Vanguard

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Portfolio perspectives

Each month, you'll receive the latest insights from our Portfolio Solutions experts to help you address evolving issues that may affect your clients' portfolios.

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Discover the impact of price stability's goal on bond markets

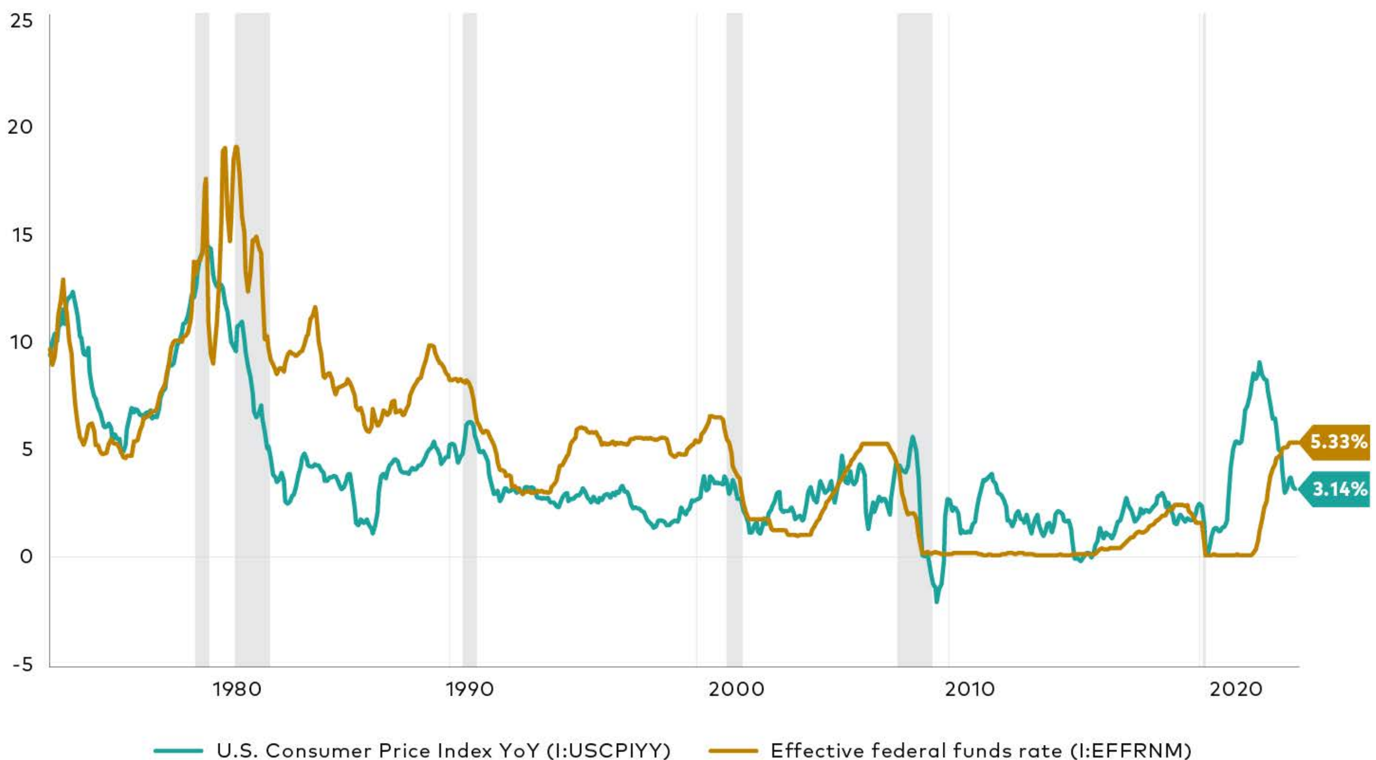
The fight to reduce inflation is succeeding, with the Consumer Price Index having fallen from its high of 9% in June 2022 to its most recent print of 3.4% for the 12 months ending December 2023, according to the U. S. Bureau of Labor Statistics. However, some components of inflation are still too high and remain a concern for the Fed. In line with falling inflation, bond markets have already begun adjusting to reflect a lower-rate environment, where the Fed seeks to return its funds rate to a neutral policy setting.

Why a 2% target inflation rate?

A key role of global central banks, such as the Federal Reserve, is to achieve price stability in the economy. However, the target inflation rate of 2% has only been considered by central banks since the early 1990s, and it wasn't until 2012 under the leadership of Chair Ben Bernanke that the Fed officially adopted this target.

An inflation rate that is too high creates uncertainty for businesses and individuals. Household budgets become strained as purchasing power is eroded. Businesses are uncertain as to whether to invest to grow now or save for the future. A 2% inflation rate creates confidence in markets and the economy, which is what central banks are hoping to achieve.

