



Debt: the hair of the dog that bit me

Fixed income quarterly outlook - second quarter 2020

FOR WHOLESALE INVESTORS ONLY - May 2020

Key points

- It is possible that debt levels could rise much higher than we might think without spurring an increase in government bond yields, that is, as long as there is either a sufficient number of willing domestic investors or a willing central bank to buy the debt.
- One of the most immediate concerns is the economic outlook and whether enough fiscal and monetary support is being provided to offset the impact of the social distancing measures imposed to combat the virus.
- If citizens are kept home for too long and businesses remain shut, the odds rise of a much bigger increase in business failures, high levels of unemployment and the inability of governments to fully replace the lost activity. Governments cannot borrow a year's worth of GDP.
- Encouragingly, estimates for the year as a whole are less dispersed as the steep fall in the second quarter is expected to be followed by commensurately large rebounds in the third and fourth. But estimates for the full year, currently average -4.4%, are worse than the 3.9% fall in GDP during the global financial crisis.

Macro Context

One of the inevitable consequences of the global coronavirus recession looks set to be a large increase in the level of government debt. To the degree that the 2008 global financial crisis and the 2011-12 eurozone crisis were caused by excessive leverage, addressing the current crisis with more debt might not seem to be the best solution. But in much the same way as more alcohol is preferred as a solution to a hangover (“the hair of the dog that bit me”), more debt seems to be the solution to the economic collateral damage caused by necessary government measures to combat the coronavirus pandemic.

It wasn't supposed to be like this. Central bankers had hoped that governments would take advantage of low interest rates from their quantitative easing (QE) measures to lower indebtedness. Not surprisingly, just the opposite happened. With the notable exception of Germany, debt-to-GDP levels in most large countries rose sharply after the global financial crisis.

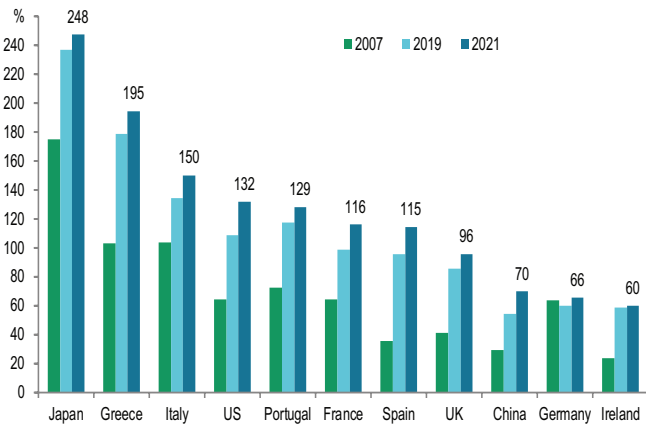
With global GDP set to fall sharply this year and nearly USD 5 trillion in stimulus announced so far, these ratios are bound to rise even further (see figure 1). The increases are smaller than after the GFC, however, and central banks are likely to buy a significant share of the new debt as QE programmes are expanded and extended.



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Figure 1: Gross government debt-to-GDP levels look set to rise further (in %; 2021 estimated)

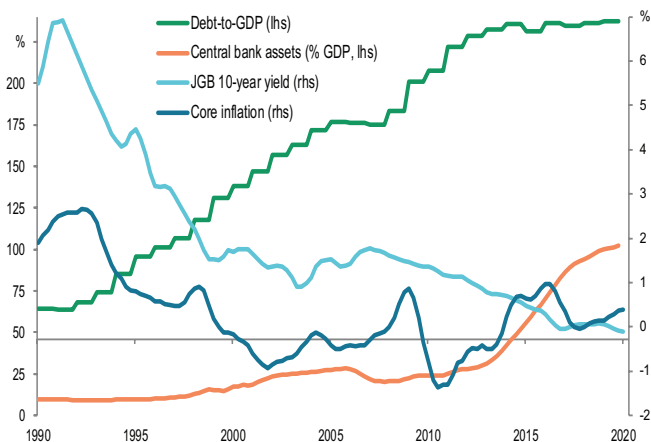


Data as at 9 April 2020. Source: IMF, BNP Paribas Asset Management

How sustainable is this, and what are the implications for government bond yields and economic growth? The nearest historical parallel that is relevant for the US and Europe is Japan where the government debt-to-GDP ratio rose from just under 50% in the early 1990s to over 200% by 2012. Nominal interest rates initially fell as Japan moved closer and closer to deflation but then were relatively stable over the next decade.

