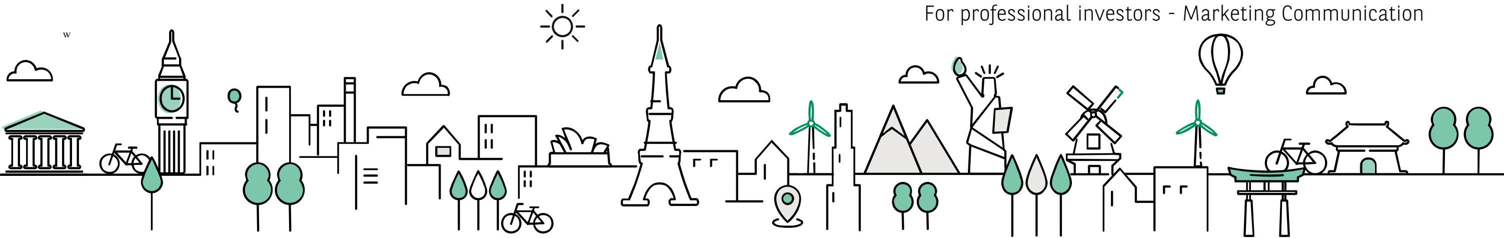


Fixed Income Outlook – 2Q21

Dominick DeAlto
CIO fixed income

Daniel Morris
Chief market strategist

- **The key drivers of economies and markets remain:**

  1) Developments in public health related restrictions and vaccine rollouts

  2) Divergence in the fiscal policy response

  3) Differences in the monetary policy response and framework

- **We are increasingly constructive on the inflation outlook**

- **The odds of a significant and persistent inflation overshoot have clearly risen**

- **The main question is whether, with a fiscal impulse of the magnitude we have seen, the economy is at risk of overheating**

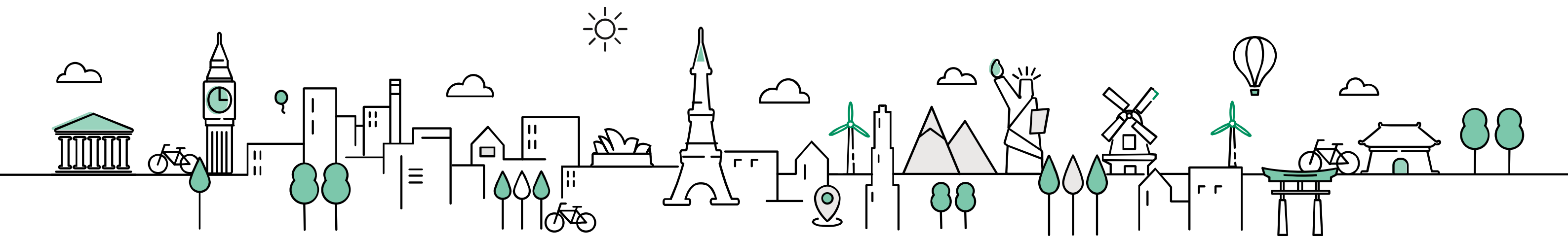
THE WHITES OF THEIR EYES

The US Federal Reserve's new average inflation targeting framework means that the central bank will not raise policy rates until realised inflation has risen sustainably to above its 2% target. That is, it does not intend to pull the rate trigger until it sees the 'whites' of inflation's eyes. This is in stark contrast to the measures it took after President Donald Trump's tax cuts. Then, the (mistaken) expectation that fiscal loosening would boost inflation too much led the Fed to raise the fed funds rate by 200bp over two years.

Investors, however, have greeted with scepticism the Fed's recent protestations that it will be patient on raising rates. The central bank itself has indicated it will not increase rates until 2024. It will do so only once it has tapered its asset purchases, and the Fed will only even begin that process once it sees that inflation and the labour market have recovered. Bond markets, however, have priced in two rate increases over the next two years. The resolution of this divergence will be the key driver of markets at least through the rest of this year.

BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world



"The challenge for investors: calibrating the new average inflation reaction function even as Chair Powell seeks to retain flexibility."

GOVERNMENT BONDS AND INFLATION

The three main factors driving economies and financial markets remain:

1) Developments in public health related restrictions and vaccine rollouts to contain the pandemic given the emergence of more infectious and dangerous coronavirus variants
2) Divergence in the fiscal policy response
3) Differences in the monetary policy response and framework.

If lockdowns succeeded in subduing outbreaks in 2020, it is now evident that their effectiveness has diminished amid a combination of lockdown fatigue and the higher infectiousness of new variants. The prospects for a reopening of economies, therefore, increasingly depend on mass vaccination rather than on containment measures. Many governments are now in a race to roll out vaccines and contain the spread of the new strains at the same time. Reinforcing the importance of vaccines, preliminary scientific data indicates that 1) existing vaccines generally provide good protection against the new variants, and 2) vaccinations prevent the spread of the virus by those who have been inoculated. Put simply, those countries that progress the fastest towards vaccinating their populations will be first to reopen their economies.

