Vanguard

Q1 2024

Active fixed income perspectives

Key takeaways

Performance: The fourth quarter of 2023 was one of the best on record for fixed income markets since the 2007-2008 Global Financial Crisis (GFC), fuelled by more dovish signals from the US Federal Reserve (Fed) and positive signs that inflation is steadily declining.

The buoyant sentiment was in stark contrast to earlier in the quarter, when concerns that persistent inflation would keep interest rates higher for longer than initially anticipated had pushed yields on 10-year US Treasuries above 5%. Then, in late November, data showing inflation had cooled and a more dovish tone from the Fed in December drove an all-asset rally through to the end of the year. Ten-year US Treasury yields quickly fell below 4% and credit spreads tightened.

Looking ahead: We maintain our positive view on the relative value of fixed income. We expect interest rates to ultimately settle at levels above those in recent memory. Investors can capture durable, resilient yields with the potential for additional price appreciation if rates decline, in our view.

Approach: Credit spreads are narrow, but overall yields remain attractive. We still hold a bias towards higher quality credit. Corporate credit and high yield spreads should widen later this year as the economy weakens, but not to extreme levels. We await a better entry point to add lower quality risk.

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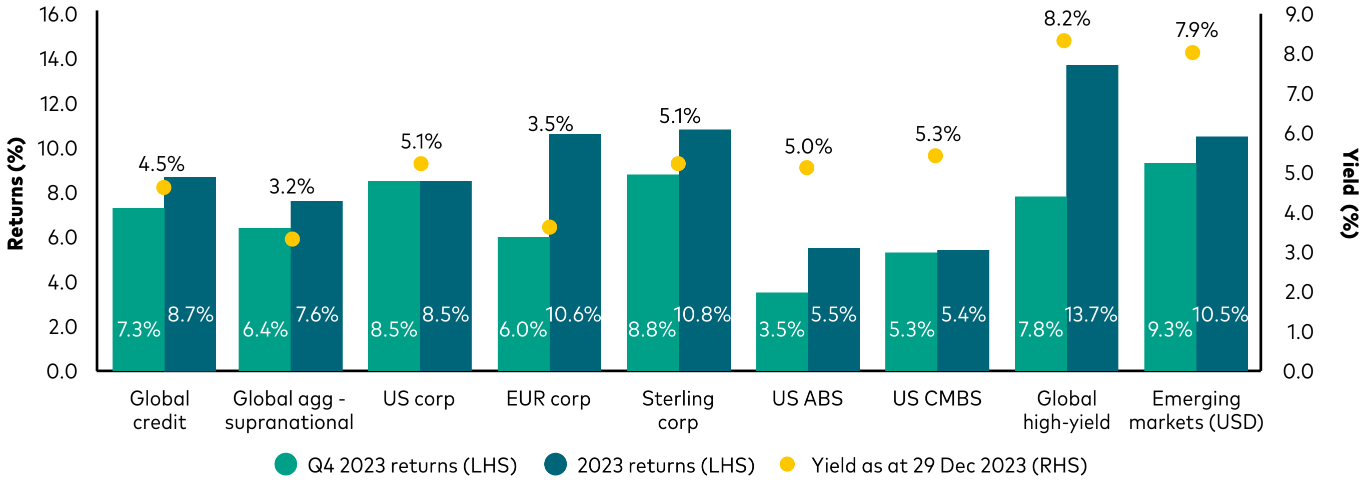
Are the good times already over?

Global bond markets had a spectacular end to 2023, generating their best returns over a two-month period in November and December since the GFC. The jump in performance helped confirm the role of fixed income in investor portfolios, both as an income generator and as a potential capital appreciation vehicle.

The main catalyst for the price action was the continued softening in economic data; but perhaps more importantly, the change in tone by central banks at their December meetings demonstrated a potential pivot in their reaction function. Whereas policymakers previously seemed intent on fighting inflation at all costs, they appear to have shifted gears to a more balanced approach.

The shift in sentiment led markets to price in significant rate cuts by central banks in an almost uniform fashion. Moreover, markets are now skewed in their pricing to reflect a soft landing and mild recession, with little room for an alternative outcome to play out – such as an inflationary re-acceleration, which appears to be the least-favoured scenario by the markets.

Fixed income sector returns and yields



Sources: Bloomberg indices and J.P. Morgan EMBI Global Diversified index. Q4 data from 29 September 2023 to 29 December 2023. 2023 data from 1 January 2023 to 29 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.

Risks

Though yields are higher, there remains plenty to be concerned about, especially as the economic environment grows more uneven and growth shifts towards a lower trajectory. Credit spreads remain uncomfortably tight, in our view, leaving credit markets, especially those of lower quality, more exposed to risks in the event of a recession – and this at a time when heightened fiscal deficits are already a concern.