With the launch of Abenomics in 2013, the Bank of Japan began to buy assets on a massive scale, but importantly, the Abe government also lowered the budget deficit as it raised taxes and cut spending on pensions and healthcare. Low interest rates thanks to QE also helped. As a result, the debt-to-GDP ratio stabilised (see Figure 2).

Figure 2: Japan's debt-to-GDP stabilised as QE was stepped up and interest rates fell



Data as at 9 April 2020. Note: Debt is gross debt. Source: IMF, BNP Paribas Asset Management

What might this tell us about the outlook for the US and Europe? Perhaps that debt levels can rise much higher than we might think without spurring an increase in government bond yields, that is, as long as there is either a sufficient number of willing domestic investors or a willing central bank to buy the debt. This still accurately describes the situation in the US and Europe, with the US having the additional advantage of many international investors eager to buy US dollar-denominated Treasuries.

While there must still be some limit on how high debt-to-GDP ratios can rise, there is no theoretical cap on how much of it the central bank can buy. While the Bank of Japan already owns assets worth more than 100% of the country's GDP, in Europe and the US, the proportions are much lower, at just 32% for the US Federal Reserve, 30% for the Bank of England and 42% for the ECB.

The discussion among European leaders about fiscal and monetary support for those countries particularly hard hit by the coronavirus leaves open the question about the potential for the ECB to indefinitely purchase 'peripheral' eurozone government bonds.

The central bank's current EUR 750 billion Pandemic Emergency Purchase Programme (PEPP) should enable 'peripheral' governments to finance any supplementary expenditures this year. This explains why the yield on 10-year Italian BTPs is still below the level reached during the market sell-off in the fourth quarter of 2018. Whether these assets can remain on the ECB's balance forever will be a key factor for investors in evaluating the long-term solvency of these countries.

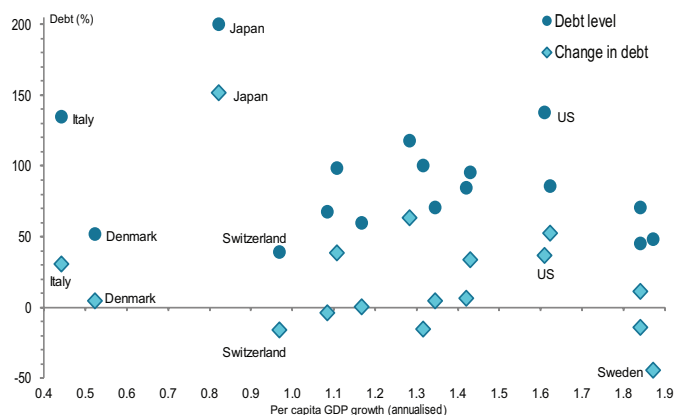
The other concern besides the impact of high debt levels on bond yields is the effect on growth. The traditional argument is that the government can 'crowd out' private sector investment by absorbing a disproportionate share of household savings.

This concern seems less relevant today when, if anything, there is insufficient supply of highly rated government debt to meet the needs of investors, particularly those looking to match liabilities over a long-term horizon. Nor is it obvious that Japan's rising debt was the cause of its poor economic performance over the last few decades. If anything, it was likely the reverse: insufficient growth due partly to rigid labour markets and poor demographics necessitated more borrowing to finance social obligations.