United States

US fiscal and monetary developments

The sheer scale of the fiscal packages has profound implications for the prospects for US growth in 2021 and 2022. Indeed, some prominent economists have accused the Biden administration of irresponsibility by risking an overheating of the economy. The administration's aggressive fiscal stance clearly removes any risk of a fiscal cliff in 2021 and has profound implications for fixed income, equity and foreign exchange markets. Moreover, with Janet Yellen and Jay Powell heading up macroeconomic and central bank policymaking, respectively, and with US rates at the lower bound and the Fed having adopted Average Inflation Targeting (AIT), 2021 is likely to bring previously unseen coordination between the fiscal arm of the federal government and the central bank.

Monetary policy developments and outlook

The Fed's latest summary of economic projections shows the economy is forecast to be back at full employment, with inflation at the target 2% by the end of 2022 (see Exhibit 1). To us, this suggests that an early-2022 taper of quantitative easing (QE) may be plausible. Those same projections, however, also revealed that policymakers do not foresee a rate increase until at least 2024. Herein lies the challenge for investors – calibrating the new average inflation reaction function even as Chair Powell seeks to retain flexibility.

The Fed has committed to accommodating an extraordinarily large fiscal expansion and tightening its policy stance only in a reactive fashion, rather than proactively on the basis of forecasts. It has essentially admitted its difficulty in calibrating inflation dynamics, acknowledged the general decline in inflation expectations, and committed to run the economy hot to fend off the threat of deflation.

This degree of harmonisation between fiscal and monetary authorities, as well as the aggressiveness of each side's policies, is unprecedented in peacetime. The objective appears to generate a (mild) economic boom rather than a 'soft landing'.

Many investors are not yet convinced of the Fed's commitment to AIT. There are reasons to be sceptical: the Fed has underdelivered before. Will the central bank really tolerate an overheating of the economy that generates financial imbalances?

We believe the Fed has learnt some humility about its ability to forecast inflation and regards the consequences of falling into a deflationary trap as more serious than the risks posed by frothy equity markets. Over the coming months, the Fed will need to repeat its message to burnish its credibility.

Exhibit 1: Fed economic projections

Percent

Variable	Median			
	2021	2022	2023	Longer run
Change in real GDP	6.5	3.3	2.2	1.8
December projection	4.2	3.2	2.4	1.8
Unemployment rate	4.5	3.9	3.5	4.0
December projection	5.0	4.2	3.7	4.1
PCE inflation	2.4	2.0	2.1	2.0
December projection	1.8	1.9	2.0	2.0
Core PCE inflation[4]	2.2	2.0	2.1	
December projection	1.8	1.9	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	0.1	0.1	0.1	2.5
December projection	0.1	0.1	0.1	2.5

Data as at 17 March 2021. 1. If the number of projections is even, the median is the average of the two middle projections. Source: US Federal Reserve.

US economy: Developments and outlook

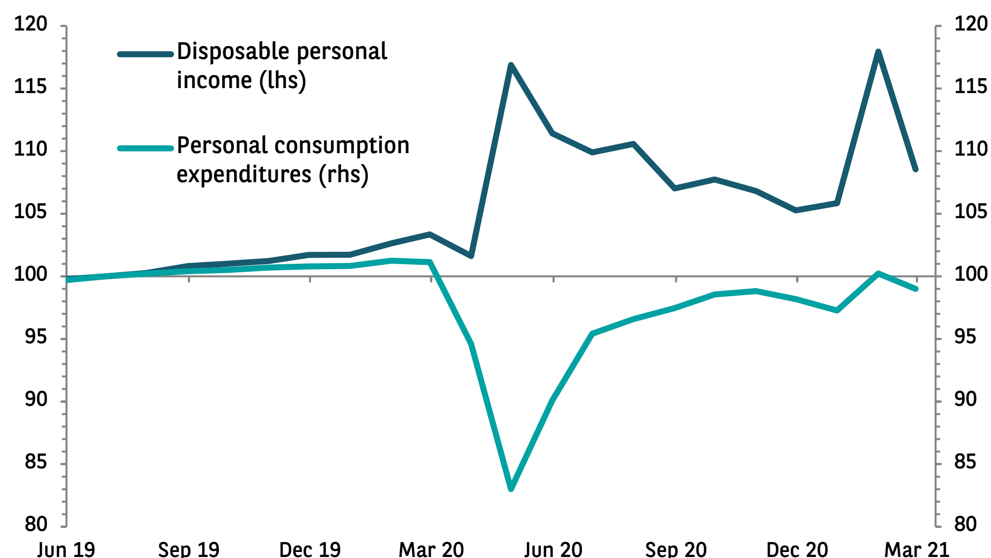
We believe the acceleration in payroll gains in the first quarter is merely a foretaste of what is yet to come in 2021. We expect monthly payroll gains exceeding a million jobs for the next several months. Our Macro Research Team forecasts that first-quarter GDP growth will come in at 6.3% quarter-on-quarter annualised. It expects the momentum of GDP growth to strengthen thereafter. The reasons for our optimism are:

(i) The rapid rollout of vaccines in the US is allowing the hard-hit services sectors to reopen and to start re-hiring people. With the US now vaccinating more than three million people a day, and with the federal government promising enough doses to vaccinate every adult by the end of May, the US could be among the first countries to reach herd immunity. Prospects for a lifting of most public health related restrictions by the third quarter therefore look good.

