Vanguard

Vanguard economic and market outlook for 2024: Global summary

The global outlook summary highlights the top-level findings of Vanguard's full economic and market outlook, to be distributed in mid-December.

Higher interest rates are here to stay. Even after policy rates recede from their cyclical peaks, in the decade ahead rates will settle at a higher level than we've grown accustomed to since the 2008 global financial crisis (GFC). This development ushers in a return to sound money, and the implications for the global economy and financial markets will be profound. Borrowing and savings behaviour will reset, capital will be allocated more judiciously and asset class return expectations will be recalibrated. Vanguard believes that a higher interest rate environment will serve investors well in achieving their long-term financial goals, but the transition may be bumpy.

Monetary policy will bare its teeth in 2024

The global economy has proven more resilient than we expected in 2023. This is partly because monetary policy has not been as restrictive as initially thought. Fundamental changes to the global economy have pushed up the neutral rate of interest – the rate at which policy is neither expansionary nor contractionary. Various other factors have blunted the normal channels of monetary policy transmission, including the US fiscal impulse from debt-financed pandemic support and industrial policies, improved household and corporate balance sheets and tight labour markets that have resulted in real wage growth. In the US, our analysis suggests that these offsets have almost entirely counteracted the impact of higher policy interest rates. Outside the US, this dynamic is less pronounced. Europe's predominantly bank-based economy is already flirting with recession, and China's rebound from the end of Covid-19-related shutdowns has been weaker than expected.

The US exceptionalism is set to fade in 2024. We expect monetary policy to become increasingly restrictive in real terms as inflation falls and offsetting forces wane. The economy will experience a mild downturn as a result. This is necessary to finish the job of returning inflation to target. However, there are risks to this view. A "soft landing," in which inflation returns to target without recession, remains possible, as does a recession that is further delayed. In Europe, we expect anaemic growth as restrictive monetary and fiscal policy lingers, while in China, we expect additional policy stimulus to sustain economic recovery amid increasing external and structural headwinds.

Zero rates are yesterday's news

Barring an immediate 1990s-style productivity boom, a recession is likely a necessary condition to bring down the rate of inflation, through weakening demand for labour and slower wage growth. As central banks feel more confident in inflation's path towards targets, we expect they will start to cut policy rates in the second half of 2024.

That said, we expect policy rates to settle at a higher level compared with after the GFC and during the Covid-19 pandemic. Vanguard research has found that the equilibrium level of the real interest rate, also known as r-star or r*, has increased, driven primarily by demographics, long-term productivity growth and higher structural fiscal deficits. This higher interest rate environment will last not months, but years. It is a structural shift that will endure beyond the next business cycle and, in our view, is the single most important financial development since the GFC.

Vanguard's 2024 economic forecasts

	GDP growth			Unemployment rate			Core inflation		Monetary policy		
	2024			2024			2024				
Country/ region	**Vanguard**	**Consensus**	**Trend**	**Vanguard**	**Consensus**	**NAIRU**	**Vanguard**	**Consensus**	**Year-end 2023**	**Year-end 2024**	**Neutral rate**
US	0.5%	0.8%	1.8%	4.8%	4.4%	3.5%–4%	2.5%	2.5%	5.5%–5.75%	4%–4.5%	3%–3.5%
Euro area	0.5%–1%	0.8%	1.2%	7%–7.5%	6.8%	6.5%–7%	2.1%	2.5%	4%	3.25%	2%–2.5%
UK	0.5%–1%	0.4%	1%	4.5%–5%	4.8%	3.5%–4%	2.8%	N/A	5.25%	4.25%	3%–3.5%
China	4.5%–5%	4.5%	4.1%	4.8%	5%	5%	1%–1.5%	N/A	2.3%–2.4%	2.2%	4.5%–5%

Notes: Forecasts are as of 14 November 2023. For the US, GDP growth is defined as the year-over-year change in fourth-quarter GDP. For all other countries/regions, GDP growth is defined as the annual change in GDP in the forecast year compared with the previous year. Unemployment forecasts are the average for the fourth quarter of 2024. NAIRU is the non-accelerating inflation rate of unemployment, a measure of labour market equilibrium. Core inflation excludes volatile food and energy prices. For the US, euro area and UK, core inflation is defined as the year-over-year change in the fourth quarter compared with the previous year. For China, core inflation is defined as the average annual change compared with the previous year. For the US, core inflation is based on the core Personal Consumption Expenditures Index. For all other countries/regions, core inflation is based on the core Consumer Price Index. The neutral rate is the equilibrium policy rate at which no easing or tightening pressures are being placed upon an economy or its financial markets.

Source: Vanguard.

