For professional investors - Marketing communication - October 2024

FIXED INCOME OUTLOOK
4Q 2024

What may come

- As we move through the fourth quarter, we see two main investment themes as the key drivers for the US Treasury market over the coming weeks:

- Whether the US economy remains on a 'soft landing' path or whether the strength of the September labour market report suggests that output risks could once again push up against capacity limits.

- Investors must also assess the possible outcomes and investment consequences of the US elections in November. The two candidates have very different visions and the policies have the potential to significantly alter the path for growth, inflation, monetary policy, Treasury issuance, government debt sustainability and term premia.

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The sustainable investor for a changing world

UNITED STATES

As we move through the fourth quarter, we see two main investment themes as the key drivers for the US Treasury market over the coming weeks:

(i) Investors must assess whether the US economy remains on the 'soft landing' / 'Immaculate Disinflation' path in which the economy grows slightly below potential, permitting a further rebalancing of the labour market and a gradual return of underlying inflation to the central bank's target; or whether the strength of the September labour market report suggests that output risks could once again push up against capacity limits. This analysis will inform the range of possible paths for the monetary policy rate, and hence the front end of the Treasury curve.

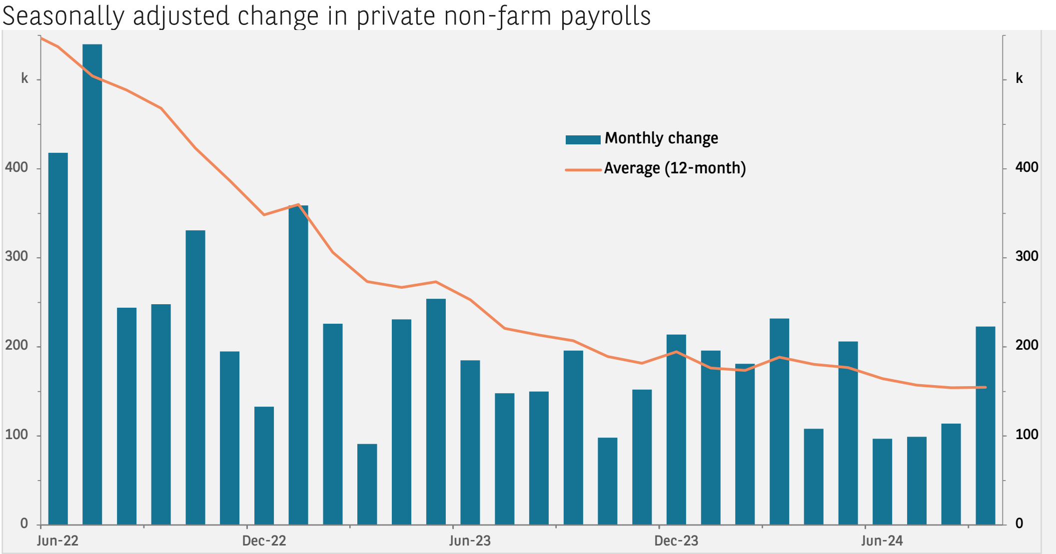
(ii) Investors must assess the possible outcomes and investment consequences of the US elections in November. The two candidates, Kamala Harris and Donald Trump, have very different visions for trade, immigration, taxation and government spending, as well as environmental and business regulation. These policies have the potential to significantly alter the path for growth, inflation, monetary policy, Treasury issuance, government debt sustainability and term premia – and with the election result on a knife-edge, the range of possible market outcomes is exceptionally wide.

On the first theme, we are of the view that the strong September labour market report is more noise than signal (see Exhibit 1). We think that the US remains on a path towards a so-called soft landing, with core inflation set to gently descend to target (or slightly above).

Exhibit 1

US labour market is normalising

Seasonally adjusted change in private non-farm payrolls



Data as at 17 October 2024. Sources: BLS, BNP Paribas Asset Management.

Looking at the broad range of labour market indicators, we see an employment market that has rebalanced despite historically strong output and employment growth, suggesting that the US economy is operating beneath its (currently elevated) potential growth rate.

