

## Vanguard economic and market update

28 September 2020

### Key points

- Globally, the pace of economic recovery from COVID-19 is uneven, with the US tracking at the optimistic end-of-expectations but economies such as the UK lagging behind Vanguard's mid-year forecasts.
- Economic growth in the US has returned at a quicker-than-expected rate partly as a result of less-stringent lockdowns helping to boost the near-term economic outlook. Longer-term, Vanguard continues to expect US economic growth won't return to pre-COVID levels until the end of 2021.
- There are signs international trade is picking-up after the lows of May and June with China as a stand-out in global trade. China's export position has benefited from its dominance in the global production for COVID-related products such as protective gear, pharmaceuticals and office equipment.
- A rapid intensification of COVID-19 cases in many developing nations points to a pessimistic outlook for growth in emerging markets, particularly Latin America.

## Economic growth

### Australia

Vanguard foresees a return to modest growth in the third and fourth quarters following on from a second quarter which saw the country enter its first recession in 29 years. A sharp pullback in GDP of –7.0% in second quarter was the largest fall in quarterly Australian GDP since records were first kept in 1959. Vanguard continues to forecast a contraction in full-year GDP of around –4% with the possibility of regional lockdowns factored into the baseline scenario.

### China

A relatively upbeat growth picture for China was affirmed in August with a monthly gain in retail sales—the first such gain this year. High-frequency data indicators for August paint a relatively upbeat picture for growth in China, making it less likely that policymakers will choose to stimulate the economy, especially as equity and housing prices rise. Retail sales rose by 0.5% in August compared with a year earlier, the first such gain this year, though they're down by 8.6% for the first eight months of the year. Exports remained resilient, up 9.5% compared with August 2019. Vanguard is seeing a broadening in China's export goods after a period where exports were concentrated in protective equipment, medical instruments, and work-from-home technology. We'll watch for whether subdued spending in the developed world may weigh on China's exports in the months ahead.

### United States

Vanguard notes a shift-forward in growth expectations for the U.S. economy in 2020 although the longer-term picture hasn't changed. Despite a second-quarter GDP forecast signalling an economy-wide collapse in activity, areas of the country with less-stringent lockdowns have supported economic activity even as infection trends have worsened in other areas. The overall picture is one of an improved economic growth outlook in 2020, though the long-term picture for U.S. economic growth remains unchanged. Vanguard doesn't foresee GDP returning to pre-COVID levels until the end of 2021, with the caveat that those forecasts would be subject to change without the fiscal stimulus of around \$1 trillion currently forecast.

### Japan

Vanguard foresees Japan's full-year GDP contracting in a range around –3% to –5% with little near-term economy

impact from the resignation of Prime Minister Shinzo Abe. We expect a moderate economic rebound in the neighbourhood of 5%, above consensus, in both the third and fourth quarters as industrial indicators point to a manufacturing recovery.

### United Kingdom

The early stages of economic recovery in the United Kingdom were weaker than in the euro area as the trajectory of new virus cases continued high for longer. We expect only gradual recovery the rest of the year. Although most supply is back online, demand is likely to return more slowly as households remain reluctant to engage in highly social activities, especially amid a recent uptick in new cases in some areas. Vanguard expects U.K. GDP to be around –11% for the full-year, or somewhere between our baseline and downside cases set out in our mid-year update of the Vanguard economic and market outlook.

### Emerging Markets

The International Monetary Fund (IMF) lowered its forecast for growth in emerging markets for both 2020 and 2021 on June 24, owing to a rapid intensification of COVID-19 infection rates in many countries. The IMF foresees emerging markets contracting by 3.0% before rebounding with positive growth of 5.9% in 2021. The IMF outlook for Latin America is particularly pessimistic with an expected contraction of 9.4% for all of 2020, before rebounding to 3.7% in 2021.

## Monetary policy

Given our expectations for a slow recovery in demand, Vanguard continues to expect monetary policy to remain loose into 2021, with risks skewed toward further easing.

