Vanguard economic and market outlook for 2018: Rising risks to the status quo

Joseph Davis, Ph.D. | December 2017

Global economic outlook: *An 'inflation scare'?*

The financial markets' low volatility underscores investors' conviction that the long-term global economic trends of modest growth and tepid inflation will also define shorter-term cycles. But risks lie in mistaking the trend for the cycle.

The most pronounced risk in our 2018 outlook is that already tight global labor markets will grow tighter, finally leading to a cyclical uptick in inflation. A wage or inflation spike in 2018 could lead markets to anticipate a more aggressive normalization from historically low interest rates just as central banks are either normalizing monetary policy or contemplating doing so, thereby producing a market-rattling shock.

Global investment outlook: *Higher risks, lower returns*

For 2018 and beyond, our investment outlook is modest, at best. Elevated valuations, low volatility, and secularly low interest rates are unlikely to be allies for robust financial market returns over the next five years. Downside risks are more elevated in the equity market than in the bond market.

In our view, the solution to this challenge is not shiny new objects or aggressive tactical shifts. Rather, our market outlook underscores the need for investors to remain disciplined and globally diversified, armed with reasonable return expectations and low-cost strategies.

What follows is a brief overview of our economic and investment outlook for 2018.

Economic growth: *Unemployment, not growth, is the key*

We expect economic growth in developed markets to remain moderate in 2018, while strong emerging-market growth should soften a bit. Yet investors should pay more attention to low unemployment rates than GDP growth at this stage of the cycle for prospects of either higher spending for capital expenditures or wage pressures. We see low unemployment rates across many economies declining further. Improving fundamentals in the United States and Europe should help offset weakness in the United Kingdom and Japan. China's ongoing efforts to rebalance from a capital-intensive exporter to a more consumer-based economy remains a risk, as does the need for structural business-model adjustments across emerging-market economies. We do not anticipate a Chinese "hard landing" in 2018, but the Chinese economy should decelerate.

Inflation: *Secularly low, but cyclically rising*

Previous Vanguard outlooks have rightly anticipated that the secular forces of globalization and technological disruption would make achieving 2% inflation in the United States, Europe, Japan, and elsewhere more difficult. Our trend view holds, but the cycle may differ.

In 2018, the growing impact of cyclical factors such as tightening labor markets, stable and broader global growth, and a potential nadir in commodity prices is likely to push global inflation higher from cyclical lows. The relationship between lower unemployment rates and higher wages, pronounced dead by some, should begin to re-emerge in 2018, beginning in the United States.

Monetary policy: *The end of an era*

The risk in 2018 is that a higher-than-expected bounce in wages—at a point when 80% of major economies (weighted by output) are at full employment—may lead markets to price in a more aggressive path or pace of global monetary policy normalization. The most likely candidate is in the United States, where the Federal Reserve is expecting to raise rates to 2% by the end of 2018, a more rapid pace than anticipated by the bond market. The European Central Bank is probably two years away from raising rates or tapering bond purchases, although a cyclical bounce may lead to a market surprise. Overall, the chance of unexpected shocks to the economy during this tightening phase is high, as is the chance that balance-sheet shrinkage will have an unpredictable impact on asset prices.

Investment outlook: *A lower orbit*

The sky is not falling, but our market outlook has dimmed. Since the depths of the 2008–2009 global financial crisis, Vanguard's long-term outlook for the global stock and bond markets has gradually become more cautious—evolving from bullish in 2010 to formative in 2012 to guarded in 2017—as market returns have risen with (and even exceeded) improving fundamentals. Although we are hard-pressed to find compelling evidence of financial bubbles, risk premiums for many asset classes appear slim. The market's efficient frontier of expected returns for a unit of portfolio risk now hovers in a lower orbit.

Based on our "fair-value" stock valuation metrics, the medium-run outlook for global equities has deteriorated a bit and is now centered in the 4%–6% range. Expected returns for the U.S. stock market are lower than those for international markets, underscoring the benefits of global equity strategies in the face of lower expected returns.

And despite the risk for a short-term acceleration in the pace of monetary policy normalization, the risk of a material rise in long-term interest rates remains modest. For example, our fair-value estimate for the benchmark 10-year U.S. Treasury yield remains centered near 2.5% in 2018. Overall, the risk of a correction for equities and other high-beta assets is projected to be considerably higher than for high-quality fixed income portfolios; balanced portfolios are expected to stunt a rise in return volatility.

Vanguard®

Vanguard Research

P.O. Box 2600
Valley Forge, PA 19482-2600