Our investment and economic forecasts, May 2023

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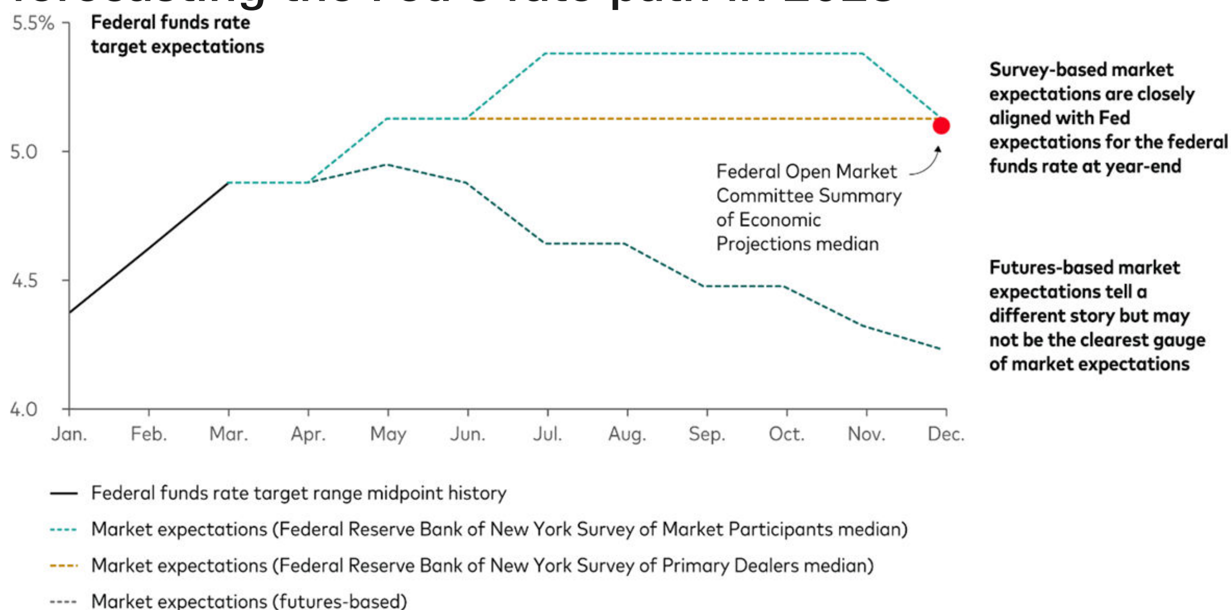
Expectations for the U.S. Federal Reserve's target for the federal funds rate—the central bank's key interest rate target—have diverged for months. On one side is the Fed itself, which issues a quarterly summary of the projections of individual Fed policymakers. On the other are "the markets," with their expectations often gauged by the prices of derivatives (federal funds futures) traded on the Chicago Mercantile Exchange.

In mid-March, the last time the U.S. Federal Reserve issued rate projections, policymakers foresaw no rate cuts by year-end. Futures pricing suggested a starkly different view in the markets—a bit more than 70 basis points (0.70 percentage points) of rate cuts by year-end. By mid-May, futures prices had changed modestly, implying about 60 basis points of rate cuts.

Yet “the Fed’s views and those of the market may not be as far off as they appear,” said Rhea Thomas, a Vanguard economist.

The Federal Reserve Bank of New York conducts surveys of both primary dealers —firms authorized to trade government securities directly with the Fed—and market participants. Those surveys should largely reflect the views of key market actors. And in mid-March they were much more closely aligned with the Fed’s own projections, looking for the rate target to end the year close to its peak. (Vanguard participates in the New York Fed survey of market participants.)

Surveys versus a market-based approach to forecasting the Fed’s rate path in 2023



Notes: Although the Federal Reserve doesn’t publish official expectations for the federal funds rate target, it does publish the median of policy-setting committee members’ individual projections quarterly in the Summary of Economic Projections. The most recent published results available for the New York Fed surveys were for those conducted March 8–14, 2023.

Source: Vanguard calculations, using data from the Federal Open Market Committee, the Federal Reserve Bank of New York, and Bloomberg. Fed survey data are through March 14, 2023, the end date of the New York Fed’s most recent surveys of primary dealers and market participants. Futures-based market expectations are based on federal funds rate futures pricing as of the same date. Fed Summary of Economic Projections data are through the most recent projections, on March 22, 2023.

