Vanguard

JULY 2024

Active Fixed Income Perspectives Q3 2024: The high road

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 down as growth and inflation moderated. Lower-quality credit performed best as spreads widened modestly across taxable sectors and narrowed in municipals.

Looking ahead
Inflation has decelerated to levels that now allow the Federal Reserve to cut interest rates if needed, which improves the total-return prospects for bonds. We don't foresee significant Fed easing in 2024, but investors shouldn't miss the opportunity to lock in attractive yields and potentially benefit from the price appreciation that would occur when rates eventually decline.

Approach
All-in yields remain attractive across fixed income sectors, but tight spreads keep us cautious about below-investment-grade risk.

Tax-exempt credit still offers more room for spreads to tighten. Higher-rated municipal bonds look rich because of separately managed account (SMA) buying, but considerable value remains, especially in the middle tiers of credit.

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Taking the high (quality) road

In her book *How to Decide: Simple Tools for Making Better Choices*, cognitive psychology expert Annie Duke says: "Most decisions have a mix of upside and downside potentials. When figuring out whether a decision is good or bad, you are essentially asking if the upside potential compensates for the risk of the downside."

We are always asking that question. 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 fear for bonds—a reacceleration in inflation and likely higher interest rates—has faded. Growth indicators have been somewhat mixed, but there are more signs of weakness and recent inflation readings have been lower than expected.

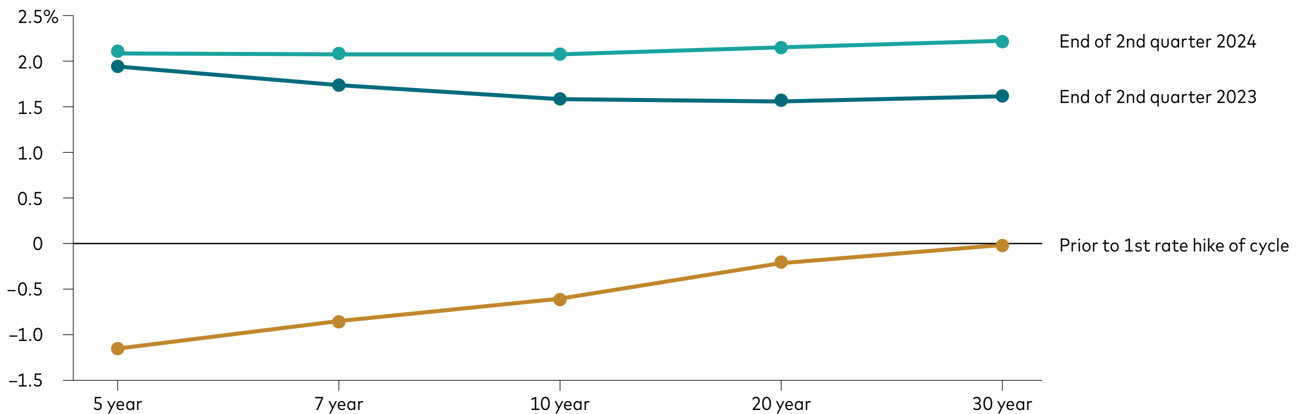
We believe we are approaching a turning point in the economic cycle, which historically has been a good environment for higher-quality bonds. In our view, the risk of a near-term downturn is still low, but we are mindful that a prolonged period of restrictive policy rates poses a risk to the most vulnerable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

Yields well above inflation

Investors should 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.

