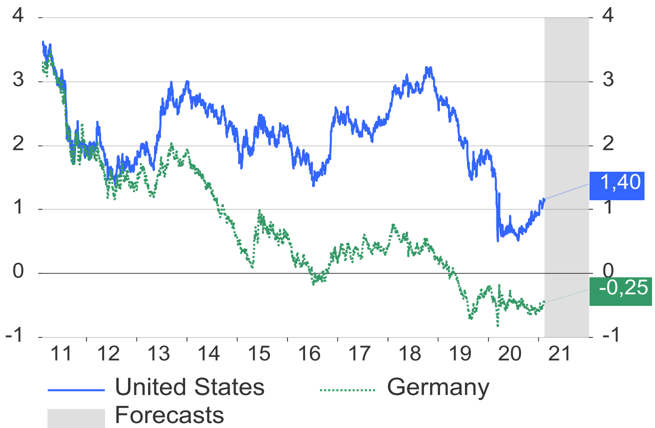
Short-term rates are likely to remain relatively stable this year as we do not expect any central banks to make any hikes in key rates.

Long bond yields have risen in recent months in the United States (vs. barely in Germany) due to rising inflation expectations. **We only expect a small increase in long bond yields over the 12-month horizon** as central banks will continue their bond buying programmes. That said, US yields could be more volatile in the second half of the year as the market is going to anticipate Fed tapering - which will not be effective until 2023, in our view.

March will be a real testing time for the Fed and US rates. A flood of US Treasury issuance in the region of $400bn is anticipated as the Fed buys only $80bn worth of bonds per month.

We forecast the 10-year yield at 1.40% in 12 months in Germany and -0.25% in the US.

10-YEAR BOND YIELDS



Source: Refinitiv Datastream, 12/02/2021

	Maturity (in years)	11/02/2021	12-month targets
United States	2	0.11	0.25
	5	0.46	0.50
	10	1.16	1.40
	30	1.95	1.90
Germany	2	-0.72	-0.50
	5	-0.71	-0.40
	10	-0.46	-0.25
	30	0.03	0.30
United Kingdom	2	-0.03	0.25
	5	0.08	0.25
	10	0.49	0.60
	30	1.07	1.20

Source: Refinitiv Datastream, BNP Paribas WM

CONCLUSION

The improving economic outlook is likely to push bond yields higher. However, any sudden and extended rise is unlikely, in our view, as central banks will continue to make bond purchases this year.

Theme in Focus

Government bonds in three continents

The rise in long bond yields in the United States has been largely due to the rise in inflation expectations. This has heavily penalised long bond yields. Since the low in March 2020, the 10-year yield has more than doubled and long-term sovereign bonds (with a maturity of at least 10 years) have posted a loss of more than 5%. **We maintain our negative recommendation on long-dated US government bonds,** in line with our higher yield targets.

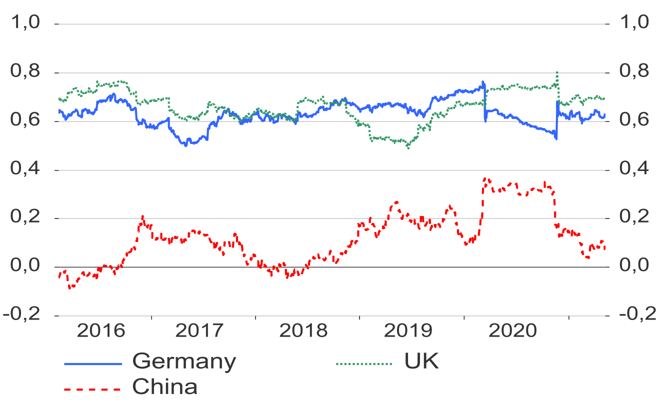
One strategy may be to focus on Chinese bonds. Indeed these have very little correlation to US bonds and bonds in major developed countries in general. They offer a yield of more than 3% for the 10-year benchmark bond in CNY, much more than in developed countries whose central banks have pushed bond yields down considerably.

Chinese bonds are increasingly included in the indices tracked by asset managers. As such, they represent 7% of the Bloomberg Barclays Global Aggregate Index and 45% of the EM Local Currency Sovereign Index.

In Europe, **the Italian 10-year bond** plummeted to an all-time low (0.46%) thanks to the arrival of Mario Draghi, who is set to become prime minister. All this good news seems to have been priced in. **We are no longer buyers at these levels.**

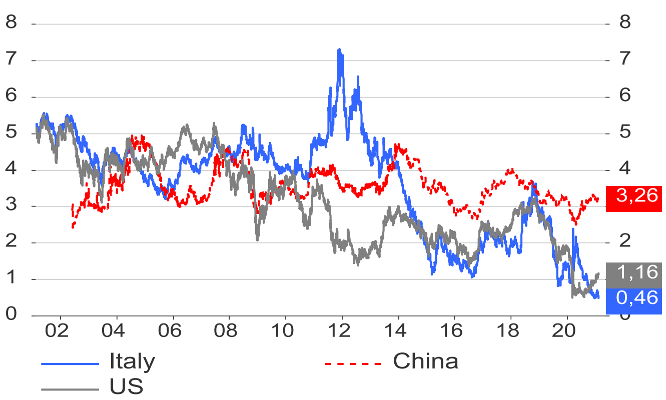
Long-dated UK yields are on the rise, driven by the Bank of England which sees a faster-than-expected economic recovery and is starting to consider putting an end to its lax monetary policy. **We avoid long-dated UK sovereign bonds.**

