For professional investors - Marketing communication - April 2022

FIXED INCOME OUTLOOK

APRIL 2022

To neutral and beyond

- The US labour market is at full employment with annual wage gains of 5% to 6%. This pace is likely incompatible with the Fed's 2% Personal Consumption Expenditures (PCE) inflation target at current levels of productivity growth.

- We anticipate policy rates between 3.25%–3.50% by year-end 2022 with additional increases possible in 2023. Our view is that the Fed needs to engineer a significant economic slowdown, and most likely a recession, to bring wage pressures to a level consistent with a 2% PCE inflation target.

- We believe the ECB will be on a less aggressive path for monetary tightening relative to the US. In the near term, we see risk for 'peripheral' eurozone spreads to underperform.

- Investment grade credit valuations are now closer to long-run averages and we anticipate credit will outperform government bonds from here.

- In emerging markets, we think that this will be the year of the "great normalization" of Asia spreads, and believe that outsized returns are likely to be driven by Asia high yield.

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The sustainable investor for a changing world

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

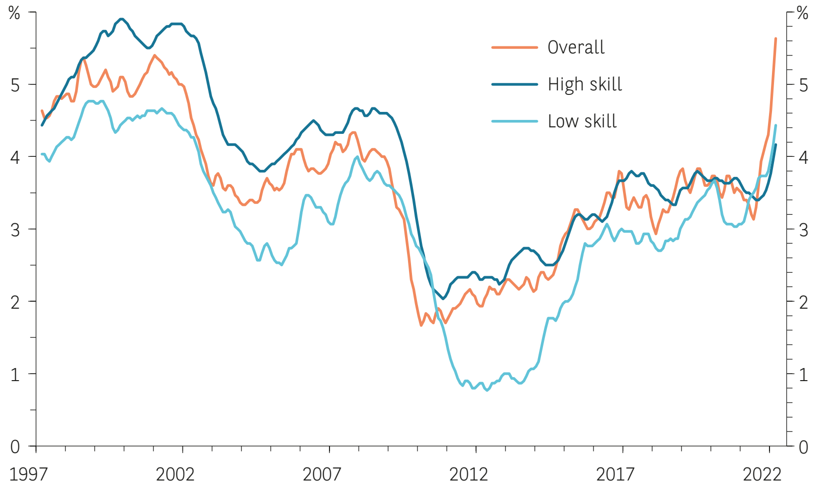
The first quarter of 2022 was tumultuous for the global economy and financial markets. The conflict between Russia and Ukraine spawned a rally in US Treasuries, but the disruption to metals, agricultural and energy commodity markets only spurred inflation further. Central banks reacted to the surge in headline inflation by turning more hawkish. They sought to rapidly normalise their policy stance to prevent above-target inflation rates from becoming entrenched, even as growth slowed amid higher energy prices and a waning fiscal impulse.

The net result of all this for sovereign bond markets has been the fastest sell-off in many years. The Treasury yield curve has undergone a rapid bear flattening, while US breakeven rates have widened amid demand for inflation protection. Eurozone sovereign curves, meanwhile, have bear steepened, with breakeven inflation rates also widening in response to sharply higher energy prices. 'Peripheral' eurozone sovereign yield spreads have also widened on the prospect of a faster conclusion to ECB asset purchases.

UNITED STATES

The US economy continued to grow at a steady clip in the first quarter, generating consistent employment growth and taking the labour market to full employment. Importantly, neither the Omicron Covid variant nor the breakout of conflict in Ukraine appear to have much dented the pace of hiring by US firms. The tightness in the labour market is reflected in compensation trends. Average hourly earnings rose at 5.6% year-on-year (YoY) in March, with non-supervisory employee wages climbing at a 6.7% YoY pace. The Atlanta Fed's Wage Tracker data tells a similar story (see Exhibit 1). Wage gains in the 5% to 6% range, however, are likely incompatible with the Fed's 2.0% Personal Consumption Expenditures (PCE) inflation target at current levels of productivity growth, suggesting that a cooling of the labour market will be necessary to contain inflation pressures. We return to this question in a later section.

