Vanguard

Q1 2021

VANGUARD ACTIVE FIXED INCOME PERSPECTIVES

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Key points

Performance: An expected rise in longer-maturity US Treasury yields prompted sales of developed market government bonds and led to challenging conditions across fixed income. Credit spreads were resilient over the quarter.

Looking ahead: There are many positive signs across the global economy but prices already reflect a smooth transition back to normal. We will be watching for higher and more persistent, realised inflation—a key risk factor.

Approach: We remain cautious and patient. Near-term opportunities exist in higher-quality financials and select cyclical issuers. Inflation could surge this spring and early summer as people get back to work and life begins to return to normal following the pandemic. However, we don't expect this temporary spurt to turn into runaway inflation over the medium term.

Patience should bear fruit

Three months ago, we said that it was likely all uphill from here for the fixed income market. As if on cue, the long end of yield curves across developed markets steepened significantly this past quarter. In the US, the yield on 10-year Treasuries increased by more than 80 basis points over the period and around 100 basis points since this time last year[1].

The result was a broadly negative quarter for bonds and we expect volatility to continue. Credit spreads remain at historically tight levels[2] and inflation concerns are heightened. Yield levels can go higher and curves can get steeper but, based on our forecasts, we don't see 10-year US Treasury yields rising much above 2% in the near term, given prevailing conditions.

In Europe, monetary policy also remained on hold but the European Central Bank (ECB) announced an increase in the pace of its pandemic emergency purchase programme (PEPP) over the coming months, indicating a continuation of supportive accommodative policy, alongside an upgraded inflation outlook.

Similarly in the UK, the Bank of England's (BoE) monetary policy committee unanimously voted to leave interest rates unchanged and continue with its bond purchases for the remainder of the year, an indication that it was not unduly concerned by rising gilt yields.

Government bond yields rose and the yield curve steepened in all core markets; US, German and UK 10-year maturity bonds saw yields rise 83, 28 and 65 basis points respectively[3].

Despite rising yields, credit remained relatively resilient over the quarter and spreads tightened across the board. The outlier was emerging markets, where idiosyncratic events and inflationary concerns caused spreads to end the quarter slightly wider.

[1] Bloomberg, 31 December 2020 - 31 March 2021.

[2] Bloomberg Barclays, J.P.Morgan and Vanguard, as at 31 March 2021.

[3] Bloomberg, 31 December 2020 - 31 March 2021.

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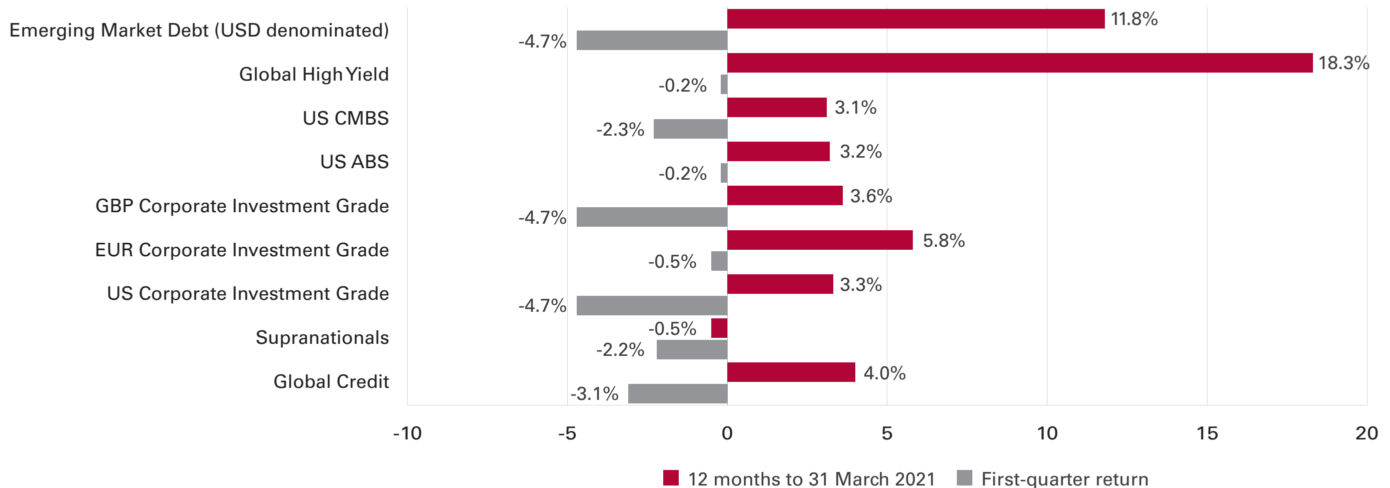
Waiting for better opportunities

We are focused on relative value and security selection as a means to generate outperformance. Valuations remain rich across sectors – as a result, we remain cautious and patient, a strategy that worked well for us last year.

