QUARTERLY ECONOMIC AND MARKET UPDATE

March 2023 Quarter

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QUARTER IN REVIEW

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Global markets advanced through the first quarter of 2023 with generally positive returns in both equity and bond markets. Inflation and the tightening of central bank policy remained in the spotlight for the markets, punctuated by a spike of volatility triggered by the failing of two large U.S. banks in March, and UBS's takeover of the failing Credit Suisse in Europe.

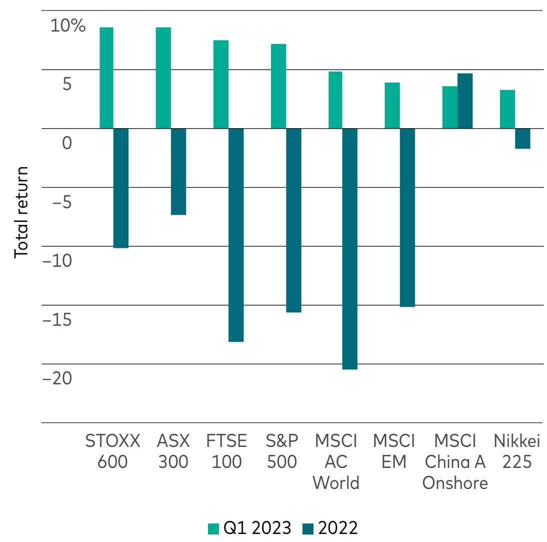
The global equity market experienced a strong start in January as markets looked towards signs of fading inflation as a signal that central banks may soon pause the interest rate hiking cycle, providing relief to borrowers. However, markets reversed course over February as stronger-than-expected inflation data prompted central banks to continue hiking.

In March, the collapse of SVB contributed to a spike in volatility, but the tension was eased as central banks and regulators intervened, soothing market concerns over the banking sector.

Overall, global equity markets closed the quarter 7.2% higher in local currency terms (Figure 1) as equity indexes held on to their January gains. The S&P/ASX 300 Index returned 3.3% over the quarter as all sectors except energy and financials advanced. Similar sector weakness in global equities were offset by a resurgence in technology companies. Emerging markets stocks returned 3.8% over the quarter, weaker than their developed peers, as the U.S. dollar strengthened in February, which can be a headwind for emerging markets equities.

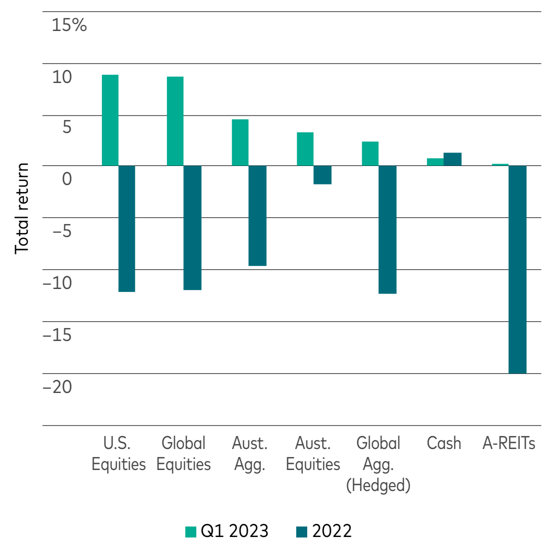
Bonds also advanced as investors sought safehaven assets and expectations for interest rate rises eased (Figure 2). Bond indexes experienced a slight rise this quarter as global bonds gained 2.4% (AUD hedged), while Australian bonds saw a greater return of 4.6%. The 10-year bond yields fell in Australia by 75 basis points to 3.3% and in the United States by 38 basis points to 3.5%.

Figure 1. Global equities gained



Note: Returns are cumulative total returns in local currency.
Sources: FactSet, as of 31 March 2023.

Figure 2. AUD indexes broadly advanced



Note: Returns are cumulative total returns denominated in AUD.
Source: FactSet, Refinitiv, as of 31 March 2023.

