Economic and market update
August 2021

KEY TAKEAWAYS

• Inflation has run above central bank targets in the United States and the United Kingdom as the newly reopened economies face a mismatch in supply and demand. As formidable as the COVID-19 Delta variant appears to be, its effect on economic output in the United States so far has been minimal.

• Growth momentum remains strong the euro area, though high-frequency indicators suggest a modest softening in activity, particularly where cases of the COVID-19 Delta variant have risen.

Economic growth

• As formidable as the COVID-19 Delta variant appears to be, its effect on economic output in the United States so far has been minimal. Mobility data suggest activity may be leveling off, though not reversing, as case counts accelerate in some parts of the country. And even where vaccination rates are low, they’re robust above those over age 65, who would otherwise most likely have the most adverse health outcomes. Still, we’re watching closely for how resilient the economy can be, as U.S. output would need to hold around current levels to achieve full-year growth in Vanguard’s forecast range of 7% to 7.5%. GDP increased at an annual rate of 6.5% in the second quarter, according to an advance estimate by the U.S. Bureau of Economic Analysis (BEA), surpassing revised growth of 6.3% in the first quarter. The BEA’s second estimate of second-quarter GDP is scheduled to be released Thursday, August 26.

• Gross domestic product grew by a seasonally adjusted 2.0% in the euro area in the second quarter, the European Union’s statistical agency reported in a flash estimate on Tuesday, August 17. Growth momentum remains strong, though high-frequency indicators suggest a modest softening in activity, particularly where cases of the COVID-19 Delta variant have risen. Vanguard continues to expect growth in the third quarter to be slightly stronger than in the second, and that full-year growth could reach 5%. GDP remains 3% below its pre-pandemic level, a gap we foresee being erased in the fourth quarter of 2021. Euro area GDP had declined by – 0.3% in the first quarter, reflecting a period with significant virus-related restrictions still in place. The next estimate of second-quarter GDP is scheduled to be released on Tuesday, September 7.

• GDP rebounded in the United Kingdom in the second quarter compared with the first, up by 4.8%, the Office for National Statistics reported on August 12. The second-quarter gain followed a decline of – 1.6% in the first quarter. Purchasing Managers Index numbers suggested a softening in activity to start the third quarter, particularly in the services sector, as rising virus numbers dented optimism. But a full economic reopening proceeded as scheduled on July 19, and mobility indicators revealed an uptick in activity later in July as virus case counts fell back. We continue to expect full-year GDP growth around 7%, with activity reaching its pre-pandemic peak before year’s end. GDP stood 4.4% below its fourth-quarter 2019 level, before the pandemic, through the second quarter. The next U.K. GDP figures are scheduled to be released on Thursday, September 30.
• Indicators of economic activity in China weakened in July, hit by the COVID-19 Delta variant, flooding in central China, and lagged effects of recent policy tightening. And given that much of the effect of COVID-19-related lockdowns isn’t reflected in the July numbers, the worst may be yet to come in August. As a result, Vanguard has downgraded its expectation for third-quarter GDP growth from 1% to 0.5%. We anticipate China’s full-year economic growth at just below 8.5%, with risks tilted to the downside. Retail sales fell by −0.5% from June’s levels, while investment slowed by −0.7%. Both indicators had risen in June. Exports declined by −1.3%, having increased 3.4% in June, while growth in industrial production slowed to 0.2% from 0.5%. Vanguard expects exports to provide less of a buffer in the second half as developed markets reopen and the consumption mix rebalances from goods to services. As such, we expect macro policy in China broadly to become easier in the months ahead, with fiscal policy likely used more proactively.

• Lockdowns in New South Wales and other states in response to the spread of COVID-19’s Delta variant have led us to lower our full-year growth forecast for Australia from a range of 5% to 5.5% to a range of 4.5% to 5%, with risks skewed to the downside. We assume that a 12-week lockdown in New South Wales and sporadic restrictions in Victoria and South Australia will lead to a GDP contraction of −1.5% to −2% in the third quarter, compared with our previous view of quarterly growth in a range of 0.5% to 1%. A longer New South Wales lockdown could put further downward pressure on GDP. Still, we expect GDP to rebound in the fourth quarter to growth around 2% as vaccination efforts accelerate. Real GDP grew by 1.8% on a seasonally adjusted basis in the first quarter. GDP data for the June quarter are scheduled to be released Wednesday, September 1.

