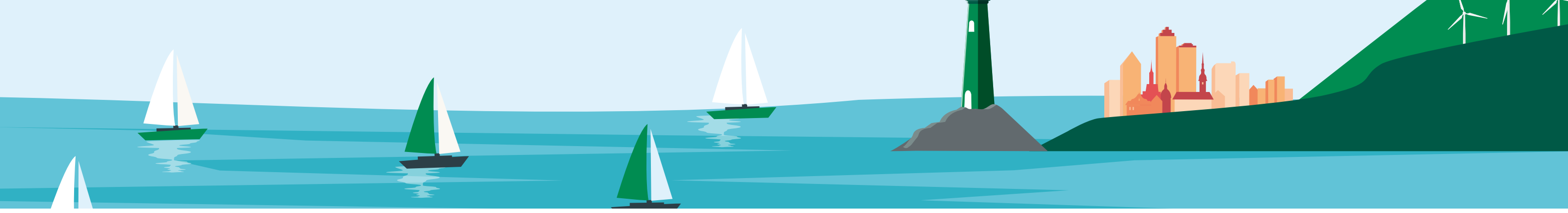
For professional investors - Marketing communication - January 2023

FIXED INCOME OUTLOOK
JANUARY 2023



Sticky inflation

- The latest data suggests that the US economy is headed towards a period of below-trend growth, if not outright recession. The effect of monetary tightening on aggregate demand is becoming evident, while supply chain pressures appear to be easing.

- The crucial question is whether the slowdown will be accompanied by a rapid decline in inflation, allowing the US and other central banks to take policy rates back to neutral, or even below.

- The Federal Open Market Committee's (FOMC) messaging remains clear – it is unwilling to take the chance of letting inflation become embedded and is willing to risk keeping policy too restrictive for too long. Our view is that real yields need to be in restrictive territory for some time.

- We expect the eurozone recession to be shallower than previously thought; we have probably seen the peak of headline inflation, but core inflation will likely be sticky.

Olivier de Larouzière
CIO fixed income

Daniel Morris
Chief market strategist

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

"The latest data suggests that the US economy is headed towards a period of below-trend growth, if not outright recession."

UNITED STATES

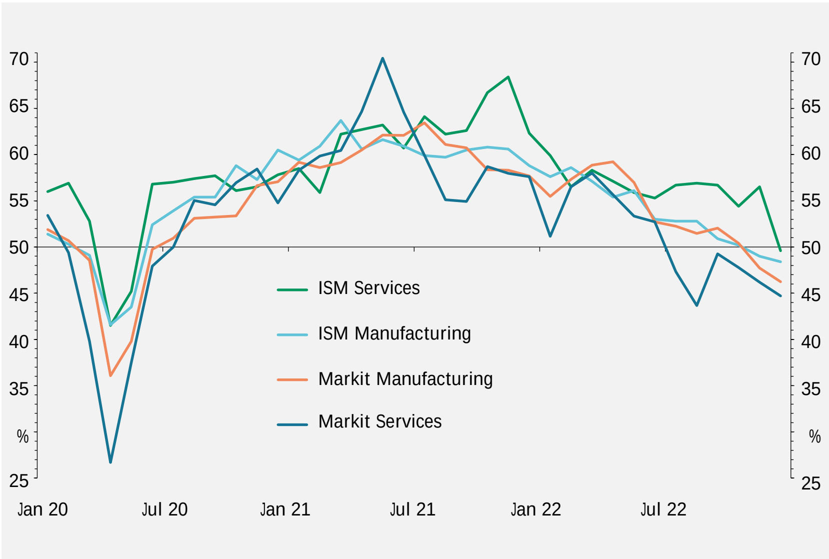
In early 2023, the effect of monetary tightening on aggregate demand is becoming evident, while supply chain pressures appear to be easing. Higher interest rates have already put the brakes on residential investment, and business investment is also likely to slow as corporate earnings are inevitably impacted and hurdle rates for new projects rise. So far, consumption has held up as households have been drawing on their considerable accumulated savings to satisfy pent-up demand, particularly for services. However, that stock of savings is steadily shrinking as incomes have not kept up with higher prices.

The latest Institute for Supply Management (ISM) services data for December, released in January, revealed a sharp plunge into contraction, catching up with the declines we had already seen on the separate Markit Purchasing Managers' index (PMI). The ISMs have a historically strong record as leading indicators on growth. The latest data suggests that the US economy is headed towards a period of below-trend growth, if not outright recession (see Exhibit 1)

Exhibit 1

The US economy looks to be headed towards a period of below-trend growth

Manufacturing and service sector PMIs



Data as at 20 January 2023. Sources: FactSet, BNP Paribas Asset Management.

