Asset Allocation Report

September 2021

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RISING VACCINATION RATES AND ECONOMIC RESILIENCE

QUARTER IN REVIEW

The third quarter saw the broad market finish largely flat as investors weighed rising vaccination rates and signs of economic resilience against sporadic outbreaks and a gradual tapering of policy support.

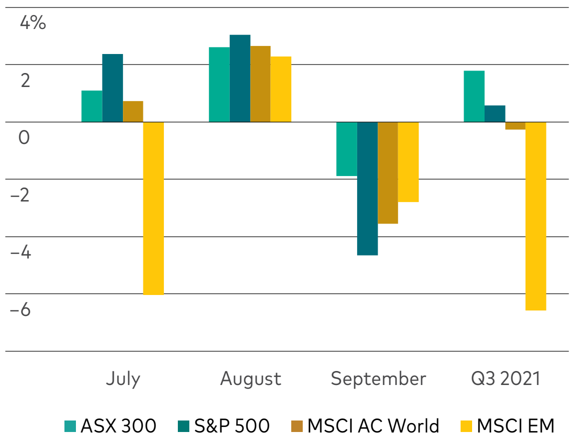
For developed markets, an early-quarter rally through August was supported by strong earnings and accommodative policy expectations. However, this quickly reversed course in September as stubborn inflation drew a more hawkish tone from the U.S. Federal Reserve, and a bout of policy uncertainty from Washington over a potential U.S. debt default stoked volatility (**Figure 3**). The final weeks of the quarter saw a late rotation away from interest rate sensitive growth stocks and into cyclical sectors such as energy and financials, narrowing the performance gap between value and growth from 4% to 1.5% for the quarter.

Meanwhile, emerging markets were weighed down by the underperformance of Chinese equities. Uncertainty over the Chinese administration's regulatory actions in the services and property sectors continued to dampen investor appetite, causing volatility to briefly spill into broader international indexes. Falling commodity prices and a relatively dovish Reserve Bank of Australia (RBA) saw the Australian dollar provide a buffer to international woes, seeing a fall in global indexes of 0.3% in local currency terms, ultimately improving to a gain of 2.9% for AUD investors (**Figure 4**).

On the fixed income front, returns were positive but nonetheless modest as Treasury yields ended the quarter at similar levels to where they started.

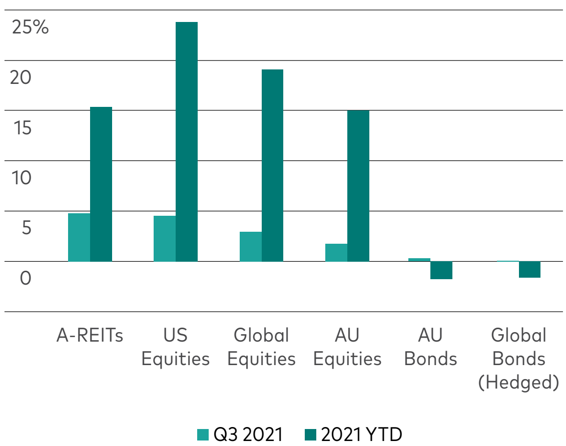
Despite relatively wellanchored breakeven inflation, real yields declined early in the quarter as markets bought in to more dovish central bank forward guidance. Yields retraced in the latter half of the quarter as inflation concerns prompted an acceleration of the timeline for tightening in the U.S. and euro area.

Figure 3. Mixed performance for global indices



Notes: Returns are cumulative total returns denominated in local currency.
Source: FactSet, Refinitiv

