Active Fixed Income Perspectives: The power of income

VANGUARD FIXED INCOME GROUP

JUNE 2025

Key takeaways

Performance
Bonds continue to flex the power of income. They not only provided stability during the tariff-related volatility, but returns have been solid. In the first half of 2025, broad fixed income indices have returned between 4% and 7.25%, largely driven by income from higher coupons.

The big picture
Downside risks remain to the global and U.S. economies, even as the most severe policy scenarios appear to have been avoided. The disruption to U.S. exceptionalism demonstrates the need for diversification and having a global reach when looking for opportunities.

Across sectors, fixed income still offers one of the most attractive entry points in decades to add income.

Our approach
While credit spreads have reverted to early 2025 levels, all-in yields near 5% or higher should continue to draw investor interest and serve as a technical tailwind. We continue to seek the best opportunities globally, remaining selective in lower quality bonds, and we see value in the belly of the yield curve as a hedge to our credit exposure. In municipals, we favor high-quality credit, with historically attractive yields relative to U.S. Treasuries on the long end.

Making a comeback

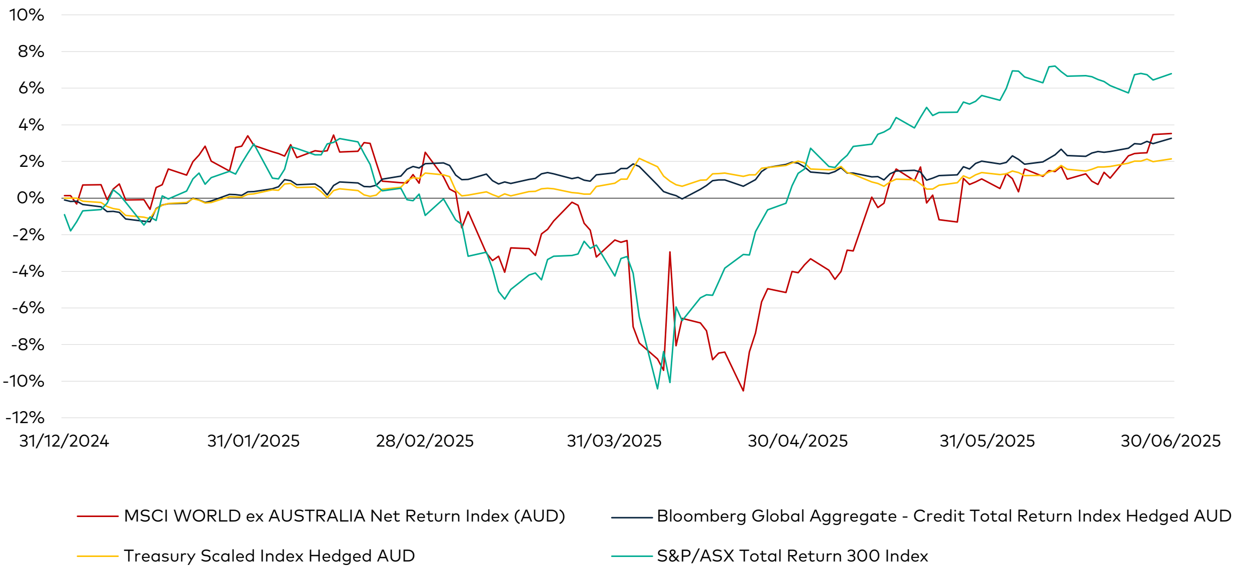
The markets have been remarkably resilient in the face of substantial policy and geopolitical uncertainty over recent months. The de-escalation of trade tensions helped spark the strong rally in risk assets following their initial sharp selloff post Liberation Day. Momentum continued through the end of the second quarter as investors managed to shake off the negative implications of rising Middle East tensions and the eventual U.S. involvement in the Israel-Iran conflict.

Credit-sensitive sectors experienced the greatest benefit from the rebound in market sentiment, as spreads promptly recovered from their brief widening and concluded the quarter at tighter levels. Uncertainty around the direction of U.S. policies propelled the performance of international bonds as Global and ex-U.S. indices outpaced broad U.S. indices.

