Vanguard

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Vanguard economic and market update

The points below represent the house view of the Vanguard Investment Strategy Group's (ISG's) global economics and markets team as at 16 November 2022, on several current macroeconomic and market topics.

Key highlights:

- US interest rates expected to peak at 4.5% to 4.75% by the end of March 2023.
- Chinese economic growth forecast for 2023 cut to 4.5% amid a changing political environment.
- Euro area still on course for a mild recession this winter with ECB rates set to rise to 2.5%.
- UK economy now expected to contract by between 1% and 1.5% in 2023 as fiscal policy tightened.

Economic growth

The economy in the **United States**, grew by an annual rate of 2.6% in the third quarter, the Bureau of Economic Analysis (BEA) reported on 27 October, a solidly positive number but one that Vanguard believes overstates the strength of the US economy. The underlying data composition confirms that growth has slowed considerably in 2022 amid a dramatically changed interest rate environment. Housing was especially weak, falling 26% from the second quarter and detracting from GDP for a sixth straight quarter. Consumption grew by 1.4% in the quarter which, while a positive number, is barely above average consumption growth during recessions. Vanguard expects below-trend growth of around 1.7% in the fourth quarter, allowing the economy to eke out a gain for the full year, and growth of between 0.25% and 0.5% in 2023, which is likely to include a recession.

The **euro area** and its four largest economies appear to have avoided recession in the third quarter, but the outlook has deteriorated in recent weeks. Euro-area GDP grew by 0.2% in the third quarter compared with the second, according to a second flash estimate by the European Union's statistical office on 15 November, slower than a 0.8% second-quarter increase. Growth was 2.1% compared with a year earlier, a significant slowdown from year-on-year growth of 4.3% in the second quarter. Key indicators continue to decline, including purchasing managers' indices (below a contractionary level region-wide for a fourth straight month) and new orders minus inventories. We continue to expect a mild recession in the fourth quarter of 2022 and first quarter of 2023, with full-year 2023 GDP in a range of between –0.5% and 0.5% growth.

The government in the **United Kingdom** has provided details of its medium-term fiscal plan. As expected, the plan bolstered government finances, with conditions being tightened sufficiently to show the UK's debt to GDP ratio falling by the end of the plan's horizon. This approach should also tackle inflation and, if successful, limit the need for Bank of England interest rate hikes, although we also expect the plan to add to the UK's growth challenges. We foresee GDP contracting by between –1% and –1.5% in 2023, a downgrade since our October update and greater than consensus expectations for a –0.5% contraction (though consensus may change now that the plan details have been announced). GDP contracted by –0.2% in the third quarter compared with the second, the Office for National Statistics reported on 11 November. Services output was flat in the quarter as consumer-facing services output fell, while production output decreased by –1.5%, including a decline in all 13 manufacturing sub-sectors. On a monthly basis, GDP decreased by –0.6% in September, with activity reduced by a bank holiday for the state funeral of Queen Elizabeth II.

A delayed GDP release revealed a surprisingly strong pickup in economic activity in **China** in the third quarter. GDP grew by 3.9% in the third quarter on both a year-on-year and quarter-on-quarter basis, the National

Bureau of Statistics reported on 24 October, a week after the originally scheduled report date. That number was well above the consensus estimate of economists surveyed by Bloomberg for 3.3% quarter-on-quarter growth and in sharp contrast to a contraction of –2.7% in a second quarter during which activity was besieged by Covid-19-related lockdowns. But it left China well behind its target for full-year 2022 growth of 5.5%. For full-year 2023, we now foresee growth of 4.5%, a downgrade from our most recent view of 5% growth, given a slowing fourth-quarter 2022 momentum and considering that National Party Congress developments are seemingly at odds with private enterprise. Our view nonetheless reflects a cyclical bounce in activity. With potential for some stabilisation in the real estate sector (the government issued a 16-point plan to shore up the sector on 11 November) and a gradual easing of zero-Covid-19 lockdown policies, we see risks as skewed to the upside.

We foresee GDP growth of 3.3% **in emerging markets** in 2023, far stronger than the 0.3% growth rate we anticipate for developed markets. But we expect the pace of growth to vary significantly across regions. We expect emerging Asia to lead the way, given an anticipated cyclical rebound in China, with regional growth exceeding 4%. We foresee marginal growth of around 1% in Latin America, restrained by a slowdown in the United States. And we expect economies in emerging Europe to reflect the continent's developed-market challenges, with GDP likely to be flat in 2023.

