Vanguard

Fixed income commentary

June 2022

The conundrum facing fixed income investors today

Commentary by: Kunal Mehta, head of fixed income specialist team and Kelly Gemmell, investment product manager, Vanguard Europe

- Amid higher inflation and rising interest rates globally, fixed income markets have been significantly impacted this year.
- We believe that high-quality fixed income could soon be at a turning point with persistently high inflation and interest-rate rises already factored into bond prices.
- Bonds continue to play an important role in balanced portfolios as risk diversifiers and volatility dampeners.

Introduction

Amid higher inflation and rising interest rates globally, markets year to date have been challenging. Fixed income has been significantly impacted and as the market begins to adapt to this period of 'normalisation' in monetary policy, we can see further challenges to global growth ahead, including higher inflation and heightened concerns around recessionary risks.

For many, fixed income markets have disappointed this year as returns in all areas of fixed income have been negative year to date, following the very long positive period for bonds post the global financial crisis.

However high-quality fixed income could soon be at a turning point due to valuations, with aggressive market expectations already built into prices, strong fundamentals and supportive technicals. Furthermore, as markets start to price in an increased risk of recession, investors could start to see fixed income as 'heroes', especially at a time of slowing global growth.

Monthly performance by market

Global government bonds	Corporate bonds				Emerging market bonds
	UK	Europe	US	HY	
Bloomberg Global Aggregate Treasuries (USD Hedged)	Bloomberg Global Aggregate GBP Corporate (USD Hedged)	Bloomberg Global Aggregate EUR Corporate (USD Hedged)	Bloomberg Global Aggregate USD Corporate (USD Hedged)	Bloomberg Global High Yield (USD Hedged)	JP Morgan Emerging Markets Bond Index EMBI Global Diversified (USD Hedged)
-9.26%	-13.53%	-11.41%	-14.57%	-12.96%	-19.05%

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, 31 December 2021 to 15 June 2022. Bloomberg indices are used as proxies for each exposure.

Growth versus inflation: The debate we never wanted

Post Covid-related lockdowns, rocketing oil and gas prices and the ongoing conflict in Ukraine have all led to significantly higher levels of inflation, driven in part by supply-chain disruptions. These factors have seen inflation increase to the highest levels in recent memory.

Inflation expectations have been rising

Source: Bloomberg, as at 31 May 2022. UK Consumer Prices Index EU harmonised year on year non-seasonally adjusted.

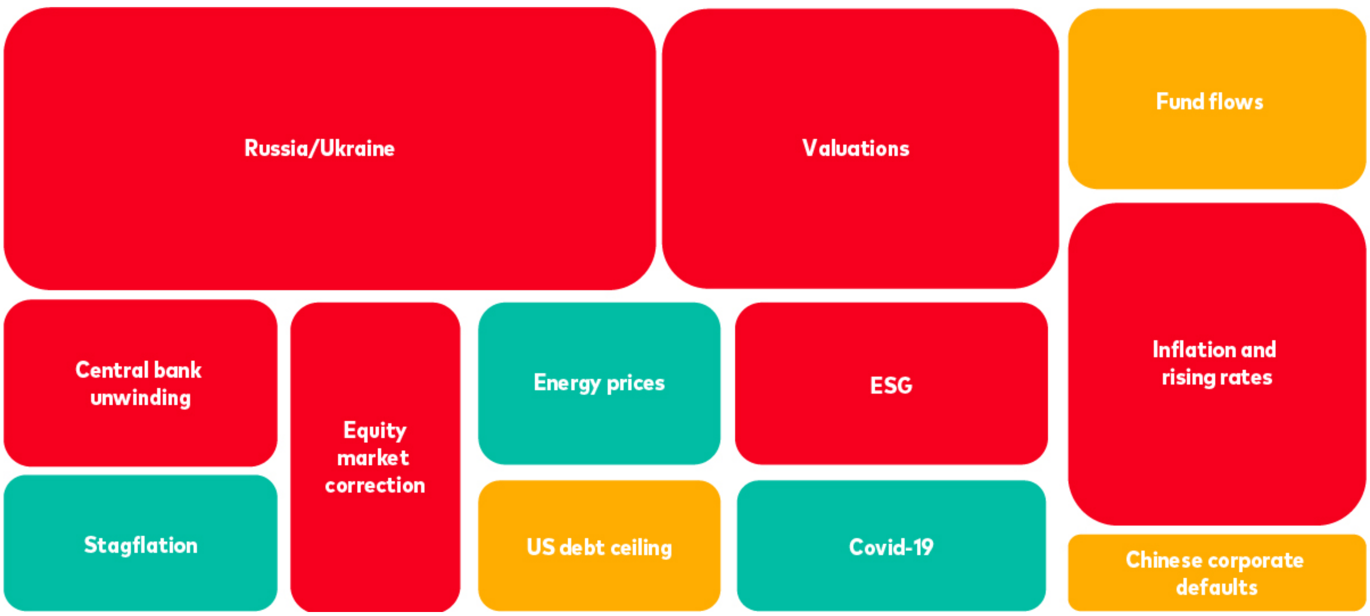
At the same time, global growth has been revised down. In June 2022 the World Bank1 lowered global growth expectations for 2022 significantly from 4.1% in January to 2.9% in June, citing the surge in energy and food prices. This comes on top of supply and trade disruptions triggered by the war in Ukraine at a time when the normalisation in monetary policy is underway,

