Vanguard®

Q3 2022

Active fixed income perspectives

Key points

Performance: It has been the worst first half-year of performance for global fixed income markets in decades[1] Interest rates are up, credit spreads have widened and the Russian invasion of Ukraine has spooked global bond markets. The pain has been felt across asset classes, with fixed income the first to react.

Looking ahead: Despite all the agonies—and continuing concern over how long higher inflation may run—US bonds with maturities over five years now offer real yields above the rate of longer-term expected inflation. Corporate, high-yield and emerging market bonds offer more opportunities than at any time in the recent past. At current valuations, bonds arguably offer a reasonable level of income and have also re-established their role as a portfolio hedge against equity risk.

Approach: Uncertainties remain around the economic outlook, so patience is still needed. In recent weeks, markets have priced in lower growth projections and fewer rate hikes for this cycle. Valuations have improved as recession fears grow, offering more value and better long-run returns. Risks of stickier-than-expected inflation or a policy overreaction must be factored in.

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Bonds are back

The "new reality" we discussed in our last quarterly update arrived quickly. Caught by surprise inflation, central banks—notably the US Federal Reserve (Fed)—had to signal, and start enacting, a series of higher rate hikes than previously anticipated. Since then, central banks around the globe have been hiking in earnest throughout the year so far. Even the dovish European Central Bank (ECB) had to signal a pivot to tighter policy in the past quarter.

Markets have started to consider the possibility of a recession and, later on, rate cuts as well. In our view, it's probably premature to price in cuts for now, but those concerns brought down longer-term US Treasury rates and helped to push credit spreads wider.

Bond yields are now above the rate of longer-term expected inflation in some markets—such as the US—for the first time since a brief spike during the initial Covid-19 panic of March 2020. The bottom line for investors is that yields are now broadly above longer-term inflation expectations and bond markets are providing a tangible income.

Critically for investor portfolios, bonds have also started once again to behave as a stable hedge against equity risk after having spent most of the year correlated with risk assets. Signs of a weaker economy ahead are likely to further validate the role of bonds as a diversifier. That has been the case over the longer term, and we believe it will be going forward as well.

Is the turmoil over?

That's not to suggest that all the risks are behind us. Inflation has proven much more persistent than many in the market had expected, but we believe this is, in many respects, an old story, as inflation has likely peaked and has largely been priced into fixed income assets.

Our outlook and positioning will be closely linked to how central banks respond once policy rates reach their presumed 'neutral levels'[2]. It is very likely that at that point inflation will still be uncomfortably high, making the trade-off between avoiding a recession and curbing rising prices more challenging for policymakers. We expect the Fed in particular to push into restrictive territory, but how far is a question we'll continue to assess.

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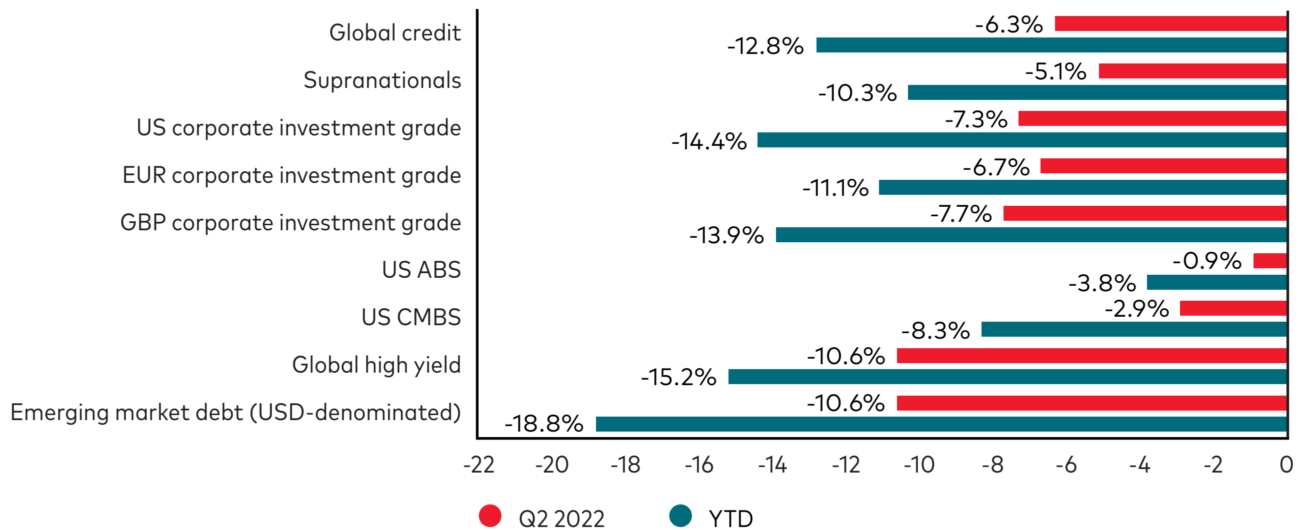
Market sector returns



