Vanguard

Q2 2024

Active fixed income perspectives

Authors

Christopher W. Alwine, CFA
Global Head of Taxable Credit

Kelly Gemmell, CFA
Head of Fixed Income Product Specialism

Roger Hallam, CFA
Global Head of Rates

Key takeaways

Performance: Stronger economic data curtailed 2024 rate-cut expectations in the first quarter of 2024. Interest rates moved higher across the curve and credit spreads tightened further. Lower-quality credit and shorter-term bonds performed best. The Bloomberg Global Aggregate Index (USD hedged) ended the quarter broadly unchanged, returning 0.01%.

Looking ahead: The US Federal Reserve (Fed) aims to ease policy, but strong growth and sticky inflation complicate the path forward. Rate cuts may come later than the market expects, in our view, giving investors an extended window to lock in attractive yields for the long-term. In Europe, weaker growth could signal a divergence in the timing of policy decisions with the US. Credit sectors easily absorbed a record amount of issuance in the first quarter, supporting a positive outlook for the rest of the year.

Approach: We are positioned to take advantage of higher market volatility, which should provide more opportunities for our portfolio. In credit, valuations are justifiably rich given sound fundamentals and strong demand.

Trying to find a landing

Since the US Federal Reserve (Fed) paused its interest rate hiking cycle in July 2023, the focus of the asset management and economic forecasting complex has been on when and by how much the Fed will cut rates.

Financial markets had good reason to follow a soft-landing narrative into 2024, as inflation rates had been falling and economic growth remained strong in the face of tighter monetary policy.

However, recent economic releases in the United States have shifted the narrative from a gradually cooling economy to one that now appears more robust. Additionally, inflation appears to be stuck above target levels, raising doubts about the Fed's ability to achieve its 2% target while growth and labour markets are this strong.

Our base-case scenario remains that the Fed has concluded its hiking cycle and is likely to remain on hold until later in the year. Policy, and investors, will be data dependent. If above-trend growth and persistent inflation continue, the Fed could have limited room to cut rates and may need to remain on hold until the end of the year.

Achieving a true soft landing is challenging, as cutting rates too late can push the economy into a recession, while cutting too soon can reignite inflationary pressures.

Looking ahead

With restrictive monetary policy, there is an above-average risk of an economic slowdown, particularly if the tailwinds that have supported growth begin to fade.

If the potential for another rate hike rises, it could cause turmoil in both the stock and bond markets.

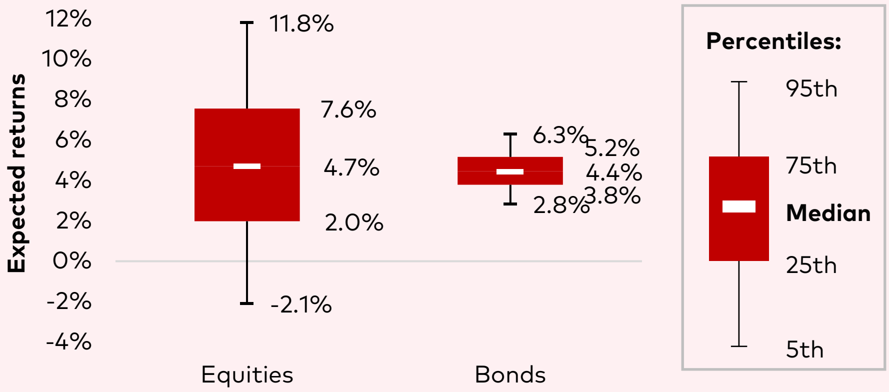
Over the coming months, all eyes will be searching for signs of a more definitive trend for inflation. We are positioned to take advantage of higher market volatility, which should provide more opportunities for our portfolios.

However, we think investors should also take a longer-term perspective and take the opening to right-size their portfolio allocation to bonds and lock in attractive yields for longer.

