FEBRUARY 2024

Fixed Income Focus

Summary

1. **Central banks are not in a rush to cut rates** given the absence of material economic slowdown. As inflation drops, real policy rates have increased and are becoming too restrictive. Central banks will therefore cut rates to engineer a soft landing for the economy. Recent stronger-than-expected data will delay the rate-cutting cycle in the US. We now anticipate the Fed to cut rates by 100bps this year (150bps previously), starting in June (May previously). We continue to think that the ECB will cut rates by 75bps this year, from June.
2. **The short-term correction in government bonds may not be over yet:** bond yields have started to adjust to central bankers' pushback against early rate cuts, and have moved higher. Tactical investors should not exclude the possibility of modestly higher long-term bond yields in the next few weeks or months. Hence, we prefer short term durations. Strategically, considering the 1-year expected returns, we maintain a Positive stance on US government bonds and a Neutral view on German government bonds. Our 12-month targets for 10-year yields are 4% in the US and 2.25% in Germany.
3. **AT1 financial bonds are back in fashion:** investors have shifted focus, with UBS's AT1 oversubscribed issue, marking a notable event, given what happened a year ago. With an average yield of 7.8% and cheap valuations compared to high yield corporate bonds, AT1s remain attractive on average, but are very risky, not suitable for all investors, and require careful credit analysis especially if the issuer has an exposure to the commercial real estate sector.
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 short duration. We are also Positive on Emerging Market bonds in hard and local currency.

Drafting completed on 15 February

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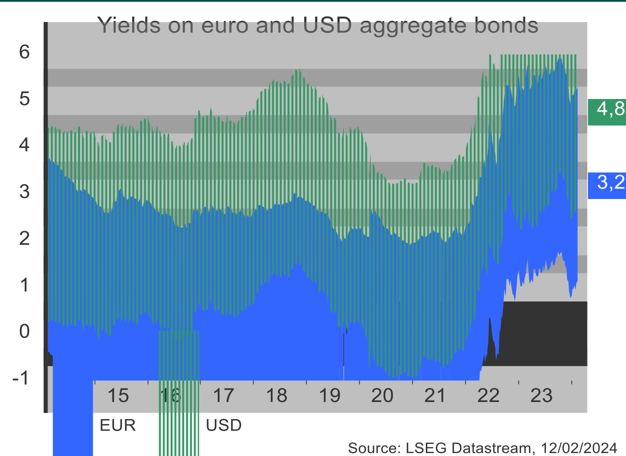
RISING BOND YIELDS SINCE THE START OF THE YEAR GIVE INVESTORS A SECOND CHANCE TO LOCK IN HIGHER YIELDS



Source: LSEG Datastream, 12/02/2024

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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

Second soughts

European Central Bank (ECB)

Too early: while policymakers feel some satisfaction with the decline in inflation, they are not yet ready to cut rates. Prudence dominates, given the possible short-term flare up of inflation, as the Red Sea crisis could trigger supply chains disruptions, and services inflation remains sticky.

Encouraging: the ECB's latest Survey of Professional Forecasters points to a gradual decline in wage growth looking ahead and shows that long-term inflation is well anchored at 2%.

Our view: we doubt the ECB will deliver the 120bps that markets expect. We continue to anticipate 75bps of rate cut this year, with the first one in June, as policymakers wants to be reassured about the evolution of salaries and corporate profits, and those data are due after the April's policy meeting. Hence, we see the deposit rate of 3,25% by year-end. We foresee another 75bps of rate cuts in 2025, resulting in a policy rate of 2.5% at the end of the rate-cutting cycle.

US Federal Reserve (Fed)

Not so fast: at the December meeting, the Fed led markets to believe that rate cuts were imminent. But it has called for patience at the January meeting.

Data dependency: the Fed seeks greater confidence in the path of inflation before starting the rate-cutting cycle. There is no need for better data, just more data.

