SEPTEMBER 2023

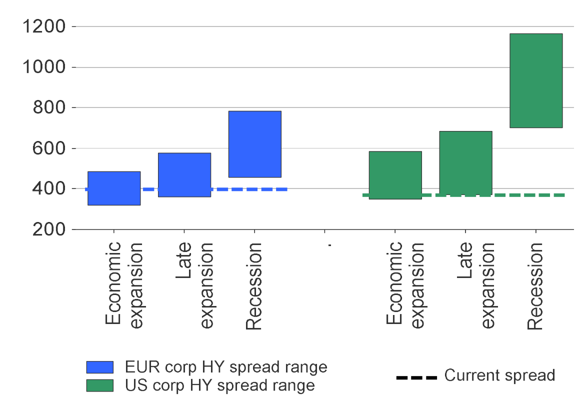
Fixed Income Focus

Summary

1. **Peak policy rates?** Eurozone and US central bankers have been softening their stance as growth has weakened sharply. Their ambition to continue hiking rates seems to have translated into maintaining rates at restrictive levels for a sustained period. We think that both the ECB and the Fed have finished hiking rates and will maintain rates at current levels for several quarters (3.75% for the ECB deposit rate and 5.50% for the Fed). We expect rate cuts in Q2 2024 for the Fed and in Q3 2024 for the ECB.
2. **German government bonds:** we expect German rates to remain range-bound over the next 12 months. Our 12-month target for the 10-year yield is 2.50%. We keep a Neutral view on German government bonds.
3. **US assets: the good ones and the dangerous one.** We think that we are at the end of the range for US long-term interest rates. This opens up opportunities given that the main driver for expected returns is the yield's starting point. Plus, we expect long-term rates to drop as the economy weakens. We thus see value in US government bonds, including maturities up to 10 years, US inflation-linked bonds, Agency Mortgage-Backed Securities and US investment grade corporate bonds. However, we do not recommend US high yield corporate bonds as valuations are stretched.
4. **Other opportunities in Fixed Income:** we are Positive on UK gilts, as well as European and US investment grade corporate bonds with a duration of up to 5 years in EUR and 10 years in USD. We are also Positive on Emerging Market bonds in hard and local currency.

Contents

OUR STUDY OF THE HISTORIC SPREAD RANGE UNDER THREE ECONOMIC REGIMES SUGGESTS THAT THE SPREADS OF HIGH YIELD CORPORATE BONDS ARE TOO TIGHT



Source: LSEG Datastream, BNP WM, 07/09/2023

Writing completed on 7 September.

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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

Restrictive policy for longer

European Central Bank (ECB)

A tough spot: the ECB is in a tricky situation, having to deal with persistent high inflation (headline and core inflation above 5%) and weak economic growth at the same time.

Dovish: several dominant ECB members softened their stance recently, citing risk for growth and arguing that inflation should slow in coming months for both goods and services.

No more rate hikes: we think that the ECB will keep rates on hold from now on, at 3.75% for the deposit rate and 4.25% for the main refinancing rate. We believe that the ECB will achieve its inflation goal by maintaining rates at current restrictive levels for several quarters as policy transmission is working.

No rate cuts this year: we do not envisage any rate cuts before Q3 2024.

US Federal Reserve (Fed)

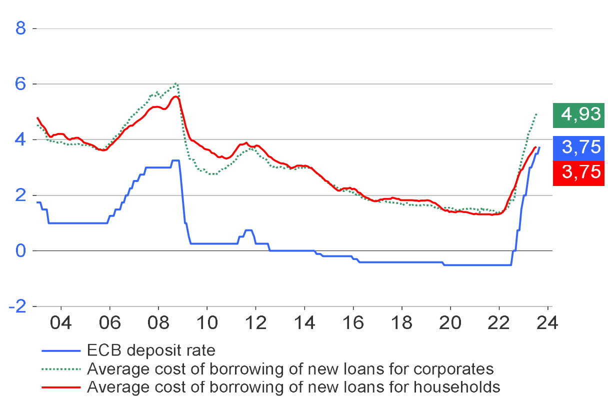
Soft landing? The economy has not collapsed despite the massive increase in policy rate. The labour market has only just started to cool. Inflation has dropped to 4.2% (July Personal Consumption Expenditure data).

