Vanguard

2020 MID-YEAR UPDATE

Vanguard economic and market outlook: Forecasting in the time of coronavirus

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Executive summary

The global Covid-19 pandemic and associated lockdowns has caused the sharpest and deepest economic contraction in modern economic history. Even as countries in Asia and Europe bring the number of cases under control in early July, the count continues to grow globally, fuelled by further outbreaks in emerging economies and parts of the United States. The twin crises of health and economics is far from over.

In fact, the main economic impact of the pandemic has not been directly caused by the virus itself but instead by a combination of necessary government-mandated lockdowns and voluntary social distancing by individuals. Our estimate of the maximum impact on national GDP of the pandemic shock ranges from 13% in Australia, 18% in the US, 20% in China and Germany, around 25% in the UK and as much as 30% in Italy.

Having seen double-digit negative quarterly growth rates in the US and Europe during the second quarter of 2020 (China's big pandemic hit was in the January-March quarter), strong recoveries are likely to occur in the third quarter. Indeed, as social distancing measures are gradually reversed, we expect economic activity to recover quite quickly, initially, as productive potential is brought back on stream. But thereafter we foresee a slower recovery in aggregate demand as consumers remain reticent about resuming activities requiring face to face contact.

In the language of comparing the recovery to letters of the alphabet, we see an initial V-shaped recovery followed by a more prolonged U.

For 2020 as a whole, we now foresee a contraction in global GDP of around 3%, the largest-ever recorded outside wartime. This is nearly five percentage points lower than our forecast for 2020 at the end of last year.

Annual GDP in the US, UK and euro area, more specifically, is expected to be between 8% and 12% lower than last year, with the economies of Japan and Australia doing better by coming in 4% lower. Only in China, out of the major economies, do we see positive growth (2%) for the full calendar year.

We do not expect GDP to recover to its more normal pre-virus trajectory until late next year. And even then we expect some 'scarring' as a result of permanent job losses, bankrupted businesses and the costs associated with the possible reallocation of resources.

Huge fiscal interventions have been very effective in keeping unemployment rates from rising sharply in Europe and Asia as furlough and short-term working schemes have insulated the labour market. For example, in the euro area and the UK the unemployment rate is only expected to rise by two to three percentage points in 2020. Without these schemes, the unemployment rate in both these regions would have likely soared to close to 30% at its worst point in April 2020. The major exception to this is in the United States, where furloughed workers count as unemployed; here the unemployed rate surged by 11 percentage points to 15% before dropping down again as these workers were called upon as lockdown restrictions eased.

In the longer term, we believe that the productive potential of Europe will likely be some 3% smaller in 2022 that would've been the case if the pandemic hadn't struck, slightly less in the United States, and relatively unaffected in China and Japan.

Loose policy well into next year

The policy response in terms of monetary policy accommodation and fiscal policy support has been impressive in its speed and scale, as we at Vanguard have been advocating. Monetary policy has become even more accommodative with interest rates at their effective lower bound in most major economies with additional quantitative easing conducted, as well as generous liquidity provided to the financial sector.

We expect monetary policy to stay loose well into next year with future tightening happening cautiously and flagged well in advance. Total fiscal support for the major economies has been, if anything, even more extraordinary, amounting to more than $9 trillion (approximately 10% of GDP) in the form of direct fiscal support (government spending and income transfers) and loans and grants. These fiscal measures are largely designed to provide income support to those made unemployed or furloughed by the pandemic shock, or to provide financing to businesses who would otherwise be insolvent.

Further fiscal support seems likely later this year given the sluggish recovery that we expect, as the need to provide income support persists to the end of 2020.

The burden of the resulting increase in public sector debt should be lessened by current extremely low financing costs. In the current political environment, we do not think policymakers will be attracted to tough austerity measures. And given the slow and protracted recovery, we expect aggregate inflation measures to remain low although we do anticipate more short-term variability in price changes as supply shortages bite in some sectors.

Risks and returns

The risks around our forecast are skewed to the downside and strongly linked to health outcomes. Our baseline forecast, with a 50% probability, sees a gradual return to work and no major flare-ups in the virus with a vaccine becoming available by the end of 2021. Our upside scenario, a relatively low probability outcome at 15%, sees a healthcare solution emerging more quickly than that. But our downside scenario, happening at an uncomfortably high 35% probability, sees further waves of Covid-19 and renewed shutdowns which prevent a meaningful recovery in global GDP for much of this year and next.

During the pandemic, asset prices have been volatile, with global shares falling around 20% before recovering completely by the end of June, with gains driven by the United States.

Global equity market return expectations have risen, mainly because of the resulting improvement in valuations, especially outside the United States. For UK investors, we expect the average annualised return over the next ten years to be between 5.5% and 7.5% for UK shares and between 5% and 7% for non-UK shares — 1.5 percentage points higher for UK shares and one percentage point higher for non-UK shares than our median expectation at the time of our end-year outlook in December 2019.

Given accommodative monetary policy, our global fixed income return expectations remain muted at home and abroad, with returns between 0% and 1.5% — about half a percentage point lower than we expected at the end of 2019.

Considerable uncertainty remains, with the possibility of further market corrections ever present. We advise investors to focus on long-term expected returns and avoid the temptation to time such turbulent markets.

Potential pandemic side-effects

Without doubt, the Covid-19 pandemic will accentuate many of the structural forces that were already in play at the beginning of the year, and perhaps introduce new aspects. Rising inequality will perhaps be aggravated with the disadvantaged in society tending to be the most badly hit by the pandemic.

Whether that strengthens or undermines the tendency towards populist politics remains to be seen.

Globalisation, already weakened by a trend towards protectionism, might be damaged further by the need to close borders or be reinvigorated by the manifest need to find a global solution to a global problem. And improvements in working methods, accelerated by the need for workers globally to work remotely, might provide the boost to productivity the global economy has been seeking, albeit at the expense of considerable sectoral disruption.

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