Even adjusting for Japan's declining population, though, GDP growth has been disappointing. Since 1992, per capita growth has averaged just 0.8% versus an average of 1.3% for other developed countries. While another highly-indebted country, Italy,

has had even worse economic growth per capita, other much less levered countries have hardly done much better, for example Denmark and Switzerland (see Figure 3). With interest rates low and likely to stay low, both because of subdued inflation and thanks to central bank support, higher debt burdens should not materially affect a country's growth prospects. Economic reform (or the lack thereof) will matter much more.

Figure 3: Per capita GDP growth, debt levels and debt growth
(in %; selected developed countries)



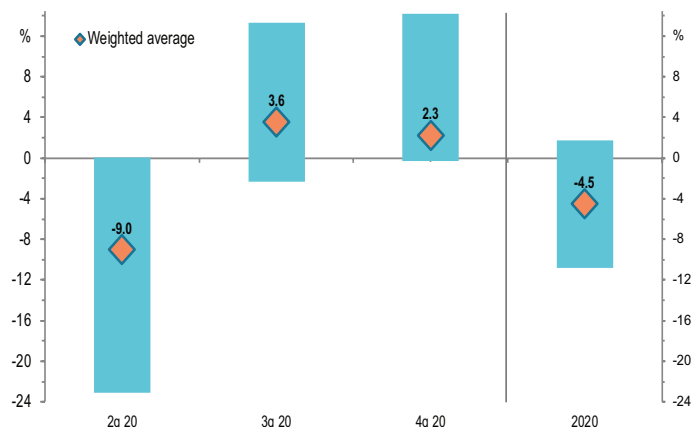
Data as at 10 April 2020. Note: Debt level is latest debt-to-GDP ratio. Change in debt is change from 1992 or earliest available date in the debt-to-GDP ratio. Source: Haver, BNP Paribas Asset Management

The more immediate concern is the economic outlook and whether enough fiscal and monetary support is being provided to offset the impact of the social distancing measures imposed to combat the virus.

Estimating GDP growth for the upcoming quarter is inevitably hazardous given the multitude uncertainties we face. We do not know to what degree social distancing measures will be imposed (moderately as in Sweden or severely as in Italy), where else they will be imposed (will other large cities in the US be forced to follow New York's example), or for how long. Even if we knew all these things, we could hardly estimate the effect on GDP given that these measures have never been imposed so broadly before or that a country consciously shut down a large share of its economy. During the three previous large pandemics in the US (of the Spanish, Hong Kong, and Asia flus), social distancing measures were limited despite a far higher number of infections and deaths.

The final difficulty in forecasting GDP growth is that we have to account for the offsetting impact of the trillion dollars of fiscal and monetary support measures. Consequently, there is an extraordinarily wide range in economist estimates for US GDP growth through the rest of the year, for example, from 0% to -24% in the second quarter (see Figure 4).

Figure 4: US GDP forecasts
(in %, quarter on quarter)



Data as at 29 April 2020. Source: Bloomberg, BNP Paribas Asset Management

Encouragingly, estimates for the year as a whole are less dispersed as the steep fall in the second quarter is expected to be followed by commensurately large rebounds in the third and fourth. Nonetheless, estimates for the full year, currently average -4.4%, are worse than the 3.9% fall in GDP during the global financial crisis.

The most obvious risk to these forecasts is that the rebound in the second half of the year does not occur. This is either because the removal of restrictive measures is followed by a rebound in infections and then a subsequent re-imposition of the restrictions. Or it is because consumers, lacking a vaccine, are reluctant to return to the shops and demand does not rebound as strongly as hoped.

If citizens are kept home for too long and businesses remain shut, the odds rise of a much bigger increase in business failures, sustained high levels of unemployment and the inability of governments to fully replace the lost activity. No government can simply borrow a year's worth of GDP. While this scenario is unlikely, it is nonetheless possible and investors should consider how to hedge their portfolios against this outcome.

Government bonds

US 10-year Treasury yields have moved in a wide range of 0.5% and 1.2% since March depending on market sentiment and oil prices. Thanks to the Fed's unlimited Treasury purchase plan, yields are unlikely to get close again to 1% in the near term, barring an unexpectedly swift improvement in the coronavirus pandemic and a rebound in oil prices.

