APRIL 2024

Fixed Income Focus

Summary

1. **Rate cuts incoming:** we expect both the ECB and the Fed to cut rates in June, with the ECB taking the lead for the first time ever (albeit by only 6 days). Our forecast is for three 25bps rate cuts this year and three more next year in the eurozone. In the US, we expect the Fed to cut rates by 25bps three times this year, four times next year and three times in 2026.

2. **US and German 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% over the next 12 months, while the German equivalent should reach 2.25%. We have extended our preference for intermediate maturities (up to 10 years) in both the US and Germany.

3. **Have corporate credit spreads become too tight?** Credit spreads in both EUR and USD, as well as IG and HY, have tightened and appear low. However, historical data shows that they can remain low for years. Fundamentally, tight spreads can be justified because the risk of recession has decreased, and companies are financially strong. Elevated yields are attracting investors, resulting in strong demand and absorption of new bond supply. Credit spreads may tighten slightly further in the coming months. We predict low but positive returns in credit. Favour IG corporate bonds over HY, and EUR over USD. Prefer intermediate maturities (up to 7 years).

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.

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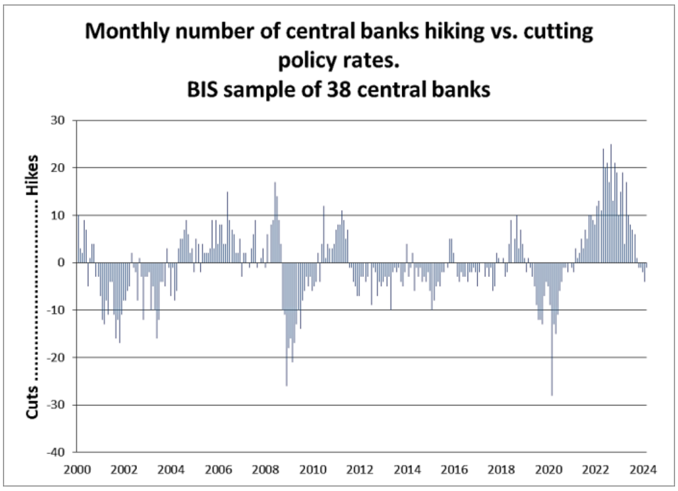
THE GREAT CENTRAL BANK POLICY REVERSAL HAS STARTED: CENTRAL BANKS ARE GRADUALLY EMBARKING IN RATE-CUTTING CYCLES



Source: BIS, LSEG Datastream, BNPP WM, 31/03/2024

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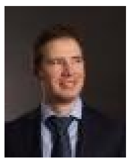

BNP PARIBAS
WEALTH MANAGEMENT

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Central banks

The plan is to cut rates in June

European Central Bank (ECB)

Heading in the right direction but slowly: headline inflation over Q1 was in line with the ECB's projections. However, services inflation remained stable at 4.0% for five consecutive months. Wage developments indicate a gradual return to normal, reducing the urgency for the ECB to act quickly. Meanwhile, risks to the growth outlook remain tilted to the downside.

No commitment for June but a clear intention to start dialling back the restrictive monetary policy stance: the ECB remains cautious and prefers data-driven decisions. Barring surprises, we think that the plan is to start cutting rates in June.

Our view: we forecast three 25bps rate cuts this year (June, September and December) and three more next year. By the end of 2025, we expect the ECB rate to reach 2.5%. This will mark the end of the rate-cutting cycle, as 2.5% is a good estimate of the neutral rate, which neither stimulates nor slows economic activity.

US Federal Reserve (Fed)

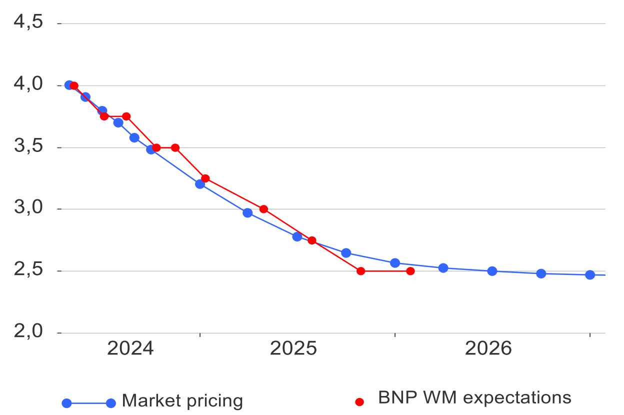
The economy is doing better: the Fed revised its projections for 2024 to higher growth, lower inflation and lower unemployment rate, compared to its last projections made in December 2023.