A fall in interest rates would ease the immediate fiscal pain of higher interest payments, but the core issues facing economies haven't been addressed, in our view. As a result, investor concerns could very well resurface, putting upward pressure on rates. Additionally, the downtrend in inflation could stall, holding levels above their long-run targets.

Considerations for investors

Investors can earn a compelling yield in money markets or other cash instruments – at least up until central banks start cutting rates. The question for many investors is when to lock in yields for longer. Previously, we've highlighted the merits of adding some duration exposure as hiking cycles mature – and we continue to hold that view.

We think bonds will prove their worth again as a valuable source of income and a diversifier to equities in investor portfolios. We expect there will be more opportunities ahead, even if accessing them requires traversing a few bumps in the economy along the way. Avoiding downside risk will ultimately prove more important; as will capturing income and opportunities created from increases in market volatility and credit dispersion.

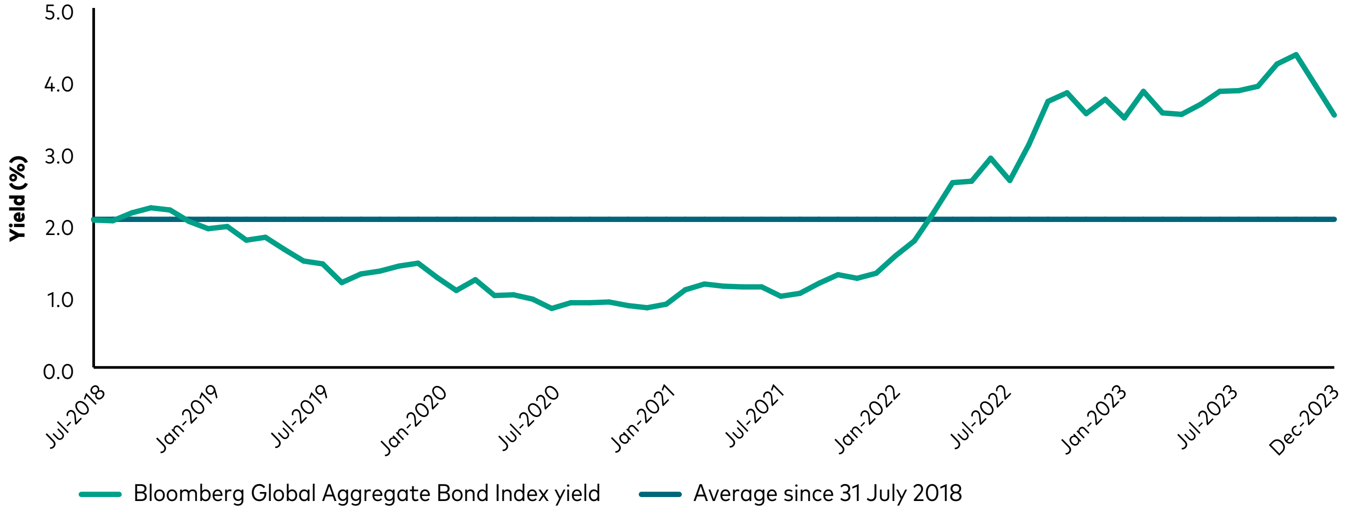
Rates and inflation: Have yields peaked?

Early last year, many investors sought the safety of money markets as the fear of higher rates led to large outflows from bonds. As markets remained volatile, investors continued to hawkishly watch for an optimal entry point back into bonds. Those who entered the market in mid-October saw 10-year US Treasury yields decline from 5% to 4% over the ensuing two months to mid-December.

As yields fell, bond prices rose significantly. The Bloomberg Global Aggregate Bond Index (USD Hedged) gained 6.2% from 16 October 2023 to 29 December 2023[1]. Investors who had remained safely parked in cash may have felt they missed out.

1. Source: Bloomberg, based on total returns for the Bloomberg Global Aggregate Bond Index (USD Hedged) for the period 16 October 2023 to 29 December 2023.

