DECEMBER 2024

Fixed Income Focus

Summary

1. **Central banks:** we think the Fed wants to cut rates to return to a neutral rate but will be forced to stop in September 2025 at a rate of 3.75% as inflation picks up. The market is pricing in less potential for rate cuts, with a pricing of 4% in September 2025. In Europe, the ECB will cut rates more than in the US given disinflation and weak growth. We anticipate a terminal rate of 2% in September 2025. The market pricing is exaggerated in our view, pricing in a terminal rate of 1.6%, which is way below the ECB's estimate of the neutral rate (2-3%).
2. **Bond yields:** Our 12-month targets for 10-year yields are 4.25% in the US and 2.25% in Germany.
3. **Government bonds:** We keep a Neutral view over a 12-month horizon on US long-term Treasuries and German government bonds. We recommend US short-term Treasuries for a better risk/reward balance, given elevated rate volatility and a low probability, in our view, that the Federal Reserve will raise rates.
4. **Theme in focus: Top Pick for H1 2025.** We recommend short-term US investment-grade credit (1-5 years) to mitigate duration risk amidst rate volatility. Fundamentals are strong, with solid economic growth, corporate tax cuts boosting earnings, and solid credit quality. Supply is high but net supply is manageable. Yields are attractive and short-term US IG Credit should deliver above 4% total return in our view, with low downside risk and limited volatility.
5. **Opportunities in Fixed Income:** we are Positive on US short-term Treasuries, US Agency Mortgage-Backed Securities, as well as European and US investment grade corporate bonds.

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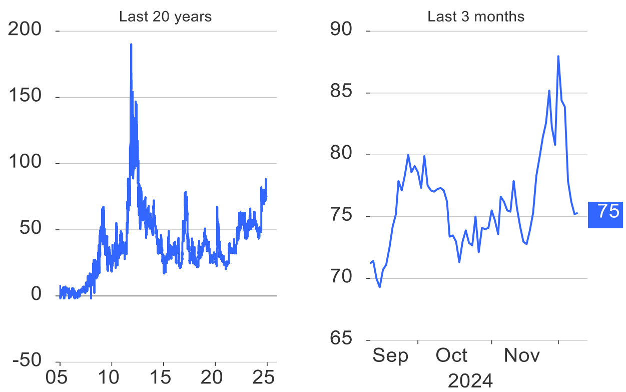
CHART OF THE MONTH: THE 10-SPREAD ON FRENCH GOVERNMENT BONDS HAS ALMOST FULLY RETRACED SINCE THE GOVERNMENT COLLAPSED



Source: LSEG Datastream, 11/12/2024

Drafting completed on 10 December

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BNP PARIBAS WEALTH MANAGEMENT

The bank for a changing world

Central banks

Synchronised monetary easing (for now)

European Central Bank (ECB)

First debate: Should the ECB cut rates by 25bp or 50bp in December? Following the weak PMI data, some argue for a 50bp cut. However, we find this excessive. The European Commission's business confidence survey, another reliable economic growth predictor, remained stable in November, pointing to modest but positive GDP growth—no recession.

Second debate: Should the ECB push the policy rate below the neutral rate? The neutral rate is estimated between 2% and 3% by most ECB members. Given projected growth near potential for 2025, we see no need to cut below 2%.

Our view: The disinflation trend continues, but growth risks have risen. We forecast 25bp cuts at the next three meetings (December, January, March), followed by a quarterly pace (June, September), ending with a policy rate of 2% by September 2025. Markets expect more cuts than we do, pricing a terminal rate of 1.6%.

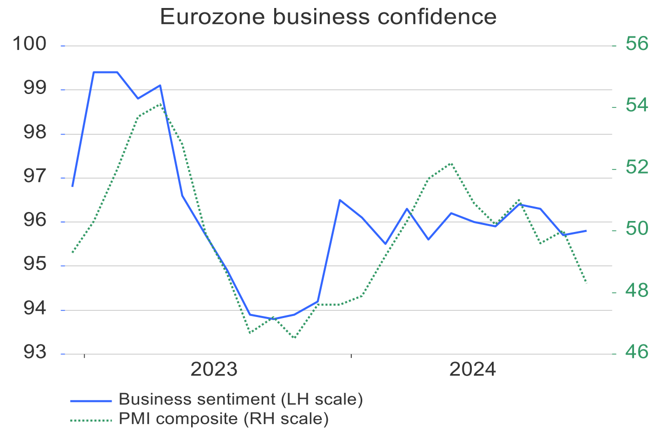
US Federal Reserve (Fed)

No speculation: Despite upcoming administrative changes and Trump's unpredictable actions, the Fed will base decisions on actual data, avoiding speculation over political implications.

