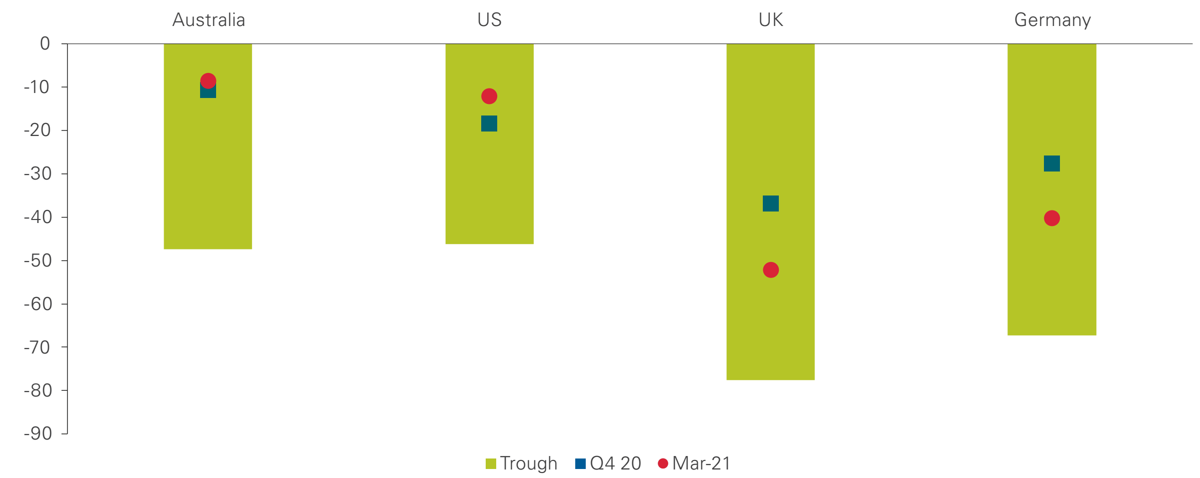
Vanguard expect output to reach its pre-virus level by the end of the first half of this year, compared to later in 2021/ 2022 for most of its developed peers.

Figure 5. Mobility indicators suggest uneven recovery across countries

oogle Mobility Index.

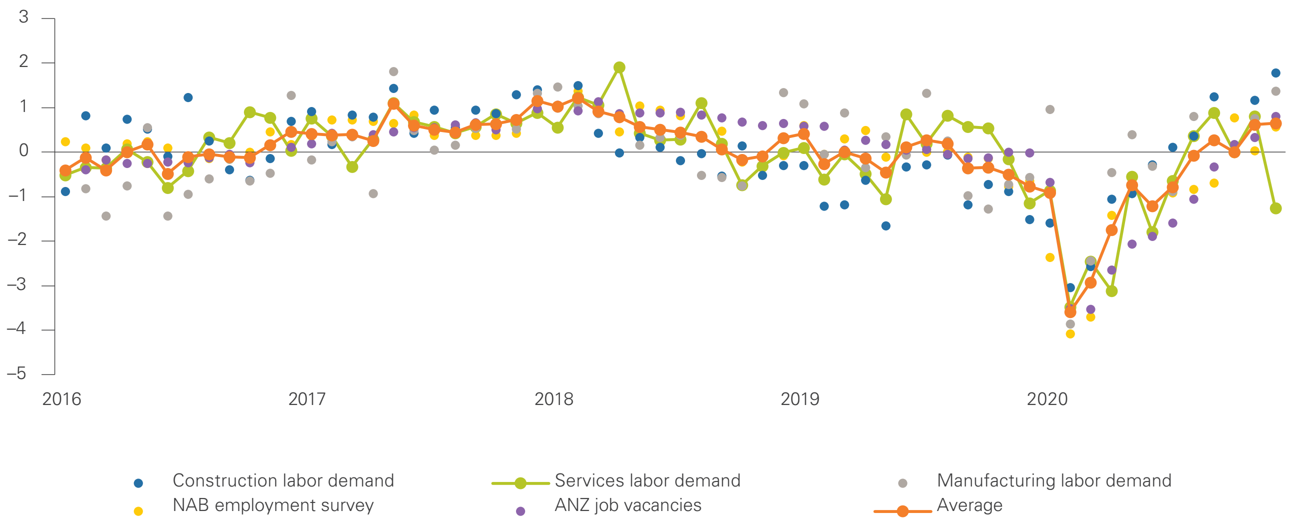


Source: Vanguard, using data from google

A key risk to the Australian outlook lies with the roll-off of the JobKeeper Payment scheme at the end of March, which to date has benefitted millions of Australians. Without the JobKeeper scheme, Vanguard estimate job losses in Australia could have been 700,000 higher and the unemployment rate at its peak would have been around 12% instead of 7.5% last year. The key challenge ahead is how the labour market situation will fare now that the 1.1 million people that were participating in JobKeeper have rolled off the scheme. Should all of these people lose their jobs, the unemployment rate could rise to around 13.8% in April/May (assuming labour force participation rates remain unchanged).

