SEPTEMBER 2025

Vanguard

Active Fixed Income Perspectives—Monthly Pulse

Key takeaways

1. **Tariff impacts, though delayed, will continue to build, driving the risk of slower growth and higher inflation near term.**
2. **Further rate cuts and pro-growth policies can counteract tariff friction. We see moderate growth through next year.**
3. **The Fed is normalizing, but—absent a recession—it's unlikely to cut as much as the market is currently expecting.**
4. **Credit valuations are stretched but justified. Credit selection remains an important driver of alpha.**

Our outlook: Tariffs are gradually impacting the economy, but offsets are on the horizon

The labor market has downshifted and building tariff impacts drive the risk of a softer economy over the next several months. At the same time, the Federal Reserve is acting proactively, and we foresee more pro-growth policy next year, supporting economic momentum. In portfolios, we are balancing this more benign outlook against full valuations and the risk of the economy slowing more than anticipated in the near term.

The labor market: realigning to a new equilibrium. Continued slow job growth in August, downward revisions, and a job-openings-to-unemployed-persons ratio under 1:1 for the first time in four years highlight labor market risks. So far, both the demand for and supply of labor have fallen, keeping the unemployment rate in check. AI productivity and other factors may further subdue demand to counterbalance a new normal of low labor growth. However, the current equilibrium is fragile and warrants vigilance.

Tariffs: a slow burn with broad reach. Trade policy is still a key economic catalyst, and its effects are growing, evidenced by rising goods inflation. We estimate about a third of the new tariffs' impact has passed through the economy already, and we'll see about half by year-end and the rest in 2026. A slow pace of implementation has helped the economy digest the changes and companies mitigate the impact, but risks to growth and inflation persist.

The Fed: easing, but with eyes wide open. The recent string of soft labor market data opened the door for the Fed to cut rates by 0.25%. We view the September cut as policy normalization guided by risk management, and we expect further cuts this year and into 2026. However, absent a recession, we do not expect the Fed to deliver all the cuts the market is presently expecting.

Offsetting forces: growth catalysts on the horizon. Tax cuts and deregulation should help the economy and counteract tariffs' impact. We forecast the new tax and spending bill alone to add roughly 0.4% to GDP growth next year. Continued investments in and productivity gains from AI, as well as less restrictive monetary policy, may also serve as economic tailwinds.

Our active positioning: A bottom-up focus amid full valuations

Rates: a nimble stance in a shifting landscape. Short-term yields appear too low, as the market may be expecting too many rate cuts. Farther out the curve, risks are balanced between downside risk from labor market vulnerability and upside risk should the growth outlook brighten. We view current 10-year Treasury yields as fair but are biased to lengthen duration should yields rise toward the higher end of recent ranges.

Credit: tight, but tenable. Credit spreads are near historical lows, but healthy fundamentals, attractive all-in yields, robust investor demand, a proactive Fed, and low recession risk support current valuations. Capitalizing on seasonally higher bond issuance, we have added credit risk across our portfolios and are focused on individual bond selection and subsector allocation.

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