Vanguard

JULY 2025

Active Fixed Income Perspectives Q3 2025: The power of income

Key takeaways

Performance

Bonds have continued 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 indexes have returned between 4% and 7.25%, largely driven by income from higher coupons.

The big picture

Downside risks to the U.S. and global economies remain, even as the most severe policy scenarios appear to have been avoided. The disruption to U.S. exceptionalism demonstrates the need for diversification and to have a global reach when looking for opportunities. Across sectors, fixed income still offers one of the most attractive entry points to add income in decades.

Contents

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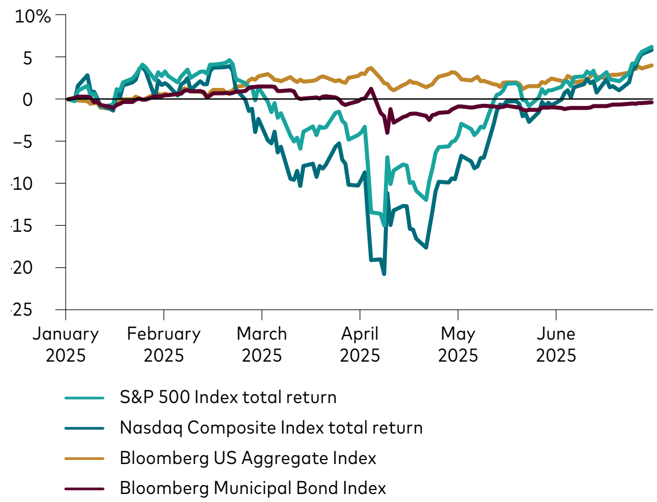
Making a comeback

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 sell-off following the April 2, 2025 ("Liberation Day") tariff announcement. Momentum continued through the end of the second quarter as investors managed to shake off the negative implications of rising tension in the Middle East and eventual U.S. involvement in the Israel-Iran conflict.

Credit-sensitive sectors experienced the greatest benefit from the rebound in market sentiment; spreads promptly recovered from their brief widening and ended the quarter at tighter levels. Uncertainty about the direction of U.S. policies propelled the performance of international bonds as global and ex-U.S. indexes outpaced broad U.S. indexes.

Bonds held steady versus equities during the selloff after the tariff announcement

(Cumulative returns from January 1 through June 30, 2025)



Source: Bloomberg, as of June 30, 2025.

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.

The power of income

In a landscape that has 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 amid 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.

Broader taxable and tax-exempt bond indexes now offer 2.5 to 3.5 times the income buffer than they did as recently as mid-2021. That means that upward movements in interest rates have a less negative impact on total returns for those who 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 (bps) 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 yields mean bonds hold more potential upside than downside

		Starting yield	Modeled 12-month returns under different interest rate-change scenarios (in basis points)				
			−100 Total return expectations	−50 Total return expectations	0 Total return expectations	+50 Total return expectations	+100 Total return expectations
As of 6/30/2025	U.S. aggregate	4.5%	10.3%	7.3%	4.5%	1.8%	−0.7%
	Municipals	4.0%	10.2%	7.1%	4.0%	0.8%	−2.4%
As of 12/31/2021	U.S. aggregate	1.8%	8.2%	4.9%	1.8%	−1.3%	−4.2%
	Municipals	1.1%	5.6%	3.4%	1.1%	−1.2%	−3.6%

>8% | 4.9%–7.9% | 1.5%–4.8% | −1.5%–1.5% | <−1.5%

Note: The model assumes a one-time move in interest rates then assumes the investor holds the position for the next 12 months and captures the price change and the income return using the current yield to worst, which is the lowest potential yield an investor can receive on a bond without the issuer defaulting.

Source: Vanguard calculations, based on the Bloomberg US Aggregate Bond Index and Bloomberg Municipal Index, as of June 30, 2025.

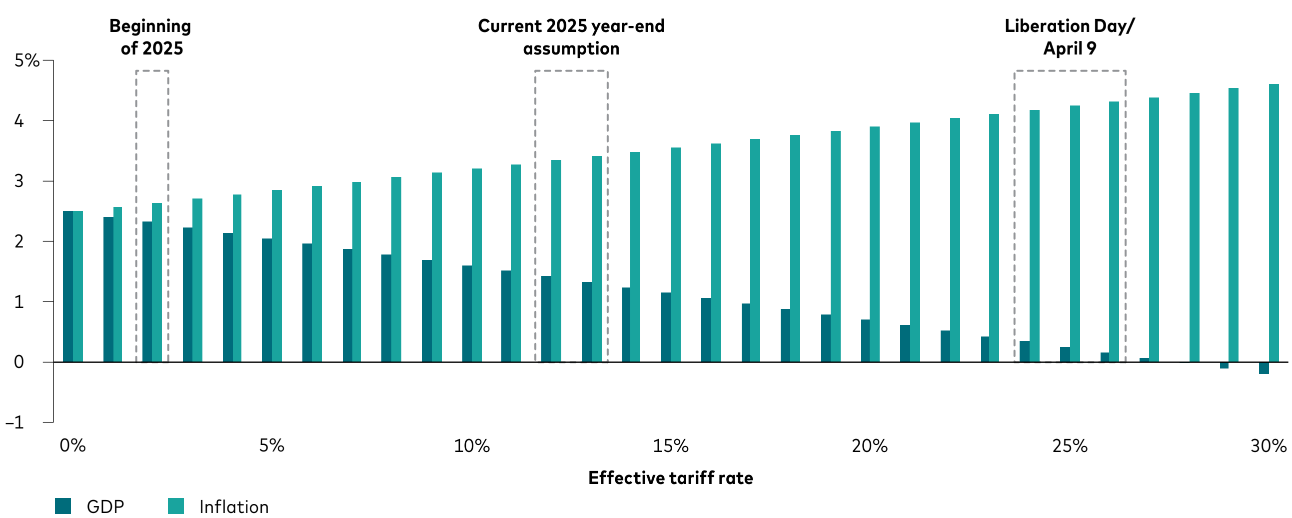
Higher return potential also means that high-quality bonds are better equipped to be portfolio hedges. At current levels, interest rates have a lot more room to rally in the event of a growth slowdown. If a recession were to occur, we would expect a significant decline in interest rates to cause strong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

