Vanguard

2020 MID-YEAR UPDATE

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

Q&A with senior Vanguard economists | July 2020

How – and when – will the global economy recover from the shock of Covid-19? What will the post-pandemic economy look like and what is driving confidence in financial markets?

At the end of last year, Vanguard published its annual global economic outlook for 2020 and beyond. Then the Covid-19 pandemic hit, upending financial markets and the global economy.

Senior economists from Vanguard's Investment Strategy Group discuss how the pandemic has reshaped their global economic outlook and the likely future direction of markets.

The title of Vanguard's outlook for 2020 was 'The New Age of Uncertainty'. It seems almost prophetic in retrospect.

Joe Davis, Vanguard global chief economist: It's true that we were expecting heightened uncertainty this year owing to concerns about global growth, unpredictable policymaking, trade tensions and Brexit negotiations. But we couldn't have foreseen a viral pandemic that would be so devastating in terms of human cost, curtailed economic activity and disrupted financial markets. It's really an unprecedented event that defies conventional labels.

We've been broadly supportive of the extraordinarily rapid and robust monetary and fiscal responses from governments worldwide to blunt the damage. Many central banks have embraced a 'whatever it takes' approach, which has included slashing interest rates and providing liquidity to financial markets. And the world's largest economies have committed more than $9 trillion in spending, loans, and loan guarantees towards countering the negative effects of the pandemic[1].

That notwithstanding, while this may be the deepest and shortest recession in modern economic history, I want to stress that we see a long road back to a pre-virus economy.

With many countries having just gone through extraordinarily quick and sharp declines in GDP, there's been a lot of speculation in the financial media about what shape the recovery will take. What's Vanguard's view?

Peter Westaway, Vanguard chief economist for Europe: The hit to economic activity has been severe. We estimate the overall peak-to-trough global GDP contraction was around 9% in the first half of 2020. Comparable collapses in economic activity are hard to find outside wartime: Global GDP fell 6% peak to trough during the global financial crisis[2], for example, and by 1.8% during the 1973 oil crisis[3].

1 International Monetary Fund as of May 13, 2020.

2 The Impact of the Great Recession on Emerging Markets, International Monetary Fund working paper, 2010.

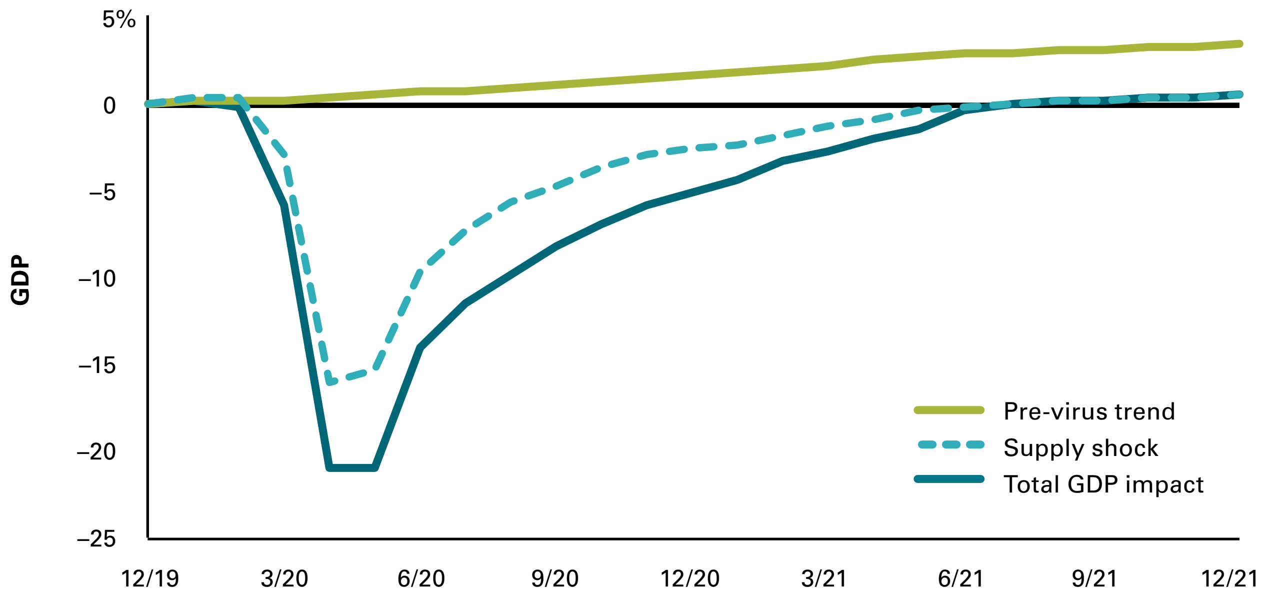
3 Maddison, Angus, 1991. Business Cycles, Long Waves and Phases of Capitalist Development.

