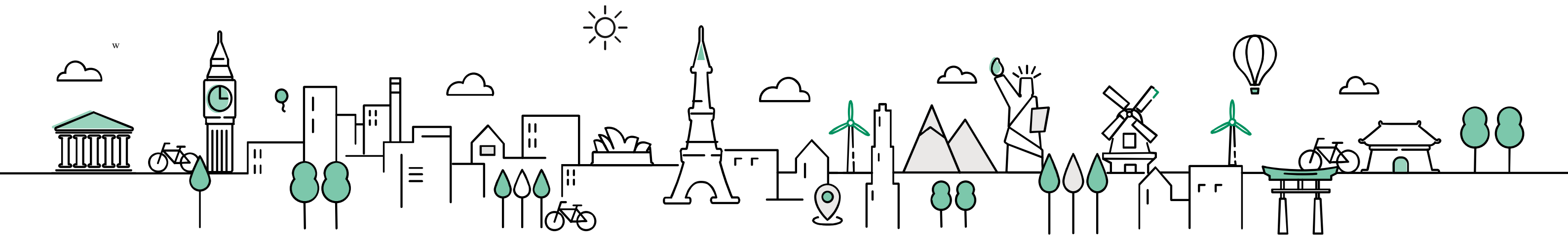

Fixed Income Outlook – 1Q21

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- **Reflation driven by US fiscal stimulus and the exit from lockdowns should lead to modestly higher inflation expectations and nominal bond yields**

- **A renewed 'taper tantrum' is unlikely as excess capacity and high unemployment rates will prevent inflation from reaching a level that would prompt either the US Federal Reserve or the ECB to signal a change in monetary policy**

- **While corporate credit spreads are tight, robust economic recoveries this year should permit positive returns from carry**

- **Emerging market debt spreads are attractive compared to developed market counterparts; improving capital accounts and the return of investor flows should support local currency returns**

FROM DESPAIR TO HOPE

Investor sentiment has swung from despair last spring about the coronavirus pandemic to hope for a return to normality later this year. The path is not smooth, however, and the fortunes of financial markets continue to be driven by COVID-19 infection rates, virus mutations, vaccine development and rollouts, lockdowns, and the fiscal and monetary policy responses.

The near-term hurdles should eventually be overcome, however, and we believe the arrival of the eagerly awaited post-pandemic world has only been temporarily delayed. Another reason for optimism is further fiscal stimulus in the US, though the exact amount and timing are not yet known. Central banks are accommodating fiscal stimulus by purchasing enough government bonds to prevent real yields from rising. These factors should enable an accelerated recovery in economic growth in the second half of the year.

"THE COVID-19 VACCINES ARE GAME-CHANGERS."

