Active fixed income perspectives Q3 2024: The high road

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Key takeaways

Performance: Bond yields initially moved higher in the second quarter in response to hotter-than-expected inflation readings early in the year but then drifted back down as both growth and inflation moderated. Lower-quality credit performed best despite developed-market spreads inching modestly wider.

Looking ahead: In the US, inflation has decelerated to levels that, if growth were to weaken faster than expected, would now allow the US Federal Reserve (Fed) to cut rates, which has improved the total return prospects for bonds going forward. We don't foresee significant Fed easing in 2024, but investors shouldn't miss the opportunity to lock in attractive yields and potential diversification benefits from the price appreciation that would result from any surprise cuts in interest rates.

Approach: All-in yields remain attractive across fixed income sectors, but tight spread levels keep us cautious on below-investment-grade risk.

Taking the high (quality) road

In monitoring fixed income markets for opportunities, we are constantly asking ourselves whether the potential upside of a decision adequately compensates us for the risk of the downside. Getting to the right answer, however, requires an assessment of potential market outcomes well beyond a base-case view. For us, constructing optimal portfolios starts with a detailed analysis across a range of economic scenarios. A probability-weighted approach provides a better foundation to identify opportunities and manage risks.

In recent months, the worst-case scenario for bonds—a re-acceleration in inflation, and even higher interest rates—has faded. Growth indicators have been somewhat mixed, but there are increasing signs of weakness and recent inflation readings have been lower than expected.

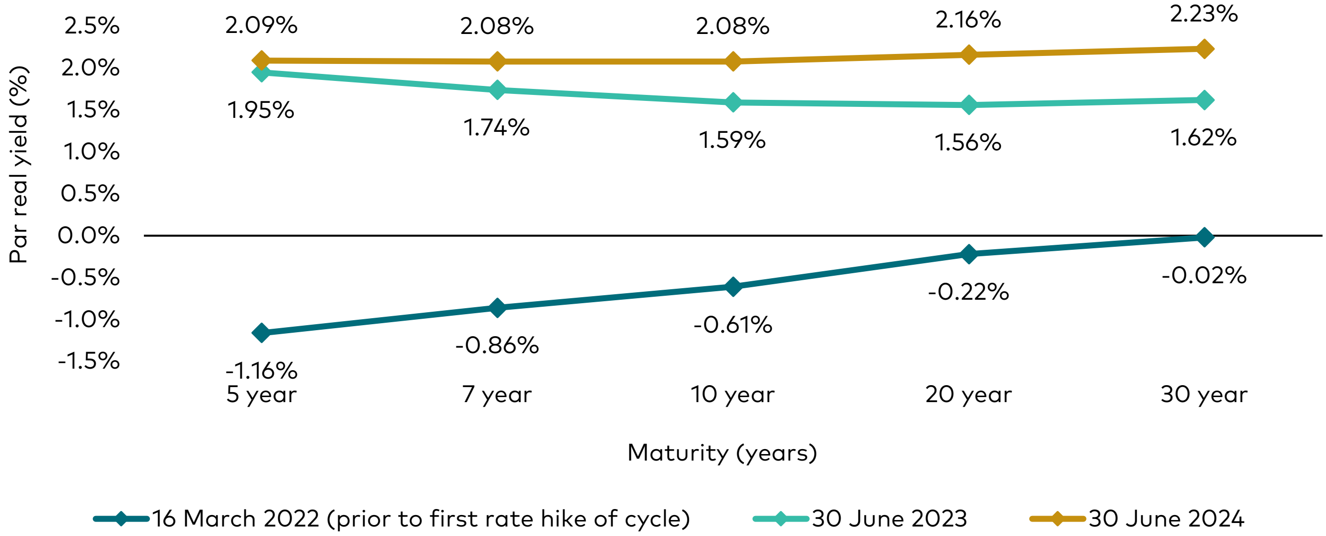
We believe we are approaching a turning point in the economic cycle, which historically has been a good environment for higher-quality bonds. In our view, the risk of a near-term downturn is still low, but we are mindful that a prolonged period of restrictive policy rates poses a risk to the most vulnerable fixed income segments, where most of the good news has already been priced in.

Yields well above inflation

Investors should take note that real interest rates—the expected return from yields after expected inflation is subtracted—remain near recent historical highs. The entire real yield curve is higher today than it was a year ago, and two to three percentage points higher than the day before the Fed started raising rates.