The key question is no longer about how much tightening is needed but rather for how long the policy rate should remain high. Most policymakers appear confident that the current policy stance is sufficiently restrictive to lower inflation to target.

Peak rate has been reached is our view: we think that the Fed is done with its rate tightening cycle and will keep rates on hold for several quarters.

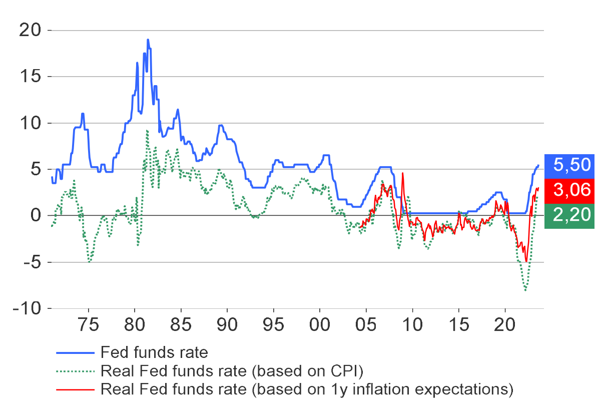
No rate cuts this year: we don't see any rate cuts before Q2 2024 as the Fed will want to avoid a loosening of financial conditions.

ECB POLICY TRANSMISSION IS WORKING: THE COST OF BORROWING FOR NEW LOANS HAS SURGED



Source: LSEG Datastream, 07/09/2023

THE FED USUALLY HIKES UNTIL REAL FED FUNDS RATE TURNS POSITIVE



Source: LSEG Datastream, juil. 23

INVESTMENT CONCLUSION

Eurozone and US central bankers have been softening their stance as growth has weakened sharply. Their ambition to continue hiking rates seems to have translated into maintaining rates at restrictive levels for a sustained period. We think that both the ECB and the Fed have finished hiking rates and will maintain rates at current levels for several quarters (3.75% for the ECB deposit rate and 5.50% for the Fed). We expect rate cuts in Q2 2024 for the Fed and in Q3 2024 for the ECB.

Bond yields

Long-term rates at cycle highs

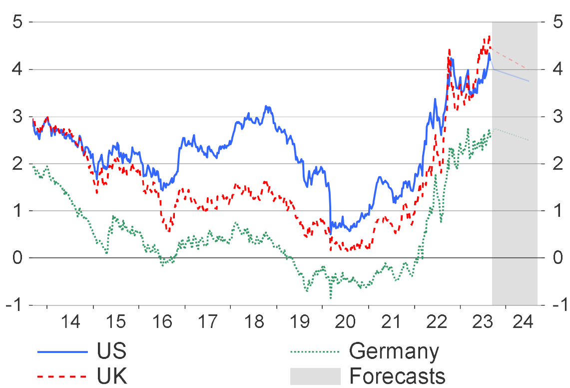
Big moves: long-term rates have surged in the past two months, especially in the US, due to the combination of resilient economic growth, elevated supply coming to market in the summer when liquidity is thinner, and less demand for US Treasuries from Japanese and Chinese investors.

Peak? It seems to us that the 10-year yield has reached a cyclical high in the US and perhaps as well in Germany. Further bond supply and/or an acceleration of capital repatriation from Japanese and Chinese investors could prove us wrong, but that risk seems limited.

US: we turned positive on US Treasuries, and we think it makes sense to add duration with maturities up to 10 years.

Germany: we remain Neutral on government bonds as the end of the ECB's tightening cycle, the risk of bond supply and the expected economic recovery in 2024 could be reasons for rates to remain range-bound over the next 12 months.

