Vanguard

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VANGUARD ACTIVE FIXED INCOME PERSPECTIVES

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Key points

Performance: Investors ratcheted credit spreads tighter over the past three months. Interest rates pulled back from recent highs and returns were positive but bond market yields reached historic lows.

Looking ahead: We are watching for signs of sustained inflation, including higher wages and a faster movement of asset flows. But demographics, technology and a flexible US Federal Reserve should ultimately keep inflation and interest rates under control.

Approach: We have reduced credit risk, collected excess return where we could and built in flexibility to speedily action promising investments as they arise. Broad-based opportunities targeting specific sectors, business models or credit quality have largely dissipated. Outperformance in the near term will likely come from security selection in idiosyncratic opportunities.

Where do we go from here?

For many advisers and market professionals, the question remains, where do we go from here? There have been enormous sums of money stacked up in the short end of the yield curve as many investors have been positioned to avoid the negative price impact of a large move higher in interest rates. Others have gone searching for yield in more obscure assets. We see neither of these, in the extreme, as the solution to a difficult market. Instead we prefer to be patiently opportunistic using a diversified set of strategies to add value.

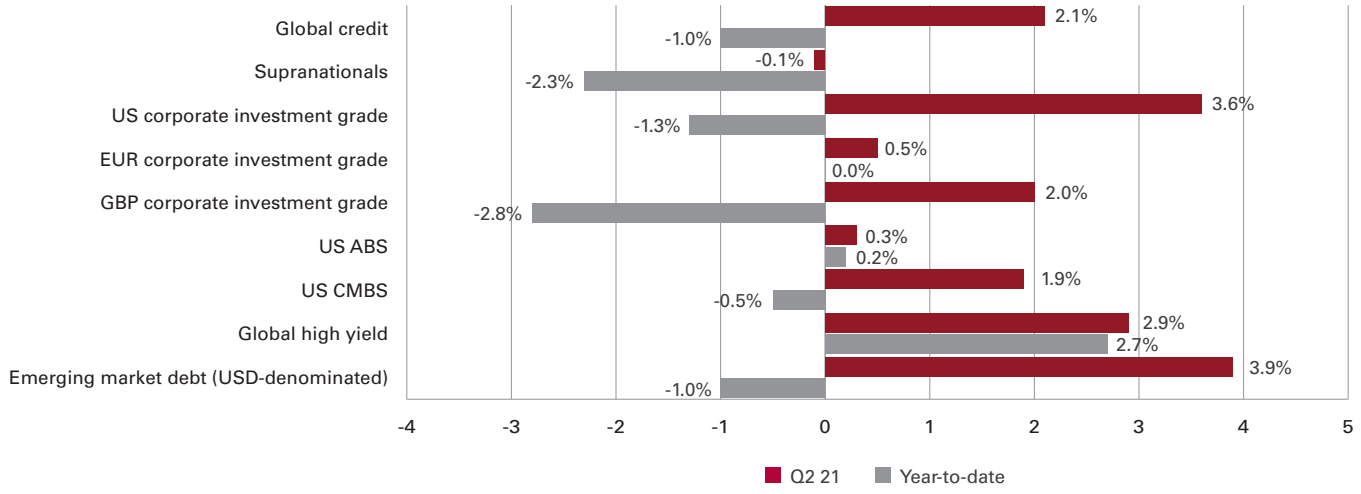
Bond prices rose in the second quarter as the US Federal Reserve (Fed) turned more hawkish. Investors reasoned that the Fed would keep inflation reined in, putting downward pressure on yields. Credit responded well and spreads continued to narrow. While inflation remains a significant risk, it is hard to envision a scenario in which it runs unchecked by the Fed.

Value in duration

Bond yields continue to be persistently low and credit spreads are at or near historically tight levels. Nonetheless, there are fundamental reasons for the prevailing bond prices and the market has factored in a steady path for rate rises.

