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# Vanguard economic and market outlook for 2020: The new age of uncertainty

## Global outlook summary

### Global economy: Trade tensions and broader uncertainty drag on demand and supply

The continued slowdown in global growth foreseen a year ago has been accentuated during 2019 by a deterioration in the global industrial cycle. A broad escalation of policy uncertainty, especially tensions between the U.S. and China, has largely driven this downturn through postponed investments and declines in production.

In the year ahead, we don't foresee a significant reversal of the trade tensions that have occurred so far. And with continued geopolitical uncertainty and unpredictable policymaking becoming the new normal, we expect that these influences will weigh negatively on demand in 2020 and on supply in the long run. A continuing contraction of world trade relative to GDP and a persistent state of high uncertainty both tend to undermine potential output. This happens by restricting investment and hampering the propagation of technologies and ideas that stimulate growth in productivity. As such, we expect growth to remain subdued for much of the next year.

We see U.S. growth falling below trend to around 1% in 2020, with the U.S. likely to avoid a technical recession, typically described as two successive quarters of economic contraction. China, too, has seen its growth fall short of its 6% target rate this year and will likely slow to a below-trend pace of 5.8% in 2020. The euro area economy has continued to slow because of the importance of industrial trade to its economy and some drag from Brexit-related uncertainty.

Growth in the euro area is likely to stay weak at around 1%.

At home, Australia will likely stabilise at a sub-trend growth rate of around 2.1%, with tailwinds from more accommodative monetary and fiscal policy battling against the persistent headwinds from global uncertainty and lacklustre domestic household income.

Emerging markets have turned down more sharply in Asia than in Latin America and parts of Europe as world trade

slows. This divergence is likely to persist in 2020, as emerging markets in Asia continue to decelerate while growth in emerging markets in Latin America and Europe modestly strengthens relative to 2019.

### Global inflation: Full (symmetric) credibility remains elusive for central banks

Recent years have been characterised by a continuing failure of major central banks to achieve their inflation targets. This can partly be explained by a combination of persistent structural factors—including technology advancement and globalisation—pushing down some prices, and by a seeming failure of product and labour markets to respond to falling unemployment and rising capacity utilisation.

As these secular forces endure and output gaps widen in the current downturn, inflation will likely remain soft. We expect inflation to barely reach 2% in the U.S., with the Federal Reserve's core inflation gauge staying below its 2% policy target. Similarly, inflation will likely undershoot central banks' targets in the euro area, Japan and Australia.

Policy credibility is a critical determinant of inflation. For years the inflation expectations held by consumers and financial markets have consistently fallen short of most policy targets, implying increasing doubts about the effectiveness of monetary policy for a variety of reasons, some technical, others political.

These low inflation expectations support our outlook for subdued inflation trends.

### Monetary policy: The pivot to looser policy continues

In 2019, global central banks turned on respective dimes, cents, and sixpences, reversing from actual and expected policy tightening to additional policy stimulus in the face of the deteriorating growth outlook and consistent inflation shortfalls.

With the Fed having cut rates by 75 basis points so far in 2019, we expect it to further reduce the federal funds rate by 25 to 50 basis points before the end of 2020. The European Central Bank (ECB) has cut its policy rate further

into negative territory, by 10 basis points, to -0.5%. In 2020 we expect the ECB to leave policy broadly unchanged.

Risks are skewed toward further easing in the form of additional rate cuts and potentially an expansion of the ECB's quantitative-easing program.

Despite the doubts relating to the effectiveness of further monetary policy stimulus, we do not expect that fiscal policy measures will be forthcoming at sufficient scale to materially boost activity. For example, China has already halted its active encouragement of deleveraging and will probably step up both monetary and fiscal stimulus amid growing headwinds. These efforts would be calibrated to engineer a soft landing rather than a sharp rebound in growth, given policymakers' financial stability concerns.

Increasing downside risks to growth and subdued inflation may prompt the Bank of Japan to fine-tune its policy framework, but any action will likely be modest, with offsetting measures to cushion the negative impact on financial institutions. In Australia, we see a rising possibility of a mild version of quantitative easing being introduced once the lower bound of the cash rate (0.25 - 0.5%) is reached, given the lack of a strong alternative for spurring wage-growth and inflation. Emerging-market countries are likely to loosen policy along with the Fed.

### **Global investment outlook: Subdued returns are here to stay**

As global growth slows further in 2020, investors should expect periodic bouts of volatility in the financial markets, given heightened policy uncertainties, late-cycle risks, and stretched valuations. Our near-term outlook for global equity markets remains guarded, and the chance of a large drawdown for equities and other high-beta assets remains elevated and significantly higher than it would be in a

normal market environment. High-quality fixed income assets, whose expected returns are positive only in nominal terms, remain a key diversifier in a portfolio.

Returns over the next decade are anticipated to be modest at best. The fixed income return outlook has fallen further because of declining policy rates, lower yields across maturities, and compressed corporate spreads. The outlook for global equities has improved slightly from our forecast last year, thanks to mildly more favorable valuations, as earnings growth has outpaced market price returns since early 2018.

Annualised returns for Australian fixed income are likely to be between 0.5% - 1.5% over the next decade, compared with a forecast of 2.5% - 3.5% last year. The outlook for global ex-Australia fixed income returns is slightly higher in the range of 1.0% - 2.0%, annualised. For the Australian equity market, the annualised return over the next ten years is in the 4.0% - 6.0% range, while returns in global ex-Australian equity markets are likely to be about 4.5% - 6.5% for Australian investors, because of slightly more reasonable valuations elsewhere.

Over the medium term, we expect that central banks will eventually resume the normalisation of monetary policy, thereby lifting risk-free rates from the depressed levels seen today. This will lead to more attractive valuations for financial assets. Nonetheless, the return outlook is likely to remain much lower than in previous decades and the post-crisis years, when global equities have risen over 10% a year, on average, since the trough of the market downturn. Given our outlook for lower global economic growth and subdued inflation expectations, risk-free rates and asset returns are likely to remain lower for longer compared with historical levels.