Vanguard®

Q1 2023

Active fixed income perspectives

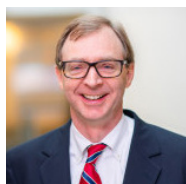
Key takeaways

Performance: Tighter credit spreads and higher coupon payments helped generate positive fourth-quarter returns amid an otherwise historically bad year for bonds, during which virtually all fixed income sectors delivered negative returns.

Looking ahead: The outlook for 2023 is much brighter. We still see a bumpy road ahead, but investors can lock in higher yields that haven't been seen in years. More stability in interest rates and clarity on monetary policy should bring flows back into fixed income.

Approach: Credit spreads have room to widen, but higher yields will provide more cushion. Valuations warrant a more defensive positioning focused on higher-quality securities. We believe that 2023 could offer an opportune time to add risk.

Authors



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The other side of the storm

Last year's fixed income market was hit by the brunt of a storm. Low interest rates during the first half of the year, surprisingly high inflation and a coordinated hiking campaign by most developed market central banks led to historic bond market losses.

After 2022's bond market rout, we believe we are now past the worst of the storm. There are undoubtedly further challenges ahead: Though rates may not go much higher, a recession is looming, inflation remains high, credit spreads are tight and many core developed market economies face fiscal challenges. As a result, we believe that volatility is likely to remain heightened for the foreseeable future. However, higher yields mean bond investors have a larger buffer to weather any additional volatility and market shocks.

Opportunity ahead

Just as in a game of football, where it doesn't always pay to constantly press the opposition and leave yourself open to counterattack, in fixed income investing, it's often wise not to keep adding risk all the time. Sometimes it's best to bide your time and strike on the break when the opportunity rises.

While we expect more volatility this year, we see greater opportunity ahead for active management to add value. Active sector, relative value and security selection decisions should carry more weight in a market that's not overwhelmed by macroeconomic forces or—as was especially the case following the global financial crisis—dominated by unorthodox central bank policy. Bond investors are more likely to be paid for adding risk in this environment.

Attractive yields can now be found across most fixed income segments, with some of the best value in higher-quality bonds that should hold up well even if economic conditions weaken further. With yields more attractive, it's also an opportune moment for investors to think about the long term and lock in higher rates in their portfolios.

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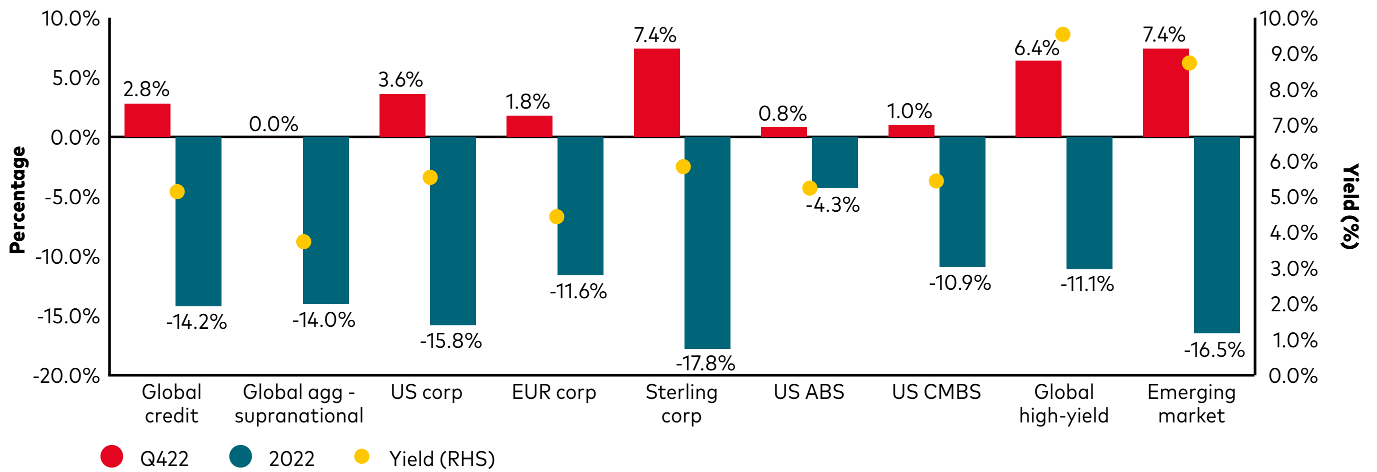
Fixed income sector returns



Sources: Bloomberg indices and J.P. Morgan EMBI Global Diversified Index. Data from 31 December 2021 to 30 December 2022.
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.