ECONOMIC OUTLOOK

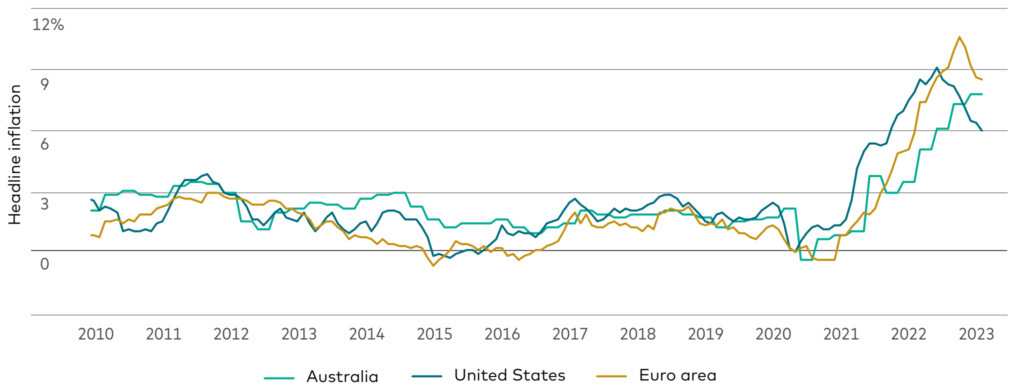
Since the pandemic, the global economy has recovered strongly, with the demand for goods and services generally outstripping supply.

This has helped push inflation to its highest level since the early 1990s and compelled central banks to raise interest rates rapidly in an effort to cool the economy and re-anchor inflation. In Australia, the Reserve Bank of Australia (RBA) has raised interest rates from 0.1% to 3.6% since May 2022, but inflation unfortunately remains well above the RBA's 2–3% inflation target.

In 2023, Vanguard base case is one of falling inflation.

Indeed, recent data suggest that inflation has likely peaked, with headline inflation falling from a high of 9.1% to 6.4% in the United States and from 10.6% to 8.6% in the euro area (see Figure 3). Australia's quarterly inflation data, widely seen as the most reliable gauge for inflation, has also likely peaked. More timely Australian inflation-related measures suggest that inflation is now on a downward path.

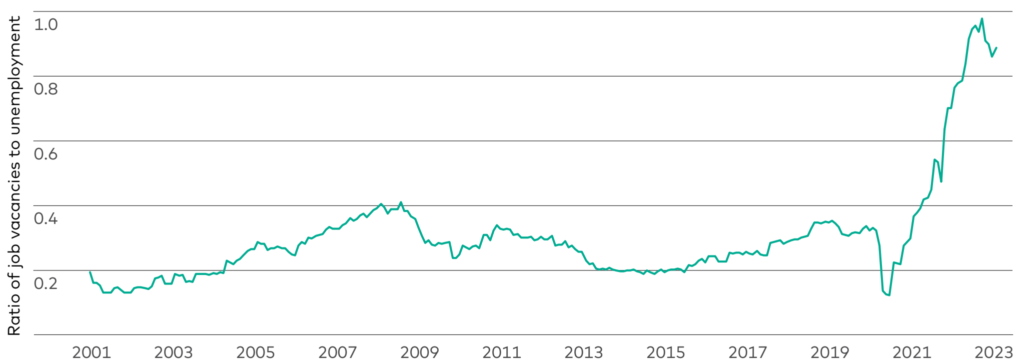
Figure 3. Inflation has peaked in most developed markets



Sources: Bloomberg, as of 5 April 2023.

Vanguard expect inflation to trend lower over the rest of 2023 as energy prices settle and the economy slows. Reducing wage-based inflation pressures will, however, take longer. The labour market remains tight, with the vacancy-tounemployment (V/U) ratio, a measure of the labour demand/supply balance, still at generational highs (see Figure 4). When labour markets are tight and workers are in short supply, employees have greater bargaining power and are able to demand higher wages, which is something Vanguard have observed in Australia over the past year. Higher wages help support consumer spending and therefore put upward pressure on inflation. Given that the labour market remains tight and wages are growing at a faster pace, central banks are unlikely to achieve their inflation targets until 2024.

