

OCTOBER 2025

Active Fixed Income Perspectives Q4 2025: Caught in the crosswinds

Key takeaways

Performance

Bonds have delivered this year. Higher coupons combined with price appreciation from a decline in yields and further spread compression has boosted bond returns across sectors. Year to date as of September 30, the broader U.S. bond market as measured by the Bloomberg US Universal Index has produced returns of 6.31%. Our outlook anticipates that conditions for strong performance will continue.

The big picture

The labor market is realigning to a lower trajectory, and the impact from tariffs will build into 2026. However, positive growth drivers are on the horizon, which should help the economy over the coming quarters. With additional rate cuts on the way, we see an opportunity for investors to lock in durable yields further out on the curve.

Our approach

Strong investor demand has pushed spreads even tighter in taxable credit, despite near-record September issuance. We expect credit to continue to perform well and are leaning into segments that have lagged in recent tightening. In municipals, investor flows have returned and there's considerable value further out on the curve and in coupon and call selection.

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Taxable bonds recorded positive performance across sectors during the quarter. Yields ended the quarter slightly lower, with the front end outperforming the long end, resulting in a steeper curve. Credit spreads narrowed further across sectors as economic conditions remained supportive and investor demand exceeded near-record new supply. U.S. credit spreads touched their lowest levels since 1998. Mortgage-backed securities also performed well, aided by a decline in implied interest rate volatility.

The Fed gets proactive

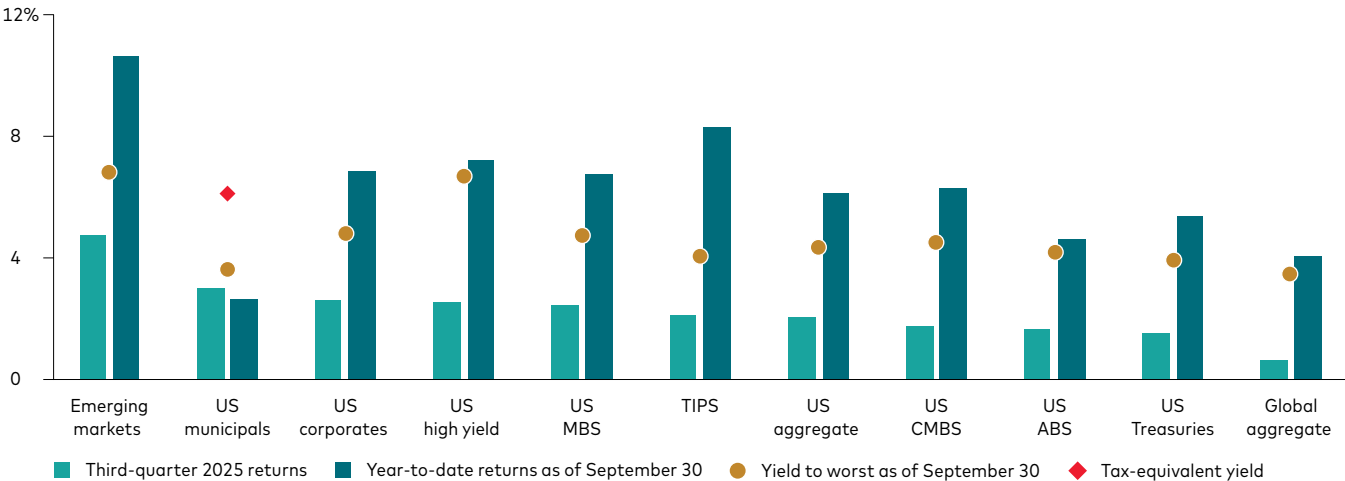
After a nine-month pause, signs of labor market weakness opened the door for the Fed to lower the federal funds rate by 25 basis points in September and signal two additional cuts before the end of the year. Fed Chair Jerome Powell called the decision a "risk management cut,"

suggesting a proactive stance toward normalizing monetary policy in support of the economy. But he also acknowledged that there are no risk-free paths for monetary policy right now.

Inflation risks remain, but the Fed can assess tariff and non-tariff inflation separately, as long as long-term inflation expectations remain anchored. If that holds, we expect the Fed to look through tariffs as a one-time price increase.