Past performance is not a reliable indicator of future returns. Sources: Bloomberg indices and J.P. Morgan EMBI Global Diversified Index for emerging market debt. The performance of the indices reflect the reinvestment of dividends but do not reflect the deduction of any fees or expenses which would have reduced total returns. Returns are USD hedged for consistency. Data from 31 March 2022 to 30 June 2022.

Rates and inflation

Inflation concerns quickly gave way to recession worries after the Fed's mid-June meeting and its larger-than-expected 75-basis-point interest rate hike. The largest inversion between the 2-year and 10-year Treasury yields since 2000 clearly signalled the market's recession fears. Yet June's 9.1% print of the Consumer Price Index offered the Fed little choice but to remain aggressive.

Markets now see the Fed hiking faster but pulling back more quickly than previously expected. By mid-July, markets were anticipating the overnight rate peaking at 3.7% in December, followed by 70 basis points of cuts in 2023.

In contrast to the US—and despite heightened concerns over persistent inflation—the ECB has been hesitant to raise interest rates at this time, though it has alluded to potential future rate hikes. Euro area GDP increased by 0.6% in the first quarter, although the potential for an abrupt end to Russian natural-gas supplies remains a downside risk.

Euro area inflation stood at 8.6% in May, driven by high inflation primarily in eastern member countries, such as Estonia (20.1%), as well as in Germany (8.7%) and Italy (7.3%).

At its June meeting, the ECB left its deposit rate unchanged, though signalled a potential 25-basis-point hike at its July meeting, with the possibility of a subsequent 50-basis-point increase in September. The ECB has also announced an end to net purchases under its Asset Purchase Program (APP), which led to a sell-off in euro area bonds. For example, 10-year German government bond yields rose by 79 basis points during the quarter.

As a result, markets have priced in sharp rate hikes in the short term, observable in the steepening of the German bund yield curve, led by the part of the curve ranging from 1-month- to 2-year-maturity bonds. This is also driven by market sentiment that inflation is now past its peak and a recessionary environment could be likely in the long term.

Looking ahead, the ECB's recently devised 'anti-fragmentation tool' should help contain any major blowout of euro area periphery—notably Italian—bond spreads but will also give the ECB a pathway to hike rates more aggressively if needed. We believe we may continue to see a repricing of German bunds, but an even weaker economic outlook for the region is likely to weigh heavily on the path for European government bonds.

In the UK, inflation reached a new 40-year high—of 9.1%— in May. The unemployment rate remained consistent with Q1, while average weekly earnings grew by 1.2%. UK consumer confidence also fell to record lows, as the economy shrank by 0.3% in April, although it subsequently surprised to the upside in May, growing by 0.5%.

