Vanguard

Vanguard economic and market outlook: Midyear 2022 update

This update highlights some of the major developments and changes since we released our 2022 economic and market outlook in December 2021.

Inflation, policy elevate the risk of recession

A lot has changed since Vanguard published its economic and market outlook for 2022, *Striking a Better Balance*. At the start of the year, we expected global economies to continue to recover from the effects of the COVID-19 pandemic but at a more modest pace than in 2021. While that holds true, the pace of change in macroeconomic fundamentals such as inflation, growth, and monetary policy has failed to live up to expectations.

Labor and supply-chain constraints were already fueling inflation before the year began, but Russia's invasion of Ukraine and China's zero-COVID policy exacerbated the situation. Central banks have been forced to play catchup in the fight against inflation, ratcheting up interest rates more rapidly and possibly higher than previously expected. But those actions risk cooling economies to the point that they enter recession.

"Global economic growth will likely stay positive this year, but some economies are flirting with recession, if not this year, then in 2023," said Andrew Patterson, Vanguard senior international economist.

Compared with the start of the year, Vanguard has downgraded its 2022 GDP growth forecasts for all the major regions, increased its inflation forecasts, and become more hawkish about monetary policy.

United States

In the United States, inflation has reached 40-year highs, eroding consumers' purchasing power and driving the Federal Reserve to aggressively raise interest rates. We expect the equivalent of 12 to 14 rate hikes of 25 basis points for the full year, with the target federal funds rate landing in the 3.25%–3.75% range by year-end. We expect a terminal rate of at least 4% in 2023—higher than what we consider to be the neutral rate (2.5%) and above what's currently being priced into the market. (The neutral rate is the theoretical rate at which monetary policy neither stimulates nor restricts an economy.)

We have downgraded expected U.S. GDP growth from about 3.5% at the start of the year to about 1.5%. The factors that led to our downgrade will likely continue through 2022—namely, tightening financial conditions, wages not keeping up with inflation, and lack of demand for U.S. exports. Labor market trends are likely to keep downward pressure on the unemployment rate through year-end, though increases in 2023 are likely as the impacts of Fed policy and slowing demand take hold. We assess the probability of recession at about 25% over the next 12 months and 65% over 24 months. We believe that a period of high inflation and stagnating growth is more likely than an economic "soft landing" of growth and unemployment rates around or above longer-term equilibrium levels (about 2% for growth and 4% for unemployment).

Euro area

In the euro area, headline inflation driven by high energy prices may spike to above 10% in the third quarter. Inflation has become widespread, spurring the European Central Bank into what it expects will be a "sustained path" of interest rate increases. In September, rates will likely be out of negative territory for the first time in a decade. We forecast economic growth to be about 2% to 3% for the full year. However, Europe's dependence on Russian natural gas and the challenges of managing monetary policy for 19 countries put the euro area at a higher risk of recession than the United States in the next 12 months. A complete cutoff from Russian gas would likely lead to rationing and recession. We assess the probability of recession around 50% over 12 months and 60% over 24 months.

United Kingdom

In the United Kingdom, energy prices will likely drive the headline inflation rate to roughly 10% late in the year. We expect the Bank of England to raise the bank rate by an additional 1.25 percentage points over the next 12 months to reach our estimate of a 2.5% neutral rate. The bank has signaled that it's prepared to enact larger than 25-basis-point rate hikes, depending on the economic and inflation outlook.

Even with rising inflation and a slowing economy, the labor market will likely stay strong, given record job vacancies and unemployment near a 50-year low. But a drop in real wages, combined with diminished consumer and business confidence and tightening financial conditions, could push the United Kingdom into recession. Vanguard sees the probability of recession at about 50% over the next 12 months and 60% over 24 months. For 2022, we've downgraded our 5.5% forecast at the start of the year to 3.5%–4%. Further out, the pending leadership change in the U.K. may bring some policy uncertainty.

China

China will fall far short of policymakers' growth target of about 5.5%, given that it's a challenge to achieve all three of their goals: the growth target, financial stability, and a zero-COVID policy. (The latter affects not just China's economy, but the global economy as well.)

We believe the actual 2022 GDP growth rate will be just above 3%, far below China's pace for many years. Given China's zero-COVID policy, additional outbreaks resulting in renewed lockdowns could further detract from growth. That said, recession is unlikely, with probability at 30% over 12 months and 35% over 24 months.

Emerging markets

We recently downgraded our forecast for full-year 2022 growth in emerging markets, from about 5.5% at the start of the year to about 3%. Emerging markets continue to face headwinds from slowing growth in the United States, the euro area, and China, as well as from developed markets' central bank tightening and from domestic and global inflation. Although higher commodities prices do benefit some emerging economies, they're a negative in the aggregate.

Expected 10-year asset class returns have risen

Stock and bond markets have been hit hard so far in 2022. But there is an upside to down markets: Because of lower current equity valuations and higher interest rates, our model suggests higher expected long-term returns than our forecasts as of year-end.

For U.S.-based investors, our latest 10-year annualized return forecasts are in the 3.4% to 5.4% range for U.S. stocks, 6.1% to 8.1% for international stocks, 3% to 4% for U.S. bonds, and 2.9% to 3.9% for international bonds (hedged in U.S. dollars). The figures are based on a 1-point range around the 50th percentile of the distribution of VCMM return outcomes for equities and a 0.5-point range around the 50th percentile for bonds.

IMPORTANT: The projections and other information generated by the 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 May 31, 2022. Results from the model may vary with each use and over time.
For more information, please see the last page.

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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.

All investing is subject to risk, including the possible loss of the money you invest. Diversification does not ensure a profit or protect against a loss in a declining market. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

Investments in stocks and 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.

Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

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