AllianceBernstein®

July 22, 2025

A Note from the AB Fixed Income Trading Desk

Thoughts from Our Senior Portfolio Managers

Halftime: Prepping the Second Half

"It's better to look ahead and prepare, than to look back and regret." —Jackie Joyner-Kersee

In our last note, we looked backwards and graded our advice to clients with a midyear scorecard—determining how well we framed out the first half of 2025 at the start of the year. Overall, we think we did a pretty good job and don't have many regrets. We characterized the year as being driven by tariff, fiscal, geopolitical and policy uncertainty. We also claimed that growth, core inflation and, eventually, central bank policy rates would move further into balance.

Now that we've crossed the halfway mark, we're once again looking ahead and preparing. With the "One Big Beautiful Bill Act" (OBBA) behind us and tariff negotiations reescalating, we're reattempting to help clients craft a view on how the remainder of the year may or may not play out. If this year has taught us anything, it's that the most effective portfolios take a longer-term view but also retain the flexibility to react when conditions shift quickly. Here's how we see the landscape for the months ahead—and where our attention is focused now.

Key Takeaways

- As we look ahead to the second half of the year, we're mindful of the shifting macro landscape—growth appears to be cooling, inflation is easing unevenly, and central banks are increasingly charting their own paths. We're preparing for a world where policy divergence and geopolitical developments will continue to shape the outlook.
- Market conditions remain fluid, with volatility still a defining feature. We're seeing opportunities emerge as rates fluctuate within ranges, currencies adjust to changing narratives, and credit spreads reflect a more selective risk environment.
- We continue to lean into strategies that offer flexibility and resilience. Whether it's short-duration high yield for its defensive carry, or global and core plus strategies for their adaptability, we're focused on staying nimble and disciplined as we navigate what's next.

Midyear Outlook: Our View

Trade Policy: We expect tariff discussions to remain a persistent source of noise in the near term—especially now that the fiscal outlook has been clarified by the passage of the OBBA. With the administration's evolving posture, shifting tariff levels, changing effective dates, and varying sector and country targets, it is difficult to pinpoint where final tariff rates will land or when. However, the increased formality of the process (letters rather than tweets) and more active engagement among trading partners suggest that tariffs are on the way to settling at levels near historical highs. The resulting uncertainty—and its impact on business and consumer sentiment—will continue to show up in macro data in the weeks and months ahead.

Growth: We expect global growth to slow but remain positive, with US GDP growth finishing around 1.3% for 2025 (*Display 1*). The US consumer and labor markets are softening, but both remain resilient enough to avoid recession. Headline GDP prints will likely remain volatile due to trade and inventory effects, while business surveys and consumer activity suggest cooling underlying momentum. Europe faces more pronounced challenges: the recent announcement of a 30% baseline tariff for EU exports to the US could prove significant, as it would likely tip the region into recession and force the ECB to ease further in response. Nevertheless, we currently see eurozone growth at around 0.8%.

Inflation: We see inflation decelerating globally, with the exception of the US, where we see core CPI ending 2025 near 3.8% (*Display 2*) and eurozone inflation around 2.1%. Goods inflation is now flat to negative, and services inflation is easing. However, headline prints may prove sticky due to energy prices and tariff effects; other sticky components like shelter and wage growth, while still elevated, have recently shown signs of softening. The path back to target is likely to be very uneven given the current policy outlook.

Central Bank Policy: We expect divergence among global central banks to become even more pronounced. We believe the Fed will deliver three cuts in 2025 (*Display 3*), ending the year with a policy rate near 3.63%. The ECB, having front-loaded its easing cycle, is likely to cut once more—unless tariff shocks accelerate the need for further cuts. The Bank of England may cut rates twice more, targeting 3.75%, while the Bank of Japan is expected to remain cautious and gradually tighten as inflation pressures persist. Looking ahead, market attention will increasingly focus on Fed independence and the selection process for Jerome Powell's successor.

Rates: We expect US rates to remain range-bound, with the 10-year US Treasury yield ending 2025 near 4.0% (*Display 4*). We continue to favor curve steepeners in the belly of the curve—positions that benefit as the gap between short- and long-term yields widens—along with tactical trading ranges. We're most comfortable taking interest-rate risk where policy and fundamentals are supportive. In Europe, yields likely have further to fall, with German 10-year Bunds ending the year near 2.2%. Uncertainty around fiscal policy and global politics will keep volatility elevated.

