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 of 15 February 2023 on several current macroeconomic and market topics.

Key highlights:

- We expect further US rate rises as strong jobs data show the Federal Reserve's work is still not done.
- We've raised our euro area growth forecast, helped by a slide in natural gas prices, but we still see recession as likely.
- We anticipate further rate rises in the euro area and also in the UK, where the jobs market remains tight.
- The opening up of China should boost domestic growth as well as that across emerging Asia.

United States

A very strong January labour market report underscored the notion of a US Federal Reserve (Fed) with more work to do. The US economy created 517,000 jobs in January, more than double consensus estimates and the highest job-creation number since July 2022, when the Fed's policy interest target was more than two percentage points lower than the current target of 4.5%–4.75%. The unemployment rate fell to a 54-year low of 3.4%. Annual year-end Bureau of Labor Statistics adjustments suggested the labour market was even stronger in 2022 than initially reported.

Restrictive monetary policy takes time to work through an economy, however, and we expect that higher interest rates will translate to moderate labour market cooling in the second quarter. We anticipate a transition to job losses in the second half of the year, with the unemployment rate rising towards 5% by the end of 2023.

The strong labour market report doesn't change our expectation that the Fed will increase its rate target by a total of 50 basis points over its next two meetings, to a range of 5%–5.25%, and keep it at that level throughout 2023 as the pace of inflation subsides gradually. On 1 February, the Fed increased its target for the federal funds rate by 25 basis points, a second consecutive slowing in the pace of increases in recognition that a disinflation process has begun.

The 14 February Consumer Price Index release also keeps the Fed in the spotlight. The CPI increased by 0.5% in January on a seasonally adjusted basis compared with December, up from December's 0.1% rise. Shelter inflation accounted for more than half the monthly gain, in line with our view that it will remain elevated throughout the first quarter. Compared with a year earlier, CPI increased by 6.4%, down modestly from December's 6.5% year-on-year rise. We expect the pace of inflation to slow throughout 2023, with gains in shelter inflation in the first half of the year offset to a degree by faster deceleration of goods inflation. Core inflation, which excludes volatile food and energy prices, registered 0.4% in January on a monthly basis, the same as in December, and 5.6% compared with a year earlier. We expect the Fed's favoured inflation gauge, the core Personal Consumption Expenditures index, to fall below 3% by the end of 2023 and to 2% by year-end 2024. Core PCE registered 4.4% in December compared with a year earlier, decelerating from a 4.7% gain in November, a third straight month of slowing.

The US economy grew at an annual rate of 2.9% in the fourth quarter, the Bureau of Economic Analysis reported. That figure was down from 3.2% growth in the third quarter. Compared with a year earlier, and after two quarters of contraction to start 2022, GDP grew by 1%. Consumption, driven largely by services, increased by 2.1% in the quarter. Activity attributed to housing was exceptionally weak, as expected, falling 27% in the quarter, a seventh straight quarter of negative contribution to GDP. We continue to assign a high probability to a mild recession over the course of 2023, though the odds of the economy navigating a soft landing have risen.

Euro area

Fast-falling natural-gas prices, a resilient industrial sector and the reopening of China's economy are mitigating a challenging euro area economic outlook. We continue to expect a recession in the euro area, beginning this quarter, though we believe it will last just two quarters. We've upgraded our growth forecast for the region to 0% in 2023, from our previous view of a 0.5%–1% contraction. We also foresee euro area GDP growth of around 0.7% in 2024.

Underlying momentum, however, is weak. The economy eked out growth of just 0.1% on a seasonally adjusted basis in the fourth quarter compared with the third, according to a flash estimate by Eurostat, the European Union's statistical agency. But it would have contracted if not for 3.5% growth in Ireland. GDP was up by 1.9% in the euro area compared with the same quarter a year earlier. For all of 2022, it grew by 3.3%.

We've downgraded our forecast for 2023 headline inflation, largely because of an almost 85% decline in natural-gas prices since their August 2022 peak but also amid expected falling food and goods prices. We expect headline inflation to average 4.5% in 2023, down from our previous expectation for 6.1% average inflation. That's well below a consensus view of 5.7% that we expect will come down in the weeks ahead. Headline inflation is expected to have slowed to 8.5% in January according to a 1 February Eurostat flash estimate. That would be down from a 9.2% year-on-year rate in December Energy remained the main contributor to inflation in the euro area flash figure, up 17.2% year-on-year. But that level has fallen steadily since October 2022, when it registered 41.5%.

Core inflation, which excludes volatile food and energy prices, remained at a record high of 5.2% in January compared with a year earlier - the same year-on-year rise as in December. We continue to foresee core inflation averaging 4% in 2023 as wage pressures in the services sector remain strong, given a historically tight labour market.

We expect wage pressures to start to ease only in early 2024 and to continue to influence monetary policy in the interim. The European Central Bank (ECB) on 2 February increased its deposit facility rate by 50 basis points, to 2.5%, and said it intends to raise the rate by another 50 basis points at its next policy announcement on 16 March. We still expect the ECB to raise rates to 3.5% in the second quarter of 2023, with two 25-basis-point increases to follow the 50-basis-point increase signalled for March. We foresee rate cuts in the second half of 2024 at the earliest.

The energy shock from Russia's 2022 invasion of Ukraine, meanwhile, appears milder than initially feared. Natural-gas prices are down and the region has adapted well to significantly lower Russian energy imports.

