Fixed Income Focus

Summary

1. **Markets are too excited about rapid rate cuts:** we think central banks will cut rates 1-2 months later than the market is pricing. We anticipate the Fed to cut rates by 150bps this year, starting in May, and the ECB to follow suit with 75bps from June, along with the Bank of England with 100bps of rate cuts from June. We think markets are way too optimistic by expecting the ECB to cut rates by 150bps this year.

2. **The other challenge for central banks is the management of their balance sheet:** central banks will need to revise their plans for quantitative tightening. Indeed, rate cuts and quantitative tightening don't go along. Quantitative tightening tightens financial conditions by reducing the amount of money available, countering the stimulative effect of rate cuts.

3. **The short-term correction in government bonds may not be over yet:** we anticipate a year divided into two halves, expecting bond yields to rise in Q1 due to high bond supply before retracing to more or less current levels by year-end. Tactical investors may want to wait then, but long-term investors should continue to take advantage of current yields, with a preference for short-term durations. Strategically, we maintain a Positive stance on US Treasury bonds and a Neutral view on German sovereign bonds. Our 12-month targets for 10-year yields are 4% in the US and 2.25% in Germany.

4. **Why we like EM bonds, in both hard and local currency:** we believe we are at a point in the economic and monetary cycles that is favourable for EM bonds. Additionally, yields are high, and the default outlook seems manageable. Both EM hard currency bonds and local bonds are expected to outperform this year in our view

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 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.

Drafting completed on 12 January

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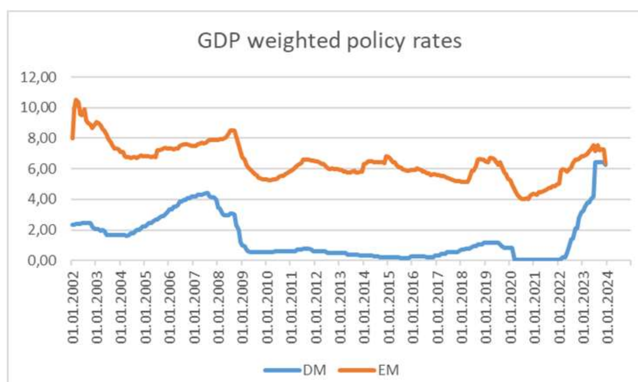
POLICY RATE CUTS HAVE ALREADY STARTED, LED BY EMERGING MARKETS



Source: BIS, BNPP WM

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Central banks

Rate cuts and quantitative tightening don't go along

European Central Bank (ECB)

Rate cuts: While policymakers acknowledged the progress made on inflation, they did not discuss rate cuts at the December meeting. In fact, the rapid pace of disinflation could slow down this year, and inflation varies significantly among eurozone countries.

Balance sheet management: the tapering of the PEPP portfolio that will start in July is quite cautious, but it adds up with significant TLTROs (loans to banks) reimbursements to be made in 2024 (EUR 491bn) and the ongoing reduction of the APP portfolio. Overall, it's a drain on liquidity, with implications for global markets.

Our view: the ECB is traditionally more cautious than the Fed. With heterogeneous inflation among the members, the ECB is likely to be patient. We expect a much more modest amount of rate cuts than the market forecast (75bps vs. 150bps), with the first rate cut expected in June 2024, leading to a deposit rate of 3.25% by year-end.

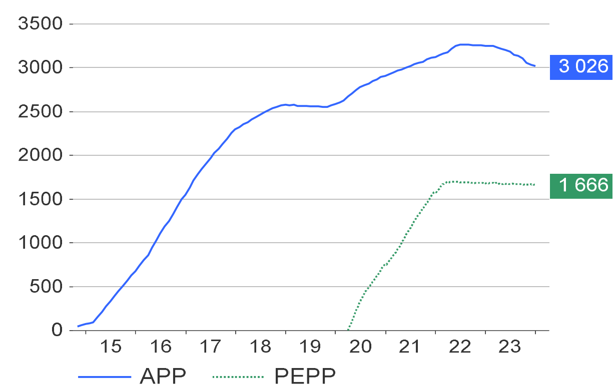
US Federal Reserve (Fed)

Rate cuts: the Fed's unexpected pivot at the December FOMC meeting sparked a year-end rally. It seemed like Powell supported the market's anticipation of 130bps in rate cuts for 2024 (equivalent to more than 5 rate cuts). Some policymakers pedalled back on Powell's comments.

