MARCH 2025

Fixed Income Focus

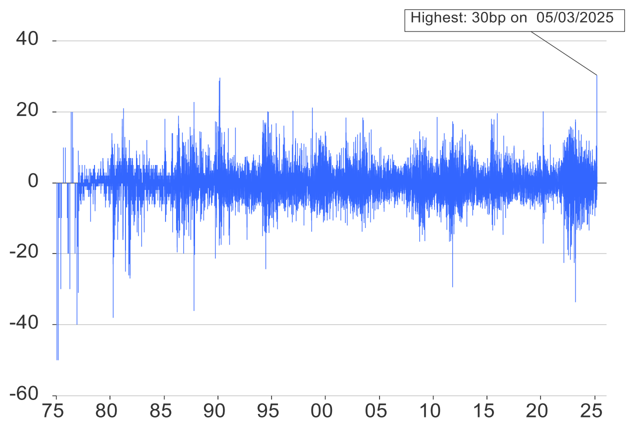
Summary

1. **Germany is making a fiscal U-turn:** This implies a higher public debt-to-GDP ratio, increased bond issuance, higher economic growth and inflation in the medium term, thereby reducing the likelihood of the ECB cutting rates too low. As a result, we have raised our 12-month Bund yield target from 2.25% to 2.50%. We still expect German yields to decline gradually over 2025 and have shifted our stance on euro core government bonds from Neutral to Positive. We recommend maturities between 5 and 10 years.
2. **Rate cuts are back on the table in the US:** The market has increased the expected number of rate cuts this year from one to three, as the economy shows signs of deceleration. We maintain our expectation of two 25bp rate cuts this year, bringing the policy rate to 4% by year-end. We keep our 12-month target for the US 10-year yield at 4.25%. However, we believe the market has moved too far ahead, and bond yields have fallen excessively. Therefore, we have turned Neutral from Positive on US Treasuries after the rally.
3. **Topic in focus: US credit losing ground to Europe.** We have turned Neutral on USD investment grade credit, as tight spreads, low bond yields, and economic risks limit upside potential. In contrast, we prefer European investment grade credit, supported by ECB rate cuts, stronger fundamentals, and resilient demand. With better-rated issuers and lower expected defaults, euro credit offers a more attractive risk-reward profile than USD credit in the current environment.
4. **Opportunities in Fixed Income:** In addition to the above, we are Positive on US Agency Mortgage-Backed Securities, US TIPS, UK bonds (government and corporate), and European investment grade corporate bonds.

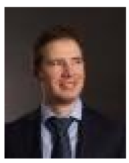
Drafting completed on 13 March

Contents

**CHART OF THE MONTH:
THE GERMAN 10-YEAR YIELD JUMPED 30BP ON THE DAY THE GERMAN PARTIES AGREED ON FISCAL LOOSENING, THE BIGGEST ONE-DAY JUMP SINCE 1973**



Source: LSEG Datastream, 13/03/2025



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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

The market has repriced the path of policy rates

European Central Bank (ECB)

The disinflationary process is "well on track" according to the ECB, which enabled them to cut rates by 25bp to 2.50% as expected at the March meeting. The latest wage tracker data remains consistent with easing wage pressures.

Policy is becoming "meaningfully less restrictive" said Lagarde. To us, this suggests that their job is not yet done and that further rate cuts are still required. This appears to pave the way for lowering interest rates towards a more neutral stance.

Our expectations: We maintain our forecast that the ECB will implement 25bp rate cuts in June and September. This would bring the end-of-cycle deposit rate to 2%. We believe that the German fiscal plan should prevent the ECB from cutting rates too aggressively, as it raises medium-term prospects for economic growth and inflation. The market has taken this into account by reducing the number of rate cuts priced in (see chart).

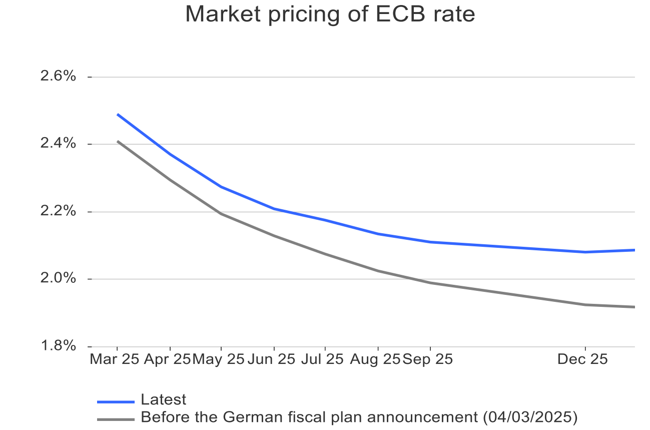
US Federal Reserve (Fed)

Change of narrative: Consumers' one-year inflation expectations have risen sharply. However, both long-term inflation expectations and market-based measures of inflation expectations have declined. Furthermore, a series of recently released sentiment indicators suggest that the US economy is slowing. As a result, traders have increased their bets on interest rate cuts this year, from one in mid-February to three.

