February 19, 2025

A Note from the AB Fixed Income Trading Desk

Thoughts from Our Senior Portfolio Managers

A Short (High Yield) Story

"The path of least resistance is what makes rivers run crooked."—Elbert Hubbard

Markets are sending mixed signals. Equity valuations are stretched, credit spreads remain tight, and private credit is awash with capital in search of deployment. At the same time, duration trades keep getting upended, trade policy in Washington is shifting, and the global growth outlook remains murky. With relative valuations and the economic outlook less clear than before, the temptation is to take the path of least resistance—stick with what's worked. But in markets like these, the real question isn't where to be right, it's where not to be wrong. A small shift in positioning or sentiment can go a long way, and short-duration high yield may be the right move for investors looking to navigate against an uncertain backdrop.

Key Takeaways

1. Continued strength in Tier 1 macro data has decreased expectations for Fed cuts in 2025 and continues to support stretched valuations in equity and credit.
2. The yield curve remains highly volatile, and the upside in risk assets appears to be limited.
3. The short-duration high-yield bond space offers attractive carry with great risk mitigation risk compared to equities. Shifting exposure toward short-duration high yield provides investors with a strong opportunity to "not be wrong" while capturing attractive yields along the way.

What Happened

Perhaps the best indicator of why markets remain complacent—though not without some uncertainty—lies in the latest Tier 1 macro data. On the complacency side, January's labor market and inflation reports signaled continued strength in the US economy. While the headline jobs number came in slightly below consensus, upward revisions to the prior two months underscored a labor market that remains resilient. On a three-month and 12-month rolling basis, job growth has actually accelerated compared to mid-2024 (***Display 1***).

At the same time, January CPI came in slightly hotter than expected, reinforcing the view that disinflation has stalled (***Display 2***). Together, these data points align with Chair Powell's testimony to Congress last week: there is no urgency for the Fed to cut rates. The market has interpreted this to mean fewer rate cuts in 2025 and continued economic strength.

However, not all signals point to smooth sailing. Retail sales were significantly below expectations, a reminder that risks to the economy remain ever present. Softness in retail sales could mean that personal consumption expenditures (the Fed's preferred measure of inflation) may be softer than implied by the CPI numbers.

The net effect of these dynamics has reduced expectations of Fed cuts as well as support for risk assets. Equities and credit spreads have both pushed back toward record valuations—the S&P 500 was up 1.3% in the first two weeks of February, stretching multiples even further (***Display 3***). In fact, the index's price-to-earnings ratio has only been higher 8% of the time over the past 35 years. Meanwhile, credit spreads have tightened modestly on the month and remain at the lower end of long-term ranges and well below long-term median levels (***Display 4***).

Our View

The economic data and market interpretation both suggest that investors should "keep calm and carry on." However, much like when that phrase was coined in wartime Britain, there's always potential for shrapnel nearby. Markets tend to extrapolate near-term trends too far and too confidently—a harsh reality that often catches investors off guard.

This is why the best trades never feel comfortable. It's natural for investors to ask, "*Why reduce risk when equities are up 60% over the past two years?*" or "*Why add duration when cash has outperformed bonds yet again?*" The answer to these questions lies in the consideration of how sustainable these trends are and, more importantly, in what could go wrong. Managing to a range of possible outcomes, rather than a single forecast, is key.

To be fair, our core view is not far from the market consensus—broad economic fundamentals remain supportive. But from a valuation standpoint, and despite strong underlying conditions, history suggests that periods of complacency rarely last. Any shift in the current landscape may require a catalyst, and we don't know what that will be or when it will occur. This makes it essential to assess both upside and downside risks.

Rates: Managing Volatility
The yield curve remains highly volatile as markets grapple with evolving central bank narratives, shifting fiscal policies and the first shots fired in an escalating trade war. Investors should manage this volatility—not by eliminating duration entirely but through a preference for short- and intermediate-duration securities. The two-year yield now sits at roughly 4.25%, nearly a full point higher than where the 10-year US Treasury yield was when inflation peaked this cycle. This is despite inflation now running at less than half of what it was in September 2022. As mentioned above, jobs data have also cooled significantly, as has GDP growth. In the context of the change in economic, inflation and labor-market data, the increase in yields stands out (***Display 5***). This suggests that real rates may be undervalued or even cheap, and if a growth shock or credit event emerges, those valuations could compress significantly.

Risk Assets: Limited Upside, Asymmetric Risk
If growth continues to hold up, equity valuations and credit spreads may continue their gradual grind toward historically rich levels. However, we see limited further upside from here and expect valuations to remain range-bound rather than meaningfully extend from current levels. Historically, valuation excesses do not persist indefinitely—eventually, they revert toward historical norms or worse, depending on the catalyst. Since we don't know when or how that adjustment might happen, positioning should reflect the trade-off between limited upside potential, maintaining exposure, and help to protect against downside risks.

