Vanguard

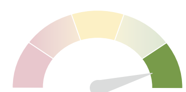
Global macro matters

A look back before looking ahead: Assessing our 2015 outlook

Vanguard research | Joseph Davis, Ph.D. | November 2015

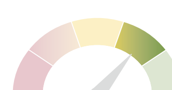
Vanguard has been publishing an annual economic and investment outlook for a number of years. We believe that to treat the future with the deference it deserves, our market forecasts are longer-term and best viewed in a probabilistic framework rather than the traditional "point forecast" approach. This publication reflects on and assesses how our outlook published in December 2014 has tracked so far in 2015.

Global economy



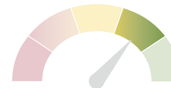
Looking back	Assessing our views
We view the world as being in the midst of structural deceleration and world economic growth as likely to remain frustratingly fragile for some time.	Consistent with our long-run view of global structural deceleration, growth continued to decelerate this year. Agencies such as the International Monetary Fund and the World Bank downgraded near-term growth prospects.
China's economic growth is in a protracted but gradual downward shift, with gross domestic product (GDP) growth likely to be below 7% and to fall toward 5% by 2020. An immediate emerging-market (EM)-style hard landing is not likely.	As expected, Chinese economic growth continued to disappoint this year, given the continuing real estate slowdown and manufacturing contraction, but China so far has avoided a hard landing.
A replay of the late-1990s EM crises is unlikely. Select emerging-market economies can be expected to continue struggling to adjust to evolving global growth dynamics.	A potent combination of plummeting commodity prices, weaker Chinese demand, and a stronger U.S. dollar led to significant weakness in many EM economies.
The euro will survive intact. Given concerns over additional crises, a more vibrant and balanced European economy still seems several years away.	European growth surprised modestly on the upside, despite raised concerns over a "Grexit" from the euro zone in the summer. Select periphery countries such as Spain have improved somewhat quicker than expected, although structural headwinds remain.
The U.S. economy will likely remain resilient despite the global slowdown. Still, the nation's recent cyclical thrust above its 2% trend growth is not immune to the downside risks in Europe and China.	The U.S. economy remained resilient, despite harsh winter weather and the reverberations of weaker EM growth and a strong U.S. dollar. The labor market continued to tighten toward a 5% unemployment rate.

Inflation



Looking back	Assessing our views
A deflationary threat still hovers over a world with excess capacity, despite continued reflationary monetary policies.	Our structural view that deflationary risks outweigh inflationary ones was underscored this year by the sharp, unexpected drop in commodity prices. In most countries, consumer price index inflation rates were either negative or close to 0%.
In the United States, commodity and import prices and the prospect of a stronger dollar are tempering the rise in core inflation. Nascent wage pressures should build in the United States in 2015 and beyond, suggesting that core U.S. inflation is likely to approach its 2% target over the next year or so.	U.S. core inflation rates did not drop below 1%, although they remained below the Federal Reserve's target of 2%. U.S. wage growth generally averaged 2% in 2015, increasing only modestly and unevenly.
In Europe and emerging markets, disinflation continues to be a significant risk.	European Union inflation stayed below the target of 2% set by the European Central Bank (ECB), and deflationary pressures remain a concern despite the ECB's quantitative easing program.

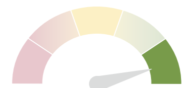
Monetary policy

Looking back	Assessing our views 
Central bank policies should diverge over the next several years. The ECB and Bank of Japan (BoJ) may be hard-pressed to raise rates this decade.	The ECB, BoJ, and People's Bank of China all pursued or gave strong indications of additional policy stimulus this year. Global monetary policy remained accommodative.
We view a Fed liftoff in the second half of 2015 as likely, and we stress that the Fed's rate rise will likely be more gradual (either moving in smaller increments or pausing) and will end lower than some predict.	As of November 2015, the Fed had yet to raise short-term interest rates, although a rise in December seems increasingly likely. The Fed did, however, lower its long-term rate estimates and Fed officials are messaging a very gradual pace of rate increases and the possibility of a pause around 1%.

Capital markets

Looking back

Assessing our views



Global fixed income

Looking back	Assessing our views
Given the macroeconomic backdrop, the increased "reach for yield" in the bond market, and compressed credit spreads, we view credit risk as a potentially greater risk than duration risk in the near term.	Bond investors underestimated credit risk and overestimated the risk of a sharp rise in rates. Our forecast played out in the global bond market, with segments such as high-yield and EM debt underperforming U.S. Treasury and high-quality fixed income benchmarks.
Short-duration strategies entail substantial foregone income and may not necessarily result in outperformance of a broadly diversified fixed income portfolio in the years ahead.	In the U.S. and most other developed markets, long-term rates declined, leading to another year of outperformance for longer-maturity portfolios. In fact, the 10-year Treasury yield remained at or below the bottom end of our estimated "fair-value" range for most of 2015.
We expect the diversification benefits of investment-grade fixed income in a balanced portfolio to persist, despite low interest rates and the concern of some that the Fed "taper tantrum" of 2013 might repeat.	During August, a bottom-decile equity performance month, high-quality investment-grade bonds did in fact provide ballast to balanced portfolios as expected.

Global equity

Looking back	Assessing our views
After several years of suggesting that strong equity returns were possible despite a prolonged period of subpar economic growth, our medium-term outlook for global equities is more guarded than bearish.	Although our capital markets outlook is long term, global equity returns were flat and the market correction in the summer did not materially change our medium-run outlook for the global capital markets.
For select "frothy" segments of the equity market that we noted in 2014 (i.e., small-caps and dividend- or income-focused equity strategies), the central tendency can be even lower.	The referenced market sectors underperformed the broad market.

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