OCTOBER 2023

Fixed Income Focus

Summary

1. **Central banks have switched their views** from the willingness to hike rates more to the willingness to keep rates at current restrictive levels for a longer period than forecasted. Rising oil prices reinforces that new narrative but are unlikely to cause either the Fed or ECB to hike further in our view. We think that the Fed and the ECB have reached their end-of-cycle rates. The next phase is a long pause. Then, rate cuts, that we foresee in June 2024 for the Fed and in September 2024 for the ECB.

2. **Bond sell off.** Long-term bond yields have been rising sharply on the back of central bank's "restrictive policy rates for longer" message, fiscal concerns and rising oil prices. Long-term bond yields are probably at cycle highs. We are Positive on US government bonds as they offer an elevated carry and potential price appreciation if the recession hits in Q1-Q2 2024 as we expect. We stay Neutral on German government bonds. German yields are lower than US yields, hence, if interest rate rise more, the expected return is not as attractive for German government bonds versus US Treasuries.

3. **The credit cycle calls for defensive carry.** We believe we currently are in late cycle of the Expansion regime. There is a little but growing concern that we may move quite soon to the next regime, the credit Downturn. Hence, we prefer to position carefully. We focus on defensive carry. We like investment grade corporate bonds in the eurozone and the US. We are Neutral on high yield bonds, despite elevated yields. Credit spreads on high yield bonds are very tight and are likely to widen if the recession hits as we expect, in Q1-Q2 2024. Better entry point will emerge then.

4. **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 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.

Writing completed on October 3rd.

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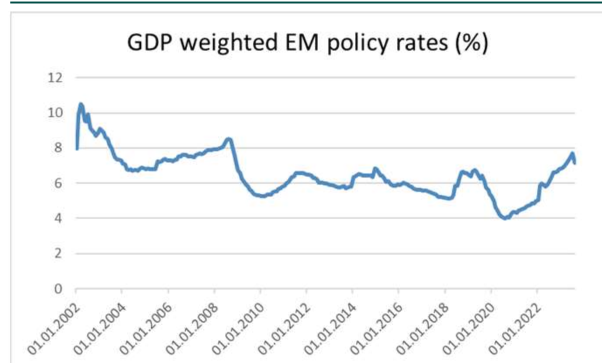
CENTRAL BANKS IN EMERGING MARKETS HAVE ENDED THEIR RATE HIKE CYCLE ON AVERAGE



Source: Bank for International Settlements, BNP Paribas WM

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Central banks

Restrictive monetary policy for longer

European Central Bank (ECB)

September meeting: the ECB hiked rates again (to 4% for the deposit rate) as the staff revised higher its near-term headline inflation forecast.

Concerning: the ECB downgraded sharply its growth forecasts in every year through 2025, suggesting the rate hikes are inflicting pain to the economy and that the economy may not withstand more.

ECB guidance: policymakers seemed comfortable enough to believe that no more rate hikes will be needed.

Our view: we expect the ECB to keep rates on hold at current restrictive levels for a sustained period to keep financial conditions tight and allow inflation to decelerate. As inflation drops, real policy rates will become too restrictive, and the ECB will be able to cut rates. We foresee 100bp of rates cuts from September 2024 to mid-2025.

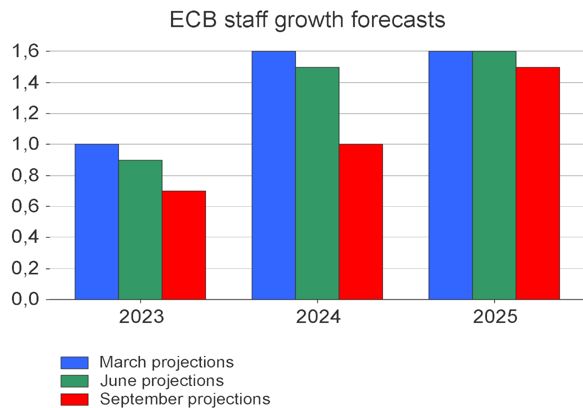
US Federal Reserve (Fed)

September meeting: the Fed left rates unchanged as widely expected, but surprised markets with the hawkish revisions of economic projections and potential future evolution of the policy rate.