Rates and inflation

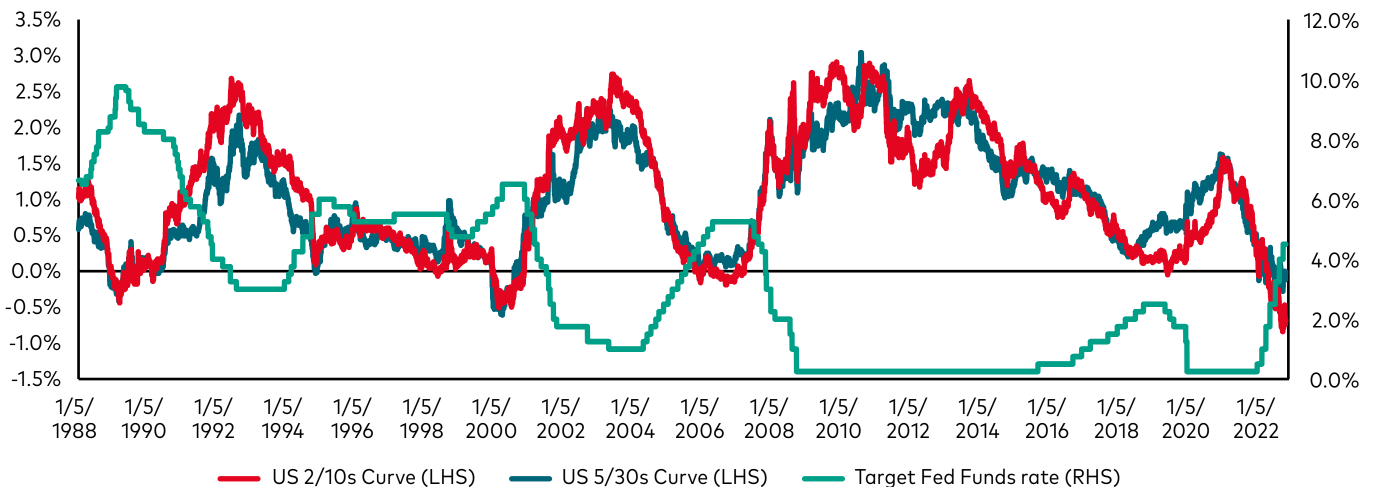
The US: brighter outlook for Treasuries
Market-priced expectations for interest rates have moved closer to the US Federal Reserve's (Fed's) forecasted terminal rate of 5.1%, but the market continues to anticipate a pivot to interest rate cuts by mid-year. For now, market participants either predict a faster deceleration in inflation than the Fed expects or they question officials' resolve to keep interest rates in restrictive territory for long periods.

We think that price pressures are likely to take longer to correct across markets than the market currently anticipates. Even after reviewing new inflation data released in early January, we project that the Fed will hike interest rates by 50 basis points in February, and by another 25 basis points in March. That leads us to a terminal rate range of 5.00 - 5.25%, and we expect the Fed will hold rates there until at least the end of the year.

The outlook for the US Treasury market has become much brighter. Higher yields provide a stronger starting point for investors, although there could be upward pressure on longer-maturity yields if the Fed does follow through on its 'higher-for-longer' rhetoric.

Historically, the yield curve starts to steepen several months before the last hike of a Fed tightening cycle, which we believe will be in the first half of 2023. Add in global influences—particular relating to potentially stalling economic growth—and the outcome will likely be a steeper US Treasury curve offering more term premium[1]. As we approach the end of the hiking cycle, we are positioned to benefit from such a change in yield curve shape. As the chart shows, curve steepness measures typically start to tick upwards shortly before hiking cycles end.