The big picture: Attractive risk-adjusted returns

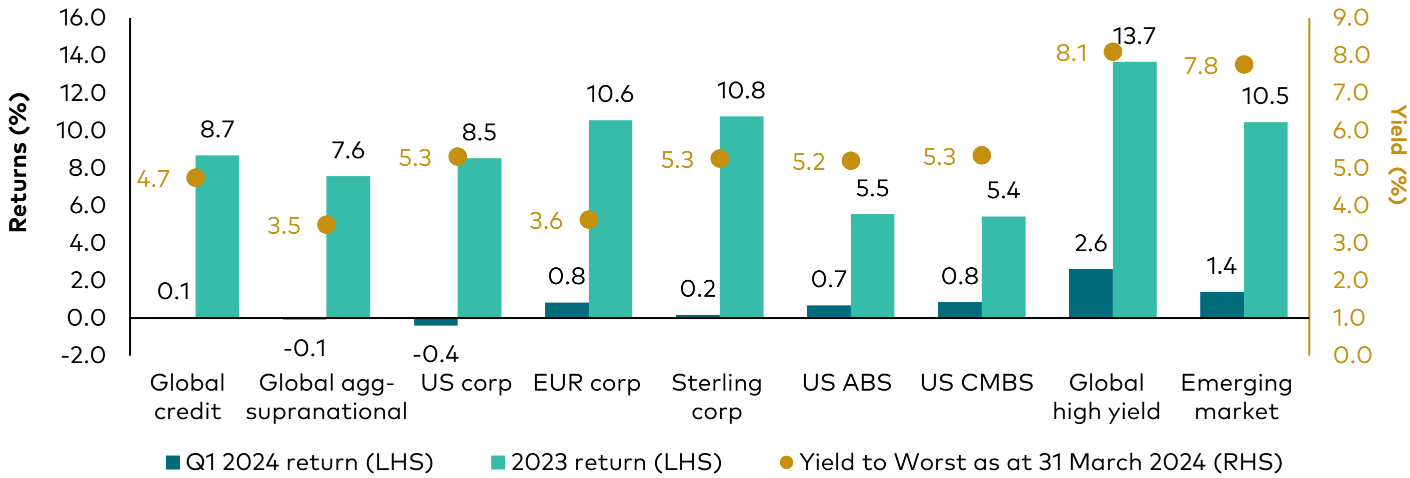
Yields on bonds are now more attractive than they have been for much of the period since the financial crisis, and because we expect lower volatility from bonds than equities, risk-adjusted returns can look compelling. This is particularly the case for US equities and US bonds, where Vanguard's forecasts show there's a 50% chance that US aggregate bonds will return about as much over the next five years as US equities—4.4% for bonds versus 4.7% for stocks—with one-third of the median expected volatility.

Projected 10-year returns for US equities and bonds



Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results. Notes: Distribution of 10-year annualised return outcomes from the VCMM are derived from 10,000 simulations for each modelled asset class. Equities represented by MSCI USA Broad Market Index in USD; bonds represented by Bloomberg US Aggregate Bond Index in USD. Source: Vanguard calculations, as at 31 December 2023.

Fixed income sector returns and yields



Sources: Bloomberg indices and the J.P. Morgan EMBI Global Diversified Index. Q1 2024 data from 31 December 2023 to 31 March 2024; 2023 data from 31 December 2022 to 31 December 2023. **Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Performance is provided on a total return basis, in the base currency of the index, or for global indices, USD hedged.**

