NOVEMBER 2023

Fixed Income Focus

Summary

1. **No future rate hikes from major central banks:** the Fed and the ECB are set to keep rates on hold for several quarters. We anticipate total rate cuts of 125bps in 2024, starting in June for the Fed and 75bps from September for the ECB.

2. **Fall in long bond yields over the coming 12 months in our view,** especially in the US, as we see a recession in Q1-Q2 2024. However, the premium between short and long rates should remain positive and prevent bond yields going into freefall. We are Positive on US government bonds because they offer high carry and upside price potential. We remain Neutral on German sovereign debt as most of the rate cuts have already been made, in our view.

3. **Two international events are impacting bond yields:-** the Bank of Japan and the quarterly schedule of US Treasury bond issuance have had a significant impact on global interest rates. 1) Japanese investors now find Japanese government bonds more attractive than currency-hedged US Treasury bonds, putting upward pressure on US rates. 2) The next US debt refinancing plan (February 2024) could be the last with increases in the size of issues. However, prospects for supply/demand remain unequal given the deficit and the continued reduction in central banks' balance sheets (tapering). The term premium should therefore remain relatively high.

4. **Opportunities in fixed income.** We are Positive on US Treasuries, US inflation-linked bonds, US agency MBS (mortgage-backed securities), UK Gilts, as well as European and US Investment Grade corporate bonds with a duration of up to 5 years in EUR and up to 10 years in USD. We are also Positive on emerging bonds in hard and local currency.

Drafting completed on 16 November

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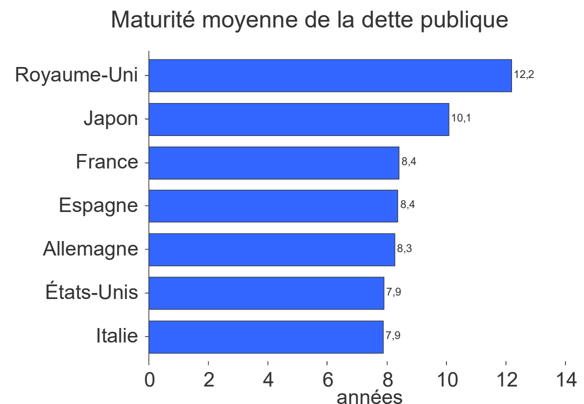
THE RELATIVELY LOW MATURITY OF ITALIAN PUBLIC DEBT IS A WEAKNESS GIVEN THE PERSISTENCE OF HIGH INTEREST RATES



Source: LSEG Datastream, 16/11/2023

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Central banks

A restrictive monetary policy for longer

European Central Bank (ECB)

The ECB's last meeting confirmed that the terminal rate had been reached: members seemed more confident about the downward trajectory of inflation.

Towards faster quantitative tightening? The ECB did not discuss this point, so we assume that it will continue reinvesting maturing bonds from the PEPP (Pandemic Emergency Purchase Programme) portfolio until at least December 2024. However, we expect it to discuss a faster normalisation of monetary policy in December 2023/January 2024, which should lead to the end of the PEPP reinvestments in March 2024.

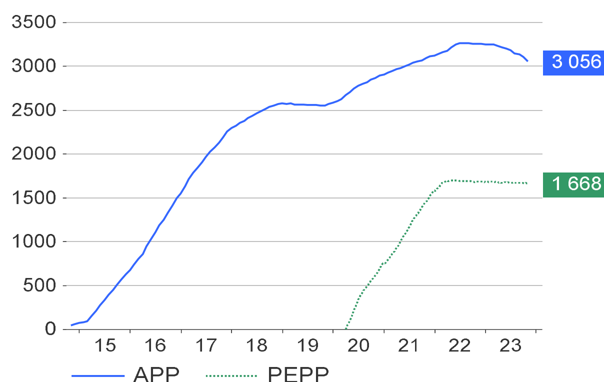
Our view: the ECB is set to keep its rates unchanged at current restrictive levels for several more quarters. We expect a total of 75bps in rate cuts in 2024, from September onwards.

US Federal Reserve (Fed)

The FOMC meeting in November confirmed that the terminal rate had been reached: the Fed was less aggressive than expected. Recent strong data (GDP more than doubled between Q2 and Q3 to 4.9% annualised) did not worry Fed members. Instead the committee focused on the "sufficiently restrictive" level of policy rates, which have "significantly tightened" financial conditions. This factor plus leading indicators pointing to lower inflation support our view that the Fed will stop raising its policy rate.

