



Overturning stones: the hunt for inflation

Fixed income quarterly outlook - first quarter 2020

FOR WHOLESALE INVESTORS ONLY - January 2020

KEY POINTS

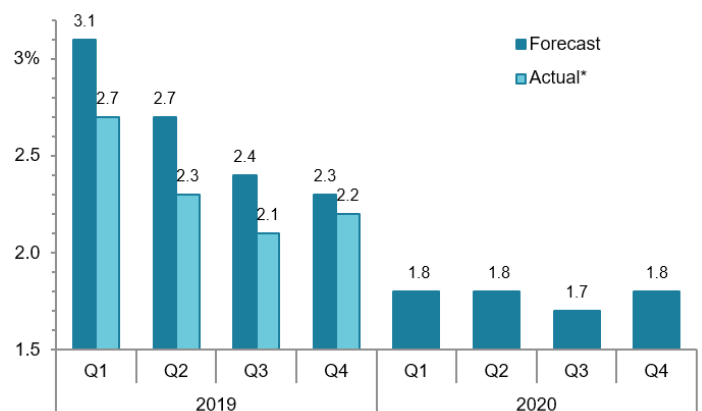
- We expect yields to move in a relatively narrow range from now on with the US presidential election, trade tensions, and inflation expectations becoming the key drivers.
- With the expected signing of a “phase one” US-Sino trade agreement later this month, there are hopes global trade and therefore global growth will recover. However, even taking this into consideration, we do not believe that there will be a significant reduction in trade tensions this year, either with China or with other countries.
- The most significant developments in monetary policy in 2020 are unlikely to be changes in policy rates, but rather the reviews being undertaken by both the US Federal Reserve (Fed) and the European Central Bank (ECB) to evaluate the conduct of monetary policy in a world of persistently low – and below-target – inflation.
- The Fed is unlikely to change interest rates until after the US presidential election as GDP growth slows to trend, even though further cuts are arguably needed given that inflation is still below target.
- The US dollar appreciated against the euro and most emerging market currencies in 2019 despite decelerating growth and reductions in policy rates. We do not see this continuing.

MACROECONOMIC CONTEXT

The last year of the previous decade was the story of a slowdown foretold. While many analysts and investors were evidently surprised by the deceleration in growth in 2019, at least in the US, it had almost entirely been expected.

At the end of 2018, knowing that the boost to US GDP from the Trump administration’s tax cuts and fiscal spending was always going to fade, the consensus estimate for the growth rate in the fourth quarter of 2019 was 2.3%. In the end, the actual growth rate turned out to be 2.2% as the economy reverted towards long-run trend growth of 1.9% (see Exhibit 1).

Exhibit 1: US GDP forecasts and actual growth rates
Year-on-year, in percent



Data as at 2 January 2020. Note: 2019 forecasts as at 31 December 2018; 2020 forecasts as at 2 January 2020. Source: Bloomberg, BNP Paribas Asset Management



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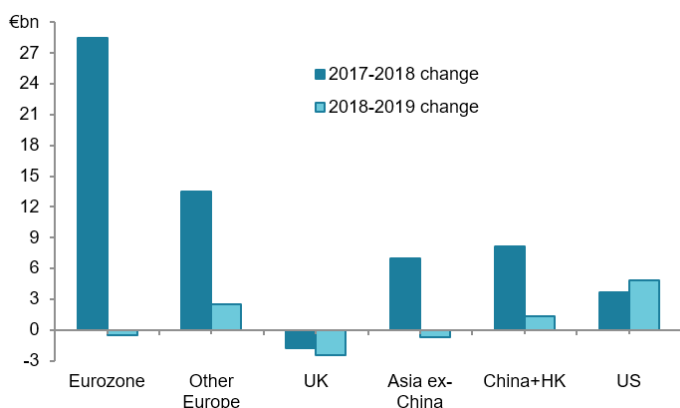
With such an outlook for more muted growth, it should not have been any surprise that US Treasury yields fell over the course of the year. For 2020, GDP growth is expected to stabilise near the trend rate. If that estimate is accurate, we would expect yields to move in a relatively narrow range from now on with the US presidential election, trade tensions, and inflation expectations becoming the key drivers.

