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Vanguard's economic and market outlook

Midyear investing perspectives

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Index

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Vanguard's economic and market outlook

An uneven U.S. labor market: Not broken but not booming

For institutional and sophisticated investors only. Not for public distribution.

Key points

- A fragmented U.S. labor market is strong for some and strained for others.
- A low unemployment rate and a muted pace of layoffs mask underlying weakness.
- The labor market's mixed signals may make the Federal Reserve less reactive to the unemployment rate alone, as policymakers weigh a broader set of indicators before adjusting interest rates.

The health of the U.S. labor market, which is a primary consideration for the Federal Reserve when setting interest rates, can be a matter of individual perspective right now:

- If you're a registered nurse, you may believe the job market's health to be excellent. The unemployment rate for experienced health care practitioners is currently below 2%.
- If you're young and just entering the labor force or you're older and seeking to reenter it, prospects may seem bleak. The number of unemployed in these two categories has been rising, as it did during the global financial crisis and the COVID-19 pandemic.
- If you already have a job and aren't looking to switch, the labor market's health may not matter at all. Hiring is down, but so are layoffs, and your wages are still growing faster than inflation.

Taken together, such contrasts suggest a subtle weakening that isn't apparent from the 4.1% unemployment rate. And there's one more important vantage point to consider:

- If you're a Federal Reserve policymaker concerned with setting a key interest rate, the labor market may appear just strong enough to wait for greater clarity about another potential development—the prospect of a tariff-induced reacceleration in inflation.

A hiring slowdown is making it tougher to enter or reenter the workforce

The graph shows combined total of unemployed new entrants and re-entrants

Notes: New entrants to the labor market are unemployed people with no previous work experience looking for their first job. Re-entrants are unemployed people who have past work experience but were not in the labor force for a period of time prior to beginning their current job search.

Sources: Vanguard calculations, based on seasonally adjusted data from the Federal Reserve Bank of St. Louis and the U.S. Bureau of Labor Statistics, as of June 30, 2025.

A gradual drift rather than a sudden shift

Historically, a decline in hiring has been accompanied by a swift rise in layoffs, a one-two punch that drives up the unemployment rate. Today's labor market is defying that pattern. Firms are pulling back on hiring without shedding existing workers in significant numbers. The result is a labor market that is softening gradually, not collapsing.

Why layoffs remain low

The lack of layoffs can be traced to two sectors that have historically driven periods of job losses when hiring has slowed: manufacturing and construction. Today, both sectors are benefiting from long-term trends that have muted cyclical behavior.

Manufacturing now constitutes a much smaller share of the U.S. labor force than it did in decades past, so there is simply less headcount to cut. Moreover, the sector is adapting to structural forces, including onshoring and a shrinking labor supply, which is helping to stabilize employment levels even amid broader economic uncertainty.

Construction reflects a similar situation. High demand amid a persistent shortage of residential housing construction, particularly acute since the global financial crisis, has generally helped insulate construction activity and employment even as elevated interest rates have challenged affordability.

Other less-cyclical industries, such as professional and business services, are following their historical playbook of achieving desired staffing levels through attrition and reduced hiring.

The hidden cost of low hiring

Although layoffs are low, the hiring slowdown is exacting a toll, especially on younger workers entering the labor force and older workers reentering it after a hiatus. These groups depend on job creation to gain traction, and in today's environment, that traction is elusive. Sentiment data show a growing level of frustration, with job seekers experiencing longer searches and fewer opportunities.

Emerging risks to the low unemployment rate

There are worrisome signs that the labor market is in for a more difficult second half of the year. In the construction industry, which has contributed to the overall low-layoff environment, home prices and the number of planned housing construction projects are now falling as the prolonged higher mortgage rates have priced many would-be buyers out of the market. We anticipate these headwinds will curb construction employment in the coming months.

And while the private sector has added an average of almost 110,000 new jobs per month since the start of the year, roughly 60% of those have been in the health care and social-assistance sector.

