JULY 2025

Active Fixed Income Perspectives Q3 2025: The power of income

Big picture

Returns: Broad fixed income indexes have returned 4%–7.25% in the first half of 2025, driven by higher coupon income.

Taxable bonds: Current yields near 5% or higher are appealing. If rates were to decline, returns on higher-rated bonds would be enhanced.

Municipals: High-quality muni bonds, particularly those with long maturities (15+ years), are attractive due to historically favorable yields.

Credit

Slow but steady: We expect credit to perform well for the rest of the year in a slower growth economy. Still, we remain defensive and prefer high quality as credit spreads remain tight.

Economy, policy, & outlook

Growth: We expect the economy to grow by 1.5% in 2025.

Unemployment: We expect unemployment to rise to 4.7% by year-end.

Inflation: Personal Consumer Expenditures inflation is projected to reach close to 3%, year over year, by the end of 2025.

Federal Reserve: We think that two rate cuts over the rest of 2025 is a reasonable expectation.

More upside than downside potential

			Modeled 12-month returns under different interest rate-change scenarios (in basis points)				
		Starting yield	–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.

Takeaways to consider:

1. **See the power of income:** With interest rates still high relative to the past 20 years, bonds can weather some volatility and provide meaningful income.
2. **Take on some duration:** Staying short can still produce attractive income returns but provides less of a hedge to risk assets if growth disappoints. Some duration can provide extra ballast during periods of economic weakness or market turmoil. We see the best value in the short- to intermediate-term part of the yield curve.

(Contined on next page.)

3. **Stay diversified:** Ample opportunities in global bonds, corporates, and mortgage- and asset-backed securities justify broad investment. Emphasize high-quality bonds over high yield.
4. **Look at municipals (for taxable clients):** Municipals can offer great value for high income investors. For those with longer-term investment horizons, long-term bonds, while more volatile, are exhibiting rarely seen tax-exempt yields nearly on par with U.S. Treasuries.

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

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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.

Although the income from a municipal bond fund is exempt from federal tax, you may owe taxes on any capital gains realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal Alternative Minimum Tax.

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