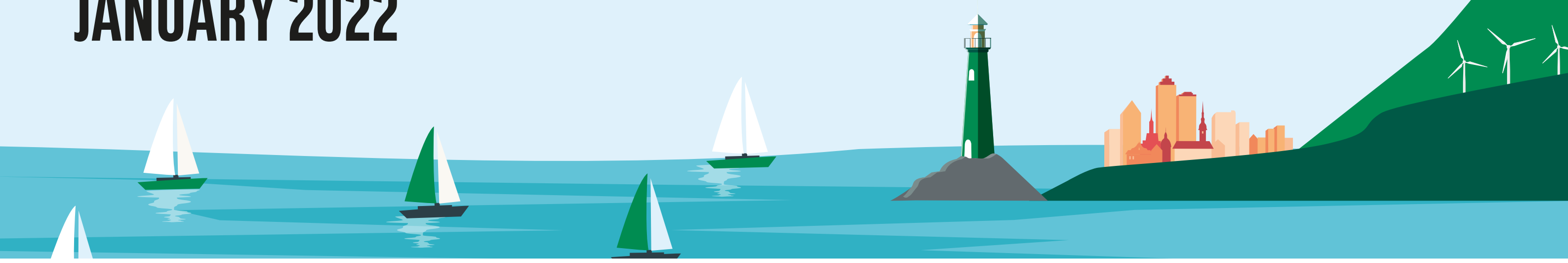
For professional investors - Marketing communication - January 2022

FIXED INCOME OUTLOOK

JANUARY 2022



Tightening the screws

- Global supply-side disruptions remain intransigent and could continue for many months. Inflation is spreading beyond core goods to services and price indices for many non-shelter service categories have risen, reflecting higher input costs, including wages.

- The FOMC's projections for policy rates remain inconsistent with its growth, employment and inflation forecasts. We believe the US economy is already very close to full employment, and while a large proportion of current inflation is due to temporary supply blockages which will eventually recede, cyclical and structural inflation forces are also in play, such that the FOMC will need to become restrictive in its policy stance.

- A restrictive monetary policy stance can be achieved either by taking policy rates significantly above the 2.5% 'neutral' rate, and/or via a more rapid reduction in the Federal Reserve's balance sheet. We anticipate that the FOMC will start raising rates at its March 2022 meeting, and cease reinvesting coupons and maturing securities in June 2022. The Fed could hike as frequently as every meeting, and will likely raise rates to 2.5% or higher by the end of 2023.

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ASSET MANAGEMENT

The sustainable investor for a changing world

"Trends in retail and recreation show that household consumption remains strong."

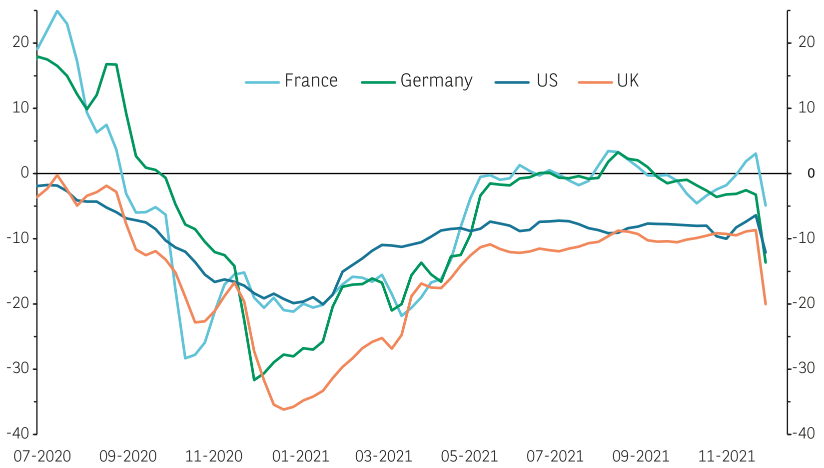
Developments on vaccines and the pandemic

With the world about to begin its third year of the pandemic, and another Covid-19 variant sweeping through the global population, we agree with France's Prime Minister Castex that "it feels like a movie without an ending". But the reality is that there are sound reasons to be hopeful that 2022 might well mark the beginning of the end of this awful episode. With immunity rates (both natural and vaccine-acquired) rising steadily, second-generation vaccines under development, effective antivirals now available, treatment protocols improving and the virus probably mutating towards less dangerous variants, public health experts are increasingly arguing that Covid-19 may soon become endemic and manageable.

