Fixed Income Focus

Summary

1. **The plan is to cut rates in June** unless macroeconomic data consistently surprise to the upside, which we think is unlikely. Both the ECB and the Fed want to gain more confidence in the path of inflation before cutting rates. We forecast 4 cuts (of 25bps each) in the US and 3 in the eurozone this year, compared with 3.6 and 3.9 priced in by the market.
2. **Long-term bond yields should fall in Q2 and Q3, and could find some support in Q4.** We are Positive on US government bonds and Neutral on German government bonds. We expect the US 10-year yield to fall to 4% in 12 months' time and the German equivalent to 2.25%. For the time being, we prefer short maturities (2-3 years) in the US, and we extended maturities up to 10 years in the eurozone
3. **High short-term rates won't last forever:** Short-term EUR and USD rates are high, so instruments such as short-term deposits appear to be very low-risk, high-reward opportunity. However, there is one crucial caveat: reinvestment risk. The forwards markets are pricing in 3-month EUR and USD rates to fall by more than 50% in 4 years' time. It is therefore expected to be more rewarding to buy and hold a medium-term investment grade corporate bond than to enjoy the high short-term rates and roll them at falling rates.
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. We are also Positive on Emerging Market bonds in hard and local currency.

Drafting completed on 11 March

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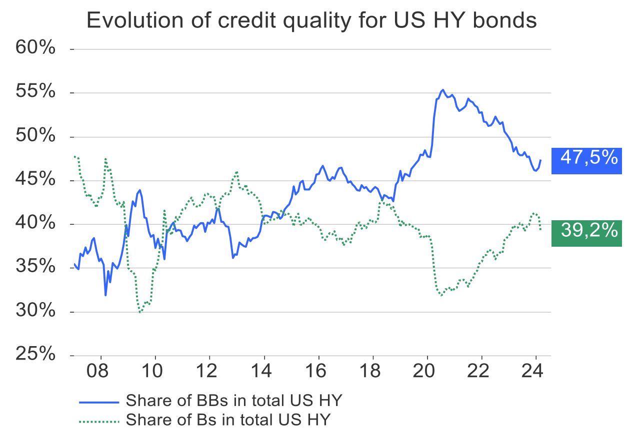
THE US HIGH YIELD CREDIT QUALITY HAS BEEN DETERIORATING SINCE MID-2020



Source: LSEG Datastream, 11/03/2024

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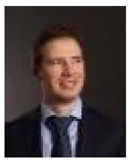


BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

The plan is to cut rates in June

European Central Bank (ECB)

Not yet: the ECB forecasts that inflation will reach its 2% target in the medium term (2026), and sees a narrowing of the range between the measures it uses. However, policymakers are not confident enough to cut rates yet, citing wage growth as still too hot and corporate profit margins.

Wage growth has fallen from its peak to 4.5% for Q4 2023. The move is encouraging. The next data will be released on 23 May, and should provide the additional confidence the ECB is looking for.

Corporate profit margins: the ECB expects growth in profit margins to compress significantly this year.

Our view: we continue to believe that the ECB will cut rates in June, and that there will be 3 rate cuts (of 25bps each) this year. Our view is more cautious than what the market is pricing in (3.9 rate cuts this year). We expect another 3 rate cuts in 2025 (2.6 priced in), taking the key ECB rate to its natural rate of 2.5% by the end of 2025.

US Federal Reserve (Fed)

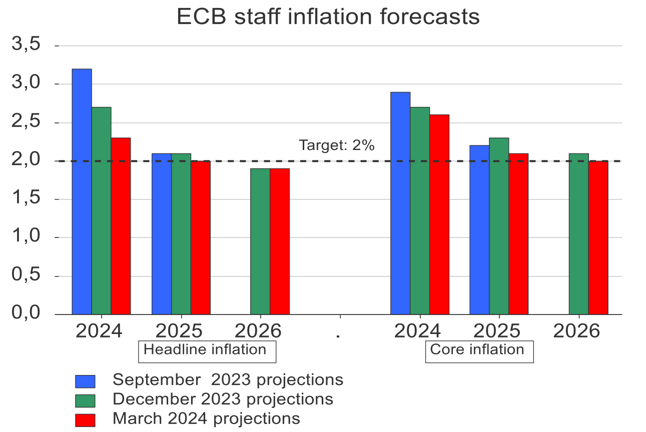
Doubts: traders have significantly dialled back their expectations for rate cuts, from a high of 7 to 3.5 for this year, on the back of a more resilient economy than expected. Some market participants are becoming more dovish, calling for no rate cuts and hedging against rate hikes.