Higher starting yields imply higher returns and better downside protection. Even if rates generally moved up, higher yields today relative to the beginning of 2022 can help offset any losses from price changes.

Treasury par real rate curve



Notes: Graph shows the par real rate yield curve for US Treasuries on 16 March 2022, 30 June 2023 and 30 June 2024. 16 March 2022 is the day before the Fed began raising interest rates in the latest hiking cycle. Par value is the face value of a bond and is typically $100; a par yield therefore is calculated using the par value.
Source: US Treasury.

Economy, policy and markets

It's been almost a year since the Fed last raised its policy rate. Despite substantially higher borrowing costs, the US economy continues to show strength. After a brief scare in the first quarter of 2024, inflation appears to be back on a better path. While recent readings are encouraging, our forecasts show core inflation, which excludes volatile energy and food prices, trending sideways around the high 2% range into 2025, which underlines the challenge of slowing all the way back down to target.

Stable growth and sticky inflation alongside a firm, but gradually normalising, labour market are consistent with the market narrative that policy rates are likely to remain higher for longer. Our base-case view continues to be that the Fed will remain on hold with its policy for most, if not all, of this year. Monetary policy is highly data-dependent, and the data has shown that it is too soon for the Fed to start cutting yet.

If the economy were to weaken faster than expected, the more modest inflation trend we've seen recently would allow the Fed to cut rates if needed.

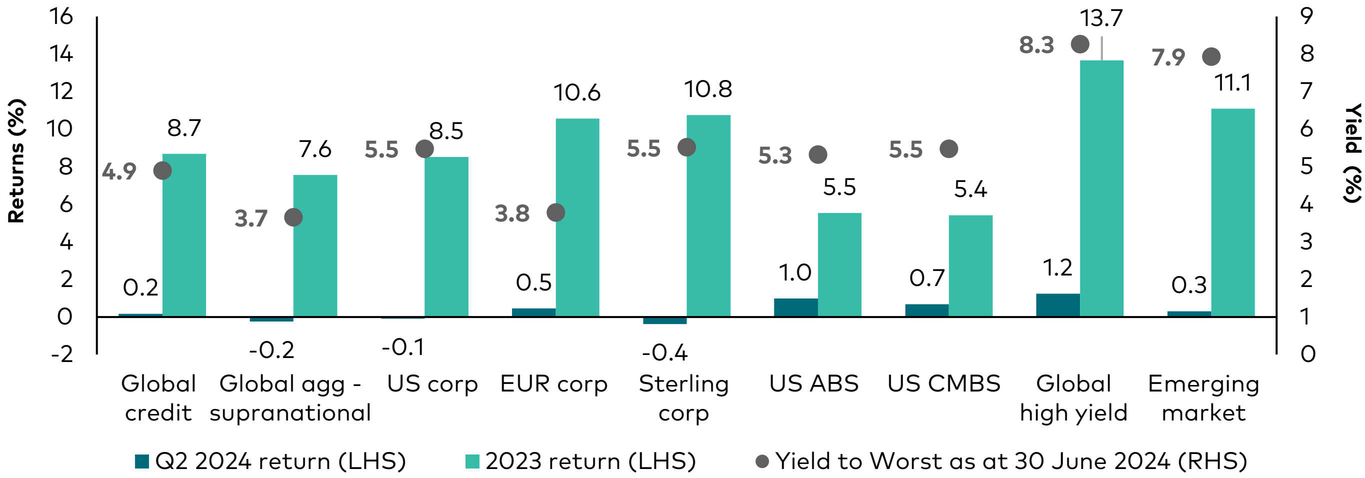
Growth outside the US has improved and progress in taming inflation has allowed some central banks to begin to ease policy. However, the Fed's approach is likely to impact, to varying degrees, what rate cutting cycles will look like globally.

Portfolio positioning and strategy

A higher-for-longer scenario for rates can be supportive for markets if certain conditions hold. If inflation continues to slow gradually, markets will have less uncertainty around the next moves by major central banks. If growth is good enough, cracks are less likely to appear in credit markets. In that scenario, markets can hold within predictable ranges while higher yields generate more attractive returns for investors.

The risk that concerns us most is around the potential for 'higher-for-longer' to become 'higher-until-something-breaks'. For us, valuations and credit quality are still the key factors driving our portfolio strategy. In our view, government bond markets are more appropriately priced for these uncertainties whereas the lower-quality segments of credit are not.

