

FIXED INCOME OUTLOOK FOURTH QUARTER 2025

US SOVEREIGN DEBT

Growth holding up

We view the current strength of US GDP growth as heavily reliant on the investment boom related to artificial intelligence (AI), both in terms of direct capital expenditure and the wealth effect that surging equity valuations have provided to overall consumption. Without this support, we think the negative impact of sharp increases in effective tariff rates and ongoing uncertainty on growth and employment would have been more evident.

Though the AI investment cycle is probably still in its early stages, equity valuations are clearly stretched, meaning that AI stocks need to deliver on ambitious earnings forecasts to justify valuations. This provides considerable scope for an AI-sector equity pullback that would have negative consequences for confidence, consumption and investment.

No hiring, no firing status quo in US job market

In the meantime, US labour market data (after significant revisions) is showing a significant deceleration in hiring, mostly – but not entirely – explained by tighter immigration and stalling participation rates. So far, the job market is characterised by a ‘no hiring, no firing’ status quo.

However, with private sector job creation threatening to turn negative and surveys suggesting jobs are increasingly hard to find, the probability of an external shock starting a wave of layoffs is, in our view, not small. Tariffs, for example, will lower profits and squeeze household purchasing power.

In addition, the Department of Government Efficiency (DOGE) layoffs from the first and second quarters will be counted in October, and the federal government is also threatening to fire employees during the (ongoing) shutdown rather than furlough them.

For these reasons, we anticipate US payrolls data will deteriorate further in the fourth quarter. Looking ahead to 2026, however, we are mindful that fiscal policy is set to deliver a modest 0.3% boost to GDP growth next year, that the tariff impact will be largely behind us, and that the administration’s deregulation agenda could be also supportive for growth. In addition, should they be delivered, foreign pledges of direct investment into the United States could provide another source of investment and growth.

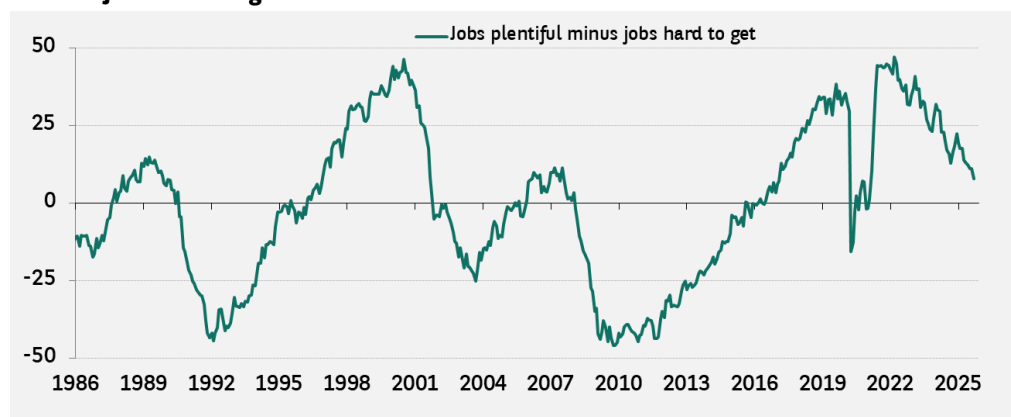


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Exhibit 1

A distinct downturn in job availability in the US – Graph shows data for 'jobs plentiful' minus 'jobs hard to get'



Source: Bloomberg, BNP Paribas Asset Management, Oct 2025

US inflation to run above Fed’s target

On the inflation side, we anticipate that tariffs will contribute approximately 80 to 100bp to the overall US consumer price index (CPI) level over a span of around nine months, beginning around May 2026. This impact is likely to be a one-off and will reduce real incomes. Businesses will also likely absorb a large proportion of the tariff bill, with implications for profits.

A soft labour market is likely to prevent second-round effects via higher wage demands. But we nevertheless anticipate that the less open, more protectionist environment promoted by the Trump administration will have longer-term consequences for prices. In addition, the surge in electricity demand from AI datacentres looks set to maintain upward pressure on energy prices for some time. All this suggests a normalisation of inflation after the tariff-induced peak.

