For professional investors - Marketing communication - October 2023

FIXED INCOME OUTLOOK
4Q 2023

Slowdown ahead

- Though Treasury yields had retraced somewhat recently due to geopolitical worries, the sell-off we have seen in US government bonds was in our assessment due to a combination of fundamental and technical factors. They have now reached levels that we believe offer attractive value.
- The tightening of financial conditions will help to slow the economy, thereby permitting the Federal Open Market Committee (FOMC) to eventually ease policy rates, and encourage flows out of other asset classes and into government bonds.
- The eurozone's economy was more resilient than expected during the first half of 2023, but GDP growth has stagnated recently and is likely to continue to do so over the coming quarters.
- We expect eurozone inflation to decline, but sticky core inflation will likely keep the European Central Bank cautious in the medium term. Policy rates will remain restrictive for a prolonged period until there is more certainty that inflation will return to 2% sustainably.
- The Bank of England is unlikely to hike policy rates further and will more likely maintain the Bank Rate at 5.25% in the near term.

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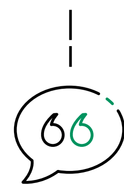


"The bond sell-off is both fundamental and technical."

UNITED STATES

Though Treasury yields have retraced recently due to geopolitical worries, the sell-off we saw in saw in US Treasuries and Treasury and Treasury Inflation-protected Securities (TIPS) was in our assessment due to a combination of fundamental and technical factors:

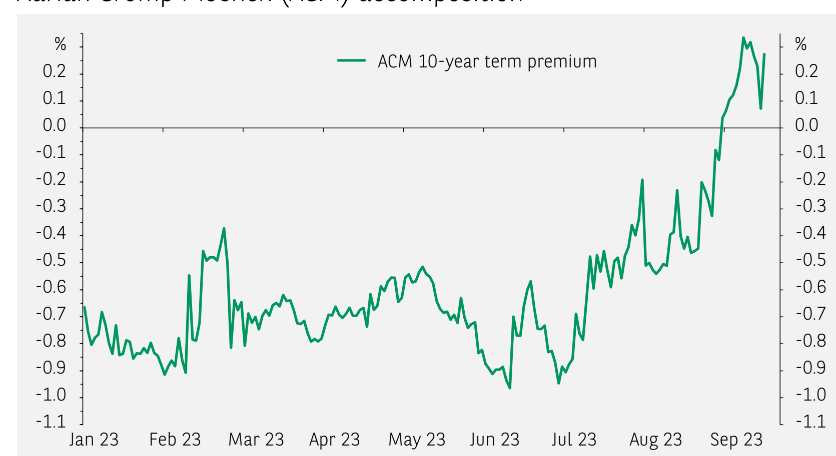
- Guidance from the US Federal Reserve (Fed) at Jackson Hole and the September FOMC meeting that rates would be higher for longer, and that the US economy was now expected to avoid a recession
- Concerns over larger-than-anticipated fiscal deficits, leading to heavier longer-dated Treasury supply, as indicated in the US Treasury's Quarterly Refunding announcements
- Forced **convexity-hedging** sales by mortgage-backed securities (MBS) holders facing slowing pre-payment speeds
- Forced selling of Treasuries by investors facing a significant duration extension as a result of the switch in the cheapest-to-deliver in the December 2023 (USZ3) bond contract.
- Heavy selling by momentum-following **CTA** accounts
- Already stretched positioning by asset managers who had set up for a recession in 2023
- '**Stop-outs**' from a range of investors, particularly asset managers.

Treasury and TIPS yields have reached levels that we believe offer attractive value. Notably, 5-year/5-year forward and 10-year/10-year forward real yields trade at levels that exceed most estimates of trend GDP growth and ought to provide excellent entry levels from a long-term perspective. For 5-year/5-year forward real yields, this represents a stunning increase since the end of June, driven in large part by a surge in the term premium on 10-year notes (as measured by the **Adrian Crump Moench decomposition**; see Exhibit 1).

