Vanguard

DECEMBER 2023

Opportunities and cautionary signals from the higher rate environment

VALUATIONS INSIGHTS

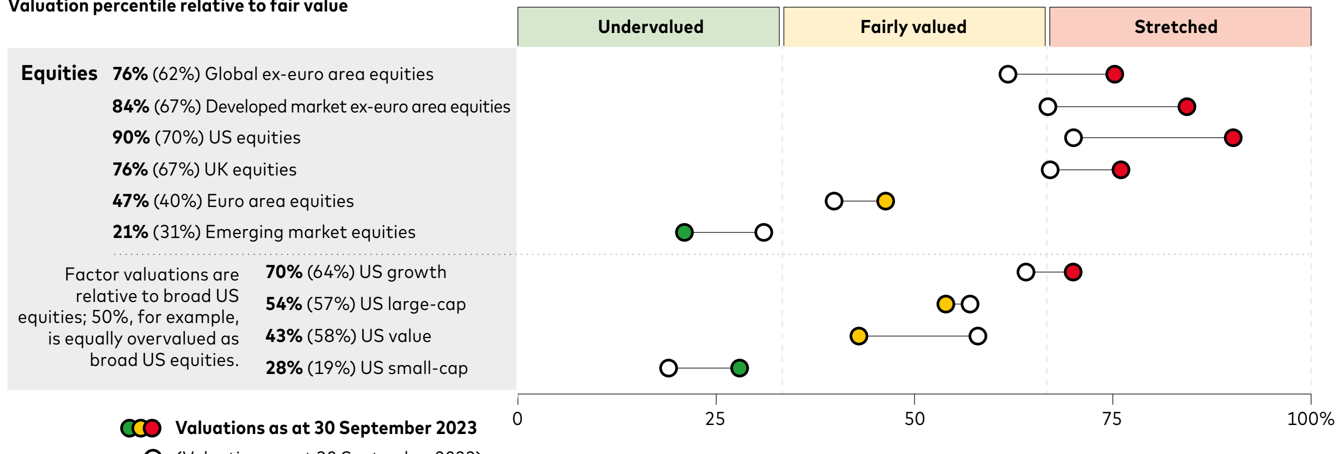
Higher interest rates are here to stay. Read our latest views on equity and bond valuations from the Vanguard economic and market outlook for 2024 to help inform your decision-making.

Higher rates shift valuations

As we explore in our *Vanguard economic and market outlook for 2024,* we expect interest rates to settle at a higher level than we've seen since the 2008 global financial crisis. This development ushers in a return to sound money, or the persistence of positive real interest rates, which will have profound implications for investors.

Higher interest rate environments tend to depress equity valuations across global markets while squeezing profit margins as companies find it more expensive to issue and refinance debt. On the other hand, higher interest rates mean higher returns for long-term bond investors. After some meaningful shifts in valuations over the past year, this has left portfolio constructors with potential opportunities—or risk signals.

Equities: A mixed picture across regions



Notes: The US, UK and euro area equity valuation measures are the current cyclically adjusted price/earnings ratio (CAPE) percentile relative to our fair-value CAPE estimate for the MSCI US Broad Market Index, the MSCI UK Index and the MSCI EMU Index. The global ex-euro area and developed market ex-euro area valuation measures are the market-capitalisation-weighted CAPE percentiles relative to our fair-value CAPE estimate for the MSCI US Broad Market Index, MSCI UK Index, MSCI Japan Index, MSCI Canada Index, MSCI Australia Index and MSCI EM Index. The valuation measure for the MSCI EM Index is only used for the global ex-euro area equity. The emerging market valuation measure is based on the percentile rank based on our fair-value model relative to the market. Factor valuations are relative to US equities as the base at the 50th percentile. Growth, value and small-cap valuation measures are all based on the percentile rank based on our fair-value model relative to the market. The large-cap valuation measure is a composite valuation measure of the style factor to US relative valuations and the current US CAPE percentile relative to its fair-value CAPE. The valuation percentiles are as at 30 September 2023 and 30 September 2022 (in parentheses).

Sources: Vanguard calculations, based on data from Robert Shiller's website, at aida.wss.yale.edu/~shiller/data.htm, the U.S. Bureau of Labor Statistics, the Federal Reserve Board and Refinitiv, as at 30 September 2023.