Bond yields fell sharply at the end of 2023



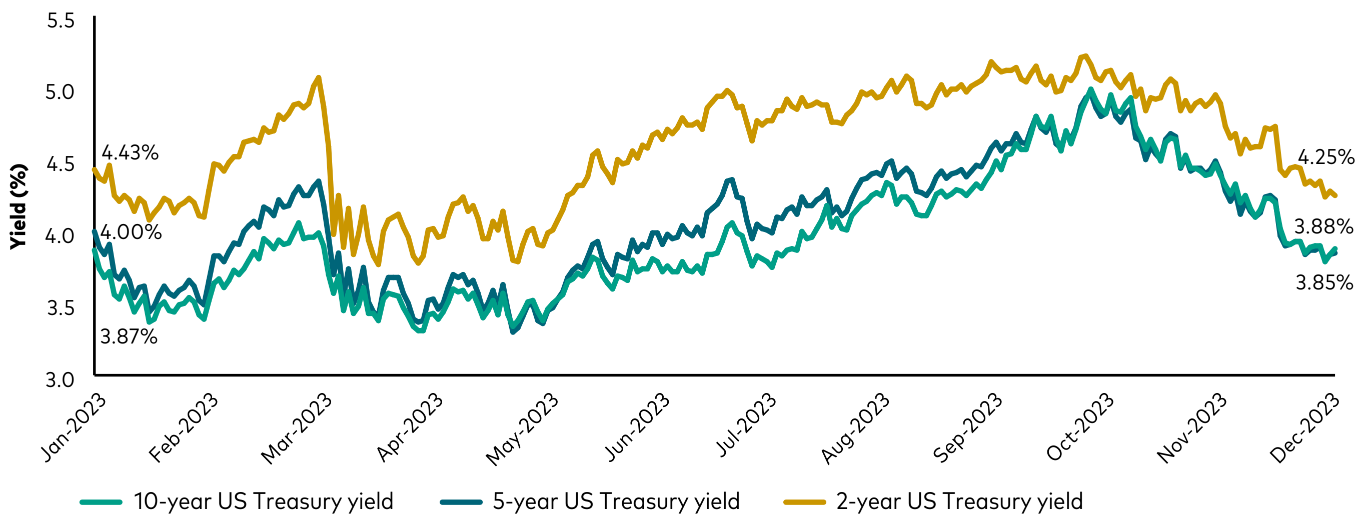
Source: Bloomberg Global Aggregate Bond Index yield-to-worst (USD Hedged) for the period 31 July 2018 to 29 December 2023.
Past performance is not a reliable indicator of future returns.

Where do fixed income markets go from here?

In the US, we expect core inflation[2] data for the fourth quarter to show a steady fall to end 2024 near the Fed's 2% target. Looking ahead, we believe the Fed will cut interest rates, with the potential for more easing if a recession occurs; however, in either case we don't expect policy to return to the low rates of the past. We also expect the yield curve to steepen as short-term rates decline.

Although growth decelerated in the fourth quarter from its peak in the third quarter, there is still little evidence that a near-term recession is imminent, in our view. Slower inflation in the second half of 2023 led the Fed to signal that a normalisation of policy could begin in 2024, assuming core inflation remains within the 2%-2.5% range. As such, rates markets quickly priced in a significant number of rate cuts in 2024, but have since re-calibrated to reflect a less aggressive pace.

US Treasury yields declined rapidly in the fourth quarter



Source: Bloomberg. Chart shows the historical 10-, 5- and 2-year US Treasury yields, for the period 30 December 2022 to 29 December 2023. Calculations are in USD.

2. As measured by Core Personal Consumer Expenditures price index (CPCE), the Fed's preferred inflation metric.

What's next?

US

The recent easing in financial conditions helped open up the path for a soft landing to occur in the US; however, we see risks to this consensus view. Even if a recession is avoided, the Federal Open Market Committee is likely to ease policy rates around the middle of 2024 to prevent real policy rates from becoming overly restrictive. We think the potential for a large move higher in yields is limited from here, but rate cuts could come later than the market expects if growth stays above trend and inflation remains sticky.

We hold a preference for exposure to the belly of the yield curve, with carry very negative at the front end of the curve and the potential for steepening in longer maturities. Our view is that yield levels reflect a soft landing but have room to decline much further if a recession arrives. As rates rallied into the end of 2023, we took this as an opportunity to reduce our long duration positions and are now neutral to our benchmarks.

Europe and the UK

In Europe, growth has been weaker than expected in both the UK and eurozone economies. Nevertheless, even as both regions benefitted from very strong base effects in 2023 putting downward pressure on inflation, wage growth continues to be elevated.

In the UK, wages are still increasing at a pace of around 7%, and in many eurozone countries, where multi-year collective wage agreements are the norm, we see new contracts with wages growing 3%-5% over the next couple of years.

This tug-of-war between higher inflation and anaemic growth has led markets to price in faster rate-cutting cycles by central banks in Europe than by the Fed in the US. While a significant or unexpected growth shock would force policymakers to move more quickly, as things now stand we expect central banks to err on the side of caution and keep rates elevated for as long as required to bring inflation back down to target levels.