Figure 4. AUD returns broadly advanced

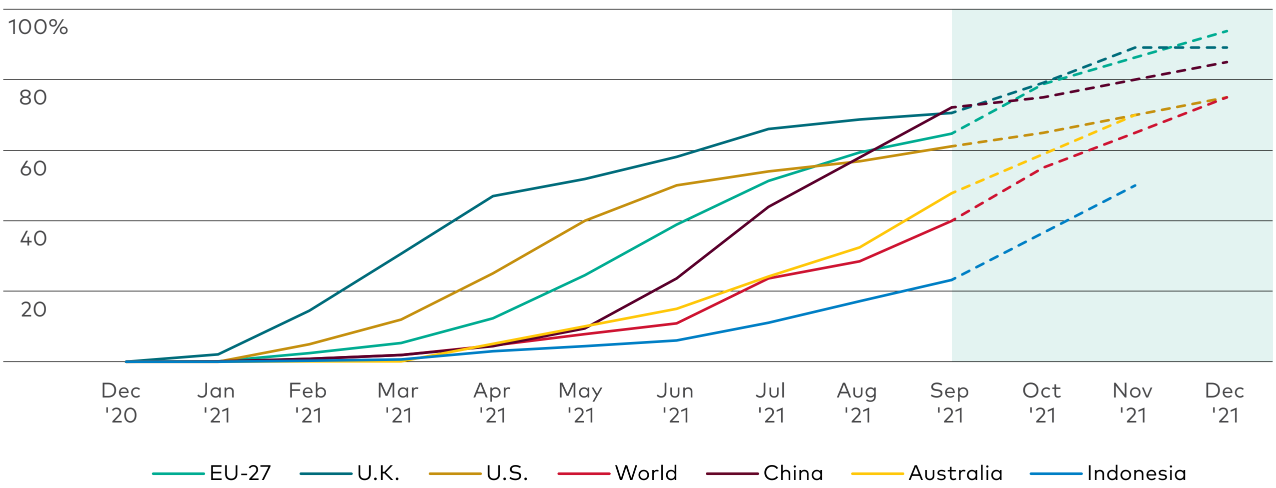


Notes: Returns are cumulative total returns denominated in AUD.
Source: FactSet, Refinitiv

ECONOMIC OUTLOOK

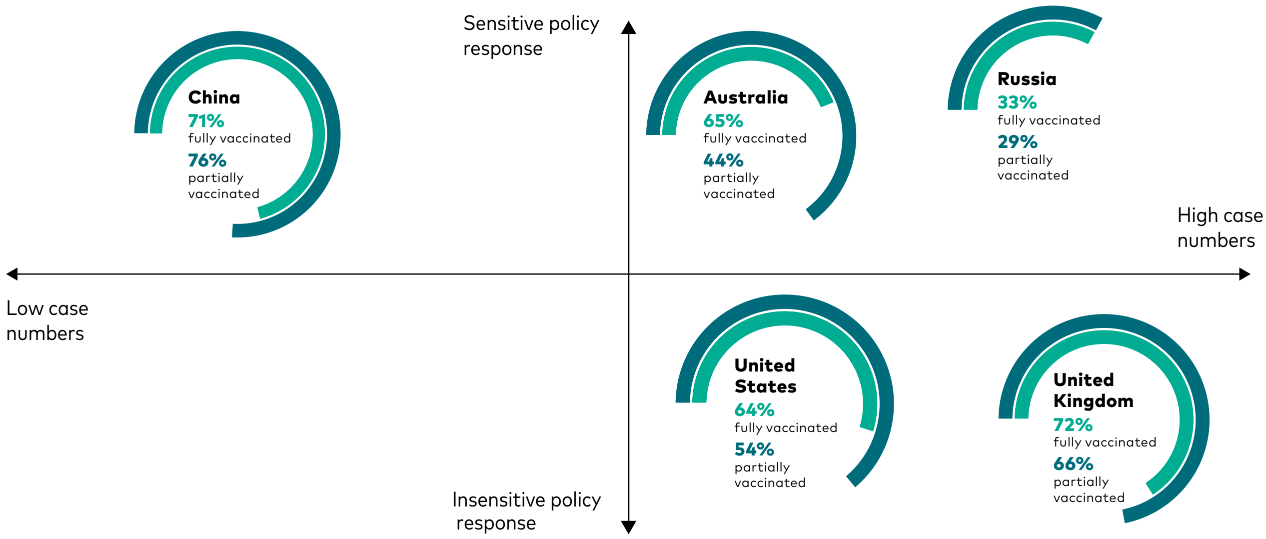
Vaccination progress has ramped up significantly around the world. Around 45% of the world's population has received at least one dose as of Q3, close to double that of the rate seen at the end of June. A closer look at the data, however, suggests that vaccination rates still differ widely across regions, with developed markets far outpacing emerging markets (Figure 5).
The unevenness in vaccination outcomes has led to different health policy responses around the world. Countries experiencing high vaccination rates, such as the United States and United Kingdom, proving to be less sensitive to rising cases than countries with lower vaccination rates like Australia (Figure 6). The exception to this rule is China, which continues to pursue a zero-COVID strategy despite close to 70% of its population having received at least one dose of the vaccine.