The balance of growth and inflation is a very big challenge for central banks and this navigation will be key to avoid a 'hard landing'.

What has impacted bond markets this year?

Bond markets often do not react to 'expected' changes but to 'unexpected' changes. Coming into 2022 the market expected a degree of interest-rate rises and liquidity removal as the US Federal Reserve (Fed) told us in November 2021. Fixed income yields have risen this year largely due to unexpected changes, such as higher inflation than expected, higher energy prices than expected, as well as the war in Ukraine.

What are bond markets concerned about?



Source: Vanguard

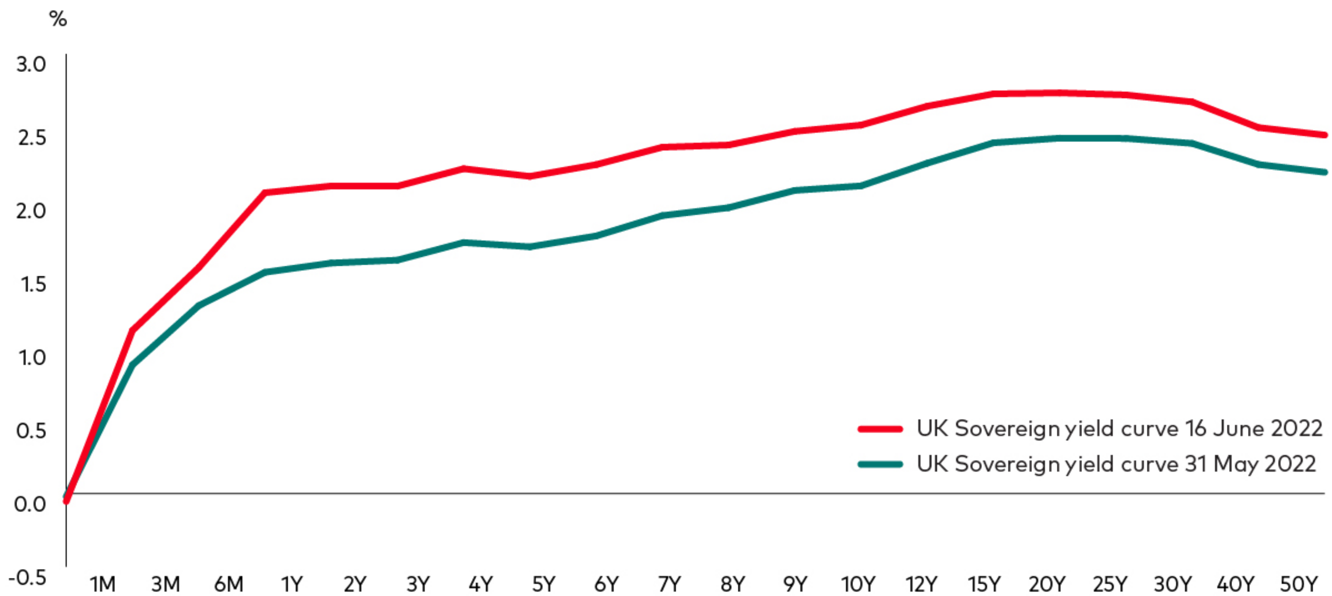
As a result, monetary policy has had to adapt quickly across core developed markets. This has been evident in June as central banks – led by the Fed and European Central Bank (ECB) – have pivoted significantly.