10-YEAR RATES



Source: LSEG Datastream, 08/09/2023

	Maturity (in years)	06/09/2023	12-month target
United States	2	5.03	3.50
	5	4.44	3.7
	10	4.30	3.75
	30	4.37	4
Germany	2	3.12	2.25
	5	2.66	2.50
	10	2.66	2.50
	30	2.77	2.60
United Kingdom	2	5.23	3.60
	5	4.81	3.65
	10	4.54	3.65
	30	4.79	4

Source: LSEG Datastream, BNP Paribas WM

Investment Conclusion

We think that US long-term rates are at cycle highs. We see new opportunities in US government bonds, including maturities up to 10 years. We stick to a Neutral view for German government bonds as we expect German interest rates to remain range-bound over the next 12 months.

Theme in Focus

US assets: the good ones and the dangerous one

The rate backdrop: US long-term rates have surged in the past two months, and reached a 14-year high. With both inflation and the labour market cooling, and economic growth weakening, US long-term rates are set to drop. We do not expect a spectacular drop since the Fed is unlikely to cut rates aggressively. Still, some long-term US assets will benefit.

The first good one: US government bonds. We see new opportunities in US government bonds, including maturities up to 10 years. The main driver for expected return is the yield starting point. With a 10-year yield at 4.3% and the potential for it to drop, we see some value in US Treasuries.

The second good one: US TIPS. We also like US inflation-linked bonds (TIPS). With the real 10-year yield currently trading at 2.0%, a level last seen 14 years ago, TIPS investors can finally earn income while holding a hedge against a potential surprise in inflation.

The third good one: US Agency mortgages. We see an opportunistic buying opportunity as valuations are cheap. The average spread trades wide compared to history. Those bonds yield 5.2%, are government-guaranteed and have defensive features: low historic volatility and less correlation with equities than corporate bonds.

The fourth good one: US corporate investment grade (IG) bonds. The average spread is tight but we are not worried at this stage because bond supply is being well absorbed. As time passes and the economic slowdown is felt more, investors will increase their exposure to IG corporate bonds to the detriment of high yield.

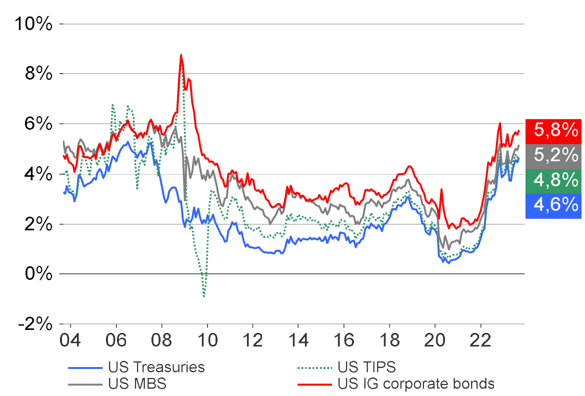
The dangerous one: US corporate high yield bonds. The average spread has tightened to very low levels, inconsistent with the economic cycle in our view. It no longer compensates for the increasing risks ahead such as the expected economic slowdown and defaults moving back to historical averages.

ASYMMETRY IN 12-MONTH EXPECTED TOTAL RETURNS FOR US GOVERNMENT BONDS

	Expected 12-month total return given a change in interest rates				
	-0.5%	-0.25%	no change	+0,25%	+0,5%
2-year Treasury	5.9%	5.4%	5.0%	4.5%	4.0%
5-year Treasury	6.6%	5.5%	4.4%	3.3%	2.2%
10-year Treasury	8.4%	6.3%	4.3%	2.3%	0.3%
30-year Treasury	13.2%	8.7%	4.4%	0.3%	-3.5%

Source: LSEG Datastream, BNP Paribas WM

MANY DEFENSIVE BONDS OFFER ELEVATED YIELDS IN THE US



Source: LSEG Datastream, 08/09/2023

Investment Conclusion

We think that we are at the end of the range for US long-term interest rates. This opens up opportunities given that the main driver for expected returns is the yield's starting point. Plus, we expect long-term rates to drop as the economy weakens. We thus see opportunities in US government bonds, including maturities up to 10 years, US inflation-linked bonds, Agency MBS and US investment grade corporate bonds. However, we do not recommend US high yield corporate bonds as valuations are stretched.

