Vanguard®

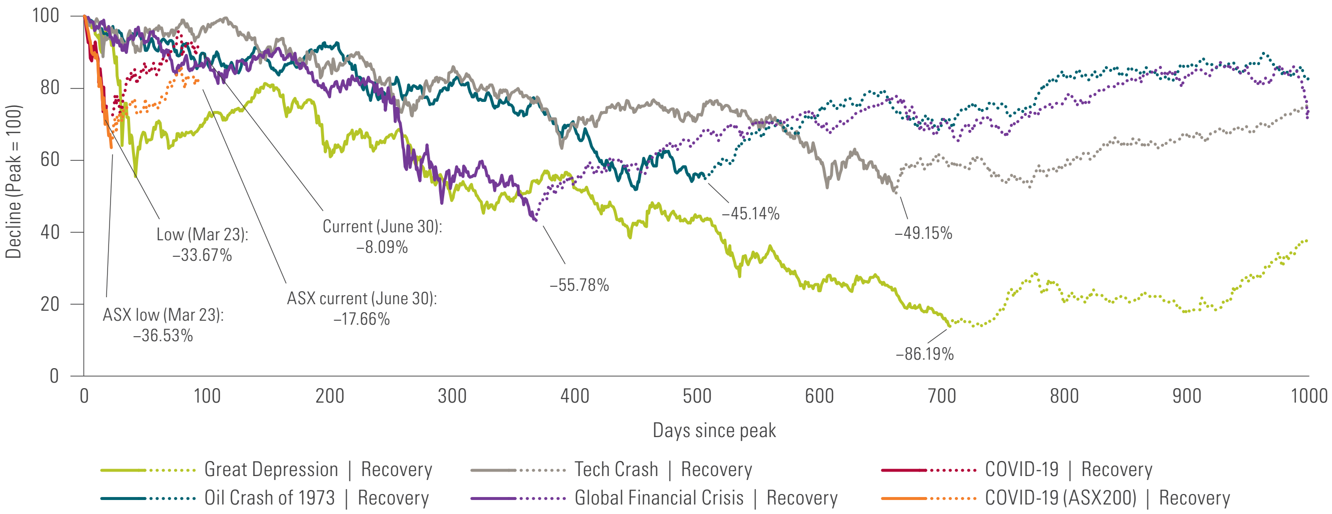
Quarterly economic and market update

June quarter 2020

Quarter in review

Following the sharp fall in markets at the start of the year, Q2 saw strong rallies across global equity markets as investors shed their bear skins for bull horns. Despite the continual spread of COVID-19 across the globe, the backdrop of ultra-loose policy and expectations that economic lockdowns could soon ease restored some positive sentiment in markets, fostering conditions for a "V-shaped" recovery in risk assets. (**Figure 1**). However, there is validity in questioning the speed and magnitude of the rebound given much of the real economy is only slowly emerging from hibernation. Indeed, towards the latter part of Q2, markets started showing signs of "slight fatigue" after retracing much of their losses in April and May. We interpret this as a suggestion that investors have begun incorporating some caution into their outlooks, especially when assessing the loss of output, profits and employment that can be recouped in 2020.

Figure 1. From bear to bull: "Lightning speed" in markets



Source: Vanguard, using data from Factset.

A closer look at Q2's macro data highlights the uncertainty that lies ahead. In the labour market for instance, the impact of the lockdowns on unemployment has remained substantial, even considering the huge fiscal interventions designed to mitigate the impact on the real economy. Vanguard estimates the global economy lost over 300 million full-time jobs in Q2 alone, with official measures of unemployment rates rising by historically unprecedented amounts in a short time. In fact, our calculations suggest that the 'true' unemployment picture is even worse once furloughed workers are taken into account, that is, people who have been given a temporary leave of absence from work. The 'true' levels of unemployment paint a much bleaker picture, with the US unemployment rate exceeding 15%, while a rate higher than 30% is observed in Europe.

In Australia, the unemployment situation is not as gloomy given the role of expensive fiscal programs assisting businesses to retain workers. But those programs will eventually be wound down, casting doubt on the shape of the recovery in jobs and spending towards the second half of this year.

Economic outlook

As developed markets begin easing lockdown measures, many have begun focussing their attention on the shape of the recovery. Will the recovery be a more aggressive "V-shape", as priced in by the equity markets, or will it be a more conservative "U-shape" as reflected in the bond market? Vanguard expects it will be a little of both. The sharp downward-slope experienced in a V-shaped recovery is so severe that it is unlikely to continue for extended periods of time. In technical terms, a recession is over once GDP rebounds from pandemic-induced lows and unemployment starts to decline. Vanguard expects both these trend have already begun as reflected in our high frequency indicators (**Figure 2**).

Figure 2. High frequency indicators show a quick rebound from the trough, though certain face-to-face intensive sectors remain lacklustre

Source: Vanguard, based on data from OpenTable, CityMapper, Apple, Google, Box Office Mojo, OAG and Westpac.

But initial signs of positivity doesn't mean the road to recovery will be easy going. Getting business activity back to pre-COVID levels could take more than a year in a scenario more closely resembling a U-shaped recovery. This is owing to shocks to both supply (stemming from containment measures) and demand (stemming from consumers' likely reluctance to resume face-to-face activities such as dining out, traveling, or attending large events). The confluence of these two shocks leads us to expect a "two-phased" path to recovery. Phase one would likely exhibit stronger growth rates as restrictions on the ability to transact and produce are eased, such as when factories can begin operations and restaurants can receive customers once again. However, the second phase will take a longer time to unfold. Once the initial bottlenecks on growth ease, industries that have a higher direct exposure to consumer demand will likely be the most vulnerable in this stage, given their dependence on face-to-face activities.

On the fiscal front, while most unemployment benefits are slated to end by Q3, we expect governments around the world to recognize the fragility of the recovery and continue to provide targeted and tapered support, particularly to those industries less able to restart fully.

The sense in staying the course

Recent rallies in equity markets pushed valuations upward over the quarter, but they still fall within fair value range. The disciplined investor who opted to stay the course, held fast and rebalanced during the March downturn, would have enjoyed much higher returns with the market rebound. Vanguard advocates for the power of sticking with an investment discipline even amidst unprecedented market events such as these.

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