MAY 2024

Fixed Income Focus

Summary

1. **Monetary policy decoupling:** we forecast three 25bps rate cuts at the ECB this year (June, September and December), while the Fed may only cut once (September) given the resilience of the economy. This would be quite unusual as the ECB traditionally follows the Fed. The ECB must tread carefully, as too much policy decoupling for too long will hurt the eurozone economy.
2. **We expect the US 10-year yield to fall to 4.25% over the next 12 months, while the German equivalent should reach 2.25%.** We are Positive on US government bonds and Neutral on German government bonds. We favour intermediate maturities (up to 10 years) in Germany, and we prefer to wait before adding duration in the US (3-5 years for now).
3. **France's fiscal challenges and credit rating outlook:** the French budget deficit was large and higher than expected. Nevertheless, Moody's and Fitch maintained their ratings with a stable outlook. The next key date is 31 May, when S&P's rating review is due. While we expect some volatility in the French government bonds ahead of the announcement, we do not expect the 10-year OAT-Bund spread to widen significantly. Any spread widening will be seen as a buying opportunity. We forecast the 10-year OAT-Bund spread at around 50bps in 12 months' time.
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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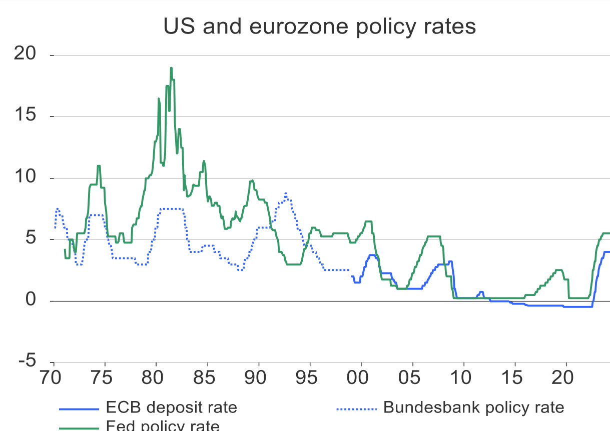
MONETARY POLICY DECOUPLING BETWEEN THE US AND THE EUROZONE IS RARE



Source: LSEG Datastream, 14/05/2024

Drafting completed on 10 May

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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)

An imminent rate cut: a rate cut in June is gaining support among ECB policymakers. This would be quite unusual as the ECB traditionally follows the Fed. However, i) inflation in the eurozone is under better control than in the US and wage growth is softening, and ii) growth is half that of the US and is expected to remain so next year.

Policy decoupling: the second-round effects are that if the ECB cut rates several times while the Fed does not even hint at rate cuts, this would lead to a weaker euro and higher energy bills, which could hit purchasing power and dampen economic growth in the eurozone.

Our view: we forecast three 25bps rate cuts this year (June, September and December) and three more next year. We expect the ECB rate to reach 2.5% by the end of 2025. 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.

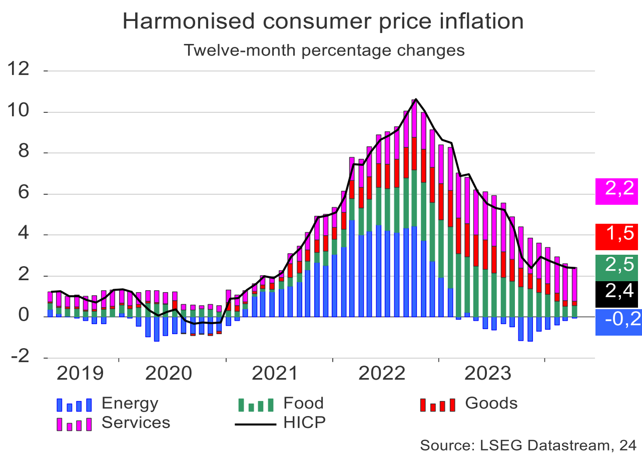
US Federal Reserve (Fed)

Dovish bias: FOMC members see monetary policy as already restrictive and weighing on demand. The lack of progress on disinflation forced Powell to admit that it will take more time to gain the confidence to cut rates. Nevertheless, he sees a rate hike as unlikely.