The Fed plan? The Fed signaled borrowing costs will likely stay high for longer than expected. Most members believe one more 25bp rate hike could be appropriate this year. They foresee only 50bp of rate cuts next year (versus 100bp projected in June).

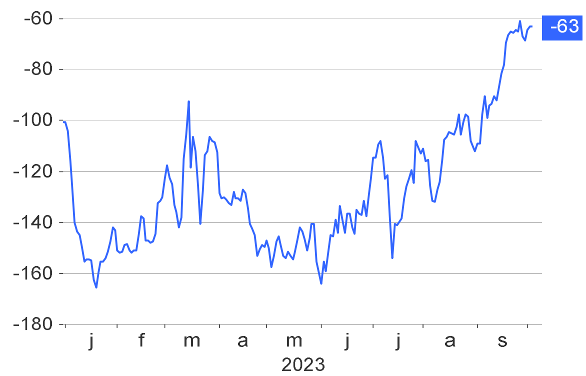
Our view: while the Fed believes there is a decent chance for a soft landing, we think a recession is in the cards for Q1-Q2 2024. Hence, the Fed will likely keep rates on hold (even more so if there is a government shutdown as some economic data won't be available) and start cutting rates in June 2024 to normalize monetary policy. We foresee 225bp of rates cuts from June 2024 to mid-2025.

THE SHARP REVISION TO GROWTH AND THE DROP OF THE EURO INDICATE THAT THE ECB IS OVERTIGHTENING



Source: LSEG Datastream, 28-09-18

THE MARKET EXPECTS AROUND 60BP RATE CUTS IN 2024. IT WAS 160BP FOUR MONTHS AGO!



Source: LSEG Datastream, 04-10-23

INVESTMENT CONCLUSION

Central banks have switched their views from the willingness to hike rates more to the willingness to keep rates at current restrictive levels for a longer period than forecasted. Rising oil prices reinforces that new narrative but are unlikely to cause either the Fed or ECB to hike further in our view. We think that the Fed and the ECB have reached their end-of-cycle rates. The next phase is a long pause. Then, rate cuts, that we foresee in June 2024 for the Fed and in September 2024 for the ECB.

Bond yields

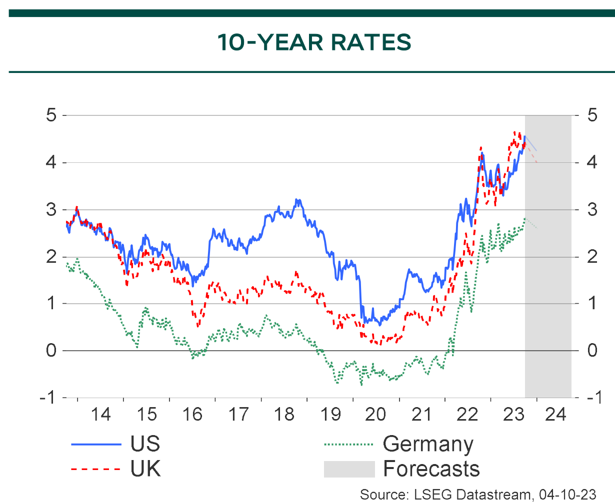
Long-term rates at cycle highs

New cycle highs: the first wave of higher long-term bond yields was driven by fundamentals (notably stronger-than-expected growth, central banks expectations, rising inflation expectations). The second wave that is currently occurring is more of a technical nature (higher term premium, higher bond supply, positioning with a substantial reduction in long positions and hedging technicals).

Have long-term bond yields reached a peak? We think that the bulk of the rise has already occurred. Long-term bond yields may trade range bound in the next quarter as the central banks' theme "restrictive for longer" is still at play. After that, bond yields are likely to drop as there should be more evidence about the upcoming recession in the US.

