Vanguard

SEPTEMBER 2022

Vanguard economic and market update

The points below represent the house view of the Vanguard Investment Strategy Group's (ISG's) global economics and markets team as of 14 September, 2022, on several current macroeconomic and market topics.

Key highlights:

- We expect a moderate recession to start in the euro area later this year.
- We've trimmed our expectations for US growth this year, with a recession still seen likely in 2023.
- European gas market has adapted surprisingly well to the cutoff in Russian supplies.
- New energy price cap may boost growth in UK, although to what extent remains unclear.

Economic growth

GDP growth in the **United States** in the second quarter was upwardly revised but was still in negative territory with an annualised rate of −0.6%, according to a second estimate released by the Bureau of Economic Analysis. It did little to change our assessment that the US would struggle to attain above-trend growth in the current and future quarters. Growth activity has stabilised through this quarter around the trend rate of 1.8%. We now expect full-year 2022 US economic growth in the 0.25%–0.50% range, with the upper end down from 0.75% last month. Recession looks unlikely this year given the strength of the labour market. Our expectations for recession are essentially the same, with a 25% chance of a recession in 2022 and a 65% chance in 2023. Declines in purchasing power continue to be a threat, and we continue to watch energy prices in particular. Persistent oil prices in the $130–$150 range would present significant cycle risks. Oil prices are currently hovering around $90.

We're also watching the yield curve for signs of recession. The spread between 10-year and 2-year Treasuries has been inverted—with the shorter-term yield higher than the longer-term yield—since early July; the spread was −21 basis points as at 12 September. Vanguard would need to see the inversion continue in the weeks ahead to view it as a recession signal. We believe that the 10-year/3-month Treasury spread is a more reliable recession indicator. As at 12 September, that spread was 20 basis points. At its 2022 peak, on 6 May, it was 227 basis points.

We are now expecting a moderate recession in the **euro area**, with negative GDP for the last quarter of 2022 and the first quarter of 2023—followed by a period of stagnation, then a recovery. While we still expect 2022 growth to be in the 2%–3% range, we have lowered our 2023 forecast to a range between −0.5% and 0.5%. Our Vanguard Leading Economic indicator points to continued weakness. Composite indices of purchasing managers have contracted for a second straight month in August. Consumer sentiment remains depressed. More important, Russia cut off the flow of natural gas through Nord Stream 1, which provides more than one-third of this commodity to Europe. We expect a 15% contraction in gas consumption because of this and the impact will be uneven among countries. Germany, Europe's biggest economy and dependent on Russian gas, will be most affected. However, the European gas market has adapted surprisingly well and we believe risks are no longer skewed to the downside. Countries have been successfully stockpiling gas and some fiscal policies are in play to counter the geopolitical challenge. And euro countries are coordinating to find alternative sources of gas. Euro area GDP grew by 0.6% on a seasonally adjusted basis in the second quarter compared with the first, according to a 17 August flash estimate by Eurostat.

With a new prime minister and a new monarch in a matter of days, the **United Kingdom** is in a period of transition. But it may be Prime Minister Liz Truss's plan to impose an energy price cap that will have the most impact on the nation's economy, inflation and

monetary policy. The cap would limit the energy bills of a typical household to no more than £2,500 per year for the next two years. The current existing cap is around £1,900 and was scheduled to go to more than £3,500 by October, then to more than £4,000 in 2023. Vanguard is still assessing the implications from Truss's announcement. Before this announcement, we believed that the UK was on track for a more protracted recession than the one projected for the euro area, with a UK recession lasting three quarters starting in the fourth quarter of 2022. We had downgraded our projected annual growth for 2023 to a range between –1% and 0%. But the new energy price cap may boost economic growth. For its implications for inflation and monetary policy, please refer to that content in the later sections of this paper. Meanwhile, estimated monthly GDP in July partly reversed the decline of the previous month. GDP rose 0.2% in July, following a fall of 0.6% in June. Monthly GDP is now 2.3% higher than the same period last year and it has reached pre-Covid levels from February 2020. An increase of 0.4% in services in July offset the continuing declines in production and construction.