The power of income
In a landscape that's been dominated by uncertainty, fixed income has shown itself to be an indispensable component of a well-diversified portfolio. Bonds have been a stabilizer to portfolio performance this year propelled by higher starting yields. Higher income returns have helped provide a cushion against recent market volatility, keeping bond returns steady amidst larger swings in equities.

Our portfolios have been positioned to take advantage of the higher all in yield environment by focusing on yield per unit of risk. This approach has provided a yield cushion that helped steady returns against broader market volatility.

Bonds held steady vs equities during the tariff sell-off: YTD cumulative returns



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.
Source: Bloomberg, as at 30 June 2025.

Relative to just a few years ago, broad based bond indices now offer 2.5 to 3.5 times the income buffer. That means that upward movements in interest rates have a less negative impact on total returns for investors that remain invested long enough to reap the benefits of higher coupon income.

For example, even if rates across the curve were to rise by 50 basis points from current levels, returns over the subsequent year would remain firmly positive for the broad market. In scenarios where rates decline, higher income returns would be further enhanced by the corresponding rise in bond prices.

Higher return potential also means that high quality bonds are better equipped as a portfolio hedge. At current levels, interest rates have a lot more room to rally in the event of a growth slowdown. If a recession were to occur, we would expect a significant decline in interest rates producing strong returns across high quality fixed income.

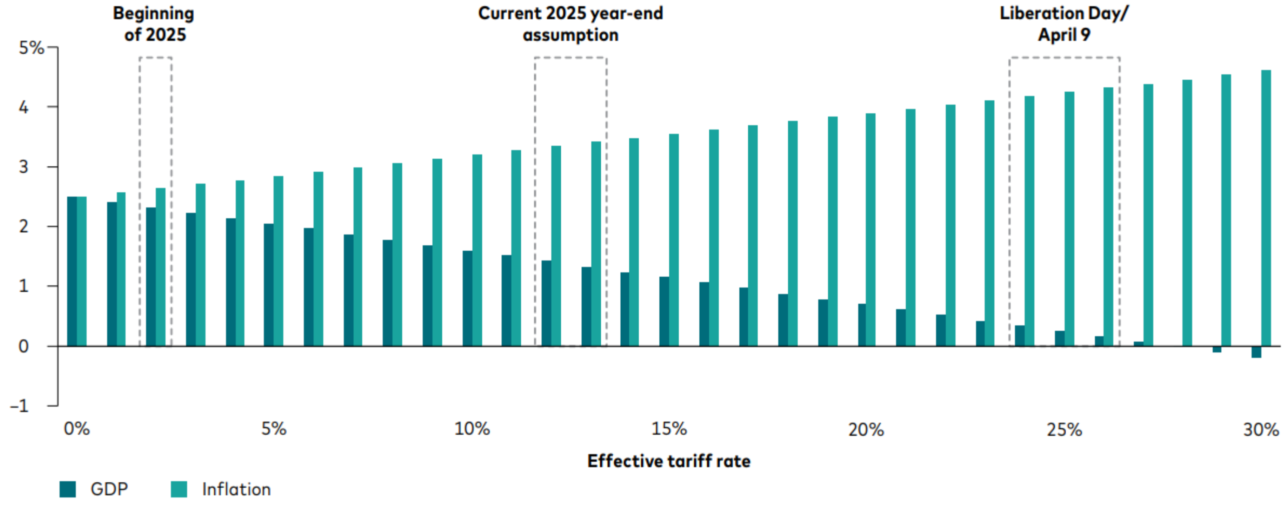
Tariffs still matter

While the most extreme tariff outcomes appear to have been avoided, the impact of tariffs will continue to be a significant factor in our projections for the global economy. For the U.S., we expect the weighted average tariff rate to settle near 12% with the highest tariff rate applied to China the lowest to Canada and Mexico, and the rest of world somewhere in the middle. Relative to the initial levels proposed on April 2nd we see a more muted stagflationary impulse to the economy.

However, even though the rate is roughly half of what it was immediately following Liberation Day, it would still settle roughly 10% higher than it was at the end of 2024.

Trade policy changes hold the key to our economic outlook

Vanguard forecasts of tariff impacts on growth and inflation



Source: Vanguard, as of 30 June 2025.

