Vanguard

OCTOBER 2024

Active Fixed Income Perspectives Q4 2024: Temperature check

Key takeaways

Performance
The Bloomberg U.S. Aggregate Index soared in the third quarter, with its 5.20% advance representing the second-highest quarterly return since 1996. Municipal bonds also performed well, with a 2.71% return. Higher expectations for an aggressive start to the Federal Reserve's interest rate-cutting cycle boosted bond prices and drove yields lower. Treasury rates across the curve have moved up since mid-September, pressuring recent returns.

Looking ahead
A surprisingly robust September payrolls report tempered expectations for further slowing in the economy. Additional rate cuts will hinge on incoming jobs data, but the Fed must also watch inflation risks. U.S. elections may inject volatility, but we expect bonds to perform well in a range of economic scenarios and to act as a reliable ballast to equity volatility.

Approach
With strong growth and a proactive Fed, the risk of a U.S. recession next year remains low, a sentiment reflected in market prices. We remain constructive on credit but conscious of expensive valuations and possible downside risk.

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Keeping soft landing hopes alive

Milton Friedman, the late economist and Nobel laureate, once compared a central bank's task to a "fool in the shower," meaning someone who can't wait for the right temperature to set in. It was a metaphor comparing the delays in hot and cold water traveling through home plumbing to the long and variable lags in monetary policy.[1]

Now 64 years later, the job of a central banker is just as difficult, but the availability and range of leading economic indicators has much improved. For example, data from our phones now tracks customers foot traffic into malls and stores, allowing the market to see trends sooner.

So far in this cycle, monetary policy has had delayed impacts, yet the markets seem to believe the Fed's control of the U.S. economy is now akin to employing an app-controlled smart shower. Prices reflect a belief that central banks will be able to normalize policy without economic cost.

With the global interest rate-cutting cycle underway, the probability of that occurring has meaningfully improved. Nonetheless, history suggests that the path to a soft landing is difficult.

Temperature check

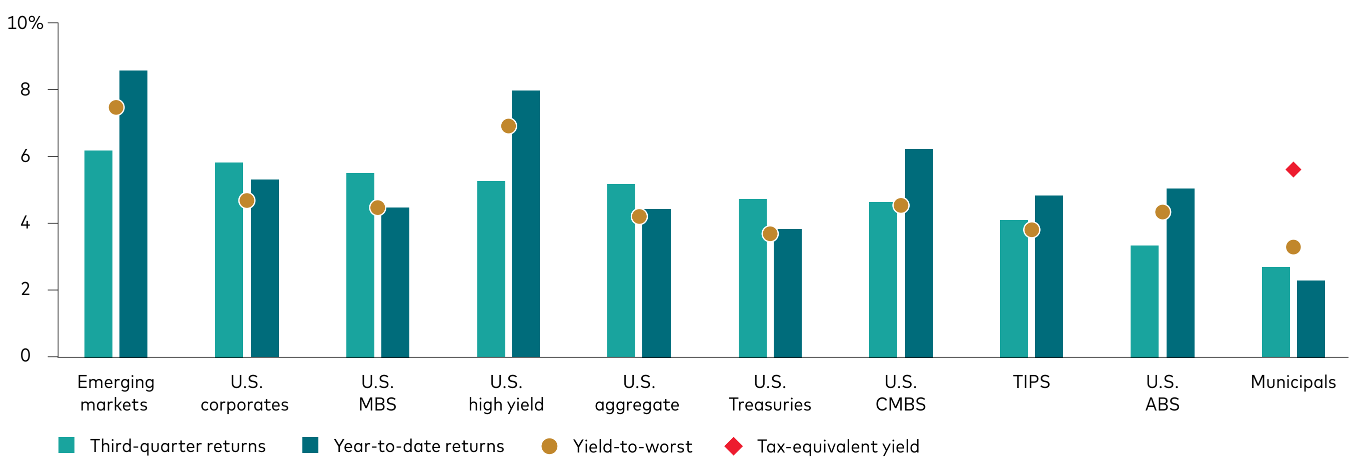
Over the long term, starting yields have consistently been reliable indicators of fixed income returns, and disciplined active management can enhance these returns. While average yields have fallen from peak levels, they remain attractive relative to recent history and expected inflation. Moreover, the current level of 10-year real yields (10-year nominal yields less expected inflation) sits well above levels observed for most of the post-financial-crisis era.

Investors can still lock in income at respectable levels, with the potential for significantly higher returns if the economy softens faster than expected and rates decline meaningfully.

When taking a shower, at some point, the warm water runs out. For those seeking clearer guidance in the markets about a better entry point in fixed income, it's a good time to check the temperature.

