Vanguard

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Active Fixed Income Perspectives Q3 2026:

Finding higher ground

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Contents

Key takeaways 2

Macro backdrop 3

Rates market and strategy 5

Credit markets and strategy 7

Portfolio positioning 9

Active fixed income at Vanguard 10

Key takeaways

Performance recap

The second quarter was a story of divergence. US short-end rates rose and the curve flattened, while in Europe, yields fell across the curve. Japan, meanwhile, saw its curve steepen. Strong economic growth in the US and above-target inflation pushed up yields, while the Iran conflict added a temporary stagflationary risk premium that faded late in the quarter. Credit markets remained stable, supported by solid fundamentals, strong demand and smooth absorption of elevated issuance.

The big picture

We remain constructive on the fixed income outlook. While inflation remains above target in the US and Europe, and geopolitical developments could create periods of volatility, higher yields provide stronger income potential and a greater cushion against uncertainty. Dispersion in rates and credit markets can create both opportunities and risks - however, overall, fixed income remains well positioned to deliver income and diversification benefits to portfolios.

Our approach

Income remains the anchor for returns, but active management will be critical in determining where that income is best sourced.

In credit, conditions remain favourable, but spreads are tight and we maintain a selective approach.

Macro backdrop

From geopolitical risk to policy uncertainty

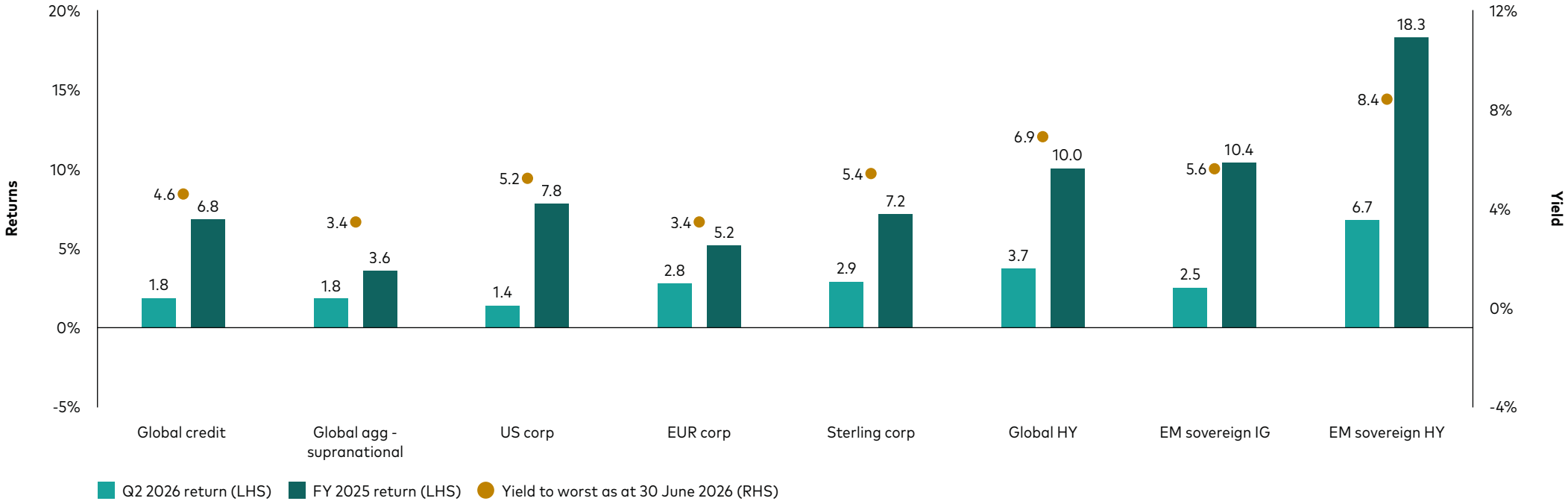
Three themes framed our outlook heading into 2026: the continuation of the AI-driven capital expenditure cycle, the implications of new US Federal Reserve (Fed) leadership and signs of rising stress in private credit markets.