While the rally in equities from 23 March has been partly fuelled by the Fed's actions, the gains are much greater than can be explained by the relatively modest decline in Treasury yields and the discount rate. Given a renewed disconnect between the bond and equity markets, the risk is that equities reflect a too complacent view of the ability of countries to quickly remove social distancing restrictions. The expectation is that earnings recover in the second half of the year. Consensus estimates are calling for 40% growth. This could prove to be far too optimistic; investor sentiment could quickly turn negative again and Treasury yields could revisit or surpass year-to-date lows.

On the other hand, a deal among OPEC members to limit production to support oil prices would provide a badly needed boost to member country revenues. Breakeven inflation, however, may already partially reflect this outcome as linkers have sold off since mid-March. Consequently, they pose less of a threat to Treasury yields. Over the medium term, broken supply chains could lead to price increases. However, with the unemployment rate skyrocketing, consumers cautious on spending and businesses wary of investing, inflationary pressures should remain minimal.

Bunds have been unable to match the fall in US Treasury yields this year despite the arguably greater economic fallout from the pandemic in Europe. In fact, 10-year Bund yields are not far from where they started the year. The stability in yields reflects a comparatively less potent central bank (or at least one buying fewer Bunds than in the past) and already negative rates damping further declines.

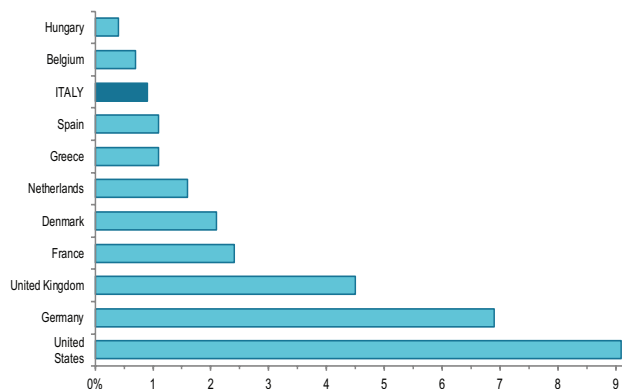
The growth outlook of Germany relative to that of the US is mixed. The fiscal measures adopted so far in Germany to support the economy are somewhat larger than in the US, but more stimulus is likely to come in the US.

Germany is better placed to withstand the impact of the crisis than the US as the government reacted relatively quickly to the outbreak, but then again the lockdown has been more restrictive. The healthcare system has managed well under the strain and the country has seen comparatively few deaths. The Kurzarbeit system, which proved its worth during the GFC, keeps workers employed (if not necessarily working) and paid so that they can quickly return to their posts once it is allowed. Without the kind of uncertainty that unemployment causes for workers in the US, even with supplemental income payments from the government, Germany consumers might be less inclined to reduce consumption.

The net effect is that the 10-year Treasury-Bund spread has fallen from the 200bp it has averaged over the last five years to about half that. While the domestic economy may be resilient, Germany still depends on demand from its European neighbours. Two-thirds of Germany's exports are to the rest of Europe and one-third to the eurozone. While the euro has depreciated against the US dollar, it has strengthened by around 4% this year on a trade-weighted basis versus other European currencies. German growth and Bund yields should reflect this drag and we would anticipate the spread widening again due to a fall in Bund yields.

The key issue for the Italian government is that even if 10-year BTP spreads over Bunds have widened, the absolute yield is low (1.5%-2.0%) and the government should have no difficulties in refinancing existing debt and raising additional funds to support the economy through the crisis. In fact, Italy's fiscal stimulus so far has been modest compared to that of many other developed countries. This reflects the constraint the country (along with Spain and Greece and unlike Germany) faces in increasing already high debt levels (see Figure 5).