It's possible we'll see flashes of hotter inflation, but the cooler economy that we expect over the coming months should create a comfortable environment for bonds.

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 JPMorgan, as of September 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.

1 Friedman, Milton. *A Program for Monetary Stability*, Fordham University Press, 1960.

Economy, policy, and markets

In September, the Fed joined an expanding cohort of central banks that have initiated a downward shift in policy rates as global inflation pressures declined toward more acceptable levels.

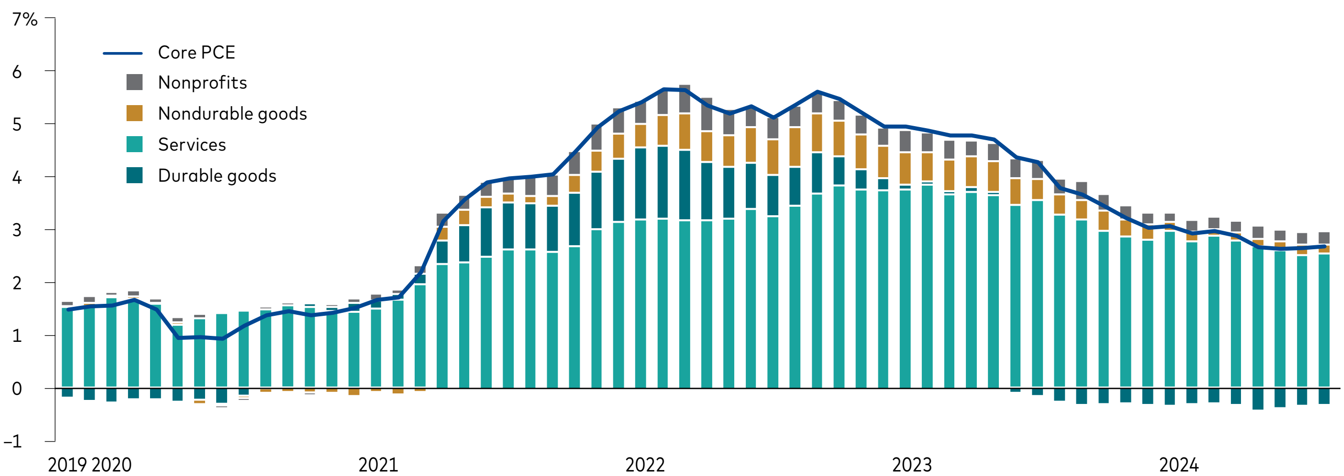
The Fed's decision to lower rates by 50 basis points signals a proactive approach to better align monetary policy with recent inflation and labor market trends. In our view, more Fed easing this year lowers the probability of a recession next year, but the overwhelmingly positive September payrolls data showed that there's little case for another 50-basis-point rate cut in November.

Observed weakness in labor market data in the third quarter was the catalyst for markets to price in an aggressive path for rate cuts, which pushed yields lower across the curve throughout August and into September. As the economic narrative has turned more positive, 10-year Treasury yields have retraced back to the 4% levels last seen at the end of July.

With a roughly 4% unemployment rate and annualized wage growth holding at 4%, markets are rationally repricing their expectations for Fed cuts in 2024. We maintain our expectation of 25-basis-point cuts in November and December, predicated more on the Fed looking to normalize policy than feeling an urgency to "save the labor market."

Central banks now have ample room to continue cutting rates at whatever pace is needed to provide the appropriate cushion if growth is at risk. We're focused on identifying asymmetric opportunities where market expectations dislocate from our view of fair value.

Core Personal Consumption Expenditures (PCE) Price Index shows strength in services



Source: Bureau of Economic Analysis, from November 31, 2019 through August 31, 2024.

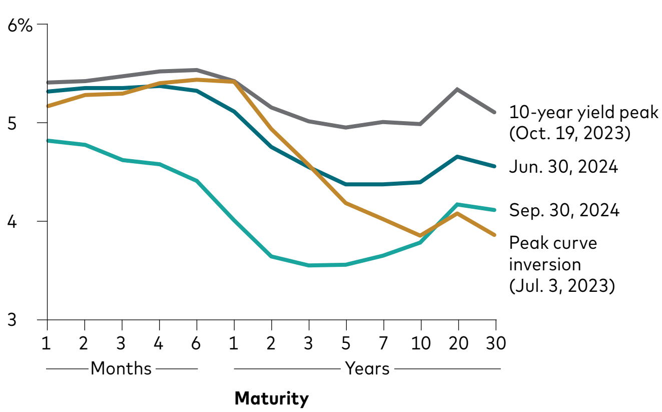
Portfolio positioning and strategy

Our central scenario remains that the U.S. economy will slow to below-trend growth but avoid recession. We expect the yield curve to revert toward its typical upward-sloping shape. In early September, the slope between 2-year and 10-year yields flipped positive for the first time since July 2022. By the start of the fourth quarter, Treasury yields were priced for about 140 basis points of additional rate cuts over the next 12 months.

