SEPTEMBER2022

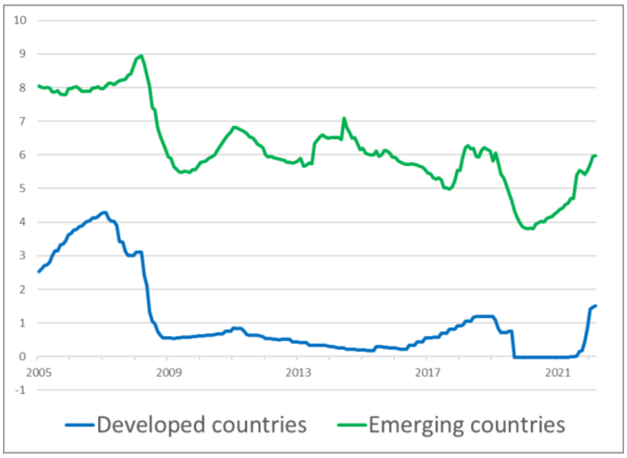
Fixed Income Focus

Summary

1. **Environnement more challenging** in the US and Europe: growth is expected to slow down and lead to a short-lived recession in the eurozone and in the UK. Meanwhile, inflation will remain above the targets of central banks, forcing them to pursue a restrictive monetary policy.
2. **Central banks will continue to aggressively raise interest rates** in order to claim victory over inflation. We anticipate the end of the ECB's monetary tightening cycle in 1Q23, with a deposit rate at 2.25%. In the US, the end-of-cycle rate is expected to be reached by year-end.
3. **The rise in long-term rates should continue,** especially via real rates, but the bulk of the rise is behind us. Our 12-month targets are 3.25% for the US 10-year rate and 1.75% for the German equivalent. We are Neutral on US and German government bonds, and Positive on short-dated US government bonds.
4. **Investment ideas in this more challenging economic environment:** we prefer short-term high quality corporate bonds as well as short-term US sovereign bonds for dollar-based investors. For those willing to take on more risk, some emerging market bonds present opportunities.

Contents

AVERAGE KEY INTEREST RATES OF THE 38 MAIN CENTRAL BANKS, WEIGHTED BY THEIR GDP (%)



Source: Refinitiv, BNP Paribas WM

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Central banks

Fighting inflation at all costs?

European Central Bank (ECB)

Phrase of the month: According to Mrs Lagarde, "*Where we are is not the neutral rate, but are going in that direction. [...] further rate increases* [data dependent] *will be needed to achieve this. But we are getting there.*"

The rise in interest rates is not over: The historical rise in key interest rates in September, +75 basis points (bps), simply puts an end to the very lax monetary policy. A number of rate hikes are still needed to stop inflationary pressures. The ECB expects inflation to remain above its target in 2024 (2.3%). Some members of the ECB fear that a wage-price spiral will begin (see chart).

Our scenario: we forecast a key rate hike of 50 bps in October, followed by increases of 25 bps at each of the next three meetings. The deposit rate would therefore reach 1.5% at the end of the year and 2.25% at the end of 2023. The main refinancing rate would be 0.5% higher.

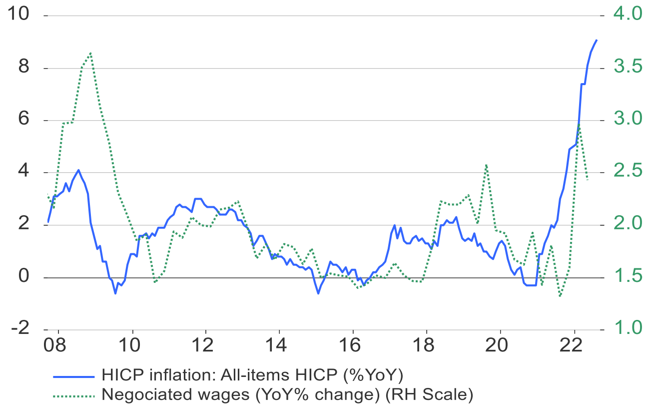
US Federal Reserve (Fed)

Phrase of the month: The Fed is determined to lower inflation and "*will keep at it until the job is done*". Powell has repeatedly pointed out that doing too little to counter inflation would be worse than doing too much.