Figure 5: Immediate fiscal boost from stimulus packages
Percent of 2019 GDP, measures announced as at 31 March 2020



Data as at 13 April 2020. Source: Bruegel, BNP Paribas Asset Management

Additional support from the European Union, even if not in the form of eurobonds as the Italian government would prefer, will also help the economy recover into 2021. There is political risk as the failure of the Eurogroup to approve eurobonds could embolden eurosceptic parties in Italy, but any realistic moves away from the euro still appear improbable. Long-term debt sustainability questions have, if anything, become more pertinent thanks to the crisis. Since the ECB is able to support the government bond market, at least for now, yields on Italian government bonds appear attractive, though in the short term, spreads could widen as discussions among EU members drag on.

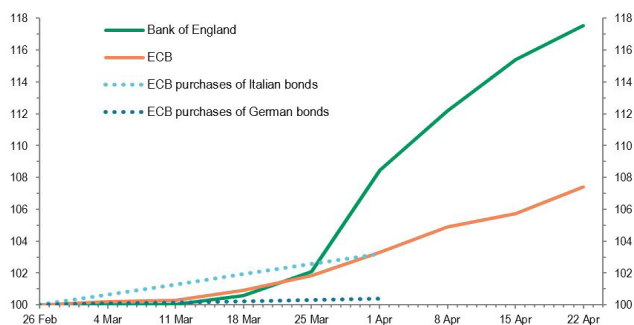
The UK remains the inflationary outlier with expectations falling by less this year than they have in the US and other large European countries. One reason is the currency: sterling has depreciated by about 2% this year, while both the euro and the US dollar have gained on a trade-weighted basis.

Though all countries will see a slowdown in economic growth due to the crisis, the UK may fare slightly better thanks to somewhat less onerous social distancing restrictions than elsewhere in Europe. The government is also providing generous income replacement (80% of wages) to those workers (including the self-employed) unable to work because of the virus. This should support inflation expectations relative to the continent.

The risk of a cliff-edge Brexit at the end of the year has not disappeared, however, as the UK government still insists that agreement can be reached this year despite negotiations having been suspended for several weeks because of the coronavirus outbreak. While the crisis could give the government a face-saving way to extend the negotiations, which is an option a majority of the public supports, there are few indications the government plans to take this path.

While gilts rallied commensurately to Bunds in early March, they have sold off by less since, perhaps because of the larger amount of QE purchases by the Bank of England relative to the ECB. Though the additional purchases planned by the two central banks are of the same size relative to the amount of bonds outstanding (at around 10%), the ECB's purchases have been concentrated on Italy and Spain rather than Germany (see Figure 6). Consequently, we expect gilt yields to remain range-bound until the crisis is past and the market is able to evaluate the country's growth outlook.

Figure 6: Change in central bank government bond holdings
26 February 2020 = 100



Data as at 22 April 2020. Source: ECB, Bank of England, BNP Paribas Asset Management

With regard to government bond positioning in our portfolios, we continue to favour being modestly long duration, both in the US and in core Europe, at least in the short term. Over a long run, it is likely that rates views will be influenced by the development of vaccines and testing and tracking mechanisms. Consequently, the information ratio on rates is increasingly diminishing, as is their usefulness as a hedge against risk assets, as we witnessed during the selloff in March.

Corporate credit

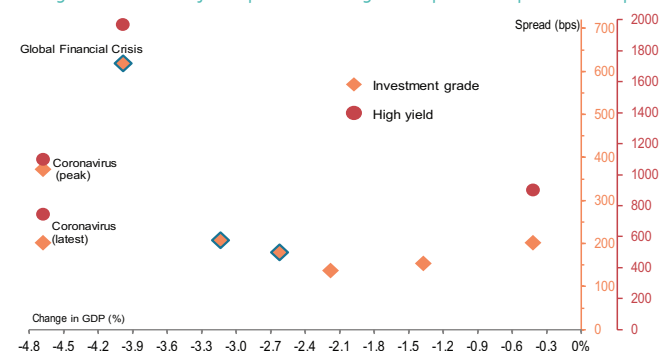
The most significant innovation in central bank policy responses to the coronavirus was the decision by the US Federal Reserve to not only purchase corporate bonds (which the Bank of England and ECB had already done), but to also expand the programme to include high-yield corporate debt exchange-traded funds (ETFs). No other central bank had done this before, though the ECB may now follow suit to some degree. Not only did these decisions spark a rally in the corporate bond market, they also has allowed companies to raise funds again directly from investors.