• GDP contracted by −0.3% in Canada in May compared with April, a second straight month of decline following 12 months of increases. Vanguard sees the drop as a blip, however, as an advance estimate for June pointed to a 0.7% gain compared with May. Vanguard recently upgraded its outlook for full-year economic growth to around 7% from a previous outlook around 6% as the economy performed strongly in the first quarter despite lockdowns in various provinces. Through May, GDP stands 1.5% below its pre-pandemic levels. Real GDP rose by 1.4% on a seasonally adjusted basis in the first quarter, or a 5.6% annualized rate, behind factors that boosted demand for housing investment, the nation’s statistical agency reported. Statistics Canada is scheduled to release second-quarter GDP data on Tuesday, August 31.

• Low COVID-19 vaccination levels have put any impulses toward accelerated growth in emerging markets on hold likely until late this year or early next year, when an anticipated ramp-up in vaccine production from three leading manufacturers is likely to bolster supply. Vanguard foresees full-year growth for emerging markets above 6%, with COVID-19 management playing an important role. Countries that have had the most success in warding off COVID-19, notably in Asia, may be at greatest risk of having to initiate further restrictions on economic activity that could weigh on growth. Countries such as Vietnam and Thailand have used lockdowns effectively and limited the spread of COVID-19. But in an ironic twist, a smaller share of their populations will have been protected through infection-acquired immunity, making further lockdowns a likely strategy in the face of the highly contagious Delta variant. GDP in Mexico rose by a slightly less than expected 1.5% on a seasonally adjusted basis in the second quarter compared with the first, and by 19.7% compared with the second quarter of 2020. Vanguard foresees Mexico’s full-year growth in a range of 5.5% to 6.5%, greater than we anticipated at the start of the year, with recovery in the U.S. economy lending support.
Monetary policy

- The **U.S. Federal Open Market Committee** (FOMC) voted on July 28 to leave the target range for its federal funds rate unchanged at 0%–0.25% and its bond-buying program unchanged. But Chairman Jerome Powell acknowledged that the two components of the Fed’s dual mandate—price stability and maximum sustainable employment—have been “in tension” lately, with inflation having risen higher than the Fed had expected, but with further recovery still to come in the labor market. Although the Fed sees inflation at recent levels as transitory, it sees risks as skewed to the upside. Vanguard believes the Fed will want to see further labor market gains in the months ahead before it starts paring its pace of asset purchases—and we believe the Fed will indeed see those gains. Market watchers will be looking for clues as to when the Fed may reduce its pace of asset purchases when Mr. Powell speaks at the Federal Reserve Bank of Kansas City’s Jackson Hole Economic Symposium, scheduled for August 26 to 28. The Fed’s next monetary policy decision is scheduled to be announced Wednesday, September 22.

- The **European Central Bank** (ECB), delivering its first monetary policy statement since adopting its new inflation targeting regime, said on July 22 that it would “maintain a persistently accommodative monetary policy stance.” The bank left its main deposit rate unchanged at negative 0.50%. It said it would continue net purchases in its €1.85 trillion Pandemic Emergency Purchase Programme (PEPP) and maintain its monthly pace of €20 billion in purchases in its Asset Purchase Programme (APP). Vanguard believes the ECB’s September 9 meeting will be important as the Governing Council will have new economic forecasts with which to align its decisions. In our baseline scenario, we foresee the ECB communicating after that meeting that it will slow the pace of PEPP purchases in the fourth quarter of 2021 and that it will end purchases in the first half of 2022. We foresee the APP, which was in place before the onset of the pandemic, at that point being expanded to smooth out the transition. We foresee APP purchases eventually being phased out in the final quarter of 2023. At the July 22 meeting, the Governing Council noted that it expected to keep key ECB interest rates “at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon.”

- The **Bank of England** (BOE) maintained the bank rate at 0.1% at its August 5 Monetary Policy Committee (MPC) meeting, but delivered a hawkish tone, leading Vanguard to bring forward its projection for rate liftoff. We now expect the BOE to begin to raise the bank rate in the second half of 2022, compared with our previous projection of the first half of 2023. The hawkish tone is related to the bank’s revised inflation predictions. The bank foresees inflation peaking at 4% by year’s end, and it upgraded its third-quarter 2022 inflation forecast to 3.3%. The MPC said that “should the economy evolve broadly in line with the central projections … some modest tightening of monetary policy over the forecast period is likely to be necessary to be consistent with meeting the [2%] inflation target sustainably in the medium term.” The MPC voted to leave the target for the bank’s stock of asset purchases at £895 billion, including £875 billion of government bonds and £20 billion of investment grade corporate bonds. Vanguard continues to foresee the bank purchasing bonds until around the end of the year. The bank additionally confirmed that its traditional “exit sequencing” strategy remained intact—that it would raise interest rates before it began to reduce its balance sheet. But it lowered its threshold interest rate at which the balance sheet run-off could start, from 1.5% to 0.5%. The lower threshold and the consequent earlier balance sheet reduction would give the bank more headroom to act forcefully in the event of future liquidity events.