While the US economy ultimately performed as expected in 2019, the Eurozone economy, by contrast, disappointed. Instead of the 0.4% quarterly growth rate expected this time in 2019, the common currency area will likely have managed only half of that. Much of the blame has been focused entirely on the trade war with China and skirmishes over trade with numerous other countries. While it is true that the drag on growth from lower net exports was much larger in 2019 than in 2018 (offsetting a robust expansion in business investment), there are other factors to consider.

Firstly, trade in goods actually improved compared to 2018; it was a deterioration in the services balance of payments that drove the negative contribution from net exports.

Second, as far as German exports are concerned, trade with Europe and Brexit were far bigger problems than the Sino-US trade war. German exports increased by EUR 55 billion from 2017 to 2018, but by just EUR 7 billion from 2018 to 2019 (data through October of each year). The biggest drop came in exports to other European countries: exports to the rest of the eurozone actually fell, particularly to Italy and the Netherlands. Exports to the US rose and the fall in exports to China was less than the drop for most other regions (see Exhibit 2).

Exhibit 2: Change in German exports
Trailing 12-months, through October of each year



Data as at 2 January 2020. Source: German Federal Statistical Office, BNP Paribas Asset Management

Encouragingly, the most recent data shows a recovery in the growth rate across all regions.

With the expected signing of a “phase one” US-Sino trade agreement later this month, there are hopes global trade and therefore global growth will recover. We do not believe, however, that there will be a significant reduction in trade tensions this year, either with China or with other countries. Moreover, we do not believe that the trade war was the primary cause of the slowdown in growth in the first place, meaning a trade truce would not necessarily reverse it.

Markets have certainly been relieved that additional tariffs were not imposed on trade between the US and China, but there is still significant scope for disappointment over what has been agreed and consequently significant risk that tariffs are re-imposed. Notably, the reduction in existing tariffs has been modest, by just 11%. This may explain the only modest rally in equity markets after the deal’s announcement.

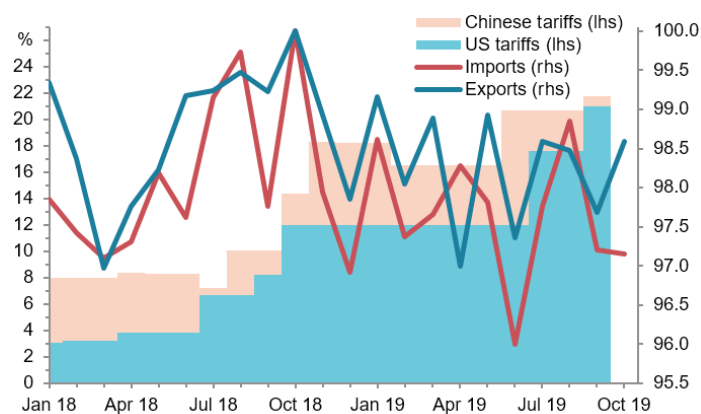
Secondly, many of the commitments China has supposedly made around intellectual property rights and increased market access are open to interpretation and verification. It seems almost inevitable that the interpretations and conclusions will differ between the two countries.

Thirdly, the promise that China will increase its imports of US goods by USD 200 billion over the next two years seems ambitious given that imports in 2017, before the beginning of the trade war, were just USD 187 billion. Even if everything goes to plan, President Trump could view this agreement, alongside the new NAFTA accord, as a sign that his strategy of using tariffs to pressure US trading partners works. This could lead to repeated use of them against other countries, particularly in Europe.

While the trade war has clouded investor sentiment, its economic impact, particularly at a global level, is likely less significant than imagined. There has been a drop in global trade volumes of about 2% over the last year, reversing some of the 6% gain in the previous period. Perhaps coincidentally, trade volumes peaked around the time tariffs between the US and China rose sharply (see Exhibit 3).

Exhibit 3: Merchandise world trade volumes and tariffs

Trade volumes, seasonally adjusted; average tariffs



Data as at 2 January 2020. Source: CPB World Trade Monitor, Peterson Institute for International Economics, BNP Paribas Asset Management

But while the US and China together account for about 25% of global trade, trade between them only makes up 4%, and the tariffs have been applied on just half of that. Even accounting for indirect effects (countries exporting to China that then export on to the US), the amount of trade involved is not large enough to drive a global slowdown.