Two facts: 1/real policy rates are currently high and higher than the Fed expected in its December projections. 2/in the past 19 cycles, only once (1984) has the Fed started a hike or a cut cycle less than 6 months before the election.

Our view: the Fed is likely to gain the desired confidence in the inflation path next month, allowing it to cut rates this year. We forecast 4 rate cuts of 25bps each in 2024, with the first in June. We expect a further 4 cuts in 2025 and 3 in 2026, bringing the Fed funds rate down to the neutral rate of 2.75%.

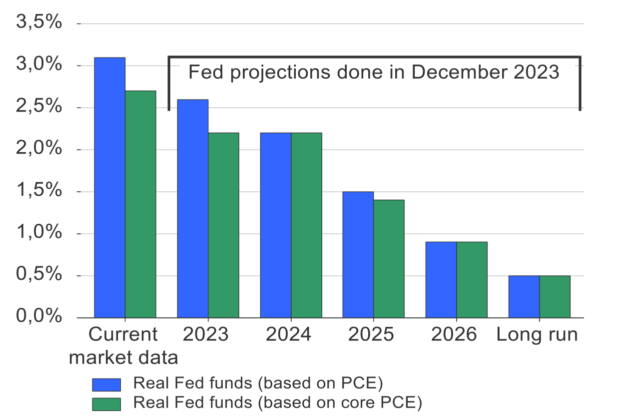
Balance sheet management: we forecast the Fed to slow the reduction of its balance sheet from April.

INFLATION IS EXPECTED TO MOVE TO TARGET ACCORDING TO THE ECB STAFF PROJECTIONS



Source: LSEG Datastream, 28/09/2018

CURRENT REAL FED FUNDS RATE ARE CURRENTLY TOO HIGH COMPARED TO FED PROJECTIONS



Source: LSEG Datastream, 31/01/2024

INVESTMENT CONCLUSION

While the resilient macro data confirm that there is no rush to cut rates, both the Fed and the ECB are likely to cut rates this year. Indeed, inflation is falling, so real policy rates are rising. We expect both central banks to make their first cut in June. We forecast 4 cuts in the US (of 25bps each) and 3 in the eurozone this year, compared with 3.6 and 3.9 priced in by the market.

Bond yields

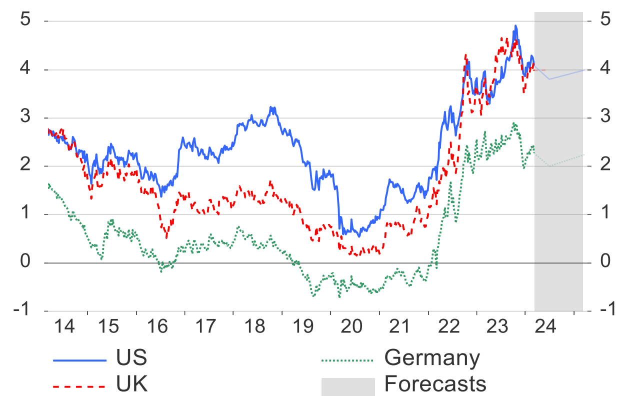
Long-term rates at cycle highs

Stronger-than-expected macroeconomic data and the reluctance of central banks to cut rates prematurely have pushed up the US and German bond yields by around 40bps since the beginning of the year.

In the US: while the market's pricing of central banks should have stabilised, the expected increase in bond supply and the recent weakness in long-term Treasury auctions could prevent the US 10-year yield from falling in March. We therefore prefer short maturities (2-3 years) in US government bonds. We remain Positive on the asset class given the attractive expected returns.

In the eurozone: we were confident about extending maturities up to 10 years as the 10-year bund reached 2.5% at the end of February. Bond supply has been historic, with volumes exceeding €500bn in the first two months of 2024, and demand has been 5.2 times higher on average, the highest bid-to-cover ratio on record. In terms of recommendations, we are Neutral on German bonds. Expected returns are positive, but other asset classes offer better value in our view.