As has been the situation all year, rates markets have been volatile while credit markets have been steadier. Fixed income credit has performed well, and spreads above Treasuries across most sectors have stayed range-bound around what we consider rich levels. Credit has been buoyed by strong underlying fundamentals, and investors have viewed any spread widening as an invitation to buy.

Our portfolios are set up to make the most of opportunities across credit sectors, but we're more selective about lower-quality issuers that have greater sensitivity to economic weakness. Historically, when economic growth has slowed but stayed positive, higher-quality fixed income has done well. We're sticking to that playbook for now.

U.S. Treasury yield curve: Change has come in waves



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

Rates

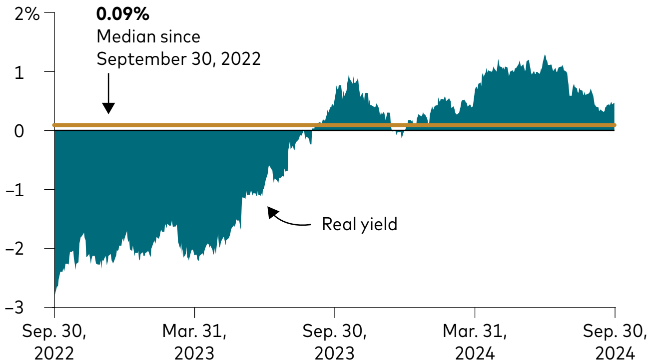
Duration and Curve: With Treasury yields back up near 4%, we see more room for rates to rally than to sell-off further over the medium term. If recession fears re-emerge on weaker data, it's possible for rates to plunge below 3%. Signs of economic strength could push yields higher, but current coupon income provides substantial price cushion for investors.

As of early October, the yield on the Bloomberg U.S. Aggregate Index was 4.50%, which means rates would need to rise more than 75 basis points before investors would see negative returns over the next year. That asymmetric risk profile paints a positive picture for bonds.

In our portfolios, we're approaching our rates positioning more tactically over the near term. Yields are reasonably priced for a backdrop in which the economy holds up and the expectation holds that the Fed will continue to cut rates. We continue to look for attractive entry points to position our portfolios longer in duration, as we expect growth to slow into next year.

Outside the U.S.: We continue to believe that quantitative tightening and further rate hikes by the Bank of Japan will pressure the Japanese government bond yield curve higher and flatter. We remain short and positioned for flattening. In Europe, we're long on euro rates versus U.S. rates. That's because a weaker European growth outlook should result in the European Central Bank (ECB) delivering a faster pace of easing relative to the Fed, and the market has not yet priced in that scenario.

10-year U.S. Treasury real yield (yield-to-worst minus Core Consumer Price Index)



Source: Bloomberg, as of September 30, 2024.

Credit

The Fed's strong start to the easing cycle, combined with solid flows into bonds, has provided additional support to spread sectors. Higher-rated credit performance has been driven by the decline in rates, while lower-quality credit has benefited from higher starting yields and relative stability in spread levels.

Those investors who have favored the lower rungs have enjoyed the returns so far. The biggest risk to credit performance is the possibility of a U.S. recession, but sustained evidence of a soft landing could push tight spreads even tighter.

We remain constructive on higher-quality credit, but we're more valuation-conscious across lower-quality segments with narrow spreads. Greater price dispersion across lower-quality segments offers attractive security selection opportunities but not enough yield pickup for large allocations.

Fixed income credit index returns

		Third quarter	Year-to-date
U.S. corporates	AA	6.1%	4.3%
	A	5.9%	5.1%
	BBB	5.8%	5.7%
	BB	4.3%	6.8%
	B	4.5%	7.1%
	CCC	10.2%	12.5%
U.S. leveraged loans	BB	2.3%	6.0%
	B	3.5%	8.4%
	CCC	8.3%	20.4%
European corporates (USD hedged)	AA	3.6%	4.4%
	A	3.6%	4.6%
	BBB	3.8%	5.6%
	BB	7.4%	7.2%
	B	8.4%	9.3%
	CCC	10.6%	9.6%
EM sovereign credit (U.S. dollar-based)	Investment-grade	5.6%	5.1%
	High yield	6.7%	12.2%
	All	6.2%	8.6%
EM corporate credit	Investment-grade	4.4%	6.6%
	High yield	4.6%	11.8%
	All	4.5%	8.5%
EM local debt	Returns for bonds based in local currency	4.1%	5.8%
	Returns after hedged to U.S. dollar	9.0%	4.9%
ABS	AAA	3.4%	5.0%
	Non-AAA	3.3%	6.2%
CMBS	AAA	4.6%	5.9%
	AA	4.8%	6.2%
	A	4.1%	14.6%
	BBB	2.1%	12.6%

Source: Bloomberg, as of September 30, 2024.