(ii) The federal government's USD 900 billion December fiscal package and the USD 1.9 trillion March package should provide a powerful tailwind for the economy over the next 12 to 18 months, worth about 13% of GDP.

(iii) Household balance sheets and incomes have been strong despite pandemic-related job losses. Many households have built up large reserves of forced savings, estimated at USD 1.5 trillion and rising. While earned income declined, government stimulus and unemployment cheques together more than made up for the shortfall. Disposable incomes actually rose. We believe there is likely to be substantial pent-up demand as the economy reopens, as corroborated by recent consumer confidence surveys. Exhibit 2 showing disposable personal income versus personal consumption expenditures (PCE) indicates the potential.

Exhibit 2: Personal income and spending



Data as at 13 April 2021. Sources: BEA, BNP Paribas Asset Management.

(iv) Business confidence has been solid, with services sector and manufacturing sector surveys pointing to robust recoveries in new orders and employment, while historically low business inventory/sales ratios are indicating a need for inventory restocking.

(v) Monetary policy has remained broadly supportive, with the Fed emphasising its commitment to the new AIT framework.

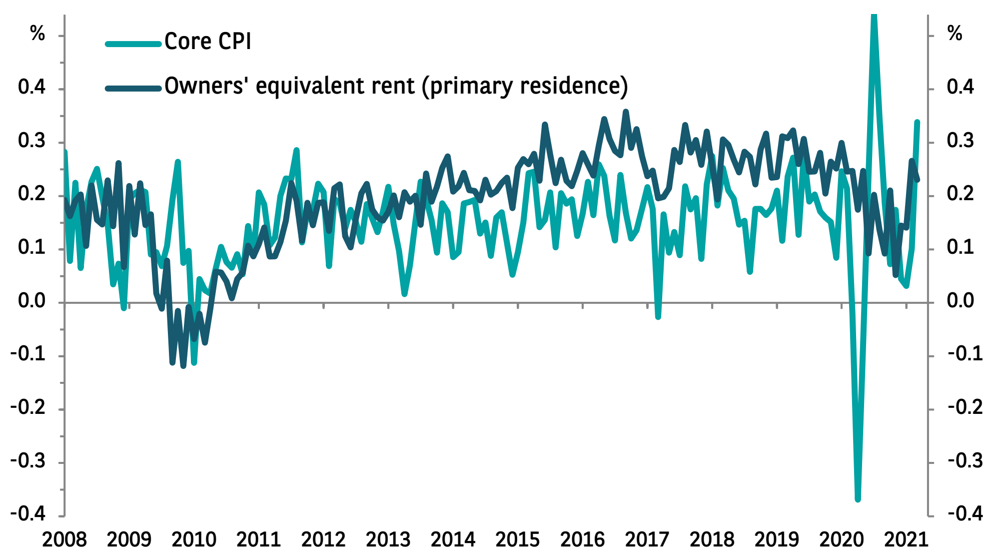
Beyond the gains in payrolls, the effects of the reopening of the US economy can be seen in real-time indicators such as driving trends, mobility indices, credit card spending data, traveller numbers and OpenTable restaurant reservations. All these metrics confirm that activity in the retail, leisure, hospitality and transport sectors is rebounding. The only area where activity may be tapering off is residential investment given the recent increase in mortgage rates.

With the US en route to reaching herd immunity and employment gains likely to gather momentum in the coming months, the recovery should become self-reinforcing. We expect the economy to have returned to full employment by mid-2022. The main question now is whether, with a fiscal impulse of the magnitude we have seen, the economy is at risk of overheating in late 2022 and 2023.

Development in consumer prices and inflation

The US inflation picture is complex at the moment. Core inflation pressures have remained muted: March data showed the core consumer price index (CPI) rising by just 1.6% YoY, though headline inflation jumped to 2.6% thanks to an increase in energy prices. A notable outlier was the upturn in shelter costs (see Exhibit 3). Some observers have dismissed this as a statistical anomaly. Our view is that rents are likely to recover, supported by the reopening of the services sector, rising incomes, firming housing prices and the need for larger spaces more suitable for working from home. While it is true that some renters are in a precarious financial situation, we expect that to improve as the economy returns towards full employment. Over the last few months, the weakness in shelter costs had been a major contributor to lower services inflation, given its weight in the CPI. If rents and owners' equivalent rents do recover, this will remove a significant disinflationary force.

