Vanguard

Q1 2022

Active fixed income perspectives

Key points

Performance: Bonds suffered their largest quarterly loss in several decades after a sharp rise in interest rates. Markets have adjusted to a more aggressive monetary policy response to fight the highest inflation seen in decades. Credit markets have held relatively steady, but a removal of accommodative policy will likely challenge that.

Looking ahead: Markets are anticipating that the Fed-led developed market central bank hiking cycle will likely take core government rates into restrictive territory over the next year. These tighter financial conditions could calm inflation but are still creating much uncertainty.

Approach: The current market volatility presents opportunities and we've increased liquidity levels across our portfolios to capitalise on this. We see fewer top-down sector opportunities, but a wider variety of attractive bottom-up trades. In our view, this market is vulnerable to a number of potential shocks.

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The "new reality"

The fixed income market began the year in a precarious position, with low global yields and historically tight credit spreads.

Then the world changed. Russia's aggression against Ukraine reasserted totalitarianism into international affairs and market dynamics. This added pressure—combined with already-high levels of global inflation—forced policymakers to correct their course to an even more hawkish stance.

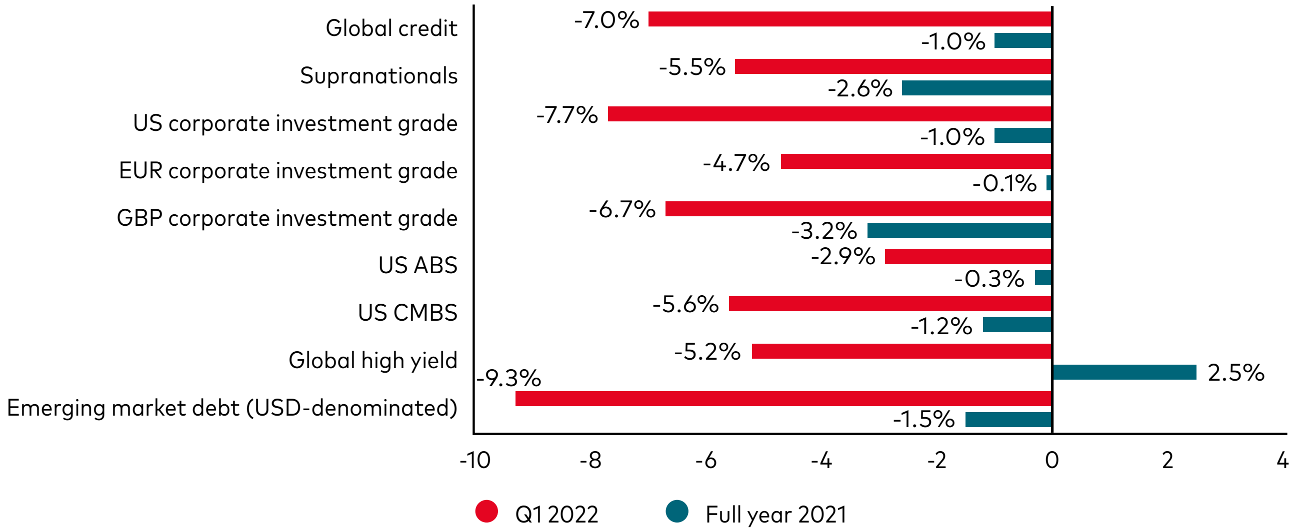
Given that many termed the period after the great financial crisis the "new normal", a post-Covid-19, post-Ukraine invasion world could reasonably be named the "new reality", an environment with much more uncertainty and little recent historical precedent. The new reality will affect geopolitics, supply chains, currencies and investment decisions. Access to natural resources, such as food and fuels, as well as production, will matter more. As a result, higher risk premiums will need to be priced in.

Better future return potential

The losses in the bond market during the quarter—the worst in several decades—hurt, but the reduction in prices also means that yields have adjusted higher. There may well be more re-pricing to come in the next year or so. But future return potential in fixed income is increasing.

Many investors fear that an upward spiral of inflation and further interest rate increases are on the way. Energy prices and fiscal spending do appear to be on a higher trajectory. But various market indicators are already warning about an economic slowdown in the not-too-distant future. That could mean that interest rate highs—at least in some parts of the curve—are already within reach. Investors who are reinvesting coupon payments at higher rates should now find that their bond holdings are helping to provide more of a return buffer against shocks that should increase portfolio stability.

Market sector returns



Past performance is not a reliable indicator of future returns. Sources: Bloomberg 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. Q1 2022 data as at 31 March 2022. 2021 data as at 31 December 2021.