Our view: the weakening economy has increased the likelihood of rate cuts. However, policymakers seek further progress towards the 2% inflation target before considering reductions. We maintain our view that the Fed will cut rates twice this year (June and December), bringing the rate-cutting cycle to an end at 4%.

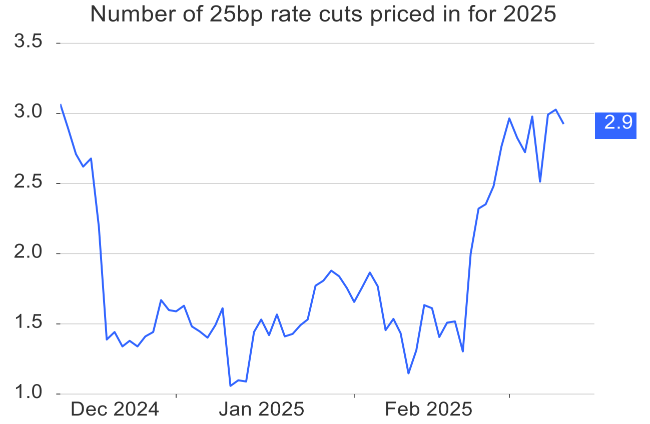
Quantitative Tightening (QT): We pencilled in QT ending in June, expecting a conservative approach from the Fed. However, depending on how debt ceiling negotiations evolve, the risk of an even earlier endpoint has increased.

FEWER RATE CUTS PRICED IN AFTER GERMAN NEWS



Source: LSEG Datastream, 11/03/2025

THE MARKET NOW EXPECTS CLOSE TO 3 RATE CUTS OF 25BP THIS YEAR IN THE US



Source: LSEG Datastream, 12/03/2025

INVESTMENT CONCLUSION

There has been a shift in the perception of the US economy, now seeing decelerating, and the market has increased the possibility of rate cuts this year to three from one. In contrast, the market pricing of rate cuts in the eurozone has moved towards less rate cuts following the German fiscal U-turn, to 1,7 cuts by year-end. We keep our base case of 2 cuts this year in the US (June and December) and 2 in the eurozone (June and September), leading to a terminal rate of 4% in the US and 2% (deposit rate) in the eurozone.

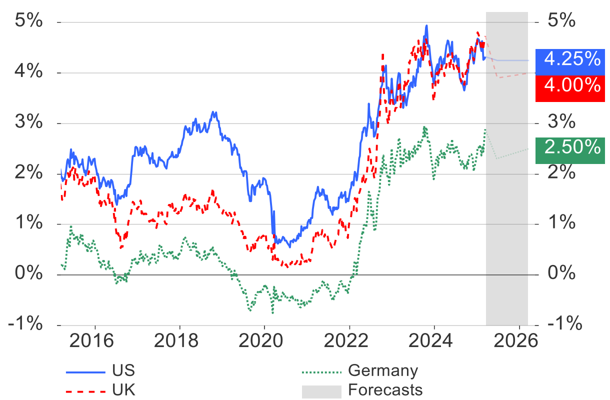
Bond yields

The great rise and the great slide

Bond yields have surged in the eurozone following Germany's announcement of plans to reform the debt brake and launch a EUR 500bn special-purpose vehicle over 10 years. This implies a higher public debt-to-GDP ratio, increased bond issuance, higher economic growth and inflation in the medium term, thereby reducing the likelihood of the ECB cutting rates too low. As a result, **we have raised our 12-month Bund yield target from 2.25% to 2.50%**. We still expect German yields to decline gradually over 2025 and **we have shifted our stance on euro core government bonds from Neutral to Positive**. We recommend maturities between 5 and 10 years to avoid the short end of the curve, where most issuance will take place, and to steer clear of the very long end, which is more vulnerable to a repricing higher of the term premium.

By contrast, we have moved from Positive to Neutral on US government bonds following the recent rally, and we recommend lowering duration to below benchmark (6 years). The 10-year yield has fallen by more than 50bp since its peak in mid-January, and in our view, traders are expecting too many rate cuts from the Fed.

