Vanguard economic and market outlook for 2022: Global summary

Navigating an exit from exceptionally accommodative policy will be critical to the global economy in 2022.

The global economy in 2022: Striking a better balance

Our outlook for 2021 focused on the impact of Covid-19 health outcomes on economic and financial conditions. Our view was that economic growth would prove unusually strong, with the prospect of an "inflation scare" as growth picked up. As we come to the end of 2021, parts of the economy and markets are out of balance. Labour demand exceeds supply, financial conditions are exceptionally strong even when compared to improved fundamentals and policy accommodation remains extraordinary.

Although health outcomes will remain important in 2022, the outlook for macroeconomic policy will be more crucial as support and stimulus packages enacted to combat the pandemic-driven downturn are gradually removed into 2022. The removal of policy support poses a new challenge for policymakers and a new risk to financial markets.

The global economic recovery is likely to continue in 2022, although we expect the low-hanging fruit of rebounding activity to give way to slower growth, whether supply-chain challenges ease or not. In both the United States and the euro area, we expect growth to normalise lower to 4%. In the UK, we expect growth of about 5.5% and in China we expect growth to fall to about 5% given the real estate slowdown.

More importantly, labour markets will continue to tighten in 2022 given robust labour demand, even as growth decelerates. We anticipate several major economies, led by the US, will quickly approach full employment even with a modest pick-up in labour force participation. Wage growth should remain robust and wage inflation is likely to become more influential than headline inflation for the direction of interest rates in 2022.

Global inflation: Lower but stickier

Inflation has continued to trend higher across most economies, driven by a combination of higher demand as pandemic restrictions were lifted and lower supply from global labour and input shortages. Although a return to 1970s-style inflation is not on the cards, we anticipate that supply/demand frictions will persist well into 2022 and keep inflation elevated across developed and emerging markets. That said, it is highly likely that inflation rates at the end of 2022 will be lower than at the beginning of the year given the unusual run-up in certain goods prices.

Although inflation should cool in 2022, its composition should be stickier. More persistent wage-based inflation should remain elevated, given our employment outlook, and will be the critical determinant in central banks' adjustment of policy.

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Policy takes centre stage: The risk of a misstep increases

The global policy response to Covid-19 was impressive and effective. Moving into 2022, how will policymakers navigate an exit from exceptionally accommodative policy? The bounds of appropriate policy expanded during the pandemic, but it's possible that not all these policies will be unwound as conditions normalise. On the fiscal side, government officials may need to trade off between higher spending—due to pandemic-driven policies—and more balanced budgets to ensure debt sustainability.

Central bankers will have to strike a delicate balance between keeping a lid on inflation expectations, given negative supply-side shocks, and supporting a return to pre-Covid employment levels. In the United States, that balance should involve the Federal Reserve (Fed) raising interest rates in 2022 to ensure that elevated wage inflation does not translate into more permanent core inflation. At present, we see the negative risks of too-easy policy accommodation outweighing the risks of raising short-term rates. Given conditions in the labour and financial markets, some are likely underestimating how high the Fed may ultimately need to raise rates this cycle.

The bond market: Rising rates won't upend markets

Despite modest increases during 2021, government bond yields remain below pre-Covid levels. The prospect of rising inflation and policy normalisation means that the short-term policy rates targeted by the Fed, the European Central Bank (ECB) and other developed-market policymakers are likely to rise over the coming years. Credit spreads remain generally very tight. In our outlook, rising rates are unlikely to produce negative total returns, given our inflation outlook and given the secular forces that should keep long-term rates low.

Global equities: A decade unlike the last

A backdrop of low bond yields, reduced policy support and stretched valuations in some markets offers a challenging environment despite solid fundamentals. Projections from our Vanguard Capital Markets Model®, which explicitly incorporates such variables, continues to reveal a global equity market that is drifting close to overvalued territory, primarily because of US equity prices. Our outlook calls not for a lost decade for US stocks, as some fear, but for a lower-return one.

The outlook for the global equity risk premium is still positive but lower than last year's, with total returns expected in the range of 2 to 4 percentage points over bond returns. Recent outperformance has only strengthened our conviction in non-US equities, which have more attractive valuations than US equities.

For British pound investors, our 10-year annualised nominal return projections[1] for UK equities are 4.6%-6.6%, while for global ex-UK equities (unhedged) they are 2.8%-4.8%. For UK aggregate bonds, expected returns are 0.8%-1.8%, while for global ex-UK bonds (hedged), they are 0.7%-1.7%.

For euro investors, our 10-year annualised nominal return projections[1] for euro area equities are 2.7%-4.7%, while for global ex-euro area equities (unhedged), they are 1.4%-3.4%. For euro area and global ex-euro area aggregate bonds, expected returns are -0.5%-0.5%.

1 Our 10-year annualised nominal return projections 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

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. 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. Simulations as at 30 September 2021.

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

Vanguard global economics team

Joseph Davis, Ph.D., Global Chief Economist

Americas

Roger A. Aliaga-Díaz, Ph.D.,
Chief Economist, Americas

Joshua M. Hirt, CFA

Andrew J. Patterson, CFA

Asawari Sathe, M.Sc.

Adam J. Schickling, CFA

Maximilian Wieland

David Diwik, M.Sc.

Amina Enkhbold, Ph.D.

Asia-Pacific

Qian Wang, Ph.D.,
Chief Economist, Asia-Pacific

Alexis Gray, M.Sc.

Beatrice Yeo, CFA

Europe

Peter Westaway, Ph.D.,
Chief Economist, Europe

Shaan Raithatha, CFA

Roxane Spitznagel, M.Sc.

Griffin Tory, M.Phil.

Capital Markets Model Research Team

Qian Wang, Ph.D., Global Head of VCMM

Kevin DiCiurcio, CFA

Daniel Wu, Ph.D.

Ian Kresnak, CFA

Vytautas Maciulis, CFA

Olga Lepigina, MBA

Akeel Marley, MBA

Edoardo Cilla, M.Sc.

Lukas Brandl-Cheng, M.Sc.

Alex Qu

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Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results.

Simulated past performance is not a reliable indicator of future results.

Funds investing in fixed interest securities carry the risk of default on repayment and erosion of the capital value of your investment and the level of income may fluctuate. Movements in interest rates are likely to affect the capital value of fixed interest securities. Corporate bonds may provide higher yields but as such may carry greater credit risk increasing the risk of default on repayment and erosion of the capital value of your investment. The level of income may fluctuate and movements in interest rates are likely to affect the capital value of bonds.

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