Fixed Income Focus

Summary

1. **ECB: Nearing the endgame.** The ECB delivered another rate cut in June amid falling inflation forecasts, bringing the policy rate to 2%—the midpoint of its neutral range. Lagarde signaled the easing cycle is nearly done, with one more cut likely (most plausibly in September) before a policy pivot in late 2026.
2. **Fed on hold:** The Fed is holding steady as disinflation progresses. Caution prevails due to fiscal risks and potential tariff shocks. We see cuts starting in September and December, ending with a 3.50% terminal rate in 2026.
3. **Revised bond yield targets:** We have increased our 10-year yield targets over the next 12 months to 2.75% in Germany and 4.20% in the UK, while maintaining our target of 4.25% in the US. We remain Positive on core EU, US and UK government bonds, favouring intermediate maturities. Bunds remain a safe-haven asset during turbulent times.
4. **Topic in focus: Japan's bond market awakening.** Japan's move towards monetary normalisation represents a significant structural shift. The Ministry of Finance is managing this transition by considering both buybacks and adjustments to issuance, which should help mitigate the risk of abrupt, destabilising global capital flows. Japanese investors are likely to remain selective buyers of foreign bonds. The overall pace of capital reallocation is likely to be gradual. We anticipate further rate hikes and higher bond yields ahead. Consequently, we are avoiding Japanese government bonds at this time.
5. **Opportunities in Fixed Income:** In addition to core eurozone, US and UK government bonds, we are Positive on US Agency Mortgage-Backed Securities, US TIPS, and eurozone and UK investment grade corporate bonds.

Drafting completed on 12 June

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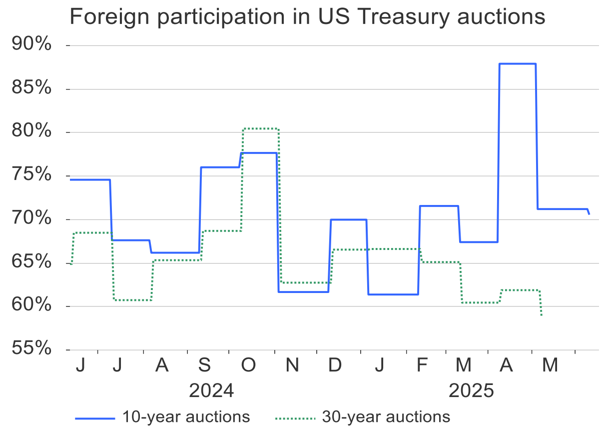
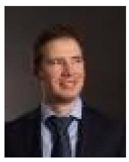
CHART OF THE MONTH: NON-US INVESTORS HAVE BEEN REDUCING THEIR PARTICIPATION IN US TREASURY AUCTIONS DUE TO CONCERNS OVER US POLICY, THE DEFICIT AND DEBT



Source: LSEG Datastream, 11/06/2025



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Central banks

Fed holds, ECB moves

European Central Bank (ECB)

Another cut: In June, the ECB cut rates again in light of the significant downward revision to the near-term inflation forecast (see chart). However, President Lagarde cautioned against placing too much importance on the staff forecasts, stating that they are largely influenced by technical assumptions regarding energy prices and the euro exchange rate.

Almost done: The policy rate is now at 2%, which is at the midpoint of the ECB's estimated neutral range (1.75–2%).

Our view: We continue to expect one final rate cut to conclude the cycle. This view is supported by Lagarde's assertion that the cutting cycle is 'nearly' over, by the fact that projections imply another cut and by the risks stemming from asymmetrical trade policy. However, divisions among policymakers make it less likely that this will happen in July, with a greater likelihood in September. We anticipate two rate hikes in the second half of 2026, as the ECB shifts its focus to fiscal policy in Germany and elsewhere.

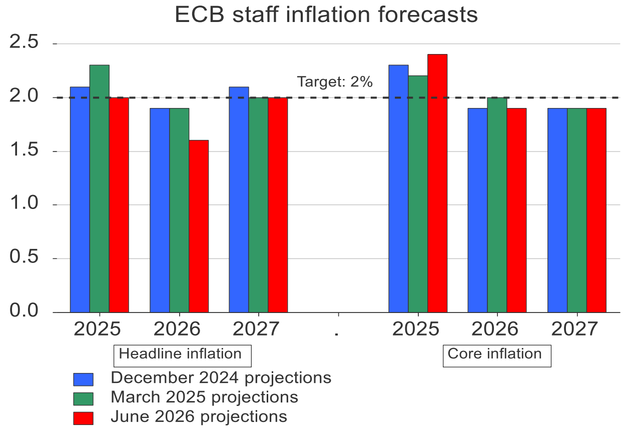
US Federal Reserve (Fed)

Fed pause: Progress on disinflation is visible, with the core PCE index reaching 2.5% in April — the lowest figure since 2021 — yet inflation remains above the target level. This has prompted the Fed to adopt a patient stance, especially given the uncertainties surrounding Trump's tariff policy and the ongoing fiscal looseness, both of which could potentially fuel inflation and restrict the Fed's ability to ease policy.