Going forward, the pace and depth of cuts will be dependent on labor market and inflation outcomes, as well as the evolving composition of the Federal Open Market Committee. We expect the Fed to deliver more rate cuts this year and into 2026, but not as many as the approximately four additional cuts that the market has priced in through next year.

Fixed income sector returns and yields



Notes: The municipal tax-equivalent yield is calculated using a 40.8% tax bracket, which includes a 37.0% top federal marginal income tax rate and the 3.8% net investment income tax to fund Medicare. Yield to worst represents the lowest yield possible for a security given the current price, taking into account both call dates and maturity.

Indexes used in chart: The following indexes are represented in the sector returns and yields chart: J.P. Morgan EMBI Global Diversified Index, Bloomberg US Municipal Index, Bloomberg US Corporate Index, Bloomberg US Corporate High Yield Index, Bloomberg US Mortgage Backed Securities Index, Bloomberg US Treasury Inflation-Linked Bond Index (Series-L), Bloomberg US Aggregate Index, Bloomberg CMBS: Erisa Eligible Index, Bloomberg US Asset-Backed Securities Index, and Bloomberg Global Aggregate Index.

Sources: Bloomberg indexes and JPMorgan, as of September 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.

A job market in transition

As evidenced by the August jobs report and downward revisions to prior months, the labor market is realigning to a new equilibrium. Both the demand for and supply of labor have declined this year in roughly even amounts. That's limited an upward drift in the unemployment rate, but the balance is fragile and there are downside risks. A year ago, the breakeven rate of job creation that would keep the unemployment rate steady was near 150,000 jobs per month. Since then, a faster pace of retirements and low immigration rates have reduced the supply of workers while companies have been conservative about hiring new workers. By the end of 2025, we expect the breakeven rate to fall to 50,000 per month and hold there through next year. Additionally, artificial intelligence (AI)-related productivity gains and other factors may further subdue demand for labor over the coming quarters.

Competing policy forces

Tariffs continue to shape our outlook. The direct effects have been slow to build in 2025, but economic pressures will persist as the realized tariff rate increases. We estimate about one-third of the new tariff impact has passed through already and expect about half to be reflected by year-end, with the balance to come through next year.

Looking forward, several pro-growth policies are projected to exert a greater influence in the coming year, which should help offset the economic drag caused by tariffs. Tax cuts and deregulation are expected to support the economy. Notably, the One Big Beautiful Bill Act is expected to increase GDP by 0.4% in 2026. Sustained momentum in AI investment has been significant this year and is expected to persist throughout next year. In 2026, we expect companies to experience productivity gains as a direct result. Combined with our expectations for looser monetary policy, we see this policy mix as a net positive for the economy over the coming quarters.

A delicate balance

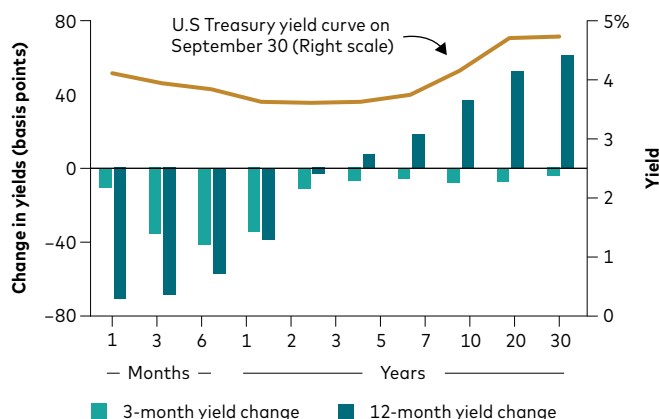
Our medium-term outlook is positive for rates and credit. We expect to see U.S. growth improve as the tariff-driven inflation shock subsides. The possibility of a recession is the main risk to credit spreads, but it is more likely to come from an exogenous shock than a policy mistake. Across our portfolios, we are balancing our constructive economic view against full valuations and the risk that the economy slows more than anticipated in the near term.

U.S. rates and yield curve

Yields across the curve held mostly steady before rallying late in the quarter in response to weaker-than-expected U.S. payroll data and have since settled into a lower range. The 10-year U.S. Treasury, for instance, had held between 4.25% and 4.50% over the past few months, but has traded between 4.0% and 4.25% in recent weeks.