The lack of breadth in job growth raises questions about the sustainability of the current 4.1% unemployment rate. Other measures of private-sector employment reported more modest growth in the first half of 2025.

The labor market's importance to Fed policy

The labor market matters not only as a barometer of the broader economy's health, but also because of its critical function in determining monetary policy. Congress requires the Fed to promote price stability and maximum sustainable employment. This is known as the Fed's "dual mandate" in setting its key interest rate target.

If the unemployment rate creeps higher in the second half of the year, as we expect it to, the Fed may be in position to respond with the rate cuts that markets have been eagerly awaiting. (Vanguard anticipates the equivalent of two quarter-percentage-point rate cuts this year.)

That assumes, of course, that the Fed doesn't have its hands full with a continued inflation fight.

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Vanguard's economic and market outlook

Regional Outlook

Our year-end global economic outlook

Global tariff discussions have a more dominant role of playing and driving the outlooks for both the U.S. and the global economy. Tariffs are likely to have an impact on both the growth and inflation numbers for the rest of the year. Extra judgment will need to be exercised in discerning what the signal is and what the noise is in the numbers, which are likely to be very volatile.

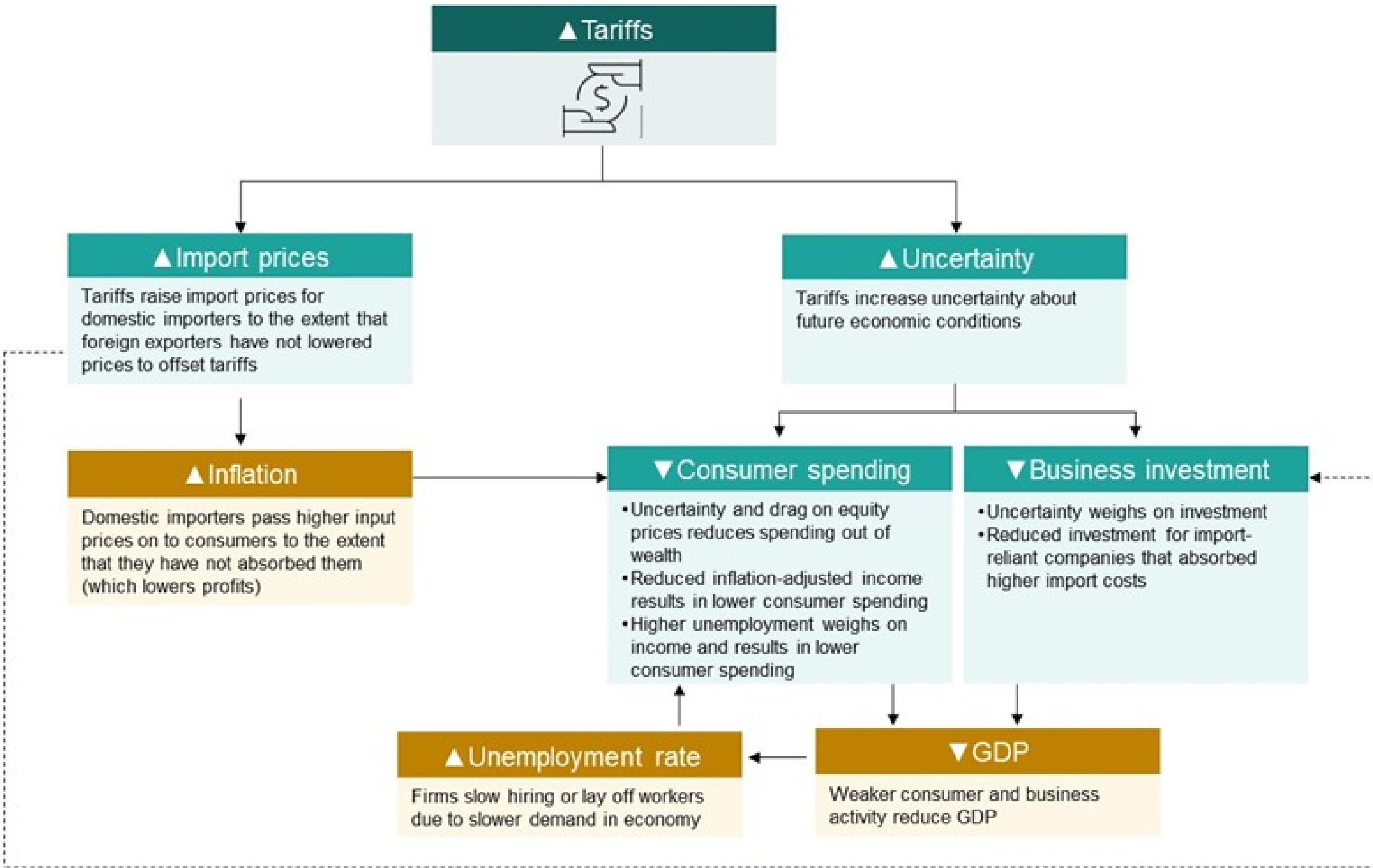
Region	Real GDP growth	Unemployment rate	Core inflation	Monetary policy
United States	1.5%	4.7%	3%	4%
Mexico	<1%	3.2%-3.6%	3.5%	7.5%
Euro	1.1%	6.3%	2.1%	1.75%
United Kingdom	1.1%	4.8%	3%	3.75%
China	4.8%	5.1%	0.5%	1.3%
Japan	0.7%	2.4%	2.4%	0.75%