Figure 4. The Australian labour market is still tight



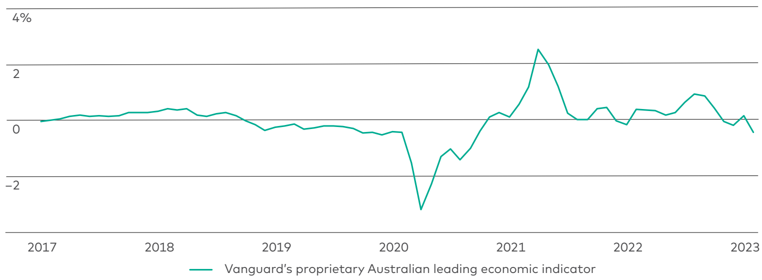
Source: Vanguard calculations based on data from Bloomberg, as of 5 April 2023.

In the broader Australian economy, clear signs have emerged in recent months that activity is slowing. National house prices have also fallen by 9.1% since April 2022, household consumption has slowed, and consumer sentiment is very weak. Vanguard's proprietary leading indicator for Australia has also fallen since mid-2022 and is now just below its longrun average (see Figure 5). And Vanguard's proprietary recession probability index is elevated (see Figure 6), suggesting a roughly 50% chance of recession in the next 12 months.

With inflation pressures easing, Vanguard expect central banks, including the RBA, the U.S. Federal Reserve and the European Central Bank, to soon pause the interest rate hiking cycle (see Figure 7). A pause allows central banks time to assess the impact of higher interest rates, which typically take one to two years to fully pass through to economic growth and inflation. In Vanguard's view, the next rate move after the pause is likely to be a rate cut sometime in 2024. However, the key risk is that inflation remains stubbornly high and central banks are forced to resume the hiking cycle.

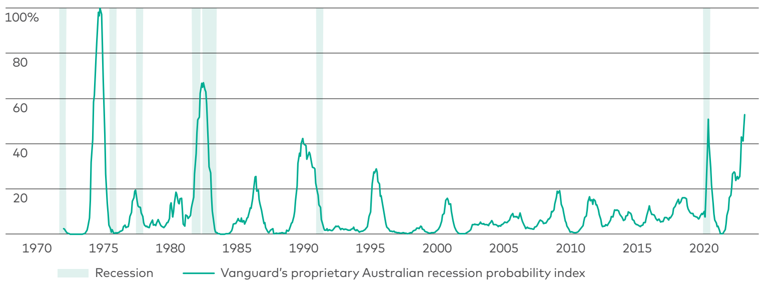
To assess this risk, Vanguard are keeping a close eye on the labour market, and in particularly on wages and the V/U ratio (shown in Figure 2). These dynamics are critical to the outlook for inflation and interest rates in 2023.

Figure 5. The Australian economy has slowed



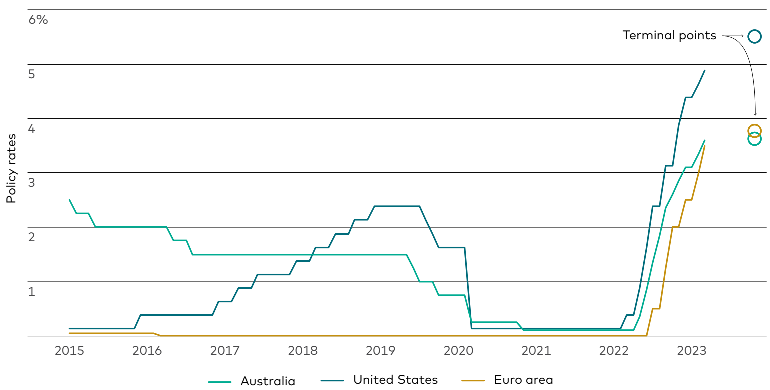
Source: Vanguard, as of 5 April 2023.