Figure 1: The fed funds rate is a key lever to impact inflation



Sources: Vanguard and YCharts, as of December 31, 2023.

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Here's our view on the implications for portfolios

Since inflation targeting became part of global central bank mandates, annual inflation rates have reduced meaningfully. Figure 1 above represents year-on-year U.S. inflation and the U.S. fed funds rate. While goods inflation has been deflationary year-on-year, services inflation (which is much stickier) such as shelter (e.g., rent) and transportation services are still running at an annualized rate above 4%.

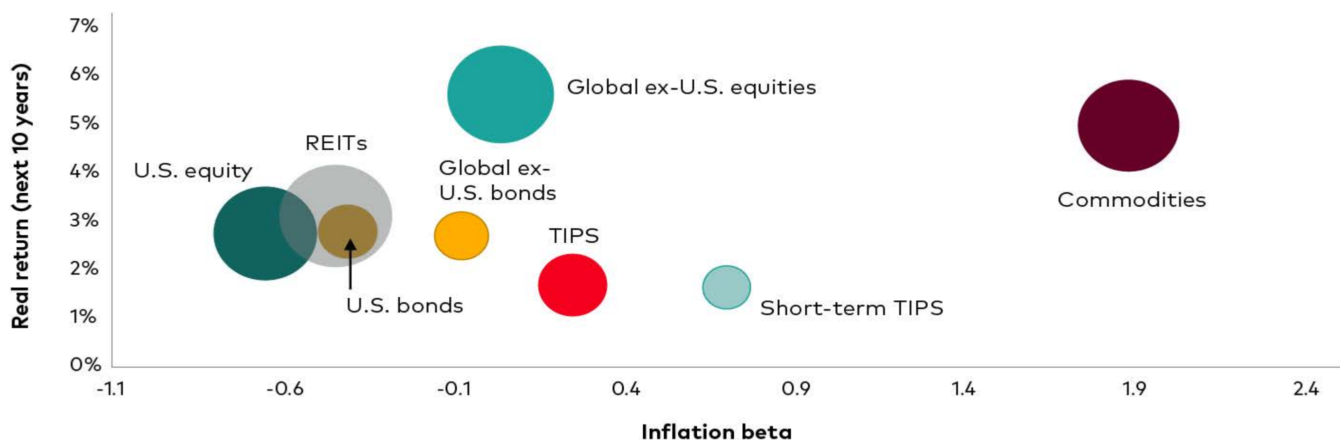
The Vanguard economic and market outlook for 2024 points to the impact of rising rates becoming increasingly restrictive to the U.S. economy through this year. We believe the economy will experience a mild downturn, which is necessary to return inflation to its 2% target. We also expect policy rates to remain higher than those encountered after the most recent shocks, being the Global Financial Crisis and during the COVID-19 pandemic. The implications on portfolios can vary depending on your view on inflation (and interest rates).

Inflation returns to target: With interest rates at restrictive levels, as inflation approaches its 2% target, investors can expect a normalization to the Fed's terminal rate—the long-term target interest rate where prices are stable and full employment is achieved—which Vanguard believes to be around 3.0–3.5% (source: Vanguard economic and market outlook for 2024: A return to sound money). This expected decline provides an opportunity to extend bond duration to not only capture higher yields, but also to provide stronger diversification to equity risk. Investors should be mindful, however, that the path to "normalization" is not linear: There will likely be some bumps along the road. As such a diversified approach to bond exposure is a prudent way to spread risk and capture the higher yields that are currently available.

Higher inflation: Investors who believe that the fight against inflation has not been won just yet, who expect inflation to be stickier and remain higher than the market's expectations, may wish to consider including exposures that are more effective to hedge against inflation. Figure 2 below highlights the effectiveness of various asset classes against unexpected inflation. These include commodities, short-term TIPS, and intermediate-term TIPS. Inflation hedging can be particularly beneficial for retirees or those about to transition to retirement, where real returns are important to maintaining their desired lifestyle. Vanguard's own Target Retirement Funds introduce TIPS into the portfolio allocation when investors reach the age of 60.

Investors may also consider high real return assets such as equities to increase purchasing power over longer time horizons. Of course, additional investments into equities will increase the risk in a portfolio with respect to other asset classes. Any decision to adjust the risk profile of a portfolio should be considered in light of the investor's goals, time horizon, and overall tolerance to risk.

Figure 2: How well subasset classes help protect against unexpected inflation



IMPORTANT: The projections and other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modeled asset class. Simulations as of September 30, 2023. Results from the model may vary with each use and over time. For more information, please see the Notes section at the end of the article.