What has happened in June?

The Bank of England (BoE)

Yields moved higher across the curve as markets priced in a more hawkish tone from the BoE. The greatest uplift was seen in the short end as per the chart below, which shows the absolute level of yields as at the end of May 2022 and 16 June 2022. The market now expects a 50 -basis point hike at the next meeting in August.

Changes in UK government bond yields



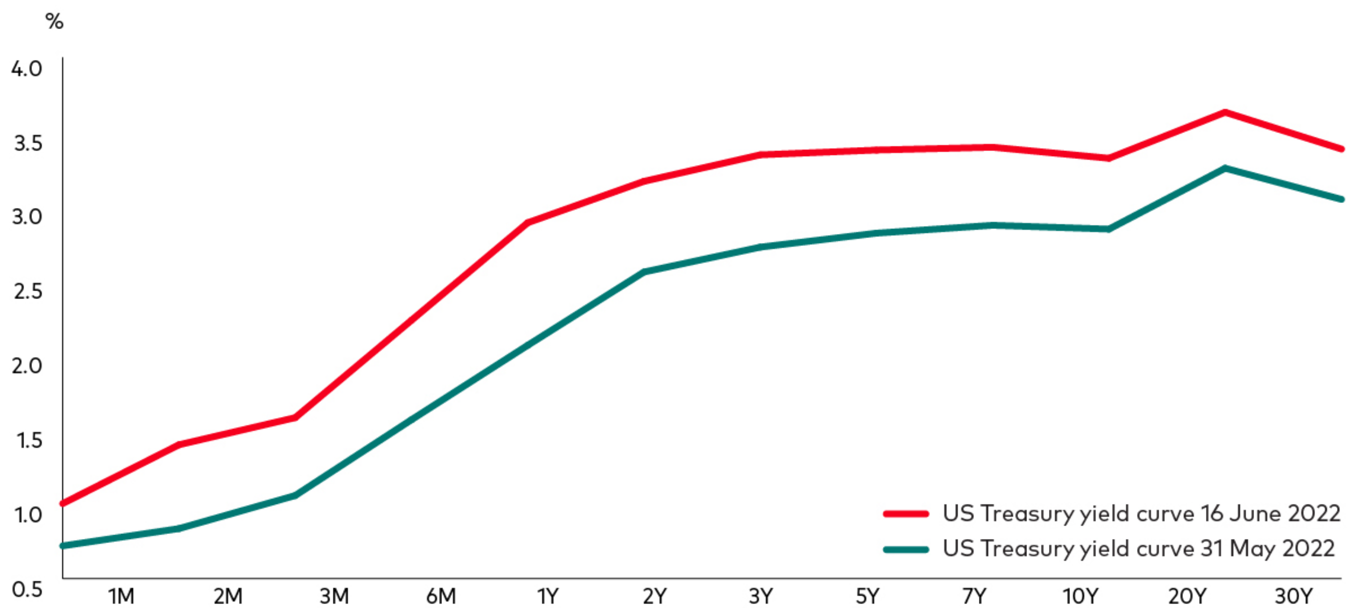
Source: Bloomberg, as at 16 June 2022.