Facing its fight against inflation amid a backdrop of slowing demand and increased recessionary fears, the Bank of England (BoE) raised interest rates for a fifth consecutive meeting, hiking by 25 basis points to 1.25% at its June meeting. Some members of the bank's Monetary Policy Committee (MPC) voted for an even greater 50-basis-point hike, and the MPC has signalled that larger rate hikes could be possible at future meetings, depending on the economic and inflationary outlook. Ten-year UK government bond yields rose by 62 basis points during the quarter. Additionally, the UK government announced a £15 billion fiscal programme to support households with rising costs, which the BoE expects will boost GDP by 0.3%.

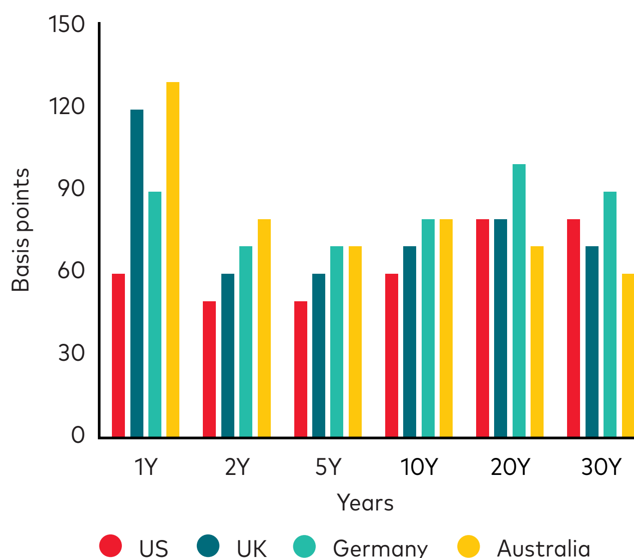
In light of rising inflation, the BoE argued that "some further modest tightening in monetary policy" might be needed over the coming months, but that there were risks on both sides of that judgement.

Yields moved higher across the UK gilt curve, mostly at the short end: 1-month gilt yields rose 44 basis points to 0.93%, 6-month yields by 108 basis points to 1.96% and 1-year yields by 75 basis points to 1.79%. We expect UK government bonds to exhibit elevated levels of volatility in line with inflation, which is itself highly volatile. As a result, we remain opportunistic.

Implications for Vanguard funds

- We remain neutral on duration, but we have shifted from a curve-flattening bias to having more exposure in the intermediate part of the yield curve where we see better value.
- In Europe, we may continue to see an upward repricing of German bunds, but an even weaker economic outlook for the region is likely to weigh heavily on the path for European government bonds.
- In UK government bonds, we expect elevated levels of volatility in line with highly volatile inflation. We remain opportunistic.

Government bond yields quarterly change by maturity in basis points



Past performance is not a reliable indicator of future returns.
Source: Bloomberg. Data from 31 March 2022 to 30 June 2022.

Credit

Credit spreads widened over the quarter as markets continued to adjust to tighter financial conditions and heightened recession risks. As we stated earlier in the year, risk premiums would likely increase to compensate investors for the downside risks of aggressive central bank policy, which has now occurred. However, not all segments of fixed income credit have fully priced in these risks.

Emerging market (EM) bonds have corrected the most while higher-quality corporate bond spreads may need to widen further, although they are now close to the turning point. As valuations improve, we are taking the opportunity to move up in credit quality. We are adding positions that, in our view, have overcorrected and can withstand a weaker growth environment.

Credit valuations today offer a better cushion against any additional price drops, although it appears likely that some further negative performance is still ahead. In a recession scenario, credit spreads can move significantly wider. As the Fed's path forward becomes clearer, there are a wide variety of security selection opportunities to take advantage of that would not subject our funds to large downside risks.

