

Vanguard economic and market outlook for 2022: Global summary

The global outlook summary highlights the top-level findings of Vanguard's full economic and market outlook.

The global economy in 2022: Striking a better balance

Our outlook for 2021 focused on the impact of COVID-19 health outcomes on economic and financial conditions. Our view was that economic growth would prove unusually strong, with the prospects for an "inflation scare" as growth picked up. As we come to the end of 2021, parts of the economy and markets are out of balance. Labor demand exceeds supply, financial conditions are exceptionally loose even when compared with improved fundamentals, and policy accommodation remains extraordinary.

Although health outcomes will remain important in 2022 given the emergence of the Omicron variant, the outlook for macro-economic policy will be more crucial as support and stimulus packages enacted to combat the pandemic-driven downturn are gradually removed into 2022. The removal of policy support poses a new challenge for policy-makers and a new risk to financial markets.

The global economic recovery is likely to continue in 2022, although we expect the low-hanging fruit of rebounding activity to give way to slower growth in most parts of the world, whether supply-chain challenges ease or not. In both the United States and the euro area, we expect growth to slow down to 4%. In the U.K., we expect growth of about 5.5%, and in China we expect growth to fall to about 5%. By contrast, in Australia, we expect stronger growth in 2022 of around 4.5% following lackluster growth in 2021, as lockdowns ease on the back of positive vaccination progress.

More importantly, labor markets will continue to tighten in 2022 given robust labor demand, even as growth decelerates. We anticipate that several major economies, led by the U.S., will quickly approach full employment even with a modest pickup in labor force participation. Locally, we also expect the unemployment rate to normalize back towards 4.5% in 2022 as effects of the lockdown fade. With major economies approaching full employment, wage inflation is likely to become more influential than headline inflation for the direction of interest rates in 2022.

Global inflation: Lower but stickier

Inflation has continued to trend higher across most economies, driven by a combination of higher demand as pandemic restrictions were lifted and lower supply from global labor and input shortages. While we don't envision a return to 1970s-style inflation, we anticipate that supply/demand frictions will persist well into 2022 and keep inflation elevated across developed and emerging markets. That said, it is highly likely that inflation at the end of 2022 will be lower than at the beginning of the year given the unusual run-up in goods prices.

Although inflation should cool in 2022, its composition may be stickier. More persistent wage- and shelter-based inflation will be the critical determinant in central banks' adjustment of policy.

Policy takes center stage: The risk of a misstep increases

The global policy response to COVID-19 was impressive and effective. Moving into 2022, how will policymakers navigate an exit from exceptionally accommodative policy? The bounds of appropriate policy expanded during the pandemic, but it's possible that not all these policies will be unwound as conditions normalize. On the fiscal side, government officials need to trade off between higher spending—due to pandemic-driven policies—and more balanced budgets to ensure debt sustainability.

On the monetary side, central bankers will have to strike a balance between keeping a lid on inflation expectations, given negative supply-side shocks, and supporting a return to pre-COVID employment levels. In the United States, that balance should involve the Federal Reserve raising interest rates in the second half of 2022 to ensure that elevated wage inflation does not translate into more permanent core inflation. At present, we see the negative risks of too-easy policy accommodation outweighing the risks of raising short-term rates. Given conditions in the labor and financial markets, the Fed may ultimately need to raise rates to at least 2.5% this cycle, higher than some are expecting. In Australia, better growth prospects and rising inflation expectations are likely to see the RBA taper off its quantitative easing program by the first half of 2022. However, we only see the first rate hike happening after 2022, as we do not anticipate wage pressures to surge to the extent seen in the U.S.

The bond market: Rising rates won't upend markets

Despite modest increases during 2021, government bond yields remain below pre-COVID levels. The prospect of rising inflation and policy normalization means that the short-term policy rates targeted by the Fed, the Reserve Bank of Australia, and other developed-market policymakers are likely to rise over the coming year. Credit spreads remain generally very tight. Rising rates are unlikely to produce negative total

returns over the medium and long term, given our inflation outlook and given the secular forces that should keep long-term rates low.

Global equities: A decade unlike the last

A backdrop of low bond yields, reduced policy support, and stretched valuations offers a challenging environment despite solid fundamentals. Our Vanguard Capital Markets Model fair-value stock projections, which explicitly incorporate such varied effects, continue to reveal a global equity market that is drifting close to overvalued territory, primarily because of U.S. stock prices. Our outlook calls not for a lost decade for U.S. stocks, as some fear, but for a lower-return one.

Specifically, we are projecting the lowest 10-year annualized returns for global equities since the early 2000s. We expect the lowest ones in the U.S. (1.9%–3.9% per year), with more attractive expected returns for non-U.S. developed markets (5.0%–7.0%) and, to a lesser degree, emerging markets (3.8%–5.8%). Meanwhile, returns for the Australian market are expected to be in the range of 3.5%–5.5%, which is around 2 percentage points lower than our outlook last year given elevated valuations. The outlook for the global equity risk premium is still positive but lower than we expected last year, with total returns expected in the range of 2 to 4 percentage points over bond returns.

For Australian investors, this modest return outlook belies opportunities for those investing globally, and continues to present a case for being broadly diversified. Although emerging-market and U.S. equities are above our estimate of fair value, we still see these markets as potential sources of diversification for Australian investors given divergences in economic momentum. Within U.S. markets, we think value stocks are still more attractive than growth stocks, despite value's outperformance over the last 12 months.

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model® (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 VCMM are derived from 10,000 simulations for each modeled asset class. Simulations as of September 30, 2021. Results from the model may vary with each use and over time.

The 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 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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