Future returns may be more muted than in decades past but in the near term, fixed income assets should be able to generate positive returns with support from an improving global economy, accommodative fiscal and monetary policy and favourable supply and demand dynamics. There is value in owning some duration exposure (sensitivity to interest rates). As of 30 June, the US Treasury yield curve was steeper than it was a year ago, offering some term premium (compensation for lending for longer periods) in higher-quality fixed income sectors. Our team takes some solace in that as we await better circumstances.

Market sector returns



Sources: Bloomberg Barclays indices and J.P. Morgan EMBI Global Diversified Index for emerging market debt. The performance of the indices reflect the reinvestment of dividends but do not reflect the deduction of any fees or expenses which would have reduced total returns. Returns are USD hedged for consistency. Data as at 30 June 2021.

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.

Rates and inflation

The US Federal Open Market Committee (FOMC) surprised the market in June when it reacted more hawkishly to macroeconomic data releases. This effectively took the scenario of an inflation overshoot off the table. The market reacted accordingly, by bringing forward expectations of a rate hike and reducing term and inflation premia in the long end of the yield curve. In response, the yield curve flattened as the yield on the 10-year US Treasury fell below 1.3% in early July[1].

In addition, strong technical factors came into play that exacerbated the move lower in yields. Low summer supply was outstripped by bond-buying at the longer end of the yield curve by banks and international investors.

Rising rates over time

We view rates as relatively range-bound in the near term, with some room to move gradually higher as the economy continues to recover and the Fed tapers purchases. Elsewhere, the central banks of many developed economies are facing similar price pressures. In Europe, inflation is expected to fall back well below central bank targets and likely keep the European Central Bank's (ECB) monetary policy accommodative for an extended period.

The market had doubted the ability of the Fed to create inflation but we've seen that the Fed has the ability to be patient. We expect more detailed guidance from the Fed on the future tapering of asset purchases either at the Jackson Hole Economic Policy Symposium (in late August) or at the September FOMC meeting.

In Europe, growth has rebounded significantly on the back of improved roll-out of vaccination programmes and the easing of lockdown restrictions. Business and consumer confidence, as well as services Purchasing Managers' Indices (PMI), all continue to point to a strong recovery. The ECB has continued to target favourable financing conditions over the pandemic crisis period. Its main tool remains the pandemic emergency purchase programme (PEPP) of EUR 1,850bn to March 2022, and reinvestment of maturing principal to at least the end of 2023.

At the June meeting of the its Governing Council, the ECB decided to maintain a "significantly higher" pace of purchases under PEPP over the next quarter, despite upward revision to GDP growth in 2021 and 2022. We see the ECB seeking to balance the risk of a rise in sovereign yields prematurely tightening financing conditions with the accompanying risk to growth and inflation.

We do not envisage the ECB being willing to allow an abrupt increase in real interest rates, on the back of improving global growth prospects, to jeopardise the economic recovery. We expect it to maintain accommodative policy for the foreseeable future, with an open question on whether it will extend PEPP beyond March 2022 or increase the size of its Asset Purchase Programme (APP) instead. In terms of spreads, these have retraced to their tightest levels for 10 to 15 years, making valuations very unattractive[2].

In terms of positioning, we continue to see European bonds outperforming those from the US and UK over the medium term with the Fed and Bank of England (BoE) expected to tighten policy before the ECB. We expect the yields on European bonds to increase and curves to steepen as European economies reopen, European and global vaccination programmes improve and global growth picks up. The main risk to this outlook is the increasing spread of Covid-19 Delta variant cases.

[1] Source: Bloomberg as at 8 July 2021.