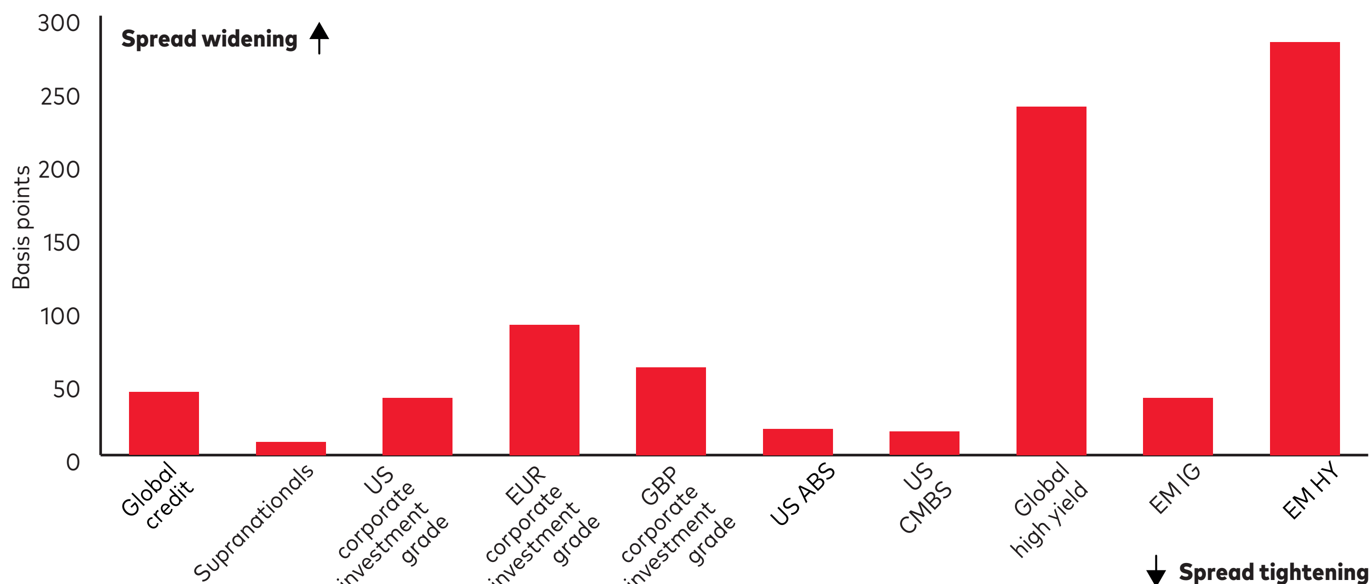
Investment-grade corporates

Credit spreads have widened considerably this year for both US and European corporate bonds, but there's been a big divergence in recent weeks as European spreads moved wider at a much faster pace. US spreads have moved from below 100 basis points at the start of the year to around 160 basis points, while spreads in Europe have doubled from 100 to 200 basis points. The sector has faced steady pressure from fund outflows over the course of 2022, but lighter new-issue supply has helped restrain the widening in spread levels.

US market valuations, in our view, don't yet fully reflect the full set of risks on the table, but pockets of value exist with current spreads about 25 basis points above 10-year averages. European valuations, by contrast, are very cheap, but there's little dispersion across sectors and the region is in the crosshairs of a recession. A more selective approach is appropriate, in our view.

We expect the long-running trend of BBB-rated outperformance to diminish in the months ahead and we see the best risk-reward opportunities as being among higher-rated bonds. Similarly, we've been moving away from cyclical sectors towards companies with more earnings stability through this part of the credit cycle. Overall, corporate fundamentals are still quite strong with a cushion above pre-pandemic levels. Issuers with low liquidity needs and strong balance sheets should hold up well.

Change in spreads



Past performance is no guarantee of future returns. Sources: Bloomberg and J.P. Morgan EMBI Global Diversified indices. Data from 31 March 2022 to 30 June 2022.

High-yield corporates

Yields on below-investment-grade bonds currently hover near 9%[3]. Behind the headlines of improving valuations lies a fundamental credit picture that remains strong even in the face of the economic headwinds ahead.

