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January 7, 2025

A Note from the AB Fixed Income Trading Desk

Thoughts from Our Senior Portfolio Managers

2025 Outlook: Mind the Gaps

The only thing we know about the future is that it is going to be different."—Dr. Peter Ferdinand Drucker

The consensus forecast for 2025 may look like 2024 in many ways, but the differences are in the details. Many anticipate continued “normalization” in developed economies, characterized by slower (yet positive) global growth with inflation stabilizing slightly above central bank targets. Labor markets are expected to remain healthy overall but may prove more vulnerable to economic shocks than in recent years.

As a result, expectations are for robust capital-market returns, despite starting from rich valuations. The largest risks to such forecasts, however, are tied to the softening of the labor market and the policies to be enacted by the new regime in Washington. Geopolitical tensions, alongside these policy uncertainties, could further challenge an already uncertain outlook.

While we broadly agree with the baseline consensus, we see a wider range of potential outcomes for 2025. We are less optimistic on growth in some regions and believe that the global landscape will present many idiosyncratic opportunities. Importantly, we believe this outlook should be written in pencil, not pen. While these broad trends provide a sense of stability, growing divergences across the global economy should create opportunities for active managers. Investors would be wise not to overweight the consensus view and to mind the gaps that could define the year ahead.

2025 Forecasts: Redefining Normal

Key questions: We view 2025’s key questions as “*Will economic growth continue to be surprisingly resilient or will cracks begin to show?”* and *“What effects will restrictive trade policy and tariffs have on growth and inflation?”*

Macro: We expect global growth to continue to slow—but remain positive—for the largest economic blocs. Both the US and eurozone should see below-trend growth, with Europe facing greater challenges than the US. Through much of 2024, the strength of the US economy surprised market participants. Ultimately, though, the US labor market is at risk of further softening, and restrictive policy rates are likely to remain a headwind for economic activity. Additionally, tariffs and aggressive trade policy may increase the risk of growth softening further than expected. All things considered, we believe growth will come in below consensus expectations.

Around the globe, inflation is more benign than it was one year ago (*Display 1*). This trend of disinflation should continue in the year ahead but at a slower pace. We expect tariffs, geopolitical risks and continued budget deficits to potentially cause adverse price shocks and temporarily keep inflation expectations elevated. Hence, even though central banks continue to reiterate their inflation goals, we believe they will be comfortable with inflation levels that are slightly above target, especially if labor markets remain in equilibrium.

As far as tariffs and trade policies are concerned, there remains broad uncertainty regarding their implementation and potential impacts. In Europe, Germany is potentially the most at risk, as its economy relies more on exports to the US than do the economies of other member nations. On the other hand, the UK is likely to be more insulated from policy changes given its services-oriented economy. Emerging markets will be challenged in select regions given the effects of US tariffs; however, economic growth is largely expected to remain positive.

Rates: As predicted, central banks around the globe eased policy rates in 2024 as inflation subsided and labor markets cooled (*Display 2*). We expect that trajectory to continue in 2025. However, as economic conditions evolve, we believe that the pace of rate cuts is likely to vary more across central banks. This should create compelling opportunities for active global fixed-income investors.

In the US, we expect the Fed to cut four times (for a total of 100 basis points [bps]) in the coming year. The current data and market consensus argue for fewer cuts, with futures currently pricing in under two cuts this year (*Display 3*). However, as we saw in 2024, the narrative can change quickly and drive significant volatility in investor sentiment. In this vein, we expect that markets will continue to be more sensitive to labor market data than to inflation data. Ultimately, we expect labor market data to begin to show greater softness in the coming months. This trajectory of Fed policy, in combination with risks to labor markets and increased term premiums, suggest that the yield curve should continue to steepen.

In Europe, growth will continue to be more challenged, and inflation there is expected to be lower than in the US. As a result, we anticipate that the ECB will follow a more front-loaded cutting cycle in 2025. In the UK, we see higher planned government spending leading to a boost in activity, which should also result in inflation taking longer to reach target levels than previously expected. We expect that the Bank of England, much like the Fed, will take a more staggered approach to rate cuts this year.

Credit: We maintain our cautiously optimistic stance on credit in 2025. All-in yields are still relatively attractive and remain above the historical median. As a result, technicals have remained supportive, with institutional and retail demand easily absorbing supply. All the while, fundamentals are relatively strong and economic conditions are expected to remain marginally supportive for credit.

That said, we are less constructive on credit than we were at this time last year. Foremost, spreads have tightened further, meaning that valuations are less compelling than they were at the start of 2024 (*Display 4*). Second, even though fundamentals are strong, they have weakened over the course of the year as higher borrowing costs for corporations and consumers continue to flow through the financial system. As a result, we don't believe investors are adequately compensated for taking undue risk and shouldn't stretch for yield.

