Vanguard

MARCH 2020

Market perspectives

Vanguard's monthly economic and market update

KEY TAKEAWAYS:

- Growth will take a hit in the aftermath of the coronavirus outbreak.
- Trade uncertainty continues—especially with China and the E.U.
- Headwinds will make it difficult for the Fed, and Vanguard expects two rate cuts in 2020.
- Low inflation remains the risk for central banks.
- Research shows that a president's political party has little effect on asset returns.

Coronavirus affects China's GDP

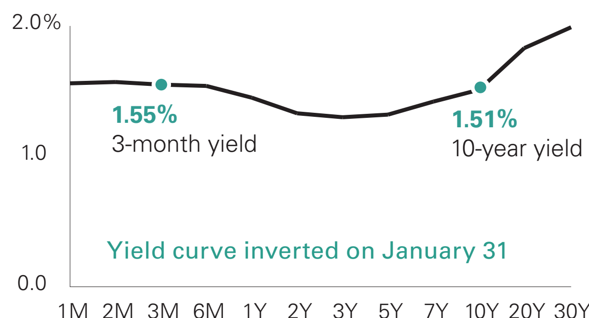
Growth slows below trend

- Our leading indicators have improved, but they nonetheless suggest only a modest rebound in global growth this year. *We believe that markets are pricing in an overly optimistic economic outlook amid uncertainty that remains elevated.*
- We've lowered our 2020 growth outlook for **China** from a range of 5.5%–6.0% to a range of 5.0%–5.5% given the effects of the coronavirus. The onset of the coronavirus adds greater uncertainty to China's economic path and the potential for spillover across the globe.
- We continue to see GDP growth in the **United States** slowing below trend, and below market consensus, in 2020, to a range of 0.75%–1.75%, despite a recent uptick in leading indicators. Forward-looking indicators appear to show that business investment bottomed out in the fourth quarter.
- We also continue to see growth in the **euro area** below trend in 2020. Manufacturing remains weak. But supply chains, the services sector, and the labor market remain resilient for now.

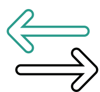
Yield curve inverts again

What does a newly reinverted yield curve mean for the economy and investors?

- Economists tend to focus on the relationship between 3-month and 10-year U.S. Treasuries, the curve for which inverted briefly in late January and early February. (The yield curve's inversion historically has preceded recession by about 18 months.)
- Although the yield curve's recent inversion may be explained partially by a flight to safety amid coronavirus concerns, the signs we see suggest that the probability of recession remains elevated.



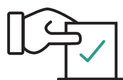
Source: U.S. Department of the Treasury daily yield curve rates.



Coronavirus dampens trade

Trade uncertainty remains a factor

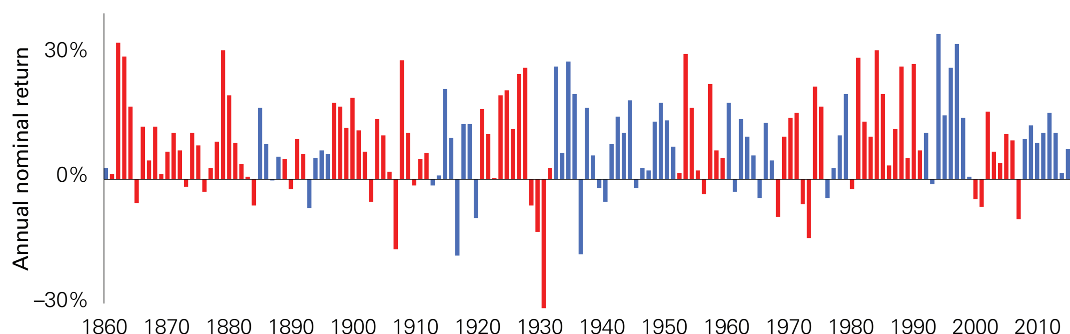
- While some trade policy uncertainty appears to have dissipated in the early weeks of 2020, a new uncertainty not related to policymaking—the coronavirus—surely is dampening **China's** trade. We'll need to wait a little longer to learn the extent of the slowdown.
- Vanguard is watching whether **China** will be able to make purchases of U.S. goods to the level specified in its "Phase 1" trade deal with the **United States**. About two-thirds of the incremental purchases of U.S. goods that China agreed to was expected to occur this year. Reduced Chinese import volumes owing to the virus would make it less likely that China will be able to meet the Phase 1 deal's targets.
- A dispute between the **United States** and the **European Union** remains an important risk. Jockeying at the World Economic Forum in Davos over potential E.U. digital and carbon-offset taxes highlighted that the threat of retaliatory auto tariffs also remains possible.
- The **United States-Mexico-Canada Agreement** (USMCA) still awaits Canada's ratification. Vanguard expects Canada's ratification in the coming weeks.