At Jackson Hole, US Federal Reserve (Fed) Chair Jerome Powell noted the Federal Open Market Committee's (FOMC) comfort with inflation, but also its concern over upside unemployment risks. These worries justified a 50bp cut in September.

Even if the FOMC upgraded its assessment of labour market conditions, we believe the argument for returning rates to neutral would remain valid, albeit less urgent. Neutrality for the fed funds rate, to our mind, is probably 3%, but could be as high as 3.5%.

It is, however, difficult to make a call on the path for policy rates independently of a view on the US elections, currently just weeks away. The election result is on a knife-edge — and the uncertainty of the result and unpredictability of the investment implications appear to be dissuading many investors from placing large active bets on the result. Nevertheless, as the timeline to election day shortens, we anticipate brave investors establishing trades, and hesitant investors establishing hedges.

Should Vice President Harris win the White House, we deem it unlikely that the Democrats will also win control of the Senate

Should Vice President Harris win the White House, we deem it unlikely that the Democrats will also win control of the Senate (Realclearpolling.com has Republicans winning 51 seats to 44 for Democrats with 5 toss-ups as at 22 October 2024). This would limit her room for maneuvre on fiscal policy and require compromise with Republicans in Congress to pass some of her legislative priorities, such as an expansion of child tax credits.

We would expect a portion of the Trump tax cuts to expire, but spending to keep increasing, thereby leading to a modest deterioration in deficits.

Immigration policy would likely be tightened. The impact on growth and inflation would probably be modest in the first couple years of Harris's term, permitting the Fed to proceed on a rate cutting path towards neutral.

A second Trump presidency, however, could reshape US trade, immigration, regulatory, tax and spending policies — though changes to fiscal policy would require the assent of Congress. Of particular relevance are **Trump's proposals** to:

- Tighten immigration controls, which would, over time, reduce labour force growth and potential GDP growth
- Impose tariffs, either in a targeted fashion or on all imports, at rates between 10% and 60%
- Cut corporate taxes from 21% to 15% and extend the 2017 personal tax cuts expiring in 2026, thereby providing a significant fiscal impulse but widening deficits further (at a **potential cost** of up to USD 6 trillion over the next decade)

Although some of these proposals are likely merely election promises, or require the approval of Congress, the first two could be delivered using Presidential executive powers.

From a growth perspective, lower taxes and deregulation should be stimulative. Erecting trade barriers, imposing tariffs and tightening immigration, however, would raise prices, constrain competition and reduce labour supply. This could be expected to damage growth over the medium to longer term – leading to a stagflation scenario.

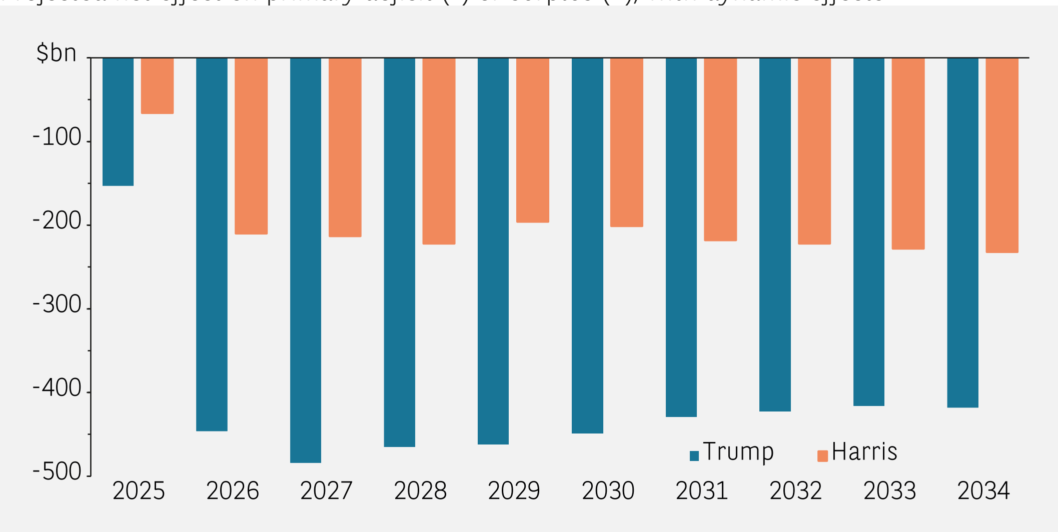
Furthermore, should Trump be in a position to enact his full range of tax and spending proposals, the potential consequences for US federal debt sustainability are significant, and would likely elicit a sharp market reaction from displeased Treasury investors.