Exhibit 1: Atlanta Fed Wage Tracker, % YoY



Data as at 21 April 2022. Sources: Bloomberg, Federal Reserve Bank of Atlanta, BNP Paribas Asset Management.

"We think the Fed will continue to raise policy guidance until the FOMC accepts that rates need to go into restrictive territory.

Meanwhile, inflation is spreading beyond core goods to services. Many non-shelter services CPI categories are seeing strong inflation, reflecting higher input costs, including wages. Our proxy for inflation in labour-intensive services continued to gather momentum and is now running above 4.0% YoY. Price pressures remain broadly distributed across categories, with more than 50% of CPI price categories rising at rates of 5% and above, and less than 20% of categories growing at 2% or below. Shelter costs, comprised mostly of primary rents and owners' equivalent rents (and with a 32% weight in the overall CPI basket) firmed significantly to 4.8%, catching up with the surge in prices for new leases. This trend is likely to continue for several more months, and should take rents and Owners' Equivalent Rent to around 5.5% YoY. Housing costs have been supported by rising house prices, strengthening household incomes and a desire to upsize to larger properties amid the pandemic and the shift to home-working.

Outlook for monetary policy

Looking at the Federal Open Market Committee's (FOMC) Summary of Economic Projections (SEP) in detail, we continue to see some inconsistencies in the US Federal Reserve's (Fed) forecasts. It is difficult to see the mechanism by which core PCE will soften towards target if growth is simultaneously only slowing towards trend, and insufficiently to drive up the unemployment rate. From a monetarist perspective, a passive balance sheet roll-off strategy combined with rate increases to just above neutral seems insufficient to address core inflation pressures. From a Keynesian perspective, it is hard to see how inflation would moderate if growth never falls below potential and the unemployment rate never rises meaningfully (to soften wages).

Still, the SEP 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 indeed temporary (i.e., transitory) and driven by supply blockages rather than cyclical – meaning that a more forceful response is not required. Regardless, the broader point is that the Committee has been iteratively raising policy rate guidance – and we think this trend will continue until the FOMC accepts that rates need to go into restrictive territory.

Our view is that the FOMC should be returning the stance of monetary policy to a neutral setting as 'expeditiously' as possible, and then take rates into restrictive territory. We now anticipate that the FOMC will begin passive balance sheet roll-off in May, and quickly ramp up towards the USD 95 billion monthly cap. Having raised rates by 25 basis points (bp) in March (it likely would have been 50bp were it not for the conflict in Ukraine), we now anticipate a series of 50bp hikes for the remainder of 2022. With six meetings left in 2022, that would take policy rates to 3.25%-3.50% by year-end 2022.

Additional rate increases are possible in 2023, depending on the stickiness of underlying US inflation and the resilience of the US and global economies to the commodity market disruptions caused by the Ukraine / Russia conflict. This is a significantly more aggressive path for policy rates than we had projected in our first quarter outlook. It reflects new information we have received on wages and the outlook for commodities and supply disruptions as a result of new lockdowns in China in response to Omicron. In line with this, we anticipate further upward adjustments from the SEP 'dots' in June.

"The Fed needs to engineer a significant economic slowdown, and most likely a recession, to reduce wage pressures."

The question of how much the Fed will need to tighten policy to cool an overheating economy and soften underlying inflation pressures is a difficult one. For one thing, monetary policy influences the economy in concert with fiscal policy. Nevertheless, the Fed's own economic projections from March suggest that raising policy rates to 2.8% by 2024 would be insufficient to drive unemployment above 3.6%, let alone above the 4.0% NAIRU (Non-Accelerating Inflation Rate of Unemployment) estimate, or pull economic growth below trend. Furthermore, it now appears that unemployment could well be headed to 3.0% by the end of 2022, intensifying wage pressures further.