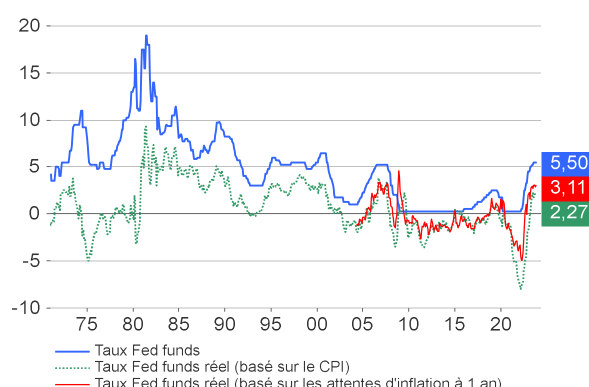
Our view: real policy rates (stripping out inflation) will become too restrictive at some point, as the disinflation process continues and signs of an economic slowdown emerge. We expect a mild recession in Q1-Q2 2024 and a total of 125bps in cuts in the Fed funds rate in 2024 from June onwards.

THE ECB IS REDUCING THE SIZE OF ITS BOND PORTFOLIOS, BUT NOT THE PEPP YET



Source: LSEG Datastream, oct. 23

REAL POLICY RATES ARE ALREADY RESTRICTIVE



Source: LSEG Datastream, nov. 23

INVESTMENT CONCLUSION

In our view, both the ECB and the Fed have reached the end of their hiking cycle. Both central banks are expected to keep rates on hold (4% for the ECB's deposit rate and 5.5% for the Fed funds rate) for an extended period. We anticipate rate cuts of 125bps in 2024, from June onwards for the Fed, and 75bps from September for the ECB.

Bond Yields

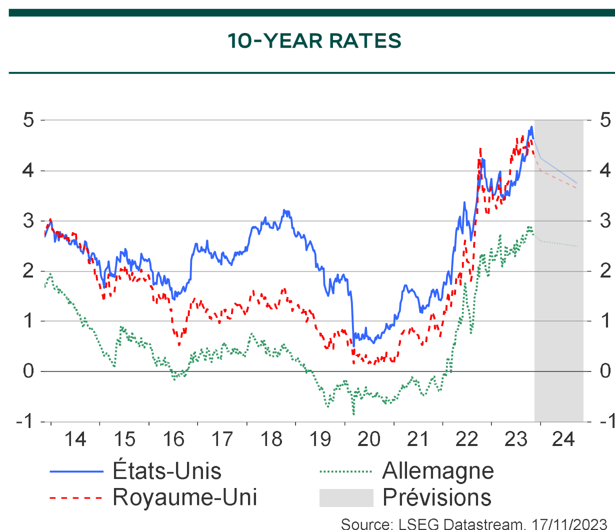
Long-term rates reach cycle highs

New cycle highs: 10-year rates peaked close to 5% in the US and 3% in Germany in October, mainly due to the revaluation of the term premium, before falling in November for various reasons (weaker macroeconomic data, a less aggressive Fed, hedge funds covering short positions).

What is the term premium? It is an estimation derived from financial models that measures the excess return that investors demand to hold onto longer duration bonds rather than reinvesting each time in short-term bonds. A number of factors support a high premium (supply/demand imbalance, reduction of central banks' balance sheets, uncertainty about inflation expectations, etc.), which should prevent long-term rates from going into freefall, even in the event of a recession.

Our recommendation: we are Positive on US Treasury bonds and Neutral on German sovereign bonds in view of expectations of steeper rate cuts in the US than in Germany in 2024.

10-YEAR RATES



	Maturity (years)	16/10/ 2023	3-month target	12-month target
USA	2	4.85	4.75	3.50
	5	4.43	4.50	3.70
	10	4.45	4.25	3.75
	30	4.63	4.50	4
Germany	2	2.95	3	2.25
	5	2.52	2.50	2.50
	10	2.59	2.60	2.50
	30	2.83	2.80	2.60
UK	2	4.54	4.25	3.60
	5	4.16	4.20	3.65
	10	4.15	4	3.65
	30	4.59	4.30	4

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

We expect long bond yields to fall over the next 12 months, especially in the US as we see a recession in Q1-Q2 2024. However, the term premium should remain positive and prevent bond yields from going into freefall. We are Positive on US government bonds because they offer high carry and potential for price appreciation. We remain Neutral on German sovereign debt because we believe that most of the rate cuts have already occurred.

Theme in Focus

Two global events impact bond yields

In October, the **Bank of Japan** (BoJ) took a further step towards normalising its monetary policy on the back of i) more confidence in meeting the 2% price stability target and ii) less tolerance for the yen's persistent weakness. It has modified its bond yield control, replacing the 0.5% upper bound on the 10-year bond with a new benchmark cap of 1%.

We expect the BoJ to revise its outlook in January and end its negative interest rate policy (NIRP) in March 2024.

The BOJ's actions have global implications for yields, because Japanese investors, traditionally big buyers of US Treasury bonds, are now finding it more attractive to invest in Japanese government bonds rather than currency-hedged US Treasuries, hence creating upward pressure on US yields.

