VANGUARD COMMENTARY

Vanguard economic and market update

20 May 2020

Economic recovery ahead, but key risks remain

Key points

- Expect a moderate recovery in the global economy in the second-half, although individual economies are likely to lag pre-COVID-19 growth trends.
- Australia's economic growth is forecast to contract in the vicinity of 4% in 2020, however this could improve depending on demand from China.
- Unresolved Brexit negotiations and rising U.S.-China tensions will weigh on markets for the foreseeable future.
- Vanguard has revised its 10-year annualised return forecast for Australian equities.

Economic growth

Vanguard expects a moderate recovery in the global economy in the second-half of the year as supply gradually comes back online after interruptions owing to COVID-19 containment efforts. But we expect economies to lag behind pre-virus trends as shocks to incomes and contagion fears limit demand. And a new wave of the virus owing to premature easing of social distancing measures is a risk that can't be overlooked.

China

The economy in China contracted by 6.8% in the first quarter of 2020, and our outlook is cautious in the near term. We expect that weak global demand and slower than expected normalisation in domestic services industries will prohibit a strong bounce-back in growth in the second and third quarters. As a result, we expect China's growth for all of 2020 to be in the low single digits, in a range of 1.0% to 2.0%. Earlier this month China announced it would not set an economic growth target for this year due to uncertainty around the COVID-19 pandemic and the world economic and trade environment.

Japan

Japan's economy contracted by –0.9% on a seasonally adjusted basis in the first quarter, the Cabinet Office announced on Monday, May 18. It was the second consecutive quarterly contraction for Japan, which was struggling even before the onset of the COVID-19 pandemic. With just more than 16,000 reported cases and fewer than 1,000 deaths, Japan has fared remarkably well in the pandemic. We expect Japan's economy to contract by a value in the mid- to high-single-digit range in the second quarter before rebounding moderately in the third and fourth quarters. Weak external demand could hurt export sectors, though Japan's orientation toward durable goods, which would be less affected by social distancing measures, would be a mitigating factor. We see Japan's full-year GDP contracting in a range around –3.5% to –4.5%.

Fewer cases of disease could lessen the fear factor and bode comparably well for Australia as it eases lockdown restrictions. We foresee a full-year contraction in the vicinity of 4% in 2020, though that estimate could improve depending on demand from China—by far Australia's largest trading partner. Australia on May 8 announced a three-step framework to relax COVID-19 restrictions by July as new cases have averaged around just 20 per day the last few weeks.

United States

We believe that the economy in the United States will contract by deep single digits for all of 2020, and that GDP in the second quarter could decline by –30% to –40%. With more than 1.5 million disease cases and 90,000 deaths as of May 19, according to the Johns Hopkins University Coronavirus Resource Center, the United States has been hit far harder than any other nation. The main challenge, then, regardless of whether lockdown measures can be eased, is the extent to which consumers are willing or have the money to engage with face-to-face service sectors into the third quarter and beyond. Still, given the anticipated sharp second-quarter fall, we foresee growth in the third quarter in the low single digits, and approaching double digits in the fourth.

Europe

The euro area and the United Kingdom have also been hit hard by the disease, to the extent that we'd expect the economic shock to only truly subside once fears dissipate. In our base case, we expect 2020 GDP to be just less than 10% lower than a year earlier in the United Kingdom and slightly worse than that in the euro area.

Canada

The steep drop-off in domestic and global demand will likely cause Canada's economy to contract in a range of –6% to –7% in 2020, compared with anticipated growth of nearly 2% at the start of the year. Vanguard believes that fiscal support thus far can help avert a large default cycle among highly leveraged households, though this remains a key risk. We expect the depth of Canada's downturn to be closely tied to the persistence of low oil prices. Given the significant role that the oil sector plays in Canada's economy (around 8% of GDP), the risk of a permanent loss in oil output can't be discounted.

Emerging markets

The International Monetary Fund (IMF) predicts that emerging markets will contract by –1.0% in 2020, with emerging Asia bucking the trend with positive growth of 1.0%. The IMF sees Latin America contracting by –5.2% and Mexico being hit harder, with a contraction of –6.2%, for 2020.