A return to sound money

For households and businesses, higher interest rates will limit borrowing, increase the cost of capital and encourage saving. For governments, higher rates will force a reassessment of fiscal outlooks sooner rather than later. The vicious circle of rising deficits and higher interest rates will accelerate concerns about fiscal sustainability. Vanguard's research suggests the window for governments to act on this is closing fast – it is an issue that must be tackled by this generation, not the next.

For well-diversified investors, the permanence of higher real interest rates is a welcome development. It provides a solid foundation for long-term risk-adjusted returns. However, as the transition to higher rates is not yet complete, near-term financial market volatility is likely to remain elevated.

Bonds are back

Global bond markets have repriced significantly over the last two years because of the transition to the new era of higher rates. In our view, bond valuations are now close to fair, with higher long-term rates more aligned with secularly higher neutral rates. Meanwhile, term premia have increased as well, driven by elevated inflation and fiscal and monetary outlook uncertainty.

Despite the potential for near-term volatility, we believe this rise in interest rates is the single best economic and financial development in 20 years for long-term investors. Our bond return expectations have increased substantially. We now expect euro area bonds to return a nominal annualised 2.9%–3.9% over the next decade, compared with the -0.5%–0.5% annualised returns we expected before the rate-hiking cycle began. Similarly, for hedged global ex-euro area bonds, we expect annualised returns of 2.8%–3.8% over the next decade, compared with a forecast of -0.5%–0.5% when policy rates were low or, in some cases, negative.

If reinvested, the income component of bond returns at this level of rates will eventually more than offset the capital losses experienced over the last two years. By the end of the decade, bond portfolio values are expected to be higher than if rates had not increased in the first place.

Similarly, the case for the 60/40 portfolio[1] is stronger than in recent memory. Long-term investors in balanced portfolios have seen a dramatic rise in the probability of achieving a 10-year annualised return of at least 5%, from close to a 0% likelihood in 2021 to 44% today.

Moving up the risk spectrum, credit valuations appear fair in the investment-grade space but relatively rich in high-yield. What's more, the growing likelihood of recession and declining profit margins skew the risks towards wider spreads.

Higher rates leave equities overvalued

A higher-rate environment depresses asset price valuations across global markets while squeezing profit margins as corporations find it more expensive to issue and refinance debt.

Valuations are most stretched in the US. As a result, we have downgraded our US equity return expectations for euro area investors to an annualised 2.4%–4.4% over the next 10 years from 3.1%–5.1% heading into 2023. Within the US market, value stocks are more attractive than they have been since late 2021, and small-capitalisation stocks also appear attractive for the long term.

US equities have continued to outperform their international peers. The key drivers of this performance gap over the last two years have been valuation expansion and US dollar strength beyond our fair-value estimates, both of which are likely to reverse. Indeed, our Vanguard Capital Markets Model® (VCMM) projections suggest an increasing likelihood of greater opportunities outside the US. We project 10-year annualised returns of 5.0%–7.0% for non-US developed markets, 4.3%–6.3% for euro-area equities and 4.6%–6.6% for emerging markets, all from the perspective of a euro area investor.

The global equity risk premium that emerges from current stock and bond market valuations is the lowest since the 1999–2009 "lost decade." The spread between global equity and global bond returns is expected to be 0 to 2 percentage points annualised over the next 10 years. In contrast to the last decade, we expect return outcomes for diversified investors to be more balanced. For those with an appropriate risk tolerance, a more defensive risk posture may be appropriate given higher expected fixed income returns and an equity market that is yet to fully reflect the implications of the return to sound money.

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 modelled asset class. Simulations as of 30 September 2023. Results from the model may vary with each use and over time. For more information, please see the Notes section.

Notes:

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 importantly, 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 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.

1 In our analysis, the 60% equity/40% fixed income portfolio is represented by the following indices: Equity: MSCI AC World Total Return Index. Fixed income: Bloomberg Global Aggregate Bond Index Euro Hedged.

Those asset classes include US and international equity markets, several maturities of the US Treasury and corporate fixed income markets, international fixed income markets, US money markets, commodities and certain alternative investment strategies. The theoretical and empirical foundation for the VCMM 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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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.

Any projections should be regarded as hypothetical in nature and do not reflect or guarantee future results.

Funds investing in fixed interest securities carry the risk of default on repayment and erosion of the capital value of your investment and the level of income may fluctuate. Movements in interest rates are likely to affect the capital value of fixed interest securities. Corporate bonds may provide higher yields but as such may carry greater credit risk increasing the risk of default on repayment and erosion of the capital value of your investment. The level of income may fluctuate and movements in interest rates are likely to affect the capital value of bonds.

Important information

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