Election and asset returns

Investors benefit from ignoring political noise

Since 1860, the return of a 60% stock/40% bond portfolio has averaged 8.2% during the terms of Republican presidents and 8.4% for Democratic presidents, far from being a statistical difference.



Source: Vanguard calculations based on data from Global Financial Data through December 31, 2018.

Modest easing on policy

Expect one or two rate cuts in 2020

- Vanguard continues to anticipate a modest easing of monetary policy by the Federal Reserve. The Fed left the target for its federal funds rate unchanged in January at 1.50%–1.75%. Vanguard's interest-rate outlook for 2020 continues to differ from that of the Fed.
- Given our view that U.S. economic growth will be weaker than consensus, that job creation will tail off, and that inflation will remain below the Fed's 2% target, we continue to expect one or two rate cuts in 2020.
- The European Central Bank (ECB) left the interest rate on its deposit facility unchanged in January, at –0.50%, and said it expects to keep its key rates "at their present or lower levels" until inflation approaches its 2% annual target.

Low unemployment continues

More people enter the labor force

- The **United States** added 225,000 jobs in January, the Bureau of Labor Statistics (BLS) reported, much higher than the consensus expectation of 162,000.
- Participation for prime-age workers has been trending higher, an indication, Vanguard believes, that ample job opportunities are pulling people into the labor force despite lackluster wage growth.

Brexit: The U.K. is out but the future is unclear

Negotiating the next phase

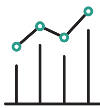
The **United Kingdom's** withdrawal from the **European Union** has been concluded, albeit with a transition period in place that leaves the legal and regulatory terms of the U.K.-E.U. relationship unchanged for the remainder of 2020.

- Official negotiations won't formally start until early March, when the U.K. and E.U. begin to discuss general, economic (including trade), and security (including foreign policy and defense) arrangements for their future relationship.

Low inflation remains the risk

Outlook for global inflation remains muted

- Slowing GDP and wage growth limit upward pressure and make it difficult for developed market central banks to reach their inflation targets. The sensitivity of core inflation to labor markets is likely weaker than in past cycles, owing to increasing labor market competition from low-wage offshore workers and through the substitution of technology for labor.
- In the **United States**, Vanguard's view is that core inflation is likely to rise yet remain below the Federal Reserve's 2% target.
- In the **euro area**, medium-term inflation expectations have stabilized since the ECB's easing package in September, but remain low around 1.3%. Vanguard expects inflation to remain well below the ECB's 2% target the rest of the year.
- In **emerging markets,** we continue to see inflation creeping up, albeit within most central bank target ranges.



The most attractive equity returns may be outside the U.S.

Asset-class return outlooks

Our 10-year annualized nominal return projections, as of September 30, 2019:

Equities	
U.S. equities	3.5%–5.5%
U.S. growth	2.5%–4.5%
U.S. value	6.0%–8.0%
U.S. large-cap	3.5%–5.5%
U.S. small-cap	4.5%–6.5%
U.S. real estate investment trusts	2.5%–4.5%
Global equities ex-U.S. (unhedged)	6.5%–8.5%

Fixed income	
U.S. bonds	2.0%–3.0%
U.S. Treasury bonds	1.5%–2.5%
U.S. credit bonds	2.5%–3.5%
U.S. high-yield corporate bonds	3.0%–4.0%
U.S. Treasury inflation-protected securities	1.0%–2.0%
U.S. cash	1.5%–2.5%
Global bonds ex-U.S. (hedged)	1.5%–2.5%

These probabilistic return assumptions depend on current market conditions and, as such, may change over time.

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. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of September 30, 2019.

Results from the model may vary with each use and over time. For more information, please read the following page.

Source: Vanguard Investment Strategy Group.

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All investing is subject to risk, including possible loss of principal.

Investments in bonds are subject to interest rate, credit, and inflation risk.

Investments in stocks or bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. These risks are especially high in emerging markets.

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 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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