**The US Federal Reserve** left its key federal funds rate unchanged at 0%–0.25% on September 16. Policymakers also broadly expect the rate to stay at this level through 2023. **The European Central Bank** left its main deposit rate unchanged at –0.5% on September 10 and said it would keep rates at current negative levels, or lower them further, until it sees the inflation outlook “robustly converge to a level sufficiently close to, but below, 2%.” **The Reserve Bank of Australia (RBA)** maintained its cash rate and three-year government bond target at 0.25% on September 1, and extended its Term Funding Facility through June 2021.

## Trade

Leading indices suggest global trade has swung back to an upward trajectory following the steep drops of May and June, with China leading the way thanks to healthy demand for products during COVID lockdowns. China is supported by its position at the centre of global goods products, particular for those products in demand during COVID lockdowns, and by lower prices for commodity inputs.

## Inflation

Inflation in the **United States** is expected to remain below 2% by the end of 2021. Potential upside risks to forecasts include virus-related supply shocks, fiscal support and/or monetary stimulus and the willingness of the Federal Reserve to tolerate above-target inflation.

The consumer price index in the **United States** rose by 0.4% in August compared with July on a seasonally adjusted basis, having risen by 0.6% in July. Compared with a year earlier, inflation rose by 1.3%, while core inflation—which excludes volatile food and energy prices—rose by 1.7%.

Headline inflation was -0.2% in the **euro area** on an annual basis in August, according to preliminary estimates—the first slide below zero in four years. Core inflation—which excludes energy, food, alcohol and tobacco—rose just 0.4% on an annual basis, which is down from 1.2% in July and is an all-time low. We expect the euro's recent appreciation against other major currencies to exert further disinflationary pressure as less expensive imports and more expensive exports weigh on GDP. We don't expect the core rate of inflation to rise close to the European Central Bank's 2% target over the next 12 months.

In **Australia**, consumer prices fell 1.9% in the June 2020 quarter compared with the March 2020 quarter,

and by 0.3% compared with a year earlier—the first such contraction since 1997. An update on third-quarter inflation data is expected on October 28.

## Employment

The unemployment rate in the **United States** fell for a fourth straight month in August, to 8.4%. Although the pace of job gains has slowed in the last two months, the labour market has surpassed expectations. With growth in the US expected to accelerate over the rest of the year, we believe it will finish 2020 with an unemployment rate of about 7% to 9%, compared with the 8% to 10% previously expected.

Unemployment in the **euro area** rose to 7.9% in July from a revised 7.7% in June, with the number of unemployed people rising by 344,000. Furlough and other job support schemes have been successful in limiting unemployment rates so far. Vanguard has been encouraged by the recent extension of furlough programmes in Germany and France.

In **Australia**, unemployment fell for the first time since the start of the pandemic—falling to 6.8% in August from 7.5% in July. An extended virus lockdown in the State of Victoria is expected to result in further job losses in September.

**Asset class return outlooks:** Vanguard's 10-year annualised outlooks for equity and fixed income returns are unchanged since the August 2020 economic and market update.

Our 10-year annualised nominal return projections for **Australian dollar investors** are as follows. Please note that the figures are based on a 1-point range around the 50th percentile of the distribution of return outcomes for equities and a 0.5-point range around the 50th percentile for fixed income.

Asset class	10-year annualised return forecast	Median volatility
Australian equities	5.8–7.8%	20.6%
Global ex-Australia equities (unhedged)	5.4–7.4%	19.3%
Australian aggregate bonds	0.5–1.5%	4.4%
Global bonds ex-Australia (hedged)	0.9–1.9%	3.0%

**IMPORTANT:** The points above represent the house view of Vanguard's Investment Strategy Group's (ISG's) global economics team and other experts as of 17 September, 2020 on a number of economic and market topics. The projections or other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modelled asset class.

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The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include Australian, and international equity markets, several maturities of the Australian Treasury and corporate fixed income markets, international fixed income markets, Australian money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

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