

FIXED INCOME OUTLOOK

OCTOBER 2022



Tightening the vice

- The United States is facing a combination of slowing but still strong demand (from an excessively easy monetary and fiscal policy response to the pandemic) and large negative supply shocks (from associated China lockdowns, the reversal of globalisation, and the Ukraine conflict).
- We anticipate rates at between 4.25%-4.50% by the end of 2022. Further hikes in 2023 are entirely possible if core inflation does not moderate soon.
- In the eurozone, headline inflation will depend on energy prices and on government reactions. The outlook for underlying inflation is more clear. The increase in wholesale energy prices will continue to filter through to consumers. Surging input costs will put pressure on corporate margins, leaving companies little choice but to pass higher prices on to consumers. Alongside a weaker euro, these factors will drive the rise in core-industrial goods inflation in the coming months.



Olivier de Larouzière
CIO fixed income



Daniel Morris
Chief market strategist



BNP PARIBAS
ASSET MANAGEMENT

The sustainable
investor for a
changing world



**"Central banks
reacted to the surge
in headline inflation
by turning more
hawkish."**

UNITED STATES

The United States is facing a combination of slowing but still strong demand (from an excessively easy monetary and fiscal policy response to the pandemic) and large negative supply shocks (from associated China lockdowns, the reversal of globalisation, and the Ukraine conflict). With headline and core inflation far above target and threatening to de-anchor inflation expectations, and a very tight labour market driving up wages, the appropriate policy response is a combination of tighter fiscal and/or monetary policy.

How much the Fed needs to tighten policy will depend on inflation developments. Recent inflation data highlights the breadth and persistence of the inflation dynamic. The strength of wage gains and shelter costs is driving services inflation, and the gap between productivity growth and wage gains gives little indication that the situation will improve quickly or that a recession can be avoided. While it is likely that goods inflation will begin to ease amid reductions in supply disruptions and US dollar strength, prices may see renewed upward pressure from ongoing disruptions from the Ukraine conflict and China's rolling Covid lockdowns.

An "immaculate" disinflation scenario, whereby excess job openings are removed but no job losses occur and wage pressures normalise is, in our opinion, wishful thinking. The risk is that inflation is more entrenched and structural than is widely appreciated, and that a modest slowdown is not going to be sufficient to vanquish it.

Our working assumption is that real yields need to be driven higher than was the case at the end of the last hiking cycle in late 2018, when policy rates reached 2.75% but core personal consumption expenditures (PCE) inflation was barely 2.1% (versus 4.9% currently).

Real yields, after falling back in July, have now surpassed the levels seen in late 2018 (see Exhibit 1). A reasonable target for intermediate-maturity 5-year/5-year real yields would seem to us to be somewhere between 1.5% and 1.9%, considering that forward real yields often top out close to potential economic growth rates – which we peg at around 1.75%. The 2-year/2-year real yield, however, has the potential to rise significantly further, as the Fed will use the fed funds rate as its policy instrument. A target of 2.5% on the 2-year/2-year real yield is not implausible if the Fed needs to apply more pressure on the monetary brakes.



"Further hikes in 2023 are entirely possible if core inflation does not moderate soon."

Exhibit 1

Real yields have surpassed late 2018 levels

Forward real yields



Data as at 11 Oct. 2022. Sources: Bloomberg, BNP Paribas Asset Management.

Our view is that the Federal Open Market Committee (FOMC) needs to continue raising policy rates into restrictive territory, eventually slow the pace of increase, and then hold them there. After the September FOMC meeting, policy rates are at 3.00%-3.25%. We anticipate rates at between 4.25%-4.50% by the end of 2022, which is the same level as current market pricing.

Further hikes in 2023 are entirely possible if core inflation does not moderate soon. If Fed Chair Powell is true to his word that he will keep raising rates until he has "compelling evidence" that inflation is declining, the hiking cycle could in theory last for some time yet.

More realistically, given the time lags in monetary policy transmission, the FOMC will at some point opt to pause rate hikes to assess the impact of prior tightening. At what level could the Fed take such a pause? We think the earliest it could consider doing so is once rates are between 4.75%-5.00%, since the fed funds rate would need to be at least as high as the current rate of core PCE, which is currently 4.9% year-on-year (YoY).