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Current positioning in taxable portfolios

	Exposure	View	Strategy
Rates	U.S. duration & curve	• 10-year yields close to fair value for soft-landing scenario. Higher yields toward 4.25% would provide an opportunity to add duration. • Yields have room to decline substantially if recession probabilities rise.	• Neutral duration, with a focus on tactical trading opportunities where markets dislocate from our outlook. • Would look to add duration in a yield backup.
	Global duration & curve	• Bank of Japan policy normalization to pressure Japanese government bond yield curve higher/flatter. • We think deeper cuts may be necessary for the ECB and see the Bank of England lagging other developed central banks.	• Underweight Japanese government bonds and in yield-curve flatteners. • Short 10-year U.S. and U.K. bonds vs. German bunds. • Selective exposure to peripheral European government bonds.
	Mortgage-backed securities (MBS)/ agencies	• MBS index spread valuations are near year-to-date tights. • We are more defensive on this sector, expecting implied volatility to remain elevated.	• We are underweight recently issued coupons. • Lower coupon bonds offer better risk/ reward.
Credit	Investment-grade (IG) corporates	• Spreads remain well supported by strong investor demand and lower supply through year-end. • Expensive valuations are justified given the economy and balance-sheet health.	• Front-end bonds offer more attractive valuations. • By credit quality, we see more opportunities in BBB rated bonds. By sector, we like banks and utilities. • Would look to add exposure if spreads widen.
	High-yield corporates	• Our outlook continues to be constrained by rich valuations, particularly in higher-rated segments. • Credit fundamentals are favorable. • We see more opportunities in stressed and distressed issuers but remain highly selective.	• We hold a lower-than-average allocation to this sector. • Focus is on bottom-up security selection as dispersion across issuers remains high.
	Emerging markets	• Added exposure when spreads widened in August. • New issuance through year-end will be muted. • A return of fund flows could drive spreads tighter.	• Targeting names with greater resilience to a downturn. • Highly selective in lower-quality bonds.
	Structured products	• Heavy asset-backed securities (ABS) supply pushed spreads wider and made valuations more attractive relative to IG corporates. • The potential for lower rates is a positive scenario for refinancing and property values in commercial real estate.	• We like below-AAA-rated ABS opportunities with strong credit enhancement and attractive spread pickup to IG corporates. • In commercial MBS, 5-year AAA bonds are attractive in absolute terms and relative to higher-rated corporates.

Distressed emerging markets sovereigns offer compelling new opportunities

A potentially rewarding class of emerging markets (EM) debt has, like the mythological Phoenix, arisen from the ashes of sovereign defaults.

The new debt offers opportunities for active managers who can identify successful issuers that are returning to the bond markets after restructuring.

It also offers EM countries—many in Africa, where some experts believe the Phoenix myth originated—the chance to build credibility in the eyes of investors, allowing them access to the capital markets and lower credit costs over time.

The new bond design came after a wave of EM sovereigns defaulted during the COVID-19 pandemic. Since the start of 2024, four EM sovereign bond issuers have completed—or are soon to complete—restructuring negotiations designed to put them on a more sustainable footing.

Sri Lanka, Ghana, and Zambia are among the issuers whose bonds have posted significant returns as their debt restructurings approached their conclusion. Zambian bonds, for example, have returned approximately 25% through September 30. For some countries, much of the return materialized before the new bonds were issued. But for Ghana, a sizeable rally took place during the first week in the life of the new instruments.

Innovative new bond features

Unlike the legacy bonds they replace, the new instruments come with a range of contingency provisions.

The contingencies are linked to the sovereign meeting certain financial performance targets. When triggered, bondholders could receive a higher coupon, faster amortization, and greater replenishment of the initial principal "haircut" or a mix of these elements.

Factors that trigger contingency provisions should be transparent, easy to track, and not subject to potential manipulation. For example, with the new bonds issued by the Zambian government, the payouts are linked in part to the country's output and price of copper, one of its chief exports. Both of these figures are regularly published and can be monitored.