In terms of economic impact, the current explosion in Omicron cases risks a repeat of the production and distribution disruptions that occurred during the Delta wave. But it is the near-term disruption to existing workforces that will likely be the main problem, as the tsunami of infections could force a sizeable proportion of the labour force to self-isolate – possibly putting provision of some essential services (including healthcare) at risk.

High-frequency data on mobility trends in retail and recreation show that household consumption remains strong – even if spending is still heavily concentrated in goods rather than services. Omicron may well trigger a (likely short-lived) pull-back in activity. Taking a broader view, it is clear that developed market (DM) economies have adapted to each new Covid wave, with each surge being less disruptive than the preceding one. For DM economies, therefore, perhaps we are at the beginning of the end of this pandemic. A full return to normality, however, will likely require either a more concerted effort to vaccinate emerging market (EM) populations, or for the virus to provide herd immunity via infection.

Exhibit 1: Mobility trends
Percent deviation from baseline



Data as at 17 January 2022. Sources: Google mobility trends, BNP Paribas Asset Management.

UNITED STATES

The US Federal Reserve (Fed) has highlighted its desire to reach full and 'inclusive' employment, with reference to a broad range of labour market indicators. So how close is the US to full employment?

(i) In terms of the actual jobs gap, as of December, the economy was only around 3.6 million jobs shy of the 152.5 million payrolls in February 2020, versus a peak gap of 22.362 million jobs in April 2020.

(ii) The standard U3 unemployment rate has also fallen sharply, from a peak of 14.8% in April 2020 to 3.9% in December 2021 – actually falling below the Federal Open Market Committee's (FOMC's) 4.0% estimate of the longer-run rate. However, the U3 measure is flawed if working-age people are dropping out temporarily from the labour force for reasons such as childcare difficulties while schools and nurseries are closed, or to reduce the risk of getting (or spreading) Covid.

(iii) A better measure of labour market slack may be the employment-to-population ratio, which recovered to 59.5% in December versus a pre-pandemic peak of 61.1% (see Exhibit 2). However, since the demographic profile of the population has aged since 2019, an adjusted 'full-employment' level would be closer to 60.4%.

(iv) Another metric is the labour force participation (LFP) rate, for the working age (16 to 64 years) and prime-age (25 to 54) segments. Overall, LFP has dropped by around two percentage points versus the peak, while the prime age LFP rate has only declined by around 1 percentage point. The inference is that many older people appear to have dropped out of the reckoning, whether because of early retirement, disability, lifestyle choices or concerns about pandemic risks.

(v) In addition, turnover indicators such as the JOLTS survey Quits rate, show that existing workers are voluntarily leaving and switching jobs at high rates – historically a good indicator of a tight labour market.

(vi) The tightness in the labour market is also becoming apparent in compensation metrics. The Employment Cost Index (ECI) and Atlanta Fed Wage Tracker metrics confirm anecdotal evidence that employers are having to raise wages and improve working conditions to attract workers, especially in low-skill sectors. As examples, the most recent third-quarter ECI showed wages climbing at 3.7% year-on-year (YoY), while the Atlanta Fed Wage Tracker for November showed wages for prime-age workers climbing at 4.5% YoY.

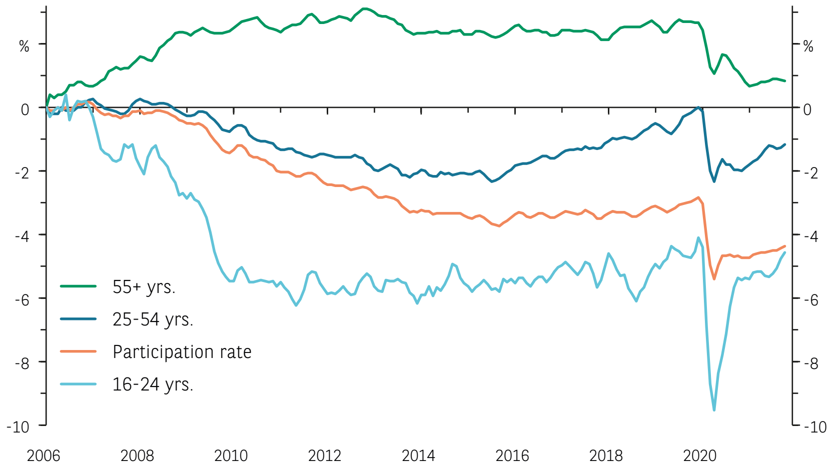
The experience of the decade prior to the pandemic was that wages rose only slowly during the expansion, because labour force participation steadily rose as inactive workers re-joined the labour force once jobs became available. The current situation appears different, with JOLTS Job openings above 10 million, not enough qualified applicants to fill them, and firms having to raise wages. So, is this occurring because of workers temporarily withholding labour and job-matching frictions? If so, will workers return as the pandemic fades? Or has a structural shift taken place, requiring wages to rise further to encourage job uptake?