US Dollar: We see dollar softness as a dominant theme (*Display 5*), reflecting a moderation in US exceptionalism and narrowing rate differentials. The dollar should remain volatile, with tail risks on both sides: renewed US fiscal or growth concerns could prompt strength, while diversification and global capital flows could drive further weakness. The interplay between policy, flows and sentiment will be crucial for the remainder of the year.

Credit Conditions: Credit fundamentals remain supportive overall, with high yield default rates expected to remain below 3% in both the US and Europe. Downgrades and defaults should rise modestly but remain manageable. Despite tight spreads, as we highlighted at the start of the year, we believe high yield is still likely to outperform equities in risk-off episodes, while technicals remain supportive for higher-quality credit. Security selection and risk management are central as new issuance and sector dispersion create opportunity.

Cross-Sector/Relative Value: We believe the current landscape is truly a global multi-sector manager's playground. Regional divergence, sector rotation, and dispersion in credit, sovereign and currency markets create a wide opportunity set for security selection and tactical allocation. Maintaining a bias toward quality and liquidity is prudent, but flexibility and a global perspective will be essential for capturing value as conditions shift.

Volatility: Volatility remains a defining feature, with persistent spikes driven by geopolitical tensions, trade disputes and shifting central bank narratives. Active management is not just an advantage but a necessity; we believe alpha will come from security selection, dynamic risk budgeting and the ability to reposition portfolios as new information arrives.

Risks to Our Forecast: While our base case is for a gradual slowdown and continued disinflation, humility remains essential. Downside surprises in growth or employment, unanticipated fiscal or trade shocks, and escalating geopolitical risks ("unknown unknowns") could upend our current assumptions and force rapid portfolio pivots. Structural market fragilities—including liquidity, concentration risk and passive flows—may amplify volatility. Above all, we recognize the value of an ongoing process review and a willingness to reevaluate and recalibrate as conditions evolve.

Investment Implications

We believe navigating the second half of 2025 will reward those who balance conviction with flexibility and keep a sharp focus on process, risk management and relative value. This isn't an environment for market-timing or chasing headlines; it's a time for staying invested, disciplined and adaptable—an approach that has served us and our clients well so far this year.

- **Short-Duration High Yield** continues to offer the best of both worlds—meaningful yield, resilient risk mitigation, and the potential for equity-like returns with less volatility. As volatility remains elevated and defaults inch up from historical lows, credit selection and risk management are paramount, but the carry and structural advantages of the asset class remain compelling. The strategy's ability to perform in both rallies and risk-off episodes has reinforced its role as an "all-weather" solution. All-in yields at the current level of ~7% still rival many Wall Street forecasts for equity returns, and we remain convinced that short-duration high yield continues to be one of the best risk-adjusted returns for investors in the intermediate term.
- **Core Plus** strategies remain a cornerstone for diversified portfolios, giving us the flexibility to rotate across sectors, adjust curve and duration exposures, and seek yield in the right places while maintaining a bias toward quality and liquidity. The capacity to add risk selectively—when dislocations arise—has delivered strong results and positioned us to both capture opportunity and protect capital.
- **Global Fixed Income** provides an expanding set of tools for managing risk and finding incremental yield as global cycles diverge. Regional and sector dispersion have created a genuine playground for active managers; exposure to non-US rates and credit, combined with active currency management, has allowed us to generate alpha and diversify away from single-market risk.

Above all, our disciplined approach—anchored in preparation and a willingness to adapt—has delivered strong performance in a challenging year. We don't expect the path ahead to be easy, but we do believe that staying liquid, staying diversified and staying humble are the best ways to keep portfolios and clients one step ahead.

On behalf of the team,

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 other market insights, visit [Fixed-Income Investments | AB](#).

