ECONOMIC AND MARKET UPDATE | SEPTEMBER 2020

Vanguard economic and market update

Vanguard's key points:

- The pace of the global economic recovery from the Covid-19 pandemic appears uneven, with US data at the optimistic end of expectations but activity in the UK lagging behind what we expected at the end of June.
- The risks of a second Covid wave (and, potentially, more severe lockdowns) appear elevated. But better-than-expected activity data, plus vaccine hopes, also increase the probability of upside scenarios materialising.
- Amid signs of a trade pickup, China appears to be the main winner, buoyed by products in demand during Covid lockdowns.

Economic growth

- We still see it taking until the end of 2021 for GDP in the **United States** to return to pre-Covid levels and into 2022 to reach a pre-Covid trajectory. However, the near-term picture has improved. The second government estimate of second-quarter GDP, at minus 31.7%, confirmed an economy-wide collapse in activity led by services but was at the more optimistic end of Vanguard's forecast range. Some parts of the economy rushed to reopen, leading to a mixed bag of worsening virus infection trends but also a brighter near-term US economic picture. With these unexpected developments and owing to less-stringent lockdowns, Vanguard now sees full-year economic growth in 2020 of minus 4% (compared with our forecast range of –7% to –9%) but a slower pace of recovery in 2021 (positive 4% growth compared with a previously expected 7% to 9%). Our view anticipates further fiscal stimulus of around $1 trillion; we'd likely reduce our outlooks in the absence of such stimulus.
- Vanguard continues to foresee an economic contraction of around 10% for the **euro area** economy in 2020. GDP readings have been higher than we had expected at the start of the pandemic and fiscal policy, including the €750 billion Next Generation EU recovery fund, should be supportive. But a stronger euro since May, including a nearly 10% appreciation against the US dollar, is a negative for exports. Covid-19 cases have also risen, especially in Spain and France, so we expect economic recovery for the rest of the year to be gradual. We're also watching whether Spain will extend a job furlough scheme scheduled to expire at the end of September. The euro area economy contracted by 11.8% in the second quarter compared with the first quarter.
- 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. The UK economy grew by 6.6% in July compared with June, but contracted by 7.6% in the three months through July and remained nearly 12% below pre-crisis levels. We expect UK GDP to come in at –11% for the full year, in between our baseline and downside cases as set forth in our midyear update.
- High-frequency indicators and August activity data continued to paint a relatively upbeat picture for growth in **China** in August and make it less likely that policymakers will choose to stimulate the economy, especially with local share and house prices rising. 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 remain resilient, rising 9.5% compared with August 2019. Vanguard continues to foresee full-year growth for China in a 1% to 3% range.

Note: These points represent the house view of the Investment Strategy Group's (ISG's) global economics team and other experts as of 17 September 2020.

- Vanguard expects the resignation of Prime Minister Shinzō Abe to have little near-term effect on the economy or consumer sentiment in **Japan**. The nation's longest-serving prime minister announced his resignation on August 28, citing health considerations. We expect a moderate economic rebound of around 5% in both the third and fourth quarters, which is above consensus, as indicators point to a manufacturing recovery. Rising Covid-19 infection numbers present a risk to spending on services. We continue to expect Japan's full-year GDP to contract by around 3% to 5%.

- The International Monetary Fund 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.

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 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%. We see inflation remaining below 2% by the end of 2021, though virus-related supply shocks, fiscal support and/or monetary stimulus, plus the willingness of the Federal Reserve to tolerate above-target inflation may yet serve as potential spurs to higher prices.

- 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, down from 1.2% in July and an all-time low. Vanguard expects headline and core inflation to begin converging early next year as the effects of pandemic hit to energy prices fall out of year-on-year comparisons. We also expect the euro's recent appreciation against other major currencies to exert some 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.

- Headline inflation in the **United Kingdom** rose by 0.2% in August from a year earlier, compared with a 1.0% rise in July. Vanguard expects inflation to run close to zero in the near term. This is as a consequence of a temporary value-added tax cut in the hospitality and accommodation sectors, although last month's slump in inflation was broad-based, with only the recreation and culture sector seeing an increase. Over the medium term, we expect demand to recover more slowly than supply and the labour market to weaken, exerting more disinflationary pressure. With the risk of tariff imposition following Brexit, in addition to significant monetary and fiscal stimulus, we foresee inflation rising toward the Bank of England's 2% target within the next two years.

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 US growth expected to accelerate over the rest of the year, we believe the United States will finish 2020 with an unemployment rate of about 7% to 9%, compared with the 8% to 10% that we 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, and believes that Spain will need to follow suit before its programme expires at the end of September.