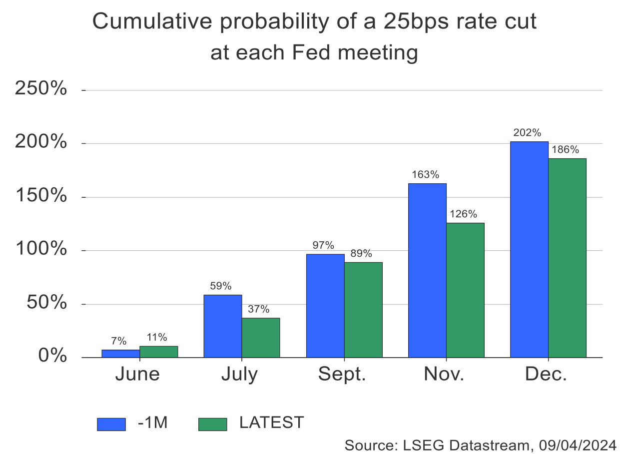
Balance sheet management: the Fed will reduce the pace of QT (Quantitative Tightening) from 1 June, allowing $25bn of Treasuries to mature without being reinvested instead of $60bn. This will reduce the risk of a liquidity squeeze, allow the the Fed to continue QT for longer, and will help the Treasury, which has a lot of Treasuries to sell this quarter and next.

Our view: the Fed is adjusting its plan as the data comes in. We expect only one 25bps rate cut this year, in September. We forecast 4 cuts in 2025 and 2 in 2026, bringing the Fed funds rate down to the neutral rate of 3.75%.

INFLATION IS DECELERATING TOWARDS ECB'S TARGET



THE MARKET EXPECTS ALMOST TWO RATE CUTS THIS YEAR, THE FIRST ONE BETWEEN SEPTEMBER AND NOVEMBER



Investment Conclusion

We forecast three 25bps rate cuts at the ECB this year (June, September and December), while the Fed may only cut once (September) given the resilience of the economy. This would be quite unusual as the ECB traditionally follows the Fed. The ECB must tread carefully, as too much policy decoupling for too long will hurt the eurozone economy.

Bond yields

Expect lower bond yields in 12 month's time

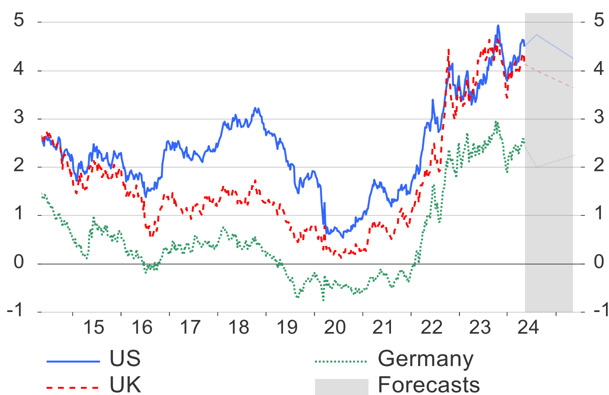
US and German 10-year yields fell about 20bps off their peak that occurred at the end of April. A sharp fall linked to dovish central banks, weak US economic indicators and weaker-than-expected labour market in the US.

There are reasons to believe that the move has gone too far and that bond yields may grind modestly higher. Currently the 10-year term premium is at zero. We suspect it should be higher given further increases in US Treasury supply, higher long-run inflation expectations and elevated volatility.

Bond yields may find some support with the US election as neither candidate seem to be willing to deal with the deficit. Historically, a change of president in the US bring more volatility on the 10-year yield and almost every time the trend stay the same between 1 month before the election until 3 month after the election.

In 12 month's time, we think 10-year yields will be lower than they are today, as central banks would have delivered some rate cuts.

