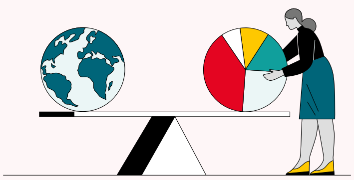
DECEMBER 2023

Why higher interest rates are positive for long-term investors

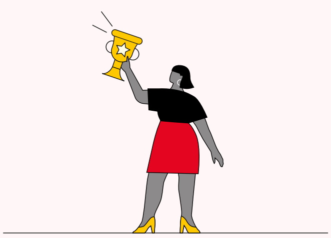
Key takeaways

Higher interest rates: here to stay

Bonds are back



Strong case for balanced portfolios

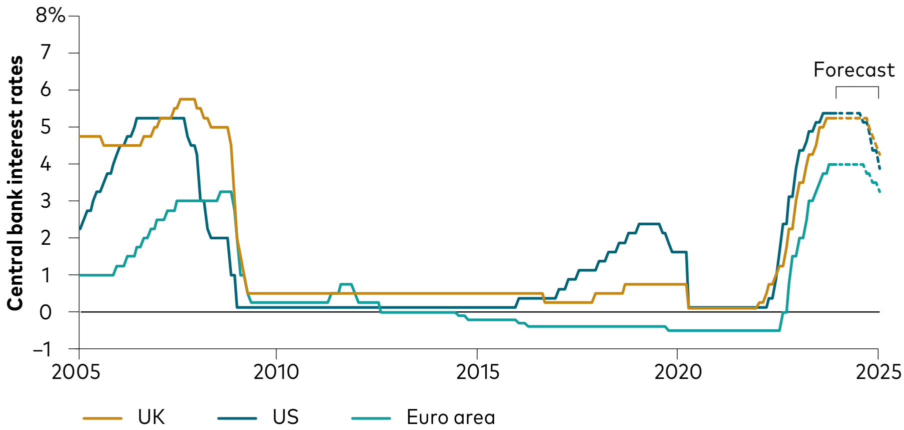


Principles to aid financial success

Higher interest rates are here to stay

Central banks have raised interest rates at the fastest pace in decades in a bid to get inflation under control. In the years ahead we expect them to settle at a higher level than we have grown accustomed to since the global financial crisis, as the chart below illustrates.

Interest rates are likely to be cut but remain elevated



Notes: Monthly data are from January 2005 to November 2023. Forecasts thereafter run to year-end 2025.

Sources: Vanguard calculations, based on data from Bloomberg, as at 30 November 2023.

This marks a return to 'sound money', which is essentially when interest rates are above the rate of inflation. This is a structural shift which, in our view, is the single best economic and financial development in the last 20 years for long-term investors. It has significantly increased our market return expectations for bond[1] investors over the next 10 years[2].

Thanks to higher interest rates, bonds are back

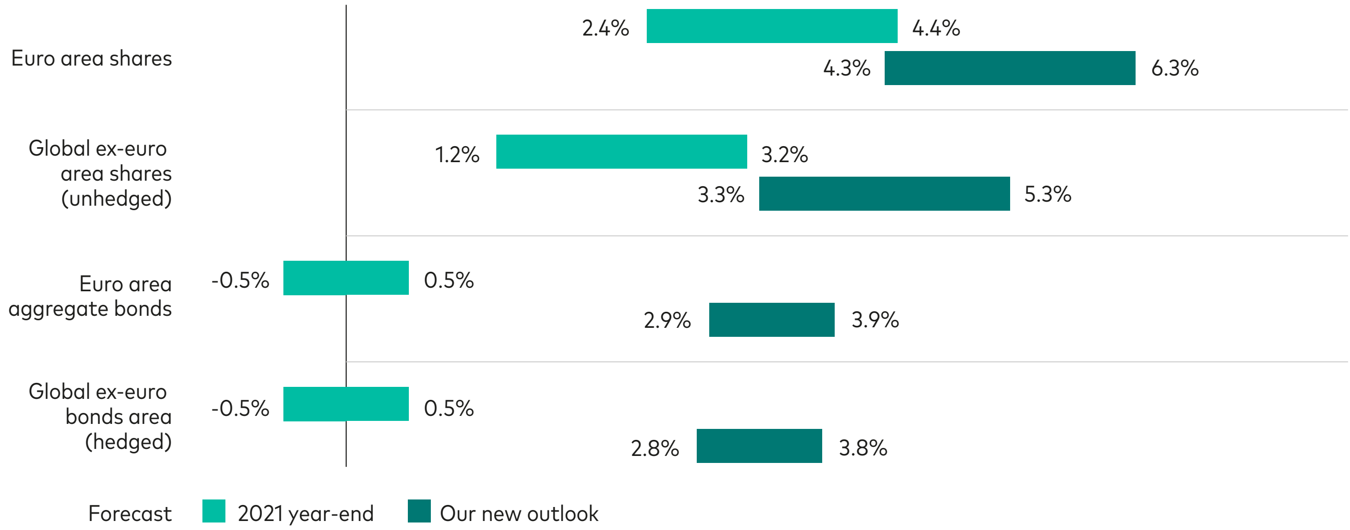
Global bond prices have fallen (and yields[3] risen) over the last two years because of the transition to the new era of higher interest rates. Despite the potential for short-term volatility (or fluctuations in prices), our return expectations for bonds have increased substantially.

