FEBRUARY 2025

Fixed Income Focus

Summary

1. **Monetary policy paths are becoming less synchronised this year.** We expect the ECB to continue cutting rates in response to weak growth and inflation near target, with three 25bp cuts anticipated (March, June, and September). Meanwhile, the Fed has the flexibility to wait, given strong economic data and uncertainty surrounding the new administration's policies. We expect two 25bp cuts from the Fed in June and December.

2. **Bond yields:** We maintain our 12-month targets at 4.25% for the US 10-year yield, 4% for the UK 10-year yield and 2.25% for the bund yield. We have taken advantage of the bond sell-off, shifts in central bank expectations, and term premium repricing to take a more constructive stance on US government bonds, extend recommended maturities in the US, and turn Positive on UK gilts. However, we remain Neutral on German and peripheral eurozone bonds due to less attractive expected returns.

3. **Topic in focus: Recent changes to our recommendations.** In the current macroeconomic environment, US Treasuries and UK bonds present compelling risk-adjusted returns. Disinflation, a dovish Fed bias, and a favourable carry make US Treasuries attractive, while weak UK growth and anticipated BoE rate cuts support gilts. With falling yields on the horizon, US Treasuries (including Treasury Inflation-Protected Securities) and UK bonds represent a strong investment opportunity for both domestic and international investors.

4. **Opportunities in Fixed Income:** In addition to the above, we are Positive on US Agency Mortgage-Backed Securities, as well as European and US investment grade corporate bonds.

Drafting completed on 10 February

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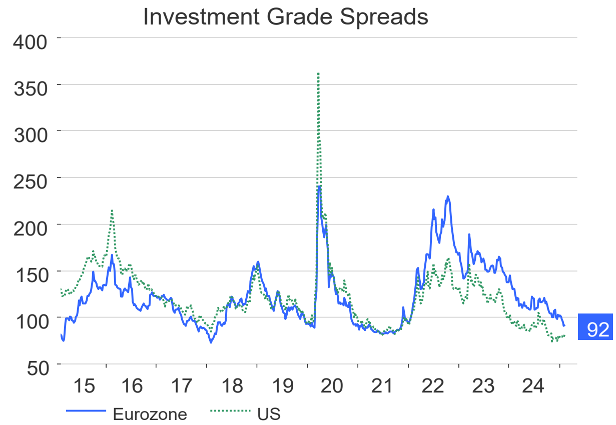
CHART OF THE MONTH: INVESTMENT GRADE BOND SPREADS HAVE REMAINED REMARKABLY STABLE DESPITE POLITICAL UNCERTAINTIES



Source: LSEG Datastream, 11/02/2025

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Central banks

Less synchronised policies

European Central Bank (ECB)

Latest developments: The ECB has further reduced rates as expected, bringing the deposit rate down to 2.75%. Despite weak Q4 GDP growth and sticky domestic and services inflation, the ECB remains confident that rising real incomes and the fading effects of past monetary tightening will support economic activity.

Potential risks to the ECB's outlook: Trade frictions could have a "global negative impact" on growth while also making the eurozone inflation outlook "more uncertain", according to President Lagarde.

Our view: We maintain our forecast that the ECB will implement 25bp rate cuts in March, June, and September. This would bring the end-of-cycle rate to 2%, aligning with the midpoint of our estimate of the neutral rate. Market expectations are consistent with our view, with 3.4 rate cuts priced in by year-end. There is a risk of further rate cuts if economic growth slows under high tariffs.

US Federal Reserve (Fed)

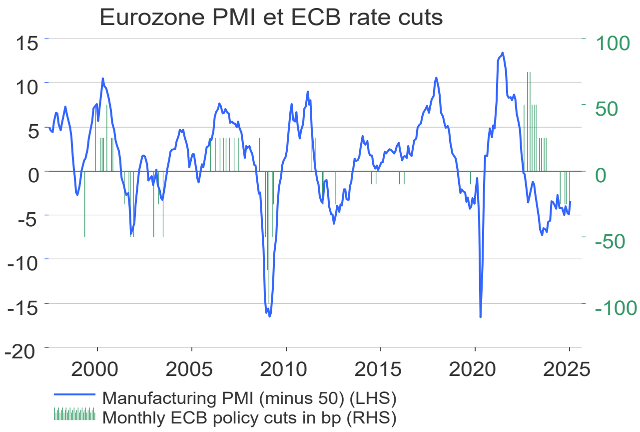
Policy stance: The Fed maintained its policy rate at 4.5% in January. The FOMC statement retained a hawkish tone, indicating that the committee sees no need for additional monetary easing and is frustrated by the progress of inflation.