Our view is that the Fed needs to engineer a significant economic slowdown, and most likely a recession, to bring wage pressures to a level consistent with a 2.0% PCE inflation target. Our conviction is that the policy stance will need to become considerably tighter than was projected by the FOMC in March, with rates (and real yields) moving into restrictive territory in coming months.

How much higher could yields rise? Our best guess is that 5-year / 5-year forward real yields, currently at +0.08% in swaps format, should rise by another 75bp to 150bp to provide sufficient economic headwind to the US economy, dampen wage pressures and return inflation to target. Furthermore, it is worth noting that for the US, unlike Europe, higher energy prices do not represent a terms-of-trade shock (as the US economy is largely self-sufficient), so its impact on US growth should be muted.

We note that some analysts are beginning to discuss the prospects of a recession from the tightening of financial conditions that has already occurred. We believe a recession is indeed probable, but that the Fed will need to press harder on the monetary brake to achieve one.

As to the Fed balance sheet, Chairman Powell and Governor Brainard have both signalled that balance sheet roll-off would begin soon after rate hiking starts, and be ramped up relatively quickly to a pace that would significantly exceed the pace in the prior episode of balance sheet reduction. The Fed's objective would be to return the System Open Market Account (SOMA) portfolio to an all-Treasury portfolio. The March FOMC minutes noted a proposal to roll off USD 60 billion of Treasuries and USD 35 billion of mortgage-back securities per month from the Fed's USD 9 trillion portfolio, and hinted that this could be announced at the May meeting.
However, it is worth bearing in mind that even at this pace of roll-off, returning the balance sheet to early 2020 levels would take between five and six years (three times as long as it took to accumulate), and in the meantime that excess liquidity could continue to weigh on risk premia, including Treasury term premia.

The question of whether balance sheet reduction should lead to a re-steepening of the US Treasury curve is also complex. Certainly, policymakers have repeatedly emphasised their preference for a 'passive' roll-off of the balance sheet, rather than active sales, given their greater level of comfort with interest rates as a policy tool. The duration impact of an end to SOMA reinvestments will therefore depend on how the Treasury chooses to raise the financing that would otherwise have come from the Fed, and how its overall funding needs change as the US economy continues to grow.

Our view is that the Treasury is likely to rotate its debt issuance towards Bills – which have shrunk as a proportion of outstanding debt held by the public and are in evident demand from money market funds. The impact on net duration from a passive balance sheet reduction should therefore

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be limited. In addition, demand for longer-dated Treasuries from pension plans has been strong as pension plan solvency levels have improved.

We believe that the surge in commodity prices triggered by the Ukraine conflict may not be entirely reversed. Economists have warned that higher natural gas prices have driven up the cost of fertilizer production, which will have an impact on global agricultural production and drive food prices significantly higher in coming months. New inflation risks are also emanating from spreading lockdowns in Shanghai and other major ports and cities, as China seeks to control the spread of the Omicron variant. In addition, the surge in energy prices associated with the Ukraine conflict has highlighted the structural inflationary pressures from the transition to sustainable energy and the reversal of globalisation, and warrants a premium on BEIs.

EUROZONE

Just as the eurozone was about to emerge from the Covid-19 restrictions, the outbreak of the Russia-Ukraine conflict since late February has injected significant uncertainty into its economic outlook. Successive supply shocks caused by the pandemic, the Russia-Ukraine conflict, and the longer-term consequences for globalisation and the green energy transition mean that the inflation outlook has worsened. The risk for energy and commodity prices, and therefore yet higher inflation, is skewed to the upside in the near future.

There remains significant uncertainty about how the geopolitical conflict will evolve, how persistent the increase in energy prices will become, how much of the higher costs will be passed through to consumers, and how much fiscal support there will be to help offset the income squeeze. However, it is reasonable to assume that energy prices will remain high in the near term, and given this scenario, eurozone inflation is forecast to accelerate to 7% to 8% for much of 2022, before falling back closer to the central bank's 2% target in late 2023 or early 2024 as and when the effects of the rapid rise in energy prices fade.

