SEPTEMBER 2024

# Fixed Income Focus


## Summary

1. **Central banks: money-market bets on interest-rate cuts have gone too far.** While recession fears in the US have receeded, markets continue to price in a deep cycle of US rate cuts, which we think is overdone. We expect 150bp of rate cuts through December 2025, versus approximately 225bp priced in. We expect a series of quarterly 25bp cuts from September until the Fed Funds rate reaches 3.5% in 2026. Market pricing is also somewhat aggressive in the eurozone, but to a much lesser extent than in the US. We expect 125bp of cuts by December 2025, versus roughy160bp priced in.

2. **The decline in US interest rates has gone too far.** We expect bond yields to rise in the coming months. We are therefore tactically moving from Positive to Neutral on US government bonds. We intend to re-enter the asset class with a better starting yield in a few months as we remain constructive on US Treasuries strategically. Our revised 12-month target for the US 10-year yield is 4% (4.25% previously). No change in Europe, where we expect the Bund yield to move to 2.25% in 12 months and we stay Neutral on German government bonds

3. **Theme in focus: Four summer news with views.**
   - The Bank of Japan surprised markets by hiking rates. We expect no more surprises, a prudent pace and further hikes until the policy rate reaches 1.50% by mid-2026.
   - The earnings season supports our view of favouring IG corporate bonds over HY corporate bonds.
   - US money market funds have record assets under management. Where will this money go when short-term rates drop? Equities or bonds?
   - The French spread remains volatile. We keep a Neutral view on French government bonds.

4. **Opportunities in Fixed Income:** we are Positive on 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.


Drafting completed on 30 August

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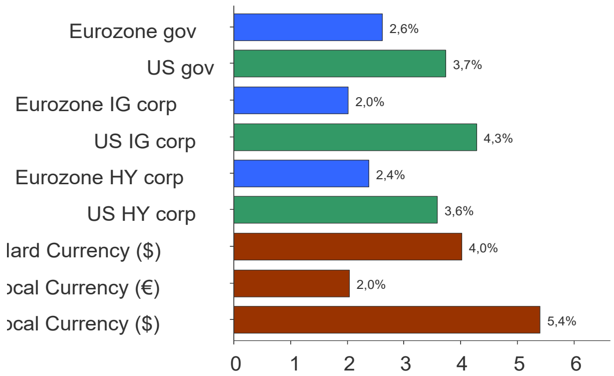
**SOLID PERFORMANCES FOR FIXED INCOME ASSETS DURING THE SUMMER PERIOD (30/06/2024-29/08/2024)**




Source: LSEG Datastream, Bloomberg and JPM indices, 29/08/2024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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

# Central banks

## The end of the monetary policy decoupling

### European Central Bank (ECB)

**Mixed activity:** recent leading indicators have pointed to weakness in eurozone manufacturing activity, particularly in France and Germany. By contrast, services activity remains in expansion.

**Encouraging disinflation:** While the disinflationary trend has stalled in recent months, with headline inflation at 2.6% and core inflation at 2.9% (both above target), 1/the decline in negotiated wages (from 4.7% in Q1 to 3.6% in Q2) should help to ease fears of persistent wage pressures, and 2/market inflation expectations have collapsed.

**Our view:** the market is pricing in a rate cut cycle that we think is a bit too aggressive, with approx. 160bp of cuts by end-2025. We maintain our forecast of a 25bp rate cut in September, another in December and 3 more in 2025. We therefore expect the rate cut cycle to amount to 125bp, ending with a deposit rate of 2.5% at the end of 2025.

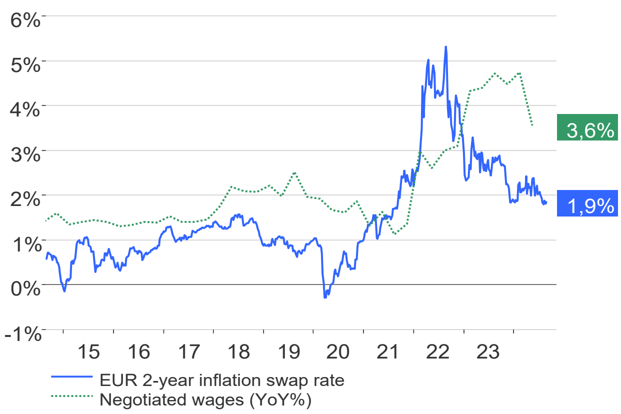
### US Federal Reserve (Fed)

**Rate cuts ahead:** Clear pivot at the Jackson Hole Symposium. Powell said it was time for policy to adjust. However, he didn't shed any light on the length and speed of the rate cut cycle. With the Fed convinced that inflation is trending towards its 2% target, the key data to watch is the labour market.

