2023: The year ahead

WEALTH MANAGEMENT OUTLOOK

Marketing material

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2023 Summary views

Economic outlook

Global economy: Our base case is for developed markets to fall into recession in 2023 before rebounding in 2024.

Inflation: Inflationary pressures could remain elevated in the UK, although we may see US inflation fall faster given greater self-sufficiency in both energy and agriculture.

Interest rates: In the near term, we expect rates to move slightly higher in both the US and UK. Rate cuts may be on the cards for late 2023 as central banks shift their focus to supporting economic growth.

Corporate earnings: Analyst expectations remain too optimistic. Earnings and margins could come under pressure as the global economy slows.

Energy prices: Risks skewed to upside given potential for further supply disruptions.

Investment strategy

Equity: Remain underweight given elevated near term uncertainty, with a preference for large-cap, higher-quality companies. Looking for opportunities to increase exposure.

Fixed income: Neutral fixed income but see increasing opportunity in both corporate and government bonds. A preference for short-dated bonds in the near term, with an eye on extending maturity to increase defensiveness.

Alternatives: We remain positive on alternatives as diversifying assets and see good longer-term opportunities in areas including real assets and commodities.

Cash: Maintaining an elevated cash position in the near term to take advantage of tactical opportunities.

Forecast year-on-year change (%)	2022	2023	2024
Real Gross Domestic Product (GDP)			
World	2.7	1.3	2.2
US	1.8	-1.0	2.0
UK	4.4	-0.8	0.3
Consumer Price Index (CPI)			
World	7.6	4.9	3.9
US	8.0	4.1	2.2
UK	9.2	9.3	4.1

Source: Schroders Economics Group, December 2022.
Forecasts are not guaranteed and should not be relied upon.

Our core investment beliefs

Long term
power of compounding

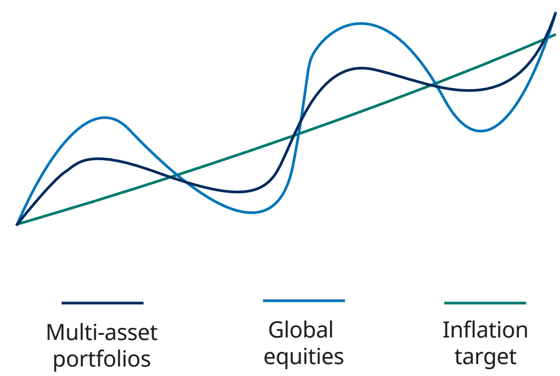
UK asset real returns (% pa) since 1899

	10 years	20 years	50 years	122 years (entire sample)
Equities	4.7	2.9	4.9	4.9
Gilts	1.0	2.4	3.0	1.3
Cash	-2.5	-1.1	0.9	0.6

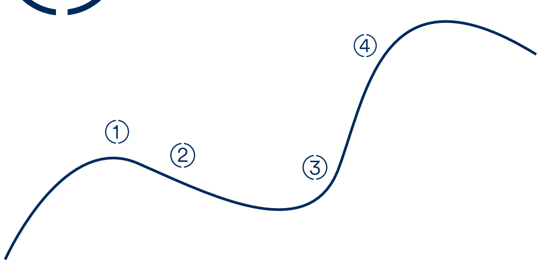
■ Equities outperform over the longer term but are volatile

Past performance is not an indicator of future returns and may not be repeated.
Source: Barclays Equity Gilt Study 2022.

Diversification
to help the journey



Active decisions
value through the cycle



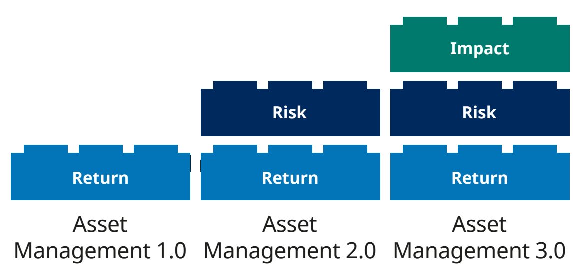
1 **Slowdown:** prefer corporate bonds

2 **Recession:** prefer government bonds and cash

3 **Recovery:** favour developed market equities

4 **Expansion:** favour developing market equities

Impact
on people and planet



"Now there is a new dimension to investing. Investors must understand the cost of a company's entire activities – they must value their stocks based on 'impact adjusted profits'".
Peter Harrison, Chief Executive Officer, Schroders plc

Our investment philosophy

At Schroders Wealth Management, we are focused on preserving and growing our client's wealth in a responsible manner to fulfil their lifetime and multi-generational goals. We meet this objective by looking to achieve a reasonable inflation-adjusted return for portfolios, whilst placing significant emphasis on capital preservation.

