FIXED INCOME FOCUS

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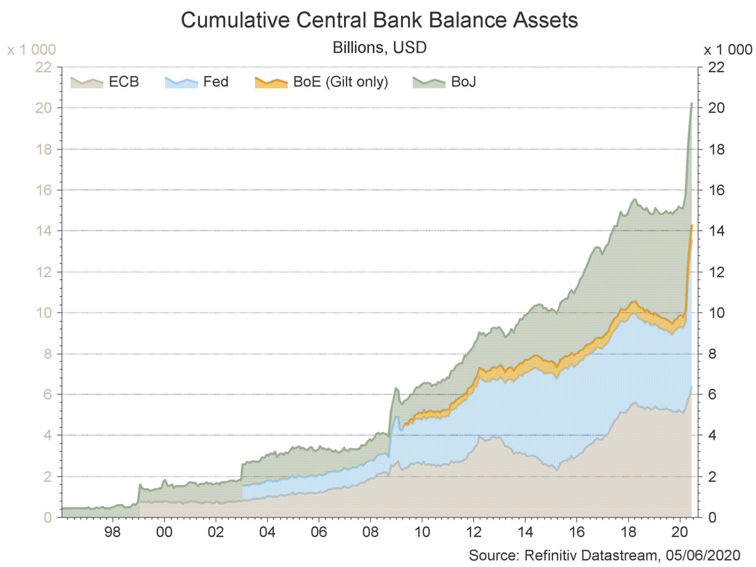
IN A WORD: Central banks are not even thinking about thinking about tightening monetary policies

The appetite for risk has returned even though it is now losing a little bit of breath. US and German sovereign bond yields edged up slightly in recent weeks while peripheral bond yields fell sharply. On the corporate side, credit spreads have narrowed but have not yet fully returned to their pre-crisis levels on average. This is a direct consequence of central banks actions and government stimulus packages. As the Fed Chairman said on 10 June, "We're not even thinking about thinking about raising rates". We believe that risk appetite may still last over the next few weeks or even months in the bond markets. Central banks are determined not to let financial conditions tighten and a European recovery plan is gradually taking shape.

We maintain a positive view on periphery sovereign bonds as well as Investment Grade corporate bonds. We are also positive on short-term US sovereign bonds and Emerging Market bonds in local currency.

Chart of the month: Size of central bank balance sheets

The size of the balance sheets of the major central banks soared as a result of all Quantitative Easing (QE) programmes. The Fed, for example, has bought as many bonds in the last 12 weeks as it has done in the last 12 years. These so-called "unconventional" instruments have finally become indispensable steering tools given that key rates are at zero or negative in the major developed countries. They have contributed to a sharp reduction in interest rate volatility.



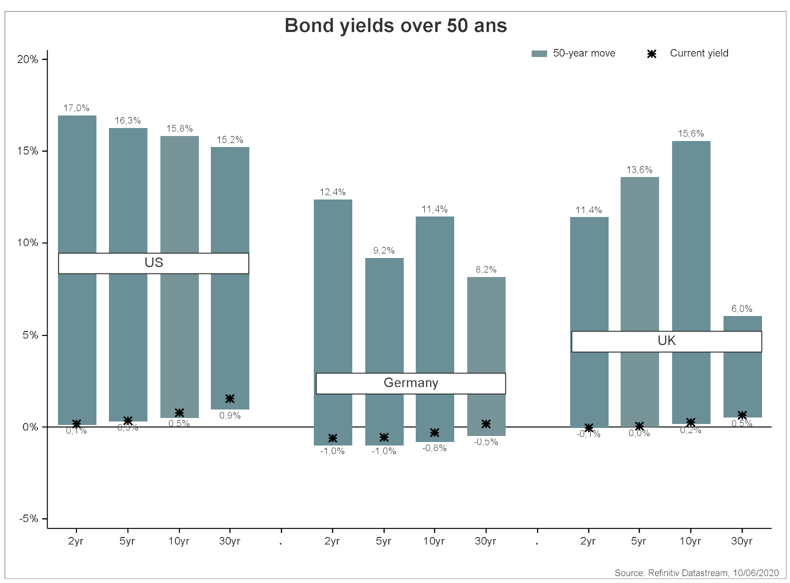
Central banks: leading the way

- **US Federal Reserve: not even thinking about thinking about raising interest rates**
  - The Fed wants to leave rates at zero to support the economy at least until the end of 2022. It believes that it will take almost three years for the US economy to return to its pre-crisis level of activity. It intends to continue its bond purchase program at the current pace (USD80bn Treasuries and USD40bn Mortgage Backed Securities every month) and admits to discussing the possibility of implementing yield curve control.
  - Yield curve control means that the central bank explicitly sets a rate at a certain level and buys (or sells) bonds to achieve this objective. It therefore no longer commits to a monthly purchase volume. Such a system already exists in Japan where the 10-year yield is set at 0% and in Australia where the 3-year yield is set at 0.25%. Targeting rates would enable the Fed to prevent a tightening of financial conditions and thus guarantee low financing costs for the real economy.
  - We don't think the Fed will lower its key rates in negative territory. This would in fact create a money market shock that would result in a tightening of financial conditions, the opposite of what the Fed wants.
  - In the future, the Fed could adjust its QE to make it more effective. This could be done, for example, by simplifying the self-certification process for corporate debt eligibility or by removing the maximum 20% share that the Fed can acquire in an ETF.