Our view: We continue to anticipate rate cuts in September and December, followed by two more in 2026. This would result in a terminal rate of 3.50%. However, markets are currently pricing in two cuts this year and a lower terminal rate of 3.30%.

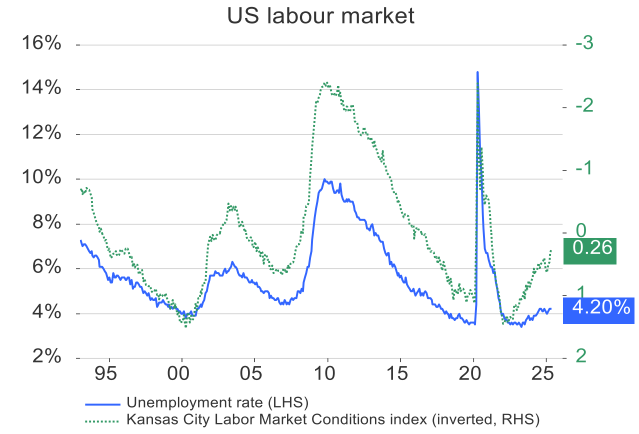
Jobs watch: Key watchpoints include the labour market (see chart), as the Fed is expected to act swiftly if the job market deteriorates. For now, however, concerns about unemployment are muted. Further data is required to evaluate the impact of soft indicators (surveys) on hard economic outcomes.

A MATERIAL DOWNWARD REVISION TO THE NEAR-TERM INFLATION FORECAST



Source: LSEG Datastream, 06/06/2024

THE LATEST KANSAS CITY LABOR MARKET CONDITIONS INDEX POINTS TO A HIGHER UNEMPLOYMENT RATE TO COME



Source: LSEG Datastream, May 25

Investment Conclusion

In the US, we are anticipating two cuts in 2025, followed by a gradual easing into 2026, with a terminal rate projected to be 3.5%. In the eurozone, we expect one last rate cut to conclude the easing cycle, leading to a terminal deposit rate of 1.75% this year, in September rather than July. We anticipate two rate hikes in the second half of 2026.

Bond yields

Deficits and yield drift

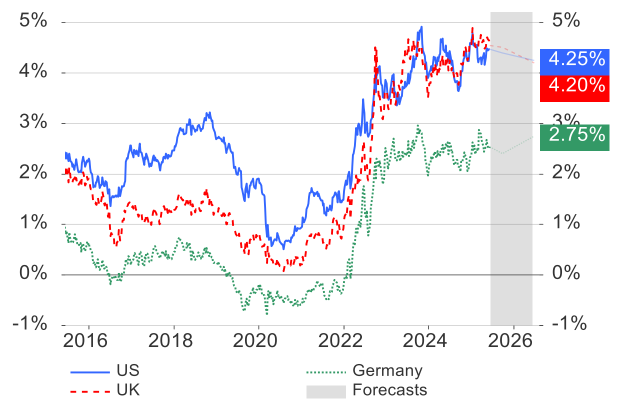
Since the beginning of April, global bond curves have bear-steepened, with long-term rates reaching multi-year highs in the US, Germany and Japan. This increase is primarily due to higher term premia, which reflect elevated fiscal risk and supply-demand imbalances, particularly in the US. The US term premium has risen to its 30-year average of 0.8%.

Drivers for higher bond yields vary: in the US, it's the 'America First' policy, debt concerns and weak long-end auctions; in Germany, higher defence spending; in Japan, inflation and weak super-long-end auctions; and in the UK, persistent inflation.

Long-term bond yields peaked in mid-May, as anticipation grew that Japan would reduce long-term issuance, and positive news emerged regarding inflation and US-China trade relations. This boosted investor demand.

We changed our recommended maturities from short to intermediate in the US and from long to intermediate in Germany, having increased our 10-year Bund yield target to 2.75%.