The Penn Wharton Budget Model has **estimated** the deficit impact of Trump's fiscal plans at nearly USD 4 trillion over 2025-2034, while the Committee for a Responsible Federal Budget has **costed** it at USD 7.5 trillion (versus USD 1 trillion and USD 3.5 trillion for the Harris plan, respectively; see Exhibit 2).

Exhibit 2

US budget deficits would increase if platforms implemented

Projected net effect on primary deficit (-) or surplus (+), with dynamic effects



Data as at 17 October 2024. Sources: Penn Wharton Budget Model, BNP Paribas Asset Management.

Our view is that the inflation risks and debt sustainability risks associated with a Trump presidency (especially in a Republican sweep scenario) are not fully priced by the market.

We anticipate policy rates will not decline as much as expected following the strength in September payrolls, and the possibility of a Republican win at the US presidential election (Realclearpolling.com puts the **odds of a Trump victory** at 60.1% as at 22 October 2024). A rise in term premia, as investors balk at forthcoming supply in the absence of Fed purchases, could lead to a steeping of the yield curve. A second Trump administration,however, might lead to a different outcome.

We see breakeven inflation rates potentially rising as we believe they are currently cheap and could move up in the event of worsening Middle East tensions and higher oil prices. Investor anticipation of inflationary policies from a Trump administration could also lead to gains.

EUROZONE

We anticipate moderate aggregate eurozone economic growth but at an unevern rate across sectors and member states, with core economies continuing to underperform. As the slump in the manufacturing sector deepens, the services sector has been the sole support to growth.

The weakness in Germany's economy reflects the structural challenges faced by its manufacturing sector, which was hit hard by the energy shock.

In France, the fiscal situation has worsened and is in need of reform and consolidation against a fragile political backdrop. In contrast, more services-driven economies, such as Spain's, will likely continue to see better economic growth (see Exhibit 3)

Exhibit 3
Latest Purchasing Manager Indices

	Germany	France	Italy	Spain	UK
Services	50.6	49.6	50.5	57.0	52.4
Manufacturing	40.6	44.6	48.3	53.0	51.5

Data as at 17 October 2024. Sources: S&P Global, BNP Paribas Asset Management.
Note: Values greater than 50 indicate the sector is expanding, below 50 indicate contraction.

The unemployment rate also diverges across countries. It has risen in Germany, while in aggregate, the labour market in the eurozone remains fairly tight but has started to loosen. Against this backdrop, wage growth will likely remain elevated but is set to slow. The gradual moderation in wage growth means that further improvement in underlying inflation over the rest of 2024 will likely be limited, as the 'quick wins' of lower goods and energy inflation are exhausted.

The rise in real household income as a result of high wage growth and falling inflation should continue to support consumption. We note, however, that consumption has disappointed over the recent past, especially in core economies, as saving rates are high.

On the fiscal front, European Union fiscal rules and the associated Excessive Deficit Procedures (EDP) will increasingly come into focus. While we do not expect fiscal austerity to return, an easier monetary policy stance might be required to balance the negative impacts from the tighter fiscal stance.

In balancing a slightly weaker growth outlook with still-sticky price pressures, we believe the European Central Bank (ECB) is unlikely to take an activist approach given its single mandate on price stability. We see it as more likely to chart a gradual path of policy normalisation until the depo rate reaches around 2.25%, a level we would consider broadly neutral.

At the time of writing, front-dated interest rate pricing implies an ECB depo rate at around 2% by the third quarter 2025, which we see as largely fair. That said, recent economic data releases in the eurozone highlighted a rising downside risk to growth, which in turn could help inflation to moderate a little more quickly than currently assumed. This is sharp contrast to the US, where the Atlanta Fed's GDPNow estimate is tracking growth at around 3%. As a result, we would expect eurozone government bonds to outperform US Treasuries.

