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Quarterly economic and market update

June quarter 2023

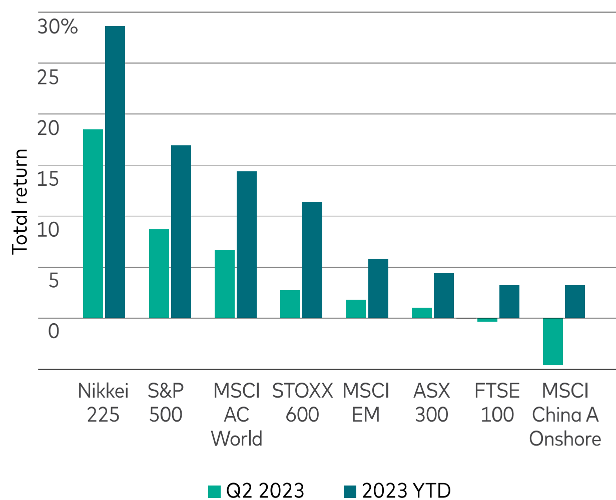
Quarter in review

Global equity markets continued their rebound in the second quarter of 2023, driven by resilient company earnings and growing optimism over artificial intelligence. This marked a reversal in the same rate-sensitive sectors that felt the most pain in 2022. However, continued economic strength posed challenges to central banks and bond markets as efforts to rein in inflation saw yields rise over the quarter.

Equities in developed markets were led higher by a surge in Japanese equities. U.S. equities also delivered outsized returns as the tech sector lifted the broader S&P 500 Index 8.7% and into a new bull market (**Figure 1**). Meanwhile, gains in emerging markets were modest as China's Q1 rally reversed and demand softened. Combined with expectations for a global slowdown, the Australian equity market was weighed down by a decline in the materials sector and low exposure to the rally in technology. Australian shares advanced 1.0% over the quarter, with unhedged global equities delivering 7.0% (**Figure 2**).

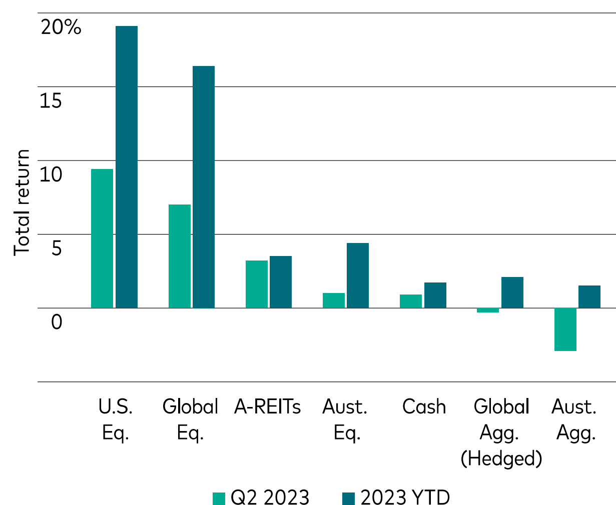
Bond markets were mixed as central banks grappled with inflation across most developed markets. The United Kingdom and Australia in particular saw yields rise (bond prices fall) in the face of above-expectation inflation. Australian bonds fell 2.9% over the quarter, delivering a 1.5% gain year to date, while global hedged bonds fell 0.3%. 10-year yields climbed 0.72 percentage points in Australia and 0.32 percentage points in the United States.

Figure 1. Global equities continued to rally in Q2



Note: Returns are cumulative total returns denominated in the local currency of each security's country of domicile.
Source: FactSet, as of 30 June 2023.

Figure 2. AUD indexes broadly advanced



Note: Returns are cumulative total returns denominated in AUD.
Sources: FactSet, Refinitiv, as of 30 June 2023.