- **European Central Bank: not even thinking about thinking about exiting its easing policy**
    - The ECB increased the PEPP (QE pandemic) by a more than expected EUR600bn to EUR1,350bn and extended the programme by at least six months. It will therefore end in June 2021 at the earliest. The ECB has also decided to reinvest the bonds that have matured, at least until the end of December 2022, which allows for a further extension of the programme and means that the ECB will be able to buy a larger share of the issues linked to the future EU recovery fund.
    - The ECB's new economic projections suggest that it will have to do more monetary easing. This could involve a further increase in PEPP as early as September, as the current PEPP, if the pace of purchases remains similar, will be fully exhausted already in February 2021. The ECB could also include purchases of fallen angels corporate bonds (Investment Grade bonds downgraded to High Yield) rated BB. It could be tempted to lower rates, and adjust its tiering system accordingly, if the euro becomes too strong. However, the probability remains low in our view, given the negative consequences on the banking system and household savings in particular.

Bond yield targets

- Benchmark bond yields rose slightly after hitting lows on the back of better-than-expected economic statistics, unprecedented monetary support and numerous fiscal stimulus packages. Central banks are slowing the rise in yields to avoid a tightening of financial conditions.



- We expect the trend to continue, with a slow rise in bond yields.

Bond yields	Maturity (years)	10/06/2020	12-month targets
US	2	0,18	0,25
	5	0,34	0,50
	10	0,75	1,25
	30	1,52	1,75
Germany	2	-0,61	-0,50
	5	-0 ,57	-0,25
	10	-0,33	0
	30	0,16	0,25
UK	2	-0,05	0,25
	5	0,02	0,25
	10	0,27	0,50
	30	0,66	1,00
Sources: Refinitiv Datastream, BNP Paribas WM			

Periphery bonds

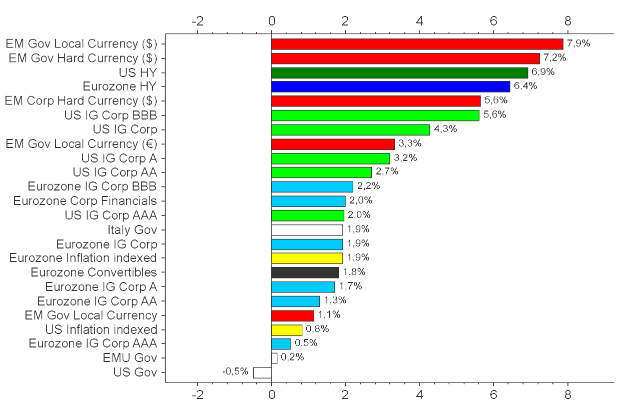
- Yield spreads have tightened sharply thanks to the ECB and the EU proposal of common borrowing.
- Demand was strong for the numerous issues that came on the market in recent days (Italy, Greece, Spain, Portugal, Ireland, etc.). An emblematic example with Italy: its 10-year bond with a 1.65% coupon attracted 108 billion in demand (a record!) and not only domestic demand, 76% of the 108 billion came from international investors.
- The ECB did not slow the pace of its purchases last week although optimism had returned to the markets, suggesting that it wants to lower yields further. It is particularly attentive to the average spread of all eurozone countries weighted by their GDP. The latter (45 basis points) has not yet tightened back to its pre-crisis Covid-19 level (20-30 basis points).
- A political/judicial solution should be found in relation to the ruling of the German Constitutional Court.
- Yields are high compared with the core or semi-core euro area countries. Carry is particularly attractive as the ECB is removing rising by suppressing volatility and preventing spreads from rising.
- We remain positive on the asset class, with a buy on weakness strategy.

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.
EMERGING	+	• We are positive on EM local currency bonds, for both USD and EUR based investors.
	=	• Neutral on EM hard currency bonds (sovereigns and corporates).

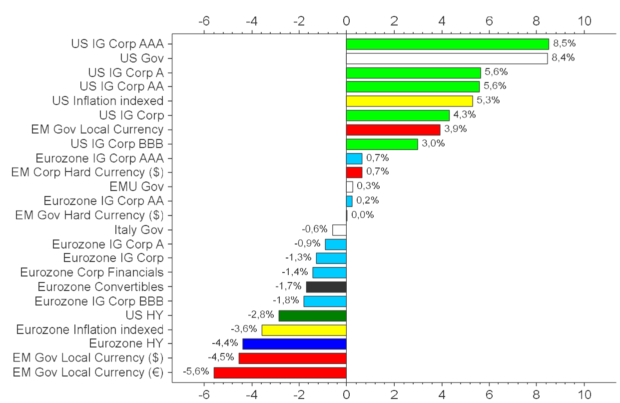
Fixed Income returns

Over the past 30 days



Source: Refinitiv Datastream, 10/06/2020 Index source: JPMorgan for Government Bonds and Emerging Markets (EM); Bloomberg Barclays for Investment Grade (IG) credit; ICE BofA for High Yield (HY) credit; Exane for Convertibles.

Since 31 December 2019



Source: Refinitiv Datastream, 10/06/2020 Index source: JPMorgan for Government Bonds and Emerging Markets (EM); Bloomberg Barclays for Investment Grade (IG) credit; ICE BofA for High Yield (HY) credit; Exane for Convertibles.

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