

FIXED INCOME OUTLOOK

NOVEMBER 2021



The temporality of inflation

- It has become clear that US and global inflation pressures are more than simply transitory. Supply-side disruptions that were supposed to be fleeting proved to be more persistent as the pandemic affected both consumption and production patterns.
- The rotation of consumer demand from services to goods, alongside massive fiscal intervention to support incomes and spending, led to a drawdown in goods inventories, straining supply chains. In services, meanwhile, worker shortages will likely take several months to decline given the hesitation among many to return to work while Covid-19 risks remain.
- The picture is thus one where 'transitory' refers to a period of 12 to 24 months, rather than three or four months. This could be long enough to dislodge inflation expectations.



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BNP PARIBAS
ASSET MANAGEMENT

The sustainable
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"It is clear
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US

In theory, central banks are supposed to look beyond temporary supply-driven spikes in inflation. Central bankers cannot print more semiconductors or truck drivers, for example. However, central banks can keep demand from pushing too hard against constrained supplies, and financial conditions are now extremely accommodative. In the US, the fiscal response to the pandemic may well have been excessive, as argued by Larry Summers. Indeed, easy policy has triggered an asset price boom that flags up financial stability concerns. For all these reasons, major central banks have started the process of normalising policy, beginning with a reduction of their large-scale asset purchases.

As expected the FOMC declared at its November 3rd meeting that the 'substantial further progress' test for the labor market had been met, and that tapering of asset purchases would begin in mid-November. Chairman Powell also indicate that asset purchases would be completed by mid-2022. However, Chairman Powell also stuck to the FOMC's 'transitory' inflation narrative, and noted that the FOMC should be patient before raising policy rates. Investors who had been positioned for the prospect of a more 'hawkish' message bought back underweight positions and took 10-yr Treasury yields back below 1.50%. The buying momentum was helped by a dovish surprise from the Bank of England the day after. Despite the relatively dovish tone, the slope of the US Treasury yield curve soon resumed its flattening trajectory. A wave of stop-outs of short positions in BEIs and real yields appears to be exaggerating the post-FOMC demand for TIPS.

We remain of the view that more persistent inflation pressures are building, and that US economic growth will reaccelerate in Q4 2021 and 2022 as the Delta variant fades, the economy reopens, hiring reaccelerates, and consumers resume spending. The successful trials of an anti-viral pill to treat COVID also help reduce the downside risks to US growth. Accordingly, we believe that the US economy should re-attain full employment at some point in H2 2022, as evidenced by a closing of the jobs gap and strength in wages. Inflation, meanwhile, is likely to show increasing evidence of persistence, and we will be looking for strength in shelter and non-shelter services components. This should convince the FOMC that rate hikes beginning in September 2022 are warranted, and we anticipate that rate hikes would proceed at a pace of 25 bps per meeting.

Ultimately, the date of rate lift-off depends on the employment gap. We expect the short-term factors limiting labour supply to fade gradually. Employer and school vaccine mandates should improve vaccine coverage, childcare should become more dependable, excess savings should be spent, and Covid hesitancy should decline. Thus, the impact of the Delta wave on payrolls should no longer be seen in the payrolls data, and the pace of job creation should climb back to about 500 000 a month. This would be enough to clear the employment gap of roughly 6.3 million jobs by the end of the third quarter of 2022, but it is slower than the one million a month pace that was hoped for after the lifting of the first-quarter 2020 lockdown.

Looking at longer maturities, there are a few factors to consider. First, the Fed's intolerance of persistent inflation overshoots means the argument for pricing any inflation or real yield risk premia is weak. The pullback in TIPS (Treasury Inflation-Protected Securities) purchases by the Fed as it tapers is unlikely to be matched by a reduction in issuance. Indeed,

according to TD Bank's rates strategists, we are likely to see a swing from a net negative supply of USD 20 billion in 2021 to a surplus of USD 45 billion in 2022. This limits the room for any further widening in breakevens, and improves the prospects of a rise in real yields. Finally, we should note that even as the Fed tapers its asset purchases, this would merely offset reduced Treasury funding needs. On a net basis, Treasury issuance will be largely unchanged. Hence, it will be monetary policy, rather than Treasury supply, that will remain the primary driver of the yield curve.

