RATES MARKET OUTLOOK

RISING YIELDS DESPITE RISING RISKS

FREDERIC LASRY
BMCG – ECB - 9 October 2018

BNP PARIBAS

The bank for a changing world

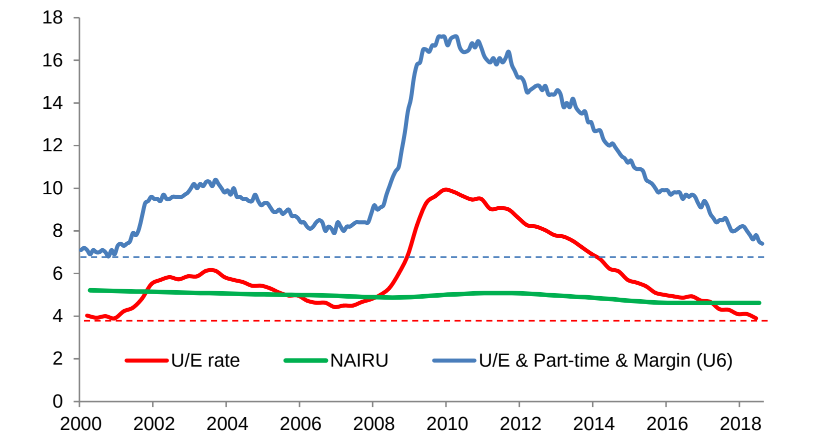
US: Riding high but running out of gas

- **Q2 GDP: roaring economy**
  - Second estimate of Q2 GDP shows growth of 4.2% QoQ (SAAR), with domestic demand even stronger:
    - Real final sales of domestic product grew by 5.3%, its best outturn since Q1 2006.
    - Real final sales to private domestic purchasers grew by 4.3%.
- **August FOMC: only 2 changes to the statement, both hawkish**
  - Pace of economic activity upgraded to "strong" from "solid";
  - Household spending assessed as having "grown strongly" from having "picked up".
- **Latest data remain strong:**
  - Manufacturing output rose 3.1% y/y in August, its highest level since 2012.
  - August inflation disappoints but wages grew 2.9% y/y, the strongest level since June 2009.
  - Core PCE hits 2% y/y in July, first time at Fed's target since 2012.

BNPP forecasts: the end is near(er)

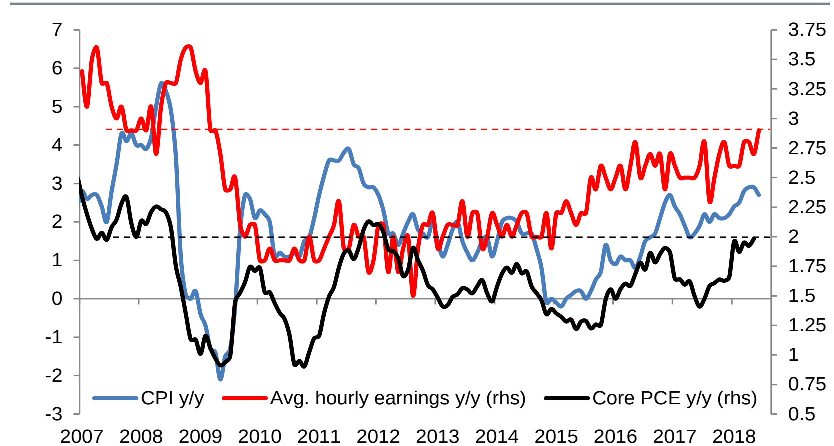
- **GDP: we believe Q2 was the peak.**
  - Economy to ease but remain strong near-term: GDP forecast at 2.8% and 2.5% in Q3 and Q4.
  - More significant slowdown next year: GDP to fall to 1.3% in 2019 (from 2.9% in 2018) as fiscal stimulus fades, tighter monetary conditions begin to bite, and a slower global growth momentum.
- **Inflation: on the rise.**
  - Based effects, higher energy costs and upward pressure on wages and healthcare and shelter prices to lift inflation. We see core PCE hit 2.2% by Q3 and peak at 2.3% by the end of 2019. Tariffs pose upside risks.
  - Minutes reveal the Fed is aligned with us on growth's near-term outlook and is increasingly confident on inflation but still waiting on wages.

Unemployment rate U6 approaching the lows



Source: BNP Paribas, FRED, Bloomberg

Wages are picking up, core PCE hit 2%



Source: Bloomberg, BNP Paribas

US FOMC: Cautiousness revealed

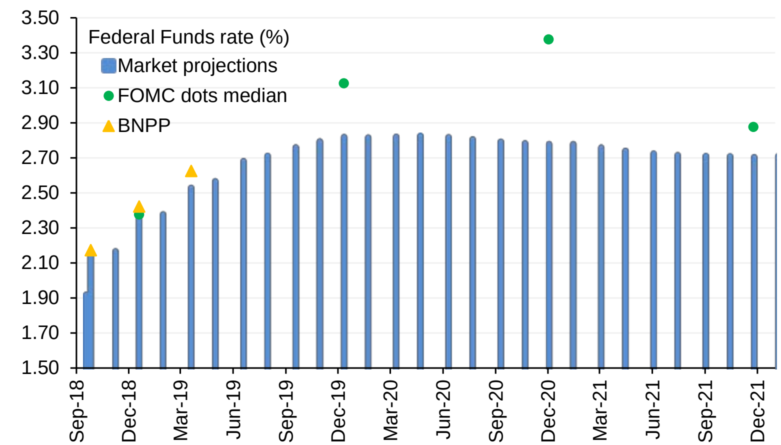
<u>August FOMC Minutes show more risks discussed, and divisions</u>:

- **More risks though risk to outlook is 'roughly balanced':** trade dispute, a faster-than-expected fading of the fiscal impetus, or on the contrary, larger or more persistent positive effects from fiscal policy and strengthening labour market, housing sector weakening, sharp increase in oil prices, severe slowdown in emerging markets.
- **Stance should "at some point fairly soon" no longer be 'accommodative'** given the FF rate heading closer and closer to estimates of its neutral level.
- **Hold up on estimating neutral?** Providing an explicit assessment of the FF rate versus its neutral level convey a false sense of precision.
- **Changes to balance sheet policy in September?** Comments on the implications of regulatory changes in the demand for reserves and for the size and composition of the Fed's balance sheet. Chair Powell suggested discussions would likely resume in the fall.
- **Divisions over how to interpret a flattening yield curve:**
  - "Several participants cited statistical evidence for the United States that inversions of the yield curve have often preceded recessions";
  - "Other participants emphasized that inferring economic causality from statistical correlations was not appropriate", citing a number of global factors contributing to downward pressure on term premiums, including QE and strong global demand for safe assets.