Strong economy: PMI manufacturing rebounded in November, and PMI services remain robust. Unemployment is rising moderately, as the Fed anticipated. Inflation rose slightly in October, aligning with expectations.

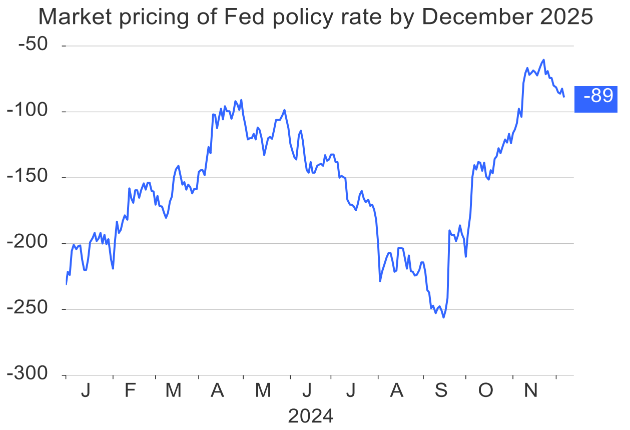
Our view: The disinflation trend supports reducing policy restriction. We expect the Fed to continue cutting rates: 25bp in December, March, June, and September 2025, with a terminal rate of 3.75% in September. As Trump's policies impact the economy, inflation might rise late in 2025, prompting a pause. Markets, previously overestimating cuts, now underprice them in our view, projecting a policy rate of 4% in September 2025.

THE ECONOMY MAY NOT BEEN AS BAD AS THE MARKET IS PRICING IN



Source: LSEG Datastream, Nov 24

THE MARKET IS PRICING IN 89BP OF RATE CUTS BY DECEMBER 2025



Source: LSEG Datastream, 06/12/2024

INVESTMENT CONCLUSION

Disinflation is driving our view that both the ECB and the Fed will cut rates, but with key differences. We expect the ECB to cut to a terminal rate of 2% by September 2025, while the Fed will cut more gradually, reaching 3.75% in September 2025. The ECB is debating deeper cuts and neutral rate limits, while the Fed is focusing on incoming data as policy decisions under Trump are unpredictable.

Bond yields

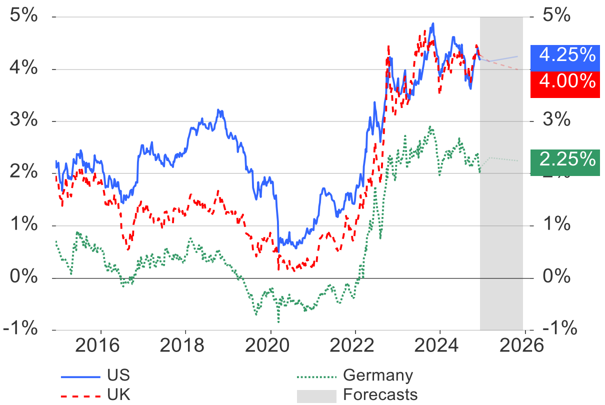
From the Trump trade to the Bessent trade

The Trump trade: higher nominal yields, higher real yields, higher inflation breakevens, higher term premiums, and steeper curves. A massive repricing has occurred in the US, driven by Trump's policies, including tariffs, reduced immigration, and tax cuts—measures that are inflationary and involve increased fiscal spending.

Bessent's nomination calms Treasury market: the Trump trade was partly reversed by the nomination of Bessent as Treasury Secretary, a Wall Street veteran, who pledged to monitor the US deficit, reassuring bond markets. While the US 10-year yield may decline in the coming months, it is anticipated to rise again as inflation rises in H2 2025. In contrast, we maintained our bond yield targets in Germany, with the ECB expected to stay on course and disinflation continuing.

Our recommendation: We keep a Neutral view over a 12-month horizon on US long-term Treasuries and German government bonds, with a short-duration bias in the US (under 5 years) and a neutral duration bias in Germany (around 7 years). We recommend short-term Treasuries.

