Vanguard

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Active Fixed Income Perspectives Q4 2026: Looking through the fog

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Key takeaways

Performance recap

The U.S. economy remained resilient in the third quarter, supported by consumer spending and AI-related investment. Firm growth, elevated energy prices, and a stable labor market led the Federal Reserve to raise rates in September, lifting Treasury yields across the curve. Credit markets remained well supported by healthy fundamentals and strong investor demand. Higher volatility led mortgage-backed securities (MBS) to underperform, while record municipal issuance overwhelmed demand and lifted tax-exempt yields to their highest levels since 2008.

The big picture

Looking forward, the case for owning fixed income has become more compelling. Elevated yields provide investors with attractive income and a larger cushion against uncertainty, even as policy and geopolitical risks remain in focus. Importantly, the recent rise in yields has been driven more by resilient growth and higher real yields than by higher long-term inflation expectations. With global bond yields near their highest levels in roughly two decades, we believe fixed income offers value across a range of potential economic outcomes.

Our approach

Higher yields and greater dispersion across fixed income markets have expanded the opportunity set for active investors. We are focusing on areas where valuations have improved and security selection holds greater advantage. As a result, we remain underweight sovereign risk in favor of sectors we view as offering more attractive risk-adjusted return potential and are neutral U.S. duration and curve at the fund level relative to benchmarks. We see attractive opportunities in MBS following the recent repricing and remain constructive on investment-grade credit and securitized assets, where yields continue to offer compelling income potential. In global rates markets, we favor select relative-value opportunities, including an overweight to German bunds versus U.S. Treasuries and short duration and curve flattening exposures in Japan. In municipals, elevated yields and attractive structures have created meaningful value in high-grade bonds further out on the curve.

Macro backdrop

A justified increase in yields

The rise in yields this year reflects a more resilient economic backdrop than markets had anticipated. Corporate earnings have exceeded expectations, particularly in the U.S., while elevated energy prices have added to inflation pressures. At the same time, heavy fixed income issuance, driven by large sovereign borrowing needs and record AI-related capital spending, has increased competition for investor capital.

Fed Chair Kevin Warsh's observation that he would be "hard-pressed to describe broad financial conditions as restrictive" highlights a key challenge for policymakers. A healthy labor market has allowed the Federal Reserve to focus primarily on inflation, where progress has been slower than expected. If growth remains resilient and if inflation fails to move convincingly toward the Fed's 2% target, policy rates may need to move higher still, a possibility increasingly reflected in market pricing.

The global monetary policy U-turn

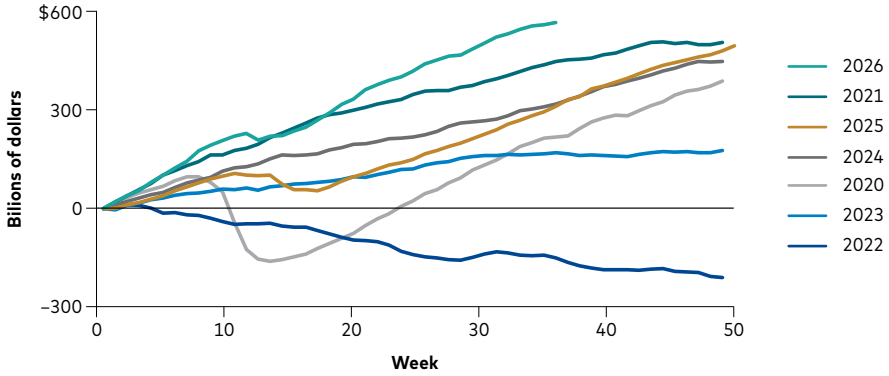
This backdrop has led to a global monetary policy reversal. Markets began the year expecting rate cuts, but major central banks have instead moved toward tighter policy. In the U.S., the Federal Reserve raised rates by 25 basis points in September, and markets now expect a further removal of the "insurance cuts" delivered in 2025. The European Central Bank (ECB) began a new tightening cycle in June, while the Bank of Japan (BOJ) continued its policy normalization efforts. Together, these developments have pushed global yields higher and increased dispersion across fixed income markets.