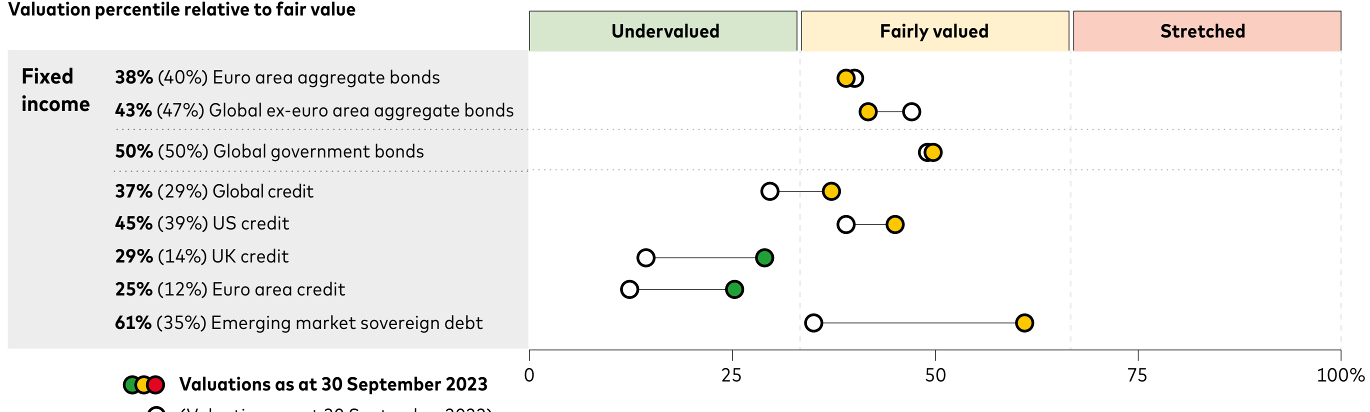
IMPORTANT: The projections and other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modelled asset class. Simulations are as at 30 September 2023 and 30 September 2022. Results from the model may vary with each use and over time.

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.

Before central banks started raising interest rates around the end of 2021, US equity valuations had reached a level not seen since the dot-com bubble. While valuations moderated in the sell-off that followed in 2022, they have since increased. US valuations now again look highly stretched, due in part to a rally in growth stocks in 2023[1]. In light of higher interest rates and inflation—which decrease our fair value estimate—UK equities also now appear overvalued, while euro area equities are more fairly valued. Emerging markets, by contrast, look undervalued, even more so than a year ago.

Despite the mixed picture, we still see long-term opportunity in equities within a portfolio given we expect the correlation between stocks and bonds to be negative over the long term. But during the transition period as investors adapt to higher rates, there could be heightened volatility. In other words, no pain, no gain.

Bonds: Valuations look broadly fair to undervalued



Notes: Aggregate bond valuation measures are market-capitalisation-weighted averages of credit and government bond valuation percentiles for the euro area and global ex-euro area (which in turn is a market-capitalisation weighted average of the US, the UK, Japan, Canada and Australia aggregate bond valuation measures that are calculated the same way). The global government bond valuation measure is based on a market capitalisation weighted average of the valuation measures for the euro area, the US, the UK, Japan, Canada and Australia, comparing current yields relative to the VCMM simulation of equilibrium yields in year 30 of our forecast. Credit and emerging market sovereign debt valuation measures are based on current spreads relative to the VCMM simulation of equilibrium spreads in year 30 of our forecast, with global credit based on a market capitalisation weighted average of the valuation measures for the euro area, the US, the UK, Japan, Canada and Australia. The valuation percentiles are as at 30 September 2023 and 30 September 2022 (in parentheses).

Sources: Vanguard calculations, based on data from Robert Shiller's website, at aida.wss.yale.edu/~shiller/data.htm, the U.S. Bureau of Labor Statistics, the Federal Reserve Board and Refinitiv, as at 30 September 2023.

IMPORTANT: The projections and other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modelled asset class. Simulations are as at 30 September 2023 and 30 September 2022. Results from the model may vary with each use and over time.

Global fixed income markets have repriced significantly in the past two years amid the shift to higher rates and, in our view, bond valuations now look broadly close to fair if not undervalued, as the chart above shows. While the sharp increase in yields has driven down the prices of bonds significantly over the last few years, these higher yields today mean that the outlook for long-term investors is better than it has been in more than a decade.

Digging beneath the surface, euro area aggregate bonds have moved only slightly and remain in fairly valued territory compared with a year ago. On the other hand, emerging market sovereign debt is now in the upper half of our fair value range whereas it was closer to undervalued 12 months ago.

1 This is also highlighted by an increase in the valuation of US growth stocks relative to the broad market to 70%, meaning that growth stocks are even more overvalued than the US market as a whole.

Looking ahead

We believe the structural shift to higher real interest rates marks the single best economic and financial development of the past 20 years. This shift provides a solid foundation for long-term risk-adjusted returns. However, the transition to higher rates is not yet complete and near-term financial market volatility is likely to remain elevated.

To find out more about what a return to sound money could mean for managing client portfolios, visit our outlook resources page or speak to your local Vanguard sales representative.

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.

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

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 herein 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 does not constitute legal, tax, or investment advice. You must not, therefore, rely on the content of this document when making any investment decisions.

The information contained herein is for educational purposes only and is not a recommendation or solicitation to buy or sell investments.

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.

© 2023 Vanguard Group (Ireland) Limited. All rights reserved.

© 2023 Vanguard Investments Switzerland GmbH. All rights reserved.

© 2023 Vanguard Asset Management, Limited. All rights reserved. *12/23_1619_IW_EUR_EN*

Connect with Vanguard®

global.vanguard.com