Rates and inflation

US Federal Reserve (Fed) officials pivoted quickly after the publication of higher-than-expected inflation data, and the market has priced in around ten quarter-point interest rate hikes over the next year. The war in Ukraine may have prevented—for now—a 50-basis-point hike in rates (the Fed only raised the federal funds rate by 25 basis points at its March meeting), but such a move in the coming months remains a strong possibility.

The bond market now realises that the Federal Open Market Committee is going to be determined in its approach to tightening financial conditions and bringing inflation back to its target in the near term. That includes both faster rate hikes as well as an accelerated reduction of its $9 trillion balance sheet. Fed Chairman Jerome Powell's recent laudatory comments about famous inflation fighter Paul Volker, Fed chairman in the 1980s, are a foreshadowing.

Signals for the future

Because of rising wages and consumer spending, the Fed may be even more aggressive by the end of this cycle than the bond market currently anticipates. We expect the core Personal Consumption Expenditures Index—the Fed's preferred measure of inflation—to peak during the second quarter. But wage pressures are likely to persist, keeping inflation near 4% through 2022, and closer to 3% by the end of 2023.

In the coming months, the surge in food and energy prices, alongside a red-hot labour market are likely to produce one of the largest Consumer Price Index figures since the 1970s, with headline inflation near 8.5% and core inflation approaching 7% on a year-over-year basis.

Inflation could continue to surprise to the upside in the coming quarters, but with the Fed committed to curbing rising prices, the upside for longer-term inflation expectations is limited.

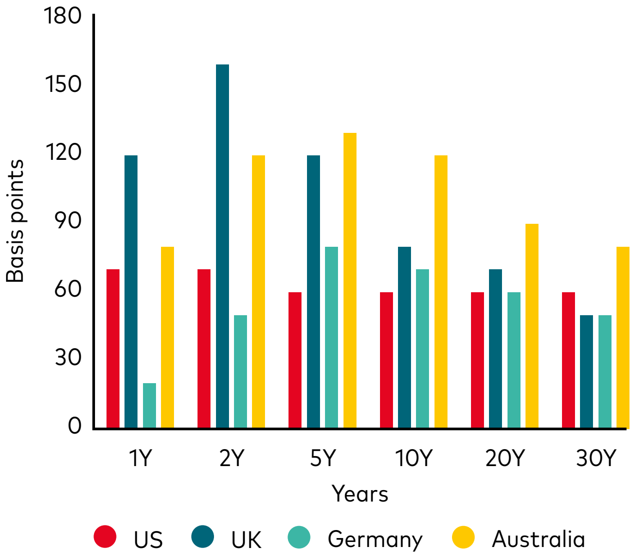
In Europe, the European Central Bank's (ECB's) Governing Council announced at its March meeting a quicker reduction of its bond buying programme than expected with its asset purchases potentially coming to an end if the medium-term inflation outlook does not weaken. The ECB's monetary policy minutes also cited that any adjustment to its key interest rates would take place sometime after the end of the net purchases under its asset purchase programme and that this would be gradual.

This was off the back of downward revisions to growth, while the inflation outlook was revised upwards over the next few years. Further along, the ECB's Governing Council believes that inflation is likely to stabilise at its 2% target. Based on current expectations, markets have begun pricing in one to two ECB interest rate hikes in 2022.

In the UK, inflation continued to march higher, rising to 6.2% year-over-year in February, a level not seen since the early 1990s. Inflation is expected to rise further due to tight labour markets, Covid-19-related supply-chain disruptions and rising commodity prices, which were exacerbated by Russia's invasion of Ukraine.

The UK unemployment rate fell further to 3.9%, job vacancies reached record highs and average weekly earnings grew by 4.8%. Against this backdrop, the Bank of England (BoE) raised interest rates by 25 basis points in February and by a further 25 basis points in March, to end the quarter at 0.75%. The BoE's Monetary Policy Committee continued to emphasise the primacy of price stability in the UK monetary policy framework, but there was a change in tone between meetings. In February, four policy makers voted for a larger, 50-basis point hike, while in March, there was a single dissenting vote to leave policy unchanged. The committee also recognised that while business confidence and the labour market had remained strong, consumer confidence was falling and the expected squeeze on household incomes had increased, thus weakening growth prospects. Despite weaker growth, the market is now pricing in 200 basis points of rate hikes this year.

Government bond yields quarterly change by maturity in basis points



Past performance is not a reliable indicator of future returns.
Source: Bloomberg. Data from 31 December 2021 to 31 March 2022.

Implications for Vanguard Active Funds

- We are positioned for higher rates, but there is much uncertainty about the path forward.
- We remain opportunistic based on relative-value views across core government bond markets.

Credit markets

Fixed income credit returns moved well into negative territory in the first quarter. The move in government rates created a large performance headwind, while credit spreads managed to rally back somewhat from a large initial sell-off in response to the outbreak of the Russia-Ukraine conflict.