Looking through the fog

Despite ongoing uncertainty around inflation, deficits, geopolitics, and interest rates, the case for fixed income has strengthened. Higher yields provide attractive income and have materially improved prospective returns. Investors have taken notice. Fixed income funds attracted roughly $678 billion of net inflows through September 30, a record pace for the asset class and roughly double the amount flowing into equity funds.[1] The strong demand reflects growing recognition that today's yield environment offers attractive value across a range of potential outcomes.

Despite poor performance, fixed income flows remain very strong

Cumulative annual long-term taxable bond fund and ETF flows

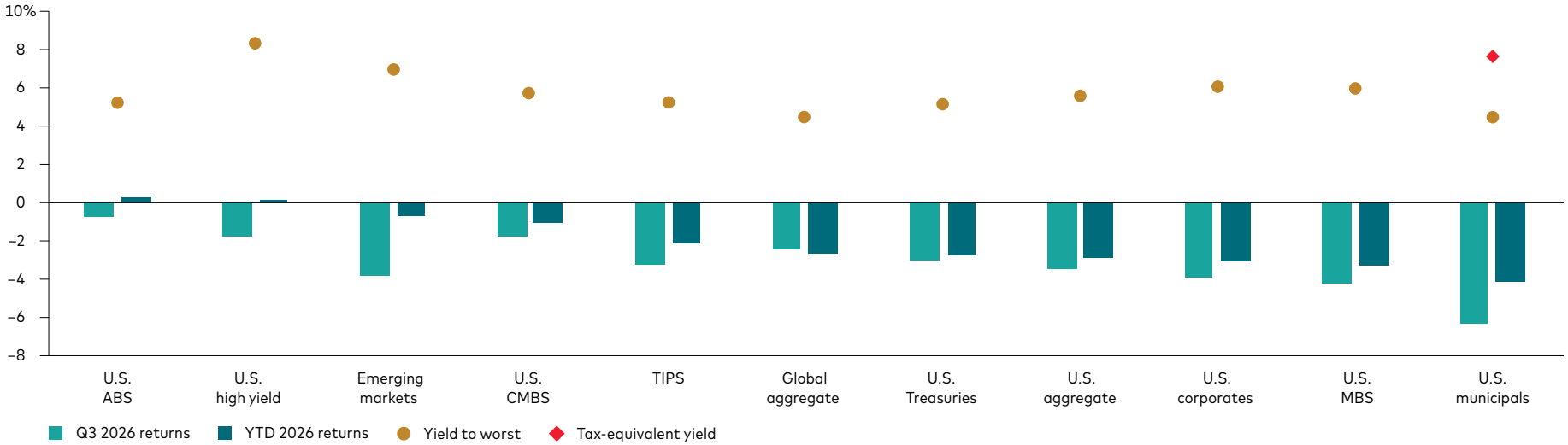


Source: Bloomberg, as of September 30, 2026.

1 Source: Morningstar.

If growth remains resilient and inflation stays elevated, coupon income can help offset further increases in yields. If yields remain near current levels, investors can continue to benefit from today's higher income. And if growth weakens, declining yields could create price appreciation while restoring bonds' traditional role as a portfolio ballast. In each scenario, today's higher starting yields provide a stronger foundation for future returns.

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, considering 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 U.S. Corporate High Yield Index, Bloomberg U.S. Mortgage Backed Securities Index, Bloomberg U.S. Corporate Index, Bloomberg CMBS: Erisa Eligible Index, Bloomberg U.S. Aggregate Index, Bloomberg U.S. Treasury Inflation-Linked Bond Index (Series-L), Bloomberg U.S. Treasury Index, Bloomberg U.S. Asset-Backed Securities Index, Bloomberg Global Aggregate Index, and Bloomberg U.S. Municipal Index.

Sources: Bloomberg indexes and JPMorgan, as of September 30, 2026.

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.

