SCHRODERS CIO LENS

Q3 2023

Schroders

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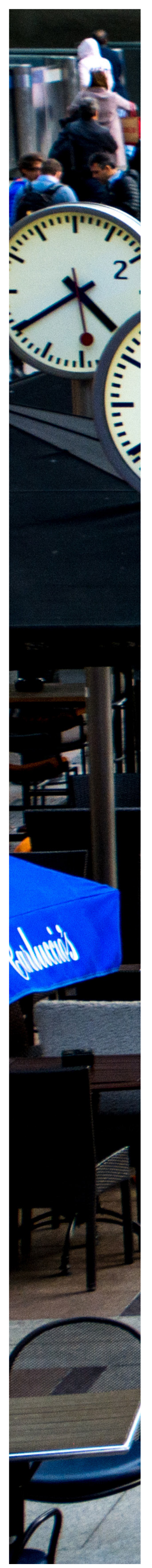

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LESSONS FROM THE SCHOOL OF HARD MARKETS

Johanna Kyrklund
Group Chief Investment Officer
and Co-Head of Investment

As we reach the mid-point in the year, it's important to reflect on our investment performance and discover what we can learn from both our successes and our mistakes.

As a parent I am always trying to instil good habits into my children, especially at this time of year when my son is sitting exams. Although he barely listens to a word I say, I persevere in the hope that he'll remember some of what I say one day, and it will help him in the future.

Hopefully he knows that both personally and professionally I believe in having a learning mindset – always looking to learn from others and from my own mistakes.

From my side, the market keeps on schooling me on the importance of staying humble and focused on our investment process. The halfway point of the year is a particularly good time to reflect on our investment performance; what's gone wrong and what's gone right, and what I can learn.

And not everything has gone to plan recently.

Earlier this year, the multi-asset team positioned for a slowdown in economic activity. We did this through an overweight position in bonds and an underweight position in equities.

THE HALFWAY POINT OF THE YEAR IS A PARTICULARLY GOOD TIME TO REFLECT ON OUR INVESTMENT PERFORMANCE; WHAT'S GONE WRONG AND WHAT'S GONE RIGHT, AND WHAT I CAN LEARN

In the last month we've seen this view challenged on multiple fronts. Labour market conditions remained tight. All the major central banks surprised markets with higher interest rates or hawkish comments. In the US, continued strength in services outweighed the ongoing signs of weakness in the manufacturing and goods sector. Meanwhile, the potential tail risk represented by the US debt ceiling wrangling was averted.

As a result, equity markets – which had been trading in a fairly narrow range in recent months – rose and bond markets fully reversed any expectation of the Federal Reserve (Fed) pivoting on interest rates, seeing bond yields climb.

Over the last 12 months we have repeatedly said that signs of softening in the labour market would be required for the Fed to back off from raising rates. Although other measures of inflation such as energy and food have clearly turned, wage growth is still too high for comfort. This means monetary conditions are likely to remain restrictive and we expect economies to slow down later this year as credit conditions gradually tighten.

At the same time, we are still concerned about equity valuations at a time where you can still get a decent yield just by sitting in cash. The challenge is that timing is important. With the labour markets still resilient, it is difficult to see an imminent move into recession this summer and there is less short-term danger to corporate earnings. Consequently, we have decided to reduce our underweight position in equities to manage our risk and move closer to neutral.

In the case of bonds, the main challenge is that the inverted yield curve (with longer-term bonds yielding less than their short-term counterparts) makes an overweight position in US bonds expensive to hold. Consequently, we have rotated our overweight position in government bonds into a long position in European investment grade debt as this offers a high-quality spread that buys us time as we wait for the slowdown. We remain overweight in local currency denominated emerging market debt as many of these markets offer improving inflation dynamics and relatively attractive yields. In short, we favour strategies that give us a positive carry as we await fresh opportunities.

So, as I look back over the year so far, it's clear some of our positioning hasn't worked and we have struggled to catch a trend. We are now reducing or closing some of our defensive positions, reflecting the reality that the expected slowdown has failed to materialise quickly enough.