We disagree with those who suggest abandoning fixed income, especially in exchange for more exotic—and usually more expensive—alternatives. We believe that fixed income will maintain its ability to help diversify against equity risk in client portfolios. We are confident that low-cost, sophisticated, active fixed income can uncover opportunities in this market environment through security selection and thoughtful portfolio construction. If the roaring stock market stumbles, we expect that fixed income—as it did in 2020—will prove itself again.

Market sector returns



Past performance is not a reliable indicator of future returns.

Source: Bloomberg Barclays indices and J.P. Morgan EMBI Global Composite, as at 31 March 2021. Returns are gross and in USD or USD hedged. Bloomberg Barclays Indices are used as proxies for all of the above exposures with the exception of Emerging Market Debt where the index is provided by J.P.Morgan.

Developed market government bonds and inflation

The US Treasury sell-off was initially driven by a rebound in inflation expectations, then by an increase in real interest rates, as markets priced in higher expected economic growth. This triggered memories of 2013's "taper tantrum" (a collective reactionary panic that caused a spike in US Treasury yields after investors learned that the Federal Reserve (Fed) was slowly putting the brakes on its quantitative easing (QE) programme). Positive Covid-19 news on most fronts, since early January, has helped economic data improve, and there has been a steady recovery in the labour market and continued strength in housing and manufacturing.

There is little reason to doubt the near-term economic recovery. In response, market pricing has run well ahead of the Fed's forward guidance, pulling nearer expectations for future rate hikes. The market now sees the timing of the first rate rise as soon as the fourth quarter of 2022, with as many as three hikes in 2023. Comparatively, the Fed's Open Market Committee has been emphasising the downside risks still present and focuses on supporting a broad-based recovery. It does not anticipate raising rates before 2024.

Both forward-looking inflation expectations and realised inflation have increased. The Fed's latest Summary of Economic Projections (17 March) revised upwards its core inflation forecast to just above 2% in each year through to 2023.

We expect the Fed to maintain its accommodative stance and commitment to its average inflation targeting framework. In this environment, we remain most constructive on shorter-maturity break-even inflation exposure, which best captures any further increase in near-term inflation expectations.

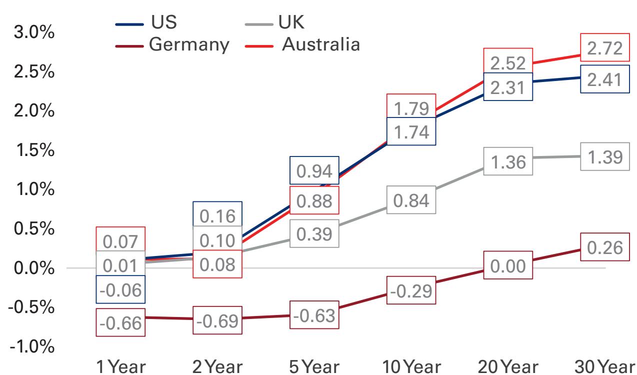
Although risks have increased, we believe that long-term inflation remains anchored by well-established structural trends. Those trends include population demographics, income inequality, globalisation and technology enhancements. These forces have been decades in the making and are not easily reversed.

In Europe, the rebound continues to get pushed back due to a significant rise in new Covid-19 cases, driven by new and more infectious variants and slow vaccination programmes in the majority of European countries. This third wave has led to governments across Europe extending and tightening lockdown restrictions and the expectations are that these restrictions will last until May. The easing of restrictions and reopening of economies should lead to a boost in consumption from pent-up demand and accumulated consumer savings. We believe that the fiscal and monetary responses are now more supportive for the recovery. Further, at the country level, fiscal policy should continue to be expansionary in 2021. On the monetary policy front, the ECB's main tool remains the PEPP, which has totalled €1.85 trillion to March 2022 and includes the reinvestment of maturing principal to at least the end of 2023.