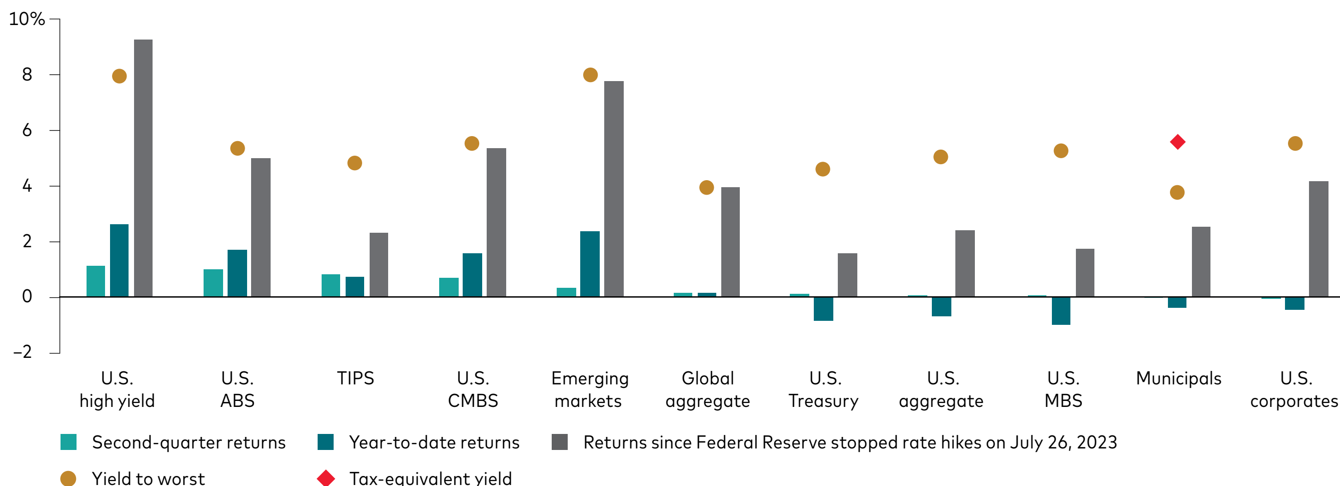
Higher starting yields imply higher returns and better downside hedging. Even if rates generally moved up, higher yields today—relative to the beginning of 2022—can cushion losses from price changes.

Treasury par real rates curve



Notes: March 16, 2022 is the day before the Federal Reserve began raising interest rates in the latest hiking cycle.
Source: U.S. Treasury.

Fixed income sector returns and yields



Note: The municipal tax-equivalent yield is calculated using a 40.8% tax bracket, which includes a 37.0% top federal marginal income tax rate and the 3.8% Net Investment Income Tax to fund Medicare.

Sources: Bloomberg indexes and J.P. Morgan, as of June 30, 2024.

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.

Economy, policy, and markets

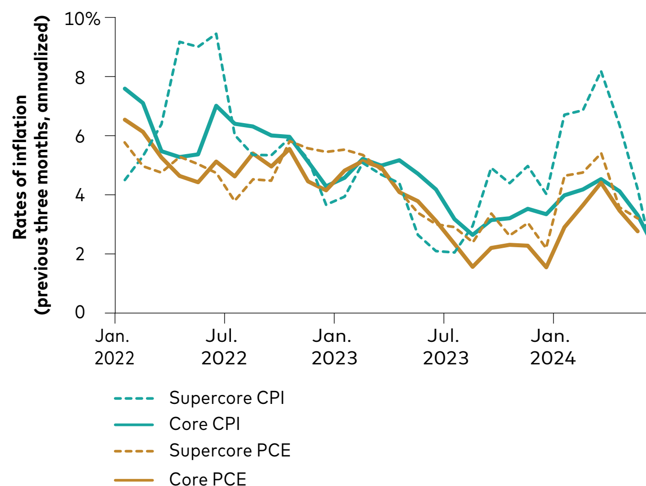
It's been almost a year since the Fed last raised its policy rate. Despite substantially higher borrowing costs, the U.S. economy continues to show strength. After a brief scare in the first quarter, inflation appears to be back on a better path. While recent readings are encouraging, our forecasts see Core PCE inflation trending sideways around the high 2% range into 2025, which underlines the challenge of slowing the inflation rate to the Fed's target.

Stable growth and sticky inflation alongside a firm but gradually normalizing labor 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 for most, if not all, of this year. Monetary policy is highly data-dependent, and the data have shown that it is too soon for the Fed to start cutting.

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 U.S. has improved and progress on inflation has allowed some central banks to begin to ease. However, the Fed will dictate, to varying degrees, what rate-cutting cycles will look like globally.

Rates of inflation (previous three months, annualized)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, as of June 30, 2024. PCE data as of June 30, 2024 not yet reported as of publication.

Portfolio positioning and strategy

Higher-for-longer rates can be a support for markets if certain conditions hold. If inflation continues to slow gradually, markets will have less uncertainty about the Fed's next move. If growth is good enough, cracks are less likely to appear in credit. Then markets can hold within predictable ranges while higher yields generate more attractive returns for investors.

The risk we worry about is the potential for "higher for longer" to become "higher until something breaks." Valuations and credit quality are still the key factors driving our portfolio strategy.