Key focus areas: In the near term, policymakers are closely monitoring the new administration's policies, particularly on tariffs, and their potential economic impact.

Our view: We believe the Fed is keeping its options open, given the wide range of possible policy outcomes from the new administration. With little downside to waiting, we anticipate the Fed will cut rates in June and December, concluding the cycle at 4%.

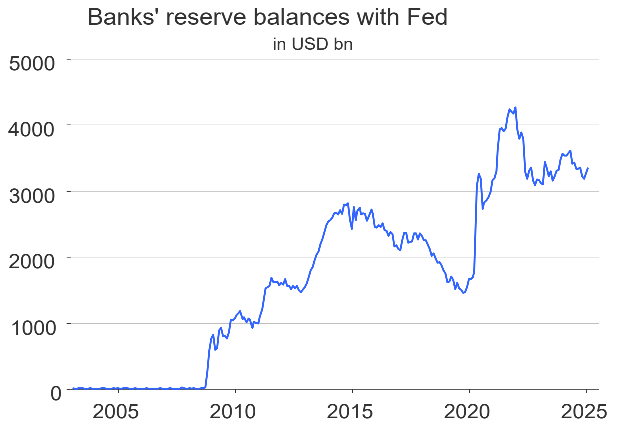
Quantitative Tightening (QT): Powell's "scarcity indicators" suggest that reserves remain abundant. As a result, we now expect the Fed to announce the end of QT at the June FOMC meeting, with implementation beginning in July.

WEAK EUROZONE MANUFACTURING PMI POINTS TO RATE CUTS



Source: LSEG Datastream, Jan 25

BANK'S RESERVES ARE STILL ABUNDANT



Source: LSEG Datastream, 05/02/2025

Investment Conclusion

Monetary policy paths are becoming less synchronised this year. We expect the ECB to continue cutting rates in response to weak growth and inflation near target, with three 25bp cuts anticipated (March, June, and September). Meanwhile, the Fed has the flexibility to wait, given strong economic data and uncertainty surrounding the new administration's policies. We expect two 25bp cuts from the Fed in June and December.

Bond yields

A peak was reached

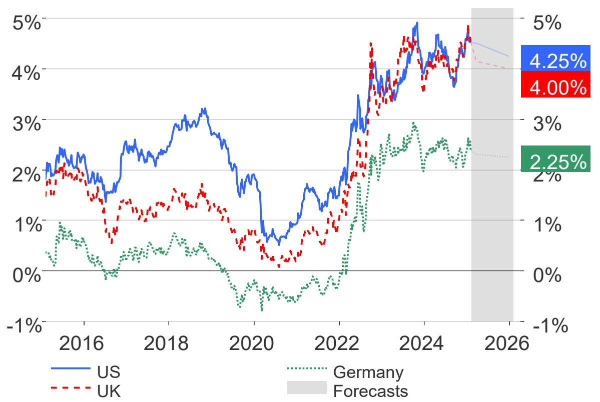
Despite headlines regarding tariffs, interest rate volatility has remained broadly stable in recent weeks.

Ten-year yields in the US, UK, and Germany peaked in mid-January. We believe the US 10-year yield will remain capped below 5%, provided discussions around rate hikes remain limited –such hikes would require significantly higher inflation data, which is not our base case-.

We have taken advantage of the recent bond sell-off, the recalibration of market expectations on central banks, and the repricing of term premia to adjust our fixed-income positioning.

In the US, we have turned Positive on government bonds and increased recommended maturities. We have also upgraded our stance on Treasury Inflation-Protected Securities (TIPS). In the UK, we have shifted to a Positive outlook on gilts. However, we remain Neutral on German government bonds, as expected returns are less attractive relative to other regions.