Rate markets and strategy

The market now expects three additional quarter-point Fed hikes over the next 12 months, which would place the federal funds target range between 4.50% and 4.75%. We view that path as broadly consistent with our outlook for approximately 3% growth and inflation moderating toward 2.5%. Our base case is that the Fed continues to remove the insurance cuts delivered in 2025 before reassessing inflation and labor-market conditions to determine whether additional tightening is warranted.

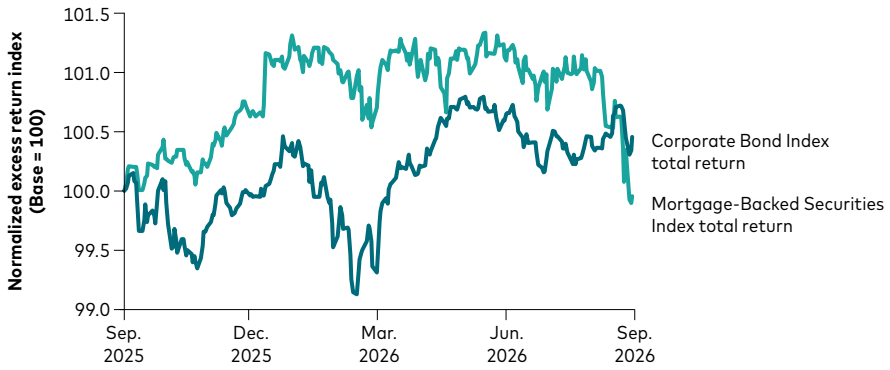
We view current yield levels as fair and hold a neutral view on U.S. duration and curve.

Mortgage valuations have improved

Higher rate volatility created a meaningful improvement in MBS valuations during the quarter. At today's mortgage rates, few borrowers have an economic incentive to refinance, while newer production mortgages are trading at discounted prices.

These conditions have made prepayment and convexity risks more manageable while improving relative valuations across the sector. As a result, we continue to find attractive opportunities in MBS and have increased our overweight, particularly in structures with more predictable cash flows and less extension risk.

MBS sold off in the third quarter, creating a value opportunity



Source: Bloomberg, as of September 30, 2026.

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Global volatility

Policy normalization in Japan and diverging fiscal dynamics in Europe are creating relative value across global rates markets. In Japan, the BoJ's continued tightening has pushed government bond yields higher and flattened the yield curve as investors price a faster pace of normalization. In Europe, persistent inflation and renewed fiscal concerns have increased dispersion across sovereign bond markets, with France at the center of the repricing.

France's elevated debt burden, rising borrowing costs, and growing political uncertainty have raised questions about the country's fiscal trajectory. With markets increasingly focused on fiscal sustainability, investors are demanding greater compensation for holding French government debt relative to other European issuers. At the same time, the ECB appears unlikely to intervene unless market conditions become significantly more disorderly.

We believe this environment favors active positioning. We remain underweight France and Italy relative to Germany amid elevated fiscal and political risks and continue to favor German bunds relative to U.S. Treasuries. In Japan, we maintain a short-duration, curve-flattening bias, while remaining overweight European inflation-linked exposure.

French OAT spread over German bunds

Source: Bloomberg, as of September 30, 2026.

Credit markets and strategy

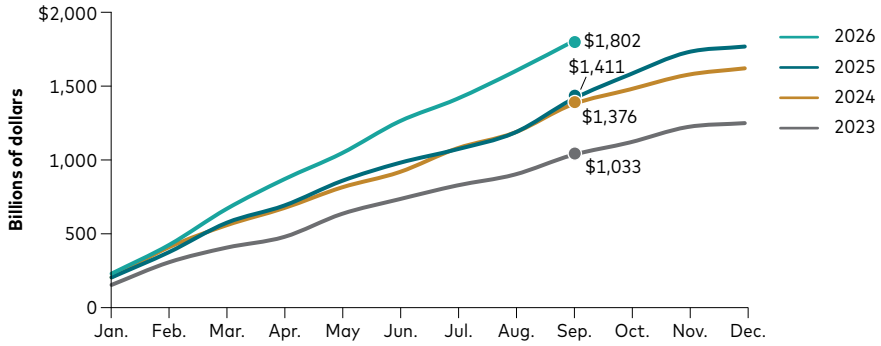
We remain constructive on credit markets as resilient fundamentals and strong investor demand continue to create a stable backdrop for risk assets. While credit spreads across most sectors remain near the tighter end of their historical ranges despite recent widening, yields remain compelling and should continue to serve as the primary driver of returns.