<u>Powell delivers a cautious speech at Jackson Hole</u>:

- **Focus on uncertainty around real-time estimates of the 'stars'** (the neutral rate of interest (r*), NAIRU (u*), and rate of potential growth (g*)).
- Clear takeaway is to **be cautious of relying too much on estimates of the stars as "the stars are sometimes far from where we perceive them to be"**: this follows heightened discussions over the level of neutral interest rates, with regional Fed presidents offering their own estimates.
- **Committee to remain data dependent but inflation not the best indicator:** Powell notes that a flat Philips curve could make Greenspan's strategy no longer useful while in the run-up to the past 2 recessions it was in the financial markets where destabilizing excesses appeared.

Fed funds rate projections



Source: BNP Paribas, FOMC, Bloomberg

We believe that growth is peaking and that the Fed will pause in 2019:

- We forecast 2 more hikes for this year, and 1 for next year, taking the terminal Fed Funds rate to 2.5-2.75% in March 2019.
- Signs of a slowing economy in 2019 should cause the Fed to pause its hiking cycle, after having pushed rates to neutral levels.
- It might remain on a hiking path if economic strength continues or core PCE pushes beyond 2.5% y/y, the Fed's comfort threshold we believe.

- Powell concludes that **modern-day risk management suggests "looking beyond inflation for signs of excesses"**, citing W. Brainard that **"when you are uncertain about the effects of your actions, you should move conservatively"**.
- Takeaway from Powell's speech: cautiousness revealed as the Committee continues its gradual rate hikes and **continued reliance on a meeting-to-meeting data dependence, with that data comprising a wide range of indicators and specifically not contingent on inflation moves.**

US: Further flattening… before a re-steepening in H2 2019

We expect the 2s30s curve to flatten to 0bp by mid-2019:

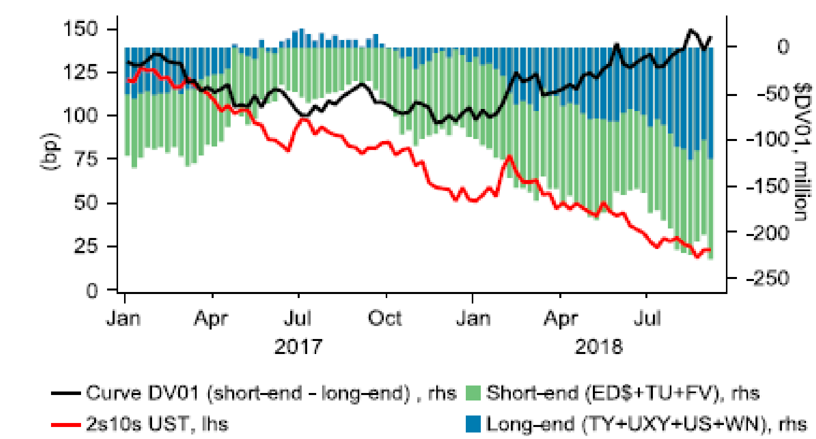
- **Hiking cycle:** historically, the 2s10s UST curve moves with a beta of -0.5 to changes in Fed funds rate. Based on this, the 2s10 curve may flatten to 0bp (from roughly 125bp at the start of the hiking cycle).
- **Less demand at the front-end due to the end of 'shadow QE':** corporates no longer buy ~USD 100bn/y of 1-5y USTs and credit (our estimates) due to the tax reform. Q2 earnings show a further drop in the size of bond portfolios held by corporates, with ongoing distributions.
- **UST supply skewed to the front end:** August's refunding announcement keeps incremental UST issuance skewed to the front-end (FRNs, 2s, 3s and 5s auctions increased the most), T-bill issuance typically rises in Q4.
- **Pensions Liability Driven Investments:** we expect pension LDI buying of long-end USTs to continue with improving solvency and higher PGBC premiums (Pension Benefit Guaranty Corp) although at a slow rate than H1 as the tax break ends in September.
- **Positioning:** CFTC Treasury future positioning data show new record shorts (USD 237.6mn DV01) and suggest speculators are increasingly in steepeners.

Risk of steepening as we head into the latter stages of the business cycle:

- **Fed policy:** a flatter yield curve impacts Fed policy. However, the new "near-term forward approach" suggests the likelihood of a recession is much lower. See *(Don't Fear) The Yield Curve* (by Engstrom and Sharpe).
- **Fed B/S normalisation:** an early end would flatten the curve on a continuation of implicit Twist. But a change in policy could materially steepen the curve (e.g. inverse Twist, untwist).
- **Economic slowdown:** we expect the 2s10s UST curve to bull-steepen by 50bp in H2 2019 under our economists forecasts for a slowdown.
- **De-anchoring of inflation expectations:** market and survey-based expectations are still low by historical standards, despite strong growth, low unemployment, and rising trade tariffs. Watch wages.

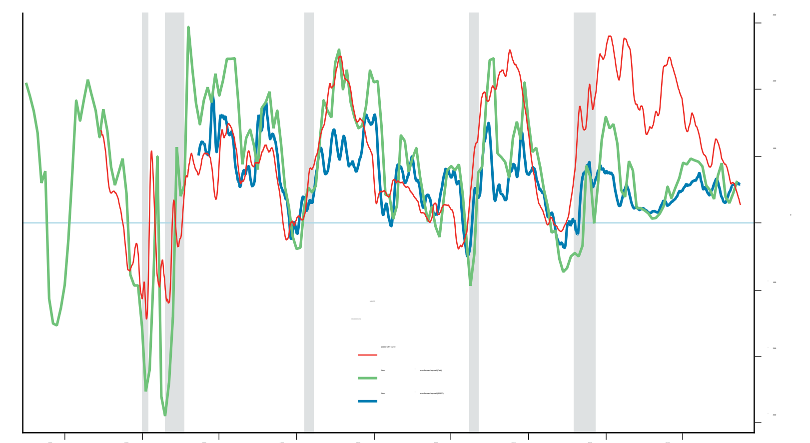
Trade: 10s30s UST flattener. Current: 15bp. Target: -20bp. Carry: -0.5bp/m.