The questions facing investors now are two-fold. Had spreads widened by enough prior to the Fed's announcement to offer an attractive risk-reward trade-off given the rising downgrades and defaults? Have the Fed's moves simply reduced the reward, but not the risk?

The answer to these questions depends on how damaging one expects the recession to be. If it is sharp but short with a swift recovery, only the most over-levered companies should default and many fallen angels could be restored to at least a financial 'holy' status.

At least judging by the amount of spread widening we saw through 23 March, the markets seemed to have a more pessimistic view. During recessions in the US over the last 50 years, investment-grade bond spreads widened from 50bp to 500bp points depending on the depth of the recession. The GFC was exceptional in that spreads widened by much more relative to the fall in GDP, but the increase in yields arguably reflected the financial stresses during the crisis as much as the actual decline in economic activity. During most recessions, the widening has averaged just 90bp (see Figure 7).

Figure 7: Credit spreads and US recessions
Change in GDP in % from peak to trough and peak in spreads in bp



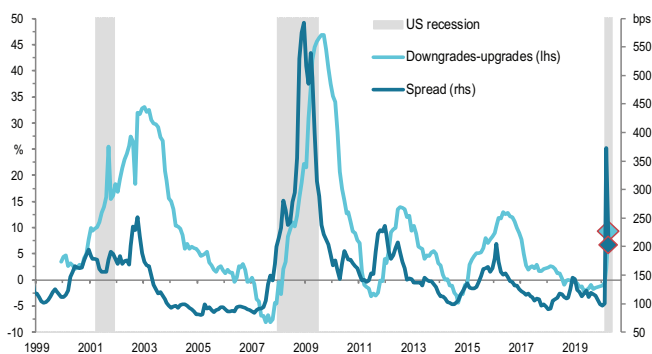
Data as at 1 May 2020. Note: Recessions from 1973. Blue border indicates recession of above-average length. "Coronavirus (peak)" shows spreads as at 23 March 2020. "Coronavirus (latest)" is as at 21 April 2020. GDP estimate is Bloomberg weighted average consensus. Source: Bloomberg, BEA, BNP Paribas Asset Management

The three orange diamonds in the chart with a blue border correspond to the three lengthier recessions (17 months vs. 7 months for the other three).

At peak spreads, we believe IG credit offered an attractive risk-reward trade-off, but thanks to the Fed's commitment to buy bonds in both the primary and secondary markets, spreads have fallen back to nearer 200bp over Treasuries. Given the uncertainty about the duration of the current recession and subsequent downgrade risk, spreads may well resume climbing over the next several months.

Historically, once the economic outlook begins to deteriorate, spreads can widen over a considerable period. Even the brief sell off in 2011 around the eurozone crisis lasted six months (see Figure 8).

Figure 8: Credit spreads and rating downgrades
Trailing 12-month moving average



Data as at 1 May 2020. Note: Downgrades less upgrades is expressed as a share of total number of issuers. Source: ICE, BNP Paribas Asset Management

Beyond the impact of the recession on corporate profits, there is the additional impact on sectors such as retail and office space. Nonetheless, the downside risk to bond yields has been minimised by the Fed's new initiative and spreads are still nearly as high as they have been over the last 20 years (excluding the exceptional GFC), and we would be overweight IG credit at current levels.

History is less helpful in evaluating high-yield spreads as there have only been two recessions when there were published high-yield bond indices. While the Fed is also buying high-yield bond ETFs, it will not prevent corporate defaults. We expect defaults to reach 10% in the US this year, well above periods in the past when spreads were at commensurate levels. As a result, we are underweight high-yield.

