

# Fixed Income Focus

## Summary

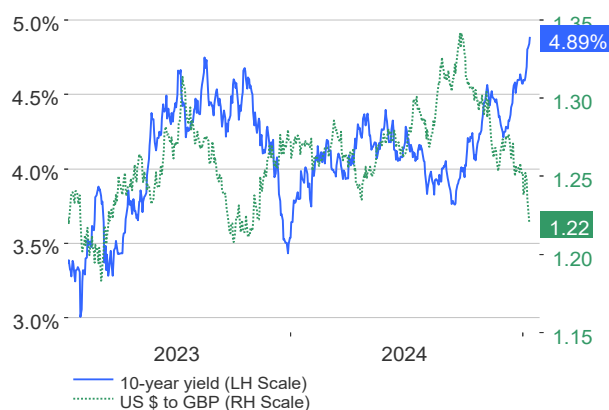
- 2025 started with a bang**, with rising geopolitical tensions ahead of Trump's inauguration, rising bond yields in most developed markets, a deluge of bond issuance and strong demand.
- Uncertainty in the US:** a resilient economy and doubts about Trump's policies, which will weigh on inflation expectations, coupled with a data-dependent Fed, make it difficult to predict the Fed's move this year. We expect two 25bp rate cuts this year and a terminal rate of 4% by the end of the year. The 10-year yield will be volatile, and our 12-month target is 4.25%.
- A more predictable eurozone:** weak growth and disinflation should support our view that the ECB will cut rates four times this year, ending the rate-cutting cycle with a key rate of 2% in September. We expect the German 10-year yield to fall to 2.25% in 12 months' time.
- Government bonds:** taking into account risk/reward and return expectations, we favour short-term US government bonds (positive view) and are neutral on long-term US and German government bonds over a 12-month horizon, with a short duration bias in the US (under 5 years) and a neutral duration bias in Germany (around 7 years).
- Theme in focus: EUR High Yield corporate bonds.** The strong performance of 2024 is unlikely to be repeated in 2025. We hold a neutral view on euro-denominated High Yield corporate bonds. While all-in yields are elevated, rich valuations present a risk, and both fundamentals and technicals may weaken, albeit from strong starting points. Total returns will depend heavily on carry, highlighting the importance of careful credit selection in a challenging economic environment.
- Opportunities in Fixed Income:** we are positive on US short-term Treasuries, US Agency Mortgage-Backed Securities, as well as European and US investment grade corporate bonds.

Drafting completed on 14 January

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### BOND VIGILANTES RETURNED TO THE UK, SELLING BOTH BONDS AND CURRENCY



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# Central banks

## Synchronised monetary easing (for now)

### European Central Bank (ECB)

**Higher inflation:** eurozone inflation rose to 2.4% year-on-year in December due to increased energy prices. However, this temporary spike is unlikely to deter the ECB from cutting rates in our view. We forecast inflation to hover around the 2% target throughout 2025. The ECB is expected to justify the next cut based on anchored inflation expectations close to target and waning economic momentum.

**Our view:** we maintain our expectation that the ECB will cut rates by 25bp at each of the two upcoming meetings (January and March), followed by cuts in June and September. We anticipate the ECB will conclude the rate-cutting cycle in September with a deposit rate of 2%. The market has slightly lowered its rate cut expectations to 86bp this year (see chart) and is pricing a terminal rate just below 2% in early 2026.

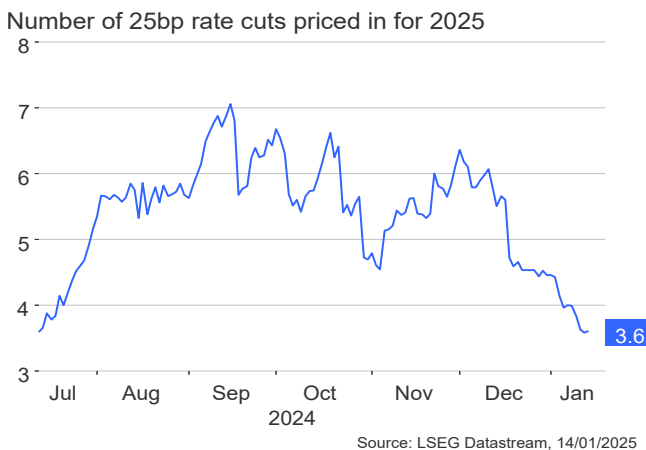
### US Federal Reserve (Fed)