Exhibit 3: Inflation (MoM %)



Data as at 14 April 2021. Sources: BLS, BNP Paribas Asset Management.

Base effects should push YoY headline and core inflation higher in March and April, before it recedes again. As locked-down sectors reopen in the coming months, we could see temporary supply bottlenecks in goods and services such as semiconductors, cars, transport and leisure & hospitality, particularly in areas where inventories are low. Higher commodity prices as well as 'prices paid' readings from purchasing manager surveys are pointing to rising input prices, which may be passed through into output prices. A quick recovery in employment will likely limit any downward pressure on wages; some industries are even facing a shortage of qualified workers.

Looking beyond the next few months, we wonder whether the rapid closing of the output gap could mean that the economy will run into supply constraints in 2022. With the government focused on tackling inequality and the Federal Reserve looking for an inclusive recovery that will lift wages across the workforce, the unemployment rate is likely to be pushed to extremely low levels to trigger wage gains. Companies in the US – and the EU – will seek to make their supply chains more robust and more local, partly as a response to the pandemic and partly due to ongoing trade tensions between the US and China. In addition to fiscal stimulus boosting the US economy in the coming months, we should see the Philips curve slope upwards again before long.

In summary, we are increasingly constructive on the inflation outlook for a number of reasons:

- A rapid vaccine-led economic reopening
- A highly expansionary fiscal and monetary policy mix that should quickly close the output gap
- A legislative agenda that is supportive of unionisation, increased worker benefits, and higher minimum wages
- A Fed focused on fulfilling its new average inflation goal
- A hardening of the US's protectionist stance on China.

It is not clear to us whether these factors will overwhelm the structural disinflationary impact of technology, but **the odds of a significant and persistent inflation overshoot have clearly risen.**

Implications for Treasury and TIPS markets:

The Fed's AIT framework should ensure monetary policy remains accommodative. The Fed will likely keep policy rates on hold until at least early 2023, anchoring the front end of the Treasury bond curve. A rapid return to full employment and faster growth as a result of aggressive fiscal stimulus should end the Fed's asset purchases earlier than expected and raise longer-dated real yields. We expect the Fed to taper its asset purchases in early or mid-2022. It will likely tolerate increases in longer-dated real yields that do not tighten financial conditions. Calibrating the tipping point is difficult, but we expect 5y5y real yields to impact other asset markets (i.e., equities) if they rose sustainably to above 0.75%. At the time of writing, the 5y5y yield is around 0.35%.

We expect core inflation to overshoot in 2023 as employment pushes up against the labour market's limits. Investors will continue to buy inflation protection and push 10-year breakeven inflation wider.

Finally, while we expect Treasury bond issuance to rise somewhat due to the Biden fiscal plans, the impact of this additionaL supply on real yields should be limited. First, the spending will be largely paid from the Treasury's existing cash balance. Second, the Fed will continue to purchase a large proportion of net supply as it is adding USD 960 billion of Treasuries per year to its balance sheet. Third, we expect the Fed to react to an increase in real yields that threatens the recovery and/or equity markets. Instead of more supply, we believe the bigger concern for duration positions is that the Fed may taper its asset purchases earlier if the economy returns to full employment faster.

Eurozone

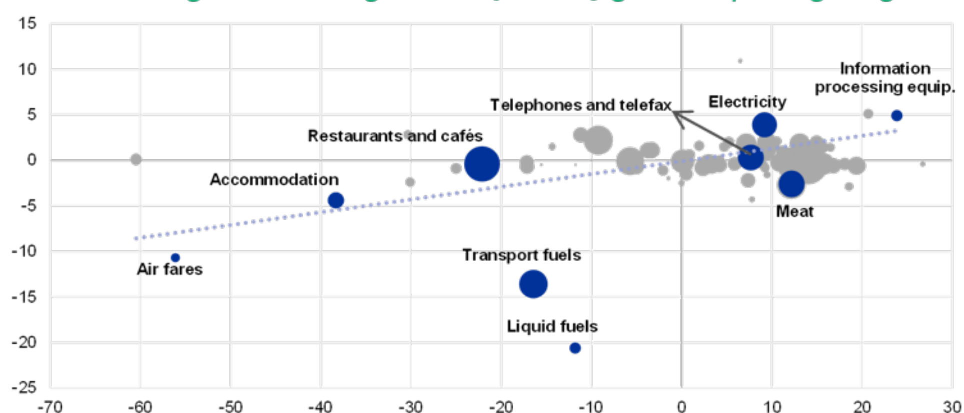
Macroeconomic developments and outlook

Over the past few months, eurozone economies have increasingly adapted to COVID-related constraints. Recently stepped-up lockdown measures have had a relatively muted impact on social mobility. Important sectors such as manufacturing have been left out of scope of the tighter restrictions and will likely continue to benefit from the recovery in the global economy. Another round of expansionary government fiscal responses should help soften the blow to those businesses and employees harder-hit by the renewed lockdowns. Moreover, more mobility restrictions will likely translate into a further accumulation of households' forced savings. Some of this money will likely be spent later in the year when public health situations allow for an easing in restrictions. This should provide impetus for a stronger recovery. The slow progress of vaccination programmes is the biggest headwind to the lifting of lockdown measures, but we believe EU governments' target of achieving herd immunity by mid-July is not too far off the mark.