In addition to the adverse supply shock, the fallouts from the conflict will also weigh heavily on aggregate demand. The substantial rise in inflation cuts into household incomes in real terms, despite some fiscal help and positive developments in the labour market. Greater economic uncertainty could also make households more reluctant to run down savings accumulated through the pandemic, and businesses more cautious about their investment plans.

Inflation outlook

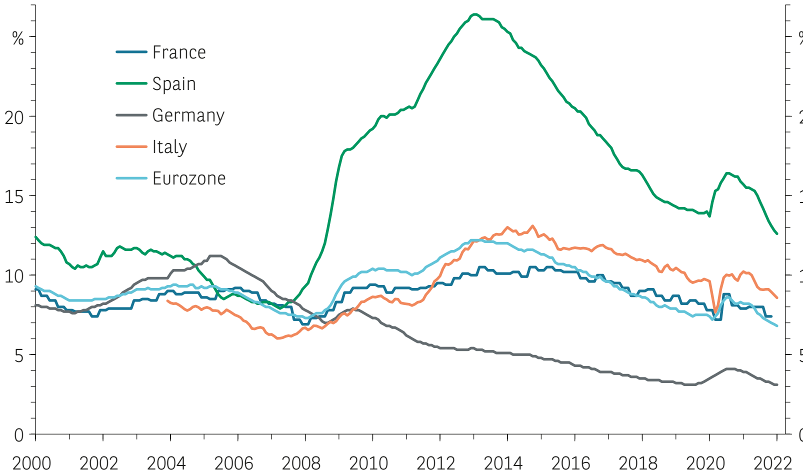
Developments in wages will determine whether the eurozone will see even more sustained inflation. Short-term labour shortages due to disruptions from the pandemic may help to support wages in the near term, and the recent higher realised inflation may also lift wages if pay settlements are tied to cost-of-living adjustments. Nonetheless, wage growth so far in the eurozone appears relatively contained. Nominal negotiated wages grew by around 1.5% during the fourth quarter of 2021, meaningfully below inflation, although the low frequency and backward-looking nature of the

"Developments in wages will determine whether the eurozone will see even more sustained inflation."

measure may not give an accurate or timely enough assessment.

Looking ahead, the combination of a tight labour market and high realised inflation will likely continue to support wage growth for the rest of this year. The eurozone unemployment rate fell to a new low at 6.8% in February, about 0.3% below the NAWRU (non-accelerating wage rate of unemployment). The fall in unemployment was broad-based across countries, with Italian and French unemployment now nearly 1 percentage point below their respective NAWRU (see Exhibit 2).

Exhibit 2: Unemployment Rates in the Eurozone Area



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

Demand for labour remains robust, with job vacancies still high. At the same time, a recent ECB survey of large European companies indicated that wage growth in 2022 could be somewhat stronger, with some respondents citing the current high levels of inflation as a contributing factor. High inflation and labour market shortages may increase workers' bargaining power in the coming wage negotiations.

Lastly, in Germany, the minimum wage will increase by 25% in October this year to EUR 12/hour. This will impact employees some 45% of all workers. The rise the minimum wage will push German wages up by around 2%, and contribute roughly 0.6% of wage inflation to the eurozone in the fourth quarter of 2022.

However, there are also downside risks to wage growth. Companies need to cope with rising input prices and pressures on margins, and growth headwinds may dampen worker unions' bargaining power. Moreover, any further escalation in the Russia-Ukraine conflict would hit economic growth and the labour market. While we still expect robust wage dynamics in the near term, what will be important to watch closely is survey data on employers' hiring intentions for early signs of labour market headwinds.

Faced with higher-for-longer inflation, the ECB has so far prioritised policy normalisation rather than holding off in the face of geopolitical uncertainties and rising downside risks to growth. Overall, the March ECB meeting minutes can be interpreted as a hawkish prelude to the April meeting, where the sense of urgency might translate into more concrete guidance on interest rates lift-off.

"The Ukraine conflict has also made room for greater flexibility in EU fiscal rules from 2023."