The rise in interest rates is not over: The Fed must react in a bid to bring down inflation, of which a significant part stems from excess demand. There is also a risk of runaway wages, potentially fuelling an inflationary spiral.

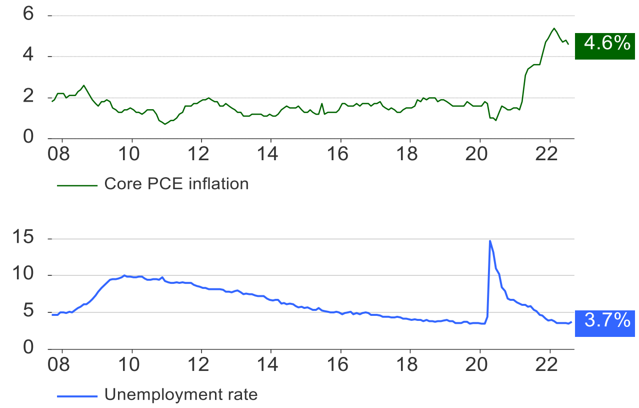
Our scenario: we expect hikes in the Fed funds rate of 50 basis points (bps) in September, 25 bps in November and 25 bps in December, bringing the Fed funds rate to 3.50% by year-end. This rate should be kept at the same level in 2023. We therefore no longer expect a rate cut at the end of 2023. The risk is that the strength of the labour market (see chart) will prompt the Fed to hike further (75 bps) later this month. The real estate market would especially suffer.

IN THE EUROZONE, WAGES TEND TO FOLLOW THE RISE IN INFLATION WITH A LAG OF 3 QUARTERS



Source: Refinitiv Datastream, Aug 22

THE FED'S DUAL MANDATE: PRICE STABILITY AND MAXIMUM EMPLOYMENT



Source: Refinitiv Datastream, Jul 22

INVESTMENT CONCLUSION

Central banks will continue to aggressively raise interest rates in order to be able to claim victory over inflation. The price to be paid will be a short recession at the end of 2022 in the eurozone, in our view, and an economic slowdown in the US. We anticipate the end of the ECB's monetary tightening cycle in 1Q23, with a deposit rate of 2.25%. In the US, the end-of-cycle rate is expected to be reached at the end of the year.

Bond yields

Massive moves

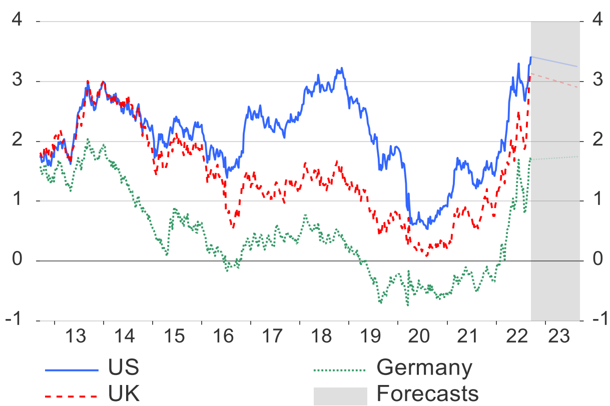
Interest rate volatility remains high.

Long-term US, German and UK yields are expected to continue to rise over the coming months, given high inflation, uncertainty about the magnitude of future inflation fluctuations and the willingness of central banks to adopt a restrictive monetary policy. Moreover, fiscal measures put in place by some governments to support households through this period of high energy prices are inflationary in nature, in the medium term, which does not facilitate the task of central banks.

Short-term bond yields have risen sharply in recent weeks, driven by central bankers. It seems that the former are close to peak in the US, but there is still upside potential in the eurozone.

We remain Neutral on US and German long-dated government bonds. We are Positive on US short-term government bonds for dollar-based investors.