Exhibit 1

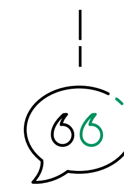
Long-term term premium has increased dramatically

Adrian Crump Moench (ACM) decomposition



Data as at 16 October 2023. Sources: Bloomberg, BNP Paribas Asset Management.

We believe that yields at the levels we have seen will, if maintained, provide a material headwind to US growth and inflation over time. The current robustness of growth and employment reflects the combination of extraordinary fiscal stimulus, high household savings, and the delayed pass-through from the hikes in interest rates (as households and corporations used low rates to refinance debt in 2021 and 2022), as well as an artificial intelligence (AI)-related investment boom. In other words,



"The question arises as to how high Treasury yields could trade."

we believe yields have risen not because long-term equilibrium rates have undergone a regime shift (although we do think the natural rate of interest (**r-star**) has risen somewhat), but rather because (i) the impact of monetary policy tightening has been delayed, buffered and offset; and (ii) term premia have decompressed.

The primary fiscal deficit is likely to decline in 2024, perhaps dramatically if Congressional politics yields a fiscal deal to avoid another government shutdown. Second, most households have already used up most of their excess savings, perhaps helping to explain why labour force participation has recovered so swiftly. Third, financial conditions are tightening, credit provision is shrinking and households and companies will gradually need to access credit at the new, higher rates. We think it inconceivable, for example, that 30-year mortgage rates now approaching 8% will not, over time, constrain residential investment, lower home prices, and limit housing turnover. Finally, the subsidies handed out for climate change, infrastructure, microchip and electric vehicle (EV) investments are likely to decline in 2024, after a remarkable pace of take-up in 2023.

Given the rapid Treasury selloff since August, with 10-year Treasury yields touching 4.88% in early October, the question arises as to how high Treasury yields could yet trade. Certainly, it is possible that the term premium on long-dated bonds could rise further. Quantitative tightening (QT) is ongoing, Treasury supply is growing, macroeconomic uncertainty remains high, and volatility has risen markedly. On the positioning front, **curve steepeners** remain a consensus trade, but positioning does not appear stretched. More steepening is clearly possible.

At the same time, the recent rise in long-dated yields has tightened financial conditions. This will both help to slow the economy, thereby permitting the FOMC to eventually ease policy rates, and encourage flows out of other asset classes and into government bonds.

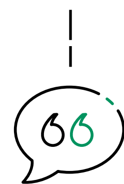
Indeed, equities and corporate spreads have come under pressure on days when bond yields have surged higher, and a number of analysts suggest that bonds look particularly cheap versus equities. Furthermore, as 10-year yields approach 5% and the curve steepens, the yield give-up from buying long bonds versus holding bills has become far less punitive, encouraging investors to move further out the curve. Duration positioning also seems less stretched, following the recent wash-out of '**weak hands**'.

Our baseline view is that:

- Tighter monetary policy will make itself felt in 2024 (given longer-than-usual policy lags)
- Fiscal stimulus will by necessity be reined in
- Credit provision will contract, and
- Asset prices will be constrained by these higher real yields.

We believe this economic slowdown will reduce labour demand, helping to rebalance the labour market and temper wage pressures. This would allow core inflation to decline towards the Fed's 2% target, even if the structural problems of deglobalisation, demographics and climate change will challenge policymakers. The confluence of these factors should allow the FOMC to begin lowering policy rates in the second half of 2024 and return rates towards a slightly higher neutral rate sometime in 2025 or 2026.

In the near term, though, the September non-farm payrolls data poses



"Eurozone growth has been more resilient."

a challenge to the view that the US economy is yet slowing sufficiently to allow the Fed to ease back on policy rates. There is, for instance, a risk that as wages catch up with inflation, higher real wages will support real incomes and permit a re-acceleration in consumption. Additionally, any indications that Congress is willing to risk further deterioration in the Treasury's credit standing might introduce more credit risk premium on longer-dated bonds. In short, Treasury yields may not yet have peaked. But we believe we are close.