Tariffs still matter

While the most extreme tariff outcomes appear to have been avoided for now, 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 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 2, we see a more muted stagflationary impulse to the economy. However, even though the rate is half of what was initially proposed, it would still settle at roughly 10 percentage points 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 June 30, 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 with a series of shorter-term bonds, has risen by approximately 1.5 percentage points over the past two years. In June 2023, the yield on 2-year Treasuries was more than one percentage point higher than the yield on both 10-year notes and 30-year Treasury bonds. Today, the 10-year note offers a yield premium of 0.50% and the 30-year offers a pickup of 1.0%. In our view, investors are now more appropriately compensated to take on duration risk.

U.S. policymakers appear to be cognizant of rising term premium dynamics and have underscored the importance of maintaining healthy demand for Treasuries and keeping borrowing costs at sustainable levels. This has led market participants to believe that the Treasury Department will not increase long-maturity issuance for several quarters and will instead skew any increase toward shorter maturities, where there is likely to be greater demand. Policymakers also have started to take other actions that could support Treasury market dynamics, including a proposed reform to the Supplementary Leverage Ratio and a slowing of the Federal Reserve's balance sheet runoff. 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 better compensated for taking on longer duration

Source: Bloomberg, as of June 30, 2025.

Economy, policy, and outlook

Several factors have raised our expectations for the U.S. economy through the back half of the year compared with our expectations last quarter. However, our outlook remains softer relative to what we initially forecast 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 positive for growth into 2026, but markets may pay more attention to the growth of the deficit.

Growth: We expect the economy to expand 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" announcement (0.75%).

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

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

Inflation: Tariff-related cost increases should push inflation up in the latter half of the year, with the core Personal Consumption Expenditures (PCE) price index projected to reach close to 3% year over year by the end of 2025. While the front-running of goods imports has 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 rest 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 that long-term inflation expectations remain anchored.

Monetary policy: The Federal Open Market Committee decided in June to keep the federal funds rate unchanged for the fourth time this year.

The Fed is assessing monetary policy, which is still restrictive, even as there are some indications of slowing growth and risks of rising inflation.

As long as the labor market remains steady, the Fed can continue to take a measured approach. Although 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 pass-through effects of tariffs. If the pass-through impact is weaker than expected, conditions should allow for maintenance rate cuts later this year. We think two cuts over the rest of 2025 is a reasonable expectation.

Portfolio positioning and strategy

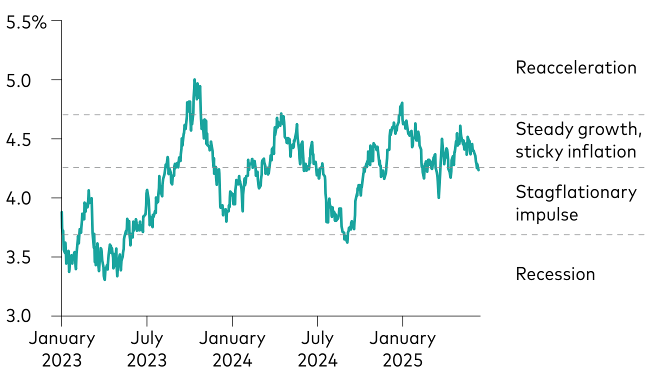
U.S. rates and yield curve

So far this year, 10-year Treasury yields have mostly traded inside our forecasted range of 4.25%–4.75%, notwithstanding significant intraquarter 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 bps higher, while 2-year yields settled 16 bps lower.

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

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

U.S. 10-year Treasury yield



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

The outlook for Treasury yields is a balance between the effects of restrictive monetary policy and a gradually moderating economy. Although 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 labor 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-U.S. rates

Outside the U.S. we remain relatively bearish on euro zone duration exposure versus comparable U.K. gilts. Downside risks to U.K. growth could result in a faster pace of rate cuts by the Bank of England, while the uptick in Germany's future fiscal spending and associated greater government bond issuance should drive underperformance of German bonds relative to gilts.

