Asset allocation report

June quarter 2022

Contents

Resetting to a modestly higher neutral rate

The era of ultra-low neutral interest rates around the world may be coming to an end. Those rates have fallen by about 4 percentage points across developed economies over the last 40 years, boosting asset returns. Some of the drivers behind the decline, however, are lessening or even reversing. The transition to modestly higher neutral rates is setting the stage for some pain for the markets in the short term but better prospects further out, according to recently published research by Vanguard economists.

How we got here: Key drivers behind the fall in neutral rates

"Our research shows that neutral rates—which are the estimated levels of real interest rates that would support both full employment and stable inflation—have been driven lower by similar forces across all 24 developed-market economies," said Roxane Spitznagel, a London-based Vanguard economist. The standout driver has been demographics, which has accounted for roughly half the decline in neutral rates, largely because of the drop-off in the number of new workers entering the workforce.

Investors' reluctance to take on risk and the global savings glut have also contributed to the decline in neutral rates. Income inequality played a modest role as well.

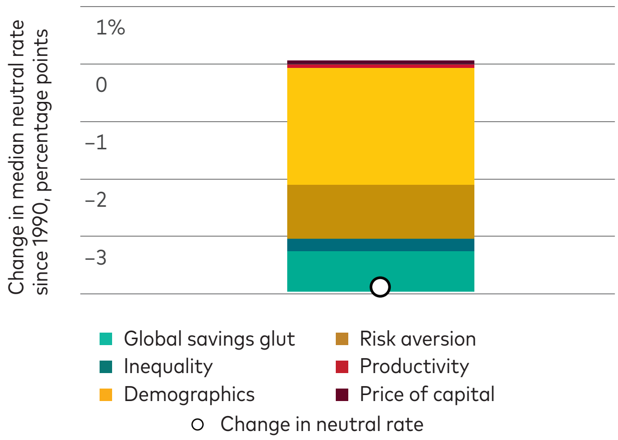
The road ahead: Lower for not much longer

"Our forecast is for an overall rise in global neutral rates of around 1.1 percentage points over the next decade," said Alexis Gray, a Melbourne-based Vanguard senior economist, "with all developed-market economies tracing an upward trajectory."

Demographic dynamics are set to pivot and will soon help lift neutral rates. More new entrants to the workforce will add about 0.2 percentage points to the expected rise for the overall median developed-market neutral rate.

Three other primary contributors—some shrinkage in the global savings glut, decreased

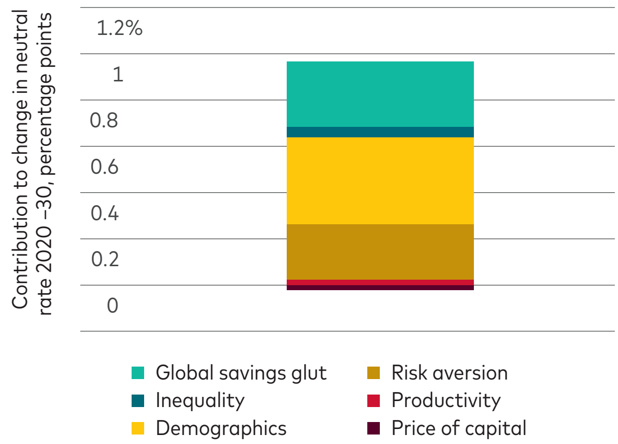
Figure 1. Demographics have been the key driver pushing developed-market neutral rates lower in recent decades



Notes: We estimate the median neutral rate for 24 developed-market economies. These include Australia, Canada, Germany, Japan, Switzerland, the U.K., and the U.S. We include seven variables in our data set, all on a yearly basis. These are the short-term real interest rate and the six variables that drive developments in the neutral rate in our analysis. We include four-year moving averages of the driver variables to smooth out cyclical fluctuations.

Source: Vanguard, as of April 2022.

Figure 2. Previous trends abating or reversing will contribute to a rise in neutral rates in developed markets



Notes: We forecast the median neutral rate for 24 developed-market economies. These include Australia, Canada, Germany, Japan, Switzerland, the U.K., and the U.S.

Sources: Vanguard model estimates are based on data from Penn World Tables, the Organisation for Economic Co-operation and Development, Our World in Data, the International Monetary Fund, the World Inequality Database, and the St. Louis Federal Reserve Database, as of April 2022.

investor risk aversion, and cross-country convergence in income inequality—will be key, adding another 0.85 percentage points to our estimate.

Although it's not a direct component of our econometric model, green investment to reach carbon neutrality would most likely boost neutral rates as well.

(It should be noted that our neutral rate forecasts depend on developments to underlying variables, some of which, like demographics, we can be quite certain of, while others, like risk aversion and inequality, we accept more humility in forecasting.)