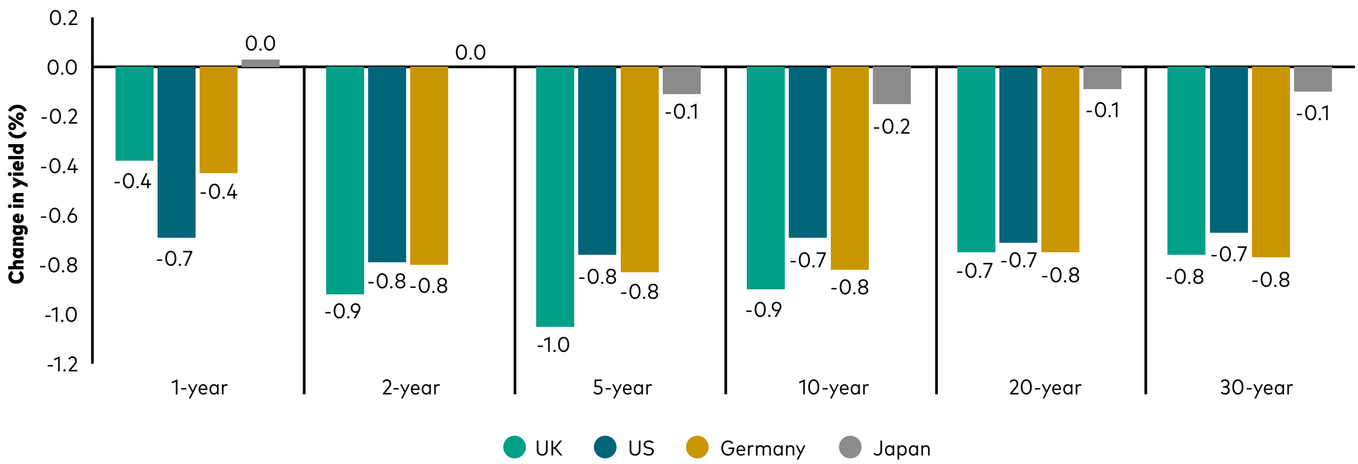
Japan and Australia

Japan and Australia are the two countries where we believe markets are underpricing potential hawkish signals by central banks; as a result, we remain underweight.

We view Japan as unique relative to other economies, as the central bank has been fighting an entrenched deflationary mindset for many years. We believe policymakers have actually been more successful than they give themselves credit for; when coupled with strong wage gains and a new fiscal package in the first half of 2024, we can see a scenario arising where the Bank of Japan could be behind the curve in terms of policy normalisation.

On a similar note, Australia's economy has been more resilient than expected, with migration and housing data surprising to the upside for the fourth quarter of 2023. Inflation continues to run above 5% and we don't expect it to move below 3% until at least 2025. That may lead the Bank of Australia to conclude that an extra rate hike is warranted to help speed up the fall in inflation towards target levels.

Change in core market government bond yields



Source: Bloomberg, calculations reflect the quarterly change in yields for the period from 29 September 2023 to 29 December 2023.
Past performance is not a reliable indicator of future returns.

Implications for Vanguard funds

- We expect growth and inflation to soften globally as central banks prepare for rates cuts. Emerging market (EM) countries should see the most activity.
- In developed countries, markets expect the Fed to be the first central bank to ease rates; however, the European Central Bank may need to act more quickly due to weak growth and falling inflation in the eurozone.
- In the US, we are positioning for a shallow recession in the back half of 2024, which should pull down short-term yields when rate cuts by the Fed appear imminent.
- We are generally neutral in US duration risk relative to our benchmarks. We hold a preference for exposure to the belly of the yield curve, with carry very negative at the front end and the potential for steepening in longer maturities.
- In the UK, we believe rate cuts by the Bank of England may come later than anticipated due to more persistent inflation.
- Policy normalisation by the Bank of Japan should push Japanese government bond yields higher, although yield gains will be limited if recession risks in the US are realised.

Investors should feel more comfortable about the path ahead for the bond market. In our view, the range of potential outcomes for fixed income total returns has narrowed and leans towards the positive.

Credit

Credit markets posted robust gains in the fourth quarter, led by the Fed's unexpectedly dovish tone, which added fuel to the rally in risk assets that was already underway. With growth still above trend, credit sector valuations are now fully priced for a soft landing scenario.

Though we believe there is still value in credit, returns will likely come more from yields than price appreciation going forward. We believe yields are at attractive levels and spread widening should be contained for higher-quality bonds.

