DECEMBER 2023

Fixed Income Focus

Summary

1. **Markets are too excited about rapid rate cuts:** the Fed and the ECB may disappoint by not delivering rate cuts as early as the markets expect (Q1 2024). We anticipate the Fed to cut rates by 150bps, starting in May 2024, and the ECB to follow suit with 75bps from June.

2. **The rally in government bonds seems a bit overdone:** we expect bond yields to stabilise and even rebound a bit in the near term. Over a 12-month horizon we see limited potential for US and German long-term bond yields to fall.

3. **We have updated our 12-month targets for 10-year yields** to 4% (3.75% previously) in the US and to 2.25% (2.50% previously) in Germany. We stay Positive on US Treasury bonds and Neutral on German sovereign bonds given the greater upside potential for Treasuries versus Bunds.

4. **Our preferences for 2024:** with central bankers signaling the end of the tightening cycle, long-term government bond yields have declined. Yet, they remain attractive for now. In government bonds, we prefer US and UK government bonds over the German equivalent. We also find US inflation-linked bonds (TIPS) and Agency Mortgage-Backed Securities appealing. Among corporate bonds, our preference leans towards investment grade bonds over high yield, and European over the US. In emerging bonds, the Fed tightening cycle's end signals potential outperformance, and we like EM bonds in both hard and local currency.

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Drafting completed on 14 December

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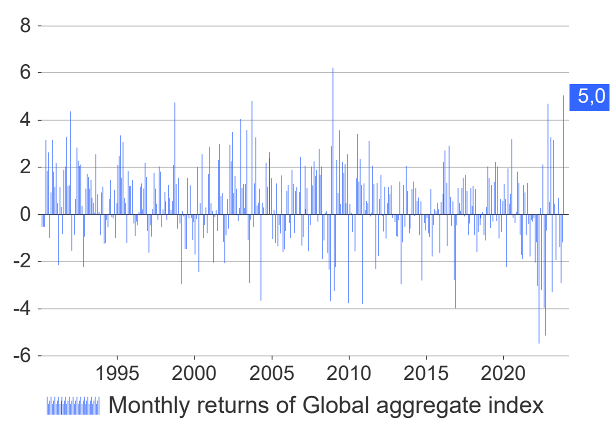
GLOBAL BONDS ROSE +5.0% IN NOVEMBER. THE SECOND-BEST MONTH EVER!



Source: LSEG Datastream, 30/11/2023

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BNP PARIBAS WEALTH MANAGEMENT

La banque d'un monde qui change

Central banks

The "higher for longer " mantra is no more

European Central Bank (ECB)

Balanced tone: the day after the Fed meeting, the ECB did not convey the Fed's dovish message. ECB policymakers did not discuss rate cuts but they did acknowledge the progress made on inflation.

Cautious balance-sheet management: the ECB's December decision to phase out reinvestments of matured bonds in the PEPP portfolio came earlier than expected, but the implementation is later than expected and the pace is slower than expected.

Our view: incoming data (the upcoming wage negotiations in particular) will dictate the timing of the first rate cuts. We expect the ECB to start cutting rates in June rather than in September in light of the quick deceleration of inflation. We foresee a moderate pace of reduction, 75bps rate cuts in 2024, much less than what the market is pricing (155bps).

US Federal Reserve (Fed)

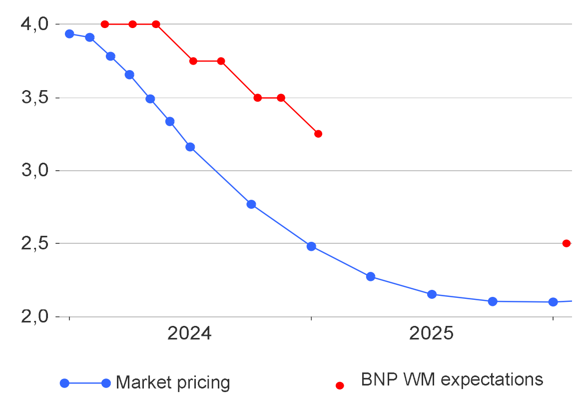
The pivot: the Fed was surprisingly dovish at the December meeting. Policymakers did not push back against market pricing of rate cuts in early 2024, or the ongoing loosening of financial conditions.