In the UK, we expect a strong rebound beginning in the second quarter as a result of the successful vaccine roll-out, sooner-than-expected lockdown easing and the eventual full reopening of the economy targeted for June 2021. The recovery should continue to be supported by strong fiscal stimulus, high saving rates and pent-up demand. The BoE left its base rate at 0.10% and its QE target at £895 billion and maintained a dovish bias, emphasising that it would not tighten monetary policy until there was significant progress in eliminating spare capacity and achieving its 2% inflation target. We expect gilt yields to increase as the UK economy rebounds and the BoE reduces the pace of its QE purchases and updates its forward guidance.

In terms of opportunities, most are currently focused on discrepancies in macroeconomic fundamentals, the EU lagging the US and the UK. We expect EU government bonds to continue outperforming the US and UK in the short term. Over the next three to six months, we expect EU yields to increase and curves to steepen as vaccination roll-out improves and the EU reopens.

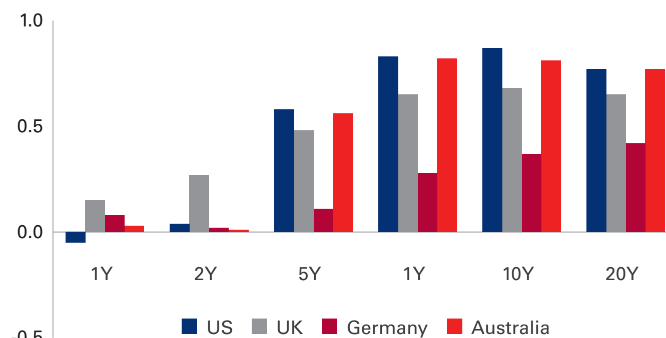
Government bond yield curves



Past performance is not a reliable indicator of future results.

Source: Vanguard calculations of changes in absolute yields, 31 December 2020 - 31 March 2021.

Sovereign rates change by maturity (bps)



Past performance is not a reliable indicator of future results.

Source: Vanguard calculations of changes in rates, 31 December 2020 - 31 March 2021.

Mortgage-backed securities

Rising interest rates and rate volatility created headwinds for mortgage-backed securities (MBS) over the quarter, though the sector marginally outperformed duration-equivalent Treasuries. Lower-coupon securities underperformed because the steady increase in mortgage borrowing rates lowered the attractiveness of refinancing for those securities and created duration-extension risk for investors.

The Fed continues to be the largest buyer of agency MBS, committing to purchase a net $40 billion a month. Banks have also been substantial buyers this year, much more so than in prior years. However, with valuations now looking stretched relative to levels over the last 10 years[4], the outlook for continued bank demand is less certain. With home mortgage rates sitting about 50bps above[5] recent lows, we expect to see a modest slowing of refinancing activity and slower prepayment speeds on MBS securities over the coming months. Slower prepayments are a positive for the sector; however, their effect has been offset by higher hedging costs for market participants.

Longer durations, greater volatility relating to interest rates and a steeper US Treasury curve keep us less constructive on MBS and we have reduced our exposure to the sector. We maintain our view that the Fed is unlikely to withdraw its support for the sector because MBS purchases are one of the most direct ways for monetary policy stimulus to reach households. With a wider set of risk factors to account for, we are focused on security selection to drive performance and believe actively managed MBS strategies will continue to produce positive returns.

Implications for Vanguard funds:

- We remain positioned for yields in the US to rise modestly higher. However, after the recent large moves, we expect rates to trade within a narrow range over the near term.
- We see value in shorter-maturity break-even inflation exposure as the fundamental backdrop remains strong and inflation risks are skewed to the upside.
- We expect EU bonds to continue outperforming US and UK bonds in the short term.

[4] Bloomberg Barclays U.S. Mortgage Backed Securities Index and Vanguard, as at 31 March 2021.