We anticipate long-dated eurozone breakeven inflation (BEI) to underperform US BEI

We also anticipate long-dated eurozone breakeven inflation (BEI) to underperform US BEI, reflecting the divergence of risks surrounding the outlook for growth and outlooks in the two regions. In addition, while the race in the US presidential election remains extremely tight, the probability of a Republican sweep outcome is meaningful. We see room for US BEI to outperform as market participants look to hedge against Trump's potentially inflationary trade, immigration and fiscal policy proposals.

In country selection, we expect outperformance of German and Spanish inflation-linked bonds relative to France and Italy.

For Germany, we believe higher valuations are warranted on a relative basis due to their scarcity and a higher sovereign credit rating.

We see Spain outperforming due to stronger economic growth versus core countries. The services sector in Spain remains dynamic, and investment flows from Next Generation EU (NGEU) funds further support growth.

In France, although the short-term risk of a government collapse and the subsequent failure to pass the budget have decreased, Prime Minister Barnier faces the challenging task of consolidating public finances at a time when the fragmentation of parliament and infighting in his minority government will make it hard to push through reforms.

French and Italian government bond spreads vs. German Bunds could see renewed widening pressure as the budget negotiations under the reintroduction of EU fiscal rule increasingly come into focus.

UK

Post-election optimism has already started to fade. The UK fiscal position remains difficult, and households and businesses have been warned repeatedly about 'tough' and 'unpopular' decisions amid talks of tax increases ahead of the Budget announcement scheduled for end-October.

The focus in the coming weeks will be on the government's fiscal plan. The Chancellor is working with limited fiscal room to manoeuvre under current rules. With the Liz Truss 'mini-budget' experience still fresh in memory, preparing a credible budget with a pro-growth agenda is no easy task.

The rising prospect of a change to the fiscal rule leading to more government borrowing has raised uncertainty

The rising prospect of a change to the fiscal rule leading to more government borrowing has raised uncertainty regarding the UK's fiscal and growth outlook. The worries about yet more Gilt issuance on top of the current massive financing need have started to put upward pressure on Gilt yields, and could continue to weigh on longer-dated Gilts in the near future.

However, we believe the UK government intends to formulate additional fiscal headroom dedicated for long-term capital investment, not unfunded tax cuts. The current government will also respect fiscal orthodoxy and the institutional guardrails, such as the Office for Budget Responsibility, in its fiscal decisions. As such, we do not foresee a repeat of the 'mini-budget' market volatility.

We could see higher Gilt yields ahead thanks to rising term premia, reflecting massive bond issuance in the pipeline, high debt levels, and an impending change in the government's fiscal rules. We would anticipate the curve steepening as front-dated yields should be well anchored by expectations for further rate cuts from the Bank of England.

CREDIT

Global corporate bonds have performed well year to date despite periods of economic uncertainty and political volatility. While uncertainties remain, we retain our positive outlook for the asset class, supported by resilient economic growth in the US and Eurozone, steady demand for the asset class, and a supportive monetary easing cycle underway in Europe and just beginning in the US.

While the historical data is somewhat mixed on how corporate bonds perform during a monetary easing cycle, our analysis suggests that in each instance where there was either no recession or only a minor one, corporate bonds performed well relative to other asset classes. Nevertheless, lower official interest rates in the US should support the outlook for companies not just in the America but across the developed world, while declining global government bond yields could benefit corporate bond's total return even if yield spreads remain stable.

Demand for corporate bonds has remained robust throughout the year and we do not expect this to change in the coming quarters

Demand for corporate bonds has remained robust throughout the year and we do not expect this to change in the coming quarters. Despite periods of uncertainty and volatility earlier in 2024, near record issuance of investment-grade corporate bonds was quickly consumed — in the US demand has exceeded supply by 3.7 times year-to-date[1]. Insofar as lower short-dated yields fall with lower policy rates, we could see demand increase further in the coming quarters as investors rotate from increasingly lower yielding money-market funds to higher-yielding corporate bond funds.

Election-related volatility and geopolitical uncertainty remain the key risks, but we believe the combination of strong fundamentals and steady demand for the asset class justify maintaining exposure to corporate bonds.