AS AN INVESTOR, RESILIENCE IS A KEY TRAIT AND EVERY TIME YOU MAKE A WRONG CALL, YOU CHIP AWAY AT IT

At times like these, it is as important as ever to be disciplined about how you manage your risk.

As I've mentioned before, our investment processes often exist to "cope with failure". With a hit rate of 60% seen as being very strong, the reality is that, even if we are good at our jobs, we are making "wrong" decisions 40% of the time.

It is important to recognise mistakes early and guard against "rationale drift"; in other words, making sure you don't lose sight of the original reason for making an investment.

As an investor, resilience is a key trait and every time you make a wrong call, you chip away at it. I sometimes describe it as having to manage a "failure budget" over your career.

By cutting your losses or having other means of managing your psychology through difficult markets, you can preserve your emotional energy and your ability to take risk for when opportunities avail themselves. This allows you to use up your failure budget slowly and live to fight another day in markets.

Johanna Kyrklund

Sustainable investment: Why the silent majority are more focused on returns than ideology

Andy Howard
Global Head of Sustainable Investment

While the debates at either end of the sustainable investing spectrum attract the most attention, the silent majority in the middle is far larger and, for the most part, focused on investment returns more than ideology.

Sustainable investing has always attracted a wide range of views from advocates to sceptics. Recently the investment industry has been stretched by "anti-ESG" voices at one end of the spectrum, and by calls for more strident action at the other as those views have moved further apart.

On the one hand, several US states have created "blacklists" of financial firms, reflecting their concerns that asset managers are pursuing sustainability goals rather than focusing on investment returns. Schroders has been caught on two of those lists, in Texas and Kentucky. On the other, calls to divest from larger parts of the market or to demonstrate sustainability commitments by opposing management in voting decisions are also growing louder.

Voting patterns on environmental and socially-focused shareholder resolutions are at least an objective measure of market views on different topics, even if imperfect. Levels of support for high profile shareholder resolutions, such as those calling for greater climate ambition at BP[1] or Shell[2], were very similar this year compared to the previous year. In our view, there is no obvious move in the aggregate picture towards either extreme.

Looking globally, the charts below show the average levels of support for sustainability-focused shareholder resolutions, which has dipped in recent years. That drop becomes much less pronounced when we strip out resolutions developed or filed by advocacy groups, which have grown to around one third of the total and which have clear environmental or social priorities.

While the debates at either end of the spectrum ignite coverage and commentary, the silent majority in the middle is far larger and, for the most part, focused on investment more than ideology.

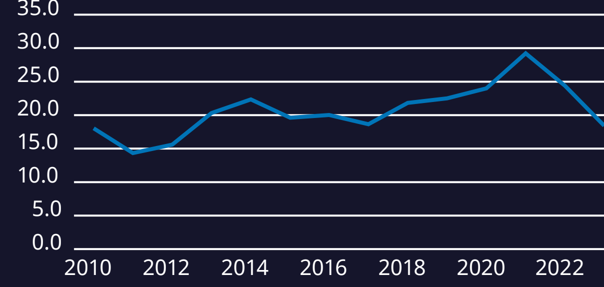
Virtually all of our clients are concerned with risk and return, which is our primary focus, but some of our clients are looking for investments that connect their capital to solutions to global environmental and social challenges, and we have developed strategies to help them do so.

Across Schroders, the view we take on this type of investing is framed by a conviction that social and environmental forces will become increasingly important investment drivers in markets. We believe that companies better placed to navigate those challenges or seize opportunities will be better positioned. Moreover, those that can transition their businesses to become more sustainable will be well placed to unlock value and returns for shareholders.