We tailor investment portfolios specifically to fit clients individual requirements, while following these key Wealth Management principles:

We construct investment portfolios with a medium to long-term time horizon

This is intended to align portfolios to clients' longer-term objectives and also allow their capital to benefit from the power of compounding returns. This does not preclude us from considering shorter-term investments.

We typically hold a range of investments to diversify portfolios

Diversification can dampen the volatility of returns and improve the expected return for a given level of risk.

We take active decisions on asset allocation and investment selection

Asset allocation is based on our assessment of each asset's risk/reward profile in the context of the business cycle and longer-term secular trends. Individual investments are selected based on an evaluation of the opportunity set and expected return net of investment costs.

We believe that all investments have an impact on people and planet

This impact, where measurable, must be considered alongside the risk and return characteristics of each investment. Where applicable we use our influence to engage with managers and companies to improve the impact of their activities.

2023 Summary views

Positive Neutral Negative

Asset classes	Outlook	
Equities		Equities could remain under pressure as the global economy contracts and corporate earnings fall. We remain underweight. Within equities, we prefer higher-quality companies that are better positioned for a challenging environment. A peak in US interest rates and an end to earnings downgrades could prompt us to increase exposure.
Government bonds		Nominal government bonds have attractive defensive characteristics in a more challenging economic environment. They are now more attractively valued relative to recent history. We prefer US Treasuries, given that the US is likely nearer a peak in interest rates than other markets.
Credit		Yields look attractive relative to other asset classes. We prefer shorter-duration and higher-quality credit in the near term. There is the potential for spreads to widen if corporate earnings deteriorate.
Absolute Return		We see select opportunities in equity long/short strategies given increased high stock dispersion and diversification characteristics. However, bonds may now provide a better source of portfolio diversification over the medium term.
Real Assets		Long-dated revenue streams and income characteristics remain attractive in select parts of the market. We see good opportunities in digital infrastructure, specialist property and exposure to private companies. Valuations are attractive following recent market volatility.
Cash		Cash can protect portfolios in potentially volatile markets.

Source: Schroders Wealth Management, December 2022

1 2023 Economic outlook

Schroders' economics team shares its forecasts for the year ahead

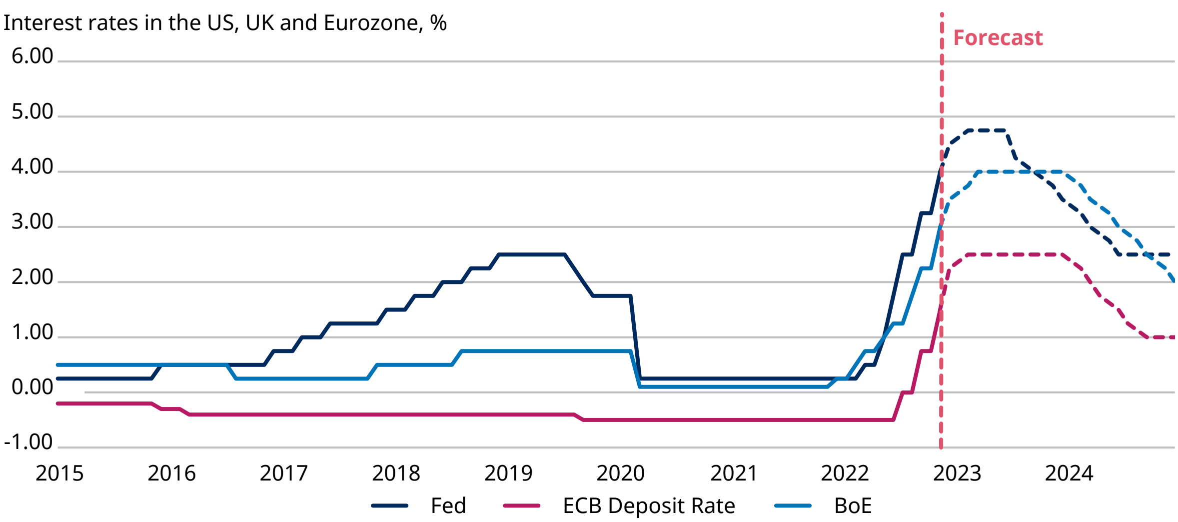
Keith Wade, Chief Economist, Schroders

The coming year is expected to be one of recession for the advanced economies with the eurozone now expected to join the US and UK in recording a fall in output for the year as a whole. The emerging markets have also been downgraded in our latest forecasts, but we still expect a modest pick-up in 2023 as China revives.

Overall global growth is expected to come in at 1.3% next year after an expected 2.7% in 2022. This puts us slightly below consensus with the biggest difference coming from our US view, where we expect GDP growth of -1% compared with consensus of a 0.2% rise.