Inflation

The volatility in recent inflation data can be largely attributed to the nature of the pandemic shock, where the impact of disinflationary forces seen in 2020 is unwinding in 2021. The numbers should not be interpreted as a sustained shift in inflation dynamics. Indeed, one-off factors contributed to the large increase in inflation in January. In the coming months, changes in seasonal patterns and distortions related to new basket weights should generate further volatility (see Exhibit 4; HICP = Harmonised Index of Consumer Prices). Upward price pressure from delayed winter sales in Italy and France should largely dissipate by April. In addition, distortions from tourism-related prices should start dragging inflation lower over the summer months, leading forecasts for core inflation at between 0% and 0.5% YoY in July. Inflation is expected to climb back to moderately above 1% by the end of 2021.

Exhibit 4: Changes in HICP weights and inflation by granular spending categories



Data as at January 2021.Note. The chart shows the correlation between the change in HICP weights (x-axis) and the change in the year-over-year HICP inflation rate (y-axis). Each bubble represents an HICP item at the COICOP-4 level of aggregation. Bubbles are scaled according to the 2021 HICP weights. Blue bubbles indicate selected items. The blue dotted line is a linear fit of the data. Source: Eurostat.

Apart from these technical factors, there could be upside surprises from goods prices in the near future. Purchasing manager surveys have been pointing to surging input prices for some time and the European Commission's latest survey found a stronger propensity among manufacturers of consumer goods to raise prices. Companies may also pass on some of the recent rise in energy prices and international freight costs to consumers as demand picks up. On the other hand, there are no clear indications of upward price pressures in the services sector in the near term. The expected recovery in services sectors such as hospitality has been delayed further by the extension of the lockdown measures.

Looking beyond the short-term volatility, underlying inflation will likely remain subdued thanks to the drag from spare economic capacity and a downward shift in inflation expectations. Substantial slack in the labour market suggests that wage pressures will be muted. As a case in point, Germany's largest workers union, IG Metall, which represents almost four million employees, has recently agreed to a 2.3% wage increase over a 21-month period. The increase is designed as a series of lump-sum payments rather than a higher base salary. The fixed salary structure effectively reduces the base for future wage increases and provides safeguards for employers facing difficulties during the pandemic. It reinforces the view that considerable spare economic capacity will continue to put a lid on wage inflation.

Monetary policy

The ECB's commitment to stepping up asset purchases meaningfully should weaken the euro rates market's sensitivity to higher US rates and stabilise euro government bond yields in the short term. In the longer term, however, the lack of clarity on the yield levels

that the ECB is targeting, and for how long, may have an adverse effect. It could incentivise investors to unwind their European government bond positions ahead of the ECB's next quarterly assessment.

Fiscal policy

In light of the recent resurgence of COVID-19 infections and the associated extension in lockdown measures, another round of expansionary government budget revisions is under way. Germany's updated budget showed an increase in the deficit of EUR 60 billion (or around 1.7% of GDP) in 2021 to finance additional fiscal support, including assistance to companies in the hospitality sector. This will bring Germany's total proposed deficit to EUR 240 billion in 2021, which is significantly higher than last year's record EUR 130 billion. The proposals include a suspension of Germany's constitutional 'debt brake' that is extended to 2022. In France, shops affected by the lockdowns will be eligible for subsidies. Workers who cannot work at home due to childcare issues when schools are closed will be eligible for the short-time working scheme which covers 84% of net wages with no costs for employers. Similarly, Italy and Spain have approved new fiscal packages in response to longer lockdowns. These moves show that governments are committed to doing what is necessary to mitigate the economic impact of the pandemic and that there is no appetite for austerity at this stage.

Although still far less than the recent US fiscal package worth 9% of GDP, the eurozone's fiscal response to the pandemic is now growing. An easy fiscal stance is underpinned by the ECB's accommodative policies. With asset purchases keeping interest rates low, there is little pressure on eurozone governments to address fiscal deficits. Despite the high and rising level of government debt, member states can be expected to take advantage of the favourable financing conditions and run larger-than-usual deficits over the next two years.