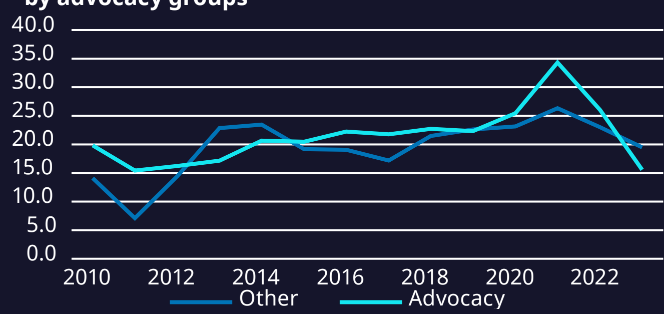
Companies that have successfully reduced emissions faster than their peers over the last five years have outperformed those in the worst quintile of emissions management by around 3% annually over the last five years[3]. By allocating capital to well positioned companies and assets, and by encouraging the transition towards more sustainable business models, we believe we can help our clients to benefit financially from action to tackle social and environmental challenges.

Looking forward, we expect more dispersion and more debate by advocates at both ends of the spectrum. We continue to focus on the connection between the investments we manage and increasingly acute and disruptive social and environmental challenges.

Average support for E&S shareholder resolutions has dropped in recent years...



...and fallen most sharply among resolutions proposed by advocacy groups



Source: Proxy Insight, Schroders analysis. Note that 2023 data is based on available data through end-June, which reflects roughly half of the total votes we expect will be cast this year. A growing number of "anti-ESG" resolutions are emerging, which we have removed from this analysis based on our estimates of their volume and average support.

1 https://www.reuters.com/business/energy/bp-climate-shareholder-resolution-wins-1675-support-2023-04-27/
2 https://esgclarity.com/shell-climate-resolutions-20-support-triggers-company-action/
3 Based on Schroders analysis of changes in carbon intensity (CO2 emissions relative to sales) for MSCI ACWI IMI constitutions, relative to their ICB sector peers over the last five years.

Most read content this quarter

Azad Zangana
Senior European Economist and Strategist

UK should brace for 6.5% interest rates: here's why we've raised our forecast

"Events of the past few weeks, incoming data, and a surprise 0.5 percentage point (pp) rise in the base rate, suggest that the BoE remains far from getting on top of inflation. Consequently, we now anticipate interest rates to peak at 6.5% by the end of 2023, a full 1.5 pp higher than our previous forecast for a peak of 5.0%."

Read the full article here

Masaki Taketsume
Fund Manager, Japanese Equities

Taku Arai
Investment Director – Japanese Equities

Japanese shares have hit 33-year highs – but why?

With Japanese stocks scaling heights not seen since 1989, we look at what's driving them and explain why the Tokyo Stock Exchange has called on companies to enhance their corporate value.

Read the full article here

Mark Lacey
Head of Global Resource Equities

Three ways in which the energy industry must change and what this could mean for investors

We look at three ways in which the energy industry has to evolve in order for the energy transition to materialise, and how equity investors could benefit.

Read the full article here

Simon Webber
Lead Portfolio Manager, Global and International Equity

Big tech turnaround: what's behind the recovery?

After dominating stock market returns amid the Covid pandemic, the household names of the US tech sector endured a miserable 2022. In recent months the tables have turned once again – we look at why.

Read the full article here

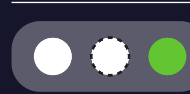
Overall asset allocation views

Short / negative neutral Long / positive Previous score

Equities

At the beginning of the quarter, we downgraded our equity view to negative. The rally in the previous quarter was narrow in nature, and we positioned for an economic slowdown as the Fed continued in their relentless pursuit of raising rates. We held this bearish stance through May, as inflation remained persistent and fragility in US regional banks illustrated rates were beginning to bite. In June, this view was challenged as labour markets remained surprisingly tight and markets priced out any expectation of a Fed pivot. We have pushed out our expectation of a slowdown, and reverted to a neutral view as earnings may grind higher in the short term without the imminent threat of recession.

Government bonds

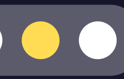


Our view on government bonds switched to neutral at the end of the period, with both US and UK government bonds downgraded to neutral from positive. At the beginning of the period, we believed that we were close to a peak in interest rates, with portfolios positioned for an anticipated economic slowdown. However, due to tight labour markets and a deal being reached on the US debt ceiling, the global slowdown we had predicted, during which bonds would be expected to perform well, is now not deemed to be imminent.

