



A Note from the AB Fixed Income Trading Desk

Thoughts from Our Senior Portfolio Managers

BBQs and Big Beautiful Bills

"The only certainty is that nothing is certain."—Pliny the Elder

Summer has unofficially kicked off, and risk assets seem to be embracing some R&R while the market skies have been anything but blue. The long end of the yield curve has been volatile, and the dollar has retested local lows (*Display 1*). Tariff news continued its roller-coaster ride—first with US-China negotiations de-escalating trade tensions, then with renewed disputes with Europe to begin the holiday weekend. Meanwhile, a slew of headlines out of Washington—from budget packages to credit downgrades—continues to remind us that uncertainty remains high.

This disconnect between the relatively serene pricing of risk assets and disruptive underlying trends should give investors pause. The backdrop may have improved since early April, but macro conditions likely warrant a more balanced approach. With ongoing policy flip-flops and mixed economic signals, now is not the time to simply sit back. Our message remains clear: in this environment, only a disciplined, active approach positioned to take advantage of a range of outcomes can ensure that you're prepared for whatever comes next.

Key Takeaways

- Despite the rebound in risk assets, macro uncertainty—from tariffs to fiscal policy—remains elevated, warranting a more balanced and adaptable portfolio approach.
- Fiscal noise and global tensions continue to pressure the long end of the curve, reinforcing the case for short-to-intermediate duration and global diversification.
- With traditional correlations showing signs of breaking down, capturing opportunity and managing downside require the flexibility and precision only active strategies can deliver.

What Happened

The last two weeks have delivered a series of headline-grabbing developments with real implications for investors.

Tariffs: The US and China agreed to roll back a large portion of mutual tariffs for 90 days, replacing earlier hikes with a 10% universal rate. While this was a positive development, new threats emerged—most notably a potential 50% tariff on European imports announced on Friday, only to be curtailed over the weekend to take effect in July. The result: a policy backdrop that remains fluid and fragile, keeping markets on edge.

Inflation and Growth: US inflation data came in softer than expected, with core CPI falling to 2.8% (*Display 2*) and headline CPI to 2.3%—giving the Fed some breathing room. However, retail sales were soft on net, and the University of Michigan's Index of Consumer Expectations posted its weakest forward outlook on record (*Display 3*), reflecting growing pessimism among US consumers.

Fiscal and Credit: Moody's downgraded the US long-term credit rating from Aaa to Aa1—the first time in over a century that the US no longer holds a top rating across all three major agencies. Meanwhile, the House passed the administration's "Big Beautiful Bill"—a sweeping tax and investment package now under Senate review. Investors are watching closely, not just for content but for implications on long-term deficits and term premia.

Fed Independence: A ruling from the US Supreme Court reaffirmed that the President cannot unilaterally remove the Fed Chair—a key win for institutional credibility and policy stability.

Our View

Tariffs, Trade and Macro Impact: Despite headline progress with China, the effective tariff rate remains historically elevated—and well above where markets were priced just weeks ago, pre-"Liberation Day" (*Display 4*). The 90-day pause in US-China tariffs is a meaningful development, rolling back a large share of previously enacted measures. But the net effect still reflects heightened geopolitical tension and a drag on economic growth. Meanwhile, renewed threats of a 50% tariff on EU imports underscore just how

fragile and fluid the trade landscape remains. Policy instability continues to weigh on business and consumer confidence, delaying discretionary investment decisions. While we don't anticipate this leading to a collapse in growth, we do expect moderation—particularly if uncertainty continues to cloud visibility and constrain capital allocation.

Fiscal Outlook: Moody's recent downgrade did little to rattle markets, but it reinforced a familiar concern: US lack of fiscal discipline remains constant. The proposed "Big Beautiful Bill" leans expansionary in its intent—delivering near-term support via tax cuts, border adjustments and investment incentives. However, it also meaningfully lifts the projected deficit trajectory. Current estimates suggest that the bill could increase the federal deficit by roughly \$3.0 trillion over the next decade, primarily due to reduced government revenue from incoming tax receipts. While there are proposed offsets—such as spending cuts, tariff revenues and workforce reductions—these appear unlikely to fully close the gap.

Importantly, we do not expect the bill to be finalized in the Senate until closer to the September 30 government funding deadline, prolonging uncertainty and keeping fiscal risk front and center. More broadly, the lack of structural fiscal restraint continues to feed into long-term concerns about US creditworthiness—keeping the narrative of a potential buyer strike and elevated term premia in play. Against this backdrop, we continue to see long-end US Treasuries as particularly vulnerable to volatility, especially compared to more stable developed-market sovereign curves.