This is why we believe short-duration high yield remains one of the most attractive opportunities in asset allocation today. It allows investors to participate in both interest-rate and growth upside while clipping a ~7% coupon should conditions remain stable. At the same time, it helps provide risk mitigation protection if an exogenous shock materializes, offering a more balanced risk/reward profile in an increasingly uncertain landscape.

Investment Implications

For investors wondering where to deploy the next incremental dollar, short-duration high yield stands out as a compelling choice. It offers an attractive balance of income potential, risk mitigation and resilience in an uncertain macro environment.

Heightened volatility and greater uncertainty can create dispersion among credit issuers. There will be many issuers who will benefit from the shifting landscape—and many who will struggle. This places a greater emphasis on active management's ability to find attractive opportunities and avoid landmines. This is especially true in high yield, where the downside to selecting the wrong credits can be a meaningful draft on returns.

There are also logical areas to source this allocation from—ones where short-duration high yield may offer superior risk-adjusted returns:

- **Bank Loans/Floating Rate Funds.** As the Fed continues to cut rates, floating rate funds tied to the Secured Overnight Financing Rate will see their coupons reset lower, reducing income potential with no duration benefit to offset it. In contrast, short-duration high yield—with a two-year duration and a starting risk-free rate of ~4.2%—can generate total return from falling yields while also offering excess income. From a credit perspective, bank loans carry greater default risk, with ~70% of holdings rated B or lower, compared to the typically ~30% in short-duration high-yield products. Defaults for bank loans issuers are running ~4% versus ~1% for high-yield bonds, with historically weak recovery rates due to looser covenants. Liquidity is another key risk—bank loans take weeks to settle, creating forced selling dynamics in stressed markets, whereas short-duration high yield is fully liquid daily.
- **Equity De-Risking.** With equity valuations stretched, the forward return outlook is increasingly challenging. The S&P 500 price-to-earnings ratio is near historical highs, and historically, when valuations have been at these levels, the three-year forward return has always been negative. Meanwhile, most sell-side forecasts project long-term equity returns in the mid-single digits—roughly in line with or below the ~7% yield to worst currently available in short-duration high yield. However, short-duration high yield has historically delivered these returns with only about one-third of the volatility and drawdown risk of equities. Reallocating a portion of equity exposure to short-duration high yield provides similar return potential while significantly improving risk-adjusted outcomes.
- **Complimenting Core.** For investors looking to enhance income without taking on significant additional risk, short-duration high yield presents a compelling complement to traditional core fixed income. While both asset classes have historically generated similar long-term returns, they have taken different paths—core bonds providing diversification benefits and short-duration high yield offering higher income with lower interest-rate sensitivity. Recent rate cycles have been more volatile than in the past, making duration management more challenging. Allocating to short-duration high yield allows investors to capture attractive income while maintaining lower-duration exposure, improving overall portfolio balance and risk-adjusted returns.

In short, we believe that shifting exposure toward short-duration high yield offers investors the best opportunity to *not be wrong* while also capturing attractive yields along the way.

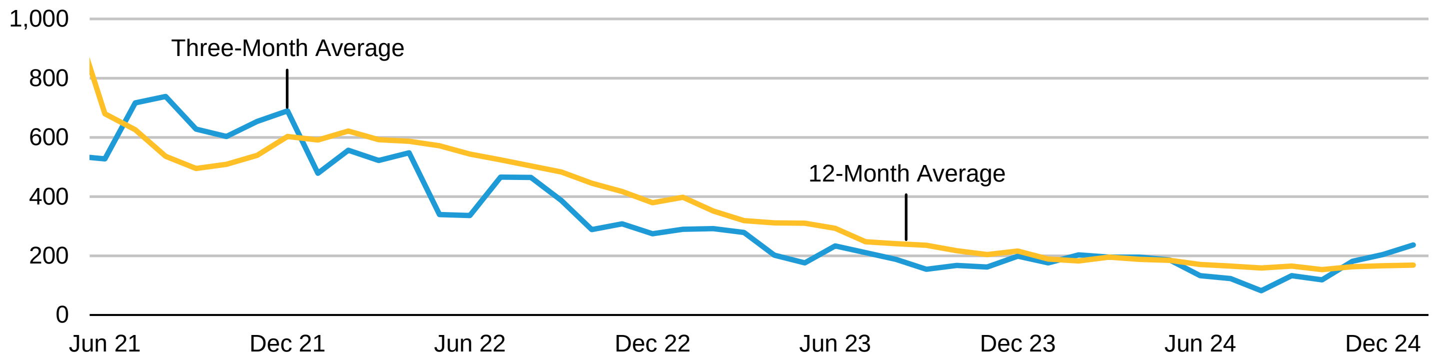
Wishing you continued success in your investment journey,