CFTC spec positioning: record shorts, more at the long end



Source: US Treasury, BNP Paribas, Milliman

"Near-term forward spread" approach for predicting recessions

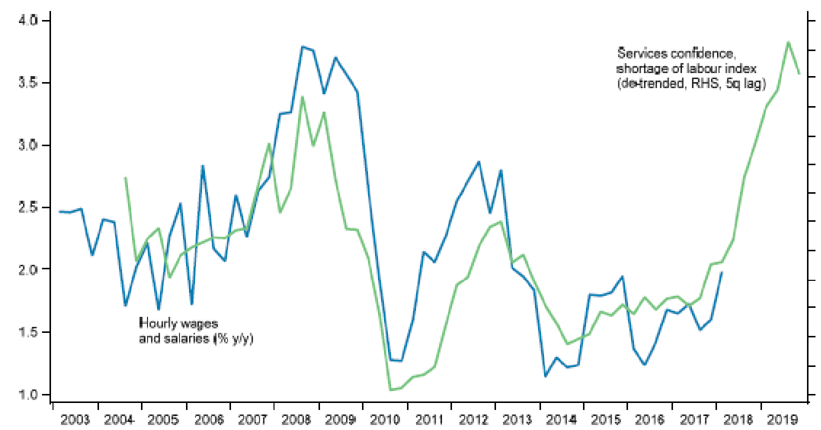


Source: Federal Reserve Bank of New York, Federal Reserve Board staff estimates

Eurozone: Bullish on inflation

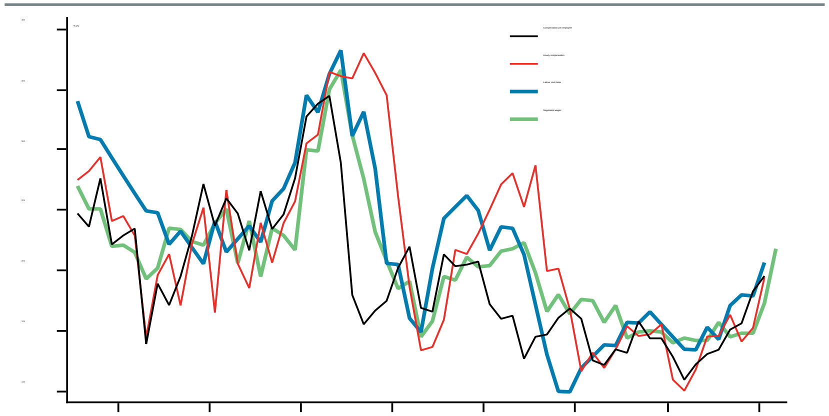
- **Growth keeps disappointing but remains above trend:** we expected a rebound in GDP in Q2 confirming the temporary nature of the first quarter slowdown. Instead, GDP data for Q2 showed unchanged 0.4% QoQ rate.
- **Solid but moderating growth towards trend in 2019:** expect QoQ growth to run at the same pace until the beginning of 2019, before slowing further down to 0.3% for the rest of 2019.
  - A supportive policy mix suggests domestic demand should remain resilient and offset some of the external headwinds.
  - Continued job gains support household sentiment and with it spending.
  - Risks are mostly to the downside: weaker global growth amid monetary tightening might be worse than in our forecasts, political uncertainty might exert a drag on investment growth, more than we forecast.
- **More bullish than the market on inflation:** expect headline and core inflation to pick up in Q4, to 2.3% and 1.5% y/y, respectively, above market consensus.
  - **Declining spare capacity has led to mounting pipeline price pressures**, which should soon filter into core inflation, according to a number of indicators:
    - Output prices are increasing faster than input prices.
    - The share of firms reporting supply constraints due to labour and equipment shortages is close to all-time highs in most member states. This indicates a tightening labour market and point to higher wage growth.
    - Suppliers' delivery times have continued to lengthen.
  - **Past currency strength to continue to weigh on core goods inflation until the end of this year**. That said, the currency pass-through looks somewhat more limited than in the past, probably owing to robust domestic demand which has allowed firms to boost margins instead of passing on lower import prices.
  - **This year's pickup in energy prices** should lend further support to the inflation outlook.

Labour shortages



Source: Eurostat, EU Commission, Macrobond, BNP Paribas

Wages are accelerating across a broad range of measures



Source: Eurostat, European Commission, Macrobond, BNP Paribas

ECB: Dovish but still on a normalisation path

- **ECB turns gloomier on growth at September meeting:**
  - Growth projections downgraded;
  - "Solid" omitted to describe the ongoing recovery, on the ground of slower external demand.
- **Wider list of risks to include developments in emerging markets:**
  - Risks still perceived as balanced, although downside risks have gained prominence.
  - Trade tensions seem to be the predominant concern at the ECB, Draghi highlighting a number of possible channels of transmission, including disruption of value chains and confidence effects.
  - Draghi however also emphasised a number of upside risks, including a "less neutral" fiscal policy stance and the improved outlook for labour markets.
- **Strengthening confidence on the inflation outlook** amid recent developments in the labour market and higher wages
- **ECB seems in line with our view for a while:**
  - Capacity constraints are to blame for some of the slowdown from last year's strong growth pace and now that these are biting these will eventually translate into higher core inflation.
  - Draghi's reference to improved labour markets is one of the reasons why we continue to believe that consumption and therefore overall growth will remain resilient to potential external shocks, at least over the next few quarters.
- **On end of QE:** "the end of the purchases is still conditional on incoming data".
- **On reinvestments:** still not discussed but confirmed an announcement is on the cards, for either October or December, pending technical work on the matter. Capital key rule remains the "guiding principle".

- **Based on our above-consensus call on inflation, we continue to forecast the first depo-rate hike in September 2019, a 20bp hike, 4-months in advance of what the market prices in.**

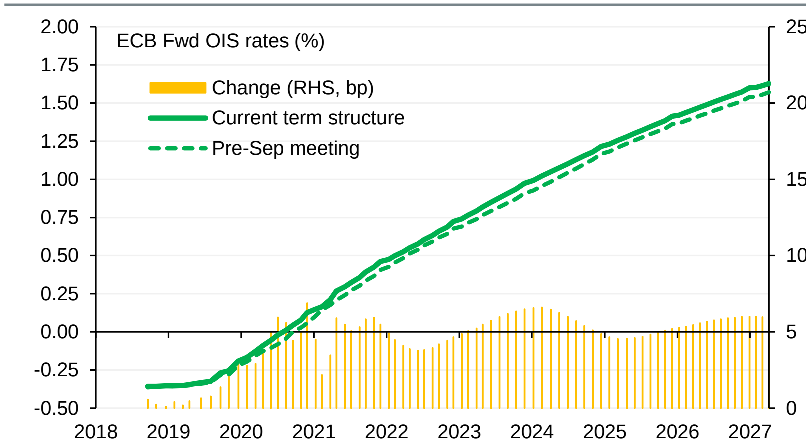
ECB versus BNPP forecasts, and changes over time