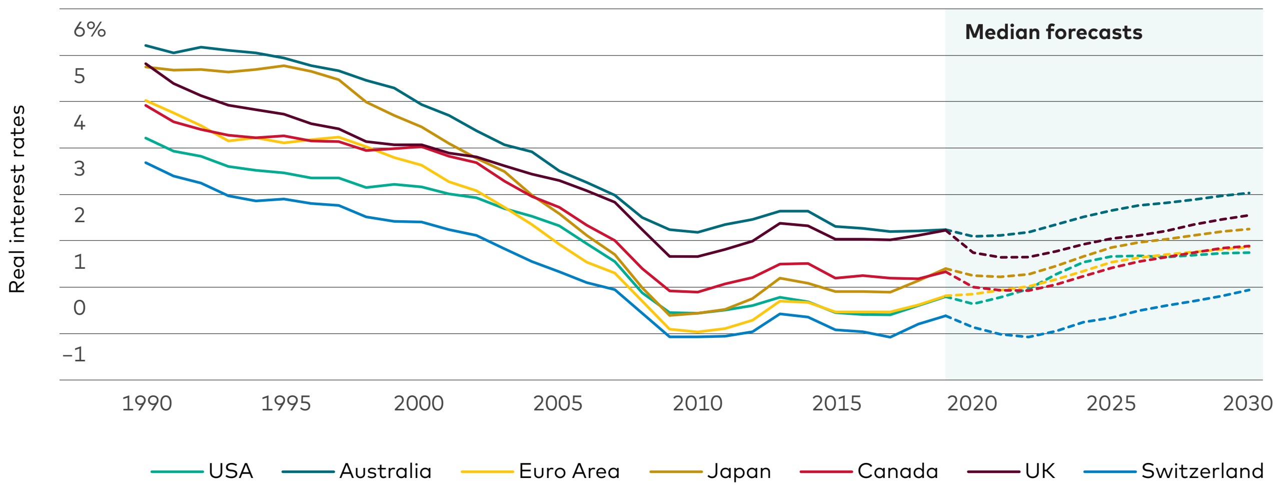
By region, the starting points and the magnitude of the increases will vary, but we expect to see this general pattern across developed-market economies.

What it could mean for investors

The secular decline in rates in recent decades has been a key determinant of global fiscal and monetary policy and a tailwind for economic growth and asset returns.

"For investors, the initial transition period to higher neutral rates may bring with it some short-term headwinds for equity and bond prices—higher interest rates result in negative price increases for bonds and, all else equal, reduce equity valuations," said Adam Schickling, a U.S.-based Vanguard economist. "Over the coming decade, though, once neutral rates reach their new, higher equilibrium, the prospect of higher rates should translate into higher forward-looking asset returns via a higher risk-free rate that bond yields and equity returns are built upon."

Figure 3. Neutral rates are expected to rise modestly across developed markets this decade



Sources: Vanguard model estimates from 1990 through 2020 are based on data from Penn World Tables, the Organisation for Economic Co-operation and Development, Our World in Data, the International Monetary Fund, the World Inequality Database, and the St. Louis Federal Reserve Database, as of April 2022.

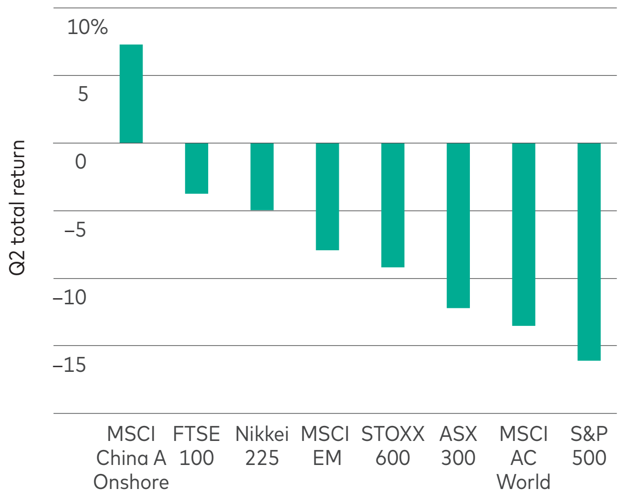
Quarter in review

Investors navigated yet another volatile quarter as a deteriorating economic outlook saw risk appetite take a downward turn. Inflation remained a key focus as central banks aggressively hiked rates in efforts to contain it. Equity and bond markets continued to sell off as recession risks emerged, with global equities returning their first negative financial year in a decade (as measured by the MSCI World Index AUD).

Equities were once again led lower by tech stocks and other interest rate-sensitive sectors, while concerns over corporate earnings and slowing economic growth weighed on the broader market. Global equities fell 14% over the quarter, with Australian equities following developed market peers down by 12% (**Figure 4**). European markets remained concerned over energy supply disruptions and elevated inflation, while China's easing of COVID lockdowns spurred a rebound in Chinese markets from the first quarter's woes. A weaker Australian dollar provided some respite from declines in global equities, dampening losses to 8% for AUD investors (**Figure 5**).

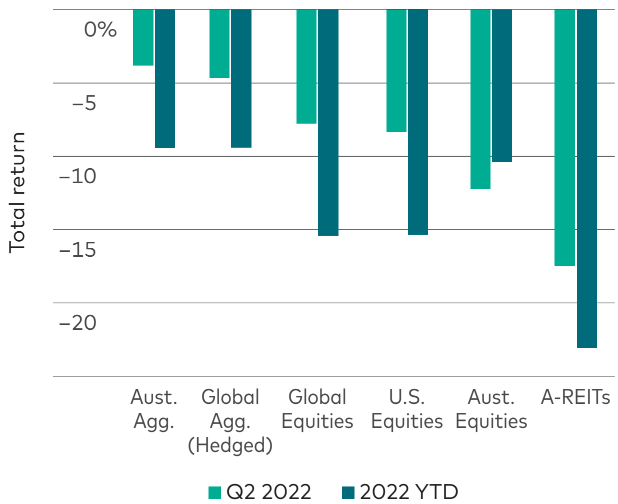
Bond markets continued to endure the near-term pain of tightening monetary policy as central banks persisted with hiking interest rates. Yields trended upwards as markets weighed the prospects of increasingly hawkish policy against a picture of slowing growth and rising recession fears. Global bonds fell a further 4.7% and Australian bonds fell 3.8% over the last quarter as yields on U.S. and Australian 10-year government bonds rose by 66 basis points (0.66%) and 83 basis points (0.83%) respectively.