Volatility: Despite our optimistic view, we continue to expect heightened volatility in 2025. Central banks remain focused on evolutions in economic data to drive policy. As a result, markets will continue to have knee-jerk reactions to data releases and economic surprises. Geopolitical concerns add another layer of complexity. Further transparency on US trade policy and budgetary concerns are also likely to drive outsize market reactions as new information is digested by market participants. Therefore, much like last year, investors should expect heightened volatility this year (*Display 5*).

Risks to forecast: As with any forecast, there is a reasonable probability that unforeseen events could result in deviations from our expectations. On the downside, economic growth and labor markets may soften more than expected. Although we think a deep recession remains unlikely, there are a number of catalysts that could cause exogenous shocks to the global economy and capital markets. In a scenario where growth is constrained, central banks would be forced to ease rates at a more accelerated pace, unemployment could increase, and corporate profits would likely be pressured. Ultimately, duration would perform well, but credit sectors would be challenged.

On the other hand, economic activity could prove to be more robust than expected—as it has in the past two years. Tariffs and trade policy may also catalyze reacceleration in inflation, rather than just the temporary effects most forecasters are considering. In this environment, the central banks would either slow or completely pause easing cycles, resulting in policy rates being higher for longer. This scenario should lead risk assets (such as credit) to perform well, but Treasury yields would likely remain elevated.

Investment Implications

Given that our cautiously optimistic baseline forecast is strewed with uncertainty, we believe that the best path for investors is to position themselves for a wide range of potential outcomes in 2025. We recommend that allocators:

1. **Own duration.** Despite the recent backup in yields, central banks are generally expected to continue to lower rates in 2025. This bodes well for owning duration. The US 10-year Treasury yield is roughly 100 bps higher today than it was in mid-September. This means that owning duration is cheaper today despite the economy continuing to slow and the Fed lowering its policy rate by 100 bps in recent months. Downside risks to economic growth and labor markets also favor a duration bias. Government bonds, the purest source of duration, also provide ample liquidity and help to offset equity market volatility. Diverging policy rate paths across central banks present opportunities, and we recommend globalizing curve exposures. At current levels, we prefer the short end of the yield curve and are positioned for curve steepening.

2. **Maintain a neutral stance on credit exposure, with a preference for quality.** Despite tight spreads, yields are generally the best predictor of future returns and current levels remain compelling from a historical context. There are still many pockets of credit that present attractive risk/reward profiles. Credit exposure also diversifies against rate risk, as the two tend to have a low to negative correlation under benign inflationary regimes. We prefer investment grade and the higher-quality segments of the high-yield market. We also favor quality parts of securitized credit (such as agency mortgage-backed securities and collateralized loan obligations), which still offer a relatively attractive yield for low levels of credit risk. Industries such as energy and financials should also benefit from deregulation, while import-reliant industries may face greater challenges. We view today's landscape as a "credit-picker's market" in which a greater emphasis will be placed on finding the right sectors, industries and issuers—and, most importantly, avoiding the wrong ones. Credit is a necessary part of an allocator's portfolio and still offers strong return potential, but we suggest that investors should exercise more discretion than they did last year.

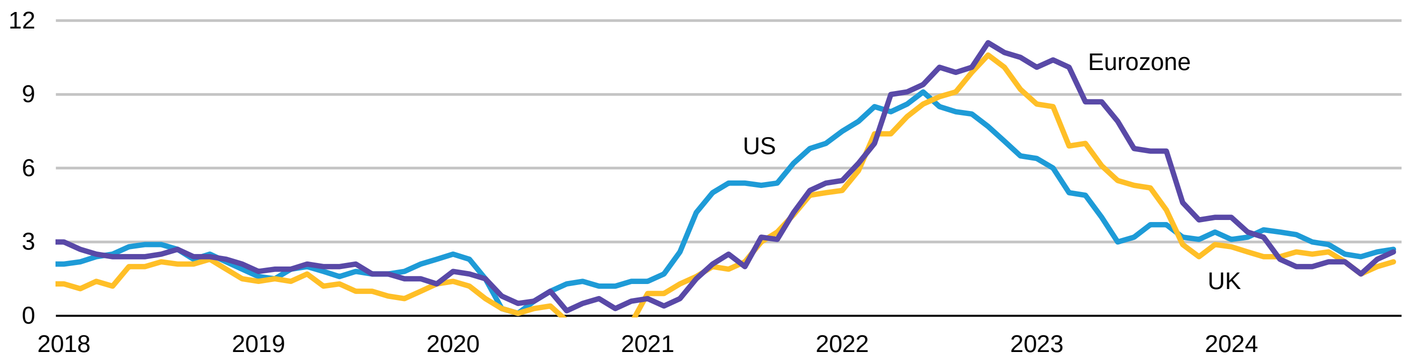
3. **Take a balanced approach and prioritize liquidity.** Bouts of volatility will continue. To better weather these episodes, investors need to remain vigilant to mitigate drawdowns and take advantage of buying opportunities when they arise. Today's environment also increases potential alpha from security selection. The changing macro and geopolitical landscape will weigh on certain parts of fixed income more than others. Balanced portfolios that emphasize liquidity are best positioned for the year ahead.