ECB	2017	2018	2019	2020
HICP				
Sep-18	1.5	1.7	1.7	1.7
Jun-18	1.5	1.7	1.7	1.7
Mar-18	1.5	1.4	1.4	1.7
Core HICP				
Sep-18	1	1.1	1.5	1.8
Jun-18	1	1.1	1.6	1.9
Mar-18	1	1.1	1.5	1.8
Real GDP				
Sep-18	2.5	2.0	1.8	1.7
Jun-18	2.5	2.1	1.9	1.7
Mar-18	2.5	2.4	1.9	1.7

BNP	2018	2019
HICP		
Sep-18	1.9	1.9
May-18	1.8	1.8
Mar-18	1.7	1.7
Core HICP		
Sep-18	1.1	1.6
May-18	1.2	1.6
Mar-18	1.3	1.7
Real GDP		
Sep-18	2	1.5
May-18	2.2	1.7
Mar-18	2.8	2.1

Source: BNP Paribas

Post-summer rise in yields continues after ECB Sep meeting



Source: BNP Paribas

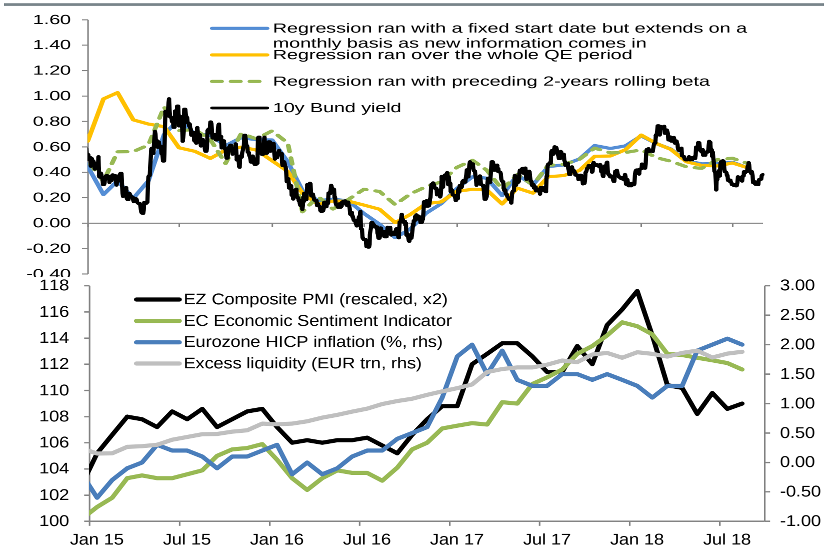
Bund valuation: Partial depricing of QE premium as QE ends

- **Our model's fair value for the 10y Bund yield declined further at the end of August, to 0.40%,** amid a further fall in our leading indicator of activity as well as a slight downward correction in inflation.
- **Our intrinsic valuation model suggests that the QE premium embedded in the 10y Bund yield amounts to 140bp.** We have looked at two approaches:
  - 10y Bund yield's sensitivity to excess liquidity and the QE-led rise in the latter: we find that the QE premium could be as much as 140bp, which was reached in October 2017 and has been relatively stable since then.
  - QE regime versus pre-QE regime model: we could argue that the differential between our QE regime and our pre-QE regime model should reflect the QE premium. The differential between these two models also amounts to 140bp.
  - The latter suggests that the QE premium would have increased considerably from April 2016, when the ECB raised the QE size to EUR 80bn, reaching a high of 150bp in March 2017, before declining as the APP size returned to EUR 60bn and then 30bn.
  - Less intuitively, the QE premium under the latter approach would have risen again after Q1, to return to 140bp currently. However, we could argue that larger reinvestments since April have been playing a part.
- **QE stock versus QE flow:** the first approach measures the QE stock effect while the second seems to reflect more the QE flow effect, declining/increasing with the size of QE and of reinvestments.

Conclusion:

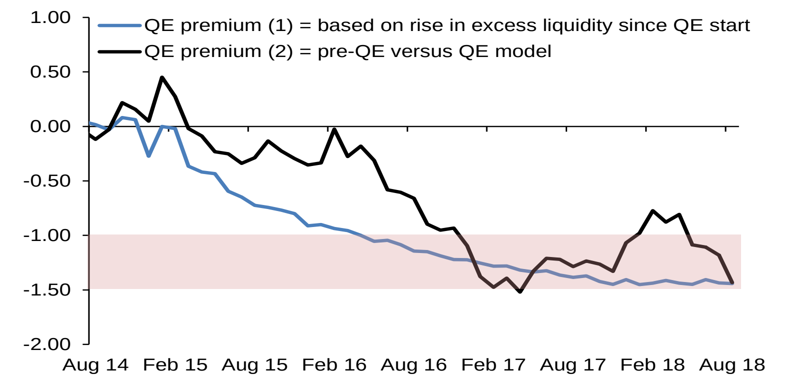
- QE stock and QE flows both matter. In fact, one interrelates with the other as the flow effect is the first derivative of the stock effect.
- So as we head into next year, the QE premium should decline, catching up with the size of reinvestments (QE flow effect), but the stock should prevent it shrinking materially (QE stock effect).
- **A reduction of the QE premium by a quarter would see the 10y Bund yield rises towards 0.75% as the market factors in the end of ECB QE.**

10y Bund's Intrinsic Valuation Model (%) – QE regime



Source: BNP Paribas

Assessing a QE premium for the Bund (%)