10-YEAR RATES



Source: LSEG Datastream, 14/03/2025

	Maturity (years)	11/03/ 2024	3-month target	12-month target
USA	Policy rate	4.50	4.25	4.00
	2	3.94	4.25	4.25
	5	4.03	4.30	4.25
	10	4.28	4.50	4.25
	30	4.60	4.60	4.50
Germany	Policy rate	2.50	2.25	2.00
	2	2.20	2.10	2.00
	5	2.52	2.15	2.15
	10	2.87	2.30	2.50
	30	3.19	2.55	2.75
UK	Policy rate	4.50	4.25	3.50
	2	4.18	4.00	3.60
	5	4.29	4.00	3.75
	10	4.68	4.00	4.00
	30	5.28	4.50	4.45

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

We turned Positive from Neutral on euro core government bonds following the surge in bond yields after Germany's fiscal plan announcement. Conversely, we turned Neutral from Positive on US government bonds after the recent rally. We remain Positive on US inflation-linked bonds and UK bonds.

Topic in Focus

US credit losing ground to Europe

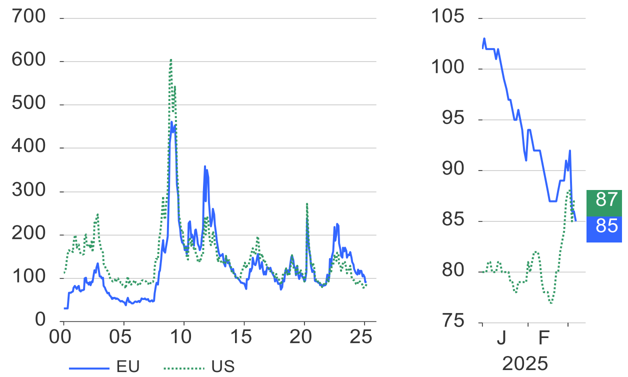
Market Divergence: The corporate bond market has witnessed a clear divergence between euro and USD segments. Euro credit spreads have tightened, while USD credit spreads have widened across both high-yield (HY) and investment grade (IG) corporate bonds. European markets are benefiting from accommodative monetary policy and strong investor demand, whereas US markets face both political and macroeconomic uncertainty, inflationary pressures, and signs of economic slowdown.

Turning Neutral on USD IG corporate bonds: The asset class has benefited from the decline in bond yields and spread compression to near historic lows, reflecting strong investor confidence. However, this optimism appears increasingly disconnected from underlying economic fundamentals. Looking ahead, we see limited potential for bond yields to decline further—unless a recession occurs, which is not our base case. Likewise, there is little room for additional spread compression, suggesting limited upside potential in price appreciation. In fact, the current risk-off environment points to wider credit spreads and balance sheet deterioration, particularly for lower investment grade-rated bonds.

US credit valuations: Historically, during the late stages of economic expansion, US IG tend to trade around 120 basis points, while HY spreads typically exceed 400 basis points. Current spreads remain well below these levels, suggesting that valuations are rich relative to the economic cycle.

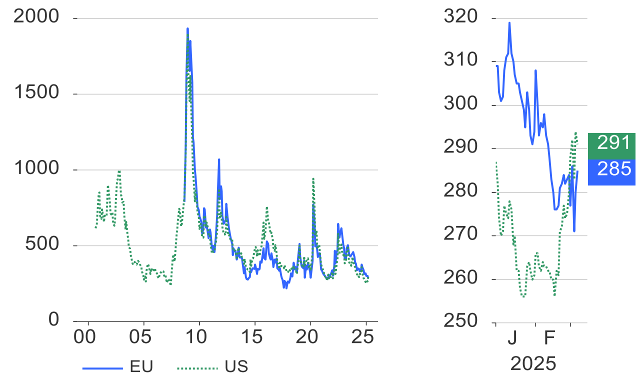
European IG advantage: By contrast, we believe European IG bonds remain attractive, supported by the ECB's projected 50 basis point rate cuts, stronger fundamentals relative to the US, and favourable technical factors. The primary market has been highly active since the beginning of the year, with issuance volumes being easily absorbed and new issue premiums often minimal or even negative. Additionally, European credit has a defensive tilt, with better-rated issuers. We forecast a 1.5% default rate in Europe versus 2.4% in the US this year.

