Yield Curve: What Is It Telling US?

Key questions

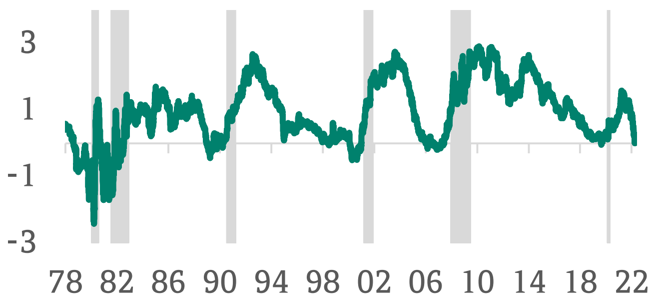
- **What is the Yield Curve trying to tell us?** Parts of the yield curve have recently inverted. What does that mean for the current equities and fixed income bond yields? How impacted has it been by quantitative easing?
- **Important to examine the lead and lags** to see if the yield curve is a useful lead indicator to impact asset allocation with regards to equity bear markets and the timing of recessions.
- Finally, what is the probability of recession and how much has it been brought forward by geopolitics?

The Yield Curve Inverts

What are the economic and market implications?

In March, the real action had been in the bond markets with US Treasury bonds registering their worst quarter since 1973. **Treasury bonds actually underperformed the S&P 500 for the quarter.** There has been a rapid repricing of yields year-to-date with US 2-year Treasury yields rising +174 basis points, even faster than 10-year US Treasury yields climbing by +82 basis points. **Hence, the yield curve has inverted on several maturities.** (Chart 1) In particular, the shorter end of the curve with the 2-year Treasury yields at 2.4% reflects the market pricing of eight more hikes this year.

US 10Y - 2Y SPREAD (%)



Source: Bloomberg, BNP Paribas (WM), as of 31 Mar 2022. Past performance is not indicative of current or future performance.

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In addition, other curves like the 10 year–3 month are actually steepening. Keep in mind, the 3-month yield is anchored by the fact we have only had one Federal Reserve rate hike, but nonetheless it normally would more correlate with the other curves.

What has driven these yield moves? The rapid economic recovery triggering continued supply chain inflation, rising wage inflation, and commodity price inflation. The Ukraine War has further exacerbated this situation in particular, in Europe.

How useful is the Yield Curve as an Indicator: Long Lead and Lag Times

The problem with basing all your asset allocation on the yield curve are the lags. What does history tell us?

Since 1967, across 7 tightening cycles, the S&P 500 peaks anywhere from 2 months before to 20 months after a yield curve inversion of 10 year–2 year yields. **On average, the S&P 500 peaks 11 months after the curve inversion with on average a 15% return.** The returns vary between -4% again in 1973 and +34%. Therefore, on AVERAGE, there is upside in equities after inversion.

With regards to recession, on average, a recession begins 5 months after the S&P 500 peaks. Hence, if we combine the time that on average the S&P peaks 11 months after and a recession 5 months after that, for a **combination of 16 months after inversion.**

While we have made downgrades to GDP and upgrades to inflation, we do not expect a recession in 2022. Keep in mind the lags on monetary policy as discussed above.

How Do Equity Markets Perform In Fast Rate Hiking Cycles?

It is interesting to separate the performance of S&P 500 during periods of fast and slow rising rate hike cycles.

Historically, going back to rate hike cycles since WW2, the S&P 500 rises on average 5.3% one year after the first rate hike. However, in slow tightening cycles, the returns are +10.5% and fast tightening cycles -2.7%. At the same time, returns are positive in the second year in slow tightening +1.6% and fast rate rise cycle +4.3%. Of course, this is just one factor driving part of our neutral equity view made before consensus in February.

The global equity market had a bounce-back in March due to the containment of the Ukraine War. At the same time, **we upgraded US equities from underweight back to neutral as well as raising US technology which incidentally led the rally and consumer discretionary sectors back to neutral.** We felt that the US could rally short-term and indeed that transpired with the S&P closing down at the end of the quarter -4.9% recovering from a year-to-date drawdown of -14%. **From here on, we expect a more range-bound environment in the S&P 500 and most global equity markets, pending the situation in Ukraine, the extent of inflation and the upcoming tightening from the Federal Reserve.**

GLOBAL GDP AND INFLATION FORECAST

Annual (% YoY)	GDP		Inflation	
	2022	2023	2022	2023
US	3.7	2.5	7.5	3.4
Eurozone	2.8	2.7	6.7	3.2
UK	3.6	1.7	7.0	3.2
China	4.9	5.5	2.1	2.5
Japan	1.6	2.0	1.5	1.1

Source: Bloomberg, BNP Paribas (WM), as of 31 Mar 2022.
Past performance is not indicative of current or future performance.