The curve steepened over the quarter as front-end yields declined more than those on the long end. This broader trend has remained intact since the Fed stopped raising rates in 2023. Back then, the yield curve was deeply inverted, with 2-year Treasury yields a full percentage point higher than 30-year Treasury yields. As of September 30, 30-year yields were 112 basis points higher than 2-year yields, offering investors more term premium compensation for taking on longer duration.

U.S. Treasury yield curve has reversed course in past year



Source: Bloomberg, as of September 30, 2025.

Past performance is no guarantee of future returns.

We expect the Fed to deliver additional insurance cuts in this year. However, the path in 2026 is less clear. For example, cuts this year may provide enough relief for the labor market, reducing the need for future cuts.

We are maintaining a strategically neutral U.S. duration position, since we see upside and downside risks to yields as balanced. We continue

to favor exposure in the belly of the U.S. curve, as intermediate duration still offers a balance of yield, cushion against equity drawdowns, and less exposure to term premium risks that could put upward pressure on long-term yields.

U.S Treasury yield curve: Steep and steeper



Source: Bloomberg, as of September 30, 2025.

Past performance is no guarantee of future returns.

Non-U.S. rates

Long-end yields across the developed world have moved higher this year, which reflects a shifting preference from investors who are requiring a higher premium to own longer-duration bonds of countries with rising debt levels. We are positioned for that trend to continue in Europe, Canada, and Australia.

In Germany, its fourth-quarter issuance plans confirmed our expectations for a dramatic increase in government bond issuance. We believe that will put upward pressure on long-end yields and expect 30-year bunds to underperform 30-year U.K. gilts. We remain constructive on government bonds in Spain and Greece, where we observe continued favorable credit trends.

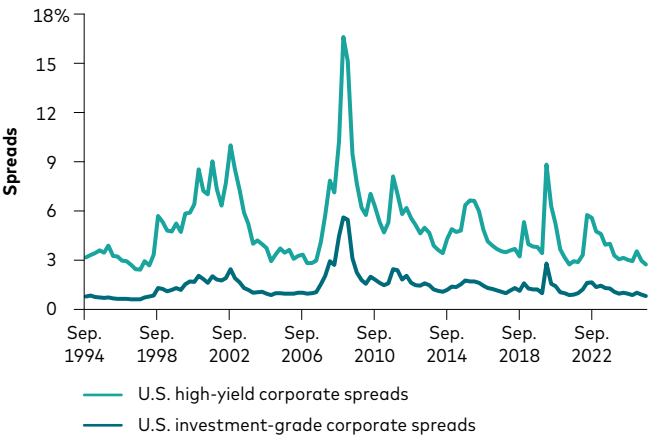
We believe the market's expectation for Bank of Japan (BoJ) rate hikes is insufficient relative to the building inflation risks. We continue to expect the yields to move higher and the curve to flatten.

Credit outlook

Fixed income credit has performed well across sectors and credit-quality tiers. Spreads trended lower over the quarter, with investment-grade credit 10 basis points tighter and high-yield 30 basis points tighter. Emerging-market (EM) credit has been one of the best-performing segments of the market this year, maintaining that momentum in the third quarter as spreads narrowed 40 basis points.