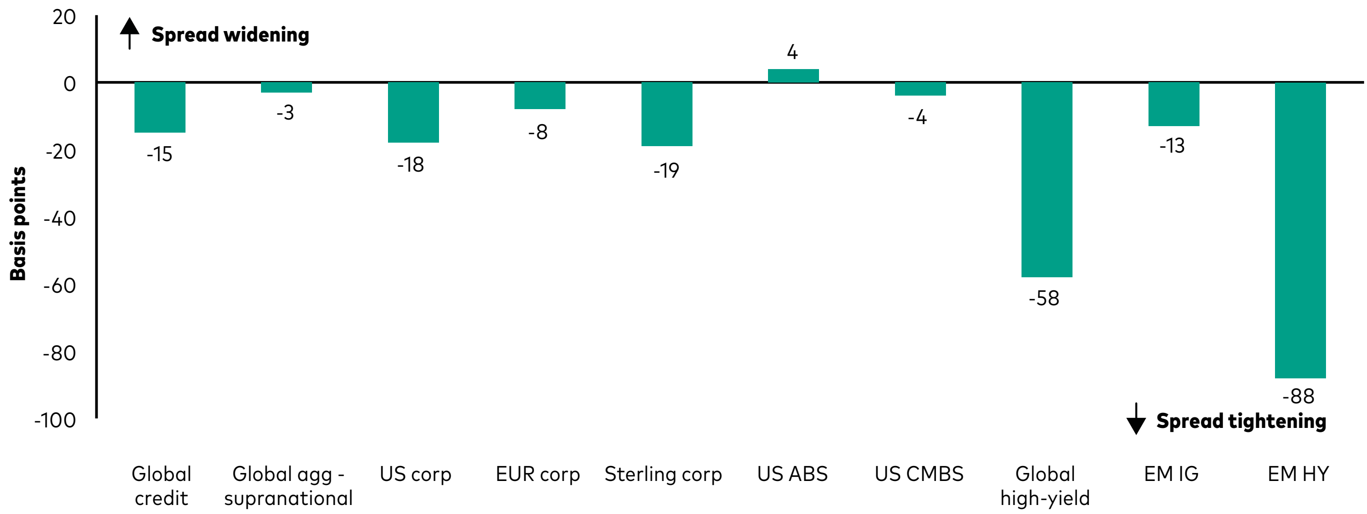
The bigger picture

Yield levels across credit sectors began 2024 at lower levels than their mid-October peaks, but still well above their ten-year averages. We see a strong case for credit to outperform government bonds this year, primarily due to the higher coupons on offer.

Spreads have little room to tighten much further, but in a selloff, price drops should be relatively contained because of a positive supply and demand technical backdrop and strong fundamentals.

Lower-quality segments are more vulnerable to a slowdown in growth, even though they have performed well of late. We remain cautious on high-yield exposure but constructive on investment-grade corporates.

Quarterly changes in spreads



Source: Bloomberg and J.P. Morgan indices; data from 29 September 2023 to 29 December 2023.
Note: EM IG and EM HY refer to emerging market investment-grade and high-yield, respectively.
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.

Investment-grade corporates

High quality corporate spreads averaged 125 basis points (bps) last year and held for long periods within that range for the last several months before falling below 115 bps during December's all-asset rally[3].

In 2023, the number of corporate credit ratings upgrades exceeded downgrades by a ratio of four to one[4]. Companies in cyclical industries, which typically carry more leverage, led the way. As higher rates have increased the cost of capital, many companies have pivoted towards reducing debt to protect their balance sheets and credit ratings.

Corporate fundamentals continue to look strong even as interest expenses rise and operating margins narrow. While we don't anticipate the pace of upgrades to continue, last year's ratings changes show that investment-grade companies are adjusting relatively well to the new economic environment.

We maintain our view that investment-grade corporates are broadly entering a recessionary environment in a strong position. With the exception of select sectors (for example, real estate), many companies have deleveraged over the past few years and are better positioned in terms of their leverage and interest coverage ratios than before the Covid-19 pandemic. In our view, spreads already reflect an expected economic slowdown, although we remain cautious on cyclical sectors.

Earnings broadly as expected

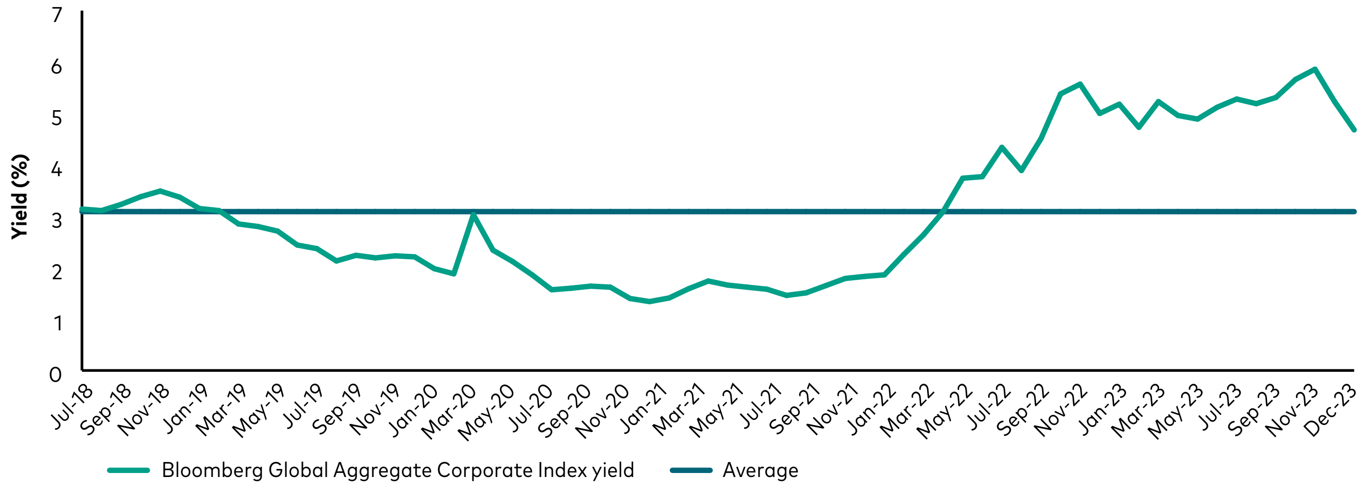
Third-quarter corporate earnings came in broadly as expected. The low-double-digit year-over-year earnings decline was primarily due to a challenging comparison period. Earnings surprises were slightly better than the long-term average, albeit with a large variation between sectors. There were a few prominent earnings misses but mostly for idiosyncratic reasons rather than owing to any broad-based deterioration in corporate performance. We expect fourth-quarter earnings to show a continuation of the same trends seen in the third quarter. All eyes will be on the outlook for 2024 from management teams.