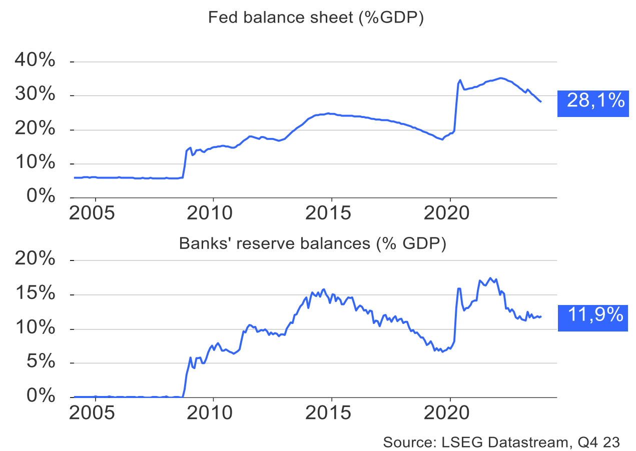
Real Fed funds matter: the Fed projected Fed funds rate at 2.2% in 2024 and 1.4% in 2025. Currently, real Fed funds are much higher (2.6%).

Our view: recent stronger-than-expected data (wages, January inflation) shall not derail the broad macro narrative (inflation to return to target, and job market to weaken) but will delay the rate-cutting cycle and invite policymakers to be more prudent. Hence, we now expect the Fed to start cutting rates in June (May previously) and we see 100bps of rate cuts this year (150bps previously). We expect the Fed to slow the reduction of its balance sheet from April.

MARKETS HAVE BEEN PRICING A SLIGHT RISE IN INFLATION, BUT INFLATION REMAINED WELL ANCHORED

Source: LSEG Datastream, 09/02/2024

FED BALANCE SHEET STILL LARGE BUT RESERVES ARE NOT FAR FROM OPTIMAL LEVEL (10-11% OF GDP)



Source: LSEG Datastream, Q4 23

INVESTMENT CONCLUSION

Central banks are not in a rush to cut rates given the absence of material economic slowdown. As inflation drops, real policy rates have increased and are becoming too restrictive. Central banks will therefore cut rates to engineer a soft landing for the economy. Recent stronger-than-expected data will delay the rate-cutting cycle in the US. We now anticipate the Fed to cut rates by 100bps this year (150bps previously), starting in June (May previously). We continue to think that the ECB will cut rates by 75bps this year, from June.

Bond yields

Long-term rates at cycle highs

Rollercoaster: long-term bond yields have fluctuated a lot in the past few months. Falling inflation data and renewed concerns about US regional banks have pushed bond yields. However; central banks pushing back early rate cuts and the resilience of the US job market have pushed bond yields higher.

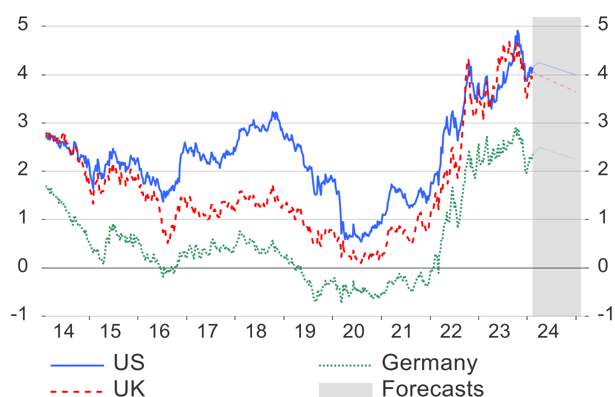
How might long-term bond yields evolve this year?

In Q1: long-term bond yields could grind modestly higher, alongside the reversal of the previous flight to quality move that was triggered by concerns on US regional banking system, macroeconomic data exceeding estimates and risk of bond supply.

In Q2-Q3: long-term bond yields could drop as central banks engage in the rate cutting cycle.

