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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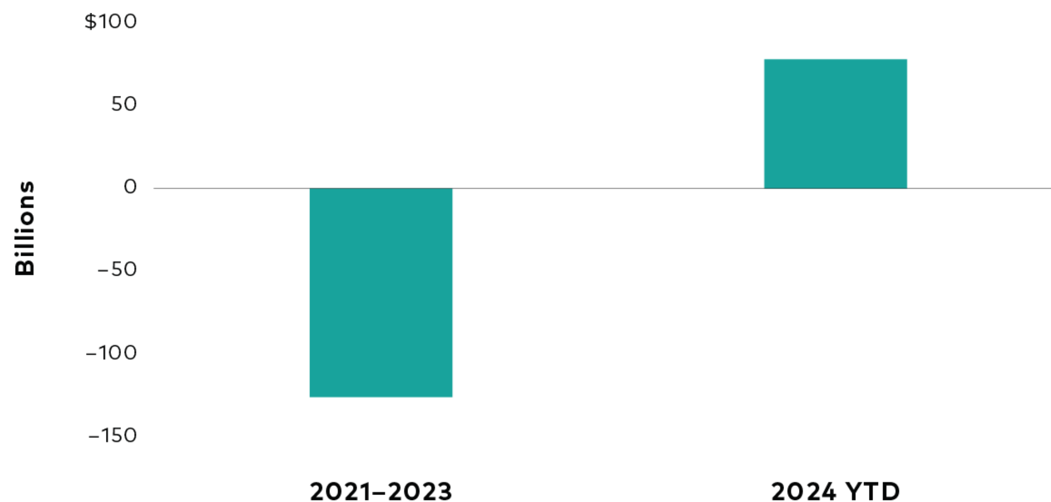
Get your clients comfortable with a little more duration

The focus of many of your client conversations has probably changed in the first quarter from *"should I* extend my duration" to *"how can I* extend duration?" Based on taxable mutual fund and ETF flows during the first quarter of 2024, it's reasonable to conclude that many of you have decided it's time to extend duration. In fact, there have been over three times the cash flows moving into active taxable funds/ETFs in the first three months of the year than in the last three years combined (see Figure 1). Most advisors are ready to move from T-bills, but they're still:

- Getting comfortable redeploying cash.
- Determining the optimal segment in the fixed income market.

FIGURE 1: Active taxable bond flows have shifted positive



Source: Morningstar, Inc., as of March 31, 2024.

Both circumstances are challenging to navigate because they are highly dependent on the needs of your clients. We've found, through discussions with advisors, that short-dated credit funds/ETFs are a suitable alternative to cash and a palatable solution for many underlying clients. How did we get there? In our role as specialists, we help our financial advisor clients manage their practice and clients by considering a range of outcomes. From there, we discuss risk and opportunity. The risk/reward tradeoff for short-dated credit funds/ETFs looks like a suitable alternative for many advisors, depending how the economic backdrop evolves. Consider these scenarios:

- **Later landing.** Growth and employment remain strong; inflation remains stickier above Fed target, which keeps interest rates at these elevated levels. In this environment, our fixed income professionals believe credit bonds will outperform Treasuries. An inverted yield curve and good credit conditions are a favorable backdrop to short credit portfolios.
- **"Softish" landing.** The economy remains resilient, and inflation continues to moderate closer to target. The Fed gets the opportunity to "right size" policy from restrictive with a handful of modest, strategic cuts. The yield curve will potentially flatten, and credit will likely outperform Treasuries. That creates an even better environment as rates reset lower for money markets, but short-credit funds/ETFs benefit from rising prices.

- **Economic slowdown**. The long lags of restrictive policy take effect, and the Fed responds with several rate cuts. The short end of the yield curve falls from these levels, but credit spreads could widen. In this backdrop, our fixed income experts believe the tailwinds from locking in higher interest rates (and bond price appreciation) will offset any spread-widening due to slower economic conditions. Cash and T-bill rates will reset lower, while short-dated bond funds will capture price appreciation from falling rates. But we need to recognize that, in this scenario, longer-dated higher-quality bonds will likely outperform short-credit.

Next steps to consider: Help clients put cash to work

The economic and fixed income environment is nuanced. Outcomes are uncertain, but the opportunity to strategically deploy capital from cash when appropriate is present. Our Portfolio Solutions team is available to take our insights and customize a solution for your clients. If you would like to learn more about Vanguard short-credit funds/ETFs as a transition strategy, contact us.

Interest rates: Higher for longer

As the market is dealing with the highest interest rates seen in over a decade, corporations may be anticipating "higher for longer." This year, through March, there has been a significant surge in high-quality debt issuance across maturities—a 36% increase over first-quarter 2023 (see Figure 2).

FIGURE 2: Bond volume is up year-over-year

Tenors	YTD March 30, 2024 Volume ($M)	%Vol	YTD March 30, 2023 Volume ($M)	%Vol
1.5–3y	27,950	5%	32,100	8%
3–5y	80,500	15%	57,575	15%
5–7y	131,725	24%	95,775	24%
7–10y	35,080	7%	18,250	5%
10–30y	178,450	33%	128,015	32%
30y+	84,140	16%	63,175	16%
Total	**537,845**		**394,890**	

Source: Bloomberg, Inc., as of March 30, 2024.

Despite the market's expectation for modest easing of monetary policy, companies seem to be positioning themselves for the possibility that higher interest rates might persist for longer than anticipated. In addition, longer-dated maturities are less influenced by the path of the fed funds rate. It's not surprising, then, that 80% of this year's issuance has been in maturities of 5+ years. Perhaps the most influential factor driving this increase is the relatively low level of credit spreads (see Figure 3).

According to the ICE BofA index data, investment-grade bond market spreads are around 93 basis points, which is close to the 10th percentile over the past 20 years.

FIGURE 3: Investment-grade credit spreads continue to remain tight

Source: ICE BofA US Corporate Index data, as of March 31, 2024.

What is keeping spreads tight is the strong demand for investment-grade corporate bonds. In fact, new issues are oversubscribed by a rate of three to one—with three buyers for each bond being issued. This suggests that investors still want to lock in current yields, especially if they think that rates will come down. Major corporations across various industries, such as AbbeyVie, Cisco, and JP Morgan, have seized this opportunity to issue multibillion-dollar debt offerings.

The upcoming U.S. presidential election adds another layer of complexity. Corporations, possibly anticipating prolonged higher rates and seeking to lock in current low spreads, are moving quickly to secure financing ahead of potential election-induced market volatility.

The investment corporate bond market in 2024 has a dual narrative: Market expectations reflect upcoming easing monetary policies, even while corporate actions seem to hedge against a scenario where rates stay higher for longer. Corporations' cautious optimism reflects a desire to capitalize on the current conditions while preparing for future market uncertainty.

For your clients, this represents a landscape filled with both opportunities and the need for strategic foresight. In this environment, Vanguard's active fixed income team has adopted a cautious approach that considers the "higher for longer" possibility. The team engages selectively in the primary market, prioritizing high-quality credit, given strong fundamentals. The team has a more selective approach to lower-quality corporates largely due to their present tight valuations and higher sensitivity to investor risk appetite. This cautious approach positions the team for smart risk-taking so it can capitalize on opportunities as the market environment evolves.

Next steps to consider: Check out core bond funds

The future is uncertain. But Vanguard's active fixed income productscould provide a solution to help your clients navigate different potential outcomes as the market works out which direction it may go.

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