Monetary policy:

The **US Federal Reserve** (Fed) raised its federal funds rate target by 75 points for a fourth consecutive meeting on 2 November and emphasised that it has more work to do to bring inflation under control. The new target is within a range of 3.75% to 4%. Fed Chair Jerome Powell suggested that how high the Fed's rate target climbs and how long it stays at that level have become more important questions than how fast it gets there, and that forthcoming inflation data—more so than labour market data—will help answer those questions. In our baseline case, Vanguard foresees the federal funds rate target climbing to a range of 4.5% to 4.75% by the end of the first quarter and staying there for the rest of 2023, though we ascribe a 40% chance to the prospect of the target rate needing to be moved beyond that. We expect meeting-by-meeting data, to influence the Fed's path.

The **European Central Bank** (ECB) increased its deposit facility rate by 75 basis points on 27 October, doubling the rate to 1.5%. The first successive hikes of that magnitude in the bank's history came alongside an indication that the pace of rate increases is poised to slow: the bank said it "expects to raise interest rates further", but dropped a previous reference to such increases occurring "for several meetings". Such language is consistent with Vanguard's view that the ECB will raise the deposit rate by 50 basis points at its next meeting, on 15 December. Against a challenging backdrop of a weakening global economy and increasing underlying inflationary pressures, we anticipate that the ECB will continue to raise its deposit rate until it reaches 2.5%, which we believe will occur in the first quarter of 2023. Our view is below market expectations for a 3% terminal rate. We believe the euro area economy will be in recession at that point and inflation will have passed its peak, giving the ECB ample reason to end its hiking cycle. In a hawkish twist to an otherwise dovish announcement, the bank said it would change how it calculates interest on certain targeted longer-term refinancing operations (TLTROs) effective from 22 November, a move likely to weigh on banking sector profits. We expect the bank to begin discussing quantitative tightening at its 15 December meeting, but we don't expect any related balance-sheet action until the second half of 2023. We don't believe that the bank will actively sell bonds at that point but, rather, will allow some of the €6.6 trillion in bonds it added to its balance sheet since the start of quantitative easing to roll off by not reinvesting proceeds in new bonds.

The **Bank of England** (BOE) increased its bank rate by 75 basis points on 3 November. The largest increase in 33 years took the bank rate up to 3%, its highest level since December 2008. In its statement, the BOE described a "very challenging outlook for the UK economy" that included its views that headline inflation would peak at around 11% this quarter. In its quarterly monetary policy report, the bank said it expected the UK economy to remain in recession until the first half of 2024. It said it expected that inflation would fall to 2.2%, just above its 2% target, by the end of 2024 if the policy rate stayed at its new 3% level. Strong pushback from BOE Governor Andrew Bailey against the policy path discounted in the markets at the time of the announcement suggests the bank will be attentive to needs of cushioning the blow to the economy that higher rates are likely to influence. Vanguard expects the bank rate to rise to 3.5% by the end of 2022 on the way to a terminal and year-end-2023 rate of 4.5%.

The **People's Bank of China** kept its one-year medium-term lending facility rate at 2.75% for a third straight month on 15 November. Vanguard expects monetary policy to remain accommodative in the months ahead to counter weakness in the real estate sector and the effects of ongoing Covid-19 lockdowns. More important may be what happens with fiscal policy, where we expect restraint given concerns about financial stability. As the economy rebounds in 2023, we expect policy to switch from accommodative to neutral.

The start of policy interest rate cutting cycles is likely to occur in **emerging markets**, with Latin America leading the way in 2023. We expect rate cuts to occur later and be less dramatic in emerging Asia, where rates didn't go as high as in Latin America, while central banks in emerging Europe continue to grapple with high inflation.

Inflation

An anticipated decline in goods prices materialised in the **United States** in October in a consumer price inflation report that financial markets reacted to enthusiastically. Market participants saw the report as evidence that the Fed could slow its pace of rate hikes at its next meeting. Core goods prices fell by –0.4% compared with September, with both durable and non-durable goods prices falling. Headline inflation rose by a less-than-expected 0.4% from a month earlier, and by a less-than-expected 7.7% from a year earlier. Core inflation, which removes volatile food and energy prices, slowed to 0.3% compared with September and to 6.3% compared with October 2021, down from a 40-year high of 6.6% in September. Vanguard sees inflation risks remaining to the upside as services prices (up 7.2% year-on-year and 7.8% on a three-month annualised basis) accelerate even as goods prices come down. The Fed's preferred inflation indicator in considering monetary policy, the core personal consumption expenditures (PCE) index, rose by 0.5% in September, the same as a revised 0.5% in August, the Bureau of Economic Analysis reported on 28 October. Compared with a year earlier, core PCE reached 5.1%, higher than August's 4.9% reading.