10-YEAR RATES



Source: LSEG Datastream, 10/12/2024

	Maturity (years)	09/12 2024	3-month target	12-month target
USA	Policy rate	4.75	4.50	3.75
	2	4.12	4.00	4.00
	5	4.07	4.00	4.10
	10	4.20	4.15	4.25
	30	4.39	4.30	4.50
Germany	Policy rate	3.25	2.50	2.00
	2	2.00	2.10	2.00
	5	1.97	2.15	2.10
	10	2.12	2.30	2.25
	30	2.34	2.55	2.50
UK	Policy rate	4.75	4.75	3.75
	2	4.25	4.10	3.60
	5	4.12	4.10	3.75
	10	4.27	4.15	4.00
	30	4.82	4.60	4.45

Source: Refinitiv Datastream, BNP Paribas WM

INVESTMENT CONCLUSION

We recommend US short-term Treasuries for a better risk/reward balance, given elevated rate volatility and a low probability, in our view, that the Federal Reserve will raise rates. We keep a Neutral view over a 12-month horizon on US long-term Treasuries and German government bonds.

Theme in Focus

Top Pick for H1 2025: Buy Short-Term US IG Credit

If we had to choose a single investment idea for the next six months, what would it be?

We recommend short-term (1-5 years) US investment-grade (IG) credit as a strategy to minimise exposure to duration risk amidst potential rate volatility under Trump.

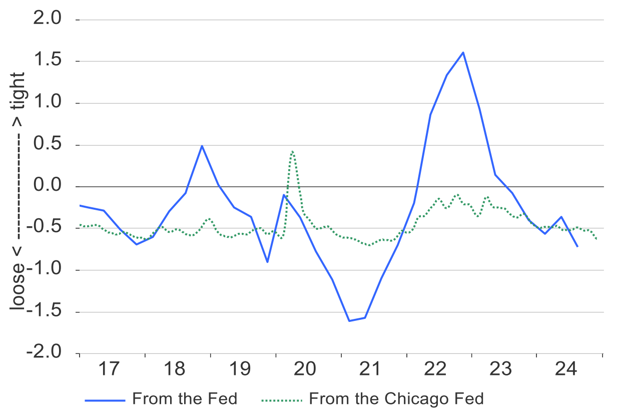
Solid fundamentals: The macroeconomic environment is highly favourable. The Federal Reserve continues to ease rates, financial conditions are improving, and economic growth remains robust. Pro-business policies, such as Trump's proposed corporate tax cuts, could enhance earnings by 6-7%. On the microeconomic front, earnings growth is exceeding expectations (IG: +5% vs +1% forecast). Lower rated IG companies have been de-leveraging, with fewer Merger & Acquisition plans due to elevated funding costs, while rating agencies highlight improving credit quality with positive rating trends.

Strong technicals: Issuance has been substantial, with $1.5 trillion in 2024—the second-highest on record. However, net supply has been tempered by coupon payments and maturities returned to investors. Hence, spreads can remain tight without the need of an excessive demand.

Tight valuations: The average spreads for 1-5 year US IG corporates is moderately tight at 55bp. Historically, spreads tend to remain compressed during periods of strong economic growth, as seen from 2004 to 2007.

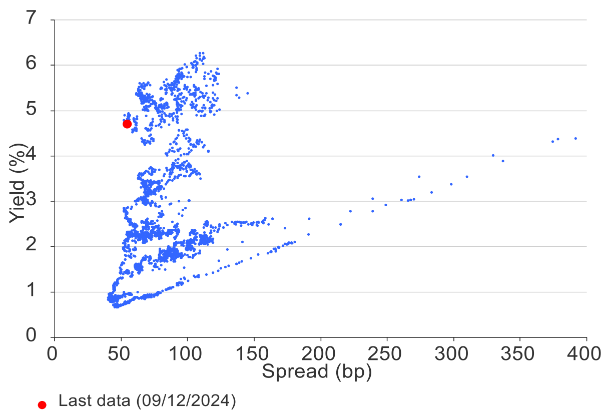
Our view: Over the next six months, we anticipate a modest rise in Treasury yields and stable credit spreads, assuming no recession and sustained demand for credit driven by attractive yields. Within this framework, short-term US IG credit is well-positioned to deliver returns above 4%, offering an excellent balance of yield and low volatility. Current yields at 4.75% provide an attractive entry point with limited downside risk. Even under adverse scenarios, total returns should exceed inflation. To result in zero total returns, an unlikely combination of a nearly 100bp increase in Treasury yields and a 100bp widening in spreads would be required.