Rates and inflation

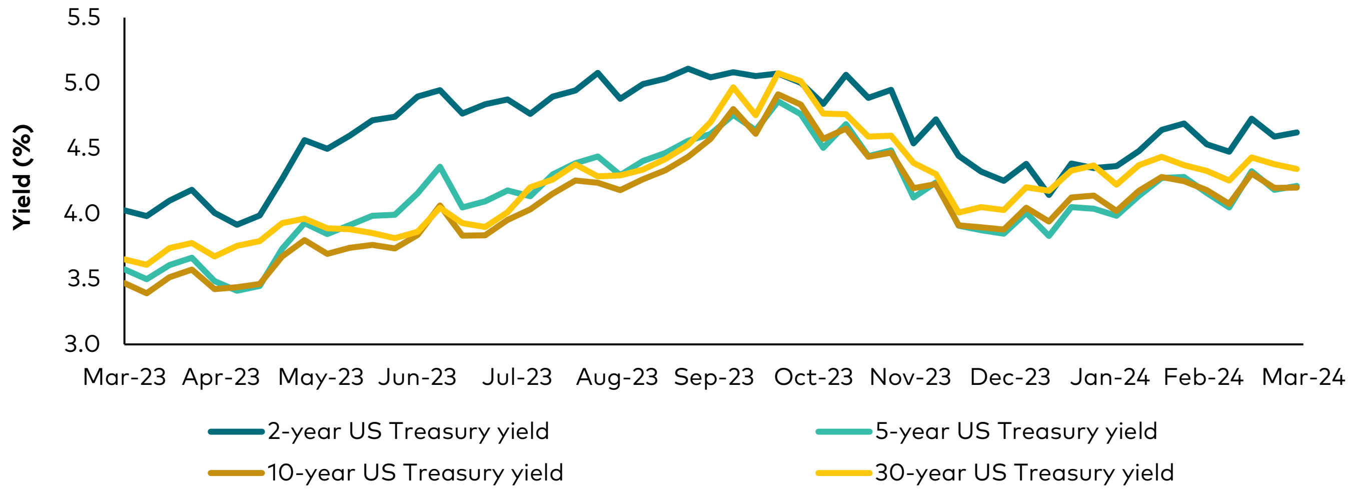
In the US, higher-than-expected inflation readings led rates markets to scale back their ambitious expectations for rate cuts in 2024. Market pricing is now more closely aligned with the Fed's forecast, which they reaffirmed in March, and indicates an anticipated easing of 75 basis points (bps) this year.

US Treasury yields responded to the shallower projected path for rate cuts by increasing more than 30 bps across the curve. The yield on the 10-year US Treasury has held above 4% since February and ended the first quarter at 4.20%.

Recent US inflation readings have accelerated compared to the pace of disinflation observed at the end of 2023. The downward trend which the Fed had cited as evidence that its policies were having their intended effect and which had buoyed markets, is no longer apparent, and core inflation measures have been moving in the wrong direction over recent months.

After a burst of productivity and employment growth last year, we expect to see the US economy start to settle down in the latter half of this year. Similarly, we see inflation continuing to move lower, but the path back to target will be a long one. In our view, core Personal Consumption Expenditure (PCE) inflation is not expected to fall back to 2% target until 2025.

US Treasury yields have climbed on stronger data, but not to cycle peaks



Source: Bloomberg. Chart shows the historical 30-, 10-, 5- and 2-year US Treasury yields, for the period from 31 March 2023 to 31 March 2024. Calculations are in USD.

If economic conditions hold, rates are likely to stay rangebound. Bumpy inflation should keep the Fed cautious over the near term but, when rate cuts do appear imminent, the curve should steepen with short-term rates falling.

We think the bar is high for any additional rate hikes, but a sustained pattern of inflation above 3% and growth above 2% would spark that debate. In that scenario, we expect markets would see upward pressure on rates and higher market volatility. There is a higher probability of the Fed delivering fewer cuts than what's currently priced into markets, in our view.

After taking profits on our long duration positions earlier this year, we see the upside and downside risks for rates as fairly balanced over the near term and do not have a strong bias towards US duration and yield curve positioning.