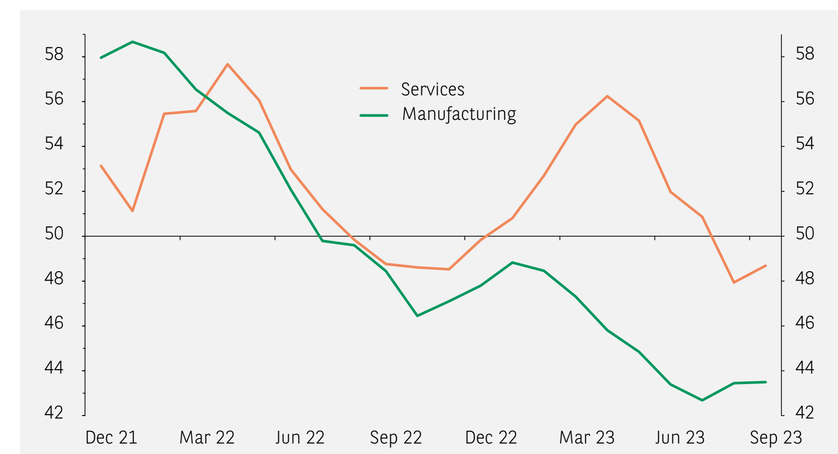
EUROZONE

While the eurozone's economy was more resilient than expected during the first half of 2023, GDP growth has stagnated recently and is likely to continue to do so over the coming quarters. Purchasing Managers' Index (PMI) surveys point to more weakness ahead (see Exhibit 2). The once-buoyant services sector is losing momentum, and the manufacturing sector is still being held back by a combination of cyclical factors and – particularly in Germany – structural ones. That said, the decline in the manufacturing PMI has been somewhat overdone relative to the hard data. Credit dynamics will likely be another driver of weakness ahead as the effects of higher interest rates continue to weigh on corporate and household demand.

Exhibit 2

Purchasing Manager Indices point to more weakness ahead

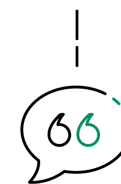
Eurozone area



Data as at 16 October 2023. Sources: FactSet, BNP Paribas Asset Management.

After years of fiscal loosening that provided public support during the pandemic and the energy crisis, fiscal aids will be gradually rolled back as the focus shifts to restoring medium-term fiscal sustainability. The good news is that public investment expenditure will likely be protected with contributions from the NextGenerationEU (NGEU) funds and other EU budgets.

Another positive factor for growth is that robust nominal wage growth and fading inflation mean real wages are now recovering, which should support consumption. We also anticipate structural factors such as demographics and sectoral mismatch to keep the labour market tight, and job shedding against a backdrop of a stagnating economy will likely be mild with widespread labour skill shortages.



"We believe the ECB is likely to pause tightening in the coming quarter."

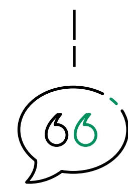
Overall, there are buffers in the eurozone that should help it weather weak foreign demand and tighter credit conditions, thereby avoiding an outright recession. However, risks to the economic cycle are skewed to the downside. While volatility in natural gas prices has subsided, the energy shock left the eurozone's manufacturing sector less competitive. Greater economic uncertainty could also result in more labour shedding than expected, which in turn may offset the positive effects from rising real incomes.

