Vanguard

Economic and market update

May 2022

Key points

- Persistently high inflation is challenging central banks' efforts to keep economies from running too hot or too cold.
- The U.S. economy appears to have contracted in the March quarter, although the labour market remains tight and wage pressures persist.
- Inflation in Australia rose 5.1% in the March quarter, the greatest annual gain since the GST came into effect in 2000.
- China is showing signs of an economic slowdown as zero-COVID policies force the government to pull other growth levers.

Australia

Gross domestic product (GDP) increased by 3.4% in the December 2021 quarter as several states emerged from extended COVID-19 lockdowns. For all of 2021, GDP grew by 4.2%. We continue to foresee full-year growth for 2022 in a range of 3.5% to 4%. However, a faster-than-expected pace of rate hikes could start to dampen confidence and would be a growth headwind in the second half of the year.

The Reserve Bank of Australia (RBA) increased the cash rate by 25 basis points to 0.35% at its May meeting—its first hike in 11 years. The bank said Australia's growth outlook remained positive, citing rising wage growth in a labour market with participation at a record high. Its central forecast for headline inflation to reach 6% in 2022, moderating to around 3% by mid-2024, assumes further increases in interest rates. We foresee the cash rate rising to at least 1.5% in 2022, given clear evidence that inflation is broad-based and persistent.

The consumer price index (CPI) rose by 5.1% year-on-year in the March quarter, the greatest annual gain since the GST came into effect in 2000. Automotive fuel prices rose by 11% compared with the December quarter, reaching a third consecutive quarterly record level. Trimmed mean CPI, a measure of inflation that excludes large, one-off price impacts, rose by 3.7% compared with a year earlier, the strongest year-on-year gain since 2009, reflecting price pressures broadening throughout the economy, including pass-through effects of higher energy prices.

The unemployment rate in Australia held steady at a 14-year low of 4% in March and the labour force participation rate remained at its highest level in more than a decade, at 66.4%. We expect the unemployment rate to fall below 4% by midyear, keeping wage pressures elevated.

United States

GDP decreased at an annual rate of 1.4% in the March quarter according to the advance estimate, in no small part owing to a decrease in net trade. Our forecast for full-year U.S. growth around 3.5% is unchanged, although we're watchful for signs of slowdown, with early indicators suggesting June-quarter activity is tracking below expectations.

The Federal Reserve raised the target for its key interest rate by 50 basis points to a range of 0.75% to 1%, the first hike of that magnitude in more than 20 years. The Fed additionally announced plans to begin reducing its USD 8.5 trillion balance sheet at the start of June. We foresee further Fed rate hikes of 100 to 150 basis points in 2022, an outlook that has become more dovish than the market's expectation for a 2.75% federal funds rate at year end.

The CPI rose by 8.3% in April compared with April 2021, moderating from an 8.5% year-on-year gain in March. Core CPI, which excludes volatile food and energy prices, rose by 6.2% year-on-year in April, down from a 6.5% rise in March. Although the report supports our view that headline and core inflation are likely to peak in the second quarter, it shows that the Fed will need to remain vigilant, especially given an accelerated pace of core services price gains. Increases in air fares stood out in the CPI report; they were up nearly 19% on a seasonally adjusted basis in the month and by 33% compared with a year earlier.

The U.S. labour market created 428,000 jobs in April, continuing to show broad-based strength. The unemployment rate remained at 3.6%, just above its 3.5% pre-pandemic level. Wage gains moderated, with average hourly earnings up 0.3% from March, lower than a 0.5% February-to-March gain. We expect year-on-year increases in monthly wage data to remain above 5% throughout 2022.

Euro area

GDP in the euro area increased by 0.3% in the March quarter, according to a second flash estimate. We believe that the euro area can avoid recession, although there is a narrow margin of safety in its ability to withstand further shocks, such as an abrupt cut-off in energy supplies from Russia, significant new supply disruptions, or a U.S. Fed 'hard landing'. We continue to foresee full-year growth in a range of 2.5% to 3%, lower than our outlook before the war in Ukraine for growth around 3.5%.

The European Central Bank (ECB) left its main deposit rate unchanged at –0.5% at its April meeting and reinforced expectations that it would end asset purchases in the third quarter. The bank confirmed plans to reduce purchases under its Asset Purchase Program to €40 billion in April, falling to €30 billion in May and €20 billion in June. We now anticipate ECB rate hikes totalling 50 basis points this year, up from our previous expectation for one 25-basis-point hike, given a hawkish shift in the ECB's stance.

Headline inflation in the euro area remained stable in April, reaching 7.4% year-on-year. Energy prices, which have been driving gains in the euro area's headline inflation, were up by 37.5% year-on-year, although that was less than a 44.3% year-on-year gain in March. However, prices for food, non-energy industrial goods, and services all rose by more than they did in March.

The unemployment rate in the euro area fell to 6.8% in March from a revised 6.9% in February and from 8.2% in March 2021. We continue to foresee the euro area labour market strengthening in the months ahead, with wage pressures continuing to build, though at a more moderate pace than in the United Kingdom or the United States.

