JULY 2024

Fixed Income Focus

Summary

1. **Monetary policy: decoupling and prudence.** The ECB struck a hawkish tone at its annual forum, while the Fed sounded dovish. Both central banks will base their upcoming monetary policy decisions on incoming data. We expect two more rate cuts from the ECB (in September and December) and only one from the Fed (in September). In 2025, we expect three rate cuts in the eurozone and four in the US.

2. **Politics have been driving rate markets, but at some point, monetary policy will take over.** We expect the US 10-year yield to fall to 4.25% over the next 12 months, while the German equivalent should reach 2.25%. We are Positive on US government bonds and Neutral on German government bonds. We favour intermediate maturities (up to 10 years) in Germany, and we prefer to wait before adding duration in the US (3-5 years for now).

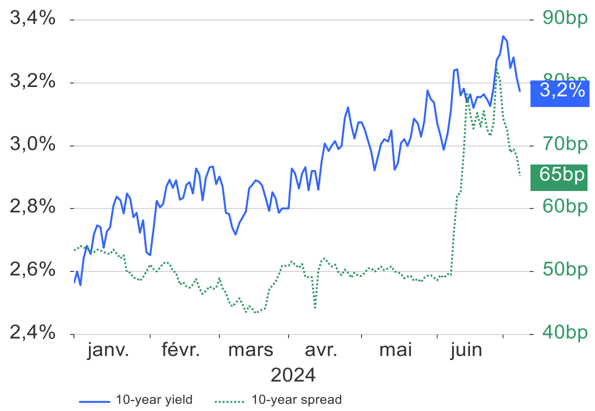
3. **French political risk has receded. We stay Neutral on French government bonds.** The 10-year OAT-bund spread is unlikely to return to the pre-election range of 45-55bp. We expect it to trade in a range of 55-70bp in the medium term.

4. **Theme in focus: EM hard currency bonds.** Fundamentals are improving. Yields are elevated. Supply is likely to fall in 2H24. Financing needs look manageable, and EM sovereigns are finding new financing channels. In addition, falling interest rate volatility and an expected lower dollar should support EM bonds. We are Positive on EM hard currency bonds.

5. **Opportunities in Fixed Income:** we are Positive on US Treasuries, US inflation-linked bonds, US Agency Mortgage-Backed Securities, UK gilts, as well as European and US investment grade corporate bonds. We are also Positive on Emerging Market bonds in hard and local currency.

Contents

BOTH YIELD AND SPREAD HAVE FALLEN BACK IN FRANCE FOLLOWING THE OUTCOME OF THE LEGISLATIVE ELECTIONS



Source: LSEG Datastream, 08/07/2024

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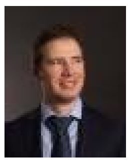


Central banks

Decoupling and prudence

European Central Bank (ECB)

Policy rates: The small drop in headline eurozone inflation in June suggests that though the overall trend remains disinflationary, price pressures in the eurozone are sticky. Underlying pressures remain stubborn, as core inflation was constant. At the ECB's annual forum, President Lagarde once again emphasised the importance of studying the drivers of inflation (wages-productivity-profit) and remarked that inflation is "heading in the right direction" even if the road is likely to be "bumpy" until the end of the year. We forecast a 25bps rate cut in September and December and 3 more in 2025. Future rate cuts depends on incoming data and Fed's decision. We forecast the end of the rate cut cycle at the end of 2025, when the deposit rate reaches 2.50%.