Notes: GDP growth is defined as the annual change in real (inflation-adjusted) GDP in the forecast year compared with the previous year. Unemployment rate is as of December 2025. Core inflation is the year-over-year change in the local price index, excluding volatile fresh food prices, as of December 2025. Monetary policy is the local central bank's year-end target for the overnight rate.

Source: Vanguard

Anatomy of a tariff shock

Tariffs flow through to the economy via several different channels which ultimately impact GDP; two key channels are highlighted here.



Source: Vanguard analysis as of March 31, 2025.

1. Import price channel: tariffs raise import prices for domestic importing firms to the extent that foreign exporters have not lowered prices to offset tariffs.

- Inflation moves higher as domestic importers pass higher input prices on to consumers to the extent that they have not absorbed these higher import prices (which lowers company profits).
- Higher inflation in turn reduces consumer purchasing power, which lowers consumer spending.

2. Uncertainty channel: higher tariffs raise uncertainty as firms and consumers adjust to new economic conditions.

- Consumer spending is weighed down due to this uncertainty as well wealth effects due to a drag on equity prices.
- Business investment is hit due to uncertainty, as well as reduced spending power to the extent that company profits are hit by absorbing higher import prices.

United States: a resilient first-half performance

Recent trade developments have helped reduce some uncertainty for the U.S. economy, leading us to raise our baseline assumption for the effective tariff rate modestly higher to a range near 17% by year-end. However, the economic impact of offsetting factors such as foreign investment agreements and the delayed pass-through of elevated tariff rates to consumers will need to be evaluated as more information emerges. For now, we see the economy tracking in line with our expectations of a softening labor market, GDP growth of around 1.5%, and core inflation of around 3% by year-end.

The coming months will be pivotal in assessing how well the economy is able to absorb tariff-related pressures, which will then play a leading role in determining monetary policy. For the first time in this cycle, revisions to the July labor market report showed an economy that added fewer jobs than what we estimate to be the replacement rate (around 75K), a sign that the economy is oscillating around a neutral growth rate.

Prior to the labor market report, we viewed communication from the July Federal Reserve meeting to be mildly hawkish toward a September rate cut, a stance we expect will now shift toward a renewed focus on the employment side of the Fed's dual mandate. We see the Fed as on track for two rate cuts this year, given recent softness in the labor market and with monetary policy still a percentage point above our estimate of a neutral stance.