10-YEAR RATES



Source: LSEG Datastream, 12/03/2024

	Maturity (years)	08/03 2024	3-month target	12-month target
USA	Policy rate	5.50	5.25	4.25
	2	4.48	4.25	3.50
	5	4.05	4	3.75
	10	4.09	3.80	4
	30	4.26	4.25	4.25
Germany	Policy rate	4	3.75	3
	2	2.74	2.50	2.25
	5	2.28	2.25	2.25
	10	2.27	2	2.25
	30	2.43	2.25	2.50
UK	Policy rate	5.25	5	4
	2	4.25	4	3.60
	5	3.91	4	3.65
	10	3.98	4	3.65
	30	4.41	4.30	4

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

We are Positive on US government bonds and Neutral on German government bonds. We expect the US 10-year yield to fall to 4% in 12 months' time and the German equivalent to 2.25%. For the time being, we prefer short maturities (2-3 years) in the US, and we extended maturities up to 10 years in the eurozone.

Theme in Focus

High short-term rates won't last forever

Short-term interest rates have soared since central banks embarked on one of the fastest rate-hiking cycles in history. Investors can now earn an average of 4.1% on a 3-month deposit in EUR and 5.4% in USD, according to the Refinitiv index. While this may seem like a very low-risk, high-reward opportunity, there is a crucial caveat: reinvestment risk.

Indeed, once the deposits mature, investors will have to reinvest the principal at the prevailing market rate, which, based on current pricing of forward rate pricing, could be significantly lower than the current rate. In fact, as of 7 March, the 3-month EUR rate, at 3.9%, is priced to fall to 2.2% in 1 year and 1.9% in 2 years. The same downward trend is seen in the dollar: the current 3-month rate of 5.4% is priced to fall to 4.0% in 1 year and 3.7% in 2 years.

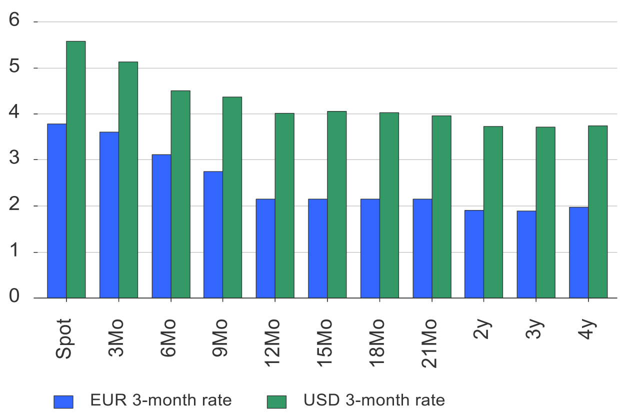
So the question is whether it is more rewarding to enjoy the high short-term rates and roll them at falling rates, or to buy and hold an equivalent medium-term bond.

The maths is clear: if you buy a €100,000 3-month deposit and reinvest the proceeds every 3 months for 4 years, you will earn around €9,200 in coupons, considerably less than the €15,700 you would get by buying and holding a 4-year corporate bond. The same conclusion can be drawn for an investment in USD. Rolling a 3-month deposit over 4 years would generate about $20,300 worth of coupons, compared to $21,900 from a 4-year corporate bond.

Admittedly, this is a based on current forward rates, which are likely to move over time, but in our view, the downward trend in bond yields is here to stay so the numbers may vary, but the conclusion should stand.

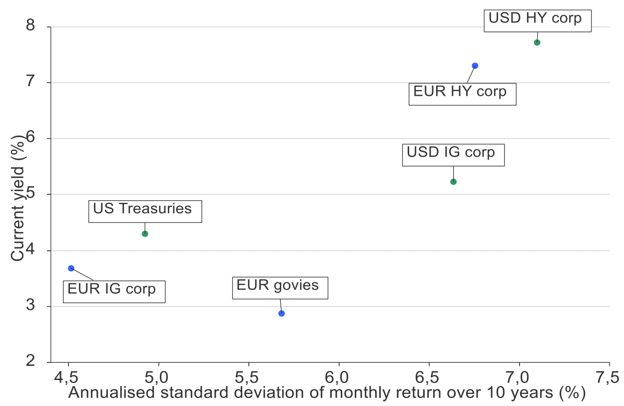
Admittedly, corporate bonds do carry volatility and credit risks– the chance that the issuer will default. But the volatility has been low and the 40-year average default rate for an EUR investment-grade bond is 0.3%, and 0.9% for its USD equivalent. Therefore, by focusing on investment-grade bonds issued by financially sound companies, investors can significantly reduce this risk while still reaping the reward of locked-in high yields.