The most notable development since then has been the conflict in Iran, which increased concerns around energy prices, inflation and global growth. While the initial reaction introduced a modest stagflation risk premium, the market impact proved more contained than feared as tensions declined from their peak.

When oil prices moved back down, inflation concerns eased and attention shifted back to domestic fundamentals. Geopolitics remains a risk, but the dominant driver of markets has shifted towards domestic drivers of inflation, growth and central bank policy.

That shift is important. In the US, markets are increasingly focused on whether the current mix of resilient growth and persistent inflation requires tighter policy. On a relative basis, Europe faces a softer growth outlook and rising inflation, which prompted the inflation-focused European Central Bank (ECB) to hike its policy rate by 25 basis points (bps) in June.

Fixed income sector returns and yields



Sources: Sources: Bloomberg indices and the J.P. Morgan EMBI Global Diversified Index. Q2 2026 return data from 31 March 2026 to 30 June 2026.

Past performance is no guarantee of future returns. Performance is provided on a total return basis, in the base currency of the index, or for global indices, USD hedged.

A supportive mix

The US economy remains on a solid footing. Labour markets have been stable, corporate profits are at or near record levels and AI-related investment continues to support demand. In the first quarter, for example, AI-related investment contributed more than half of US GDP growth. We expect this investment cycle to remain an important contributor to growth over the next 12–18 months, with broader productivity benefits likely to materialise over a longer horizon.

Inflation remains above target, but the character of the risk has changed. The issue is less about energy-driven inflation shock and more about inflationary persistence in a growing economy. This can continue to be a supportive mix for risk assets, but a more nuanced environment for rates as recession risks remain low in the US and the path back to lower inflation may be gradual.

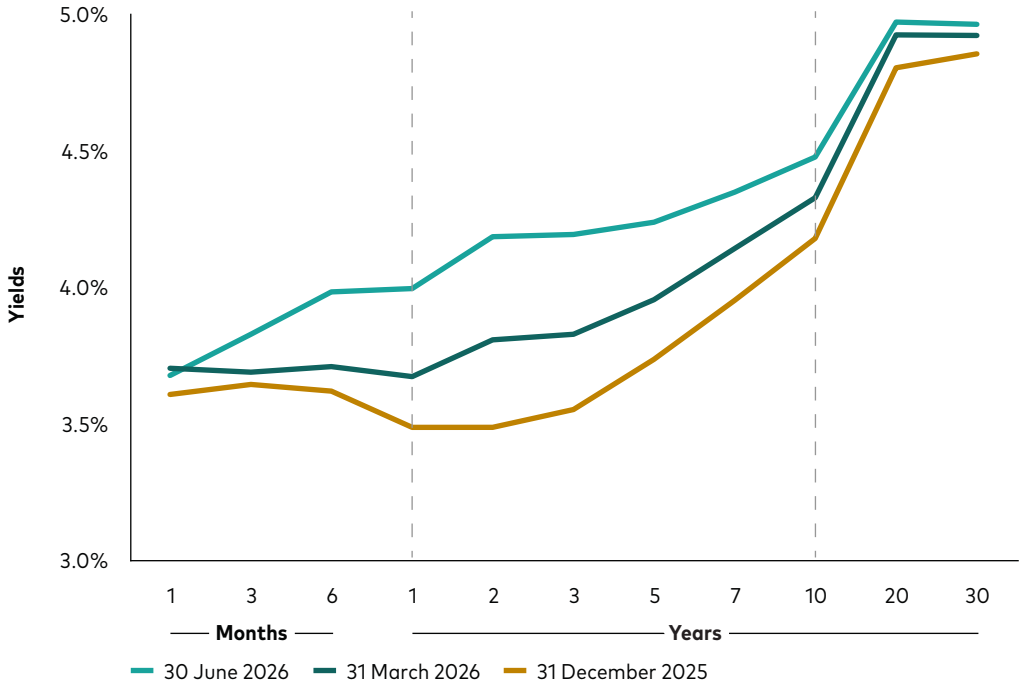
The labour market is the key swing factor. Job creation has been somewhat stronger, while wage growth remains contained. We expect a gradual loosening over the second half of the year with monthly payroll gains slowing and the unemployment rate rising modestly.