Our 2021 year-end target for the 10-year US Treasury yield remains 1.75%, with 1.90% achievable by the end of Q1 2022. We remain underweight duration in 5-yr Treasuries, to position for a repricing of the path of policy rates. The risks to this forecast are a possible slowdown in Chinese growth amid a credit crunch in residential construction. Additionally, the virus will continue to disrupt global supply chains, a problem being exaggerated by energy shortages in some countries. On the inflation front, we believe the new longer-run fair value for 10-year BEIs (breakeven inflation) is likely around 2.30%, but current inflation concerns are motivating steady inflows into the product that will keep 10-yr BEIs between 2.50% and 2.75%. We are positioned flat BEIs. While current valuations argue for an underweight BEI position, the flows into TIPS argue for patience. On the yield curve, a more hawkish Fed will eventually reduce inflation and real yield term premia on longer maturities, and raises the odds of earlier but more limited rate hikes at shorter maturities – hence we maintain a curve flattening bias.

It is worth noting that October's spike in natural gas and crude oil prices revealed a new phenomenon – the potentially inflationary nature of the transition from fossil fuels to sustainable power. The variability and unreliability of wind and solar power production, combined with the climate-change mandated declines in investment in fossil fuel development and production, can lead to occasional price spikes. While sustainable energy promises to be cheaper than fossil fuels in the long term, the near-term investments and the carbon taxes needed to incentivise a rapid shift could add to inflation pressures. If nothing else, businesses will look to build energy resiliency into their operating models.

EUROZONE

In the Eurozone, since the middle of September, the rapid rise in energy prices and the associated upward revisions to the forecasts of near-term inflation path have led to an intensifying debate about the temporality of higher inflation. The specter of inflation becoming more persistent has also triggered speculation of earlier central bank rate liftoffs. While the ECB has tried push back against the timing of rate hikes priced by the market, investors seem to be skeptical about the ECB's inflation assessment and its commitment to their new forward guidance. The lack of guidance on what would replace PEPP at the end of March 2022 has also frustrated the market, and price movements in peripheral bond markets highlighted their vulnerability to the eventual withdrawal of ECB support. With natural gas inventory levels still at multi-year lows, and seasonal demand set to pick up in the winter months, it is likely that shorter-dated real yields and BEI rates will remain well supported in Q4. Longer-term, development in wages will determine whether the Eurozone sees even more sustained and generalised inflation. Our view is that slack in the labor market will likely weigh on wage growth, and longer-



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"Supplier delivery times are still close to their longest on record."

term inflation expectations remain contained. As such, we maintain a yield curve steepener and a small short position in BEI at the longer-end of the curve. In country allocation, we hold a small overweight in Italy given its improving growth outlook and near-term political stability, but we are cognizant that filling the demand gap left by the end of PEPP will not go totally smoothly.

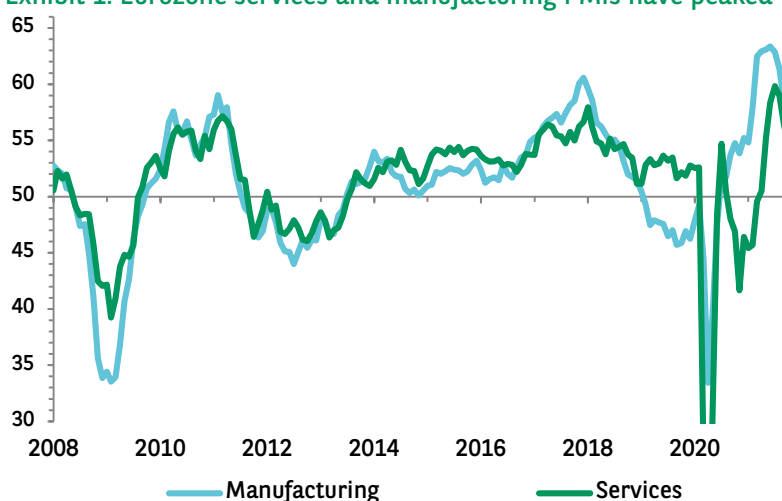
Slowing growth momentum

In the eurozone, manufacturing and services PMIs have decelerated meaningfully from the peaks in June and July, although they were still in expansion territory at above the 50 mark in the latest October release. The slowdown signals that the reopening boost in the services sector is waning, while manufacturing still struggles with deteriorating supply conditions.

