A BETTER BUT STILL BUMPY ROAD AHEAD

June 2021

Quarter in Review

Despite concerns about rising inflation, global equity markets capped off the financial year with yet another strong quarter as economic activity rebounded, corporate earnings strengthened, and policy support remained accommodative **(Figure 1)**. The roll out of vaccinations remains critical to the reopening of economies and continued to gain pace over the quarter, particularly in the euro area. The percentage of its population receiving at least one dose of the vaccine increased from just 12% at the start of the quarter to 53% in June.

The progress on health outcomes saw European equity indices retain their year-to-date lead, while the U.S. outperformed in its Q2 performance as economic optimism continued to be fueled by a strong earnings season and the Biden administration's announcement of an additional USD 1.2 trillion infrastructure stimulus plan. Meanwhile, strong economic data in Australia saw the S&P/ASX 300 reach new highs, closing the quarter 8.5% higher as investors cheered on the quick normalisation in the labour market and gross domestic product (GDP). A dovish Reserve Bank of Australia (RBA) helped to support a weaker Australian dollar, which ultimately saw international equity investments outperform the local market in AUD terms.

In fixed income markets, total returns for most bond classes were positive as yields declined modestly by 29 bps, marking a reversal from the first quarter. The decline in yields was driven by the market's view that recent increases in inflation are likely to be temporary and should moderate once pent up demand fades and supply-chain issues are resolved. Australian yields also ended the quarter around 26 bps lower after an 81bp rise in Q1 as real yields were capped by the RBA' commitment to keep the cash rate on hold until 2024.

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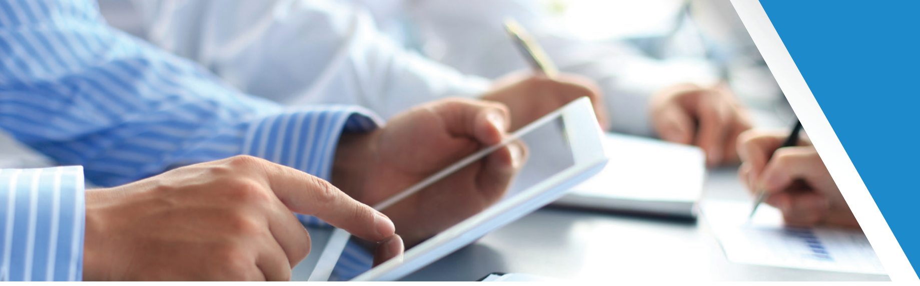
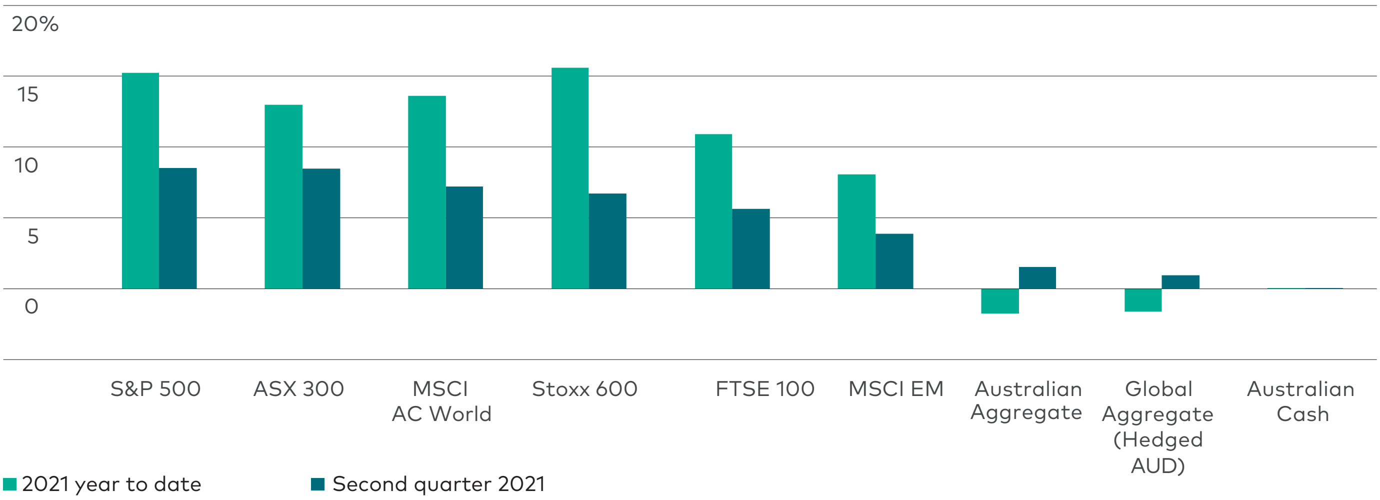


Figure 1. Local currency returns for global indices



Notes: Returns are cumulative total returns. Global Aggregate hedged to AUD, other indices in local currency terms.
Source: Vanguard, July 2021 using data from FactSet, Refinitiv

Economic and Market Outlook

As vaccinations ramp up across the world, health risks are expected to gradually decline over the next few months, which could pave the way for a more robust recovery in face-to-face service sectors. However, differences in vaccination rates and varied levels of policy support are likely to produce uneven economic results in the near term.

