February 4, 2025

A Note from the AB Fixed Income Trading Desk

Thoughts from Our Senior Portfolio Managers

Broader Horizons for Better Opportunity

"Variety is the spice of life."—William Cowper

After years of similar movement among major economies and central banks, investors are now encountering increased divergence within the fixed-income landscape. The Fed, European Central Bank and Bank of Japan all took different actions in recent weeks, highlighting the wide range of environments and trajectories taking shape. The macro backdrop in each region showed further signs of separation. Additionally, the diversification benefits between fixed income and equities have returned to more normal levels after a period in which the two often moved in tandem. Tariffs and policy changes will also weigh on industries differently, driving different trajectories. Together, these shifts present a greater opportunity for investors to generate returns while also mitigating risk. Adopting a global, multi-sector perspective should enable investors to generate income more efficiently in the months ahead.

What Happened

Recently, there have been signals indicating the return of a phenomenon that many investors have been missing: variety. Over the past few years, bond and equity returns have been much more correlated than usual. History tells us that as inflation falls, so too does the correlation between the two asset classes (*Display 1*). This means that as inflation is expected to cool throughout 2025, bond and equity correlation should decline.

Uncorrelated investments can help drive better risk-adjusted returns, so the diversification benefits between bonds and equities should be a welcome development for allocators. This change is happening at the same time that the yield on the bond market is exceeding the earnings yield of equities by the most since 2002 (*Display 2*). Another supportive sign for bonds.

There has also been a return of variance within the fixed-income landscape. In recent years, many central banks around the globe have raised policy rates nearly simultaneously as a response to elevated inflation. That has dramatically shifted in recent months (*Display 3*). For example, in just the last two weeks, some major central banks have cut rates (Bank of Canada and European Central Bank), some have left rates unchanged (US Federal Reserve), and some have raised their policy rate (Bank of Japan).

Why has monetary policy become so divergent recently? Now that inflation has generally cooled to more benign levels, central banks are facing unique economic backdrops as they attempt to normalize policy rates. Economic growth in different regions now varies significantly. For example, GDP growth in the fourth quarter was 2.3% for the US, far outpacing that for the eurozone, which saw no growth during the same period.

As a result of the divergence between growth rates and policy rates, credit industries have also seen increased divergence. In fact, dispersion across major credit indices has increased in recent months and is now well above normal (non-COVID period) levels (*Display 4*). Political and policy uncertainty add an additional layer of uncertainty. The Trump administration has announced a wave of new tariffs tied to Canada, Mexico and China—and leaders in those countries are looking to enact additional restrictions in response. Higher tariffs and greater restriction on the flow of goods can weigh on some specific industries more than others. It is only logical that the path forward is for a continued divergence across fixed-income markets.

Our View

The reemergence of variety is a good thing for allocators. Just as we expect inflation to continue to fall through the course of 2025, we expect the correlation between bonds and equities to do the same. A more normal (lower) correlation between equities and bonds adds the benefit of diversification to portfolios. This generally increases the risk-adjusted returns that allocators get by investing across the asset classes.

Within fixed income, different macro and policy rate environments mean that government yields should continue to diverge. We expect the Fed to hold its policy rate at the current level until its June meeting. Conversely, we expect the European Central Bank to continue to cut its policy rates at each of its next three meetings. If that happens, that means that the ECB will have lowered its policy rate by 100 basis points during a period in which the Fed's rate will have remained unchanged. For this reason, we generally prefer owning government debt in regions that are facing more challenges to growth than the US.

The divergence across economies also leads to disparities within credit sectors and industries. All else being equal, slower growth is a greater challenge to lower-rated credit. Additionally, changes in policy, specifically tariffs, will affect industries differently. New tariff policy can be complicated, with select industries getting hit the hardest while others get preferential treatment. Cyclical and import-heavy businesses will face greater challenges from a more restrictive trade environment than defensive businesses that are not as reliant on cross-border trade.

Collectively, this means that markets should present a much wider range of investment opportunities for allocators and asset managers alike. This variance places a greater importance on asset managers with the tools, team and process to evaluate a diverse set of scenarios across many different markets. Amid all the variety, we expect bouts of volatility to continue, allowing tactical managers to take advantage of swings in valuations and mispriced securities.

Investment Implications

The return of greater diversification benefits between equities and fixed income means that allocators should make sure that they have the appropriate level of fixed income in their portfolios. In recent years, when correlations between the two asset classes were higher, many investors shifted more portfolio weight to equities. With lower correlations between the two asset classes and equity valuations at extremely high multiples, allocators would be wise to reevaluate the balance between bonds and equities in their portfolios.