In services, it was unsurprising that activity started to lose steam after the initial surge. However, the slowdown was more rapid than expected. At its peak, the services PMI reached 59.8 in July. By October, it was down to 54.6, a disappointment versus market expectations.

The manufacturing PMI fell from its June peak of 63.4 to 58.3 in October, reflecting slower growth caused by continued supply challenges. Details of the PMI survey showed that output, demand, and employment growth rates declined, while price increases accelerated (see Exhibit 1).

Exhibit 1: Eurozone services and manufacturing PMIs have peaked



Data as at 14 November 2021. Sources: Markit, BNP Paribas Asset Management.

Supplier delivery times improved only slightly in October and are still close to their longest on record (see Exhibit 2). This reflects pandemic-related disruptions as lower vaccination rates and the zero-Covid strategy adopted by the suppliers' domicile countries led to renewed lockdowns. According to IHS Markit, survey respondents reported shortages of key components and commodities, as well as disruptions to transport and ports. Moreover, the disruptions had left input and output prices high, while manufacturing output fell to its lowest since January.

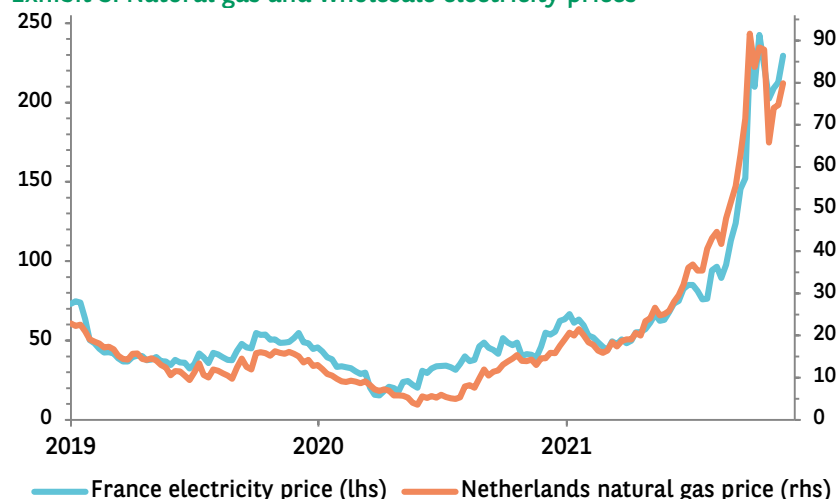
Exhibit 2: Eurozone manufacturing PMI supplier delivery times

Data as at 14 November 2021. Sources: Markit, BNP Paribas Asset Management.

“Big swings in gas prices have quickly translated into higher electricity prices.”

Inflation developments

Natural gas and electricity prices have shot higher in Europe due to a myriad of factors. Since the beginning of the year, the price for natural gas has been rising as economies emerged from the pandemic. However, the rise in demand also came at a time when supplies were falling short, and natural gas inventories were at below-normal levels given the continent's increasing reliance on renewable energy sources. Then the perfect storm hit – natural gas imports from Russia were limited as suppliers prioritised rebuilding domestic inventories, and the flow of gas from Norway was lower than normal due to maintenance work. Away from the eurozone, weather-related supply disruptions in the Gulf of Mexico, higher demand for natural gas for electricity generation due to lower wind and hydro electricity output, and higher demand from China added to the tightness in the market. As a result, the rise in natural gas prices accelerated; on a year-to-date basis, prices have increased almost fourfold (see Exhibit 3). Since around a quarter of electricity consumed in the EU is generated with natural gas, and electricity is hard to store, the big swings in gas prices have quickly translated into higher electricity prices.