Monetary policy

Across major economies, the response of both central banks and fiscal authorities has been unprecedented in size and swiftness. Vanguard believes that such a "whatever-it-takes" approach is appropriate to combat the effects of the COVID-19 pandemic, given the unprecedented nature of the situation. Most of the policy announcements to date are best thought of as "bridging" measures to avert permanent job losses, minimise corporate bankruptcies and defaults, and ensure proper market functioning and liquidity, rather than outright stimulus. How such large fiscal expansion is funded and whether this materially increases sovereign credit risk could become an issue at some point.

In the United States, we believe that additional fiscal policy will likely be necessary to stem job losses and support business. Similarly, we believe additional fiscal support will be required in the euro area and the United Kingdom, to protect both households and corporations from long-lasting effects of the coronavirus.

In Japan, the announced fiscal stimulus package amounted to ¥27 trillion (USD 250 billion), or about 5% of GDP, in new spending. That's less than many developed markets, but appropriate given the lower incidence of disease in Japan. We don't expect that the Bank of Japan will cut its key short-term rate target below the current –0.1%.

The Reserve Bank of Australia maintained its cash-rate target at 0.25% on May 8 and said it had scaled back the size and frequency of bond purchases as the yield on 3-year Australian Government Securities was around the target.

In Canada, all eyes will be on Tiff Macklem, who takes the reins as Bank of Canada governor on June 3 with policy rates at all-time lows. Vanguard believes that negative rates can't be ruled out; such an action would be a negative for the banking sector but could be part of the bank's toolkit should a worsening economy cause households to deleverage.

In addition to the catastrophic effects of COVID-19, some of the key risks identified in the Vanguard economic and market outlook for 2020 continue to be concerns.

Brexit

That no-deal-Brexit fear that went away in January when the United Kingdom officially left the European Union? It's back, with the parties unlikely to be able to kick the can any further down the road. A transitionary period during which the UK-EU relationship continues under pre-withdrawal terms ends on December 31, 2020. In the absence of a trade deal by then, future trade will be conducted under broad World Trade Organization rules, a situation Vanguard views as akin to a no-deal Brexit. We've believed since before the United Kingdom and European Union signed the Withdrawal Agreement that more than a year would be needed to conclude a trade agreement. Now it appears that progress on an agreement is stalling owing to ideological differences regarding the agreement's scope and obligations.

The European Union wants the United Kingdom to adopt and maintain so-called level-playing field provisions on EU rules, such as those governing the environment and labour, in return for access to its markets. The United Kingdom is at this stage refusing to agree to such obligations given its newly acquired status as an independent sovereign state. A third round of talks that concluded on May 15 yielded no progress on these issues ahead of final talks before a June summit of EU leaders and UK Prime Minister Boris Johnson. Mr. Johnson says he has no plans to seek an extension to the transitionary period before the June 30 deadline. That suggests a fraught and volatile year-end, with potential implications for the economy and markets already exacerbated by the challenges of the COVID-19 pandemic.

Meanwhile, Her Majesty's Treasury recently concluded a consultation on the proposed post-Brexit regulatory framework governing overseas retail and money market funds being sold into the United Kingdom. Vanguard broadly supports the Treasury's approach, which would base the Overseas Funds Regime (OFR) on an outcomes basis rather than a more technical assessment of the more than 8,000 non-UK funds currently available to investors in the United Kingdom. Vanguard believes the OFR should ensure that UK investors continue to have access to diversified, low-cost investment products such as UCITS funds. We also argued that a key outcome of the OFR should be that it create the least possible disruption, costs, and complexity for UK investors. The consultation closed on May 11.

Trade

Sharply reduced demand for goods has supplanted the short-term impact of supply-chain disruptions as the greatest immediate threat to global trade. But the COVID-19 pandemic emphatically reinforces the value of supply-chain diversification and dependability and promises to accelerate a trend from globalisation to regionalisation, Vanguard believes. We believe that Mexico and Southeast Asia will benefit as companies diversify amid realisation that excess efficiency and lack of redundancy have their own risks and costs.