Inflation is expected to moderate next year. Inflation is less of a problem in emerging economies as central banks in the region moved earlier than in the advanced economies. In the latter, monetary policy is now expected to tighten more aggressively than previously expected with the US Federal Reserve (Fed) raising rates to 4.75% in Q1 2023 and the Bank of England (BoE) and European Central Bank (ECB) stepping up the pace of rate rises.

Central banks have more work to do



Source: Refinitiv, Goldman Sachs, Schroders Economics Group. 24 November 2022.
Please note the forecast warning at the back of the document.

In the near term, our interest rate forecasts are close to market expectations in the US and eurozone, but looking further out we expect the downturn in economic activity to cause both central banks to ease by more than is priced in. Although inflation will still be above target at this point we believe the onset of recession and increase in unemployment will allow rate cuts as central banks anticipate further easing of inflationary pressure. The pivot occurs much earlier in the US than in Europe where central banks have been slow to address their inflation problems, particularly the BoE.

Inflation to fall, but at the cost of a recession

The path of inflation is critical to the outlook. Although there are signs that headline consumer price index (CPI) inflation has peaked in the US we are concerned that it will prove costly to reduce in terms of the loss of GDP.

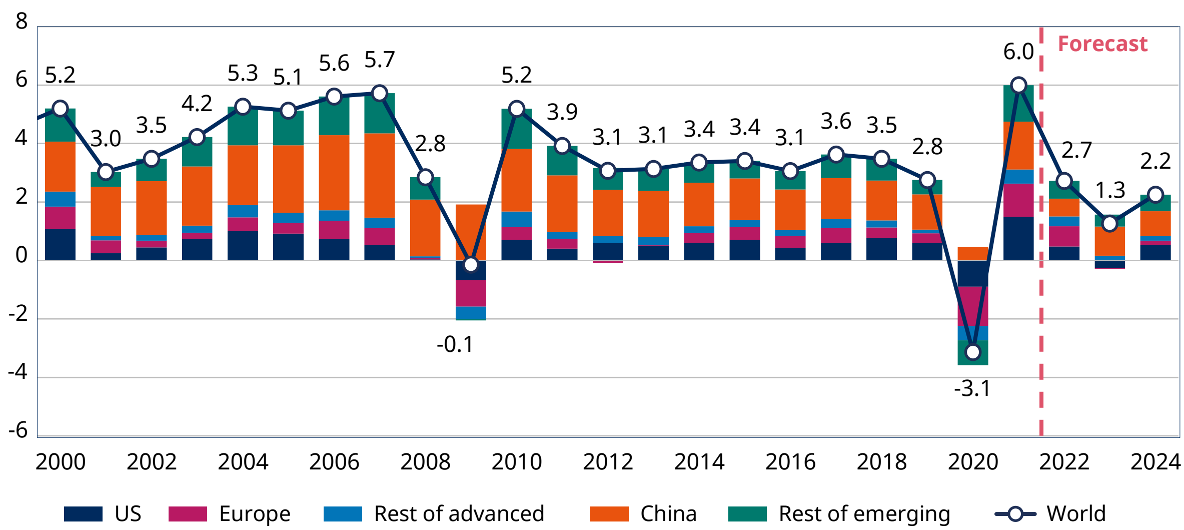
Inflation continues to run well above central bank targets of 2% around the world. Recent data in the US has been softer than expected and the headline CPI rate appears to have peaked in June at 9.1%. Nonetheless, year-on-year (y/y) inflation is at its highest for 40 years and elsewhere the trend is still upward.

The fall in inflation has been largely due to an easing in oil prices. "Core" inflation (CPI excluding food and energy) is running at 6.0% or higher in the US, UK and eurozone and just under 2% in Japan. This is lower than the headline figure, but still well above target. Again, there are tentative signs that core inflation may have peaked in the US, but it remains on an upward trajectory elsewhere.

We continue to believe that inflation will come down in coming months, but unfortunately this will require a recession in the advanced economies.

World GDP growth – history and forecast

Contributions to world GDP growth (% y/y)



Source: Schroders Economics Group. 24 November 2022. Please note the forecast warning at the back of the document.

② Equities: are the headwinds easing?

We may have seen the peak in inflation, but a peak in interest rates could still be some way off. This suggests it is still too early to add to equities – for now.

Higher inflation, rising bond yields and rising interest rates were the main headwinds to equity markets in 2022, bringing valuations into focus while also removing the central bank "safety net" that investors have grown accustomed to.

Central bankers may become less anxious about inflation in 2023. But equity markets must still contend with higher interest rates, weaker consumer demand and falling corporate earnings against a deteriorating economic backdrop as the US and other developed markets fall into recession.

The key question for investors is how deep a recession this will be – and how long it will last. Much will depend on how quickly inflation cools and how soon central banks, in particular the Federal Reserve, signal that a peak in interest rates is in sight.