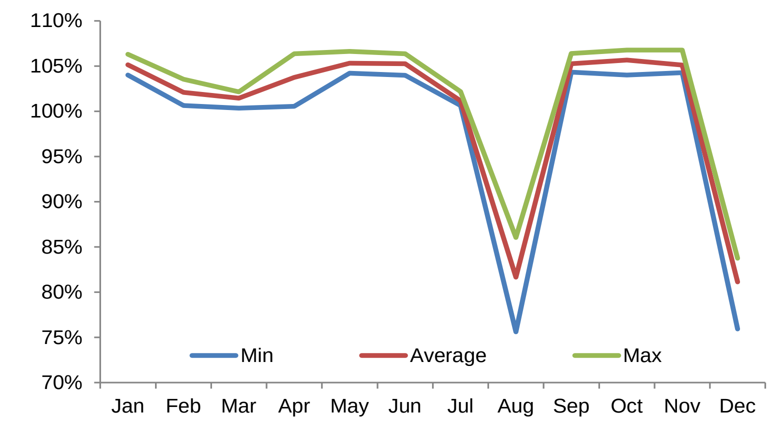


Source: BNP Paribas

QE flows: Beware the tapering

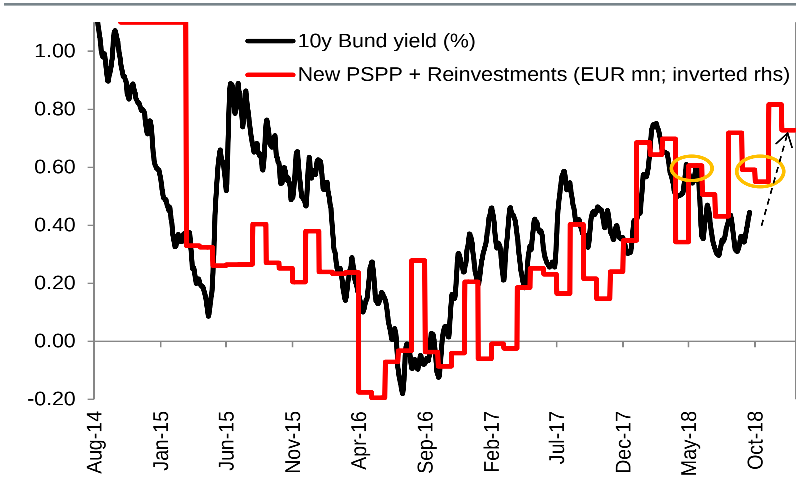
- **Net QE purchases to decline:** monthly APP fell in August, to 82.7% of the EUR 30bn/month target, broadly in line with the 82% average for August. In Sep-Nov, net purchases usually make up ~105% of the monthly target, but the tapering will ultimately bring net purchases down to just below EUR 16bn a month in October/November, from EUR 31.5bn forecast in September.
- **PSPP share on the rise:** PSPP made up 91% of APP purchases in August as the share of CSPP returned to all-time lows of 6% (vs. YTD avg of 16%). We expect corporate supply, and thus CSPP purchases, to have rebounded in September. Still, having continually risen since March, we expect the share of PSPP to remain higher than the 70% seen in Q1, or 78% in Q2, especially with the end of APP looming. We assume an 80% share until November.
- **Gross PSPP purchases back to May's lows, then below:** October is the 2nd heaviest month of the year in terms of redemptions (EUR 21bn). New PSPP and reinvestments could thus amount to EUR 33.8bn in October, slightly above September (EUR 31.3bn forecast), but well below July's 41bn spike, and closer to May's EUR 30bn which saw the 10y Bund yield broke through 0.60%.

APP as a % of targeted size since the start of QE



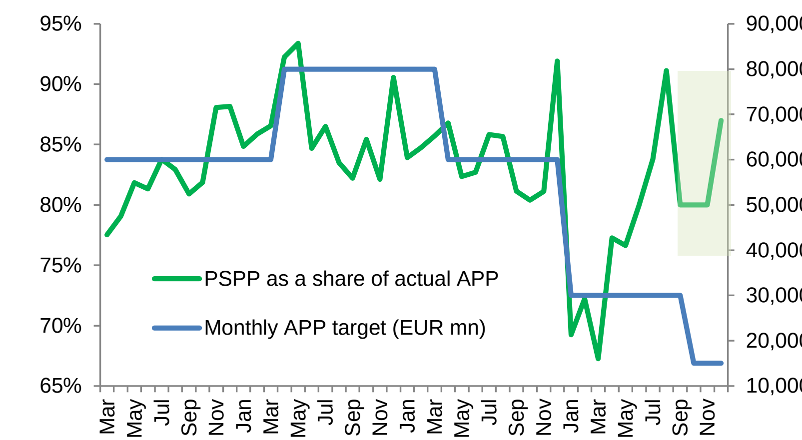
Source: ECB, BNP Paribas

Gross PSPP flows on a downward trajectory



Source: BNP Paribas

PSPP as a share of APP

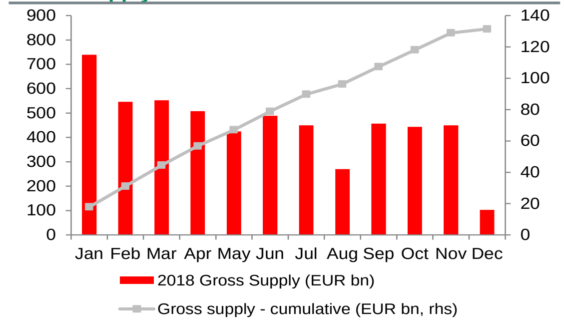


Source: ECB, BNP Paribas

EGB supply: Large repayments in October

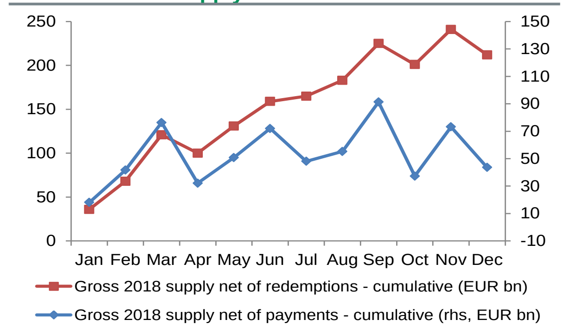
EGB Gross Supply	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Austria	5.4	1.4	1.2	1.2	1.2	1.6	1.8	1.4	1.8	1.4	1.7	1.6	22
Belgium	5	4.5	4.2	4.4	0	3.7	3.7	0	3.7	0	1.8	0	31
Finland	0	3	0	1	0	0	0	4.2	0	1.4	1.4	0	11
France	21.7	21.7	22.7	18.1	22	20.6	20.8	8.1	23.1	18	19.1	4.2	220
Germany	16	13.5	13.5	12	12.3	10.5	15	16	13.5	12.5	15.3	3	153
Ireland	4	1.3	1.1	4	1	0.7	0.5	0	0.6	2.2	0.7	0	16
Italy	36.5	22.1	26	23.6	17	20.9	18.2	8.5	15.3	19.6	17.2	0	225
Netherlands	1.9	0	5.8	2	1.8	2.3	1.3	0	3.3	3.8	3.8	0	26
Portugal	4	1.3	1.3	4	1.2	0.5	0.5	0.7	0.4	0.6	0.5	0	15
Spain	20.6	15.9	10.3	9.2	9.6	15.3	8.5	2.8	9.1	9.2	8.9	6.9	126
Total (EUR bn)	**115.1**	**84.7**	**86.1**	**79.5**	**66.1**	**76.1**	**70.3**	**41.7**	**70.8**	**68.7**	**70.4**	**15.7**	**845**