**A rapid rate cut cycle?** The market is pricing in a deep rate-cutting cycle, with more than 200bp of cuts over the next 12 months. Such a pace is consistent with a recession scenario, which we do not support.

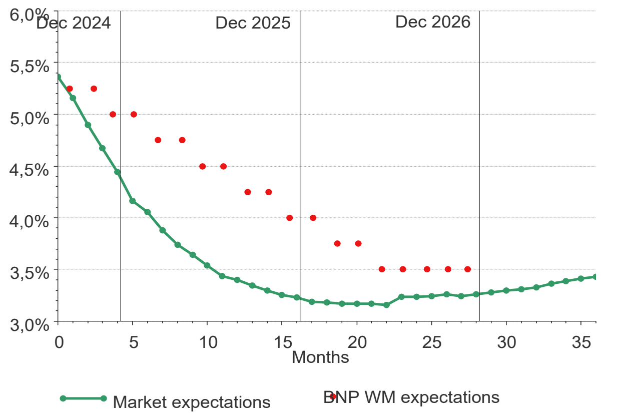
**Our view:** We believe the Fed can afford to be gradual as 1/inflation remains above target and 2/the labour market is slowing, not collapsing. Given the deterioration in the labour market, we have revised our expectations and added one 25bp rate cut this year. We now expect the Fed to cut rates in September and December this year, and at a quarterly pace of 25bp until the policy rate reaches 3.5% in 2026.

### ENCOURAGING INFLATION TREND IN THE EUROZONE




Source: LSEG Datastream, 27/08/2024

### MONEY-MARKET BETS ON RATE CUTS HAVE GONE TOO FAR IN OUR VIEW




*Source: LSEG Datastream*

**INVESTMENT CONCLUSION**

While recession fears in the US have receded, markets continue to price in a deep cycle of US rate cuts, which we think is overdone. We expect 150bp of rate cuts through December 2025, versus approx. 225bp priced in. We expect a series of quarterly 25bp cuts from September until the Fed Funds rate reaches 3.5% in 2026. Market pricing is also too aggressive in the eurozone, but to a much lesser extent than in the US. We expect 125bp of cuts by December 2025, versus roughly 160bp priced in.

# Bond yields

## Recession fears overdone

The rise in US unemployment, coupled with the massive unwinding of JPY carry trades in early August, moved markets strongly. Investors feared an upcoming recession in the US. This led to a sharp fall in long-term bond yields. As a result, valuations are no longer cheap. Since then, interest rate volatility has fallen as recent data has failed to confirm recession fears.

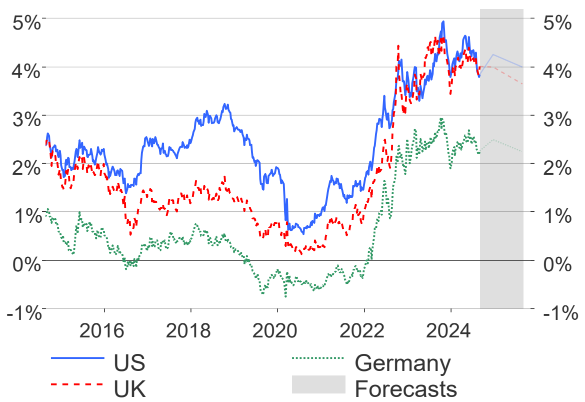
We believe that the move in rates has gone too far and that both short- and long-term rates should move higher in the coming months. We are therefore tactically moving from Positive to Neutral on US government bonds. We intend to re-enter the asset class in a few months' time, as we expect rates to move lower again as the rate-cutting cycle continues is underway.

We have revised our 12-month target for the US 10-year yield to 4% from 4.25%. We maintain our Bund yield target at 2.25% and remain Neutral on German government bonds.

| | Maturity (years) | 29/08 2024 | 3-month target | 12-month target |
|---|---|---|---|---|
| USA | Policy rate | 5.50 | 5.00 | 4.50 |
| | 2 | 3.87 | 4.25 | 4.00 |
| | 5 | 3.66 | 4.25 | 4.00 |
| | 10 | 3.84 | 4.25 | 4.00 |
| | 30 | 4.13 | 4.50 | 4.25 |
| Germany | Policy rate | 3.75 | 3.25 | 2.75 |
| | 2 | 2.38 | 2.50 | 2.25 |
| | 5 | 2.16 | 2.50 | 2.25 |
| | 10 | 2.26 | 2.50 | 2.25 |
| | 30 | 2.50 | 2.75 | 2.50 |
| UK | Policy rate | 5.00 | 4.50 | 3.75 |
| | 2 | 4.12 | 4.00 | 3.50 |
| | 5 | 3.92 | 4.00 | 3.50 |
| | 10 | 4.02 | 4.00 | 3.65 |
| | 30 | 4.54 | 4.30 | 4.00 |