As a result, we believe income generation, rather than further broad-based spread compression, is likely to be the dominant source of excess return in the quarter ahead.

Investment-grade supported by fundamentals

Within investment-grade corporates, fundamentals remain favorable. Corporate balance sheets are healthy, refinancing activity remains manageable, and investor demand is absorbing a historically strong pace of issuance—with over $1.8 trillion in new issues, up 30% year-over-year. Some 13% of that is for the buildout of AI-related infrastructure, and we anticipate this issuance to continue as large technology and hyperscaler companies access capital markets to finance data centers, networking assets, and power requirements.

U.S. investment-grade issuance surges again



Source: Bloomberg, as of September 30, 2026.

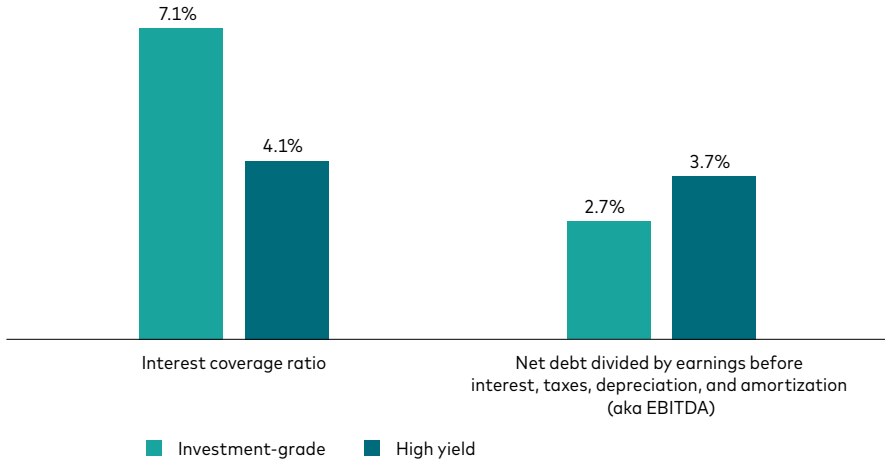
The resulting supply has caused spreads to widen in the technology sector, even as overall spreads remain tight. This environment has created opportunities for our team to capitalize on issuer-specific dislocations. We continue to see investment-grade credit as one of the most attractive areas of the market, offering a compelling combination of yield, quality, and resilience. One example is in financials, where large banks with strong capital and liquidity positions can benefit from rising interest rates as their net interest margins expand.

U.S. corporate investment-grade spreads remain within our forecasted range

Note: Option-adjusted spread of the Bloomberg U.S. Corporate Index. The top two dotted lines represent the Fixed Income Group's current expected ranges for corporate credit spreads.

Source: Bloomberg, as of September 30, 2026.

Resilient earnings growth has kept corporate balance sheets strong



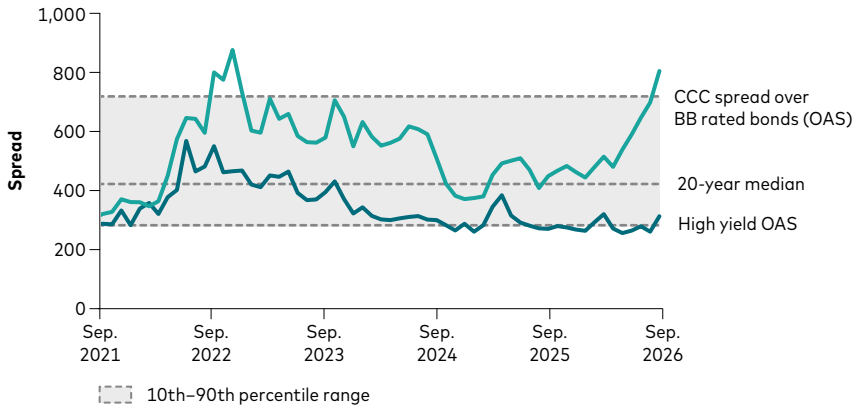
Source: Bloomberg, as of September 30, 2026.