The pandemic overshadows China's efforts to fulfil its commitments to buy U.S. goods under its Phase One deal with the United States. More important is global backlash building against China around the origins of COVID-19 and its early response to it, with several developed nations joining the United States in its criticism. As the dispute threatens to spill into the financial space—the principal U.S. government retirement fund last week halted plans to move some investments into an index that includes Chinese companies—the likelihood grows that U.S.-China tensions will weigh on markets for the foreseeable future.

Inflation

Amid the challenges brought about by the COVID-19 pandemic and the stringent measures taken to contain it, it's understandable that inflation concerns are surfacing. The supply of a range of goods has been disrupted, and governments are spending trillions of dollars to stabilise global economies. In the short run, Vanguard believes that a slowing in the rate of inflation may continue. Vanguard senior U.S. economist Andrew Patterson discusses the situation in his blog, Why inflation isn't of immediate concern. However, once the immediate COVID-19 challenge is over, getting central bank balance sheets and fiscal budgets back toward normal will take some doing and may involve somewhat higher-than-target inflation. But as the experience of the global financial crisis shows, 1970s-style runaway inflation need not be part of it.

Employment

The official unemployment rate reached 14.7% in the United States in April, the highest in the 72-year history of the Bureau of Labor Statistics' jobless gauge. But Vanguard believes that an alternative measure, which includes workers not actively looking for jobs as well as part-time workers, paints a truer picture of the labour market. That measure, known as the U6 unemployment rate, suggested that 22.8% of the labour force may be affected by the pandemic-induced shutdowns of the economy. The potential for permanent job losses increases as COVID-19 curtails economic activity for longer. Vanguard has said since the pandemic began that a bold, swift, and efficient policy response is required to limit economic scarring such as bankruptcies, insolvencies, and permanent layoffs, global chief economist Joe Davis writes in his latest blog.

Vanguard expects unemployment in the euro area to rise to just shy of 15%. That would be higher than during the euro zone debt crisis in the last decade and the 2008 global financial crisis. The figure doesn't include workers put on furlough schemes, meaning a risk exists for a long-plateaued peak as furloughs end, even as jobs start to return amid economic recovery. We expect the unemployment rate in the United Kingdom to hit around 10%, with similar dynamics regarding furloughed workers as in the euro area.

The unemployment rate reached 6.2% in Australia in April, up from 5.2% in March. This was roughly in line with our forecasts but lower than market expectations, with the rise cushioned by the sharp fall in the labour force participation rate and the government's JobKeeper wage scheme. The underutilisation rate, meanwhile, rose 5.9 points to 19.9%, a historical high. The underutilisation rate includes people who are underemployed or working fewer hours than they would like to. Hours worked fell 9.2% month-on-month, twice as large as the 4.6% fall in employment, as many workers who received the JobKeeper payments were counted as employed even if they did not work any hours. Vanguard expects some improvement in these numbers as economic activity increases and businesses reopen.

The unemployment rate in Canada climbed 5.2 points to 13.0%, the second-highest on record. The rate would have been 17.8% if those who had worked recently and wanted a job but didn't search for work were included. Immigration makes a strong contribution to growth and employment in Canada, but it typically declines during a recession. Vanguard will be watching for the effect on Canada's labour supply once recovery begins.

Asset class return outlooks

Vanguard has updated its 10-year annualised outlook for asset class returns through the most recent running of the Vanguard Capital Markets Model® (VCMM). Our 10-year annualised nominal return projections for Australian dollar investors are as follows:

Asset class	10-year annualised return forecast
Australian equities	6.6%–8.6% (20.7% median volatility)
Global ex-Australia equities (unhedged)	6.8%–8.8% (19.6%)
Australian aggregate bonds	0.5%–1.5% (4.2%)
Global bonds ex-Australia (hedged)	1.0%–2.0% (3.2%)

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