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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Contents

Keeping soft landing hopes alive 2

Economy, policy, and markets 3

Portfolio positioning and strategy 4

Current positioning in taxable portfolios 6

Distressed emerging markets sovereigns offer compelling new opportunities 7

Municipals 8

Current positioning in tax-exempt portfolios 10

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

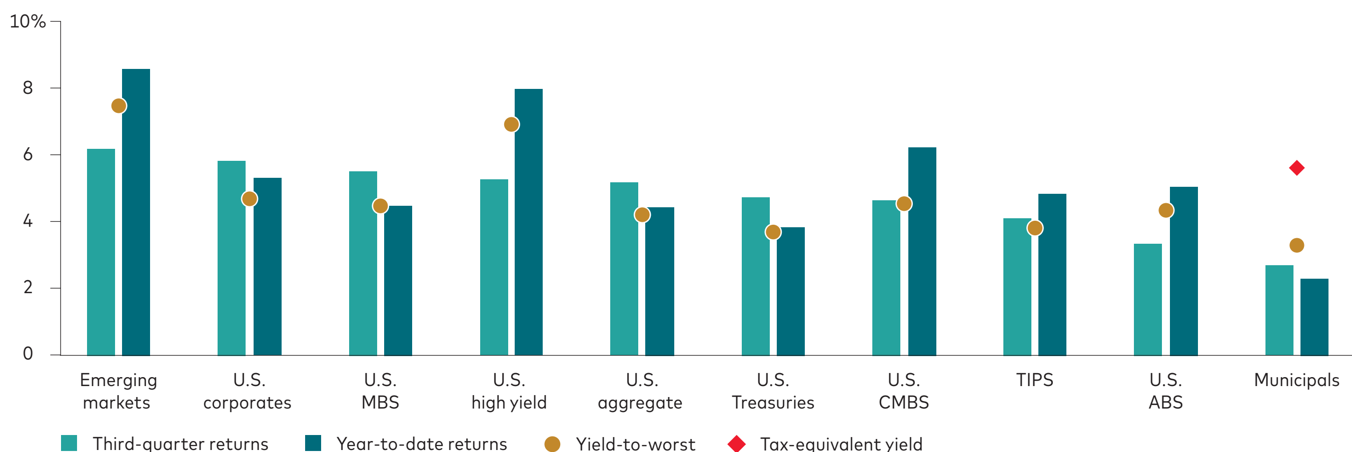
Over the long term, starting yields have consistently been reliable indicators of fixed income returns, and disciplined active management can enhance these returns. While average yields have fallen from peak levels, they remain attractive relative to recent history and expected inflation. Moreover, the 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.

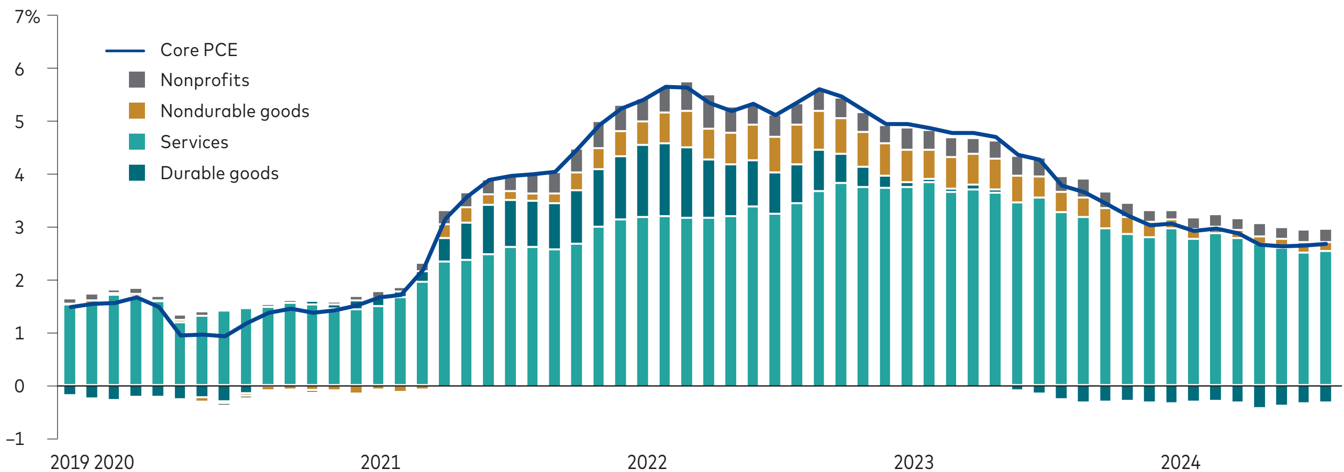
The Fed's decision to lower rates by 50 basis points signals a proactive approach to better align monetary policy with recent inflation and labor market trends. In our view, more Fed easing this year lowers the probability of a recession next year, but the overwhelmingly positive September payrolls data 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.