High yield: Less margin for error

In high yield, the outlook remains supportive, though selectivity is increasingly important. Credit spreads are very tight by historic standards, but the asset class continues to benefit from a favorable fundamental backdrop. Default activity remains contained, distressed debt levels are low, and the overall quality of the high-yield universe has improved as the riskiest issues remain with private credit or leveraged loans.

These dynamics support maintaining exposure to the sector, but they also reinforce the importance of disciplined security selection. With valuations providing less margin for error, we favor an active approach focused on identifying issuers with durable cash flows, improving credit trajectories, and attractive risk-adjusted return potential. One sector we are focusing on is specialty chemical producers (versus generics) that have more stable demand and pricing dynamics.

CCC rated bond spreads have widened out in recent months



Source: Bloomberg, as of September 30, 2026.

Securitized credit remains strong

Securitized credit continues to be one of the most compelling opportunities across fixed income markets. Structured products, particularly asset-backed securities (ABS), offer attractive carry potential, strong structural investor protections, and favorable relative valuations. In particular, the stand-alone nature of the structures insulates the assets from troubles at the corporate parents, while embedded equity is in place to absorb any initial losses.

In an environment where corporate spreads remain compressed, securitized sectors can provide comparable income with additional diversification benefits and, in many cases, less exposure to corporate earnings risk. Issuance here is also strong, with over $25 billion in data center asset-backed securities and commercial MBS this year so far, which is more than the last three years combined. We continue to favor higher-quality structured products where valuations remain attractive relative to fundamentals.

Overall, our preference remains tilted toward higher-quality carry sectors, particularly investment-grade corporates and securitized credit. While tight spreads suggest more modest space for broad-based spread appreciation, today's yield environment continues to offer high income potential relative to before the global financial crisis.

In a market where valuation dispersion is increasing and benchmark composition is evolving, we believe active management is increasingly valuable in identifying relative value opportunities, managing risks, and enhancing portfolio outcomes.

Taxable portfolio positioning

Rates

Exposure	View	Strategy
U.S. duration and curve	• The market is pricing in multiple hikes from the Fed through late 2027. • 10-year Treasury yields are fairly valued, supported by a strong economy and persistent inflation pressures, offset by robust fixed income demand.	• Neutral view on duration and curve. • Underweight Treasuries versus German bunds.
Global duration and curve	• Rising energy prices to keep ECB on hawkish path. • France faces mounting fiscal pressure as higher debt-servicing costs and political fragmentation leave little margin for economic or policy disappointments. • Rising fiscal and monetary policy risks in Japan argue for higher JGB yields.	• Underweight to France and Italy versus Germany. • Overweight front-end Eurozone inflation. • Short duration with a curve-flattening bias in Japan.
Mortgage-backed securities (MBS)/agencies	• Recent spread-widening has improved MBS valuations, though elevated volatility supports a patient and selective approach. • We see the best relative value opportunities in specific sub-sectors outside of index exposure.	• Select spec pools, fixed-rate CMOs, ARMS, and non-agency RMBS offer the most attractive relative value. We are increasing our overweight to the sector.