Balance sheet management: quantitative tightening (QT) is progressing smoothly. The Fed is currently reducing its balance sheet at a rate of approximately $80 billion per month ($60bn in Treasuries and $20 bn in MBS). The Fed's overnight reverse repo facility, reflecting excess cash in the system, has declined from $2500 billion to $800 billion and could potentially reach zero in H2 2024, necessitating a reduction in QT from April in our view.

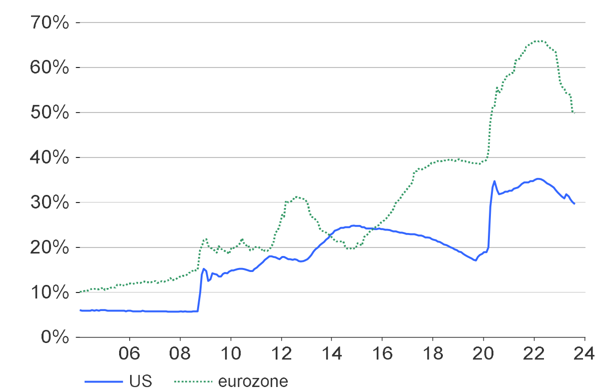
Our view: we think the Fed will be able to cut rates from May as inflation decelerates. We expect 25bps of rate cuts at each meeting, so 150bps in 2024 and Fed funds at 4% by year-end.

THE ECB HAS BEEN REDUCING THE SIZE OF ITS APP PORTFOLIO AND WILL START WITH THE PEPP PORTFOLIO IN JULY (EUR BN)



Source: LSEG Datastream, déc. 23

CENTRAL BANKS ' BALANCE SHEETS ARE STILL VERY LEVERAGED COMPARED TO PRE-COVID PERIOD (% GDP)



Source: LSEG Datastream, Q3 23

INVESTMENT CONCLUSION

Rate cuts are coming in 2024 as inflation is decelerating. We anticipate the Fed to cut rates by 150bps, starting in May 2024, and the ECB to follow suit with 75bps from June. Central banks will need to revise their plans for quantitative tightening. Indeed, rate cuts and quantitative tightening don't go along. Quantitative tightening tightens financial conditions by reducing the amount of money available, countering the stimulative effect of rate cuts.

Bond Yields

Long-term rates to trade range-bound in 2024

The rebound: the Fed triggered a sharp drop in bond yields at the end of 2023. Long-term bond yields reached levels we considered too low, likely prompting central bankers to react due to excessively softened financial conditions. While maintaining a positive stance on US Treasuries given their high yield, we shifted our preference to short-term durations.

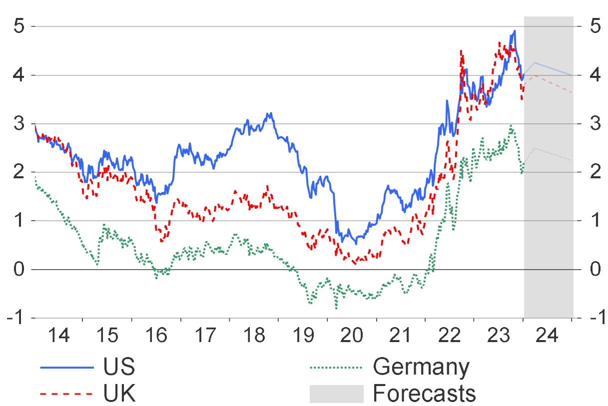
In the next few months, we think long-term bond yields have room to grind modestly higher due to higher term premium as investors demand compensation for the record bond supply to come in Q1. In the US, we suspect the US Treasury could announce an additional round of auction increases at the February refunding. In Europe, we anticipate bond supply, net of quantitative tightening, to remain historically high. Tactical investors may want to wait then, but long-term investors should continue to take advantage of current yields.

In 12 months time, we see 10-year yields retracing back to around current levels, with targets of 4% in the US and 2.25% in Germany.