Our view is that US core CPI inflation will have difficulty returning to the 2.3% level that is consistent with the 2.0 % target for personal consumption expenditures (PCE).

Accommodative monetary policy from the Fed

In the absence of a sudden deterioration in labour market data, the policy-setting Federal Open Market Committee will wish to be cautious about cutting rates and signalling a destination for the policy rate.

The minutes of the September FOMC reveal two groups on the committee: a hawkish group that is uneasy about cutting while overall financial conditions are loose, inflation remains above target and tariffs are driving prices higher, and a dovish group focused on rising unemployment. They see the divergence between growth and employment gains as indicative of accelerating productivity and tariffs as a one-off inflation story. For these reasons they think policy rates are still restrictive.

To clarify, we have much sympathy with the hawks, but the risks of further labour market deterioration over the next three months appear significant to us, and we think negative data on payrolls would force the Fed into a faster cutting cycle.

Over the next 12 to 18 months, though, we remain of the opinion that political pressure on the Fed, possible personnel changes on its Board, and Chairman Powell's replacement as Fed chair in May, will impact the FOMC's reaction function, leading to a marginally more accommodative policy stance that is more tolerant of inflation overshoots. That is likely to result in rates being held below levels consistent with a prudent [Taylor rule](#).

We now expect the Fed to lower rates twice more in 2025, and at least three times in 2026, taking policy rates below 3.00%.

Over time, of course, persistent tolerance of inflation in the upper end of a 1% to 3% range is likely to beg the question of whether the central bank has effectively raised the inflation target. Put another way, we note that 2026 will be the sixth consecutive year in which core PCE inflation has printed above the Fed's target, and we see no realistic appetite within the FOMC to ensure that 2026 is the last year of an overshoot.

Views on US Treasuries going into the fourth quarter

We expect further steepening of the US yield curve between 5 and 30 years. The US yield curve shifted higher and steepened for much of the third quarter taking the US 5s30s Treasury curve to a peak of 125bp.

Although there was a sharp reversal towards the end of the third quarter, with longer-dated bonds outperforming short maturities, we believe the fundamental arguments for higher term premia and a steeper curve still hold.

The primary driver for a steeper yield curve has been investors pricing in a softening of the US labour market and a one-off tariff impact on inflation. This has opened the way for the Fed to focus on the employment side of their mandate and resume the rate cutting cycle.

Exhibit 2

The US yield curve has steepened considerably – Graph shows changes in the spreads between 2-year and 30-year yields since 2000



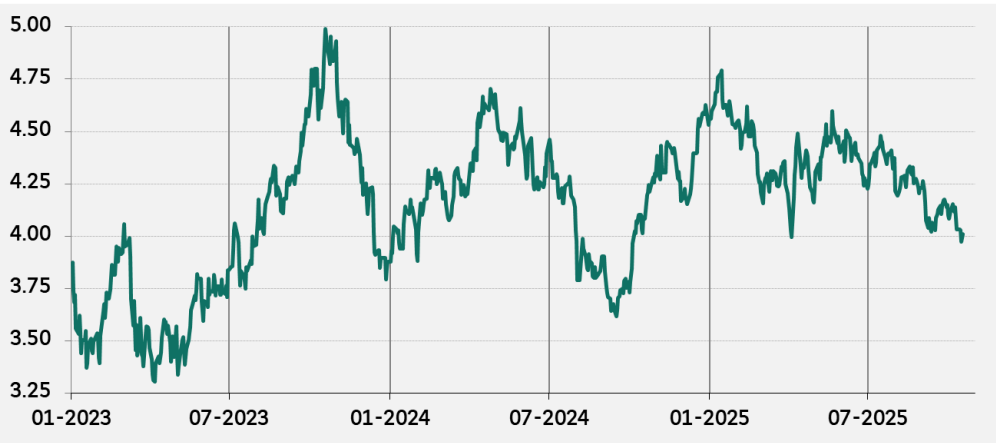
Source: Bloomberg, BNP Paribas Asset Management, Oct 2025

We expect the Fed to take official rates to below the 3.00% ‘neutral’ level in 2026. We anticipate more Fed cuts than are currently priced into the market. For longer-dated US Treasuries, we think inflation and sovereign credit risks are not sufficiently rewarded.