Gross supply



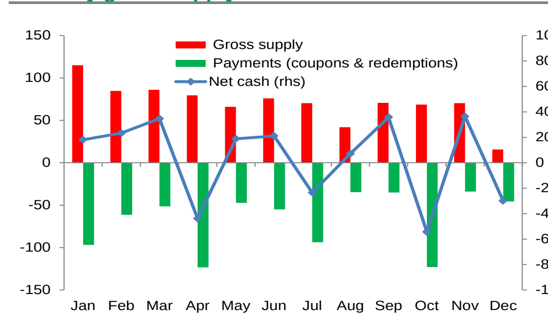
EGB Net Supply	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Austria	-6.6	1.4	1.2	1.2	1.2	1.6	1.8	1.4	1.8	-5.6	1.7	1.6	3
Belgium	5	4.5	-4.8	4.4	-3	-5.3	3.7	0	3.7	0	1.8	0	10
Finland	0	3	0	1	0	0	0	4.2	-5	1.4	1.4	0	6
France	21.7	7.7	22.7	-8.9	4	20.6	11.8	8.1	23.1	-10	-0.9	4.2	104
Germany	-4	-3.5	0.5	-20	12.3	-3.5	-6	16	0.5	-4.5	15.3	-10	-7
Ireland	4	1.3	1.1	4	1	0.7	0.5	0	0.6	-6.8	0.7	0	7
Italy	21.5	0.1	15	11.6	3	2.9	18.2	-15.5	4.3	7.6	7.2	-32	44
Netherlands	-11.1	0	5.8	-10	1.8	2.3	-11.7	0	3.3	3.8	3.8	0	-12
Portugal	4	1.3	1.3	4	1.2	-6.5	0.5	0.7	0.4	0.6	0.5	0	8
Spain	1.6	15.9	10.3	-7.8	9.6	15.3	-12.5	2.8	9.1	-10.8	8.9	6.9	49
Total (EUR bn)	**36.1**	**31.7**	**53.1**	**-20.5**	**31.1**	**28.1**	**6.3**	**17.7**	**41.8**	**-24.3**	**40.4**	**-29.3**	**212**

Cumulative net supply



EGB Net Payments*	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Austria	-7.3	1.3	-0.2	0.8	1	1.2	0.7	1.4	1.2	-6.3	1.3	1.6	-3
Belgium	5	4.5	-9.8	4.4	-3	-7.7	3.7	0	1.2	0	1.8	0	0
Finland	0	3	0	0.3	0	0	-0.7	4.2	-5.2	1.4	1.4	0	4
France	21.7	7.7	22.7	-23.2	-1.4	20.4	8.9	8.1	23.1	-23.6	-2.3	4.2	66
Germany	-10.4	-4.6	0.5	-20.6	11.8	-3.5	-14	14.5	-0.5	-4.8	15.3	-10	-26
Ireland	4	1.1	-0.1	3.5	0.6	0.2	0.5	0	0.6	-7.9	0.7	-0.2	3
Italy	21.4	-5.8	4.2	10.9	-2.7	0.7	12.8	-24.7	2.6	1.7	5.4	-32.4	-6
Netherlands	-14.9	0	5.8	-10	1.8	2.3	-15	0	3.3	3.8	3.8	0	-19
Portugal	4	0.2	1.3	2.7	1.2	-7.7	0.3	0.7	0.4	-0.4	0.5	0	3
Spain	-5.3	15.9	10.3	-12.6	9.6	15.3	-20.6	2.8	9.1	-18.1	8.5	6.9	22
Total (EUR bn)	**18.2**	**23.3**	**34.7**	**-43.8**	**18.9**	**21.2**	**-23.4**	**7**	**35.8**	**-54.2**	**36.4**	**-29.9**	**44**

Monthly gross supply and net cash*

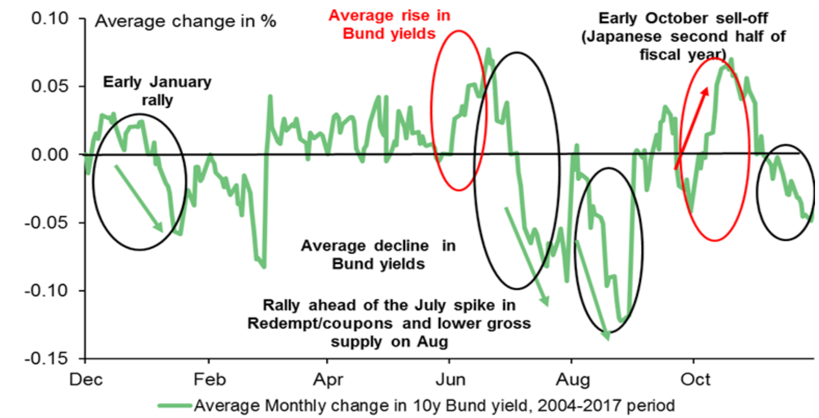


All sources: BNP Paribas (including coupon payments)*

EUR: Short the 10y real yield

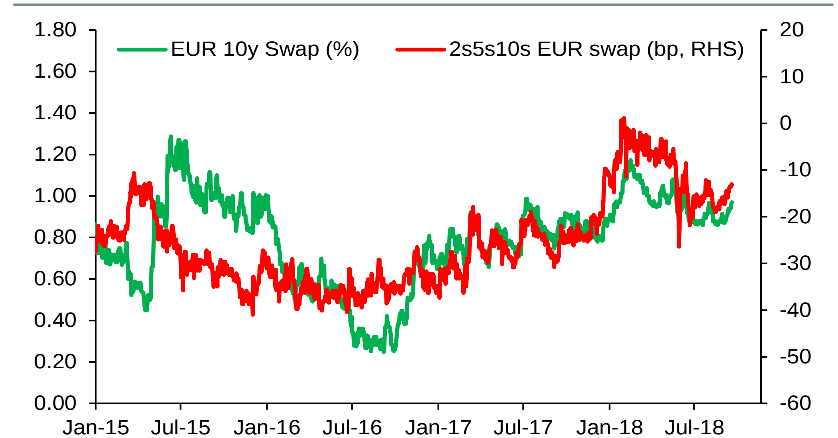
- **Short the BUNDei-26 real yield. Entry: -1.27%. Current: 1.12%. Target: -0.70%. Positive carry.**
  - In July we recommended waiting until towards the end of August to be short, in light of a seasonal rally in August spurred by the lack of issuance, and targeting the 0.25-0.30% area. The 10y Bund yield broke through 0.30% again in the 3rd week of August. It prompted us to enter a short position, via the BUNDei-26 real yield where the carry is positive (+9bp until end of March).
  - Gross QE flows (new PSPP plus reinvestments) will remain well below July's high going forward, closer to May's levels when the 10y Bund yield broke through 0.60%, before declining further into year-end.
  - Supply has resumed.
  - <u>Risk: temporary correction into October to follow the 20bp sell-off?</u>
    - Redemptions and coupon payments will pick up again in October, to the extent where October will be the most negative month of the year when it comes to net payments.
    - A short seasonal pattern usually sees a rally into October (from the end of this week; 85% of the time, by 15bp).
    - But this might be partly counterbalanced news over the Italian budget (targets to be announced by the end of the month).
    - What's more, the 2nd and 3rd week of October usually give way to a seasonal sell-off (which has occurred 85% of the time, by up to 15bp).
- Other shorts we have:
  - **Pay 2s5s10s EUR swap. Entry: -16bp. Target: -4bp. Stop-loss: -21bp. Carry and roll: -3.2bp/3m.**