The curve usually steepens before rate hikes end



Source: Bloomberg, data from 5 January 1988 to 6 January 2023. The US 2s/10s curve measures the 10-year US Treasury yield minus the 2-year US Treasury yield. The US 5s/30s curve measures the 30-year US Treasury yield minus the 5-year US Treasury yield.

1. The term premium is the difference between the yield on a long-term bond and the yield on shorter-term bonds.

Japanese savers stay close to home

Japan's interest rate decisions are important because Japan is the largest holder of US Treasuries. But because the cost of currency hedging had become prohibitive to Japanese investors, the Japanese had begun reducing their US Treasury holdings after July.

Higher JGB yields and a stable (and potentially stronger) yen make JGBs even more attractive to domestic Japanese investors, likely further reducing Japanese demand for foreign fixed income assets, including Treasuries. Japanese households—who have long sent their savings overseas in search of yield—may now be more likely to invest domestically.

Other core markets: ECB hike expected
The European Central Bank (ECB) is widely expected to hike interest rates by a full percentage point and begin a quantitative tightening programme in March, dramatic changes for a policymaker previously known for its dovishness.

The significant increase in euro zone and UK government bond supply as funding needs rise is likely to dramatically change the supply and demand dynamics in those markets. We believe this could place upward pressure on European and—as a knock-on effect—US Treasury yields.

More significant is the policy pivot by the Bank of Japan (BoJ). BoJ Governor Haruhiko Kuroda surprised markets last month by increasing the cap on the 10-year Japanese government bond (JGB) yield to 0.50%. Overnight, yields on 10-year JGBs surged by the biggest margin in almost two decades, approaching the top of the new policy band, while the yen appreciated by more than 4% against the US dollar.

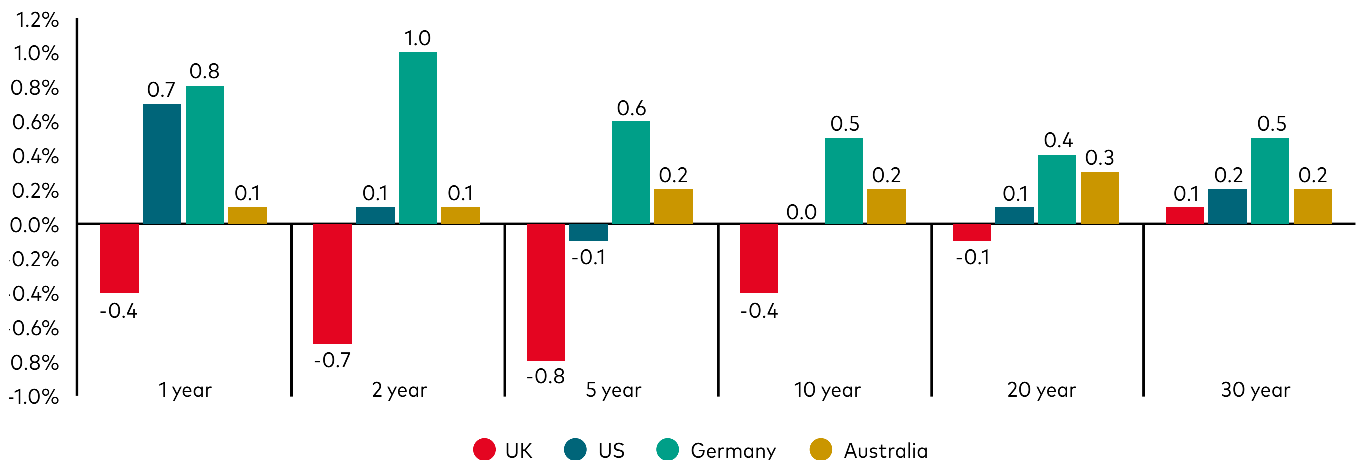
Like the market itself, we believe that the BoJ could abandon its yield curve control policy, which is likely to have implications throughout global fixed income markets.

Risks to the outlook

There are risks to the outlook for core government bonds. The path of US inflation remains uncertain, and there is a substantial chance that wages could remain high as employers seek to retain valued workers.