GOVERNMENT BONDS AND INFLATION

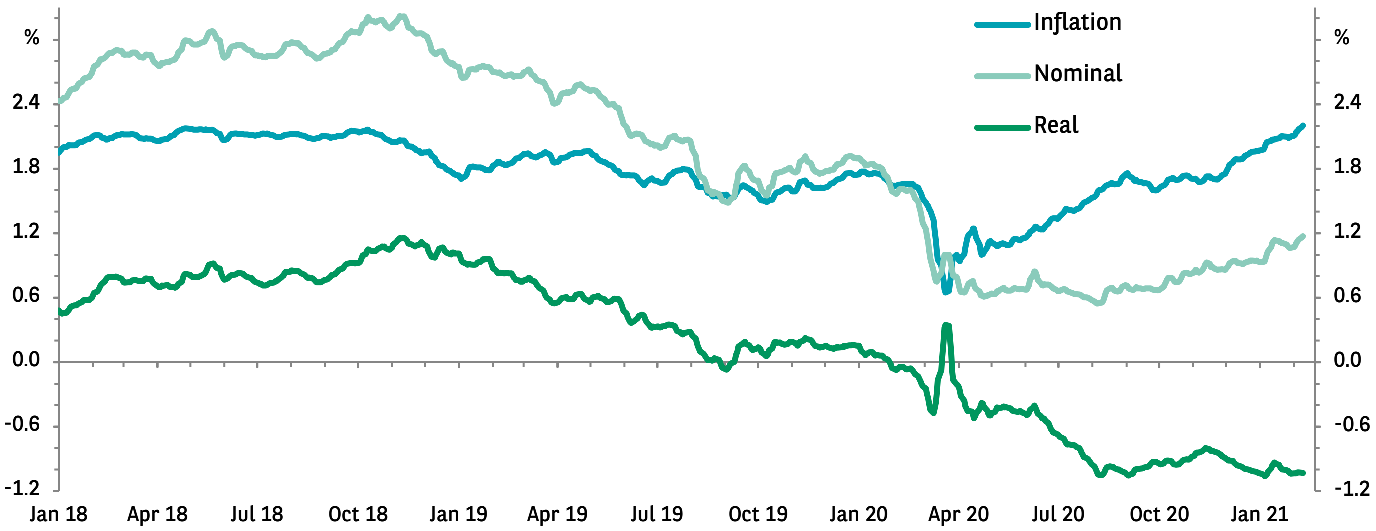
United States

The COVID-19 vaccines are game-changers as long as they can be distributed quickly enough and prove to be robust against emerging strains of the coronavirus. Global deployment of vaccines would mean most public health restrictions could be removed, possibly in the second quarter of 2021, lifting the aggregate supply side of the economy.

Monetary policy, however, has largely exhausted its options for providing new stimulus. At this point, its role is to accommodate fiscal stimulus by purchasing the amount of Treasury issuance required to prevent real yields from rising. Only fiscal policy is now able to provide a significant impulse to growth. In this context, the Democrats' sweep of the White House and Congress sets the scene for a highly expansionary fiscal stance that should support aggregate demand.

We expect unprecedented coordination between fiscal and monetary policy, i.e. the administration and the US Federal Reserve. This means monetary policy will only be tightened once the economy is at full employment. Given the Fed's Flexible Average Inflation Targeting (FAIT) framework, a tapering of asset purchases and eventual interest rate increases should be some way off – but not as far off as would have been the case without the Georgia Senate seat wins. If it is to be credible, an AIT framework should keep real yields low and push breakeven inflation (BEI) wider (see Exhibit 1).

Exhibit 1: Nominal yields, real yields and inflation
10-year yields



Data as at 10 February 2021. Source: Bloomberg, BNP Paribas Asset Management

While we expect much higher Treasury bond issuance, the impact of this additional supply on real yields should be limited. The Fed will purchase a large proportion of the net supply, given that it is adding USD 960 billion of Treasuries per year to its balance sheet. We believe that the Fed would react to an increase in real yields that threatened the recovery and/or equity markets. Instead of worrying about supply, we think the bigger concern for duration positions is that the Fed may taper its asset purchases earlier if the economy returns to full employment faster. We see a modest further bear steepening of the real yield curve as warranted as investors reassess the fiscal and growth outlook.

At the same time, the combination of fewer supply constraints, the injection of fiscal stimulus, the boost to confidence from vaccines and a supportive monetary policy ought to be highly supportive of risk assets and commodity markets. The impact on inflation will likely be modest in the near term, but the prospect of the economy returning to full employment at a fast clip ought to generate price pressures in due course, especially if the Fed delays any monetary tightening until actual evidence of higher inflation emerges.

The Fed's commitment to its Flexible Average Inflation Targeting framework, however, is not assured, and policymakers will need to build their inflation-boosting credentials. The Fed chose to adopt the weakest form of AIT, and has not followed up with a more forceful policy stance, so we are left to conclude that the consequences of the framework change will only be observable when the economy does return to full employment and inflation pressures emerge. Given the Fed's history of under-delivery, some investors can be expected to be reluctant to buy break-even inflation (BEI) simply because of a change to the policy framework. This can provide an opportunity if it becomes clear that the Fed is serious about tolerating inflation overshoots, or if it becomes clear that the output gap will close more quickly than anticipated.

While a significant output gap is now putting downward pressure on underlying inflation, the prospect of a rapid reopening of the economy in the context of a highly expansionary fiscal and monetary policy mix means that we are now more constructive on the near and medium-term prospects for underlying inflation in the US.

Longer term, the Biden administration's focus on reducing inequality is likely to mean legislation that supports unionisation, increased worker benefits, and higher minimum wages. A protectionist stance on China would reverse some of the disinflationary impact of globalisation. A Fed focused on fulfilling its average inflation goal would help. It is not clear whether these factors will overwhelm the structurally disinflationary forces of technology, but we believe the odds of a pick-up in inflation are higher today than they were before the pandemic.