THE FED LOOKS TO HAVE ACHIEVED A SOFT LANDING

Easier monetary policy in the eurozone and the US should provide a boost to economic activity and thus corporate profits. But the Fed's likely success in achieving a soft landing is another indicator that the country's business cycle has evolved. Aside from a short-lived dip during the 2020 pandemic, the last time the US had a technical recession was more than 15 years ago, because of the 2008 Global Financial Crisis (GFC). Going further back, the US economy has only had three recessions in the last 40 years, and only one of those (the post-GFC recession) lasted more than a year. Compared to the prior 40-year period, when there were eight recessions, the declining volatility in the US business cycle is remarkable[2].

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1. Bloomberg: https://www.bloomberg.com/news/articles/2024-10-01/us-investment-grade-bonds-return-5-8-in-best-quarter-of-2024?embedded-checkout=true

1. U.S. Business Cycle Expansions and Contractions" National Bureau of Economic Research (NBER). March 14, 2023. https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions. September 30, 2024.

While past performance is no guarantee of future results, we believe corporate bond investors can take some comfort in the likelihood that business cycle volatility has declined. This could reduce the risk premium required for holding corporate bonds over government bonds, allowing corporate bond yield spreads to narrow or at least stay narrow.

SECTOR AND SECURITY SELECTION STILL MATTER

Despite our relatively sanguine medium-term outlook for the asset class, softer earnings (and some profit warnings) in select sectors are a reminder that sector and security selection are important for both risk management and finding opportunities for capital appreciation.

For example, we are increasingly optimistic on the global real estate sector, both in the investment-grade and high-yield markets. Many real estate companies — particularly in the eurozone — suffered when interest rates were high, but falling interest rates could relieve pressure on companies' funding costs, introducing a more virtuous circle.

In the banking sector, we believe conditions are supportive of outperformance

In the banking sector, we believe conditions are supportive of outperformance, but some countries may perform better than others. In the eurozone for example, the European Central Bank has confirmed the sector broadly is resilient, with plenty of capital and liquidity. But we are more cautious on the outlook within France given the political and economic environment, and more positive on the peripheral markets such as Greece and Spain. Greece looks likely to regain its investment-grade credit rating, while Spain's economic recovery is accelerating faster than many of its eurozone peers.

Finally, we recommend greater selectivity in the more cyclical sectors of the market, particularly the automotive sector. In the eurozone, for example, demand has been tepid given the weak economic environment and we expect continued pressure on profit margins from regulatory pressures, competition from Asia, and the cost of transitioning from fossil fuel engines to electric vehicles.

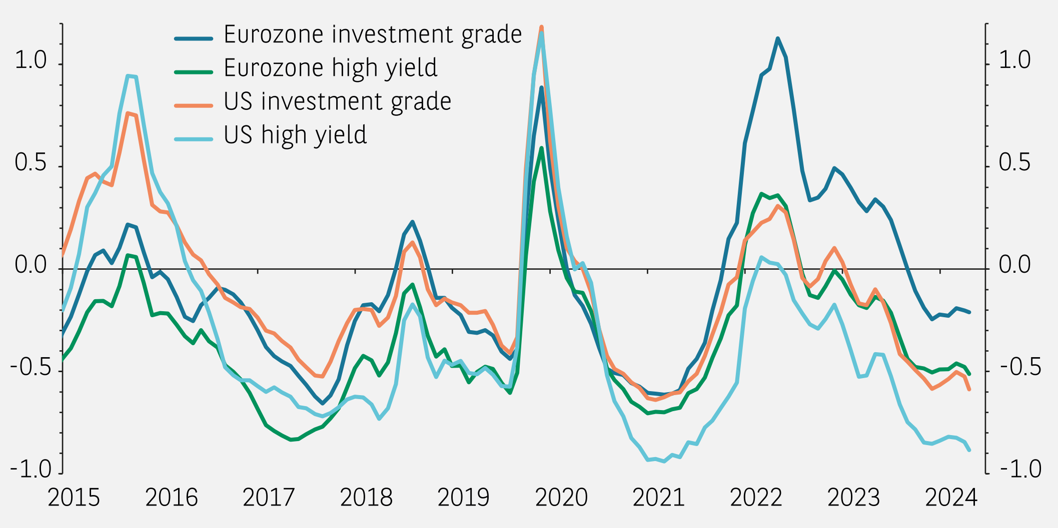
STAY INVESTED, BUT MONITOR GEOPOLITICAL RISKS

While we are constructive on the corporate bond market in both the US and the eurozone and retain our positive outlook for both the investment-grade and high-yield sectors, valuations have become more expensive, and thus the asset class is vulnerable to any deterioration in sentiment (see Exhibit 4).