Figure 4. Global equities broadly declined



Notes: Returns are cumulative total returns in local currency.
Source: FactSet, as of 30 June 2022.

Figure 5. AUD indices continued to retreat



Notes: Returns are cumulative total returns denominated in AUD.
Source: FactSet, Refinitiv, as of 30 June 2022.

Economic outlook

A lot has changed since we published our Vanguard economic and market outlook for 2022: Striking a better balance. At the start of the year, we expected global economies to continue to recover from the effects of the COVID–19 pandemic, but at a more modest pace than in 2021. While that holds true, the pace of change in macroeconomic fundamentals such as inflation, economic growth, and monetary policy has failed to live up to expectations.

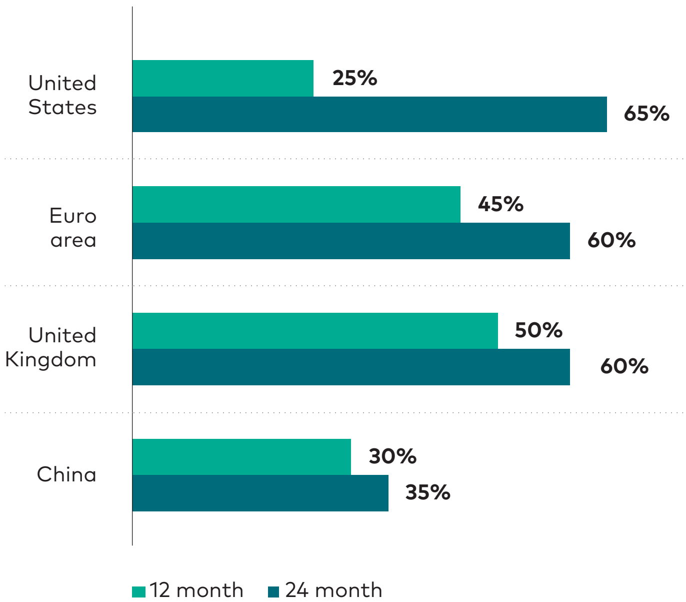
Labour and supply-chain constraints were already fuelling inflation before the year began, but Russia's invasion of Ukraine and China's zero-COVID policy exacerbated the situation. Central banks have been forced to play catchup in the fight against inflation, ratcheting up interest rates more rapidly, and possibly higher than previously expected. But those actions risk cooling economies to the point where they enter recession.

Global economic growth will likely stay positive this year, but some economies are flirting with recession, if not this year, then in 2023. Compared with the start of the year, Vanguard has downgraded its 2022 GDP growth forecasts for all the major regions, increased its inflation forecasts, and become more hawkish about monetary policy.

Inflation, policy elevate the risk of recession
In the United States, inflation has reached 40-year highs, eroding consumers' purchasing power and driving the Federal Reserve to aggressively raise interest rates. We expect the target federal funds rate landing in the 3.25%–3.75% range by year-end. We expect a terminal rate of at least 4% in 2023—higher than what we consider to be the neutral rate (2.5%) and above what's currently being priced into the market (the neutral rate is the theoretical rate at which monetary policy neither stimulates nor restricts an economy).

We have downgraded expected U.S. GDP growth from about 3.5% at the start of the year to about 1.5%. The factors that led to our downgrade will likely continue through 2022—

Figure 6. Probability of recession for select regions



Drivers / key risks

United States:
- Federal Reserve tightening path
- Inflation eroding consumer purchasing power

Euro area:
- Ukraine war impact
- European Central Bank tightening path

United Kingdom:
- Tighter global financial conditions
- Bank of England tightening path

China:
- Squeeze on real incomes
- Further COVID-19 outbreaks resulting in renewed lockdowns

Source: Vanguard, as of 30 June, 2022.

namely, tightening financial conditions, wages not keeping up with inflation, and lack of demand for U.S. exports. Labour market trends are likely to keep downward pressure on the unemployment rate through year-end, though increases in 2023 are likely as the impacts of Fed policy and slowing demand take hold. We assess the probability of recession at about 25% over the next 12 months and 65% over 24 months. We believe that a period of high inflation and stagnating growth is more likely than an economic 'soft landing' of growth and unemployment rates around or above longer-term equilibrium levels (about 2% for growth and 4% for unemployment).

Australia's status as a commodities exporter has partly insulated it from some of the economic woes elsewhere, but global factors and rising inflation still have an impact. Broad-based and persistent inflation has the Reserve Bank of Australia on course to raise its target rate to at least 2.5% in 2022. The labour market is robust, with the unemployment rate falling to an historical low. Unemployment should stabilise as growth slows, but upward pressure on wages is likely to persist for a while. We have reduced our growth forecast by a percentage point from the start of the year, to 3%–3.5%.

China will fall far short of policymakers' GDP growth target of about 5.5%, given the challenge in achieving all three of their goals: growth, financial stability, and zero-COVID (the latter affects not just China's economy, but the global economy as well). We believe the actual 2022 GDP growth rate will be 3–4%, far below China's pace for many years. Given China's zero-COVID policy, additional outbreaks resulting in renewed lockdowns could further detract from growth.