Eurozone

Unlike in the aftermath of the 2012/2013 sovereign debt crisis where the eurozone saw austerity and strengthening fiscal rules as a path to rebuilding sovereigns' debt sustainability and credibility, this time around aggressive fiscal responses have been a common feature from the onset of the coronavirus crisis across regions. European governments have deployed a range of fiscal programmes to help absorb the economic shock brought by lockdown measures and to strengthen automatic stabilisers. These measures included furlough schemes to keep workers on payrolls, direct loans to companies and large-scale guarantees of bank loans. They were designed to avoid a liquidity crisis and widespread bankruptcies, thereby preserving the supply capacity of the economy. The EU Commission estimated that the eurozone ran an aggregate budget deficit of 8.8% in 2020, of which roughly 4% can be classified as discretionary fiscal spending, representing a rapid and strong fiscal response to the coronavirus crisis.

Looking ahead, while emergency support is expected to begin to unwind in 2021, national governments remain committed to doing what is necessary to mitigate the economic impact of the pandemic in the foreseeable future – some emergency measures have been extended and new packages have been adopted for the 2021 fiscal budgets. There appears to be no appetite for austerity at this stage, and EU authorities are willing to put aside the fiscal straitjacket. Fiscal rules in the Stability and Growth Pact have been suspended until the end of 2021, and the suspension will likely be extended to the end of 2022. Germany has also suspended its constitutional debt brake, and remains open to continued fiscal support.

The easy fiscal stance is underpinned by ECB accommodative policies. With PEPP purchases keeping interest rates low, there is little endogenous or exogenous pressure on eurozone governments to address the fiscal deficits left behind by the pandemic. As such, despite the high and rising level of government debt, member states intend to take advantage of the favourable financing conditions and run larger-than-usual deficits over the coming two years. Based on individual member states' draft budget proposals, the aggregate eurozone budget deficit is forecast at 6.4% of GDP in 2021, and 4.4% in 2022.

In addition to national governments stepping up to the plate, the EU agreed to a number of programmes to complement the fiscal efforts. The emergency rescue package would provide funding sources for EU member states, including a EUR 100 billion programme known as Support to mitigate Unemployment Risks in an Emergency (SURE) to finance partial unemployment and avoid job losses, as well as EUR 240 billion in loans via the European Stability Mechanism (ESM) with mild conditionality. More importantly, in late July 2020, the EUR 750 billion Recovery Fund (also known as Next Generation EU, or NGEU) as well as the EUR 1.07 trillion multi-year EU budget (also known as the Multiannual Financial Framework, MFF) were agreed. Within the recovery fund, an important element known as the Recovery and Resilience Facility (RRF) is designed to provide fiscal support for wide-ranging investment projects over the coming years. Collectively, these EU-wide programmes provide resources that are much needed to mitigate economic scarring by the pandemic, as well as high-multiplier investment spending which will help drive the recovery and further support growth.

From a political standpoint, it is worth highlighting that the recovery fund has set a precedent for coordinated, central fiscal support in response to an economic shock. The transfer from the fiscally stronger northern member states to the worst impacted countries should provide much needed economic stimulus in the recovery phase, and reduce the risk of a two-speed Europe, which would be politically divisive. Another benefit is that the recovery fund creates a new, common European 'safe asset', which will become a standing feature for the European fixed income market for years to come given the bonds' long redemption schedules.

The ECB's messaging seems aimed at reassuring investors that monetary support will last throughout 2021 to ensure easy financial conditions are preserved until widespread vaccinations allow the economy to return to normal. The focus on preventing any tightening in monetary conditions suggests that the ECB is effectively operating an informal yield and spread curve control framework. There is considerable flexibility in the PEPP to allow the ECB to adjust the pattern of purchases according to market conditions: if spreads widen in any systemically important segment, the ECB should increase purchases in that market. In practice, we can surmise that the ECB is particularly sensitive to a widening in sovereign bond spreads. In fact, the de facto yield and spread curve control framework means that the weaker commitment on the quantity of purchases is not alarming, but logical – if the goal is to set the levels of yields and spreads, the ECB must be willing to vary the quantity of purchases, instead of setting it in advance.