10-YEAR RATES



	Maturity (years)	09/05 2024	3-month target	12-month target
USA	Policy rate	5.50	5.25	5.00
	2	4.82	5.00	4.25
	5	4.47	4.90	4.25
	10	4.46	4.75	4.25
	30	4.62	4.75	4.40
Germany	Policy rate	4.00	3.50	3.00
	2	2.94	2.50	2.25
	5	2.53	2.25	2.25
	10	2.50	2.00	2.25
	30	2.63	2.25	2.50
UK	Policy rate	5.25	4.75	4.25
	2	4.28	4.00	3.50
	5	4.01	4.00	3.50
	10	4.14	4.00	3.65
	30	4.63	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 4.25% over the next 12 months, while the German equivalent should reach 2.25%. We favour intermediate maturities (up to 10 years) in Germany, and we prefer to wait before adding duration in the US (3-5 years for now).

Theme in Focus

France's fiscal challenges and credit rating outlook

France faced a budget deficit that exceeded expectations, reaching 5.5% of GDP in 2023. The government subsequently revised its forecasts and now expects deficits of 5.1% for 2024 and 4.1% for 2025. Our forecasts are slightly higher, by 0.1% and 0.2% respectively due to lower growth prospects.

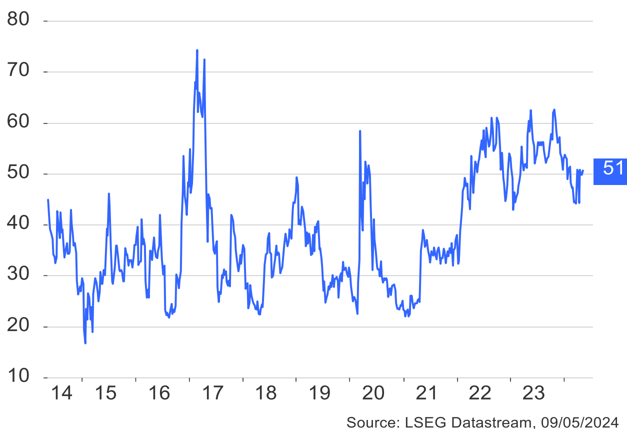
French government bonds, known as Obligations Assimilables du Trésor (OAT) underperformed following the announcement. The 10-year spread between the OAT yield and the German Bund yield widened and was volatile ahead of Moody's and Fitch rating reviews on 26 April.

Neither agency downgraded the French sovereign rating, which remain at Aa2 for Moody's and AA- for Fitch, both with a stable outlook. This implies a low probability of a rating change in the short to medium term. The next key date is 31 May, when the S&P review is due. The current rating is AA with a negative outlook. We see a risk of a downgrade to AA- given the recent deterioration in fiscal metrics, coupled with S&P's higher rating than Fitch and its long-standing negative outlook since December 2022.

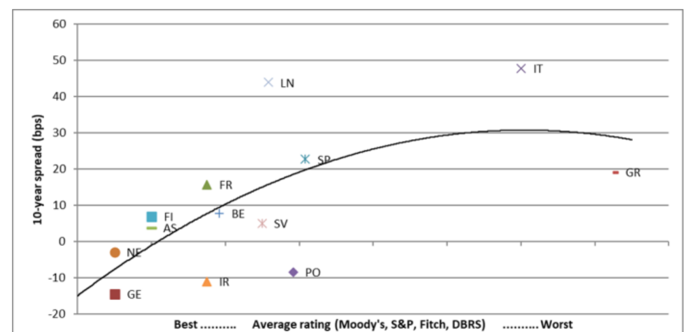
We expect the 10-year OAT-Bund spread to widen ahead of S&P's decision, but only modestly (up to 55bps). We believe that any widening will be seen as a buying opportunity as France's rating will remain in the AA bucket after the review, suggesting no forced selling by institutional investors. We would expect the spread to tighten thereafter, with the extent of the move being a function of the short positioning built up ahead of the event. We forecast the 10-year OAT-Bund spread at around 50bps in 12 months' time.

