

Quarterly economic and market update

December quarter 2023

Quarter in review

Markets rallied to close out the year as hopes of a soft landing once more came to the fore. Bond yields fell as central banks signalled a pause and markets began to price in a potential path for rate cuts. This spurred a rally in bonds and propelled developed markets equities back towards all-time highs.

Developed markets equities saw almost all sectors advancing over the quarter, led by interest rate sensitive sectors such as information technology and real estate. In the United States, the S&P 500 Index climbed 11.7% for the quarter and 26.3% for the year in local currency terms (**Figure 1**). The Australian ASX 300 was supported by elevated commodity prices, returning 8.4% for the quarter and 12.1%

for the year.

More broadly, Japanese equities held on to strong gains for the year despite a modest quarter, and emerging markets were mixed as Chinese equities continued to slump in Q4.

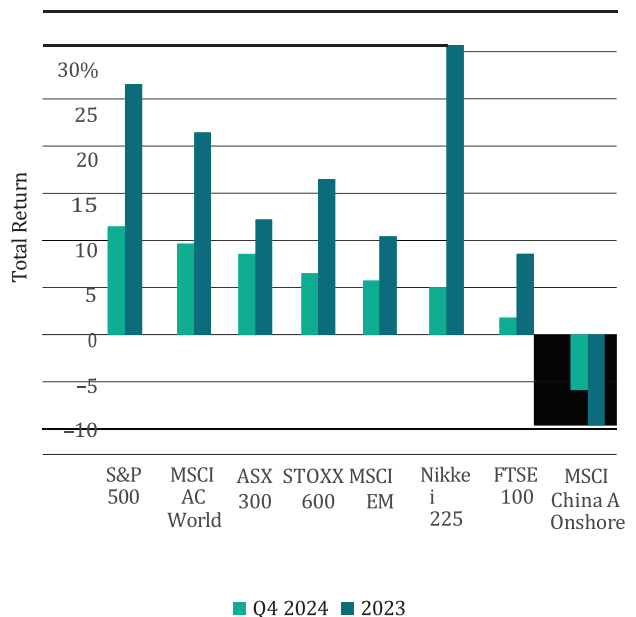
Meanwhile, the Australian dollar strengthened, buoyed by commodity demand from China and a weakening U.S. dollar. This produced headwinds for unhedged international investors, with global equities returning 9.5% in local currency terms and 5.1% unhedged to AUD for the quarter (**Figure 2**).

Bond markets were broadly positive as yields fell sharply (bond prices rose) over the quarter as markets gained confidence in rate cuts in

2024. The 10-year yield fell 69 basis points in the U.S. and 53 basis points in Australia. Hedged global bonds rose 5.4% and Australian

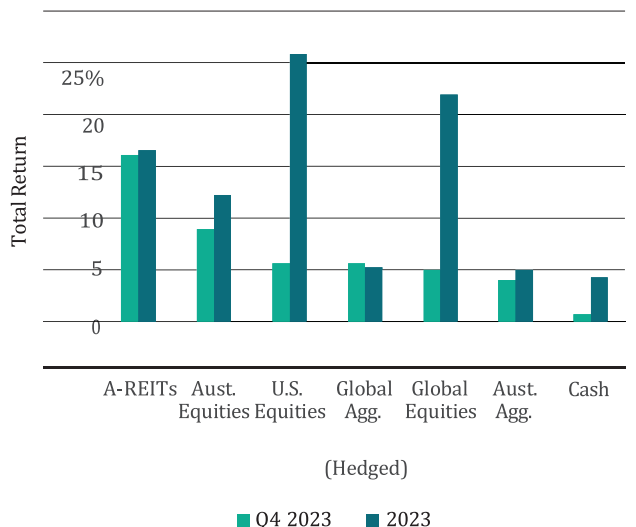
bonds rose 3.8% over the quarter.

Figure 1. Global markets broadly advanced



Note: Returns are cumulative total returns in local currency.
Source: FactSet, as of 31 December 2023.

Figure 2. AUD indexes rallied in Q4



Note: Returns are cumulative total returns denominated in AUD.
Source: FactSet, Refinitiv, as of 31 December 2023.

Economic outlook

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

The global economy has proven more resilient than some expected in 2023. This is partly because monetary policy has not been as restrictive as initially thought. Various other factors have blunted the impact of monetary policy, including the U.S. fiscal impulse from debt-financed pandemic support and industrial policies, improved household and corporate balance sheets, and tight labour markets that have resulted in real wage growth.