A credible, reactive Fed

New Fed Chair Kevin Warsh is seeking to establish a quieter and more disciplined direction for policy. By reducing forward guidance, shortening the policy statement and declining to submit a dot plot projection, the Fed has shifted towards a less transparent framework.

Markets interpreted the tone of the Fed's June meeting as more hawkish than expected, but the renewed emphasis on price stability has strengthened the Fed's credibility. The central bank appears willing to hike, if necessary, but it seems patient to wait for confirmation from incoming data rather than tighten preemptively. Our base case is that inflation and employment trends will soften, allowing the Fed to remain on hold. However, the bar for additional hikes has been lowered, leaving markets sensitive to incoming data and creating both volatility and opportunity.

Belly up: One- to ten-year US Treasuries moved the most



Source: Bloomberg data, as at 30 June 2026.

Rates market and strategy

A higher trading range in the US

Over the quarter, US yields pushed into a higher range as markets adjusted to stronger growth, persistent inflation and a less dovish Fed. The largest repricing occurred at the front end of the curve, as expectations firmed up that one to two rate hikes may be delivered over the coming quarters. Higher yields continue to offer investors higher ground, providing meaningful income and helping strengthen portfolio resilience.

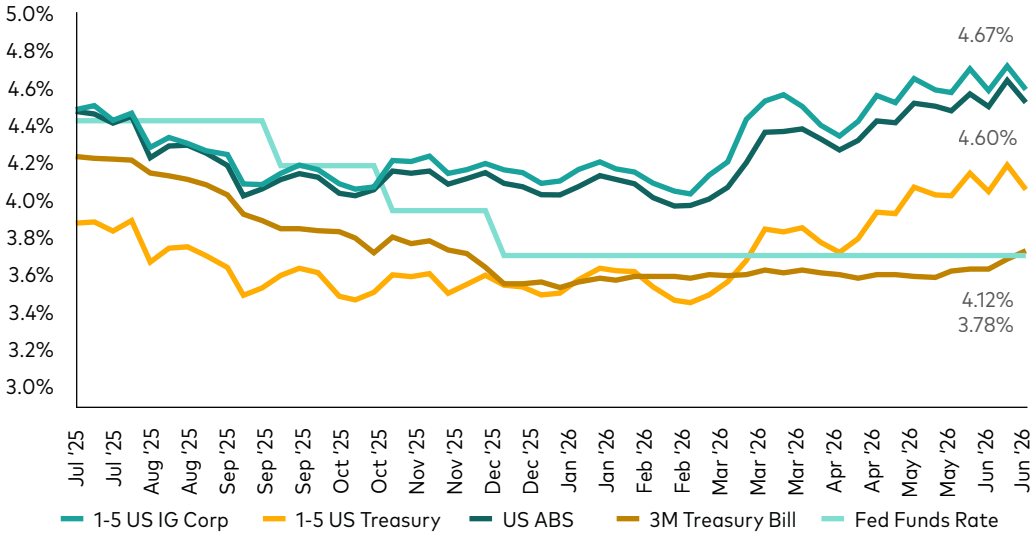
Late in the quarter, yields retraced from recent peaks as progress on Iran-US negotiations led to a resumption of traffic through the Strait of Hormuz, significantly reducing stagflationary risks. Still, strong data and a more hawkish Fed bias suggest limited room for a sustained rally unless inflation declines more quickly or labour market data softens.

We expect the Federal Open Market Committee to look to incoming data to determine whether policy action is warranted later this year. We continue to see the 10-year Treasury yield trading in a 4.25%–4.75% range in the near term, reflecting trend growth, inflation that remains above the Fed's comfort zone and demand for fixed income at current yield levels.