Outlook and current eurozone inflation-linked bond exposures

We expect the recent improvement in the path of inflation and expectations of a robust economic rebound, albeit delayed, to point to higher Bund yields. In the near term, the ECB's sized-up asset purchases will likely contain any sell-off in eurozone government bonds. We expect 10-year Bund yields to trade in a range between -0.4% and -0.2% in the coming quarter, with upside risks for yields to breach 0%.

In our view, the diminishing risks of deflation and the higher probability of higher inflation have been fully reflected in breakeven inflation rates. These rates have already rallied by more than those in the US despite stronger US fiscal tailwinds and the Fed's stated tolerance of an inflation overshoot. We are concerned about the longevity of the reflation theme: core inflation is seen heading back to closer to 0% YoY over the summer months.

We are maintaining our overweight position in Italian government debt versus that of core countries in the eurozone, although we see limited room for Italian bonds to continue to outperform core government bonds. The ECB has demonstrated its determination to quash eurozone fragmentation risks. Italy's unity government has raised hopes for structural reforms and an efficient use of the eurozone Recovery Fund. However, a lot of the good news has already been priced in. The ECB will likely slow the pace of its asset purchases when progress on vaccinations and the public health situation allow the economy to reopen, leading to reduced demand for 'peripheral' bonds from the central bank. Italian BTP-German Bund yield spreads have been near historical lows since the eurozone sovereign debt crisis, meaning a game-changing catalyst is required to compress spreads further. Although a Draghi-led Italian government should be positive for European integration, the prime minister's ambitions will likely focus on a national agenda given the immediate challenges at hand.

UK

Macroeconomic developments and outlook

Economic activities

Even with the UK government's success with its vaccination programme, the road to normalcy remains challenging. Uncertainty over the side-effects of the AstraZeneca vaccine may lower its uptake, vaccine supply bottlenecks may delay the rollout, and there are concerns over the vaccines' efficacy against virus variants. Still, the rising vaccination rate and a careful reopening plan should allow the UK to gradually restart its economy safely in the coming months.

Fiscal and monetary policy

Despite talks of 'hard choices' and 'fiscal responsibility' by the UK Treasury, the March budget included more-generous-than-expected emergency support and medium-term incentives for investments. There are plans for repairing the public finances, but they will not

be executed until fiscal year 2022/23 to allow the recovery to establish itself over the next 12 months. According to Office for Budge Responsibility (OBR) forecasts, the budget deficit will not be eliminated until 2024/25.

The Bank of England has a sanguine view on the recovery, with its forecasts suggesting that the output gap will close by the end of this year. Its negative interest rate policy (NIRP) opens up room between the current 0.1% bank rate and the new effective lower bound. This should allow the BoE to start unwinding its balance sheet first, should the economic outlook warrant a tightening in monetary policy. Discussions around appropriate guidance for tightening could invite speculation on asset purchase tapering and even a balance sheet runoff in the near term. If anything, the pace of the central bank's Gilt purchases will have to slow in the coming months if the size of the programme remains unchanged and the implementation timeframe is to still last through the end of 2021.

Brexit developments and implications

Apart from the challenges of the pandemic, the UK faces significant economic shocks from trade now that the Brexit transition period has ended. Under the EU-UK Trade and Cooperation Agreement (TCA), the UK continues to enjoy preferential zero-tariff and zero-quota access to the EU goods market, but there are significant new non-tariff barriers for trade in both goods and services. The UK's growth trajectory will not only depend on how quickly the vaccine rollout can stem the spread of COVID-19, but also on how well the economy transitions to the more distant UK-EU trade relationship. The implementation of the Northern Ireland Protocol (NIP) has been rocky and has caused an increase in violence in the region. In Scotland, a robust pro-independence majority in parliament remains likely after elections on 6 May. This would bolster calls for a second Scottish independence referendum. Resistance in Westminster may not be sustainable and tension on the issue will likely escalate in the coming months.

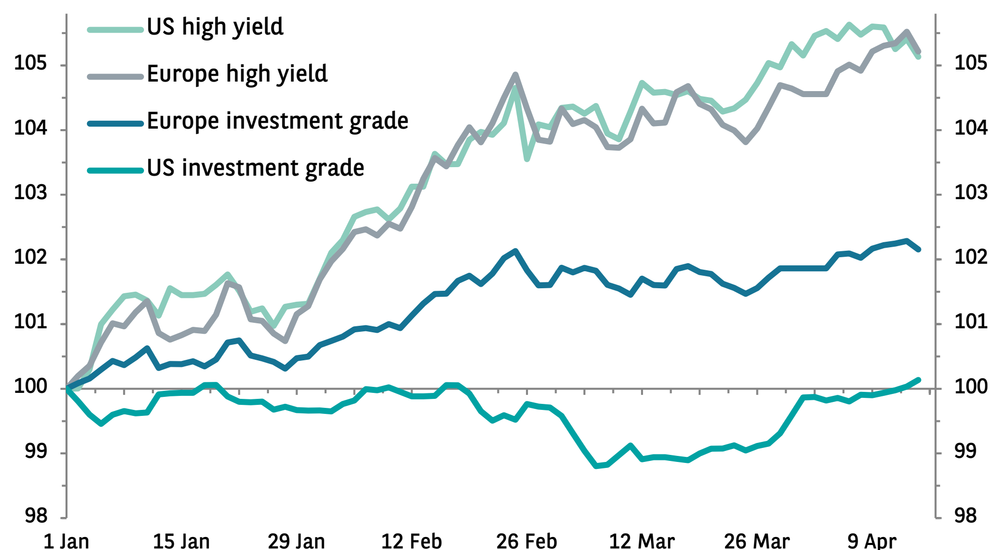
Outlook and current UK index-linked Gilts exposures