The notable moderation in core inflation in the latest data released was encouraging. This moderation, alongside the decline in various indicators of underlying inflation, is consistent with monetary transmission having an increasing impact on the path of inflation. Looking ahead, the European Commission's yearly headline Harmonised Indices of Consumer Prices (HICP) is expected to continue falling quickly in the coming months, thanks mostly to base effects from last year's energy price shock. Food inflation should also slow on the back of contained food commodity prices. Within core inflation, non-energy industrial goods prices are expected to dis-inflate steadily, reflecting the improvement in supply chains and the associated softening in producer prices. However, services inflation will likely be persistent. Forward-looking information from recently concluded wage negotiations does not yet show clear signals of a turning point in wage growth. A tight labour market constrained by structural factors could mean that wage growth is unlikely to fall back sharply, and without meaningful productivity growth, domestic price pressures could persist. Overall, we expect eurozone inflation to decline, but sticky core inflation will likely keep the European Central Bank cautious in the medium term.

We believe the ECB is likely to pause tightening in the coming quarter, leaving the deposit rate at 4%. While it may maintain a hawkish bias, additional rate hikes are hard to justify given the current macroeconomic backdrop. Rather, policy rates will remain restrictive for a prolonged period until there is more certainty that inflation will return to 2% sustainably. With the ECB putting rate hikes on pause, the focus will move to the speed of QT, where the ECB may end Pandemic Emergency Purchase Programme (PEPP) reinvestments earlier than its current guidance (end of 2024), and further tweaks to the level of minimum reserve requirements are also probable. The potential end of PEPP reinvestments will remove the ECB's 'first line of defence' against unwarranted peripheral spread widening, but the Transmission Protection Instrument (TPI) will remain as a safeguard.

We anticipate further declines in bond yields. A continued decline in inflation, subdued growth outlook, and an end to the ECB's tightening cycle should entice demand for euro government bonds. The recent US-led sell-off in global bond yields has pushed 5-year/5-year euro forward real yields from around a peak of 0.6% seen earlier in the year to around 1%, which looks attractive from a long-term valuation perspective. However, with eurozone government bond issuance at historical highs, and the fight against inflation not yet over, we are cognizant that term premia can continue to rise. As such, we also anticipate the yield curve steepening.

As for peripheral eurozone spreads, we are aware that political risk in Italy has receded, and cheap loans and grants from the NGEU programme should help Italy's debt sustainability outlook, at least in the near term. However, Italy's updated 2024 budget includes sizeable deficit-funded tax cuts and shows no obvious improvements in the public debt-to-GDP ratio, which may raise some concerns in Brussels. Moreover, optimistic GDP growth assumptions and still-growing tax credits point to risks of Italy overshooting the new deficit and debt targets. This raises the risk



“Recent developments in UK inflation have been encouraging.”

that the debt-to-GDP ratio starts growing again over the next two to three years, albeit modestly, after retrenching in recent years. In addition, an earlier end of PEPP reinvestments could also bode poorly for peripheral government bond spreads.

We feel that the combination of tightening credit conditions and slower growth could threaten euro breakeven inflation (BEI). We believe the risk of a wage-price spiral is low, and the ECB's strong focus on real-time inflation outcomes in its current framework increases the risk of overtightening. Over the past year or so, inflation hedging flows in the wake of the substantial energy price shock has supported rich BEI valuations. Looking ahead, with headline and core inflation falling amid a subdued growth outlook, we expect inflation hedging demand to recede and inflation risk premia to decline.

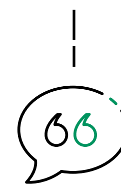
UK

UK economic growth has shown considerable resilience for most of 2023, but recent data suggests it is approaching an inflection point. Momentum in the services sector is slowing, and the construction sector is starting to contract as headwinds from tighter monetary policy start to build. Households and businesses have been running down their stock of excess savings in lieu of borrowing, and as these savings shrink, tighter credit conditions will likely weigh more heavily on household consumption and business investment.

Wage growth is unlikely to reaccelerate, but it is still too high relative to the Bank of England's (BoE) price stability goal. The recent broad-based increases in wages across the public and private sectors cannot be entirely attributed to the rise in the national minimum wage, and the upward momentum in public sector wage growth may not yet be over. The good news is that the extent of strikes seems to have levelled off, and upward pressure on public sector wage growth should moderate in the near term. As for the private sector, a recent survey pointed to a sharp decline in recruitment and slower starting salary increases, indicating a continued fall in labour demand. Taken together, this suggests wage growth will probably moderate over the next few quarters as labour market slack increases.