Headline inflation in the **euro area** climbed to 10.7% in October, according to a 31 October flash estimate by the European Union's statistical office, above expectations and driven by energy and food prices. We expect headline inflation to peak at around 11% in December and average 8% to 8.5% for all of 2022 before falling to 5% to 5.5% on average in 2023. Risks of higher wages feeding into higher inflation are elevated even as survey- and market-based inflation expectations remain anchored.

Headline inflation in the **United Kingdom** climbed to 11.1% in October compared with October 2021, the Office for National Statistics reported on 16 November, up from a 10.1% year-on-year increase in September and the highest level since October 1981. On a monthly basis, consumer prices rose by 2% in October, far higher than a 0.5% rise in September and the greatest month-on-month increase since April 2022. Utility prices contributed materially to the monthly increase given a rise in the Energy Price Guarantee to £2,500 for the average annualised household bill. Food prices were also strong contributors, while transport, which includes motor fuels and used automobiles, provided the greatest partial offset to the CPI rise. We expect headline inflation to peak in the fourth quarter of 2022 and to average 6% to 6.5% in 2023, though tightening from the government's new fiscal plan could dampen some of the inflationary pressures.

Consumer prices rose by less than expected in **China** in October while producer prices fell for the first time in nearly two years as Covid-19 lockdowns continued to weigh on demand. The consumer price index rose by 2.1% in October compared with a year earlier, its lowest annual increase since May and down from a 2.8% year-on-year rise in September. Food prices, which were up 7% year-on-year to drive the annual increase, rose just 0.1% from September. Producer prices, meanwhile, fell by –1.3% in October compared with a year earlier, the first decline since December 2020. On a monthly basis, producer prices rose by 0.2%. We have downgraded our 2023 inflation forecast from 3.2% to 2.2% given our expectation that growth will remain tepid, the renminbi will stabilise and food prices, which are an important component of the inflation basket, will moderate faster than anticipated.

Slowing developed-market growth is starting to have a cooling effect on inflationary pressures in **emerging markets**. Vanguard expects falling commodities prices to alleviate headline inflation in a number of emerging economies where food and energy prices have been primary inflation drivers.

Employment

The unemployment rate in the **United States** rose to 3.7% from 3.5% in October, an early sign that Fed interest rates may be starting to take effect. Still, October's jobs report was generally strong amid growing economic headwinds. The economy added 261,000 jobs in October, based on the jobs report's survey of employers. We believe that headwinds driven by the Fed's rate-hiking cycle will begin to curb employment growth in the first quarter of 2023, with the unemployment rate rising to 4.4% by the end of 2023.

The unemployment rate in the **euro area** stood at a record low of 6.6% in September, down from a revised 6.7% in August. We expect that the labour market will remain tight, keeping upward pressure on wage growth. But we believe the unemployment rate will rise to an above-consensus 7.4% in 2023 amid broader economic weakness.

The unemployment rate in the **United Kingdom** rose to 3.6% for the three months to September, higher than the 3.5% reading in the three months to August, which had been the lowest rate since February 1974. Growth in pay excluding bonuses reached 5.7%, the strongest growth seen outside of the Covid-19 pandemic. In our base case, we expect the UK unemployment rate to rise to 4.7% by the end of 2023.

Asset class return outlook improves

The projections listed below are based on the 30 September 2022 running of the Vanguard Capital Markets Model® (VCMM). The probabilistic return assumptions depend on market conditions at the time of the running of the VCMM and, as such, change with each running over time[1].

Our 10-year annualised nominal return projections are as follows. The figures are based on a 2-point range around the 50th percentile of the distribution of return outcomes for equities and a 1-point range around the 50th percentile for fixed income. Numbers in parentheses reflect median volatility.

	Median projected volatility (%)	10 year annualised nominal return projections
UK equities £	19.2	4.6%-6.6%
Global equities ex-UK (unhedged) £	19.7	6.1%-8.1%
UK aggregate bonds £	9.7	4.7%-5.7%
Global bonds ex-UK (hedged) £	4.5	4.3%-5.3%
Euro area equities €	25.5	4.9%-6.9%
Global equities ex-euro area (unhedged) €	19.5	3.7%-5.7%
Euro area aggregate bonds €	4.0	2.2%-3.2%
Global bonds ex-euro area €	4.6	2.1%-3.1%

IMPORTANT: 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 at 30 September 2022. Results from the model may vary with each use and over time.

1. ISG updates these numbers quarterly. The projections listed above are based on the full 30 September 2022 running of the VCMM.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Past performance is not a reliable indicator of future results.

IMPORTANT: The projections and 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. VCMM results will 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.

Important information

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