Barring any significant, unforeseen economic shocks, and with a large PEPP envelope already in place, the monetary policy path is largely laid and the ECB may not need to make significant changes to it in the near term. The focus in the coming quarter will likely be on the ECB's strategy review, which is due to be concluded by mid-2021. President Lagarde discussed some preliminary considerations for the ECB's monetary policy strategy review in a speech at the ECB and Its Watchers conference at the end of September 2020. In essence, through the "ECB Listens" programme, the ECB will:

- Examine how to formulate the inflation aim, to ensure that the target is perceived to be symmetric and easy to understand by the public.
- Determine the horizon over which price stability should be achieved by examining the merits of an inflation 'make-up' strategy that would take into consideration a backward-looking element of past inflation misses.
- Consider improvements in measuring inflation such as including owner-occupied housing costs when measuring price changes as well as a potential target shift from overall HICP to underlying inflation.

A rethinking of monetary policy transmission and effectiveness in a world where monetary policy everywhere has approached the lower bound is warranted. President Lagarde pointed out that the ECB must prepare for the likely scenario in which unconventional policy tools become more 'normal', that a clear consensus is needed on what tools are available for the ECB when inflation is too low, and how these tools should be systematically deployed in response to different types of economic shocks. Also, the ECB will need to reflect on the interactions between monetary and fiscal policies. She argued in favour of better coordination of monetary and fiscal policy as the goals of fiscal and monetary policies are naturally aligned in disinflationary conditions when the economy is running below its potential. Climate change is also high on the ECB's agenda. Lagarde advocated factoring in the implications of climate change in the ECB policy framework as climate change affects economic output, inflation, long-term interest rates and policy transmission, and the failure to do so may affect the central bank's ability to protect price stability against large and persistent climate shocks. In fact, the ECB is already working on the possibility of having a 'carbon filter' applied to assets that it purchases.

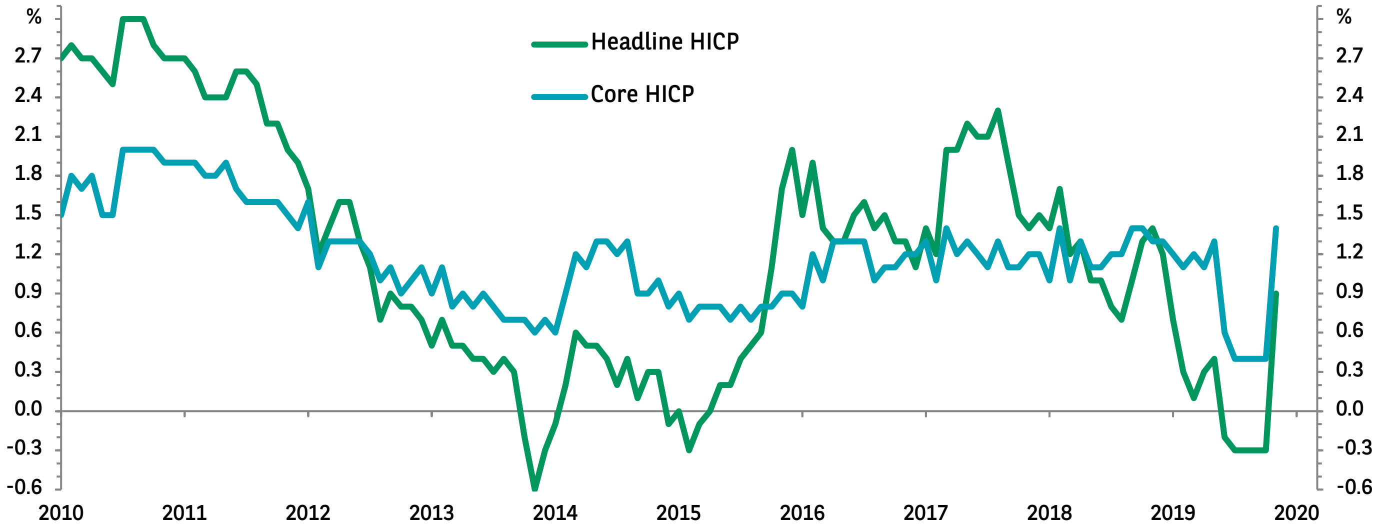
While mobility restrictions have been extended in early 2021 as high COVID-19 caseloads and more transmissible virus variants threaten to put further strain on the healthcare system, we expect market sentiment to remain positive as investors look through the near-term difficulty to a much-anticipated return to normal thanks to vaccine rollout and ample monetary and fiscal policy support. Vaccinations have already started, and more vaccines will likely be approved in the coming months as more trials reach completion. The ECB's continued support for easy financial conditions was clearly laid out with the expansion of its PEPP programme, and with the final sign-offs on the EU Recovery Fund secured and national fiscal budget approved, coordinated monetary and fiscal accommodation will provide very favourable conditions for the economic recovery once lockdown measures can be scaled down.