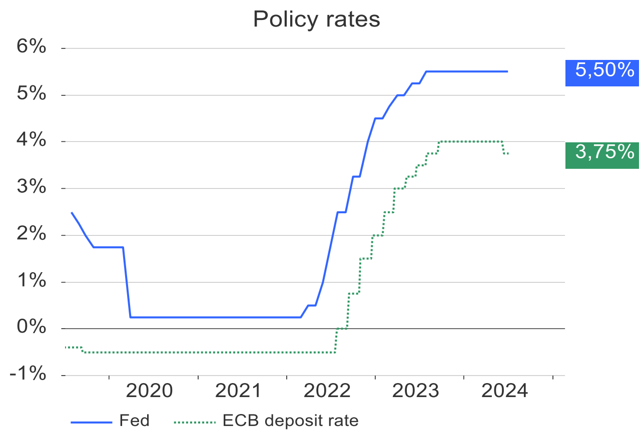
Balance sheet management: the ECB has two bond portfolios resulting from QE. It started to reduce the APP portfolio in March 2023 and the PEPP in July 2024. The goal is to withdraw policy accommodation and reduce its market footprint.

US Federal Reserve (Fed)

Policy rates: At the ECB's annual forum, President Powell sounded dovish as he stresses that inflation was making "quite a bit of progress". However, he would not commit to a specific date for a rate cut. Powell believes there is a risk of waiting too long, but more data is needed to give the committee the confidence to cut rates. In the meantime, the June job report shows a cooling off, and that restrictive policy is taking its toll on economic growth. We believe that the Fed will gain enough confidence in the disinflation process to cut rates by 25bps in September, and we expect four 25bps cuts in 2025 and two in 2026, bringing the Fed funds rate down to 3.75%.

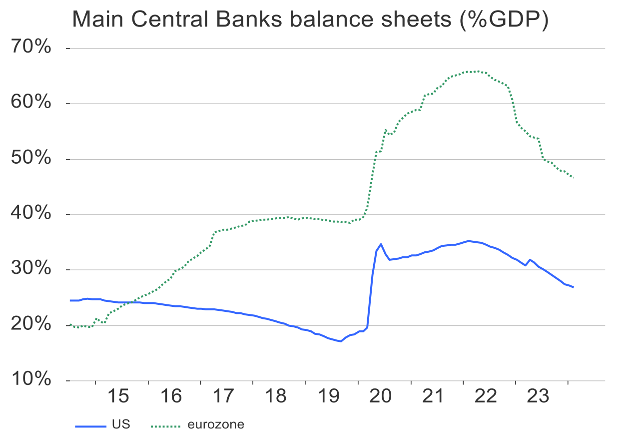
Balance sheet management: the Fed's balance sheet has been shrinking at a slower pace than before since 1 June. The idea is to allow the Fed to continue QT for longer while reducing the risk of a spike in long-term interest rates.

POLICY DECOUPLING ON POLICY RATES



Source: LSEG Datastream, juin 24

BALANCE SHEET MANAGEMENT



Source: LSEG Datastream, Q1 24

INVESTMENT CONCLUSION

The ECB struck a hawkish tone at its annual forum, while the Fed sounded dovish. Both central banks will base their upcoming monetary policy decisions on incoming data. We expect two more rate cuts from the ECB (in September and December) and only one from the Fed (in September). In 2025, we expect three rate cuts in the eurozone and four in the US.

Bond yields

When politics drive rate markets

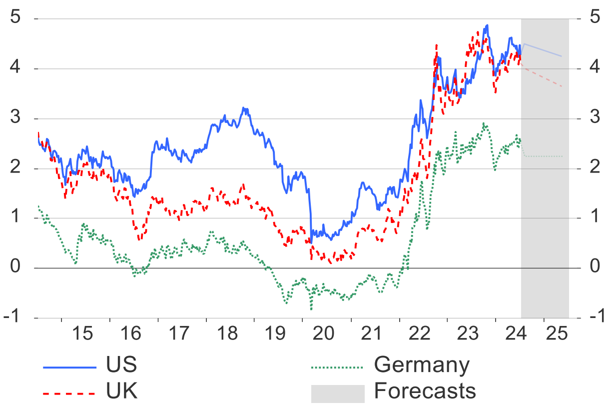
Rate markets have been volatile following recent political surprises in France and the US.