FINANCIAL CONDITIONS ARE IMPROVING IN THE US



Source: LSEG Datastream, Q3 24

THE SPREAD ON SHORT-TERM US IG BONDS IS TIGHT BUT ALL-IN YIELDS ARE HIGH



Source: LSEG Datastream, 09/12/2024

INVESTMENT CONCLUSION

We recommend short-term US investment-grade credit (1-5 years) to mitigate duration risk amidst rate volatility. Fundamentals are strong, with solid economic growth, corporate tax cuts boosting earnings, and solid credit quality. Supply is high but net supply is manageable. Yields are attractive and short-term US IG Credit should deliver above 4% total return in our view, with low downside risk and limited volatility.

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 are tactically 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. We are also Neutral on US TIPS.
Corporate bonds Investment Grade	Eurozone United States	+	• Eurozone and US: Positive opinion. Prefer short maturities 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	=	We are Neutral on EM hard currency bonds (sovereign and corporate).
	In local currency	=	We are Neutral on EM local currency government bonds.

Market Data

	10-year rate (%)	Spread (bp)	Spread change 1 month (bp)
United States	4.20	---	
Germany	2.12	---	
France	2.87	75	0
Italy	3.19	107	-22
Spain	2.76	64	-10
Portugal	2.51	39	-12
Greece	2.91	79	-14

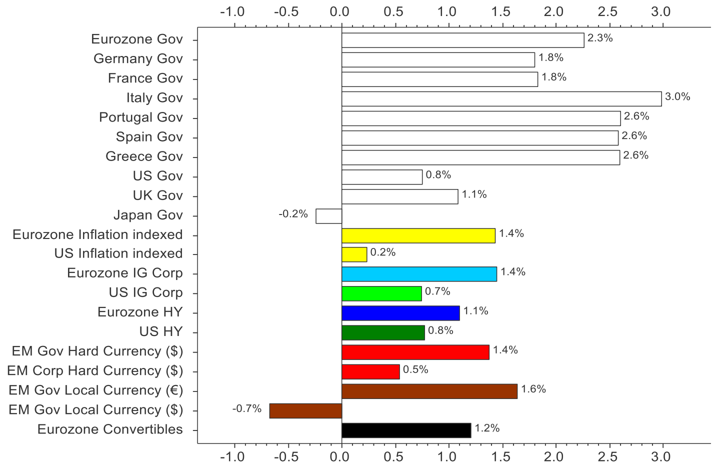
09/12/2024
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.50	34	0
Corporate bonds IG EUR	3.01	99	-1
Corporate bonds IG USD	5.02	77	3
Corporate bonds HY EUR	5.58	305	-11
Corporate bonds HY USD	7.07	262	6
Emerging government bonds in hard currency	6.77	254	-1
Emerging corporate bonds in hard currency	6.35	210	12
Emerging government bonds in local currency	6.32	225	1

09/12/2024
Source: Refinitiv Datastream, Bloomberg

Returns

OVER ONE MONTH



Source: LSEG Datastream, 10/12/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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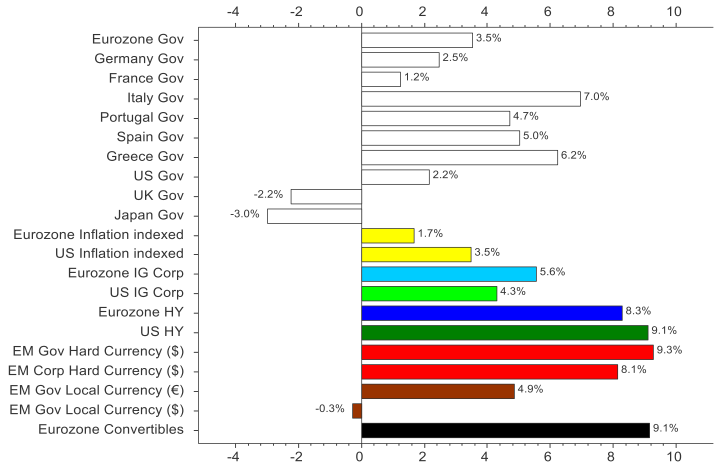

Source: LSEG Datastream, 10/12/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

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