	Maturity (years)	11/01 2024	3-month target	12-month target
USA	Policy rate	5.50	5.50	4
	2	4.26	4.25	3.50
	5	3.90	4.25	3.75
	10	3.98	4.25	4
	30	4.18	4.50	4.25
Germany	Policy rate	4	4	3.25
	2	2.63	2.50	2.25
	5	2.16	2.50	2.25
	10	2.21	2.50	2.25
	30	2.43	2.80	2.60
UK	Policy rate	5.25	5.25	4.25
	2	4.25	4.50	3.60
	5	3.76	4.20	3.65
	10	3.84	4	3.65
	30	4.44	4.30	4

Source: Refinitiv Datastream, BNP Paribas WM

10-YEAR RATES



Source: LSEG Datastream, 12/01/2024

INVESTMENT CONCLUSION

We anticipate a year divided into two halves, expecting bond yields to rise in Q1 due to high bond supply before retracing to more or less current levels by year-end. Tactical investors may want to wait then, but long-term investors should continue to take advantage of current yields, with a preference for short-term durations. Strategically, we maintain a Positive stance on US Treasury bonds and a Neutral view on German sovereign bonds. Our 12-month targets for 10-year yields are 4% in the US and 2.25% in Germany.

Theme in Focus

Why we like EM bonds, in both hard and local currency

Favourable growth outlook: while we expect US growth to slow down, we see growth picking up in Emerging Markets (EM), along side a rangy trend in China. We expect growth in Asia and Central and Eastern Europe to catch up with pre-pandemic trends, while Latin America is set to outperform. Typically, favourable growth prospects lead to tighter spreads for EM bonds.

Favourable inflation outlook: inflation is projected to continue declining, albeit unevenly, settling around the upper bound of central banks' targets. By year-end, we anticipate some EM countries (Indonesia, Brazil, South Africa, India, and Chile) to approach their inflation targets, while others are expected to reach this milestone in 2025, except for Poland.

Central bank rate cuts: favourable inflation trends should enable certain central banks to cut rates to neutral by year-end for some countries and by the end of 2025 for most. Egypt and Turkey, in our view, are exceptions (expecting rate hikes) due to persistently high inflation. On average, we anticipate slightly more rate cuts for EM than what the market is currently pricing, presenting a tailwind for EM bonds valuations.

Weaker dollar: we expect the dollar to weaken as the Fed cuts rates this year, bolstering EM finances. This could also prompt larger inflows into EM local debt, given its strong correlation with the direction of the USD.

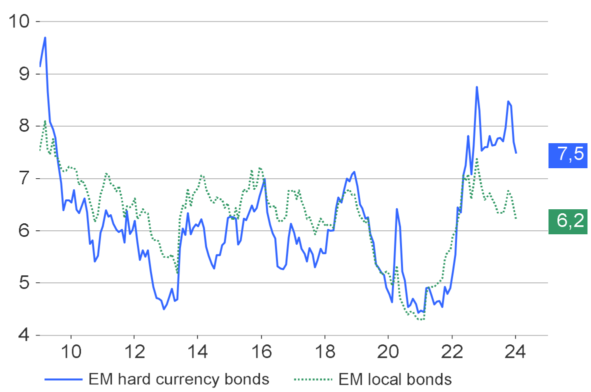
High carry, with quality: EM bonds in hard currency offer a 7.5% yield, and EM local bonds yield 6.2%. A higher initial yield enhances the likelihood of generating total returns. Although this EM yield level is comparable to US high yield bonds (7.8%), only 48% of EM bonds consist of high yield issuers, with the remainder being investment grade.

Manageable default risk: the peak in rating downgrades and default activity likely lies behind us. Current distressed countries include Argentina, Pakistan, and Tunisia, with defaults already factored into prices.

Decorrelation: EM local bonds have low correlation to Developed Market bonds.

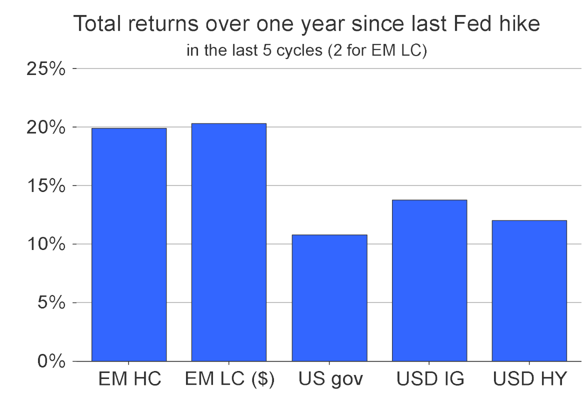
Favourable historical pattern: EM debt typically outperforms other asset classes at the end of the Fed tightening cycle.

