AllianceBernstein®

December 10, 2024

# A Note from the AB Fixed Income Trading Desk

Thoughts from Our Senior Portfolio Managers

### Year-End Report Card: Grading Our 2024 Outlook

*“We do not learn from experience…we learn from reflecting on experience.”—John Dewey*

In our final note of 2024, we look back at a volatile and event-filled year, paying specific attention to the guidance and recommendations we provided at the start of the year. Though many of our predictions proved to be correct, others missed the mark. We invite you to join us in grading our expectations from a year ago as we lay the foundation for what is to come in 2025.

### 2024 in Review: Anything but Average

Barring any dramatic moves in the last few weeks of the year, 2024 fixed-income returns should be broadly in line with long-term averages. The Bloomberg US Aggregate Bond Index, a proxy for the US fixed-income market and the most frequently used benchmark index, is poised to deliver annualized returns that slightly exceed the average returns investors have experienced over the past two decades (*Display 1*). Investment-grade and high-yield bond index returns are tracking toward returns of 5% and 10%, respectively—both of which are slightly above long-term averages.

Despite this result, 2024 has been far from “average” in many respects. After a coordinated period of rising rates in recent years, major central banks have recently started to reverse course and lower rates. The period of elevated rates has taken its toll on growth to varying degrees around the world. The two major wars being fought at the start of the year (Ukraine/Russia and the Middle East) have both only escalated further in 2024. Over half of the world’s population had elections, resulting in regime changes in the US and other important economies. Political turmoil has been felt around the globe, with recent turbulence in Germany, France and South Korea. As a result of all this economic and geopolitical uncertainty, fixed-income volatility has been elevated and valuations have moved dramatically. In our view, there was nothing average about this year.

### Macro Forecast: B+

**What We Got Right:** Entering the year, our macro forecasts could generally be summed up in one word: “normalization.” We expected inflation to continue to fall, labor markets to weaken and economic growth to slow (albeit stay positive) across the US, euro area and other major economies. All three of those dynamics have come to fruition—and are now much closer to “normal” levels.

First, 2024 inflation levels have declined meaningfully relative to 2023 levels. Even with a small recent uptick, US inflation is now 2.8%, down 60 basis points (bps) from its level at the same point last year (*Display 2*). Second, the US unemployment rate has increased while the rate at which jobs are being added has declined, putting both numbers more in line with pre-pandemic levels. Third, US GDP growth this year is tracking below 2023’s rate. The same trajectory has played out for all these measures across many of the world’s major economic regions.

**What We Missed:** What we, and many other forecasters, underestimated was the resilience of the US economic engine. Although an impending US recession was never our base case, we now see it as a far less likely scenario than we did last year. The same is true of forecasters in general. Currently, just 25% of economists surveyed by Bloomberg expect a recession to occur in the next 12 months, compared to 50% in December 2023 and 65% in June 2023. This surprising strength has led to a recalibration of rates and credit expectations.

### Rates Forecast: B–

**What We Got Right:** We forecasted that many major central banks would begin to ease rates in 2024 on the heels of cooling inflation. Specifically, we anticipated that the European Central Bank (ECB) and Bank of England would initiate their rate-cutting cycles in the summer, a few months before the Fed. We expected all three of these central banks to cut their policy rates a few times before the end of the 2024, with the pace of cuts likely to slow in 2025. That prediction has proven to be correct (*Display 3*).

The surprising resilience of the US economy resulted in the Fed beginning its cutting cycle later in the year than we had anticipated. As a result, the amount the Fed is likely to cut this year is going to be slightly below what we had expected entering 2024. The market expects the ECB to cut by another 25 bps at its meeting next week, which would result in a total reduction of its policy rates by 100 bps—in line with what we had forecast.

As a result of this easing and a normalization of economic growth, we forecasted yield curves to steepen. At the start of 2024, the yield on the two-year US Treasury was greater than the yield on the 10-year US Treasury. This inversion of the yield curve presented investors with a unique opportunity. As expected, the yield curve is now upward sloping.