On the fiscal side, with the UK general election likely to take place either in the spring or autumn of 2024, there has been increasing focus on the Conservative and Labour parties' fiscal plans in their election campaigns. Both have so far emphasised fiscal credibility, as there is a broad recognition of the need for fiscal discipline following the experience of the 'mini-budget' turmoil last year and rising debt interest costs. That said, with the Conservative party trailing significantly in election polls, the incumbent government may still seek to bolster support by hinting at or announcing near-term stimulus measures.

Recent developments in inflation have been encouraging (see Exhibit 3). Both headline and core consumer price index (CPI) inflation have fallen back; inflation expectations have so far remained well anchored; and the



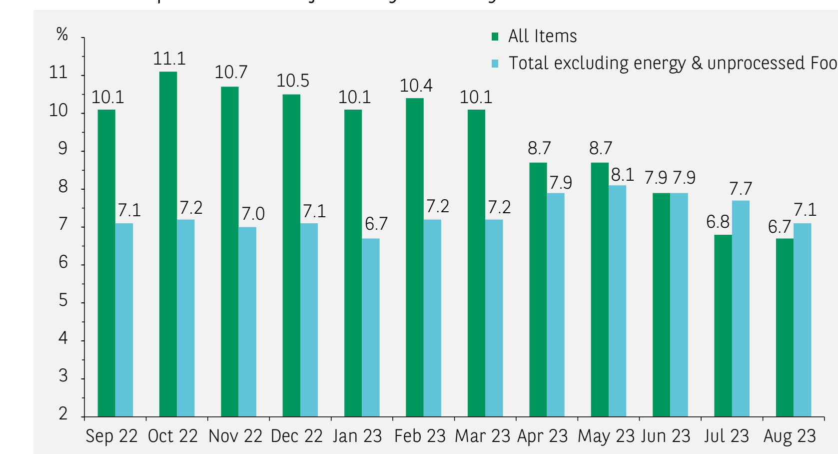
“We believe UK real yields offer significant value.”

labour market has shown further signs of loosening. However, the pace of loosening has been slow, and the labour market overall remains relatively tight. Measures of wage growth and services inflation have remained at rates above those consistent with meeting the BoE's 2% inflation target sustainably in the medium term. While inflation has finally started to move in the right direction, the central bank still has some work to do to bring inflation back to target.

Exhibit 3

Recent developments in inflation have been encouraging

Consumer price index inflation year-on-year



Data as at 16 October 2023. Sources: FactSet, BNP Paribas Asset Management.

In terms of monetary policy, the risks of over-tightening and under-tightening have swung back into balance, as evident from the BoE chief economist's references to Table Mountain and the Matterhorn, and his preference for the former, as the possible routes for the BoE to bring inflation back to target. With growth stagnating, services inflation moderating, continuing signs of loosening in the labour market and little scope for fiscal easing, the BoE is unlikely to hike policy rates further and will more likely maintain the Bank Rate at 5.25% in the near term.

With the recent sell-off in global bond yields, long-dated forward real yields have risen markedly. We believe these real yield levels offer significant long-term value, particularly with the UK's supply side constraints weighing on the economy's growth potential. At the same time, while term premia have risen meaningfully over the past couple of months, they are still low from a historical perspective. Given the large issuance needs and ongoing quantitative tightening, we realise that term premia could have further room to rise. We are currently neutral on UK breakeven inflation rates. On the one hand, limited linker issuance relative to conventional Gilts, persistent inflationary pressures, and a potential return of liability-driven demand should be supportive for BEI. On the other hand, the BoE's desire to get on top of the inflation narrative and the lacklustre growth outlook would likely contain BEI rates.

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