



A pause that refreshes, but for how long?

Fixed income quarterly outlook - first quarter 2019

FOR PROFESSIONAL INVESTORS - January 2019



Dominick DeAlto

Chief Investment Officer - Fixed Income

dominick.dealto@bnpparibas.com

KEY POINTS

- Tighter financial conditions and a weakening global backdrop have led the Federal Open Market Committee to signal a pause in the hiking cycle. We suspect other developed market central banks could put their own normalization plans on hold this year.
- Continued stimulus from Chinese authorities, combined with signs of progress in the US-China trade dispute, also support our cautious optimism on the global growth outlook this year. Global growth is set to slow this year, but concerns over a 2019 recession in the US or other major economies are likely misplaced.
- Still, market volatility is likely to remain elevated. Monetary policy is not providing the level of accommodation it was a year ago, the fiscal impulse is set to fade in the US, and corporate profit growth in most economies is slowing. A host of political risks will continue to weigh on risk sentiment as well.

FULL COMMENTARY

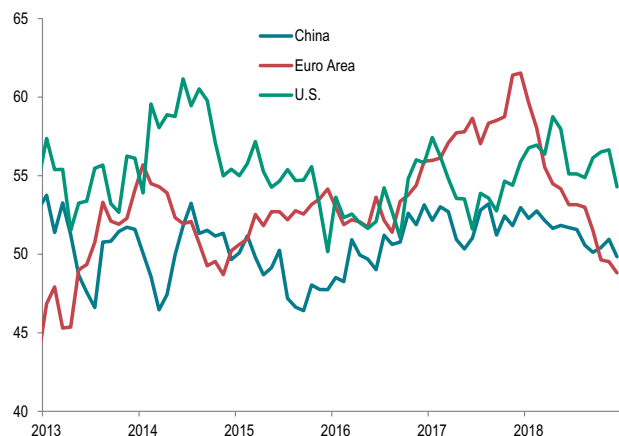
Federal Reserve Chairman Jerome Powell has garnered his fair share of criticism for what has been viewed as a number of communications missteps last quarter. We have indulged in some of these criticisms ourselves, but dwelling on Federal Reserve (Fed) communications masks some larger points about the global economy and markets. There are a number of signs pointing to a downshift in global growth, sparking concerns about the willingness of developed market central banks to pivot quickly from their plans for policy normalization. Investor concerns about the reaction of policymakers to weakness in the data are not limited to developed markets. China remains a significant point of focus, given what many perceive to be an insufficient policy response to signs of slowing growth. The wall of worry confronting markets also extends into the political arena as well, and includes the ongoing US-China trade dispute, increasing disfunction in US politics, and the final stages of the Brexit process, to name a few. All of these issues have contributed to tighter financial conditions in many economies, and in the case of the US, elevated concerns about the durability of the expansion.



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Chart 1: New orders component, manufacturing PMI surveys



Source: Markit, December 2018

We share many of these concerns, but at least for the time being, we see reasons for optimism that a weaker growth environment will not spiral into recession. First, the global policy backdrop will remain somewhat accommodative for the foreseeable future. Federal Reserve policymakers have already pivoted to signal a pause in the policy normalization process in response to tighter financial conditions, a weaker global backdrop, and some deterioration in forward-looking survey indicators. Monetary policy looks set to remain on hold at least until the middle of the year, and if anything, the risks are skewed towards this pause being extended into the second half of the year. This is because a relatively benign inflation environment provides policymakers significant flexibility. Recent comments from policymakers also suggest a degree of confidence about the supply side of the US economy, and this confidence should translate into additional policy patience given the disinflationary implications of rising trend growth.

Chart 2: Underlying US inflation gauge



Source: Federal Reserve Bank of New York, Prices Only Measure, through November 2018

Despite this perceived pause in US policy tightening, we cannot ignore the tightening effects of continued balance sheet runoff. The Federal Reserve is in a difficult position because it continues to downplay the significance of runoff for the economy, even as investors express concern with the policy being on auto-pilot.

Still, the notion of a policy pause could extend to other developed market central banks. In the euro-area, the end of quantitative easing and a compromise on Italy's budget suggest greater scope for policy flexibility than was the case last year. The European Central Bank (ECB) has signaled that an initial rate increase could occur in the fourth quarter, but with inflation risks skewed to the downside, the start of interest rate normalization could be delayed until 2020. Similarly, we do not expect any further steps by the Bank of Japan to widen the yield band for the 10-year government bond absent an improvement in the inflation data, which does not appear in the offing. The forthcoming consumption tax increase will also limit the Bank of Japan's appetite to take any measures that could be perceived as a withdrawal of policy accommodation.