Why interest rates will remain higher

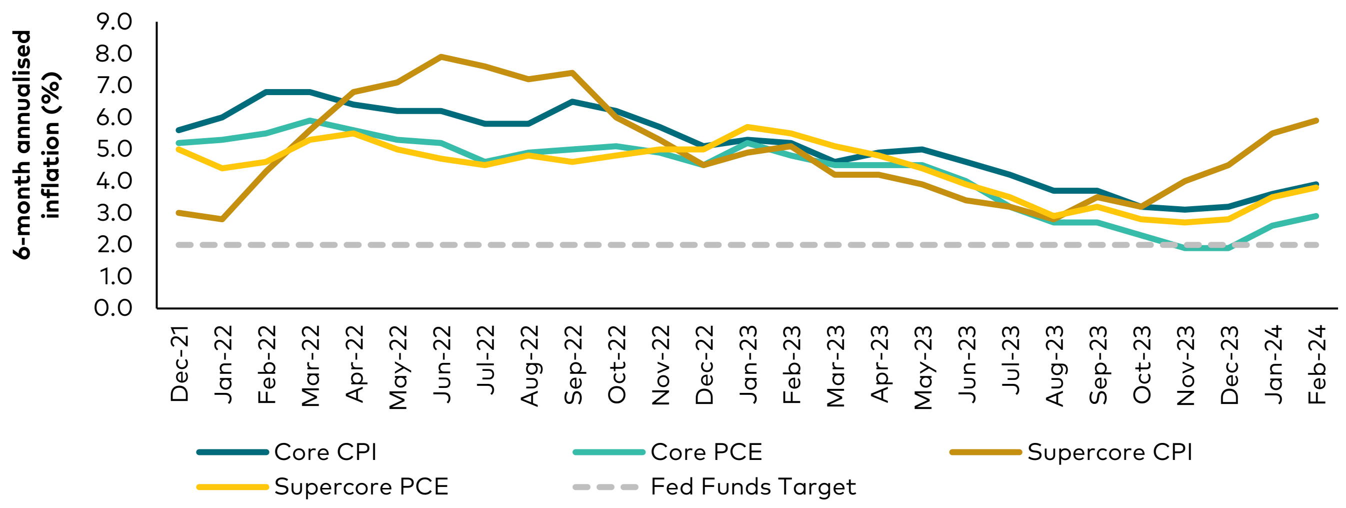
Vanguard research[1] from last year argues that r-star — the real (inflation-adjusted) central bank interest rate that would neither stimulate nor restrict the economy — is higher than what the Fed believes it to be. R-star is a crucial determinant of monetary policy.

The research projects that the r-star has risen by 100 basis points since the Global Financial Crisis to 1.5% today, driven primarily by demographics, long-term productivity growth and higher structural fiscal deficits.

The investment implications of a higher r-star are significant. Our analysis reveals that the rise of r-star reflects secular changes that are unlikely to quickly reverse. This strongly suggests that the era of secularly low rates is over.

[1]Davis, Joseph H. and Zalla, Ryan and Rocha, Joana and Hirt, Josh, "R-Star is Higher. Here's Why" (14 June 2023). Available at SSRN: https://ssrn.com/abstract=4478413.

Recent data suggest inflation's path to 2% will be bumpy



Source: Vanguard calculations based on Bloomberg indices. Data period is 31 December 2021 to 29 February 2024.
Notes: The US Core Consumer Price Index (CPI) measures the changes in the price of goods and services, excluding food and energy. Core Personal Consumption Expenditure (PCE) measures consumer spending on goods and services among US households, excluding food and energy. Supercore CPI and PCE are similar inflationary measures excluding the cost of housing.

In the euro area, the inflation outlook is more benign. Inflation is tracking below 2% while growth remains below-trend amid still-restrictive monetary and fiscal policy and the lingering effects of the energy crisis.

In Japan, the central bank delivered its first interest rate hike in 17 years as it became the last central bank to end the use of negative rates as a monetary policy tool. It also removed its yield curve control policy, which capped the yield of 10-year Japanese government bonds (JGBs).

Given the data divergence between Europe and the US, the potential for monetary policy divergence has grown. The European Central Bank (ECB) has indicated they are data dependent, but may be ready to cut rates as early as June, and the Bank of England (BOE) acknowledged that cuts are on the horizon. With an eye on inflation, we continue to monitor strong wage growth in the UK, especially as the impact of rises in minimum wage thresholds ripple through the labour market.

In Japan, wages are also relevant – negotiations between the largest employers and labour unions point to growth above 5%. If this translates into higher household consumption, it could lead to inflation and future monetary policy hikes. Across Japan and Europe, we continue to be mindful of commodity prices, which have risen since the start of the year and could contribute to inflationary pressures.