Economic and market outlook

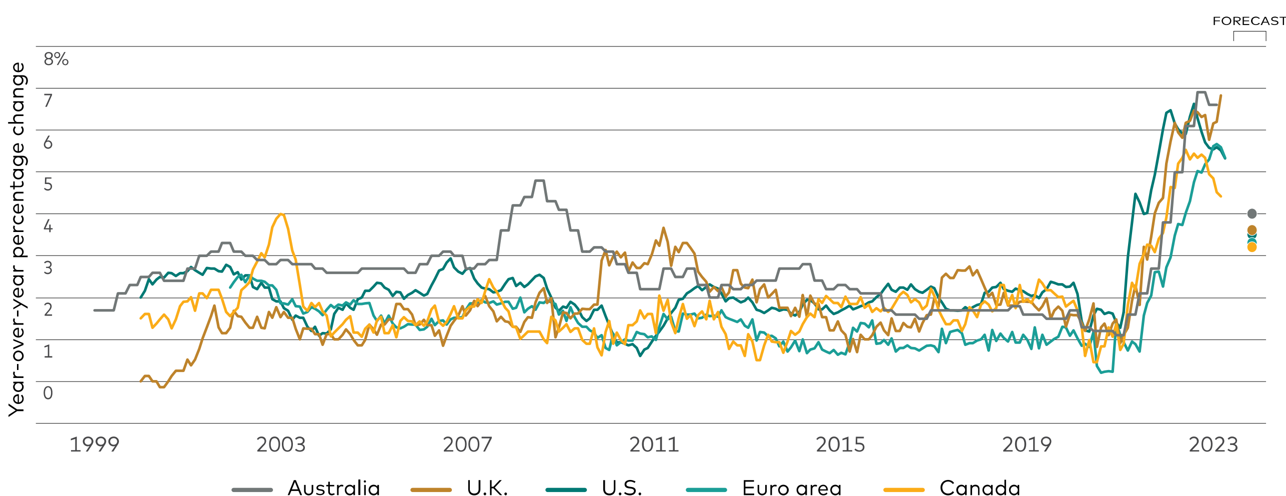
In Australia, interest rates continue to climb amid sticky inflation. Our 2023 growth forecast of 1%–1.5% year-over-year is little changed from the start of the year. But tepid first-quarter growth and our expectation for subdued consumption in the coming quarters skew risks to the downside. We place a 40% probability on recession in the next 12 months—below that of many developed markets but still significant.

Despite some mixed signals recently, we believe inflation has peaked; our forecast for its pace at year-end, 4.5%, is unchanged. We foresee inflation falling to the high end of the Reserve Bank of Australia's (RBA) 2%–3% target range only in late 2024 or 2025.

A historically aggressive effort to slow the Australian economy—and thereby quell inflation—almost certainly will continue. The RBA raised its cash rate target a dozen times between May 2022 and June 2023. We foresee two more rate hikes, taking the rate target to 4.6% by year-end.

In the United States, the recovery from the shortest recession in more than 150 years—a two-month downturn in early 2020—has endured one of the most aggressive interest rate-hiking cycles in Federal Reserve history. Recent growth has been stable at about 2%, annualised. We still assign a high probability to a recession, though the odds have risen that it could be delayed from 2023 to 2024.

Figure 3. Slow but sure progress on inflation



Notes: We use year-over-year changes in the core consumer price index (CPI) for all locations except Australia, where we use trimmed mean CPI. Year-end 2023 figures are Vanguard forecasts.

Sources: Vanguard calculations, using data from the U.S. Bureau of Labor Statistics, Statistics Canada, Eurostat, the U.K. Office for National Statistics, and the Australian Bureau of Statistics accessed through Macrobond on June 15, 2023.

In the euro area, we expect the slight economic contraction in the fourth quarter of 2022 and the first quarter of 2023, likely caused by the energy crisis, to give way to a new but short-lived expansion. Another downturn is likely to arrive this year or next as the lagged effects of monetary policy tightening are realised.

In China, we now expect year-over-year economic growth of 5.5%–6% in 2023, more than we anticipated at the start of the year. But the bulk of those gains have already

occurred, meaning that slower growth is coming in the second half of the year. Full-year growth above a conservative government target is likely, but three years of policy uncertainty will weigh on confidence.

Although near-term uncertainty persists for the economy, expected returns for equity and bond markets remain far above their levels at the end of 2021, prior to

Figure 4. Vanguard's forecasts for year-end 2023

	2023 economic growth	2023 inflation*	2023 monetary policy**	2023 unemployment rate
U.S.	0.75%	3.3%	5.25–5.5%	4.5%
Canada	0.8%	3.2%	5%	5.5%
Mexico	1.8-1.9%	5.6%	11.25%	3.5%
U.K.	0%	4.9%	5.5%–5.75%	4%–4.5%
Euro area	0.5%	3.3%	3.75–4%	7%–7.5%
China	5.5%–6%	1%	2.45–2.55%	4.7%
Australia	1%–1.5%	4.5%	4.6%	4%

*Inflation forecasts are for core inflation, which excludes volatile energy and food prices, except for Australia, where we measure headline inflation, which includes food and energy.