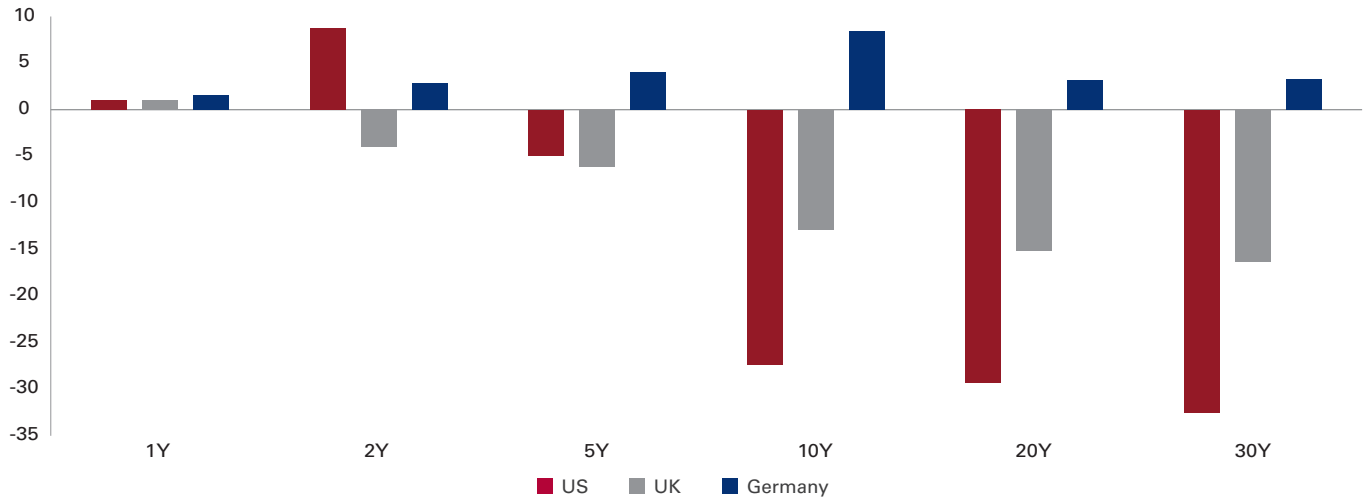
[2] Source: Bloomberg Barclays EUR Aggregate Index as at 30 June 2021.

In the UK, similar to Europe, we expect the rebound that began in Q2 to gain momentum on the back of successful vaccine roll-out, lockdown easing and the eventual full reopening of the economy. Market data such as GDP has rebounded significantly and point to a strong recovery through 2021. Further, labour market data has been much better than many expected, unemployment lower and wages and job vacancies higher. This has steered higher growth expectations for 2021, led by a consumer recovery.

At its last meeting, the BoE left the base rate at 0.10% and its quantitative easing (QE) target at £895 billion. It views the increase in inflation as transitory and does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity. It is our impression that the Bank does not want to undermine the recovery by prematurely tightening policy. We expect the BoE to continue QE until its assigned allocation runs out, in December. The market consensus on the timing for a UK rate rise is currently the second half of 2022.

In terms of positioning, we expect UK yields to increase as the economy rebounds and the BoE reduces the pace of its QE purchases and updates its forward guidance. We expect UK gilt yields to recover and underperform German Bunds on the back of the quicker economic rebound and successful vaccination roll-out relative to other countries in Europe.

Government bond yields quarterly change by maturity in basis points



Source: Bloomberg. Data as at 30 June 2021.

US mortgage-backed securities

Elevated levels of US mortgage-backed securities (MBS) supply and reduced demand from yield-sensitive MBS buyers pushed spread levels a bit wider over the quarter, although the sector was still able to generate positive returns. Mortgage borrowing continues to be low by historical standards but activity in the housing market remains robust.

Net supply of MBS has increased significantly this year, with estimates now exceeding US $600 billion for the remainder of 2021[3]. The sector has been supported by the Fed's MBS purchases as well as demand from more opportunistic buyers, particularly banks and international investors. As the MBS valuations were driven to extremes, we anticipated less investor interest and that has started to take shape.

Underperformance expected

The Fed's hawkish turn in June hit the MBS market hard. Valuations cheapened slightly but spreads are still historically tight. When the Fed starts to taper and as bank purchases start to slow, we expect MBS to underperform.

Relative to this time last year, the opportunities in the MBS market are much less broad-based. We've reduced exposure but still see value and diversification benefits in segments of the market that offer relatively attractive yield with protection against prepayments.