EUROZONE

Developments in energy prices will continue to drive volatility in eurozone headline inflation. In Italy, the energy authority announced that regulated household electricity prices would increase by 59% in the fourth quarter of this year. Measures by governments, such as France increasing the cap on fuel and electricity prices at the start of next year, will pose upside risks to inflation in the coming months. There are, however, measures to lower inflation. Germany said it is setting aside EUR 200 billion to impose caps on firms' and households' gas and electricity bills. While the details of how this will be done are still missing, preliminary proposals suggest that the price cap could shave up to 2 percentage points from Germany's headline inflation in the coming year.



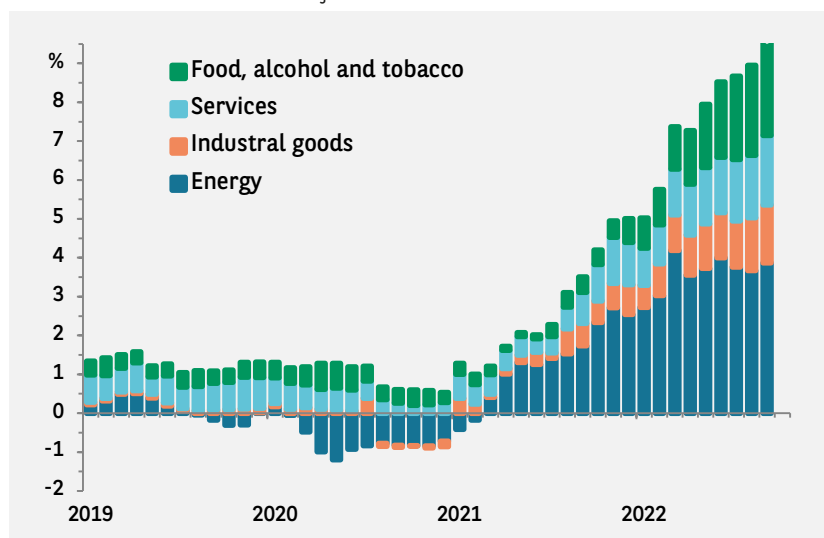
"Wage growth will determine whether the eurozone sees even more sustained inflation."

Broader discussions about imposing a natural gas price cap have started at the EU level. While imposing a limit on EU gas prices could entail risks to the security of gas supply, a growing number of EU member states have embraced the idea. Details of implementation are being discussed, with options including a cap on all gas prices, a 'dynamic corridor', or a price ceiling on gas used for power generation specifically for Russian gas only.

While movements in energy prices at the consumer level will depend on when and how national and EU interventions play out in the coming months, the outlook for underlying inflation is more clear. The increase in wholesale energy prices will continue to filter through to consumers in areas where there are no government interventions. Surging input costs will put pressure on margins, leaving companies little choice but to pass higher prices on to consumers. Alongside a weaker euro, these factors will drive the rise in core-industrial goods inflation in the coming months.

Exhibit 2 Inflation still rising

Contribution to eurozone inflation



Data as at 30 Sept. 2022. Sources: FactSet, BNP Paribas Asset Management.

Wage pressures

Developments in wages will determine whether the eurozone sees even more sustained inflation. Labour shortages due to disruptions from the pandemic are supporting wages, and recent high realised inflation may also lift wages if wage settlements are tied to cost-of-living adjustments. For example, the labour union, IG Metall, for example, is demanding an 8% increase over a period of 12 months in the upcoming round of negotiations.

The combination of a tight labour market and high realised inflation will likely continue to reinforce real wage resistance, where workers resist sharp cuts to their real income by demanding large pay raises. Though the economy is already slowing, the lagging nature of the labour market means that the employment outlook will likely remain robust. Companies have so far been generous with one-off bonus payments to compensate workers for the cost-of-living squeeze.



“The ECB is also likely to tighten policy through balance sheet reduction.”



It is unclear whether unions can achieve more sustained wage increases. In the tradable sector, faced with higher energy input costs and global competition, manufacturers will likely be under pressure to keep labour costs low. In the services sector, employment growth will likely start to wane once reopening effects fade and higher cost-of-living cuts into consumption, which in turn could help contain wage growth.

Outlook

Domestic business climate surveys, such as Ifo in Germany, show that economic sentiment remains especially weak in the retail sector. The risks of insufficient natural gas supply for the winter are mounting. In an adverse scenario of gas rationing for industrial companies, the German regulator estimates a loss of GDP of around 0.7% to 1.6%. There would also be second-order effects on business and consumer confidence.

