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Economic and market update

April 2022

Key points

- Years of accommodative monetary policy are coming to an end, thanks to inflation that has lasted longer and gone higher than anticipated.
- We expect the impact of higher energy prices on Australian inflation to subside, but a tightening labour market is likely to keep headline CPI above 2%.
- Job creation remains strong in the United States, with the unemployment rate falling to 3.6%, just a shade above its pre-pandemic low.
- COVID outbreaks and lockdowns in China are creating economic pain, with some indicators pointing to a sharp slowdown taking hold in March.

Australia

The moderately stimulative effects of April's federal budget are likely to be offset by the moderately restrictive effects of a more hawkish Reserve Bank of Australia (RBA). We expect full-year growth in gross domestic product (GDP) to be between 3.5% to 4%, down marginally from our forecast before the war in Ukraine for growth of around 4%. Meanwhile, higher energy prices resulting from the war are likely to feed inflation and serve as a drag on growth.

The RBA will be on the alert for rising inflation expectations ahead of its May meeting when it will also present updated GDP and inflation forecasts. We foresee the first hike in a tightening cycle to occur in August, although risks have risen for a hike in June after the federal election on 21 May. We foresee a second hike in 2022, followed by hikes in each quarter of 2023.

We foresee the sharp rise in global energy prices pushing headline inflation in Australia above 4% and core inflation above 3% for the first time in a decade. We expect the impact of higher energy prices on inflation to subside over the next 12 months, but a tightening labour market and higher wages are likely to keep inflation above 2% through 2023. We don't believe that inflation expectations have become unanchored, though they've risen, and the market will be keen to see how the RBA responds. The Consumer Price Index (CPI) rose by 1.3% in the December quarter and by 3.5% for all of 2021.

The unemployment rate in Australia fell to 4.0% in February, the lowest since August 2008. The unemployment rate has only been lower before 1974, when the labour market survey was conducted quarterly. The labour force participation rate climbed to 66.4% on a seasonally adjusted basis, the highest in more than a decade.

United States

Recent developments have been consistent with our view for full-year GDP growth around 3.5% in the United States. GDP grew at an annual rate of 6.9% in the December quarter, up from 2.3% in the September quarter. For all of 2021, real GDP grew by 5.7%, compared with a contraction of 3.4% in 2020 when the pandemic set in.

Accelerating inflation and a still-tightening labour market have led us to revise our view on the Federal Reserve. We foresee the equivalent of six to eight 25-basis-point hikes in the funds rate target in 2022, with the potential for one or two 50-basis-point hikes in the mix. The Fed's March minutes revealed discussion around balance sheet reduction (so-called quantitative tightening), which could be announced as early as May. This would be achieved by allowing maturing Treasury and agency mortgage-backed securities to roll off, with the amount reduced ramping up to USD 95 billion per month.

The CPI rose by 8.5% in March compared with a year earlier, higher than the 7.9% year-on-year gain in February. Gasoline, food and shelter contributed the most to the broad increase. The core Personal Consumption Expenditures Price Index (PCE), the Fed's preferred inflation indicator, rose 0.4%, a slower pace of increase than the 0.5% reading in each of the four preceding months. We believe core inflation may have neared its peak but that elevated headline inflation, reflecting not just high energy prices but also accelerating food prices, is likely to be an increasingly important factor in the Fed's thinking.

The unemployment rate fell to 3.6% in March, just a shade above its pre-pandemic low, as job creation remained strong. We expect the unemployment rate to fall to its 3.5% pre-pandemic level in the second quarter and even further by year-end.

Euro area

The growth environment in the euro area is challenged by the war in Ukraine, the resulting higher energy prices, reduced confidence, and somewhat tighter financial conditions. We continue to foresee full-year GDP growth in a range of 2.5% to 3%, lower than our outlook before the war for growth of around 3.5%. Consumer confidence is at its lowest since the start of the pandemic, although additional fiscal stimulus (expected to amount to 1% of GDP) and the spending of accumulated savings from the pandemic should provide an economic boost.

The European Central Bank (ECB) left its main deposit rate unchanged at –0.5%. The ECB finds itself trying to balance significant risks, with record-high inflation suggesting a hawkish path and economic risks from the war in Ukraine suggesting a continuation of policy accommodation. At its March meeting the bank laid out a quicker reduction to its pace of bond buying. Monthly purchases under the Asset Purchase Program will total €40 billion in April, falling to €30 billion in May and €20 billion in June. It will then come to an end if the medium-term inflation outlook hasn't weakened.

Headline inflation in the euro area shot up to 7.5% in March compared with March 2021. The increase was higher than what had already been a record 5.9% year-on-year rise in February. More than half of the latest surge in inflation was driven by energy prices. We continue to foresee headline inflation averaging between 6% to 7% for all of 2022, above our expectations before the war in Ukraine of 3% to 4%.

The unemployment rate in the euro area fell to 6.8% in February from a revised 6.9% in January, the 12th straight month of decline. Wage pressures continue to build, but less so than in the United Kingdom or the United States.