Exhibit 4

Credit spreads are below average across the board

Spread z-score



Data as at 21 October 2024. Sources: FactSet, BNP Paribas Asset Management.

War in Ukraine, increasing tensions in the Middle East, supply disruptions in the Gulf of Arabia — all have the possibility of accelerating on short notice, creating concern and volatility, weighing on sentiment. Likewise, corporate bond markets in the eurozone were more volatile around the recent national and EU parliamentary elections, and thus we expect investors will be cautious ahead of the November US elections. While it's impact could be significant, particularly in regard to fiscal policy and global trade, the outcome may remain uncertain beyond the election should it be a close or contested. As markets dislike uncertainty, anything short of a clear win by one party or another, with clear policy implications, could both increase volatility and diminish support as investors are loath to take additional risk.

EMERGING MARKETS

We remain positive on the outlook for emerging market (EM) bonds as we expect economic growth to remain resilient into 2025, supported by robust private consumption, investment, and exports. Meanwhile, inflation has declined closer to normal levels, which should support further monetary policy easing. Finally, money continues to flow into EM hard currency external bonds, local currency denominated bonds, and corporate bonds, while the supply of these bonds remains below the pre-pandemic levels.

However, volatility may persist because of the US November elections, commodity prices responding to geopolitical concerns, and uncertainty about the pace of economic growth in China. As we do not expect any of these factors are likely to fundamentally derail the EM economies or bond markets, they may create compelling opportunities to adjust exposure. In the meantime, the current combination of positive fundamental and technical factors support staying invested in EM bonds, enjoying the relatively higher yields they provide.

LOCAL CURRENCY BONDS OFFER THE MOST COMPELLING OPPORTUNITIES

The beginning of a US Federal Reserve (Fed) rate cutting cycle has typically not supported strong returns in EM bonds. However, previous rate cutting cycles have usually been accompanied by recessions and little demand for higher-yielding assets while this cycle has robust growth and strong demand. Additionally, the same history shows that EM local-currency denominated bond yields are more likely to follow the Fed, falling in yield and rising in price.

Emerging market local-currency bond yields rose significantly in recent years

Furthermore, EM local-currency bond yields rose significantly in recent years and their real (adjusted for inflation expectations) yields are now at historically attractive levels, particularly relative to real yields in the US. The combination of renewed economic growth, stable inflation, lower interest rates, and attractive valuations suggests the asset class could provide compelling returns over both the short and medium term.

Country selection is important, however, as some regions or individual countries are further along in their monetary easing cycle than others and some have yet to start. We expect Latin America will remain a leader in lowering rates, driven by Colombia, Chile and Peru. In Eastern Europe, Hungary, Czechia and Romania are likely to lead in cutting rates, while countries like Turkey and Egypt seem to be on the path to achieving a level of stability that could could allow lower interest rates in the quarters ahead.

