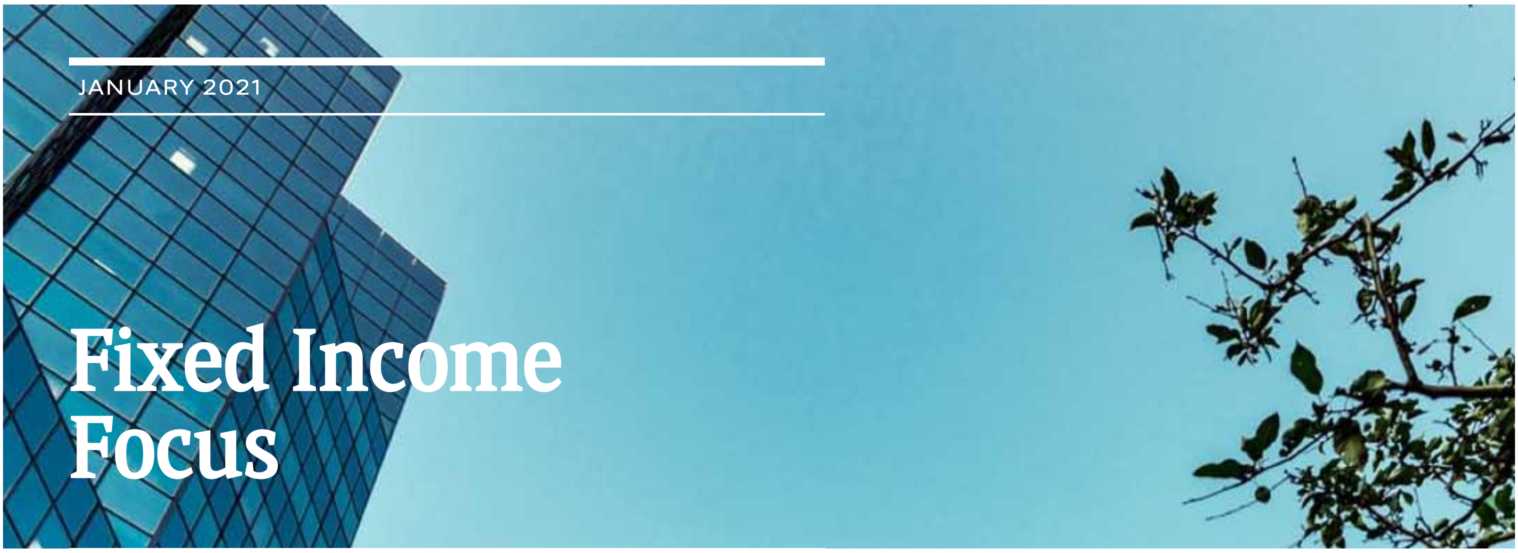


JANUARY 2021

Fixed Income Focus

Summary

1. **Central banks (ECB, Fed) are likely to remain very accommodative in 2021,** pursue their asset purchase programmes and not raise policy rates. Take advantage of any dips to strengthen holdings in sovereign bonds of peripheral countries in the eurozone.

2. **Short-term rates are likely to remain low,** due to lack of impetus from central banks. Short-term US Treasury bonds are alternatives to cash for dollar investors.

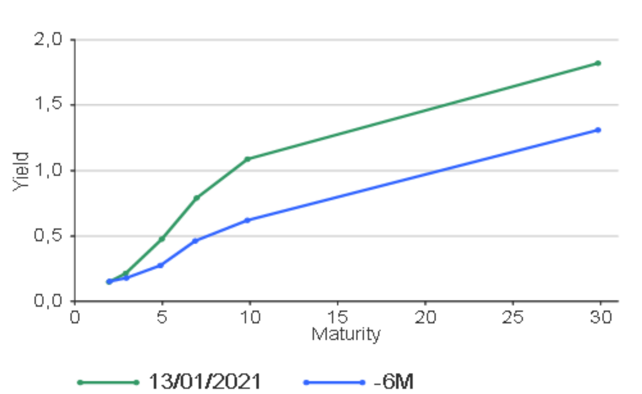
3. **Long-term yields are likely to rise slightly, but remain historically low.** Our 12-month targets are: -0.25% for the German 10-year yield and 1.40% for the US equivalent. Prefer corporate bonds over government bonds.

4. **The hunt for yield will continue.** Almost 70% of bonds around the world offer yields below 1%. Focus on corporate bonds, emerging market bonds and peripheral bonds.