In the euro area, headline inflation driven by high energy prices may spike to near 9% in the third quarter. Inflation has become widespread, spurring the European Central Bank on in what it expects will be a "sustained path" of interest rate increases. In September, rates will likely be out of negative territory for the first time in a decade. We forecast economic growth to be about 2.5%–3% for the full year. However, Europe's dependence on Russian natural gas and the challenges of managing monetary policy for 19 countries put the euro area at a higher risk of recession than the United States in the next 12 months. A complete cut-off from Russian gas would likely lead to rationing and recession.

In the United Kingdom, energy prices will likely drive the headline inflation rate to roughly 10% late in the year. We expect the Bank of England to raise the bank rate by an additional 1.25 percentage points over the next 12 months to reach our estimate of a 2.5%

Figure 7. Vanguard's forecasts for year-end 2022

	ECONOMIC GROWTH	HEADLINE INFLATION	MONETARY POLICY	UNEMPLOYMENT RATE
United States	~1.5%	7%–7.5%	3.25%–3.75%	3%–3.5%
Canada	~4%	~6.5%	~3%	~5.5%
Mexico	~2%	~5%	8%–9%	~3.5%
Euro area	2.5%–3%	~7.5%	0.5%–0.75%	~7%
United Kingdom	3.5%–4%	~10%	2.25%–2.5%	~4%
China	~3%	<2.5%	2.75%	~5.5%
Australia	3%–3.5%	~7%	~2.5%	~4%

Notes: Forecasts evolve with new data, and our views will inevitably change. Growth is the change in annualised GDP year over year. Inflation is the headline consumer price index, which includes the volatile food and energy sectors. Monetary policy is our year-end projection for the central bank's short-term interest rate target.

Source: Vanguard forecasts as of 30 June 2022.

neutral rate. The bank has signalled that it's prepared to enact rate hikes larger than 25 basis points, depending on the economic and inflation outlook.

Even with rising inflation and a slowing economy, the labour market will likely stay strong, given record job vacancies and unemployment near a 50-year low. But a drop in real wages, combined with diminished consumer and business confidence and tightening financial conditions, could push the United Kingdom into recession. Vanguard sees the probability of recession at about 50% over the next 12 months. For 2022, we've downgraded our 5.5% forecast at the start of the year to 3.5%–4%.

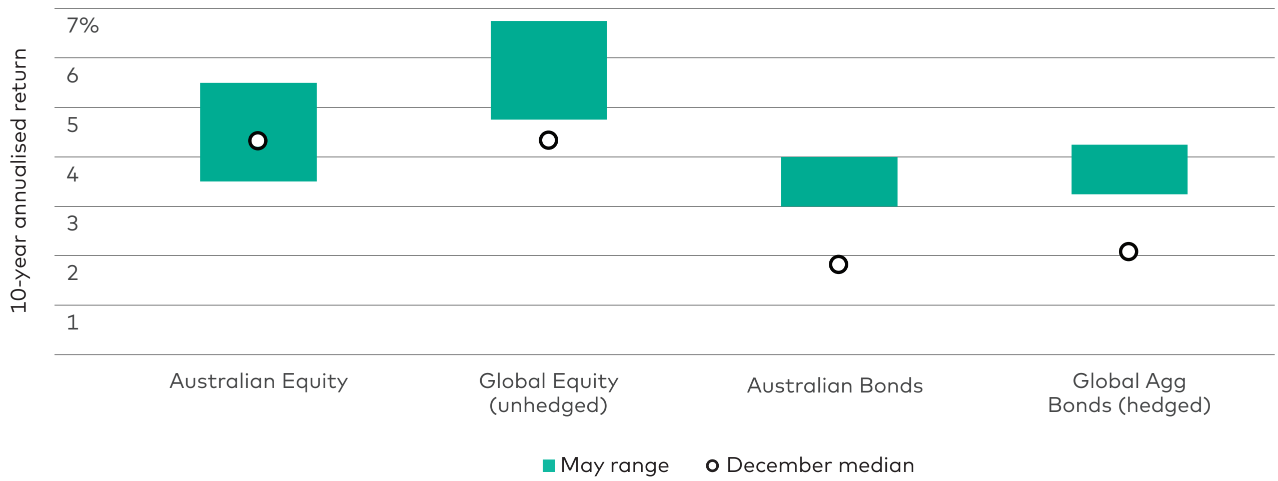
Market outlook

Stock and bond markets have been hit hard so far in 2022, but there is an upside to down markets. Because of lower current equity valuations and higher interest rates, our model suggests higher expected long-term returns.

Our 10-year annualised return forecasts for equity markets are largely 1 percentage point higher than at the end of 2021. More attractive equity valuations improve our return outlook on a relative basis, particularly internationally, although volatility is expected to persist as markets navigate the earnings season and further policy tightening.

Bond yields have continued to rise in many regions and improve the return outlook, which has broadly increased by 1.5 percentage points year-to-date. Rising yields may detract from bonds' current prices, but that means higher returns in the future as interest payments are reinvested in higher-interest bonds.

Figure 8. An improved outlook



Source: Vanguard, 30 May 2022 and 31 December 2021 VCMM simulations

Long-term market outlook

The charts below shows the Vanguard Capital Markets Model (VCMM) return forecasts over the next 10 years for a range of asset classes and Vanguard's Diversified Funds.