The risk to our expectation of a steeper yield curve comes from the prospect of further positioning unwinds into year-end or the prospect of the FOMC defying political pressure and choosing to focus on upside inflation risks rather than downside employment risks. Yield curve steepening could also be thwarted if the US Treasury decided to shift issuance away from 30-year bonds to five and 10-year T-notes.

For the moment, we do not expect 10-year US Treasury yields to move into a range below 4.00%.

Exhibit 3
Yields of 10-year US Treasuries have moved in a range this year (%)



Source: Bloomberg, BNP Paribas Asset Management, Oct 2025

EUROZONE

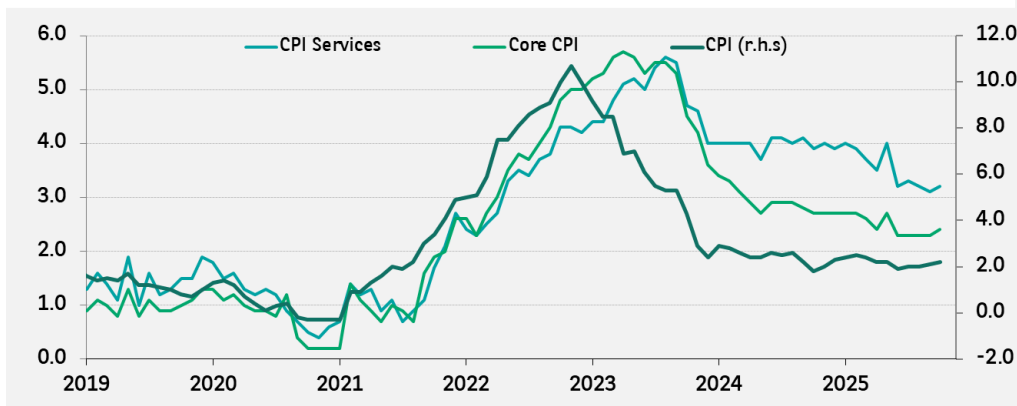
The eurozone economy grew 0.6% quarter-on-quarter (QoQ) in the first quarter and 0.1% QoQ in the second, taking the year-over-year growth rate to a decent 1.5% level. While some of the strength was attributed to export front-loading ahead of anticipated US tariffs as well as GDP volatility in Ireland, survey data pointed to a recovery in sentiment over the past few months, indicating growth resilience in the face of trade uncertainty.

Looking ahead, Europe’s fiscal policy shift is likely to offset the drag from higher US trade tariffs. Beyond an initial sentiment boost, the combination of the EU’s ReArm Europe plan and Germany’s infrastructure investment fund and increase in defence spending will likely boost growth in the medium term. Germany has been running below its potential growth due to both structural and cyclical issues, but the new government’s new fiscal plans could potentially boost demand and help the economy to close the gap, and the strong investment component of the financial package can also lift Germany’s potential growth.

Inflation has successfully returned to the European Central Bank’s (ECB) 2% inflation target, with headline Harmonised Index of Consumer Prices moving sideways between 1.9% to 2.2% since March. Headline HICP is projected to print at levels around the ECB’s 2% target in 2026, as recent euro strength continues to pass through and suppress core goods inflation, and moderation in wage growth continues to contain services inflation.

Exhibit 4

Eurozone Inflation has fallen back to the ECB’s 2% target – Graph shows changes in inflation rates since 2019 (%)



Source: Bloomberg, BNP Paribas Asset Management, Oct 2025

Rate cuts over in the eurozone?