**Our forecast for the United States year-end monetary policy rate reflects the low end of the Federal Reserve's federal funds target range.

Notes: Figures related to economic growth, inflation, monetary policy, and unemployment rate are Vanguard forecasts for the end of 2023. Growth and inflation are comparisons with the end of the preceding year; monetary policy and unemployment rate are absolute levels.

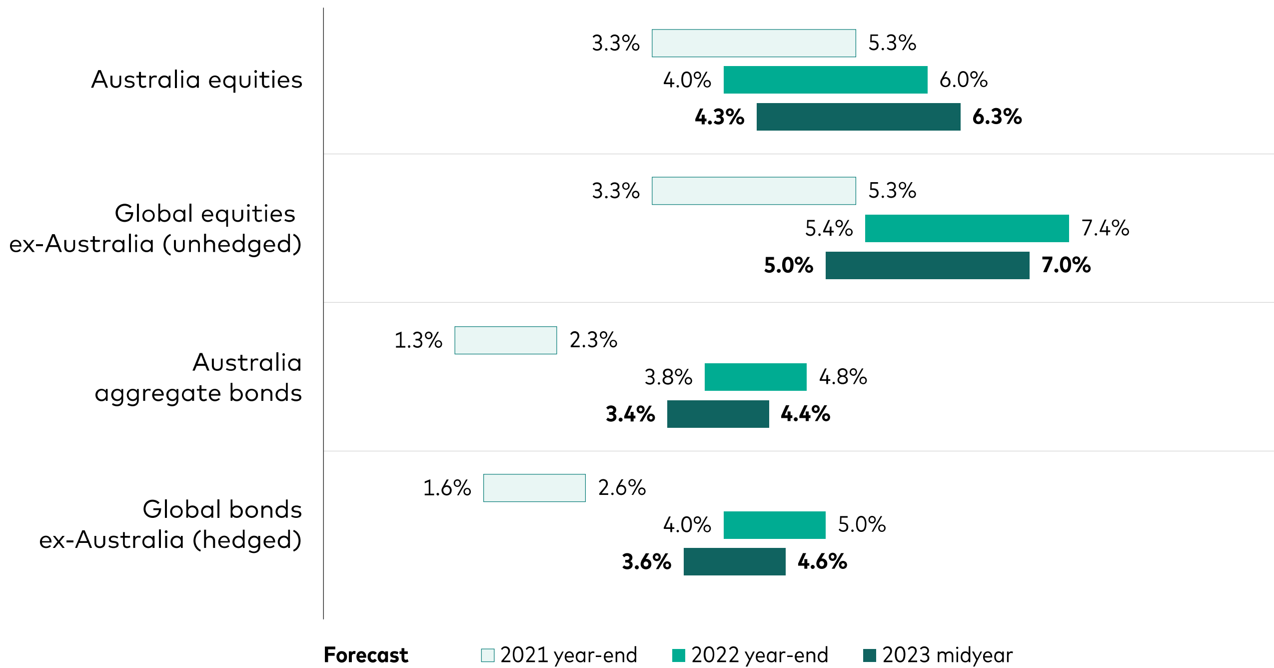
Source: Vanguard, as of June 26, 2023.

corrections through 2022. For long-term investors, the opportunity set remains far more attractive across both asset classes. Even as risk-free yields rise, equities are still expected to deliver a risk premium to investors with appropriate risk tolerance and time horizon, acting as the driving growth asset within a portfolio. Meanwhile, higher interest rates mean bonds are better positioned to deliver income and dampen volatility within a portfolio.

High inflation and rising interest rates throughout 2021 and 2022 prompted some investors to question the value of diversification. However, even amid an incredibly challenging period, diversification has rewarded patience and will continue to be fundamental to achieving your goals.

In the current market, the best advice is still to focus on what is in your control, which is your exposure to risk and how you react when the 'unexpected' happens. Remind yourself of the 'why' behind your investment strategy and focus on whether you are still on track to meet those goals.

Figure 5. Vanguard Economic and Market Outlook



IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of December 31, 2021; December 31, 2022; and May 31, 2023. Results from the model may vary with each use and over time. For more information, please see the important information slide.

Note: Figures are based on a 2-point range around the 50th percentile of the distribution of return outcomes for equities and a 1-point range around the 50th percentile for fixed income.

Source: Vanguard.

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The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

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