Victory over inflation: the Fed revised both headline and core inflation lower for 2023 and 2024, and signalled three rate cuts for next year (one more than in the September projections).

The end of the "higher for longer" mantra: policymakers are now thinking and talking about when it will be appropriate to cut rates.

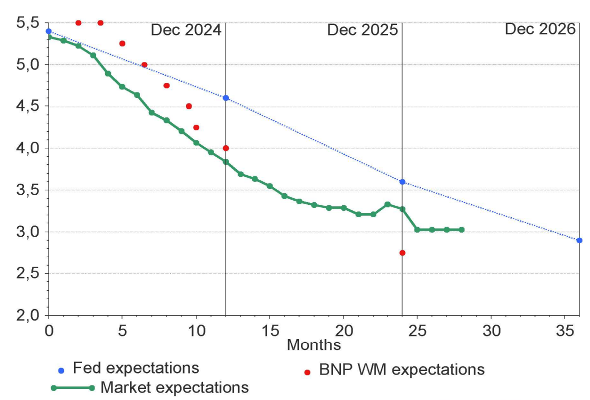
Our view: declining inflation and slower growth will allow the Fed to cut rates and try to engineer a soft landing of the economy. We have pushed back our expectations of a first rate cut to occur in June rather than July, with a series of 25bps rate cuts at each meeting, hence 150bps of total cuts in 2024.

WE EXPECT A SOFTER RATE-CUT CYCLE FOR THE ECB THAN THE MARKET



Source: LSEG Datastream, 15/12/2023

WE THINK THE FED WILL CUT RATES MORE THAN IT PLANS BUT LESS THAN WHAT THE MARKET IS PRICING



Source: LSEG Datastream

INVESTMENT CONCLUSION

Main central banks will cut rates in 2024 as inflation will have made enough progress. However, the markets are too excited about rapid rate cut, in our view, and the Fed and the ECB may disappoint by not deliver rate cuts as early as the markets expect (Q1 2024). We anticipate the Fed to cut rates by 150bps, starting in May 2024, and the ECB to follow suit with 75bps from June.

Bond Yields

Long-term rates to trade range-bound in 2024

The sharp decline: the drop in inflation has caught the eye of some policymakers on both sides of the Atlantic and the market was quick to reprice an earlier-than-anticipated sequence of policy rate cuts, that pushed bond yields much lower. Consequently, 10-year rates have been falling off the cliff since October when they reached almost 5% in the US and 3% in Germany.

Is it exaggerated? We think so. The rally in government bonds seems a bit overdone. We expect bond yields to stabilise and even rebound marginally in the near term.

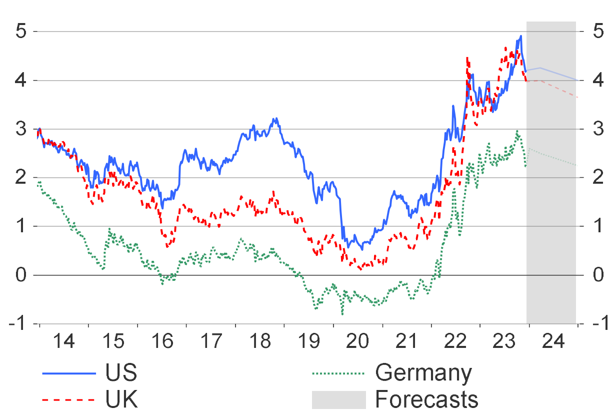
We have updated our 12-month targets for 10-year yields to the upside in the US, to 4% from 3.75%, as the recession should be narrowly missed, and to the downside in Germany, to 2.25% from 2.50%, given the faster-than-expected decline in inflation.

Our recommendation: we stay Positive on US Treasury bonds and Neutral on German sovereign bonds given the greater upside potential for Treasuries versus Bunds.

