Vanguard economic and market outlook for 2024: Global summary

The global outlook summary highlights the top-level findings of Vanguard's full economic and market outlook, to be distributed in mid-December.

Higher interest rates are here to stay. Even after policy rates recede from their cyclical peaks, in the decade ahead rates will settle at a higher level than we've grown accustomed to since the 2008 global financial crisis (GFC). This development ushers in a return to sound money, and the implications for the global economy and financial markets will be profound. Borrowing and savings behavior will reset, capital will be allocated more judiciously, and asset class return expectations will be recalibrated. Vanguard believes that a higher interest rate environment will serve investors well in achieving their long-term financial goals, but the transition may be bumpy.

Monetary policy will bare its teeth in 2024

The global economy has proven more resilient than we expected in 2023. This is partly because monetary policy has not been as restrictive as initially thought. Fundamental changes to the global economy have pushed up the neutral rate of interest—the rate at which policy is neither expansionary nor contractionary. Various other factors have blunted the normal channels of monetary policy transmission, including the U.S. fiscal impulse from debt-financed pandemic support and industrial policies, improved household and corporate balance sheets, and tight labor markets that have resulted in real wage growth. In the U.S., our analysis suggests that these offsets almost entirely counteracted the impact of higher policy interest rates. Outside the U.S., this dynamic is less pronounced. Europe's predominantly bank-based economy is already flirting with recession, and China's rebound from the end of COVID-19-related shutdowns has been weaker than expected.

The U.S. exceptionalism is set to fade in 2024. We expect monetary policy to become increasingly restrictive as inflation falls and offsetting forces wane. The economy will experience a mild downturn as a result. This is necessary to finish the job of returning inflation to target. However, there are risks to this view. A "soft landing," in which inflation returns to target without recession, remains possible, as does a recession that is further delayed. In Europe, we expect anemic growth as restrictive monetary and fiscal policy lingers, while in China, we expect additional policy stimulus to sustain economic recovery amid increasing external and structural headwinds.

Zero rates are yesterday's news

Barring an immediate 1990s-style productivity boom, a recession is likely a necessary condition to bring down the rate of inflation, through weakening demand for labor and slower wage growth. As central banks feel more confident in inflation's path toward targets, we expect they will start to cut policy rates in the second half of 2024.

That said, we expect policy rates to settle at a higher level compared with after the GFC and during the COVID-19 pandemic. Vanguard research has found that the equilibrium level of the real interest rate, also known as r-star or r*, has increased, driven primarily by demographics, long-term productivity growth, and higher structural fiscal deficits. This higher interest rate environment will last not months, but years. It is a structural shift that will endure beyond the next business cycle and, in our view, is the single most important financial development since the GFC.

Vanguard's 2024 economic forecasts

	GDP growth			Unemployment rate			Core inflation		Monetary policy		
	2024			2024			2024				
Country/ region	Vanguard	Consensus	Trend	Vanguard	Consensus	NAIRU	Vanguard	Consensus	Year-end 2023	Year-end 2024	Neutral rate
U.S.	0.5%	0.8%	1.8%	4.8%	4.4%	3.5%–4%	2.5%	2.5%	5.5%–5.75%	4%–4.5%	3%–3.5%
Euro area	0.5%–1%	0.8%	1.2%	7%–7.5%	6.8%	6.5%–7%	2.1%	2.5%	4%	3.25%	2%–2.5%
U.K.	0.5%–1%	0.4%	1%	4.5%–5%	4.8%	3.5%–4%	2.8%	N/A	5.25%	4.25%	3%–3.5%
China	4.5%–5%	4.5%	4.1%	4.8%	5%	5%	1%–1.5%	N/A	2.3%–2.4%	2.2%	4.5%–5%

Notes: Forecasts are as of November 14, 2023. For the U.S., GDP growth is defined as the year-over-year change in fourth-quarter GDP. For all other countries/regions, GDP growth is defined as the annual change in GDP in the forecast year compared with the previous year. Unemployment forecasts are the average for the fourth quarter of 2024. NAIRU is the non-accelerating inflation rate of unemployment, a measure of labor market equilibrium. Core inflation excludes volatile food and energy prices. For the U.S., euro area, and U.K., core inflation is defined as the year-over-year change in the fourth quarter compared with the previous year. For China, core inflation is defined as the average annual change compared with the previous year. For the U.S., core inflation is based on the core Personal Consumption Expenditures Index. For all other countries/regions, core inflation is based on the core Consumer Price Index. The neutral rate is the equilibrium policy rate at which no easing or tightening pressures are being placed upon an economy or its financial markets.

Source: Vanguard.

A return to sound money

For households and businesses, higher interest rates will limit borrowing, increase the cost of capital, and encourage saving. For governments, higher rates will force a reassessment of fiscal outlooks sooner rather than later. The vicious circle of rising deficits and higher interest rates will accelerate concerns about fiscal sustainability. Vanguard's research suggests the window for governments to act on this is closing fast—it is an issue that must be tackled by this generation, not the next.