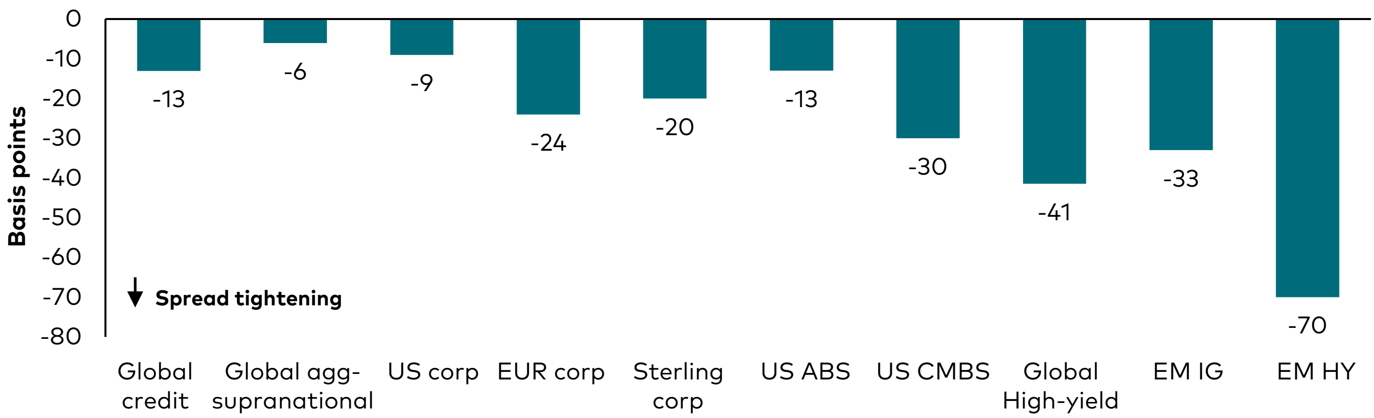
Looking ahead

We expect a gradual improvement in the macroeconomic backdrop in Europe and are taking advantage of the uplift in yields in countries like Spain and Greece, where we remain overweight in both Spanish and Greek sovereign bonds.

In Japan, we believe that 10-year JGB yields will rise towards 1%.

Credit

Quarterly changes in spreads



With the Fed on hold and US growth still above-trend, the backdrop for fixed income credit sectors continues to be supportive. Fundamentals remain mostly stable and strong demand from all-in yield buyers helped credit spreads narrow in the first quarter, even amid record levels of new bond issuance.

We expect these tailwinds to continue into the second quarter. We're likely past the largest wave of issuance for the year, which will limit supply and provide a supportive technical backdrop as we believe demand should remain constant and could even intensify.

Looking ahead

We continue to have a positive outlook on credit but recognise that the window of opportunity for continued outperformance is getting smaller.

We don't think small deviations from our base-case view would be overly detrimental to credit performance, particularly in higher-quality segments.

We still see value in sectors where spreads have lagged and have room to tighten further, including shorter-maturity investment-grade corporates, emerging markets and segments of structured products.

It might not all be plain sailing in credit markets, however. An extended higher-for-longer rate environment provides more opportunity for risks to emerge. If economic conditions worsen—either because of inflation or slower growth—spreads have room to widen from expensive levels.

Sources: Bloomberg and J.P. Morgan indices; data from 31 December 2023 to 31 March 2024. Note: EM IG and EM HY refer to emerging market investment-grade and high-yield, respectively. **Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.**

Investment-grade corporates

The path of least resistance for high-grade corporate spreads this year has been to continue drifting tighter. The biggest performance obstacle over the first quarter was the expected surge in the volume of new issuance.

Year-to-date, the high-grade primary market has seen record levels of activity with over $500 billion of new issuance. Strong demand from a wide range of investors more than offset this headwind and spreads have remained under 1% since early January.

All-in yields, however, have held above 5%, which historically has been an attractive entry point for institutional yield-focused buyers. With the Fed biased towards cutting rates at some point, investors have flocked to lock in attractive longer-term yields.