However, this assumption vastly overstates the workers “at risk” because those benefitting from JobKeeper in the last quarter of 2020 or the first quarter of 2021 will not necessarily lose their jobs. Given Australia’s minimal COVID–19 restrictions, many companies that qualified for JobKeeper in 2020—particularly those in Victoria—won’t feel the need to lay-off employees in the second quarter. In fact, forward looking indicators of aggregate labour demand are showing signs of strength at the moment **(Figure 6)**, especially in sectors such as construction and manufacturing. Thus, even if some people in the service sector do lose their jobs, Vanguard think this will be partially offset by people getting jobs in other sectors that are doing well.

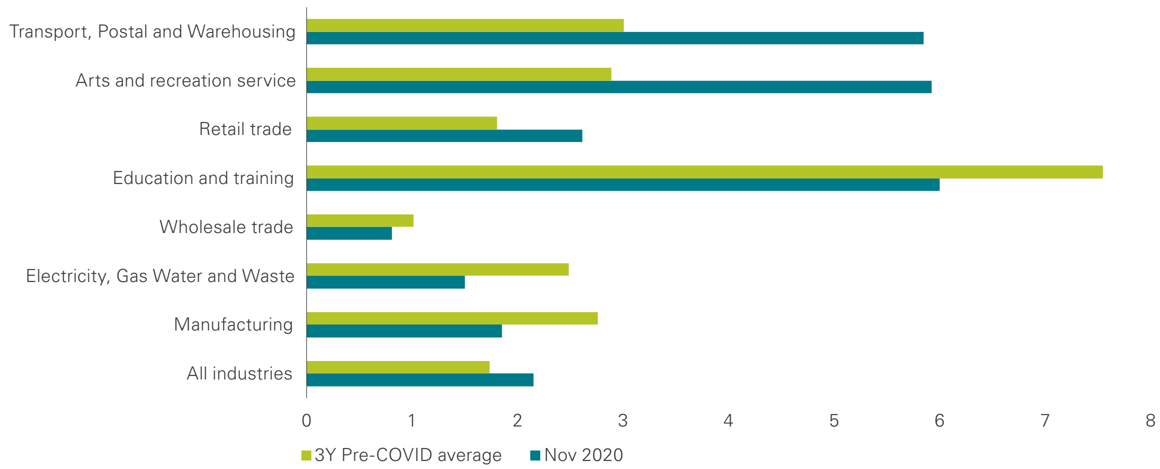
Figure 6. Aggregate labor demand remains strong



Source: Vanguard, using data from Refinitiv.

Within the more vulnerable service industry, Vanguard estimate that there are around 300,000 workers in high-risk sectors. These include the Aviation industry, Hotels and Accommodation, and in Arts and Recreation given ongoing international border closures and restrictions on large-scale public gatherings in some locations. As **Figure 7** illustrates, many of the more vulnerable sectors have not yet experienced a meaningful reduction in the unemployment/job vacancy ratio, which remains much higher than pre-COVID levels and more elevated than heavy industries such as manufacturing and utilities.

Figure 7. Unemployment still outweighs job vacancies in the most virus-sensitive sectors
Unemployment to job vacancies



Source: Vanguard, using data from the Australian Bureau of Statistics.

One way to estimate the number of job losses in these sectors post JobKeeper is to look at the number of employees currently working zero hours for economic reasons, as this group is most vulnerable to layoffs once the scheme rolls-off.

In our baseline scenario, Vanguard assume around 90% of this group of workers within the Arts and Recreation as well as the Accommodation sector will likely lose their jobs in April/May. The Aviation industry, on the other hand, faces a lower risk given the government's recent announcement of the extension of the wage subsidy scheme[1] for workers in this industry. Meanwhile, Vanguard assume the other less vulnerable sectors will recover at least 50% of jobs given the ongoing reopening and normalisation of activity nationally, with a lower risk of the "fear factor" deterring activities. Under these baseline assumptions, unemployment will likely rise by about 60,000–80,000 in April/May, and the unemployment rate by around 0.4–0.6 percentage points.