10-YEAR RATES



Source: Refinitiv Datastream, 9/15/2022

	Maturity (in years)	09/09/2022	12-month targets
United States	2	3.57	3.25
	5	3.45	3.25
	10	3.32	3.25
	30	3.46	3.25
Germany	2	1.32	1.50
	5	1.54	1.50
	10	1.70	1.75
	30	1.81	1.90
United Kingdom	2	3.03	2.90
	5	2.98	2.90
	10	3.10	2.90
	30	3.47	3.10

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

Most of the rate hikes are probably behind us, especially in the US. Long-term German yields should continue to rise in the next few months under the impetus of the ECB, via increases in real rates. We are Neutral on US and German government bonds. We have a positive view on short-term US government bonds for dollar-based investors.

Theme in Focus

Investment ideas

The sharp rise in bond yields coupled with the widening of risk premiums (credit spreads) have put an end to negative-yielding bonds at maturity. Investors can now obtain attractive returns across most asset classes.

However, we are still cautious on fixed income assets. Central banks will continue to raise key interest rates, the macroeconomic environment is becoming more challenging and uncertainty is high, as evidenced by the sharp variations in bond yields almost every day. So bond yields could therefore continue to rise, even though the movement is mostly behind us, in our opinion.

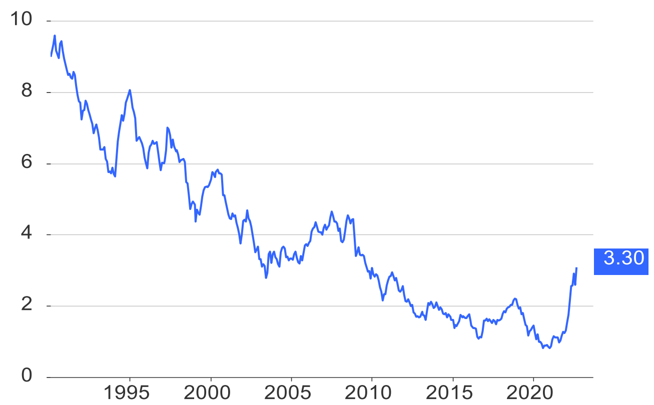
We await the peak in inflation and the peak in central bankers' aggressiveness about raising key interest rates before upgrading our opinion to Positive on government bonds. For the moment, only short-term US sovereign bonds seem attractive to us, at least for investors whose reference currency is the dollar.

The Italian spread should remain volatile ahead of the elections. We are Neutral on peripheral debt for the time being.

Turning to corporate bonds, the yields offered are much more attractive than before (see chart) but risk premiums could increase further in the coming months. Therefore we think it is appropriate to increase its exposure gradually. We prefer short-term corporate bonds with strong credit ratings. We prefer Investment Grade bonds to High Yield bonds.

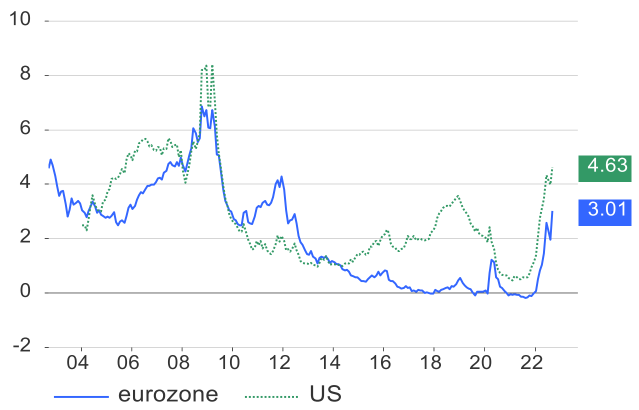
As for emerging market bonds, returns have been very mixed since the beginning of the year, due to a record level of terms of trade divergence and very different inflation cycles. We prefer countries with solid/resilient fundamentals, exporters of commodities and those where the monetary tightening cycle is nearly over. In short: China, Middle East countries, Brazil, Mexico and South Africa.

RISING GLOBAL BOND YIELDS (BLOOMBERG GLOBAL AGGREGATE USD INDEX)



Source: Refinitiv Datastream, 9/15/2022

SHORT-TERM INVESTMENT GRADE CORPORATE BOND YIELDS (1 TO 3 YEARS)



Source: Refinitiv Datastream, 9/15/2022

Investment Conclusion

In a macroeconomic environment of lower growth, above-target inflation and soon restrictive monetary policies, we favour quality short-term corporate bonds as well as short-term US sovereign bonds for investors whose base currency is the dollar. For those willing to take more risk, some emerging market bonds present opportunities.