Such evidence that the growth prospects have deteriorated is not unexpected. The point of tightening monetary policy is to slow the economy. The crucial question, though, is whether the slowdown will be accompanied by a rapid decline in inflation (allowing the US and other central banks to take policy rates back to neutral, or even below). Will inflation prove persistent, or 'sticky' (requiring a longer period of restrictive policy)? We believe the persistence of inflation will depend on

(i) Whether inflation has embedded itself into inflation expectations
(ii) Whether the labour market is in balance, allowing wage gains to fall back into line with productivity and the Federal Reserve's inflation target.

In 2022, our view was that labour market imbalances were partly structural, as suggested by a labour force participation rate that did not return to pre-pandemic levels and the problems matching available jobs with

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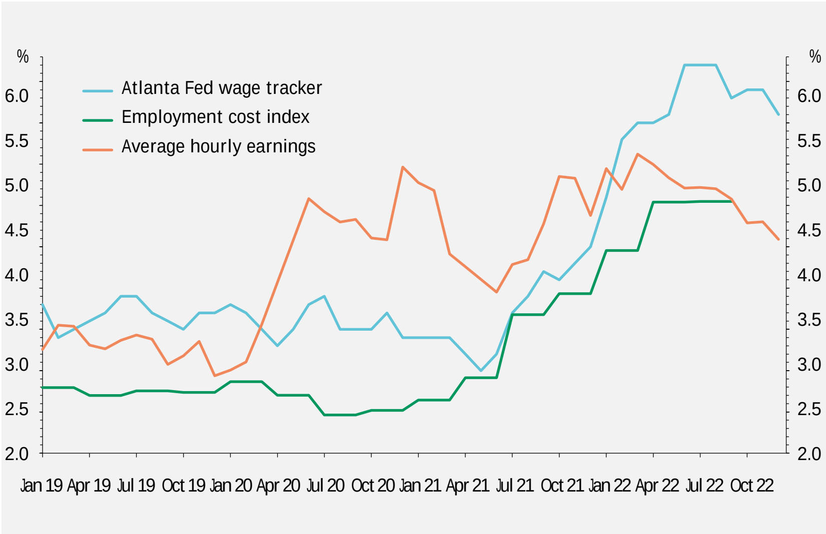
appropriately skilled workers, which meant employers were struggling to fill positions vacated during the pandemic. The JOLTS (Job Openings and Labor Turnover Survey) data on open positions and labour force participation numbers that suggest significant numbers of workers have left the labour market still support this view.

We believe employers will be unwilling to let workers go during a slowdown, given the rehiring difficulties they faced in 2021 and 2022. This gives workers more negotiating power. However, the most recent downward revisions to average hourly earnings (AHE), estimated to have risen at 4.6% year-on-year (YoY) in December versus 5.1% in November, cast some doubt on the stickiness of wage growth. Still, as AHE is not adjusted for compositional effects, it can give a misleading picture of compensation trends. That is why we will be watching the Atlanta Fed Wage Tracker and Employment Cost index measures of compensation closely (see Exhibit 2).

Exhibit 2

Wage growth appears to be decelerating

Year-on-year change in wages



Data as at 20 January 2023. *April-May 2020/2021 period smoothed to remove distortions. Sources: BLS, Atlanta Federal Reserve, BNP Paribas Asset Management

In the near term, we believe the Federal Open Market Committee's (FOMC) messaging remains clear – it is unwilling to take the chance of letting inflation become embedded and is willing to risk keeping policy too restrictive for too long. In practice, this means its guidance that it will take rates to at least 5.00%-5.25% and keep them there for the rest of 2023 should be taken at face value. The FOMC is clearly already concerned about the easing of financial conditions since mid-October despite 125bp of rate rises and reinforced guidance. One should bear in mind that all of the tightening in financial conditions occurred in the first three quarters of 2022 and is now affecting the economy. Should conditions now be allowed to loosen, it could provide a tailwind to growth in the second half of 2023, at the same time as falling energy prices raise real incomes. The Fed can be expected to be at pains to reinforce its message that a a couple of months of softer core consumer price index (CPI) data and tentative indications of wage moderation will not cause it to pivot.