"Should we expect wages to rise further to encourage job uptake?."

"Inflation is spreading beyond core goods to services."

The truth is probably that job-matching frictions, temporary supply shortages and structural shifts are all significant factors in reduced labour force participation. BNPP AM's Macro Research team estimates that only one-third of the remaining LFP shortfall is temporary, with the remaining two-thirds more persistent or structural. If structural factors are indeed at play, the economy may already be close to full employment. In this context, it is worth noting that the December FOMC meeting minutes stated that "a number of participants judged that a substantial improvement in labour force participation would take longer than previously expected", suggesting that some members of the FOMC are coming to the same conclusion.

Exhibit 2: US labour market participation rates



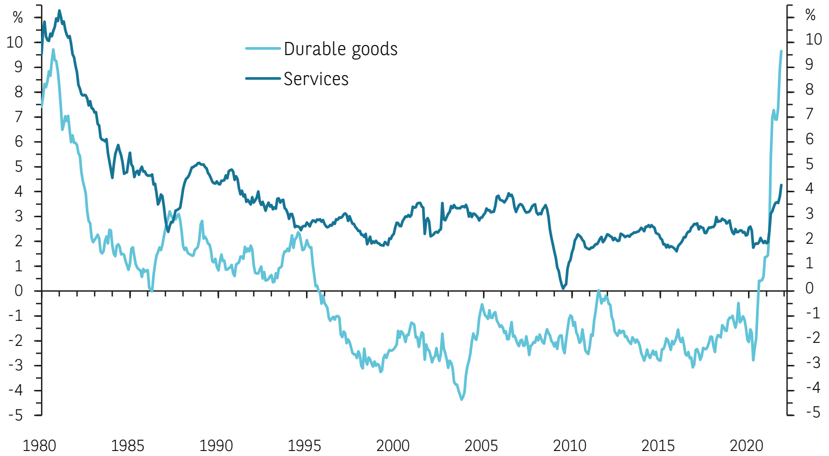
Data as at 17 January 2022. Sources: BLS, BNP Paribas Asset Management.

Inflation developments in the fourth quarter

The most recent consumer price index (CPI) and personal consumption expenditures (PCE) price index inflation data shows used vehicle prices surging again, while new vehicle prices continue to steadily strengthen. Global supply-side disruptions remain intransigent and could continue for many months. In this sense, the term 'transitory' when describing inflation is no longer helpful. Moreover, inflation is spreading beyond core goods to services (see Exhibit 3). Price indices for many non-shelter service categories have risen, reflecting higher input costs, including wages.

Primary rents and owners' equivalent rents (the largest components of shelter, and 32% weight in the overall CPI) have firmed significantly, catching up with the surge in prices for new leases. This trend is likely to continue for at least a year, and should take rents and OER to around 5.0% YoY. Housing costs have been supported by lower mortgage rates, rising home prices, strengthening household incomes and a desire to upsize to larger properties amid the pandemic and the shift to home-working.

Exhibit 3: Breakdown of year-on-year core PCE: Goods and services

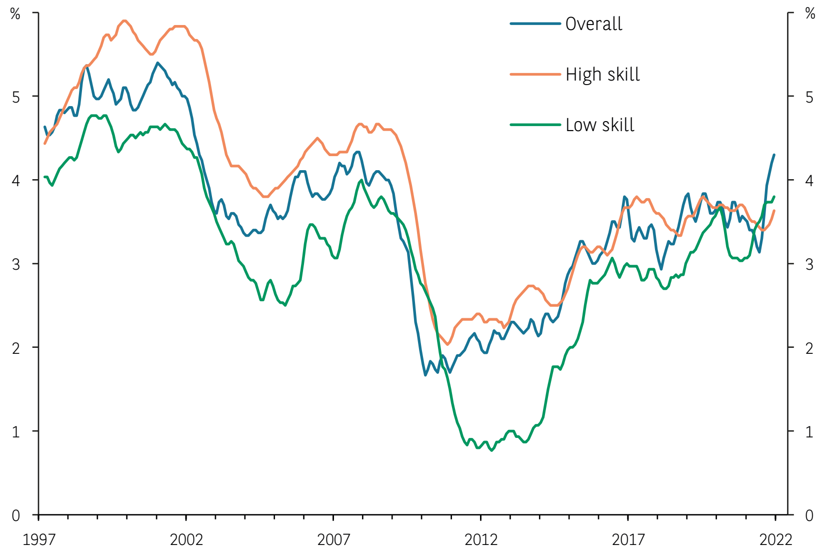


Data as at 17 January 2022. Sources: Bloomberg, Bureau of Labour Statistics, BNP Paribas Asset Management.