We expect Japanese 10-year yields to reach 1.35% by the end of 2024, and 3.75% for US Treasury yields.

The US **Treasury** increased the size of its issues as part of its quarterly funding schedule in a bid to reduce the deficit. This sent shockwaves through the markets and pushed long bond yields sharply higher. The 10-year rate reached 5% in October. In fact, all eyes were on the announcement of November's quarterly financing plan, to assess how the (probably record) issuance of debt in the market will be absorbed.

As expected, the Treasury confirmed further increases in auction sizes but chose to moderate the pace of increases for longer-dated maturities. This decision clearly reassured the markets, consequently bringing down long bond yields.

The next US debt refinancing plan (February 2024) could be the last one with increases in the size of issues. However, the supply/demand outlook remains unequal in view of the deficit and ongoing quantitative tightening (the Fed no longer buys Treasuries). The term premium should therefore remain relatively high.

THE JAPANESE 10-YEAR YIELD HAS JUMPED SINCE THE BOJ MODIFIED ITS POLICY

Source: LSEG Datastream, 17/11/2023

US TREASURY TERM PREMIUM ESTIMATED BY THE ACM MODEL

Source: LSEG Datastream, 15/11/2023

Investment Conclusion

The Bank of Japan and the quarterly US Treasury issuance schedule have had a significant impact on global interest rates. 1) Japanese investors now find Japanese government bonds more attractive than currency-hedged US Treasury bonds, hence generating upward pressure on US rates. 2) The next US debt refinancing plan (February 2024) could be the last with increases in the size of issues. However, the supply/demand outlook remains unequal in view of the deficit and the ongoing quantitative tightening. The term premium should therefore remain relatively high.

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	4.45	---	
Germany	2.59	---	
France	3.15	56	-6
Italy	4.35	176	-22
Spain	3.59	100	-13
Portugal	3.25	66	-7
Greece	3.85	126	-29

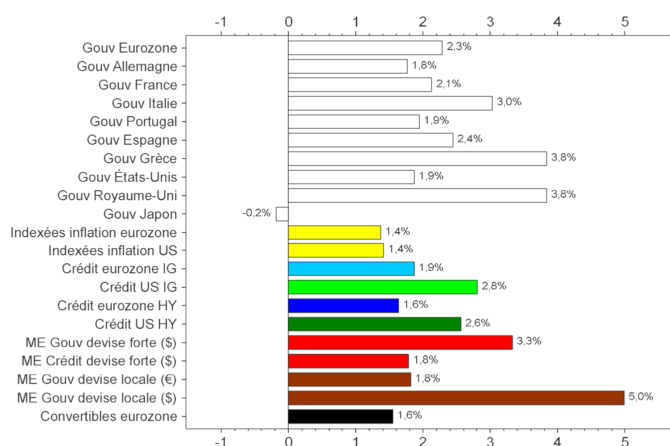
16/11/2023
Source: Refinitiv Datastream

	Yield (%)	Spread (bps)	Spread change 1 month (bps)
Global	4.04	49	-3.0
Corporate bonds IG EUR	4.23	148	-13
Corporate bonds IG USD	5.84	117	-7
Corporate bonds HY EUR	8.18	443	-13
Corporate bonds HY USD	8.75	392	-17
Emerging government bonds in hard currency	8.65	401	56
Emerging Corporate bonds in hard currency	7.76	305	9
Emerging government bonds in hard currency	6.52	209	-26

16/11/2023
Source: Refinitiv Datastream, Bloomberg, JP Morgan

Returns

OVER ONE MONTH



Source: LSEG Datastream, 16/11/2023 Source : Bloomberg Barclays, sauf ME devise locale (JP Morgan) et Convertibles (Refinitiv)

EM = Emerging Markets

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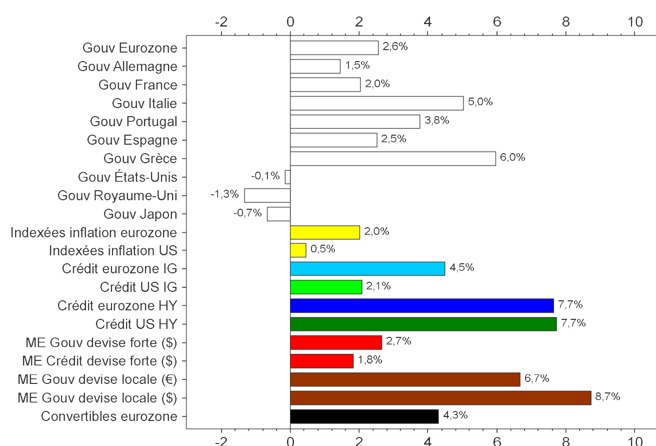

Source: LSEG Datastream, 16/11/2023 Source : Bloomberg Barclays, sauf ME devise locale (JP Morgan) et Convertibles (Refinitiv)

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