Implications for fiscal policy

The Russia-Ukraine conflict presents fiscal challenges for the eurozone. The bloc's member state governments are using fiscal policy to mitigate the impact of inflation on households and businesses, through VAT cuts, subsidies and energy price caps. There will also be budgetary costs in terms of spending on the refugee crisis and increase in defence spending.

At the EU level, the fiscal policy response so far is focusing on investment in diversifying energy supplies across liquefied natural gas (LNG) and renewable energy, which will be costly. It remains unclear at this stage whether the new costs would be mutualised by extending joint borrowing programmes, or through redeploying Covid-19 recovery funds. While new schemes involving additional borrowing by the European Commission can be contentious among EU member states, the nature of the common external shock from the conflict alongside asymmetric impacts across national economies will likely warrant policy responses that entail some sharing of the burden.

The conflict has also made room for greater flexibility in EU fiscal rules from 2023. The European Commission has already signalled a suspension of the requirement for countries to cut public debt every year by 1/20th of the excess above 60% of GDP for 2023. The Netherlands and Spain have jointly proposed scrapping the one-size-fit-all fiscal rule and replacing it with country-specific targets, with a debt reduction path that is "realistic, gradual but ambitious, as well as compatible with economic growth and job creation". While their proposal is not new, it was notable in being a joint effort from the Netherlands – largely seen as part of the 'thrifty North' – and Spain, from the 'lavish South'.

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. There are numerous upside inflation shocks to consider in the coming quarters. These include another round of higher energy prices, particularly in the case of further expansion of sanctions against Russian imports. Another surprise could also come from non-energy durable goods, as second-round effects slip through with businesses passing on higher input costs to consumers. Services inflation could also be on the rise, as the combination of high inflation and a tight labour market gives workers more bargaining power and allows wages to rise.

At the same time, there are increasing headwinds to economic growth. The eurozone's high dependency on natural gas imports, high industrial energy usage and its limited ability to substitute existing energy supply in the short term has already led to disruption in its manufacturing sector and a decline in business confidence. The situation could deteriorate further if sanctions against Russia escalate.

Policy outlook

We see current market pricing of the ECB commencing its rate tightening cycling during the second half of this year as fair. After all, the accommodative stance of quantitative easing and negative interest rates is no longer warranted given the steep trajectory of inflation for the next 18 months.

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However, with survey data already pointing to a deterioration in economic, business and consumer sentiment, the ECB is likely to be careful not to rush into tightening monetary policy too aggressively, especially compared to the Fed's tightening path.

Relative to the US, the eurozone is more vulnerable to the economic fallouts from the Russia-Ukraine conflict. Of course, the conflict has exacerbated both the upside inflation risk and downside growth risk, and the extent of ECB tightening will partly drive how these risks materialise. In contrast, the US economy is enjoying stronger fiscal tailwinds, and is facing inflationary pressures that are more intense and endogenous. Given the divergence, we believe the ECB will be on a less aggressive path for monetary tightening relative to the US.

In the near term, we see risk for 'peripheral' eurozone spreads to underperform. Countries such as Italy and Spain were hit harder by the pandemic. While the Next Generation EU funding should help these economies with cheap financing and provide targeted EU fiscal support in the recovery phase, Italy and Spain still have less fiscal space than Germany and France to tackle the economic fallouts brought by yet another crisis.

At the same time, the ECB's pandemic emergency purchase programme (PEPP), which had the flexibility to help contain uneven monetary policy transmission within the eurozone, has already come to an end. With the end of the asset purchase programme (APP) also in sight, we expect peripheral bonds to remain under pressure in the near term. In the longer term, however, fiscal solidarity within the EU and the ECB's willingness to fight fragmentation risk should help contain peripheral spreads from widening meaningfully. It is likely that the EU may repurpose the Next Generation EU funds, or, better yet, create a similar programme to pool resources within the EU to fund spending on defence and energy transition.

On the monetary policy front, the press has reported that the ECB is "designing a tool that would be available to the Governing Council to use against debt-market stress caused by shocks outside the control of individual governments". While an announcement of the new tool might not be imminent, there is clear awareness among even the most hawkish council members that fragmentation poses a risk to the ECB's policy normalisation plans, and that there might be a need to provide extra assurances.

