Fixed Income Focus

Summary

1. **Fed holds, cuts deferred:** In May, the Fed stood pat, leaning on robust hard data over softer survey readings. As the Fed is waiting for more clarity on developments in unemployment and inflation, we are delaying our expectation of two rate cuts this year until September and December. We anticipate a further two cuts in 2026 and a terminal Fed funds rate of 3.5%.
2. **ECB easing:** Core inflation is moving towards the 2% target, driven by slowing wage growth and a stronger euro. We have moved from expecting one cut (in June) to two (in June and July), taking the deposit rate to 1.75%—the bottom of the ECB's neutral range.
3. **Safe-haven rate recalibration:** In April, the shock of the tariffs sent German Bund yields sharply lower, in contrast to the steadier performance of US Treasuries. Since then, both 10-year Bund and Treasury yields have rebounded amid hopes of a US–China deal. We remain positive on safe and liquid core EU, US and UK government bonds. Our 12-month yield targets remain unchanged: 4.25% in the US, 2.50% in Germany, and 4.00% in the UK.
4. **Topic in focus: Did April rattle the markets?** The widening of credit spreads in IG and HY in early April was swiftly erased, as was the widening of EM bonds. We remain cautious: valuations are tight against slowing growth and sticky inflation. We are focusing on high-quality, liquid credits and monitoring Q2 earnings alongside CCC spreads for signs of stress.
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 15 May

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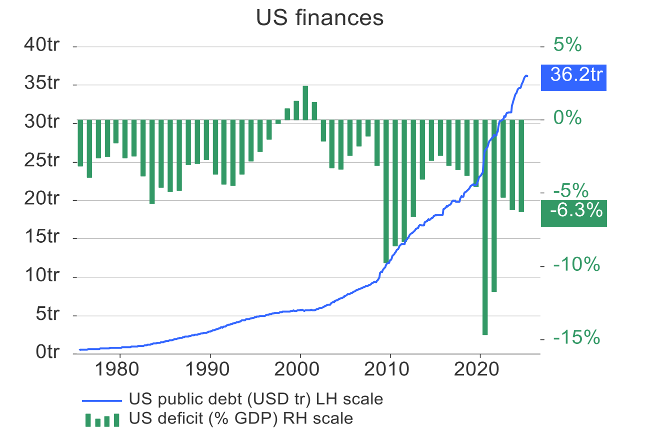
CHART OF THE MONTH: CONCERNS ABOUT THE US DEFICIT HAVE RESURFACED AS THE US IS SET TO REACH THE DEBT CEILING IN AUGUST



Source: LSEG Datastream, Apr 25

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Central banks

Fed holds, ECB moves

European Central Bank (ECB)

Disinflation path: The ECB sees disinflation as being on track, with core inflation projections in line with its medium-term target of 2%. Moreover, the ECB's wage tracker signals a sharp slowdown ahead (see chart). In addition, a stronger euro should dampen imported price pressures, reinforcing the downward trend.

Growth headwinds: Economic uncertainty, the recent financial turmoil and the strength of the currency have added a new drag on growth. President Lagarde cited "exceptional uncertainty" from global trade tensions and slower expansion, while stressing that euro area markets continue to function well.

Our view: We have moved from expecting one cut (in June) to two (in June and July), setting our terminal deposit rate at 1.75%, the lower end of the ECB's estimated range of neutral rates (1.75-2.25%). Traders now expect two rate cuts by the end of the year (compared to an expectation of 3.5 cuts in mid-April), and anticipate a terminal rate of around 1.7%.

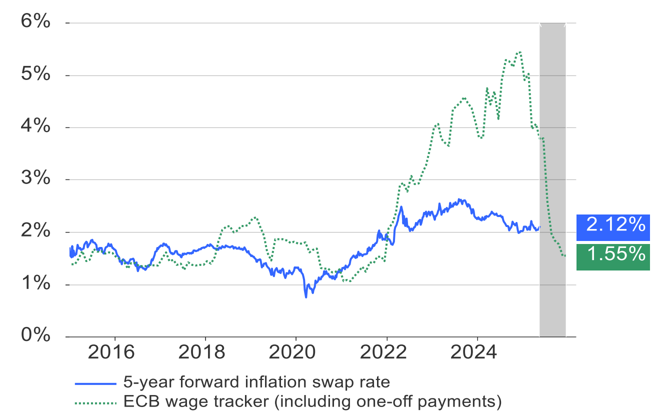
US Federal Reserve (Fed)

The courage to do nothing: The Fed left rates unchanged at the May FOMC meeting, resisting political pressure to cut. It gave more weight to hard economic data, which remains strong, than to more volatile and weaker survey-based indicators.