In France, the outcome of the second round of legislative elections has provided temporary relief to the market as the tail risk of an extreme party wining has been removed. The market is pricing in a scenario of a broad coalition or a technocratic government. The 10-year OAT-bund spread is unlikely to return to the pre-election range of 45–55bp. We expect it to trade in a range of 55–70bp in the medium term.

In the US, interest rates have moved higher following the US presidential debate, Biden's disappointing performance, and his 20% overnight drop in betting markets.

Once the dust has settled in France, attention will turn to the 2025 budget and the US elections. We can expect volatility and temporary upward pressure on interest rates, but eventually the dominant force should be downward as both the Fed and the ECB cut rates.

10-YEAR RATES



Source: LSEG Datastream, 09/07/2024

	Maturity (years)	08/07 2024	3-month target	12-month target
USA	Policy rate	5.50	5.25	4.75
	2	4.63	4.75	4.25
	5	4.24	4.50	4.25
	10	4.28	4.50	4.25
	30	4.46	4.75	4.40
Germany	Policy rate	3.75	3.50	2.75
	2	2.91	2.50	2.25
	5	2.53	2.25	2.25
	10	2.52	2.25	2.25
	30	2.70	2.40	2.50
UK	Policy rate	5.25	5.00	4.25
	2	4.13	4.00	3.50
	5	3.97	4.00	3.50
	10	4.12	4.00	3.65
	30	4.62	4.30	4.00

Source: Refinitiv Datastream, BNP Paribas WM

INVESTMENT CONCLUSION

We are Positive on US government bonds and Neutral on German government bonds. We favour intermediate maturities (up to 10 years) in Germany, and we prefer to wait before adding duration in the US (3-5 years for now). We stay Neutral on French government bonds. We expect the 10-year OAT-bund spread to trade in a 55–70bp range in the medium term.

Theme in Focus

EM hard currency bonds

EM hard currency bonds have performed well so far this year, with a gain of 2.3%, largely driven by the outperformance of EM high yield (HY) bonds (+6.0%) while EM investment grade (IG) bonds have been broadly flat (+0.2%). In fact, carry was the main driver of the asset class's performance. High carry provides protection against adverse movements such as higher US rates and wider spreads.

The average yield is high (7.1%), above the 20-year average of 6.0%. EM IG bonds yield 5.6% and EM HY bonds yield 9.8%.

The spread on EM hard currency bonds has widened in response to three elections in quick succession over the past month (leaving more risk premium in Mexico, while South Africa and India have retraced as the dust has settled) and in response to rising volatility generated by developed market geopolitical risks, including the French elections and the US presidential debate.

However, the move was relatively contained thanks to easy US financial conditions and expectations of looser monetary policy. EM spreads should narrow thanks to robust activity indicators (PMIs) and lower interest rate volatility. The widening of EM spreads, especially among high-beta names, offers opportunities to buy on dips, in our view.

EM debt fundamentals are improving, contrasting with a more challenging fiscal picture in DM. Debt-to-GDP ratios are significantly higher in DM than EM and have risen faster in DM than EM. Many EM countries have improved primary balances. EM rating trends are broadly improving, with sovereign upgrades outnumbering downgrades by 24 this year (including outlook/watch changes), while corporate trends are also positive outside of China.

The dollar outlook and technicals look favourable. We expect a lower dollar. Issuers frontloaded given the health of the primary market and the US election. Financing needs look manageable and supply likely to decline in 2H24.

THE AVERAGE YIELD ON EM HARD CURRENCY BONDS IS HIGH

Source: LSEG Datastream, 08/07/2024

EM HARD CURRENCY BONDS COULD OFFER 8+% TOTAL RETURN IF SPREAD TIGHTEN TO OUR TARGET

							Current & Target			
							▼			
		EMBI Global		US 7-year yield						
				3,5	3,75	4	4,25	4,5	4,75	5
		Spread	500	0,1	-1,6	-3,2	-4,9	-6,6	-8,3	-9,9
			450	3,5	1,8	0,1	-1,6	-3,2	-4,9	-6,6
			400	6,8	5,2	3,5	1,8	0,1	-1,6	-3,2
Current	→		350	10,2	8,5	6,8	**5,2**	3,5	1,8	0,1
Target	▶		300	13,5	11,9	10,2	**8,5**	6,8	5,2	3,5
			250	16,9	15,2	13,5	11,9	10,2	8,5	6,8
			200	20,2	18,6	16,9	15,2	13,5	11,9	10,2