Exhibit 3: Natural gas and wholesale electricity prices

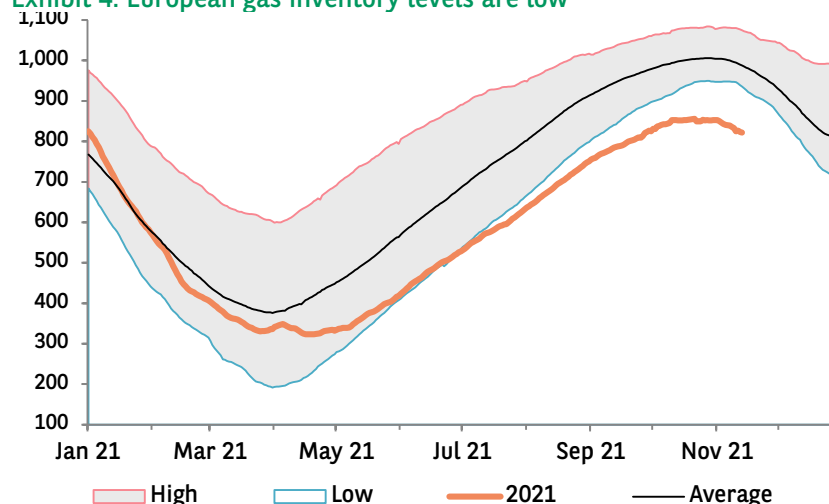
Data as at 14 November 2021. Sources: Bloomberg, BNP Paribas Asset Management.



"It is too early to tell whether supply-side disruptions and energy have fed into underlying inflation."

Governments across the eurozone have acted to help households cope with rising electricity bills. In Spain, the government tried to reduce households' electricity bills over the fourth quarter of this year and the first quarter of 2022 by clawing back utility companies' excess revenues of around EUR 2.6 billion. The French government awarded a one-off EUR 100 energy voucher to low-income households, and it is likely to suppress the rise in regulated electricity prices in its next review. In Italy, news reports suggested that the government would spend around EUR 3.5 billion to protect households from higher energy bills. While these unorthodox measures should help shield consumers from some of the pass-through effects of higher energy costs, the magnitude of the price jump means that consumers will still face substantially higher energy bills until the supply-demand imbalance is resolved. In addition, with natural gas inventories at record lows as the northern hemisphere heads into winter, the energy crisis will likely persist for some time (see Exhibit 4).

Exhibit 4: European gas inventory levels are low

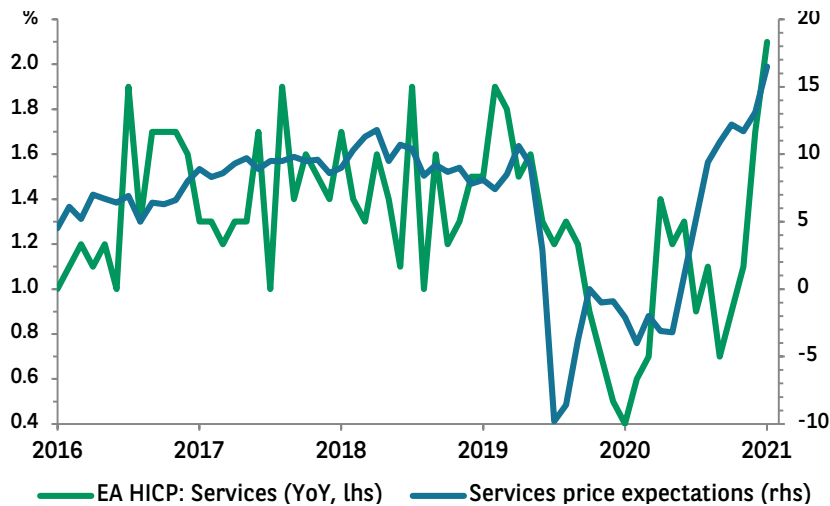


Data as at 14 November 2021. Sources: AGSI, BNP Paribas Asset Management.

Increase in HICP not limited to energy costs

Headline harmonised index of consumer prices (HICP) reached 4.1% YoY in October, a meaningfully jump from the around 2% level seen between May and July. While energy was the main driver of inflation, having risen 23.5%, prices also accelerated in other sub-categories. Core inflation rose to 2.1% from 0.9% YoY in June, reflecting the pass-through from higher input prices and logistics costs to consumers. Services inflation accelerated from 0.7% YoY four months ago to 2.1% YoY, supported by a boost in activity after economies reopened (see Exhibit 5).

Exhibit 5: Inflation in the services sector surged with reopenings



Data as at 14 November 2021. Sources: FactSet, BNP Paribas Asset Management.