So what will the recovery look like? Will it be V-shaped or U-shaped? Probably a little of both. We anticipate a first phase characterised by a rapid recovery in the supply side of the economy as businesses reopen and restrictions are eased. We expect that to be followed by a second, more protracted phase in which demand, especially in sensitive face-to-face sectors, only gradually returns.

Overall the trajectory of the recovery is likely to be an elongated U-shape, with GDP growth not returning to normal until well into 2021 and quite possibly beyond in major economies. The one exception is China. Our baseline assessment is that a vaccine won't be widely available before the end of 2021; a vaccine sooner than that would make us more optimistic about the prospects for recovery. But we unfortunately see risks around our forecast skewed to the downside, strongly linked to health outcomes and the potential for instances of the virus to necessitate renewed widespread shutdowns.

Qian Wang, Vanguard chief economist for Asia-Pacific: Peter mentioned that China would be an exception. We expect the recovery to be faster and more V-shaped in China for a couple of reasons. China has so far managed to contain the virus relatively quickly and its economy has a larger share of manufacturing and construction activities, which rely less on face-to-face interaction and benefit from the government's boost to infrastructure investment. In fact, we're seeing many industries in China not only recovering but clawing back lost output not produced during the lockdown, so we expect its economy to return more quickly to pre-virus levels.

Figure 1. Projected economic recovery in the United Kingdom



Note: The chart shows Vanguard's expectation that the percentage point change in quarterly GDP as a whole for the United Kingdom will fall more sharply in the second quarter of 2020 then recover more slowly through much of 2021 than the part of GDP attributable to the supply shock from Covid-19. Even at the end of 2021, GDP as a whole is forecast to be below its pre-virus trend level.

Source: Vanguard.

Roger Aliaga-Díaz, Vanguard chief economist for the Americas: Latin America faces an especially challenging period. Brazil, Latin America's largest economy, has had a particularly hard time containing the virus. The World Health Organization (WHO) puts the number of confirmed cases in that country second only to the number in the United States[4]. Peru, Chile, and Mexico also are among the ten countries with the highest number of confirmed cases, according to the WHO. The International Monetary Fund in June downgraded its economic outlook for Latin America to a full-year contraction of 9.4%, having projected a contraction of 5.2% for the period just three months earlier.

Joe Davis: I'd add a word of context about GDP data for the second half of 2020. We expect to see a rebound in quarterly GDP growth rates, especially in the third quarter, when restrictions on activity related to the virus will have eased to a degree. And that will doubtless generate positive headlines and more talk of a V-shaped recovery. A more relevant measure than the quarterly rate of change, though, is the underlying level of GDP. And for 2020, for the first time in modern economic history, we expect the global economy to shrink, by about 3%. We believe that some of the largest economies, including the United States, United Kingdom and euro area, will contract by 8% to 10%.

What does the prospect of only gradual economic growth mean for employment?