Against this backdrop, the ECB decided to hold its deposit rate unchanged at 2% in July and September. ECB President Lagarde subsequently said that the central bank ‘continues to be in a good place’ and downplayed the undershoot in the ECB’s inflation forecasts.

Despite the preliminary trade deal with the US setting tariffs higher than the ECB’s baseline assumption, the ECB described risks to growth as ‘more balanced.’ We largely agree with the market consensus that the ECB’s rate cutting cycle is over, with a chance of one more ‘insurance’ cut in the near term if downward pressures on inflation intensify. We believe the prospects for steady monetary policy outcomes are largely reflected in market pricing and have taken a more tactical approach to our euro duration strategies. We expect the 10-year German Bund yield to remain in a tight trading range and will look for opportunities to trade the range tactically.

Towards a steeper yield curve

In terms of the yield curve, we believe the weight of rising issuance in Germany, fiscal concerns in France, and the broader narrative regarding debt sustainability could lead to further steepening in the medium term. In the

near term, the implementation of the Dutch pension system transitioning from a defined benefit (DB) to a collective defined contribution (CDC) model will likely put pressure on the longer end of the yield curve as pension funds look to unwind their duration hedges. As such, we have started to reduce our overweight in the 30-year sector of the Italian real yield curve and establish positions anticipating a steeper yield curve.

Inflationary pressures in the eurozone and US to diverge

In breakeven inflation, we maintain a modest underweight bias in euro and French breakeven inflation against US BEIs as the recent euro appreciation and moderating wage growth will likely contain inflation in the eurozone, while higher tariffs will likely be passed on to US consumers. Specifically for French CPI, in addition to the political turmoil which looks set to continue to weigh on France’s growth and inflation outlook, the *Livret A* (government-regulated savings account) remuneration rate has fallen to an unattractive level, which will continue to dampen demand for these inflation-hedging deposits, and therefore hedging demand in the French CPI market.

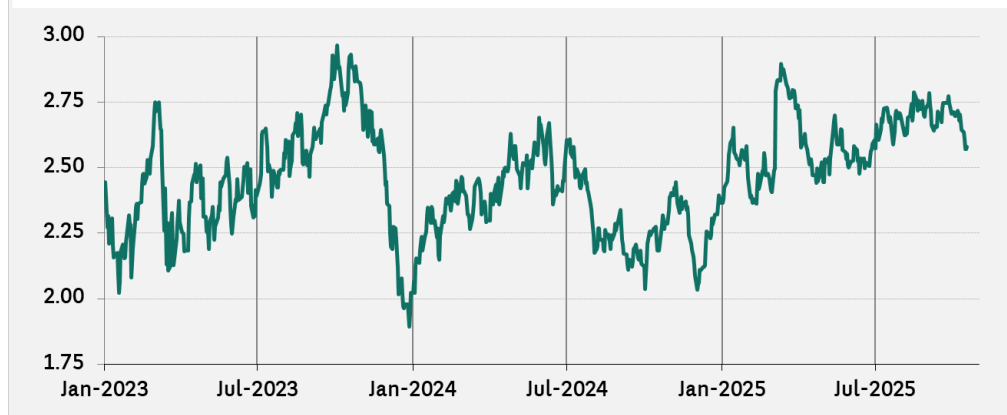
Overweight the ‘peripherals’ versus the core

In sovereign spreads, we maintain an overweight in Italy and Spain against France and Germany in the portfolio. The ReArm EU proposal represents an encouraging first step to fostering deeper integration. Italy’s fiscal outlook has also improved as the government is running a primary surplus this year and looking to exit the EU deficit procedure in 2026.

In contrast, the task of reducing fiscal deficits remains challenging in France, and there is also persistent political risk given the fragmentation in Parliament. French government bonds have already underperformed their peers, and we believe this is unlikely to reverse in the near term, given the lack of realistic fiscal consolidation in sight. We anticipate little change in policy direction in the short term, as the political landscape remains highly fragmented and parties struggle to form a coherent platform for a stable government coalition. In this scenario, the spread between French and German government bonds will likely continue to hover around current levels and therefore provide limited upside for owning French debt. In contrast, recent events suggest that the risks of a snap election are increasing. The associated political uncertainty could push the spread in yields between France and Germany wider still.