For well-diversified investors, the permanence of higher real interest rates is a welcome development. It provides a solid foundation for long-term risk-adjusted returns. However, as the transition to higher rates is not yet complete, near-term financial market volatility is likely to remain elevated.

Bonds are back!

Global bond markets have repriced significantly over the last two years because of the transition to the new era of higher rates. In our view, bond valuations are now close to fair, with higher long-term rates more aligned with secularly higher neutral rates. Meanwhile, term premia have increased as well, driven by elevated inflation and fiscal and monetary outlook uncertainty.

Despite the potential for near-term volatility, we believe this rise in interest rates is the single best economic and financial development in 20 years for long-term investors. Our bond return expectations have increased substantially. We now expect U.S. bonds to return a nominal annualized 4.8%–5.8% over the next decade, compared with the 1.5%–2.5% annualized returns we expected before the rate-hiking cycle began. Similarly, for international bonds, we expect annualized returns of 4.7%–5.7% over the next decade, compared with a forecast of 1.3%–2.3% when policy rates were low or, in some cases, negative.

If reinvested, the income component of bond returns at this level of rates will eventually more than offset the capital losses experienced over the last two years. By the end of the decade, bond portfolio values are expected to be higher than if rates had not increased in the first place.

Similarly, the case for the 60/40 portfolio is stronger than in recent memory. Long-term investors in balanced portfolios have seen a dramatic rise in the probability of achieving a 10-year annualized return of at least 7%, the post-1990 average, from an 8% likelihood in 2021 to 40% today.

Moving up the risk spectrum, credit valuations appear fair in the investment-grade space but relatively rich in high-yield. What's more, the growing likelihood of recession and declining profit margins skew the risks toward wider spreads.

Higher rates leave equities overvalued

A higher-rate environment depresses asset price valuations across global markets while squeezing profit margins as corporations find it more expensive to issue and refinance debt.

Valuations are most stretched in the U.S. As a result, we have downgraded our U.S. equity return expectations to an annualized 4.2%–6.2% over the next 10 years from 4.4%–6.4% heading into 2023. Within the U.S. market, value stocks are more attractive than they have been since late 2021, and small-capitalization stocks also appear attractive for the long term.

U.S. equities have continued to outperform their international peers. The key drivers of this performance gap over the last two years have been valuation expansion and U.S. dollar strength beyond our fair-value estimates, both of which are likely to reverse. Indeed, our Vanguard Capital Markets Model® (VCMM) projections suggest an increasing likelihood of greater opportunities outside the U.S. from a U.S. dollar investor's perspective. We project 10-year annualized returns of 7.0%–9.0% for non-U.S. developed markets and 6.6%–8.6% for emerging markets.

The global equity risk premium that emerges from current stock and bond market valuations is the lowest since the 1999–2009 "lost decade." The spread between global equity and global bond returns is expected to be 0 to 2 percentage points annualized over the next 10 years. In contrast to the last decade, we expect return outcomes for diversified investors to be more balanced. For those with an appropriate risk tolerance, a more defensive risk posture may be appropriate given higher expected fixed income returns and an equity market that is yet to fully reflect the implications of the return to sound money.

IMPORTANT: The projections and other information generated by the 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 VCMM are derived from 10,000 simulations for each modeled asset class. Simulations as of September 30, 2023. Results from the model may vary with each use and over time. For more information, please see the Notes section.

Notes:

All investing is subject to risk, including the possible loss of the money you invest. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Diversification does not ensure a profit or protect against a loss.

Investments in bonds are subject to interest rate, credit, and inflation risk.

Investments in stocks and bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk. These risks are especially high in emerging markets.

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time.

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the

VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

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.

Vanguard global economics team

Joseph Davis, Ph.D., Global Chief Economist

Americas

Roger A. Aliaga-Díaz, Ph.D.,
Chief Economist, Americas,
Global Head of Portfolio Construction

Andrew Patterson, CFA, Senior International Economist

Joshua Hirt, CFA

Asawari Sathe, M.Sc.

Adam Schickling, CFA

Vytautas Maciulis, CFA

Rhea Thomas

Maria Fernanda Estrada

Asia-Pacific

Qian Wang, Ph.D.,
Chief Economist, Asia-Pacific

Carole Okigbo,
Head of ISG, Asia-Pacific

Alexis Gray, M.Sc.

Grant Feng, Ph.D.

Europe

Jumana Saleheen, Ph.D.,
Chief Economist, Europe

Shaan Raithatha, CFA

Ranieri Arcella

Josefina Rodriguez

Capital Markets Model Research Team

Qian Wang, Ph.D.,
Global Head of VCMM

Kevin DiCiurcio, CFA,
VCMM Senior Investment Strategist

Daniel Wu, Ph.D.

Olga Lepigina, MBA

Ian Kresnak, CFA

Lukas Brandl-Cheng, M.Sc.

Ryan Zalla, Ph.D

Alex Qu

Ben Vavreck, CFA

Taylor Regensburger

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