For yields to break below our expected range, markets would likely be pricing a weaker growth outlook. Above it, investors would likely be anticipating a more aggressive tightening cycle.

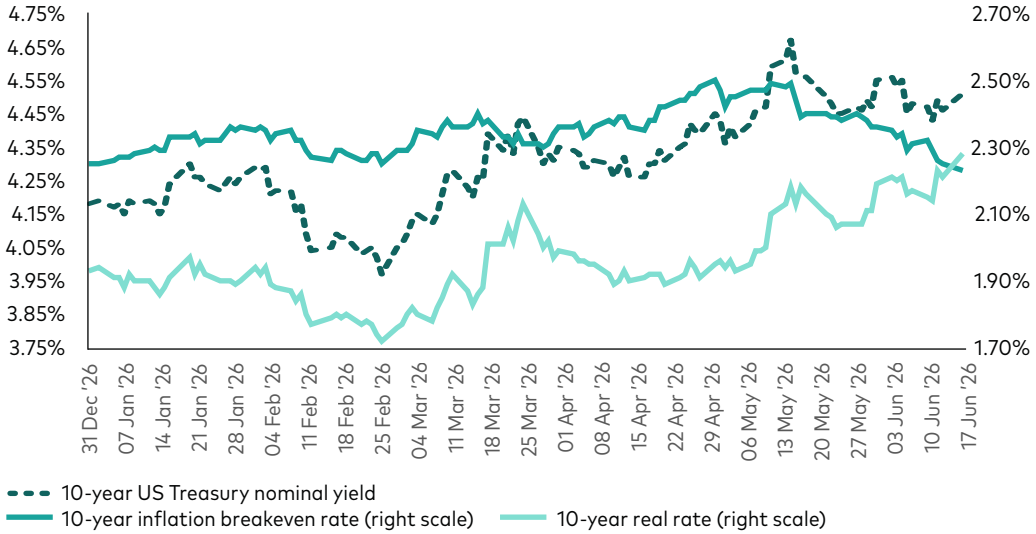
We are neutral US duration and view market pricing of one to two hikes as justified by recent data, but not indicative of a fixed policy path, which remains highly data-dependent.

Front-end yields have improved relative to cash



Source: Bloomberg data, as at 30 June 2026.

The rise in yields is a real-rate story



Source: Bloomberg, as at 30 June 2026.

International rates – a story of divergence

The US central bank – with a mandate of both an inflation and labour market mandate, could be expected to lag its European peers, and indeed it has.

The ECB has already hiked 25 bps and firmly refuted the notion that it was an 'insurance hike' but was rather fully merited by its projections of higher inflation. The central bank plotted three scenarios – all of which suggest there could be more to come. We project one further hike, but if the Middle East conflict persists, there could be more to come. Growth has broadly held in, and we are watching natural gas prices and storage levels, which are lower-than-average for this point in the year. Moreover, refined oil prices remain elevated.

While European growth has broadly remained steady, we are mindful of the higher growth anticipated in the US – fuelled by a resilient consumer and the AI capex boom. We therefore continue to tactically trade the relationship between the US and Europe through a short bund, long US position - but we are opportunistic in execution.

Within peripheral Europe our stance has changed. We had been overweight the periphery for some time, given relatively strong and improving fundamentals. However, the exposure of countries like Italy to imported energy prices and the relative volatility of the trade led us to reduce the position as the Iran war unfolded. We are now short the euro area periphery, and have also reduced exposure to France, where political risk has pushed OATs to trade with more periphery-like characteristics. It may be some time before the market moves to focus on these risks, but we currently prefer the strong balance sheets of investment-grade credit versus the rising political risk in parts of the periphery.

Political risk has reduced in the UK but fiscal risks remain. The UK now has its seventh Prime Minister in 10 years, and the incoming leadership of this Labour government could have further fiscal surprises in store, committed as it is to maximum budget flexibility. The gilt yield curve is steeper than that of the US or Europe, but questions around fiscal discipline are unlikely to dissipate until the Labour Party Annual Conference in September and the Autumn Budget provide further clarity on tax and spending measures.