Overall, we believe the asymmetry in risks justifies holding on to the underweight in France in the portfolio. At the same time, peripheral spreads will likely remain supported as Germany increases its debt issuance to fund the government’s spending plans.

Exhibit 5
Yield of 10-year German Bunds in a tight range in Q3 – graph shows changes in 10-year government bond yield (%)



Source: Bloomberg, BNP Paribas Asset Management, Oct 2025

UK SOVEREIGN DEBT

Prospects for the UK Gilt market outlook hinge on the government's fiscal decisions. Ahead of the Autumn Budget on 26 November, the government once again finds itself in a difficult position. Reversals on welfare spending cuts, higher government bond yields, changes in US trade policy, and an expected downgrade to the Office for Budget Responsibility's productivity assumption in its growth forecast mean that the fiscal situation has deteriorated, and meaningful fiscal consolidation is required to ensure compliance with the chancellor's 'non-negotiable' fiscal rules.

In a fiscal bind

However, the UK's fiscal situation remains constrained. First, the government reiterated its commitment to its election manifesto of not raising taxes on working people, which in turn excludes hikes in income tax, VAT and National Insurance Contributions (NICs) from the possible solutions to fiscal consolidation. This means tax revenue measures will have to rely on a narrow and less reliable tax base. Second, the current government is deeply unpopular. The Labour party performed poorly in the May local elections, and Starmer's approval rating has reached the lowest level for any prime minister in recorded history. Political pressures also exist within Starmer's own political party, as evident in the rebellion from Labour backbenchers that forced through a welfare policy U-turn in July. As such, the government may see itself not having the necessary political capital to push through tough fiscal reforms and policy measures that are needed to address the UK's debt sustainability issues.

That said, we believe there are several levers that the chancellor could pull to raise tax revenue. These include freezing the tax threshold on income tax, raising a 'sin' tax on gambling, reducing tax relief for pension contributions, introducing additional taxes on expensive properties, and other efforts to increase the tax base, particular in areas where the current policy is deemed unfair. It is also important to consider the effects of proposed policy measures on inflation. The decision from the previous budget to hike the employers' contribution to NIC led to higher costs for businesses, which was partially passed on to consumers. This, alongside other new tax levies, has contributed to sticky inflation over the past few months. Luckily, this time around, the chancellor appears to be mindful that possible tax rises could further stoke price pressures and will likely look to mitigate or avoid such outcomes.

The budget will be decisive

We are cautiously optimistic that the government will deliver a credible budget. Our baseline assumption is that the chancellor will continue to reiterate that her fiscal rules are iron-clad and will come up with fiscal consolidation measures to sufficiently restore the fiscal headroom to exceed £10 billion, with limited impact on the near-term inflation trajectory. In this baseline scenario, the Bank of England (BoE) will likely be able to incorporate the disinflationary nature of fiscal contraction into its forecasting horizon, lowering concerns about upside inflation risks, which could then allow for extending the rate-cutting cycle.

Upside risks to our baseline include a more comprehensive fiscal package that raises the fiscal headroom healthily above £10 billion. One of the reasons why the UK fiscal situation has drawn constant attention from investors was that the government has been running fiscal policy 'to the wire' by leaving a razor-thin buffer against the fiscal rules, which could easily be eroded by disappointment in macroeconomic developments or rises in global interest rates.

Greater fiscal headroom would allow the chancellor's plans to weather short-term macroeconomic and interest-rate volatility better, reducing the need for reactive fiscal tightening. The resultant fiscal policy stability could benefit the Gilt market. Another possible upside scenario is that in the Gilt remit published alongside the Autumn Budget, the Debt Management Office (DMO) could cut long-dated issuance further in the new fiscal year, thereby reducing duration supply to the market, which in turn could support Gilts' valuation.