Fed Independence: The recent Supreme Court decision—which affirmed that the President cannot unilaterally remove the Fed Chair—was a notable win for institutional credibility. In the eyes of markets, central bank independence reinforces predictability, enhances inflation control, and ensures that monetary policy remains anchored in data, not politics. Prominent research from the International Monetary Fund, Bank for International Settlements and the Fed itself confirms that independent central banks tend to deliver lower inflation volatility, reduced interest-rate swings and stronger labor market outcomes over time. In a policy environment as noisy and uncertain as this one, that kind of clarity and credibility is essential—and likely explains some of the stabilization in Treasury sentiment following the ruling late in the week.

Market Positioning: Risk assets have now round-tripped to pre-Liberation Day levels and seem to be pricing in a relatively benign outcome. That optimism feels like a miss. For index multiples to have returned to pre-tariff levels seems disconnected from the persistent macro uncertainty and the limited corporate guidance provided this cycle (*Display 5*). While excitement in tech continues to dominate headlines, broader fundamentals remain murky. As fixed-income investors, we're not overtly bearish, but we are realistic: the environment may have improved since April, but we're hardly in Goldilocks "just right" territory. Still, given how negative positioning was ahead of the recent rally, the pain trade could continue higher—unless data turn south or global tensions flare again.

Meanwhile, the rates market tells a more nuanced story and is now higher than it was pre-Liberation Day. The belly of the curve is not adequately pricing in the possibility that the Fed may need to step in more aggressively should labor market conditions weaken. The long end remains reactive—more influenced by headlines and retail-driven flows than macro fundamentals. Growth outside the US—especially in Europe and Asia—is under increasing pressure, likely adding downward bias to the global rates complex.

Taken together, these dynamics point to one conclusion: investors should brace for continued volatility and position accordingly.

Investment Implications

So, how should investors prepare for the volatility and range of potential outcomes we expect? This is a market that demands resilience—and requires adaptability. Investors don't need to predict the next headline; they need to be positioned for a range of scenarios and allocate capital where risk-adjusted returns remain compelling.

- **Belly of the Curve Remains Compelling:** We continue to favor the short-to-intermediate segment of the US yield curve. This part of the curve remains attractively valued, especially following the recent outperformance of global rates. It offers a balance of risk mitigation and return potential—insulating investors from noise in the long end (driven by fiscal concerns, trade rhetoric and retail flows) while providing more stability than the front end in the event of a slowdown or renewed Fed easing. It also minimizes reinvestment risk relative to cash-equivalent allocations. We have added duration here in our own accounts.
- **High-Quality High Yield Still Offers Balance:** Short-duration, higher-quality high yield continues to stand out as one of the most attractive risk-adjusted return opportunities in fixed income. With all-in yields near 7%, the sector offers return potential in line with long-term equity expectations—but with meaningfully less volatility. These strategies provide a way to lean into income and take advantage of potential spread compression, while limiting downside through thoughtful industry and security selection. For equity-heavy investors looking to reduce risk, this is a compelling place in which to reallocate capital without sacrificing return objectives.
- **Best of Both Worlds (Barbell):** Core Plus strategies offer a compelling way to take advantage of a range of outcomes by leveraging both rates and credit. Duration looks particularly cheap and should rally if economic conditions deteriorate. Should economic conditions remain stable, then credit and risk assets should continue to perform well. As we progress through bouts of volatility, rebalancing these factors should provide investors with attractive total return opportunities.

With traditional correlations showing signs of breaking down, capturing opportunity and managing downside require the flexibility and precision only active strategies can deliver.

In a market where complacency can be costly, the edge goes to those who stay active, stay nimble, and stay prepared.