The US Federal Reserve (Fed)

The Fed had previously guided to a 50 basis-point hike at its June meeting. However, a higher-than-expected inflation reading and rising inflation expectations led the Fed to raise rates by 75 basis points to a target range of 1.50-1.75%.

The "dot plot" of individual interest-rate projections now suggests the policy rate will rise to 3.4 % by the end of 2022 and Fed chair Jerome Powell said that Federal Open Market Committee (FOMC) officials wanted to see interest rates at a "modestly restrictive level" by the end of the year. In December 2019, the dot plot projected rates at 0.9% at the end of the year. The market now expects interest rates to reach 3.6% in December 2022

Changes in US government bond yields



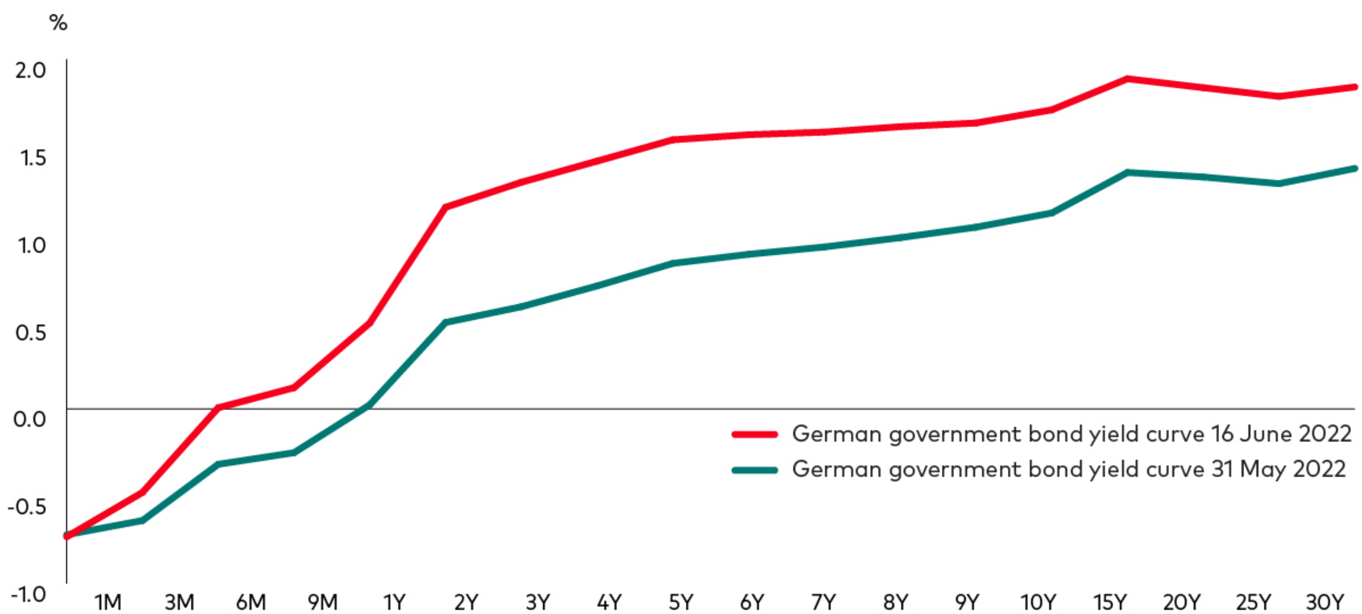
Source: Bloomberg, as at 16 June 2022.

The European Central Bank (ECB)

In the June meeting, the ECB decided to end net asset purchases in its Asset Purchase Programme. It also guided to a 25 basis-point hike at the following meeting in July as well as to a 50 basis-point hike in September if inflation doesn't improve in medium term.

Meanwhile, yields in Italy and Spain reached their highest level in June for eight years. Higher borrowing costs revived fears about a potential repeat of the peripheral debt crises in 2012 and 2014.

