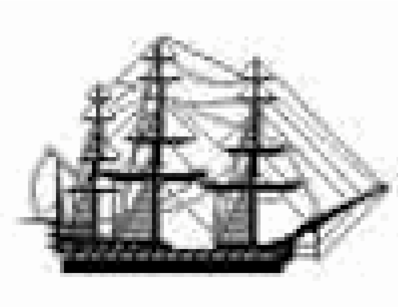
Global Economy ‘Frustratingly Fragile’

By Vanguard Global Economics Team *Fri, Jan 8, 2016*

'There is a high likelihood of an extended pause in interest rates at, say, 1%, that opens the door for balance-sheet normalization and leaves the inflation-adjusted federal funds rate negative through 2017,' say Vanguard economists in a new Global Outlook.



In a new “Economic and Investment Outlook,” the Vanguard Investment Strategy Group assesses the future of the global economy, and its forecast—notwithstanding yesterday’s drop in the Dow Jones Average—isn’t all bad.

Given the “structurally lower population growth” and removal of “the consumer-debt-fueled boost to growth between 1980 and the global financial crisis,” Vanguard’s team of economists considers the anticipated 2% growth rate for the U.S. to be about as good as can be expected.

You can find a copy of the full report **here**. The main points are summarized below:

Global economy: Structural convergence

World economic growth will remain frustratingly fragile. As in past versions of Vanguard’s Economic and Investment Outlooks, we view a world not in secular stagnation but, rather, in the midst of structural deceleration. Vanguard’s non-consensus view is that the global economy will ultimately converge over time toward a more balanced, unlevered, and healthier equilibrium, once the debt-deleveraging cycle in the global private sector is complete.

Most significantly, the high-growth “Goldilocks” era enjoyed by many emerging markets over the past 15 years is over. We anticipate “sustained fragility” for global trade and manufacturing, given China’s ongoing rebalancing and until structural, business-model adjustment occurs across emerging markets. We do not anticipate a Chinese recession in the near term, but China’s investment slowdown represents the greatest downside risk to the global economy.

The growth outlook for developed markets, on the other hand, remains modest, but steady. As a result, the developed economies of the United States and Europe should contribute their highest relative percentage to global growth in nearly two decades. Now at full employment, the U.S. economy is unlikely to accelerate in 2016, yet is on course to experience its longest expansion in nearly a century, underscoring our continuing view of its resiliency.

Indeed, our long-held estimate of 2% U.S. trend growth is neither "new" nor "subpar" when one both accounts for structurally lower population growth and removes the consumer-debt-fueled boost to growth between 1980 and the global financial crisis that began in 2007. Our interpretation fully explains the persistent drop in U.S. unemployment despite below-average economic growth.

Inflation: Secular deflationary bias waning

As we have discussed in past outlooks, policymakers are likely to continue struggling to achieve 2% core inflation over the medium term. As of December 2015, however, some of the most pernicious deflationary forces (commodity prices, labor "slack") are beginning to moderate cyclically. Inflation trends in the developed markets should firm, and even begin to turn, in 2016. That said, achieving more than 2% core inflation across developed markets could take several years and will ultimately require a more vibrant global rebound.

Monetary policy and interest rates: A 'dovish tightening' by a lonely Fed

Convergence in global growth dynamics will continue to necessitate and generate divergence in policy responses.

The U.S. Federal Reserve is likely to pursue a "dovish tightening" cycle that removes some of the unprecedented accommodation exercised due to the "exigent circumstances" of the global financial crisis. In our view, there is a high likelihood of an extended pause in interest rates at, say, 1%, that opens the door for balance-sheet normalization and leaves the inflation-adjusted federal funds rate negative through 2017.

Elsewhere, further monetary stimulus is highly likely. The European Central Bank (ECB) and Bank of Japan (BoJ) are both likely to pursue additional quantitative easing and, as we noted in our 2015 outlook, are unlikely to raise rates this decade. This view is another potential factor that could result in a pause for the federal funds rate this business cycle.

Chinese policymakers have arguably the most difficult task of engineering a "soft landing" by lowering real borrowing costs and the real exchange rate without accelerating capital outflows. The margin of error is fairly slim, and policymakers should aggressively stimulate the economy this year in an attempt to stabilize below-target growth.

Investment outlook: Still conservative

Vanguard’s outlook for global stocks and bonds remains the most guarded since 2006, given fairly high equity valuations and the low-interest-rate environment. We continue to view the global low-rate environment as secular, not cyclical.

Bonds. The return outlook for fixed income remains positive, yet muted. In line with our past outlooks, our long-term estimate of the equilibrium federal funds rate remains anchored near 2.5% and below that of the Fed’s “dot plots.” As a result, our “fair value” estimate for the benchmark 10-year U.S. Treasury yield still resides at about 2.5%, even with a Fed liftoff. As we stated in our 2015 outlook, even in a rising-rate environment, duration tilts are not without risks, given global inflation dynamics and our expectations for monetary policy.

Stocks. After several years of suggesting that low economic growth need not equate with poor equity returns, our medium-run outlook for global equities remains guarded, in the 6%–8% range. That said, our long-term outlook is not bearish and can even be viewed as constructive when adjusted for the low-rate environment. Our long-standing concern over “froth” in certain past high-performing segments of the capital markets has been marginally tempered by the general relative underperformance of those market segments in 2015.

Asset allocation. Going forward, the global crosscurrents of not-cheap valuations, structural deceleration, and the exiting from or insufficiency of near-0% short-term rates imply that the investment environment is likely to be more challenging and volatile. Even so, Vanguard firmly believes that the principles of portfolio construction remain unchanged, given the expected risk–return trade-off among asset classes. Investors with an appropriate level of discipline, diversification, and patience are likely to be rewarded over the next decade with fair inflation-adjusted returns.