Implications for Vanguard funds

- Maintaining duration has proven valuable and we will continue to seek out tactical rates opportunities along the yield curve.
- The move lower in US government bond rates in early July was surprising. Over time we expect to see yields moving gradually higher.
- We expect core EU government bonds to continue outperforming US and UK bonds over the medium term as the Fed and BoE are expected to tighten monetary policy before the ECB. We expect EU bond yields to increase and curves to steepen.
- We expect UK bond yields to rise as the UK economy rebounds and the BoE reduces the pace of its QE purchases and updates its forward guidance.
- We remain underweight MBS but hope to add value through selection in the sector.

[3] Source: Bloomberg Barclays and Vanguard estimates as at 30 June 2021.

Credit markets

While the pace of spread tightening slowed, credit sectors across the board were resilient in the face of the Fed's comments and generated positive excess returns over the quarter. The appetite for yield has continued to push investors seeking higher returns further out on the risk spectrum.

Peak global liquidity and central bank support is likely behind us, and this will be a greater challenge for lower-quality bonds.

We are constructive on credit exposure but many of the highest-quality issuers are now priced too richly, in our view, and lower-quality issuers are vulnerable to a change in market sentiment. We have therefore reduced our credit exposure over the last several months and are now focused on investment in credits that have upside potential based on improving fundamentals. Relative to more than a year ago, overweights towards specific sectors, business models or credit-quality buckets offer little value in today's market.

Going forward, all eyes will remain on economic data, most specifically that for inflation and the labour market, and the Fed's reaction to it. We expect credit to remain well supported with substantial demand from a global investor base. Expensive valuations make us more cautious and we are holding ample liquidity to add exposure if prices adjust. We are focused on security selection to drive outperformance and robust risk management to build resilient portfolios for our clients.

Year-to-date total returns of select fixed income segments

Category	Total returns
CCC rated high-yield bonds	7.20%
B rated high-yield bonds	3.35%
BB rated high-yield bonds	2.71%
Emerging markets high-yield bonds	1.42%
US investment-grade corporates	-1.27%
Emerging market investment-grade bonds	-2.45%

Sources: Bloomberg Barclays indexes, J.P. Morgan EMBI Global Diversified High Yield Index and J.P. Morgan EMBI Global Diversified Index for emerging market investment grade bonds. Data as at 30 June 2021. The performance of the indices reflect the reinvestment of dividends but do not reflect the deduction of any fees or expenses which would have reduced total returns. Returns are USD hedged for consistency.

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Investment-grade corporates

High-quality corporate bonds, as measured by the Bloomberg Barclays Global Aggregate Corporate Bond Index (USD Hedged), rebounded over the quarter and generated returns of 2.42%, which helped to recapture some of the first quarter's -3.23% performance.

Corporate bonds advanced aided by first-quarter earnings, which saw a higher-than-average number of companies outpace expectations and showed that economic activity improved across industries. Our allocations towards cyclical sectors and lower credit-quality investment-grade issuers was favourable and provided a performance boost to our portfolios. However, most of the investment-grade sector is now trading at historically expensive valuations, which leaves fewer opportunities for high-conviction bets going forward.

Fundamentals improving

We expect to see a continuation of the record pace of share buybacks funded with debt as well as elevated merger and acquisition activity, both of which should bring new supply and potentially better investment opportunities later this year. As corporate fundamentals continue to improve, our investment-grade and high-yield teams are focused on identifying the best opportunities in 'rising-star' issuers poised to get upgraded by rating agencies to an investment-grade rating.

High-yield corporates

A record pace of issuance (more than US $280 billion[4]) through the first half of the year has done little to keep spread levels on below-investment-grade issuers from continuing to narrow. This has occurred partly because most of the issuance was used for debt refinancing so that the net supply was in line with historical levels.

Little incentive in lower-quality bonds

The outperformance of lower-quality bonds continued as the yield on US CCC-rated debt (Bloomberg Barclays US High Yield CCC Index) fell to 5.65%, its lowest level on record. The spread differential between below-investment-grade debt and investment-grade debt also continued to shrink, to 184 basis points, the lowest since July 2007[5].

