OCTOBER 2024

Active Fixed Income Perspectives Q4 2024: Temperature check

Key takeaways

Performance

Bond markets soared in the third quarter, with US bonds posting a near-record quarterly return of 5.20% - the second-highest since 1996[1]. Higher expectations for an aggressive start to the US Federal Reserve's (Fed's) interest rate-cutting cycle drove yields lower and boosted bond results. Rates for US Treasuries maturing in two years or longer have moved up since mid-September, pressuring recent returns.

Looking ahead

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

Approach

With strong growth and a proactive Fed, the risk of a US recession next year remains low – a sentiment that is reflected in market prices. We favour credit but are wary of high valuations and potential downside risk.

[1] Source: Bloomberg and Vanguard. US bond return figure based on the Bloomberg US Aggregate Index, for the period 30 June 2024 to 30 September 2024.

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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" - someone who can't wait for the right temperature to set in. It was a metaphor comparing the delays in hot and cold water working through home plumbing to the long and variable lags in monetary policy.

Now, 64 years later, the availability and range of leading economic indicators guiding Fed policy is much improved. For example, geolocation data from our mobile phones now track customer foot traffic in shopping malls and stores, allowing the market to spot trends early.

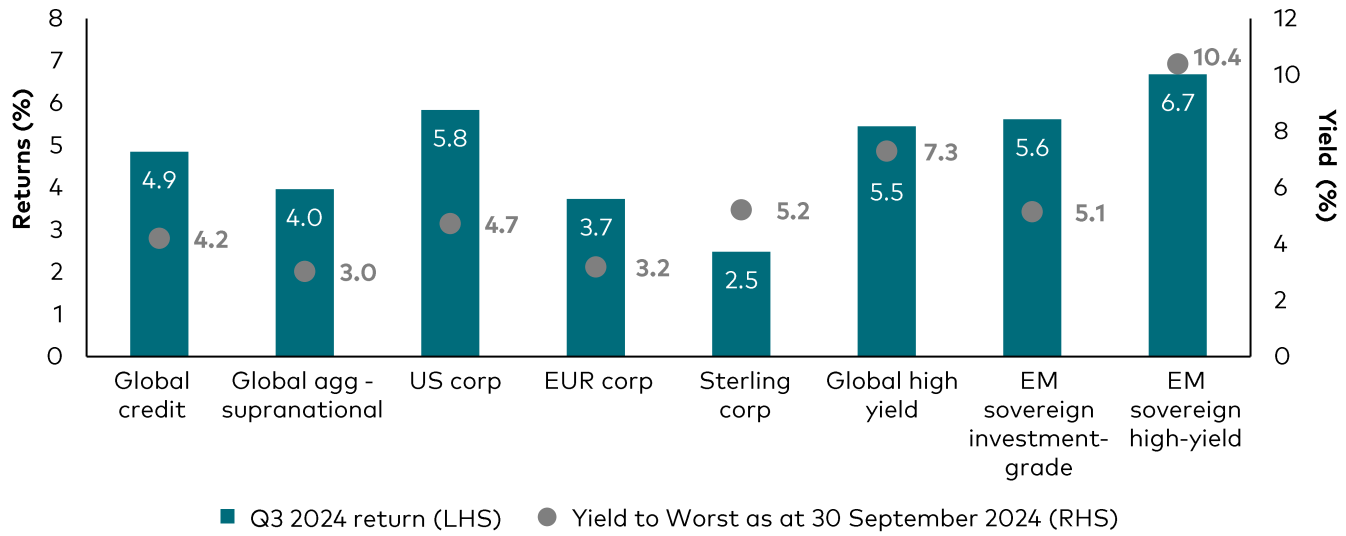
But even the most current data can't provide perfect foresight. With the global interest-rate cutting cycle underway, market prices reflect a belief that central banks will be able to normalise policy without economic cost. While the probability of this occurring has meaningfully improved, history suggests that the path to success is difficult.