- The **Reserve Bank of Australia** (RBA) left its cash rate intact at 0.10% at its August 3 policy meeting. The bank also said it would continue to purchase government securities at a rate of AUD 5 billion (about USD 3.7 billion) per week until early September, then would slow purchases to a pace of AUD 4 billion per week until at least mid-November. In remarks to the House of Representatives’ economics committee, RBA Governor Philip Lowe said the bank considered a delay in the tapering of its asset purchases, but decided against doing so given the bank’s expectation for Australia’s “return to strong growth next year.” But he said the bank would continue to review its course in the context of health outcomes. The RBA’s next policy announcement is scheduled for Tuesday, September 7.
• The resurgence of COVID-19 through the Delta variant alongside policymakers’ desire to balance near-term growth with medium-term financial stability suggests a forthcoming period of policy fine-tuning in China. Vanguard expects to see macroeconomic policy pivot toward a modestly easy stance—compared with tightening in the first half of the year—amid virus-induced economic headwinds. We expect policy to support sectors in need, such as small and medium-size enterprises. But we foresee ongoing regulation for sectors where financial stability is a consideration, such as the property market. We expect credit growth to pick up modestly in the fourth quarter as liquidity released by the People’s Bank of China’s recent 50-basis-point reserve ratio requirement cut supports corporate and local government bond issuance.

• The Bank of Canada (BOC) kept the target for its overnight rate at 0.25% and left other key rates unchanged at its policy meeting on July 14. The bank signaled its intention to scale back on its government bond purchases to a rate of CAD 2 billion per week (about USD 1.6 billion), from the previous target of CAD 3 billion per week, and Vanguard expects a further CAD 1 billion per week scaling back at the bank’s next meeting, on September 8. We anticipate the BOC raising the target for its overnight rate by the middle of 2022, though greater-than-expected inflation could accelerate that timing.

• Banco de Mexico, Mexico’s central bank, raised the target for its overnight interbank rate by 25 basis points on August 12, to 4.5%, just seven weeks after a surprise hike to 4.25%. The Central Bank of Brazil, meanwhile, raised its benchmark Selic rate by a full percentage point on August 4, to 5.25%, its fourth rate hike in a year that the Selic started at 2%. Both banks highlighted inflationary pressures both globally and locally. In its baseline forecast, Brazil’s central bank sees the Selic rising to 7% this year. Vanguard foresees both central banks raising rates as needed to protect local currencies. Inflation dynamics and the prospect of higher U.S. interest rates have constrained an accommodative bias for central banks broadly in emerging markets, whose policy decisions we continue to see as being influenced by the U.S. Federal Reserve.

• The most recent Consumer Price Index (CPI) release in the United States was consistent with Vanguard’s view that prices would begin to moderate after running high in recent months. Still, we’re watching closely to determine whether recent higher inflation figures are likely to persist or be transitory. We believe that the core Personal Consumption Expenditures Index (PCE), the Federal Reserve’s preferred inflation measure in considering interest rate targets, will remain above the Fed’s 2% inflation target until the spring of 2022. Core PCE rose by 0.4% in June from a month earlier and was up by 3.5% compared with a year earlier, the Bureau of Economic Analysis reported on July 30. CPI for July, meanwhile, increased by 0.5% on a seasonally adjusted basis compared with June, having risen 0.9% a month earlier, the Bureau of Labor Statistics reported on August 11, and was up by 5.4% compared with a year earlier. (PCE differs from CPI in that it measures prices of a broader array of goods and can reweight expenditures as consumers substitute some goods and services for others. Core PCE and CPI exclude volatile food and energy prices.) PCE readings for July are scheduled to be released Friday, August 27; CPI for August is scheduled to be released Tuesday, September 14.