Figure 5. Vaccination progress differ across regions



Source: Vanguard, using data from OurWorldinData. Data as of September 2021.

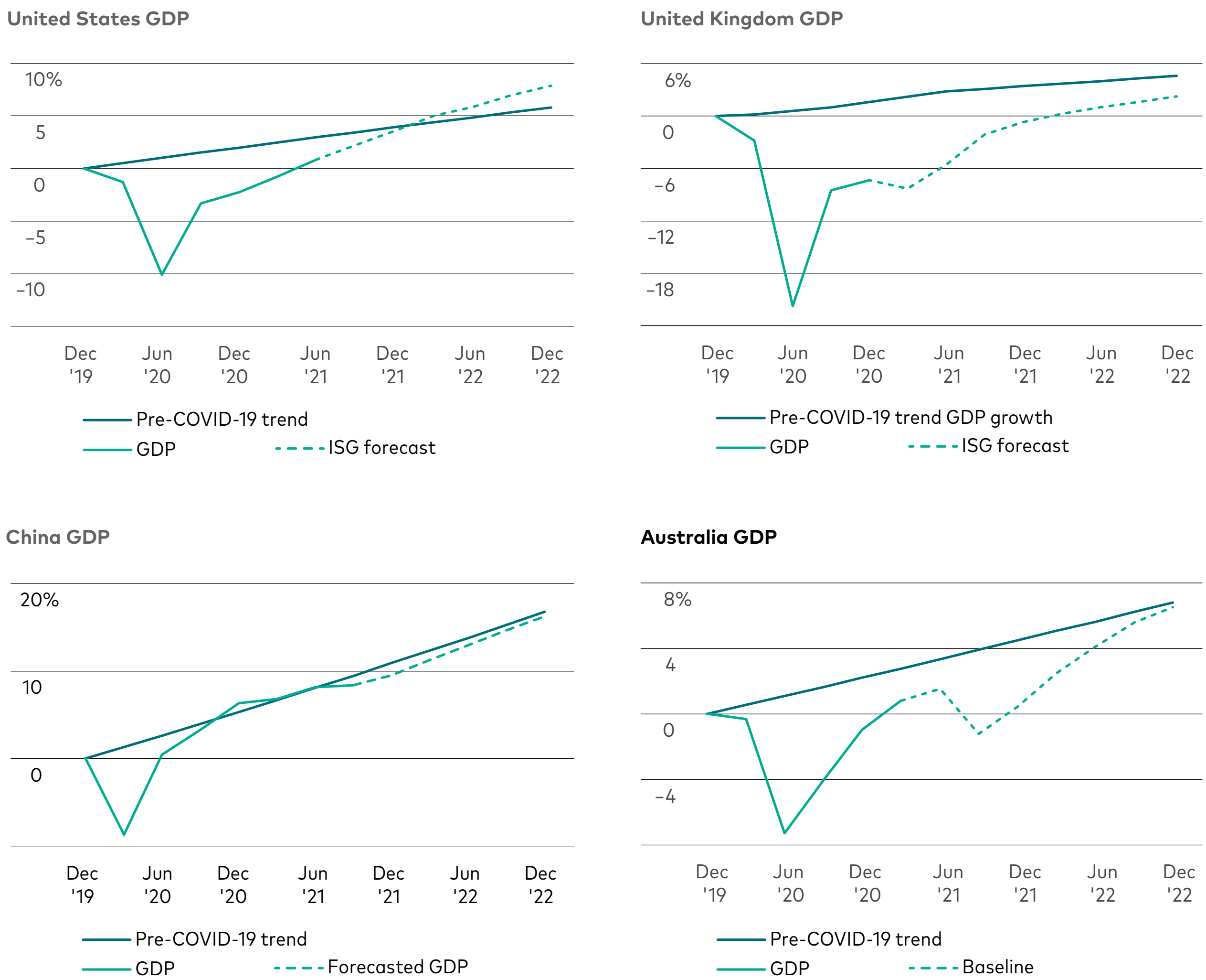
Figure 6. Policy response to Delta variant depends on vaccination progress



Source: Vanguard, using data from OurWorldinData. Data as at 30 September 2021.