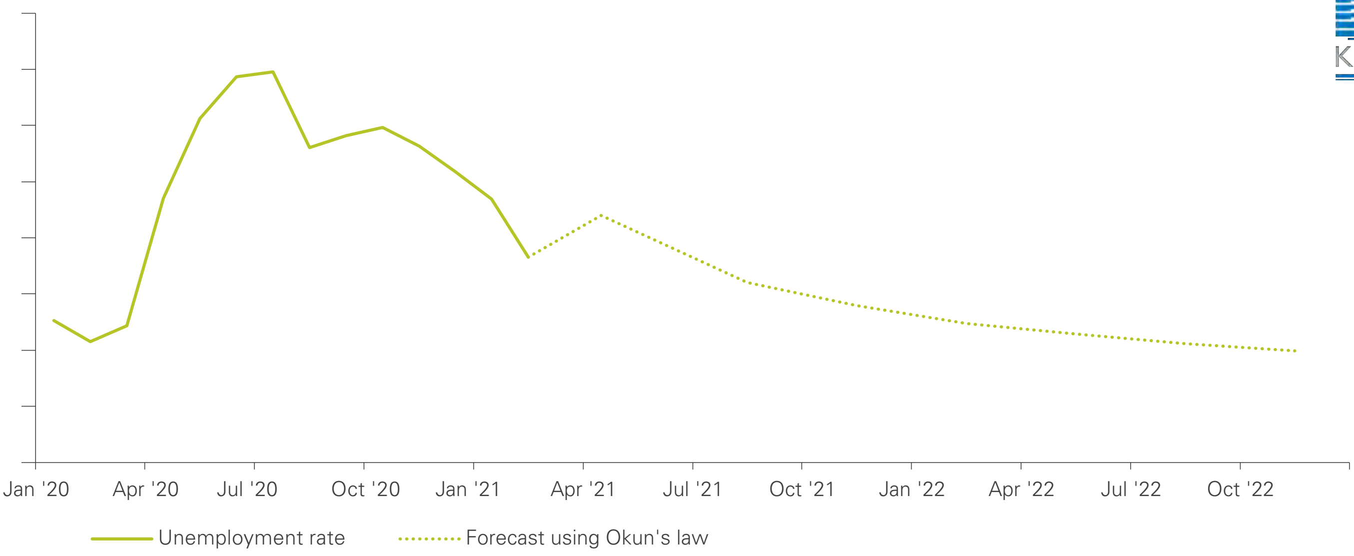
On the downside, however, if all employed workers currently working zero hours for economic reasons across industries were to lose their jobs, then the unemployment rate could rise by close to 1 percentage point. However, this seems less likely given the ongoing loosening of restrictions nationwide and the normalisation of activities.

Beyond the second quarter, the labour market situation is slated to improve given the effective control of the virus in Australia as well as positive jobs growth expected in May and June. Using Okun's law[2], which captures the relationship between unemployment and economic growth, Vanguard estimate the unemployment rate should end 2021 at around 5.3% and 4.9% at the end of 2022 given the ongoing economic recovery (Figure 8). While this is still slightly above the Reserve Bank's estimate of full employment (4–4.5%), it nonetheless marks a significant improvement in labour market conditions since the peak of the crisis last year.

In summary, temporary volatility in the unemployment numbers over the second quarter of 2021 can be expected, but this will not completely reverse the downward unemployment trend over this year.

1 https://australianaviation.com.au/2021/03/international-aviation-wage-subsidy-will-be-same-as-jobkeeper/
2 In Australia, Okun's law suggests that a percentage point increase in the output gap is estimated to decrease the unemployment rate by about a quarter of a percentage point.