CORRELATIONS TO US 10-YEAR YIELDS



Source: Refinitiv Datastream, 11/02/2021

10-YEAR YIELDS



Source: Refinitiv Datastream, 12/02/2021

CONCLUSION

Long-dated US and UK bonds are likely to suffer from rising bond yields. Conversely, Chinese bonds could benefit from their low correlation to bond markets in developed countries. On the back of their good performance, Italian sovereign bonds now offer very limited upside potential, in our view.

Our Investment Recommendations

Asset classes	Zone	Our opinion	
Government bonds	Germany	-	Negative on German sovereign bonds, irrespective of their maturity.
	Peripheral countries	+	Positive on peripheral debt (Portugal, Italy, Spain, Greece) with a "buy on dips" strategy.
	United States	=	• Positive on short-term debt for dollar-based investors. • Negative on long-term debt.
Corporate bonds Investment Grade	Eurozone and United States	+	• We prefer corporate bonds to sovereign bonds. • We favour EUR and US bonds with a similar duration to the benchmark (5 and 9 years respectively). • Positive on convertible bonds in the eurozone.
Corporate bonds High Yield	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angel* bonds.
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	1.16	- - -	
Germany	-0.46	- - -	
France	-0.23	23	2
Italy	0.46	92	-12
Spain	0.12	58	2
Portugal	0.07	53	4
Greece	0.76	122	7

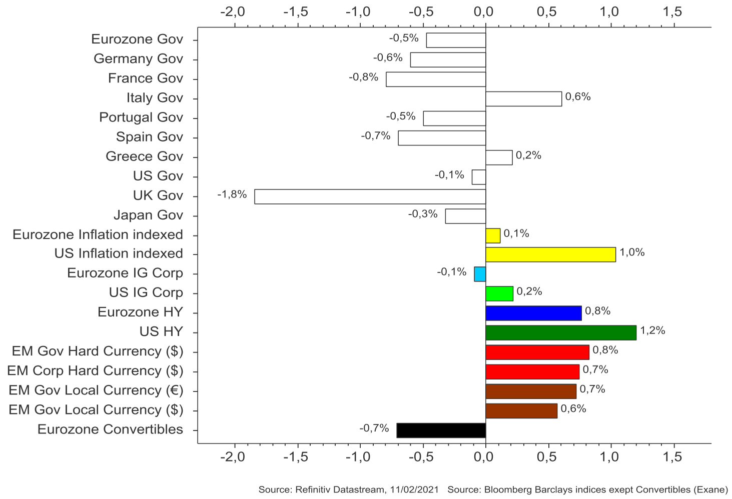
11/02/2021
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	0.91	33	-1
Corporate bonds IG EUR	0.25	88	1
Corporate bonds IG USD	1.87	92	-3
Corporate bonds HY EUR	3.03	313	-21
Corporate bonds HY USD	3.95	326	-27
Emerging government bonds in hard currency	4.40	314	-6
Emerging corporate bonds in hard currency	3.38	245	-15
Emerging government bonds in local currency	4.30	383	2

11/02/2021
Source: Refinitiv Datastream, Bloomberg Barclays and JPM indices

Returns

OVER ONE MONTH



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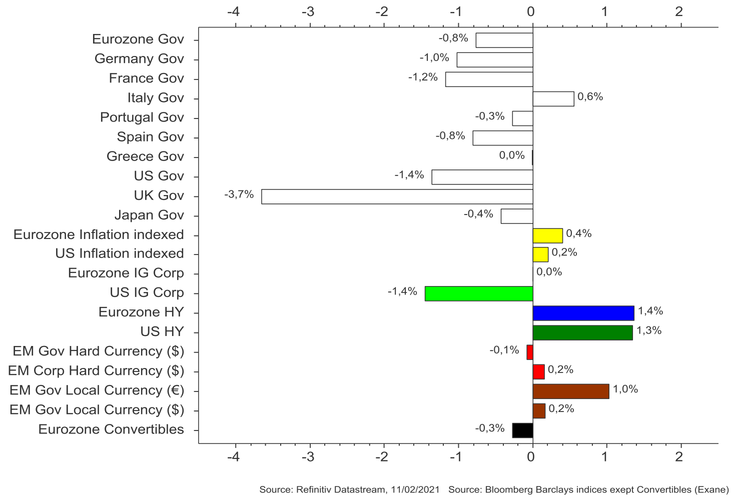

EM = Emerging Markets

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