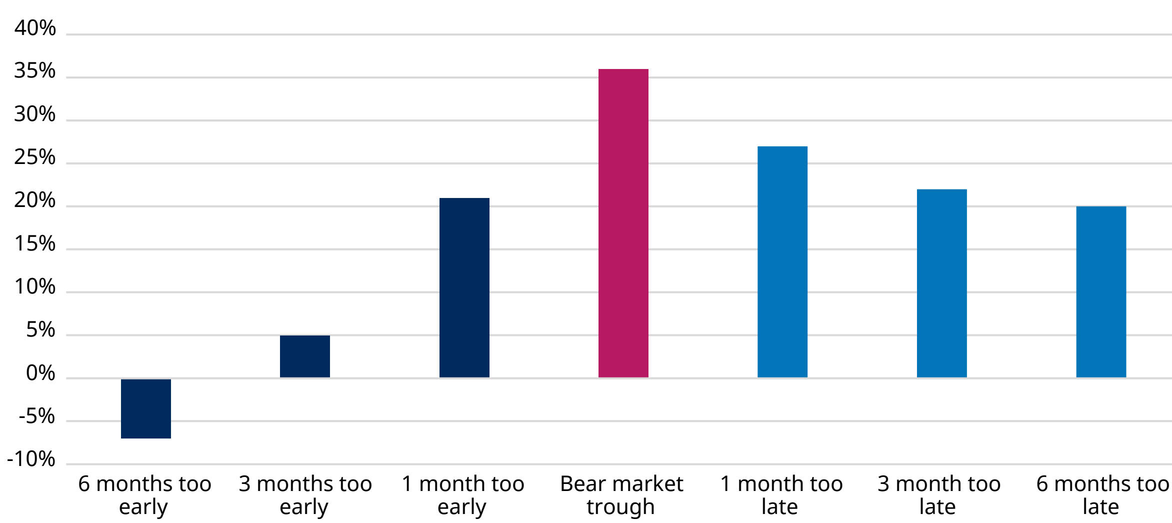
Markets were exuberant when inflation data for October came in below expectations, very possibly indicating that we have seen the peak in US inflation. The S&P500 surged 5.5% in dollar term on the day. However, markets may have been getting carried away. Annual headline inflation remains above 7% and the Federal Reserve remains committed to bringing inflation back towards its target of 2%.

We still think it is too early to turn more positive on equities, but this could change over the course of 2023. There are three factors we are monitoring.

It hasn't paid to try and pre-empt the end of the bear market

Average 12 month performance for S&P500 around bottom of "bear markets" since 1973 (in USD)

The pink column shows the average performance of the S&P500 in the 12 months following the bottom of a bear market. The blue columns show the 12-month performance from various points in time before and after the low of the market.



Past performance is not an indicator of future returns and may not be repeated.
Source: Schroders Wealth Management, Goldman Sachs.

A peak in US interest rates

The Federal Reserve has responded aggressively to US inflation, raising interest rates faster and further than other central banks. Further increases look likely. Fed Chair Jerome Powell stated at a press conference in early November that the US central bank still had "some way to go" to control inflation and that "the ultimate level of interest rates will be higher than previously expected."

Despite the positive response to the October inflation data, we think it is too early to expect a shift in policy. It would be self-defeating for the Fed to change tack now, as stronger markets have tended to support consumer confidence and spending and, in turn, inflation. We therefore expect that US interest rates will continue to rise over the coming months.

If we do see inflation moderate, it would give the Fed the flexibility to slow and then pause interest rate hikes. This would reduce the uncertainty around monetary policy and may give investors more confidence to re-allocate to equities. However, we need to see further evidence that inflation is on a more persistent downwards path before we can become confident that a peak in interest rates is at hand.

A softer labour market

In the past, a weaker labour market has tended to be a pre-condition for a more enduring fall in inflation. Higher interest rates (and therefore higher borrowing costs) have resulted in companies reducing their workforces to help defend margins. This leads, in turn, to lower household income and weaker consumer demand, reducing companies' ability to raise prices.

So the Fed will want to see signs of weakness in the labour markets to confirm the trend of falling inflation. At this point, they may begin to think about shifting their focus away from controlling inflation to supporting growth.

We have not yet seen significant weakness in US labour markets, despite a significant tightening in financial conditions.

Earnings realism

We have started to see analysts downgrade earnings estimates for 2023, but we believe they remain too optimistic. In particular, we think margin forecasts are too high. Consumers are under significant pressure while input costs remain high. This combination is likely to result in lower margins and weaker earnings.

On average, when the US economy has entered a recession, earnings have fallen by 13%. Currently, analysts have lowered their expectations for earnings in 2023 by just 4%. So there remains a disconnect between forecasts and what history suggests should happen.