We also remain cautiously optimistic that China will continue to provide sufficient stimulus to the economy to prevent anything more than a gradual deceleration in growth, to around 6.2 percent this year. The People's Bank of China has already announced a 100 basis point cut in reserve requirements, and we expect an additional 200 basis points of cuts over the remainder of the year. This and other liquidity injections from the central bank will complement fiscal expansion through infrastructure spending and tax cuts. Investors may continue to be disappointed by the targeted nature of Chinese stimulus, as policymakers are keen to prevent a deleveraging of the economy. But this does not change the fact that policymakers have both the intention and the tools to prevent a sharp growth deceleration.

The outlook for the trade dispute between the US and China has also improved on the margins. For both countries, a loss of momentum in economic activity provides a powerful incentive to reach a deal. In the case of the US, we suspect that stock market weakness provides a similar incentive for President Trump. Progress in recent negotiations suggests some scope for compromise, increasing the odds that the December agreement to halt any additional tariffs will be extended beyond March. While a comprehensive agreement remains far off, incremental news that the two countries will refrain from further escalation and continue to engage in dialogue should be a market positive.

While the monetary policy backdrop and recent signals on US-China trade negotiations are reasons for cautious optimism, we remain cognizant that many of the top-of-mind risks for investors are in the political sphere. The US government shutdown is just a taste of how volatile the political environment will be this year, with Democrats taking control of the House of Representatives and set to challenge President Trump on a host of issues. We also suspect that populist impulses in the euro area are not set to subside any time soon, and the Brexit process is coming to a head. Forecasting the eventual outcome is far from straightforward but if we eliminate the increasingly improbable then whatever is left can at least be considered reasonable probable outcomes. It looks less likely that there will be an election to resolve the problem: the Prime Minister has pledged not to call one and it looks unlikely that the opposition will have quite enough votes to topple the government. Nor does it seem likely that parliamentarians will coalesce around an alternative option and impose that upon the Prime Minister: on closer inspection the "Norway+" option does not have much to recommend it. Nor does it seem likely that Parliament or for that matter the Prime Minister will countenance leaving with no deal. Putting Brexit on pause for the foreseeable future without any public mandate is not a long-term solution. So the two most likely outcomes are the Prime Minister's deal passes on the second or third time of asking or the decision is put back to the people. Remain looks the likely winner in a second referendum, but this is also the most plausible route to a Hard (no deal) Brexit. In the event that the Prime Minister's deal passes we would expect to see sterling rally and the market price back in rate hikes, with a more aggressive move in the same direction in the event of Remain. No deal on the other hand would tip the U.K. into an economic and potentially political crisis, with the currency taking the strain.

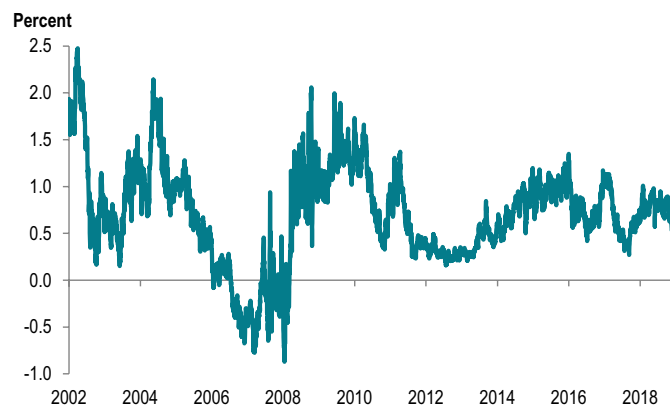
INVESTMENT IMPLICATIONS

Duration, curve and inflation

Given decelerating growth and downside risks in the US, we think we are now close to the end of the monetary policy tightening cycle, and now expect the Fed funds rates to peak at 2.75 - 3.00 percent. This is still higher than market pricing, so a cautious underweight in nominal front-end rates appears appropriate. At the same time, without an inflation problem, the FOMC has no reason to raise rates aggressively into restrictive territory and flatten the 5s / 30s Treasury curve to zero or below, as in prior cycles. With broader financial conditions having tightened for the Fed, we now prefer

5s / 30s nominal steepeners. We believe 10-year TIPS-based breakeven inflation rates are underpriced at 1.80 percent. We look for a partial recovery to 2.00 percent, which should be helped by seasonals and a stabilization of energy and risk asset pricing. It will take evidence of strengthening core to permit a re-test of 2.25 percent.