• The consumer price index in Canada rose by 3.7% in July compared with July 2020, up from a 3.1% gain in June. Prices for shelter accounted for the greatest share of the gains, which were broad-based, with six of eight categories advancing. The greater-than-expected July gain increases the risk that the Bank of Canada could raise key interest rates sooner than the currently expected liftoff toward the middle of 2022. Vanguard expects trimmed mean inflation, a measure of core inflation that excludes outliers from the calculation, to end the year in a range around 2% to 2.5%, though the prospect of consumers spending down pent-up savings presents an upside risk. The CPI data release for August is scheduled for Wednesday, September 15.
Headline inflation reached 2.2% in the euro area in July on an annual basis, up from 1.9% in June, Eurostat, the European Union’s statistical agency, said on August 18. With persistent shortages in industrial inputs and the potential for continued run-ups in energy prices, we foresee headline inflation peaking in a range of 2.5% to 3% over the second half of 2021. But we expect both headline and core inflation to fall back to around 1.5% by the end of 2022, as tax changes wash out of year-on-year calculations and input prices decelerate. We don’t expect as large or as persistent an inflation overshoot in the euro area as in the United States, as accumulated household savings are lower in Europe and inflation expectations are anchored well below 2%. A flash estimate for August inflation is scheduled to be released Tuesday, August 31.

Headline inflation fell to 2% in the United Kingdom in July compared with a year earlier, following a 2.5% year-on-year rise in June. Core inflation, which excludes volatile food and energy prices, declined to 1.8% in July compared with a year earlier, from 2.3% in June. Vanguard expects the July drop to be followed by substantial rises in the coming months. With the reversal of a value-added-tax cut in September and an increased consumer demand impulse upon full reopening of the economy, we foresee headline inflation reaching 3.5% year-over-year in the fourth quarter, and core inflation, which excludes volatile food and energy prices, reaching 3%. We expect both measures to ease in 2022 as temporary factors unwind, both ending the year around 2%. The UK Office for National Statistics is scheduled to release August inflation data on Wednesday, September 15.

The Consumer Price Index rose by 0.8% in Australia in the quarter ended June 30, and by 3.8% compared with a year earlier, the latter largely attributable to base effects, or low year-earlier prices particularly for energy near the outset of the COVID-19 pandemic. Trimmed mean CPI, a measure of core inflation that excludes large, one-off price impacts, was 1.6% compared with a year earlier, up from 1.1% in the quarter ended March 31. Vanguard expects that, given spare capacity in the economy, core CPI will undershoot the RBA’s 2% target in 2021, ending the year around 1.6%. Third-quarter inflation data is scheduled to be released on Wednesday, October 27.

Consumer prices rose by 1% in China in July compared with a year earlier, the weakest reading in three months. On a monthly basis, prices rose by 0.3%, the first gain after four months of declines. We expect headline inflation to gradually trend upward in the months ahead but be capped below the 3% target at year-end given only modest consumption recovery.

Inflation has largely diverged in emerging markets in 2021. Aggregate prices in Central and Eastern Europe as well as Latin America are at or above their pre-pandemic levels even after accounting for base effects, or low comparative reference period prices, as stimulus from the United States and the euro area passes through to regional emerging markets’ prices. Prices haven’t risen as much, however, in emerging Asia, with its many economies including China situated at the start of supply chains. Consumer prices in Mexico rose by 5.81% in July compared with a year earlier, down slightly from June’s 5.88% gain and a third straight month of weaker gains. Core inflation, however, which excludes volatile food and energy prices, rose by 4.66% in July compared with a year earlier, higher than a 4.58% increase in June. Mexico’s next inflation reading is scheduled for Thursday, September 9.

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What does maximum sustainable employment in the United States mean to the Federal Reserve? The answer could be important if the other component of the Fed’s dual mandate, ensuring price stability, has already reached a trigger point, as the Fed’s vice chairman suggested in a recent speech. The U.S. Bureau of Labor Statistics (BLS) reported that 943,000 non-farm jobs were created in the United States on a seasonally adjusted basis in July 2021 and the unemployment rate fell to 5.4%. Vanguard expects even stronger job gains in the next two months. Vanguard expects monthly job gains to average around 650,000 for the rest of the year, and for the unemployment rate, currently at 5.4%, to fall toward the mid-4% range by year-end. In a recent blog, U.S. senior economist Josh Hirt discusses why forthcoming jobs reports should have a lot to say about the U.S. economic recovery. The BLS’s August jobs report is scheduled to be released Friday, September 3.

The unemployment rate in Canada fell to 7.5% in July from 7.8% in June, a second straight monthly decline, while job gains came in at a less-than-expected 94,000. Vanguard believes that Canada’s labor market could recover quickly as the year progresses given a steady pace of vaccinations and as labor force participation, at a rate of 65.2% in July for a second straight month, has bounced back to near pre-pandemic levels. We foresee Canada’s unemployment rate falling to a range around 6% by year’s end. Canada’s August jobs report is scheduled to be released Friday, September 10.