Credit

Exposure	View	Strategy
Investment-grade corporates	• Strong fundamentals—credit rating upgrades outpacing downgrades by a nearly 2:1 ratio. • Attractive all-in yields support investor demand—spreads likely range bound.	• See attractive valuations in large U.S. and European banks. • Opportunities across companies supporting the AI build-out (for example, data center infrastructure, hardware, semiconductors, memory chips, and power generation).
High-yield corporates	• Broadly see positive fundamentals, supportive technicals, and valuations that are rich but provide good carry. • Performance dispersion is increasing, making issuer selection significantly more important than sector beta.	• High conviction views in chemicals, autos, and airline sectors where we see improving fundamentals and clear deleveraging paths.
Emerging markets	• Country-level credit metrics are improving with declining budget deficits. • Lower-rated issuers have benefitted from strong investor demand. Credit selection is paramount.	• Front-end bonds offer attractive carry. • Remain cautious on lower-rated oil exporters that recently benefited from higher oil prices.
Structured products	• ABS supply remains heavy, keeping spreads attractive relative to investment-grade corporates. • CMBS offers more limited opportunities with light supply and tight spreads.	• Favor high-quality consumer risk and selective commercial ABS exposure. • Prefer data-center-backed bonds in tier 1 markets backed by long-term leases to high-quality hyperscalers. • Continue to favor AAA CLOs with limited software sector exposure.

Municipal bonds

Highest yields in over 15 years

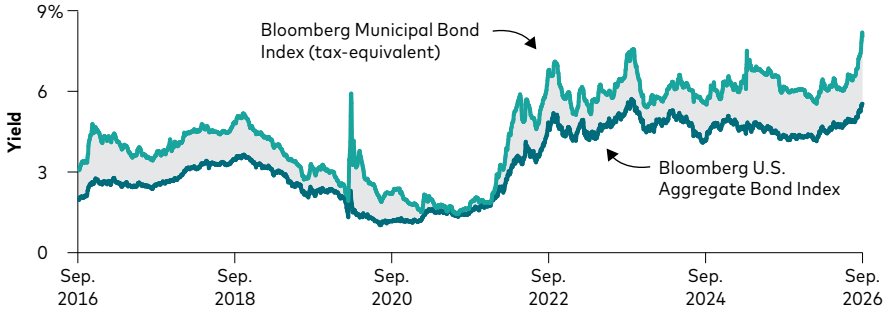
The Bloomberg Municipal Bond Index yielded 4.78% on September 30th, a level not observed since 2008. Although the sell-off in U.S. Treasuries drove much of the rise in municipal yields, record municipal issuance also began to outpace demand, contributing to tax-exempt bonds' underperformance versus taxable bonds over the past three months.

This supply-driven cheapening reflects technical drivers rather than credit-driven challenges, and it has created a compelling opportunity to put money to work in municipals, both on an absolute basis and relative to taxable fixed income alternatives.

When municipal AAA-to-Treasury yield ratios reach the mid-90% range, as they did in September (93% as of September 30th), the market historically begins attracting crossover buyers such as banks and insurance companies. These buyers can help support valuations and limit further cheapening. While the path of Treasury yields remains uncertain, current municipal valuations present a more favorable risk-reward profile, particularly in longer maturities. Even if rates remain volatile, municipals appear better positioned to withstand additional valuation pressure, while offering meaningful upside should investor demand strengthen.

We have been selectively adding exposure to higher grade municipal bonds—primarily AA ratings or better—deploying cash accumulated during the summer months. Maturities in the 10–15-year range offer an attractive combination of elevated yields, discounted valuations, and roll-down potential. Within our long-duration portfolios, we continue to favor longer maturities where nominal yields for even AAA rated municipal bonds can be 5% or higher.

Highest tax-equivalent spread (2.51%) over broad U.S. bond market yields in a decade



Source: Bloomberg, as of September 30, 2026.

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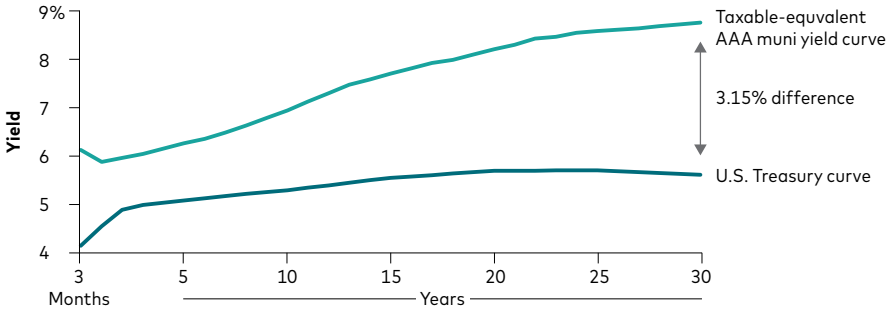
High-grade municipal yields attractive everywhere, most notably on the long end