In a historical context, during the European debt crisis (2010-2012), sovereign downgrades affected the ratings of European banks due to their exposure to the country's debt. However, while sovereign downgrades can have spillover effects across the financial system, regulatory changes have softened the link between sovereign and bank ratings, so the impact on bank ratings is not automatic and would depend on the bank's vulnerability, i.e. their exposure, diversification model and the broader economic context.

FRENCH 10-YEAR SPREAD TO GERMANY (IN BPS)



FRENCH DEBT SEEMS FAIRLY VALUED RELATIVE TO ITS CREDIT RATING



Source: Bloomberg, BNP Paribas WM

Investment Conclusion

The French budget deficit was large and higher than expected. Nevertheless, Moody's and Fitch maintained their ratings with a stable outlook. The next key date is 31 May, when S&P's rating review is due. While we expect some volatility in the French government bonds ahead of the announcement, we do not expect the 10-year OAT-Bund spread to widen significantly. Any spread widening will be seen as a buying opportunity. We forecast the 10-year OAT-Bund spread at around 50bps in 12 months' time.

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 maturities up to 7 years in the US and up to 10 years in the eurozone • 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	4,46	---	
Germany	2,50	---	
France	3,01	51	2
Italy	3,84	134	-1
Spain	3,29	79	-2
Portugal	3,15	65	-3
Greece	3,54	105	11

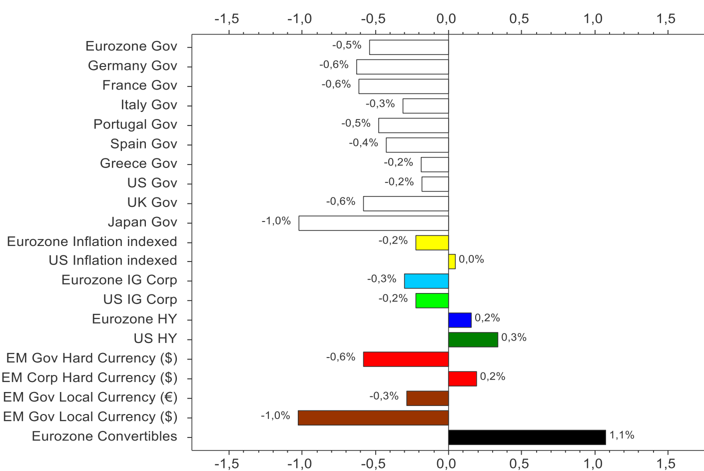
09/05/2024
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3,91	37	-1
Corporate bonds IG EUR	3,80	110	1
Corporate bonds IG USD	5,50	87	0
Corporate bonds HY EUR	6,68	341	-7
Corporate bonds HY USD	7,89	300	1
Emerging government bonds in hard currency	7,79	320	10
Emerging corporate bonds in hard currency	6,88	219	-7
Emerging government bonds in local currency	6,52	205	19

09/05/2024
Source: Refinitiv Datastream, Bloomberg

Returns

OVER ONE MONTH



Source: LSEG Datastream, 09/05/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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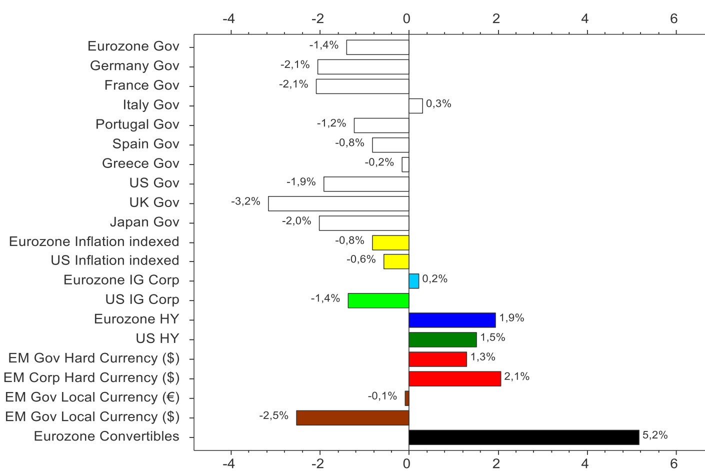

Source: LSEG Datastream, 09/05/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

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