Rates: From a rates perspective, the varied economic strength and central bank policy action presents opportunity. In the US, we favor short-dated Treasuries given our expectation that the Fed will lower rates more in 2025 than markets currently expect. Additionally, uncertainty around how policy changes can weigh on the long-term fiscal health of the US government is likely to drive long-term Treasury yields to be structurally higher. We expect the Treasury curve to continue to steepen to more normal levels and have positioned our strategies accordingly (*Display 5*).

Our base expectation is that the world is in a new regime of not only higher structural inflation but also greater vulnerability to inflation shocks, especially in the US. As a result, allocators should make sure they are adequately protected against the risks posed by inflation. We see a greater need for inflation strategies in investor portfolios.

Globally, we prefer duration in developed markets where growth is more challenged than in the US. This includes Canada, the United Kingdom and France. Conversely, we believe the Japanese yield curve should flatten. We find the 30-year part of the Japanese curve to be attractive.

Credit: We are still constructive on higher-quality credit. Spreads have compressed, meaning that investors are not getting adequately compensated for reaching down into the riskiest parts of credit markets. US investment-grade credit remains attractive despite a relatively low spread given a supportive demand for bonds and strong company fundamentals. Within the investment-grade market, we are overweight banking and other sectors that should benefit from a less-restrictive regulatory environment.

In the securitized space, we prefer US agency mortgage-backed securities given their compelling value relative to similarly rated corporate bonds. We also like credit risk–transfer securities, as borrowers are of high quality and housing market technicals are supportive as home supply remains constrained.

Within emerging markets, USD-denominated corporate debt provides an attractive risk-adjusted return opportunity. We are cautious of local-currency debt given FX volatility and the continued strength of the US dollar.

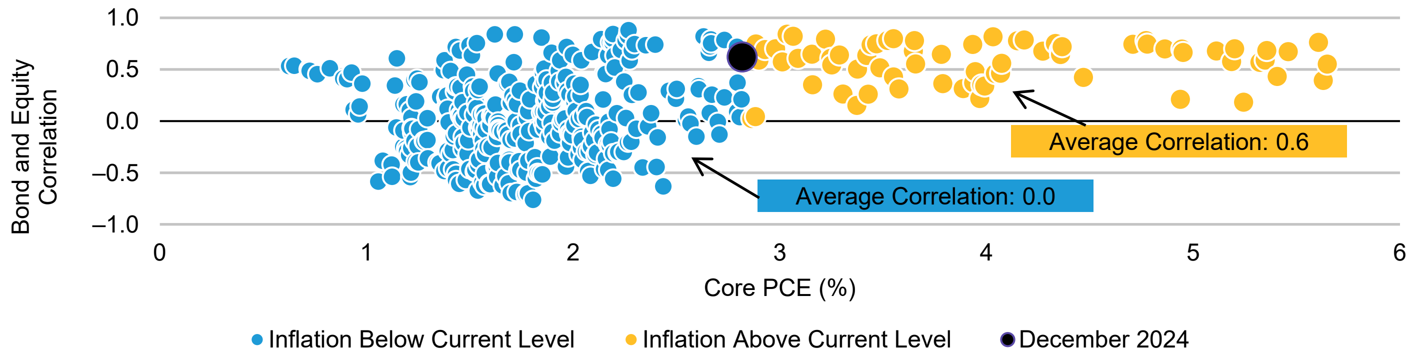
Wishing you continued success in your investment journey,

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

To learn more about AB's fixed-income solutions and access to other market insights, visit Fixed-Income Investments | AB.