Downturns are generally not friendly to below-investment-grade bonds, but there are several mitigating factors that are important to consider. For one, the mix of the high-yield market is much more skewed towards higher-quality bonds today than in years past. The BB-rated segment of the sector now represents more than 50% of the universe, up from 35% pre-global financial crisis. Over the same period, the lowest-quality CCC-rated segment has shrunk from 20% to around 10%.

Furthermore, default rates remain around 1%—well below the long-term historical average of 3.5%[4]—leverage levels are back to below pre-pandemic levels, and there is very little debt coming due in the next few years. Companies on the whole appear to be very well positioned to manage a difficult economic environment, but a targeted security selection approach is critical to mitigate downside risk.

Emerging markets

EM debt has had the worst performance this year of all fixed income sub-asset classes[5]. Expectations of slower global growth combined with pockets of social unrest in several EM countries have weighed heavily on EM bond prices.

As a result, yields on US dollar-denominated EM credit have climbed above 8.5% and, in our view, a lot of potential negative outcomes are reflected in today's prices. At these yield levels, expected one-year returns have historically been quite strong. We feel that EM debt is further along in its adjustment, and better positioned for recovery, than many other asset classes.

The rapid sell-off in spreads and global interest rates has resulted in historically low dollar prices for EM bonds. While this is most supportive for distressed issuers that may be forced to restructure (minimising the potential loss from default), it should also result in tighter spreads for healthy credits, considering the lower dollar amount investors have to put at risk for each bond purchased.

While fundamentals are mixed, valuations and technicals are very supportive. We do not expect to see a sizeable rally until investor flows into EM turn positive again; at these yield levels, we expect that to happen, but when exactly is still unclear. We have been cautious on our overall EM exposure this year, but now feel much more constructive about the 12- to 18-month outlook for returns.

Implications for Vanguard funds

- Investment-grade corporate bonds could see further spread widening, but yields are approaching 5%. Pharmaceuticals, utilities, real estate investment trusts (REITs) and financials offer value.
- With a broad 20% decline in EM bonds so far this year, there are attractive entry points across the quality spectrum.
- High-yield bonds are trading at discounted prices. We see better risk-reward in higher-quality segments, but the high-yield market offers opportunities to pick winners with larger upside.

1 Source: Bloomberg. Returns for Bloomberg Global Aggregate Index USD Hedged, as at 30 June 2022. The first-half 2022 performance is the worst since the inception of the index on 1 January 1990.

2 The neutral rate is the theoretical interest rate at which monetary policy neither stimulates nor restricts an economy.

3 Source: Bloomberg. Yields for Bloomberg Global High Yield Index USD Hedged as at 30 June 2022.

4 Source: Vanguard as at 30 June 2022.

5 Source: JPM EMBI Global Diversified Index, as at 30 June 2022.

Who we are

FIXED INCOME GROUP

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Vanguard Fixed Income Group manages $2.2 trillion globally in active and passive funds with a global team of more than 180 investment professionals.

Data as at 31 December 2021.

YEARS IN FIXED INCOME

35+ years

Vanguard's active fixed income team manages over $607 billion across various actively managed fixed income strategies. For more than 35 years, Vanguard has managed active fixed income funds with an experienced team of credit research analysts, traders and portfolio managers.

WE MANAGE RISK

90+

Our investment teams are supported by our 50-plus member economic research team that informs our economic outlook and our 80-plus member risk management team that is integrated into our investment process.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Past performance is not a reliable indicator of future results.

Some funds invest in emerging markets which can be more volatile than more established markets. As a result the value of your investment may rise or fall.

Funds investing in fixed interest securities carry the risk of default on repayment and erosion of the capital value of your investment and the level of income may fluctuate. Movements in interest rates are likely to affect the capital value of fixed interest securities. Corporate bonds may provide higher yields but as such may carry greater credit risk increasing the risk of default on repayment and erosion of the capital value of your investment. The level of income may fluctuate and movements in interest rates are likely to affect the capital value of bonds.

Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results.

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