Looking ahead

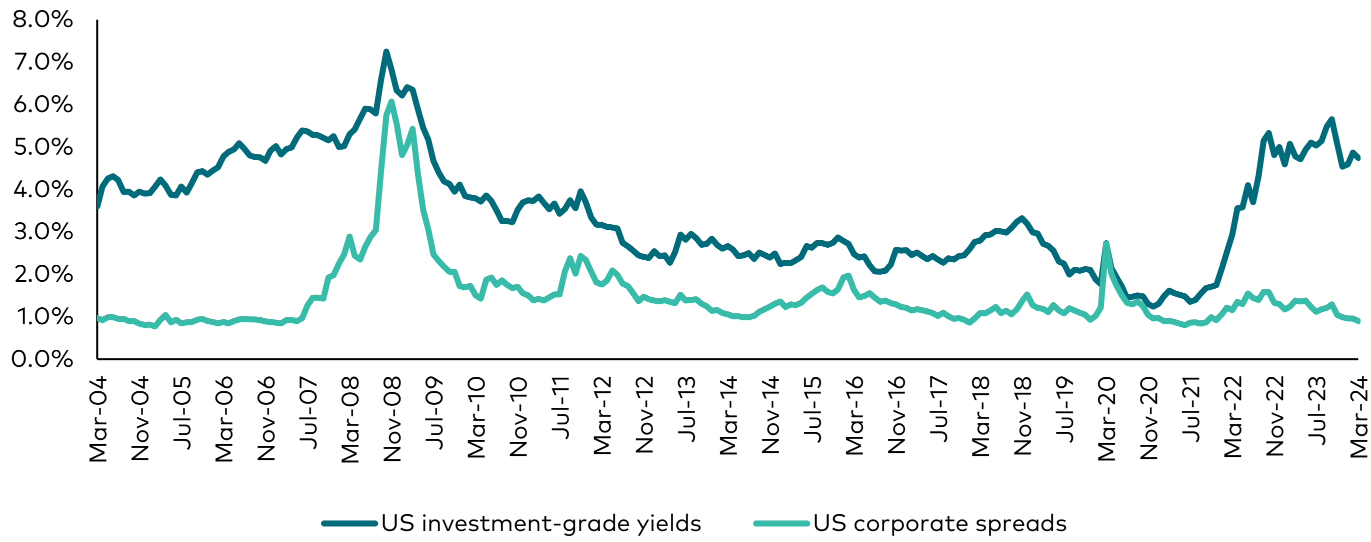
Absent a geopolitical shock or broader indications of an impending recession, credit spreads should trade within a narrow range, with buyers stepping in when rates back up.

Corporate credit fundamentals remain stable. Profit margins are near record highs and lower-rated credits have been actively reducing leverage, even as the cost of servicing outstanding debt has increased with higher rates. Conservative balance sheet management has kept corporate cash balances high, which could pose a risk to fundamentals if companies were to increase their merger and acquisition activity from very low levels today.

Modestly slower growth or, conversely, a further reduction in 2024 Fed rate cut expectations should pose limited risk to higher-quality credit. Yield buyers seeking longer duration in their bond portfolios have helped flatten credit yield curves over recent quarters. We like the relative value of shorter-maturity bonds, where spread levels look cheap.

We also like opportunities in European credit. Valuations are more compelling compared with the US, and we don't think our forecast of a soft and gradual economic recovery for the euro area should have a negative impact on strong credit fundamentals.

As US corporate bond yields have risen, spreads have tightened



Bloomberg Global Aggregate Credit Unhedged index, Bloomberg US Aggregate Corporate Index average option-adjusted spread (OAS); for the period 31 March 2004 to 31 March 2024. All calculations are in USD. **Past performance is not a reliable indicator of future returns.**

High-yield corporates

Higher yields, a supportive growth environment and lower sensitivity to interest rates have enabled high-yield bond returns to stay positive so far this year following double-digit returns in 2023.

Index-level spreads touched below 300 bps for the first time since January 2022, but beneath the surface the market is bifurcated. Performing high-yield bonds are trading at extremely expensive levels, while the percentage of distressed securities (with option-adjusted spreads above 1,000 bps) has grown. If you remove the distressed part of the market, high-yield spreads are only 249 bps – within the 2nd percentile over the last 20 years.