In the near term we expect to see further weakness in corporate earnings which could lead equity markets lower. When earnings downgrades slow, and we stop seeing equities react negatively to them, it could be an indication that most of the bad news is "in the price." This may be a signal that it is time to buy equities.

What about valuations?

Historically, there has been a strong correlation between equity market valuations at the point of investment and the subsequent returns over the next decade. Over the course of 2022, global equity markets meaningfully de-rated as rising interest rates forced investors to re-evaluate the multiples they were willing to pay for potentially weaker future earnings.

As at the end of November, global equity markets were trading below 15 year average valuations. While valuations may have further to fall as interest rates continue to rise, we feel current levels offer a relatively better entry point for those looking to invest over the long term.

Over the coming months, we expect that equity markets will remain volatile. We do not expect to see a more sustainable equity market recovery until the factors highlighted have fallen into place. We are not quite there yet.

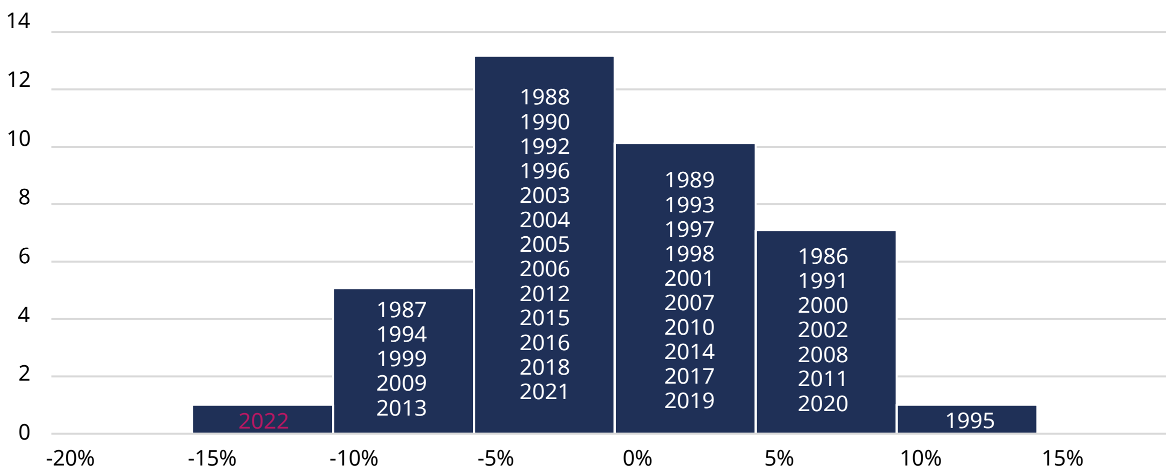
Easing our way back into the bond market

Developed bond markets have experienced their worst performance since records began. There's no clear playbook for what comes next, but we think opportunities are starting to emerge.

2022 has been an unprecedented year for fixed income markets. High inflation and rising interest rates resulted in a very sudden rise in yields from the exceptionally low levels that prevailed in 2020 and 2021. When bond yields rise, their capital values fall.

Even US Treasuries - the safe-haven asset par excellence – fell by a double digit percentage amount. As our data shows, investors in this market are not used to these kinds of losses. In many areas of fixed income, 2022 has wiped out a decade's worth of returns.

US Treasuries total return (USD, %)



Past performance is not an indicator of future returns and may not be repeated.
Source: Schroders Wealth Management.

The poor performance has also been very painful for multi-asset investors who look to bonds as a way of smoothing portfolio returns. Normally, government bonds are negatively correlated to equities in periods of market stress. But in 2022, both assets fell in tandem as they responded to the outlook for monetary policy. A "traditional" medium risk portfolio comprised of 60% equities and 40% government bonds has experienced the worst year of performance since 1937.

When the dust has settled

The repricing could present opportunities. Government bond yields are at their most attractive levels in over a decade. Government bonds across developed markets are now yielding the same as high yield debt did a year ago – but with much lower credit risk. Similarly, holders of 10-year US inflation-linked treasuries are currently receiving an after-inflation yield of more than 1%. The last time this was possible was in 2011.

Bond markets will continue to be impacted by the direction of central bank policy, as is the case with equities. If we see inflation fall further, both asset classes could rally as investors anticipate an end to monetary policy tightening and the correlation of returns could remain elevated. As fixed income volatility falls, however, we expect the correlation between bonds and equities to be more similar to historic experience. The traditional benefits of holding bonds as a way to manage portfolio risk should become evident once again.

What are we doing in portfolios?

We have gradually been increasing our exposure to nominal government bonds as valuations have improved and economic data has suggested the risk of recession has increased. Our caution reflects the fact that interest rates could continue to rise and the bond market has been through a period of turmoil that may not have run its course. In particular, the volatility seen in UK bond markets following the "mini-budget" suggest caution remains appropriate. While the drivers of this particular crisis were UK-specific, the situation highlighted the risks to a market when a price insensitive buyer, such as a central bank, turns from a buyer to a seller.