Eyes on the long-end

The long end of the U.S. yield curve has attracted significant attention this year. Although forecasts have pointed toward slower economic growth, yields on longer-term securities have remained near their cyclical peaks, even as short-term yields have declined, resulting in a significant steepening of the yield curve.

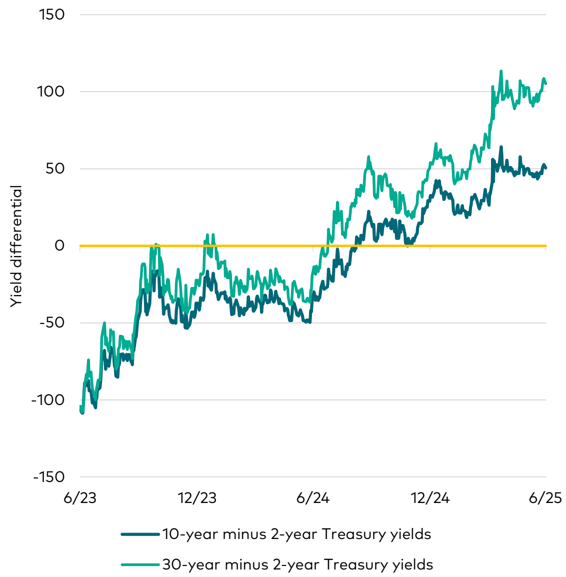
Ongoing uncertainty regarding tariffs, coupled with expectations of sustained bipartisan deficit spending, has led investors to require higher yield premiums for bonds with extended maturities. This term premium, which is the additional return an investor earns from holding a long-term bond compared to a series of shorter-term bonds, has risen by approximately 1.5 percentage points over the past 2 years. In June 2023, the yield on 2-year Treasuries was more than 1% higher than the yield on both the 10-year and 30-year Treasury bond. Today, the 10-year bond offers a yield premium of 0.50% and the 30-year offers a pickup of 1.0%.

In our view, investors are now being more appropriately compensated to take on duration risk.

U.S. policy makers appear to be cognizant of rising term premium dynamics and have underscored the importance of maintaining healthy demand for Treasuries and for keeping borrowing costs at sustainable levels. This has led market participants to believe the Treasury will not increase long maturity Treasury issuance for several quarters and will instead skew any increase in issuance toward shorter maturities where there is likely to be greater demand.

Policy makers have also started to take other actions that could support Treasury market dynamics, including proposed SLR reform and slowing of the Fed's balance sheet run-off. Nevertheless, elevated deficits and the need for fiscal policy to be put on a more sustainable path will remain an important medium-term theme in markets.

Investors are now being better compensated for taking on longer duration exposure



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Economy, policy and markets

Relative to last quarter, several factors have raised our expectations for the U.S. economy over the back half of the year, however our outlook remains softer relative to our initial forecasts for the year. Growth in the first half of 2025 has been slower than last year, but overall, the economy remains resilient and tariff de-escalation and a moderation in inflation have reduced the downside risks for markets. In Washington, the newly signed tax and spending bill is expected to be modestly growth positive into 2026, but markets may pay more attention to the growth of the deficit.

Growth: We expect the economy to grow by 1.5% in 2025. This is lower than our initial expectations at the beginning of the year (2%), but significantly higher than our base case forecast post-Liberation Day (0.75%).

We expect growth to slow in coming months due to the rise in the realised tariff rate among other factors, but consumer strength should help the U.S. avoid a recession this year.

Labour force: The labour market is gradually cooling but remains stable. We anticipate the unemployment rate will rise to 4.7% by year-end as job growth slows, however, labour supply headwinds, including lower immigration, will constrain the rise in the unemployment rate.

Inflation: Tariff-related cost increases should push up inflation in the latter half of the year, with overall core PCE projected to reach close to 3% year-over-year by the end of 2025. While the front-running of goods imports have lessened the impact so far, we still expect tariff-related costs to push goods prices up over the coming months.