Fixed income sector returns and yields



Sources: Bloomberg indices and the J.P. Morgan EMBI Global Diversified Index. Q2 2024 return data from 31 March 2024 to 30 June 2024; 2023 return 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

In the US, 10-year Treasuries have traded with yields in a range of 4.25% to 4.75% in recent months. We think recent data have likely shifted the yield range lower over the near term, to between 4.00%-4.50%, but we are conscious that rising fiscal concerns could present upside risks to yields. At this point in the cycle, we are biased towards adding duration and will look for attractive risk/reward opportunities to do so if rates test the top end of our expected range.

In Europe, the European Central Bank (ECB) lowered its deposit facility rate to 3.75% at its 6 June meeting, after holding it at a cycle high of 4% for nine months. We continue to expect euro area periphery countries to outperform Germany economically. As a result, we anticipate that the yield spreads of government bonds issued by periphery countries like Greece and Spain will narrow relative to German government bonds, along with the periphery countries' improving relative economic fundamentals. Post-Covid spending across the region has shifted towards service-led sectors, leaving economies with a greater industrial footprint, like Germany, not reaping the benefits to the same extent as peripheral countries. Additionally, Germany's disciplined approach to fiscal policy has helped it keep its debt levels sustainable but has limited the fiscal stimulus available to support stronger economic activity and growth.

The UK and France both called snap elections during the second quarter, and voters headed to the polls in early July. In the UK, the Labour party won a landslide victory—as markets had expected—increasing the party's share of parliamentary seats by 209 to 411 and defeating the governing Conservative party. The extent of Labour's majority in parliament should facilitate the implementation of their plans in the coming years.

In France, strong support for the country's right-wing National Rally party surprised markets ahead of the first round of elections, causing spreads between French and German bonds to widen amid concerns around potential higher fiscal spending in France. However, a series of withdrawals in the second round of elections by left- and centre-leaning candidates left voters with fewer choices on second-round polling day; this paved the way for the left-wing New Popular Front party to win the highest number of seats (188 out of 577) in the French parliament, but failed to secure them a majority position. While spreads on French bonds could narrow in the near term, a hung parliament may present challenges, especially given the pressures on the new government to bolster France's weakened economy by raising spending while also tackling rising fiscal deficit concerns.

Elsewhere, we continue to underweight Japan as interest rates there remain low and wages continue to rise – which could support inflation. We expect the Bank of Japan (BoJ) to reduce their purchases of Japanese government bonds (JGBs) and increase interest rates in the coming months.

On curve positioning, we continue to look for ways to benefit from the steepening trend in the yield curve that we believe will continue to develop. Timing is challenging, but thematically there are several factors that should contribute to a more typical upward-sloping curve shape. In the near-term, however, we remain more opportunistic.

Outside the US, we see opportunities across global government bond markets. We are overweight to Greece and Spain relative to Germany and remain underweight to Japan, for example.

Credit

Our outlook for credit markets is positive over the near term but downside risks are growing more prevalent, especially in lower-quality segments that have benefitted from the soft-landing scenario that has helped drive spreads lower over the last eight months.

Broadly, we still see strength in underlying credit fundamentals and the supply/demand dynamic is looking more favourable now that we've made it through the front-loaded wave of new issuance at the start of the year.