Pessimistic scenarios include a fiscal package of largely backloaded tax increases, which are vulnerable to backtracking or implementation risks, or a package that includes spending increases that are not 'paid for' or

disguised as investments. In other words, a fiscal plan that takes the least painful measures to simply restore the fiscal headroom to a bare minimum of £10 billion, which would damage the government's fiscal credibility. Another downside risk is that the chancellor may find herself politically too constrained and underdeliver versus market expectations.

Waiting for disinflation

From a valuation perspective, UK real yields remain attractive. Long-dated UK real yields have moved back to the highs, with 10-year/ 10-year forward real yields revisiting levels above 3%, a high not seen since 1997, and far exceeding the level of the UK's trend growth. We therefore maintain a long bias in duration but prefer to trade it tactically and modest sizes given the ongoing fiscal concerns. With the 10-year Gilt yield near the upper end of this year's trading range, we have recently re-initiated a long duration position in the portfolio.

In the near term, however, we are cognizant that, since July, macroeconomic data has pointed to a glacially slow disinflation process. Wage growth and services inflation are still close to 5%, and the BoE has been sounding cautious about the more salient food and energy price increases which could have a larger impact on households' formation of inflation expectations. With headline inflation projected to head higher to around 4% in the next print, and the fiscal outlook remaining unclear until the end of November, we see little room for front-dated yields to rally from their current levels. We have therefore reduced our 2-year to 10-year curve steepener recently.

In the longer term, if our baseline scenario for the Autumn Budget plays out, we believe the disinflationary impact from fiscal consolidation could open the door to further rate cuts once headline inflation resumes its downward trajectory. This could help shorter-dated Gilt yields to outperform on the curve.

CORPORATE DEBT

For the fourth quarter, with European high-yield debt continuing to deliver positive returns and strong demand for this segment of the fixed-income asset class against a background of solid company earnings, we provide a specific focus by [Olivier Monnoyeur](#), European high-yield portfolio manager.

The third quarter saw credit spreads tighten by 35-40bp to 240bp for a total return for the BB-B European high-yield index ex-financials of 2.08%, for a year-to-date return of 5% (ICE Data Indices LLC as of 10/10/2025).

A bumper year for issuance?

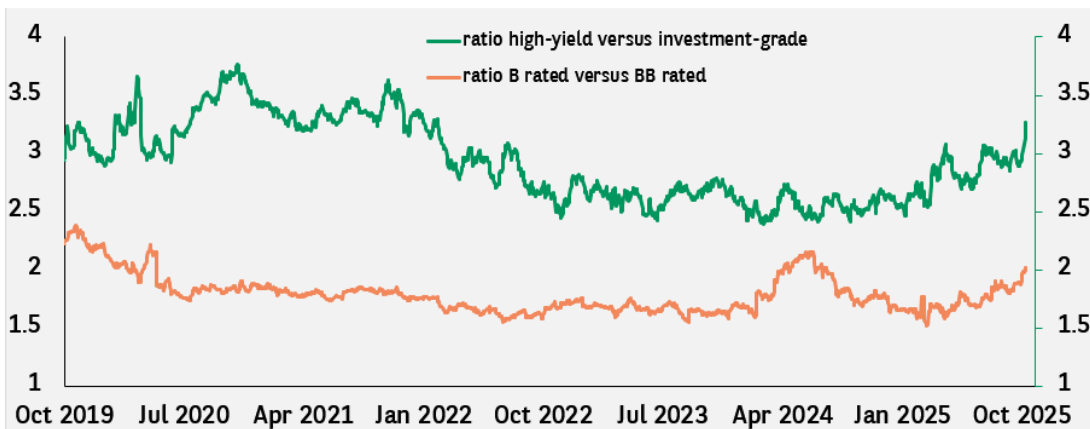
Continued strong demand for European high-yield (HY) bonds facilitated an active primary market, with €37 billion of new bonds issued over the quarter and September seeing a record level of €20 billion. That takes year-to-date issuance to €107 billion.