This becomes even more apparent when one considers where the slowdown has taken place. If the trade war were the primary cause, one would expect to see the biggest drop in volumes between the US and China. In fact, the biggest declines have been in emerging Asia ex-China (particularly South Korea and India), while aggregate Chinese exports have actually increased over the last year. US trade volumes have decreased by less than those in the eurozone or other advanced economies. There are likely several factors behind the trade slowdown, and they are unlikely to be resolved with the signing of a preliminary agreement.

In the absence of a recovery in global trade volumes, and given the limited scope of monetary policy in the eurozone to boost growth, attention has turned to fiscal stimulus as the driver of any rebound. It is not at all clear, however, how much scope there really is. The country with the greatest potential to boost spending is Germany: the largest economy in Europe, accounting for nearly 30% of eurozone GDP, runs a balanced budget, has relatively little government debt, and can borrow at negative interest rates out to nearly 20 years.

The political and cultural inhibitions, however, are significant. The government (in particular the CDU/CSU) remains committed to a balanced federal budget (the 'schwarze Null' or 'black zero'), though the new leadership of the SPD advocates for deficit-funded spending (as do the Greens and Left parties).

Even if a government were to move to greater investment spending, the economy may not be able to support it. The unemployment rate is already at an historically low 5% and many industries are unable to find qualified workers.

While German GDP growth in 2019 is forecast at just 0.6%, it is expected to recover in 2020 to 1.1%, so it is not clear that a big stimulus is critical. Moreover, the demands for greater deficit spending are made not so much with Germany in mind, but rather with the objective of boosting eurozone growth and employment. If the German populace already views QE as an implicit bailout of the eurozone 'periphery', the concept of Germany indebting itself to support growth elsewhere is unlikely to be popular.

Finally, the wider economic impact would be limited. An increase in Germany spending – programs costing EUR 50 billion have been suggested – is not likely to change the outlook for the EUR 13 trillion economy of the common currency area. As has long been obvious, what is needed in the eurozone is economic and labor market reform. That still looks very unlikely.

INVESTMENT IMPLICATIONS

Exhibit 4: Fixed income index returns

Returns are total returns in local currency except for GBI-EM which is in USD

Index	Market Value (\$tr)	Yield (%)	Total Return (%)	
			4q19	2019
Multiverse	59.7	1.7	-0.3	8.5
Intermediate (1-10 years)	45.1	1.6	0.3	6.4
Long (10+ years)	14.6	1.9	-2.2	15.3
Government	30.4	1.0	-1.2	7.3
United States	9.1	1.8	-0.8	6.9
Japan	8.2	0.0	-1.2	1.7
Eurozone	7.4	0.2	-3.0	6.8
Core	1.6	-0.3	-3.2	3.2
Semi-core	2.7	-0.1	-3.2	5.9
Periphery	3.0	0.6	-2.7	9.7
UK	1.8	0.9	0.0	13.5
Inflation-Linked	3.3	-1.0	7.3	7.3
US	1.5	0.3	8.8	8.8
UK	0.7	-1.9	6.3	6.3
Eurozone	0.5	-0.5	6.6	6.6
Corporate (IG)	10.7	2.2	12.5	12.5
US	5.8	2.8	14.5	14.5
Europe	3.2	0.8	6.7	6.7
High Yield	1.6	4.6	14.4	14.4
US	1.3	5.1	14.3	14.3
Europe	0.4	3.4	11.4	11.4
Emerging markets	2.0	4.9	14.0	14.0
USD sovereign (EMBI)	0.7	4.9	15.0	15.0
USD corporate (CEMBI)	0.3	4.2	13.6	13.6
Local sovereign (GBI-EM)	1.0	5.2	13.5	13.5

Data as at 5 January 2020. Note: eurozone core = Finland, Germany, Netherlands; semi-core = Austria, Belgium, France, Ireland; 'periphery' = Italy, Portugal, Spain. Source: Bloomberg Barclays, JPMorgan, BNP Paribas Asset Management