While this is not our base case, we could see the Fed, faced with continued wage inflation, being forced to raise its fed funds rate closer to 6%. While higher bond yields could help temper the pain of this eventuality, the market has not yet begun to price such a possibility, in our view.

Core government bond yields: Change in yield curves during fourth quarter



Source: Bloomberg, data from 30 September 2022 to 30 December 2022.
Past performance is not a reliable indicator of future returns.

Implications for Vanguard funds

- While the immediate path of inflation remains unclear, longer term we expect interest rate volatility to trend lower as the Fed slows and eventually stops raising interest rates.
- In Europe and the UK, supply and demand dynamics are likely to put upward pressure on yields.
- In Japan, we believe the BoJ could abandon its yield curve control policy, which is likely to have further implications throughout the global fixed income universe.
- We anticipate that developed market yield curves will flatten in the near term before steepening throughout the remainder of the year as volatility continues

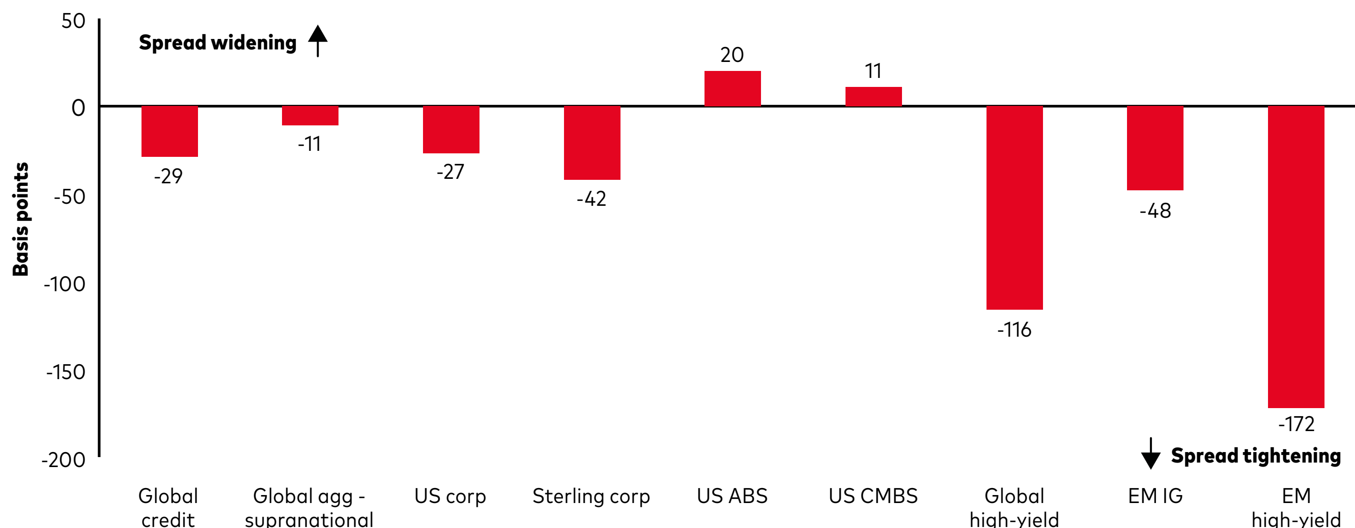
Credit markets

Credit markets enjoyed an end-of-year boost, fuelled by a slowdown in the Fed's pace of interest rate hikes. Scant new issuance, more attractive yields and a return of investor flows also contributed to the rally.

However, we expect the market to shift its attention away from interest rates and inflation concerns in the first half of this year towards the effects of a global recession on credit fundamentals and performance during the second half.

Credit sector spreads do not yet reflect the late-cycle conditions we are observing. We've steadily upgraded the credit quality mix across our portfolios and added liquidity to combat what we expect will be a challenging environment for risk assets. The range of possible outcomes is wide, but we believe 2023 will offer a lot of opportunities for sector and security selection.

Credit spreads broadly tightened over the quarter



Sources: Bloomberg indexes and J.P. Morgan EMBI Global Diversified Index, data from 30 September 2022 to 30 December 2022.
Note: 'EMIG' refers to 'Emerging Market Investment Grade'.