Credit

We remained neutral in credit for most of the quarter as valuations were not attractive given the macro backdrop. In June, we upgraded credit as the resolution of the debt ceiling issue in the US has removed a tail risk and improved the economic outlook. Moreover, allocating to credit gives us access to the defensive properties of duration but with a positive carry compared to government bonds.

Commodities



We have kept our neutral score over the quarter. The goods sector has remained weak, inventory levels have remained stable, and China's reopening has been underwhelming.

Source: Schroders. Forward looking views and forecast may not be realised.

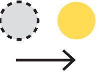
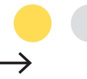
Regional equity views

Q3 2023

Short / negative neutral Long / positive Previous score

Equities

US

At the beginning of the quarter, we were cautiously positioned in anticipation of an economic slowdown. Strains in the banking sector and tightening credit conditions illustrated the impact of increased rates, and markets were pricing in a Fed pivot in the autumn. Since then, labour markets have remained surprisingly tight, the services sector strong, and the tail risk from the US debt ceiling discussion has been removed. We therefore have pushed out our expectation of a recession, and upgrade our view to neutral as we expect that earnings may grind higher in the short term.

UK

We have downgraded UK equities to negative. Prices rose in April, then steadily declined over the quarter. The Bank of England (BoE) raised the UK's base rate an unexpected 0.5% in June, taking the overall level to 5%. This follows payroll data showing positive growth in employment and wages and the highest headline rate of inflation in the G7. We expect further hikes, and for the lagged consequences of these hikes to be felt throughout the economy.

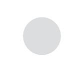
Europe ex. UK

We have downgraded our view on Europe to negative. Like the UK, the eurozone has suffered from persistent inflation and stubbornly tight labour markets over the quarter. In June, the eurozone entered into recession, in part due to countries such as Germany being heavily reliant on the struggling manufacturing sector. Despite this, the European Central Bank (ECB) has maintained its hawkish tone as controlling inflation looks to dominate fears of recession.

Japan

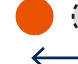
At the beginning of the quarter, we downgraded our view on Japan to negative. China's reopening was underwhelming, and our expectation of an economic slowdown boded poorly given the market's cyclical nature. Since then, we have re-upgraded our view to neutral. We have pushed out our expectations of a slowdown, and valuations remain attractive despite the recent rallies. Although it is too early to tell, abating deflation and corporate governance reform present potential tailwinds longer term.

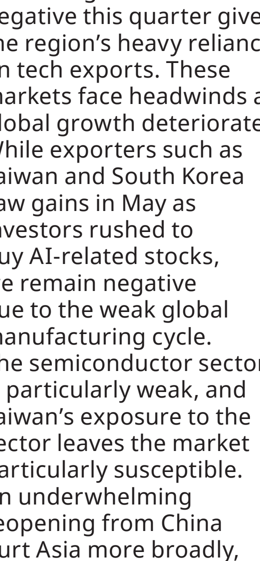
China



At the beginning of the quarter we maintained our positive view on Chinese equities. Data and PMI surveys supported our view that China's reopening would lead to a strong services sector rebound. However, the rebound quicky lost momentum. China's manufacturing and construction sectors remain weak, and a 10bps reduction in the People's Bank of China's (PBoC) short-term lending rate did little to lift sentiment. It is, however, expected that the PBoC will inject more stimulus in the near future. Overall, we have downgraded our view to neutral.

Asia ex. Japan





We downgraded Asia to negative this quarter given the region's heavy reliance on tech exports. These markets face headwinds as global growth deteriorates. While exporters such as Taiwan and South Korea saw gains in May as investors rushed to buy AI-related stocks, we remain negative due to the weak global manufacturing cycle. The semiconductor sector is particularly weak, and Taiwan's exposure to the sector leaves the market particularly susceptible. An underwhelming reopening from China hurt Asia more broadly, and growing geopolitical instability has also been undermining investor sentiment.