The relentless rise in inflation has increased pressure within the ECB Governing Council to tighten policy faster, despite previous reassurances by policymakers that the ECB would move only gradually. Comments from the hawks within the Governing Council pointed to their intention to take policy rates to restrictive levels, and they would be keen to use the near-term trajectory of rising inflation as their window of opportunity to push through more policy tightening.

In addition to rate hikes, the ECB is also increasingly likely to tighten policy through balance sheet reduction. There are two possible channels through which to do this. First, around EUR 2.2 trillion of targeted longer-term refinancing operation (TLTRO) will expire by the end of 2024. The ECB may change the TLTRO formula, or implement a new tiering system to incentivise banks to repay their TLTRO earlier. Second, the ECB may announce in the coming months a reduction in reinvestment of maturing bonds in the Asset Purchase Programme (APP) as another way to shrink the balance sheet.

In terms of fiscal policy, efforts from policymakers both at the national and EU levels to reduce energy demand and shield consumers and businesses from high energy prices are ongoing. Moreover, given the nature of the common external shock from the Russia-Ukraine crisis with asymmetric impacts across national economies, the EU may deploy fiscal responses that entail some burden sharing.

Nevertheless, eurozone governments cannot afford to massively increase issuance given that the ECB is no longer buying government bonds and has started its tightening cycle. Ideally, these measures will need to be targeted and revenue neutral. For highly indebted countries, such as Italy, the recent rise in interest rates has already pushed up government borrowing costs significantly. As the ECB continues to withdraw liquidity from the market, investors may become increasingly concerned about Italy's fiscal sustainability.



"Brexit and Covid-19 lockdowns have led to more constrained labour supply."

UK

The UK economy was already in a very difficult position before the chaos in September. The UK has been grappling with multiple major supply shocks, which have translated into a huge headwind for living standards.

Firstly, similar to the eurozone economy, the UK has been hard hit by the impact of the Ukraine war on the supply of energy. Even though the UK does not import as much gas directly from Russia as the eurozone, it is still exposed to developments in international markets for wholesale gas.

Second, Covid-19 seems to have had a scarring effect on labour supply around the world, but the shortfall of workers has been particularly acute in the UK due to strains within the primary healthcare system. The number of people in Britain reporting that they are not looking for work because they are long-term sick has increased by around 250 000 over the past year.

In addition, the combination of Brexit and Covid-19 lockdowns has also led to more constrained labour supply. Lastly, on top of Covid-related supply disruption, the implementation of the Brexit agreement has created trade barriers between the UK and the EU, and those barriers may increase given ongoing tensions with the EU over the situation in Northern Ireland.

Unfortunately, the UK did not enter this period of macroeconomic turbulence in a strong financial position. It has been running a significant current account deficit for some time, and the surge in the price of natural gas worsens this already bad situation. The large deficit means that national savings have been consistently insufficient to cover domestic investment. As former Bank of England (BoE) Governor Mark Carney once said, the UK relies on the "kindness of strangers" to plug the gap. In fact, an analysis by the BoE suggests that the UK has been "using its past foreign investment to fund its lifestyle of excess" – that is, in aggregate, the gap between exports and imports and net sales of UK assets by overseas investors has been offset by large sales of overseas assets by UK investors. Of course, this process cannot continue indefinitely, and the large current account deficit puts the UK economy in a very fragile position.

The recent market and fiscal developments are important factors for the next BoE rate decision. While the Bank intervened with Gilt purchases to stem the rout in the market in late September, it was clear that the decision was made out of financial stability concerns, that there was no direct intention to cap Gilt yields, and active Gilt sales would start once markets become less dysfunctional.

In the near term, the pound sterling and Gilt markets will remain on edge as the underlying source of macroeconomic volatility remains unresolved (see Exhibit 3). Currently, fiscal and monetary policies are still working against each other. We believe the market is yet to be convinced that the UK's macroeconomic policy framework will be able to control inflation over the medium term.