UK

Beyond the first quarter, the UK's growth outlook looks increasingly murky. Households face a significant real income shock from higher inflation and income tax hikes, while higher input costs could start to weigh on businesses' profitability. Public sector spending has also been a significant contributor to growth recently, but as the pandemic fades, public sector economic output will likely be scaled down and limit growth in the near term. In fact, while macroeconomic developments over the past few months have pointed to continued strength in the labour market, market participants have become increasingly focused on the implications of the substantial increase in the cost of living and its potential detrimental impact on consumption.

"Recent surveys show another sharp increase in both short and long-run inflation expectations."

Looking ahead, the persistent strength in utility prices and the mechanism of price caps set by the Office of Gas and Electricity Markets (Ofgem) mean that inflation will push higher still in April. Recall that Ofgem's energy price cap (per unit of energy consumed) is reset twice a year in February and August, with the new cap starting in April and October, respectively. The February price cap was increased by 54%, and will therefore push utility bills higher starting in April, which in turn will drive headline inflation through 8% over the second quarter this year.

From then on, although inflation is expected to peak and fall steadily thereafter, with the labour market still tight and geopolitical factors adding pressures on supply chains, food and energy prices, inflation is biased to stay high over the coming quarters. Energy prices, which have been volatile since the initial spike caused by the start of the Russian-Ukraine conflict at the end of February, have generally risen further since then. While the UK government has announced a £200 discount on household energy bills in October to help absorb some of these higher costs, families will still see a significant, albeit less dramatic, rise in utility bills.

Results of survey-based inflation expectations are often heavily influenced by realised inflation. Indeed, a recent survey saw another sharp increase in both short and long-run inflation expectations over the last quarter. Similarly, the Bank of England (BoE)/Ipsos Inflation Attitudes Survey pointed to a sharp increase in median short-run inflation expectations. Long-term inflation expectations only rose slightly and look stable for now (see Exhibit 3)

Exhibit 3: UK CPI inflation and household inflation expectations

Data as at 21 April 2022. Sources: ONS, Bank of England, BNP Paribas Asset Management.

Another interesting highlight from the BoE/Ipsos Inflation Attitudes Survey was that when asked what consumers planned to do in light of rising inflation expectations, an increasing majority of the respondents opted for cutting back spending or shopping around for better deals, and only a small minority would pull forward spending plans or ask for pay increases. Sustained increases in wage and accelerated consumption to avoid future price increases are the ingredients of an inflation spiral. This survey suggests the problem of higher prices could be self-correcting and inflation expectations could be better anchored than feared.

In the UK, rising inflation is increasingly a headwind for economic growth. In the coming months, the UK economic outlook faces multiple threats. First, from April onwards, UK consumers face significantly higher energy bills as a 54% increase in the utility price cap comes into effect. The government has provided some relief to households in the battle against the rising cost of

"In the UK, rising inflation is increasingly a headwind for economic growth. The economy faces multiple threats."

living, but relative to those in eurozone countries, the UK energy subsidies have been much more limited. On top of this, National Insurance taxes will be raised in April, to a total of 2.5% of workers' income to be borne equally between the employer and employee, in order to pay for public health services. As a result, disposable incomes will fall.

It is perhaps not too surprising that the BoE, being one of the first central banks to raise interest rates, is now starting to sound more cautious. Given the uncertain but high inflation backdrop, we believe the BoE will continue to hike policy rates gradually in the coming quarters. Larger hikes of 50bp are less likely in the near term, in our view. As the Bank Rate reaches the 1% threshold, active Gilt sales will still be on investors' radar. But given the BoE's intention to use the Bank Rate as the main policy tool, we expect the execution of active Gilt sales will be designed to minimise its market impact.

We are aware that net issuance of conventional and index-linked Gilts will increase significantly, starting in April. The duration supply will be on average about twice what market participants have been accustomed to over the last two years, and the question remains whether larger supply can be absorbed by the market in a rising inflation and interest-rate environment without much volatility.