Headline HICP is expected to reach around 4% YoY in November due partly to the energy price surge plus the combination of constrained supply and recovering demand supporting companies' pricing power. Inflation is likely to stay above 2% in the first half of 2022 until base effects set in and push it down. Longer term, wage trends will determine whether the eurozone sees even more sustained inflation. The current labour shortages may help to support wages in the near term, and higher realised inflation may lift salaries if wage settlements are tied to cost-of-living adjustments. For example, in France and Spain, minimum wages will be raised by 2.2% and 1.6%, respectively. However, so far, the rise in negotiated wages has been benign across the eurozone. Without more evidence on a surge in wages, it is too early to assess whether second-order effects from persistent supply-side disruptions and surging energy prices have started to feed into underlying inflation.

As exploratory coalition talks are ongoing, one cannot yet fully assess the implications of a 'traffic light' coalition for Germany's economic policy and growth outlook. However, the debt brake will likely remain in place to limit fiscal policies. This limits federal government borrowing to 0.35% of GDP and obliges the government to repay excess borrowing over a reasonable timeframe. In euro terms, the fiscal deficit is capped at around EUR 12 billion per year through the cycle, but the need to repay debt accumulated during the pandemic will likely mean that the government has to run a small budget surplus instead. An SPD-led government with CDU/CSU in opposition will not be able to gather the required two-thirds majority in parliament to change the debt brake. While a SPD-led government can likely push through some fiscally expansive policies using creative means, the debt brake will likely limit the new government's fiscal ambitions.

We are cognisant of the risks of another spike in energy prices in the winter months, and of continued supply backlogs keeping manufacturing input and output prices high in the near term. However, we expect energy prices to normalise after the winter, and supply chain disruptions to ease as the Covid-19 risks recede. We also expect wage trends to be benign. Wage increases in the eurozone so far reflect a normalisation of work patterns rather than higher negotiated wages and slack in the labour market will likely restrain wage growth.



"We expect supply chain disruptions will ease and wage trends will be benign."



**“Central banks
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Monetary policy

On monetary policy, the ECB faces difficult decisions in December about what to do after the end of the Pandemic Emergency Purchase Programme (PEPP) asset purchase programme. There has been market chatter about ECB staff studying a new tool to complement the APP programme after PEPP ends. This tool could conduct purchases not restricted by the capital key, to be used as an insurance measure against the risk of spread widening. On one hand, it is perhaps too early to read too much into this as it is normal for ECB staff to look at all the possibilities in the run-up to the December policy meeting, and proposals from ECB staff are not always adopted by the governing council. Moreover, the threshold for such an insurance policy tool could be high, such that the tool would only be used in extreme market stress scenarios without unnecessarily jeopardising the ECB's capital key principle. On the other hand, with the recent surge in energy prices and continued price pressures coming from supply bottlenecks, some council members are expressing their concerns about the risks of inflation proving to be more sustained. Some members have already distanced themselves from the inflation forecasts released in September, which pointed to core HICP averaging 1.3% in 2021, 1.4% in 2022 and 1.5% in 2023. They consider these projections too low. The debate in the December meeting will likely be lively, but it seems clear already that the size of asset purchases will be scaled back meaningfully once PEPP is out of the way.

In terms of duration risks, on the one hand, global central banks including the ECB moving towards stimulus withdrawal should put upward pressure on yields. In the eurozone, while the economy will not continue to grow at the remarkable, reopening-driven rates seen in 2021, investment flows from the Next Generation EU funds and individual countries' recovery plans will likely keep growth above the long-term trend for the coming quarters. This suggests that the sell-off in yields will likely continue.

With the flow of PEPP purchases still ongoing amid light government bond supply into year-end, government bond yields could ease in the next couple of months. Moreover, market participants have so far been focusing on the risk of rising inflation expectations in the inflation debate. However, higher costs also cut into corporate profits and consumers' disposable incomes. Governments have rushed to intervene with policies aimed at shielding consumers from rising energy costs, but their actions might not suffice to mitigate the significant downside risks to growth created by the higher cost of living.