Peripheral Europe has shown resilience to recent volatility; elevated trade tensions and geopolitical uncertainly have increased 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 with Germany.

In Japan, recent volatility may delay further Bank of Japan (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 (JGBs). Meanwhile, the sharp sell-off in long-end JGB yields has steepened the yield curve to levels at which we believe adding duration in 30-year JGBs is attractive, effectively adding to our flattening bias in Japan.

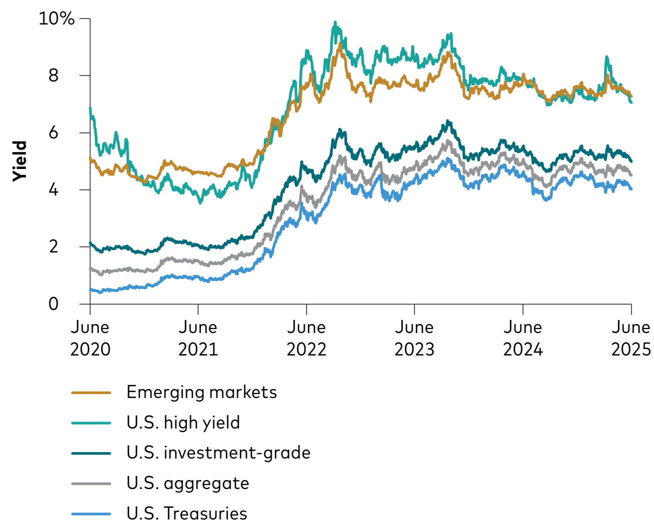
Credit outlook

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 levels before the April 2 tariff announcement. Credit continues to exhibit much lower volatility than equities and rates.

With the growth forecast 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, and neither is our base-case forecast.

Our credit strategy is to remain defensive and focused on issuers with earnings stability and economic resiliency. Our preference for higher-quality credit exposure hasn't changed. Compared with lower-quality credit, 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 bps and 90 bps.

Credit continues to offer attractive yields



Source: Bloomberg, as of June 30, 2025.

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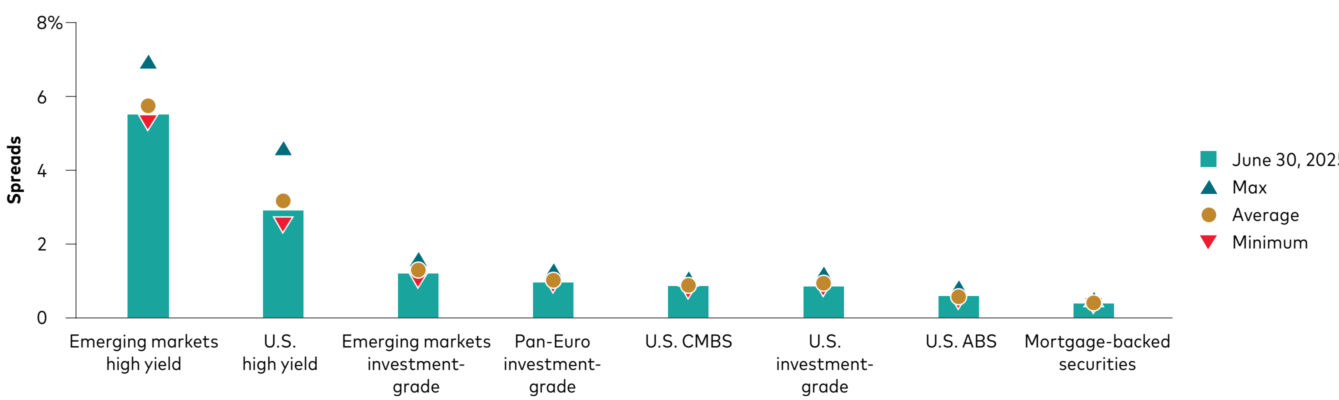
Spreads have mostly held within a narrow range this year



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.

Vanguard active bond funds and ETFs

Vanguard active bond funds and ETFs		Admiral™ Shares or ETF ticker symbol	Expense ratio*
Investment-grade corporate	Ultra-Short Bond ETF	VUSB	0.10

Active fixed income leadership team

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In industry since 1992

Chris Alwine, CFA
Global Head of Credit
In industry since 1990

Roger Hallam, CFA
Global Head of Rates
In industry since 2000

Paul Malloy, CFA
Head of U.S. Municipals
In industry since 2005

Active fixed income at Vanguard

$478B Vanguard Global Active Bond AUM

$282B Vanguard Global Active Taxable Bond AUM

$196B Vanguard Global Active Municipal Bond AUM

25+ Portfolio managers

35+ Traders

60+ Credit research analysts

130+ Dedicated team members

* As reported in each fund's prospectus. A fund's current expense ratio may be higher or lower than the figure shown.
† Investment advisor: Wellington Management Company LLP.
‡ Investor Shares available only. There is no minimum investment required for advised clients.
Note: Data as of June 30, 2025.

For more information about active fixed income, speak with your financial advisor.

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