However, the Fed has not changed its view on rate cuts: three times 25bps this year according to the median view of each policymaker. Note, however, that the average view has moved from 2.7 to 2.3 rate cuts.

Why? The Fed is implicitly saying that it will tolerate inflation running above target and that it is not worth damaging the labour market to get back to the 2% inflation target faster.

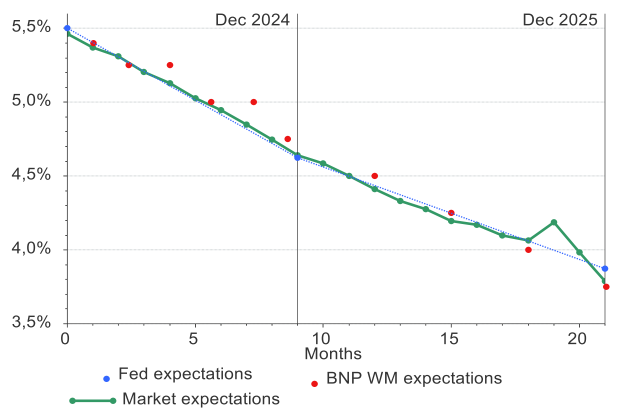
Our view: the Fed's plan is to cut rates in June, barring a major surprise on the inflation front. Given the strength of the economy, we expect the Fed to cut rates 3 times (25bps each) this year (previously 4). We expect 4 cuts in 2025 and 3 in 2026, bringing the Fed funds rate down to the neutral rate of 3%.

WE FORECAST A RATE-CUTTING CYCLE BROADLY IN LINE WITH MARKET EXPECTATIONS



Source: LSEG Datastream, 05/04/2024

OUR EXPECTATIONS FOR THE FED'S POLICY RATE, THE MARKET PRICING AND THE FED'S PLAN ARE QUITE IN LINE



Source: LSEG Datastream

INVESTMENT CONCLUSION

Both central banks plan to cut rates in June in our view. This would mark the first time in history that the ECB initiates a rate-cutting cycle before the Fed, as the ECB's meeting is six days prior to the Fed's. Our forecast is for three 25bps rate cuts this year and three more next year in the eurozone. In the US, we expect the Fed to cut rates by 25bps three times this year, four times next year and three times in 2026.

Bond yields

Long-term rates likely to decline modestly

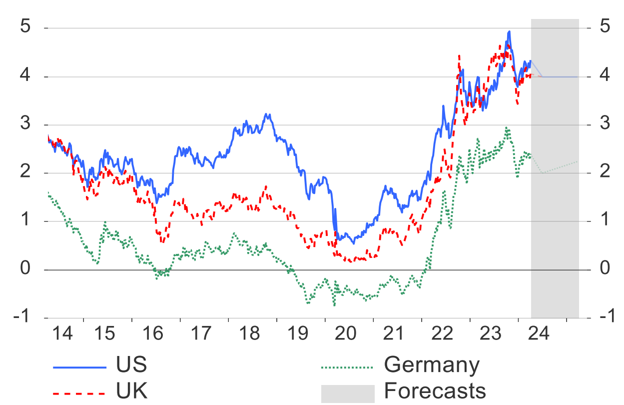
The correlation between daily changes in US and German 10-year yields has remained consistently high, at around 100% over the past 6 months. However, this correlation has weakened somewhat recently.

In March, interest rates in the US stalled, while they fell in Germany, following a significant rise in February. These movements can be attributed to fewer revisions in the pricing of central bank rate cuts.

A notable development was the decline in interest rate volatility, which collapsed to levels close to its long-term average. This decline could be attributed to a clearer outlook for upcoming central bank decisions, which bodes well for risk assets and for carry products.

We anticipate a modest decrease in long-term interest rates in Q2 and Q3 as central banks implement rate cuts, followed by a slight increase in Q4, considering the political risks and a potential higher term premium.

