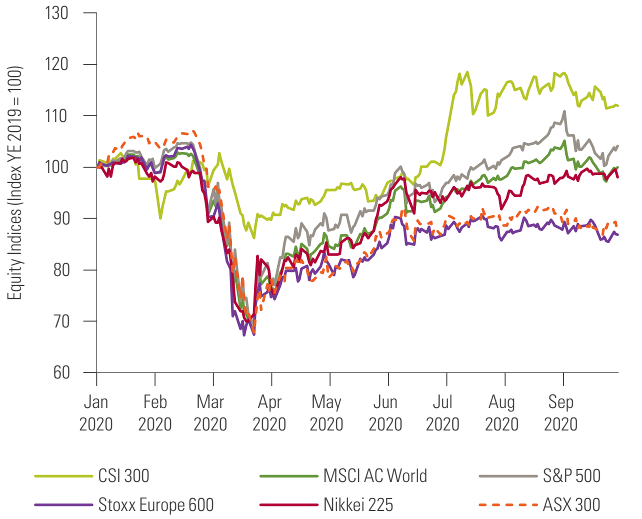
Quarterly economic and market update

September quarter 2020

Quarter in review

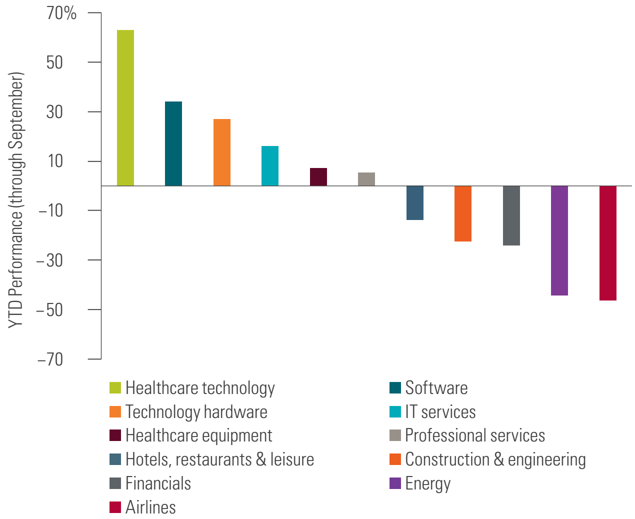
Markets were changeable in Q3, with investors whipsawed by policy announcements, economic data and changing COVID-19 case counts. The picture across regions (**Figure 1**) was mixed: China outperformed the rest of the world owing to its first-in-first-out (FIFO) experience with the pandemic; U.S. markets benefited from tech-heavy weightings, while Australia was a laggard against other developed markets. A renewed surge in new COVID-19 cases and stringent re-imposition of lockdowns in Victoria, which accounts for around a quarter of national GDP, were a net drag on Australian stocks.

Figure 1a. Significant dispersion across countries…



Notes: Index returns are stated in local currency. Source: Vanguard, using data from Bloomberg.

Figure 1b. …and across sectors



Notes: Inter-industry performance for MSCI AC World Index in local currency Source: Vanguard, using data from Bloomberg

Vanguard's assessment of high frequency indicators suggest a pullback in the signs of economic recovery over the quarter. Retail, labour and recreational mobility data fell in the last two months of Q3, dropping below the levels seen in June. In Australia, the extension of direct fiscal support and payment holidays until March 2021 is positive for businesses and households but the lack of a meaningful economic reopening in Victoria until later in Q4 may increase the likelihood of more permanent job and business losses. In the U.S., the negative effects of having the economy in hibernation for a prolonged period of time are evident, with the proportion of temporary unemployed workers permanently losing their jobs steadily increasing over the course of the last quarter.

The prospect of further permanent job losses, with its spillover effects on consumer confidence and spending, could prove detrimental to the shape and strength of the recovery. Vanguard does not expect global output to return to its pre-pandemic levels in the very near-term, and quite possibly beyond should these dynamics intensify.

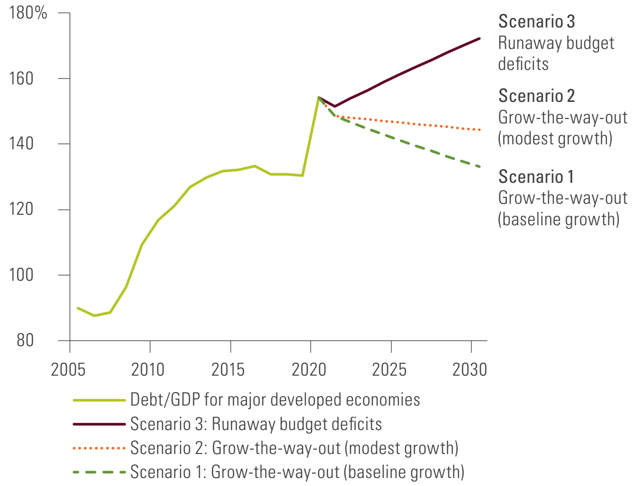
Economic outlook

As economic activity gradually re-emerges, attention shifts to the longer-term consequences of the pandemic, some of which are more evident than others. Trends such as working-from-home, e-retail and food delivery, are part of a shift away from face-to-face interactions—all of which have the potential to reshape consumption patterns. This raises the prospect of a more permanent decline in restaurant and retail activity, at least until the development of a treatment of vaccine—something we're not expecting before 2021. The uncertain consumer outlook will ensure global output will remain below pre-pandemic levels in the very near-term, and possibly longer.

As **Figure 2** shows, massive policy stimulus efforts continued over the quarter. Debt-to-GDP ratios have pushed out by more than 20 percentage points in developed economies but the low-interest rate environment offers a favourable backdrop. Vanguard forecasts an average nominal growth rate of four per cent will be sufficient for major developed economies to "grow-the-way-out" of their newfound debt and return to pre-COVID debt levels by the end of the decade.

Turning to markets and rising equity valuations over the quarter raise the question of the attractiveness of equities as an asset class. Australian equities have seen a 20-per cent rise in valuations so far this year. Despite this, Vanguard's view is Australian equity markets still appear to be fair value. This is on account of two factors – both the significant correction in valuations early in 2020 and the support of historically low interest rates.

Figure 2. The fiscal math behind debt sustainability



Notes: Countries included in the calculation are Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom, and the United States. Scenario 1 represents 4% nominal GDP growth, an average 10-year yield of 1.2%, and a 2% budget deficit. Scenario 2 represents 3% nominal GDP growth, an average 10-year yield of 1.2%, and a 2% budget deficit. Scenario 3 represents 3% nominal GDP growth, an average 10-year yield of 1.2%, and a 5% budget deficit.
Source: Vanguard calculations based on data from Thomson Reuters Datastream.

Maintain perspective and long-term discipline

Investing can provoke strong emotions. But disciplined investors who held fast and rebalanced during the March downturn, have been rewarded for their approach in the months since. Overall, a high degree of uncertainty in both the near-and-medium term outlook means investors should maintain a well-diversified portfolio and resist the temptation to time the market.

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