Buy long-term bonds? We are Positive on US government bonds but not yet on German government bonds (Neutral view). Since bonds yields are lower in Germany than in the US, there is more chance of a negative expected return on German bonds if bond yields were to overshoot more.

10-YEAR RATES



	Maturity (in years)	29/09 2023	3-month target	12-month target
United States	2	5.06	4.75	3.50
	5	4.63	4.60	3.7
	10	4.58	4.25	3.75
	30	4.70	4.5	4
Germany	2	3.30	3	2.25
	5	2.92	2.85	2.50
	10	2.97	2.60	2.50
	30	3.13	2.90	2.60
United Kingdom	2	4.93	4.25	3.60
	5	4.58	4.20	3.65
	10	4.49	4	3.65
	30	4.90	4.30	4

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

Long-term bond yields are at cycle highs. We are Positive on US government bonds as they offer an elevated carry and potential price appreciation if the recession hits in Q1-Q2 2024 as we expect. We stay Neutral on German government bonds. German yields are lower than US yields, hence, if interest rate rise more, the expected return is not as attractive for German government bonds versus US Treasuries.

Theme in Focus

The credit cycle calls for defensive carry

Credit is a cycle asset class. Understanding how the cycle evolves and defining where Credit stands in the different regimes is important. It leads to higher returns than a buy-and-hold strategy.

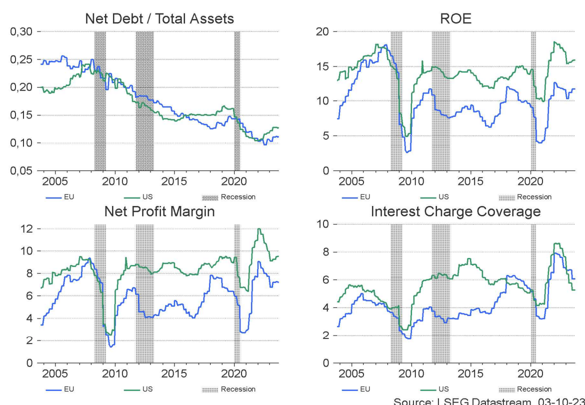
The credit cycle can be divided into four regimes. Each have a different risk/reward profile: 1/Repair, when bonds rally, 2/Recovery, when bonds offer low but steady and positive return, 3/Expansion, which is the turning point, and 4/Downturn, the bear market.

How it works? When credit spreads are wide, risk aversion is also high, and the economy weakens. Central banks react by easing policy, corporates by deleveraging and investors by de-risking portfolios. As a result, credit risk declines and spreads tighten. When credit spreads are tight, risk appetite is high, and the economy strengthens. Central banks tighten policy, corporates increase leverage and investors re-risk portfolios. Hence, credit risk increases and spreads widen. And the cycle is complete.

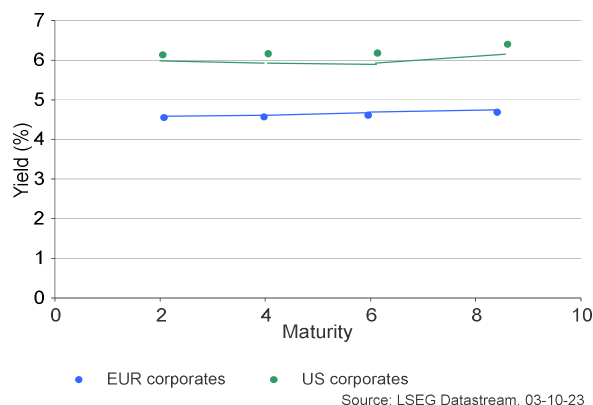
Where are we? We believe we currently are in late cycle of the Expansion regime. It's a phase when credit conditions are tight but fundamental risk is still low, as corporate fundamentals are sound but deteriorating. We've been in that phase for the last 23 months. The historical average is 18 months. Hence, there is a little but growing concern that we may move quite soon to the next regime, the credit Downturn.