Heading into the first half of 2024, we think the technical backdrop is favourable. As the rate hiking cycle concludes, flows into investment-grade funds have returned, with European investment-grade funds seeing eight consecutive weeks of inflows in the final months of 2023[5]. Lower volatility in rates and declining sovereign bond yields should continue to support inflows into credit funds this year.

We also expect 2024 gross supply to be flat or potentially lower relative to 2023 levels. Financials are unlikely to see large balance sheet growth due to a slowdown in lending, whilst many corporates are expected to contain their capital expenditures and M&A spending amid higher borrowing costs and a less certain economic outlook. In line with the seasonal patterns in past years, we expect supply in 2024 to be front-loaded in the first quarter, but believe it will be largely digested by the market thanks to stronger demand for credit. However, a more severe economic downturn than expected, or re-escalation of geopolitical tensions, remain key downside risks to our base case technicals outlook, as they could derail investor flow stabilisation.

In terms of positioning, we still like the defensive characteristics of higher quality credit at this point in the cycle. We see opportunities in the banking sector in particular, which lagged the broader market in 2023 and now has more room to outperform. Bank earnings in the quarters following the US regional banking crisis that started in March last year have shown their balance sheets are sound. The recent decline in government bond yields has helped improve banks' asset portfolios, and earnings should improve if the yield curve steepens this year, as we expect.

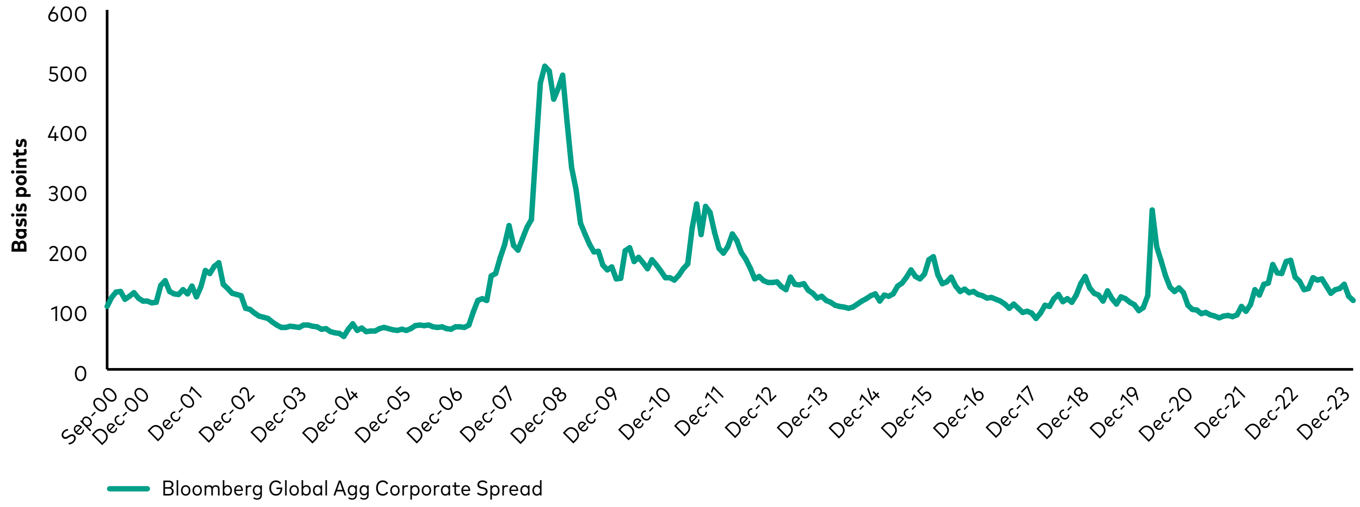
Bloomberg Global Aggregate Corporate Yield (%)



Source: Bloomberg Global Aggregate Corporate Index yield-to-worst; for the period from 31 July 2018 to 29 December 2023.
Past performance is not a reliable indicator of future returns.