	Maturity (years)	14/12 2023	3-month target	12-month target
USA	Policy rate	5.50	5.50	4
	2	4.38	4.25	3.50
	5	3.89	4.25	3.75
	10	3.91	4.25	4
	30	4.03	4.50	4.25
Germany	Policy rate	4	4	3.25
	2	2.56	2.50	2.25
	5	2.09	2.50	2.25
	10	2.13	2.50	2.25
	30	2.34	2.80	2.60
UK	Policy rate	5.25	5.25	4.25
	2	4.34	4.50	3.60
	5	3.81	4.20	3.65
	10	3.79	4	3.65
	30	4.29	4.30	4

Source: Refinitiv Datastream, BNP Paribas WM

10-YEAR RATES



Source: LSEG Datastream, 15/12/2023

Investment Conclusion

The rally in government bonds seems a bit overdone. We expect bond yields to stabilise and even rebound a bit in the near term. We have updated our 12-month targets for 10-year yields to 4% in the US and to 2.25% in Germany. We stay Positive on US Treasury bonds and Neutral on German sovereign bonds given the greater upside potential for Treasuries versus Bunds.

Theme in Focus

Our preferences for 2024

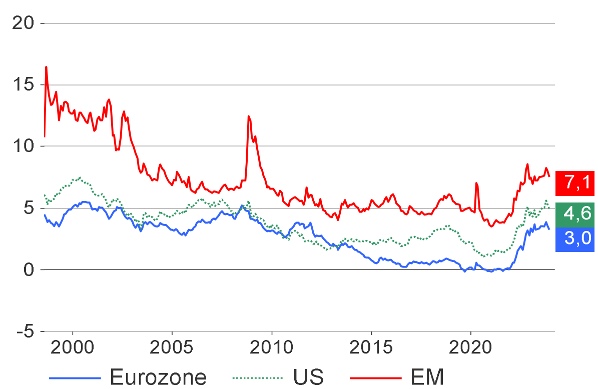
Government bonds: with central bankers signalling the end of the tightening cycle, long-term bond yields have started to decline. The window to secure elevated yields is gradually closing. However, bond yields remain high on a 10-20 year horizon, suggesting that there is still an opportunity to invest in government bonds. We expect prices to increase further as growth decelerates and inflation declines further. We favour US and UK government bonds over German government bonds due to their higher yields. Additionally, we find US inflation-linked bonds and Agency Mortgage-Backed Securities appealing, given their attractive valuations and the US government guarantee.

Corporate bonds: the credit cycle is in its late expansion phase in both the US and the eurozone. This stage signifies that credit conditions are tight but the fundamental risk is still low, as corporate fundamentals are sound but deteriorating.

The economic slowdown is exerting pressure on corporate earnings, while elevated interest rates are increasing borrowing costs for companies refinancing in 2024. From our perspective, US credit spreads are tight, making them more susceptible to widening. Additionally, spreads on high yield (HY) bonds are at risk due to anticipated elevated bond supply. Our preference leans towards investment grade (IG) bonds over high yield, and Europe over the US.

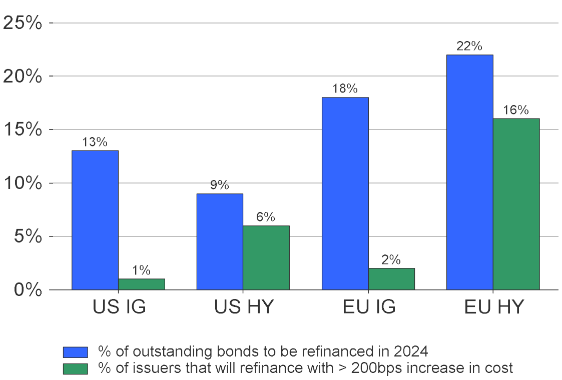
Emerging bonds: EM debt typically outperforms at the end of the Fed tightening cycle. The peak of rating downgrades and defaults appears to be behind us. Ahead of better economic growth in EM countries than in developed countries, a weaker dollar, and decelerating inflation, we expect EM central banks to continue cutting rates, and bond yields to fall. We like EM bonds in both hard and local currency.