Important Factors to Monitor:

- Rates are forecasted to rise faster than "normal" rate hiking cycles. We expect a 50bps rate hike in May rather than 25bps. We thus expect an additional 150bps of rate hikes this year. As the Fed frontload its hikes, we now anticipate 75bps next year rather than 100bps. Our 2023 Fed funds target remains at 2.75%.
- Rate hikes do not help supply chain inflation.
- There are parallels and differences with the 1970s, when the S&P 500 peaked two months before the 10Y – 2Y yield curve inversion.
- How much has quantitative easing distorted the yield curve by capping longer dated yields? Could the curve steepen as quantitative tightening begins?

In that regard, it was interesting the yield curve flattened into the upcoming quantitative tightening, when normally it steepens.

Upgrading Government Bonds To Neutral For The First Time In 9 Years After Global Bond Carnage

After the increase in Treasury yields and German yields we turn neutral on developed market government bonds. This is the first time in 9 years. There are finally some emerging alternatives to cash, as we favour US short-term government bonds within the overall neutral view.

Additionally, we increase our 10-year yields targets to 2.50% in the US and 0.75% in Germany in one year. We expect balance sheet reduction to be announced / start in May rather than July. The ECB could taper its QE in Q3 and hike rates in December.

CONCLUSION / STRATEGY:

- The yield curve normally inverts on average well before equity market peak; recessions has large lead and lags making its sole use for equity and bond decisions asset allocation not completely useful.
- We remain neutral global equities taking a non-consensus view to downgrade back in February. We have subsequently upgraded US equities from underweight back to neutral in March after it entered correction territory.
- For the first time in 9 years, **we turn neutral on developed market government bonds.** There are finally some emerging alternatives to cash, as we favour US short-term government bonds within the overall neutral view.
- In addition, **we increase our 10-year yields targets by 25bps to 2.50% in the US and 0.75%** in Germany in one year. **We expect the balance sheet reduction to be announced and start in May** rather than July.

Overview of our CIO Asset Allocation for April 2022

	Views Current	Views Prior	Constituents	We like	We avoid	Comments
EQUITIES	=	=	Markets	UK, Japan		■ We upgraded US equities to neutral from negative. We remain neutral overall on Equities as an asset class.
			Sectors	Healthcare, Semiconductors, Construction, Precious/battery metals		■ We upgraded the US tech and consumer discretionary sectors to neutral.
			Styles/ Themes	Megatrend themes		**Inflation hedging theme** and good potential remains for secular themes such as **Metaverse, 5G, AI, cloud, cybersecurity, smart consumers, health tech, water, waste & infrastructure.**
BONDS	=	=	Govies	US short-end Treasuries		■ **We revised up our 10-year US bond yield target to 2.5%.** ■ We **turn neutral on US government bonds** and see value in the US short-end Treasuries.
			Segments	Emerging Markets Bonds (USD + local currency) & Rising Stars		■ We are **neutral on US investment grade (IG) & high yield (HY).** ■ We prefer **Rising Stars.** ■ We are **positive on EM bonds, in both hard and local currency.**
CASH	=	=				
COMMO-DITIES	+	+		Gold & Base Metals		■ **Gold - positive**: gold to trade in the $1900-2100 range ■ **Oil - neutral**: Brent to stabilize in the $95-105 range at the end of 2022. ■ **Base metals –positive:** strong demand dynamics combined with limited supply growth
FOREX			EURUSD			Our 12-month target remains 1.12.
ALTERNATIVE				Real Estate; Private Equity; Macro & Event-driven Hedge Funds		We are neutral on Relative Value & Long/Short Equity, with a preference for Macro & Event Driven strategies.

Note: + Positve / = Neutral / - Negative

GDP & CPI Forecasts

		GDP (YoY%)			CPI (YoY%)		
		2021f	2022f	2023f	2021f	2022f	2023f
	Global	5.6	4.8	3.8	-	-	-
Developed	US	5.7	3.7	2.5	4.7	7.5	3.4
	Japan	1.7	1.6	2.0	-0.2	1.5	1.1
	Eurozone	5.3	2.8	2.7	2.6	6.7	3.2
	UK	7.5	3.6	1.7	2.5	7.0	3.2
	Developing Asia	5.9	8.2	5.2	3.8	4.0	3.6
North Asia	China	7.7	4.9	5.5	0.9	2.1	2.5
	Hong Kong*	6.4	3.5	3.1	1.9	2.1	2.3
	South Korea	3.9	2.7	2.2	2.3	2.3	1.7
	Taiwan*	5.9	3.3	2.6	1.6	1.5	1.4
South Asia	India	8.1	9.5	7.3	5.4	6.3	5.2
	Indonesia	3.6	5.8	5.1	1.5	1.9	2.2
	Malaysia	2.6	4.7	5.1	2.3	1.7	1.9
	Philippines*	4.3	3.0	3.0	4.3	6.3	7.0
	Singapore*	6.0	3.2	2.7	1.6	1.5	1.5
	Thailand	1.2	3.6	4.0	1.1	1.1	1.1