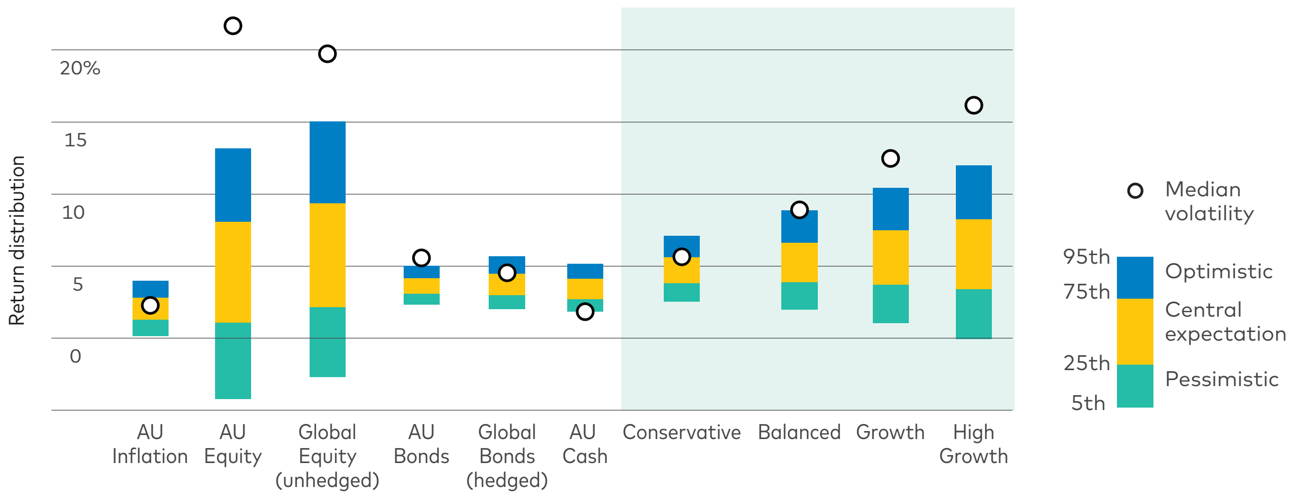
It shows two concepts: the range of annualised 10-year nominal returns and the median volatility experienced.

The bars show the range of return outcomes over a 10-year period. The central return expectations for the asset class or portfolio are shown in the middle of the bars. Observations in the optimistic or pessimistic regions should not come as a surprise though; goals and portfolios should always be positioned with these possibilities in mind.

The white circles show the median volatility forecasts. This represents the volatility of the asset classes that can be expected over the 10-year period. The chart shows that equities are expected to produce a higher return over a 10-year period than bonds, however the trade-off is that an investor can expect a more volatile experience and greater uncertainty over the end point, which could be a much wider range of outcomes.

An important point to remember is that asset returns are not perfectly correlated, which means that if an Australian equity return over 10 years is in the optimistic range, this does not necessarily mean that Australian bond returns will also be in the optimistic range. Combining assets can therefore present strong diversification benefits.

Figure 9a. Projected 10-year nominal return outlook



Source: Vanguard, June 2022 using 30 May 2022 VCMM simulation.

Figure 9b. Projected 10-year nominal return median volatility outlook

	RETURN PERCENTILE					MEDIAN VOL.
	5TH	25TH	MEDIAN	75TH	95TH	
Australian Inflation	0.2%	1.3%	2.1%	2.8%	3.9%	2.3%
Australian Equity	–4.2%	1.1%	4.5%	8.1%	13.2%	21.7%
Global Equity (unhedged)	–2.7%	2.2%	5.8%	9.4%	15.0%	19.7%
Australian Bonds	2.3%	3.1%	3.6%	4.2%	5.0%	5.5%
Global Aggregate Bonds (hedged)	2.0%	3.0%	3.8%	4.5%	5.6%	4.5%
Australian Cash	1.9%	2.7%	3.4%	4.1%	5.2%	1.8%
Conservative	2.5%	3.8%	4.7%	5.6%	7.1%	5.6%
Balanced	2.0%	3.9%	5.2%	6.6%	8.8%	8.9%
Growth	1.1%	3.7%	5.6%	7.5%	10.4%	12.4%
High Growth	0.0%	3.4%	5.8%	8.3%	12.0%	16.2%

Source: Vanguard, June 2022 using 30 May 2022 VCMM simulation.

The next two charts show the trade-off between targeting a CPI+ return target and the risk of a loss along the way.

Taking more risk means that an investor increases the probability that they will achieve their target over 10 years.

Highlighting the importance of managing expectations, it also means there is the increased probability of experiencing a negative return or a large annual loss in at least one year over the 10 year period.