> "For inflation to truly persist, one needs to see wages rise."

This rise in inflation is, of course, entirely consistent with the metrics of input prices, such as the producer price index (PPI) reports on basic, intermediary goods and factory gate prices, and surveys of business cost pressures, such as the ISM survey of 'prices paid'. However, for inflation to truly persist, one needs to see wages rise – otherwise rising prices quickly eat into disposable income and destroy demand. Hence, the outlook for the labour market is crucial. In this context, it is worth noting that wages – when measured using the Atlanta Fed's Wage Tracker series – generally remained stable over the first 18 months of the pandemic, but are now rising across the board.

Exhibit 4: Atlanta Fed Wage Tracker
Year-on-year



Data as at 17 January 2022. Sources: Atlanta Fed, BNP Paribas Asset Management.

One implication, if indeed workers have accrued more wage bargaining power, is that the infamous Phillips curve may be resetting itself at a slightly higher level following the pandemic. As unemployment falls back down, wages are clearly rising, and perhaps on a Phillips curve that sits above that of the post-financial crisis period of 2010–2019. If so, wage costs could provide ongoing input cost pressures, helping to maintain support for inflation and – alongside shelter costs - permit a period of persistent, cyclical inflation strength to take hold.

Macroeconomic policy developments

Our view is that the FOMC's projections for policy rates (even after the latest upward revision) remain inconsistent with its growth, employment and inflation forecasts (Exhibit 5). It is peculiar that rates should still be forecast to be accommodative (below the FOMC's 2.5% neutral rate estimate) by late 2024, with unemployment at 3.5% and below the neutral rate estimate, with core inflation still above target after three years of overshoot. Still, the Summary of Economic Projections represents a collection of individual forecasts, rather than an agreed FOMC forecast – and it is perhaps unreasonable to hope for internal consistency. It is also possible that the Committee still largely believes that inflation pressures are temporary and driven by supply blockages rather than being cyclical – meaning that a more forceful response is not required. Regardless, the broader point is that the FOMC has been iteratively raising policy rate guidance – and we think this trend will continue.

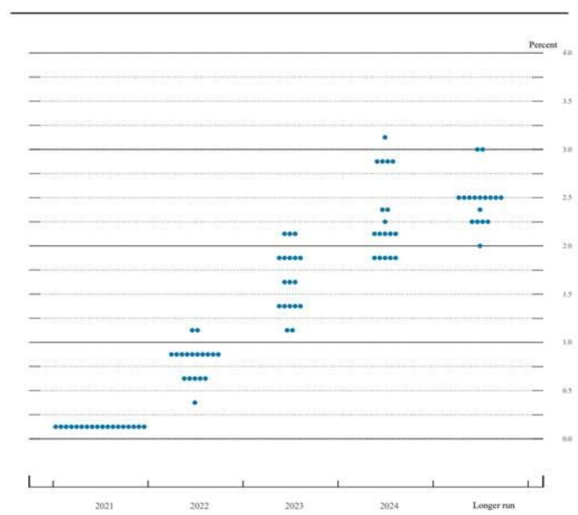
Exhibit 5: US monetary policymakers' interest-rate projections look inconsistent with their forecasts for major economic indicators

December 2021 Summary of Economic Projections

Percent

Variable	Median 2021	2022	2023	2024	Longer run
Change in real GDP	5.5	4.0	2.2	2.0	1.8
September projection	5.9	3.8	2.5	2.0	1.8
Unemployment rate	4.3	3.5	3.5	3.5	4.0
September projection	4.8	3.8	3.5	3.5	4.0
PCE inflation	5.3	2.6	2.3	2.1	2.0
September projection	4.2	2.2	2.2	2.1	2.0
Core PCE inflation	4.4	2.7	2.3	2.1	
September projection	3.7	2.3	2.2	2.1	
Memo: Projected appropriate policy path					
Federal funds rate	0.1	0.9	1.6	2.1	2.5
September projection	0.1	0.3	1.0	1.8	2.5

FOMC projections for US policy rates



Source: US Federal Reserve; January 2022

We believe the US economy is already close to full employment, and while a large proportion of current inflation is due to temporary supply blockages which will eventually recede, cyclical and structural inflation forces are also in play, such that the FOMC will need to become restrictive in its policy stance. With the unemployment rate at 3.9%, but the headline CPI inflation rate at 6.8%, the Fed's clear priority at this juncture is to ensure inflation returns to target.