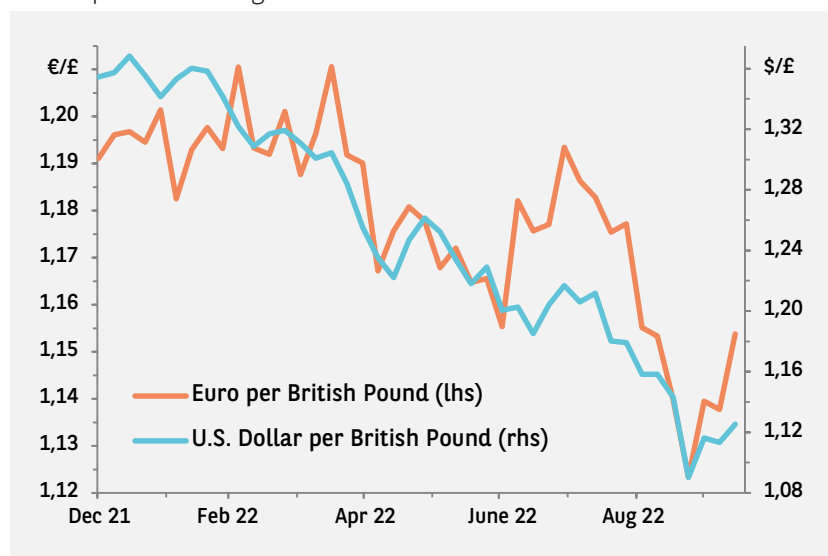


"A gap has opened up between spreads for eurozone IG credit and other markets."

Exhibit 3

Political turmoil has weakened sterling

British pound exchange rates



Data as at 21 Oct. 2022. Sources: FactSet, BNP Paribas Asset Management.

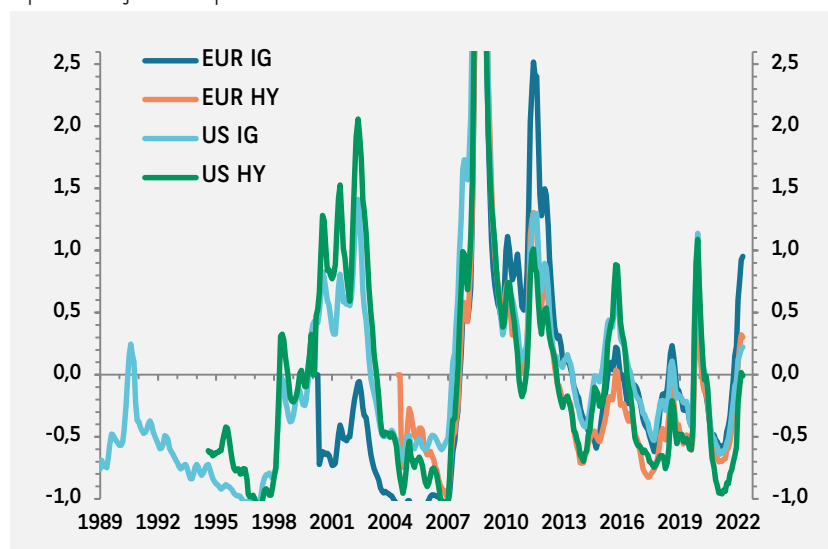
CORPORATE CREDIT

A significant gap has opened up between spreads for eurozone investment grade (EUR IG) credit and other major credit markets. On a relative basis, spreads for EUR IG debt are nearly one standard deviation above average, while for eurozone high yield and US dollar debt, spreads are either average or slightly above (see Exhibit 4). On one hand, the wider spreads in the eurozone reflect economic reality. The region is likely already in a recession while the US is not expected to enter one until 3q 2023. The question is whether current eurozone spreads reflect any further slowdown ahead.

Exhibit 4

Eurozone investment grade credit spreads most appealing

Option-adjusted spread z-score



Data as at 20 Oct. 2022. Sources: FactSet, BNP Paribas Asset Management.



“One can question
how resilient
European earnings
will turn out to be.”

We believe that they do. Though things can always get worse, many of the more negative scenarios imagined at the outbreak of hostilities in the Ukraine in February have in fact been realised. Both oil and gas deliveries have fallen dramatically. On the other hand, EU governments appear determined to offset as much as possible the economic impact of higher energy prices. Though the details have yet to be worked out, the lesson governments have taken from Coronavirus lockdowns is that borrowing is the best response to a crisis.