10-YEAR RATES



Source: LSEG Datastream, 05/04/2024

	Maturity (years)	04/04 2024	3-month target	12-month target
USA	Policy rate	5.50	5.25	4.50
	2	4.64	4.50	4.00
	5	4.29	4.25	4.00
	10	4.30	4.00	4.00
	30	4.47	4.25	4.25
Germany	Policy rate	4	3.75	3.00
	2	2.86	2.50	2.25
	5	2.36	2.25	2.25
	10	2.36	2.00	2.25
	30	2.52	2.25	2.50
UK	Policy rate	5.25	5.00	4.25
	2	4.19	4.00	3.50
	5	3.88	3.75	3.50
	10	4.02	4.00	3.65
	30	4.54	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 expect the US 10-year yield to fall to 4% over the next 12 months, while the German equivalent should reach 2.25%. We have extended our preference for intermediate maturities (up to 10 years) in both the US and Germany.

Theme in Focus

Have corporate credit spreads become too tight?

Credit spreads have been tightening for the past five months, with only minor exceptions such as EUR high yield (HY) spreads in March due to a handful of specific issuers. This raises the question of whether credit spreads are now too tight.

Admittedly, credit spreads appear low, with the one-year percentile sitting at a very low level for both EUR and USD investment grade (IG) and HY bonds. On a longer historical range, USD spreads remain very low, around the 6th percentile for both IG and HY bonds. However, EUR spreads are close to the median spreads over the past 10 years, around the 43rd percentile.

From a historical perspective, current credit spreads are not unprecedented, and periods such as 2004-2007 demonstrate that spreads can remain low for several years.

Tight spreads make sense because the risk of recession has decreased, economic growth is holding up in the US and slowly recovering in the eurozone. Corporate earnings are robust, balance sheets are generally strong, and companies have ample cash.

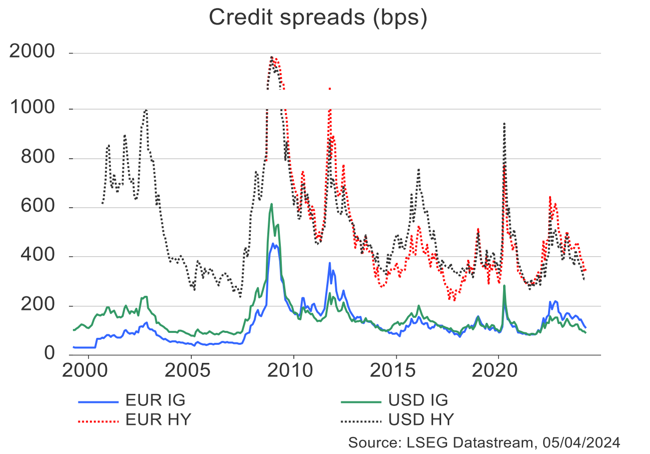
Additionally, yields are high due to elevated risk-free rates, and stand above the 80th percentile over the past 10 years in both EUR and USD, as well as IG and HY. This explains investors' appetite for credit and the strong oversubscription of new issues. The supply of new bonds has been abundant since 1 January and has been readily absorbed.

Looking ahead, short-term interest rates are expected to decrease as central banks cut rates. As a result, some of the USD6 trillion currently held in money market funds will be invested elsewhere, including in credit markets, providing a further boost.

Credit spreads may tighten slightly in the coming months. We anticipate low but positive returns in credit, due to strong demand and improvements in both fundamentals and credit conditions. We favour IG over HY bonds, which we believe are priced to perfection, and EUR credit over USD credit.

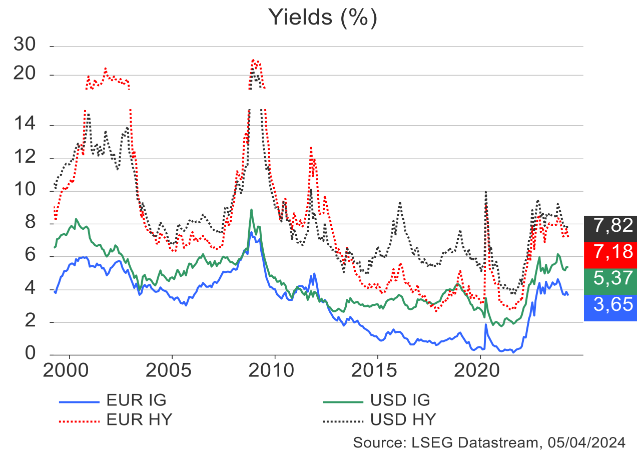
We may reconsider our stance on corporate bonds in a few months' time, as the summer lull and the US election risk could lead to some volatility in interest rates, which typically has a negative impact on carry products.