However, the 30-year sector and longer part of the curve will likely be well supported by pension demand, given the exceptionally strong pension solvency ratios. With this in mind, we maintain our view that the higher net Gilt supply, combined with increasing chances of faster quantitative tightening through active Gilt sales from the BoE balance sheet, should help drive term premia higher. Shorter-dated Gilt yields, on the other hand, might have run out of room to sell off, given the amount of rate hikes already priced at the short-end of the curve and our view that the BoE rate hikes will likely be limited in the near future.

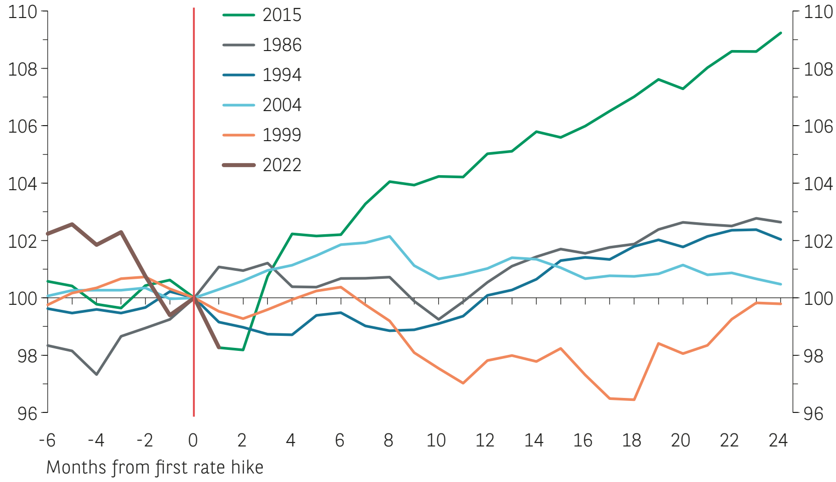
The narrative of central banks having to tighten policy to tame inflation expectations will likely continue to weigh on fixed income markets. However, on a relative basis, we believe UK Gilts will likely outperform US Treasuries given the divergence in the UK versus US growth outlooks. The real income squeeze, combined with BoE tightening, will likely slow the economy, weigh on inflation expectations, and reduce the need for aggressive BoE rate hikes.

Corporate bonds

The performance of investment grade corporate bonds has echoed that in previous Fed hiking cycles, underperforming in the months leading up to the first hike and continuing to underperform immediately after (see Exhibit 4). The degree of underperformance has been somewhat greater this time due a combination of high valuations/low spreads in the run-up to the first hike, and the Ukraine conflict raising greater concerns about the outlook for growth.

"Corporate balance sheets remain in robust shape; the growth outlook remains supportive for corporate credit."

Exhibit 4: Relative return of US investment grade corporate bonds vs. US Treasuries during Fed hiking cycles



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

The widening in spreads triggered by Russia's invasion of Ukraine has now reversed, but US and eurozone corporate IG spreads are on average still 30bp higher than at the beginning of the year. The increase has returned valuations closer to long-run averages and we anticipate credit will outperform from here. As we believe this outperformance will come primarily from the greater coupon as opposed to a narrowing of spreads, we are neutral within credit.

Corporate balance sheets remain in robust shape due to both the record levels of refinancing activity that occurred in 2020 and 2021 and the strong earnings growth achieved in 2021. The growth outlook remains supportive for corporate credit as both corporate CAPEX and consumer spending should continue to provide tailwinds. Nonetheless, geopolitical risks, continued cost pressures and an increasingly hawkish Fed will require vigilance; security selection remains a key risk factor.

The sell-off in European high yield was exacerbated by deteriorating technicals, that is, outflows from investment grade and high yield accounts and the bearish repositioning of long-only investors. We believe valuations now are pricing in some credit stress and there are questions about the ability of high yield issuers to refinance debt as the primary market has been closed for 10 consecutive weeks. Spreads, however, are not quite pricing in either a recession or a default cycle. We do not anticipate a recession in the medium term and consequently are becoming more constructive on European high yield. Fundamentals are supportive, corporate liquidity is ample, and we see the default rate staying very low for the next 12-24 months.