Shelter inflation rates are approaching their pre-pandemic levels and rental price indicators suggest further slowing is likely over the balance of 2025. Further out, we see core PCE trending back down toward 2% in 2026. Tariff effects may be viewed by the Fed as a one-time price increase, provided long-term inflation expectations remain anchored.

Monetary policy: The Federal Open Market Committee decided in June to keep the Fed funds rate unchanged for the fourth time this year. The Fed is balancing their assessment of monetary policy that is still restrictive with some indications of slowing growth and upside risks to inflation over the summer.

As long as the labour market remains steady, the Fed can continue to take a measured approach. While there is limited evidence to support significant rate cuts in 2025, there is still a case for moving toward a neutral policy stance if inflation continues to moderate.

In the months ahead, we anticipate that economic data will offer greater insight into the passthrough effects of tariffs. If the passthrough impact is weaker than expected, conditions should allow for maintenance cuts later this year. We think that two rate cuts over the rest of 2025 is a reasonable expectation.

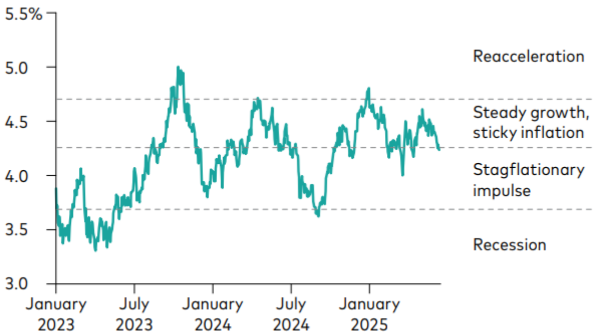
Portfolio positioning and strategy

US Rates and curve
So far this year, 10-year Treasury yields have mostly traded inside of our forecasted range of 4.25-4.75%, notwithstanding significant intra-quarter volatility which saw lows of 3.86% and highs of 4.6% in the weeks around peak tariff uncertainty. The curve continued to steepen as 30-year yields moved 20 basis points higher while 2-year yields settled 16 basis points lower.

Across our portfolios, we strategically added duration exposure when yields pushed toward the higher end of the range seeing it as an attractive hedge to our credit positions exposed to weakening economic data, but have now reduced that exposure as yields across the curve have rallied to the lower end of the range.

Ten-year yields have mostly stayed within our forecasted range in 2025

U.S. 10-year Treasury yield



Past performance is no guarantee of future returns.
Source: Vanguard and Bloomberg, as of 30 June 2025.

The outlook for Treasury yields is a balance between the effects of restrictive monetary policy and a gradually moderating economy. While inflation registered lower-than-expected figures in the second quarter, it is expected to experience an increase over the coming months due to anticipated tariff impacts. Persistent large deficits and elevated Treasury issuance also weigh on investors' minds and may pressure term premia higher over the medium term.

Against this background, we foresee a range-bound yield environment. We are now trading duration more tactically, but with a long duration bias given our outlook for slowing growth and a belief that the Fed will prioritize its employment mandate over inflation should a weaker labour market become evident. We prefer to hold duration exposure in the belly of the yield curve given rising term-premium risks in longer maturities.

Non-US Rates
Outside the U.S, we remain relatively bearish on Eurozone duration exposure vs. the U.K. Downside risks to U.K. growth could result in a faster pace of rate cuts by the BoE while the uptick in Germany's future fiscal spending and associated greater government bond issuance should drive relative underperformance of German bonds relative to Gilts.