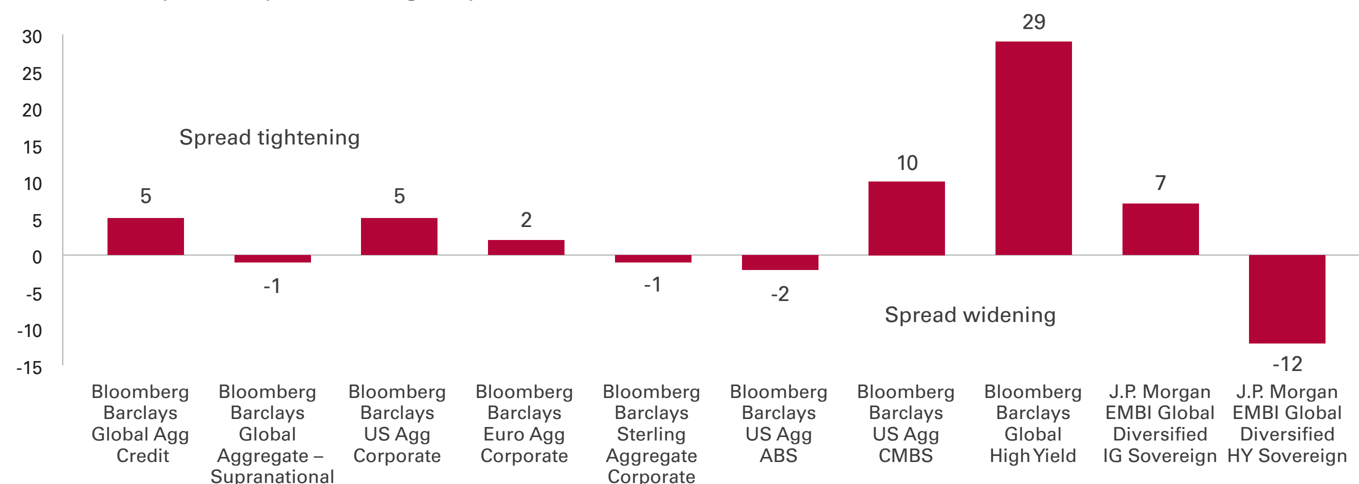
[5] Bloomberg and Vanguard, as at 31 March 2021.

Credit markets

Credit spreads traded within a tight range during the quarter, doing little to help offset the negative impact of rising interest rates. Most credit sectors posted a negative return, though corporate high yield benefitted from investors seeking refuge from rising rates.

We have reduced risk in our credit position based on the outlook for credit returns and the expensive valuations. We still see pockets of value in cyclical sectors and mid-quality issuers but we remain cautious on the lowest-credit-quality tiers. Price appreciation in the months ahead will likely be limited.

Quarter-on-quarter spread change (bps)



Source: Bloomberg Barclays Global Credit and J.P.Morgan emerging market indices. Data as at 31 March 2021.

Investment-grade corporates

Higher-quality credit is the most sensitive to movements in interest rates and with the duration on the broader corporate index now above seven years, its longest ever, aggregate returns were sharply negative at -3.08% for the quarter[6].

High-grade corporate spreads proved resilient, narrowing slightly over the quarter across most segments. Cyclicals fared best with energy and materials outperforming other subsectors, but the overall cushion from spread returns was minimal against such a large move in rates.

In Europe, following the sell-off in government bonds, central banks rushed to reassure the markets with increased corporate bond purchases in March, relative to January and February. We expect economic activity to pick up, as does the market, which has already priced in this development. We continue to favour sectors poised to benefit from the recovery but which at the same time offer attractive risk-adjusted returns.

Silver linings

It's a positive sign that the sector held up well, considering that starting valuations were expensive on a 10-years comparison[7] and the market needed to absorb a glut of new supply at the start of 2021. That mix of challenging conditions was offset by investor flows into the sector, which have slowed but remain positive. Improving corporate fundamentals and strong policy support for risk assets have also helped.

Our positions still favour larger-cap BBB-rated issuers that have better-than-average valuations and less room to increase leverage. We see improved near-term opportunities in financials and cyclical issuers with improving fundamentals. We have been reducing exposure to non-cyclical segments, particularly companies with narrow profit margins and limited ability to pass on higher prices to end consumers.

[6] Bloomberg Barclays Global Aggregate Credit Index, as at 31 March 2021.

[7] Bloomberg Barclays Global Aggregate Credit Index and Vanguard, as at 31 March 2021.

High-yield corporates

The high-yield market has seen a flurry of demand. Issuance surpassed $140 billion in the first three months of the year, setting a quarterly record and surpassing the previous high reached amid 2020's lockdown[8]. Companies have become aggressive in issuing more debt but record supply did little to stem investor demand for attractive yield and lower sensitivity to movements in Treasury rates. Spreads over the period compressed 50 basis points at the index level, mostly driven by lower-quality bonds.