In Japan, we continue to believe that further hikes are needed by the Bank of Japan to tackle inflation, and as a result, support the yen. We are short the front end of the curve, and also expect a flatter yield curve over time, given the risk premia already present in the long end, and the expectation of higher near-term rates. Although there has been recent headlines about encouraging Japanese pension funds, including the GPIF, to invest more in Japanese financial assets, we do not expect a material near-term increase. The key headwind is that public pension funds exist for the benefit of their recipients, not as a conduit for macro policy.

Credit markets and strategy

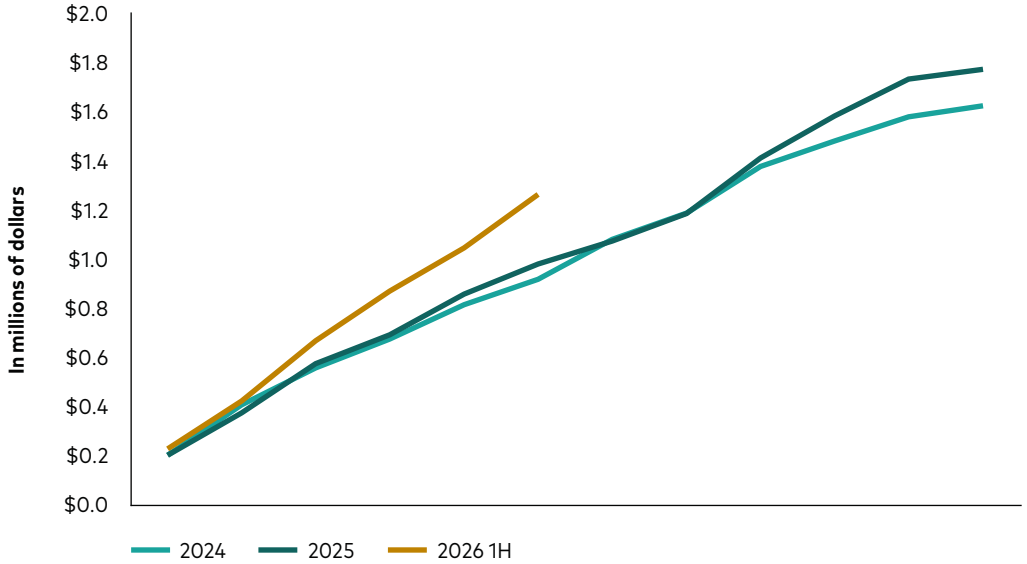
Supported, but increasingly selective

We remain overweight credit exposure across portfolios, as strong corporate fundamentals and resilient technical demand suggest outperformance versus government bonds throughout the second half of the year, even with spreads already tight.

Investment-grade companies, in particular, are in sound shape. Record profits and disciplined balance sheet management are supported by a sturdy labour market and continued consumer strength. Issuance over the first half of the year reached a record pace, exceeding $1.2 trillion, with roughly a quarter tied to AI-related investment. So far, strong investor demand has readily absorbed the higher supply keeping spreads in a narrow range.