5. **Political uncertainty in Italy could push up risk premiums.** Take advantage of this to reinforce positions as the ECB is likely to maintain its support.

Contents

THE YIELD CURVE HAS STEEPENED IN THE UNITED STATES FOLLOWING THE RISE IN LONG-TERM YIELDS



Source: Refinitiv Datastream, 13/01/2021

Edouard Desbonnets
Investment Advisor, Fixed Income
BNP Paribas Wealth Management

BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

Dovish, and for a long time

European Central Bank (ECB)

The ECB decided to ramp up its support for the economy at its December meeting, **but did the bare minimum.**

The temporary asset purchase programme created in the wake of the pandemic (PEPP or Pandemic emergency purchase programme) was increased by EUR 500bn and extended until March 2022. With regards to bank financing, the ECB extended its support measures with new subsidised loans on condition that they finance the real economy (businesses, households).

The ECB lowered its inflation forecasts: 1.2% in 2023 for core inflation (excluding volatile energy and food prices), while its target is “below, but close to, 2%”.

Assuming no rise in inflation, we therefore expect the ECB to continue its **very lax policy in 2021** and exclude any hike in key rates.

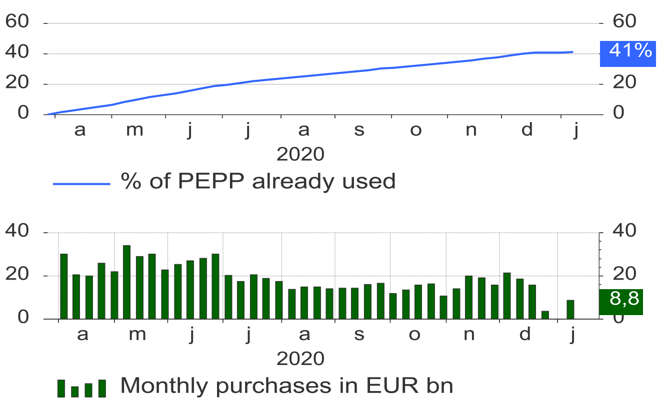
US Federal Reserve (Fed)

The Fed has reiterated its intention to **maintain a very accommodative monetary policy** for a long time, although it has revised up its economic projections and is expecting herd immunity to Covid-19 by mid-2021.

Dissonant voices are being heard in the Fed: a few members are beginning to talk openly about tapering, i.e. reducing the amount of asset purchases as early as 2022, or even as early as mid-2021.

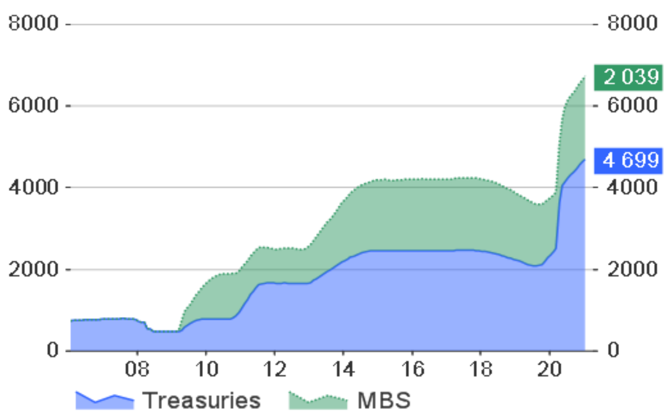
Our view is that it is difficult to envisage tapering this year because the US Treasury must fund a massive deficit. The Fed is not expected to slow its asset purchases until substantial progress is made in terms of inflation and the job market. **The tapering could be made in early 2023.** The Fed would begin by reducing its purchases of MBS (mortgage-backed securities) before scaling back its purchases of Treasuries.

PANDEMIC EMERGENCY PURCHASE PROGRAMME (PEPP)



Source: Refinitiv Datastream, 08/01/2021

FED BALANCE SHEET ASSETS (USD, BN)



Source: Refinitiv Datastream, 06/01/2021

CONCLUSION

The main central banks are likely to continue to pursue their very accommodative monetary policies. It is essential that they do not tighten financing conditions in order to support stimulus measures in the wake of the health crisis. Asset purchase programmes are set to continue and we do not expect any rate hikes this year or next year.