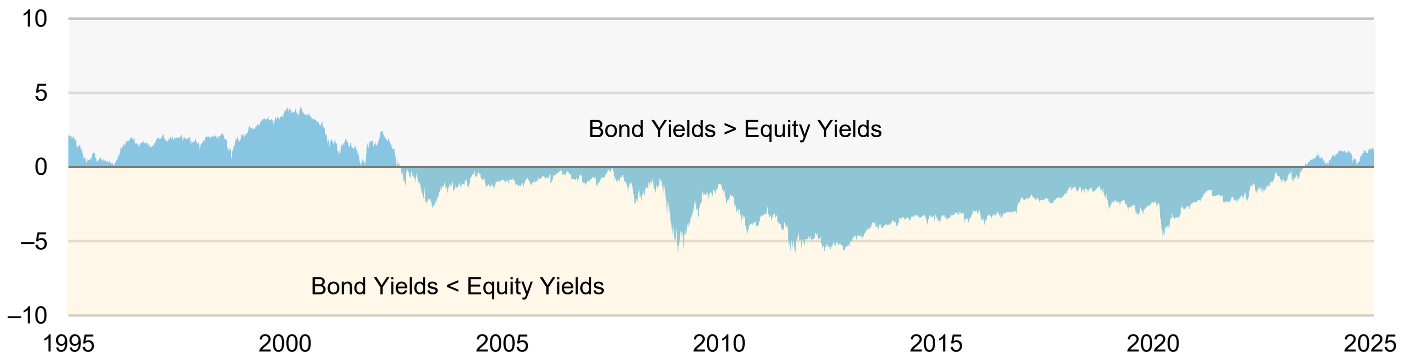
Area	Where We See Opportunity	Where We Are Cautious
Duration	**Short-Dated Part of Curve:** Yields are similar for short-term and long-term Treasuries, but greater uncertainty means more risk in the long end. We expect the Fed to cut rates quicker than markets currently expect. **Steepeners:** Yield curves remain flat relative to history, particularly during a rate-cutting cycle. As the Fed and other central banks cut rates, we expect more money to be put to work in the front end of the curve.	**Outright Duration:** Uncertainty around the timing and scale of policy will likely drive heightened volatility in US Treasuries. We are tactical with overall US duration positioning.
Global Bonds	**UK:** We are overweight duration in the UK, as the market is pricing in a less-aggressive monetary policy easing than what we expect, and fiscal concerns are more than priced into the curve. **Canada:** We prefer Canadian duration with a steepening bias, as we expect further policy easing and curves to steepen. **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:** Despite looser monetary and fiscal support, uncertainty around growth and a potential trade war with the US may be a drag on the longer parts of the yield curve. We prefer owning some offshore “dim-sum bonds” (bonds denominated in Chinese renminbi but issued outside of China).
Investment-Grade (IG) Corporates	**Broadly:** IG credit offers attractive yields despite relatively low spread levels. We prefer BBB credits, as the yield pickup for moving down to high-yield bonds has compressed significantly. **Banks:** Senior bank debt trades at attractive levels relative to other industries and should benefit from less-restrictive regulation. **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 (CLOs):** Attractive spread pickup relative to similarly rated corporate bonds; offer strong structural protections **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 remain tight. Housing market technicals are supportive as home supply remains constrained.	**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: The Correlation Between Bond and Equity Returns Tends to Be Lower When Inflation Is Lower



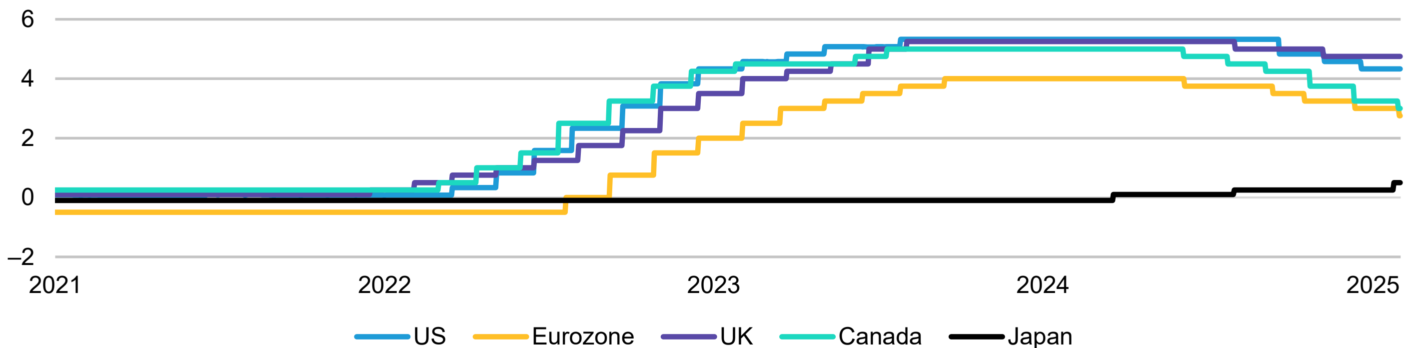
Note: Inflation based on Core PCE year-over-year level. Correlation based on trailing twelve-month returns of the Bloomberg US Aggregate Index minus the earnings yield of the S&P 500
As of January 31, 2025
Source: Bloomberg