Our Investment Recommendations

Asset classes	Zone	Our opinion	
Government bonds	Germany	=	We are Neutral on German sovereign bonds.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United States	+ =	• Positive on US short-term Governement bonds for USD-based investors. • We are Neutral on long-term debt.
Corporate bonds Investment Grade	Eurozone United States	=	• Neutral view on corporate bonds. Focus on duration below benchmark (< 5 years in EUR and < 8 years in USD). • Prefer short-term quality corporate bonds. • Neutral on convertible bonds in the eurozone.
Corporate bonds High Yield	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angel* and *rising stars.*
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	3.32	---	
Germany	1.70	---	
France	2.27	57	2
Italy	4.01	231	18
Spain	2.86	116	5
Portugal	2.78	107	4
Greece	4.26	256	26

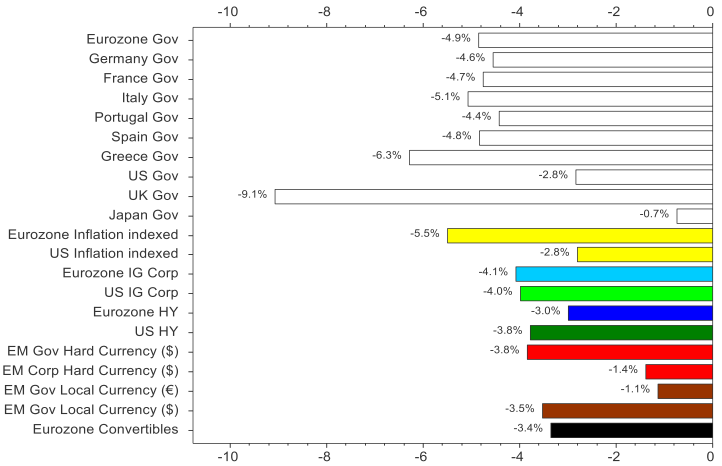
09/09/2022
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	3.22	55	1
Corporate bonds IG EUR	3.47	197	13
Corporate bonds IG USD	4.95	141	2
Corporate bonds HY EUR	7.32	546	10
Corporate bonds HY USD	8.21	449	17
Emerging government bonds in hard currency	7.68	416	-18
Emerging corporate bonds in hard currency	7.56	404	-37
Emerging government bonds in local currency	4.23	78	-43

09/09/2022
Source: Refinitiv Datastream, Bloomberg

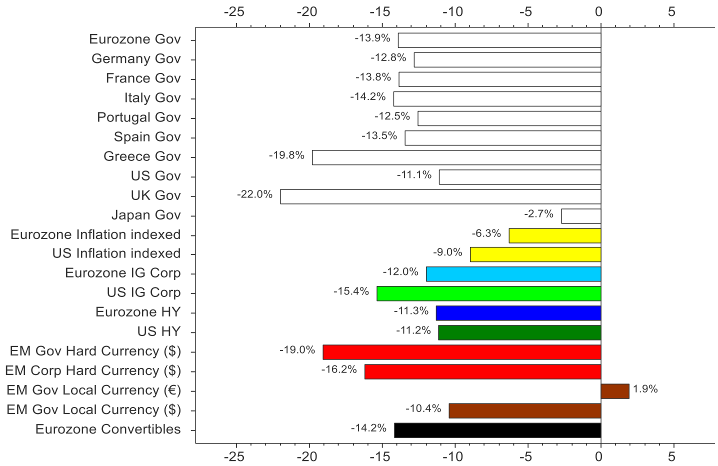
Returns

OVER ONE MONTH



Source: Refinitiv Datastream, 9/14/2022 Source: Bloomberg Barclays indices exept Convertibles (Exane)

SINCE THE BEGINNING OF THE YEAR



Source: Refinitiv Datastream, 9/14/2022 Source: Bloomberg Barclays indices exept Convertibles (Exane)

EM = Emerging Markets

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