DEVELOPED MARKET DURATION AND INFLATION

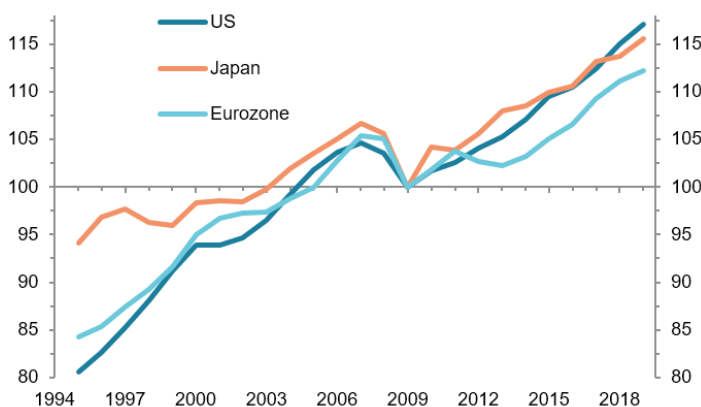
The most significant developments in monetary policy in 2020 are unlikely to be changes in policy rates, but rather the reviews being undertaken by both the US Federal Reserve (Fed) and the European Central Bank (ECB) to evaluate the reaction function of that monetary policy in a world of persistently low – and below-target – inflation. The underlying concern of many central bankers is the Japanification of their own economies. This can be defined as the process whereby an economy becomes highly indebted, while suffering from low growth, low interest rates, and low inflation.

At first blush, Japan's situation does seem dire: average real GDP growth stands at just 0.9% per year over the last two decades, the population is in decline, and the ratio of workers to retirees is deteriorating. Japanese government bonds have returned just 1.8% over the last 20 years compared to 5.2% for the Bloomberg Barclays Global Aggregate ex-Japan bond index. Equities have lagged by a similar amount.

However, by other measures, it is not clear that the situation is necessarily so bad. While debt levels are high, low interest rates also mean that the burden of the debt is equally low and with the bulk of the debt held domestically, there is little likelihood that a loss of confidence would affect the currency. The latest unemployment rate was just 2.2%, below that even in the US, and while one might question the quality of the employment and the flexibility of the labour market, at least nearly everyone is working.

Japan's GDP growth is inevitably lower than in countries with rising populations, but relative to the number of people in the country, Japan's performance is strikingly good. Since the global financial crisis, GDP per capita growth has until just recently outpaced that of the US and has easily outpaced that of the eurozone (see Exhibit 5).

Exhibit 5: GDP per capita
Real GDP, in local currency terms; 2009 = 100



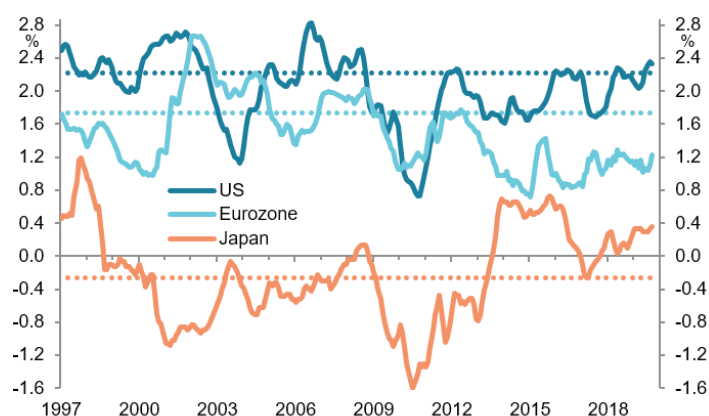
Data as at 3 January 2020. Source: Haver, BNP Paribas Asset Management

Even if Japan's situation were not as bad as assumed, central bankers would still rather have higher inflation and higher interest rates to have greater scope for cutting rates to offset an economic slowdown.

The question remains, however, whether they can have much impact on inflation or inflation expectations. The Bank of Japan (BoJ) set a 2% inflation target in 2013 and then, alongside negative interest rates and yield-curve control in 2016, announced it intended to overshoot it consistently.

On one hand, the BoJ has arguably had some success. Core inflation is now nearly 90bp higher than it was at the end of 2012, even if it is well below the target, while US inflation is 40bp higher and the eurozone rate is 35bp lower. For both Japan and the US, core inflation is currently above the average of the 10 years prior to the global financial crisis (see Exhibit 6).