10-YEAR RATES



Source: LSEG Datastream, 12/06/2025

	Maturity (years)	11/06/ 2025	3-month target	12-month target
USA	Policy rate	4.50	4.25	3.50
	2	3.94	3.75	3.60
	5	4.01	3.75	3.75
	10	4.41	4.40	4.25
	30	4.91	4.75	4.50
Germany	Policy rate	2.00	1.75	1.75
	2	1.85	1.75	2.00
	5	2.13	2.00	2.15
	10	2.54	2.50	2.75
	30	3.03	3.00	3.25
UK	Policy rate	4.25	4.00	3.50
	2	3.91	3.80	3.60
	5	4.05	4.00	3.75
	10	4.55	4.50	4.20
	30	5.28	5.20	4.75

Source: Refinitiv Datastream, BNP Paribas WM

Investment Conclusion

We have increased our 10-year yield targets over the next 12 months to 2.75% in Germany and 4.20% in the UK, while maintaining our target of 4.25% in the US. We remain Positive on core EU, US and UK government bonds, favouring intermediate maturities. Bunds remain a safe-haven asset during turbulent times.

Topic in Focus

Japan's bond market awakening

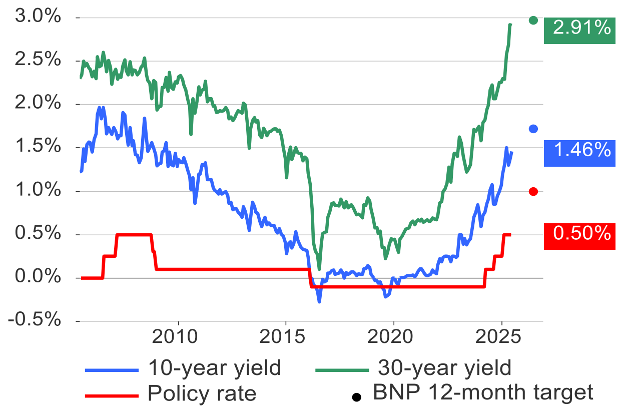
A new dawn for Japanese yields: The Bank of Japan's move away from negative interest rates and its gradual loosening of yield curve control have pushed Japanese government bond (JGB) yields to levels not witnessed for years (see chart). This reflects both domestic inflationary pressures and the BoJ's decision to raise interest rates.

Life insurers: Caught in the crossfire: Japanese life insurers, who hold around 13% of outstanding JGBs, have seen their portfolios suffer as bond prices have fallen in response to rising yields. This means that these unrealised losses are reducing their capital buffers, which could limit their ability to absorb further JGB supply or participate actively in upcoming auctions. While most insurers hold bonds to maturity and are not forced sellers, the scale of these losses has raised concerns about liquidity and the risk of a self-reinforcing sell-off. The Ministry of Finance (MoF) has responded proactively by soliciting feedback from primary dealers regarding optimal issuance volumes across different maturity periods, with the aim of adjusting supply in order to stabilise the market.

Repatriation fears: Fact or fiction? The sharp rise in JGB yields has reignited fears of a large-scale repatriation of Japanese capital from overseas bond markets, particularly US Treasuries. However, this narrative warrants nuance. While higher domestic yields do provide Japanese investors with more attractive local options, a mass exodus from foreign assets is unlikely.

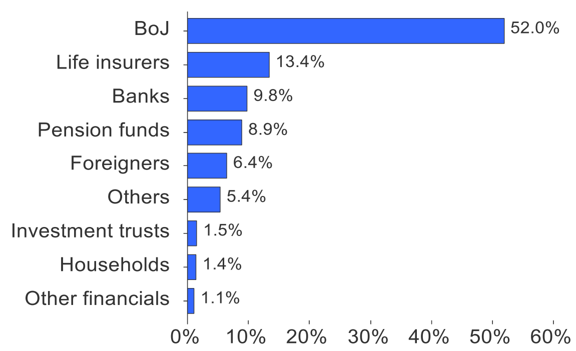
Diverse motives: Japanese investors are far from homogeneous. Large institutions, such as life insurers and pension funds, typically hold bonds to maturity and are not forced sellers. Furthermore, although hedged investors, such as banks and life insurers, may reduce their exposure to foreign bonds when hedging costs rise, as was seen in 2022, unhedged investors, such as pension funds, are willing to diversify their assets, tolerate currency risk, and have benefited from yen depreciation. The BoJ, which still holds roughly half of the JGB market, is not expected to become a net seller, further limiting the risk of disorderly market moves.

LONG-TERM BOND YIELDS HAVE SURGED AND THE MOVE IS LIKELY NOT OVER YET



Source: LSEG Datastream, 12/06/2025

WHO HOLDS JAPANESE GOVERNMENT BOND?