Why the difference between survey-based market expectations and those based on futures prices? One key reason is that survey-based expectations reflect the

modal, or most likely, expected outcome. In contrast, futures-based pricing incorporates the *average* expectation across the distribution of all probabilities—including outliers that may distort the average—along with a risk premium. As a result, survey-based expectations may provide a clearer picture of where markets ultimately expect the federal funds rate target to land.

Vanguard's own view is that the Fed won't cut its key rate target before 2024 because of its need to keep policy sufficiently restrictive to bring inflation back toward its 2% target.

The views below are those of the global economics and markets team of Vanguard Investment Strategy Group as of May 17, 2023

Vanguard's outlook for financial markets

Our 10-year annualised nominal return and volatility forecasts are shown below. They are based on the March 31, 2023, running of the Vanguard Capital Markets Model® (VCMM). Equity returns reflect a 2-point range around the 50th percentile of the distribution of probable outcomes. Fixed income returns reflect a 1-point range around the 50th percentile. More extreme returns are possible.

	Return projection	Median volatility
Australian equities	4.0%–6.0%	21.5%
Global ex-Australia equities (unhedged)	4.7%–6.7%	19.2%
Australian aggregate bonds	3.1%–4.1%	5.4%
Global bonds ex-Australia (hedged)	3.3%–4.3%	4.7%

Notes: These probabilistic return assumptions depend on current market conditions and, as such, may change over time. **Source:** Vanguard Investment Strategy Group.

Region-by-region outlook

Australia

The pause in the Reserve Bank of Australia's (RBA's) rate-hiking cycle was short-lived. Having interrupted a string of 10 consecutive hikes at its April meeting to

“assess the state of the economy and the outlook,” the RBA raised its cash rate by 25 basis points this month. The rate, now 3.85%, is at an 11-year high. In its statement, the bank said that although inflation had passed its peak, it is “still too high and it will be some time yet before it is back in the target range.”

- We’ve increased our outlook for the RBA’s terminal rate, from 3.6% to 4.1%, based on the bank’s comments and our view that the unemployment rate will remain lower for longer, which could keep upward pressure on wages and services inflation. Our view is more hawkish than that of financial markets, which assign only about a 20% chance of a further rate hike.
- “Our baseline view for the RBA is one more rate hike, with risks skewed toward even further tightening if services inflation remains sticky, and no rate cuts this year,” said Alexis Gray, a Vanguard senior economist.
- We expect headline inflation to fall to around 4.25% on a year-over-year basis by the end of 2023, as higher interest rates dampen demand, and to fall to the RBA’s target band of 2%–3% in late 2024 or 2025.
- We expect the unemployment rate, which was unchanged at 3.5% in March, to rise gradually this year as financial conditions tighten.
- We continue to expect GDP growth of 1%–1.5% for all of 2023, and we assign a 50% probability of recession over the next 12 months

United States

With inflation still too high and the labor market still tight, we expect Federal Reserve policymakers to raise their target for short-term interest rates once more next month. In a change to our forecast, we expect that hike to be the last in a series that so far spans 10 meetings and 5 percentage points. We now see the Fed’s terminal rate in a range of 5.25%–5.5%, just a quarter of a percentage point higher than the current rate target. We also have raised our year-end inflation forecast and modified our labor market forecast

- “The Fed’s reaction function appears to have shifted,” said Josh Hirt, a Vanguard senior economist. “The economic data warrant further rate hikes in our view, but it’s now likely that even one more [rate hike] is going to be a close call.”
- Economic indicators that would typically drive Fed monetary policy decisions have generally moved sideways of late, Hirt said. But we perceive a shift by the Fed toward greater risk management, owing to recent banking system stresses and federal debt ceiling concerns.

- We've increased our forecast for year-end 2023 core inflation, which excludes volatile food and energy prices, from 3% to 3.3%.
- The wait for a downturn in the U.S. labor market goes on. We believe the Fed will want to see the ratio of job vacancies to the number of unemployed fall further. We anticipate an unemployment rate of around 4.5% at year-end 2023, the lower end of our previous expectation of 4.5%–5%.
- We believe the pace of services spending (2.3% on an annual basis in the first quarter) will need to slow to reduce the pace of price growth.
- Another quarter of broad-based decline in business investment, down 12.5% on an annual basis in the first quarter, suggests softening in the broader economy. We continue to expect a recession in the second half of 2023, though the odds of avoiding one have risen.