Temperature check

Historically, starting yields have consistently been reliable indicators of long-term 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 to expected inflation. Moreover, current 10-year real yields (10-year nominal yields less expected inflation) sit well above the levels observed throughout most of the post-global 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.

Fixed income sector returns and yields



Sources: Bloomberg indices and the J.P. Morgan EMBI Global Diversified Index. Q3 2024 return data from 30 June 2024 to 30 September 2024. **Past performance is no guarantee of future returns. Performance is provided on a total return basis, in the base currency of the index, or for global indices, USD hedged.**

Economy, policy and markets

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

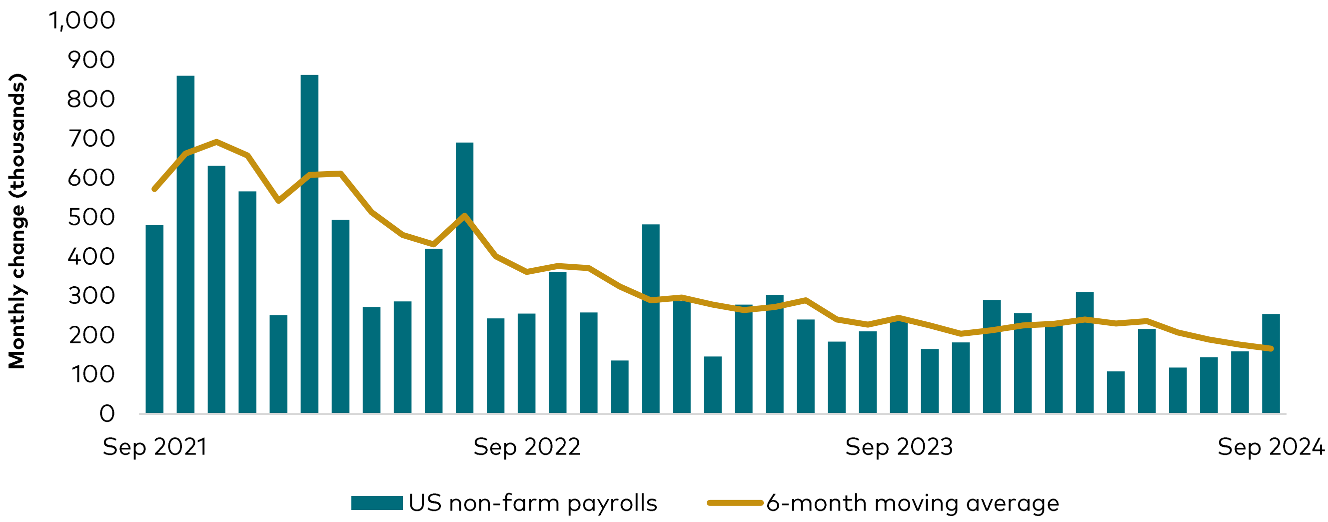
The Fed's decision to lower rates by 50 basis points (bps) signals a proactive approach to better align monetary policy in the US with recent inflation and labour market trends. In our view, more Fed easing this year lowers the probability of a recession next year, but the overwhelmingly positive September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

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

With a roughly 4% unemployment rate in the US and annualised wage growth holding at 4%, markets are rationally re-pricing their expectations for Fed cuts in 2024. We maintain our view of a 25 bps cut in November and a 25 bps cut in December, predicated more on the Fed looking to normalise policy rather than feeling an urgency to "save the labour 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.

US monthly non-farm payrolls are slowing but not collapsing



Notes: The chart shows the monthly change in US non-farm payrolls on a seasonally-adjusted basis. Data period from 30 September 2021 to 30 September 2024. Source: Bloomberg, with Vanguard calculations.

Portfolio positioning and strategy

Our central scenario remains that the US economy will slow to below-trend growth but avoid recession. We expect the US Treasury yield curve to revert towards its typical upward-sloping shape. In early September, the difference between the 10-year and 2-year yields turned positive again for the first time since July 2022. By the start of the fourth quarter, yields were pricing in approximately 140 bps of additional rate cuts over the next 12 months.