To manage our exposure to interest rate risk, we prefer shorter maturity bonds which are less sensitive to changes in interest rates. However, once it becomes clearer that interest rates in developed markets are at or near a peak, there may well be an opportunity to increase our exposure to longer maturity bonds. These would benefit more than shorter-dated bonds if central banks start to contemplate cutting interest rates to support growth.

We expect to see continued volatility in investment grade and high yield credit markets as investors assess the outlook for economic growth and corporate profits. We are likely to see more corporate profit warnings, which could give rise to greater concern about companies' ability to service and refinance their debt.

However, investment grade credit looks relatively attractive. USD corporate bonds now offer a yield of just under 5.5%. Credit spreads (the excess that companies have to pay to borrow over government bonds) have widened and are now back around long term averages suggesting that valuations are more appealing. Meanwhile, leverage metrics, which reflect how much companies have borrowed relative to their cash flow, are not at excessive levels.

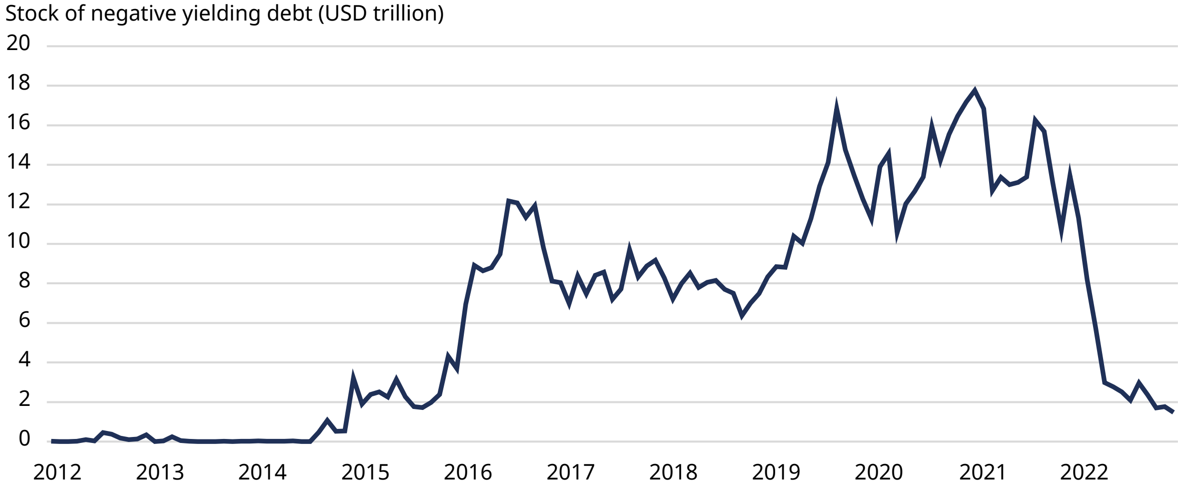
As with government bonds, we believe it makes sense to focus on shorter-dated higher quality credit at this stage. Once we see corporate earnings trough, there are likely to be more opportunities in credit markets and we may look to increase our allocation to this area.

Fixed income markets have undergone a historic shock in 2022 and haven't provided the ballast many investors expected. While we are still treading cautiously, we think the market is starting to offer attractive absolute yields and diversification benefits.

The days of negative yielding debt are almost over

Japan is the last refuge

Stock of negative yielding debt (USD trillion)



Source: Refinitiv Datastream.

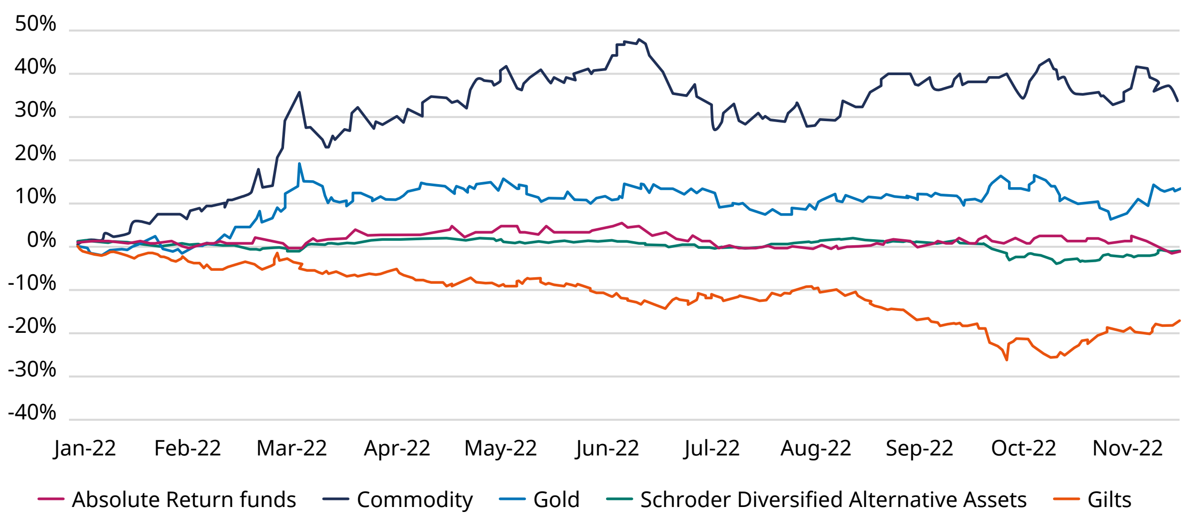
④ Alternatives: Still a valuable enhancement to our toolkit