Wishing you continued success in your investment journey,

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

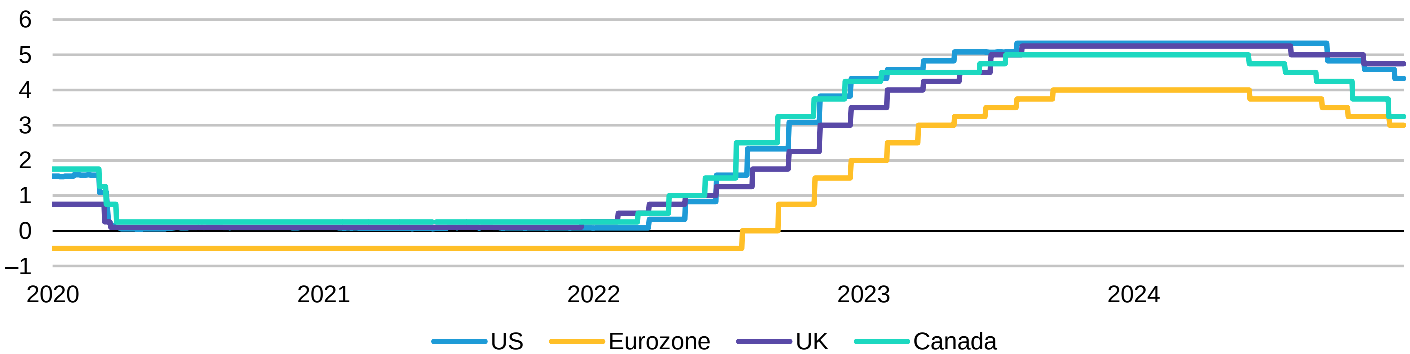
Area	Where We See Opportunity	Where We Are Cautious
Duration	**Short-Dated Part of Curve:** Yields are similar for short-term and long-term Treasuries, but greater uncertainty means more risk in the long end. **Steepeners:** Yield curves are inverted, allowing an attractive entry point for steepener 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. **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. **Banks:** Senior bank debt trades at attractive levels relative to other industries. **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 **Non-Cyclicals:** Less sensitive to slowing economic growth	**CCC-Rated Credits:** Defaults have increased, and valuations are likely to come under pressure. **Oil/Energy and Commodity Chemicals:** Valuations look full, and the risk/reward profile is not compelling. **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 **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 **Agency Residential Mortgage-Backed Securities (MBS):** Provide a compelling relative value to corporates and an offset to credit exposure in a risk-off environment **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. **Less-Liquid Segments:** Liquidity will be at a greater premium the longer that rates are at restrictive levels.

Display 1: Inflation Declined Across Major Economic Regions in 2024
Inflation Rate (Percent)



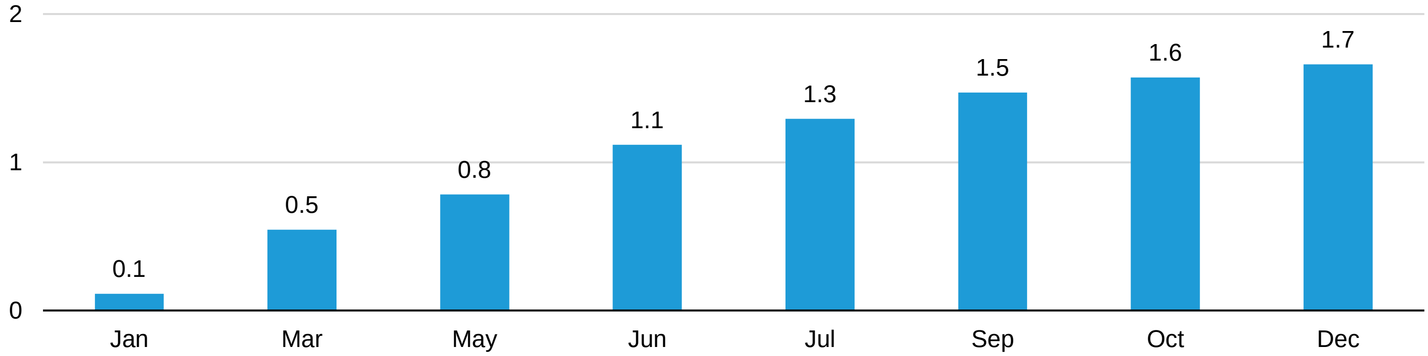
US inflation defined as year-over-year CPI. Eurozone inflation defined as year-over-year euro-area Monetary Union Index of Consumer Prices. UK inflation defined as year-over-year CPI.
As of December 31, 2024
Source: Bloomberg, UK Office of National Statistics and AB