Given the backdrop of substantial improvement in the public health situation, the associated better growth outlook, and the prospects of slower asset purchases and more hawkish rhetoric from the BoE, we believe Gilts are vulnerable to a further sell-off. Although Brexit no longer dominates the news, businesses and consumers have started to feel its impact. Post-Brexit customs paperwork and cross border hauling have proven to be costly and purchasing manager surveys are already pointing to substantial upward pressures on input costs (though COVID-19 related disruptions also play a role). Businesses may be more likely to pass on these additional costs to consumers in the reopening phase, thereby pushing inflation higher. We believe longer-dated real yields should be well supported as pension funds are incentivised to increase their liability-hedging activities given the higher solvency ratios and potentially stricter pension regulations.

CORPORATE BONDS

Amid an economic recovery, rising corporate earnings, benign inflation and supportive central banks, US and eurozone corporate bond indices have outperformed their aggregate benchmark, with the notable exception of US investment-grade (see Exhibit 5). The impact of the lockdown recessions has been far less severe than expected thanks to massive government support. Corporate bankruptcies and defaults have been well below Global Financial Crisis (GFC) levels. Even if the exit from the lockdowns is delayed further because of new virus mutations, government support will likely continue.

Exhibit 5: Corporate bond index relative returns



Data as at 15 April 2021. US relative US Aggregate Treasury Index, Europe relative to Pan-Euro Aggregate Government Index. Total return in USD. Sources: Bloomberg Barclays, BNP Paribas Asset Management.

This outperformance has come despite high valuations. Spreads have reverted to pre-pandemic levels, although they are still (modestly) above pre-GFC levels, by about 25bp for investment-grade and 50bp for high-yield (average of US and eurozone indices).

Eurozone investment-grade has outperformed US IG despite the much brighter US economic picture. Leverage is lower for European corporates and the increase in Bund yields, by only 28bp for 10-year bonds against 75bp in the US, has been supportive. Rate volatility has also been lower. We are nonetheless more positive on the US than Europe given the more supportive macroeconomic picture and the better outlook for earnings. Within the eurozone, we prefer 'peripheral' to core countries. Italy should continue to benefit from the more europhile Draghi government, although concerns over higher debt issuance and a perhaps more divided ECB has seen Italian government bond spreads widen.

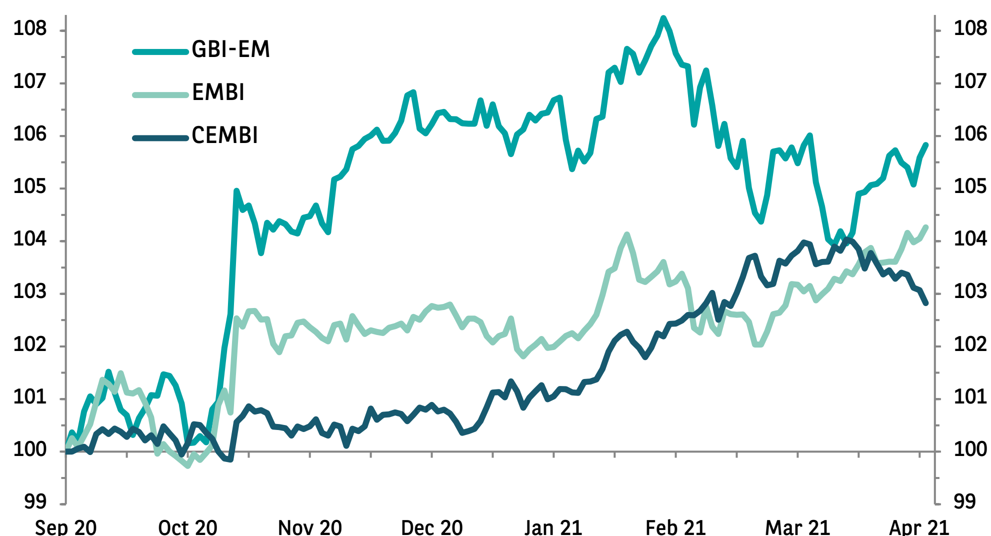
Of course, an increase of 50bp in high-yield is worth less than 25bp for investment-grade. Valuations are challenging and we are consequently neutral in high-yield (we are, however, more positive on the segment ex-energy). While performance has been supported by encouraging pandemic news, the outlook is not entirely rosy due to the prospect of mixed earnings and higher leverage. We are focusing more on issuers and looking for tactical opportunities.