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

Yields on investment-grade corporate bonds appear compelling. However, from a credit spread perspective, we see too little compensation above risk-free government bonds given the late-cycle risks in the market.

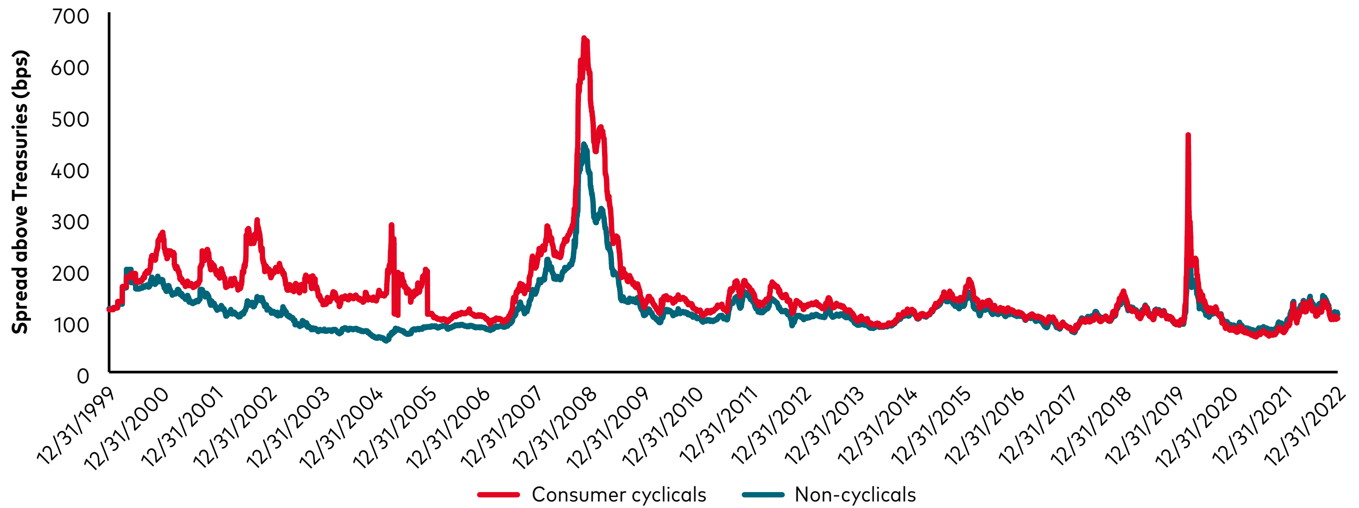
Spreads do have room to widen, but a renewed investor appetite for higher-quality bonds may put a ceiling on how wide they could drift. Particular investor focus is likely to centre on a flight to quality should a recession impact equity valuations.

Potential downgrades

Tighter financial conditions should crimp corporate finances broadly. Company upgrades from high-yield to investment-grade outpaced fallen angels (downgrades from investment-grade to high-yield) by a wide margin over the past two years; however, this year we expect more downgrades, concentrated in the lower-quality cyclical segments. The depth and duration of any market downturn would likely determine the impact, but we believe that most companies are well prepared for a 'normal' recession.

Within a more modest allocation to investment-grade credit, we see the best value in higher-quality investment-grade issuers , particularly those in financials, utilities and non-cyclical industries. Our preference for non-cyclical companies is based on their tendency to exhibit substantially better earnings resilience during economic downturns.

Investment-grade credit spreads: consumer cyclicals versus non-cyclicals



Source: Bloomberg Invest. Grade: Consumer Cyclical Statistics Index and Bloomberg Invest. Grade: Consumer Noncyclical Statistics Index. Data from 31 December 1999 to 10 January 2023.

Past performance is not a reliable indicator of future returns.

High-yield corporates

High-yield credit spreads, constrained by a lack of new supply, have held steady within a range that we see as fair to expensive. Higher borrowing costs and elevated market volatility kept many issuers away last year, pushing issuance to the lowest level since 2008.

Meanwhile, investors began to move back into high-yield bonds at the end of last year, which helped push spreads even tighter. In our view, the full scope of the economic slowdown is not currently reflected in high-yield credit spreads.

