Vanguard®

Economic and market update

March 2022

Key points

- Russia's invasion of Ukraine has injected substantial uncertainty into economies and markets at a time many are already facing challenges from the removal of accommodative policy.
- Australia's status as a net exporter of energy and other commodities will protect it from the worst of the economic fallout from Russia's invasion of Ukraine. Vanguard has marginally downgraded its 2022 growth forecast for Australia from around 4% to a range of 3.5% to 4% accounting for the impact of higher energy prices on household spending.
- Vanguard sees a growing likelihood the Reserve Bank of Australia will move to hike rates in August, a change from our base case for the RBA's first 25-basis-point rate hike to occur in November. We additionally foresee quarterly 25-basis-point hikes throughout 2023.
- Vanguard sees less risk from events in Ukraine to the U.S. economy than to that of the euro area, though the risk of recession would increase if financial conditions tightened significantly and oil prices settled into a $130 to $150 range.
- Vanguard has downgraded its 2022 economic growth outlook for the euro area and the UK to account for the possibility of higher energy prices feeding into inflationary pressures and the growth outlook more broadly.

Australia

Australia is unlikely to bear the full economic effects of the war in Ukraine owing to its geographic distance from the region and its status as a net exporter of energy and other commodities. Nonetheless, higher energy prices and increased prices for most goods will still affect household spending. As a result, Vanguard has marginally downgraded Australia's 2022 growth forecast from around 4% to a range of 3.5% to 4%. Meanwhile, GDP in Australia bounced back in the fourth quarter, up 3.4% against a loss of -1.9% in the previous quarter, helped by the re-emergence of several states from extended COVID-19 lockdowns. GDP grew 4.2 per cent annually in 2021.

The re-emergence from COVID lockdowns and associated household spending is also playing a part in keeping inflation levels elevated. Vanguard forecasts the trend to continue, particularly given Australia's only recent re-emergence from COVID-19 lockdowns, with excess savings meeting supply constraints, and with global energy prices elevated. The Consumer Price Index in Australia rose by 1.3% in the fourth quarter of 2021 and by 3.5% for the full year. Core inflation now sits in the Reserve Bank of Australia's target range of 2% to 3% for the first time since 2015.

Australia's labour market remains resilient, strengthening again in January despite the effects of the COVID-19 Omicron variant. Vanguard forecasts the unemployment rate to fall below 4.0% - the lowest it's been since August 2008. The unemployment rate, reported at a steady 4.2% in February, has only been lower that 4.0% before 1974, when the labour market survey was conducted quarterly.

Given these relatively mild inflationary factors, Vanguard views the Reserve Bank of Australia (RBA) as having less of a rate-hike dilemma than other developed market central bank. Nonetheless, it will need to strike a balance between promoting higher wage growth and at its monthly policy meeting on March 1, saying it wouldn't raise the rate until inflation was sustainably within its 2% to 3% target range. The RBA has defined "sustainably" as within the target range for several quarters and not expected to fall out of the target range within its two-year forecast horizon. Vanguard's base case has been for a first 25-basis-point rate hike to occur in November, but we believe the likelihood is growing for an August rate hike as well. We additionally foresee quarterly 25-basis-point hikes throughout 2023.

United States

Vanguard continues to foresee GDP growth around 3.5% in the U.S. in 2022, with the events in Ukraine posing less risk to the U.S. economy than to that of the euro area. That said, uncertainty around geopolitical risk and oil prices bear watching. Vanguard forecasts show a recession in the U.S. becomes more likely in the event of financial conditions tightening significantly and oil prices settling into a $130 to $150 range.

The U.S. economy continued to add jobs at a strong pace in February. Vanguard forecasts that trend to continue with the unemployment rate predicted to fall to its 3.5% pre-pandemic level in the second quarter and even further by year-end. The Bureau of Labour Statistics reported that 678,000 jobs were created in February, more than 50% above the consensus expectation.

Inflation continues apace in the U.S. with the Consumer Price Index climbing by 7.9% in February compared with a year earlier, accelerating faster than a 7.5% year-on-year pace in January. It was the highest increase in the gauge since January 1982.

Vanguard expects the core Personal Consumption Expenditures Price Index (PCE) (the Federal Reserve's preferred inflation indicator in considering monetary policy, which excludes volatile food and energy prices) to fall back toward 3% by the end of 2022 – down from December's 4.9% year-on-year rise. Our upside scenario of core PCE remaining above 4% at year's end would become more likely with continued geopolitical tensions and elevated oil prices.

The Federal Reserve raised the target range for its federal funds rate by 25 basis points, to a range of 0.25% to 0.5%, on March 16. The Fed sent a clear signal that controlling inflation means a 2022 of regular rate hikes.

Euro area

The war in Ukraine and its effect on energy prices have altered the outlook for both growth and inflation for the euro area. Those factors, along with dented business and consumer confidence, has led to a further downgrade in Vanguard's 2022 growth outlook for the region.

The euro area derives 40% of its natural gas and 25% of its crude oil from Russia. Rising energy prices had already led Vanguard to downgrade our euro area growth outlook by 50 basis points from a forecast around 4% at the start of the year. We've now made a further downgrade to the 2022 economic growth outlook for the euro area, cutting up to a percentage point from our previously anticipated 3.5% growth outlook.