EMERGING MARKET DEBT

The optimism investors felt about emerging markets in 2020 as many countries appeared to manage the pandemic better than much of the developed world has waned in the face of renewed waves of infections in Latin America and eastern Europe and slow vaccine rollouts in Asia. While the virus has remained under control in Asia, the region cannot look forward to the same significant increase in activity as we are seeing currently in the US and expect to see soon in Europe.

A challenge for the asset class has been the strengthening US dollar and higher US interest rates. This means hard currency investors have less reason to take on extra currency or political risk. Outflows have not been comparable to those seen during the 2013 taper tantrum, however. One reason for the greater resilience is that before the recent sell-off in US Treasuries, inflows had been modest, meaning investors were not particularly exposed to emerging market debt. In 2013, by contrast, EM fixed income had seen significant inflows.

Exhibit 6: EM bond index returns vs developed market benchmarks



Data as at 15 April 2021. Note: JP Morgan indices relative to Bloomberg Barclays Global Aggregate Treasury and Corporate indices. Sources: FactSet, BNP Paribas Asset Management.

The GBI-EM local currency emerging market debt index has suffered this year as the US stimulus package boosted the US dollar along with US growth and interest rates (see Exhibit 6).

Hard currency government and corporate debt has fared better. Spreads have narrowed as the pandemic-related sell-off last spring slowly reversed. Government bond index spreads now, however, are just 30bp above pre-pandemic levels, while corporate spreads have actually fallen to slightly below these levels, suggesting that further gains will be more challenging.

Growth is nonetheless on track to recover, with most economies expected to return to pre-pandemic levels of GDP by the end of 2021 (though Latin America is lagging). Inflation is rising in most countries, although larger countries such as Turkey and India are likely to see a slowdown.

The global response to the pandemic has broadly been to increase debt levels to provide fiscal support for locked-down economies. While this has also occurred in some emerging markets, it has been to a far lesser degree and EM debt levels in many cases were more favourable to begin with. Consequently, while EM debt has risen, debt sustainability has not become an issue thanks to favourable trade balances, healthy foreign exchange reserves and stable short-term financing needs.

As part of the global reflation, commodity prices are rising. This should benefit emerging markets. Many countries are not as commodity dependent as they were in the past, with manufacturing and technology accounting for a greater share of exports. Current accounts have improved since 2020. This has been driven by manufacturing exports rather than commodity exports.

Given the prospect for further increases in US interest rates, we are neutral on duration. Within hard currency debt, we are focusing on those parts of the market where spreads have not yet returned to pre-pandemic levels. We find EM high-yield in particular appealing both as a standalone investment and relative to US high-yield. EM high-yield spreads are nearly 150bp higher than in the US, which is much higher than the average over the last few years.

Within corporate debt, we favour Asia thanks to the advanced economic recoveries and attractive excess spreads relative to US high-yield. Importantly, EM high-yield default rates have remained below those for US high-yield corporates (less than half) and with superior recovery rates. The limited debt issuance by EM governments compared to developed market governments is echoed for corporates. EM corporate leverage is still below that of developed market peers and cash balances have been maintained.

We are negative on local currency rates as many EM central banks are at the end of their rate cutting cycles and the market has started to price in rate increases, just as they have in the US. Inflation could yet surprise, coming in higher than expected, as oil and food prices rebound.

Looking ahead, FTSE Russell has affirmed China's inclusion in the World Government Bond index. The country's bonds will be included over a 36-month period from October 2021 with an estimated final weight of 5.25%. This could result in about USD 4 billion in monthly passive inflows from FTSE WGBI inclusion alone over this period.

We are positive on China rates. Technicals and valuations are positive in the short to long term, the debt offers investors diversification opportunities and a higher yield, while the risk of default appears to be contained.

We expect the dollar to weaken versus emerging market currencies. EM currency valuations look attractive on a real, trade-weighted exchange rate (REER) basis, reduced imports have helped stabilise current account balances and foreign exchange reserves have remained resilient. Furthermore, we expect EM currencies to continue to benefit from potential further flows back to the asset class.

The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay.

Investing in emerging markets, or specialised or restricted sectors is likely to be subject to a higher than average volatility due to a high degree of concentration, greater uncertainty because less information is available, there is less liquidity, or due to greater sensitivity to changes in market conditions (social, political and economic conditions).

Some emerging markets offer less security than the majority of international developed markets. For this reason, services for portfolio transactions, liquidation and conservation on behalf of funds invested in emerging markets may carry greater risk.

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