We see the best opportunities in a barbell approach to the sector. We are focused on rising stars that have a high probability of upgrade in the next year as well as Covid-19-impacted companies that stand to benefit from the broader reopening of economies. Specifically, we are looking at travel and leisure segments such as airlines, cruise lines and casinos as well as more cyclical sectors like metals and mining and autos.

Emerging markets

Emerging market (EM) debt outpaced the other major bond market sectors in the second quarter, as the J.P. Morgan Emerging Markets Bond Index Global Diversified produced strong returns of 4.06%. This helped to bring the asset class closer to even for the year so far. The decline in longer-maturity US Treasury bonds drove most of the performance but credit spreads also made a contribution, narrowing by 20 basis points.

While spreads remain compressed across the globe, EM debt is a segment of the fixed income market where there remains the opportunity to access relatively higher yield. Further, an increase in commodity prices could help EM debt retain this advantage.

Lower-quality EM bonds continued to outperform. Ecuador has been the strongest of this group so far this year because of low near-term financing needs, higher energy prices and a new administration that has made progress towards fiscal reform. Our overweight to Ecuador has benefitted our portfolios.

Pockets of value

Investment-grade EM debt was held back over the quarter by political events in higher-quality Latin American countries, most notably Chile, Colombia and Peru. We've maintained an underweight to expensive, higher-quality countries, and this recent volatility has reinforced our view that investment-grade spreads leave little room for any unexpected credit deterioration. The EM market offers several pockets of value but a selective approach to lower-quality names is important. However, the recent underperformance offers opportunities to add exposure to issuers we like.

Over the last few months we've seen EM central banks turn more hawkish in the face of rising inflation. The central banks of Brazil and Russia were among the first to raise policy rates, in mid-June (by 75 and 50 basis points respectively) to fight off increasing price pressures. Mexico followed in late-June, surprising the market with a 25 basis-point hike, and Hungary (30 basis points) and the Czech Republic (25 basis points) became the first European Union countries to raise rates this cycle. We will take advantage of opportunities in EM rates in markets with steep yield curves or where the market appears to have priced in overly aggressive central bank policy.

Structured products

The new-issue market for asset-backed securities continued to be oversubscribed by investors. Credit spreads for consumer-backed debt have been pushed below pre-Global Financial Crisis levels by a good margin, highlighting just how expensive valuations have become. On the positive side, consumers have put stimulus and savings to good use by continuing to pay off debt balances.

Spreads have already narrowed significantly in commercial mortgage-backed securities (CMBS), but we believe there is room for further compression[6]. The reopening of the broader economy should translate into lower delinquency rates and continued upside in the pockets of the market which were most negatively impacted by the pandemic-induced shutdown.

While US consumers remain financially strong, we continue to keep a close eye on the health of the commercial property subsectors as the economic recovery intersects with new attitudes towards remote working. Creditworthiness within CMBS will depend on what the "new normal" looks like.

Implications for Vanguard portfolios

- Rising commodity prices and higher credit spreads make EM one of the few areas where it is possible to find more broadly attractive returns. Opportunities to add value exist but we are mindful that EM central banks have much less flexibility to support a recovery.
- The upside is limited among high-yield and investment-grade corporate bonds but fundamentals are strong and yields relative to US Treasuries are attractive. Performance in these sectors will be driven by individual security selection.
- We remain cautiously constructive on CMBS. Harder-hit segments like office, hotel and retail properties continue to recover.

[4] Source: Vanguard as at 30 June 2021.

[5] Source: Bloomberg Barclays indices as at 30 June 2021.

[6] Source: Bloomberg Barclays indices as at 30 June 2021.

Who we are

- Vanguard Fixed Income Group manages $1.7 trillion globally in active and passive funds with a global team of more than 175 investment professionals.

Data as at 31 December 2020.

- Vanguard's active fixed income team manages over $559 billion across various actively managed fixed income strategies. For nearly 40 years, Vanguard has managed active fixed income funds with an experienced team of credit research analysts, traders and portfolio managers.

- Our investment teams are supported by our 50-plus member economic research team that informs our economic outlook and our 90-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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