Bond Yields

Slight uptick anticipated

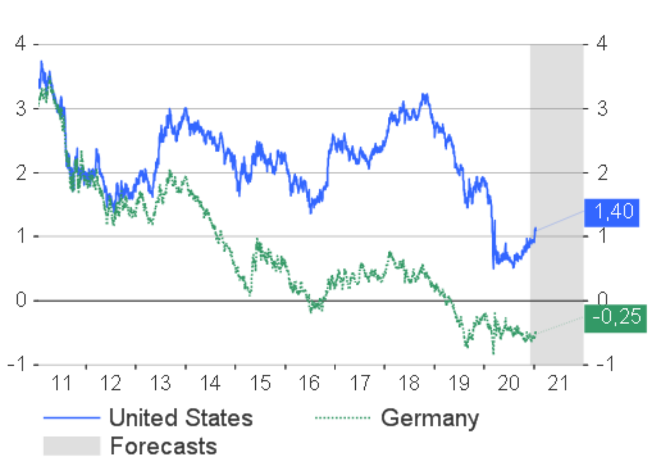
The prospect of a mass vaccination campaign is likely to unlock economies, lift growth and **drive bond yields higher** via greater inflation expectations.

However, a sharp rise in interest rates would hamper the economic recovery, making corporate and state financing more expensive at a time when governments are widening their deficits. Hence, **central banks are likely to keep rates low.** They may put pressure on real rates through their asset purchase programmes, thus curbing the rise of nominal rates.

The ECB has the capacity to absorb all euro area countries' bond issues in 2021. This is not the case of the Fed, which is expected to buy USD 960bn of Treasury bonds this year while the Treasury must fund a deficit of more than USD 3,000 billion.

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

10-YEAR BOND YIELDS



Source: Refinitiv Datastream, 14/01/2021

	Maturity (in years)	13/01/2021	12-month targets
United States	2	0.14	0.25
	5	0.47	0.50
	10	1.08	1.40
	30	1.82	1.90
Germany	2	-0.71	-0.50
	5	-0.71	-0.40
	10	-0.52	-0.25
	30	-0.12	0.30
United Kingdom	2	-0.11	0.25
	5	-0.01	0.25
	10	0.31	0.60
	30	0.88	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

The belated blue ripple

The blue wave announced in the polls last November did not take place finally. But in January there was a belated blue ripple, as the Georgia victories mean that Democrats have taken control of the Senate.

So President-elect Biden will have more latitude to pass **a new fiscal stimulus package**. Republicans will most likely prevent excessive spending but we still expect **substantial issuance of Treasury notes** in 2021 to finance the reflation policy. This points to higher long-term rates, a movement we are already seeing in the markets.

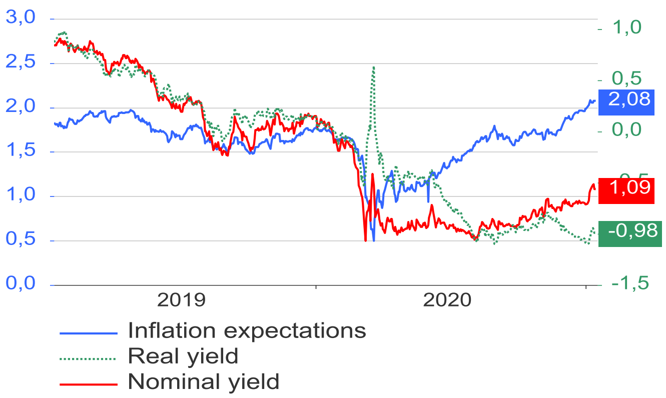
The 10-year yield soared to 1.18%, also helped by the discourse of some hawkish Fed members -in favour of a less lax monetary policy- and new bond issues (which have been heavily subscribed).

Long-term **inflation expectations** have rebounded sharply, to above 2%, a sign that investors think the massive amount of money released by central banks will generate inflation. However, unused production capacity is so large that the latest inflation data do not confirm inflationary pressure. So the Fed should not react.

Real rates remain significantly negative. New issues of inflation-linked bonds have been relatively low compared with the Fed's purchases in 2020. The rate is therefore the result of a market heavily influenced by Fed actions. It holds 22% of the inflation-linked bond market.