Exhibit 6: Core inflation rates
All items less food and energy; dashed line is 10-year, pre-GFC average



Data as at 3 January 2020. Source: Haver, BNP Paribas Asset Management

Markets are unconvinced, however, that the central banks will ultimately succeed in meeting their inflation targets. Even as core inflation rates in Japan and the US have slowly recovered, inflation expectations have continued to fall and are currently only slightly above their all-time lows. Given rising technological disinflationary headwinds (Amazon, sharing apps, etc.), the task ahead for central banks is large and success by no means guaranteed.

With steady economic growth, stable policy rates, and subdued inflation expectations, we would expect 10-year US Treasury yields to range between 1.5% and 2.0% over the course of 2020. Even with the unemployment rate at its lowest since 1969, wage inflation is decelerating instead of accelerating and there has been little pass-through to broader CPI inflation in the

economy. The Fed is unlikely to change interest rates until after the US presidential election as GDP growth slows to trend, even though further cuts are arguably needed given that inflation is still below target. While there is the prospect of further fiscal stimulus if not only president Trump wins re-election, but the Republicans to retake control of the House of Representatives, we believe the more likely outcome is a divided Congress. Such a setup would limit the scope for significant changes in either spending, borrowing or taxation regardless of who becomes president. As a result, Treasury yields are likely to be most sensitive to geopolitical events, from trade tensions with China to events in the Middle East.

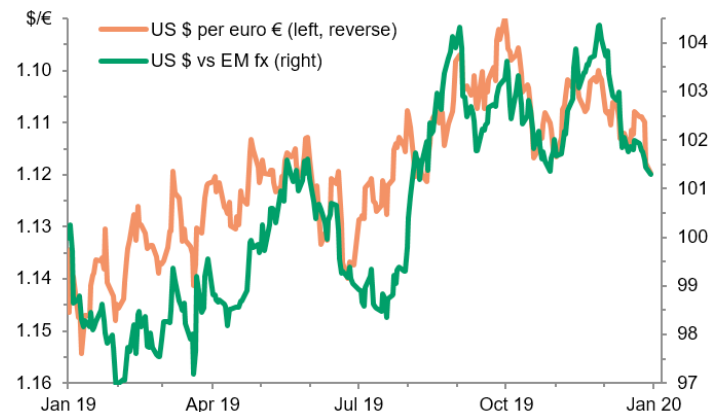
In the eurozone, we would equally expect little change in monetary policy as the ECB spends most of the year focused on its framework review. In the meantime, much attention will likely be paid to Sweden, which has led the way out of negative interest rates. The evolution of growth and inflation will tell policymakers whether the benefits of non-negative rates would outweigh what could appear as a tightening in monetary policy. While several central bankers in the eurozone might like to follow the Riksbank's lead, the ECB's commitment not to raise rates until after QE has ended ties its hands.

With the latest round of QE having begun only in November 2019, it would be challenging to end it without meaningful improvement in either growth or inflation in the eurozone. Consequently, the yield on much of the core European government debt is likely to remain negative. Investing in 'peripheral' market bonds appears to be one of the few options that may lead to (barely) positive total returns in 2020. The most obvious investment risk is Italy. Elections could return the Lega party to power, sparking a renewed widening in Italian government bond spreads.

CURRENCIES

The US dollar appreciated against the euro and most emerging market currencies in 2019 despite decelerating growth and reductions in policy rates (see Exhibit 7). We do not see this continuing.

Exhibit 7: US dollar exchange rates



Data as at 3 January 2020. Source: FactSet, JPMorgan, BNP Paribas Asset Management

Over the last few months, however, a number of foreign central banks have presented the market with a preview of their hawkish side by coming in somewhat less dovish than expected. As examples, in November, the Reserve Bank of New Zealand (RBNZ) remained on hold while market participants expected a 25 bps rate cut. In December, both the Reserve Bank of Australia (RBA) and the Bank of Canada (BoC) remained on hold. In Europe, the Riksbank hiked rates, putting an end to negative rates. More importantly, data outside the US has been coming in above expectations. We think this could represent an inflection point for the US Dollar, and could signal a weakening of the Dollar in the coming months. On the flipside, in a weakening US Dollar environment, we would expect the Yen to reverse course and perform well in Q1. A weakening dollar presents a tailwind for Emerging Market currencies too, and we expect them to turn in a strong Q1 2020.