Scott DiMaggio, Gershon Distenfeld, Matt Sheridan, Fahd Malik, Will Smith, John Taylor, Serena Zhou, Tim Kurpis, Christian DiClementi, Sonam Dorji and AJ Rivers

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

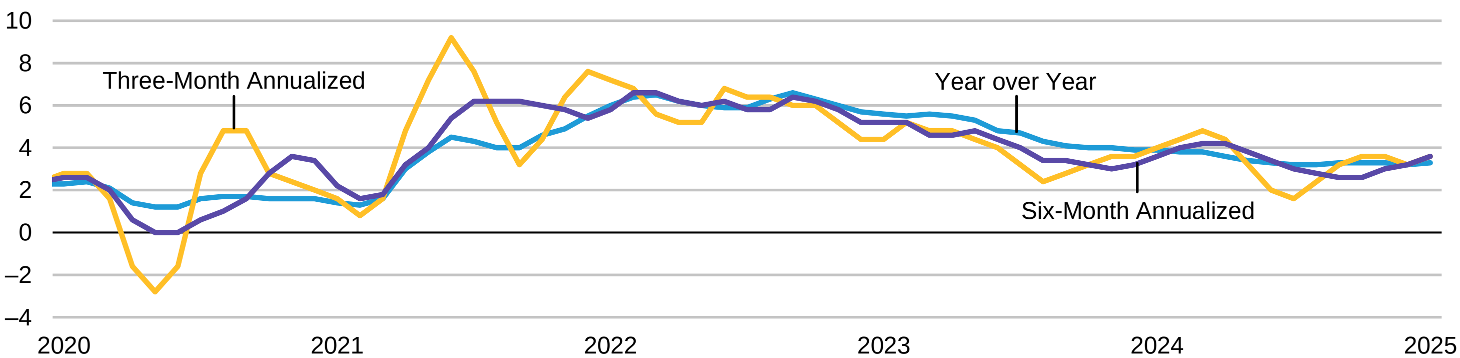
Area	Where We See Opportunity	Where We Are Cautious
Duration	**Short-Dated Part of Curve:** Yields are similar for short-term and long-term US Treasuries, but greater uncertainty means more risk in the long end. We expect the Fed to cut rates quicker than markets currently expect. **Steepeners:** Yield 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 Pace of Jobs Added per Month Has Begun to Accelerate
Jobs Added per Month in Thousands



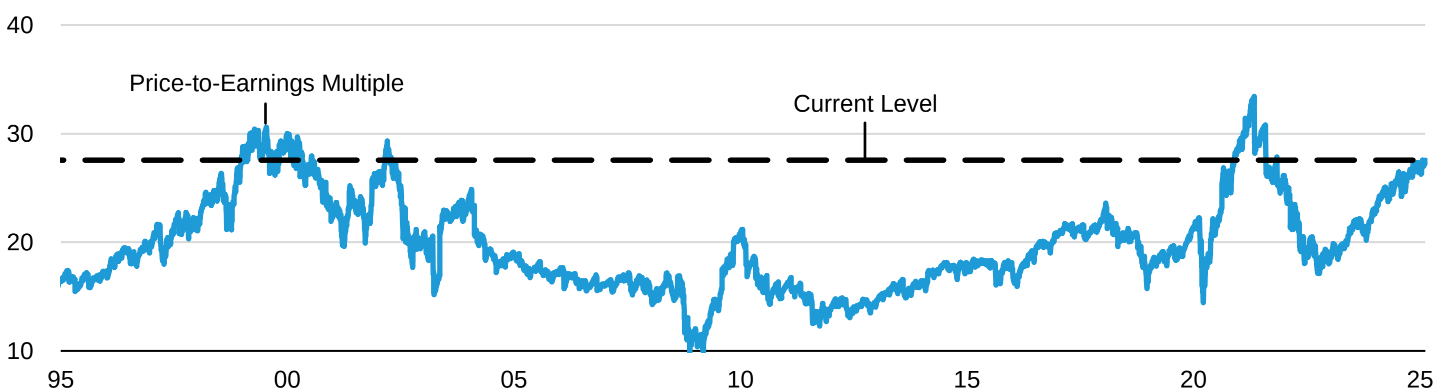
As of February 14, 2025
Source: Bloomberg

Display 2: Disinflation Has Slowed Significantly
Inflation Rate (Percent)