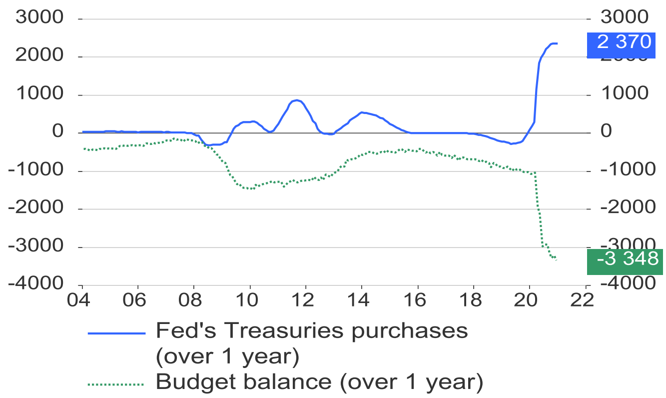
US Investment Grade corporate bonds suffered at the start of the year from the rise in long-term yields because of their high duration (8.8 years). Yields have become more attractive (1.9%) and the stimulus package is expected to support the asset class.

DECOMPOSITION OF THE US 10-YEAR YIELD



Source: Refinitiv Datastream, 14/01/2021

FED'S TREASURIES PURCHASES AND US BUDGET BALANCE



Source: Refinitiv Datastream, 06/01/2021

CONCLUSION

The Democrats' victory gives Joe Biden more scope to push through his fiscal stimulus package. This prospect is driving up long-term rates. As they become more attractive, investors took advantage of this to rush into new 10-year Treasury issues. Investment Grade corporate bonds have been affected by the rise in long-term rates but should ultimately benefit from the stimulus package.

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	1.08	- - -	
Germany	-0.52	- - -	
France	-0.31	21	-5
Italy	0.56	108	-8
Spain	0.06	59	-6
Portugal	0.00	52	-8
Greece	0.71	123	-1

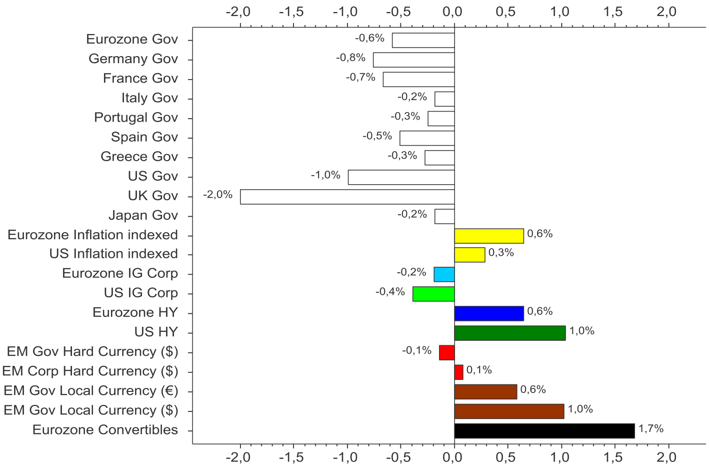
13/01/2021
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	0.87	35	-5
Corporate bonds IG EUR	0.25	90	-3
Corporate bonds IG USD	1.85	93	-12
Corporate bonds HY EUR	3.22	339	-15
Corporate bonds HY USD	4.25	354	-30
Emerging government bonds in hard currency	4.47	329	-10
Emerging corporate bonds in hard currency	3.49	257	-11
Emerging government bonds in local currency	4.31	383	-11

13/01/2021
Source: Refinitiv Datastream, Bloomberg Barclays and JPM indices

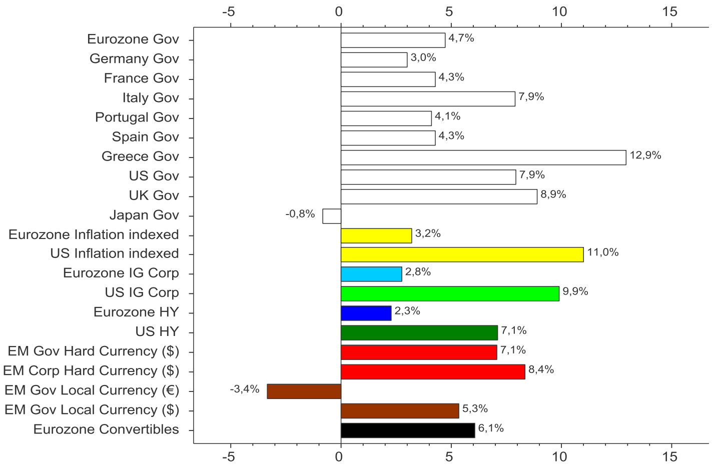
Returns

OVER ONE MONTH



Source: Refinitiv Datastream, 13/01/2021 Source: Bloomberg Barclays indices exept Convertibles (Exane)

IN 2020



Source: Refinitiv Datastream, 31/12/2020 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

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