**Pause:** the December FOMC minutes suggest that policymakers, after delivering 100bp of rate cuts in 2024, will pause.

**Tariff impact:** some policymakers asserted that tariffs are a one-time, non-recurring shock to price levels with no monetary relevance. However, the broader FOMC's view on this matter remains unclear. There are subtle indications of concern about a prolonged delay in inflation returning to 2%, potentially signalling worries about long-term inflation expectations.

**Our view:** based on the stronger-than-expected job market and our forecast for inflation to remain higher for longer, we have revised our base case to two 25bp rate cuts this year, down from three. We now expect the Fed to cut rates in June and December, concluding the rate-cutting cycle with a rate of 4%.

#### THE MARKET IS EXPECTING JUST UNDER 4 RATE CUTS IN THE EUROZONE



#### DRAMATIC REPRICING TOWARDS 1 RATE CUT IN 2025 IN THE US



#### INVESTMENT CONCLUSION

In our view, both the ECB and the Fed are poised to cut rates in 2025, albeit at different rates. We expect the ECB to cut more aggressively (four times), reaching a 2% deposit rate cut in September. The Fed, which faces a higher risk of inflation, may only cut twice. Both central banks remain data dependent, with economic growth and inflation trends guiding their decisions throughout the year.

# Bond yields

## Fresh new highs

Government bonds continued to sell off sharply on both sides of the Atlantic, extending the losses seen since early December.

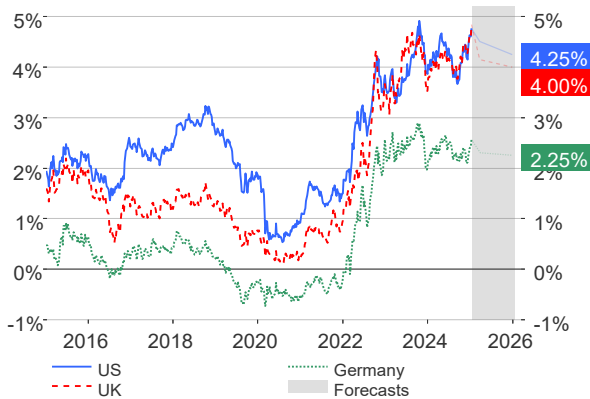
In the US, the 10-year yield climbed above 4.75%, driven by a strong labour market and a rising term premium, reflecting concerns about fiscal imbalances and inflation.

The UK also saw a sharp move, with bonds sold off aggressively alongside a weaker GBP as investors view the fiscal path as unsustainable.

A key question is when to increase duration. Uncertainty surrounding Trump's inauguration, strong US macro data and heavy bond issuance in January are key risks. We remain cautious on US duration for now and will review this view at the end of the month. However, we are more inclined to take duration risk in the eurozone, where the economy is slowing.

	Maturity (years)	13/01/2024	3-month target	12-month target
USA	Policy rate	4.50	4.50	4.00
	2	4.39	4.25	4.25
	5	4.61	4.30	4.25
	10	4.79	4.50	4.25
	30	4.97	4.75	4.50
Germany	Policy rate	3.00	2.50	2.00
	2	2.29	2.10	2.00
	5	2.40	2.15	2.10
	10	2.59	2.30	2.25
	30	2.81	2.55	2.50
UK	Policy rate	4.75	4.50	3.75
	2	4.60	4.10	3.60
	5	4.61	4.10	3.75
	10	4.89	4.15	4.00
	30	5.44	4.60	4.45

### 10-YEAR RATES



Source: Refinitiv Datastream, BNP Paribas WM

### INVESTMENT CONCLUSION

Taking into account risk/reward and return expectations, we favour short-term US government bonds (positive view) and are neutral on long-term US and German government bonds over a 12-month horizon, with a short duration bias in the US (under 5 years) and a neutral duration bias in Germany (around 7 years).