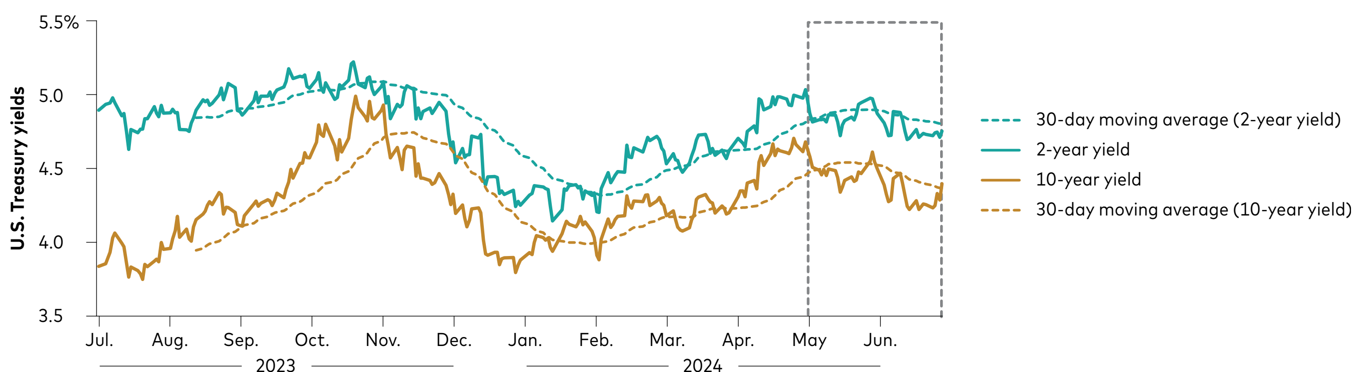
- In our view, rates markets are more appropriately priced for that uncertainty while the lower-quality segments of credit are not.

Rates

In U.S. rates, we've been trading the range in 10-year Treasuries over recent months, between 4.25% and 4.75%. Recent data have likely shifted the range lower over the near term, to 4.00%–4.50%, but rising fiscal concerns could present upside risks to yields. We are biased to add duration at this point in the cycle and will look for attractive risk/reward opportunities to do so if rates test the top end of our expected range.

- On *curve positioning*, we continue to look for ways to benefit from a steeper yield curve. Timing is challenging, but thematically we see several factors that should contribute to a more typical upward-sloping curve. Near term, we are more tactical given that steepener trades have a negative carry profile as long as the yield curve remains inverted.
- *Outside the U.S.*, we see opportunities in global rates markets. We continue to hold a short position in 10-year Japanese government bonds. We are also long Spain and Greece while being short France and Germany.
- We also continue to see value in *agency mortgage-backed securities* and maintain our overweight to bonds with a more stable cash-flow profile.
- Over the quarter, our portfolios exited positions in front-end *Treasury Inflation-Protected Securities* as the positive seasonal impact becomes less favorable over the coming months.

Treasury yields shifted lower in the second quarter



Source: Bloomberg, as of June 30, 2024.
Past performance is no guarantee of future returns.

Credit

Our outlook for credit is positive for the near term, but downside risks are more prevalent in lower-quality segments that have benefited from the "Goldilocks" environment that's driven spreads lower over the last eight months.

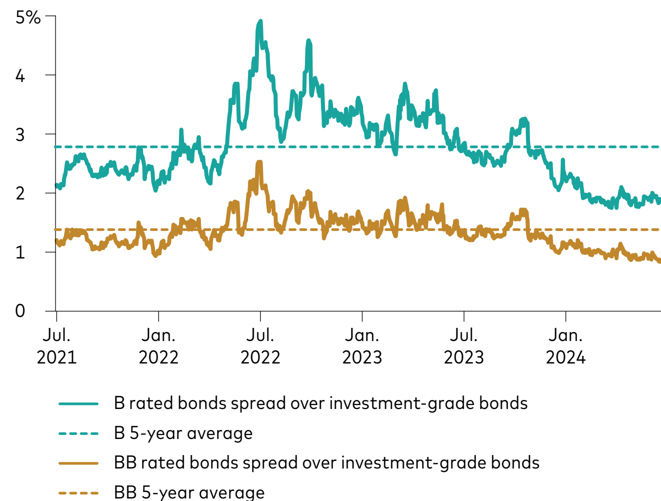
Broadly, we still see strength in underlying credit fundamentals, and supply/demand dynamics look more favorable now that we've made it through the largest wave of new issuance for the year.