**What We Missed:** Predicting rates further out the curve has proved more challenging. The yield on the 10-year US Treasury is higher today than it was at the start of the year despite macro developments suggesting that the opposite should have occurred (*Display 4*). So why have intermediate- and long-end rates backed up so much since reaching relative lows in September? First, economic growth has surprised to the upside, meaning that markets see a more gradual pace of Fed easing. Second, the US election results have pushed growth and inflation expectations higher while also adding greater uncertainty around the long-term feasibility of the US deficit.

## Credit Forecast: B+

**What We Got Right:** We entered the year cautiously optimistic on credit. At the time, many investors pointed to relatively tight spreads as a reason to avoid credit entirely. We did not feel this way and believed spreads were tight for valid reasons. Company fundamentals were in a position of strength, the economic backdrop remained positive, and technicals were supportive. As a result, we saw opportunity broadly across the credit spectrum outside of a select few pockets, specifically in the lowest-rated portions of the market.

Despite entering the year at relatively tight spread levels, credit has performed well. High yield is on pace to generate an almost 10% return this year, with spreads tightening over 60 bps to the lowest level since the global financial crisis. The leveraged loan market has also posted high-single-digit returns this year despite being a floating rate product in a period of central bank easing.

**What We Missed:** Ultimately, we were not optimistic enough. The lowest-rated portions of the credit market have performed the best this year (*Display 5*). The surprising strength of the economy has resulted in lower-than-expected defaults and further spread compression from the lowest-rated credits.

## Volatility Forecast: A

**What We Got Right:** Throughout the year, central banks frequently reminded investors that the magnitude and pace of rate cuts was going to be data dependent. As a result, we expected markets to have knee-jerk reactions to data releases throughout the year, resulting in dramatic swings in valuations. Additionally, higher rates and tight financial conditions often highlight cracks and excesses that have built up across the economy (such as during the regional banking crisis in 2023).

**What We Got Wrong:** We expected volatility in rates markets to ripple into yields offered by credit products, potentially presenting more attractive entry points. While that did occur somewhat (such as in August), credit spreads were a buffer to moves in rates. As a result, yields offered by credit products were surprisingly range bound over the course of 2024.

## Investment Implications

We plan on providing greater details about our 2025 forecasts in our first note of the new year—including macro and rates predictions. In the meantime, we continue to suggest the follow course of action for investors.

**Don't Fear Duration:** Treasury yields have backed up in recent weeks to levels that present an attractive risk/reward profile. The Fed is cutting rates, the economy is slowing, and yields are near cyclical peaks. Because Treasuries are the only sector that has cheapened lately while other asset classes have rallied, it makes sense to increase duration through holdings of Treasuries. Additionally, we see room for further curve steepening as the Fed continues to ease, while longer yields remain elevated due to concerns about the national debt.

**Continue to Hold Credit:** Government bonds and credit sectors are generally negatively correlated, helping to mitigate risks posed to one or the other. Credit fundamentals remain strong, and technicals are supportive. Though spreads are relatively tight, history tells us they can stay range-bound for extended periods of time and investors who sit out on the sidelines can miss out on attractive returns.