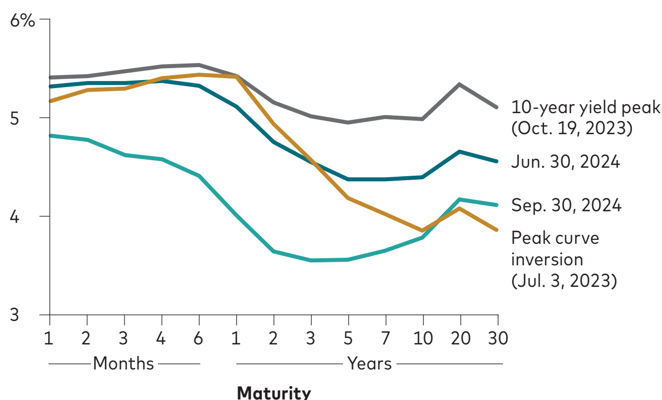
Portfolio positioning and strategy

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

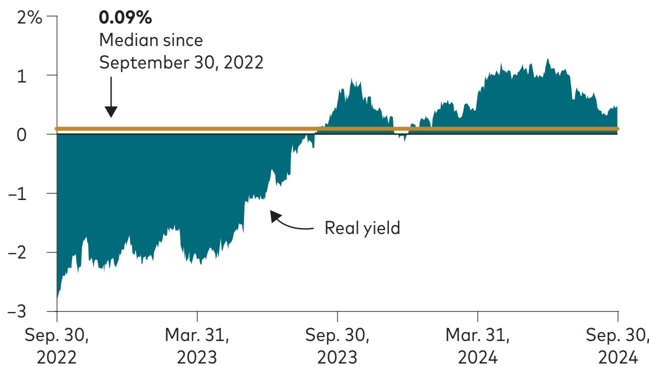
Duration and Curve: With Treasury yields back up near 4%, we see more room for rates to rally than to sell-off further over the medium term. If recession fears re-emerge on weaker data, it's possible for rates to plunge below 3%. Signs of economic strength could push yields higher, but current coupon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

Municipals

We are optimistic about municipal market returns for a combination of fundamental and technical reasons.

- **Fundamentals:** State and local balance sheets are still strong due to pandemic stimulus, even after tax revenues normalized following banner years. Therefore, we expect municipals to offer ballast and to rally against equity declines if a recession occurs.
- **Technicals:** Inflows are also expected to offer support, especially in middle-rated credits where spreads still offer room for further compression.

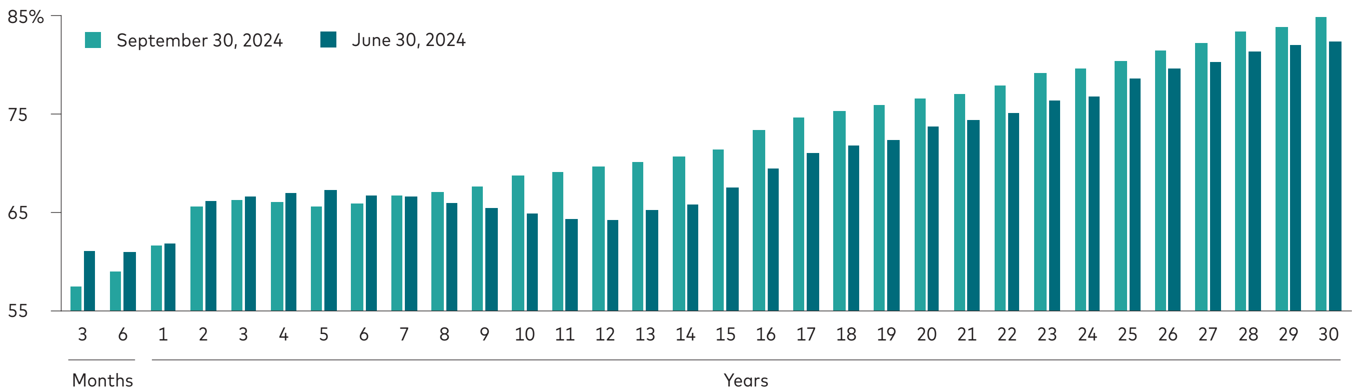
Security selection expertise is needed to sift through challenged sectors like hospitals, retirement communities, and higher education. Yield volatility—as the market continues to find its footing through the easing cycle—will offer our advanced analytics the opportunities to add value through coupon and call selection.