Display 2: Major Central Banks Have Begun Easing Policy Rates in Recent Months
Yield (Percent)



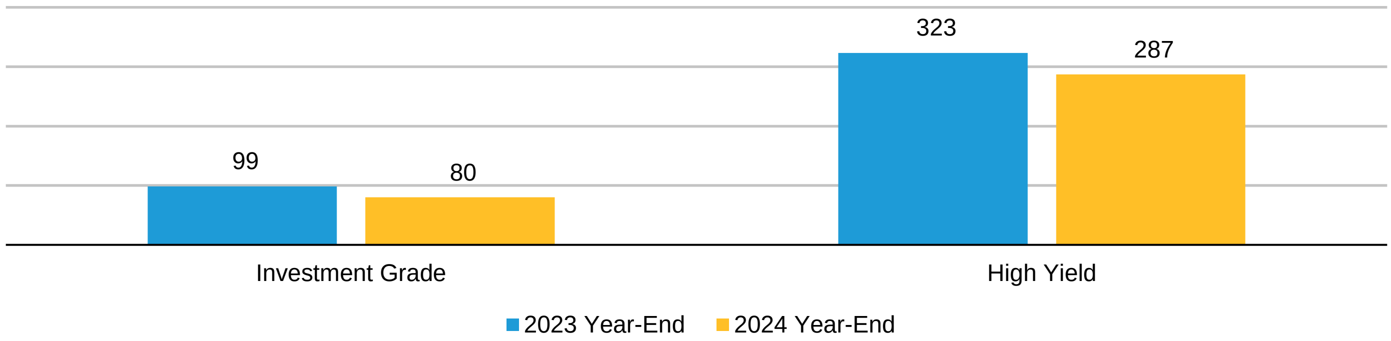
As of December 31, 2024
Source: Bloomberg

Display 3: The Market Expects Almost Two Cuts in 2025
Cumulative Number of Cuts Priced in by Futures



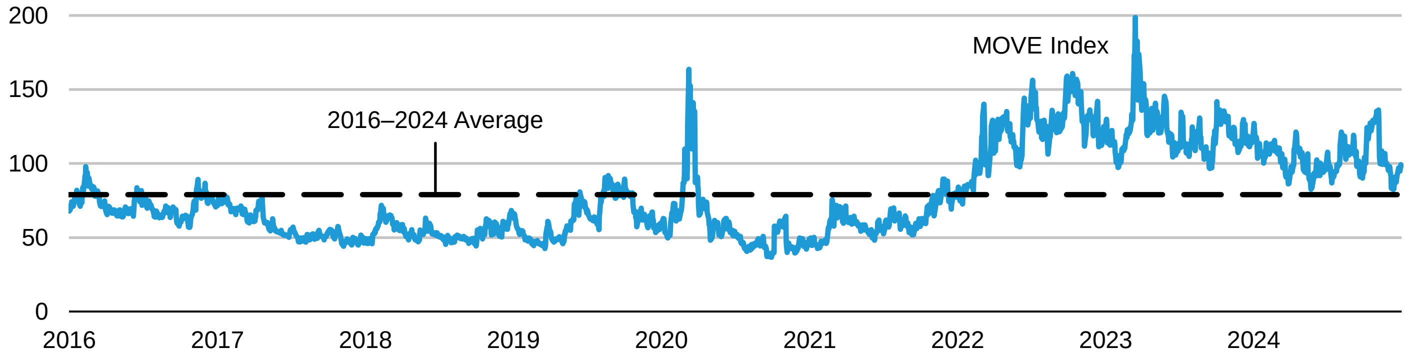
As of December 31, 2024
Source: Bloomberg

Display 4: Credit Spreads Are Lower Now Relative to the Start of Last Year
Spread (Basis Points)



As of December 31, 2024
Source: Bloomberg

Display 5: Bond Market Volatility Has Been High in Recent Years
Index Level



As of December 31, 2024
Sources: Bloomberg

Investment Risks to Consider

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