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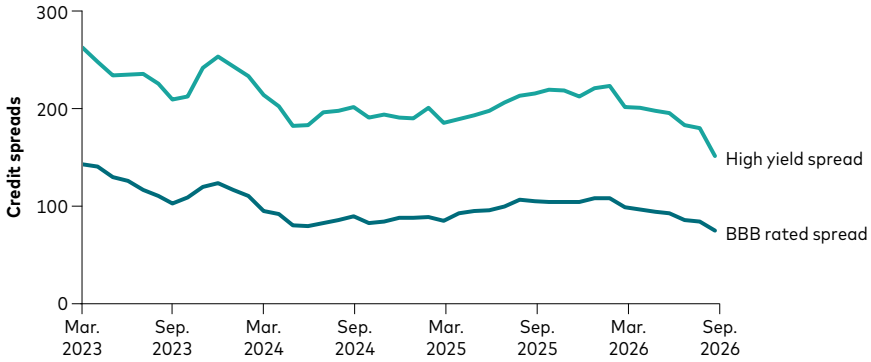
The story for municipal credit is evolving

Credit spreads have compressed to levels where we are finding fewer places in which the additional yield sufficiently compensates investors for the underlying risks.

Areas where we continue to find value include housing, prepaid gas bonds, and select opportunities within land-secured financings, hospitals, and higher education. More broadly, we are making a measured shift toward higher quality rather than outright selling credit. While we are selectively trimming credit positions that appear rich, we are facilitating this transition primarily through directing new cash flows, maturities, and interest payments into attractively valued AA and AAA rated bonds.

Spreads for lower-rated municipal bonds are at or near multi-year lows



Source: Bloomberg, as of September 30, 2026.

Structure management is firmly in the spotlight

When municipal bond yields move by this magnitude, both coupon and call selection (what we refer to as structure management) become critical drivers of both risk management and relative performance. As yields rise above a bond's stated coupon rate—typically 3%, 4%, or 5%—the likelihood that a callable bond will be redeemed early declines because the issuer has little economic incentive to refinance at a higher borrowing cost. As a result, callable bonds can experience duration extension precisely when yields are rising and bond prices are falling, creating an unfavorable dynamic for investors.

Against this backdrop, we have been focused on building portfolios with a more favorable convexity profile than that of the broader market. Put simply, we seek to own bonds that are less likely to become more interest-rate-sensitive when yields rise, helping to preserve value during periods of weakness. At the same time, we look for structures that can respond more favorably when yields fall, allowing clients to participate more fully in potential price gains. The objective is straightforward: less downside when rates move higher and more upside when rates move lower.

Tax-exempt portfolio positioning

Exposure	View	Strategy
Credit allocation	• High-grade bonds offer compelling value following the Treasury-led sell-off. • Lower-rated credit (A and below) remains richly valued even if supported by solid fundamentals.	• Direct new capital toward attractive high-grade opportunities. • Add lower-rated exposure selectively, with disciplined valuation thresholds.
Structure	• Yield-curve volatility makes convexity management critical, particularly in longer-maturity strategies. • Skilled coupon and call selection can extend benchmark-relative duration in rallies and shorten it in selloffs.	• Optimize coupon and call exposure to maintain favorable benchmark-relative duration across rate scenarios. • Avoid near-par bonds.
Duration/ curve	• The curve remains historically steep, with attractive valuations in the belly. • Supply should rebound as yields stabilize, then ease around the midterm elections and holidays. • Overall duration risk appears balanced to favorable.	• Target undervalued curve segments consistent with each strategy's maturity profile. • Maintain a modest long-duration position to offset our credit overweight.