The war in Ukraine and its effect on energy prices have also led us to update our 2022 full-year inflation forecast. If current conditions persist, we expect headline inflation to accelerate by one to three percentage points above our previous forecast. The higher energy prices increase the risk of second-round effects on wages—one reason for the European Central Bank's recent hawkish policy statement. However, we continue to expect inflation to fall back to target over the next one to two years.

The European Central Bank (ECB) left its main deposit rate unchanged at negative 0.5% at its March 10 meeting. New language from the ECB's Governing Council, suggesting rate hikes will occur "some time" after the end of net asset purchase, gives it greater flexibility to assess rapidly changing circumstances. Vanguard continues to anticipate a 25-basis-point rate hike in December 2022.

Unemployment fell for an 11th straight month in the euro area in January, to 6.8% on a seasonally adjusted basis. Vanguard foresees continued strengthening in the labour market and a building in wage pressures in the months ahead, though the experience is likely to vary by country and will likely be more limited than in the United Kingdom or United States.

United Kingdom
The U.K. is not as reliant on Russian energy imports as the euro area but higher energy prices are nonetheless feeding into inflation and the growth outlook for the U.K. economy.

Similar to our view for the euro area, Vanguard has revised growth and inflation forecasts for the U.K. to factor in higher oil and natural gas prices.

Vanguard sees the potential for continuation of current conditions to shave up to a percentage point from our previously anticipated 4% growth outlook for 2022. Similarly, if higher energy prices persist, we foresee headline inflation increasing by about one to two percentage points compared with our previous forecast.

Higher energy prices have increased the risk of second-round effects, and inflation expectations (both market- and survey-based) have risen in recent weeks. Headline inflation climbed to 5.5% in January compared with a year earlier, up from a 5.4% year-on-year reading in December and a 30-year high. Core inflation, which excludes volatile food and energy prices, rose to 4.4% year-on-year, above consensus and higher than January's 4.2% year-on-year rise.

We expect wage growth to peak above 5% in 2022 before normalising to about 3.5%—a level consistent with 2% inflation once productivity is factored in.

The Bank of England Monetary Policy Committee (MPC) has stated it would conduct monetary policy "consistent with achieving the 2% inflation target sustainably in the medium term, while minimising undesirable volatility in output." Vanguard continues to expect two additional rate hikes in 2022 but emphasises that the MPC's moves will be data-dependent.

China
Significant headwinds have developed for the Chinese economy since our last monthly report. It was always going to be a challenging year but the economic spillovers from the war in Ukraine could potentially shave 50 basis points off China's growth in our base case scenario. Stimulus will be introduced as necessary to ensure growth at least at that level.

The increase in COVID-19 cases has led to shutdowns beginning the week of March 14 in Shanghai and the key manufacturing hub of Shenzhen, among other areas. China set an official 2022 growth target "around 5.5%" at the early-March National People's Congress, the lowest growth target it has ever set and a level consistent with Vanguard's view. Vanguard maintains its forecast for growth around 5%, which in our view is the minimum that policymakers will accept. We foresee a return to trend growth in 2023 with the easing of major headwinds including strict COVID-19 restrictions and a domestic real estate slowdown.

Vanguard remains above consensus in our view of how much policy stimulus will be required for China to achieve 5% growth in 2022, given significant growth headwinds on both internal and external fronts. We continue to believe that policymakers will need to accelerate and escalate stimulus measures and to ease regulatory restrictions and COVID-19 policy. Measures announced at the early-March National People's Congress (NPC) including tax cuts support our view.

Consumer price inflation remained below target in China in February, with prices rising 0.9% compared with a year earlier, and by 0.6% month-on-month. We've revised our forecast for full-year 2022 inflation to around 2.3% from around 2%—still below the government's 3% target—given higher global oil prices. We don't expect oil prices to have a more meaningful impact given a limited pass-through of producer prices to consumer prices.

Emerging markets
Emerging markets are less impacted by the economic spillover from the war in Ukraine than areas like Central Europe and Eastern Europe. Even so, persistently higher prices for both energy and non-energy commodities are fanning inflation and slowing growth. We continue to foresee growth around 5.5% for all of 2022 for emerging markets, though we emphasise now that risks are clearly skewed to the downside.

Rising global energy and commodities prices combined with inflation that had already begun to broaden throughout sectors suggests the likelihood of more persistent inflation in emerging markets. Such a development is particularly the case in Latin America and Central and Eastern Europe. In emerging Asia, closer to the heart of global supply chains, inflation has been more tempered.

Core inflation remains stubbornly elevated in emerging markets, leaving central banks that had been proactive in raising rates the unenviable task of having to continue to hike, which in turn would likely weigh on economic growth. In fact, some markets pricing in 2022 rate hikes are also pricing in 2023 rate cuts in anticipation that central banks may need to stimulate economies again.

Asset class return outlooks:
Given market volatility related to the war in Ukraine, we're presenting outlooks updated through a February 28, 2022, partial running of the VCMM. Our 10-year outlooks for both equities and fixed income are broadly and markedly higher given reduced equity valuations and higher interest rates compared with year-end 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. The projections listed below are based on a February 28, 2022, partial running of the VCMM. Projections based on the full March 31, 2022, running of the VCMM will be communicated through the May 2022 economic and market update.

Our 10-year annualised nominal return projections are as follows:

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 28 February 2022. Results from the model may vary with each use and over time.

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