Figure 6. Recession risks are rising



Source: Vanguard, based on data from Bloomberg, as of 5 April 2023.

Figure 7. Interest rates are close to their terminal point



Source: Bloomberg historical data and Vanguard forecasts, as of 5 April 2023.

MARKET OUTLOOK

Markets have remained focused on inflation and central bank policy year to date, driving volatility in equity and bond markets alike. Clear signs have now emerged that inflation has peaked, and as such markets are now pricing in a slowing pace of interest rate hikes.

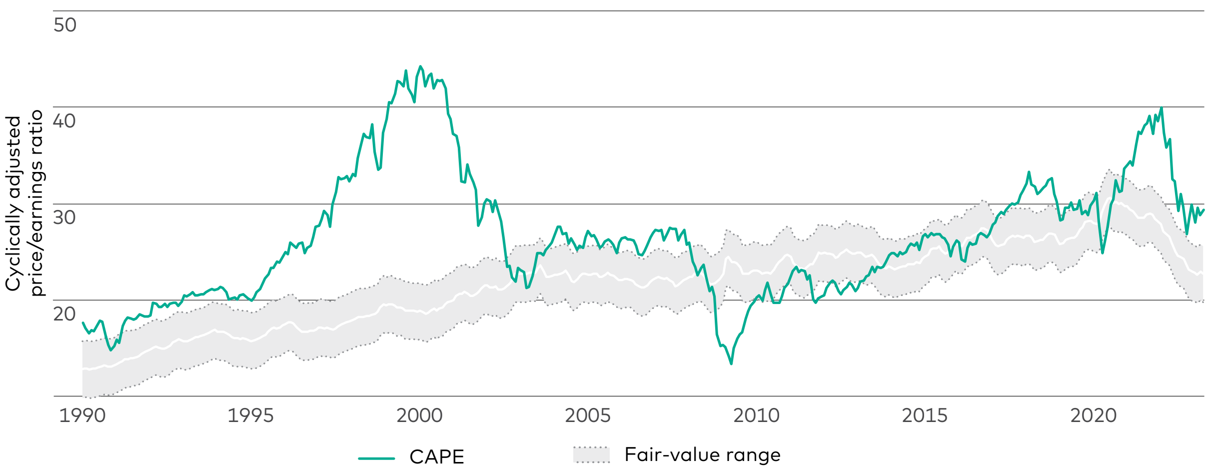
This has resulted in falling yields that have benefited bond prices quarter-to-date but are expected to moderately reduce forwardlooking returns. Despite recent declines, yields and fixed income valuations continue to be more attractive than they were a year ago when interest rates sat close to historic lows.

Meanwhile, equity valuations have remained relatively robust year-to-date despite a guarded view on corporate earnings. In Figure 8 Vanguard show a long-term measure of U.S. equity valuations, the cyclically adjusted price-earnings (CAPE) ratio, against Vanguard's estimates of fair value.

Although cheaper markets are more fairly priced than a year ago, Vanguard still see valuations sitting above their fair value when adjusting for current levels of interest rates and inflation. This presents potential downside risks for equities particularly if inflation remains stickier or if earnings expectations disappoint.

As volatility persists it's as important as ever for investors to remember their investment plans. For most investors, ensuring their plans continue to align with their investment goals, staying diversified, and maintaining discipline, are all well worth a reminder.

Figure 8. U.S. equity valuations are still above our estimates of fair value



Notes: "Fair-value CAPE" is based on a statistical model that corrects CAPE measures for the level of inflation and interest rates. The statistical model specification is a three-variable vector error correction, including equity-earnings yields, 10-year trailing inflation, and 10-year U.S. Treasury yields estimated over the period January 1940 to March 2023.

Source: Vanguard calculations, based on data from Refinitiv, 31 March 2023.

Source: *Vanguard | Quarterly Economic and Market Outlook Report, April 2023 (Page 2 - 7).*

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