Chart 3: Near-term forward US interest rate spread



Source: Bloomberg, through January 11, 2019. Near-term forward spread is the implied 3-month bill rate six quarters forward, minus the current 3-month bill rate

In the Eurozone, with the ECB moving toward the direction of policy normalization amid a low inflation environment and deteriorating external support to growth, we believe core government bond yields will likely stay in narrow ranges in the medium term. In the near term, however, we believe core government bond yields could rebound somewhat from the aggressive rally we saw at the turn of the calendar year. In our view, risk-reward has tipped in favor of holding a small tactical duration underweight at current levels, particularly since issuance will now begin to pick up meaningfully. In terms of core versus peripheral country exposures, major risk events including the credit rating decision for Italy and the Italian fiscal fight seem to be over at least for now, but we believe the BTP/Bund spread will continue to fluctuate in the new ranges established since last May as political headlines and issuance cycles wax and wane in the next few months. In the longer term, Italy's deteriorating fiscal and growth outlook remain an important fundamental issue, and should keep risk premia in Italian assets elevated. We believe the recent strength in BTPs provides a good entry point for a tactical short position in Italian duration. With net BTP issuance swinging from significantly negative in December to positive in January, we expect to see more concession built into BTP yields in the near term.

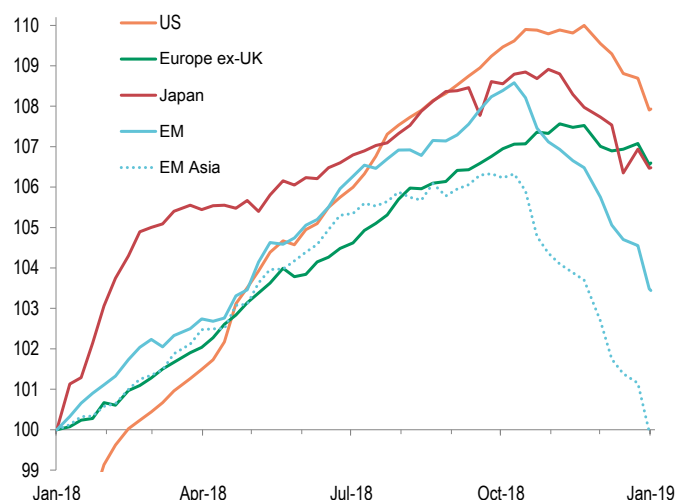


In terms of inflation, Eurozone breakeven inflation (BEI) rates have nosedived over recent months due to a combination of the collapse in crude oil prices, deteriorating market risk sentiment, and the lack of impetus from Eurozone core inflation. With BEI rates having already adjusted for these factors, we see value in holding a long position in Eurozone BEI. While the outlook for oil remains uncertain, the perfect storm of bad news from all sides seems to have subsided, helping energy prices to stabilize in recent weeks. While core inflation in the Eurozone remains low, and its recovery will likely be extremely gradual, the market may soon focus on wage increases again as several German unions obtained significant pay increases and as minimum wage picks up in a number of Eurozone member states.

Risk Sectors

While we do not share some of the market's concern over near-term recession risks, we realize that we are in a very different environment than a year ago. Financial conditions have tightened, US fiscal policy stimulus will begin to fade, and political risks remain elevated in both the US and Europe. China is providing fiscal and monetary support to its economy, but we suspect that investors will remain unimpressed with the targeted nature of the effort – absent a material deterioration in the outlook, perhaps on any worsening of the trade dispute with the US, a return to full-bore Chinese stimulus is highly unlikely. All of these factors can weigh on household and business confidence, posing risks to aggregate demand. In addition, corporate profit growth is decelerating in many major economies. Of particular note, in the US, some of the decelerating profit growth is due to margin compression. This is not a surprising development given that fiscal stimulus pushed the economy far above its potential rate of growth, leading to higher labor and input costs across a number of sectors. If this margin compression becomes more acute, hiring and investment spending could weaken, causing growth to slow below its trend rate, which we estimate as 1.75 to 2 percent. Even if this more significant scenario does not play out, an environment of declining margins could pose challenges not only to US equities, but also investment grade and high yield credit.

Chart 4: Forward earnings estimates



Sources: FactSet, BNP Paribas Asset Management, as of January 10, 2019.

From a relative value perspective, asset allocation alternatives that once were economically unappealing due to financial repression are beginning to look more interesting again. Given significant flattening of develop market government curves, traditional safe havens such as certificates of deposit ("CDs") are now yielding 2.25 percent for little-to-no risk; and commercial paper ("CP") now averages 2.7 percent. For those willing to extend just slightly further out on the maturity curve, even two-year investment grade credit with an average risk premium of 100 basis points brings the all-in yield to 3.5 percent. These alternatives have clear impacts on risk taking in a world where growth is expected to weaken and violent bouts of volatility are common. To us, this suggests that there is little benefit to taking a long spread duration position and that the best exposures are in the front end of the risk space.