# Theme in Focus

## EUR HY corporate bonds

**Solid performance in 2024:** euro-denominated high yield (HY) corporate bonds delivered a strong performance in 2024, with a total return of 8.2% (see chart), mainly driven by spread compression. A supportive economic backdrop played a key role as falling inflation paved the way for European Central Bank rate cuts, reducing liquidity risks. Demand remained robust, with retail interest reaching record levels amid attractive all-in yields.

**More challenging outlook for 2025:** first, technical factors may be less supportive than in 2024, albeit from a strong base. We expect a positive net supply of bonds this year, marking the end of the shortage of EUR HY bonds. Second, while key metrics such as liquidity and leverage are currently stable, corporate fundamentals could weaken slightly due to sluggish economic growth. Indeed, the credit quality of the asset class has been gradually deteriorating over the past few quarters. Third, the economic environment remains uncertain, influenced by domestic political dynamics within the eurozone and global trade risks.

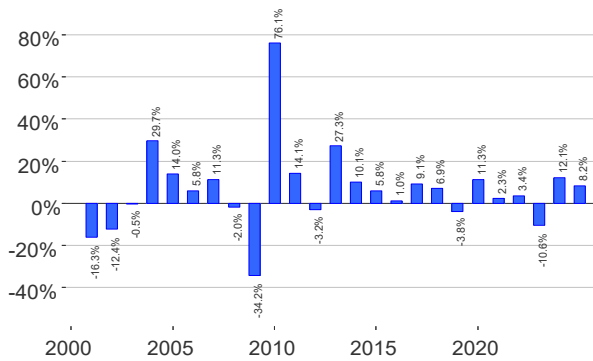
**Low default risk:** corporate defaults remain rare in Europe. The 12-month issuer-weighted default rate is 0.3% and we expect it to rise only slightly to 1.5% by the end of 2025, reflecting minimal default risk.

**Valuation concerns:** valuations remain a key concern for EUR HY (see chart). Credit spreads are tight across the spectrum, limiting the scope for further compression. BB-rated bonds trade at spreads around 200 bps below their historical average, while B-rated bonds are 280 bps below average. In contrast, spreads on CCC-rated bonds are closer to their historical norm.

**A bond picker's market:** with valuations elevated and dispersion likely to widen, the EUR HY market increasingly favours selective bond pickers. With limited upside from spread compression, total returns will be driven primarily by carry. Assuming a modest 25bp shift in HY spreads, total returns at the index level are forecast at 4.7%, comparable to the forecast for EUR investment grade (IG) bonds at 4.4%. However, EUR IG offers significantly lower return volatility than EUR HY, making it a more attractive option on a risk/return basis.

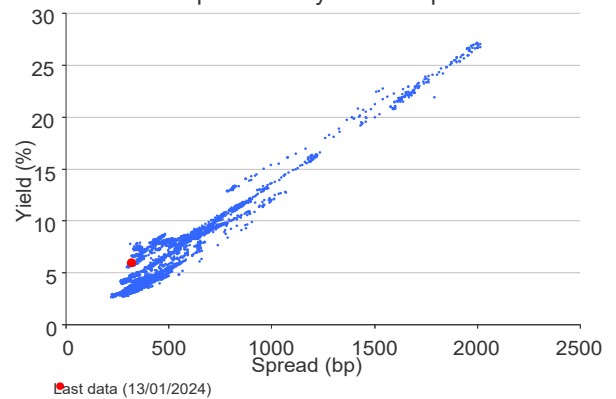
### EUR HY CORPORATE BONDS DELIVERED 8.2% TOTAL RETURN IN 2024

Yearly total returns of EUR HY corporate bonds since 2000



### SPREADS HAVE RARELY BEEN SO TIGHT AT SUCH LOW YIELD LEVELS

Historical relationship between yield and spread



#### INVESTMENT CONCLUSION

The strong performance of 2024 is unlikely to be repeated in 2025. We hold a neutral view on euro-denominated High Yield corporate bonds. While all-in yields are elevated, rich valuations present a risk, and both fundamentals and technicals may weaken, albeit from strong starting points. Total returns will depend heavily on carry, highlighting the importance of careful credit selection in a challenging economic environment.