A new mix of CCC issuers

CCC-rated securities have outperformed their higher-quality peers for several months and the gap widened further over the quarter because CCC's lower duration and higher credit risk profile made the bonds less sensitive to upward movements in Treasury rates. Of the roughly $200 billion of CCC bonds currently outstanding, only 35% were in the CCC portion of the benchmark just one year ago[9]. Substantial default activity in the more secularly challenged sectors—like energy and retail—have altered the mix of CCC issuers today, and the segment now reflects industries heavily impacted by social distancing policies.

The majority of these new CCC-rated companies are using up large amounts of cash reserves but are otherwise decent businesses with stronger long-term prospects than typical CCC issuers.

Notwithstanding the strong market, we are cautious on high yield. While we see pockets of value, the additional compensation for going down in quality within high yield is unattractive, in our view. Meanwhile, the recent underperformance of BBs presents some new opportunities. Although we are positive on the economy, we are taking a measured approach to risk and are focused on idiosyncratic and relative-value opportunities across the credit-quality spectrum.

Emerging markets

Rising long-end rates saw both hard- and local-currency emerging market (EM) securities produced negative returns over the quarter. Spreads on dollar-denominated securities were fairly flat, hiding the wider dispersion in performance seen at a country level. Both EM government bonds and currencies performed poorly in response to higher US Treasury yields.

In contrast to developed markets, EM central banks began to pivot towards tighter policy with both Brazil and Russia's central banks raising interest rates in response to high inflation. Going forward, local currency denominated government bonds exposure could offer value as other central banks follow suit, but only if real rates are positive and attractive relative to developed markets and if inflation comes under control. The case for EM currency exposure could be stronger if the US dollar weakens.

While we've reduced our overall EM risk across strategies, we remain optimistic about the prospects for the sector relative to other credit sectors and over the long term. High investor cash levels and demand for yield are likely to support the asset class. While higher-quality issuers offer limited value, idiosyncratic opportunities exist across the spectrum. We prefer credits that have already repriced on the back of recent issuance and are mindful of companies that still have large issuance needs this year.

Structured products

The shorter duration characteristics of the asset-backed securities (ABS) sector provided insulation against rising rates and produced flat returns over the quarter. The longer duration characteristics of commercial mortgage-backed securities (CMBS) felt more pressure and generated negative returns[10].

Reduced new-issue supply and light inventory on dealer balance sheets continue to be the main themes in both the ABS and CMBS markets. Strong investor demand on top of that has created a supportive technical environment for the sector and kept new-issue deals multiple times oversubscribed. Credit-spread levels have been pinned near historically low levels.

Households and CMBS are resilient

With much of the structured-product market linked to the US consumer, we are paying very close attention to the underlying fundamentals of borrowers. A big concern is the unemployment rate in the US, which is roughly double where it was this time last year and remains a key measure for the Fed to evaluate the true strength of the recovery. However, many metrics tracking consumer financial health are positive. The financial obligations ratio, a broad measure of household liabilities, is near all-time lows. The personal savings rate has increased and consumers had acquired an extra $1.7 trillion in savings through to the end of 2020 compared with 2019[11].

Helping support our fundamental view in CMBS is the substantial price appreciation that much of the commercial property market has enjoyed over the last ten years. Over the 10-year period up to 31 December 2020, the RCA US National All-Property Index increased 122%[12]. While the pandemic did have a substantial negative impact on short-term cash flows for many property types, the widespread increase in property values should help borrowers as they refinance.

Implications for Vanguard Funds:

- In investment-grade corporates, spreads are likely to remain within a narrow range in the near term. We see the best opportunities across corporate bonds in cyclically exposed BBB and BB issuers with strong fundamentals but expect security selection to drive performance.
- EM bonds may face challenges over the short term but EM remains attractive on a risk adjusted basis.
- It's time to be cautious in credit. Spreads are compressed and the lowest-quality segments are most exposed to a shift in risk sentiment and/or a setback in the economic recovery.

[8] Bloomberg Barclays Global High Yield Index and Vanguard, as at 31 March 2021.
[9] Vanguard, as at 31 March 2021.
[10] Vanguard, as at 31 March 2021.
[11] Bloomberg Barclays, Real Capital Analytics, Citigroup, Bank of America and Vanguard, as at 31 March 2021.
[12] RCA US National All-Property Index and Vanguard.

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.

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.

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