Source: LSEG Datastream, Bloomberg, May 2025

INVESTMENT CONCLUSION

Japan's move towards monetary normalisation represents a significant structural shift. The Ministry of Finance is managing this transition by considering both buybacks and adjustments to issuance, which should help mitigate the risk of abrupt, destabilising global capital flows. Japanese investors are likely to remain selective buyers of foreign bonds. The overall pace of capital reallocation is likely to be gradual. We anticipate further rate hikes and higher bond yields ahead (see chart). Consequently, we are avoiding JGBs at this time.

Our Investment Recommendations

Asset class	Zone	Our opinion	
Government bonds	Germany	+	Positive on German sovereign bonds. Prefer 5-10 years maturities.
	Peripheral countries	=	Neutral on peripheral debt (Portugal, Italy, Spain, Greece).
	United Kingdom	+	Positive on UK government bonds.
	United States	+	Positive on US government bonds, prefer 5-10 years maturities. Positive on TIPS.
Corporate bonds Investment Grade (IG)	Eurozone United Kingdom United States	+	• Positive on eurozone and UK IG corporate bonds, and Neutral on US corporate bonds. • We prefer maturities up to 7 years in the eurozone and up to 5 years in the US. • Positive on convertible bonds in the eurozone.
Corporate bonds High Yield (HY)	Eurozone and United States	=	• Neutral on HY bonds. • Positive on *fallen angels* and *rising stars.*
Emerging bonds	In hard currency	=	Neutral on EM hard currency bonds (sovereign and corporate).
	In local currency	=	Neutral on EM local currency government bonds.

Market Data

	10-year rate (%)	Spread (bp)	Spread change 1 month (bp)
United States	4.41	---	
Germany	2.54	---	
France	3.23	69	-1
Italy	3.46	93	-14
Spain	3.12	58	-6
Portugal	3.01	48	-5
Greece	3.26	72	-11

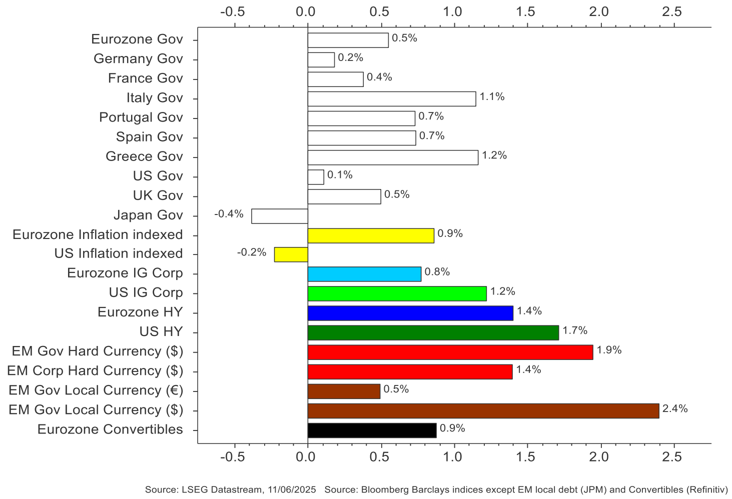
11/06/2025
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.58	32	-4
Corporate bonds IG EUR	3.09	94	-12
Corporate bonds IG USD	5.19	84	-15
Corporate bonds HY EUR	5.55	296	-48
Corporate bonds HY USD	7.36	302	-41
Emerging government bonds in hard currency	6.75	239	-25
Emerging corporate bonds in hard currency	6.60	235	-19
Emerging government bonds in local currency	6.08	207	-3

11/06/2025
Source: Refinitiv Datastream, Bloomberg

Returns

OVER ONE MONTH



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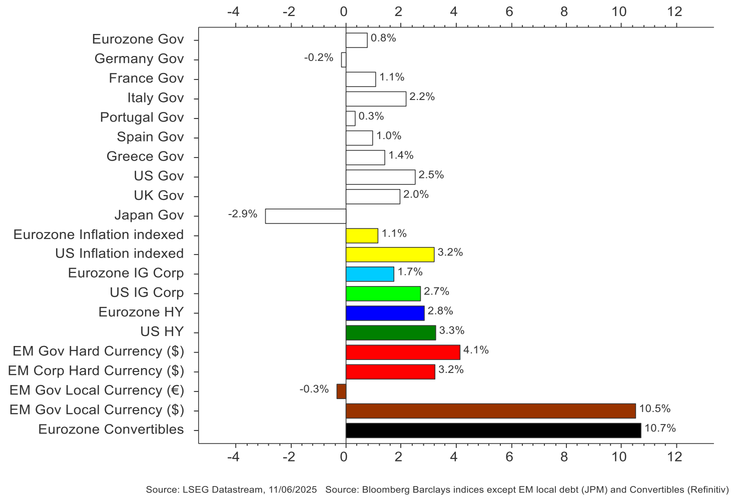

EM = Emerging Markets

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