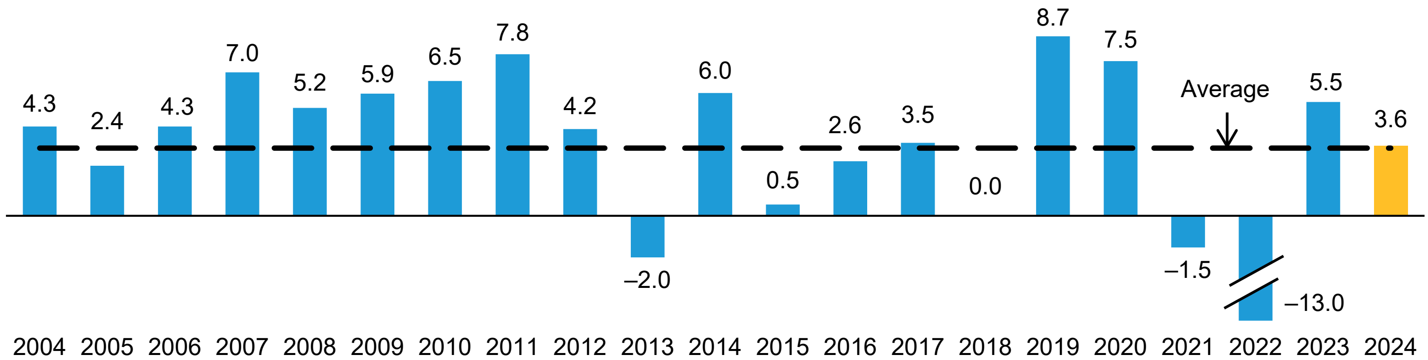
**Find the Silver Lining in Volatility:** We think investors should get comfortable with evolving policy expectations and short-term turbulence. Volatile swings in valuations, though often frustrating, can present attractive levels to enter or exit tactical trades.

Thank you for joining us on the investment journey that was 2024. We wish you and your loved ones a joyous holiday season filled with health, laughter and peace. We look forward to a prosperous 2025 and hope you will join us again for the journey.

Scott DiMaggio, Gershon Distenfeld, Matt Sheridan, Fahd Malik, Will Smith, John Taylor, Mike Rosborough, Serena Zhou, Tim Kurpis and AJ Rivers

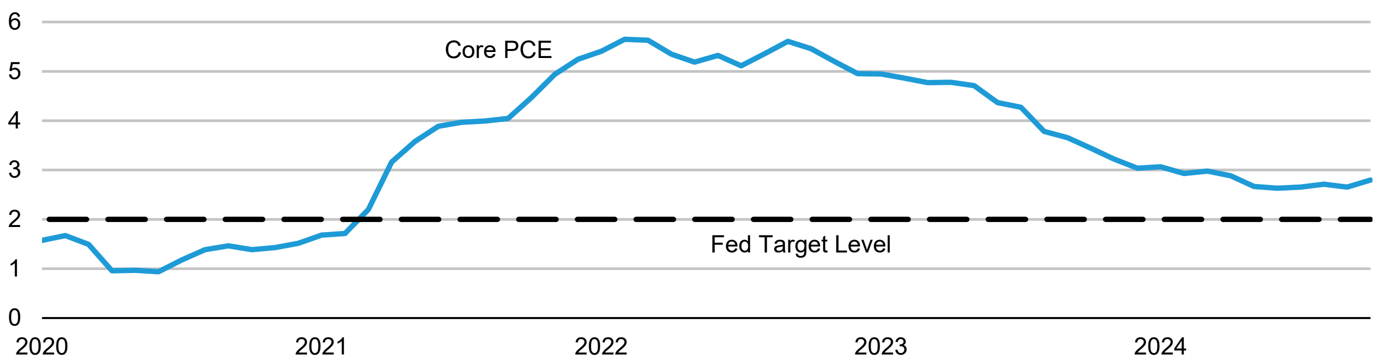
| Area | Where We See Opportunity | Where We Are Cautious |
|---|---|---|
| **Duration** | **Short-Dated Part of Curve:** Yields are similar for short-term and long-term Treasuries, but greater uncertainty means more risk in the long end.<br>**Steepeners:** Yield curves are inverted, allowing an attractive entry point for steepener positioning. | **Belly of the Curve:** Compensation is not as attractive as in short-dated and long-term segments given a lack of clarity on US fiscal and economic trajectories. |
| **Global Bonds** | **UK:** We prefer the long-end part of the curve, as the UK market is pricing in a less-aggressive removal of restrictive monetary policy than are other markets.<br>**Japan:** The long end of the curve is attractive for both local and foreign investors on a hedged basis. We expect the curve to flatten. | **China:** Uncertainty around growth and spending may be a drag on the longer parts of the yield curve. |
| **Investment-Grade (IG) Corporates** | **Broadly:** IG credit offers attractive yields despite relatively low spread levels. We prefer BBB credits.<br>**Banks:** Senior bank debt trades at attractive levels relative to other industries.<br>**Media:** Company fundamentals remain strong, and the industry offers attractive valuations. | **Long-End IG Corporates:** Curves are flat, and the long end is usually more volatile. We see limited upside in the long end of the IG space. |