Admittedly there are limits to this strategy, and it is far more costly now with inflation and interest rates significantly higher than they were in 2019. Nonetheless we believe households and businesses will receive meaningful support through the winter and as was the case during the lockdowns, the decline in GDP will overstate the impact of the recession on household finances and corporate profits. The costs of this strategy is likely to be borne more by the currency and government bond yields.

Another reason for our confidence in the outlook for eurozone corporates is that credit metrics are solid. Net debt-EBITDA ratios have not been this low since 2008. Interest expense-EBIT ratios are even lower. The region's corporates took advantage of previously low interest rates provided by the ECB to refinance themselves at attractive rates. Admittedly, the absolute level of debt is much higher (75% higher), and with positive market rates the interest rate burden will rise, but companies are starting from a strong position and investors are being well compensated.

One should still question how resilient earnings will turn out to be. One of the many surprises this year is that forward earnings estimates for European corporates (excluding commodities) have risen when one might have expected them to fall. Analysts by now have had plenty of time to incorporate the negative impact of the conflict on corporate profits, but there have also been benefits that were not appreciated initially. The 4% increase in the 2022 EPS (ex-commodities) for the MSCI Europe index since April has been driven not only by financials benefitting from the move from negative to positive policy rates, but also by the transportation and automobile industries. Offsetting the gains have been negative revisions for insurance companies and diversified financials, but so far little for industrial companies or consumer discretionary. As a result, even if earnings weaken in the months ahead, companies should have little problem meeting their obligations.

The deterioration in the outlook for US corporates is likely yet to come. Fundamentals are currently good and economic growth remains solid (if anything it is too strong for the Fed's liking), but as policy rates march steadily higher, and high inflation (both for inputs and for wages) pressures margins, more and more companies are likely to warn on their profit outlook. The Fed's pivot will likely come in the first half of next year, but given current spread levels we are neutral on the outlook for US credit and defensively positioned.



**"Emerging market
debt has
suffered
disproportionately
this year."**

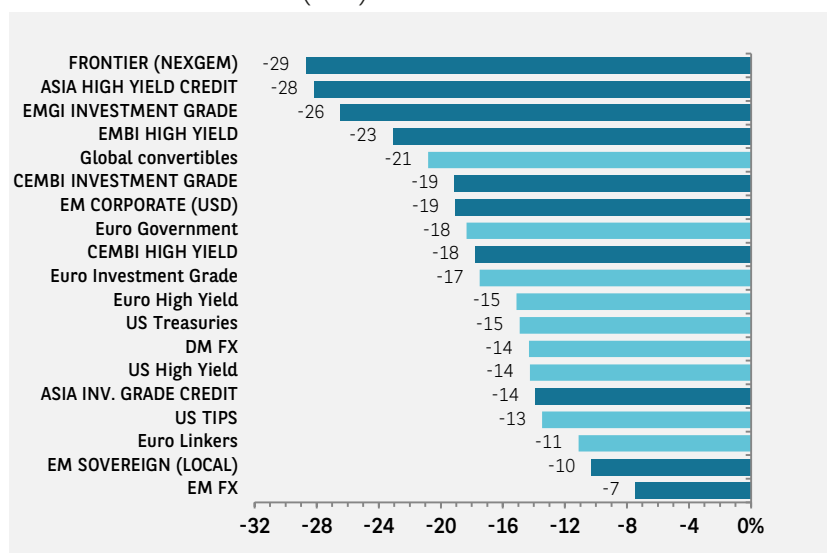
EMERGING MARKETS

Emerging market may not exactly be innocent victims of economic and political developments this year, but emerging market debt has certainly suffered disproportionately, with the notable exception of local currency debt (see Exhibit 5). One might expect a stronger dollar, rising Treasury yields, and geopolitical tensions to have led to significantly negative portfolio flows. In fact the asset class has seen inflows for most of the year, with redemptions from China debt offset by inflows to other countries (according to data from the Institute of International Finance). Foreign ownership is still low by historical standards, meaning that more substantial inflows could follow a stabilisation in US rates. A more modest issuance calendar through the rest of the year should also support the asset class. With the bulk of the move in the dollar and US Treasury yields behind us, it will be primarily those countries who now need to finance budget and trade deficits abroad at higher interest rates who will face the most challenges.

Exhibit 5

Emerging market assets have suffered this year

Year-to-date total return (USD)



Data as at 21 Oct. 2022. Sources: FactSet, BNP Paribas Asset Management.