10-YEAR RATES



	Maturity (years)	07/02/ 2024	3-month target	12-month target
USA	Policy rate	4.50	4.50	4.00
	2	4.28	4.25	4.25
	5	4.34	4.30	4.25
	10	4.49	4.50	4.25
	30	4.69	4.60	4.50
Germany	Policy rate	2.75	2.50	2.00
	2	2.06	2.10	2.00
	5	2.16	2.15	2.10
	10	2.38	2.30	2.25
	30	2.63	2.55	2.50
UK	Policy rate	4.50	4.50	3.75
	2	4.17	4.00	3.60
	5	4.18	4.00	3.75
	10	4.48	4.00	4.00
	30	5.06	4.50	4.45

Source: Refinitiv Datastream, BNP Paribas WM

INVESTMENT CONCLUSION

We have taken advantage of the bond sell-off, shifts in central bank expectations, and term premium repricing to take a more constructive stance on US government bonds (including TIPS), extend recommended maturities in the US, and turn Positive on UK gilts. However, we remain Neutral on German and peripheral eurozone bonds due to less attractive expected returns.

Topic in Focus

Recent changes to our recommendations

We have turned Positive on US Treasuries and increased duration to the benchmark level (approximately six years). Over the past four months, the 10-year yield has risen by 100bp, driven by strong economic data and concerns over policies from the new administration, such as tariffs and fiscal deficits.

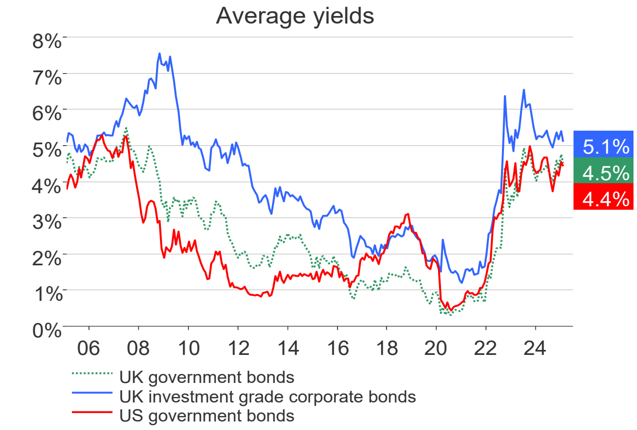
In our view, the 10-year yield is more likely to fall than it is to rise significantly and retest the 5% level – the 10-year yield would need to rise to 5.22% for its one-year expected return to turn negative, which we consider unlikely-. Several factors support this view. Firstly, recent data suggests signs of disinflation, with the Fed maintaining an easing bias and a high bar for further rate hikes. Secondly, the term premium already reflects substantial uncertainty.

Previously, we had been Positive on short-term Treasuries, but we now extend this stance to the broader index. With an average yield of 4.5% (see chart) and a duration just under six years, Treasuries offer strong carry and attractive risk-adjusted returns. While we are extending duration to the benchmark level, we refrain from going beyond it, as long-end yields remain sensitive to developments in tax policy.

We have also turned Positive on Treasury Inflation-Protected Securities (TIPS). With breakeven inflation at 2.45% and historically high real yields at 2.1%, the market is pricing in a high-growth, stable-inflation environment, which we do not fully endorse. Instead, we expect slower growth, declining real yields, and gains in TIPS. Historically, when the 10-year real yield has exceeded 2%, TIPS have generated positive returns over the following 12 months in 99.7% of instances.

We have also turned Positive on UK government and investment-grade corporate bonds. Weak economic growth prospects, a high term premium, and core inflation easing in Q2 support lower UK yields. Additionally, we anticipate more central bank rate cuts than currently priced in by the market. We also note that risks are skewed towards reduced gilt issuance from Q4 2024 onwards, providing additional support. With an average yield of 4.5% for gilts and 5.1% for investment-grade corporate bonds, both asset classes offer an attractive cushion (see chart) and strong expected returns for domestic and international investors alike, particularly given our expectation of relative stability in sterling against both the euro and the US dollar on a 12-month horizon.

AVERAGE YIELDS ARE HIGH IN THE US AND UK



Source: LSEG Datastream, 07/02/2025

HIGHER YIELDS PROVIDE A BETTER CUSHION IN THE EVENT OF ADVERSE INTEREST RATE MOVEMENTS

1-year expected total return given a change in interest rates

	current yield	-100	-50	-25	+25	+50	+100
US 2-year	4,25	5,2%	4,7%	4,5%	4,0%	3,8%	3,3%
US 10-year	4,46	12,1%	8,2%	6,3%	2,6%	0,9%	-2,6%
UK 2-year	4,12	5,1%	4,6%	4,4%	3,9%	3,6%	3,2%
UK 10-year	4,44	12,1%	8,2%	6,3%	2,6%	0,8%	-2,6%

Source: Refinitiv, BNP Paribas WM, as of 10/02/2025

Investment Conclusion

In the current macroeconomic environment, US Treasuries and UK bonds present compelling risk-adjusted returns. Disinflation, a dovish Fed bias, and a favourable carry make US Treasuries attractive, while weak UK growth and anticipated BoE rate cuts support gilts. With falling yields on the horizon, US Treasuries (including TIPS) and UK bonds represent a strong investment opportunity for both domestic and international investors.