China

A 4.5% first-quarter increase in GDP compared with a year earlier, powered by consumers tapping their savings after COVID-19-related lockdowns in 2022, may well represent peak 2023 economic activity in China.

Although strong tourism and hospitality data from the May Labor Day holidays show pent-up demand carrying into the second quarter, four recent developments cast doubt on the sustainability of the recovery:

- Service-sector activity has outpaced the production of goods;
- Public investment has outpaced private investment;
- Housing completions have increased but housing starts have declined; and
- While the overall unemployment rate has fallen, youth unemployment has climbed.

"As the reopening surge fades and external demand deteriorates, further growth recovery in China hinges on continued labor market and income recovery, improving private confidence, and continued policy support," said Grant Feng, a Vanguard economist. We foresee full-year GDP growth in a range of 6%–6.5%, higher than the government's official 2023 growth target of "around 5%" but decelerating toward trend in coming quarters.

Euro area

Unlike that of the Federal Reserve a day earlier, the European Central Bank's (ECB's) monetary policy stance, as articulated on May 4, was unequivocal: Interest

rates are not sufficiently restrictive to tame inflation. The ECB raised its deposit facility rate by 25 basis points to 3.25%. Although the seventh consecutive hike marked a slowing in the rate of increases after three successive 50-point hikes, President Christine Lagarde made clear in her post-announcement news conference that the rate-hiking cycle isn’t over.

- Based on our economic view of persistent inflationary pressures, a still-tight labor market, and the limited impact of banking stresses on credit conditions thus far, we expect the ECB to raise the deposit facility to a range of 3.75%–4% over the next several months. Markets have moved closer to our terminal rate outlook in the last month, as well as to our view that rates won’t be cut in 2023.
- We continue to expect core inflation to peak in a range of 5.5%–6% in the next few months before fading in the second half of the year as the effects of higher interest rates work their way through the economy. We foresee core inflation averaging 4.5% in 2023 and ending the year around 3.3%—still solidly above the ECB’s 2% target.
- We continue to expect 0.5% euro area growth for all of 2023, with a mild recession later in the year. However, “in both the euro area and the United Kingdom, risks have risen for a delayed landing, with recession not occurring until 2024 and higher central bank interest rates for longer required to tame inflation,” said Roxane Spitznagel, a Vanguard economist.

United Kingdom

Inflation, the labor market, and overall economic activity have been stronger than expected, leading us to increase our forecasts for GDP growth, inflation, and the Bank of England (BOE) terminal rate.

“We continue to anticipate a recession later this year, though shallower than we had previously thought,” said Roxane Spitznagel, a Vanguard economist. “Rece developments increase the risk, however, of a ‘later landing’—a deeper recessic.., delayed into 2024, with higher-than-anticipated interest rates required to counter stickier inflation.”

- We’ve revised our forecast for 2023 GDP to no growth from a previous forecast for a contraction of around 1%. We’ve ratcheted down our 2024 growth forecast from 0.6% to 0.2%, reflecting the impact of a likely higher BOE terminal rate.
- Based on the accrued inflation data and our revised growth forecast, we’ve increased our year-end 2023 forecast for headline inflation from 3.4% to 3.7%

and for core inflation from 2.8% to 3.6%.

- With upgrades to both our growth and inflation forecasts, we've raised our monetary policy forecast as well. We now expect the BOE to raise the bank rate to a range of 4.75%–5% (up from 4.5%), likely in the third quarter, and keep it there at least until 2024.

Emerging markets

Our growth upgrade for China and resilient activity globally have led us to increase our forecast for 2023 emerging markets GDP growth from 3.25% to 3.9%. "Emerging market manufacturing indexes are holding up well, and so are softer indicators such as business and consumer sentiment," said Vytas Maciulis, a Vanguard economist. "Even emerging Europe, where the inflation challenges are greatest, is contributing to the improved sentiment."

We believe:

- Emerging Asia will lead the way in 2023, growing about 5%. Latin America is likely to grow about 1.5%, and central Europe, the Middle East, and Africa are likely to grow about 1%. As in many developed markets, the chances are increasing that further economic slowdowns could be delayed until 2024.
- Inflation has largely peaked in emerging markets.
- Emerging markets central banks have largely reached the peaks of their rate-hiking cycles and will likely cut rates before developed market central banks.
- With its key rate at its highest level since at least 2005 and with inflation declining slowly, the Bank of Mexico has reached its terminal rate, though we don't expect it to cut rates before 2024.

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model (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. 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