Alternatives now face more credible competition from bonds as a source of portfolio diversification. However, we still believe that alternatives have an important role to play in portfolio construction.

In 2022, our overweight allocation to "alternative" assets - including commodities, gold, absolute return funds and real assets – was beneficial to headline returns. In a year that offered few places to hide, these assets were able to protect capital and even, in the case of commodities, increase its value.

The outlook may be getting more challenging. We have seen a significant correction in fixed income markets and government bonds are starting to look more attractively valued on a relative basis. As bond yields have risen, alternatives' position as the preferred diversifier in multi-asset portfolios is under threat. For the first time in a number years, investors have a broad choice of more defensive assets that can provide diversification while also generating returns.

Total return (GBP)



Past performance is not an indicator of future returns and may not be repeated.
Source: Schroders Wealth Management.

Despite this, we believe that an allocation to certain alternative assets will continue to play an important role in portfolios going forward.

Absolute return can deliver in all markets

The absolute return funds we invest in tend to have a strong track record of delivering returns with low correlation to either fixed income or equity markets across different market environments. As such, we continue to believe that they can help manage risk within portfolios despite the shifting market environment.

Commodities to benefit from energy transition

Commodity markets could face near-term headwinds as they grapple with the prospect of a recession. However, we are maintaining our exposure. Around a third of the broad commodity index is represented by energy. The Russo-Ukrainian War is likely to continue to disrupt European energy supply and we could see further price pressures. Exposure to physical commodities offers a hedge against this risk scenario.

Longer term, we see an increasingly strong rationale for a structural allocation to commodities. The combined challenges of energy security and decarbonisation have highlighted the importance of an accelerated transition to more renewable sources of energy. This requires significant investment in both renewable energy production and infrastructure, increasing demand for industrial metals and rare earths at a time of tight supply. Any cyclical weakness in commodities may present an opportunity to increase our allocation.

Attractive opportunities in real assets

We continue to believe that allocating to “real assets” including renewables, infrastructure and select property should benefit returns while also increasing diversification, especially in an inflationary environment. Listed UK infrastructure funds typically have a high proportion of revenue linked to inflation. Some also have fixed- rate debt, which amplifies their sensitivity to inflation. For example, a 10% change in inflation would see the revenues of HICL Infrastructure (held within the Schroders Diversified Alternative Assets Fund) rise by 8%. Furthermore, recent volatility has resulted a fall in the valuation of many of these listed vehicles. This could offer an attractive entry point for long-term investors.

Private equity can take advantage of the downturn

Where appropriate, we believe that private equity should now be playing a role in diversified private client portfolios.

Recent years have seen a marked shift in activity and capital towards private markets. As a result, the opportunity set in private markets has grown significantly in recent years and we believe that investors who exclude this area risk missing out. There is significant evidence to suggest that private equity and other private market investments can generate higher returns and help smooth portfolio returns.

Rising interest rates and lower growth are a headwind, for private equity in particular. However, we remain optimistic. The industry successfully navigated the financial crisis of 2008, the pandemic of 2020 and many other periods of stress in between. In the past, funds invested during downturns have proved to be some of the best performers.

Having said this, we are tilting our allocations in favour of those parts of the market that we think are better positioned over the medium term. This includes funds focused on smaller companies and sector-specialists. Both are likely to have more “levers” they can work with to increase the value of investee companies. We also like secondary funds, which buy investments in existing funds. They have been able to capitalize on recent market stress, which resulted in fund interests being sold at discounted valuations. Our final area of focus is venture capital. The sharp falls seen in 2022 are likely to have created opportunities for skilled managers to identify and invest in transformational businesses at more attractive valuations.

5 Another year of dollar strength

The Fed's aggressive stance on inflation turbocharged the dollar in 2022. The US central bank is likely to slow the pace of rate rises in early 2023. But we still see scope for the dollar to strengthen.