We are more cautious on US high yield. We have thus been reducing risk as spreads have remained resilient despite increasing headwinds. In contrast to investment grade, US high yield continues to trade rich on a historical basis. We are more wary of lower rated bonds (CCC) given the potential for interest coverage degradation. Nonetheless, credit metrics remain solid (interest coverage, cash/gross debt, net leverage), and early signs from the current US earnings season are encouraging as companies are beating (albeit lowered) earnings growth expectations.

"We think that this will be the year of the great normalization of Asia spreads."

Emerging market debt

The Ukraine crisis has significantly increased financial market volatility and uncertainty about the economic environment – just as the world was emerging from the pandemic. The crisis has also exacerbated pre-existing trends: inflation, supply chain bottlenecks, and rising policy rates. Within Asia, despite the ongoing resurgence of COVID in China, the largest emerging market economy, we are heartened by the continued supportive stance of policymakers, which should help embattled property developers, as well as Chinese Government Bonds (CGBs).

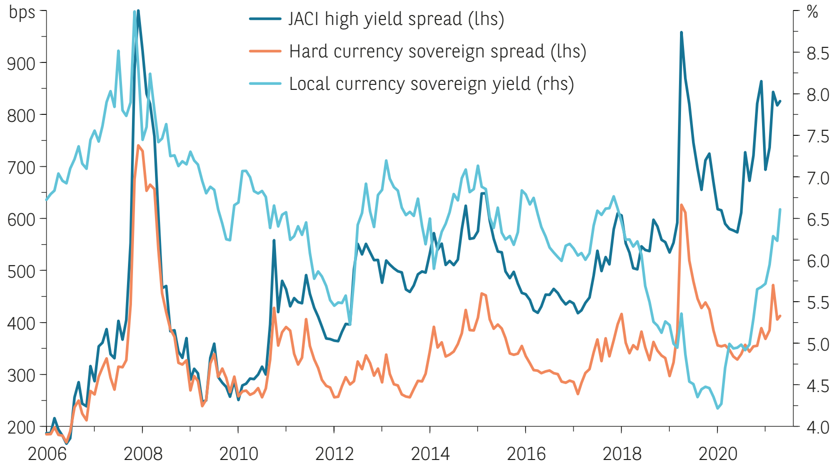
Despite the level of uncertainty out in the markets, we continue to adhere to our high-conviction approach in identifying attractive opportunities within emerging market debt.

On the hard currency EM front, we continue to be negative on US Treasuries as we are of the view that yields will move higher and continue to have a short duration bias in our portfolios. Specific to credits, we think that this will be the year of the great normalization of Asia spreads, and believe that outsized returns are likely to be driven by Asia high yield given its current attractive valuation levels, the potential for significant spread compression, as well as explicit support for property developers by Beijing (see Exhibit 5). We will also maintain a more idiosyncratic and high-conviction approach in identifying attractive credits within sovereigns and corporates.

Within local currency EMFI, over the near term, we plan to maintain our defensive stance on low yielding issuers where inflation pressures are building and where many central banks have already raised rates. However, selective opportunities remain at the long end of certain high yielding issuers. While being more cautious on EM currencies given short-term USD strength, we think that there could still be some selected and idiosyncratic opportunities to add to portfolio returns. Looking ahead to the rest of the year, we expect to see a rally in EM local currency bonds. Real rates will be relatively high in many EM countries given that their central banks have been much more proactive in hiking rates compared to their DM counterparts.

"We are heartened by the continued supportive stance of Chinese policymakers, which should help embattled property developers."

Exhibit 5: Emerging market debt spreads



Data as at 21 April 2022. Note: JACI = J. P. Morgan Asia Credit Index. Sources: FactSet, BNP Paribas Asset Management.

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INVESTORS' corner

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world