From a portfolio positioning point of view, with central bank support almost entirely priced into current valuations, instead of broad beta allocations, we prefer focusing on dispersions within sub-sectors of the IG market. The carry potential also remains attractive in the near-term. In high yield, the market expected a liquidity crunch for companies, but that is now morphing into a solvency crisis instead. Companies are likely to leave this crisis with weak demand, so the ones with operational stresses coming into March, will be further burdened in the coming months. Consequently, it is likely that the tail of the default cycle will be longer. Essentially, with defaults expected to be stretched over a longer term, a V-shaped recovery in returns for the high yield sector looks unlikely.

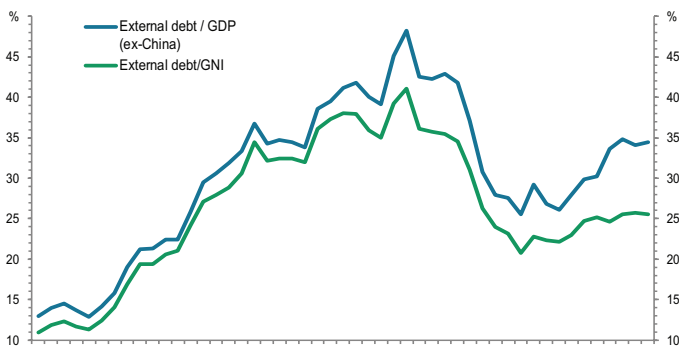
Emerging market debt

Similar to countries and companies in the developed world after the global financial crisis, emerging market countries and corporates responded to the abnormally low interest rates engendered by QE by taking on even more debt. This behaviour was welcomed by investors who were desperate to find higher yielding assets even as they choose to ignore the higher risk involved.

Unfortunately, for both parties today, few emerging markets have the equivalent of a Fed or ECB that is able to purchase the additional debt they will now need to issue to offset the effects of the coronavirus and investors have become much more cognizant of the risks of what they have bought.

If there is one consolation, it is that countries are in a better position today than before the Asian financial crisis. Following that trauma, countries built up foreign reserves and lowered debt levels, allowing them to go through the global financial crisis relatively unscathed (see Figure 9). They are unlikely to be as fortunate this time as the coronavirus crisis is truly a global one, while arguably the GFC was primarily a calamity for the US and Europe.

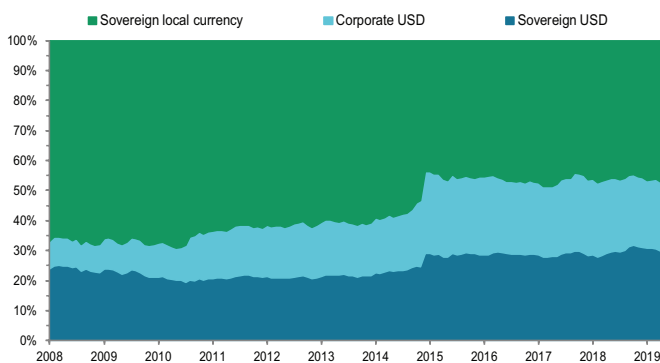
Figure 9: Emerging market external debt-to-GNI



Data as at 24 April 2020. Low & middle-income countries per World Bank definition. GNI = Gross National Income. Source: World Bank, BNP Paribas Asset Management

As debt has risen over the last decade, the share of investors' US dollar exposure to emerging markets has increased from one third of traded assets to one half today as EM corporates have also significantly increased their issuance of US dollar debt (see Figure 10).

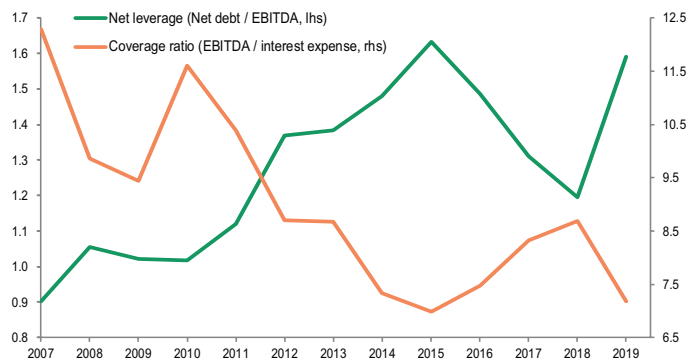
Figure 10: Composition of tradeable emerging market debt