Vanguard active bond funds and ETFs

Vanguard active bond funds and ETFs		Admiral™ Shares or ETF ticker symbol	Expense ratio*
Treasury/Agency	GNMA†	VFIJX	0.11%
	Government Securities Active ETF	VGVT	0.10
	Inflation-Protected Securities	VAIPX	0.10
	Intermediate-Term Treasury	VFIUX	0.10
	Long-Term Treasury	VUSUX	0.10
	Short-Term Government Securities Active Fund	VSGDX	0.10
	Short-Term Treasury	VFIRX	0.10
Investment-grade corporate	Core Bond	VCOBX	0.10%
	Core Bond ETF	VCRB	0.10
	Core-Plus Bond	VCPAX	0.20
	Core-Plus Bond ETF	VPLS	0.20
	Intermediate-Term Investment-Grade	VFIDX	0.09
	Long-Term Investment-Grade	VWETX	0.09
	Multi-Sector Income Bond	VMSAX	0.30
	Multi-Sector Income Bond ETF	VGMS	0.30
	Short Duration Bond ETF	VSDB	0.15
	Short-Term Investment-Grade	VFSUX	0.09
	Ultra-Short-Term Bond	VUSFX	0.09
	Ultra-Short Bond ETF	VUSB	0.10
Below-investment-grade	High-Yield Corporate†	VWEAX	0.12%
	High-Yield Active ETF	VGHY	0.22
Global/ International	Emerging Markets Bond	VEGBX	0.35%
	Global Credit Bond	VGCAX	0.25

Vanguard active municipal bond funds		Admiral™ Shares or ETF ticker symbol	Expense ratio*
National municipal	Core Tax-Exempt Bond ETF	VCRM	0.12%
	High-Yield Tax-Exempt	VWALX	0.09
	Intermediate-Term Tax-Exempt	VWIUX	0.09
	Limited-Term Tax-Exempt	VMLUX	0.09
	Long-Term Tax-Exempt	VWLUX	0.09
	Short Duration Tax-Exempt Bond ETF	VSDM	0.12
	Ultra-Short-Term Tax-Exempt	VWSUX	0.09
State municipal	California Intermediate-Term Tax-Exempt	VCADX	0.09%
	California Long-Term Tax-Exempt	VCLAX	0.09
	Massachusetts Tax-Exempt‡	VMATX	0.09
	New Jersey Long-Term Tax-Exempt	VNJUX	0.09
	New York Long-Term Tax-Exempt	VNYUX	0.09
	Ohio Long-Term Tax-Exempt‡	VOHIX	0.09
	Pennsylvania Long-Term Tax-Exempt	VPALX	0.09

* As reported in each fund's most recent 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, 2026.

Active fixed income at Vanguard

$521B

Vanguard global active bond AUM

$305B Vanguard global active taxable bond AUM

$216B Vanguard global active municipal bond AUM

25+

Portfolio managers

35+

Traders

60+

Credit research analysts

130+

Dedicated team members

Note: Data as of September 30, 2026.

Active fixed income leadership team

Sara Devereux
CIO VCM, Global Head of Fixed Income
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

Justin Schwartz, CFA
Head of U.S. Municipals
In industry since 2004

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Past performance is no guarantee of future results. All investing is subject to risk, including possible loss of principal. Diversification does not ensure a profit or protect against a loss.

Bonds of companies based in emerging markets are subject to national and regional political and economic risks and to the risk of currency fluctuations. These risks are especially high in emerging markets.

High-yield bonds generally have medium- and lower-range credit-quality ratings and are therefore subject to a higher level of credit risk than bonds with higher credit-quality ratings.

U.S. government backing of Treasury or agency securities applies only to the underlying securities and does not prevent share price fluctuations. Unlike stocks and bonds, U.S. Treasury bills are guaranteed as to the timely payment of principal and interest.

Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

Investments in bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk.

Municipal bond fund distributions, including any market discount recognized by the Fund's investments, may be taxable as ordinary income or capital gains. A majority of the income dividends that you receive from the Fund are expected to be exempt from federal income taxes. However, a portion of the Fund's distributions may be subject to federal, state, or local income taxes or the federal alternative minimum tax. You should consult your own tax advisor with respect to any particular U.S. or non-U.S. tax consequences of your investment in the Fund.

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