Source: BNP Paribas Group Economic Research, BNP Paribas Global Markets forecasts as of 31 March 2022
** IMF data and forecasts as of 31 March 2022*

GROWTH

- Global growth expectations are deteriorating due to ongoing uncertainties. The military conflict between Russia and Ukraine, lockdowns in China, higher inflation as well as hawkish central banks are leading to a fall in consumer and business confidence.
- We lower our US growth forecast to 3.7% for 2022. Growth forecast in the Eurozone, which remains the most vulnerable to the conflict, is being revised downwards to 2.8%.

INFLATION

- Inflation could rise somewhat further, driven by food and energy prices that are a subject to a new shock related to the conflict between Russia and Ukraine.
- Base effects should start to fade gradually and the peak in inflation is still expected in the coming months.

Equities

POSITIVE NEUTRAL NEGATIVE

OVERALL GLOBAL: NEUTRAL		
Positive	Neutral	Negative
COUNTRY		
UK Japan Emerging Mkt	Eurozone ▲ US	-
SECTOR		
Healthcare Financials	Energy Comms. Materials Industrials Consu. Sta. Utilities Real Estate ▲ Technology ▲ Consu. Discre.	

OVERALL ASIA: POSITIVE		
Positive	Neutral	Negative
COUNTRY		
China Singapore South Korea Indonesia	Taiwan India, Thailand Malaysia Philippines	-
SECTOR		
▲ Comms. Consu. Discre. Consu. Sta. Healthcare Technology	Energy Industrials Materials Real Estate Utilities	Financials

- We remain neutral overall on Equities as an asset class as we await further reduction in uncertainties.
- We upgraded US equities from Negative to Neutral as we believe that there is room for this stock rally to run, albeit ongoing uncertainties remain.
- We upgraded US technology and consumer discretionary to Neutral. These sectors are much less overweight today in many portfolios, hence more have room to recover.
- We upgraded Asia communications as Chinese telecom services companies' capex will start falling in 2022 and network operators in the the region trade at attractive dividend yield, supported by resilient cash flow.

		1-month (%)	YTD (%)	2021 (%)	Forward PE (x)	Trailing PB (x)	Dividend Yield (%) 2022f	EPS Growth (%) 2022f	EPS Growth (%) 2023f	ROE (%) 2022f
Developed	US	3.4	-5.5	25.2	20.5	4.7	1.8	9.7	9.7	22.2
	Japan	3.9	-2.5	11.4	13.5	1.5	2.1	45.1	5.6	9.2
	Eurozone	-0.8	-9.4	20.1	13.6	1.7	3.0	8.5	7.5	10.8
	UK	1.3	3.5	15.0	11.3	1.8	3.8	10.3	1.6	10.7
	Asia Ex-Japan	-2.9	-8.2	-6.4	12.6	1.6	2.6	11.2	12.3	11.6
North Asia	China	-7.7	-13.9	-22.7	10.6	1.3	3.1	16.6	14.9	11.2
	China A-shares	-0.4	-7.6	-5.2	14.0	2.2	1.9	18.1	13.9	11.4
	Hong Kong	-0.3	-1.9	-5.9	14.7	1.2	3.2	15.2	13.5	8.9
	South Korea	0.6	-8.2	-1.6	9.5	1.1	2.2	2.1	11.0	13.8
	Taiwan	-0.3	-3.5	21.6	13.6	2.6	2.6	3.7	4.3	19.5
South Asia	India	4.2	-0.1	27.3	21.4	3.7	1.2	20.5	14.1	15.0
	Indonesia	2.0	9.0	1.5	16.0	2.7	3.0	15.7	11.3	15.8
	Malaysia	-1.0	1.3	-7.3	15.1	1.6	3.9	-6.7	13.3	10.2
	Philippines	-1.6	3.0	0.9	17.2	1.9	1.5	25.1	21.4	8.3
	Singapore	0.3	-1.4	4.4	18.8	1.6	3.7	21.4	22.4	8.9
	Thailand	0.0	2.8	7.1	18.1	2.2	2.6	16.0	12.2	9.5