It now looks likely that issuance will surpass the full year 2024 total of €120 billion (the previous record was €150 billion in 2021). Reflecting investors' preference for quality, 'BB' rated debt has dominated primary market activity – accounting for 56%. That exceeds last year's 51%.

That preference was also observed in the spread dynamic between 'B' rated and 'BB' rated bonds, 'BB' having significantly outperformed 'B' in recent months. Exhibit 1 shows the widening gap in spreads of the two ratings cohorts. We note that in the US market, the trend has been in the other direction, with 'B' outperforming 'BB.'

Exhibit 1

'BB' rated European high-yield debt outperformed 'B' rated debt in the third quarter



Source: BNP Paribas Asset Management, ICE index as of 10/10/2025.

Investors prefer quality

We believe this spread decompression in European high-yield corporate bonds reflects a cautious positioning by high-yield investors given the considerable concerns over an economic slowdown. Cyclical sectors such as chemicals, industrials and construction have been underperforming as the preference for quality and resiliency dominates.

We are seeing a defensive market rally with situations that are more difficult to analyse being overlooked or sold by investors. While tepid fundamentals may justify some of these trades, we have been spending more time on analysing credit stories where we see merit and potential for through-the-cycle improvements in company balance sheets.

A positive outlook for European high-yield debt

The current context presents an opportunity, and we are applying our credit analysis skills and non-consensual approach to pick names whose bonds we believe are trading at an unjustifiably high premium.

We continue to believe that several positive factors will remain supportive. In the US, the Federal Reserve is loosening monetary policy in a resilient economic context, while in Europe, inflation is now contained. We believe the fiscal stimulus in Germany has positive implications for growth and could notably benefit sectors that have been struggling in the past two-three years (namely, industrials, chemicals and construction).

Corporates have been able to successfully navigate an uncertain political and economic climate in 2025 marked by tariff headwinds and political instability in parts of Europe. They have been producing resilient – in some cases, strong – earnings during the second half of 2025.

Meanwhile, high interest rates create an interesting equilibrium that keeps the pressure on companies to reduce debt and prioritise bondholders over shareholders.

At the same time, high interest rates are driving capital to investment vehicles exposed to European high-yield bonds. We therefore expect credit spreads to remain historically tight, while the yields on offer are historically wide. We believe the search for yield will continue to be the dominant driver and we are constructive on our asset class.

EMERGING MARKET DEBT – A CHANGE IN STATUS?

Key points

- Emerging market (EM) local debt has performed strongly year-to-date through September, outperforming developed markets (DM), with the 'Sell USA' theme providing tailwinds and the first significant inflows into EM local debt markets in more than a decade
- The relative perception of sovereign risk has arguably shifted in favour of EM, as DM countries face structural fiscal deficits and high debt/GDP ratios. According to the Institute of International Finance, inflows have been resilient since late 2023. 'Trump trades' reversed as Ukraine and Argentina underperformed EM frontier markets, while Asia FX remained stable and the Mexican Peso (MXN) has appreciated year-to-date (YTD)
- A weak US dollar has become consensus, with shorts overstretched. However, we think any dollar retracements will be temporary, underpinning a longer-term case for EM local currency assets
- All-in yields for EM hard currency debt remain attractive, and offer a cushion over US credit. EM investment grade corporates offer a spread pick-up over US IG, while EM high-yield provides an even more attractive pick-up compared to US HY (Bloomberg, as of October 2025).

Diversification out of the US dollar

This year, the general underpinning for inflows into EM debt has been a bearish view on the US dollar (USD). While returns for EM local currency debt have been stellar, this was largely due to a weaker USD rather than strong EM currency values. Interestingly, in euro terms (for European investors), performance has been modest, with the JP Morgan Government Bond Index - Emerging Markets (GBI EM) in euros, returning negative 5.09% through September. This underperformance was mainly due to the underperformance of EM currencies relative to EUR/USD, with the Chinese renminbi depreciating against the euro by approximately 10% year-to-date.

