

Quarterly economic and market update

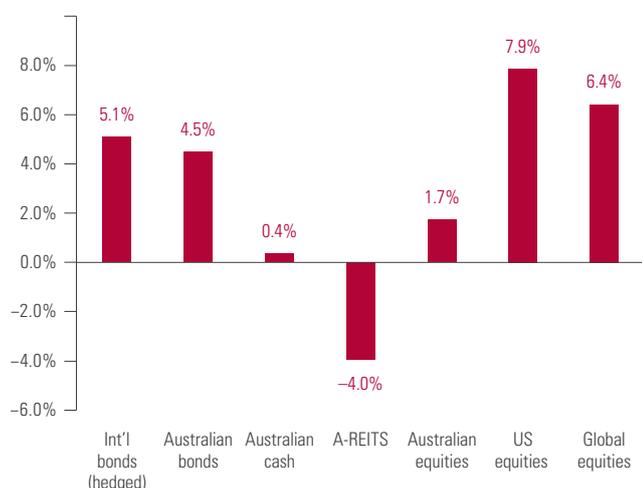
December quarter 2020

Quarter in review

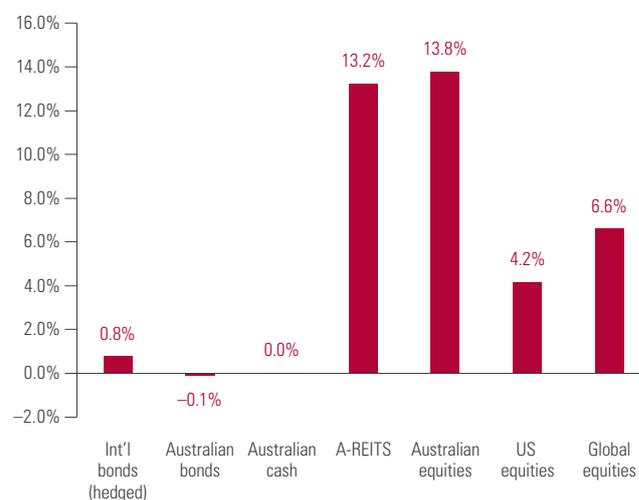
Market volatility was ever present during the final quarter of 2020, driven by the controversial U.S. election in November, the looming Brexit deal deadline in December, escalating China trade tensions and the ongoing global spread of COVID-19. Yet, despite these and other unsettling factors, investment returns over the December quarter as a whole were relatively strong. At the final 2020 trading bell, the U.S. share market closed at a record high, spurred by positive sentiment around economic stimulus measures and the impending rollout of COVID-19 vaccines. The Australian share market, although still well off the record high it reached in February, closed off the final quarter more than 10% above where it started on 1 October.

The bulk of that gain occurred during November, when the S&P/ASX 200 Index notched up its best monthly return since 1988.

Figure 1. How asset classes performed across 2020 2020 returns



Q4 2020 returns



Notes: All returns except Q4 2020 are annualised. Global equity represented by MSCI AC World in AUD, US equity represented by S&P 500 in AUD, Australian equity represented by S&P/ASX 300 Index, Australian property represented by S&P/ASX 300 A-REIT Index, Australian bonds by the Bloomberg Ausbond composite 0+ Yr Index, International bonds by Bloomberg Barclays Global Aggregate Index Hedged in AUD, and AUstralian cash by the Bloomberg Ausbond Bank Bill Index. Data through December 2020.
Source: Thomson Reuters Datastream and Bloomberg.

Room for economic optimism

It should come as no great surprise that the global economic outlook and the likely behaviour of financial markets remain hinged to COVID-19, and more specifically to health outcomes and responses. With the rollout of COVID-19 vaccines increasing, there is room for optimism. Vanguard's base case is that major economies will achieve infection immunity (when the person-to-person spread of COVID-19 becomes unlikely) by the end of 2021. This would result in economic activity normalising by the second-half and output reaching pre-pandemic levels by the end of 2021. If infection immunity does not occur, economies may only see marginal progress from current levels.



But assuming immunity rates do rise, unemployment levels are set to fall, and a cyclical bounce in inflation is expected to occur around mid-year. This brings some risk that markets could interpret higher inflation with a more pronounced, but unlikely, inflation outbreak.

Country-specific economic growth rates will be varied, with Vanguard's base case forecast for Australia at 4.3%. This will trail the United States and the euro area, which are both forecasted to grow at 5.4% and 4.5% respectively in 2021. Their stronger growth rebound comes off the back of a weaker base in 2020 and the stronger impetus that a vaccine arrival might have on their recovery. In emerging markets, Vanguard expect a more uneven recovery, with China outperforming its peer group at a growth rate of 9%.

The outlook for markets

For 2021 and beyond, Vanguard's outlook for global asset returns is guarded. High valuations and lower economic growth rates mean Vanguard expect lower equity returns over the next decade. Vanguard's outlook for global and Australian equities is in the 5%-7% and 5.5%-7.5% range respectively for returns over the next 10 years, compared with the double digit returns experienced during prior decades. Despite the marginally higher expectation for local equity, Vanguard caution against excessive concentration risk and home bias, and underscore the benefits of a globally diversified exposure in managing risk, particularly given Vanguard's expectation for elevated risks in 2021 and beyond.

On the fixed income front, Vanguard expect interest rates globally to remain low despite a constructive outlook for firming global economic growth and inflation as 2021 progresses. While yield curves may steepen, short-term rates are unlikely to rise in any major developed market as monetary policy remains highly accommodative. Bond portfolios, of all types and maturities, are expected to earn returns close to their current yield levels.

A consistent theme emerging from Vanguard's economic outlook of structurally lower interest rates across developed market economies supports Vanguard's view of a lower return environment. However, lower yield curves and still-not-overly-stretched equity valuations have also meant a modest steepening in the efficient frontier, which suggests an improvement in the equity risk premium or an increase in expected return for taking on marginal equity risk. Notably, equities are likely to continue outperforming most other investments and the rate of inflation, with returns expected to be 3 to 5 percentage points higher than that of traditional bond instruments over the next decade. That said, investors would still be encouraged to maintain a broadly diversified portfolio that is appropriately aligned to their goals and risk-tolerance, and to avoid over-reaching for yield or return at the cost of unintended risk exposures.

In 2021, it will be important for investors to remain disciplined and focused on long-term outcomes, and to accept that current macro-economic events may mean medium-term investment returns will be lower than those recorded over recent decades.

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