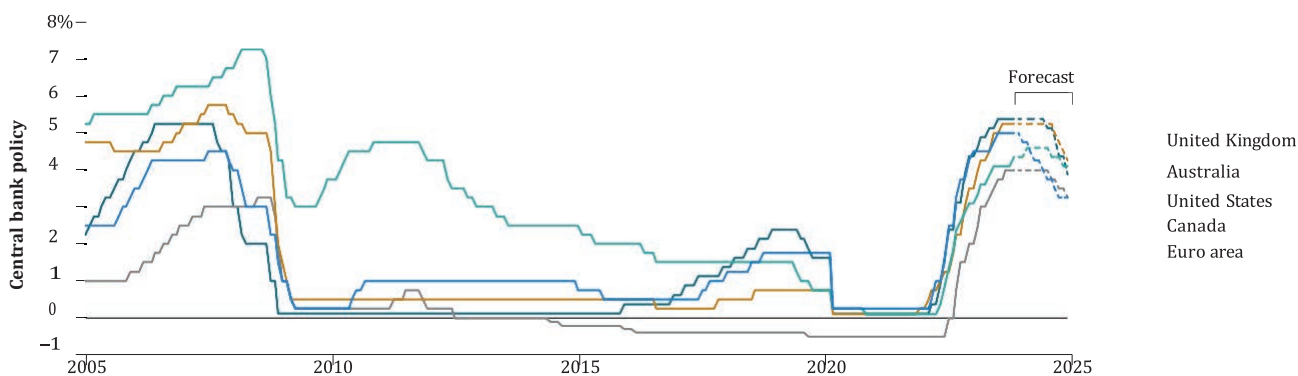
Outside the U.S., this dynamic is less pronounced. Europe's predominantly bank-based economy is already flirting with

recession, and China's rebound from the end of COVID-19-related shutdowns has been weaker than expected. In Australia economic activity has slowed, but strong population growth and strong levels of public and private investment have helped keep the economy afloat.

The U.S. exceptionalism is set to fade in 2024. Monetary policy may 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 and Australia, growth may weaken as restrictive monetary and fiscal policy lingers, while in China, additional policy stimulus may sustain economic recovery amid increasing external and structural headwinds.

Barring an immediate 1990s-style productivity boom, a U.S. recession is likely a necessary condition to bring down the rate of inflation, through weakening demand for labour and slower wage growth. As central banks feel more confident in inflation's path toward targets, they may start to cut policy rates in the second half of 2024 (Figure 3).

Figure 3. Rate cuts in 2024, but zero rates are behind us



Note: Monthly data are from January 2005 through November 2023. Forecasts thereafter run through year-end 2024.

Sources: Vanguard calculations, based on data from Bloomberg, as of 30 November 2023.

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.

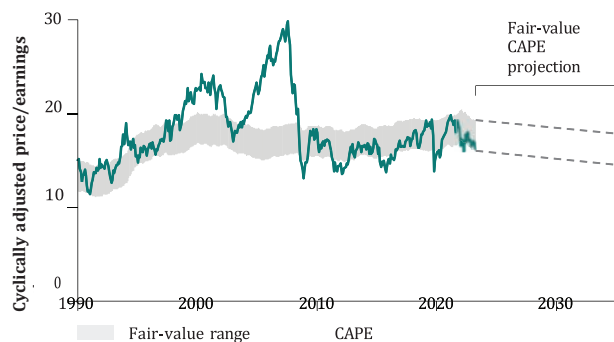
Global bond markets have repriced significantly over the last two years because of the transition to the new era of higher rates. In

our view, bond valuations are now close to fair. Despite the potential for near-term volatility, this rise in interest rates may be the best economic and financial development in 20 years for long-term investors. Similarly, the case for the 60/40 portfolio is stronger than in recent history. According to Vanguard, long-term investors in diversified portfolios see a dramatic rise in the probability of achieving a nominal 7% return, from 11% in 2021 to 38% today.

Valuations are most stretched in the U.S. Despite some expected rate relief, the prospect that the higher interest rate environment will last for years may be underappreciated (**Figure 4**). Within the U.S. market, value stocks are more attractive than they have been since

late 2021 and small-capitalisation stocks also appear attractive for the long term. Australian valuations appear more fair, however globally earnings may come under pressure as rate rises weigh on economic output and profit margins ease.

Figure 4. The U.S. neutral rate is likely to settle at a higher level



Note: The chart shows the cyclically adjusted price/ earnings (CAPE) ratio for U.S. equities, measured by the MSCI US Broad Market Index. CAPE reflects contemporaneous real equity prices and 10-year average historical real earnings. The chart also shows our estimates of fair value, considering inflation and interest rates. Our historical fair-value estimates are based on actual levels of inflation and interest rates and reflect underlying data since 31 January 1940, while our 10-year fair-value forecast considers our expectations for inflation and rates.

Source: Vanguard calculations, based on data from Refinitiv and Global Financial Data, as of 30 September 2023.

IMPORTANT: The projections and other information generated by the VCMM regarding the likelihood or 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 modelled asset class. Simulations are as of 30 September 2023. Results from the model may vary with each use over time.

Past performance is no guarantee of future returns.

The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

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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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