2004 - 2017 Bund yield and seasonal patterns (bp)



Source: BNP Paribas

2s5s10s swap fly to rise as QE ends

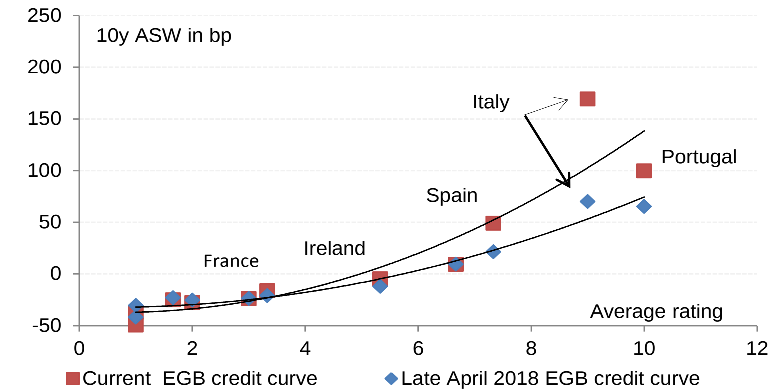


Source: BNP Paribas

Italy: Concerns remain into budget plan presentation

- **August sell-off driven by mounting concerns over the budget** with reported disagreement inside the government.
  - Di Maio and Deputy Prime Minister/League leader Salvini reportedly aiming to relax the budget so the programme can be implemented as soon as next year.
  - Tria in favour of a more moderate approach, a more neutral fiscal stance or only a slight loosening.
- **Key proposals in the government's programme include:**
  - Reform Italy's tax system, aiming to introduce a 'flat tax' system ;
  - Introduction of a universal income scheme;
  - Reversal of the so-called Fornero pension system reforms.
- **These measures are estimated to cost more than 5% of GDP so could not be implemented in full without putting fiscal debt sustainability at risk:**
  - We expect some compromise to be reached so that these measures are implemented only partially, or offset by savings elsewhere. Government could spread the impact over several years or announce a series of consultations to deliver its pledges (rather than hard-wiring them into its 2019 budget projections).
- **Key dates:**
  - Government to set new public-finance targets by 30 September;
  - Government to submit a draft budget to the EU for review by 15 October.

Italy: a lot of bad news already priced in



Source: BNP Paribas

Our baseline scenario: budget deficit target of around 2% of GDP or below for 2019.

- 2% looks ok versus a forecast of 1.8% for this year, but, compares with 0.8% in the previous government's plan.
- While technically it fulfils the Maastricht criteria of achieving a deficit of below 3% of GDP, Italy has a government debt-to-GDP ratio of over 130% – more than double the 60% allowed – so according to the stability and growth pact, Italy is required to make ongoing adjustment to keep its debt-to-GDP ratio on a downward trajectory in the medium term.
- The deficit target would therefore probably breach EU rules but we expect the EC to ignore the rule breach for now, as in recent years, until it perceives the risk of marked fiscal slippage.
- On the bright side, **2% is unlikely to be an immediate challenge to Italian debt sustainability:** the weighted average interest rate on outstanding public debt is still above market rates, so the government can still roll over its debt at lower rates, reducing its overall interest-rate bill.
- **Under our base case, the 10y BTP/Bund spread would tighten to about 225bp**, with the 10y yield rising to 0.75% as the ECB ends QE and the 10y BTP staying near 3%.

G10 rates forecasts: Rising yields despite rising risks

Our key views

We expect yields to rise by more than is priced into the forwards in Q4 2018 and H1 2019 (although by 20-30bp less than we expected in our May forecasts).

By H2 2019 the picture is less uniform. We expect eurozone and UK yields to rise, and US and Japanese yields to plateau – eventually.

What hasn't changed:

- Economic fundamentals: growth is above trend and inflation is rising.
- Monetary policy: gradual withdrawal of accommodation is set to continue.
- Supply, net of global QE, will increase substantially in H2 2018 and beyond.

What has changed:

- The pace of policy tightening will be even more glacial: ECB forward guidance has flattened the path we expect for ECB rates and BoJ 'tightening' appears over for a while.
- Trade tensions look set to persist, so we have cut our 2019 GDP forecasts.
- Risks have risen from politics and financial market volatility, in developed and emerging markets. In Italy our forecasts are based on a fairly benign scenario, but sizeable downside risks to our base case remain.
- So risk premia should rise, with core 'safe-haven' assets richer and sovereign spreads wider (especially Italy) than our May forecast.