Source: MSCI indices in local currency terms, Bloomberg, Datastream, BNP Paribas (WM), as of 31 March 2022

Fixed Income

POSITIVE NEUTRAL NEGATIVE

OVERALL GLOBAL: NEUTRAL		
Positive	Neutral	Negative
EMD (LC) EMD (HC) Short-term UST	US IG High Yield ▲ Long-term UST	-

OVERALL ASIA (USD): NEUTRAL		
Positive	Neutral	Negative
Hong Kong Indonesia	India Philippines South Korea China	-

		Total Return (%)			Yield-to-Worst (%)
		1-Month	YTD	2021	
Asia	Asia USD Bond	-2.5	-6.4	-1.7	4.5
	Asia Local Currency Bond	-2.3	-3.8	-7.0	3.9
	China	-2.8	-6.8	-4.6	5.3
	Hong Kong	-3.0	-5.8	0.8	3.9
	India	-1.4	-4.6	3.2	5.0
	Indonesia	-0.8	-6.5	0.8	4.0
	Singapore	-3.3	-5.7	0.5	3.6
	South Korea	-2.5	-4.5	-0.3	3.1
	Philippines	-0.8	-6.9	-0.1	3.9
Other Regions	US 10-year Treasuries	-3.5	-5.7	-3.0	2.3
	US Investment Grades (IG)	-2.8	-5.9	-1.5	2.9
	US High Yield (HY)	-1.1	-4.8	5.3	6.0
	Emerging Market USD Bond	-2.4	-6.9	-2.8	5.6

Source: Barclays indices, Bloomberg, BNP Paribas (WM) as of 31 March 2022

US Treasury 12-month Yield Targets (%)	2Y	10Y
	▲ 2.25	▲ 2.50

- **The Fed turned hawkish as inflation soared.** It intends to hike rates faster and harder to combat rising inflation. A soft landing is needed, while the risk is a recession due to policy error. **We forecast 5 additional rate hikes 2022, with a 50bps rate hike in May. We also expect the balance sheet reduction to be announced and start in May rather than July.**
- **Uncertainty geopolitically, as well as concerns over growth prospects and inflation are elevated.** The bond market continues to sell down given the more hawkish central banks. The moves have been massive and so is volatility. Government bonds ended 2022 Q1 as their worst ever quarter.
- We raise our bond yield targets by 25bps due to sustained inflation. **Our 12-month targets are 2.50% for the US 10-year treasury yield and 2.25% for the US 2-year treasury yield.**
- We are **positive on Indonesia** credit as Indonesian economy gains momentum on further reopening; we still **see value in Hong Kong names** where most of them have demonstrated resilience in bond price despite concerns on China policy risk and Fed rate hikes. This is primarily mitigated by their largely non-China asset portfolios and relatively short duration.

Forex & Commodities

POSITIVE NEUTRAL NEGATIVE

12-MONTH FOREX VIEW

Positive	Neutral	Negative
JPY GBP	USD EUR AUD NZD CAD HKD KRW IDR MYR SGD THB	CNY TWD INR PHP

COMMODITIES

Positive	Neutral	Negative
Gold Base metal	Oil	-

DXY Index: A hawkish Fed continues to drive the greenback upwards. Interest rates hiked by 25bps in March as expected, and the market is now expecting 50bps hike in May and June to combat the high inflation. We are also expecting balance sheet reduction to occur earlier in May

Commodity currencies (CAD, NZD, AUD) continued to appreciate on a strong uptrend. We revise our forecasts on the **Australian currency (AUD) from 0.73 to 0.76 (value of one AUD) for our 3- and 12-month horizon.**

The Bank of Japan intends to keep rates very low for an indefinite period. **The rate differential with the United States is widening and we therefore revised our target from 114 to 118 for both 3 and 12 horizon.**

GOLD: Gold reclaims its haven appeal as worries about war, inflation and growth mount The strength of the USD and rising bond yields are headwinds but investors looking to hedge stagflation risk and central bank purchases should bring support. **For next 12m we expect gold to trade in the $1900-2100 range.**

OIL: Low stockpiles and high disruption risks should keep volatility high. In our main scenario – no sanctions on Russian energy – a combination of demand destruction, higher US shale oil production and a likely lifting of Iranian sanctions should bring the **Brent in the $95-105 range at the end of 2022**.