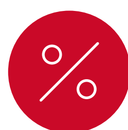
New energy price cap

Maximum £2,500 annual bill*

*For typical household over next two years.

As mentioned in last month's issue, we had downgraded **China**'s full-year GDP growth forecast to a range of 2.5%–3.5% (from our previous estimate of 3%–4%) based on data indicating a flagging economic recovery so far this quarter. Consumer spending was much lower than expected, indicating the adverse impact of zero-Covid policies, and falling property prices will continue to weigh on consumer confidence. Real estate makes up a substantial portion of the typical Chinese household's balance sheet, and 30% of local governments' revenues, harming consumer spending power and making local government stimulus less likely. Stimulus measures targeting the real estate sector, which seemed unlikely two months ago, have been announced by policymakers seeking to stem declining home prices to shore up developer finances and consumer confidence. While our expectations for a second-half recovery are below consensus, we believe growth will be uneven over the two quarters. We expect the third quarter will be below expectations, but the fourth quarter will be more robust thanks to increased stimulus and a greater chance of relaxed Covid policies following the conclusion of party conferences by early 4Q. It's unlikely that we will see anything like the V-shaped recoveries that China had in 2020 and 2021.

For **emerging markets**, we remain below consensus on full-year 2022 economic growth with an estimate of about 3%. (The IMF, for example, projects growth of 3.6%.) The primary headwinds faced by emerging economies are widespread central bank tightening and the simultaneous slowing of growth in the United States, the euro area and China. Emerging Europe is still most at risk of recession. The region's energy supply issues and accompanying high prices have necessitated interest rate increases that could dampen economic activity. Further out, markets are pricing interest rate cuts to counter slowed economies—most aggressively in emerging Europe but in Latin America as well. There are signs that inflation has peaked across emerging markets with core measures falling for two consecutive months across regional averages. The peak is most notable in Latin America, a probable cause for the rising growth expectations for the second half of this year in Latin America, amid broadly dimming growth outlooks for other emerging market regions.



Monetary policy

We are more hawkish than consensus when it comes to US monetary policy. We expect the **US Federal Reserve** to continue ratcheting up rates until it reaches a range of 3.25% to 3.75% by the end of the year, and 4.25% by the second quarter of 2023. Rate cuts in 2023 are unlikely, given that wage-inflation concerns and energy prices are the risk factors that will keep the Fed vigilant. In their last meeting on 27 July, the Fed raised the target for its federal funds rate by 75 basis points to a range of 2.25% to 2.5% and said such an "unusually large" rate increase may be appropriate again in September to bring inflation under control. The Fed said it would also continue to reduce its balance sheet as announced in May.

The **Bank of England** (BoE) meeting was postponed by one week to 22 September due to the mourning period after Queen Elizabeth II passed away. We expect the BoE will raise rates by 75 basis points at this meeting, part of a series of hikes to reach a terminal rate of 4.5% by the first quarter of 2023, followed by a recession-driven pause in rate adjustments. Inflation pressures may ease over the short run due to the energy price cap but reassert themselves over the medium term.

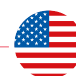
The **European Central Bank** (ECB) announced a rate hike of 75 basis points on 8 September. It was the largest rate hike in the nearly 25-year history of the euro, and it follows a higher-than-expected 50-basis-point increase in July that ended eight years of negative interest rates for the deposit facility rate (one of three key rates). Our base case is another 75 to 100 basis points of additional rate hikes in what remains of 2022, with the deposit rate hitting 1.5% to 1.75% at year-end. However, we now expect a terminal rate of 2.5% by early 2023 (we previously estimated 2.0%) and that rate will hold for all of 2023, well above what we would consider to be the neutral European policy rate of about 1.5%. (The neutral rate is the theoretical interest rate at which monetary policy neither stimulates nor restricts an economy.) Inflationary pressures are just too high for them to cut rates before 2024.