Peter Westaway: A lot depends on the fate of furloughed workers. Official measures of unemployment across the globe have risen by historically unprecedented amounts in a short time. And, unfortunately, in many countries the true unemployment picture is even worse once furloughed workers are considered—those who are not working but are being paid by governments or employers. There's a chance that furloughed workers could move straight back into work as lockdowns end, which would make this type of unemployment not so costly. But there's a risk that high unemployment will persist, especially considering those who have already lost jobs permanently and the furloughed workers who may not easily move back into work.

At the end of last year, Vanguard was expecting inflation to remain soft. Has your forecast changed in light of the pandemic?

Joe Davis: Not significantly. Many commentators have talked up the prospect of a resurgence in inflation in 2021, particularly as the debt-to-GDP ratios of developed economies have increased dramatically because of spending to mitigate the effects of the pandemic. We think it's more likely that inflation overall will be held in check by demand lagging a rebound in supply in all the major economies, especially in face-to-face sectors that we believe will experience a high degree of consumer reluctance until there is a vaccine. That, in turn, could set the stage for central banks to maintain easy terms for accessing money well into 2021.

Figure 2. How the pandemic has reshaped our GDP projections for 2020

	Australia	Canada	China	Euro area	Japan	UK	US	World
Vanguard 12/2019 projections	2.1%	1.4%	5.2%	0.7%	0.6%	0.9%	1.3%	1.3%
Base case	–4.0	–6.0	2.0	–9.6	–4.3	–9.1	–8.2	–3.1

Source: Vanguard.

4 World Health Organization Covid-19 Situation Report 178, July 16, 2020.

Let's get to what investors may be most interested in—Vanguard's outlook for market returns.

Joe Davis: In short, stock market prospects have improved since the market correction, while expected returns from bonds remain subdued. Let's take a closer look at global equities first. They lost more than 30 percentage points earlier this year and volatility spiked to record levels, then they rallied strongly to regain most of their losses. Despite the negative macroeconomic outlook, we believe there is a reasonable basis for current stock market levels given the impact of low rates, low inflation expectations and the forward-looking nature of markets.

With current valuations lower than at the end of last year and a higher fair-value range because of lower interest rates, our outlook for UK and non-UK stock market returns has improved considerably. Over the next ten years, we expect the average annual return for UK investors to be:

- 5.5% to 7.5% for UK shares
- 5% to 7% for non-UK shares

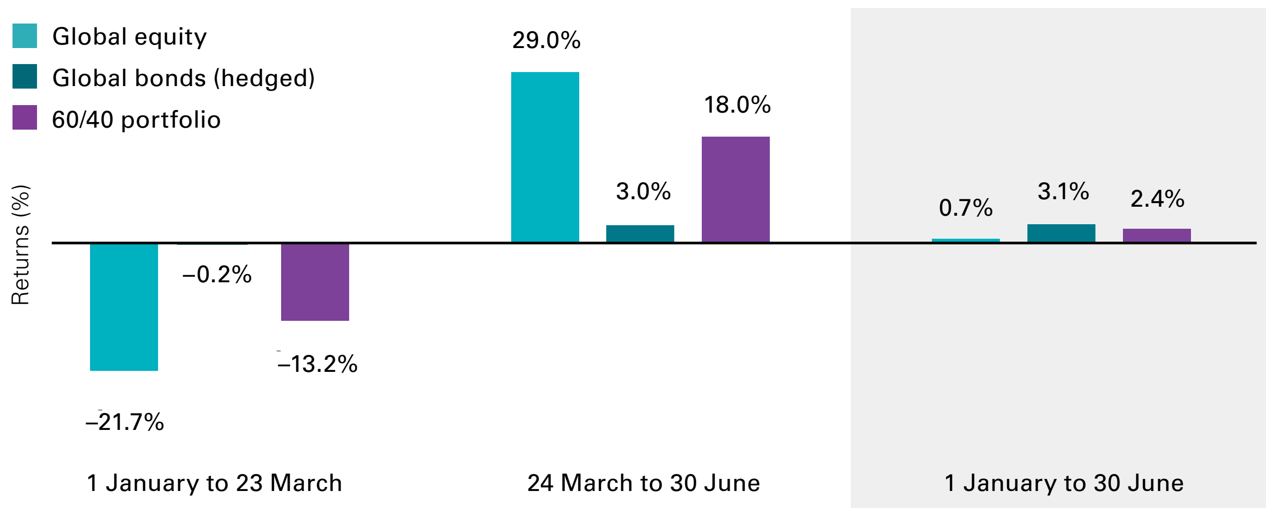
Such differentials, which change over time, help to explain why we believe portfolios should be globally diversified.