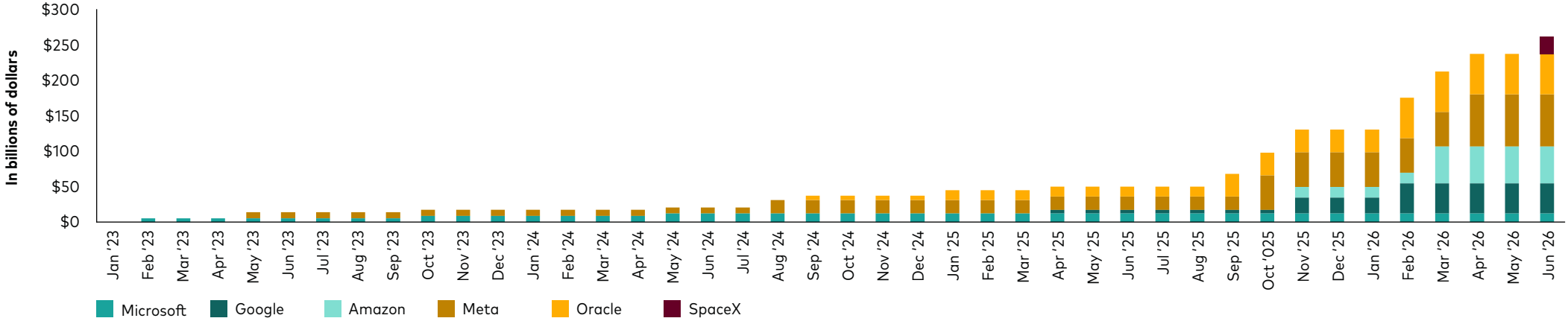
Hyperscalers such as Meta, Google, Microsoft, Amazon, Oracle and even SpaceX are becoming large, frequent issuers as they fund the buildout of AI infrastructure. Investment-grade hyperscaler issuance accounts for 13% of corporate bond market issuance year to date and now represents 4% of the investment-grade corporate credit market. In many cases we view this as an attractive addition from high-quality balance sheets that historically have been less represented in debt markets relative to their equity market footprints.

Cumulative investment-grade corporate issuance



Source: Bloomberg, as at 30 June 2026.

AI hyperscaler corporate debt issuance



Source: Bloomberg, as at 30 June 2026.

While these issuers grab most of the attention, we believe investors should not overlook the massive buildout of data centres enabling AI's computing capacity. Data centre operators are issuing debt across fixed income markets, leveraging a diverse menu of bond features and a wider investor base. Data centre proliferation is driving debt issuance across investment-grade corporate, high-yield corporate and securitised credit markets. This creates attractive opportunities for managers able to compare the value and risks across markets, as they can vary significantly.

Beyond beta

If current conditions hold, any episodic widening in spreads is likely to be contained and short-lived. However, with spreads already pricing in a benign macro environment, the scope for further compression appears limited. As a result, credit returns are increasingly driven by carry and issuer selection rather than broad beta.

This dynamic reinforces our more selective approach to building credit exposure. While we do not see near-term catalysts for a broad-based repricing in wider spreads, we do expect dispersion within and across sectors to continue to increase. This creates a more differentiated opportunity set, where active management can add value by identifying resilient issuers and avoiding weaker credits.

Emerging markets

Emerging market debt has delivered strong performance this year, supported by favourable technical conditions and robust investor inflows. Investor confidence in the asset class continues to improve, underpinned by strengthening sovereign and corporate balance sheets. This trend is reflected in the steady improvement in credit quality across many emerging markets, with net credit rating upgrades outpacing downgrades in recent years.

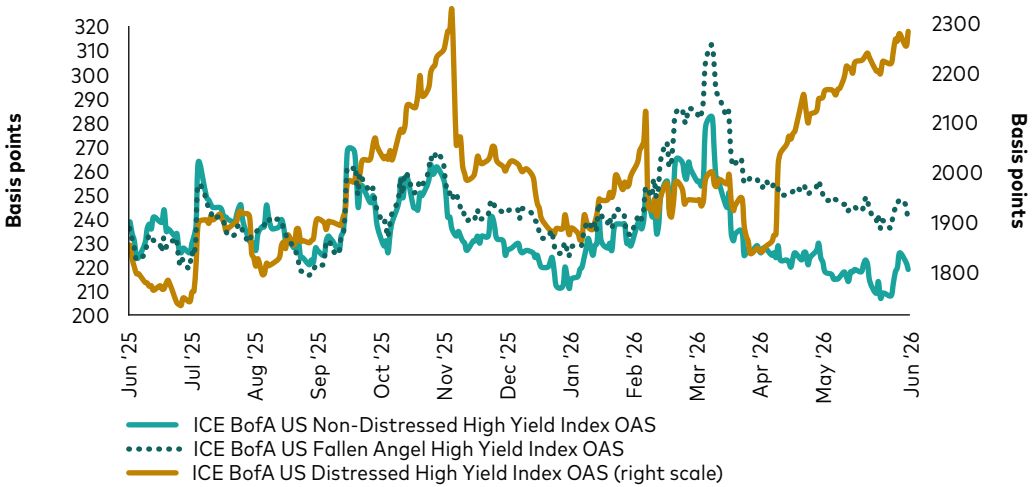
The war in Iran has also led to interesting dispersions in pricing – between importers and exporters, as well as across regions. In our view, fundamentals remain core – for example, an oil importing country that simply spends the windfall from elevated oil prices is less well placed to see lasting improvements in its credit profile than one that deploys those revenues as part of a disciplined, long-term economic strategy. The war also illustrates the need to balance portfolio exposure to single risk factors like oil. Active management in this regard can offer benefits – helping to balance portfolio risks while identifying opportunities created by widening dispersion amid an evolving geopolitical landscape. Overall, if the risk backdrop remains supportive, emerging markets could continue to benefit from their yield advantage relative to developed markets.

