# WHAT TO EXPECT FROM THE GLOBAL ECONOMY AND MARKETS IN 2021

## Approaching the dawn: what our experts think is in store for investors this year.

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The pandemic isn't over yet but the path to economic recovery is now much clearer thanks to the successful development of new vaccines to combat the virus.

For British and European shares there is the prospect, we think, of better times ahead; with valuations at more attractive levels, both markets are now well placed to outperform their US counterparts. Shares in the UK have also been boosted by the agreement before Christmas of a trade deal with the European Union. What's more, governments and central banks continue to provide extraordinary levels of monetary and fiscal support to sustain the recovery.

Human health will remain the key economic driver. As vaccines are rolled out and greater numbers of people become protected, so more and more consumers will be encouraged to engage in normal social activity, enabling output and employment to recover to their pre-pandemic levels.

The table below spells out what our global team of economists currently expect for 2021, which is for this return to normality to be achieved, broadly, by the end of the year. The risks, though, are skewed to the upside. We believe there is a 30% chance that we'll get there by the summer.

### 2021 economic scenarios: Vanguard's risk assessment

| | Vanguard assessment of risks | | |
|---|---|---|---|
| | Downside risk | Base case | Upside surprise |
| | 10% | 60% | 30% |
| Immunity gap | Little progress on infection immunity by end of 2021 | Major economies achieve infection immunity by end of 2021 | Major economies achieve infection immunity by mid-2021 |
| Reluctance gap | Social and business activity hampered through 2021 | Social and business activity normalises by the second half of 2021 | Social and business activity normalises in the first half of 2021 |
| Economic recovery | Labour market scarring possible given persistently high and long-term unemployment<br>Inflation persistently below target<br>Pre-pandemic level of output not achieved in 2021 | Unemployment rate falls through year-end 2021<br>Inflation moves toward target in 2021<br>Pre-pandemic level of output reached by end of 2021 | Unemployment rate falls and full employment is achieved by end of 2021<br>Inflation overshoots in 2021<br>Pre-pandemic level of output reached mid-2021 |

**Note:** The odds for each scenario are based on the assessment of members of Vanguard's Global Economics and Capital Markets Outlook Team. Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results.
**Source:** Vanguard, as at 30 November 2020.

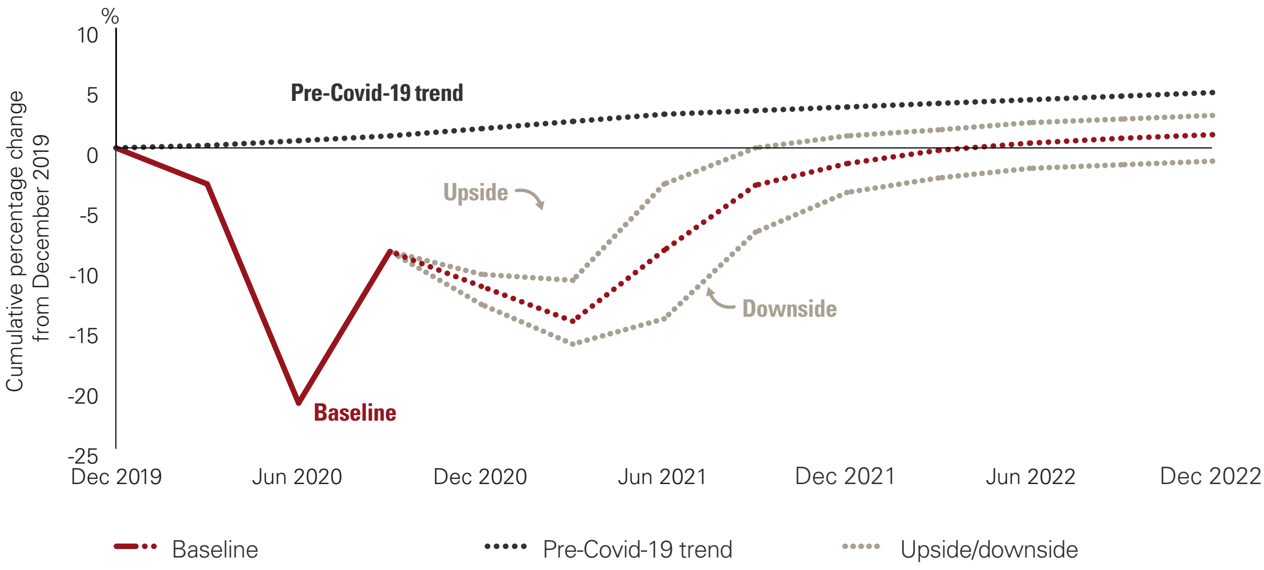
## A challenging phase, then a brighter one

Despite this gradual return to normality, a challenging period still lies ahead as winter in the Northern Hemisphere brings a new surge in virus cases. Economic recovery is likely to be uneven and extend beyond the next year.