Figure 10a. Probability of achieving real return

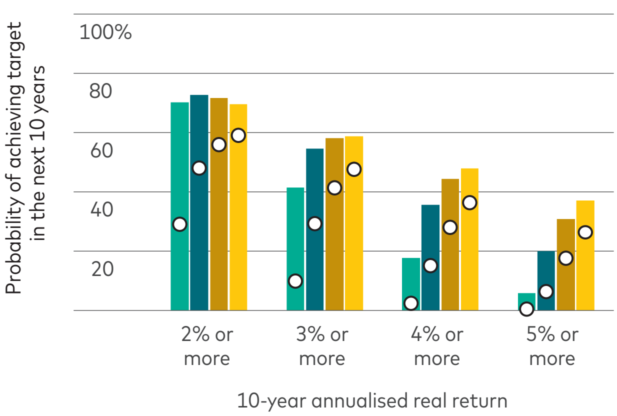
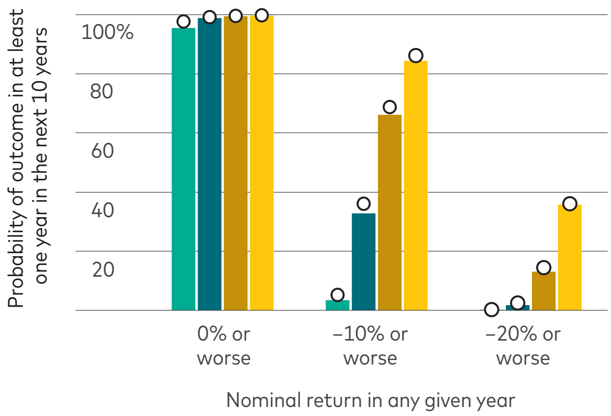


Figure 10b. Downside risks



Conservative Balanced Growth High Growth December 2021

Notes: The projections or other information generated by the VCMM 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 in AUD. Results from the model may vary with each use and over time.

Source: Vanguard, June 2022 using 30 May 2022 VCMM and 31 December 2021 simulations.

About Vanguard's Investment Strategy Group
Vanguard's Investment Strategy Group is a global team of economists and investment and portfolio construction strategists with a wide variety of specialties, ranging from monetary policy to index construction to market trends. Their research serves as the basis for Vanguard's investment principles and methodology, guides Vanguard's global leadership and influences decisions about our investment offerings and portfolio construction.

Research-based investment approach
As part of Vanguard's broader Investment Management Group, ISG plays an essential role in developing Vanguard's investment methodology, which is carried through in the implicit and explicit advice solutions available to our clients. Our global chief economist and head of ISG reports directly to Vanguard's global chief investment officer. We work closely with Vanguard's in-house portfolio managers. Notably, our global chief economist is integrated into Vanguard Fixed Income Group through our portfolio management process. Through that process, ISG advises our fixed income investment managers on the macroeconomic outlook, expected monetary policy and other factors to support day-to-day portfolio management. Vanguard's investors around the world benefit from our collaborative approach to investment management, research and thought leadership.

Vanguard Capital Markets Model
The Vanguard Capital Markets Model® (VCMM) projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based. The VCMM is a proprietary financial simulator developed and maintained by Vanguard's Investment Strategy Group. It is a long-term tool that takes into account current macroeconomic conditions and equity and bond valuations to forecast distributions of future returns for a wide range of asset classes and portfolios. The primary value of the VCMM is in its application to analysing potential client portfolios. VCMM asset-class forecasts–comprising distributions of expected returns, volatilities, and correlations—are key to the evaluation of potential downside risks, various risk-return trade-offs, and diversification benefits of various asset classes.

Asset allocation

Vanguard's approach to asset allocation is to provide long-term returns that match investors' desired level of risk. The broad allocations to defensive (fixed income) and growth (equities) are the main factors influencing the risk-return profiles of our asset allocation strategies.

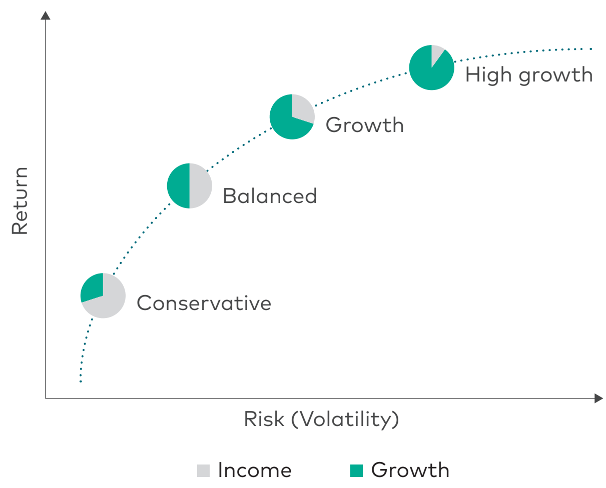
Our asset allocation approach is designed with a medium to long-term investor in mind (a time horizon of at least five years), reflecting the reality that the majority of Australian investors need to accept some market risk in order to reach their investment goals.

Why diversification matters
We believe that a successful investment strategy starts with an asset allocation suitable for its objective. In practice, diversification is a rigorously tested application of common sense: markets will often behave differently from each other—sometimes marginally, sometimes greatly—at any given time.

Owning a portfolio with at least some exposure to many or all key market components ensures the investor of some participation in stronger areas while also mitigating the impact of weaker areas.

Many investors lack the time, interest, or skills, and can become overwhelmed by the choice of investment options, asset classes, and other implementation hurdles such as choosing between index and active management. Investors also face behavioural risks in adhering to their investment plan over time due to the temptation of performance chasing or overreacting to market events.

Vanguard Diversified Funds provide professionally managed portfolio solutions designed to help medium to long-term investors achieve their goals and overcome these challenges.