United Kingdom

Mortgage approvals fell in December for a fourth straight month to the lowest level since May 2020, early in the Covid-19 pandemic, as the effective interest rate on new mortgages rose by 32 basis points, to 3.67%. More than 750,000 homeowners are at risk of defaulting on their mortgages in the next two years, the country's main financial regulator, the Financial Conduct Authority, warned a Parliamentary committee in January.

Further challenges in housing and other interest-rate-sensitive sectors are likely. The Bank of England (BoE) on 2 February increased its bank rate to 4%, from 3.5%, noting that "domestic inflationary pressures have been firmer than expected." Vanguard expects the BoE will take the bank rate to a high of 4.5% in May and keep it there until the second half of 2024 to ensure that inflation falls back to the BoE's 2% target. That view is contrary to that of markets' pricing in rate cuts in the second half of 2023.

Rising wages will likely continue to play into the BoE's decision-making. Average regular pay (excluding bonuses) increased by a greater-than-expected 6.7% in the three-month period ended in December, the UK Office for National Statistics reported on 14 February. That was up from a revised figure of 6.5% in the three-month period ended in November. The labour market remains tight, despite some signs of easing, supporting the strong wage growth. Employment in the three months to December grew by 74,000 despite a sharp fall of 217,000 in December alone. Job vacancies continued a downtrend, falling for an eighth consecutive month. The unemployment rate for the period was just above a near-50-year low of 3.7%.

Headline inflation registered 10.1% in January compared with a year earlier, continuing to fall back from its October 2022 peak but still well above the BoE target. We expect headline inflation to average 6%–6.5% in 2023. On a monthly basis, the CPI fell by 0.6% in January, compared with a 0.4% increase in December.

The economy averted a technical recession in the fourth quarter of 2022, neither growing nor contracting, the Office for National Statistics reported on 10 February. But a downward trend was evident in December, when GDP fell by 0.5%. Vanguard believes that a recession has likely begun this quarter in the UK and will persist through to the third quarter of 2023. We continue to expect GDP to contract by 1% in 2023 before growing by around 0.6% in 2024.

China

After two years of widespread lockdowns that crimped economic activity, China has rapidly moved away from its zero-Covid policy. Like the experience in developed markets, though to a lesser degree, China's consumers are poised to spend excess savings built up during the pandemic. The effect will likely be a boost to domestic growth if not a reduced likelihood of global recession.

We anticipate that China's GDP will grow by an above-consensus 5.3% in 2023, with greater strength in the first two quarters given increased service-sector activity related to the economy's reopening. But we expect GDP growth to slow in 2024 to just below 5%, as we remain pessimistic about China's structural outlook. China recently reported growth of 3.0% for all of 2022, a year marked by frequent Covid-19 outbreaks and zero-Covid lockdowns in response.

The expected recovery in consumption this year is likely to accelerate inflation, though not beyond China's 3% target. We foresee 2023 headline inflation around 2.5%, held back by moderating food prices and appreciation in China's currency. We expect core inflation to average 1.5% in 2023. Headline inflation jumped by 0.8% in January compared with December and was up by 2.1% compared with a year earlier.

We expect broad policy settings to shift from a somewhat accommodative stance to a more neutral one likely late in the first quarter, given the economy's reopening. Targeted growth support remains likely, however, such as in the property market to revive demand and prevent a large number of developer defaults. But we don't expect support to come at the expense of a continued deleveraging in the sector.

Emerging markets

China's sudden departure from its zero-Covid policy could boost growth in emerging markets, particularly in Asia. The reopening of China's economy and the increased consumption we expect it to engender will likely benefit Asian emerging markets through tourism and trade. Energy exporters would likely benefit, too, should increased economic activity boost energy prices, while the opposite is true for energy importers.

On balance, we haven't changed our below-consensus forecast for emerging markets GDP growth of 3% in 2023. Our proprietary leading indicators index signals an upside growth risk for emerging markets, however; this would be felt most in emerging Asia and somewhat in Latin America, though likely not at all in emerging Europe, given broader economic challenges there.

We believe that inflation likely has peaked in Latin America and neared its peak in emerging Asia, but inflation-related challenges haven't gone away.

Asset class return outlooks

Vanguard has updated its 10-year annualised outlooks for broad asset class returns through the most recent running of the Vanguard Capital Markets Model® (VCMM), based on data as of 31 December 2022. The probabilistic return assumptions depend on market conditions at the time of the running of the VCMM and, as such, can change with each running over time.

Our 10-year annualised nominal return projections, expressed for local investors in local currencies, 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.

Asset-class return outlook

The following are Vanguard's latest 10-year annualised outlooks for equity and fixed income returns[1].

British pound investors	Median projected volatility (%)	10 year annualised nominal return projections
UK equities £	19.2	4.2%-6.2%
Global equities ex-UK (unhedged) £	19.4	5.3%-7.3%
UK aggregate bonds £	9.3	4.2%-5.2%
Global bonds ex-UK (hedged) £	4.4	3.8%-4.8%

Euro area equities €	24.6	4.1%-6.1%
Global equities ex-euro area (unhedged) €	19.5	3.9%-5.9%
Euro area aggregate bonds €	4.2	2.6%-3.6%
Global bonds ex-euro area €	4.6	2.5%-3.5%

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 modeled asset class. Simulations are as of 31 December 2022. Results from the model may vary with each use and over time.

1. The probabilistic return assumptions depend on market conditions at the time of the running of the Vanguard Capital Markets Model® (VCMM) and, as such, can change with each running over time. ISG updates these numbers quarterly. The projections listed above are based on a running of the VCMM based on data as of 31 December 2022. Please note that 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.

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.

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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 US 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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