European economies, including the UK's, will also probably lag the recovery in other parts of the world. In the short-term, there will be a "double-dip" in activity as the latest restrictions weigh in the final months of 2020 and early 2021. Downside risks have increased more recently following the discovery of a new mutant virus strain that appears to be more contagious.

In our baseline scenario, marked by the dashed red line below, we expect the UK economy to hover close to 15% below its pre-Covid levels of output until the spring, with current restrictions staying more or less in place.

### Level of UK output




**Source:** Bloomberg and Vanguard, as of 5 January 2021.

**Note:** The y-axis represents the level impact from the baseline, which is December 2019. The downside scenario is characterised by a failure of the current restrictions to significantly reduce virus transmission in the short term, which would cause a slower recovery. Potential problems with the efficacy, adoption, distribution, or safety of a vaccine could also surface. The upside scenario is characterised by a better-than-expected clampdown of the second virus wave and a speedy large-scale distribution of an effective vaccine, which will see the economy return to normal more quickly than we currently expect.
Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results.

Even after the vaccination programme is in full swing, the pandemic's effects on consumer behaviour are likely to linger especially in face-to-face sectors such as hospitality and entertainment, where a reluctance to re-engage may only be overcome gradually.

Furthermore, departing the EU will likely cause significant disruption to many UK firms, even with the recently-announced trade deal. This is partly why we expect the UK economy to return to its pre-pandemic level of output slightly later than the rest of the euro area.

Overall, we expect the UK economy to have contracted by almost 9% in 2020, which is one of the deepest contractions amongst developed economies, in part because of the relatively high share of the economy that is vulnerable to virus containment restrictions. In 2021, however, we expect the UK economy will achieve a growth rate of around 5%, similar to what we expect for both the euro area and US.

The good news, nonetheless, is that we believe the potential scarring effect of permanent job losses will be limited.

## Inflation risks?

Central banks, globally, will continue to keep interest rates low. Government spending will play a role in sustaining the recovery too – a larger role than it did after previous recessions, including those following the 2008–09 global financial crisis – to mitigate the risks related to employment as well as business and household solvency.

Given this determined policy response, inflation rates look set to rise across developed markets this year as the factors that depressed prices last year start to reverse – namely, falling oil prices, cuts to value-added tax rates and widening output gaps.

However, we think it unlikely that any significant inflationary pressure will be sustained as, over time, the usual structural headwinds to higher prices are likely to re-assert themselves, including the weak bargaining power of labour and the growing role of technology. We expect UK inflation to approach the Bank of England's target of 2% over the coming year but believe that inflation expectations remain well-anchored.

## Market consequences

Against this economic backdrop, we expect positive but modest total returns for stock markets in the medium-to-long-term. In sterling terms, we expect global shares to provide investors with an annualised investment return of 5% to 7% over the next decade.

But within this, we don't expect the trends that have defined the last decade to persist. Largely due to lower valuations, we expect stock markets in both the UK and euro area to begin outperforming the high-flying US stock market, which has largely driven the global equity rally seen over recent years. From a UK investor's perspective, the expected annualised return outlook for the UK stock market is in the 6.4% to 8.4% range, which is higher than the projected 4.5% to 5.5% return range we see for global shares excluding the UK market.

Still, while expected returns for the UK stock market may be higher, we still believe in the diversification benefits of investing in a global portfolio of shares to offset some of the risks specific to the UK market.

With economic growth and inflation staying lower for even longer, we expect returns from bonds to remain muted over the next decade. However, we still think bonds will maintain their diversification benefits in a balanced portfolio by potentially offsetting the risks of sharp falls in the equity side of your portfolio. It remains as important as ever to ensure your investments are spread across a range of assets and markets; if you have any questions about your portfolio, please speak to your financial adviser.

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