	Rates	Spot	Dec-18 BNPP forecast	Dec-18 Forecast vs spot	Dec-18 Market-implied forward	Dec-18 Forecast vs forward	Jun-19 BNPP forecast	Jun-19 Forecast vs spot	Jun-19 Market-implied forward	Jun-19 Forecast vs forward	Dec-19 BNPP forecast	Dec-19 Forecast vs spot	Dec-19 Market-implied forward	Dec-19 Forecast vs forward
US	FF*	1.75-2.00	**2.25-2.50**				**2.50-2.75**				**2.50-2.75**			
	2y	2.66	**2.95**	+29	2.78	**+17**	**3.10**	+44	2.88	**+22**	**2.50**	-16	2.94	**-44**
	5y	2.77	**3.05**	+28	2.83	**+22**	**3.15**	+38	2.88	**+27**	**2.80**	+3	2.92	**-12**
	10y	2.88	**3.10**	+22	2.91	**+19**	**3.20**	+32	2.94	**+26**	**3.00**	+12	2.95	**+5**
	30y	3.03	**3.10**	+7	3.05	**+5**	**3.10**	+7	3.07	**+3**	**3.10**	+7	3.08	**+2**
GER	EONIA	-0.36	**-0.35**				**-0.35**				**-0.15**			
	2y	-0.58	**-0.45**	+13	-0.59	**+14**	**0.00**	+58	-0.56	**+56**	**0.30**	+88	-0.52	**+82**
	5y	-0.19	**0.15**	+34	-0.15	**+30**	**0.60**	+79	-0.07	**+67**	**0.80**	+99	0.02	**+78**
	10y	0.38	**0.75**	+37	0.45	**+30**	**1.00**	+62	0.54	**+46**	**1.20**	+82	0.62	**+58**
	30y	1.06	**1.30**	+24	1.08	**+22**	**1.50**	+44	1.12	**+38**	**1.60**	+54	1.16	**+44**
JGB	Call rate	-0.10	**-0.10**				**-0.10**				**-0.10**			
	2y	-0.12	**-0.09**	+3	-0.13	**+4**	**-0.12**	-0	-0.13	**+1**	**-0.15**	-3	-0.13	**-2**
	5y	-0.08	**-0.04**	+4	-0.07	**+3**	**-0.07**	+1	-0.05	**-2**	**-0.12**	-4	-0.04	**-8**
	10y	0.09	**0.14**	+5	0.12	**+2**	**0.10**	+1	0.15	**-5**	**0.02**	-7	0.19	**-17**
	30y	0.84	**0.95**	+11	0.85	**+10**	**0.90**	+6	0.87	**+3**	**0.80**	-4	0.90	**-10**
UK	Bank Rate	0.75	**0.75**				**1.00**				**1.25**			
	2y	0.73	**0.80**	+7	0.78	**+2**	**1.15**	+42	0.84	**+31**	**1.35**	+62	0.90	**+45**
	5y	1.04	**1.10**	+6	1.10	**+0**	**1.45**	+41	1.16	**+29**	**1.70**	+66	1.21	**+49**
	10y	1.45	**1.55**	+10	1.49	**+6**	**1.80**	+35	1.56	**+24**	**2.00**	+55	1.62	**+38**
	30y	1.78	**1.95**	+17	1.80	**+15**	**2.15**	+37	1.82	**+33**	**2.25**	+47	1.83	**+42**
AUD	Cash rate	1.50	**1.50**				**1.50**				**1.75**			
	2y	2.01	**2.10**	+9	2.10	**-0**	**2.20**	+19	2.28	**-8**	**2.40**	+39	2.50	**-10**
	5y	2.19	**2.30**	+11	2.33	**-3**	**2.70**	+51	2.48	**+22**	**2.90**	+71	2.61	**+29**
	10y	2.56	**2.70**	+14	2.63	**+7**	**2.90**	+34	2.71	**+19**	**3.10**	+54	2.79	**+31**
	Curves and spreads	**Spot**	**Dec-18**				**Jun-19**				**Dec-19**			
US	2s10s	22	**15**	-7	13	**+2**	**10**	-12	6	**+4**	**50**	+28	2	**+48**
	10s30s	15	**0**	-15	14	**-14**	**-10**	-25	13	**-23**	**10**	-5	13	**-3**
	2s5s10s	0	**5**	+5	-4	**+9**	**0**	+0	-5	**+5**	**10**	+10	-4	**+14**
GER	2s10s	96	**120**	+24	103	**+17**	**100**	+4	110	**-10**	**90**	-6	114	**-24**
	10s30s	68	**55**	-13	63	**-8**	**50**	-18	58	**-8**	**40**	-28	53	**-13**
	2s5s10s	-18	**0**	+18	-16	**+16**	**20**	+38	-12	**+32**	**10**	+28	-7	**+17**
JGB	2s10s	21	**23**	+2	25	**-2**	**22**	+1	28	**-6**	**17**	-4	32	**-15**
	10s30s	75	**81**	+6	73	**+8**	**80**	+5	72	**+8**	**78**	+3	71	**+7**
	2s5s10s	-13	**-13**	-0	-13	**-0**	**-12**	+1	-12	**+0**	**-11**	+2	-13	**+2**
UK	2s10s	72	**75**	+3	71	**+4**	**65**	-7	72	**-7**	**65**	-7	73	**-8**
	10s30s	33	**40**	+7	31	**+9**	**35**	+2	26	**+9**	**25**	-8	21	**+4**
	2s5s10s	-11	**-15**	-4	-8	**-7**	**-5**	+6	-9	**+4**	**5**	+16	-10	**+15**
AUD	2s10s	56	**60**	+4	53	**+7**	**70**	+14	43	**+27**	**70**	+14	29	**+41**
	2s5s10s	-18	**-20**	-2	-7	**-13**	**30**	+48	-4	**+34**	**30**	+48	-6	**+36**
	US-GER	250	**235**	-15	246	**-11**	**220**	-30	240	**-20**	**180**	-70	233	**-53**
	AUD-US	-32	**-40**	-8	-28	**-12**	**-30**	+2	-23	**-7**	**10**	+42	-16	**+26**

10y spreads to Germany	Spot	Dec-18 BNPP forecast	Dec-18 Forecast vs spot	Jun-19 BNPP forecast	Jun-19 Forecast vs spot	Dec-19 BNPP forecast	Dec-19 Forecast vs spot
France	34	**25**	-9	**25**	-9	**25**	-9
Italy	280	**225**	-55	**210**	-70	**200**	-80
Spain	107	**90**	-17	**90**	-17	**90**	-17

10y yield	Spot	Dec-18 BNPP forecast	Dec-18 Forecast vs spot	Jun-19 BNPP forecast	Jun-19 Forecast vs spot	Dec-19 BNPP forecast	Dec-19 Forecast vs spot
France	0.72	**1.00**	+28	**1.25**	+53	**1.45**	+73
Italy	3.18	**3.00**	-18	**3.10**	-8	**3.20**	+2
Spain	1.45	**1.65**	+20	**1.90**	+45	**2.10**	+65

**Fed funds rate. Spot rates as of 28 August 2018. Sources: Bloomberg, BNP Paribas*

Points for Discussion

- Is the bear market really there
- Major risks: how strong can it be
  - Geo-political risks
    - Italian situation
    - Brexit
    - Trade tensions
  - Economic uncertainty:
    - Slower growth with higher inflation in developed countries
    - EM risks
  - Monetary policy
    - US Fed to continue to tighten
    - ECB normalization - end of QE but Twist

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