| **High-Yield Corporates** | **High-Quality Credit:** Better insulated from economic uncertainty and default risk<br>**Non-Cyclicals:** Less sensitive to slowing economic growth | **CCC-Rated Credits:** Defaults have increased, and valuations are likely to come under pressure.<br>**Oil/Energy and Commodity Chemicals:** Valuations look full, and the risk/reward profile is not compelling.<br>**Real Estate Investment Trusts (REITs):** Valuations are not attractive, and the growing illiquidity in the space creates headwinds for the sector. |
| **Emerging-Market Debt** | **USD-Denominated Corporates:** Attractive risk-adjusted returns, driven by lower volatility, alongside strong fundamentals and supportive technicals<br>**USD-Denominated Sovereign Debt:** Slightly positive outlook as developed-market easing increases the yield differential offered by emerging-market debt | **Local-Currency Debt:** FX volatility and the strength of the dollar can be a drag on local-currency borrowings. |
| **Securitized** | **AAA Collateralized Loan Obligations:** Strong risk/reward profiles and relative value to corporates<br>**Agency Residential Mortgage-Backed Securities (MBS):** Provide a compelling relative value to corporates and an offset to credit exposure in a risk-off environment<br>**Credit Risk–Transfer Securities (CRTs):** Borrowers are of strong quality, and underwriting standards are tighter than they were a few years ago. Housing market technicals are supportive. | **Riskier Securitized Credit:** Lower-quality segments are more exposed to idiosyncratic risk or secular deterioration.<br>**Less-Liquid Segments:** Liquidity will be at a greater premium the longer that rates are at restrictive levels. |