United Kingdom

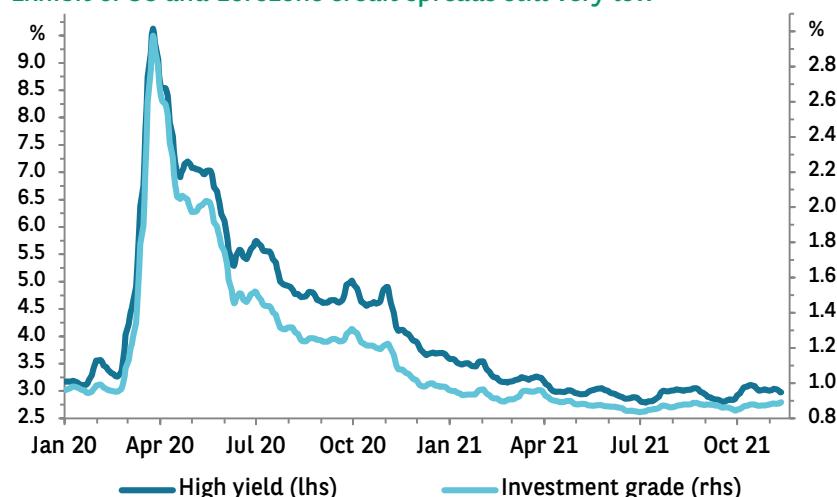
After guiding the market repeatedly with hawkish communications since the September MPC (Monetary Policy Committee) meeting, the Bank of England declined to raise interest rates in the November meeting, and instead voted 7-2 in favor of keeping policy rate unchanged and 6-3 to continue with its Quantitative Easing (QE) program as scheduled until mid-December. The dovish elements from the November meeting include the bank's caution around the end of the furlough scheme, as well as the reference to an "alternative scenario" where energy prices are conditioned to revert towards their prior levels, resulting in an inflation undershoot in the latter half of the forecasting horizon. Given the dovish shift in the MPC messaging, we believe the MPC would like to see more concrete evidence on how the labor market is transitioning away from the furlough scheme

before moving ahead with an interest rate liftoff, making a February rate hike more likely than a December one. At the same time, the massive cut in Gilt issuance over the next five months would create a temporary shortage of Gilt supply, which in turn could help yields to stay low. Over the longer term, however, we remain of the view that Gilt yields are vulnerable to a sell-off, given the robust economic recovery, rising inflation, expansionary fiscal stance, and a meaningful increase in Gilt issuance in fiscal year 2022/2023 without QE support. We will be looking for rallies in Gilts to build on our duration underweight.

Corporate credit

For all the surprises from central bank meetings and all the volatility in inflation expectations and real rates, developed market corporate bond spreads have moved little this year. Spreads are low in absolute terms – just 20bp above the post-global financial crisis low for investment-grade and 50bp for high-yield (as at 12 November 2021). However, the macroeconomic environment remains positive and we foresee continued stability in spreads (see Exhibit 6).

Exhibit 6: US and Eurozone credit spreads still very low



Data as at 12 November 2021. Note: average spread of US and Eurozone. Sources: FactSet, BNP Paribas Asset Management.

The Fed's intentions to begin tapering by the end of the year have been so clearly conveyed that investors are now focusing more on the timing of rate rises. As inflation has proven to be not only more persistent, but higher than predicted, the expected date of the first rate rise has moved closer. For now, however, monetary policy is supportive, even as the degree of support lessens. Hence, we believe that spreads will not widen meaningfully in the months ahead. Fund flows have continued steadily as investor allocations to fixed income greatly favour corporate credit over sovereign bonds. Challenging valuations, on the other hand, leave little room for further tightening.

The outlook for credit quality has if anything improved given the company results reported during the third quarter earnings seasons. Results in the US and Europe significantly exceeded consensus forecasts, with earnings rising by over 40% for US companies and nearly as much for European ones. Importantly, despite profit warnings early in the reporting season, corporate guidance has been almost as positive (1.7x upward-to-downward guidance) as it was in the second quarter when the ratio was 2.2x.

“The outlook for credit quality improved after the last earnings season.”



**"There has been
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We are neutral to negative on duration for both Europe and US given the outlook for interest rates. We prefer cyclicals to non-cyclicals as the economic growth outlook remains positive in Europe and the US for both investment-grade and high-yield. The recovery is more advanced in the US than in Europe, which suggests the Fed will be forced to tighten policy before the ECB. Earnings for US high-yield issuers have recovered from Covid (trailing 12-month EBITDA is now the same as in October 2019). Consequently, managers will likely shift their focus from recovery and cash preservation to spending and growth. While this benefits shareholders, the outcome may not be as positive for credit spreads. We will focus on security selection and on tactical valuations amid a greater dispersion of returns.