We expect a challenging market for risk assets over the next six to 12 months. The outlook for credit is highly dependent on the interplay between monetary policy and its impact on economic growth and financial market conditions. A broader slowdown in growth may not be imminent, but there is potential for higher volatility as we move further into the rate-hiking cycle.

Given the policy backdrop, we see credit as somewhat expensive and cannot currently justify a larger exposure to credit risk. Dispersion of returns across securities has increased, however. That dispersion should offer more opportunities to add security-selection alpha, without subjecting our portfolios to unwarranted exposure to lower-rated issues.

Investment-grade corporates

The rise in core government bond yields led to losses on investment-grade corporate bonds over the quarter. European and UK corporates led these losses, as their spreads widened by 34 and 33 basis points respectively. US corporate spreads widened by only 24 basis points[1].

Following several successive quarters of beating expectations, corporate earnings revisions turned negative in Q1 2022. Before the invasion of Ukraine, most investment-grade corporates were showing rapid recovery from the pandemic, as evidenced by strong margin and profit growth throughout 2021. The war is expected to stall this recovery and put pressure on margins; most of the impact will likely come from rising prices in energy and raw materials. Transport routes close to the conflict zone have been affected, which will likely worsen supply-chain disruption and intensify price competition for scarce resources. To an extent, this can be mitigated by passing increased costs to customers, and many consumer goods companies have already flagged increases in prices. The geopolitical instability and the looming prospect of tougher economic conditions are eroding consumer confidence, weakening demand and limiting companies' ability to pass on these increased costs.

In terms of technicals, the backdrop has been weakening, with policy support being withdrawn at a faster pace as central banks focus on curbing runaway inflation. Despite market volatility, we continue to expect that issuance in 2022 will be at least in line with that of 2021. The timing of market activity will continue to centre around geopolitical headlines.

Nonetheless, there has been a relatively low level of cash outflows year-to-date in credit. Both fund managers and investors were positioned for higher volatility and those cash cushions have dampened selling activity and helped keep spreads largely in check.

Valuations have retraced quickly back to less attractive levels over the last few weeks. We see fewer opportunities in thematic sector trades, so we are more focused on companies with strong balance sheets that are not looking to add substantially to their existing debt burdens and can adapt to higher inflation. We are paying close attention to earnings guidance and expect that corporate fundamentals will drive bond prices as monetary policy accommodation fades.

High-yield corporates

A lower sensitivity to rising rates and limited exposure to geopolitical risks have helped insulate high-yield corporate bonds from the full brunt of market headwinds this year. Spread compression over the last few weeks has brought valuations back to where the sector had been trading since the middle of 2021. The sector looks expensive overall but offers a number of attractive opportunities.

Credit fundamentals remain strong and trailing 12-month default rates are below 0.50%, compared with a historical average of 3.5% to 4.0%[2]. Another bright spot has been the strong credit migration from high-yield to investment-grade, the so-called "rising stars". We've been able to capitalise on that trend, which still has more room to run. In March, Kraft Heinz—one of our largest high-yield overweights—had $20 billion-worth of debt upgraded, adding substantial value to our funds.

New-issue supply is also down by 70% from the record levels set last year, far less than markets expected in 2022[3]. Lower supply has helped balance the effects of outflows from the sector.

While current valuations do not stand out as attractive, market volatility has created more single-name selection opportunities to take advantage of. With significant policy headwinds still on the horizon, we see more value in tilting towards higher-quality credits.

Emerging markets

Russia's invasion of Ukraine hurt emerging markets (EM) bonds. The dramatic decline in value of bonds issued by both Russia and Ukraine and the broader drag from higher US Treasury rates sparked the large negative performance of the sector this year.

Given the circumstances, EM debt still managed to be fairly resilient in the face of such a substantial shift in geopolitics. Contagion to other EM assets has been relatively muted outside of Eastern Europe, and many of those bonds managed strong recoveries over recent weeks as fears of a more broad-based military escalation have eased.

The longer-term implications of this conflict will continue to be felt across EM countries and in the broader macro environment. The potential downstream impacts of slower growth and higher inflation create more uncertainty and a wider range of outcomes. Countries that are reliant on commodity or food imports are most vulnerable, while higher commodity prices will benefit exporters. Market technicals remain mixed, as limited new issuance has helped offset the impact of manageable—but consistent—outflows from the asset class.

In our view, EM has re-priced more to reflect its specific challenges and broader global risk factors. The rally in spreads over recent weeks, however, has eroded much of the value cushion and we are mindful of vulnerability to further shocks. We are taking a more cautious approach overall and focusing on bond selection.