- *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 also be more resilient in a downturn. Spreads would widen if the economy slows quickly, but total returns should be supported by the corresponding decline in rates.
- *High-yield bonds* are more vulnerable in both scenarios and offer too narrow a spread premium to justify a large allocation.

With spread valuations stretched, our strategy is biased toward *higher-quality credit* and a focus on maximizing yield while reducing our portfolio's sensitivity to broad market risk. We like the opportunities at the front end of the curve in financials, investment-grade emerging markets, and asset-backed securities.

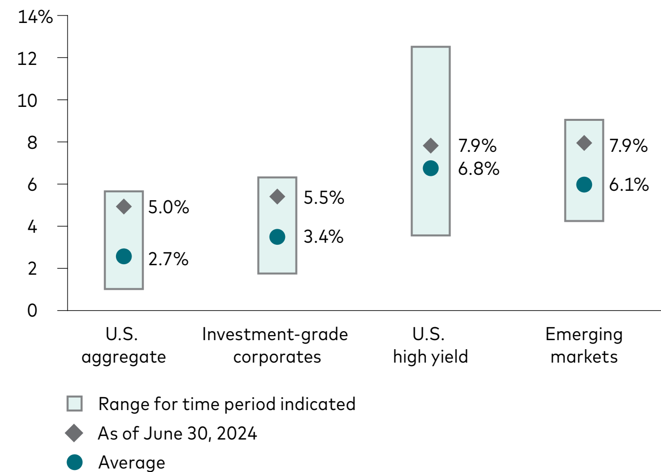
This strategy allows our portfolios to benefit if credit continues to perform well. But if the broader economy weakens, our more defensive approach should hold up better and provide room to add credit back at more attractive prices.

High-yield corporate spreads above investment-grade well below five-year averages



Source: Bloomberg, as of June 30, 2024.

Yields remain higher than long-term averages



Note: Ranges reflect the 15 years ended June 30, 2024, for U.S. aggregate, investment-grade corporates, and U.S. high yield. For emerging markets, the range reflects the 10 years ended June 30, 2024, because of the limited history of the data set.

Sources: Bloomberg indexes and J.P. Morgan.

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Current positioning in taxable portfolios

	Exposure	View	Strategy
Rates	U.S. duration & curve	• FOMC has pushed back on the timing of the first cut. Softer Q2 '24 inflation readings raise the prospect of more dovish outcomes. • 10-year Treasury yield 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, biased to add exposure toward 4.5% in 10-year Treasury yields. • Positioned in steepener trades with a less negative carry profile.
	Global duration & curve	• Better growth/sticky inflation resulted in a "hawkish cut" from European Central Bank. • Bank of Japan has more to do on policy normalization. Potential for July rate hike and asset-purchase tapering.	• Long Spain & Greece, short France and Germany. • Short 10-year Japanese gov't bonds.
	MBS/agencies	• Delayed Fed easing represents headwind for the sector. • Spreads remain within our 40bp–60bp fair value range. • Real money and dealer positioning are significantly long.	• Remain overweight MBS sectors (agency MBS, CMOs, and CMBS). • Trimmed exposure as deteriorating technicals have lowered risk/reward.
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 corporates.	• Opportunities in BBB industrials and front-end financials. • Tight spreads limit upside, but higher quality 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 because of tight valuations, particularly in higher-quality names.	• Maintaining a lower-than-average allocation given spreads offers little protection against adverse outcomes. • Focus is on bottom-up security selection as dispersion across issuers remains high.
	Emerging markets	• Reduced EM overweight 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 repriced.	• Focused on relative value opportunities while valuations remain stretched. • We like countries with greater economic resilience and more defensive bonds on the curve.
	Structured products	• Valuations are attractive. ABS and CMBS are cheap relative to IG corporates. • We remain cautious, but the commercial real estate market is showing signs of stabilization and transaction volumes are starting to pick up.	• Adding less liquid AAA rated ABS that offer attractive spread relative to the risk. • In CMBS, 5-year bonds are attractive in absolute terms and relative to higher-rated corporates.

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Active fixed income leadership team

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Active fixed income at Vanguard

$222B
Taxable bond AUM
19 funds/ETFs**

$185B
Municipal bond AUM
5 national funds/
7 state-specific funds

25+
Portfolio managers

35+
Traders

60+
Credit research analysts

130+
Dedicated team members

** Includes funds advised by Wellington Management Company LLP.
Note: Data as of June 30, 2024.

For more information about active fixed income, speak with your financial advisor.

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Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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