Nevertheless, evidence of moderating core inflation, softer growth and lower average hourly earnings should remove some of the upside risks to both nominal and real yields. The FOMC seems unlikely to take rates to 6%, something we could not have said with equal confidence in the third

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quarter. The distribution of policy rate paths looks tighter today than it did in the fourth quarter.

It remains our view that real yields need to be in restrictive territory for some time. An 'immaculate disinflation', whereby wage pressures moderate simply through the removal of excess job openings without significant actual job losses, is, in our opinion, wishful thinking. To reduce wage pressures, the Fed will need to engineer a higher unemployment rate, which will require a spell of restrictive policy rates. Given that the economy does not have any obvious financial imbalances, this may mean maintaining real yields for a while in restrictive territory.

To calibrate where real yields should trade, our working assumption is that this needs to be at levels above the 2016-2018 rate rising cycle, when policy rates reached 2.75%, but core Personal Consumption Expenditure (PCE) inflation was barely 2.1% (versus 4.7% currently).

For context, we refer to the Exhibit 3 on page five. This shows 2-year/1-year and 5-year/5-year forward real yields (we use forward yields to remove distortions from inflation accretion due to the indexation lag). We see that in 2022, these real yield measures rose steadily until July (when the market priced a first Fed policy pivot) and rose again until mid-October (when the market priced another pivot).

Since we believe this latest Fed pivot trade is unjustified (because the labour market remains tight, even if growth is moderating), our view is that real yields should resume their climb and retest October's levels unless we see convincing evidence that inflation is now solidly on a downward path (which we think is premature).

Looking at intermediate-maturity 5-year/5-year real yields, a reasonable objective would seem to us to be between 1.50% and 1.75%, given that forward real yields often top out close to potential economic growth rates – which we peg at around 1.75%. The 2-year/1-year real yield, however, has the potential to rise further as the Fed will use the fed funds rate as its policy instrument. A target of 2.00% on the 2-year/1-year real yield is not implausible if the Fed wants to squeeze the monetary brakes harder.

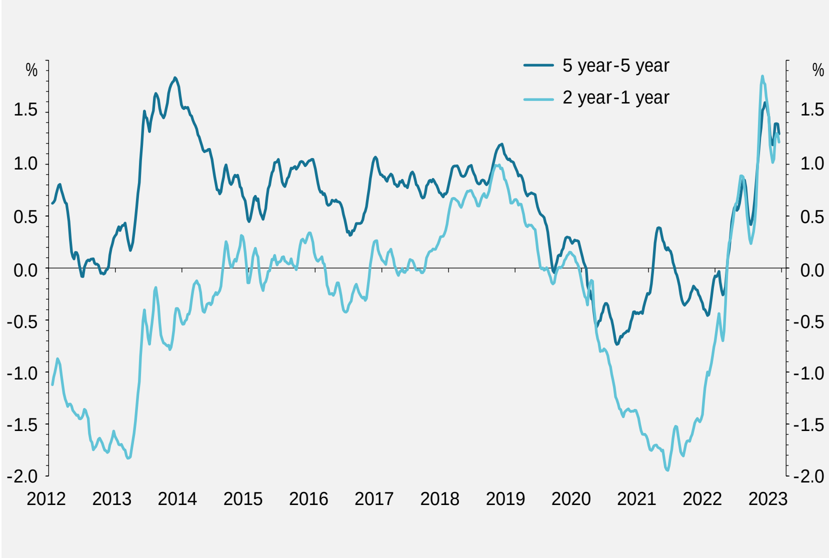
Current levels, of course, are well below these objectives (hence our net duration underweight). Still, we are seeing signs of growth moderation and the peaking of inflation and wage pressures, so we are minded to use any rise in yields to cover underweight positions and establish longs as we approach target levels.

"We expect the eurozone recession to be shallower than previously thought."

Exhibit 3

Real yields are below our targets

Forward real yields



Data as at 20 January 2023. Sources: Bloomberg, BNP Paribas Asset Management.

EUROZONE

We expect the eurozone recession to be shallower than previously thought despite the drag from high costs on energy-intensive production and real incomes. The rapid decline in dependence on piped gas supply, higher-than-expected levels of gas storage and reduced demand due to a mild autumn and an unusually warm start to the winter suggest that the risk of energy rationing is now much reduced.

While it is too early to conclude that the energy crisis is over, the decline in energy-related uncertainty is likely to boost the sentiment of European households and companies. In terms of the outlook for consumer consumption, real income growth is still negative, but nominal wage growth is positive thanks to a tight labour market, fiscal subsidies and excess savings. China's exit from stringent zero-Covid lockdowns should present challenges in the immediate term as the virus spreads, but once immunity in the population improves and economic activities normalise, the eurozone will likely benefit from greater external demand through its tourism and trading ties with China.