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

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US Economic Scenarios

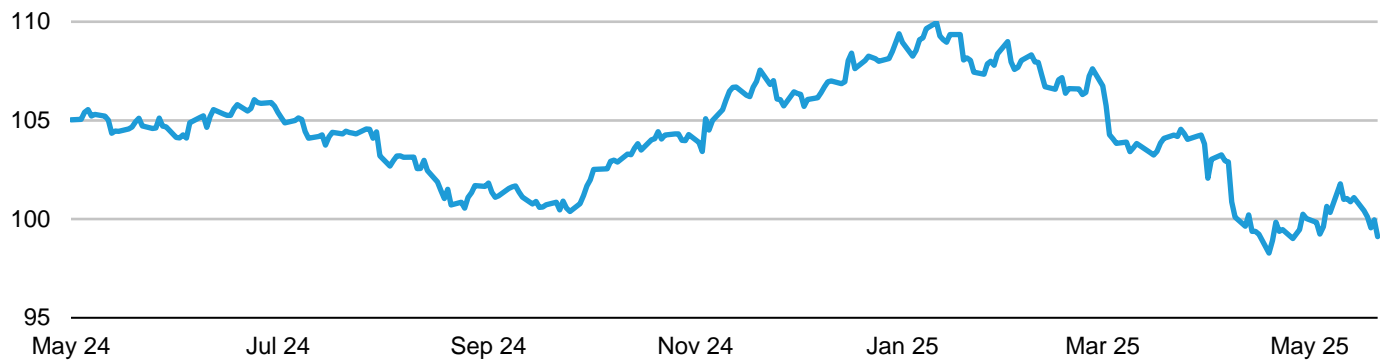
Economic Outcome	Description	Probability (Percent)
Hard Landing/Deep Contraction	Either an external shock occurs or business-cycle dynamics deteriorate sharply. Growth slows rapidly, and central banks have to act aggressively to support growth.	25
Soft Landing/Mild Contraction	Growth slows, labor markets weaken, and central banks hurry to get back to neutral. The magnitude of the slowdown defines the terminal rate, and inflation expectations determine the speed with which it is reached.	30
Rebalancing	Both inflation and growth approach trend levels only slowly, leaving the Fed comfortable easing policy slowly and remaining restrictive well into 2025: 25-basis points cuts at some, but not all, meetings until the policy hits neutral in late 2025 or 2026.	30
Stagflation	The economy slows, but inflation expectations rise, trapping the Fed between a rock and a hard place.	10
No Landing	The economy performs despite headwinds, and inflation stays elevated enough to keep the Fed on hold for some time to come.	5

European Tariff Scenarios

2025 Forecasts	Counterfactual No Tariffs at All (Percent)	Upside No Universal Tariffs (Percent)	Current Situation 10% Universal Tariffs (Percent)	April 2nd–9th 20% Universal Tariffs (Percent)	Downside 30% Universal Tariffs (Percent)
Growth (YoY)	1.10	0.80	0.06	0.30	–0.60
Inflation (Annual)	2.00	1.80	1.60	1.70	1.40
ECB Deposit Rate (Year End–2025)	2.00	1.75	1.75	1.75	1.00
Recession Probability	30.00	40.00	60.00	70.00	90.00

Display 1: The Dollar Has Retested Local Lows

The US Dollar Index

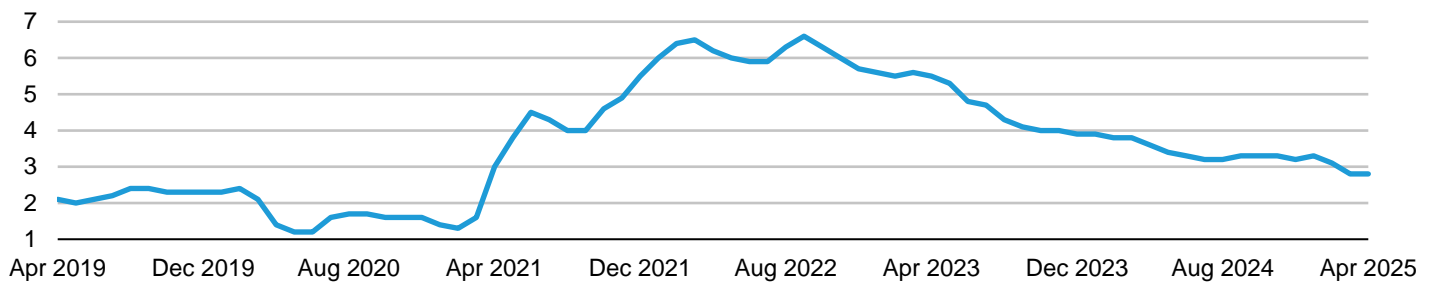


As of May 23, 2025

Source: Bloomberg

Display 2: Inflation Measures Fall to Lowest Levels Since 2021—Giving the Fed Some Breathing Room

US CPI All Urban Consumers: All Items Less Food & Energy, YoY NSA (Percent)