Data as at 28 April 2020. Source: JPMorgan, BNP Paribas Asset Management

Given the dramatic fall in the value of emerging market currencies versus the US dollar over the last few months (the JPMorgan Emerging Market Currency index has dropped by 15% in the year to date), foreign holders of US dollar debt at least have the comfort of not being directly exposed to currency risk. However, repayment has become much more difficult for the companies. Country and corporate revenues have fallen along with GDP, trade, tourism and oil prices. Before the start of the crisis, corporate credit metrics had already deteriorated sharply (see Figure 11).

Figure 11: Emerging market corporate leverage metrics



Data as at 29 April 2020. Note: 80% of universe has reported for 2019. Source: FactSet, BNP Paribas Asset Management

While USD corporate bond index spreads are now near the highs of the last 10 years, the same is also true for sovereign bonds and we feel the risk is better compensated in that part of the market. Yields on local currency government debt, on the other hand, are near historic lows. With the risk of further US dollar strength, there seems to be little upside in the asset class.

Indeed, hard currency EM continues to represent our strongest conviction area within the asset class, with relative value versus developed market corporates being the primary driver. In the EM currencies space, we favour certain Asian and Latin American currencies over a broad swathed allocation to index, such as EMCI.

Conclusion

The COVID19 coronavirus will have a lasting impact on our societies and on our markets. Debt levels will be higher, perhaps permanently, and growth will be slower, at least in the medium term. In contrast to previous periods when high debt burdens were reduced either through inflation or default, many central banks are instead simply taking the assets onto their balance sheets. With inflation quiescent, the main consequence will be even lower interest rates than investors had imagined before.

Once the crisis has passed, the hunt for yield will return. Investors will again be forced to seek out lower rated investment grade debt and emerging market bonds to meet return. One can only hope the next downturn comes with more warning than the last.

BIOGRAPHIES FOR THE FIXED INCOME AND MACRO STRATEGY TEAMS



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Dominick is Chief Investment Officer of Fixed Income for BNP Paribas Asset Management. His responsibilities include global and regional fixed income (Europe, US, Asia), including money market funds, and global emerging market debt. He has oversight responsibility for all activities relating to the management and performance of the organization's fixed income investment teams, products and portfolios. He is responsible for challenging the strategies and processes of the various investment teams. Dominick joined the firm in 2013 and is based in New York.

Prior to joining us, Dominick was Managing Director – Head of Product Management and Development (Americas) for Deutsche Asset Management where he served in a senior portfolio management capacity as Head of Fixed Income Asset Allocation. Prior to Deutsche Asset Management, Dominick held the position of Head of Fixed Income (Americas) for Robeco, Weiss Peck & Greer Investment Management where he oversaw the management of US and global fixed income assets. At Robeco, Dominick managed numerous fixed income multi-sector portfolios, with a focus on fixed income asset allocation. Prior to Robeco, Dominick held various fixed income portfolio management positions including fixed income portfolio manager for Chase Asset Management, a predecessor of J.P. Morgan Asset Management.

Dominick has over 30 years of investment experience. He earned his BS in Economics from State University of New York, SUNY – Oneonta. He is a member of the New York Society of Securities Analysts and the CFA Institute.



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Daniel is a Senior Investment Strategist at BNP Paribas Asset Management. He is responsible for promoting collaboration between investment teams and formulating alpha-generating investment views across asset classes.

Daniel joined our company in 2015 and is based in London. Prior to joining us, Daniel was Managing Director, Global Investment Strategist at TIAA-CREF, Global Market Strategist at JPMorgan Asset Management, Senior Equity Strategist at Lombard Street Research, and US Equity Strategist at Bank of America Securities.

Daniel has 23 years of investment experience. He holds a BA in Mathematics from Pomona College, an MA in International Economics and Latin American Studies from Johns Hopkins University, as well as an MBA from The Wharton School of the University of Pennsylvania. Daniel is a CFA Charterholder.



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