In Q4: rate volatility should increase ahead of the US election due to uncertainty about fiscal expansion and inflation, leading to a higher term premium and modestly higher long-term bond yields.

10-YEAR RATES



Source: LSEG Datastream, 09/02/2024

	Maturity (years)	12/02 2024	3-month target	12-month target
USA	Policy rate	5.50	5.50	4
	2	4.48	4.25	3.50
	5	4.13	4.25	3.75
	10	4.17	4.25	4
	30	4.37	4.50	4.25
Germany	Policy rate	4	4	3.25
	2	2.70	2.50	2.25
	5	2.31	2.50	2.25
	10	2.37	2.50	2.25
	30	2.56	2.80	2.60
UK	Policy rate	5.25	5.25	4.25
	2	4.55	4.50	3.60
	5	4.06	4.20	3.65
	10	4.06	4	3.65
	30	4.59	4.30	4

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

Tactical investors should not exclude the possibility of modestly higher long-term bond yields in the next few weeks or months. Hence, we prefer short term durations. Strategically, considering the 1-year expected returns, we maintain a Positive stance on US government bonds and a Neutral view on German government bonds.

Theme in Focus

AT1 financial bonds are back in fashion

Investors have definitely turned the page: a number of issuers have issued AT1 debt over the past few months, but it was the issue of UBS on 7 February that made some noise in the fixed income community. Firstly because it was oversubscribed 8 times (the USD 3.5bn offering attracted USD 36bn in demand) and secondly because of history. Remember that a year ago, the Swiss authorities took a very controversial decision to write off CHF 16bn of credit Suisse AT1s without a full depreciation of Credit Suisse shares. This triggered a loss of confidence in the market and the asset class fell 16% in a few days.

But what are AT1s? They are subordinated, perpetual bonds issued by European banks that can be called at the issuer's discretion 5 years after the issue date? AT1s offer high returns as investors are exposed to 3 types of risk. i)extension risk, if the issuer does not call the bond at the call date; ii)risk of non-payment of the coupon: iii)risk of loss of nominal value (partial or total) or conversion into ordinary shares if the bank has an urgent need of capital.

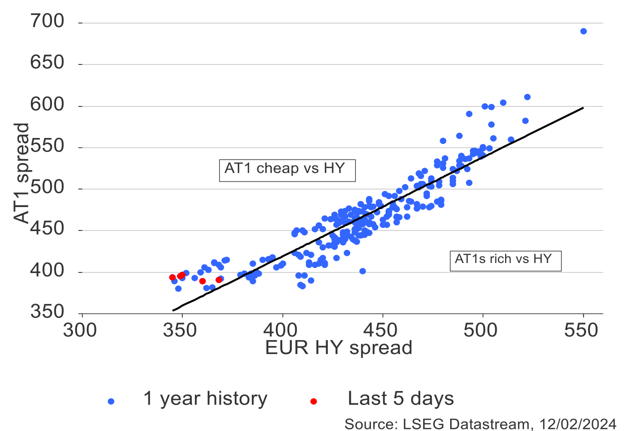
The recovery: the AT1 market suffered a significant loss of confidence in March 2023, but has since recovered. BNP Paribas SA was the first European bank to test the market with a dollar-denominated AT1 in June 2023, just 3 months after the collapse of Credit Suisse. The AT1 market regained value and closed 2023 with a performance of +3.5%. This positive momentum has continued into this year, with a performance of +1.2% as of 9 February, while EUR high yield corporate bonds are up 0.6% and EUR investment grade- corporate bonds are down 0.9%.

Attractive: on average, European banks have strong fundamentals and credit metrics could improve when the central bank begins the rate-cutting cycle. Therefore, the likelihood of converting the bond into equity is less likely. AT1s offer an average yield of 7.8% and a duration of 3.4 years. Although they are currently relatively expensive compared to their historical levels (spread at 391bps), they remain cheap relative to high yield bonds. Nevertheless, AT1 bonds are very risky, not suitable for all investors, and require a thorough credit analysis especially if the issuer has an exposure to the commercial real estate sector.