3. Source: Bloomberg; based on the option adjusted spread of the Bloomberg Global Aggregate Corporate Bond Index (USD hedged) for the period 29 December 2022 to 29 December 2023.
4. Source: Vanguard.
5. Source: Vanguard.

Corporate bond spreads narrowed at the end of the fourth quarter



Source: Bloomberg Global Aggregate Corporate Index average option-adjusted spread (OAS); for the period 29 September 2000 to 29 December 2023. All calculations are in USD.
Past performance is not a reliable indicator of future returns.

High-yield corporates

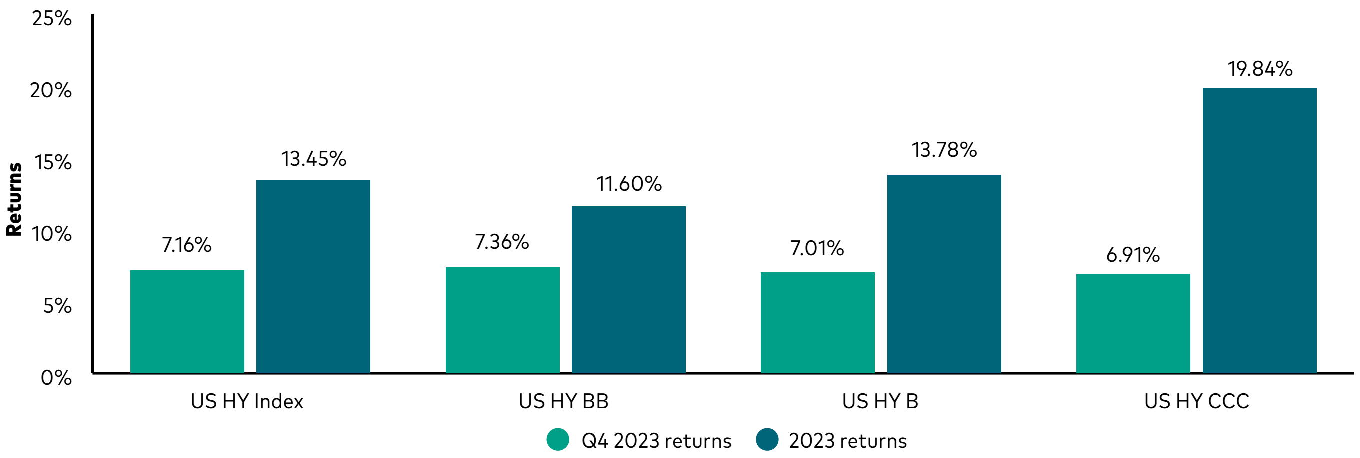
Sub-investment-grade bonds outperformed all other major bond market segments in 2023, with the Bloomberg Global Corporate High Yield Index (USD Hedged) returning 13.7%[6]. Falling US Treasury yields and a narrowing in spreads near the end of the year provided the biggest boost. The 8.7% return over November and December was the best two-month period of performance for global high-yield credit on record[7].

Company fundamentals remain stable and refinancing risks are low for the sector over the next two years. In our view, lower-quality CCC-rated companies require a higher level of growth than we expect and are therefore vulnerable, but BB- and B-rated credits should fare well. This year we expect new supply to pick up, rating upgrades to slow and defaults to rise, but not by much.

With credit spreads currently in the low-4% range, we're less excited about the value of owning generic high-yield debt. However, dispersion across the sector is wider than it has been in nearly two decades[8]. Despite the broad rally in spreads, 74% of high-yield bonds are trading at more than +/- 100 bps relative to average index yields[9]. That provides a good environment for security selection.

High-yield still offers attractive income potential, but investors should be aware that if sentiment changes, spreads now have more room to widen, which would result in lower total returns.

US high-yield corporate bond performance



Source: Bloomberg and Vanguard. Calculations based on the Bloomberg US High Yield Index (USD Hedged) for the periods 29 September 2023 to 29 December 2023 and 30 December 2022 to 29 December 2023.
Past performance is not a reliable indicator of future returns.

6. Source: Bloomberg; for the period 29 December 2022 to 29 December 2023.
7. Source: Vanguard; based on the historical performance of the Bloomberg Global Corporate High Yield Index (USD Hedged).
8. Source: Vanguard.
9. Source: Vanguard; based on the Bloomberg Global Corporate High Yield Index (USD Hedged) components, as at 29 December 2023.