Understanding Vanguard's SAA process
For multi-asset funds, such as Vanguard Australia's Diversified Funds, Vanguard's Investment Strategy Group (ISG) conducts an annual review of the strategic asset allocation (SAA) of the funds. The team considers new asset classes, currency exposure, home bias, regulatory and tax impact, investment costs, investor behaviours, and implementation factors amongst others. The ISG team presents a recommendation to maintain or change the SAA to Vanguard's global Strategic Asset Allocation Committee (SAAC), which oversees all of Vanguard's multi-asset funds. The SAAC is comprised of senior leaders from the Investment Management Group and Vanguard's advice businesses and is co-chaired by Vanguard's global chief economist. Upon approval of a change to the SAA, Vanguard assesses the feasibility, tax impact, and costs of the recommended changes and presents to the Board of Vanguard Australia for approval prior to implementing the changes.

The shaded boxes display the total return percentile rank of the Vanguard fund within its peer group*, as shown by the colour code, with the number reflecting the Vanguard fund return in excess of the peer group median return (%). The numbers below the shaded boxes indicate the number of funds in the peer groups across each time period.

Figure 13. Vanguard Diversified Funds peer group comparison as at 30 June 2022

VANGUARD FUND ASSET WEIGHTED PEER GROUP MER (% P.A.)	3 MTHS	6 MTHS	1 YR	3 YRS	5 YRS	7 YRS	10 YRS
Conservative	–1.34	–2.82	–3.09	–0.39	0.46	0.64	0.65
0.66	47	47	47	44	42	39	37
Balanced	–1.40	–3.83	–3.92	–0.47	0.32	0.31	0.61
0.80	50	48	45	41	38	33	29
Growth	–0.79	–1.93	–1.98	0.08	0.68	0.68	0.83
0.79	70	70	69	65	62	57	55
High Growth	–0.77	–1.44	–1.30	0.67	0.91	0.69	0.87
0.84	51	51	51	48	45	40	38

PEER GROUP PERCENTILE
Top 5%
1st quartile
2nd quartile
3rd quartile
4th quartile

Sources: Vanguard, June 2022. Calculations using data from Morningstar Inc. Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance. All returns are net of fees and assume reinvestment of income distributions. Returns greater than 12 months are annualised. There has been no adjustment for survivorship bias.

* The peer groups were constructed by first sourcing a universe of funds from Morningstar having the same category as the Vanguard Funds, but excluding Vanguard strategies. An automated filter was then applied to these original peer groups with the aim of removing identified duplicate investment strategies and retain unique strategies.

Figure 14. Vanguard Diversified Funds return contributions for the quarter as at 30 June 2022

FUND	3 MONTH GROSS RETURN (%)	3 MONTH RETURN CONTRIBUTION (%)			
		VCIF	VBIF	VGIF	VHIF
Vanguard Cash Reserve Fund	0.09	0.0	0.0	0.0	0.0
Vanguard Australian Fixed Interest Index Fund	–3.81	–0.7	–0.6	–0.3	–0.1
Vanguard Australian Shares Index Fund	–12.20	–1.5	–2.5	–3.4	–4.4
Vanguard International Shares Index Fund	–8.35	–0.7	–1.2	–1.7	–2.2
Vanguard International Small Companies Index Fund	–9.07	–0.2	–0.3	–0.4	–0.6
Vanguard Emerging Markets Shares Index Fund	–3.12	–0.1	–0.1	–0.1	–0.2
Vanguard International Shares Index Fund (Hedged) – AU Class	–15.02	–0.9	–1.4	–1.9	–2.5
Vanguard Global Aggregate Bond Index Fund (Hedged)	–5.27	–2.2	–1.9	–1.1	–0.4
Total Return Contribution (%)		**–6.2**	**–7.9**	**–9.1**	**–10.2**

* Figures in the return contribution table are calculated as the product of the monthly gross return and the corresponding actual asset allocation.

Omicron likely to hit China's 2022 growth hard

China's largely successful containment strategy from the first two years of the COVID-19 pandemic has run into a staunch foe: the highly transmissible Omicron variant. A zero-COVID strategy of lockdowns that allowed life to continue somewhat normally in the pandemic's pre-vaccination days is hitting China's economy hard in 2022.

A forthcoming Vanguard *Global Macro Matters* research paper quantifies the drag on China's economy from months of lockdowns affecting hundreds of millions of people. According to Vanguard's analysis, even the most optimistic scenario will leave China's 2022 economic growth far below policymakers' official growth target "around 5.5%." In our baseline case, we foresee full-year 2022 GDP growth in China just above 3%, much lower than our expectation at the start of the year for growth around 5%.

Our economic and market outlook for 2022 discussed the delicate balance that policymakers globally would face this year. The manifestation of that in China is a "policy trilemma," said Qian Wang, Vanguard Asia-Pacific chief economist. "China's policymakers have three goals, but they can't achieve all of them. We believe that, for considerations that go beyond the economy, they will likely maintain a zero-COVID policy as needed. To achieve 5.5% growth, they will need to loosen their financial stability goal and aggressively stimulate the economy."

