2020 MIDYEAR UPDATE

Vanguard economic and market outlook: Forecasting in the time of coronavirus

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Executive summary

The global COVID-19 pandemic and associated lockdowns have caused the sharpest and deepest short-term economic contraction in modern history. Even as countries in Asia and Europe brought the number of cases under control in early July, the count continued to grow globally, fueled by increased outbreaks in emerging economies and parts of the United States. The twin crises of health and economics are far from over.

In fact, the main economic impact of the pandemic has been caused not by the virus itself but by a combination of necessary government-mandated lockdowns and voluntary social distancing by individuals. Our estimate of the maximum impact of the pandemic shock to GDP compared with previrus levels is 13% in Australia, 18% in the U.S., 20% in China and Germany, around 25% in the U.K., and as much as 30% in Italy.

With late-July data releases likely to confirm double-digit negative quarterly growth rates in the U.S. and Europe during the second quarter (China's quarterly hit was in the first quarter), strong recoveries are likely to occur in the third quarter. Indeed, as social distancing measures are gradually reversed, we expect economic activity to initially recover quite quickly as productive potential is brought back onstream. But thereafter we foresee a slower recovery in aggregate demand as consumers remain reluctant to resume activities that require face-to-face contact. In the language of expressing the recovery in the shape of letters, we see an initial V-shaped recovery followed by a more prolonged U shape.

For 2020 as a whole, we now foresee a fall in annual global GDP of around 3%, the largest ever recorded outside wartime; this is nearly 5% lower than our forecast for 2020 at the end of 2019. We expect annual GDP in the U.S., U.K., and euro area to be between 8% and 10% lower than last year, with Japan and Australia 4% lower. Of the major economies, only in China do we see positive growth, at 2%.

We do not expect GDP to recover to its more normal previrus trajectory until late next year. And even then we expect some "scarring" as a result of permanent job losses, bankrupted businesses, and the costs of possible reallocation of resources. In the U.S., unemployment peaked near 15%. In other regions, such as the euro area and the U.K., furlough schemes prevented the unemployment rate from rising markedly. However, if these schemes were not in place, we estimate that the jobless rate would have risen to around 30%. In the longer run, we believe that productive potential in 2022 will likely be some 3% lower in Europe, slightly less in the United States, and relatively unaffected in China and Japan.

The response in terms of monetary policy accommodation and fiscal policy support has been impressive in its speed and scale, as Vanguard has been advocating. Monetary policy has become even more accommodative, with interest rates at their effective lower bound in most major economies, additional quantitative easing, and generous liquidity provided to the financial sector. We expect monetary policy to stay loose well into next year, with future tightening happening cautiously and flagged well in advance. Total fiscal support for the major economies has been, if anything, even more extraordinary, amounting to $9 trillion (approximately 10% of GDP) in the form of direct fiscal support (government spending and income transfers) and loans and grants. These fiscal measures are largely designed to provide income support to those who became unemployed or were furloughed because of the pandemic shock, or to provide financing to businesses that otherwise would be insolvent.

Further fiscal support seems likely later this year given the sluggish recovery that we expect, as the need to provide income support persists to the end of 2020. The burden of the resulting increase in public sector debt should be lessened by current extremely low financing costs, facilitated by loose monetary policy and large-scale asset purchases. In the current political environment, we do not think policymakers will be attracted to tough austerity measures. And given the slow and protracted recovery, we expect aggregate inflation measures to remain low, although we anticipate more short-term variability in price changes as supply shortages bite in some sectors.

The risks around our forecast are skewed to the downside and are strongly linked to health outcomes. Our baseline forecast, to which we ascribe a 50% probability, sees a gradual return to work with isolated pockets of renewed spread in the virus that are then contained by localized lockdowns, with a vaccine becoming available by the end of 2021. Our upside scenario, a relatively low probability outcome at 15%, sees a health care solution emerging more quickly than that. But our downside scenario, with an uncomfortably high 35% probability, sees further waves of COVID-19 and renewed shutdowns, possibly at a nationwide level, which prevent a meaningful recovery in global GDP for much of this year and next.

During the pandemic, asset prices have been volatile, with global equities falling around 30% before recovering almost completely by the end of June, with gains driven by the United States. Mainly because of the resulting improvement in valuations, especially outside the United States, global equity market return expectations have risen. For U.S.-dollar investors, we expect the average annualized return over the next ten years to be between 4% and 6% for U.S. equities and between 7% and 9% for non-U.S. equities—60 basis points higher for U.S. equities and 90 basis points higher for non-U.S. equities than our median expectation at the time of our end-year outlook in December 2019. Given accommodative monetary policy, our global fixed income return expectations remain muted for both U.S. and non-U.S. bonds, with returns between 0% and 2%, about 100 basis points lower than our expectation at the end of 2019. Considerable uncertainty remains, with the possibility of further market corrections ever-present. We advise investors to focus on long-run expected returns and avoid the temptation to time such turbulent markets.

Without doubt, the COVID-19 pandemic will accentuate many of the structural forces that were already in play at the beginning of the year and perhaps will introduce new aspects. Rising inequality could be aggravated, with the disadvantaged in society tending to be the most badly affected. Whether this strengthens or undermines the tendency toward populist politics remains to be seen. Globalization, already under threat by a trend toward protectionism, might be damaged further to mitigate the pandemic or be reinvigorated by the manifest need to find a global solution to a global problem. And improvements in working methods, accelerated by the need for workers globally to work remotely, might provide the boost to productivity the global economy has been seeking, albeit at the expense of considerable sectoral disruption.

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