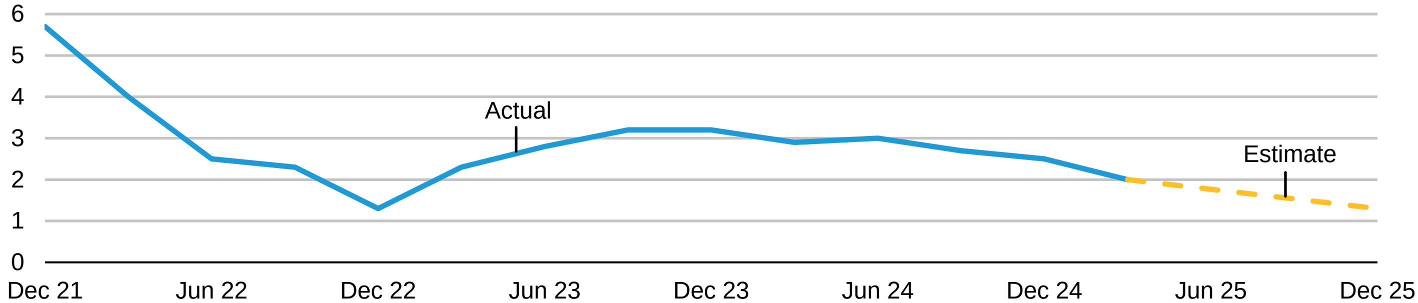
US Economic Scenarios

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.	20
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 at which it is reached.	35
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.	35
Stagflation	The economy slows, but inflation expectations rise, trapping the Fed between a rock and a hard place.	5
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

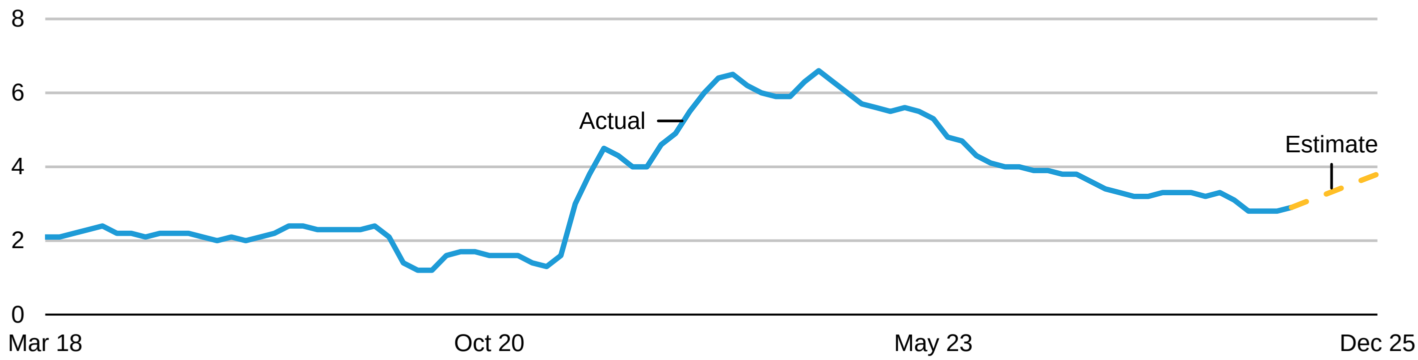
2025 Forecasts	Counterfactual No Tariffs at All (Percent)	Upside No Universal Tariffs (Percent)	Current Situation 10% Universal Tariffs (Percent)	April 2–9 20% Universal Tariffs (Percent)	Downside 30% Universal Tariffs (Percent)
Growth (YoY)	1.10	0.80	0.06	0.30	–0.60
Inflation (Annual)	2.00	1.80	1.60	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: We Expect US Growth to Slow but Remain Positive
Real GDP YoY (Percent)



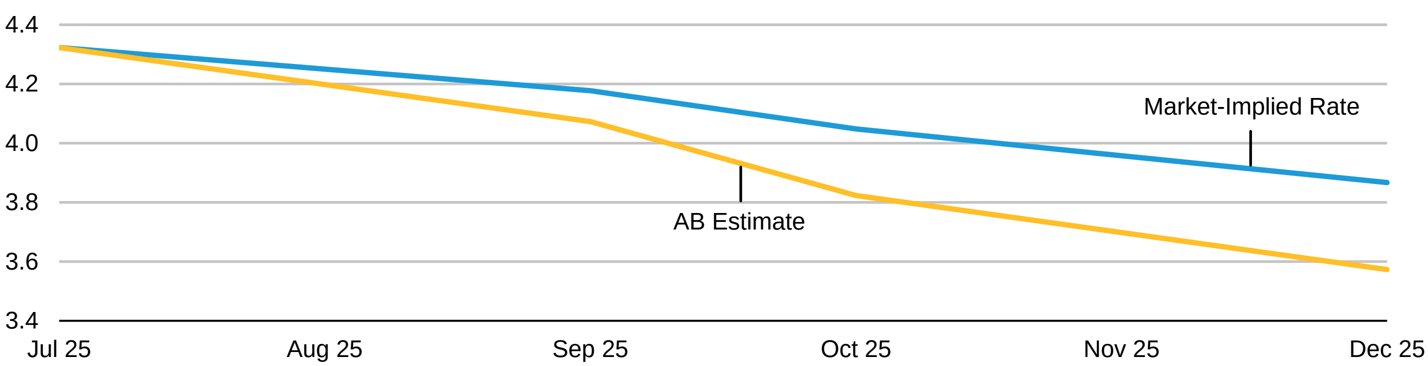
As of July 16, 2025
Source: Bloomberg

Display 2: We Expect Inflation Impact from Tariffs to Materialize in 2H25
Core CPI Index (YoY)