Cheapening out long

If there is a segment of the fixed income markets with "juice" left for additional gains following September's Fed policy move, it could be municipal bonds. The tax-exempt fixed income sector has not kept pace with the rally in taxable sectors.

Why have municipals lagged? Yield ratios reveal that municipals have been cheapening on the long end of the curve. Record tax-exempt issuance is likely contributing to such valuations. Meanwhile, on the short end, individual bond-buying and separately managed accounts (SMAs) are keeping muni bond yields anchored lower, making them appear quite rich relative to Treasury bills.

AAA Municipal/Treasury yield ratios cheapened out long



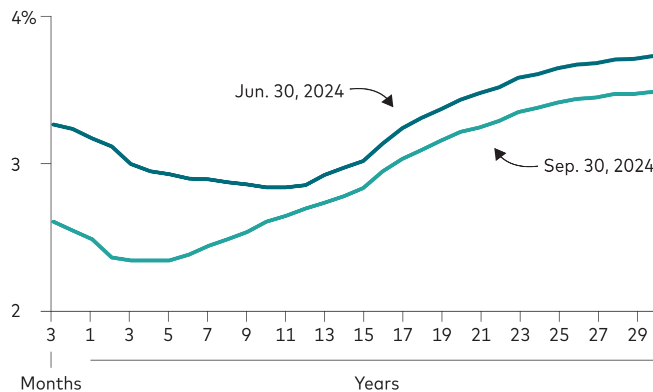
Source: Bloomberg, as of September 30, 2024.

Forget "U"

One of the more interesting muni-market phenomena over the past year has been the peculiar "U" shape of the AAA municipal curve, reflecting near-term expectations for policy cuts but also typical declining demand for paper moving into the far end of the curve. The combination of cheaper valuations on the long end and the Fed's 50-basis-point rate cut in September has left markets with a more normal upward-sloping curve. This shift is likely to persist if the Fed continues to cut.

With short-term yields moving lower and the greater potential for returns out long, high earners who have remained in cash may start to move out along the curve. Over the last year, cash holders held an average daily yield of 3.47%, as measured by the SIFMA swap index yield, distinctly underperforming investments with longer average maturities, as the Bloomberg Municipal Index returned 10.37%. Such motivations will only intensify as cash yields continue their decline without much potential for capital appreciation.

Yield curve for AAA rated municipals



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

Some municipal investors have taken a head start—muni fund and ETF flows have been positive for 12 consecutive weeks, with long-term and high-yield strategies benefiting the most, according to Morningstar. Intermediate-term and state-focused funds (especially those focusing on California and Massachusetts) have likewise garnered increasing interest. While outflows persist in short-term municipal strategies, our research shows that trend could reverse course within the next few steps of this Fed easing cycle.

We've mentioned here before, but it's certainly worth repeating, municipal fund cashflows are key to our expectations for the tax-exempt market. Munis still have room for spreads to continue driving positive returns that reflect their underlying strong fundamentals. With funds being the primary buyers of municipal credit (that is, single-A rated and below), a regime of consistent inflows could materially compress spreads.

Tax talk

The expiration of the Tax Cuts and Jobs Act of 2017 at the end of the 2025 tax year has been a central focus for municipal bond investors. Elements of individual tax rates, such as alternative minimum tax, state and local tax (known as SALT) write-offs, etc., will be subject to change through this election cycle. However, there will likely be only marginal impact on municipal bond valuations. Even if tax rates shift, the wealthiest investors will still benefit from municipal bonds as a core allocation in their portfolios.

Investors in lower brackets, on the fringe between choosing taxable or tax-exempt bonds, are unlikely to make a meaningful impact on overall demand. As a result, investors should allocate in municipal or taxable markets according to their long-term strategies rather than wait for election results, much less actual policy changes.