THE 3-MONTH RATES ARE EXPECTED TO DECLINE SHARPLY ACCORDING TO FORWARDS PRICINGS



Source: LSEG Datastream, 08/03/2024

IG CORPORATE BONDS OFFER AN ATTRACTIVE YIELD FOR AN AVERAGE LOW VOLATILITY OF RETURNS



Source: LSEG Datastream, 08/03/2024

Investment Conclusion

Short-term EUR and USD rates are high, so instruments such as short-term deposits appear to be very low-risk, high-reward opportunity. However, there is one crucial caveat: reinvestment risk. The forwards markets are pricing in 3-month EUR and USD rates to fall by more than 50% in 4 years' time. It is therefore expected to be more rewarding to buy and hold a medium-term investment grade corporate bond than to enjoy the high short-term rates and roll them at falling rates.

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 longer maturities in the eurozone (up to 7 years). • US: Positive opinion. Prefer short maturities (<5 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	4.09	---	
Germany	2.27	---	
France	2.72	45	-7
Italy	3.58	131	-28
Spain	3.08	81	-14
Portugal	2.93	66	-6
Greece	3.19	92	-11

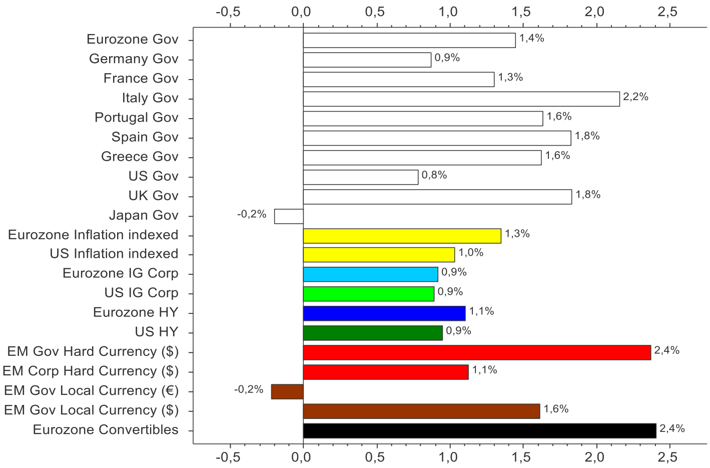
08/03/2024
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.67	39	-3
Corporate bonds IG EUR	3.68	120	-11
Corporate bonds IG USD	5.23	95	0
Corporate bonds HY EUR	7.30	348	3
Corporate bonds HY USD	7.72	314	-7
Emerging government bonds in hard currency	7.77	353	-9
Emerging corporate bonds in hard currency	6.77	242	-9
Emerging government bonds in local currency	6.17	212	-1

08/03/2024
Source: Refinitiv Datastream, Bloomberg

Returns

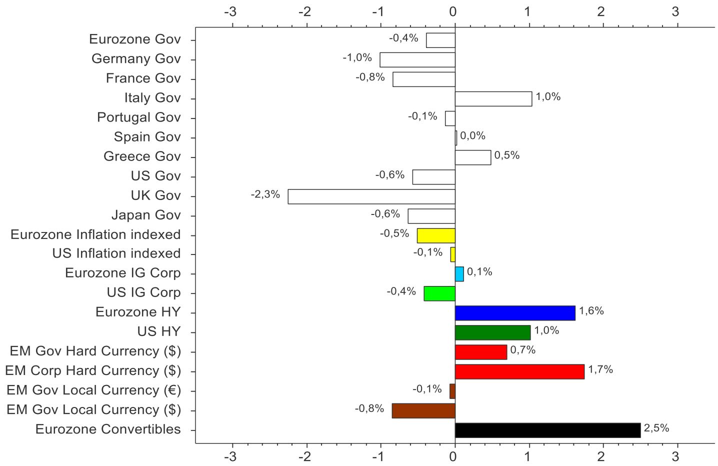
OVER ONE MONTH



Source: LSEG Datastream, 08/03/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

SINCE 01/01/2024



Source: LSEG Datastream, 08/03/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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