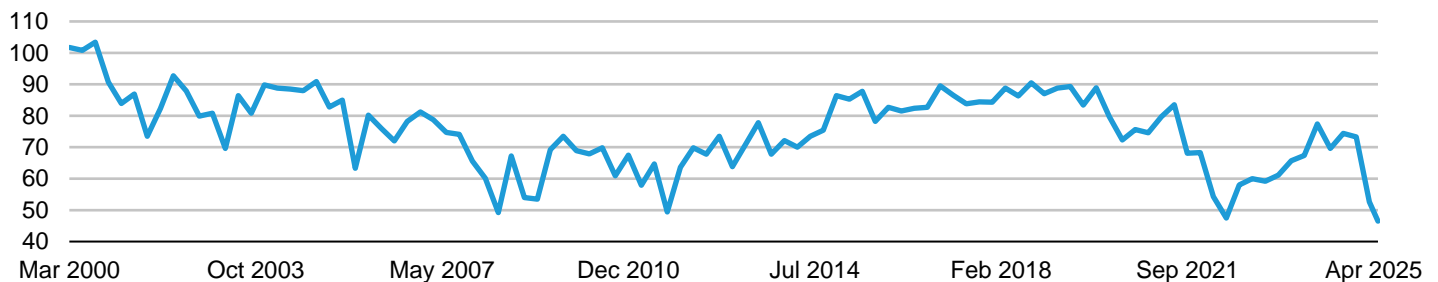
NSA: not seasonally adjusted

As of May 23, 2025

Source: Bloomberg and US Bureau of Labor Statistics

Display 3: Consumer Expectations of the Economy Hit All-Time Lows

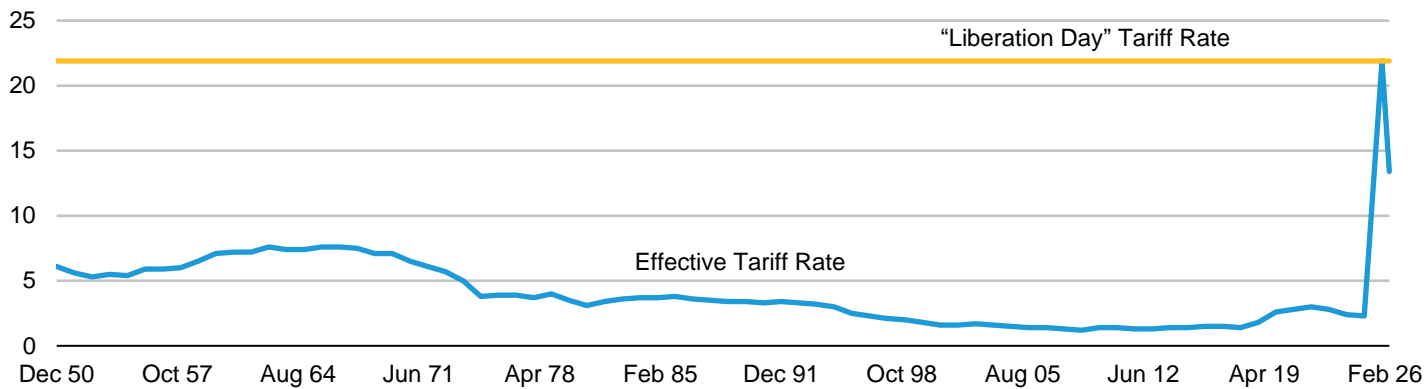
University of Michigan Index of Consumer Expectations



As of May 23, 2025

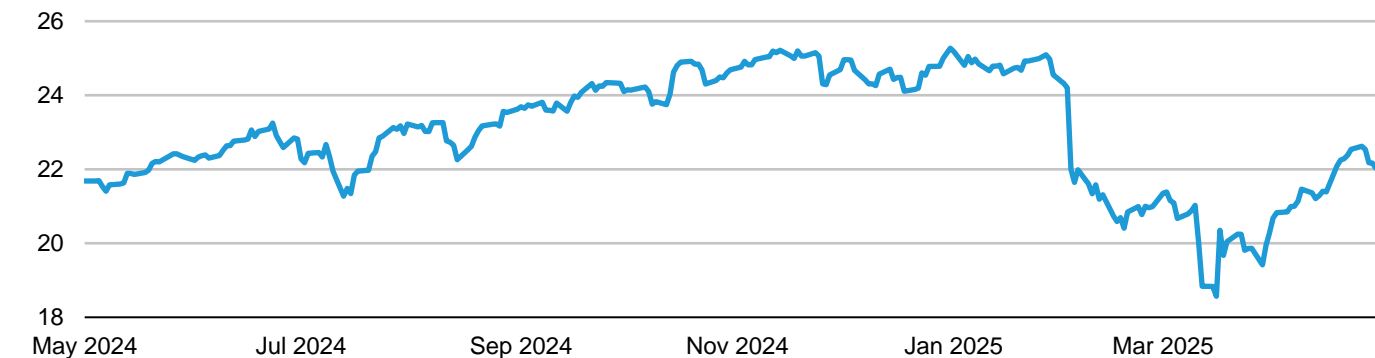
Source: Bloomberg and University of Michigan

Display 4: Tariffs Remain Elevated Despite De-Escalation with China
Tariff Rates (Percent)



As of May 23, 2025
Source: Bloomberg

Display 5: Forward PE Multiples Are Not Reflecting a Deterioration in Earnings
Adjusted Price/Estimated Earnings: S&P 500



As of May 23, 2025
Source: Bloomberg

Investment Risks to Consider

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