

Vanguard economic and market update

Key points:

- Economic rebound holding in US, euro area and UK but weakening in China and emerging Asia.
- UK rate hike expectations brought forward as inflation pressures build.
- US inflation seen staying above Fed's 2% inflation target until spring of 2022 but it's the US central bank's view of job trends that that could yet determine its policy.
- Vanguard's 10-year projections for broad asset-class returns marginally lowered, for the most part.



Economic growth

- As formidable as the Covid-19 Delta variant appears to be, its effect on economic output in the **United States** has so far been minimal. Mobility data suggest activity may be leveling off, though not reversing, as case counts accelerate in some parts of the country. And even where vaccination rates are low, they're robust above those over age 65, who would otherwise most likely have the most adverse health outcomes. Still, we're watching closely for how resilient the economy can be, as US output would need to hold around current levels to achieve full-year growth in Vanguard's forecast range of 7% to 7.5%. GDP increased at an annual rate of 6.5% in the second quarter, according to an advance estimate by the US Bureau of Economic Analysis (BEA), after revised growth of 6.3% in the first quarter.
- GDP grew by a seasonally adjusted 2.0% in the **euro area** in the second quarter, the European Union's statistical agency reported. Growth momentum remains strong, though high-frequency indicators suggest a modest softening in activity, particularly where cases of the Covid-19 Delta variant have risen. Vanguard continues to expect that growth in the third quarter will be slightly stronger than in the second and that full-year growth could reach 5%. GDP remains 3% below its pre-pandemic level, a gap we foresee being erased in the fourth quarter of 2021.
- GDP rebounded in the **United Kingdom** in the second quarter compared with the first, up by 4.8%. The second-quarter gain followed a decline of 1.6% in the first quarter. Business survey data suggested a softening in activity at the start of the third quarter, particularly in the services sector, as rising virus numbers dented optimism. But a full economic reopening proceeded as scheduled on 19 July and mobility indicators revealed a subsequent uptick in activity. We continue to expect full-year GDP growth of around 7%, with activity reaching its pre-pandemic peak before year's end.
- Economic indicators in **China** weakened in July, hit by the Delta variant, flooding in central China and the lagged effects of recent policy tightening. Given that much of the effect of Covid-19-related lockdowns isn't reflected in the July numbers, the worst may be yet to come in August. As a result, Vanguard has downgraded its expectation for third-quarter GDP growth from 1% to 0.5%. We anticipate China's full-year economic growth at just below 8.5%, with risks tilted to the downside.
- Low Covid-19 vaccination levels have put any impulses toward accelerated growth in **emerging markets** on hold likely until late this year or early next year, when an anticipated ramp-up in vaccine production from three leading manufacturers is likely to bolster supply. Vanguard foresees full-year growth for emerging markets above 6%. Countries that have had the

Note: These points represent the house view of the Investment Strategy Group's (ISG's) global economics team and other experts as at 19 August 2021.

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most success in warding off Covid-19, notably in Asia, may be at greatest risk of having to initiate further restrictions on economic activity that could weigh on growth. In an ironic twist, a smaller share of their populations will have been protected through infection-acquired immunity, making further lockdowns a likely strategy in the face of the highly contagious Delta variant.



Monetary policy

- The **US Federal Open Market Committee** (FOMC) voted on 28 July to leave the target range for its federal funds rate unchanged at 0%–0.25% and its bond-buying programme unchanged. But Chairman Jerome Powell acknowledged that the two components of the Fed’s dual mandate – price stability and maximum sustainable employment – have been “in tension” lately, with inflation having risen higher than expected and further recovery still to come in the jobs market. Although the Fed sees inflation at recent levels as transitory, it sees risks as skewed to the upside. Vanguard believes the Fed will want to see further jobs gains in the months ahead before it starts paring the pace of its asset purchases – and we believe the Fed will indeed see those gains. Market watchers will be looking for clues as to when the Fed may reduce its pace of asset purchases when Mr. Powell speaks at the Federal Reserve Bank of Kansas City’s Jackson Hole Economic Symposium, scheduled for 26 to 28 August. The Fed’s next monetary policy decision is scheduled to be announced Wednesday, 22 September.
- The **European Central Bank** (ECB), delivering its first monetary policy statement since adopting its new inflation targeting regime, said on 22 July that it expected to keep interest rates “at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon.” The bank left its main deposit rate unchanged at negative 0.50%. It also said it would continue net purchases in its €1.85 trillion Pandemic Emergency Purchase Programme (PEPP) and maintain its monthly pace of €20 billion in purchases in its Asset Purchase Programme (APP). In our baseline scenario, we expect the ECB to communicate after its 9 September meeting that it will slow the pace of PEPP purchases in the fourth quarter of 2021 and that it will end purchases in the first half of 2022. We also foresee the APP at that point being expanded to smooth out the transition before eventually being phased out in the final quarter of 2023.
- The **Bank of England** (BOE) maintained its bank rate at 0.1% at its August Monetary Policy Committee (MPC) meeting but delivered a hawkish tone, leading Vanguard to bring forward its projection for rate liftoff. We now

expect the BOE to begin raising interest rates in the second half of 2022, compared with our previous projection of the first half of 2023. The hawkish tone is related to the bank’s revised inflation predictions, with inflation peaking at 4% by year’s end and its third-quarter 2022 inflation forecast upgraded to 3.3%. The MPC also voted to leave the target for the bank’s stock of asset purchases at £895 billion. Vanguard continues to foresee the bank purchasing bonds until around the end of the year. The bank confirmed that it would raise rates before it began to reduce its balance sheet. But it lowered the threshold interest rate at which the balance sheet run-off could start, from 1.5% to 0.5%, giving it more headroom to act forcefully in the event of future liquidity events.