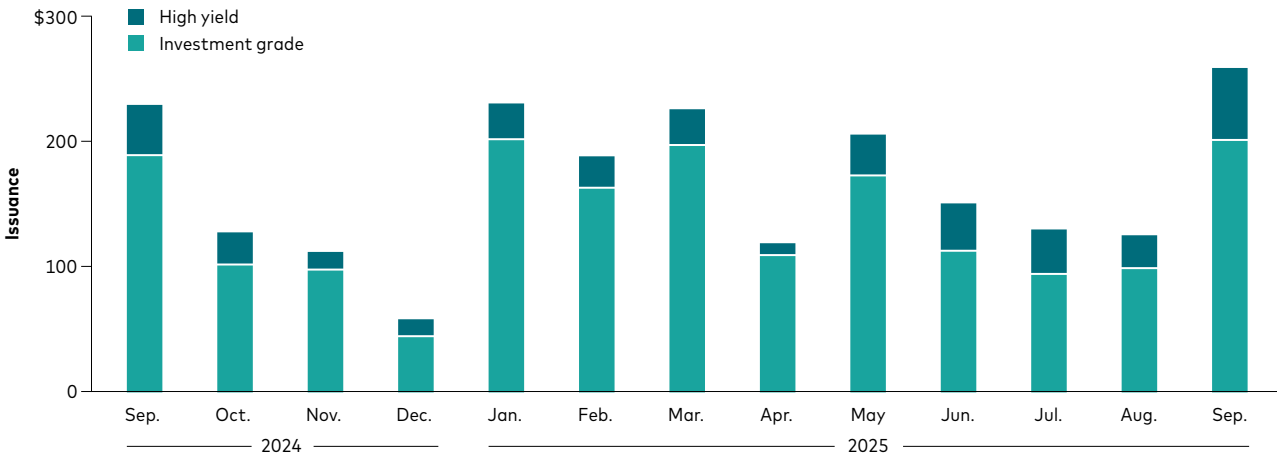
September is typically one of the busiest months for new issuance, and that proved true again as markets saw near-record levels of activity over recent weeks. Market conditions were ideal for issuers looking to refinance into better terms. Borrowing costs have come down as yields have declined from recent peaks. Investor appetite for credit has remained extremely strong: Recent deals have been oversubscribed and come without price concessions for investors.

U.S. corporate spreads sliding lower



Source: Bloomberg, as of September 30, 2025.

U.S. corporate issuance reached new heights in September



Source: Bloomberg, as of September 30, 2025.

We see a positive environment for credit into next year. Corporate leverage is stable, margins are strong, and U.S. consumer debt levels remain lower than they were before the 2020 COVID-19 pandemic. An improving growth outlook and looser monetary policy should keep spreads within recent ranges over the coming months.

Valuations continue to be a key driver for our credit allocation. We hold a lower and more targeted exposure to lower-quality segments. We took advantage of the September issuance surge to add securities that offer attractive carry with sound fundamentals.

Spreads compress across credit markets

	September 30, 2024	June 30, 2025	September 30, 2025	1-year average
U.S. investment-grade corporates	89	83	74	84
Pan-European investment-grade corporates	117	93	80	96
U.S. ABS	64	57	49	54
U.S. CMBS	93	84	75	84
U.S. high yield	295	290	267	294
BB	180	171	168	180
B	285	281	263	284
CCC	642	677	604	622
Emerging markets (USD)	361	321	283	324
Investment grade	115	118	93	116
High yield	660	550	509	567
EM corporates	214	221	187	211

Note: The chart above reflects the option-adjusted spreads (OAS), which is the yield spread added to the U.S. Treasury yield curve to discount the securities' payments to match their market price, using a dynamic pricing model.

The following indexes are used in calculating the spreads: Bloomberg US Corporate Index, Bloomberg Pan-European Aggregate: Corporate Index, Bloomberg US Asset-Backed Securities Index, Bloomberg CMBS: Erisa Eligible Index, Bloomberg US Corporate High Yield Index, Bloomberg US Corporate High Yield Ba Index, Bloomberg US Corporate High Yield B Index, Bloomberg US Corporate High Yield CCC Index, J.P. Morgan EMBI Global Diversified Index, J.P. Morgan EMBI Global Diversified Investment Grade Index, J.P. Morgan EMBI Global Diversified High Yield Index, and J.P. Morgan CEMBI Broad Diversified Index.

Source: Bloomberg, as of September 30, 2025.

Vanguard active bond funds and ETFs

Vanguard active bond funds and ETFs		Admiral™ Shares or ETF ticker symbol	Expense ratio*
Treasury/ Agency	Government Securities Active ETF	VGVT	0.10
Investment- grade corporate	Core Bond ETF	VCRB	0.10
	Core-Plus Bond ETF	VPLS	0.20
	Multi-Sector Income Bond ETF	VGMS	0.30
	Ultra-Short Bond ETF	VUSB	0.10
Below- investment- grade	High-Yield Active ETF	VGHY	0.22

Active fixed income leadership team



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In industry since 1992



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Roger Hallam, CFA
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In industry since 2000



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

Active fixed income at Vanguard

\$498B Vanguard Global Active

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 September 30, 2025.

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

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