Our Investment Recommendations

Asset class	Zone	Our opinion	
Government bonds	Germany	=	Neutral on German sovereign bonds.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United States	+	Positive on US government bonds.
Corporate bonds Investment Grade	Eurozone United States	+	• Eurozone: Positive opinion. Prefer a duration lower to that of the benchmark (5 years) • US: Positive opinion. Prefer duration up to 10 years • Positive on convertible bonds in the eurozone.
Corporate bonds High Yield	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angels* 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 (bp)	Spread change 1 month (bp)
United States	4.30	---	
Germany	2.66	---	
France	3.19	54	-3
Italy	4.41	175	7
Spain	3.71	105	-1
Portugal	3.41	76	0
Greece	3.99	133	3

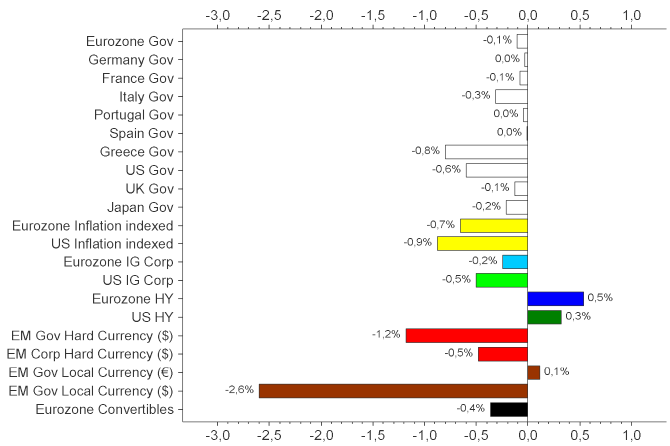
06/09/2023
Source: LSEG Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	4.05	49	1
Corporate bonds IG EUR	4.44	156	7
Corporate bonds IG USD	5.81	120	2
Corporate bonds HY EUR	7.99	429	-1
Corporate bonds HY USD	8.56	371	-19
Emerging government bonds in hard currency	8.29	376	4
Emerging corporate bonds in hard currency	7.81	306	-9
Emerging government bonds in local currency	6.51	207	16

06/09/2023
Source: LSEG Datastream, Bloomberg

Returns

OVER ONE MONTH



Source: LSEG Datastream, 07/09/2023 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

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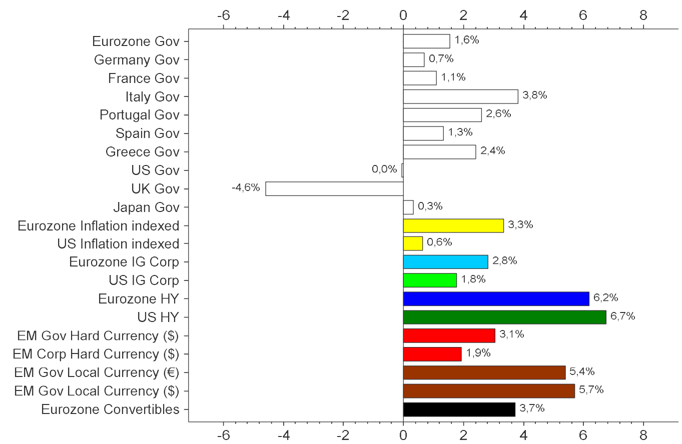

Source: LSEG Datastream, 07/09/2023 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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