The US dollar was remarkably strong in 2022, with the trade-weighted index reaching a 20-year high in September. This was a result of two factors. Firstly, interest rates in the US have been higher than in other developed markets as the Federal Reserve raised rates faster and further than other central banks in response to inflationary pressures. Secondly, economic growth concerns have seen investors turn to the dollar as a "safe haven," especially at a time when fixed income, the other key traditional defensive asset, has been struggling.

From a sterling perspective, this has only been half of the story. Demand for the UK currency has fallen as the country's current account deficit has grown – thanks in part to the soaring cost of energy. The deteriorating growth and inflation outlook has also reduced demand. These factors saw the pound briefly fall to all-time lows against the dollar in the third quarter.

The trend is the dollar's friend

We think that the factors that drove the dollar higher in 2022 could continue to support it in 2023. Although we do not expect to see a repeat of the extent of 2022's performance and we could well see more frequent changes in direction we still see scope for the dollar to strengthen further against sterling and other global currencies in the first half of next year.

While investors remain concerned over global economic growth and the risk of recession, demand for the dollar will likely hold up.

Looking slightly further ahead, the outlook for economic growth, inflation and real (inflation-adjusted) interest rates also continue to favour the dollar.

We expect that developed market economies will likely fall into recession in 2023. But the US economy remains in a comparatively better position than other developed markets, in part because of its greater self-sufficiency in both energy and agriculture. A US recession may well be shallower and shorter-lived.

US interest rates have the potential to rise higher than those in other developed markets, especially the UK. This reflects the structure of the mortgage market. US home owners have the option to fix mortgage deals for up to 30 years. As a result, their sensitivity to changes in short-term interest rates is low. In the UK, by contrast, mortgages rates are on average only fixed for two to three years, making the housing market much more sensitive to changes in interest rates. The Bank of England may not be able to raise rates aggressively without undermining confidence in the property market, which would in turn hurt UK financial institutions.

The outlook for inflation is also more favourable in the US. The Fed may have been too slow to recognise the threat of inflation, but it has subsequently acted with far greater resolve than other central banks. America's energy independence also means it does not face the same supply disruptions as Europe.

This combination of higher nominal interest rates, and lower inflation, should mean that the US continues to offer more attractive real interest rates, especially compared to sterling.

A decade of decline

Past performance is not an indicator of future returns and may not be repeated.
Source: Refinitiv Datastream.

What could change our view?

There are some scenarios that could result in more significant weakness in the dollar. Perhaps the most dramatic change to the outlook would come from a negotiated settlement between Russia and Ukraine, if it results in an easing of sanctions on Russian energy and food exports. This would bring forward the peak in global inflation and boost investor confidence, both undermining the US dollar's relative appeal.

It is also possible that we see declines in the dollar if US growth is weaker than expected. This may cause the Fed to shift the focus of monetary policy away from fighting inflation to supporting growth. This could cause interest rate differentials to move against the dollar whilst investor sentiment would also be boosted by a more supportive central bank.

Our approach in portfolios

Maintaining an overweight dollar position across portfolios has helped international investors with exposure to dollar-denominated assets this year, cushioning some of the large price declines we have seen. As we move into 2023, we are conscious of the defensive qualities of the dollar and plan to maintain exposure. However, given our expectation that the dollar may tread a more circuitous path this year, we may reduce the size of our overweight position. We will also remain focused on managing our currency exposure as the economic backdrop shifts.

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Debt securities: Investments in higher yielding bonds issued by borrowers with lower credit ratings may result in a greater risk of default and have a negative impact on income and capital value. Income payments may constitute a return of capital in whole or in part. Income may be achieved by foregoing future capital growth.

Emerging markets: You should be aware of the additional risks associated with investment in emerging and developing markets. These include: higher volatility of markets; systems and standards affecting trading, settlement, registration and custody of securities all possibly lower than in developed markets; lack of liquidity in markets and exchanges leading to lower marketability of securities and greater price fluctuation; significant currency volatility, possibly resulting in adoption of exchange controls; lower shareholder protection or information to investors provided from the legal infrastructure and accounting, auditing and reporting standards.

Structured products: Structured products are usually issued by financial institutions and in the event of these institutions going into liquidation or failing to comply with the terms of the securities you may not receive the anticipated returns and you may lose all or part of the money you originally invested. If you sell your investment before its maturity date the investment may achieve a price less than the original investment. The performance of these investments may depend on indices and defined calculations which may differ from direct investments.

Gearing: Some of the investments we may make on your behalf could be in investment companies which use gearing as a strategy or invest in other investment companies which use gearing, such as investment trusts. The strategy which the issuer of such securities uses or proposes to use may result in movements in the price of the securities being more volatile than the movements in the price of underlying investments. Such investments may be subject to sudden and large falls in value and you may get back nothing at all if there is a sufficiently large fall.

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