While other central banks were raising rates to combat inflation, the **People's Bank of China** (PBOC) kept going in the other direction to stimulate the economy. It cut the one-year loan prime rate (LPR) by 5 basis points to a record low of 3.65% and the five-year LPR (which influences the pricing of home mortgages) by 15 basis points to 4.3%. The cuts came as a surprise to markets a week after the PBOC announced it was trimming the rate it charges banks for one-year loans by 10 basis points to 2.75%. While these monetary policy changes are more substantial than the fiscal stimulus on the books, it remains to be seen how much either can make an impact when consumer sentiment is so low. We expect that China's zero-Covid policy will soften after the Communist Party's conferences in the fourth quarter.

Since our last monthly update, central banks at more than **15 emerging markets** have raised rates, with the highest rate hikes being 100-basis-point increases coming from Chile and Hungary. It continues an ongoing trend of aggressive moves to combat inflation from emerging markets, which have been ahead of the curve during the Covid recovery. We believe that inflation will generally fall across most emerging markets, including in Asia, so central banks are unlikely to follow through with hikes that some investors are anticipating.

Inflation

The consumer price index (CPI) in the **United States** resumed its upward climb, rising 0.1% in August on a seasonally adjusted basis, after staying flat in July. Over 12 months, headline CPI increased 8.3% (not seasonally adjusted), slightly lower than the 8.5% recorded in July. Excluding volatile food and energy prices, core CPI came higher than expected, rising 0.6% in August and 6.3% over 12 months. Gasoline prices fell 10.6%, more than offsetting increases in electricity and natural gas prices. Energy prices overall declined 5% for the month but are still 23.8% higher than a year ago. Food prices rose 0.8% in August and up 11.4% from the same period last year, making this the largest 12-month increase in food since May 1979. Core personal consumption expenditures (PCE), the Federal Reserve's preferred inflation indicator in considering monetary policy, rose 0.1% in July, a modest increase compared with the previous five months. (Please note that PCE data lags CPI because of the release schedule.) With food and energy prices, headline PCE fell 0.1% in June because of a 4.8% drop in energy prices. Year-over-year core PCE rose 4.6%, a modest decrease from the 4.8% recorded in the previous month. We still expect core PCE to ease toward 4% by year-end.



Core PCE to ease toward

4% by end-2022

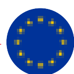
The **euro area**'s year-over-year headline inflation reached 9.1% in August, marking another all-time high, up from 8.9% in July, according to an August 31 flash estimate from the statistical office of the European Union. The acceleration was driven by food prices, which increased 10.6% from 9.8% in the previous month. Energy inflation slightly edged down to 38.3% but remains elevated. Core inflation also inched up to a fresh record of 4.3% in August, indicating price pressures continue to become more broad-based. We continue to expect inflation to peak at about 10% in the fourth quarter and the average to be 8% to 8.5% for 2022. However, we raised our inflation expectations for 2023 to a range of 5.0% to 5.5% because we now expect prices to fall less sharply than we had previously estimated. Nevertheless, we also believe inflation rates will ultimately fall towards the ECB's target of 2% at the end of 2023.

Headline inflation in the **United Kingdom** eased slightly to 9.9% in August, from 10.1% in July, the Office for National Statistics reported on 14 September. The easing was driven by fuel prices, which fell 8.6% month-over-month. This fall was partially offset by gains elsewhere. We expect inflation to decline in 2023 but remain elevated in the 6.5%-7% range.

Our full-year 2022 inflation forecast for **China** is 2.2%, but we expect the year-over-year rate to surpass 3% in

the coming months because of higher pork prices. This would exceed the policymakers' goal of 3%. China has been a relative anomaly among economies, unscathed by spiking inflation. The trend will likely continue with inflationary pressure muted given two factors: Chinese economic activity that is slightly depressed and lower energy prices because China did not impose sanctions on Russian energy imports.

Core inflation, which excludes food and energy, ebbed in all major **emerging market** regions in August, continuing a trend from July. The synchronous slowdown suggests a global factor at play—likely the slowing growth in developed economies. In addition to cooler core inflation, falling commodity prices will alleviate headline inflation pressures in a number of emerging market economies where food and energy are primary drivers of inflation, such as in Thailand, Poland, and the Czech Republic.