EM YIELDS ARE HIGH (%)



Source: LSEG Datastream, 12/01/2024

EM DEBT TYPICALLY OUTPERFORMS AT THE END OF THE FED TIGHTENING CYCLE



Source: LSEG Datastream, 11/01/2024

Investment Conclusion

We believe we are at a point in the economic and monetary cycles that is favourable for EM bonds. Additionally, yields are high, and the default outlook seems manageable. Both EM hard currency bonds and local bonds are expected to outperform this year in our view.

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).
	USA	+	Positive on US government bonds.
Government bonds Investment Grade	Eurozone USA	+	• Eurozone: Positive opinion. We prefer a shorter duration than the benchmark (5 years). • US: Positive opinion. We prefer a duration less than 10 years. • Positive on convertible bonds in the eurozone
Government bonds High Yield	Eurozone and USA	=	• Neutral on HY bonds. • Positive on *fallen angels* and *rising stars.*
Emerging bonds	In hard currency	+	Positive on EM bonds in hard currency (sovereign and corporate).
	In local currency	+	Positive on government bonds in local currency.

Market Data

	10 -year rate (%)	Spread (bps)	Spread change 1 month (bps)
USA	3.98	---	
Germany	2.21	---	
France	2.74	53	-2
Italy	3.82	162	-18
Spain	3.16	96	-7
Portugal	2.95	75	-5
Greece	3.30	109	-10

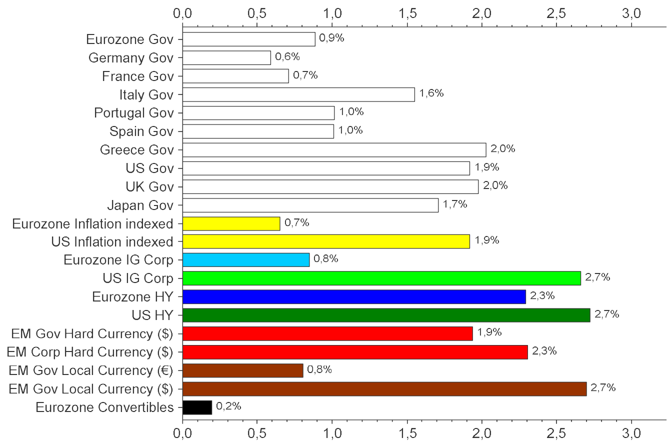
11/01/2024
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	3.61	43	-3
Corporate bonds IG EUR	3.77	140	-5
Corporate bonds IG USD	5.13	97	-8
Corporate bonds HY EUR	7.05	361	-53
Corporate bonds HY USD	7.76	337	-27
Emerging government bonds in hard currency	7.86	374	5
Emerging Corporate bonds in hard currency	6.97	280	-6
Emerging government bonds in local currency	6.20	230	-24

11/01/2024
Source: Refinitiv Datastream, Bloomberg, JP Morgan

Returns

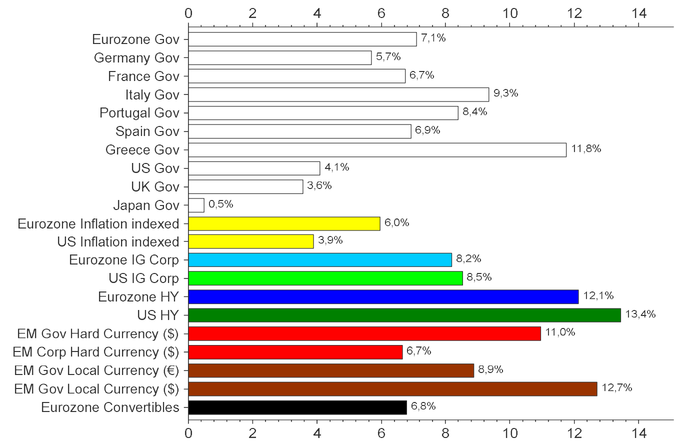
OVER ONE MONTH



Source: LSEG Datastream, 11/01/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

IN 2023



Source: LSEG Datastream, 29/12/2023 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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