Economic activity is mixed, with about half of the countries seeing an improvement in Purchasing Manager Indices over the last three months and half deteriorating, though the absolute level is above 50 for the majority of countries (63%). As in developed markets, inflation has continued to come in higher than expected and central banks have been more hawkish as a result. It appears, however, that expectations have finally come in line with reality and we anticipate fewer inflation surprises ahead. Countries with a combination of high inflation and negative real interest rates are going to require tighter monetary policy.



"Covid and a weak property market are not going to go away anytime soon."

The significant underperformance of hard currency debt this year means that spreads are now near peak post-GFC levels. We see high yield, frontier, and selected investment grade country spreads (e.g., Mexico, Indonesia and Chile) as appealing from a valuation perspective. Within corporates, we see Latin America investment grade and Asian high yield as the most compelling. Net leverage for EM corporates is just 1.2x, a 10-year low (investment grade is 1.0x and high yield 1.7x). These low ratios reflect the conservative behaviour of companies over the past few years. Instead of investing heavily in capital expenditures, or returning cash to shareholders, they have focused on managing liabilities and improving balance sheets.

Local currency emerging market debt has been one of the best relative performers this year. Real rates are still negative in all the regions, but we see some value particularly within Latin America and in some oil-exporting countries. EM currencies have also held up much better vs the US dollar than developed market currencies. Nonetheless, we believe that as global risk appetite stabilises, we should see a rebound. On a real trade-weighted basis, we see value in CEEMEA and certain Asian currencies.

China's primary challenges of zero Covid and a weak property market are not going to go away anytime soon. There are reasons to be optimistic, however. China is developing an mRNA vaccine which we believe will be rolled out at some point. We know now from experience that once a country is sufficiently vaccinated and restrictions are lifted, economic activity rebounds quickly. The problems in the property market will require more time to address and in any event it is unlikely to ever re-attain its previous degree of importance, but the government is incrementally increasing fiscal, monetary and regulatory support which should reduce the drag on the economy. In the medium term, the country will need to finally reorient the economy away from investment and towards consumption as the primary motor of growth.

CONCLUSION

Developed fixed income markets have just been through their worst period since the 1970s. The unwinding of the extraordinarily monetary policies post the global financial crisis has been unsurprisingly painful, but the inflation sparked by post-Covid reopenings and the conflict in Ukraine has made it particularly so. Real yields in the US have at least now reverted to levels where investors can anticipate some stability ahead, while hawkish central banks ensure that inflation expectations should also remain steady. The key question is whether inflation will begin to moderate, allowing the Fed to pivot, before more serious cracks emerge in global markets.

This report was finalised on 21 October 2022

BNP Paribas Asset Management France, “the investment management company,” is a simplified joint stock company with its registered office at 1 boulevard Haussmann 75009 Paris, France, RCS Paris 319 378 832, registered with the “Autorité des marchés financiers” under number GP 96002.

This material is issued and has been prepared by the investment management company.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or
2. investment advice.

This material makes reference to certain financial instruments authorised and regulated in their jurisdiction(s) of incorporation.

No action has been taken which would permit the public offering of the financial instrument(s) in any other jurisdiction, except as indicated in the most recent prospectus and the Key Investor Information Document (KIID) of the relevant financial instrument(s) where such action would be required, in particular, in the United States, to US persons (as such term is defined in Regulation S of the United States Securities Act of 1933). Prior to any subscription in a country in which such financial instrument(s) is/are registered, investors should verify any legal constraints or restrictions there may be in connection with the subscription, purchase, possession or sale of the financial instrument(s).

Investors considering subscribing to the financial instrument(s) should read carefully the most recent prospectus and Key Investor Information Document (KIID) and consult the financial instrument(s)' most recent financial reports. These documents are available on the website.

Opinions included in this material constitute the judgement of the investment management company at the time specified and may be subject to change without notice. The investment management company is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the financial instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for an investor's investment portfolio.

Given the economic and market risks, there can be no assurance that the financial instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the financial instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to financial instruments may have a significant effect on the results presented in this material. Past performance is not a guide to future performance and the value of the investments in financial instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

All information referred to in the present document is available on www.bnpparibas-am.com

October 2022 - Design: Creative Services BNPP AM - P2210057



INVESTORS'

corner



BNP PARIBAS
ASSET MANAGEMENT

The sustainable
investor for a
changing world