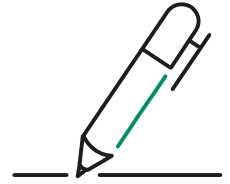


TALKING HEADS PODCAST



By **Daniel Morris**, Chief Market Strategist | **Arnaud-Guilhem Lamy**, Head of Euro Aggregate Fixed Income

CARRY IS KING AFTER 'ANNUS HORRIBILIS' IN FIXED INCOME

Daniel Morris: Hello and welcome to the BNP Paribas Asset Management Talking Heads Podcast. Every week, Talking Heads will bring you in-depth insights and analysis through the lens of sustainability on the topics that really matter to investors. In this episode, we'll be discussing eurozone fixed income. I'm Daniel Morris, chief market strategist, and I'm delighted to be joined by Arnaud-Guilhem Lamy, head of Euro Aggregate Fixed Income. Welcome, Arnaud-Guilhem Lamy and thanks for joining me.

Arnaud-Guilhem Lamy: Hello, Dan. Welcome, everyone.

Daniel Morris: Arnaud-Guilhem, we think about really what an incredible year it has been. And I guess in the broad scheme of things, we could say that perhaps this is just the transition from this 50-year bull market in fixed income that we've had to something rather different. Alongside rising rates, which is a bit of a different environment than what we've had for quite a long time, we've also seen significant volatility and what you think is right one week or one day sometimes turns out to be the opposite the next day. So, I imagine a quite challenging environment for a euro aggregate fixed income portfolio manager.

Let's start then with the increase in rates that we've seen. We've had an unprecedented selloff in fixed income markets this year. That said, the worst does seem to be behind us. We now have bond and money market funds with positive yields, which is of course, quite a good thing. The ECB has raised its deposit rate from -0.5 to 1.5% in the last four months. And another rise to at least 2% in December is priced in by the markets. We're at the point actually where markets are starting to talk about central bank pivoting. What does pivoting mean to you, Arnaud-Guilhem, and what do you think the likelihood is that it will happen?

Arnaud-Guilhem Lamy: Well, indeed, Daniel, you're absolutely right. The central bank pivot theme is now central for the market. However, if by pivot, one means that central banks are close to switching from hiking rates to cutting rates, we're definitely still a long way from that. Central banks will keep on hiking and we do expect the ECB and the Fed to hike by 75 basis points again in December.

Daniel Morris: So you say you still anticipate both the Fed and the ECB hiking by 75bp. Do you say that will be the case now, even after this surprisingly lower than expected inflation print we just had?

Arnaud-Guilhem Lamy: We still expect the ECB and the Fed to act by 75bp in December. However, it's fair to say that we might have passed the peak in terms of hawkishness, if I may say so. Indeed, we've seen three central banks surprising to the downside on rate hikes recently. The Bank of Canada raised rates by 50bp, while the market was expecting 75 basis points. The Royal Bank of Australia hiked by 25 basis points versus a 50 basis point expectation. So, of course Canada, Australia and Norway have a quicker pass through of the interest rate hikes to the economy due to their real estate markets. But it's a bit the canary in the coalmine. And so as I've said, we expect 75bp increase in interest rate hikes in December for both the Fed and the ECB. But while the risks were previously to the upside, the risks are now tilted to the downside. If they don't do 75 basis points, the alternative scenario is for 50 basis points, not for 100 basis points, unlike at previous meetings. And the other point for this switch and the fact that we're past the peak of hawkishness is what we have had in the speeches and comments of the ECB and the Fed. So in their speeches, the Fed and the ECB have kept a strong stance regarding the fight against inflation. However, in the last ECB press conference, growth and risks of recession came back much more often than in previous ones. The weighting of data and forecasts may be more balanced. Until recently data had a much bigger weight in the reaction function of the ECB. And on the other side of the pond, in the last FOMC statement, the Fed mentioned that it will take into account the cumulative tightening of monetary policy and the lags with which monetary policy affects economic activity and inflation. So, it doesn't mean that the Fed has become dovish, but



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we can expect the pace of hikes to slow down at the beginning of 2023. Most of the hikes have been done and in fact, normalisation of interest rates is done as well. When you look at five-year, five-year forward real yields, they're back to positive territory on both the euro and the US side.

Daniel Morris: Well, that's a very key point that you just raised about the Fed in particular being a bit more forward looking, whereas we've gotten the impression over the last several months that they seem to be quite backward looking. And concerns then that they could hike too much if you're waiting for inflation to fall before you actually start slowing down on the policy front. Back in the eurozone, though, we think about, of course, not only the moves in government bond yields. We also think about credit and in particular, there have been arguably bigger moves in investment-grade credit in the eurozone than necessarily in high-yield. More broadly, which sectors of the eurozone fixed income market do you see as the most attractive, and where should investors be looking to build positions yet?