Figure 8. Unemployment forecasted to resume downward trend post Q2 volatility



Source: Vanguard

Market outlook

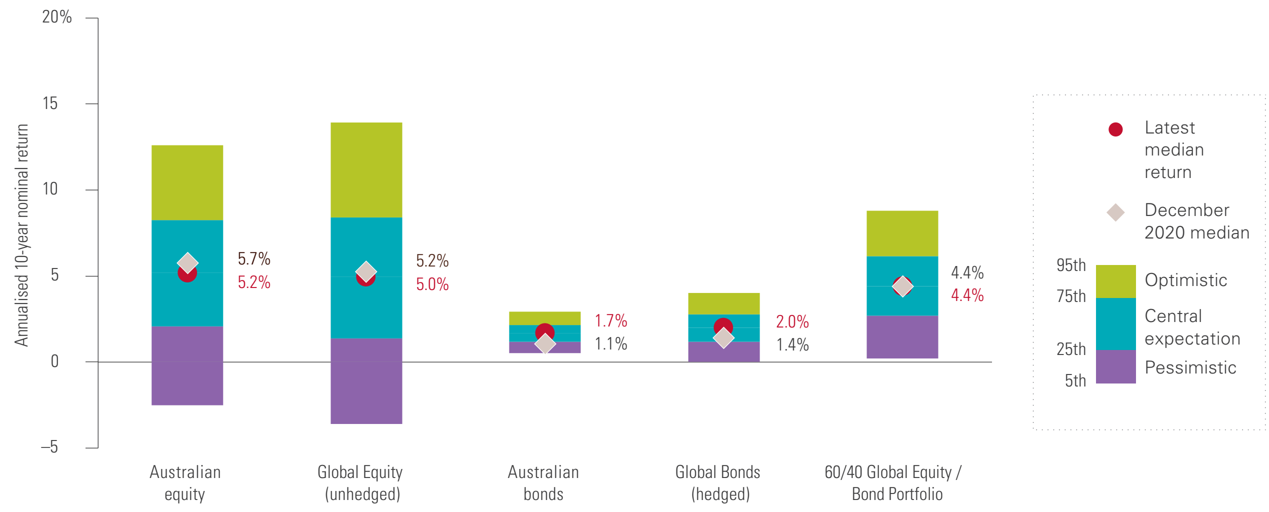
Global equity markets continued their climb in Q1, navigating a bout of bond market volatility to end at near all-time highs. Despite a repricing of inflation expectations that jostled equities, markets found comfort in the prospects of stronger economic growth, stimulus, and central banks' expectations for continued easy policy, although tail-risks still remain.

Rising yields combined with the strong gain in equities year-to-date contribute to a view on valuations that is broadly more elevated and less attractive than before, despite the support of near-term economic optimism. These movements are reflected in a decline in our 10-year annualised outlook for equities, with Australian and international equities expected to be in the range of 4–6% as of March 2021, modestly downgraded from December 2020 **(Figure 9).**

For some investors, elevated valuations have given reason for pause. As economies recover and return to trend, our equity return outlooks remain guarded and begin to resemble those from 2019 and 2020. Nevertheless, equities as part of a well-diversified portfolio are likely to continue outperforming most other investments and the rate of inflation over the long term.

Once again investors would be well advised to temper their expectations for returns over the coming decade, to ensure portfolios align with their investment objectives, and to focus on the factors within their control. Rebalancing can help to ensure that a portfolio aligns with its intended risk exposure, by responding to relative under and overvaluations within its asset allocation. However, Vanguard caution against excessive concentration risk and market timing, where downside risks may be magnified and investment objectives compromised.

Figure 9. 10Y annualised outlook: setting reasonable



Source: Vanguard, Interim 31 March 2021 and 31 December 2020 VCMM Simulations

On the fixed income front, recent rises in interest rates and inflation risks have left left many investors questioning the appeal of bonds. However, a decomposition of fixed income returns suggest that rising rates are actually good news for long-term investors. While most have tended to focus on the price return (which falls as rates rise), many forget that a bond return consists of two other components – yield distribution and reinvestment income. Higher rates will not only result in a higher yield distribution, but investors reinvesting these distributions will also be able to reinvest at higher yields, thereby allowing them to benefit from the virtuous cycle of compounding interest at a higher rate.

While this concept is probably not top-of-mind when rates are rising and bond returns are depressed, it's a classic case of enduring short-term pain for long-term gain. As a rule of thumb, investors with time horizons longer than the durations of their bond holdings may be better off in the long term with a rise in rates today. In fact, as **Figure 9** illustrates, our long-term fixed income return outlook have actually improved since December 2020 given the rise in yields.

The mantras of discipline and long-term investing are never more important than when market volatility jumps. Instead of allowing emotions to drive your asset allocation, it is more prudent to let your investment goals shape decisions about your strategic asset allocation.

Source: Vanguard Asset Allocation Report, March quarter 2021

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