Unemployment in the euro area fell to 7.7% in June from a revised 8.0% in May on a seasonally adjusted basis and from 8.0% in June 2020. With furlough schemes still in place throughout the region, the official figure may not yet present a true picture of slack in the economy. Employment figures for July are scheduled to be released Wednesday, September 1.

The unemployment rate in the United Kingdom was estimated at 4.7% in the three months ended in June, down from 4.8% in the quarter ended in May. As with the euro area, a continuing furlough scheme may not present a true picture of slack in the economy. Employers’ contributions have started to rise from July. The next unemployment reading is scheduled to be released Tuesday, September 14.

The unemployment rate in Australia fell to 4.6% in July from 4.9% in June, the Australian Bureau of Statistics reported today, August 19. Vanguard believes that lockdowns related to COVID-19 could cause unemployment to rise in the coming months, however. We expect the unemployment rate to end the year around 5%. The August Labor Force Survey reading is scheduled to be released Thursday, September 16.
Vanguard has updated its 10-year annualized outlooks for broad asset class returns through the most recent running of the Vanguard Capital Markets Model® (VCMM), based on data as of June 30, 2021. 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 outlooks for both equity and fixed income returns are, for the most part, marginally lower compared with our outlooks based on our previous running of the VCMM, on March 31, 2021. A rally in risk assets continued in the second quarter, sending valuations higher and making future gains in equities harder to come by. Developed market interest rates, meanwhile, came off first-quarter post-pandemic highs, sending current projections for fixed income returns lower. The outlook for peso-denominated bonds, however, is sharply higher, as rising short-term Mexican sovereign yields flow through to return expectations.

ISG updates these numbers quarterly. Projections based on the September 30, 2021, running of the VCMM will be communicated through the November 2021 economic and market update.

Our 10-year annualized nominal return projections are as follows. Please note that the figures 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. Numbers in parentheses reflect median volatility.

### U.S. dollar investors

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<thead>
<tr>
<th>Asset Classes</th>
<th>Return projection</th>
<th>Median volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. equities</td>
<td>2.3%-4.3%</td>
<td>16.7%</td>
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<tr>
<td>Global equities ex-U.S. (unhedged)</td>
<td>5.1%-7.1%</td>
<td>18.7%</td>
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<tr>
<td>U.S. value</td>
<td>2.9%-4.9%</td>
<td>18.9%</td>
</tr>
<tr>
<td>U.S. growth</td>
<td>-0.6%-1.4%</td>
<td>17.7%</td>
</tr>
<tr>
<td>U.S. large-cap</td>
<td>2.2%-4.2%</td>
<td>16.3%</td>
</tr>
<tr>
<td>U.S. small-cap</td>
<td>2.1%-4.1%</td>
<td>21.8%</td>
</tr>
<tr>
<td>U.S. REITs</td>
<td>2.2%-4.2%</td>
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<tr>
<td>U.S. aggregate bonds</td>
<td>1.3%-2.3%</td>
<td>4.5%</td>
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<tr>
<td>U.S. Treasury bonds</td>
<td>1.1%-2.1%</td>
<td>4.6%</td>
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<tr>
<td>Global bonds ex-U.S. (hedged)</td>
<td>1.2%-2.2%</td>
<td>3.8%</td>
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<tr>
<td>U.S. credit</td>
<td>1.5%-2.5%</td>
<td>4.6%</td>
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<tr>
<td>U.S. high-yield corporate</td>
<td>1.9%-2.9%</td>
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<tr>
<td>Emerging market sovereign</td>
<td>1.9%-2.9%</td>
<td>10.2%</td>
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<tr>
<td>U.S. TIPS</td>
<td>0.9%-1.9%</td>
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<tr>
<td>U.S. cash</td>
<td>1.2%-2.2%</td>
<td>1.2%</td>
</tr>
<tr>
<td>U.S. inflation</td>
<td>1.4%-2.4%</td>
<td>2.3%</td>
</tr>
</tbody>
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### Mexican peso investors

<table>
<thead>
<tr>
<th>Asset Classes</th>
<th>Return projection</th>
<th>Median volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexican equities</td>
<td>5.4%-7.4%</td>
<td>28.3%</td>
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<tr>
<td>U.S. equities (unhedged)</td>
<td>6.3%-8.3%</td>
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<tr>
<td>Global ex-U.S. developed market equities (unhedged)</td>
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<tr>
<td>Mexican sovereign bonds</td>
<td>6.6%-7.6%</td>
<td>11.8%</td>
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<tr>
<td>Global bonds (hedged)</td>
<td>6.8%-7.8%</td>
<td>7.1%</td>
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**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 June 30, 2021. Results from the model may vary with each use and over time.
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