Source: BNP Paribas WM, LSEG Datastream

Investment Conclusion

Fundamentals are improving. Yields are elevated. Supply is likely to fall in 2H24. Financing needs look manageable, and EM sovereigns are finding new financing channels. In addition, falling interest rate volatility and an expected lower dollar should support EM bonds. We are Positive on EM hard currency bonds.

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 and US TIPS.
Corporate bonds Investment Grade	Eurozone United States	+	• Eurozone and US: Positive opinion. Prefer maturities up to 7 years in the US and up to 10 years in the eurozone • 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	4,28	---	
Germany	2,52	---	
France	3,17	65	16
Italy	3,89	137	3
Spain	3,31	79	1
Portugal	3,13	61	0
Greece	3,58	106	1

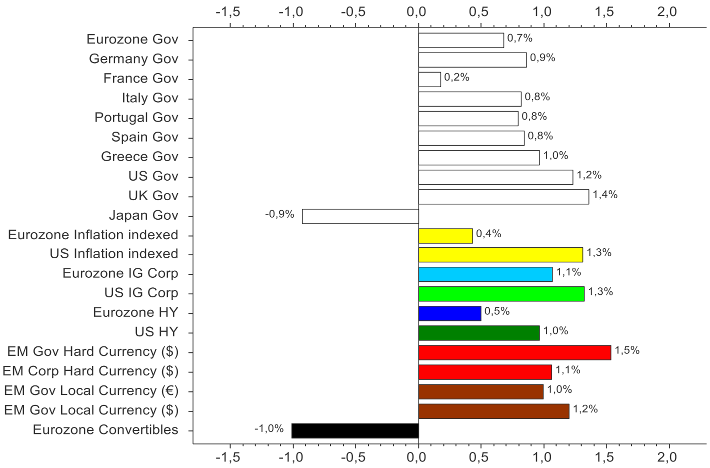
08/07/2024
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3,84	38	1
Corporate bonds IG EUR	3,74	107	-2
Corporate bonds IG USD	5,34	89	1
Corporate bonds HY EUR	6,64	343	25
Corporate bonds HY USD	7,84	311	8
Emerging government bonds in hard currency	7,63	322	-1
Emerging corporate bonds in hard currency	6,63	212	0
Emerging government bonds in local currency	6,55	232	-7

08/07/2024
Source: Refinitiv Datastream, Bloomberg

Returns

OVER ONE MONTH



Source: LSEG Datastream, 08/07/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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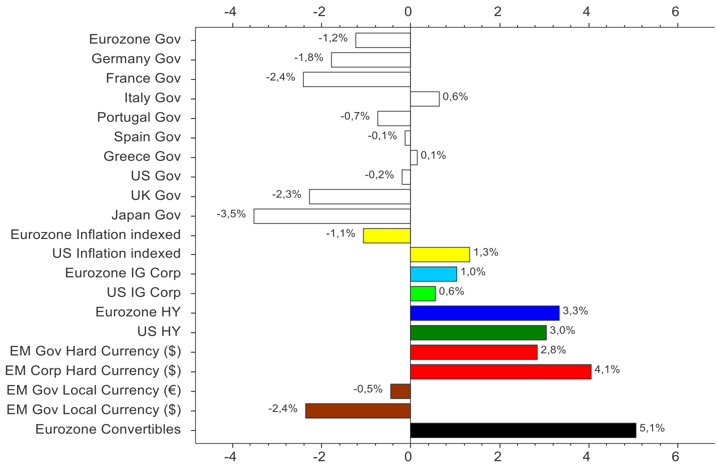

Source: LSEG Datastream, 08/07/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

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