EUR AND USD INVESTMENT GRADE CREDIT SPREADS HAVE DIVERGED (BP)



Source: LSEG Datastream, 07/03/2025

EUR AND USD HIGH YIELD CREDIT SPREADS HAVE ALSO DIVERGED (BP)



Source: LSEG Datastream, 07/03/2025

INVESTMENT CONCLUSION

We have turned Neutral on USD investment grade credit, as tight spreads and economic risks limit upside potential. In contrast, we prefer European investment grade credit, supported by ECB rate cuts, stronger fundamentals, and resilient demand. With better-rated issuers and lower expected defaults, euro credit offers a more attractive risk-reward profile than USD credit in the current environment.

Our Investment Recommendations

Asset class	Zone	Our opinion	
Government bonds	Germany	+	We have turned Positive from Neutral on German sovereign bonds. Prefer 5-10 years maturities.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United Kingdom	+	Positive on UK government bonds.
	United States	=	We have turned Neutral from Positive on US government bonds. Positive on TIPS.
Corporate bonds Investment Grade (IG)	Eurozone United Kingdom United States	+	• We turned Neutral from Positive on US IG corporate bonds. • Positive on EUR and GBP IG corporate bonds • Prefer short maturities in the US (up to 5 years) and up to 10 years in the eurozone. • Positive on convertible bonds in the eurozone.
Corporate bonds High Yield (HY)	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angels* and *rising stars.*
Emerging bonds	In hard currency	=	Neutral on EM hard currency bonds (sovereign and corporate).
	In local currency	=	Neutral on EM local currency government bonds.

Market Data

	10-year rate (%)	Spread (bp)	Spread change 1 month (bp)
United States	4.32	---	
Germany	2.89	---	
France	3.57	68	-4
Italy	3.94	105	-3
Spain	3.51	62	-5
Portugal	3.38	50	-3
Greece	3.73	84	-4

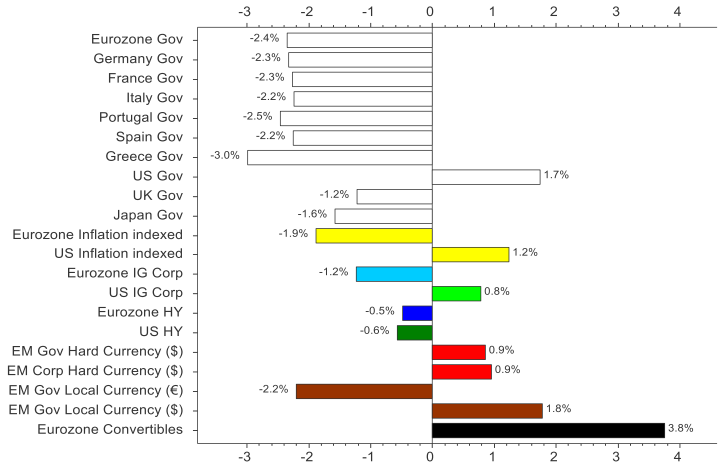
12/03/2025
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.70	33	1
Corporate bonds IG EUR	3.37	87	-4
Corporate bonds IG USD	5.24	94	15
Corporate bonds HY EUR	5.78	297	6
Corporate bonds HY USD	7.50	313	51
Emerging government bonds in hard currency	6.82	251	16
Emerging corporate bonds in hard currency	6.44	219	19
Emerging government bonds in local currency	6.36	228	2

12/03/2025
Source: Refinitiv Datastream, Bloomberg

Returns

OVER ONE MONTH



Source: LSEG Datastream, 13/03/2025 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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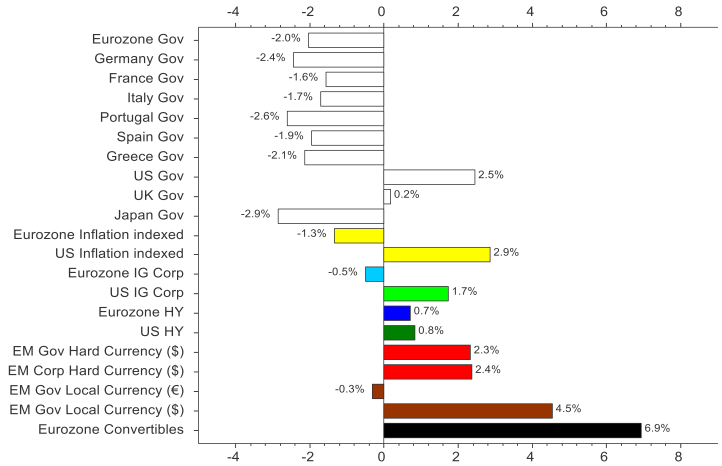

Source: LSEG Datastream, 13/03/2025 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

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