THE AVERAGE YIELD ON AT1S IS HIGH

Source: LSEG Datastream, 12/02/2024

AT1S TRADE RELATIVELY CHEAP VERSUS EUR HIGH YIELD BONDS



Source: LSEG Datastream, 12/02/2024

INVESTMENT CONCLUSION

AT1 financial bonds are back in vogue. Investors have shifted focus, with UBS's AT1 oversubscribed issue, marking a notable event, given what happened a year ago. With an average yield of 7.8% and cheap valuations compared to high yield corporate bonds, AT1s remain attractive on average, but are very risky, not suitable for all investors, and require careful credit analysis especially if the issuer has an exposure to the commercial real estate sector.

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. 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.
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	4,17	---	
Germany	2,37	---	
France	2,87	50	-3
Italy	3,92	155	-3
Spain	3,33	96	2
Portugal	3,08	72	-2
Greece	3,41	104	-7

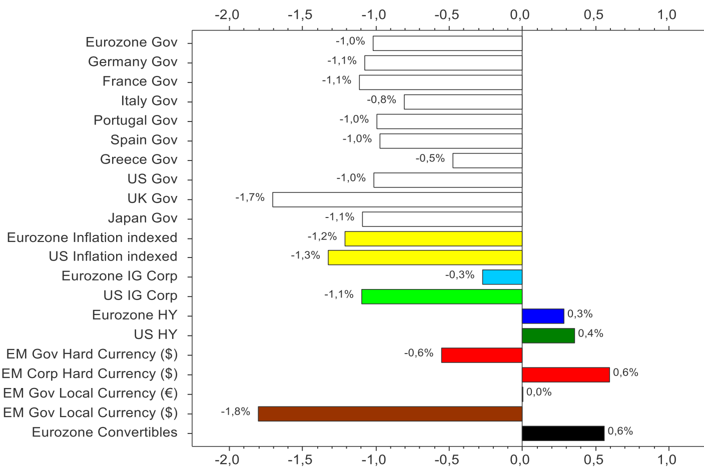
12/02/2024
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3,76	42	-1
Corporate bonds IG EUR	3,82	130	-10
Corporate bonds IG USD	5,31	96	-1
Corporate bonds HY EUR	7,90	360	-6
Corporate bonds HY USD	7,74	318	-20
Emerging government bonds in hard currency	7,93	363	-10
Emerging corporate bonds in hard currency	6,88	251	-29
Emerging government bonds in local currency	6,19	206	2

12/02/2024
Source: Refinitiv Datastream, Bloomberg

Returns

OVER ONE MONTH



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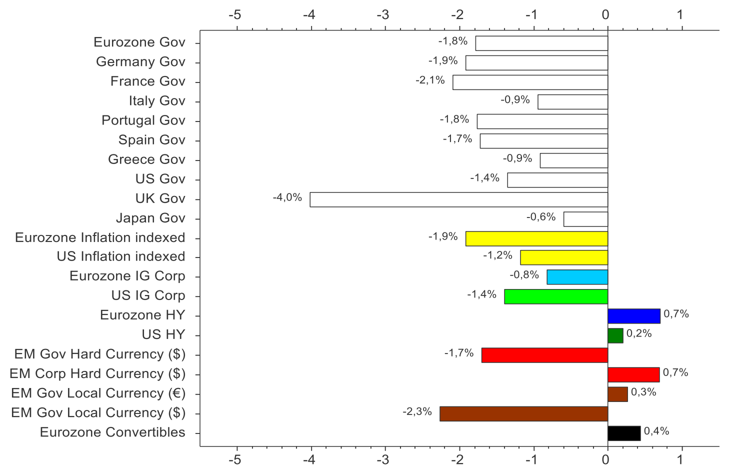

EM = Emerging Markets

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