Unemployment rate (July)

6.6%

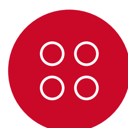
Employment

The labour market in the **United States** exceeded expectations in August, adding 315,000 jobs though the gains were modest compared with the more than half million new jobs created in July. The unemployment rate edged 0.2 percentage point higher, to 3.7%, matching the pre-pandemic levels of February 2020. The exceptionally strong labour market recovery is on track for an unemployment rate a bit above 3% by year-end. Wage pressures are moderating but year-over-year wage growth remains on a 5% pace for the remainder of 2022. We expect average monthly job growth of 250,000 through the remainder of 2022.

The jobs market continues to tighten in the **euro area**. The unemployment rate fell to a record-low 6.6% in July on a seasonally adjusted basis, down from 6.7% in June and 7.7% in July 2021. Wage growth jumped to 3.3% in the first quarter on a revised quarter-over-quarter basis. Wage growth was above 6% in Germany for the second quarter.

The unemployment rate in the **United Kingdom** fell to 3.6% in the three months through July, a multi-decade low. UK employment climbed by 40,000 but inactivity rose 154,000, driven by a surge in the number of students and the long-term sick. Regular wage growth rose to 5.2% for the three months year-over-year, up from 4.7% in June. Meanwhile vacancies declined in August, marking this the third month of decline, but it remained well above pre-pandemic norms of 1.26 million. Vanguard will continue to monitor the push-pull of wage growth and inflation in assessing the economy's health and the Bank of England's likely rate path.

Asset class return outlooks



Our economic and market update typically provides quarterly updates to our outlooks for 10-year annualised equity and fixed income returns, informed by full runnings of the Vanguard Capital Markets Model® (VCMM). Though full VCMM projections generally are based on calendar quarter-end data, we provide partial sets of projections based on data as of other month-ends when market volatility is significant. The figures below remain unchanged from last month, as conditions have not changed significantly enough in the past few months to markedly change our 10-year return projections.

Following are our 10-year annualised nominal return projections, based on data as of 30 June, 2022. The figures centre on the 50th percentiles of the distributions of our projected returns. We present 2-percentage point ranges around the central tendencies of equity return distributions and 1-percentage point ranges around the central tendencies of fixed income return distributions. Numbers in parentheses reflect median volatility estimates.

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.

	Median projected volatility (%)	10 year annualised nominal return projections
UK equities £	19.1	4.2%-6.2%
Global equities ex-UK (unhedged) £	19.2	4.3%-6.3%
UK aggregate bonds £	8.6	2.4%-3.4%
Global bonds ex-UK (hedged) £	4.1	2.3%-3.3%
Euro area equities €	25.4	4.3%-6.3%
Global equities ex-euro area (unhedged) €	19.4	3.1%-5.1%
Euro area aggregate bonds €	3.9	1.3%-2.3%
Global bonds ex-euro area €	4.3	1.3%-2.3%

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

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Past performance is not a reliable indicator of future results.

IMPORTANT: The projections and 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. VCMM results will 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 US 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.

Important information

For professional investors only (as defined under the MiFID II Directive) investing for their own account (including management companies (fund of funds) and professional clients investing on behalf of their discretionary clients). In Switzerland for professional investors only. Not to be distributed to the public.

The information contained in this article is not to be regarded as an offer to buy or sell or the solicitation of any offer to buy or sell securities in any jurisdiction where such an offer or solicitation is against the law, or to anyone to whom it is unlawful to make such an offer or solicitation, or if the person making the offer or solicitation is not qualified to do so. The information in this article does not constitute legal, tax, or investment advice. You must not, therefore, rely on the content of this article when making any investment decisions.

Issued in EEA by Vanguard Group (Ireland) Limited which is regulated in Ireland by the Central Bank of Ireland.

Issued in Switzerland by Vanguard Investments Switzerland GmbH.

Issued by Vanguard Asset Management, Limited which is authorised and regulated in the UK by the Financial Conduct Authority.

© 2022 Vanguard Group (Ireland) Limited. All rights reserved.

© 2022 Vanguard Investments Switzerland GmbH. All rights reserved.

© 2022 Vanguard Asset Management, Limited. All rights reserved. 1237/0922

Connect with Vanguard®
global.vanguard.com

Vanguard®