The U.S., for instance, with its leading vaccination efforts and strong fiscal support, is likely to lead the global economic recovery with full-year growth of at least 7%. By contrast, China, which was first to enter and first to emerge from the pandemic and an out performer in 2020, is likely to experience a sequential deceleration in economic momentum in the second half of the year as support from the export sector wanes and consumption growth normalises gradually given sporadic virus outbreaks and an initially slow vaccination roll out.

A strong U.S. economic recovery, coupled with ongoing supply constraints, has in Vanguard's view increased the likelihood of moderately higher inflation in the coming years. Sustained inflationary pressures will eventually call for the Federal Reserve to taper stimulus and raise interest rates from near zero. In the U.S., Vanguard foresee conditions for an interest rate lift-off to be met in the second half of 2023. While Vanguard expect the labour market to return to normal by the second half of 2022, Vanguard expect that modest reflation, rather than runaway inflation, is more likely in the near term.

In Australia, the RBA has adopted a more conservative approach by committing to keep interest rates on hold until 2024 given weaker inflation pressures and a slower vaccination rollout. The latter increases the risks of sporadic outbreaks and lockdowns in the second half of this year, which could see consumers become more cautious with their spending. Despite a relatively faster economic recovery to date, Australian household consumption is still below its pre-COVID level and weaker than that of other markets such as the U.S., where herd immunity is closer in sight.

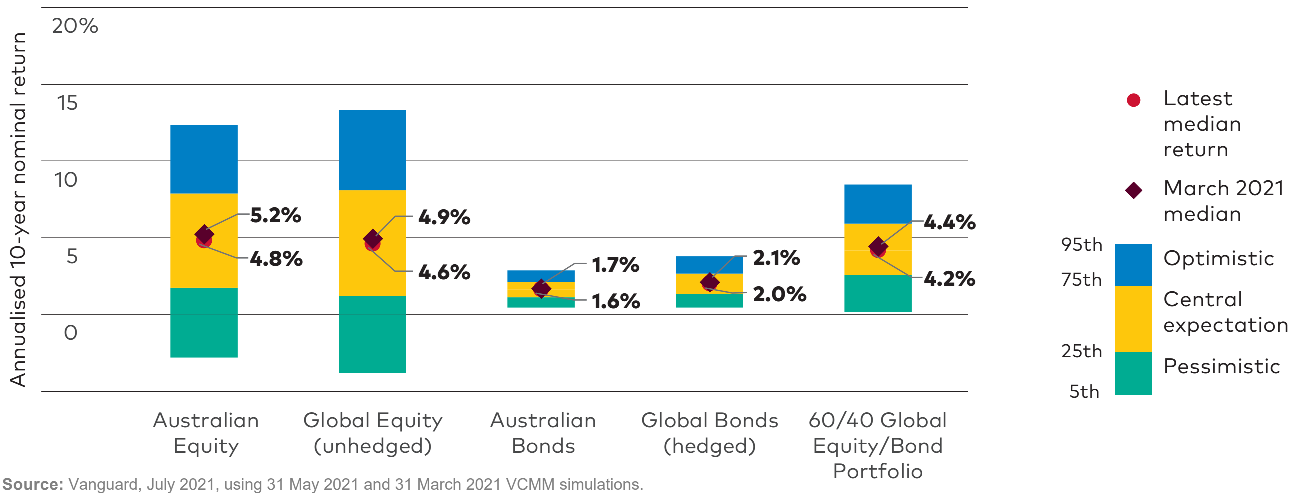
Higher Market Valuations have Softened the Return Outlook for Equities

Share markets continue to rise amid firming economic data, additional fiscal stimulus, and the assurances of central banks that they will keep interest rates lower for longer. Advancing valuations have led to a mild downgrade in Vanguard's equity market outlook, with expectations for global equities decreasing to a range of 3.6% to 5.6% over the next ten years, slightly lower compared to Vanguard's March projections. Meanwhile, the fixed income outlook remains in line with Vanguard's March forecast, as yields only retreated slightly towards the end of the quarter.

As a divergence in economic trajectories between regions is expected to persist over the near term, it is a timely opportunity to remind investors of the benefits of holding a globally diversified portfolio. Having exposure to a variety of asset classes, sectors and regions can help manage concentration risks and navigate the unpredictability of markets. Meanwhile, despite historically low yields, high-quality fixed income retains an important role in the portfolio as ballast and as a diversifier of risk.

With volatility expected to remain elevated in the near term as economies continue to navigate the policy- and health-related uncertainties of the road ahead, investors would be encouraged to tune out the noise and focus on what they can control - keeping sight of long-term investment goals, appropriately aligning their portfolios, and maintaining the discipline to stick to their plans.

Figure 8. Ten-year outlook: setting reasonable expectations



Source: Vanguard, July 2021, using 31 May 2021 and 31 March 2021 VCMM simulations.

Source: Vanguard Asset Allocation Report, June quarter 2021

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