A restrictive monetary policy stance can be achieved either by taking policy rates significantly above the 2.5% 'neutral' rate, and/or via a more rapid reduction in the Fed's balance sheet. The normalisation of the balance sheet – a topic that the Fed generally avoided discussing in 2021 – is likely to become an important theme in 2022. Indeed, the December 2021 FOMC meeting minutes revealed a lengthy discussion on balance-sheet reduction. We anticipate that the FOMC will start raising rates at its March meeting, and cease reinvesting coupons and maturing securities in June. The Fed could hike as frequently as every meeting, and will likely raise rates to 2.5% or higher by the end of 2023. By comparison, market pricing suggests policy rates will peak at around 1.6% in late 2024.

One key distinction in the upcoming tightening cycle versus the preceding one is that the Fed is likely to normalise policy rates and the balance sheet more or less simultaneously. The key reason for this is that the policy stance needs to be normalised faster. Unlike the Global Financial Crisis (GFC), this has not been a balance sheet recession. Governments have avoided austerity, and the US arguably even implemented too much fiscal stimulus. Household balance sheets are strong, corporate earnings have boomed, the US economy is already close to full employment, core inflation is at its highest levels since the early 1990s, and yet 10-year T-note real yields are still distinctly negative.

"Labour participation in the eurozone is normalising to pre-pandemic levels."

EUROZONE

In the eurozone, supply bottlenecks and rocketing energy prices have contributed to higher inflation in recent quarters, with harmonised index of consumer prices (HICP) inflation reaching an all-time high of 5% in the December flash release, while core inflation hit a record level of 2.6%. We believe we are near the peak of inflation. Base effects from soaring energy prices and tax changes in Germany should wane, which in turn should help inflation to fall throughout 2022. But we are cognizant that another spell of cold temperatures or a rise in geopolitical tensions in Russia and Ukraine could lead to another spike in utility prices given how low natural gas storage has been in the eurozone. The renewed surge in Covid cases combined with China's zero-Covid strategy could also exacerbate supply-chain constraints, leading to more goods shortages and higher prices in the near term.

In the longer term, for inflation pressures to be sustained we will need to see further evidence of the second-order effects from the current high level of realised inflation spilling over to wages. It is worth noting that the inflation shock in Europe is of a different nature from that in the US. Income replacement during the pandemic in the eurozone was provided through furlough schemes rather than direct fiscal stimulus to workers. Furlough schemes preserved the linkage between employers and employees and therefore reduced labour market friction in the recovery. Labour supply indeed appears less disrupted in the eurozone than in the US, as labour participation rates in the eurozone are normalising to pre-pandemic levels. The share of wages tied to inflation indexation has also decreased significantly in recent years and has therefore weakened the direct links to an inflation-wage spiral. We expect wages in the eurozone to pick up further in 2022, but probably not by enough to generate an increase in real disposable income. With 5-year/5-year HICP rates having reached 2% at the end of 2021, we believe the receding risks of disinflation and

"UK inflation will likely not peak at least until this April."

higher probability of better inflation outcomes have been fully reflected in longer-dated breakeven inflation (BEI) rates.

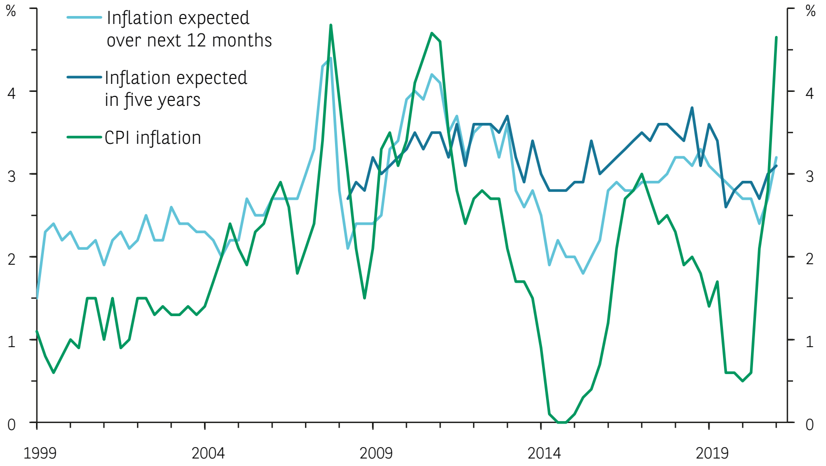
The persistent high inflation prints have led to more hawkish communications from the ECB. Despite the emergence of Omicron, which could have a negative impact on economic growth in the near term, the ECB was keen to lay out its plans for the transition away from the pandemic emergency purchase programme (PEPP) in its December meeting, and establish the optionality to raise interest rates with its forward guidance on the asset purchase programme (APP). The ECB has effectively left the APP open-ended, with purchases to continue from the fourth quarter 2022 at a pace of EUR 20 billion a month until 'shortly before' the initial rate hike. This keeps the door open for rate increases, giving the ECB the optionality to hike as soon as in 2023, if warranted. And while PEPP reinvestment guidance was extended by one year, to 'at least until' December 2024, hawks from the Governing Council have already expressed their concerns and considered the commitment to be too long.