CREDIT SPREADS ARE TIGHT…



Source: LSEG Datastream, 05/04/2024

… BUT ALL-IN YIELDS ARE HIGH



Source: LSEG Datastream, 05/04/2024

Investment Conclusion

Credit spreads in both EUR and USD, as well as IG and HY, have tightened and appear low. However, historical data shows that they can remain low for years. Fundamentally, tight spreads can be justified because the risk of recession has decreased, and companies are financially strong. Elevated yields are attracting investors. Credit spreads may tighten slightly further in the coming months. We predict low but positive returns in credit. Favour IG corporate bonds over HY, and EUR over USD. Prefer intermediate maturities (up to 7 years).

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 intermediate maturities (up to 7 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	4.30	---	
Germany	2.36	---	
France	2.86	51	3
Italy	3.72	136	-7
Spain	3.19	83	-4
Portugal	3.04	68	4
Greece	3.31	95	-3

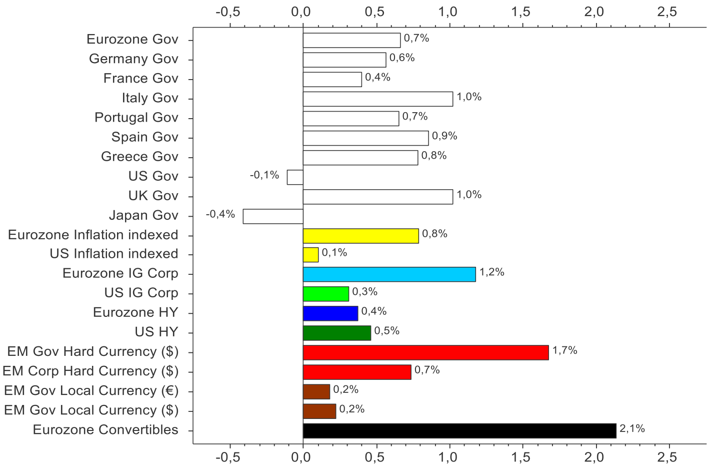
04/04/2024
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.78	39	-1
Corporate bonds IG EUR	3.65	110	-11
Corporate bonds IG USD	5.37	90	-6
Corporate bonds HY EUR	7.18	350	11
Corporate bonds HY USD	7.82	312	2
Emerging government bonds in hard currency	7.63	319	-29
Emerging corporate bonds in hard currency	6.82	230	-10
Emerging government bonds in local currency	6.29	201	11

04/04/2024
Source: Refinitiv Datastream, Bloomberg

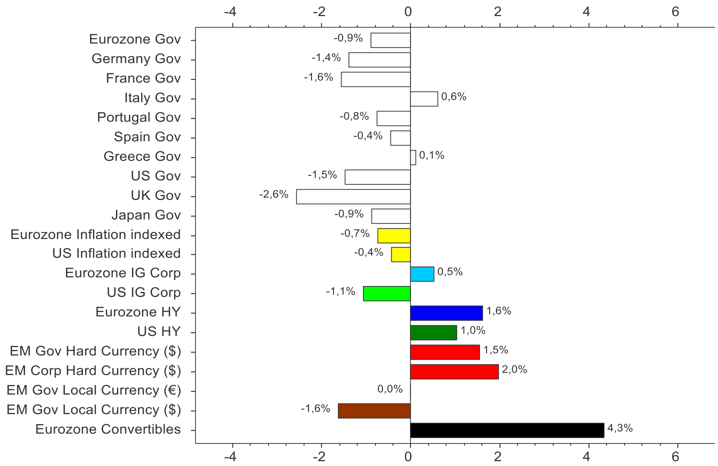
Returns

OVER ONE MONTH



Source: LSEG Datastream, 04/04/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

SINCE 01/01/2024



Source: LSEG Datastream, 04/04/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

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