The long-term challenges of returning inflation to target nonetheless remain. With the ECB's implicit yield and spread curve control framework focusing on preserving easy monetary conditions, fiscal policy will have to do the heavy lifting in terms of moving inflation closer to target, although technical changes to the HICP basket, the reversal of the German VAT cut in January, the implementation of a carbon tax, as well as base effects from energy prices will propel headline inflation back into positive territory in the coming months (see Exhibit 2). Apart from these one-off factors, core inflation will likely remain subdued given the level of excess capacity and the recent strength of the euro. Inflation is expected to remain far weaker than the ECB's current 'below but close to' 2% target throughout 2021, even if it is higher than in 2020. Consequently, the ECB is expected to maintain a very accommodative stance, and a discussion on a normalisation of monetary policy is unlikely to come up in the coming quarters. At the same time, if the ECB deploys its PEPP envelope in full, the size of the central bank's purchases of European government bonds will be larger than that net supply, taking QE-adjusted net supply to a negative EUR 300 billion.

In duration, while the prospect of an improving growth and inflation outlook may drive government bond yields higher, we expect the sell-off to be contained by the expected prolonged accommodative monetary policy stance and the negative net supply backdrop. As such, we expect Bund yields to stay in a range between -0.6% and -0.3% in the coming quarter. We would expect to put on an underweight in duration whenever Bunds reach the lower end of the range.

In BEI, we expect 5-year/5-year forward Euro HICP BEI to move within a 1.2% to 1.4% range, reflecting the dichotomy of the disinflationary impact from the economic scarring and excess capacity left by the pandemic and the optimism on global reflation as the world emerges from the pandemic awash in liquidity. We see the ECB's framework review more likely to result in an elimination of the ambiguous 'below but close to' 2% inflation target and shift to a symmetrical approach to dispel the perception of a 2% target as a ceiling. We believe it is, however, unlikely that the ECB will follow the Fed's lead in adopting an AIT framework. As such, we are neutral on breakeven inflation, but we favour shorter-dated securities on the real yield curve as they should benefit more from the upcoming technical rebound in HICP prints.