UK

Inflation developments

Looking ahead, while the emergence of the Omicron variant will likely weigh on consumer-facing activities in the near term, potentially causing a softening of prices in the hospitality sector, the persistent strength in utility prices and the mechanism of price caps set by the Office of Gas and Electricity Markets (Ofgem) means that inflation will likely not peak at least until April 2022. Results of survey-based inflation expectations are often heavily influenced by realised inflation. Indeed, the latest Bank of England survey showed a sharp increase in both short and long-run inflation expectations over the last quarter (Exhibit 6). Inflation expectations for the next 12 months jumped to 4.4% in October, the highest level since 2008, before retracing slightly to 4% in November and December. Over the same 3-month period, households' inflation expectations for five to 10 years stabilised between 3.7% and 3.8% since the surge over the summer. While not yet making new all-time records, both sets of inflation expectations remained high and exceeded their pre-pandemic highs since 2013. Of course, the rise in short-run inflation expectations is logical given the improving cyclical outlook, tightness in consumer goods markets and surging utility prices. But the sensitivity of the survey-based inflation expectations measures to recent price developments raises the risks of inflation expectations moving higher still in the coming months as headline CPI is set to accelerate in early 2022, with another sizeable utility price hike forecast for April.

Exhibit 6: UK CPI inflation and household inflation expectations
Percent, year-on-year



Data as at 18 January 2022. Sources: Bank of England/Kantar, BNP Paribas Asset Management.

After much macroeconomic volatility during the pandemic in 2020 and 2021, we expect 2022 will likely be calmer, with the economic growth trajectory normalising as the UK learns to live with the virus. With the high vaccination rates in the UK, particularly among the more vulnerable segments, the policy response to the emergence of Omicron has been markedly different than to previous variants: Restrictions are lighter and lockdowns are now firmly a tool of last resort. The looser restrictions also go hand-in-hand with less fiscal support as the government aims for a more targeted approach rather than blanket income support.

In addition to the Covid-related pressures on labour supply, imported goods price pressures are continuing to build, while recent disruption to gas and electricity supplies also translates into more inflationary momentum into 2022, with CPI inflation forecast to peak at around 6.0% in April. There are also signs that the furlough scheme has ended smoothly, and wage increases are continuing, albeit at a slower pace. Given these labour market developments and inflation forecasts, we believe the Bank of England (BoE) will likely follow its December lift-off with a 25bp rate hike in February. We expect quantitative tightening (QT) to kick start soon after that, as the Bank Rate will have reached the 50bp threshold for the BoE to stop reinvesting maturities from its Asset Purchase Facility (APF) portfolio, perhaps starting with the GBP 28 billion Gilt redemption in March.

The focus on the labour market over the past months has been on the transition away from the furlough scheme. With the unemployment rate now sitting just above 4% and not rising meaningfully following the conclusion of the furlough scheme, the focus will next be on the development of labour force participation. The UK workforce contracted during the pandemic, partly due to slowing population growth caused by Brexit and the pandemic, but more importantly due to a falling participation rate. The rise in labour inactivity has been largest among people who reported that they are temporarily or long-term sick, and also among the older cohorts. If more workers decide to remain in retirement, or are not well enough to return to the labour market, the constrained labour supply could put further upward pressure on wages.

“The focus will be on the development of labour force participation”.

"Accumulated savings should allow consumers to absorb the squeeze on real income."

Looking at the demand side of the economy, the cost of the pandemic and increased public debt will likely constrain fiscal expansion in the near term. In terms of private consumption, business sentiment should recover as the risks from the pandemic fade and business investment should be supported by the government's super deduction policy. The outlook for the export sector is less certain, as increased costs from Brexit will continue to weigh. There is also the risk of a re-escalation of tension between the UK and EU in their negotiations over the implementation of the Northern Ireland Protocol. The risk of the UK triggering Article 16 – annulling parts or all of the Protocol – cannot be written off. In such a scenario, depending on the severity of the UK's action and the EU's response, in the worst case, financial markets could return to speculating over a 'no-deal' outcome all over again.