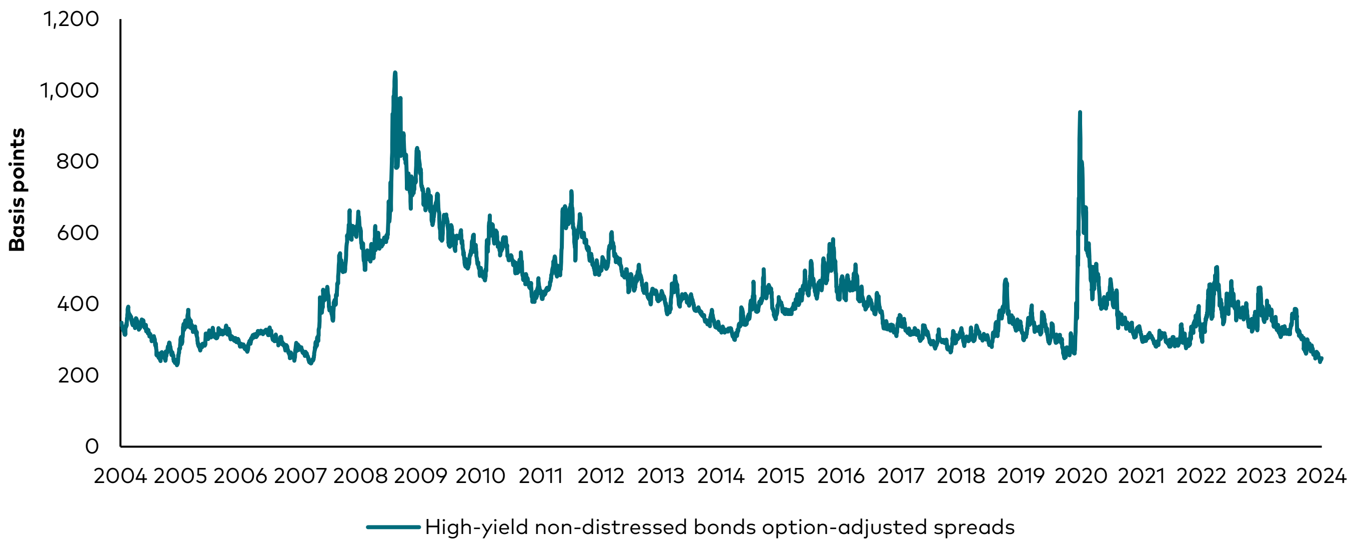
The high-yield market has benefitted from two years of ratings upgrades and muted levels of new issuance, but we believe the bulk of those tailwinds are behind us. We expect a more balanced mix of supply and demand going forward. The pace of ratings upgrades from high-yield to investment-grade should slow and we expect increasing levels of new issuance for standard refinancing needs and from the eventual pickup in debt-funded leveraged buyout and merger and acquisition activity.

Fundamentals remain stable. Similar to investment-grade, high-yield issuers have benefitted from strong profits that have helped offset higher interest costs. We expect default rates to rise but not to high levels unless we were to see a deep or prolonged recession.

Looking ahead

We remain cautious on high-yield due to tight valuations. BB and B-rated bonds offer attractive yields, but further upside from additional spread tightening is limited. We see upside opportunities in the lower-quality and distressed segments of the market and favour high-quality bank loans as a more attractive option.

High-yield bond spreads are hitting 20-year lows



Source: ICE BofA US Non-Distressed High Yield Index. Data period from 5 April 2004 to 31 March 2024.

Emerging markets

A record front-loading of 2024 new issuance from investment-grade emerging market (EM) countries widened spreads over the quarter and provided an opportunity to add high-quality bonds at attractive valuations.

Below-investment-grade rated EM bonds have significantly outperformed so far this year due to a supportive global appetite for risk and meaningful improvements in country fundamentals of issuers like Ecuador, Egypt and Argentina.

Local-currency bonds underperformed USD-denominated segments, as the dollar strengthened against most EM currencies.

With nearly half of expected 2024 issuance in EM markets already complete, the supply and demand mix for EM looks favourable over the remainder of the year. A pickup in demand would allow EM to outperform.

EM's attractive yields and longer duration profile make it uniquely poised to benefit from a rally in rates as and when central banks cut, which should attract additional investor interest.

Country fundamentals remain supportive and EM inflation rates continue to edge down towards target levels. We do not see any notable countries on the edge of default.