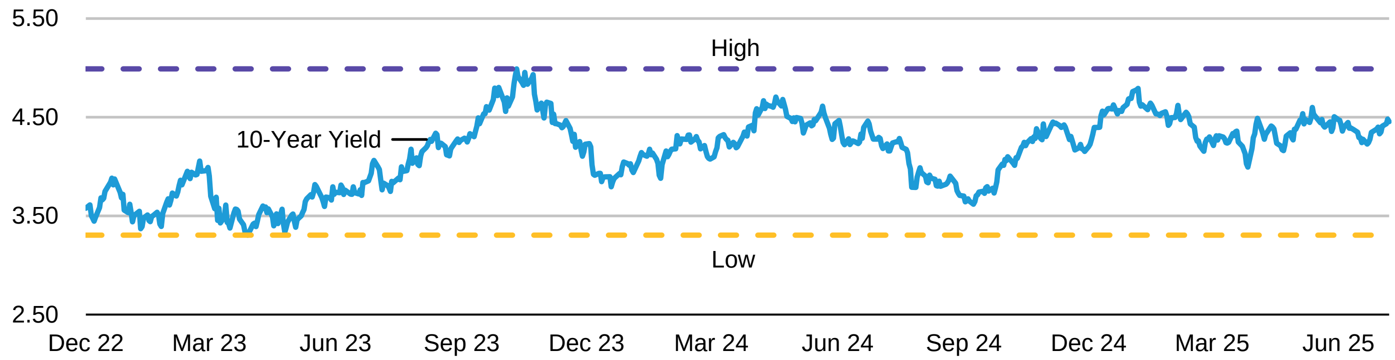
As of July 16, 2025
Source: Bloomberg

Display 3: AB Expects One More Cut than the Market Anticipates from the FOMC
Federal Funds Rate (Percent)



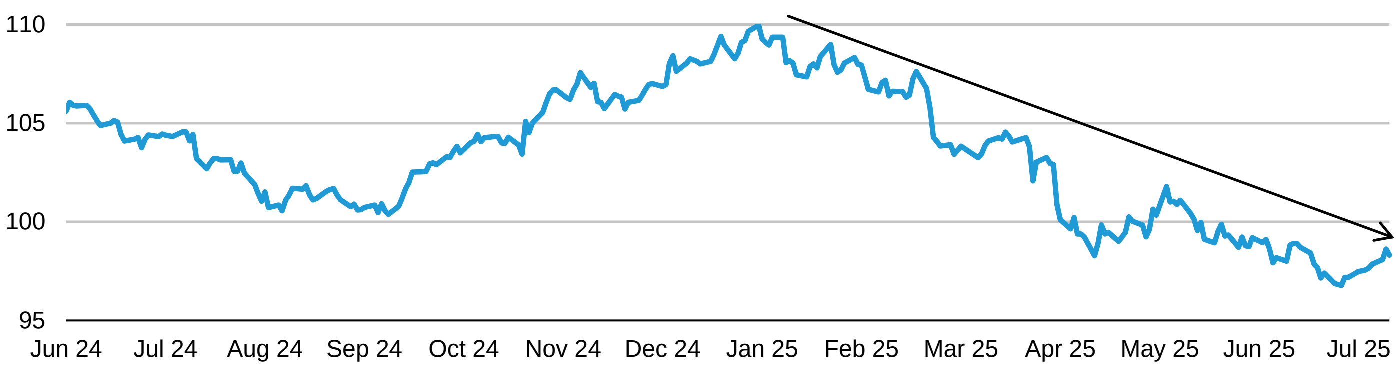
FOMC: Federal Open Market Committee
As of July 16, 2025
Source: Bloomberg

Display 4: We Anticipate 10-Year Treasury Yields to Remain Within Local Ranges
United States Treasury Bond 10-Year Yield (Percent)



Through July 16, 2025
Source: Bloomberg

Display 5: We Anticipate That Dollar Softening Will Remain a Dominant Theme Against Select Pairs
US Dollar Index



Through July 16, 2025
Source: Bloomberg

Investment Risks to Consider

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