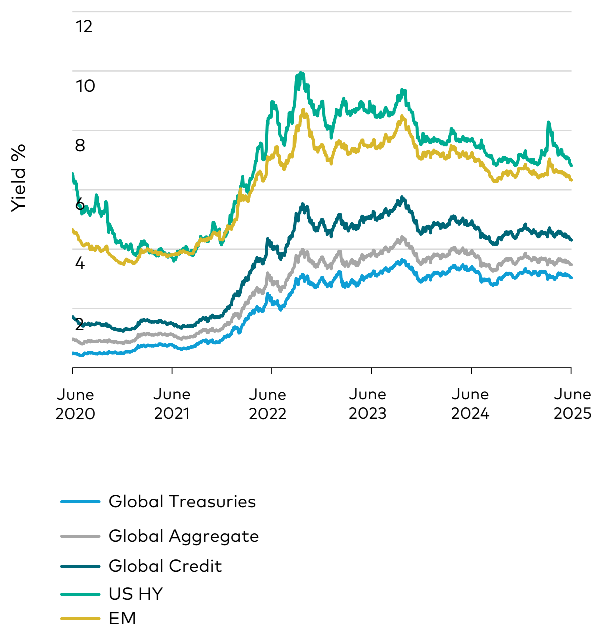
Peripheral Europe has shown resilience to recent risk asset volatility with elevated trade tensions and geopolitical uncertainty increasing political cohesion in the region. Additionally, improving fundamentals, such as Italy's recent rating upgrade, support a positive outlook for peripheral European debt. We continue to maintain an overweight position in Greece and Spain compared to Germany.

In Japan, recent volatility may delay further BoJ rate hikes. We continue to believe that the hikes priced in for 2025 are insufficient relative to the building inflation risks in Japan. We therefore continue to hold short duration positions in shorter maturity Japanese Government bonds. Meanwhile the sharp sell-off in long end JGB yields has steepened the yield curve to levels where we believe adding duration in 30-year JGBs is attractive, effectively adding to our flattening bias in Japan.

Credit outlook
Despite the heightened uncertainty over the quarter, fixed income credit outperformed the broader bond market led by lower rated segments. Spreads across sectors jumped wider on tariff concerns but sharply recovered, narrowing below their pre-Liberation day levels. Relative to equities and rates, credit continues to exhibit much lower volatility.

With growth forecasted to slow but remain positive, we expect credit to perform well through the end of the year. Current spread levels leave limited room for further tightening, but all-in yields near 5% or higher support strong total returns. The biggest risk to credit is a dramatic spike in yields or a sharper growth slowdown – neither of which is our base case forecast. Our credit strategy is to remain defensive, focused on issuers with earnings stability and economic resiliency. Our preference for higher quality credit exposure hasn't changed. Investment grade credit is more insulated from policy uncertainty and a modest growth decline. It should continue to benefit from light net supply, stable fundamentals, and sustained demand from global yield buyers. We expect investment grade spreads to be rangebound between 70 and 90 basis points.

Credit continues to offer attractive all-in yields



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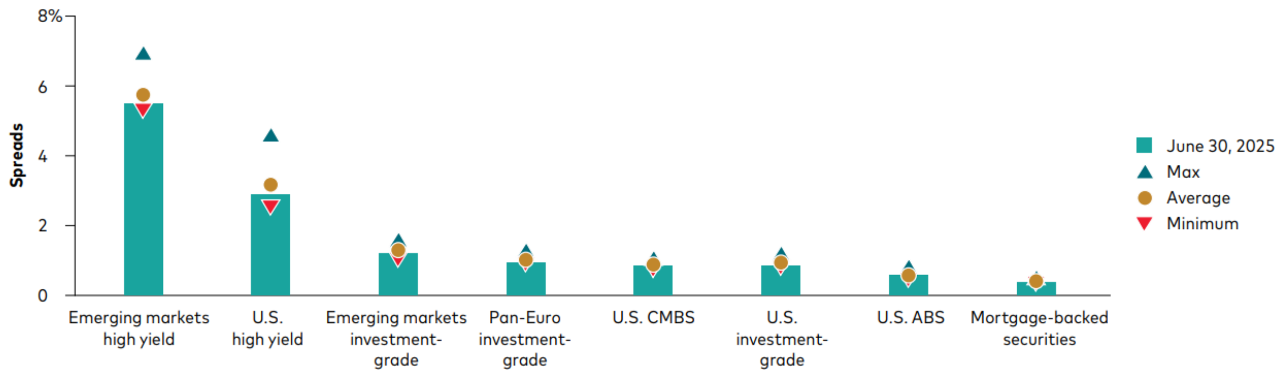
Source: Bloomberg, as of 30 June 2025.