Display 2: Bond Yields Exceed Equity Yields by the Highest Level Since 2002
Yield Differential



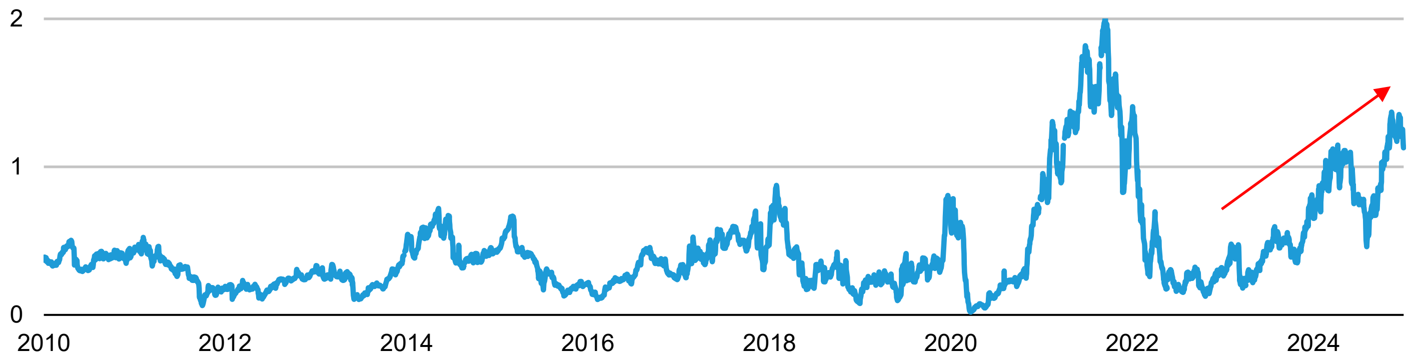
Note: Yield differential based on the yield to worst of the Bloomberg US Aggregate Index minus the earnings yield of the S&P 500
As of January 31, 2025
Source: Bloomberg

Display 3: There Has Been Divergence in Recent Central Bank Action
Yield (Percent)



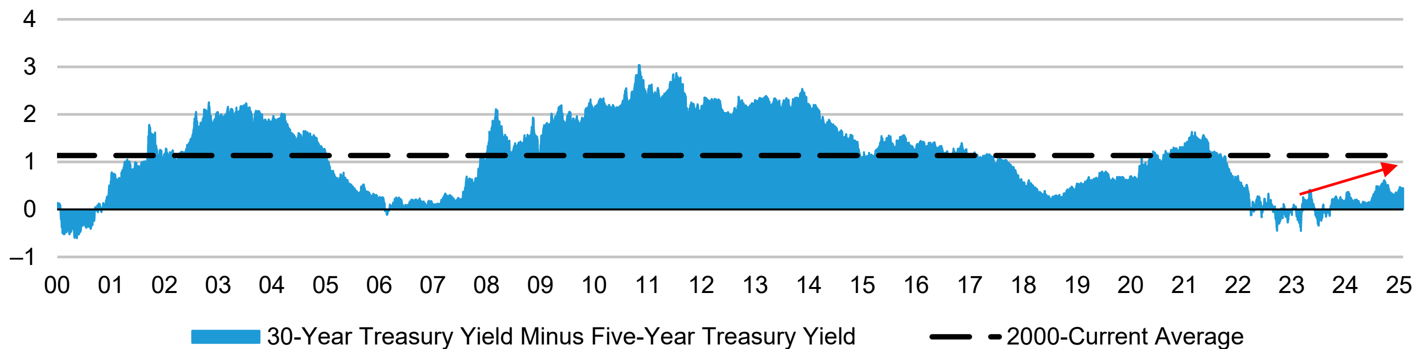
As of January 31, 2025
Source: Bloomberg

Display 4: Dispersion Across Credit Sectors Is at the Highest Non-COVID-Era Level
Dispersion



Note: Dispersion represented by standard deviation percentile of spreads divided by average percentile of spreads across US investment-grade, US high-yield, European investment-grade, European high-yield, Asia investment-grade, Asia high-yield and LatAm credit indices
As of December 31, 2024
Source: Barclays

Display 5: The US Treasury Curve Is Steepening Toward Long-Term Average Levels
Yield Basis (Percent)



Past performance does not guarantee future results.
As of January 31, 2025
Source: Bloomberg

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IMA-681392-2025-02-03