EM local currency duration gains have also been modest, particularly outside Asia. In Eastern Europe, GBI EM index yields have remained stable at around 381, while in Latin America, yields have fallen by 20bp to 9.38%¹ this year, though they are still higher than a year ago.

The primary drivers behind EM local currency returns have included the depreciation of the USD. We believe the asset class is benefiting from secular de-dollarisation trends and increasing diversification into the large Asian fixed-income market, with China and India representing circa 20% of the GBI EM local bond index. While these themes are likely to persist, we also believe that renewed fiscal risks in developed markets could provide a fresh catalyst for increased diversification into EM local currency debt. We therefore remain positive on duration in mid-yielding EM local markets like South Africa, Hungary or Mexico.

US policy making waves

Asia, notably China, along with Mexico and Ukraine, were seen as the main regions to be directly impacted by Trump's policies on EM. Some expected outcomes were already priced in as early as 2024, when Trump's lead in the polls increased. Ukraine's sovereign bond performed well in the three months before Trump's inauguration, driven by hopes of an early end to the war. Argentina's sovereign bonds also rallied during the same period on expectations that Trump's presidency could help unlock an International Monetary Fund (IMF) support programme.

Conversely, the Mexican peso, a beneficiary of the near-shoring trade, where production capacity and trade flows had been diverted from China in recent years, sold off amid fears that these trade flows would reverse and due to concerns over a potential renegotiation of the United States–Mexico–Canada Agreement (USMCA).

In addition, new tariffs have not led to the depreciation in Asia FX that many feared, with past dollarisation acting as a buffer and countries willing to play into global trade rebalancing via stronger currencies.

Despite the ongoing war, continuing support from European countries has helped Ukraine to stay on track with its IMF programme.

Furthermore, strong interlinks between the US and Mexican economies have resulted in greater leniency from the Trump administration, with the USMCA still acting as a framework for trade relations, resulting in only modest moves in the Mexican peso exchange rate YTD.

Trade negotiations and the search for alternative safe assets like gold have increased volatility in commodities. Year-to-date to August, prices of precious metals such as platinum and gold have surged, following strong increases in 2024. Meanwhile, oil prices have fallen over the same period due to increasing supply and a bleaker global growth outlook. This trend has led to improved terms of trade (export prices relative to import prices) for countries like South Africa, which exports platinum and gold, as well as Ghana and Uzbekistan, significant gold producers.

The rise in precious metals prices has boosted current account balances, reserves, and government revenues from taxes and royalties. Conversely, oil nations like Angola and Gabon face deteriorating outlooks, as declining oil revenues compel them to seek additional financing and implement spending cuts to balance their budgets. These trends have been reflected in spread movements.

EM debt offers an alternative

It is well known that DM typically have higher debt and deficit levels than EM, while their borrowing costs are usually lower. This reflects the EM 'original sin', where countries with low fiscal credibility cannot borrow in their own currency and must rely on foreign currencies (mainly USD). This limits their debt servicing capacity to their ability to generate foreign currency inflows. Conversely, DM can finance larger deficits by accessing deeper local markets or drawing upon their reserve currency status. This balance holds as long as interest costs remain manageable. For EM sovereigns, a critical indicator is the interest-to-government revenue ratio, which signals whether debt is about to 'snowball' –i.e., borrowing to repay interest on existing debt.

For the US, interest payments as a percentage of government revenue have historically been higher than in Europe due to lower tax rates. US government revenue-to-GDP is 31% compared to 39% in the UK and 52% in France. However, this metric is reaching questionable levels and is projected to hit 12% in 2025.

Of the 18 IG-rated countries issuing debt externally, only the Philippines, Malaysia and Indonesia have higher interest-to-revenue ratios than the US, highlighting the rapid deterioration in the country's fiscal situation, as interest-to-revenue has increased by 1.6 percentage points (ppt) since pre-pandemic levels, compared to 0.6ppt for France and 1ppt for the UK.

In this context, EM offer a viable alternative to DM (especially US) bond markets, with higher real yields and more sustainable government debt metrics.

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