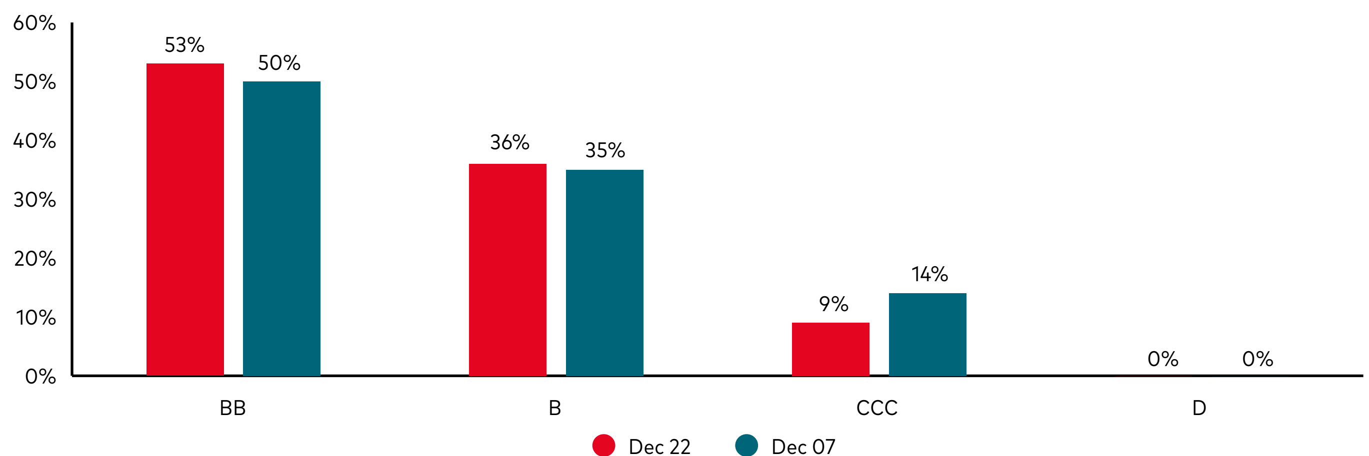
BB-rated credit

Overall credit quality in high-yield is much higher than it was a decade ago. Half of all below-investment-grade bonds are now rated BB, and only about 10% are rated CCC.

Corporate fundamentals are weakening, but they started from a strong base. Many issuers took advantage of the low-yield environment of the last few years to shore up funding needs, leaving little need for market access this year.

High-yield credit quality has improved since the global financial crisis

Global high-yield quality breakdown



Source: Bloomberg Global High Yield Index. Data as at 31 December 2022.

Default rates likely to stay low

We expect default rates to continue trending higher, but do not see a strong case for them to significantly exceed their historical average of 3%. One area of concern we'll continue to watch is the lower-quality segment of the bank loan market where 'loan-only' issuers are beginning to show signs of stress.

While we remain cautious, we see plenty of constructive opportunities to add risk ahead. Performance dispersion has increased as many investors have become more focused on differentiating between industries and issuers. More than 60% of the high-yield market trades at a price below $90, which provides a good entry point and cushion against further price declines[2].

European credit

European investment-grade credit underperformed the US market in 2022 owing to the impact of the war in Ukraine and the resulting gas crisis, as well as the conclusion of the ECB's corporate bond buying programme. We now see opportunities driven by bottom-up security selection created by the high level of issuer dislocation.

Amongst banks, elevated issuance is likely to continue, which could represent an opportunity as the sector is supported by higher interest rates. We also see attractive prices in names with lower cyclicality and strong capital levels. For example, European utilities currently possess high spread levels.

We anticipate that higher rates could persuade European insurance companies—which own $1.9 trillion of corporate bonds[3]—to tilt their portfolios more towards higher-quality, more liquid investment-grade corporate bonds as a recession develops.