United Kingdom

The U.K. economy grew by 0.8% in the March quarter, less than anticipated, suggesting that rises in the cost of living are starting to weigh on growth. We continue to foresee full-year growth in a range of 3.5% to 4%, lower than our expectation before the war in Ukraine of growth somewhat above 4%.

Our outlook factors in weakness in services activity and retail sales, although this will be partially offset by recently announced fiscal policy measures and the anticipated drawdown of household savings accumulated during the pandemic. A complete end to imports of Russian natural gas would have only a limited effect on the economy, as the United Kingdom sources only 4% of its natural gas from Russia.

The Bank of England raised the bank rate for a fourth consecutive meeting in May by 25 basis points to 1%. The bank sent ultimately dovish signals reflective of the sheer challenge involved in doing enough to quell inflation without doing too much and stifling growth. We continue to expect only an additional one or two quarter-point hikes this year.

Headline inflation in the United Kingdom rose to 9% in April compared with a year earlier, a 40-year high. The jump from March's 7% year-on-year inflation rate was largely driven by the 54% increase in the nation's energy price cap, which led to a 47.5% increase in utility prices in April compared with March. Higher energy prices resulting from the war in Ukraine and, more recently, the broadening of price pressures, have led us to revise our 2022 inflation forecast upward, to an average of 7% to 8% from our previous forecast of 5% to 6%.

The unemployment rate in the United Kingdom fell to 3.7% in the March quarter, lower than its pre-pandemic level and down from 3.8% in the three months through February. It is the United Kingdom's lowest unemployment rate since 1974.

China

Economic data confirmed a slowdown in the Chinese economy in the face of zero-COVID policies that have led to weeks of lockdowns in Shanghai and other cities. The key consumer metric of retail sales of consumer goods contracted by 11.1% in April compared with a year earlier, while industrial production fell by 2.9% year-on-year.

We believe China faces a policy trilemma. That is, we believe China won't be able to achieve all three goals of "around 5.5% growth," a zero-COVID policy, and the prioritisation of financial stability. Given that we expect China to maintain a zero-COVID approach this year, we believe aggressive policy easing beyond expected infrastructure investment will be required to hit the growth target. Should policy stimulus undershoot owing to concerns about medium-term financial stability, we believe growth in 2022 would fall well below 4%.

The People's Bank of China cut its reserve requirement ratio by 25 basis points in April, less than the expected 50-basis-point cut. Given rising yields in the United States and other developed markets, the bank likely finds itself without room to cut the rate further, which would increase the prospect of capital outflows. We foresee China's policymakers making further infrastructure investments, effecting modest interest rate cuts across policy levers, increasing total social financing to 11% (it reached 10.2% year-on-year in April), and modestly loosening real estate policy in an effort to move growth closer to the 5.5% target.

Consumer prices rose by 2.1% compared with April 2021, greater than the 1.5% year-on-year rise in March. Producer prices rose by 8% compared with a year earlier, a sixth straight month of smaller increases after an 8.3% gain in March, but still at an elevated level. We continue to foresee full-year inflation around 2.3%.

Emerging markets

Wherever their individual geographic locations, emerging markets economies face increasing headwinds from either the United States, the euro area, or China. These factors, alongside elevated inflation and global central banks' tightening, inform a downward revision to our emerging markets growth outlook.

Where at the start of the year we had foreseen full-year 2022 emerging markets growth around 5.5%, we now anticipate full-year growth only around 3%. Energy prices have risen steadily since the start of the year but have moderated recently, albeit at elevated levels. Although higher commodities prices do benefit some emerging economies, they're a negative in the aggregate.

Emerging markets central banks have largely been ahead of the rate-hike curve in 2022, but some, especially in Latin America and emerging Europe, are priced for rate cuts in 2023. Forward rate curves remain steep, however, in emerging Asia, where inflation has taken hold only more recently and rate hikes are expected.

Mexico's central bank increased its policy rate by 50 basis points to 7% in May, following a 50-basis-point hike in March. Markets are pricing in 300 basis points in further hikes in Mexico, although we believe the bank won't be quite so hawkish. Brazil, which raised its policy Selic rate by a full percentage point to 12.75% in May, is priced for a further 60 basis points in hikes. Markets are now pricing in a 25-basis-point rate cut for Chile, which raised its policy rate by 125 basis points, to 8.25%, in May.

Rising commodities prices are adding to core inflation in emerging markets. However, we believe that commodities prices are likely to retreat from recent highs in the near term, which would temper inflation in emerging markets. The CPI in Mexico rose by 7.68% in April compared with a year earlier, higher than a 7.45% year-on-year rise in March.

Asset class return outlooks

Vanguard has updated its 10-year annualised outlooks for equity and fixed income returns based on data as of 31 March 2022. 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	21.6	3.2%–5.2%
Global ex-Australia equities (unhedged)	19.3	3.7%–5.7%
Australian aggregate bonds	5.3	2.3%–3.3%
Global bonds ex-Australia (hedged)	4.3	2.5%–3.5%

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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