Notes: The chart compares real (inflation-adjusted) return projections over the next 10 years to the inflation beta for various asset classes. Inflation beta is the linear regression coefficient between the 30-year inflation forecast and the 30-year portfolio return forecast. The size of the bubble represents the median annualized volatility. The indexes used are: U.S. equities: MSCI US Broad Market Index; global ex-U.S. equities: MSCI All Country World ex USA Index; U.S. bonds: Bloomberg U.S. Aggregate Bond Index; global ex-U.S. bonds: Bloomberg Global Aggregate ex-USD Index; commodities: Bloomberg Commodities Total Return Index; U.S. TIPS: Bloomberg U.S. Treasury Inflation Protected Securities Index; U.S. short-term TIPS: Bloomberg U.S. 1–5 Year Treasury Inflation Protected Securities Index; and U.S. REITs: FTSE/NAREIT US Real Estate Index.

Source: Vanguard calculations, as of September 30, 2023.

Next steps to consider: Understand the impact of inflation on your portfolios

Vanguard's latest economic and markets outlook for 2024 provides greater details on our views for inflation, interest rates, and the broader U.S. and global economy. Further to this outlook, our team of senior portfolio specialists and investment consultants can provide further insights into your portfolio's expected return under different inflation and broader economic scenarios. With inflation falling and interest rates at elevated levels, now is an opportune time to reevaluate your bond allocation and its ability to provide portfolio diversification throughout the market cycle.

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Private credit: Understand the risks and opportunities

In recent years, there's been significant growth in the use of private credit by financial advisors. Private credit funds are funds that lend money to businesses or individuals that cannot get loans from traditional sources, such as banks or issuing bonds. These funds can potentially offer a higher yield than other types of investments, but they also come with higher risk and costs. Here are some things to consider before investing in private credit funds:

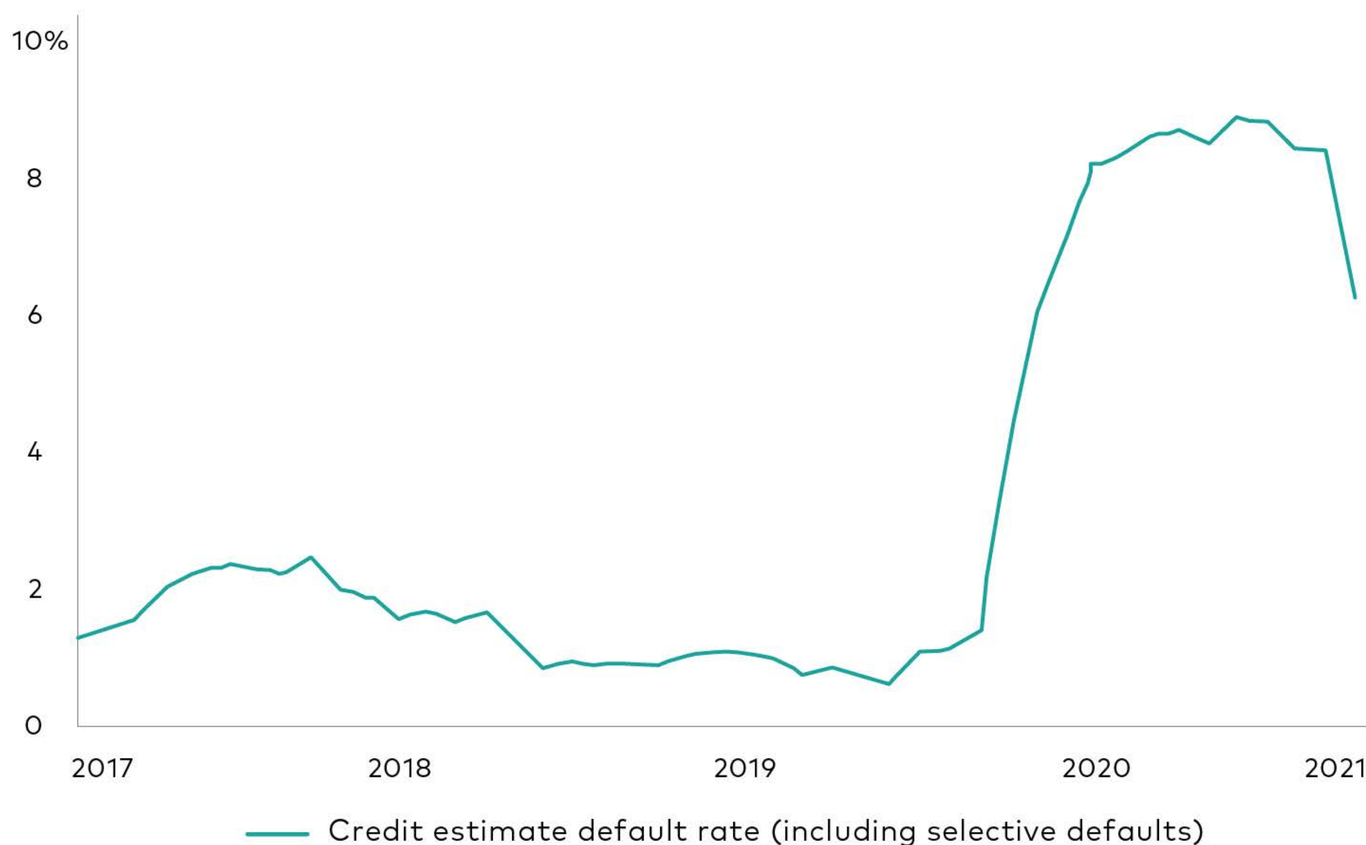
- **Lower liquidity.** Private credit funds are less liquid, which means that your clients cannot easily sell or withdraw their investments. They would have to wait until the fund matures or the borrower repays the loan, which can take several years. If your clients need money urgently, they may not be able to access it. Private credit funds have different fund vehicles, such as interval funds, closed-end funds, and private funds. Interval funds offer periodic liquidity, but they have limited capacity and may suspend redemptions in times of stress. Closed-end funds have a fixed term and lock up your capital until maturity. Investors can trade closed-end funds in the secondary market, but they may trade at discounts to their net asset value. Private funds are only available to accredited or qualified investors and have the least transparency and regulation among the fund vehicles.