1 Bonds are issued by governments and corporations when they want to raise money. By buying a bond, you're giving the issuer a loan, and they agree to pay you back the face value of the loan on a specific date, and to pay you periodic interest payments along the way, usually twice a year.
2 Our market return expectations are generated by the Vanguard Capital Markets Model® (VCMM). The VCMM is a sophisticated financial simulation engine that powers our investment outlook and asset allocation decisions.
3 This is a measure of interest that takes into account the bond's fluctuating changes in value. There are different ways to measure yield, but the simplest is the coupon of the bond divided by the current price.

A higher-rate environment typically depresses share price valuations (which are a measure of how well a company's share price is justified by fundamentals such as its earnings). Higher rates can squeeze profit margins as companies find it more expensive to issue and refinance debt. Valuations are most stretched in the US and we think there is an increasing likelihood of greater opportunities outside the US.

The chart below shows our expectations for UK shares and global ex-UK shares, as well as UK bonds and global ex-UK bonds (hedged – meaning the aim is to minimise the risks associated with changes in exchange rates) and how it compares with our forecasts from two years ago.

Expected 10-year annualised asset class returns for euro area investors



IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model® (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 in EUR from VCMM are derived from 10,000 simulations for each modelled asset class. Simulations as at 31 December 2021 and 30 September 2023. Results from the model may vary with each use and over time.

Note: Figures are based on a 2-percentage point range around the 50th percentile of the distribution of return outcomes for shares and a 1-percentage point range around the 50th percentile for fixed income. All projections are in EUR. Benchmarks used for asset classes: Euro area shares: MSCI European Economic and Monetary Union (EMU) Index; global ex-euro area shares: MSCI AC World ex-EMU Index; euro area aggregate bonds: Bloomberg Euro-Aggregate Bond Index; Global ex-euro area Bond Index: Bloomberg Global Aggregate ex Euro Index Euro Hedged.

Source: Vanguard.

The case for a balanced portfolio is much stronger

Our outlook for balanced portfolios (typically 60% shares/40% bonds) over the next ten years has improved. For those with an appropriate risk profile and/or shorter time horizon, however, more defensive portfolios may be appropriate.

Position yourself for long-term financial success

In contrast to the last few years, we expect the benefits of holding a diversified[4] portfolio to reassert themselves and the permanence of higher interest rates to serve long-term investors well. However, as the transition to this new higher interest rate environment is not yet complete, financial market volatility is still possible in the short term.

Here are four simple steps to help you position your portfolio for long-term financial success:

1. **Think about goals** that can keep you focused on building a portfolio that's right for you and your needs.
2. **Tune out the market noise** that can lead to impulsive decisions.
3. **Stay diversified** by investing across a wide range of shares and bonds in line with your risk tolerance and goals.
4. **Control what you can** by keeping costs low to keep more of your returns.

4 The combination of shares and bonds and spreading your risks across different countries and regions.

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The VCMM 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 US 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 VCMM 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.

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.

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