Where to invest? We prefer to position carefully. We focus on defensive carry. We like investment grade corporate bonds (average yield around 4.7% in the eurozone and around 6.0% in the US). We are Neutral on high yield bonds, despite elevated yields. Credit spreads on high yield bonds are very tight and are likely to widen if the recession hits as we expect, in Q1-Q2 2024. Better entry point will emerge then.

CORPORATE FUNDAMENTALS ARE SOUND BUT DETERIORATING



EUR AND US CORPORATE BOND YIELD CURVES



INVESTMENT CONCLUSION

We believe we currently are in late cycle of the Expansion regime. There is a little but growing concern that we may move quite soon to the next regime, the credit Downturn. Hence, we prefer to position carefully. We focus on defensive carry. We like investment grade corporate bonds in the eurozone and the US. We are Neutral on high yield bonds, despite elevated yields. Credit spreads on high yield bonds are very tight and are likely to widen if the recession hits as we expect, in Q1-Q2 2024. Better entry point will emerge then.

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: 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	4.58	---	
Germany	2.97	---	
France	3.54	57	4
Italy	4.92	195	29
Spain	4.06	110	7
Portugal	3.75	78	6
Greece	4.51	154	22

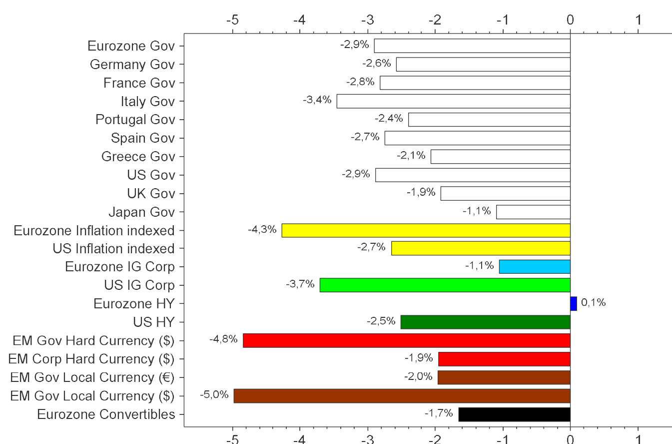
29/09/2023
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	4.25	50	1
Corporate bonds IG EUR	4.66	154	-3
Corporate bonds IG USD	6.03	120	2
Corporate bonds HY EUR	8.19	426	-13
Corporate bonds HY USD	8.91	398	21
Emerging government bonds in hard currency	8.68	390	11
Emerging corporate bonds in hard currency	8.02	309	-8
Emerging government bonds in local currency	6.82	219	38

29/09/2023
Source: Refinitiv Datastream, Bloomberg

Returns

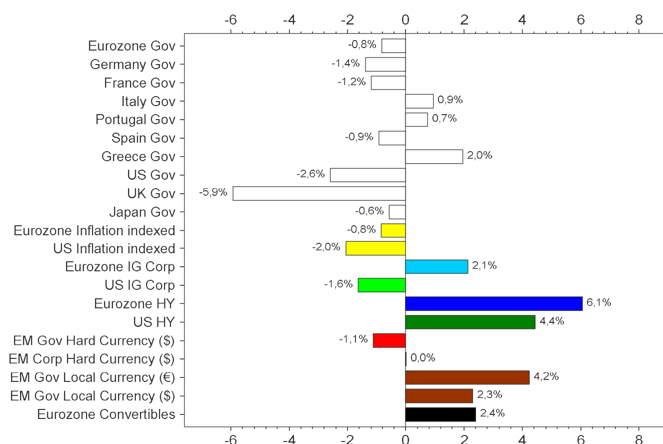
OVER ONE MONTH



Source: LSEG Datastream, 03-10-23 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

SINCE 01/01/2023



Source: LSEG Datastream, 03-10-23 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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