A more cautious stance: With the risks of higher unemployment and inflation rising, we believe the Fed will wait for clearer signs of deterioration in the labour market before easing. If a trade-off between jobs and inflation emerges, we expect the Fed to prioritise employment.

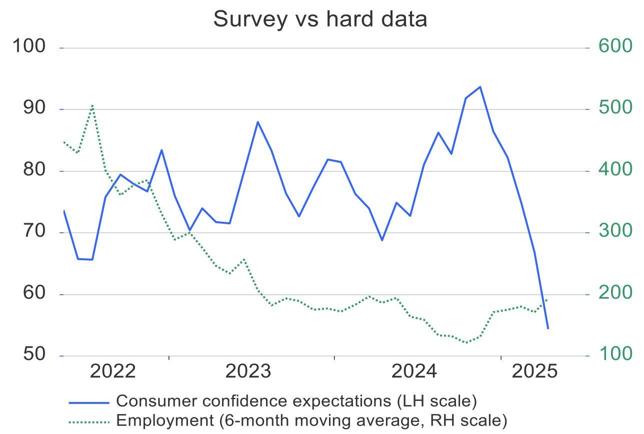
Our view: Traders have scaled back their expectations from 4.2 to 2 cuts this year in recent days. We continue to forecast 2 cuts, now postponed to September and December, instead of June and September. Looking ahead, we expect 2 additional cuts in 2026 and have lowered our terminal rate forecast from 4% to 3.5%.

LOWER INFLATION POINTS TO RATE CUTS



Source: LSEG Datastream, 15/05/2025

HARD DATA REMAINS STRONG WHILE SOFT DATA HAVE WEAKENED



Source: LSEG Datastream, Apr 25

INVESTMENT CONCLUSION

In the US, we expect two cuts in 2025 and gradual easing into 2026, with a terminal rate of 3.5%. In the eurozone, with inflation falling and further risks to economic growth, all the lights are green for further rate cuts, and we now expect another cut in July on top of the one in June, leading to a terminal deposit rate of 1.75% this year.

Bond yields

US safe-haven status challenged

In April divergent long-term rate movements highlighted contrasting safe-haven dynamics. German Bund yields plunged amid US tariff announcements and equity market volatility, while US yields did not, prompting questions about the US's haven status. Although hedge funds sold Treasuries to meet margin calls on equities, more fundamental factors eroded US exceptionalism, including reports from Mar-a-Lago of plans to weaken the dollar, threats to dismiss Powell, the potential for swapping foreign holdings for lower-coupon bonds, and the proposed introduction of taxes on overseas investors. Nevertheless, the erosion of the US's safe-haven status must be viewed with nuance, given that we have seen Treasury inflows surge and recent auctions perform well.

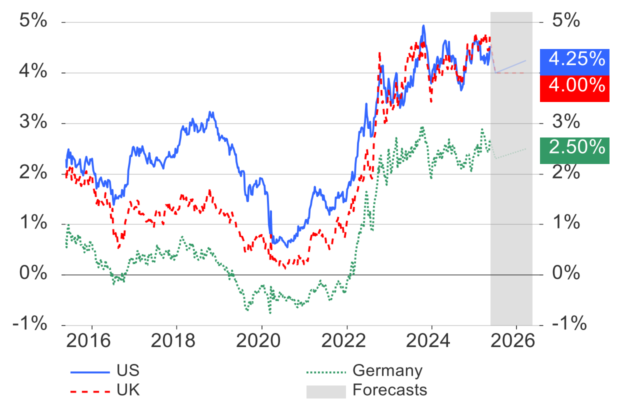
So far in May, both German and US long-term rates have risen sharply, reflecting a recalibration of growth prospects amid hopes for a US-China trade deal.

In these volatile markets, where rates are elevated and economic growth is set to decline, we remain Positive about safe, liquid core EU, US and UK government bonds.