## 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 States	+ =	We are positive on US short-dated government bonds, and tactically neutral on long-dated ones. We're looking for a better entry point on long-dated bonds. We are also neutral on US TIPS.
Corporate bonds Investment Grade	Eurozone	+	<ul style="list-style-type: none"> <li>Eurozone and US: Positive opinion. Prefer short maturities in the US and up to 10 years in the eurozone</li> <li>Positive on convertible bonds in the eurozone.</li> </ul>
	United States		
Corporate bonds High Yield	Eurozone and United States	=	<ul style="list-style-type: none"> <li>Neutral on HY bonds.</li> <li>Positive on <i>fallen angels</i> and <i>rising stars</i>.</li> </ul>
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	4,79	---	
Germany	2,59	---	
France	3,46	86	8
Italy	3,83	124	10
Spain	3,31	71	5
Portugal	3,08	49	2
Greece	3,48	89	8

13/01/2025  
Source: Refinitiv Datastream

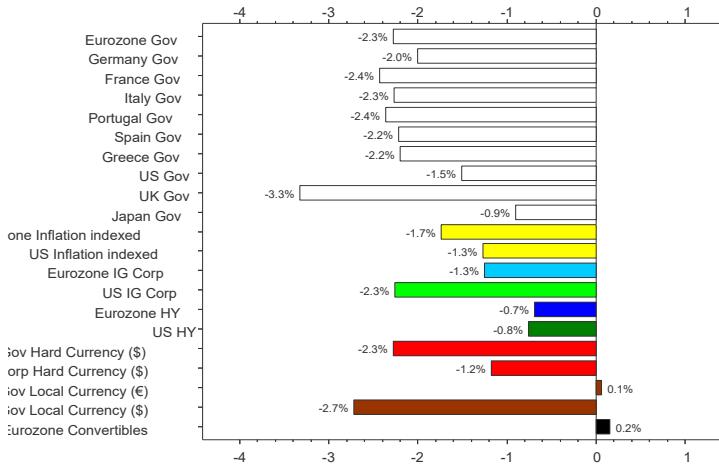
	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3,86	35	1
Corporate bonds IG EUR	3,42	102	4
Corporate bonds IG USD	5,54	81	6
Corporate bonds HY EUR	5,98	319	22
Corporate bonds HY USD	7,59	278	16
Emerging government bonds in hard currency	7,23	248	0
Emerging corporate bonds in hard currency	6,75	207	5
Emerging government bonds in local currency	6,46	185	11

13/01/2025  
Source: Refinitiv Datastream, Bloomberg



# Returns

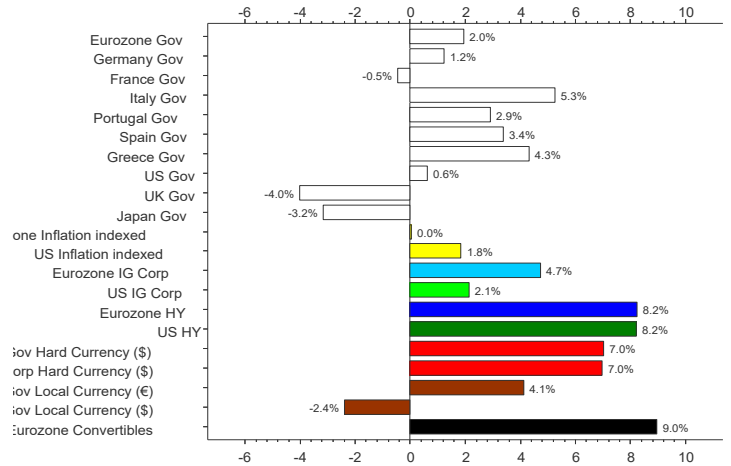
## OVER ONE MONTH



EG Datastream, 13/01/2025 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

## IN 2024



EG Datastream, 31/12/2024 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

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Senior Investment Advisor

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Chief Investment Strategist

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