On the consumer front, wage growth, while decent, has not been sufficient to offset the rise in inflation. In the coming months, further increases in inflation and tax hikes in April will detract from consumers' real disposable income. Fortunately, the savings rate shot up meaningfully during the pandemic, and the stock of savings accumulated should allow consumers to absorb the real income squeeze and continue to spend. It is worth highlighting, however, that the meaningful rise in savings during Covid were accumulated mainly by higher income households, while lower income households suffered more from the squeeze on disposable income. So, the distribution of savings may mean that on aggregate, consumers may have less capacity to absorb the rise in cost of living than it appears.

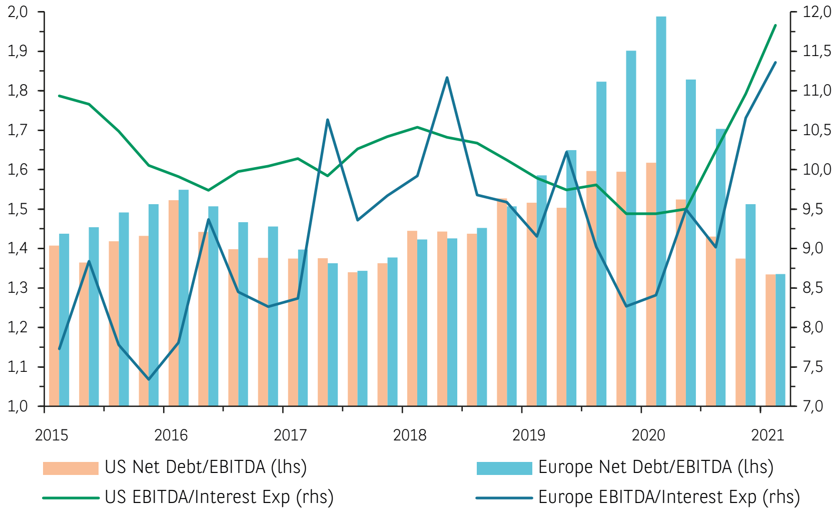
We believe the UK yield curve could be biased to steepen in the medium term. The end of quantitative easing (QE), and the prospects of QT starting this year will l;ikely translate into a substantial decline in demand for Gilts. In the near term, Gilt issuance will remain light between now and March, but markets will be focused on how well issuance can be absorbed without help from the central bank in the new fiscal year when supply starts to pick up after March. Given the BoE's updated guidance regarding monetary policy normalisation, where the Bank may start consider selling assets from its APF portfolio when the Bank Rate reaches 1%, we believe it is unlikely for short-dated yields to price in a rate-hike cycle much beyond 1%, while longer-dated yields could rise further on the prospects of BoE asset sales.

Credit

While US policy rates (and real yields) will be rising in 2022, we do not see this as a meaningful risk to economic growth, and therefore to corporate profits. Monetary policy is merely normalising as opposed to becoming actually restrictive.

Consensus earnings estimates are for 4% year-on-year growth in Europe and 9% in the US. While this is dramatically less than the reopening-boosted profits of last year, they should be more than enough to support current interest payments. The surge in leverage that was seen during the first lockdowns has been reversed and many credit metrics are now better than they were prior to the pandemic (see Exhibit 7).

Exhibit 7: Leverage and coverage ratios
Trailing 12-months



Data as at 14 January 2022. Sources: FactSet, BNP Paribas Asset Management.

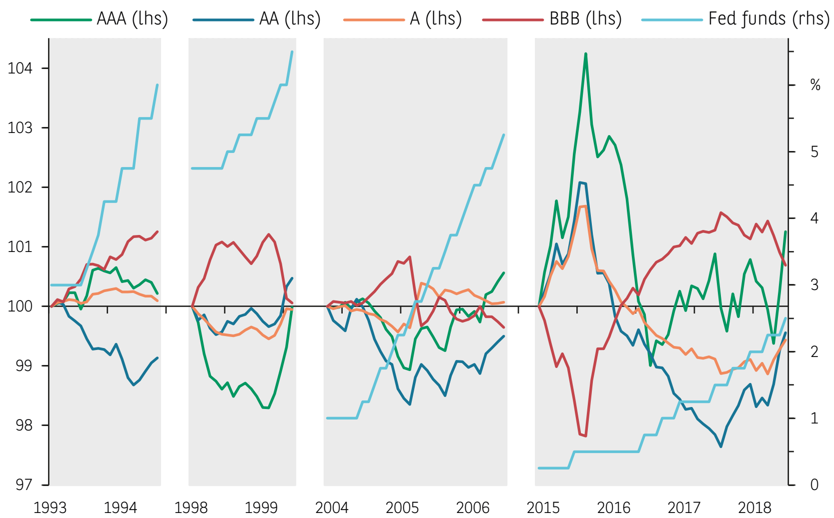
"We expect eurozone credit to outperform the US."