The International Monetary Fund (IMF) has played a key role in facilitating the negotiations. An IMF debt sustainability analysis provides a credible baseline source for valuing the payouts linked to the newly restructured debt.

A risk-managed approach

Our active EM fixed income team aims to take positions in distressed sovereign issuers that are near or in default, ideally before their restructurings have been finalized.

Once the restructuring terms have been agreed, the value of the sovereign's existing bonds can rise significantly, generating outsized returns for investors who entered the position early enough and at the right price.

Year-to-date total returns of distressed EM sovereign issuers

Country	YTD return
Kenya	9.3%
Angola	9.5%
Sri Lanka	10.6%
Ethiopia	16.1%
Ghana	22.2%
Zambia	24.6%
Egypt	30.1%
Ukraine	33.4%
Pakistan	40.1%
Argentina	51.9%

Source: Vanguard, using JPMorgan research. Calculations based on the total returns of individual countries' sovereign debt, for the period from January 1, 2024, through September 30, 2024. Returns in USD.

Past performance is no guarantee of future returns.

Vanguard active bond funds and ETFs

Vanguard active bond funds and ETFs		Admiral™ Shares or ETF ticker symbol	Expense ratio*
Global/ international	Emerging Markets Bond Fund	VEMBIUA	0.60%
	Global Credit Bond Fund	VGCIUHA	0.35%

Vanguard index bond ETFs

Total market	Total Bond Market	BND	0.03%
	Short-Term Bond	BSV	0.04%
	Intermediate-Term Bond	BIV	0.04%
	Long-Term Bond	BLV	0.04%
Treasuries	Treasury 0-1 Year Bond UCITS (Accumulating)	VDST	0.05%
	Treasury 0-1 Year Bond UCITS (MXN Hedged) (Accumulating)	VMSTx	0.10%
	USD Treasury Bond UCITS (Accumulating)	VDTA	0.07%
	USD Treasury Bond UCITS (Distributing)	VDTY	0.05%
	Short-Term Treasury	VGSH	0.04%
	Intermediate-Term Treasury	VGIT	0.04%
	Long-Term Treasury	VGLT	0.04%
	Extended Duration Treasury	EDV	0.06%
Corporates	Total Corporate Bond	VTC	0.04%
	USD Corporate Bond UCITS (Accumulating)	VDPA	0.09%
	USD Corporate Bond UCITS (Distributing)	VDCP	0.09%
	USD Corporate 1-3 Year Bond UCITS (Accumulating)	VDCA	0.09%
	USD Corporate 1-3 Year Bond UCITS (Distributing)	VDUC	0.09%
	Intermediate-Term Corporate Bond	VCIT	0.04%
	Long-Term Corporate Bond	VCLT	0.04%
	ESG USD Corporate UCITS	V3SD	0.11%
	ESG EUR Corporate UCITS	V3RE	0.11%
	USD Corporate 1-3 Year Bond UCITS (MXN Hedged)	VMCAx	0.14%
Global	Total World Bond	BNDW	0.05%
	Global Aggregate Bond UCITS (Accumulating) (USD hedged)	VAGU	0.10%
	Total International Bond	BNDX	0.07%
	Emerging Markets Government Bond	VWOB	0.20%
	USD Emerging Markets Gov. Bond UCITS (Accumulating)	VDEA	0.25%
	USD Emerging Markets Gov. Bond UCITS (Distributing)	VDET	0.25%
	EUR Eurozone Government Bond UCITS (Accumulating)	VGEA	0.07%
	EUR Eurozone Government Bond UCITS (Distributing)	VETY	0.07%
	EUR Corporate Bond UCITS (Accumulating)	VECA	0.09%
	EUR Corporate Bond UCITS (Distributing)	VECP	0.09%
Other	Mortgage-Backed Securities	VMBS	0.04%
	Short-Term Inflation-Protected Securities	VTIP	0.04%
	ESG Corporate Bond	VCEB	0.12%
	Short-Term Corporate Bond	VCSH	0.04%

Active fixed income leadership team

Sara Devereux
Global Head of Fixed Income Group
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

Paul Malloy, CFA
Head of U.S. Municipals
In industry since 2005

Active fixed income at Vanguard

$469B
Vanguard Global Active Bond AUM

$276B Vanguard Global Active Taxable Bond AUM

$193B Vanguard Global Active Municipal Bond AUM

25+ Portfolio managers

35+ Traders

60+ Credit research analysts

130+ Dedicated team members

* As reported in each fund's prospectus. A fund's current expense ratio may be higher or lower than the figure shown.
Note: Data as of September 30, 2024.

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

Connect with Vanguard®

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