	Maturity (years)	14/05/ 2024	3-month target	12-month target
USA	Policy rate	4.50	4.50	3.75
	2	4.06	3.75	3.60
	5	4.17	3.75	3.75
	10	4.53	4.00	4.25
	30	4.97	4.25	4.50
Germany	Policy rate	2.25	1.75	1.75
	2	1.94	1.75	1.60
	5	2.26	2.00	2.15
	10	2.69	2.30	2.50
	30	3.16	2.55	2.75
UK	Policy rate	4.25	4.25	3.25
	2	4.03	3.80	3.60
	5	4.19	4.00	3.75
	10	4.72	4.50	4.00
	30	5.47	5.00	4.45

Source: Refinitiv Datastream, BNP Paribas WM

10-YEAR RATES



Source: LSEG Datastream, 16/05/2025

Investment Conclusion

We remain Positive on safe and liquid core EU, US and UK government bonds. Despite recent volatility and questions around the US's safe-haven status, expected weaker economic growth, recent strong Treasury inflows and solid auctions support our view. We maintain our 12-month yield targets for 10-year yields: 4.25% in the US, 2.50% in Germany and 4% in the UK.

Topic in Focus

Did April rattle the markets?

Market turbulence and safe havens: April began with a dramatic announcement of tariffs that caused a shift in sentiment. Equities collapsed and volatility surged. US Treasuries delivered a mere 0.6% gain as investors rather sought refuge in German Bunds (up 2.0%), UK Gilts (up 1.8%), and gold (up 6.2% in dollar terms).

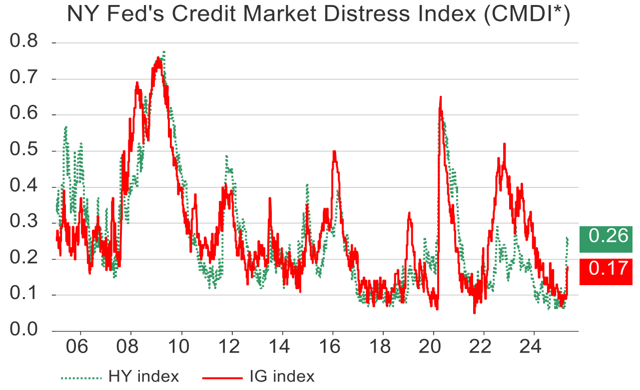
Credit market dynamics: Spreads increased in early April, particularly in high yield and the primary market froze. However, this pause was short-lived, with robust issuance and solid demand since then signalling that yield-hungry investors remain engaged despite policy risks. European IG funds posted inflows, while outflows from US mutual funds slowed. The New York Fed's Credit Market Distress Index suggests that both investment grade (IG) and high yield (HY) issuers are not facing any issues accessing the market.

IG and HY spreads retraced quickly: IG spreads widened modestly, but have since retraced fully as markets have become euphoric about the prospect of a US-China deal in mid-May. HY spreads surged during the tariff shock, but have since fallen back below pre-announcement levels. There have been renewed net inflows into HY markets, with current all-in yields standing at around 7.5% in USD and 5.7% in EUR.

Credit outlook: Following the rally, spreads are too low to reflect the forward macro backdrop of slowing growth and higher inflation. Given weak consumer confidence and business surveys, we favour high-quality, liquid credits, IG over HY. Earnings season will be pivotal; we will monitor guidance and trailing CCC spreads for early signs of stress.

Emerging markets outlook: EM hard currency spreads widened only marginally in April before fully recovering, underpinned by robust corporate fundamentals and technical support. However, given past default waves, vigilance is warranted as single B yields breach the 10% threshold. In local currencies, disinflationary trends have enabled interest rate cuts to support growth. However, we expect depreciation of EM currencies against the USD and EUR to weigh on returns.

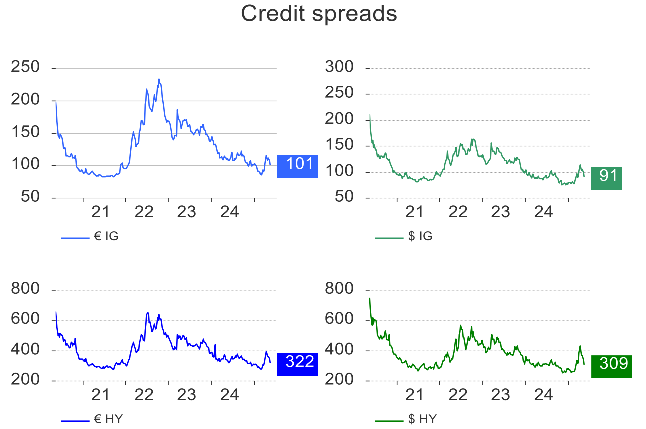
NO SIGN OF STRESS REGARDING MARKET ACCESS



Source: LSEG Datastream, 25/04/2025

* The CMDI quantifies dislocations in the primary and secondary corporate bond markets, offering a unified measure to capture access to debt capital markets.

