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Vanguard economic and market outlook for 2021: Approaching the dawn

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Global outlook summary

Global economy in 2021: *Waiting for a vaccine*

The COVID-19 pandemic has produced the most pronounced economic shock in nearly a century. In 2020, recessions around the world were sharp and deep, with significant supply-chain disruptions at times. That said, perhaps more than in previous recessions, policymakers were aggressive in supporting financial markets and their economies. While the global economy continues to recover as we head into 2021, the battle between the virus and humanity's efforts to stanch it continues.

For 2021, our outlook for the global economy hinges critically on health outcomes. Specifically, our baseline forecast assumes that an effective combination of vaccine and therapeutic treatments should ultimately emerge to gradually allow an easing of government restrictions on social interaction and a lessening of consumers' economic hesitancy. But the recovery's path is likely to prove uneven and varied across industries and countries, even with an effective vaccine in sight. As we said in our midyear 2020 outlook, it will be some time before many economies return to their pre-COVID levels of employment and trend output.

The unevenness of our cyclical growth outlook is reflected in the world's major economies. China, where control of the pandemic has been more effective, has swiftly returned to near pre-pandemic trend growth, and we see that extending in 2021 with growth of 9%. Similarly, in Australia, 2021 starts from a relatively strong base supported by lower virus incidence and sustained policy support, with growth of around 4% likely to see output return to pre-pandemic levels by Q3 2021. Elsewhere, the virus's prevalence has been less well-controlled, implying a sharper rebound in growth from a lower base in 2020 once a vaccine becomes widely available next year. We expect growth of 5% in the U.S. and 5% in the euro area, with those economies still falling short of full employment levels in 2021. In emerging markets, we expect a more incomplete recovery, with growth of 6%.

Risks to our baseline growth forecast are biased to the upside, reflecting ongoing breakthroughs in vaccine development. Both monetary and fiscal policy will remain supportive in 2021, but the primary risk factor is the pandemic's fate and path.

COVID-19's long shadow: *A pivotal moment in history*

When we peek beyond the long shadow of COVID-19, our research and read of history suggest that the pandemic will have certain effects on the economy, markets, and policy. We can split these effects into four categories:

1. **A profound yet ultimately temporary setback.** Social activities and the industries most reliant on them will rebound, as they have following past pandemics. Consumer hesitancy from fear of catching COVID-19 will determine the path, but eventually social activities ranging from concertgoing to traveling will resume. While the immediate pain of job losses is great for many families and industries, we believe that, assuming a reasonable path for health outcomes and additional policy support, the scarring effect of permanent job losses is likely to be limited.
2. **An accelerated future.** Trends that Vanguard and others have previously discussed, ranging from work automation to digital technologies to certain business-model disruptions, have only been accelerated by the shock of COVID-19. This outlook lays out how pervasive the future of virtual work could be and what broader macroeconomic effects may result.
3. **Pivots in policy.** This crisis has seemingly altered the expectations of, and preferences for, certain government policies, ranging from more forceful efforts by central banks to drive up low inflation to more aggressive spending by fiscal authorities amid economic headwinds. These intentions are unlikely to be reversed quickly, producing potential new risks on the investment horizon, though we suggest that some risks have been exaggerated.
4. **Unaltered reality.** Despite the extraordinary events of 2020, some aspects of the global economy may ultimately stay as they are. In our view, these would include the multifaceted U.S.-China relationship and the likelihood of increasing innovation in the years ahead, as suggested by Vanguard's "Idea Multiplier."

Global inflation: *Modest reflation "yes"; a return to high inflation "no"*

In 2021, we anticipate a cyclical bounce in consumer inflation from pandemic lows near 1% to more realistic rates of close to 2% due to base effects and as the recovery continues. A risk is that markets could confuse this modest reflationary bounce in inflation with the start of a return to a 1970s-type high-inflation era.

Mounting debt loads, extraordinarily easy monetary policy, and, in the case of the United States, an explicit assurance that policy will remain accommodative longer than it had in the past have all led to concerns about resurgent inflation. Our baseline projections show that such concerns are premature and unlikely to materialize in 2021. More profligate fiscal spending has the potential to influence inflation psychology, but any such influence would have to more than counteract high levels of unemployment and technology influences to drive up inflation expectations. We maintain our long-held assessment that inflation rates persistently above 3% are difficult to generate across many developed markets.

The bond market: *Interest rates staying low in 2021*

Interest rates and government bond yields that were low before the pandemic are now even lower. Our expectations are for short-term policy rates targeted by the U.S. Federal Reserve, the Reserve Bank of Australia, and other developed-market policymakers to remain at historically low (and, in some markets, negative) levels into 2022 before eventually beginning to normalize to pre-COVID levels. Yield curves may steepen slightly as long-term rates in our baseline forecast rise modestly. But given our outlook for inflation and central bank policy, bond yields are unlikely to move markedly higher. In our view, central banks would be inclined to fight a sharp rise in bond yields in 2021 through additional quantitative easing purchases or other measures should such a situation be viewed as counterproductive to the economic recovery.

Global equities: *Challenges and opportunities*

Yet again, disciplined investors were rewarded in 2020 by remaining invested in the stock market despite troubling headlines. The dramatic repricing of global equity risk during the initial shock of the pandemic was fairly uniform across global markets, with the steep drop in discount rates explaining some (but not all) of this past year's rebound in equity prices. Our fair-value stock projections, which explicitly incorporate such effects, continue to reveal a global equity market that is neither grossly overvalued nor likely to produce such outsized returns going forward.

The outlook for the global equity risk premium is positive and modest, with total returns expected to be 3 to 5 percentage points higher than bond returns. This modest return outlook, however, belies opportunities for investors by investing broadly around the world and across the value spectrum.

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