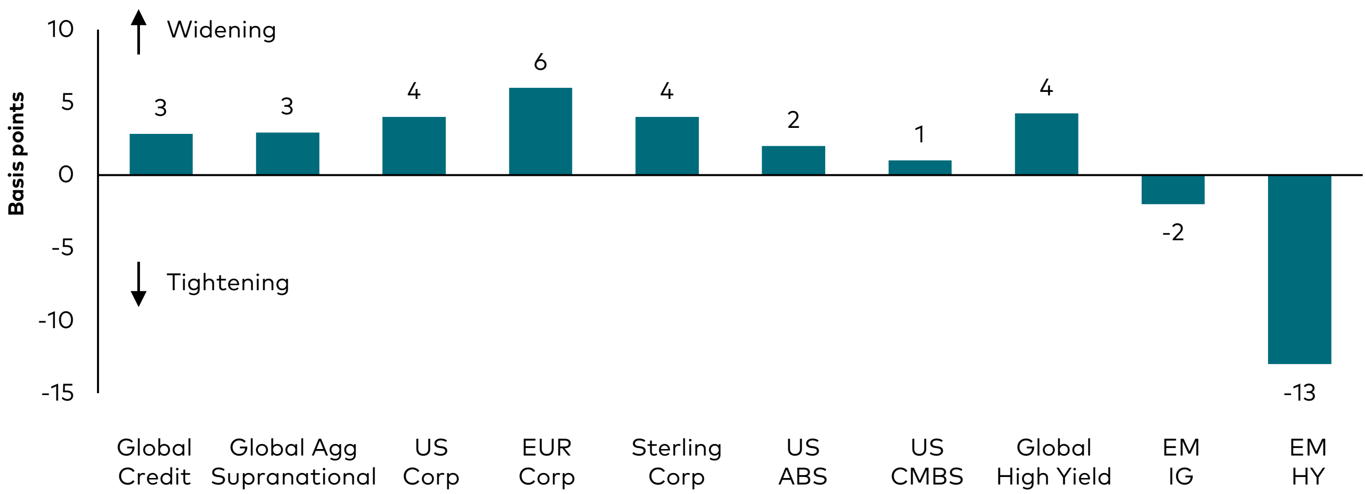
Investment-grade credit should perform well across a range of economic scenarios. Higher-rated bonds are better positioned if borrowing costs remain higher for longer, but they would likely also be more resilient in an economic downturn scenario. If the economy slows quickly, credit spreads would likely widen, but total returns should be supported by a corresponding cut in interest rates.

High-yield credit would be more vulnerable in both economic scenarios, and the asset class currently offers too narrow a spread premium to justify a large allocation.

With spread valuations stretched, our strategy is biased towards higher-quality credit and a focus on maximising yield while reducing our portfolios' sensitivity to broad market risk. We like opportunities at the front-end of the curve within financials, European corporates and investment-grade emerging markets, given the spread uplift.

This strategy allows our portfolios to benefit if credit continues to perform well. But if the broader economy weakens, our more defensive approach should hold up better and provide room to add back credit at more attractive prices.

Quarterly changes in credit spreads



Notes: Chart shows the quarterly changes in spreads for credit market sectors for the 3-month period from 31 March 2024 to 30 June 2024. EM IG and EM HY refer to emerging market investment-grade and high-yield, respectively.
Source: Bloomberg and J.P. Morgan indices.
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.

Summary: Our views and strategy

	Exposure	View	Strategy
Rates	**US duration and yield curve**	• The US Federal Open Market Committee (FOMC) has pushed back the timing of its first rate cut. Softer inflation readings in the second quarter of 2024 raised the prospect of more dovish outcomes. • The 10-year US Treasury yield curve range has likely shifted lower, to around 4.25%. Better inflation data lower the near-term risk of a sell-off in yields. • Yield curve steepening trades are thematically attractive, but timing is a challenge.	• Neutral duration, with a focus on tactical opportunities. • We would look to add duration around 4.5% in 10-year Treasury yields.
	Global duration and yield curve	• Better growth and sticky inflation resulted in a "hawkish cut" by the ECB. • The BoJ has more work to do on policy normalisation. There's potential for a July rate hike and asset-purchase tapering.	• Long Greece and Spain. • Short 10-year JGBs.
Credit	**Investment-grade corporates**	• Spreads have widened modestly but remain well supported by strong demand. • Fundamentals remain healthy and rich valuations are justified given the economy and balance sheet health. • Valuations are attractive in European corporate bonds.	• Opportunities in BBB-rated industrials and the front-end of the yield curve in financials. • Tight spreads limit upside, but higher-quality bonds should hold up even if economic conditions weaken. • Would look to add exposure if spreads widen.
	High-yield corporates	• Credit fundamentals have improved, and default rates have declined. • Technicals remain supportive with most activity tied to refinancing. • We remain cautious mainly due to tight valuations, particularly in higher-quality names.	• We maintain a lower-than-average allocation given tightness of spreads, which offer little protection against adverse outcomes. • Continued focus on bottom-up security selection as dispersion across issuers remains high.
	Emerging markets	• We reduced our EM overweight position in April, ahead of recent spread widening. • We expect credit fundamentals to remain supportive and new issuance to be modest. • Recent spread widening offers an opportunity to add back exposure to bonds that have adequately re-priced.	• Focus on relative-value opportunities while valuations remain stretched. • We like countries with greater economic resilience and more defensive bonds on the curve.

Who we are

FIXED INCOME GROUP

$1.7tn

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

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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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