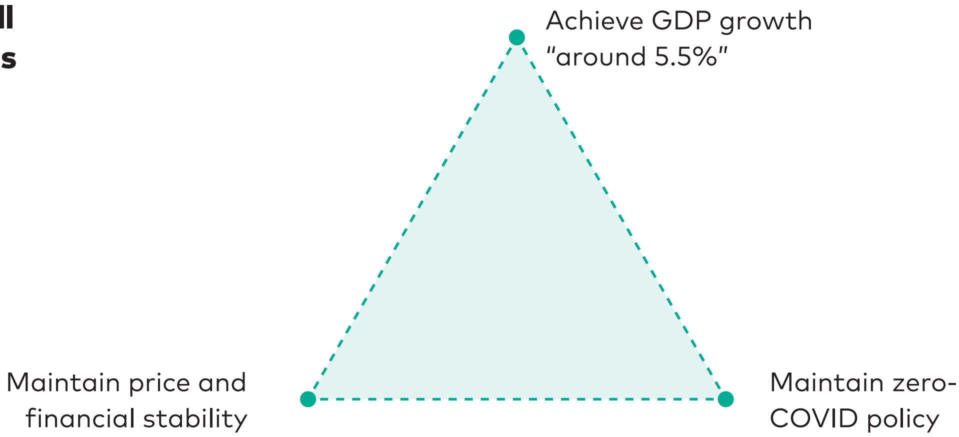
Stimulative measures to date—including modest cuts in policy and mortgage rates and the amount of cash that banks must hold in reserve; increased credit support to small businesses; and tax cuts, rebates, and infrastructure spending—fall short of levels needed to produce policymakers' growth target, according to Vanguard's analysis. We believe that concerns about financial stability will continue to limit stimulus, leaving the growth target vulnerable.

A significant easing of what had been strict COVID restrictions in Shanghai, China's largest city, on 1 June was a positive sign, but the recovery is likely to be weaker than that which followed lockdowns in 2020.

Continued page 17

Figure 11. China faces a "policy trilemma"

China can't achieve all three of its 2022 goals



Source: Vanguard.

Figure 12. Our base case: Lockdowns, insufficient stimulus limit growth

	Baseline (50% probablility)	Downside (30% probablility)	Upside (20% probablility)
Description	**Health:** Gradual easing of zero-COVID measures through the second quarter of 2022. New but lighter measures in October through the end of the National Party Congress. **Global growth:** Around 2.5% down from our forecast around 4% before Russia's invasion of Ukraine. **Policy:** Policymakers step up stimulus but still under-stimulate (total social financing growth around 11.5%).	**Health:** Slow easing of current restrictions and renewed COVID–19 outbreak in the third quarter of 2022. **Global growth:** Around 2.5%, down from our forecast around 4% before Russia's invasion of Ukraine. **Policy:** Policymakers under-stimulate (total social financing growth around 12%) and officially lower their target for growth "around 5.5%".	**Health:** Meaningful easing of zero-COVID measures at local government levels through a more targeted approach. **Global growth:** Around 2.5%, down from our forecast around 4% before Russia's invasion of Ukraine. **Policy:** Policymakers don't stimulate enough to reach their growth target (total social financing growth around 13%).
2022 starting growth forecast	**5.0%**	**5.0%**	**5.0%**
Total growth headwind	–2.8%	–4.3%	–2.5%
COVID–19 Omicron variant growth headwind	–1.8%	–3.3%	–1.5%
External growth headwind	–1.0%	–1.0%	–1.0%
Policy stimulus boost	1.0%	1.1%	1.5%
Revised 2022 GDP forecast	**3.2%**	**1.8%**	**4.0%**

From page 15

Structural factors, including a weak labour market and business confidence, the spectre of renewed restrictions amid new COVID cases, and slowing global growth will limit the pace of recovery.

Commodities exporters may feel China's slowdown most

China's Omicron lockdowns pose both supply and demand shocks to the global economy. Reduced Chinese demand will likely be felt most acutely by commodities exporters in both developed markets such as Australia and emerging markets such as Brazil. Supply shortfalls may be mitigated, however, by slowing global demand for goods and expanding supply from the rest of emerging Asia. Only in our downside scenario of a slow easing of current restrictions do China supply constraints cause U.S. goods inflation to break a recent downward trend.

In our base case, we expected lockdowns to be eased gradually through the second quarter, then for new, lighter restrictions to be put in place later in the year, driven by China's desire for social stability ahead of the fourth quarter's National Party Congress. Policymakers will want to avoid a large COVID outbreak ahead of such a strategic and psychologically important event, because China's health-care infrastructure would be ill-equipped to deal with it, even as vaccinations have reduced mortality.

China likely will act to prevent further currency depreciation

China's currency, meanwhile, weakened significantly recently given the nation's economic challenges and rising U.S. interest rates. The Chinese yuan depreciated by 6.6% compared with the U.S. dollar in little more than three weeks from mid-April to mid-May and since has regained about 1.9%. It traded around 6.66 to the dollar on 3 June.[1] Vanguard doesn't foresee runaway yuan depreciation, however. Over the next three to six months, we expect the yuan to trade in a range of 6.6–7.0 to the dollar. (A higher number indicates weakening.)

We foresee a floor for the yuan because currency markets have priced in the rest of the year's anticipated Federal Reserve rate hikes and China's policymakers have always tried to avoid prolonged one-way moves that could lead to excessive speculation and volatility in financial markets, said Alexis Gray, a Melbourne-based Vanguard senior economist who covers the Asia-Pacific region.

"Both domestic and external forces that have weakened the yuan are likely to improve in the near term," Gray said. "The end of lockdowns will be supportive, and we expect markets to stop pricing in more hawkish central bank policy rate paths as global growth slows and inflation moderates."

1 Source: U.S. Federal Reserve, as of 6 June, 2022.

Connect with Vanguard™

vanguard.com.au
1300 655 205

VAAR_072022