United Kingdom

We continue to foresee full-year GDP growth in the United Kingdom in a range of 3.5% to 4%, lower than our expectation before the war in Ukraine of growth somewhat above 4%. Consumer confidence is at a 16-month low, with accelerating inflation driven by higher energy prices testing households. GDP rose by 0.1% in February on a month-to-month basis, down from January's strong 0.8% bounce back.

As is the case with many other developed market central banks, the Bank of England (BOE) needs to strike a balance between stemming inflation and not choking off growth, which is under pressure from the effects of the war in Ukraine. The BOE voted at its March meeting to raise the bank rate by 25 basis points to 0.75%. We maintain our view that the BOE will likely initiate another 25-basis-point hike at its May meeting, with an additional hike in the second half of the year, for a bank rate of 1.25% at year-end.

Headline inflation in the United Kingdom jumped to 7.0% in March compared with a year earlier, up from a 6.2% year-on-year reading in February. Fuel prices, up 30.7% compared with March 2021 and by a record 9.9% month-on-month, drove the gains. We expect headline inflation to spike to above 8% in April to reflect a 54% increase in a government energy price cap that is adjusted twice a year.

The unemployment rate in the United Kingdom fell to 3.8% in the three months through February, hitting its pre-pandemic level and down from 3.9% in the three months through January. The decline reflected in part an increase of 76,000 in the number of working-age people considered economically inactive, driven by people who have retired or are looking after family or dealing with long-term illness.

China

Worsening COVID outbreaks have led to lockdowns affecting more people in China than at any other point since 2020. Purchasing managers' index readings imply that a sharp economic slowdown took hold in March. The March composite PMI reading of 48.8 was down more than three points from February's 51.2 reading and was the first reading below 50 (which signals contraction) since August 2021. China set an official 2022 growth target of 'around 5.5%' at the early-March National People's Congress, the lowest growth target it has ever set. We maintain our forecast for 2022 growth of around 5%.

We expect China to stimulate its economy on multiple fronts, including monetary, fiscal, and regulatory, to try to achieve its 5.5% growth target. Fixed asset investment far exceeded consumption in the first two months of the year, which we view as evidence of China's commitment to fiscal stimulus, totalling around 4.5 trillion yuan (about USD 700 billion) in the first six months of the year. We expect fiscal support, including the potential for direct stimulus checks, to facilitate consumption during lockdowns.

Consumer price inflation in China rose in March at its fastest pace in three months as food prices climbed amid widespread COVID-related lockdowns. Consumer prices were up 1.5% compared with a year earlier, greater than the 0.9% year-on-year rise in February. Fuel prices were up 25%, driven by higher energy prices related to the war in Ukraine. Producer prices, meanwhile, rose by 8.3% compared with a year earlier, greater than the consensus estimate but down from an 8.8% year-on-year reading in February. We recently revised our forecast for full-year 2022 inflation to around 2.3% from around 2% given elevated global oil prices, but that's still below the government's 3% target.

Emerging markets

We continue to see economic growth around 5.5% in emerging markets broadly in 2022, but high food and energy prices related to the war in Ukraine place risks firmly to the downside. Energy prices have risen steadily since the start of the year but have moderated at elevated levels recently. And although higher commodities prices do benefit some emerging economies, they're a negative taken in the aggregate. Higher food prices have also stoked tensions in some emerging markets.

Expectations for central bank rate cuts next year in economies that have raised rates this year speak to the slowdown risk. Even as central banks in some emerging markets continue to raise interest rates in the face of persistent inflation, markets are pricing in rate cuts for 2023 in anticipation of weaker economies. This is the case in much of emerging Europe and Latin America, although not as much in emerging Asia, where current account balances are favourable and inflation is relatively low. Markets in Poland, the Czech Republic, Chile, Brazil, and Mexico all are pricing in rate hikes through 2022 and rate cuts a year from now.

Higher global oil and commodities prices are exacerbating inflation, which has shown signs of persistence in many emerging markets.

The effect remains relatively milder in emerging Asia. The CPI in Mexico rose by 7.45% in March compared with a year earlier, higher than a 7.28% year-on-year rise in February. Mexico's central bank foresees core inflation falling back to its 3% target only in the first quarter of 2024. Year-on-year inflation in Malaysia, on the other hand, registered just 2.2% in February and core inflation came in at 1.8%.

Asset class return outlooks

Vanguard's 10-year annualised outlooks for equity and fixed income returns are unchanged since the March 2022 economic and market outlook. 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.

ASSET CLASS	MEDIAN VOLATILITY (%)	10-YEAR ANNUALISED RETURN FORECAST
Australian equities	21.8	3.7%–5.7%
Global ex-Australia equities (unhedged)	19.5	4.2%–6.2%
Australian aggregate bonds	5.2	1.9%–2.9%
Global bonds ex-Australia (hedged)	4.2	2.1%–3.1%

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 31 March 2022. Results from the model may vary with each use and over time.

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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 U.S. 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.

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