Exhibit 2: Eurozone inflation



Data as at 10 February 2021. Source: Eurostat, BNP Paribas Asset Management

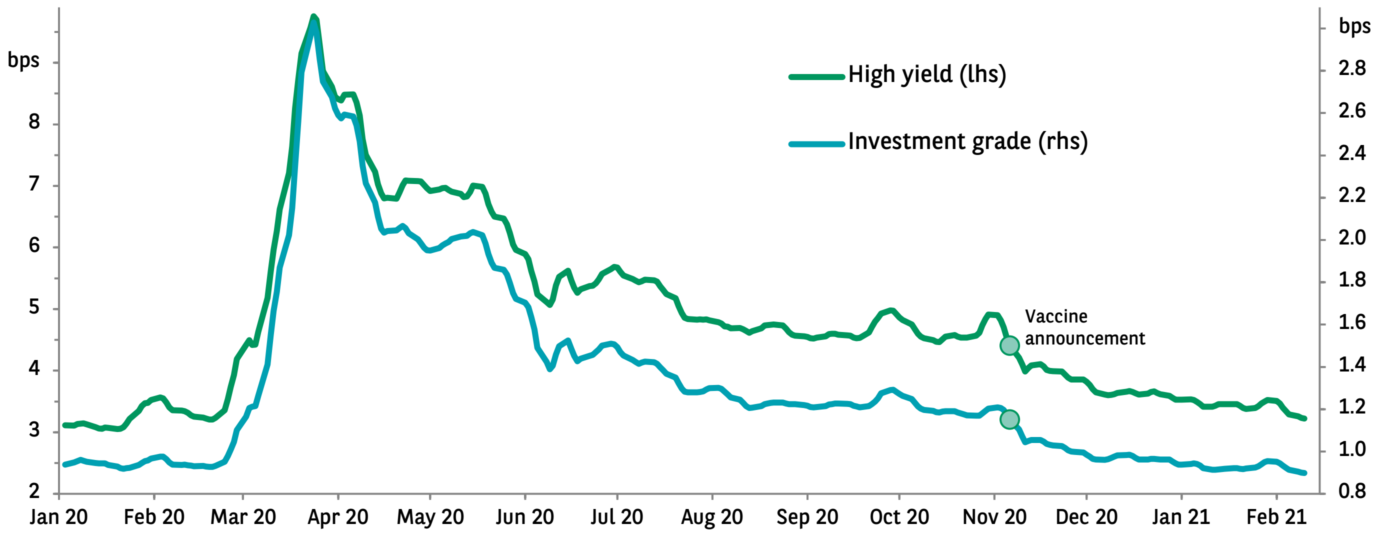
In country selection, we are adjusting our tactical allocation to Italy depending on the evolving political events. Our medium-term view is still positive, however, and we believe fresh elections will be avoided, although they remain a risk. The ECB responses and the creation of the EU Recovery Fund have shown the ECB's determination in squashing fragmentation risks and concerns over political solidarity during the pandemic. The one-third reduction in the total number of MPs as a result of the successful constitutional reform referendum means that from the individual MP's standpoint, they are less likely to be re-elected, and therefore would prefer to avoid an early election. The capacity to deploy EU recovery funds allocated to Italy in the coming years is a strong incentive for the coalition parties to seek a workable majority to govern. Given the search for yield and limited political risk in Italy, we expect BTP-Bund yield spreads to re-compress following any widening.

CORPORATE CREDIT

The rally in equities since the announcement of successful vaccine trials last November has been mirrored in corporate credit spreads, which have largely reverted to pre-pandemic levels (see Exhibit 3).

Exhibit 3: Corporate credit spreads

Average of US and European option-adjusted spreads



Data as at 10 February 2021. Source: FactSet, BNP Paribas Asset Management

It is difficult to argue that corporate bond risk is the same today as it was in early 2020. Corporate profits have collapsed, while debt levels have leapt. Extended lockdowns and/or reluctant consumers threaten the long-term viability of many businesses. Downgrades and bankruptcies will likely remain elevated or continue to rise. A positive medium-term economic outlook, continued demand from investors for credit (as opposed to government debt), relatively modest investment-grade issuance (at least in Europe), central bank support via policy rates and corporate bond purchases, and finally robust recoveries over the course of the year all suggest that spreads will remain compressed. Valuations are nonetheless challenging and we do not foresee further spread compression; if anything, a modest widening is possible if lockdown restrictions are extended for even longer in Europe, or the more contagious virus mutations spread more broadly in the US.

Given the similarly low level of spreads in both the US and the eurozone, we are neutral between the two regions, although we remain positive on 'peripheral' markets. The broad reflation trade over the last few months, while not a one-way street, should continue to benefit financials relative to industrials, although we prefer non-cyclicals to cyclicals given the slower recovery we expect in the eurozone. For example, the food, beverage, and home and personal care sector should prove resilient even if lockdowns are extended (with the exception of beverages segments exposed to bar and restaurant demand). The poor risk-reward available currently in high-yield calls for a greater focus on issuers, while we await a more attractive entry point.

EMERGING MARKETS

Despite the consensus, bullish view on emerging markets for this year (80% of investors were positive on the region, according to a recent survey by BofA Global Research), there are grounds to be cautious. Expectations in particular for good returns in local currency emerging market debt have so far been disappointed.