IT'S NOT TOO LATE TO BUILD A BOND PORTFOLIO. YIELDS ON BOTH SOVEREIGN AND CORPORATE BONDS REMAIN ATTRACTIVE



Source: LSEG Datastream, 15/12/2023

HY ISSUERS WILL FACE A SIGNIFICANT RISE IN BORROWING COSTS IN 2024



Source: LSEG Datastream, BNP Paribas, 14/12/2023

Investment Conclusion

With central bankers signalling the end of the tightening cycle, long-term government bond yields have declined. Yet, they remain attractive for now. In government bonds, we prefer US and UK government bonds over their German equivalents. We also find US inflation-linked bonds and Agency Mortgage-Backed Securities appealing. In corporate bonds, our preference is for investment grade bonds over high yield, and for Europe versus the US. As for emerging bonds, the Fed tightening cycle's end signals potential outperformance, and we like EM bonds in both hard and local currency.

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	3.91	---	
Germany	2.13	---	
France	2.66	53	-3
Italy	3.81	169	-13
Spain	3.10	97	-6
Portugal	2.87	74	4
Greece	3.33	121	-10

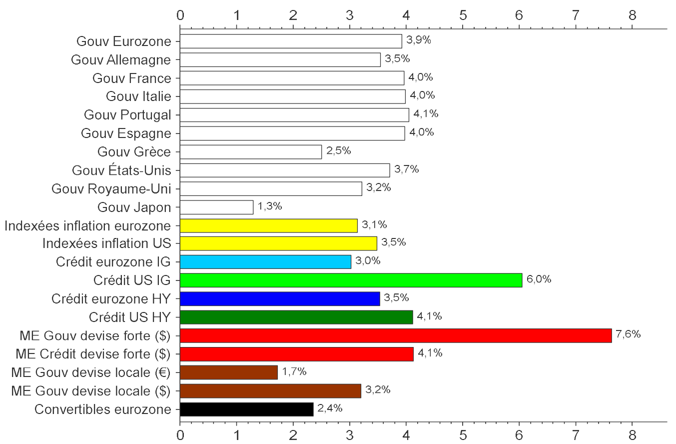
14/12/2023
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	3.61	44	-5
Corporate bonds IG EUR	3.69	138	-11
Corporate bonds IG USD	5.11	99	-20
Corporate bonds HY EUR	7.21	386	-56
Corporate bonds HY USD	7.77	334	-53
Emerging government bonds in hard currency	7.72	364	-45
Emerging Corporate bonds in hard currency	7.12	292	-21
Emerging government bonds in hard currency	6.27	238	-33

14/12/2023
Source: Refinitiv Datastream, Bloomberg, JP Morgan

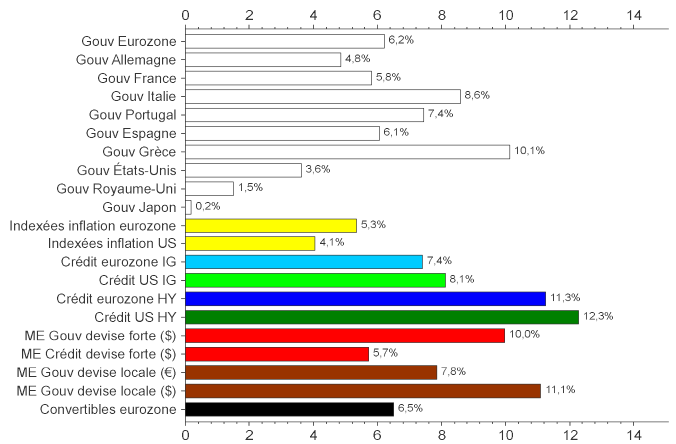
Returns

OVER ONE MONTH



Source: LSEG Datastream, 14/12/2023 Source : Bloomberg Barclays, sauf ME devise locale (JP Morgan) et Convertibles (Refinitiv)

SINCE 01/01/2023



Source: LSEG Datastream, 14/12/2023 Source : Bloomberg Barclays, sauf ME devise locale (JP Morgan) et Convertibles (Refinitiv)

EM = Emerging Markets

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