CREDIT SPREADS RETRACED QUICKLY



Source: LSEG Datastream, 15/05/2025

INVESTMENT CONCLUSION

We maintain a defensive bias towards higher-quality assets, favouring EUR IG corporate bonds for their resilience. We are neutral on USD IG and HY bonds due to economic growth risks and tight valuations relative to the forward macro environment. We are also neutral on EM bonds. Q2 earnings, policy developments and CCC spread trends will guide adjustments to our credit recommendations.

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 short-dated bonds, up to 5-year 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. • Prefer short maturities in the US (up to 5 years) and up to 10 years in the eurozone. • 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	4.53	---	
Germany	2.69	---	
France	3.37	68	-4
Italy	3.72	102	-6
Spain	3.31	62	-4
Portugal	3.20	50	-3
Greece	3.47	78	-8

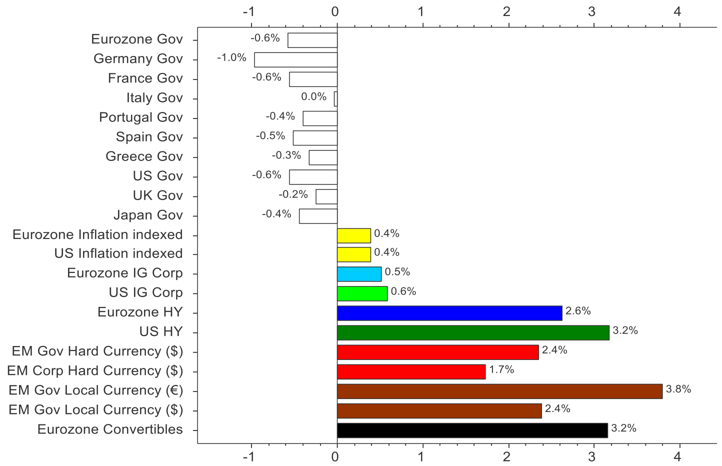
14/05/2025
Source: Refinitiv Datastream

	Yield (%)	Spread (bp)	Spread change 1 month (bp)
Global	3.68	34	-3
Corporate bonds IG EUR	3.25	99	-11
Corporate bonds IG USD	5.38	91	-11
Corporate bonds HY EUR	5.72	313	-42
Corporate bonds HY USD	7.49	301	-55
Emerging government bonds in hard currency	6.91	243	-28
Emerging corporate bonds in hard currency	6.72	234	-28
Emerging government bonds in local currency	6.15	199	5

14/05/2025
Source: Refinitiv Datastream, Bloomberg

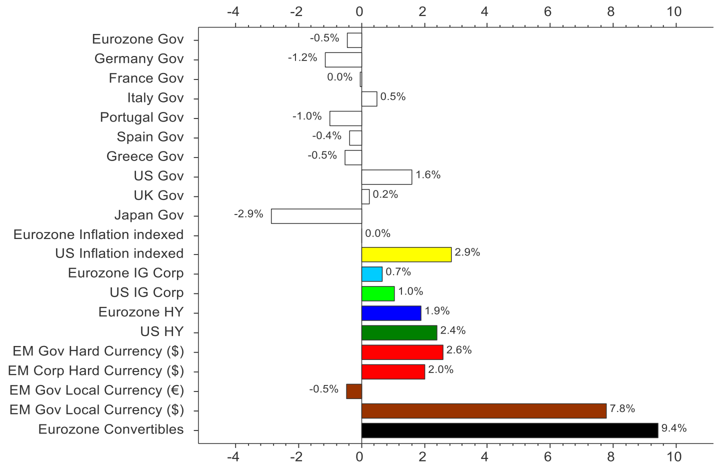
Returns

OVER ONE MONTH



Source: LSEG Datastream, 14/05/2025 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

SINCE 01/01/2025



Source: LSEG Datastream, 14/05/2025 Source: Bloomberg Barclays indices except EM local debt (JPM) and Convertibles (Refinitiv)

EM = Emerging Markets

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