**Display 1: Fixed-Income Returns Are Tracking In Line with the Average over the Prior 20 Years**
Yield (Percent)



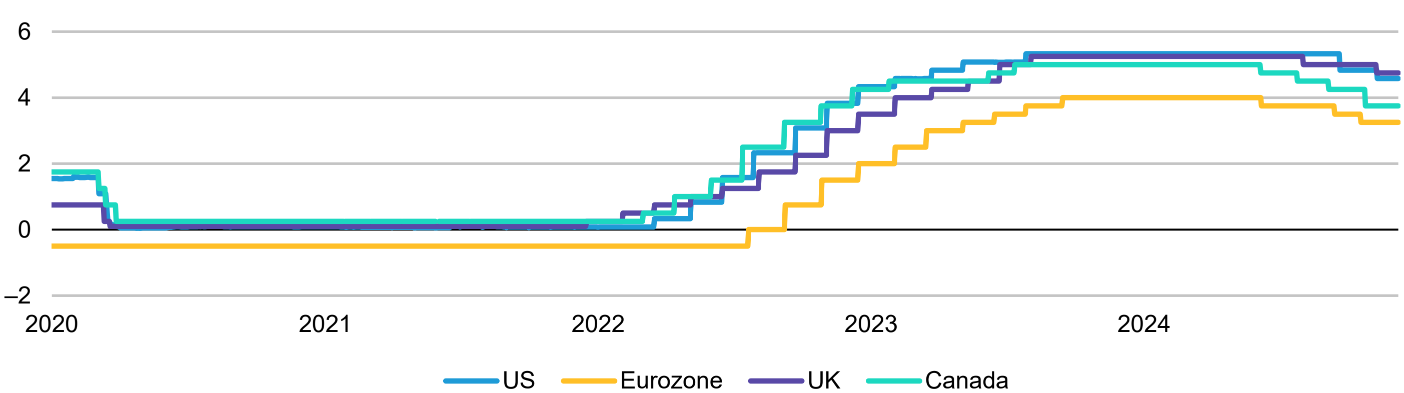

As of December 6, 2024
Source: Bloomberg

**Display 2: Inflation Continued to Normalize This Year**
Inflation Rate (Percent)



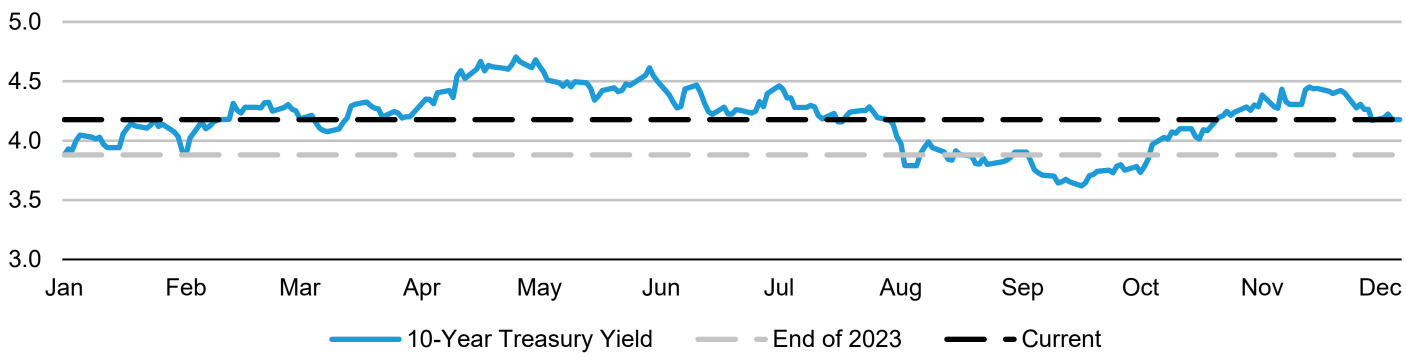

As of December 6, 2024
Source: Bloomberg

**Display 3: Major Central Banks Have Begun Easing Policy Rates in Recent Months**
Yield (Percent)



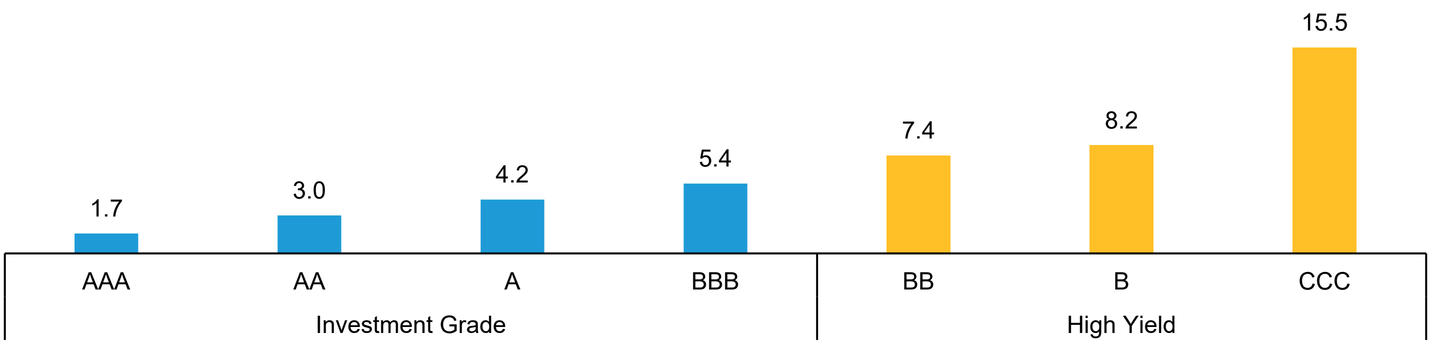

As of December 6, 2024
Source: Bloomberg

**Display 4: The 10-Year Treasury Yield Is Above Where It Was at the Start of the Year**
Yield (Percent)




As of December 6, 2024
Source: Bloomberg

**Display 5: Lower-Rated Credit Has Performed the Best in 2024**
Year-to-Date Total Return (Percent)




As of December 6, 2024
Sources: Bloomberg

**Investment Risks to Consider**

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