Mexico: playing a waiting game amid trade uncertainty

Mexico's economic momentum remains subdued in mid-2025, with growth prospects clouded by trade tensions with the U.S. While automobile exports showed surprising resilience in June, thanks to United States-Mexico-Canada Agreement exemptions and strong U.S. consumer demand, broader uncertainty around trade policy has weighed on business sentiment. Public-sector spending cuts and a second-consecutive decline in remittances, which account for nearly 4% of GDP, are also acting as headwinds. Peso appreciation has further reduced the purchasing power of remittances, adding to near-term pressures.

We continue to see long-term upside for Mexico from a U.S.-China trade realignment, given the high degree of export similarity between the two developing economies and the structural integration of U.S.-Mexico supply chains.

On the monetary policy front, the Bank of Mexico (Banxico) reaffirmed its 3% inflation target in June while cutting its policy rate by half a percentage point (to 8%), citing downside risks from trade uncertainty. With the peso strengthening and trade negotiations progressing slowly, we expect further easing, with the policy rate likely to end the year near 7.5%.

Euro area: Germany's fiscal stimulus bolsters growth outlook

We expect growth in the euro area to track around 1% in both 2025 and 2026, slightly below trend. Softening global activity, driven partly by elevated policy uncertainty and higher tariffs, is expected to weigh on final demand. The tailwinds from Germany's recent fiscal package and greater defense spending across the European Union are more of a 2026 story. Short-term implementation risks surrounding German fiscal policy have now receded.

The chances of undershooting the 2% inflation target set by the European Central Bank (ECB) are rising. Both wage growth and services inflation are now falling meaningfully. And a weakening global growth outlook, coupled with a stronger euro and lower energy prices, points to further disinflation ahead.

Following the messaging at the ECB's June press conference, in which the ECB president repeatedly stated that the central bank was in a "good position" at the current policy rate level of 2%, we think a pause at the July 24 meeting is now likely. We forecast just one more rate cut this cycle, likely in September, which would leave the policy rate at 1.75%, a touch below our estimate of neutral (2–2.5%). The balance of risks is skewed toward further easing.

China: after solid first-half growth, a slowdown in momentum is likely

China's economy demonstrated resilient growth in the second quarter, with real GDP expanding by a stronger-than-expected 5.2% year over year and a solid quarter-over-quarter increase of 1.1%. Given this strength, we have upgraded our full-year China GDP forecast from 4.6% to 4.8%. Growth was primarily underpinned by robust exports and front-loaded policy easing. A goods trade-in program has boosted consumption, and accelerated policy stimulus has supported economic growth. Exports have remained resilient in the face of U.S. tariffs, supported by frontloading and the rerouting of shipments. We expect external policy volatility to subside in the coming months, offering temporary relief to the export sector. Peak tariffs may be behind us, but headwinds remain, with the U.S. average tariff rate on China higher now than it was at the beginning of the year.

We expect China's growth momentum to moderate in the second half. Positive impulses from front-loaded exports are likely to fade, while several sources of headwinds will weigh on demand. They include the expiration of the trade-in program, new austerity measures for government officials and state-owned enterprise managers, efforts to address overcapacity, and renewed property market weakness.

The government has adopted a gradual, data-dependent policy approach. Strong growth in the first half makes additional near-term stimulus unlikely. With deflationary pressures set to persist throughout 2025, the path toward reflation is likely to be gradual and bumpy.

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Vanguard's economic and market outlook