Current positioning in tax-exempt portfolios

	Exposure	View	Strategy
Munis	Credit allocation	• With outflows from short-term funds and demand for longer funds, spreads over AAA rated municipals are most attractive on the short end of the curve. • A technically supportive environment of municipal fund inflows favors an overweight to credit overall.	• Maintain exposure in sectors like housing and prepaid gas. • Selectively add exposure in sectors with negative headlines (for example, universities). • Primary markets are screening rich, so utilize more secondary markets. • Heavy focus on valuations in conditions where many investors are simply attempting to maximize yield.
	Structure	• A historically diverse range of coupons and higher yields places convexity management as a top priority for risk management and alpha opportunity.	• Look to trade out of par issues in favor of premium callable bonds.
	Duration/curve	• Without any clear dislocation of municipal yields, look to primarily use duration as a credit hedge. • Valuations in higher-rated bonds are historically rich up to 10-year maturities due to SMA buying.	• Overweight duration proportionate to risk contribution from credit exposure. • Barbell curve positioning, with heavier exposures in cash and 12-15-year bonds to take advantage of rolldown effects into SMA demand.

Vanguard active bond funds and ETFs

Vanguard active bond funds and ETFs		Ticker symbol	Expense ratio*
Treasury/ Agency	GNMA†	VFIJX	0.11%
	Inflation-Protected Securities	VIPIX	0.07
	Intermediate-Term Treasury	VFIUX	0.10
	Long-Term Treasury	VUSUX	0.10
	Short-Term Federal	VSGDX	0.10
	Short-Term Treasury	VFIRX	0.10
Investment-grade corporate	Core Bond	VCOBX	0.10%
	Core Bond ETF	VCRB	0.10
	Core-Plus Bond	VCPAX	0.20
	Core-Plus Bond ETF	VPLS	0.20
	Intermediate-Term Investment-Grade	VFIDX	0.10
	Long-Term Investment-Grade†	VWETX	0.11
	Multi-Sector Income Bond	VMSAX	0.30
	Short-Term Investment-Grade	VFSIX	0.07
	Ultra-Short-Term Bond	VUSFX	0.10
	Ultra-Short Bond ETF	VUSB	0.10
Below-investment-grade	High-Yield Corporate†	VWEAX	0.12%
Global/ international	Emerging Markets Bond	VEGBX	0.40%
	Global Credit Bond	VGCAX	0.25

Vanguard active municipal bond funds			
National municipal	Ultra-Short-Term Tax-Exempt	VWSUX	0.09%
	Limited-Term Tax-Exempt	VMLUX	0.09
	Intermediate-Term Tax-Exempt	VWIUX	0.09
	Long-Term Tax-Exempt	VWLUX	0.09
	High-Yield Tax-Exempt	VWALX	0.09
State municipal	California Intermediate-Term Tax-Exempt	VCADX	0.09%
	California Long-Term Tax-Exempt	VCLAX	0.09
	Massachusetts Tax-Exempt‡	VMATX	0.13
	New Jersey Long-Term Tax-Exempt	VNJUX	0.09
	New York Long-Term Tax-Exempt	VNYUX	0.09
	Ohio Long-Term Tax-Exempt‡	VOHIX	0.13
	Pennsylvania Long-Term Tax-Exempt	VPALX	0.09

* As reported in each fund's prospectus. A fund's current expense ratio may be higher or lower than the figure shown.
† Investment advisor: Wellington Management Company LLP.
‡ Investor Shares available only. There is no minimum investment required for advised clients.
Note: Data as of September 30, 2024.

Active fixed income leadership team

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Global Head of Credit
In industry since 1990

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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

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

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Vanguard ETF Shares are not redeemable with the issuing Fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

Past performance is no guarantee of future results. All investing is subject to risk, including possible loss of principal. Diversification does not ensure a profit or protect against a loss.

Bonds of companies based in emerging markets are subject to national and regional political and economic risks and to the risk of currency fluctuations. These risks are especially high in emerging markets.

High-yield bonds generally have medium- and lower-range credit-quality ratings and are therefore subject to a higher level of credit risk than bonds with higher credit-quality ratings. U.S. government backing of Treasury or agency securities applies only to the underlying securities and does not prevent share price fluctuations. Unlike stocks and bonds, U.S. Treasury bills are guaranteed as to the timely payment of principal and interest.

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.

Investments in bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk.

Although the income from a municipal bond fund is exempt from federal tax, you may owe taxes on any capital gains realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal Alternative Minimum Tax.

Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

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