- The furlough programme in the **United Kingdom** has similarly limited the unemployment rate but we expect the rate to rise above 7% in the fourth quarter as the scheme unwinds. We don't anticipate an extension to the scheme unless another national lockdown is initiated. Another wave of unemployment could follow in January 2021 as an incentive to retain furloughed workers expires. We foresee a peak UK unemployment rate over 8% in the first half of 2021.

Monetary policy

- Given our expectations for a slow recovery in demand amid pandemic containment efforts, 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. It was the Fed's first meeting since it announced last month that it would allow inflation to modestly exceed its 2% target so as to achieve 2% average inflation over time. The Fed said it expects to maintain the current target range until it assesses that inflation "is on track to moderately exceed 2% for some time."
- 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 ECB additionally said it would maintain purchases under the €1.35 trillion Pandemic Emergency Purchase Programme through June 2021 and monthly asset purchases at €20 billion as needed. It didn't address recent euro strength. Vanguard expects little change in ECB policy over the next 12 months.
- The **Bank of England** maintained its bank rate at 0.1% and left other policy unchanged on September 17. However, its Monetary Policy Committee suggested that the outlook had worsened amid rising Covid-19 cases and renewed Brexit uncertainty. The BOE also indicated it was more likely now than previously that it would implement negative rates in the event of a sustained economic downturn.

Brexit

New legislation that would contravene the Withdrawal Agreement under which the UK ceased being a member of the European Union (EU) has added a new obstacle to UK-EU trade talks. The Internal Market Bill would give UK ministers the power to modify or even dis-apply rules relating to state aid and the movement of goods between Britain and Northern Ireland in the event of no trade agreement by January 1, 2021 —potentially breaching international law. It remains to be seen whether this marks the point at which negotiations began to unravel or is looked back upon as another seemingly insurmountable hurdle that was eventually overcome. However, the EU still maintains that it will need to have approved a trade agreement by October 15 for the European Parliament to have enough time to ratify the deal and for it to take effect by January 1, 2021. So time is running out, raising the risk of a "no-deal" Brexit. (Although the UK formally exited the EU on January 31, 2020, a transitionary period during which the relationship is unchanged continues through the end of this year).

US government shutdown

Vanguard expects the United States to continue to fund the government beyond September 30, when spending authorisation for the discretionary portion of the federal budget winds down. We expect agreement on a continuing resolution to fund the government at least through the November 3 presidential and congressional elections, averting a shutdown in the interim. The government is required to authorize funding each fiscal year for the approximately one-third of the federal budget that isn't authorised automatically. The 2021 fiscal year begins October 1.

Trade

Leading indices continue to suggest that **global trade** has swung back to an upward trajectory after steep drops in May and June. Similar to the trajectory of broader economic recovery in many places, the leading indices imply a sharp rebound for global trade through October, followed by a slower recovery to pre-pandemic levels. China remains the standout country, its exports buoyed by products that were in demand during Covid lockdowns, such as protective gear, pharmaceuticals, and office equipment. China has been supported by its position at the centre of global goods production and by lower prices for commodity inputs.

Asset class return outlook

Vanguard's 10-year annualised outlooks for equity and fixed income returns are unchanged since the August 2020 economic and market update. The probabilistic return assumptions depend on market conditions at the time of the running of the Vanguard Capital Markets Model® (VCMM) and, as such, can change with each running over time. ISG updates these numbers quarterly. The projections below are based on the June 30, 2020, running of the VCMM. Projections based on the September 30, 2020, running of the VCMM will be communicated through the November 2020 economic and market update.

Our 10-year annualised nominal return projections 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. Numbers in parentheses reflect median volatility.

	Median projected volatility (%)	Ten-year annualised nominal return projections
UK equities†	19.4	5.9–7.9%
Global equities ex-UK (unhedged)†	19.2	4.8–6.8%
UK aggregate bonds†	5.7	0.1–1.1%
Global bonds ex-UK (hedged)†	2.7	0.2–1.2%
Euro area equities*	25.2	5.2–7.2%
Global equities ex-euro area (unhedged)*	19.6	3.7–5.7%
Euro area aggregate bonds*	1.8	-0.2–0.8%
Global bonds ex-euro area*	3.2	-0.1–0.9%

Note: * return projections are calculated for Euro investors. † return projections are calculated for British pound investors.
Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results.

Important information

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. Simulations are as of June 30, 2020. Results from the model may vary with each use and over time.

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 U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. 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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