Our Investment Recommendations

Asset class	Zone	Our opinion	
Government bonds	Germany	=	Neutral on German sovereign bonds.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United Kingdom	+	We have turned Positive on UK government bonds.
	United States	+	We have turned Positive on US government bonds and TIPS.
Corporate bonds Investment Grade	Eurozone United Kingdom United States	+	• Eurozone, UK and US: Positive opinion. Prefer intermediate maturities in the US (up to 7 years) and up to 10 years in the eurozone. • Positive on convertible bonds in the eurozone.
Corporate bonds High Yield	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angels* and *rising stars.*
Emerging bonds	In hard currency	=	We are Neutral on EM hard currency bonds (sovereign and corporate).
	In local currency	=	We are Neutral on EM local currency government bonds.

Market Data

	10-year rate (%)	Spread (bp)	Spread change 1 month (bp)
United States	4.49	---	
Germany	2.38	---	
France	3.10	72	-10
Italy	3.48	110	-5
Spain	3.05	67	1
Portugal	2.91	53	6
Greece	3.27	89	14

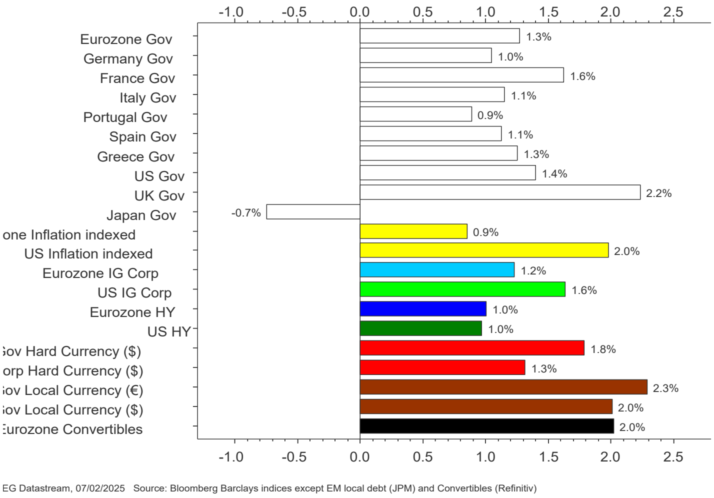
07/02/2025
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.64	33	-2
Corporate bonds IG EUR	3.10	92	-10
Corporate bonds IG USD	5.30	82	1
Corporate bonds HY EUR	5.58	295	-7
Corporate bonds HY USD	7.25	264	-7
Emerging government bonds in hard currency	6.84	236	-7
Emerging corporate bonds in hard currency	6.52	205	-2
Emerging government bonds in local currency	6.29	195	-8

07/02/2025
Source: Refinitiv Datastream, Bloomberg

Returns

OVER ONE MONTH



EM = Emerging Markets

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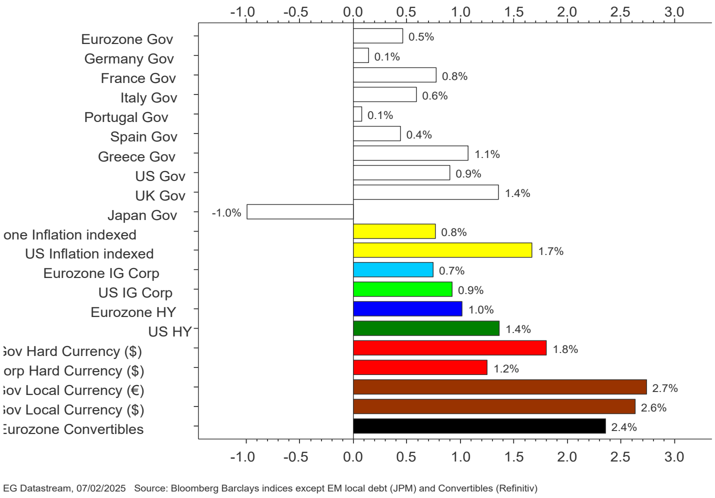

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