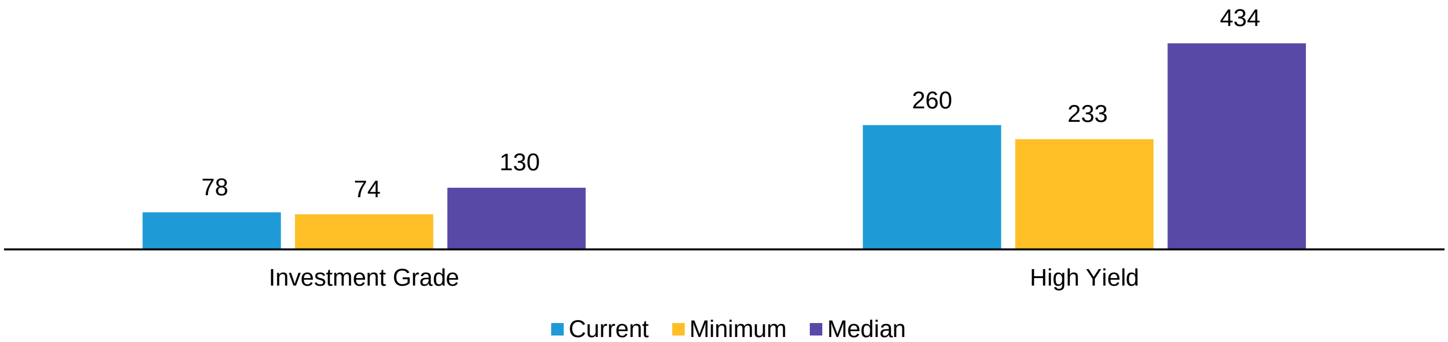
Based on core CPI
As of February 14, 2025
Source: Bloomberg

Display 3: Equity Valuations Are at Very High Multiples
Price-to-Earnings Multiple



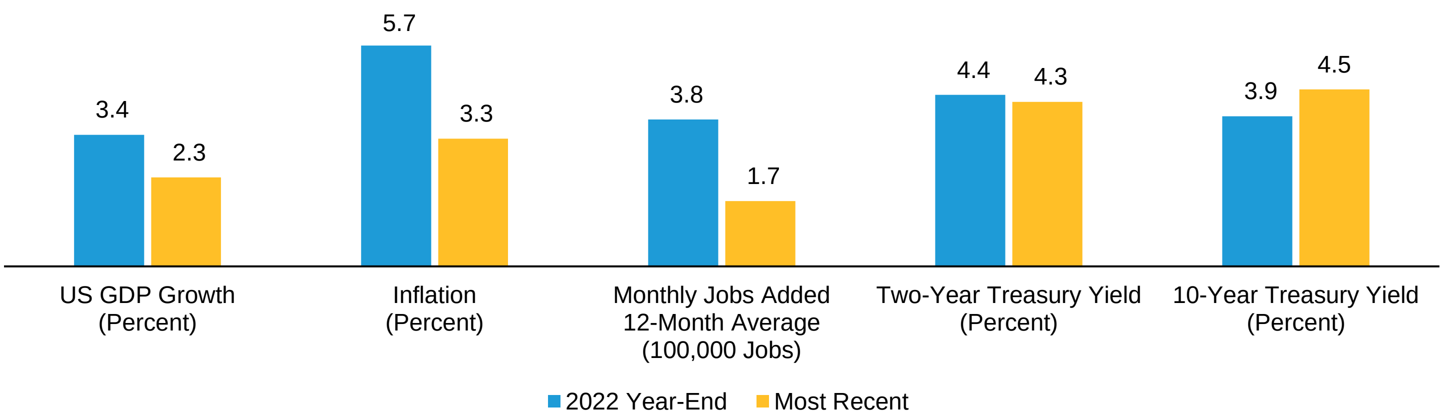
As of February 14, 2025
Source: Bloomberg

Display 4: Credit Spreads Are Close to the Tightest Levels They've Been over the Last 20 Years
Spread (Basis Points)



Investment grade represented by the Bloomberg US Credit Index and high yield represented by the Bloomberg US Corporate High Yield Bond Index. Data are from January 1, 2005, to February 14, 2025
As of February 14, 2025
Source: Bloomberg

Display 5: Treasury Yields Have Not Fallen Despite Macro Indicators Cooling



Monthly jobs added represented by the trailing 12-month average of non-farm payroll data.
Most recent data for US GDP are from 4Q:24. Most recent data for inflation and jobs are from January 2025. Most recent data points for two-year and 10-year Treasury yields are from February 14, 2025.
Source: Bloomberg

Investment Risks to Consider

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