As has been the case all year, rates markets have been volatile while credit markets have been steadier. Fixed income credit has performed well, with spreads across most sectors staying range-bound around what we consider rich levels. Credit markets have been buoyed by strong underlying corporate fundamentals, and investors have viewed any spread widening as a buying opportunity.

Our portfolios are positioned to make the most of opportunities across credit sectors, but we're more selective about lower-quality issuers that are more sensitive 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.

US Treasury yields on path to normalisation

Notes: Graph shows the spread between the average monthly 10-year US Treasury yields and the 2-year US Treasury yields. Source: Bloomberg. For the period from 30 September 2004 to 30 September 2024.

Rates

US duration and yield curve

Near term, we don't see a strategic trade opportunity on the direction of US rates or the shape of the US Treasury yield curve. Yields are reasonably priced given current US economic conditions and the expectation that the Fed will continue to cut rates. US Treasury yields could face either a backup on additional strong economic data or a significant rally on weaker data. If 10-year US Treasury yields were to rise towards 4.25%, we are biased to lengthen duration to hedge against the slowing in economic activity we anticipate next year.

Outside the US

In Europe, we're long euro rates versus US rates. This is because a weaker European growth outlook should result in the European Central Bank (ECB) delivering a faster pace of easing relative to the Fed, which the market has not yet priced in. We continue to believe that quantitative tightening and further rate hikes by the Bank of Japan (BoJ) will push the Japanese government bond (JGB) yield curve higher and flatter. We remain short JGBs and are positioned for flattening.

Credit

The Fed's strong start to the easing cycle and robust flows into bonds have provided additional support to spread sectors. Higher-rated credit performance has been driven by the decline in interest rates while lower-quality credit has benefitted from higher starting yields and tighter spread levels. The single biggest risk to credit performance is the possibility of a US recession, but sustained evidence of a soft-landing outcome could push tight spreads even tighter.

Within investment-grade credit, we continue to see value in European investment-grade bonds over US investment-grade bonds, given their wider spreads relative to historical levels. We remain constructive on higher-quality credit, but we're more valuation-conscious across lower-quality segments with narrow spreads. However, greater price dispersion across lower-quality segments offers attractive security selection opportunities, but not enough yield pickup for large allocations.