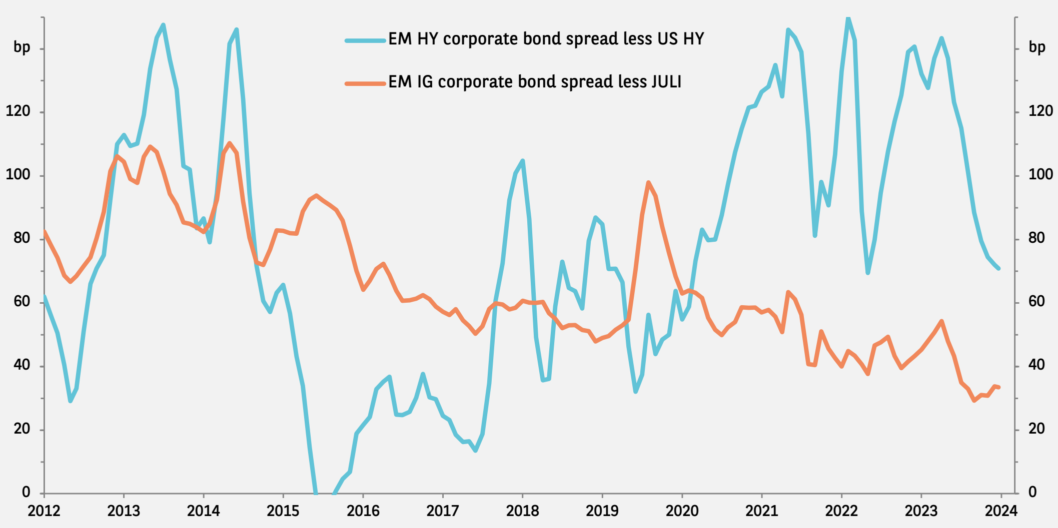
EM CORPORATE BONDS HAVE ATTRACTIVE YIELDS

EM corporate bond spreads have compressed in recent quarters and thus some countries and or sectors have begun to look expensive on an absolute basis. However, relative to their counterparts in the US or other developed markets, they remain attractive. EM investment-grade corporates currently offer yields more than 30 basis points (bp) higher than their developed market equivalents, while sub investment grade (high yield) EM corporates offer yields closer to 70 bp greater than their developed market equivalents (see Exhibit 5).

Exhibit 5

Emerging market corporate bond spreads relative to developed are attractive

Three-month moving average



Data as at 21 October 2024. Sources: J.P. Morgan, BNP Paribas Asset Management.

Emerging market corporate fundamentals remain, in aggregate, robust with recent earnings reports generally supporting a resilient outlook. And while geopolitical tensions, such as conflict in the Red Sea, have created the potential for supply chain disruptions, EM corporates have proven agile in their operating models, shifting providers or optimizing their cost structure to minimize the impact.

Finally, we see a positive technical environment containing at least through the end of 2024. The supply of corporate bonds has picked up recently but remains much lower than before the pandemic and we expect this more moderate level of bond supply at least through the end of 2024.

BE SELECTIVE IN HARD-CURRENCY SOVEREIGN

We maintain our positive outlook for EM hard-currency sovereign bonds, supported by improving fundamentals, lower developed market interest rates, and consistent demand for the bonds' relatively high yields. However, we continue to believe that performance is likely to remain somewhat diverse with select pockets having greater potential to generate outperformance. For example, the more idiosyncratic situations such as the ongoing debt restructuring in Ukraine or Sri Lanka, and amongst the more frontier markets, such as Egypt and other African sovereigns, which could benefit from more pronounced economic growth and sustained demand for the higher yields they provide.

CHINA AND POLITICS COULD FUEL VOLATILITY

The Chinese government has recently broadened and deepened its attempts to revitalize the country's economy. While it is too early to estimate how successful these measures will be or predict how much more stimulus the government will ultimately provide, success could significantly improve the outlook for regional EM economies. However, China's own challenges remain and are significant to the world economy. Growth targets will remain the primary focus into 2025, as the local property market woes weigh on economic activity. But if current or forthcoming measures are more pronounced, we could see positive growth sooner than we expect, providing further support for global emerging market bonds.

EM has endured several national elections in 2024, notably in South Africa, India, Indonesia, and Mexico, that created pockets of opportunity

EM has endured several national elections in 2024, notably in South Africa, India, Indonesia, and Mexico, that created pockets of opportunity. However, attention is turning to the implications of the November US elections. Both the US presidential and congressional elections are currently too close to call, but the outcome could have significant implications for everything from fiscal policy to monetary policy, global trade, and investor risk appetite should the election be contested.

While some caution ahead of significant events is warranted, we remain of the view that investors are better served focusing on fundamental factors that drive markets over the long term. And the fundamental outlook for EM sovereign and corporate bonds remains positive while current yields offer compelling compensation for the current uncertainties.

This report was finalised on October 2024

October 2024 - Design: Creative Services BNPP AM - P2410073

VIEWPOINT

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world