Differences in health policy responses are likely to produce a bifurcation of economic results, with the United States projected to return to its pre-pandemic trend levels by Q1 2022, compared with China and Australia, which will return to trend in the second half of 2022 (**Figure 7**). For Australia, Vanguard expect the economy to undergo a contraction in Q3 after declining by 7% in Q2 of 2020 as a result of the extended lockdown restrictions in New South Wales and Victoria. Nonetheless, the gradual move away from a Zero-COVID strategy in exchange for a higher rate of vaccination suggests that conditions are in place for a stronger rebound into 2022, with the national vaccination target of 70% likely to be met by Q4 2021. This could pave the way for improved mobility and add more resilience to the economic reopening going forward. As a result, Vanguard have upgraded their 2022 growth forecast from 3.5% to 4% to reflect a more sustainable social easing. Notably, there remains downside risks to our forecasts, especially if the vaccine rollout flattens and vaccine hesitancy rates increase, as is currently observed in Queensland.

Figure 7. An uneven global recovery



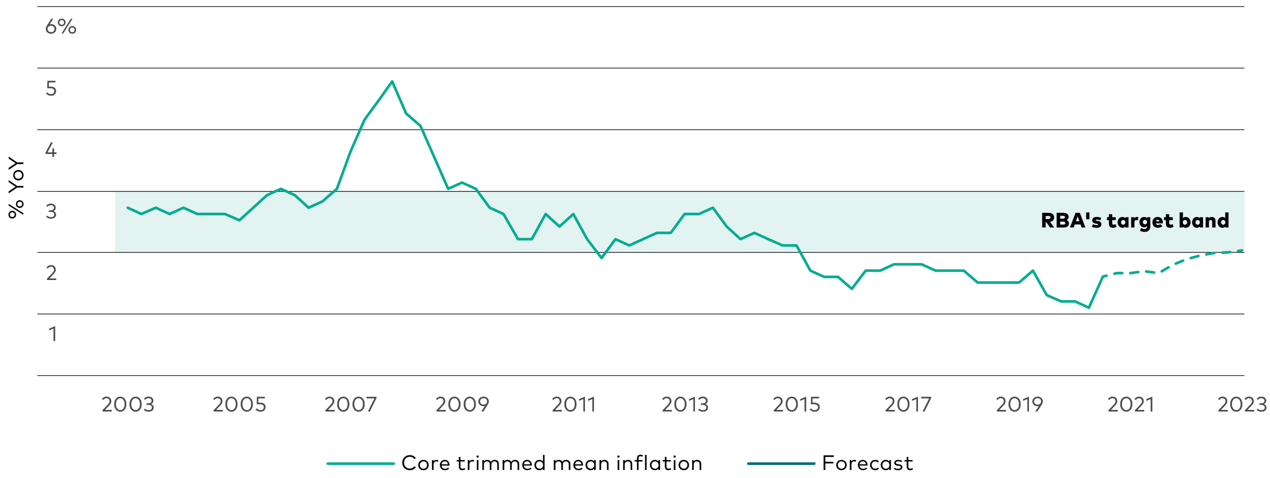
Notes: For the U.S. chart, the y-axis represents the level impact from the baseline, which is December 2019. **Sources:** For U.S. chart: Vanguard, as of September 30, 2021. For China chart: Vanguard calculations, based on data from Revinitiv as of September 30, 2021. For U.K. chart: Vanguard calculations, based on data from the Office of National Statistics as of September 30, 2021. For Australia chart: Vanguard calculations, based on data from Refinitiv as of September 30, 2021.

From the RBA's perspective, the near-term outlook has clearly deteriorated relative to its August baseline forecasts. The bank's now explicit intention to delay lift-off until realised inflation is established around the middle of the 2–3% target band also suggests that rate hikes are likely off the table in 2022.

As **Figure 8** illustrates, Vanguard do not expect core inflation in Australia to return to the lower end of the 2–3% band until 2023 given the delayed economic recovery as well as ongoing competitive cost pressures in the labour market, which are depressing wage growth.

Against this backdrop, Vanguard expect the RBA to keep the cash rate at 0.1% until at least 2023 and maintain a tapered form of quantitative easing until Q3 next year.