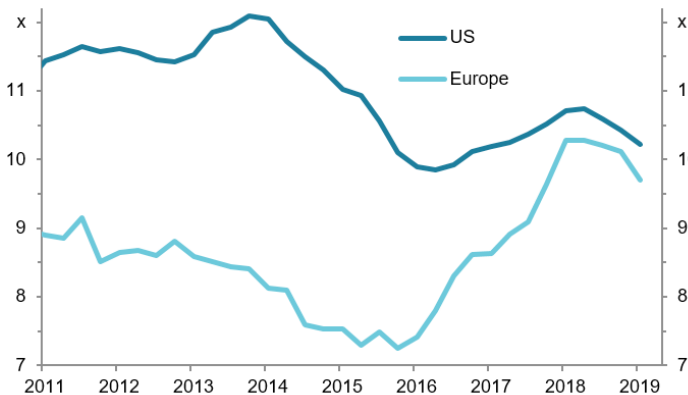
Sterling, the most volatile of the major currencies in 2019, will probably have a leading role again in 2020. Despite the perception that the Brexit will be done soon, many observers have remarked that it marks the beginning of the end. Fraught discussions lie ahead. Just as sterling waxed and waned with every twist and turn in the separation negotiations with Brussels, the question of whether the UK will ultimately extend the period to negotiate a trade deal or else risk the equivalent of a "no deal" relationship with the EU at the end of 2020 will swing the currency in similar fashion.

CREDIT MARKET

Which element of the debt-to-earnings ratio concerns corporate credit investors depends on the region. In the US, the focus is on the debt component: net debt has more than doubled since 2008. In Europe, the concern is on earnings: companies are struggling to generate consistent, strong profit growth. While the original hope was that companies would take advantage of the low QE-induced interest rates to pay down debt, they have responded to the incentives in just the opposite way by refinancing existing debt and then borrowing even more (often to finance share buybacks). However, if Japanification (meaning persistently low interest rates) is the future, high debt levels are not obviously a burden.

The latest earnings reports have shown a continued deterioration in EBITDA-to-interest expense coverage ratios in both regions. They have remained historically high in the US while improving in Europe since 2016 (see Exhibit 8).

Exhibit 8: Coverage ratio: EBITDA to interest expense
Trailing 12-months through 3Q2019



Data as at 3 January 2020. Source: FactSet, JPMorgan, BNP Paribas Asset Management

This follows a year of practically zero year-on-year EPS growth alongside nearly 30% gains in equity indices. This seemingly contradictory outcome was driven primarily by rising price-earnings multiples as recession and trade war fears waned, coupled with a declining discount rate as government bond yields fell. Analysts' forecasts are ever optimistic: expectations are for EPS gains of 8-10% in 2020. Even if this turns out to be too rosy, we still expect a recovery in earnings growth and better coverage ratios. Much of the weakness in Europe in 2019 was related to commodity sectors, and additionally semiconductors in the US. Both these sectors should see more stable prices this year.