Source: Refinitiv Datastream, BNP Paribas WM

**10-YEAR RATES**




Source: LSEG Datastream, 30/08/2024

**INVESTMENT CONCLUSION**

The decline in interest rates has gone too far, notably in the US. We expect bond yields to rise in the coming months. We are therefore tactically moving from Positive to Neutral on US government bonds. We remain Neutral on German government bonds. We have revised our 12-month target for the US 10-year yield to 4% from 4.25%. We maintain our Bund yield target at 2.25%.

# Theme in Focus

## Four summer news with views

The summer was not a quiet one for markets. The BoJ surprised markets, the earnings season continued, US money market funds hit new highs, and the French spread was volatile.

**The Bank of Japan** surprised the market by raising its policy rate, which sent the yen soaring and made the yen carry trade (buying high yielding assets financed by a cheap currency like the yen) less attractive, and markets plunged as massive amounts of positions were unwound. Given the market volatility, we expect the BoJ to raise its key rate in a timely and gradual manner. We forecast a 25bp hike in December, two hikes in 2025 (March and June) and two more in 2026, when the BoJ will end its hike cycle, to 1.5% by mid-2026.

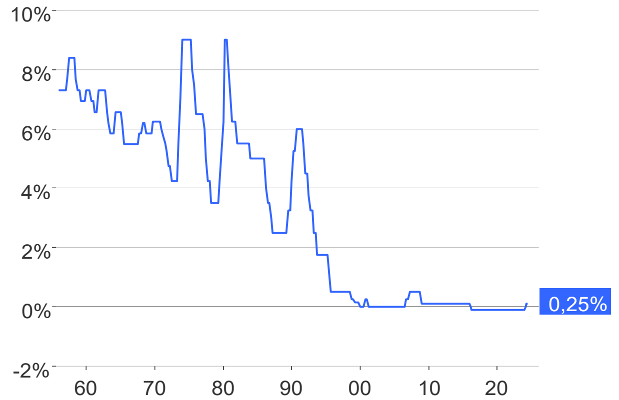
As the earnings season draws to a close, we look at **corporate fundamentals**. The majority of companies have reported earnings beats, but we note an underperformance driven by high yield companies. Credit fundamentals remain well-oriented overall.

This support our view of favouring IG corporate bonds over HY corporate bonds.

A significant amount of cash is parked in **US money market funds**, the highest ever at over USD 6.2 trillion. This reflects investors' appetite for high remuneration, very low risk and liquid products amid economic uncertainties. However, with the Fed about to begin its rate cut cycle, money market funds will become less attractive, and investors will withdraw their cash. Will this money be invested in equities or bonds?

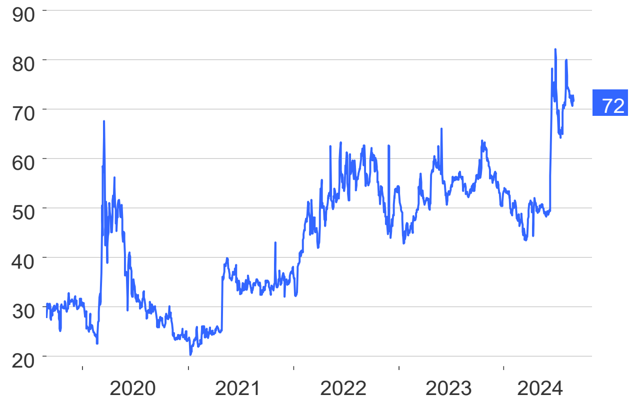
**French spread**: political uncertainty continues in France after the Olympic break, with no majority and political gridlock. While we believe that the 10-year spread over the Bund is unlikely to widen much above current levels (around 70bp), we do not expect the spread to fall back to the long-term average of 40bp given the budget deficit. There is a risk around the agreement on the 2025 budget in France, where talks could break down and volatility is likely to increase. We don't think the rating agencies will downgrade France. We keep a Neutral view on French government bonds.