Changes in German government bond yields

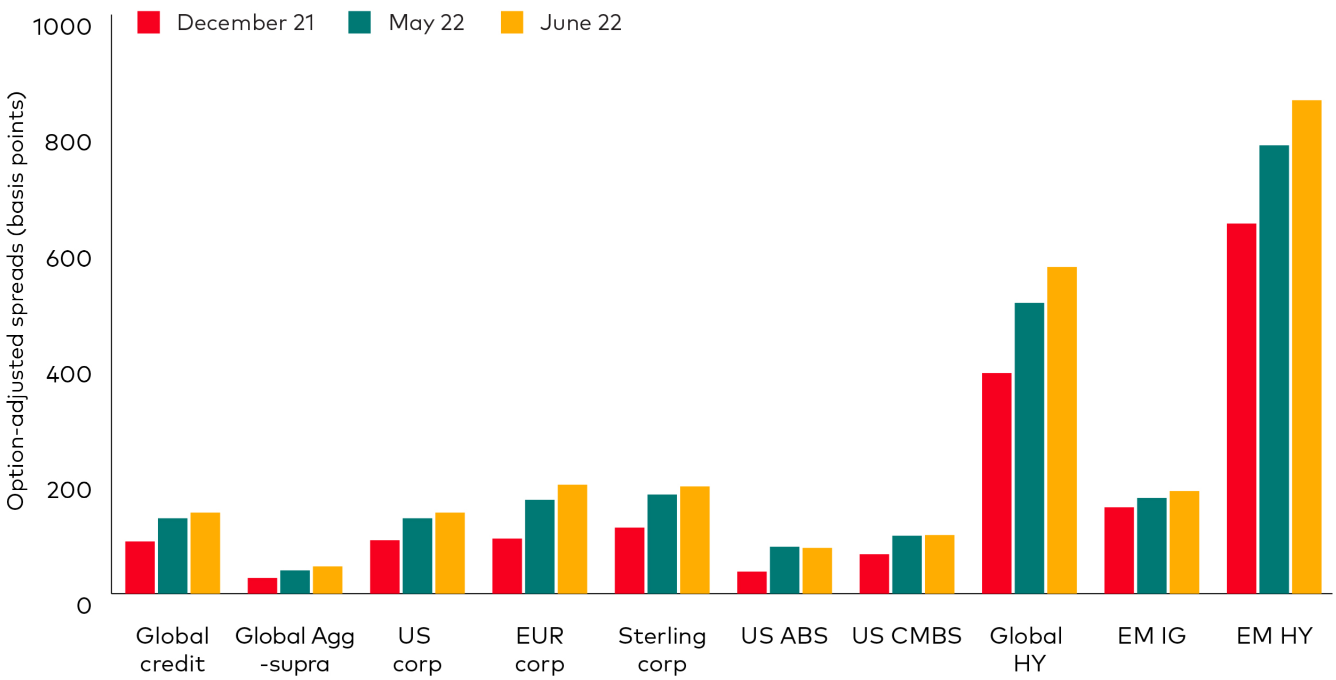


Source: Bloomberg, as at 16 June 2022.

Credit resilience

Corporate fundamentals have remained resilient this year despite the challenging macroeconomic backdrop. However, spreads have widened year to date, and month to date, spreads in global investment grade securities have risen only 10 basis points, which was less than expected, indicating a degree of resilience in high quality bonds to the shocks the market experienced in June 2022..

