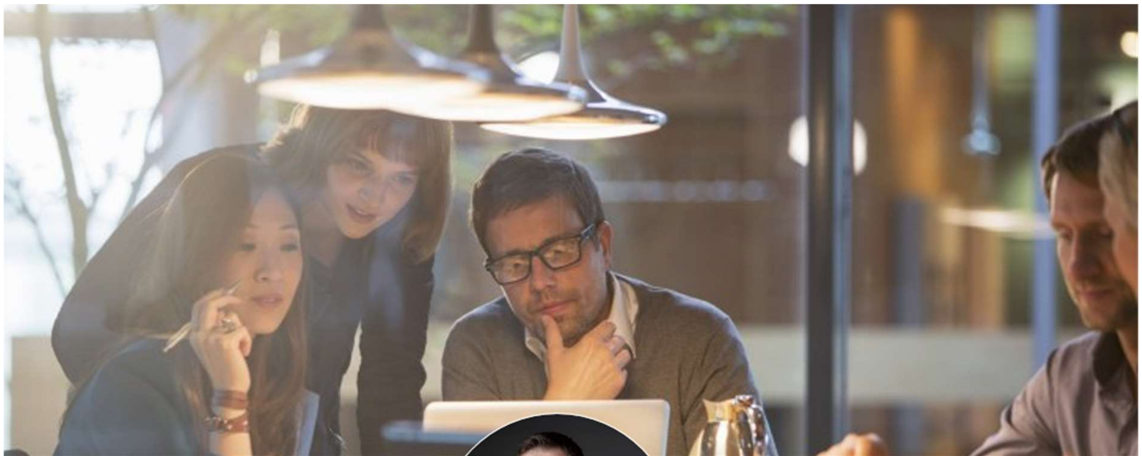
FIXED INCOME FOCUS

October 2020



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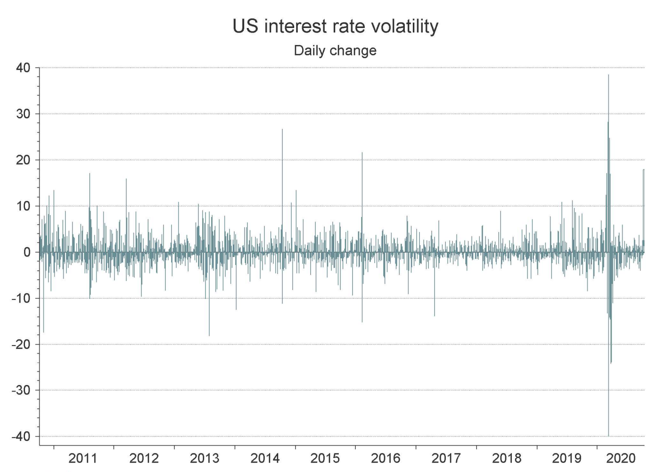
IN A WORD: Volatility, opportunity.

Short-term risks are piling up. Fortunately, central banks will remain accommodative. We explore three scenarios to take advantage of the US elections.

Chart of the month: increased volatility of US interest rates

As a sign of the uncertainty surrounding the health situation, the fiscal stimulus package in the US and the US elections, the volatility of US interest rates rebounded sharply after hitting an all-time low at the end of September. Many investors are anticipating ballot recounts and have therefore hedged their positions, not for a few days, but until January 2021 according to future contracts.



Source: Refinitiv Datastream

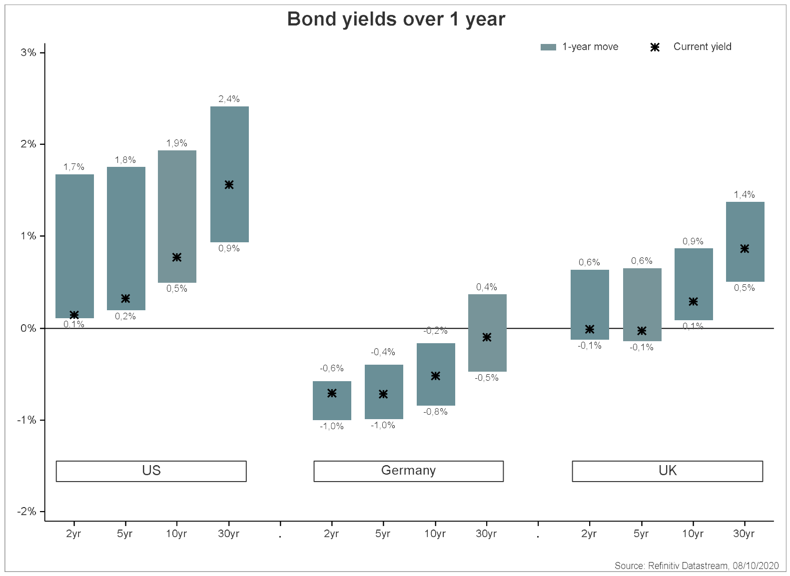
Central banks: more stimulus expected

- **US Federal Reserve:**
  - The Fed has specified the cumulative conditions necessary for it to raise its key rates: i/inflation at 2% on a sustainable basis and the conviction that it could exceed 2% and ii/full employment. According to its own projections and in view of current data, there will therefore be no rate change until at least 2023.
  - The Fed should remain on hold for its next meeting as it is scheduled for the day after the elections and it is not certain that the results will be known. In December, it could commit to larger scale bond purchases until 2021 and buy bonds with longer maturities than before.