**THE BANK OF JAPAN HAS STARTED TO HIKE RATES (%)**




Source: LSEG Datastream, août 24

**THE FRENCH 10-YEAR SPREAD REMAINS VOLATILE (BP)**




Source: LSEG Datastream, 30/08/2024

**INVESTMENT CONCLUSION**

Four summer news with views. 1/The Bank of Japan surprised markets by hiking rates. We expect no more surprises, a prudent pace and further hikes until the policy rate reaches 1.50% by mid-2026. 2/The earnings season supports our view of favouring IG corporate bonds over HY corporate bonds. 3/US money market funds have record assets under management. Where will this money go when short-term rates drop? 4/The French spread remains volatile. We keep a Neutral view on French government bonds.

## 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 | = | We tactically move to Neutral from Positive on US government bonds. We intend to re-enter the asset class with a better starting yield in a few months as we remain constructive on US Treasuries strategically. We also move to Neutral from Positive on US TIPS. |
| Corporate bonds Investment Grade | Eurozone<br>United States | + | • Eurozone and US: Positive opinion. Prefer short maturities in the US and up to 10 years in the eurozone<br>• Positive on convertible bonds in the eurozone. |
| Corporate bonds High Yield | Eurozone and United States | = | • Neutral on HY bonds.<br>• 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 | 3.84 | --- | |
| Germany | 2.26 | --- | |
| France | 2.98 | 73 | 2 |
| Italy | 3.64 | 139 | 3 |
| Spain | 3.09 | 84 | 1 |
| Portugal | 2.88 | 62 | -3 |
| Greece | 3.32 | 106 | 0 |

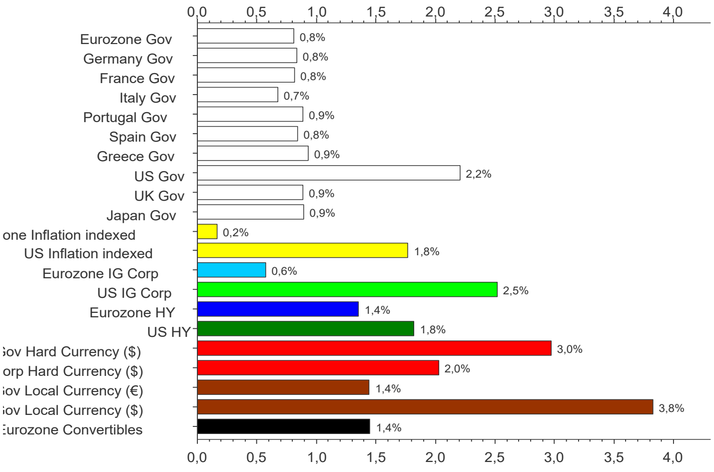
29/08/2024
Source: Refinitiv Datastream

| | Yield (%) | Spread (bp) | Spread change 1 month (bp) |
|---|---|---|---|
| Global | 3.45 | 38 | -1 |
| Corporate bonds IG EUR | 3.45 | 116 | 6 |
| Corporate bonds IG USD | 4.88 | 94 | 1 |
| Corporate bonds HY EUR | 6.30 | 352 | -13 |
| Corporate bonds HY USD | 7.30 | 310 | 4 |
| Emerging government bonds in hard currency | 7.26 | 333 | -1 |
| Emerging corporate bonds in hard currency | 6.17 | 221 | 9 |
| Emerging government bonds in local currency | 6.27 | 261 | -20 |

29/08/2024
Source: Refinitiv Datastream, Bloomberg

# Returns

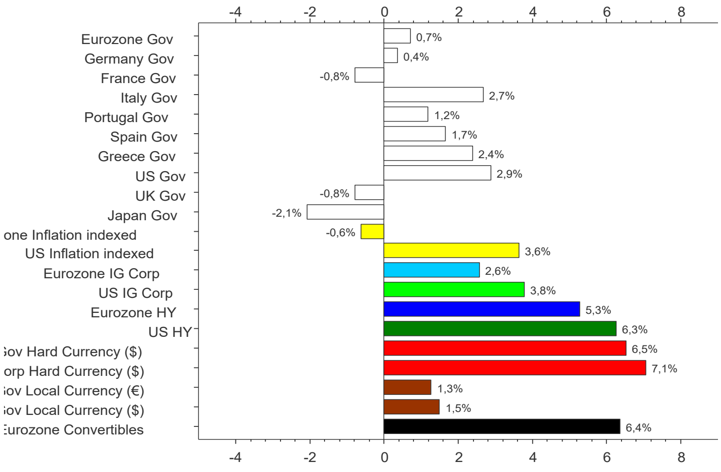
## OVER ONE MONTH




EG Datastream, 29/08/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

*EM = Emerging Markets*

## SINCE 01/01/2024




EG Datastream, 29/08/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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