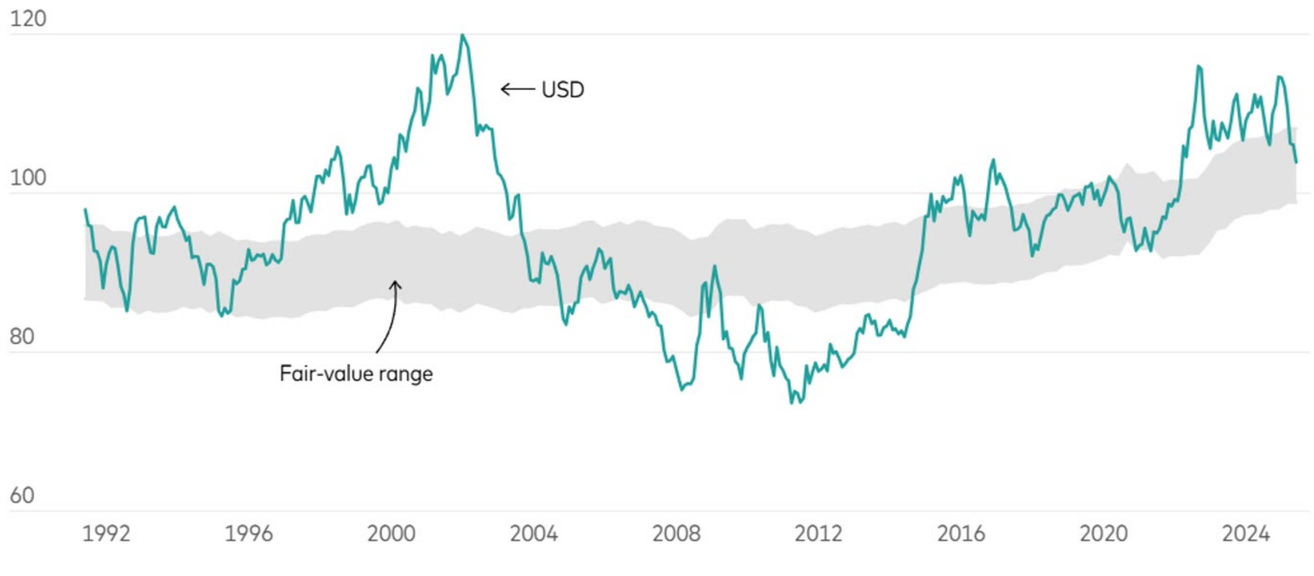
Market outlook: Expect currency to play a smaller role in future returns

Key points

- The dollar has fallen more than 9% this year on the back of a global reconsideration of U.S. dollar-denominated assets amid heightened trade tensions, rising fiscal concerns, and institutional uncertainty.
- Dollar depreciation this year has driven international equity outperformance compared with U.S. equities for U.S. investors. The recent shifts and the speed with which they occurred underscore the value of global diversification for long-term investors.
- Over the long term, the U.S. dollar appears fairly valued. While we continue to expect international equity to outperform, the gains are likely to come from corporate fundamentals rather than dollar weakening.

For the past three years, the U.S. dollar stood tall—overvalued and seemingly defying its fundamental gravity. But in recent months, it's come back down to a level that we assess to reflect long-term fair value compared with a basket of developed-market currencies.

The U.S. dollar has retreated to fair-value territory



Notes: The chart shows our fair-value estimate for the U.S. dollar against an equity market capitalization-weighted basket of the euro, the Japanese yen, the British pound, the Canadian dollar, and the Australian dollar. The fair-value estimate is based on the part of exchange-rate movements that can be explained through differentials in relative economic strength, measured by productivity (GDP per capita at purchasing power parity) and long-term real rates.

Sources: Vanguard calculations, based on data from Refinitiv and the International Monetary Fund, as of June 30, 2025.

The downward shift has been a gift to globally diversified U.S. investors. As the dollar weakened—triggered in part by a global reconsideration of appetite for U.S. assets amid tariff upheaval—international equity returns surged when translated back into dollars, giving portfolios a meaningful lift.

International returns also benefited from depressed valuations that reflected very pessimistic sentiment at the start of the year. This, along with the weakening dollar, led international equities in U.S. dollar terms to return 17.9% in the first six months of 2025. International equities returned 8.8% in local currency, while the dollar contributed the remaining approximately 9%. (U.S. equities, by comparison, returned 6% in the first half of 2025.)[1] Looking ahead, the degree to which corporate fundamentals abroad can rise to meet this renewed optimism will be key for further international equity gains.