- **European Central Bank:**
  - Some divisions are emerging among ECB members, between those who want more monetary stimulus because of persistently low inflation, and those who prefer to give time to time.
  - We believe that the ECB cannot ignore the latest inflation figures and the risks to growth. We anticipate a further increase in the PEPP (bond purchase program) by EUR 300-400bn before the end of the year, as well as a six-month extension of the program until the end of 2021. We do not believe that the ECB will lower its deposit rate, contrary to the market, which is expecting a rate cut of almost 0.10% over the next year.
  - The ECB will increasingly focus on green finance. Like the Fed, it could adopt an average inflation targeting in the coming months to raise inflation expectations. It should focus on core inflation (excluding volatile energy and food prices) and include owner-occupied housing inflation to better reflect reality. The results of the strategic review are expected by mid-2021.

Bond yield targets

- US and German 10-year bond yields have been in a tight range since April. In the very short term, they could fall due to uncertainty, or even possible contestation, of the outcome of the US elections. Looking one year ahead, yields should increase slightly thanks to the improved health situation, the better economic outlook and the large number of bond issuances to come to finance government spending.
- Short-term bond yields should remain stable on a one-year horizon.



Bond yields	Maturity (years)	07/10/2020	12-month targets
US	2	0.15	0.25
	5	0.34	0.50
	10	0.79	1.25
	30	1.59	1.75
Germany	2	-0.69	-0.50
	5	-0 .69	-0.25
	10	-0.49	0
	30	-0.06	0.25
UK	2	-0.01	0.25
	5	-0.02	0.25
	10	0.30	0.50
	30	0.88	1.00

Sources: Refinitiv Datastream, BNP Paribas WM

US elections: three main scenarios in a likely contested election

- Democrats sweep under Biden
    - Probability 65%.
    - Politics: more stimulus, taxes, regulation and environment.
    - Reaction of bond yields: first a flattening of the yield curve due to fears about corporate profitability, then a rise in long-term yields linked to a policy focused on deficits, growth and more inflation.
    - Recommendation: Prefer Investment Grade corporate bonds over High Yield. Favour green bonds.

- Trump re-elected and Republicans keep Senate
    - Probability 20%.
    - Policy: less taxes, more stimulus and trade tensions.
    - Reaction of bond yields: moderate increase in rates due to the divided Congress (Republican Senate and Democratic House of Representatives).
    - Recommendation: prefer High Yield corporate bonds over Investment Grade.

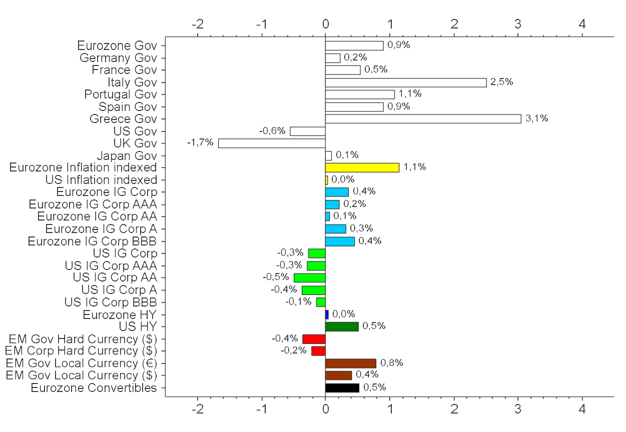
- Biden victory and Republicans keep Senate.
    - Probability 15%.
    - Politics: immobility due to a divided Congress (Republican Senate and Democratic House of Representatives). Democrats will focus on regulation.
    - Reaction of bond yields: moderate increase in rates due to the divided Congress.
    - Recommendation: favour BBB and High Yield corporate bonds in this environment of soft growth and accommodative financial conditions.

Our views

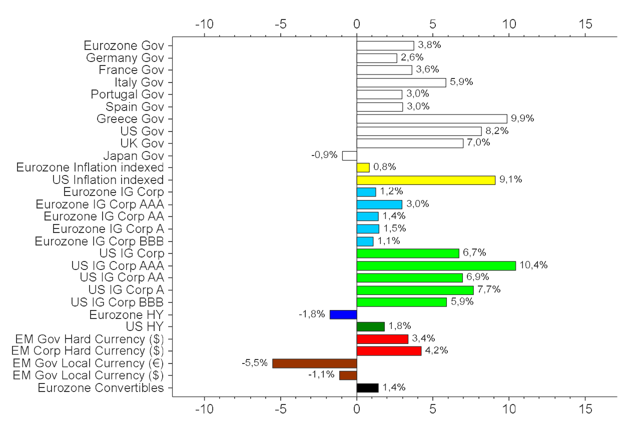
GOVIES	-/= +	• We are positive on the front-end of the US yield curve for USD-based investors as short-term yields have a limited upside. • We are negative on long-term US govies and German govies, whatever the maturity. • We stay positive on periphery debt (Portugal, Italy, Spain, Greece) on a buy on 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	= +	• 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



Since 31 December 2019



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