Corporate credit

Tactically, we are positioned for a near term rally as we open the year and we express this mostly in the US high yield market. We are expecting fourth quarter earnings to exhibit modest growth (albeit lower than second quarter and third quarter) and supply technicals should help as well given limited issuance. Spreads have widened from 300 basis points in early October to 525 basis points to open the year. At that level, the market is pricing in the possibility of recession in 2019, which we think is overdone. Longer-term, we are more inclined to be underweight credit globally and believe that security selection will play a larger role in performance this year. In particular, leverage has increased significantly, and

many over-leveraged companies will exhibit stress. Anecdotally, we have already seen market liquidity tighten in the CCC rating bucket as those companies that took full advantage of leveraged loan liquidity will seek to term out their growing debt burden. Key to this will be the health of the CLO market. If we see liquidity dry up there, we believe high yield could widen at least 100b basis points. More specifically, in the oil and commodity sectors (a substantial driver of high yield performance), we acknowledge the volatility that has occurred as oil dropped materially over the fourth quarter. We are still constructive on some energy companies that have low production costs and modest leverage. Many energy companies are in a better fundamental position compared to the 2014-2015 drop in oil prices. However, near-term performance will be driven by supply/demand dynamics – the OPEC+ agreement and the global demand outlook.

countries in question. Individual country stories will both drive and limit the upside growth view; as an example, we believe that Turkey will enter a recession in 2019, but the key driver will not be if, but how severe this recession will be. Conversely, although South Africa is enjoying a recovery from the recession they experienced in the first half of 2018, it remains unclear how strong the rebound will be.

Emerging market debt

Although 2018 ended on a positive note for all sub-segments of emerging market fixed income, we enter 2019 cautiously and with an expectation of another challenging year ahead given expectations for an uncertain global growth backdrop. These tough conditions are likely to be felt more keenly in hard currency assets, as credit spreads historically trend up with elevated volatility. Although there may be some short-term relief in spreads on technicals, we expect spreads to remain elevated, with sovereigns underperforming corporates, and a higher incidence of defaults that will generate bouts of contagion. However, we see pockets of value in high-quality high yield credit, especially since emerging market corporates demonstrate better liquidity metrics, lower leverage and more responsible borrowing than their developed market counterparts. Controlling for quality, the emerging market credit asset class remains cheap to US high yield.

We continue to be more constructive on local currency assets, where we remain overweight in our asset allocation model. Supporting this position is our belief that underlying growth concerns are overdone and that emerging market growth will not slow as much as consensus expectations suggest, especially in China. Additionally, we think that dollar strength may be a fading 2018 story as the Federal Reserve pauses adopts a more data-driven approach. However, uncertainty remains as to how this will eventually play out during the course of the year for each of the



BIOGRAPHY

**Dominick DeAlto**

Chief Investment Officer - Fixed Income

dominick.dealto@bnpparibas.com

Dominick is Chief Investment Officer of Fixed Income for BNP Paribas Asset Management. His responsibilities include global and regional fixed income (Europe, US, Asia), including money market funds, and global emerging market debt. He has oversight responsibility for all activities relating to the management and performance of the organization's fixed income investment teams, products and portfolios. He is responsible for challenging the strategies and processes of the various investment teams. Dominick joined FFTW, a predecessor of BNP Paribas Asset Management, in 2013 and is based in New York.

Prior to joining us, Dominick was Managing Director – Head of Product Management and Development (Americas) for Deutsche Asset Management where he served in a senior portfolio management capacity as Head of Fixed Income Asset Allocation. Prior to Deutsche Asset Management, Dominick held the position of Head of Fixed Income (Americas) for Robeco, Weiss Peck & Greer Investment Management where he oversaw the management of US and global fixed income assets. At Robeco, Dominick managed numerous fixed income multi-sector portfolios, with a focus on fixed income asset allocation. Prior to Robeco, Dominick held various fixed income portfolio management positions including fixed income portfolio manager for Chase Asset Management, a predecessor of J.P. Morgan Asset Management. Dominick began his career as a credit analyst at Chase Securities Inc. after graduating from their industry leading credit training program.

Dominick has over 30 years of investment experience. He earned his BS in Economics from State University of New York, SUNY – Oneonta. He is a member of the New York Society of Securities Analysts and the CFA Institute.



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