Emerging market debt

There has been rising divergence in growth and inflation across countries as some like India, Mexico, and the Philippines have experienced negative growth and high inflation, while export-oriented economies like South Korea, Taiwan, and Hong Kong have achieved higher growth and have thus far kept a lid on inflation.

There has also been some divergence in the global supply chain bottlenecks: an increase in work backlogs in Malaysia and Vietnam, with easing in Taiwan and South Korea. South Korean semiconductor export volumes and industrial production remain on the uptrend and Taiwanese exports are very strong.

The virus situation continues to improve in most Asian and Latin American countries even as infections rise in Europe. Several EM countries have some of the highest vaccination rates in the world.

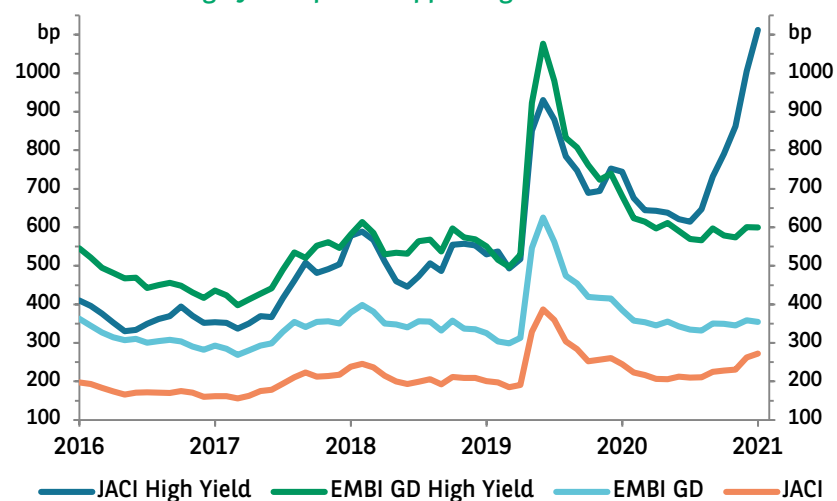
While equity flows to EM have been volatile, EM debt flows have continued to remain positive and resilient since March 2020. The market digested a lot of issuance over the first half of 2021, which should leave a fairly moderate calendar for the remainder of the year.

The upward pressure on both consumer and producer prices has already forced some EM central banks to hike rates and most of the rest are at the end of their cutting cycle. While this is a headwind for EM rates, we believe there are selective opportunities in the long end of certain high yielders.

Emerging market bonds still offer more value versus US peers given current valuations. While US IG and HY bonds continue to trade at a very narrow spread (1% to 2%-tile) relative to their historical range, there is more room for spreads to compress further for EM IG and HY bonds. Emerging market high bonds look the most attractive from a valuation perspective, especially after the recent sell-off.

Asia high yield in particular has become very appealing. The risks related to property developers in China, paired with risk of a hawkish Fed, created a classic "flight to quality" in EM credit (alongside other risk-assets), leading to spread widening in Asia HY. While defaults are likely to rise in China from the current very low base, spread widening has permeated the entire region, making it very attractive on relative value basis compared to other EM regions and global HY (see Exhibit 7).

Exhibit 7: Asia high yield spreads appealing



Data as at 12 November 2021. Sources: FactSet, BNP Paribas Asset Management.

The recent sell-off in emerging market currencies has left many starting to look attractive again; on a REER (real, effective exchange rate) basis, EM FX is cheaper now than after the 'Taper Tantrum' in 2013. Latin America and other EM high yielders, as well as oil currencies, still look undervalued. Valuations have also improved for Asian currencies.

The regulatory clampdown on lending to the property development sector – which constitutes an unsustainable 29% of GDP – has resulted in a few property developers defaulting on USD bonds. China's regulators can certainly manage the required financial restructuring, and we have no concerns about systemic risk – although investor flight is possible. However, reduced property investment will detract from GDP, so China will need to find alternative sources of growth. With households having such high savings, either alternative investments will need to be found or households must be convinced to consume more and save less. How China manages the transition to a more sustainable, consumption-driven economy while simultaneously dealing with debt reduction and a demographic decline in its working age population will matter – for the environment, global growth and global interest rates.



"Emerging market currencies are starting to look attractive again."

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