Spreads have mostly held within a narrow range this year



Note: Emerging markets high yield is represented by J.P. Morgan EMBIG Diversified High Yield Index; U.S. high yield is represented by Bloomberg US High Yield Corporate Index; emerging markets investment-grade is represented by J.P. Morgan EMBIG Diversified Investment Grade Index; Pan-Euro investment-grade corporates is represented by Bloomberg Pan European Aggregate Corporate Index; U.S. CMBS is represented by Bloomberg US Aggregate CMBS Index; U.S. investment grade corporates is represented by Bloomberg US Aggregate Corporate Index; U.S. ABS is represented by Bloomberg U.S. Aggregate ABS Index; Mortgage-backed securities is represented by Bloomberg US MBS Fixed Rate Index.
Source: Bloomberg, as of June 30, 2025.

Downgrade activity is beginning to pick up, and loan defaults remain elevated relative to their long-term average. We don't expect default rates to rise dramatically, but we do anticipate greater dispersion in performance and more opportunities to add back exposure at a better price point.

Strategy map

Rates

EXPOSURE	VIEW	STRATEGY
U.S. duration & curve	• Despite secular upside risks to rates, we see tactical opportunities in long duration exposure, especially into weakening economic data • Term premia concerns may limit the decline in longer maturity yields keeping steepening pressure on the curve	• Tactically long duration. Preference for exposure in the intermediate part of the curve.
Global duration & curve	• BoJ policy normalisation to pressure JGB yield curve higher/flatter • Seismic change in European fiscal outlook to drive Eurozone fixed income underperformance	• Short 2-year and 10-year Japanese Gov't Bonds; Long 30yr • Short Germany vs UK
Mortgage-backed securities (MBS)/Agencies	• MBS valuations are fair • Ongoing talk to restructure Fannie Mae and Freddie Mac away from their current conservatorship is difficult & unlikely to result in materially wider spreads	• Overweight agency MBS, focused in low convexity sectors • Overweight non-agency mortgage sector

Credit

EXPOSURE	VIEW	STRATEGY
Investment grade corporates	• Credit fundamentals remain healthy, but spreads are tight • Corporate margins have expanded this year as companies continue to cut costs, maintain pricing and capture higher productivity • The majority of firms are expected to pass on tariff related costs to consumers	• Prefer short-dated financials • Overweight BBB rated industrial issuers over single A rated • Overweight domestic sectors – banks, utilities, insurance
High-yield corporates	• The sector is more sensitive to the path of the economy than tariff rates • Tight spreads, slowing growth, and a softening labor market limit our overall exposure.	• We see most value in the higher quality parts of high yield • Focus is on bottom-up security selection as dispersion across issuers remains high.
Mortgage-backed securities (MBS)/ Agencies	• MBS valuations are fair • Ongoing talk to restructure Fannie Mae and Freddie Mac away from their current conservatorship is difficult & unlikely to result in materially wider spreads	• Overweight agency MBS, focused in low convexity sectors • Overweight non-agency mortgage sector
Emerging markets	• EM performance has been resilient vs U.S. credit this year, in part due to its broad investor base • Negative net supply and sustained investor demand are supportive for the sector • A weaker dollar and slowing growth is fueling EM disinflation	• With spreads back near their tightest levels this year we are focused on relative value across countries and issuers. • In EM local, we like rates exposure in economies where the slowdown in global trade will weigh heavily on growth and where currency appreciation is compounding the loss of competitiveness from tariffs.
Structured products	• ABS new issuance and investor demand remain robust. We still favor ABS as an attractive source of high quality carry. • We're seeing a promising rebound in the refinancing market for CMBS loans with refinancing success rates of 80% over the last six months	• Remain overweight ABS, prefer higher quality issuers and sectors with proven track records through multiple economic cycles. • In CMBS, prefer up in quality with selective exposure to single property deals

Who we are

FIXED INCOME GROUP

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Vanguard's Fixed Income Group manages AUD $4.0 trillion globally in active and index funds with a global team of more than 200 investment professionals.

YEARS IN FIXED INCOME

35+ years

Vanguard's active fixed income team manages over AUD$1.7 trillion across various actively managed fixed income and money market 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

85+

Our investment teams are supported by our 50-plus member Investment Strategy Group that informs our economic outlook and our 85-plus member risk management team that is integrated into our investment process.

Data as at 30 June 2025.

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