Structured products

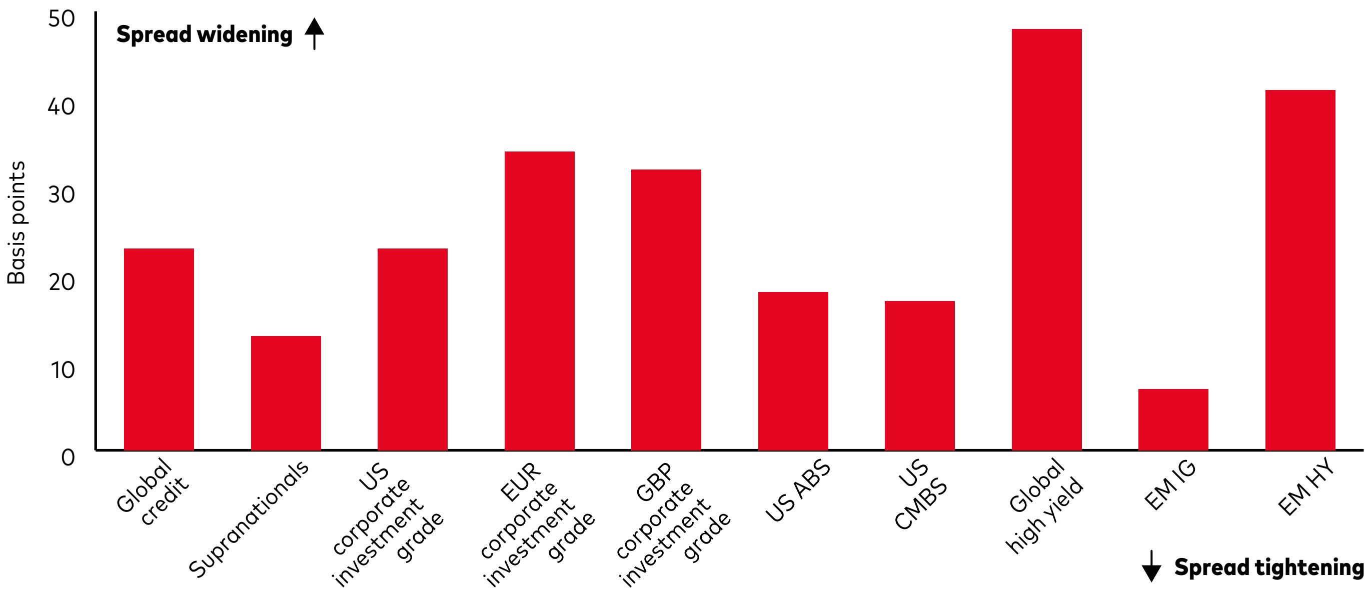
Asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) spreads lagged other structured products in the first quarter. Although ABS spreads initially outperformed, they eventually lagged the tightening experienced in other sectors.

New-issue volumes remained robust and exceeded flows in the corresponding period in 2021, largely driven by automotive ABS and esoteric sectors, but demand began to weaken in March as geopolitical risks increased.

First-quarter CMBS new-issue volumes exceeded first-quarter 2021 flows, putting technical pressure on valuations. Consumer fundamentals continued to remain strong even with the headwind of higher inflation impacting consumer purchasing power. Wage gains, built-up savings and asset-value increases from housing and automobiles continued to provide support. In addition, overall consumer balance sheets and leverage remained controlled and low relative to historical standards.

CMBS fundamentals continued to improve as rates of delinquency and losses declined for all the major sub-asset classes. Retail loans remain the one asset type where fundamentals lag the broader commercial real estate recovery and may remain challenged for several years. Additional technical stress from reduced trading volumes and flat dealer inventories also impacted valuations as geopolitical risks influenced risk taking.

Change in spreads



Past performance is no guarantee of future returns.

Sources: Bloomberg indices and JP Morgan indices for emerging markets exposure. Data from 31 December 2021 to 31 March 2022.

Implications for Vanguard funds

- Investment-grade corporates remain susceptible to both rate increases and credit spread widening.
- High-yield valuations are high, but selective opportunities are available and relatively higher coupon payments remain attractive.
- Emerging markets offer yield, but geopolitical concerns should keep investors cautious.
- Within structured products, we remain selective and opportunistic.

1 Source: Bloomberg Global Aggregate USD, EUR and GBP Corporates Index respectively.

2 Source: Vanguard, as at 31 March 2022.

3 Source: Vanguard, as at 31 March 2022.

Who we are

FIXED INCOME GROUP

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Vanguard Fixed Income Group manages $2.2 trillion globally in active and passive funds with a global team of more than 180 investment professionals.

Data as at 31 December 2021.

YEARS IN FIXED INCOME

35+ years

Vanguard's active fixed income team manages over $607 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.

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