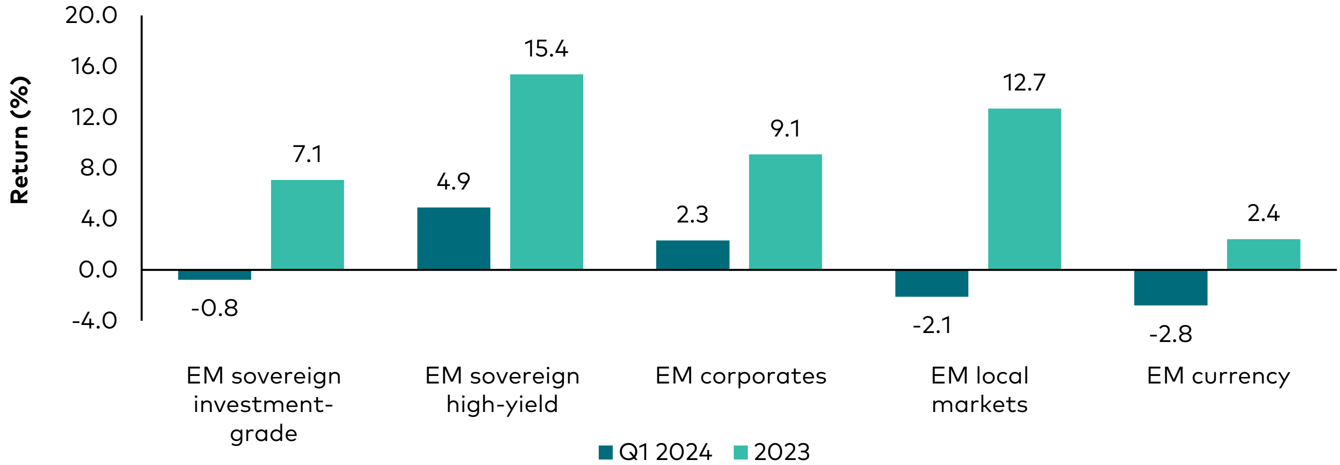
Looking ahead

Although spreads have narrowed to less compelling levels in recent weeks, all-in yields of around 8% remain attractive.

We are avoiding the most expensive segments of the sector, specifically higher-rated bonds in Asia and parts of the Middle East. EM high-yield offers better valuations but requires a more selective approach.

EM local rates are vulnerable to a US real rate sell-off. We pared back our local market positions ahead of the recent increase in yields but are maintaining positions in select markets where local fundamentals continue to justify a deep policy rate-cutting cycle or where sensitivity to US rate moves are lower.

Emerging market bonds total returns



Source: Bloomberg. Q1 2024 data from 31 December 2023 to 31 March 2024; 2023 data from 31 December 2022 to 31 December 2023. Based on data for the following indices: J.P. Morgan EMBI Broad Diversified IG index, the J.P. Morgan EMBI Broad Diversified HY index, the J.P. Morgan CEMBI broad Diversified Composite index, the J.P. Morgan GBI-EM Global Diversified Unhedged index and the J.P. Morgan GBI-EM Global Diversified FX index. **Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Performance is provided on a total return basis, in the base currency.**

Who we are

FIXED INCOME GROUP

$1.7 tn

Vanguard's Fixed Income Group manages $1.7 trillion globally in active and index funds with a global team of more than 180 investment professionals.

YEARS IN FIXED INCOME

35+ years

Vanguard's active fixed income team manages over $449 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

85+

Our investment teams are supported by our 50-plus member economic research team that informs our economic outlook and our 85-plus member risk management team that is integrated into our investment process.

Data as at 31 December 2023.

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.

Reference in this document to specific securities should not be construed as a recommendation to buy or sell these securities, but is included for the purposes of illustration only.

Important information

IMPORTANT: The projections or other information generated by the Vanguard Capital Markets Model® regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time.

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include US and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, US money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

Important information

For professional investors only (as defined under the MiFID II Directive) investing for their own account (including management companies (fund of funds) and professional clients investing on behalf of their discretionary clients). In Switzerland for professional investors only. Not to be distributed to the public.

The information contained in this document is not to be regarded as an offer to buy or sell or the solicitation of any offer to buy or sell securities in any jurisdiction where such an offer or solicitation is against the law, or to anyone to whom it is unlawful to make such an offer or solicitation, or if the person making the offer or solicitation is not qualified to do so. The information in this document does not constitute legal, tax, or investment advice. You must not, therefore, rely on the content of this document when making any investment decisions.

Issued in EEA by Vanguard Group (Ireland) Limited which is regulated in Ireland by the Central Bank of Ireland. Issued in Switzerland by Vanguard Investments Switzerland GmbH. Issued by Vanguard Asset Management, Limited which is authorised and regulated in the UK by the Financial Conduct Authority.

Connect with Vanguard®
global.vanguard.com

Vanguard