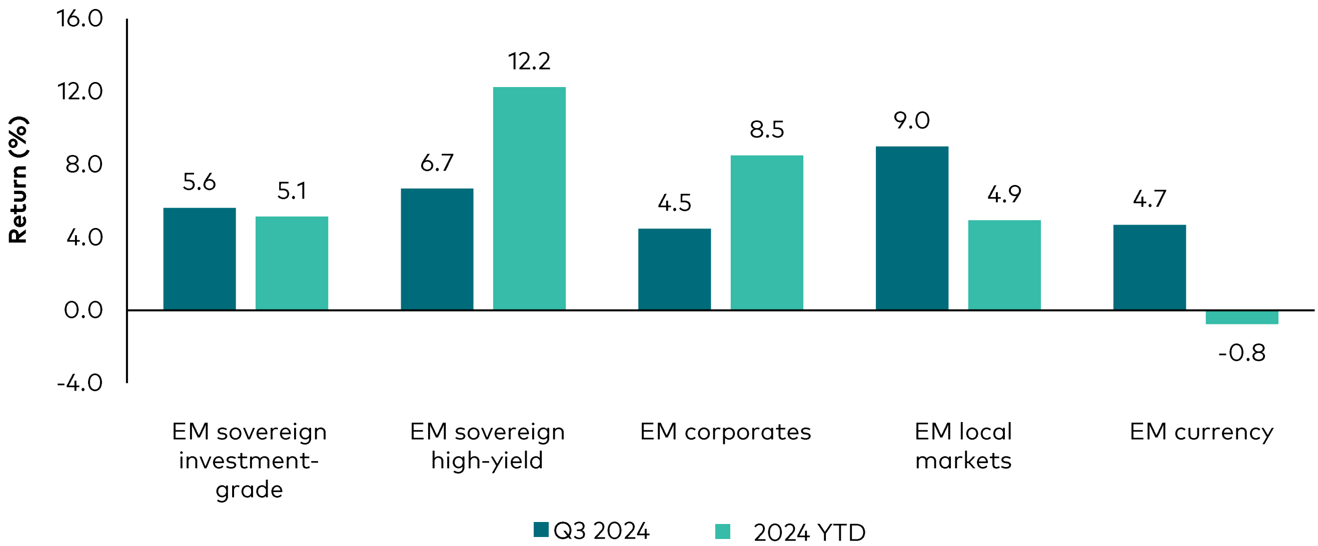
Emerging markets

Historically, the start of a global monetary policy easing cycle has been a period of outperformance for emerging market (EM) fixed income. The asset class can look attractive when policymakers are cutting rates, due to its longer duration and relatively wide spreads compared with other credit sectors. The third quarter of 2024 delivered exactly that, with EM debt posting strong total returns.

Inflows into EM fixed income in the third quarter were supported by the Fed's policy cut and more positive US economic data, which allayed concerns of an imminent recession and boosted the risk appetite of investors, as they sought to lock in EM's higher yields than those available in developed markets. Within EM, local currency bonds performed strongly as investors anticipated EM central banks accelerating policy easing following the cut by the Fed.

We continue to be selective in EM and remain cognisant of correlated and concentrated exposures to risk factors such as oil prices.

Emerging market bonds total returns



Source: Bloomberg. Q3 2024 data from 30 June 2024 to 30 September 2024; 2024 YTD data from 31 December 2023 to 30 September 2024. 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. **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.**

Spotlight: New EM restructured sovereign bond opportunities

A new set of restructured EM sovereign bonds has been attracting quite a bit of attention from active fixed income managers lately, due to their promising returns and innovative features. The new instruments, issued by countries like Zambia, Sri Lanka and Ghana, include potential additional payouts tied to the sovereign's financial performance which, if achieved, could boost returns for investors seeking differentiated sources of alpha.

Since the start of 2024, four EM sovereign issuers have completed restructurings, with impressive results. The new Zambian bonds, for example, have posted returns of 24% so far this year. Yet the complexities of the new restructured instruments requires the experience of an active EM manager with the right risk-managed approach. To find out more, read our full article on distressed EM sovereign bond opportunities.

Summary: Our views and strategy

	Exposure	View	Strategy
Rates	**US duration and yield curve**	• 10-year US Treasury yields close to fair-value for soft landing scenario. Higher yields towards 4.25% would provide the opportunity to add duration. • Yields have room to decline substantially if recession probabilities rise.	• Neutral duration. Focused on tactical trading opportunities where markets dislocate from our outlook. • Would look to add duration in a yield backup.
	Global duration and yield curve	• In Europe, we think deeper cuts may be necessary for the ECB and see the Bank of England lagging other developed central banks. • In Japan, BoJ policy normalisation is likely to push the JGB yield curve higher and flatter.	• Short 10-year US and UK government bonds versus 10-year German Bunds. • Selective exposure to peripheral European government bonds. • Underweight JGBs and in yield curve flatteners.
Credit	**Investment-grade corporates**	• Spreads remain well supported by strong investor demand and lower supply through to year end. • Expensive valuations are justified given the strength of the economy and corporate balance sheet health.	• Front-end bonds offer more attractive valuations. • By credit quality, we see more opportunities in BBBs. By sector, we like banks and utilities. • We 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 favourable. • We see more opportunities in stressed and distressed issuers but remain highly selective.	• We hold a lower-than-average allocation to the sector. • Our focus is on bottom-up security selection as dispersion across issuers remains high.
	Emerging markets	• We added exposure when spreads widened in August. • New issuance through to 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.

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

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.

Reference in this document to specific securities should not be construed as a recommendation to buy or sell these securities, but is included for the purposes of illustration only.

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