As for bonds, current yields normally provide a good indication of the level of return that can be expected in the future. Given accommodative monetary policy, our expectation for the average annual return for UK-based investors has fallen by about 50 basis points since the end of 2019, to a range of 0% to 1.5% for UK and non-UK bonds.

Admittedly, we are in a low-yield environment with low forecast returns for bonds but we expect high-quality, globally diversified fixed income to continue to play the important role of a risk diversifier in a multi-asset portfolio.

It did so earlier this year. Consider a globally diversified portfolio with 60% exposure to shares and 40% exposure to currency-hedged global fixed income, from a UK investor's perspective. It is true that over a few days the correlation between global equity and bond markets was positive and that they moved relatively in tandem, but for the first half of 2020 a globally diversified bond exposure acted as ballast, helping to counter the riskier equity component of the portfolio.

Figure 3. Bonds proved their value as a diversifier of risk in a portfolio



Notes: Global equity is represented by the MSCI All Country World Index, global bonds are represented by the Bloomberg Barclays Global Aggregate Bond Index hedged to GBP, and the 60/40 portfolio is made up of 60% global equity and 40% global bonds.

Sources: Vanguard and Bloomberg.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

I'd caution that investors may be running the risk of pricing assets close to perfection, assuming that corporate profitability will be restored soon or that central bank support can maintain buoyant asset markets for the foreseeable future.

We would advise, as always, that investors maintain diversified portfolios appropriate to their goals and invest for the long term. Attempting to time the market during extreme market volatility is tempting but rarely profitable.

Notes on risk

All investing is subject to risk, including the possible loss of the money you invest. Past performance is no guarantee of future returns. Investments in bond funds are subject to interest rate, credit, and inflation risk. Foreign investing involves additional risks, including currency fluctuations and political uncertainty. Diversification does not ensure a profit or protect against a loss in a declining market. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Company shares in emerging markets are generally more risky than in developed countries. US government backing of Treasury or agency securities applies only to the underlying securities and does not prevent price fluctuations. Investments that concentrate on a relatively narrow market sector face the risk of higher price volatility. Investments in shares issued by non-US companies are subject to risks including country/regional risk and currency risk.

Bond funds are subject to the risk that an issuer will fail to make payments on time and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments. High-yield bonds generally have medium- and lower-range credit-quality ratings and are therefore subject to a higher level of credit risk than bonds with higher credit-quality ratings. Although the income from US Treasury obligations held in the fund is subject to federal income tax, some or all of that income may be exempt from state and local taxes.

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Vanguard global economics team

Joseph Davis, Ph.D., Global Chief Economist

Europe

Peter Westaway, Ph.D., Europe Chief Economist
Alexis Gray, M.Sc.
Shaan Raithatha, CFA
Nathan Thomas

Asia-Pacific

Qian Wang, Ph.D., Asia-Pacific Chief Economist
Beatrice Yeo, CFA
Adam Schickling, CFA

Americas

Roger A. Aliaga-Díaz, Ph.D., Americas Chief Economist
Jonathan Lemco, Ph.D.
Andrew J. Patterson, CFA
Joshua M. Hirt, CFA
Jonathan Petersen, M.Sc.
Asawari Sathe, M.Sc.
Maximilian Wieland

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