We nonetheless anticipate eurozone credit will outperform the US, despite recent volatility in Europe, due to the divergence in monetary policy between the two regions. While the market is currently pricing in an ever increasing number of hikes from the Fed (currently five by the end of the year), there may be at most one by the ECB, and we are sceptical the bank will increase policy rates at all before 2024.

During hiking cycles, high yield debt has generally outperformed government bonds than investment grade date and we are more positive towards high yield currently. While valuations are stretched across both regions, they are moderately more attractive in high yield. With above trend economic growth likely this year, the credit quality outlook is reassuring. Within high yield, we are focusing on issuer quality and tactical valuation.

As for investment grade, there has most often been a similar outperformance of lower rated indices versus the broad investment grade universe (see Exhibit 8).

Exhibit 8: Fed hiking cycles and relative index performance versus US corporate bond index



Data as at 17 January 2022. Sources: FactSet, BNP Paribas Asset Management.

"We expect a significant rally in this asset class."

Among sectors were are most positive on the European banking sector. Consensus estimates for 2021-22 are on an upward trend due to the improvement of the economic outlook and the possibility of higher rates (notably in the UK) in a context of higher inflation. Loan volumes should remain strong thanks to retail segments, in particular the recovery of the consumer credit. On the corporate side, issuance should be subdued given the high level of cash accumulated on balance sheets over the recent period. Prospects remain strong for fees, with the conversion of deposits into investment products representing a significant opportunity in the coming quarters. Investment banks have solid pipelines. As for asset quality, most banks have so far seemed confident that there will be no material deterioration in the coming quarters. On capital, the delayed implementation of Basel IV should encourage more capital distribution. This is, however, not a source of concern for bondholders given strengthened capital ratios recent. The main regulatory uncertainties now relate to the impact of the ESG climate Pillar 2.

Emerging market debt

Given our view that US Treasury yields will move significantly higher, we have a bias towards being short duration in hard currency emerging market (EM) debt.

We believe 2022 will see a significant normalisation of Asia credit spreads. In our view, it is too late to be cautious, as the dislocation has already taken place. We recognise that there could be other sources of alpha (e.g., the idiosyncratic/mispriced cases of Brazil and Turkey for instance), but take the view that outsized returns will be driven by Asia high-yield bonds given their current attractive valuation levels and the potential for significant spread compression. While default rates are still likely to remain high compared to recent years, we believe 2022 will prove to be a turning point. This view has not yet been priced in by market participants, given the significant amount of scepticism by many global investors (even though Chinese policymakers have reverted to an easing stance over recent weeks). Investors also need to recognise Asia credit as a large and diverse asset class beyond only Chinese real-estate developers. Once investors have had time to re-assess the risk/ reward prospects, we expect a significant rally in this asset class.

We continue to reiterate our strong conviction for local currency Chinese debt. In our view, this is only the beginning of a marked re-allocation of assets towards the country's local fixed-income market. The second largest bond market in the world continues to be massively under-owned and we believe the macroeconomic picture will remain supportive as we expect further easing while the rest of the world is in a tightening phase. We are highly optimistic about this opportunity as it is rare to have such a large market as terra incognita for many investors. More generally on EM rates, we recognise that there is some reluctance among market participants to take a positive view as many central banks have only just started their hiking cycle and others are still waiting to see tangible signs of rapidly rising inflation. In addition, sizeable outflows from this segment could also explain why investors are waiting to dip their toes in the water again. However, we think that from Q2 2022 we should see some attractive opportunities in EM local currency bonds. Real rates are now relatively high in many EM countries given that central banks have been much more proactive in hiking rates compared to their DM counterparts. In our view, this tug-of-war between cheap valuations and unsupportive technicals will not persist, and many investors could be caught off-guard when EM FX and rates start to rally in 2022.

Last but not least, we expect 2022 to be a year of innovative thinking about environmental, social and governance (ESG) factors in EM. The last five years have been a period of assessment and soul-searching for the industry based on data gathering and engagement with both public and private sectors. We now think that the market is becoming more mature in this regard.

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INVESTORS' corner

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world