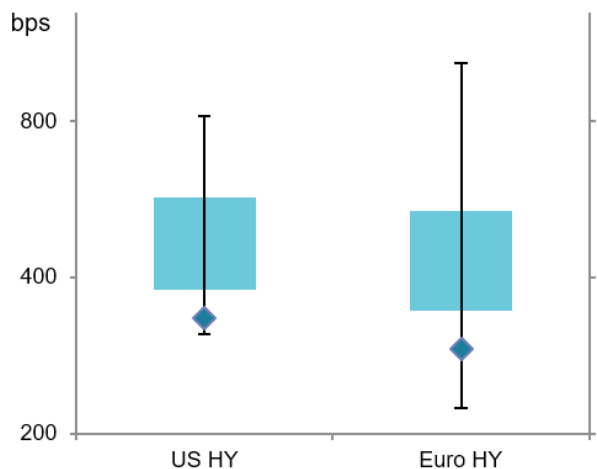
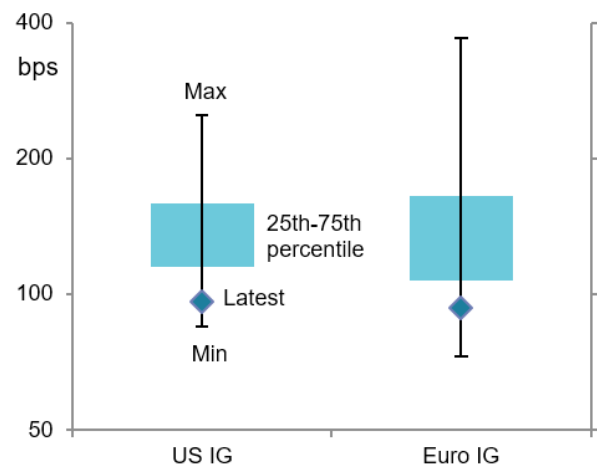
The question is whether valuations are appropriate for what is at best only a modestly positive outlook. After the hefty

outperformance of both investment-grade and high-yield debt over government bonds in 2019, spreads are now at challenging levels, particularly in the US.

Investment-grade and high-yield spreads for US corporate bonds are near the lows seen over the last 10 years (see Exhibit 9). There is little cushion for investors if rising wages and/or higher-than-expected Treasury yields start squeezing margins.

Having said that, with carry being a dominant component of excess returns in corporate credit in recent years, we think that investors have been viewing the sector as a "buy and hold" play. We expect this sentiment will persist through Q1 2020, even if spreads remain range-bound. Consequently, we are modestly positive US IG credit heading into the new year.

Exhibit 9: Corporate credit spreads
Over last 10 years



Data as at 3 January 2020. Source: FactSet, JPMorgan, BNP Paribas Asset Management

In Europe, technicals have helped foster a structural bull market for IG credit that should continue well into Q1 next year. The ECB resumed its net purchase program in November, and while much of the projected demand from the program is likely priced in already, the open-ended nature of the program is certainly a tailwind. Furthermore, high net issuance in Europe has meant that the ECB holdings of credit have actually fallen as a percentage of the eligible universe. The corporate market therefore offers the ECB plenty of capacity to ramp up its objectives quickly compared to other asset classes. Simultaneously, we expect European HY to benefit from a gradual pick up in sequential growth in the Eurozone, and lower tail risk - most recently, with the decline in the probability of a "no deal" Brexit. Lastly, within the European market we think there are notable opportunities in niche segments like Additional tier-1 (AT1) securities and contingent convertible capital instruments, known as CoCo bonds, which absorb losses when the capital of the issuing financial institution falls below a supervisor-determined level. Valuations still look attractive and the risk are lower given that banks' liquidity positions have been further improved by the ECB's new series of TLTROs.

EMERGING MARKETS

We are broadly of the opinion that the strong US versus weak EM cycle that has materialized, particularly over 2019, could reverse in 2020. With the Fed on hold and generally benign inflation globally, EM central banks should generally be able to continue, even expand, their accommodative fiscal and monetary policies. We expect these policies to start yielding results and EM growth should rebound from currently depressed levels. Moreover, if Chinese economic data continues to weaken, we could see further targeted stimulus from their policy makers, and some of that stimulus could have a derivative effect on the broader EM complex. EM growth recovery should prompt flows back into more broadly across EM assets, and that bodes well from EM currencies, in our opinion.

Despite this supportive backdrop, we expect to see meaningful dispersion in returns across the EM complex. EM High Yield defaults have been trending lower in recent years, but with a wall of maturities set to hit in 2020, we expect EM sovereign defaults, and consequently volatility, will rise in 2020.

CONCLUSION

The first year of the new decade will certainly hold many surprises, but as a challenge for investors, sentiment is better and spreads are lower than a year ago, making obvious opportunities harder to find. Successful strategies will require more nimble allocations to take advantage of moves to the extremes of what are likely to be more range-bound markets. One can only be thankful, then, that president Trump has shown himself to be more than able to provide the requisite volatility.

BIOGRAPHIES



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

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

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



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

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

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