US corporate investment-grade spreads remain within our forecasted range

Note: Option-adjusted spread of the Bloomberg US Corporate Index. The top two dotted lines represent the Fixed Income Group's current expected ranges for corporate credit spreads.

Source: Bloomberg, as ot 30 June 2026.

Increasing bifurcation between higher-quality and lower-quality high-yield



Source: Bloomberg, as at June 30, 2026.

Portfolio positioning

Rates

Exposure	View	Strategy
US duration and curve	• Near-term, we expect 10-year yields to hold between 4.25% and 4.75%. • Strong data and a more hawkish Fed bias suggest limited room to rally without a weakening in the labor market.	• Neutral duration and curve positioning.
Global duration and curve	• Rising fiscal and monetary policy risks in Japan argue for higher JGB yields.	• In Japan we remain positioned short duration and in yield curve flatteners.

Credit

Exposure	View	Strategy
Investment-grade corporates	• Strong fundamentals—credit rating upgrades outpacing downgrades by a nearly 2:1 ratio. • Attractive all-in yields support investor demand—spreads likely range bound between 70 and 90 basis points.	• See attractive valuations in large US and European banks. • Opportunities across companies supporting the AI build out (for example, data centre infrastructure, hardware, semiconductors, memory chips and power generation).
High-yield corporates	• Broadly see positive fundamentals, supportive technicals and valuations that are rich but provide good carry. • Performance dispersion is increasing, making issuer selection significantly more important than sector beta.	• Overweight the cable industry despite secular and cyclical challenges; we believe that markets have significantly overshot to the downside. • Other high conviction views in chemicals, autos and airline sectors where we see improving fundamentals and clear deleveraging paths.
Emerging markets	• Country level credit metrics are improving with declining budget deficits. • Lower-rated issuers have benefitted from strong investor demand. Credit selection is paramount.	• Front-end bonds offer attractive carry. • Remain cautious on lower-rated oil exporters that recently benefitted from higher oil prices.
Structured products	• ABS supply remains heavy, keeping spreads attractive relative to investment-grade corporates. • CMBS offers more limited opportunities with light supply and tight spreads.	• We favour high-quality consumer risk, and selective commercial ABS exposure. • Prefer data centre-backed bonds in tier 1 markets backed by long-term leases to high-quality hyperscalers. • Continue to favour AAA CLOs with limited software sector exposure.

Active fixed income at Vanguard

$539B

Vanguard global active bond AUM

25+

Portfolio managers

35+

Traders

60+

Credit research analysts

130+

Dedicated team members

Note: Data as at 30 June 2026.

Active fixed income leadership team

Sara Devereux
CIO VCM, Global Head of Fixed Income
In industry since 1992

Chris Alwine, CFA
Global Head of Credit
In industry since 1990

Roger Hallam, CFA
Global Head of Rates
In industry since 2000

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