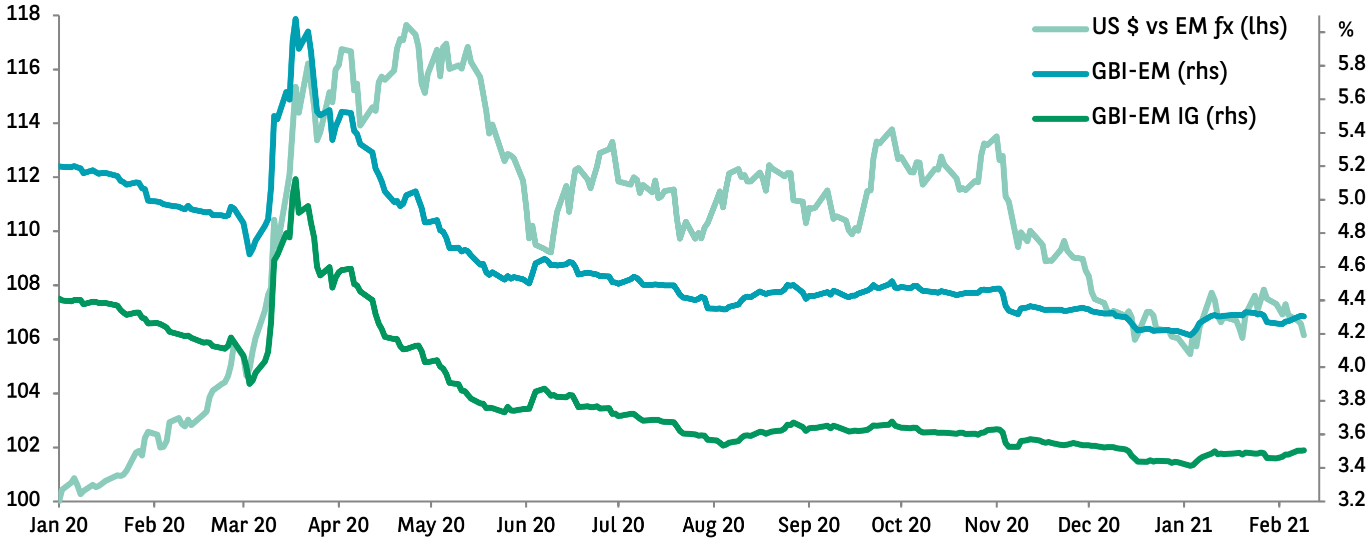
Emerging markets are expected to perform better this year thanks to a weaker US dollar, a better relationship with the new US administration, a recovery in global economic activity (to which emerging markets are very exposed), and a return of foreign investor flows. Offsetting this are structural vulnerabilities and the region's lagging recovery from the pandemic lockdowns.

Emerging markets have seen similar declines in GDP to developed markets, but will be far slower to vaccinate their populations, hindering the rebound. The massive fiscal stimulus coming in the US will dampen investor enthusiasm for emerging markets when reasonably high economic growth rates will be available in America with less political and foreign exchange risk. The economic growth that emerging markets are seeing is concentrated in Asia, while Latin America remains a laggard. As a result of the recessions and slower recovery, inflationary pressures are likely to be contained, although divergences between countries will open up over the course of the year. Rising commodity prices could push up prices more broadly, but the correlation between food and energy prices and headline inflation has been weaker over the last five years.

Investor interest has focused more on emerging market equities than debt. Flows to EM equities turned positive over the last couple of months, while they remain negative for debt. Foreign holdings of local currency government debt are still below 4q19 levels in many countries. With real policy rates expected to remain negative or at least very low in 2021, a quick turnaround in flows is not assured.

The disappointing flows, however, are one reason we are optimistic about the asset class. We expect flows to eventually normalise, which should support markets. Strong export growth will lead to improved capital accounts over the course of the year and external liquidity remains sound overall. The hunt for yield has not ended and with sentiment improving, emerging markets will benefit. Emerging market spreads have recovered from last year's sell-off, but unlike credit spreads, they have not entirely returned to pre-pandemic levels (see Exhibit 4).

Exhibit 4: Emerging market currency index and debt spreads



Data as at 10 February 2021. Source: J.P. Morgan, BNP Paribas Asset Management

Leverage levels for EM corporates have remained below developed market peers, even during the pandemic. In addition, EM cash balances relative to total debt have held steady.

High-yield credit spreads relative to developed market counterparts look attractive, with idiosyncratic stories worth seeking out. We are more cautious on investment-grade credit given our expectation of a rise in US Treasury yields. We expect EM currencies to gain against the US dollar thanks to foreign inflows and for valuation reasons (the dollar is still stronger vs an EM basket than it was before the sell-off while it is weaker against DXY). Most emerging market central banks are at the end of their rate cutting cycle and inflation could surprise to the upside as oil and food prices rebound. We are looking at selective opportunities at the long end of high yielders, and inflation-linked bonds look attractive again.

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