We have probably seen the peak of headline inflation, but core inflation will likely be sticky. Rising wages could keep core inflation high for the coming months. The focus will be on the interpretation of the core inflation increase. It could be that the pass-through of higher energy prices to core inflation is simply delayed. On the other hand, it could be that wage growth is taking over as the next inflation driver.

We expect the ECB to raise policy rates by 50bp at each of the next couple of council meetings, before slowing to a 25bp pace and pausing, taking the deposit rate to 3.25%, or higher. Economic downside risks have diminished, but inflation is still significantly above its target and underlying inflation is trending higher. We expect the ECB to hold policy rates at restrictive levels for longer than in previous cycles until there is convincing evidence that underlying inflation is slowing to a level consistent with its price stability mandate.

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In duration, we are maintaining a modest short bias. Given the declining risk of a severe recession, the ECB's hawkish stance and the substantial rise in euro government bond issuance in 2023, we see euro government bond markets remaining under pressure in the coming months. However, we are cognizant that as headline inflation has peaked, and with the end of this current monetary tightening cycle in sight, investors may want to reallocate to euro government bonds given the uncertain outlook for risky assets. We expect German 10-year Bund yields to trade in a 2.00% to 2.75% range in the first quarter of 2023.

We expect spreads in peripheral eurozone markets to widen. We believe the current spread between 10-year Italian BTPs and German Bunds is too tight. The ECB's intention to bring policy to restrictive levels should bode poorly for peripheral bond spreads. At the same time, record issuance of Italian government bonds in 2023 should drive BTP-Bund spreads wider, particularly in the first quarter as issuance will be front-loaded at the start of the calendar year. However, political risk in Italy has receded and cheap loans and grants from the Next Generation EU programme should improve Italy's debt sustainability outlook. Moreover, the recent decline in natural gas prices should alleviate pressure on Italy's growth and borrowing needs.

UK

The UK economy is likely already in a recession and 2023 looks set to be another challenging year. While improvement in the natural gas market and continued supply chain normalisation should help ease the cost-of-living crisis, the erosion in real household income has been significant. Some households may still be able to reduce the impact on their spending by dipping into savings accumulated over the pandemic, but the distribution of these savings is skewed towards higher-income households. There is evidence that lower-income households have already started cutting back on their spending.

At the same time, financial conditions have tightened and have started to weigh on the economy: There are clear signals that the housing market is slowing and will likely decline further. A good portion of households will see their mortgage loans reset at higher interest rates and this will reduce income available for consumption. Strikes across different industries will likely weigh on economic growth in the near term.

Inflation is still a problem. There are early signs of inflationary pressures easing – supply chains are loosening, energy prices are no longer skyrocketing, and survey results point to weaker pricing power as companies face a decline in demand and intense competition.

However, we see no let-up in wage growth as the supply of labour remains tight due to long-term sickness and early retirement. The National Health Service (NHS) faces a significant backlog of over seven million patients waiting for treatment, poor funding and additional strains from the recent wave of strikes. With an impaired public health system, the problem of labour inactivity due to long-term sickness will likely not be resolved anytime soon.

At the same time, the supply of labour through immigration will likely be limited in post-Brexit UK. We see continued upward pressure on wage growth, and inflationary pressures persisting, even if at a lower growth rate.

> “There are early signs of inflationary pressures easing.”

The backdrop of a tight labour market, strong wage growth and rising risks of real wage resistance points to the likelihood of another ‘forceful’ 50bp rate rise at the Bank of England’s February meeting. However, as the policy setting becomes increasingly restrictive, further deterioration in economic activity alongside signs of moderating wage pressure should allow the BoE to shift down to a 25bp rate rise in March. We expect the BoE to deliver its last increase in the current tightening cycle either at its March or May meetings, but we see risks of an earlier pause.

In the medium term, we believe the term premium should rise. Despite the back-loaded nature of the fiscal cuts and the watered-down fiscal targets in the Autumn Statement, the relatively limited market reaction suggests that the government has perhaps done enough to turn the page from former PM Truss’s fiscal experiment. While fiscal credibility is unlikely to be a prominent concern in the near term, it is unclear whether high levels of borrowing will see sufficient investor demand in the longer term. The significant borrowing will take place against the backdrop of active Gilt sales by the BoE and declining foreign Gilt demand.

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VIEWPOINT

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ASSET MANAGEMENT

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