Figure 8. Core trimmed mean inflation set to only reach 2% in late 2023



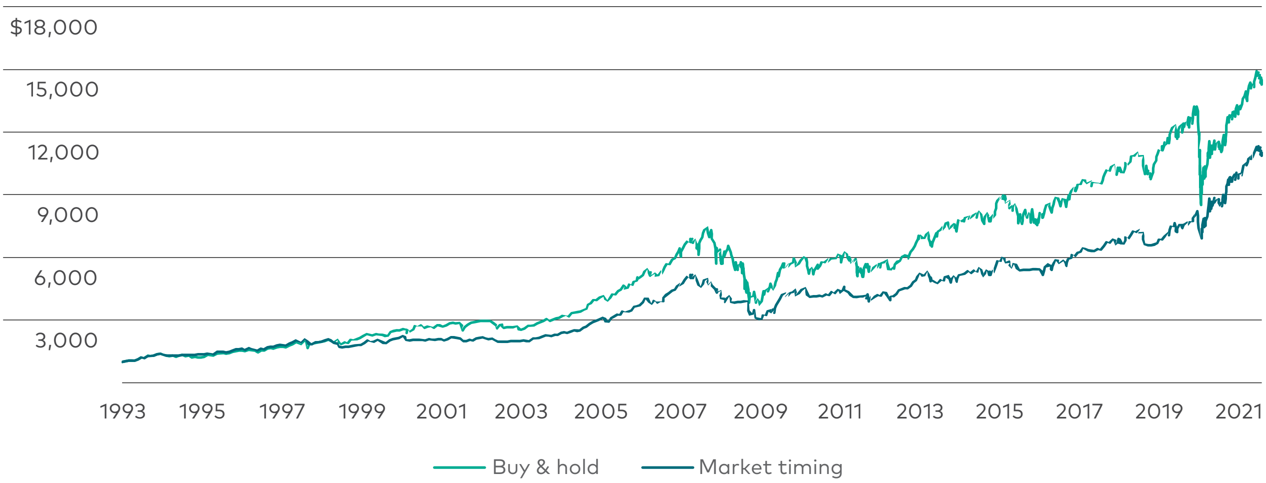
Source: Vanguard, using data from Refinitiv.

MARKET OUTLOOK

The September quarter saw broad market valuations and yields end relatively unchanged, as an intra-quarter equity rally supported by a strong earnings season and easy policy expectations reversed course in the face of concerns over corporate profit sustainability and more persistent inflation prints. Although downside risks remain in the navigation of the pandemic, signs of economic resilience persist and point to a subdued but constructive outlook for risk assets. Expectations for global equities remain positive but modest. Forecast returns for equity are sitting in the range of 3.4% to 5.4% annualised over the next decade, compared with forecast fixed income returns in the range of 1.4% to 2.4%.

While markets lost momentum during the quarter, conditions have been favourable throughout 2021. September was the first negative month for Australian shares following 11 consecutive months of gains, including a fresh all-time high in August. As markets regroup, it is timely to remind investors of the need to maintain discipline in sticking to their investment plan. Attempting to time the market or make impulsive decisions can often come at the detriment of long-term objectives, as shown below (**Figure 9**). Investors are well advised to stay calm and focus on the factors within their control: having a well-planned and diversified strategy that is aligned to their specific goals and the discipline and resolve to stay the course, even during the most volatile times.

Figure 9. Market timing doesn't pay: Growth of $1,000 using a 10% sell and 10% buy strategy



Source: Vanguard calculations using data from Factset.

Figure 10. Even for a range of market timing strategies, in the long run buying and holding has delivered superior returns

STRATEGY		ANNUALISED RETURNS		
SELLING AFTER A % FALL FROM THE PEAK	BUYING AFTER A % RISE FROM THE BOTTOM	BUY & HOLD	MARKET TIMING	BUY & HOLD OUTPERFORMS BY
10%	**10%**	9.86%	9.01%	0.85%
5%	**5%**	9.86%	3.43%	6.43%
5%	**10%**	9.86%	5.22%	4.64%
10%	**5%**	9.86%	8.39%	1.47%

Notes: The data shows a comparison of the performance of a buy and hold strategy and market timing strategy. The time period is 1 March 1993 to 30 September 2021. Australian equities are represented by the S&P/ASX 300 Total Return Index and cash by the Bloomberg Ausbond Bank Bill Index. Trading costs are set at 0.5% of transaction amounts.
Source: Vanguard calculations using data from Factset

Source: Vanguard Asset Allocation Report, September 2021 Quarter.

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