VANGUARD COMMENTARY

Vanguard economic and market update

31 March 2020

Recession looms, but equities outlook improves

Key points

- Vanguard expects a global recession, but with the potential for a quick recovery;
- The Australian economy will enter its first recession in 30 years, driven by declining services exports and lower demand;
- Vanguard has increased its 10-year annualised projections for global equities, reflecting the broad fall in equity values from the current market downturn.

The extreme measures being taken to combat the spread of COVID-19, including the shutdown of businesses around the world, makes it unfortunately clear that a global recession is at hand.

Despite this, Vanguard believes the potential exists for a quick recovery, and that the long-term outlook for equities has improved.

Economic growth

Given the strict efforts taken first in Asia, and now in many other parts of the world, to contain the virus' spread, we believe a global recession likely already is under way. This certainly will be a difficult time for individuals and for the global economy.

We expect **Australia** to enter its first recession in 30 years, despite continued stimulus from policymakers. While the bulk of Australia's activity slowdown in Q1 will likely be driven by a decline in service exports, greater restrictions on household behaviour will see a large domestic demand slowdown in Q2, given the drag from Chinese demand and the impact of disruptions to global economic activity and supply chains.

In the United States, we anticipate a profound fall-off in the real economy, with consumer spending likely to decline at the sharpest pace since at least World War II. But we also expect that this could turn out to be among the shortest recessions in U.S. history. Under a scenario of lockdowns and business closures ending sometime in the second quarter, and with aggressive fiscal and monetary policy measures in place, we would foresee a rebound in growth in the third quarter to mark the end of this sharp yet short recession.

In China, the original epicentre of the outbreak and now the bellwether for disease-recovery prospects, the first economic numbers after an annual Lunar New Year data hiatus came in significantly weaker than expected. This prompted an acknowledgment from the National Bureau of Statistics that China's 5.5% growth target for 2020 may be unrealistic. Vanguard believes the data reflect how stringent China's disease containment efforts have been. As such, we see China headed for a hard landing, albeit short-lived, with GDP growth slowing sharply in 2020.

We believe the euro area is likely already in recession, and that the economy in the United Kingdom will weaken after having shown resilience at the start of the year.

Monetary policy

The world's central bankers continue to act amid pronounced market dislocations.

The Reserve Bank of Australia (RBA) lowered its cash rate to 0.25% on Thursday 19 March, in an emergency action, having lowered it from 0.75% to 0.5% at its regular March meeting. The RBA also officially launched "yield curve control" quantitative easing in Australia, pledging to buy government bonds in the secondary market to anchor 3-year government bond yields at 0.25% while also launching a Term Funding Facility to provide banks with cheap funding.

The U.S. Federal Reserve on Monday 23 March said it would buy unlimited amounts of Treasury and mortgage-backed securities, having said a week earlier it would buy "at least US$700 billion" of the securities. In its second emergency action in less than two weeks, the Fed on Sunday, 15 March, lowered the target for its federal funds rate to near zero. At the same time, the Fed introduced several actions to support the flow of credit to households and businesses.

The European Central Bank (ECB) on Wednesday 18 March, announced a €750 billion (about US$805 billion) Pandemic Emergency Purchase Programme to buy government and corporate debt through the end of the year. The ECB noted that it would consider revising some self-imposed limits "to the extent necessary to make its action proportionate to the risks that we face." The ECB currently limits itself to buying no more than a third of a country's outstanding debt. Less than a week earlier, the ECB had announced a series of policy decisions intended to support the financial system, while leaving the interest rate on its deposit facility unchanged at –0.50%.

The Bank of England (BOE), in a special Monetary Policy Committee meeting on Thursday 19 March, cut its bank rate to 0.1% (having cut it by 50 basis points to 0.25% nine days earlier) and said it would increase its holdings of UK government and corporate bonds by £200 billion (about US$230 billion). In an additional measure on March 10, the BOE had reduced the amount of capital banks are required to hold, freeing up £190 billion (about US$220 billion) for business lending.

The Bank of Canada reduced its key overnight rate by 100 basis points in two 50-point moves, the latter on 13 March, when it also announced other measures to support the economy and the financial sector.

Brexit

The challenges facing Brexit negotiations became a little greater when the COVID-19 outbreak forced cancellation of a second round of talks. A revised timetable for negotiations is unlikely to be published until the outbreak has stabilised.

The United Kingdom, which ceased being a member of the European Union on 31 January2020, has publicly ruled out the possibility of its requesting an extension to a transitionary period that expires at the end of the year. Such a request would need to be issued by June 30. Should the UK government remain committed to existing deadlines, the risk of negotiations collapsing without a deal being reached has increased. However, the new realities open the door to the UK government's potentially reversing its opposition to extending the transitionary period to accommodate further negotiations. With both parties still far apart on details concerning their future trading relationship, including those related to financial market access, Vanguard will be watching closely for signs of whether the EU-UK relationship as we've known if for nearly 50 years ends with or without a future trading agreement in place.

Trade

Canada ratified the United States-Mexico-Canada Agreement (USMCA) on Friday 13 March, as the United States and Mexico already had done, allowing the replacement for the North American Free Trade Agreement to move toward implementation. The event opens a window through which Vanguard will watch developments in a broader theme of de-globalisation that coronavirus-related trade disruptions cast in a new light. Shutdowns of economic activity in China, geopolitical tensions, and trade disputes will likely accelerate the reorganisation of global supply chains as manufacturers become more concerned with these risks. They may wonder about the potential vulnerability of their supply chains and the diversification of their suppliers, with an eye toward potentially procuring inputs from a greater number of sources and from closer to home.

Asset class return outlooks

Significant market volatility has led to losses across many asset classes in the last month. And while we don't know where the bottom might be, our 10-year annualised Vanguard Capital Markets Model (VCMM) projections for global equities are starting to rise. The median 10-year outlook for U.S. equities produced by 10,000 VCMM simulations was lifted to 5%-7% on 12 March, owing to reduced valuations amid significant market pullbacks. Fixed income, on the other hand, remains more challenging owing to falling interest rates around the world, and we expect cash rates to remain around current levels for the foreseeable future.

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 of December 31, 2019, and March 12, 2020. Results from the model may 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 Australian. and international equity markets, several maturities of the Australian Treasury and corporate fixed income markets, international fixed income markets, Australian 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.