Credit spread levels



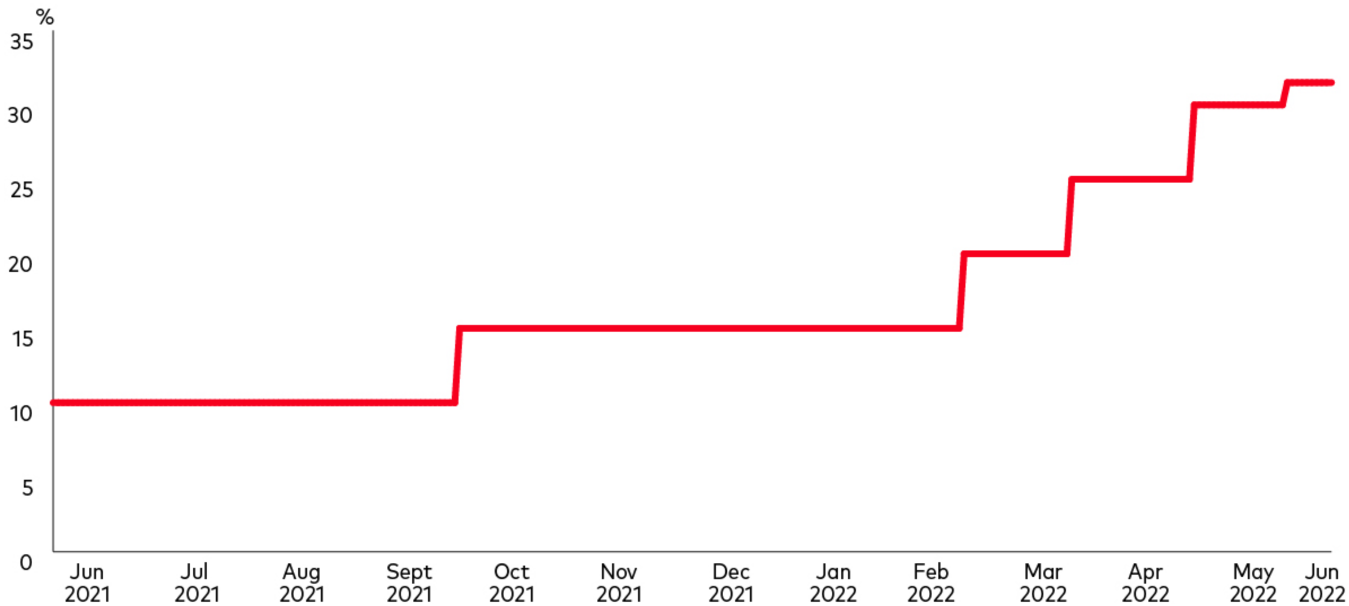
Source: Bloomberg indices: Global Aggregate Credit Average OAS Index, Global Aggregate Supranational Index, US Aggregate Corporate Average OAS Index, Euro Aggregate Corporate Average OAS Index, Sterling Aggregate Corporate Average OAS Index, US Aggregate ABS Average OAS Index, US Aggregate CMBS Average OAS Index, Global High Yield Average OAS Index. J.P. Morgan EMBI Global Diversified IG Sovereign Spread Index, J.P. Morgan EMBI Global Diversified HY Sovereign Spread Index. As at 22 June 2022.

Is there a recession coming?

Growth is slowing and being revised down globally due to a myriad of factors, however, we believe that the US, China and Europe will likely avoid a recession this year. Whether investors expect a recession or not, the market expectation has increased and we believe that investors should have a balanced portfolio to manage these unexpected shocks.

The chart below shows how the market expectation of a recession in the US has been growing since the start of the year.

Risk of recession has increased



Source: Bloomberg, as at 22 June 2022. United States Recession Probability Forecast.

What does this mean for portfolios?

Investors cannot predict market downturns, but they can prepare for them!

Though investors can look in the rear-view mirror and see that bonds have performed badly year to date, bond yields and coupons/income are now higher compared to the start of the year. Furthermore, persistently high inflation and rising interest rates are arguably already factored into bond prices, and while investors are concerned about bond returns year to date, the valuation of a bond's expected future coupon payments is higher today than at the start of the year.

The role of bonds and the need for diversification has not changed either. Having a diversified number of holdings across issuers, currencies (currency hedged), sectors, countries and maturities can help to add stability to a portfolio.

Often short duration bonds react most to interest-rate rises and Vanguard research[1] has shown that longer duration bonds can often provide a better source of downside protection than shorter duration.

As such, we believe that high quality, diversified allocations should continue to provide value, especially in today's uncertain environment. Historically, at times of significant market volatility, bonds have been 'heroes' to investor portfolios and we believe bonds can continue to offer attractive returns over the long term.

[1] Source: Vanguard research on longer duration bonds being better shock absorbers during equity market downturns.

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