- The resurgence of Covid-19 through the Delta variant alongside policymakers’ desire to balance near-term growth with medium-term financial stability suggests a forthcoming period of policy fine-tuning in **China**. Vanguard expects to see macroeconomic policy pivot toward a modestly easy stance – compared with tightening in the first half of the year.



Inflation

- The most recent Consumer Price Index (CPI) release in the **United States** was consistent with Vanguard’s view that prices would begin to moderate after running high in recent months. Still, we’re watching closely to determine whether recent higher inflation figures are likely to persist or be transitory. We believe that the core Personal Consumption Expenditures Index (PCE), the Federal Reserve’s preferred inflation measure in considering interest rate targets, will remain above the Fed’s 2% inflation target until the spring of 2022. Core PCE rose by 0.4% in June from a month earlier and was up by 3.5% compared with a year earlier, official data showed. CPI for July, meanwhile, increased by 0.5% on a seasonally adjusted basis compared with June, having risen 0.9% a month earlier, and was up by 5.4% compared with a year earlier.
- Headline inflation reached 2.2% in the **euro area** in July on an annual basis, up from 1.9% in June. With persistent shortages in industrial inputs and the potential for continued run-ups in energy prices, we foresee headline inflation peaking in a range of 2.5% to 3% over the second half of 2021. But we expect both headline and core inflation to fall back to around 1.5% by the end of 2022, as tax changes wash out of year-on-year calculations and input prices decelerate. We don’t expect as large or as persistent an inflation overshoot in the euro area as in the United States, as accumulated household savings are lower in Europe and inflation expectations are anchored well below 2%.

- Headline inflation fell to 2% in the **United Kingdom** in July compared with a year earlier, following a 2.5% year-on-year rise in June. Core inflation, which excludes volatile food and energy prices, declined to 1.8% in July compared with a year earlier, from 2.3% in June. Vanguard expects the July drop to be followed by substantial rises in the coming months. With the reversal of a value-added-tax cut in September and an increased consumer demand impulse upon full reopening of the economy, we foresee headline inflation reaching 3.5% year-over-year in the fourth quarter, and core inflation, which excludes volatile food and energy prices, reaching 3%. We expect both measures to ease in 2022 as temporary factors unwind, both ending the year around 2%.



Employment

- What does maximum sustainable employment in the **United States** mean to the Federal Reserve? The answer could be important if the other component of the Fed's dual mandate, ensuring price stability, has already reached a trigger point, as the Fed's vice chairman suggested in a recent speech. The US Bureau of Labor Statistics (BLS) reported that 943,000 non-farm jobs were created on a seasonally adjusted basis in July 2021 and the unemployment rate fell to 5.4%. Vanguard expects even stronger job gains in the next two months and for the unemployment rate to fall toward the mid-4% range by year-end.
- Unemployment in the **euro area** fell to 7.7% in June from a revised 8.0% in May, on a seasonally adjusted basis. In the **United Kingdom** it was estimated at 4.7% in the three months ended in June, down from 4.8% in the quarter ended in May. But in both cases, the official figures may not yet present a true picture of slack in the economy, given furlough schemes are still in place.



Asset class return outlooks

- Vanguard has updated its 10-year annualised outlooks for broad asset class returns through the most recent running of the Vanguard Capital Markets Model® (VCMM), based on data as of 30 June, 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.
- Our outlooks for both equity and fixed income returns are, for the most part, marginally lower compared with our outlooks based on our previous running of the VCMM, on 31 March, 2021. A rally in risk assets continued in the second quarter, sending valuations higher and making future gains in equities harder to come by. Developed market interest rates, meanwhile, came off first-quarter post-pandemic highs, sending current projections for fixed income returns lower.
- ISG updates these numbers quarterly. Projections based on the 30 September, 2021, running of the VCMM will be communicated through the November 2021 economic and market update.
- Our 10-year annualised nominal return projections are as follows. Please note that the figures are based on a 1-point range around the 50th percentile of the distribution of return outcomes for equities and a 0.5-point range around the 50th percentile for fixed income. Numbers in parentheses reflect median volatility.

	Median projected volatility (%)	Ten-year annualised nominal return projections
UK equities [†]	19.2	4.8–6.8%
Global equities ex-UK (unhedged) [†]	19.0	2.7–4.7%
UK aggregate bonds [†]	7.6	0.6–1.6%
Global bonds ex-UK (hedged) [†]	3.7	0.5–1.5%
Euro area equities*	24.3	2.8–4.8%
Global equities ex-euro area (unhedged)*	19.0	1.4–3.4%
Euro area aggregate bonds*	3.6	-0.5–0.5%
Global bonds ex-euro area*	3.8	-0.6–0.4%

Note: * return projections are calculated for euro investors. † return projections are calculated for British pound investors. Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results.

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 modeled asset class. Simulations are as of 30 June, 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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