Emerging markets

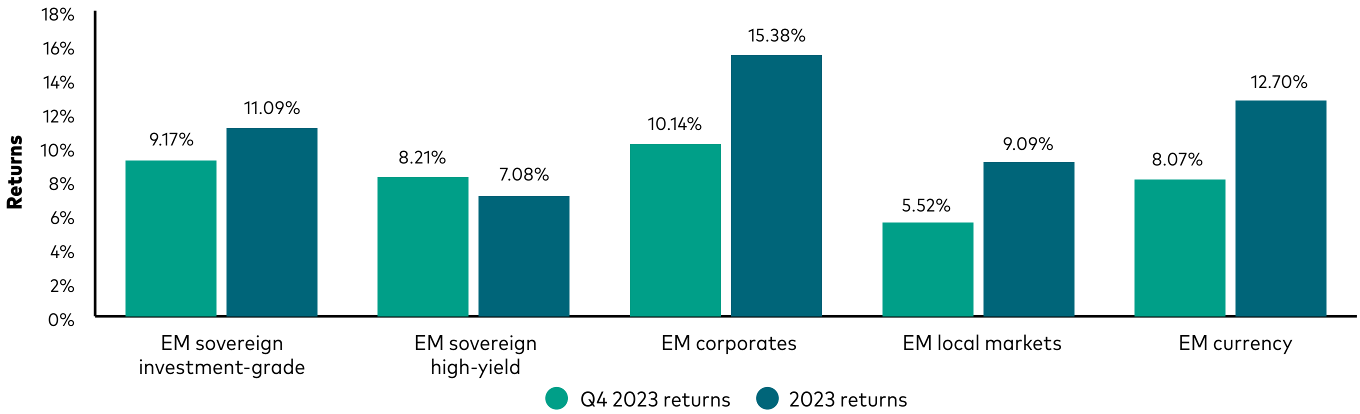
Both emerging market (EM) credit and local market EM bonds generated double-digit returns in 2023. Economic resilience supported the performance of lower-rated issuers, and a decline in interest rates boosted both US dollar- and local currency-denominated bonds. Flows turned positive near the end of the year after an extended period of outflows[10].

As we begin 2024, starting valuations in EM bond markets are looking expensive. With the exception of a few distressed countries, markets aren't pricing in much risk. In our view, this is justified as risks to non-distressed countries should be contained over the medium term, even with higher borrowing costs and weaker expected growth.

With index-level yields near 8%[11], EM credit as an asset class remains attractive. The longer duration characteristics of EM credit could provide additional upside to returns in 2024 if rates move lower as we expect.

We favour positions in local market rates that benefit from rate cuts in countries with restrictive policy levels and improving inflation. With the Fed on pause for now, EM policymakers should have more room to lower their policy rates. Patience and flexibility will be important in the quarters ahead. More dispersion across the market should unlock more opportunities for country and credit selection.

Emerging market bonds total returns



Source: Bloomberg; for the periods 29 September 2023 to 29 December 2023 and 30 December 2022 to 29 December 2023. Based on data for the following indices: J.P. Morgan EMBI Broad Diversified IG index, the J.P. Morgan EMBI Broad Diversified HY index, the J.P. Morgan CEMBI broad Diversified Composite index, the J.P. Morgan GBI-EM Global Diversified Unhedged index and the J.P. Morgan GBI-EM Global Diversified FX index.

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Performance is provided on a total return basis, in the base currency.

Structured products

Asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) lagged other credit sectors in the fourth quarter.

In CMBS, higher interest rates have increased financing costs, lowered transaction volumes and placed downward pressure on property prices. CMBS delinquency rates trended higher in the fourth quarter, with the office sector being the most impacted in 2023. Financial institutions have been hesitant to lend to the sector because of lower leasing demand, which is primarily due to the rise in hybrid work environments.

ABS valuations, relative to 1- to 5-year investment-grade corporate bonds, have become more attractive, particularly for lower-duration portfolios. Going forward, CMBS should remain cheap due to concerns over property valuations and loan extension activity.

US consumers appear to be financially healthy from a credit perspective, suggesting a relatively robust ability to service monthly debt obligations. This bodes well for ABS. That said, we have seen a more pronounced weakening in the lower credit-quality consumer cohort, making higher-rated securities backed by quality collateral a better bet, in our view.

In CMBS, we're cautious, but it's important to not paint the entire sector with a broad brush. Many property types outside of the office sector continue to perform well. For example, multi-family and industrial properties are experiencing record-low delinquency rates.

Implications for Vanguard funds

- Relative to longer-run averages, we have a more modest exposure to credit risk. We see a better risk/reward tradeoff in investment-grade corporate bonds with a focus on earnings quality.
- High-yield and EM bonds offer attractive security selection opportunities. Selective EM local interest rates can add value.
- We are keeping our overall CMBS exposure low, with room to add as opportunities arise.

10. Source: Vanguard and Bloomberg.
11. Source: Based on the total returns of the J.P. Morgan Global EMBI Diversified Index, as at 29 December 2023.

Who we are

FIXED INCOME GROUP

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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.

Data as at 31 December 2023.

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.

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.

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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