Emerging markets

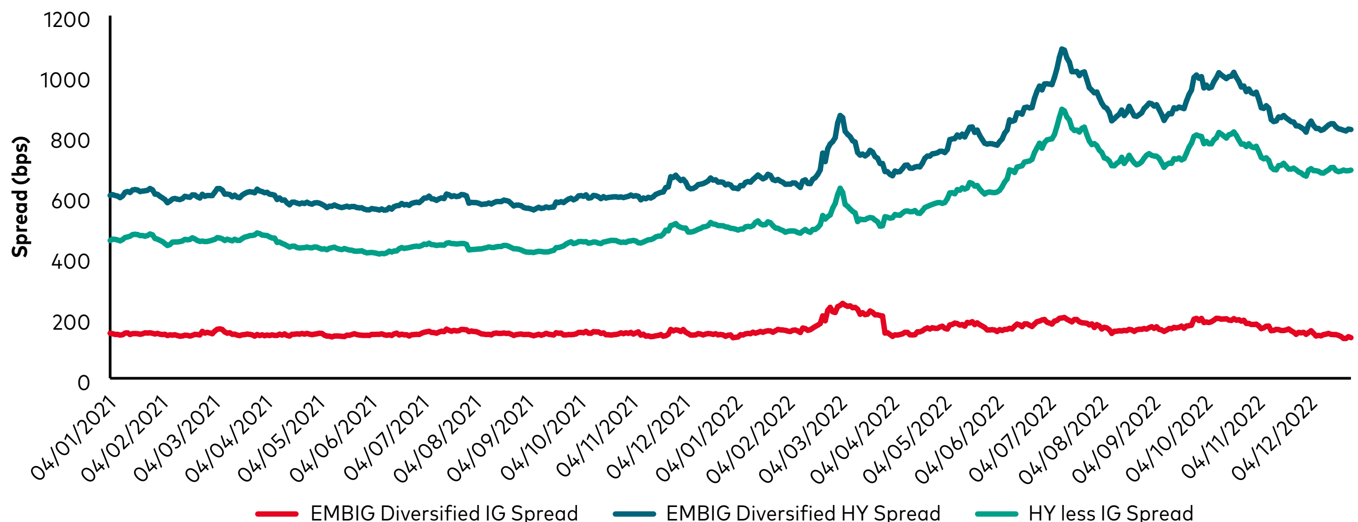
A stabilisation in US Treasury yields could be a catalyst for emerging market (EM) inflows. We've already seen this occur over the last few months during a period of light EM bond issuance, and historical data suggest an impending rebound. That should bolster the supply-demand picture for EM, as we expect another year of net negative supply.

Our more favorable view on the sector late last year reflected the 125-basis-point rally in spreads, but today we are less constructive with valuations no longer cheap.

We believe EM growth rates should improve relative to G7 countries going forward. Country fundamentals are broadly stable, though we expect significant credit differentiation as the global economy slows down in 2023. This is likely to create opportunities for relative value and active management.

Our preference for higher-quality EM bonds is balanced by the fact that spreads in investment-grade EM are very tight and additional borrowing is likely. The high-yield segment of EM, meanwhile, offers much more compelling valuations, but is also the most vulnerable to further economic disruption.

Emerging markets high-yield spreads remain wide



Source: J.P. Morgan EMBI Global Diversified Index investment-grade (IG) and high-yield (HY) spreads. Data from 4 January 2021 to 30 December 2022.

Past performance is not a reliable indicator of future returns.

2. Source: Bloomberg Global High Yield index as at 30 December 2022.
3. Source: Vanguard as at 30 December 2022.

We see 2023's market as one where the best strategy is to be defensive—but agile—with enough liquidity to act on new opportunities when they arise.

Implications for Vanguard funds

- Investment-grade corporate bonds are still broadly expensive. Within investment-grade, we prefer financials, utilities and non-cyclical industries.
- High-yield credit remains strong, but spreads are tight and many bonds may not offer adequate compensation for the risks to investors.
- EM bonds should be bolstered by a stabilisation in US Treasury yields, as well as by inflows and reduced supply.

Who we are

FIXED INCOME GROUP

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Vanguard Fixed Income Group manages $1.9 trillion globally in active and passive funds with a global team of more than 180 investment professionals.

Data as at 31 December 2022.

YEARS IN FIXED INCOME

35+ years

Vanguard's active fixed income team manages over $445 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

90+

Our investment teams are supported by our 50-plus member economic research team that informs our economic outlook and our 80-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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