Arnaud-Guilhem Lamy: First of all, one specific point is that carry should be king. With years of zero or negative rates, we focused more on mark-to-market prices and returns on fixed income markets were linked to the mark-to-market price evolution. But really, if you look over the long run, carry is the main source of return for fixed income. And fortunately, for us, after an annus horribilis for fixed income markets, carry is back on the agenda. So just to give you some levels, the euro aggregate index yield is around 3.9%, and the euro corporate index yield would be around 4.2%. So fixed income overall is definitely back to being attractive for 2023. In terms of asset classes, it's interesting to look at swap rates, indeed, prices of a 3% peak rate for the ECB deposit rate, which is in line with our own forecast. And when I say swap rates, I am talking about short-term swap contracts, so when you exchange fixed rates against, say, money market rates. So these swaps do price what we expect for an ECB rate of 3%, which is already quite high. And what we like to favour in our allocation are bonds that would behave like swap rates for which the yield would be very close to these rates. The asset class which is the most correlated to that is definitely covered bonds. We have increased the exposure to covered bonds this year. It provides a very attractive risk-return profile given the very low credit risk. We believe that in 2023, we'll see swap rates and government bond rates in Germany tightening, which would mean that covered bonds are definitely attractive. We have taken profits on our flattening position for German bonds since the two-year five-year curve has just inverted for Germany. But for the other countries, whether they are double A or triple B countries, we are keeping our curve flattening position on government bonds on the two-year tenure. So buying 10-year government bonds from double A or triple B countries in the euro area because it provides an attractive opportunity. If you compare this to the US curve, which is massively inverted, the 10-year rate in the US is 50bp lower than the two-year rate. It's interesting to see that in Europe for French bonds, you still have 50bp higher rates than two-year bonds. So whereas in the US, it is inverted, in Europe, if you take Germany, it is not inverted and it is still quite steep and provides definitely an opportunity for the belly of the curve.

Maybe another fixed income asset we like: investment-grade credit. Investment-grade credit is definitely cheap versus other asset classes, but also versus the fundamentals. The net leverage remains very low and a lot of corporates are full of cash. In fact, they're so full of cash that they have even tendered for some bonds, so buying back their own 2023, 2024 bonds in advance and buying at a pickup versus secondary market prices. So, you see that there are definitely very strong fundamentals for investment-grade credit. You have to be careful on some sectors. Overall, at the end of the day, the fundamentals of investment-grade corporates are very strong and you're very well priced even in case of recession with the spread you currently get. There is one point to monitor on the investment-grade credit. It will be the prepayments of the TLTRO in November. So, TLTRO, where the ECB lent money to banks. The ECB did make some changes to the TLTRO conditions, making them less favourable for banks and it might lead to strong redemptions, early redemptions of the TLTRO by the banks. In November, if you have redemptions, which are quite high, it would put a bit of pressure on the primary market at the start of the year. Overall, very strong fundamentals on investment-grade credit, very attractive valuations. So an asset class where we should build positions. Overall, for fixed income, what is sure is that uncertainties will remain very high and volatility, including intraday volatility, will remain very high. So, it means that investors have to remain flexible.

Daniel Morris: On one hand, then you actually sound pretty positive on the outlook for fixed income markets, which I imagine is a somewhat new sentiment after everything we've been through this year. Nonetheless, we know the risks are still out there. So, in your opinion then, what are the main underestimated risks for fixed income markets?

Arnaud-Guilhem Lamy: Well, indeed, one risk is not that much discussed by the markets, and that's the wage-price spiral risk. There is a reason why it's not much discussed. It's because for the time being, wages seem not to have reacted that much to inflation. If you look at negotiated wages, they remain pretty muted when comparing them to inflation with 2.4% as of end of June. However, these measures are lagging and outdated. So, as I mentioned, the most recent data is as of June. And in the meantime, inflation went up from 8.6% to 10.7% in October in the eurozone. In addition, we have had Germany massively increasing its minimum wage. As we discussed earlier, the Netherlands will increase the minimum wage by 10% in January. And you know that Belgian wages are indexed to inflation and that will apply at the beginning of next year. So given the timeframe of this wage data in the euro area, we've seen the Central Bank of Ireland recently publishing a research paper trying to estimate wages in a more timely way. Their economists have built a monthly wage growth tracker based on data from millions of online job postings in six euro countries. And this wage growth tracker points to a 5.2% increase. So it's much higher than the 2.4% negotiated wages increase that we got in June. So, of course, it is based on job postings, so it is based on the flow and one may not drop too quickly for a broader scope of employment. However, it shows that investors should pay attention to wages and to leading indicators on wages. So overall, with the recession coming in 2023, especially in countries such as Germany, we do not



expect the second-round effects to be the base case. However, it has to be closely monitored. But the real conclusion overall is that we're very positive on euro fixed income for 2023, given what's already priced in and on swap rates and in credit spreads, while we still keep an eye on wages.

Daniel Morris: Well, Arnaud-Guilhem: thank you very much for joining me.

Arnaud-Guilhem Lamy: Thank you, Daniel. Always a pleasure to talk to you.