- **Greater risks.** Private credit funds are vulnerable to interest rate risk and default risk (see Figure 3), which are common among many fixed income products, however, private funds also have concentration risk. Private loans typically command higher interest rates because these funds usually lend money to small- to mid-size companies that cannot access the public debt market. Smaller companies are more sensitive to negative economic down-turns because their business is less diversified. As a result and due to the riskier nature of the downturns borrowing, private loans become asymmetrically more expensive as interest rates increase to compensate for the possibility of a default.

- **Higher fees.** Private credit funds charge higher fees and expenses, which can reduce your net returns. These fees include management fees, performance fees, origination fees, due diligence fees, legal fees, and administrative fees. Average net fee for interval funds is 2.44%, according to Morningstar, as of December 31, 2023. To clarify, an investor in an interval fund will need to earn at least **2.44%** just to break even on their return. Some private credit funds may also have a complex fee structure that is hard to understand and compare. For example, performance fees are charged on top of the management fees.

- **Unsustainable growth?** Private credit funds have experienced rapid growth in assets under management (source: Morgan Stanley, Understanding Private Credit, as of September 15, 2023). However, this growth may not be sustainable or profitable in the long run. As more investors flock to private credit funds, the competition for quality loans may increase, driving down yields and increasing risks. Moreover, as interest rates have risen and economic conditions worsen, private credit funds may face more defaults and losses. Historical default rates for private credit funds have been two times larger than investment grade corporates (sources: S&P Global, Default Transition, and Recovery: 2020 Annual Global Corporate Default And Rating Transition Study; Ares Management Corporation, Private Credit: Differentiated Performance in the Midst of Rising Interest Rates, as of July 2022). However, in certain economic stressful environments, like in 2020, we have seen a spike in private credit defaults climb to 8% (source: S&P Global, Private Debt: A Lesser-Known Corner Of Finance Finds The Spotlight, as of October 12, 2021).

Figure 3: One-year lagging default rate: S&P Global credit estimates



Source: S&P Global and LCD, an offering of S&P Global Market Intelligence, as of October 12, 2021.

Next steps to consider: Do your homework before moving forward

Private credit funds may not be suitable for every client. They require a high level of risk tolerance, patience, and due diligence. When fixed income yields were close to zero, many advisors looked to private credit to provide a replacement for the yield that they weren't getting in fixed income. But with Treasury and investment grade public credit funds yielding in excess of 4% and a potential recession looming, more intensive due diligence is required to understand the underlying investments and structure in private credit funds. Private credit should be used as a diversification tool and not as a replacement for traditional fixed income.

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Notes:

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- The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

- The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

- All investing is subject to risk, including the possible loss of the money you invest. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

- Investments in Target Retirement Funds are subject to the risks of their underlying funds. The year in the Fund name refers to the approximate year (the target date) when an investor in the Fund would retire and leave the work force. The Fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. The Income Fund has a fixed investment allocation and is designed for investors who are already retired. An investment in a Target Retirement Fund is not guaranteed at any time, including on or after the target date.

- Diversification does not ensure a profit or protect against a loss.

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- Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

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