BASE METALS: We remain positive on base metals as inventories are low. There is also a need to accelerate the energy transition to reduce dependence on Russian oil and gas, and increase defense spending. **Short-term, supply risks have led to high-risk premia, so accumulate selectively on weakness.**

Forex Forecasts

		Spot	3-month		12-month	
		As of 31 Mar 2022	View	Target	View	Target
Developed	USD Index*	96.54	=	99.6	=	97.0
	Japan	115.2	+	118	+	118
	Eurozone	1.121	-	1.08	=	1.12
	UK	1.342	=	1.32	+	1.37
	Australia	0.705	=	0.76	=	0.76
	New Zealand	0.658	=	0.70	=	0.70
	Canada	1.272	=	1.25	=	1.25
Asia Ex-Japan	China	6.365	=	6.35	-	6.50
	Hong Kong*	7.798	=	7.83	=	7.83
	South Korea*	1,206	=	1,235	=	1,245
	Taiwan*	27.81	=	28.9	-	29.7
	India	74.62	=	76.0	-	78.0
	Indonesia*	14,382	=	14,100	=	14,600
	Malaysia*	4.186	=	4.18	=	4.12
	Philippines*	50.98	=	52.6	-	54.0
	Singapore*	1.352	=	1.34	=	1.32
	Thailand*	33.30	=	33.90	=	33.00

Source: BNP Paribas (WM) as of 31 March 2022
**BNP Paribas Global Markets forecast as of 31 March 2022*

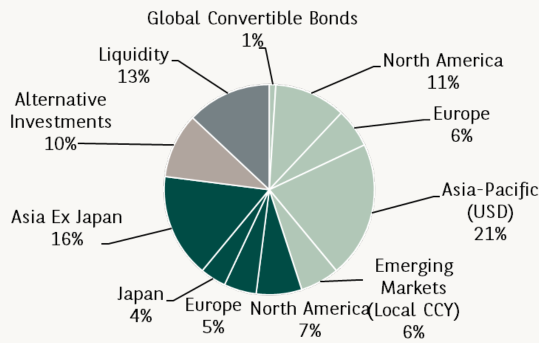
Note: + Positve / = Neutral / - Negative

Strategic & Tactical Asset Allocation

OUR TACTICAL ASSET ALLOCATION IS BASED ON OUR CIO'S ASSET ALLOCATION VIEWS. CHANGES ARE REFLECTED IN THIS MONTH'S TACTICAL ALLOCATION.

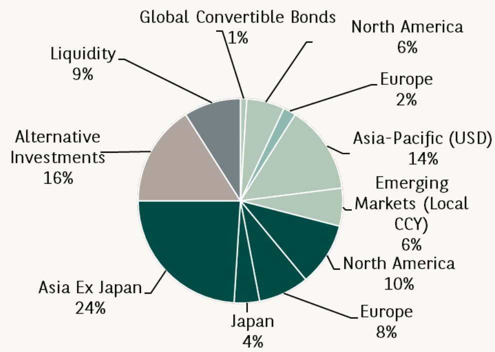
INVESTMENT PROFILE: BALANCED

	STRATEGIC ASSET ALLOCATION		TACTICAL POSITIONING		THIS MONTH'S TACTICAL ASSET ALLOCATION
FIXED INCOME	50%	+	-5%	→	45%
EQUITIES	30%	+	2%	→	32%
ALTERNATIVES	10%	+	-	→	10%
LIQUIDITY	10%	+	3%	→	13%



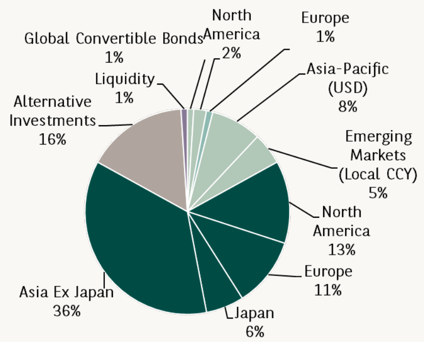
INVESTMENT PROFILE: DYNAMIC

	STRATEGIC ASSET ALLOCATION		TACTICAL POSITIONING		THIS MONTH'S TACTICAL ASSET ALLOCATION
FIXED INCOME	35%	+	-6%	→	29%
EQUITIES	45%	+	1%	→	46%
ALTERNATIVES	15%	+	1%	→	16%
LIQUIDITY	5%	+	4%	→	9%



INVESTMENT PROFILE: VERY DYNAMIC

	STRATEGIC ASSET ALLOCATION		TACTICAL POSITIONING		THIS MONTH'S TACTICAL ASSET ALLOCATION
FIXED INCOME	20%	+	-3%	→	17%
EQUITIES	65%	+	1%	→	66%
ALTERNATIVES	15%	+	1%	→	16%
LIQUIDITY	0%	+	1%	→	1%



Source: MyAdvisory, as of 6 Apr 2022
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