With the dollar now firmly back within our estimated fair-value range, we view the risks as more balanced than at any time during the last three years. Over the short term, an easing of trade tensions and greater certainty around U.S. policy may lead to dollar appreciation. Alternatively, a continued reconsideration of dollar-denominated assets among global investors could result in further declines. Longer term, however, we see higher U.S. productivity and persistently higher (but sustainable) U.S. interest rates as supportive of the current dollar valuation.

The shift reinforces the case for global diversification. With U.S. equity valuations still stretched and international markets offering more historically grounded return prospects, spreading risk across regions remains a cornerstone of a sound long-term strategy.[2]

[1] U.S. equities are represented by the MSCI USA Net Total Return Index, international equities in USD are represented by the MSCI ACWI ex USA Net Total Return USD Index, and international equities in local currency (which is not investable) are represented by the MSCI ACWI ex USA Net Total Return Local Index. All returns are based on data from Bloomberg as of June 30, 2025.

[2] Vanguard's 10-year outlook assigns a 66% probability to international equities outperforming U.S. equities, driven by valuation and earnings growth differentials.

Vanguard

Vanguard's economic and market outlook

Vanguard Capital Markets Model® forecasts

Vanguard Capital Markets Model® forecast

Our expected returns for most U.S. sub-asset classes have fallen as of June 30, 2025. Corporate fundamentals remained resilient in the face of tariff uncertainty, supporting the recent equity rally. Hopes for a Federal Reserve rate cut raised bond prices. The ongoing strength in equities reinforces Vanguard's case that bonds are attractive relative to U.S. stocks, which we anticipate will offer returns below their long-term historical averages over the next decade.

The gap between our median U.S. equity and U.S. aggregate bond forecasts on a 10-year annualized basis remained narrow, at 0.2 percentage points in favor of bonds.

The U.S. equity market continues to trade well above the top end of its fair-value range. Our estimate reflects our proprietary fair-value measure, which considers current prices in relation to average, inflation-adjusted corporate earnings over the past 10 years, as well as prevailing interest rates and inflation levels.

It is important to recognize that valuations tend to be poor predictors of performance over the short or even intermediate term and should not serve as a primary reason for changing portfolio allocations.

Note that Vanguard forecast data are not intended to imply portfolio construction advice, which should reflect such factors as an investor's objectives and risk tolerance, as well as asset class correlations and the dispersion of expected returns.

Vanguard's forecasts of asset class performance, as of June 30, 2025.
10-year annualized return forecasts in USD.

Equities	25th percentile	50th percentile	75th percentile	Median Volatility
US equities	1.0%	4.3%	7.7%	15.2%
Global ex-US equities	3.1%	6.1%	9.1%	18.8%
Developed markets ex-US equities	3.6%	6.7%	9.8%	18.2%
Emerging markets equities	-0.1%	4.1%	8.5%	25.3%
US value	3.4%	6.8%	10.3%	18.7%
US growth	-0.4%	2.9%	6.4%	16.2%

Bonds	25th percentile	50th percentile	75th percentile	Median Volatility
US aggregate bonds	3.9%	4.5%	5.1%	6.3%
Global ex-US agg. bonds (hedged)	3.9%	4.8%	5.6%	4.9%
US treasury bondss	3.7%	4.3%	5.0%	6.7%
US credit bonds	4.1%	4.7%	5.3%	6.5%
US high yield corporate bonds	4.3%	5.2%	6.1%	9.7%
Emerging markets bonds (hedged)	4.9%	5.9%	6.9%	11.2%

Other	25th percentile	50th percentile	75th percentile	Median Volatility
Commodities	1.8%	5.5%	9.3%	16.7%
US inflation	1.5%	2.0%	2.6%	1.8%
Vanguard US dollar index	-1.2%	-0.2%	0.8%	8.4%

Notes: These return assumptions depend on current market conditions and, as such, may change over time. We make our updated forecasts available at least quarterly.

Source: Vanguard Investment Strategy Group.

IMPORTANT: The projections and other information generated by the 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. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of June 30, 2025. Results from the model may vary with each use and over time. For more information, please see the Notes section below.

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