QUARTERLY ECONOMIC AND MARKET UPDATE

December 2021 Quarter

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QUARTER IN REVIEW

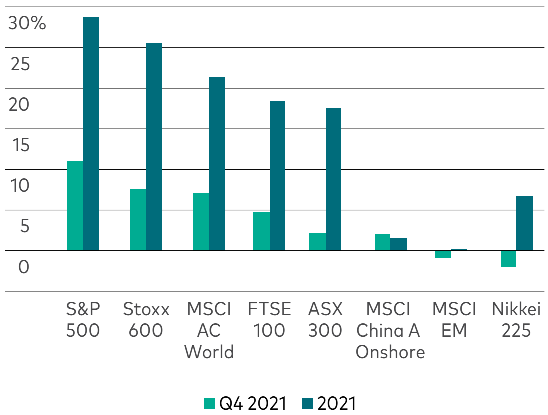
Global equity markets advanced through the fourth quarter as resilient corporate earnings and economic data continued to be challenged by prospects of higher interest rates and a new COVID variant of concern.

Markets rallied through October, fuelled by an upbeat earnings season, but momentum slowed in November as Europe faced a resurgence in COVID cases and renewed lockdowns. The emergence of the Omicron variant and the associated health and policy uncertainty saw a pre-emptive pull-back in equities, erasing gains for the month. Ultimately, optimism over the extent of the variant's impacts prevailed as central banks pushed ahead with their roadmaps for winding back stimulus, citing limited economic fallout to date.

Stocks pared losses and pushed to new record highs in the final days of 2021, led higher by the U.S. and European indexes, which retained their year-to-date leads **(Figure 1)**. Emerging markets continued to be weighed down by concerns over inflation, the withdrawal of U.S. stimulus, and underperformance of off-shore Chinese equities, ending the year flat. Australian investors saw global equities advance 6.1% for the quarter and a total of 26.3% for the calendar year **(Figure 2).**

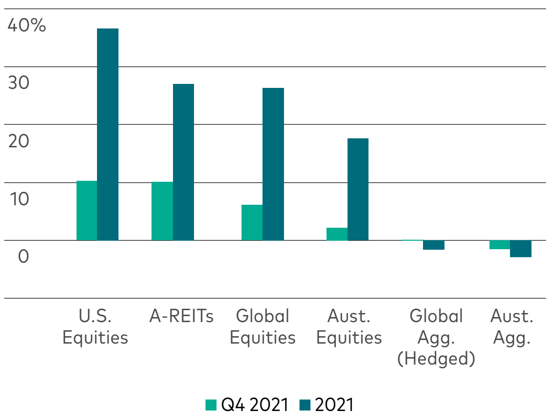
Bond markets see-sawed as reduced stimulus and ongoing inflation concerns were punctuated by surprises from the Bank of England and an Omicron-induced sell-off. Global fixed income returns finished the year flat as focus returned to inflation while long-term government yields broadly moved sideways, despite upward momentum through the end of the quarter. Meanwhile, Australian bond prices fell as markets challenged the Reserve Bank of Australia's (RBA's) yieldcurve control, prompting the bank to end the program despite maintaining a dovish policy stance relative to both market pricing and central banks abroad.

Figure 1. Global equities led higher by U.S. and Europe



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

Figure 2. AUD returns broadly advanced



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

ECONOMIC AND MARKET OUTLOOK

As Vanguard come to the end of 2021, parts of the economy and markets are out of balance. Labour demand exceeds supply, financial conditions are exceptionally loose even when compared with improved fundamentals, and governments and central banks are still providing significant support to markets.

Although health outcomes will remain important in 2022 given the emergence of the Omicron variant, the outlook for macroeconomic policy will be more crucial as support and stimulus packages enacted to combat the pandemic-driven downturn are gradually removed into 2022. The removal of policy support poses a new challenge for policymakers and a new risk to financial markets.

The global economic recovery is likely to continue in 2022, although Vanguard expect the low-hanging fruit of rebounding activity to give way to slower growth in most parts of the world, whether supply-chain challenges ease or not. In both the United States and the euro area, Vanguard expect growth to slow down to 4%. In the United Kingdom, they expect growth of about 5.5%, and in China they expect growth to fall to about 5%. In Australia, Vanguard expect stronger growth in 2022 of around 4.3%, following a lacklustre 2021 weighed down by lockdowns. Although positive vaccination progress paves the way for a more resilient economic reopening, rising Omicron cases are likely to drive consumer reluctance and be a drag on near-term growth.

Despite modest increases during 2021, government bond yields remain below preCOVID levels. The prospect of rising inflation and reduced central bank support means that the short-term policy rates targeted by the Fed, the RBA, and other developed-market policymakers are likely to rise over the coming year. Credit spreads remain generally very tight. Rising rates are unlikely to produce negative total returns over the medium and long term, given Vanguard's inflation outlook and given the long-term economic forces that should keep long-term rates low.

GLOBAL INFLATION: LOWER BUT STICKIER

Inflation has continued to trend higher across most economies, driven by a combination of higher demand as pandemic restrictions were lifted and lower supply from global labour and input shortages. While Vanguard don't envision a return to 1970s-style inflation, they anticipate that supply and demand frictions will persist well into 2022 and keep inflation elevated across developed and emerging markets.

That said, it is highly likely that inflation at the end of 2022 will be lower than at the beginning of the year given the unusual run-up in goods prices. Although inflation should cool in 2022, its composition may be stickier. More persistent wage- and shelter-based inflation will be critical to how central banks respond.

Central bankers will have to strike a balance between keeping a lid on inflation expectations, given negative supply-side shocks, and supporting a return to pre-COVID employment levels. In the United States, that balance should involve the Federal Reserve raising interest rates in the first half of 2022. The pace and number of interest rate hikes over the course of this year will depend crucially on incoming wage and inflation expectations data.

In Australia, better growth prospects and rising inflation expectations are likely to see the RBA taper off its quantitative easing program by the first half of 2022. Vanguard's baseline does not see an RBA rate hike until 2023 but the risks are now tilted to an earlier liftoff. Risks stem primarily from strong labour market progress, especially among prime-age workers, and broadening inflationary pressures.

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