Emerging markets

We continue to hold our neutral stance on emerging markets (EM) this quarter. While EM central banks are ahead in the fight against inflation, rates in the US are high and the Fed maintains its hawkish tone. Borrowing costs remain expensive for EM corporations saddled with foreign-currency denominated debt. Saudi Arabia performed well early in the quarter as it announced oil production cuts. However, China's reopening played out and the oil market remained adequately supplied. Thus, countries such as Kuwait, the UAE, and Saudi detracted later in the quarter as oil prices fell. The CE3 countries presented an opportunity as EU gas prices fell and supply-risk from the Russia-Ukraine war abated, whereas South American countries Colombia and Chile faced political uncertainty, undermining investment. All in all, we decide to remain neutral.

30 June 2023

Source: Schroders. Forward looking views and forecast may not be realised.

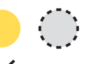
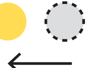
Fixed income views

Q3 2023

Short / negative neutral Long / positive Previous score

Bond and credit

Government

Despite an initial viewpoint that the Fed would reduce the pace of tightening in response to the volatility seen within the US banking sector, we have ultimately moved to neutral on US Treasuries. This is because we see an inverted yield curve combined with negative carry, which has made US government bonds expensive to hold.

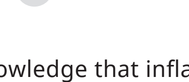
Alongside this, UK government bonds have also been downgraded to neutral, given the expectation that there will be further tightening of rates due to the persistence of inflation. We do acknowledge that gilts were trading at reasonable prices throughout May, but inflationary risks drive our cautious view.

Throughout the period, we have remained neutral on German government bonds (bunds). This aligns with our belief that the ECB has reduced its pace of rate hikes and the perception that inflation within the European Union appears to be slowing down.

With regard to Japanese government bonds, we remain neutral. It should be noted that while high inflation remains persistent in Japan, the new Bank of Japan governor, Kazuo Ueda, outlined that a loose monetary policy will be maintained for now.

The overarching view is that we are in favour of a strategy that provides a positive carry and await further fresh trends.

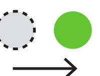
Inflation-linked



We acknowledge that inflation is expected to begin moderating, meaning the preference is to take exposure from nominal bonds. We remain neutral on inflation-linked bonds.

EMD

Denominated in USD:
Although some emerging markets offer improving inflation dynamics and relatively attractive yields, a strong dollar leads us to a neutral score. In addition, some of the world's poorest countries are facing a debt crisis that leaves EM sovereigns particularly vulnerable. A soft landing would favour EM debt, but until we have clearer signals, we prefer to stay on the side-lines.



Denominated in local currency:
Our view on local emerging market debt has been upgraded to positive because EM central banks are ahead of more developed markets within their hiking cycles. The Fed has indicated it will pause without detailing when it will cut rates. Prior to the Fed cutting rates, the current stance of EM central banks presents an opportunity to harvest carry. In comparison to other types of bonds, EM offers both improving inflation dynamics and relatively attractive yields.

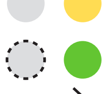
High yield (HY)

We remained neutral for US and EU high yield over the quarter as this part of the credit market tends to be more exposed to tightening financial conditions and we do not believe spreads are compelling given the deteriorating macro backdrop. In fact, in June, tighter financial conditions have led to an increase in US HY default rates, while recovery rates have been falling to historical lows. Although conditions are marginally more favourable for European HY, valuations have deteriorated and uncompelling spreads lead us to stay on the side-lines.

Investment grade (IG) corporate

US

EU



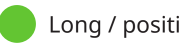
We started the quarter with a neutral view on investment grade in anticipation of an environment of tightening financial conditions and a global slowdown. Although credit fundamentals were strong, high cash rates were setting a high benchmark for the sector making it unattractive for investors. Later in the period, as spreads moved above the median demand for high quality credit increased. In addition, we observed financial conditions tightening more slowly in Europe versus the US; therefore, we upgraded European investment grade to positive in June. The sector also offers access to duration with positive carry.

30 June 2023

Source: Schroders. Forward looking views and forecast may not be realised.

Commodities views

Q3 2023



Short / negative neutral Long / positive Previous score

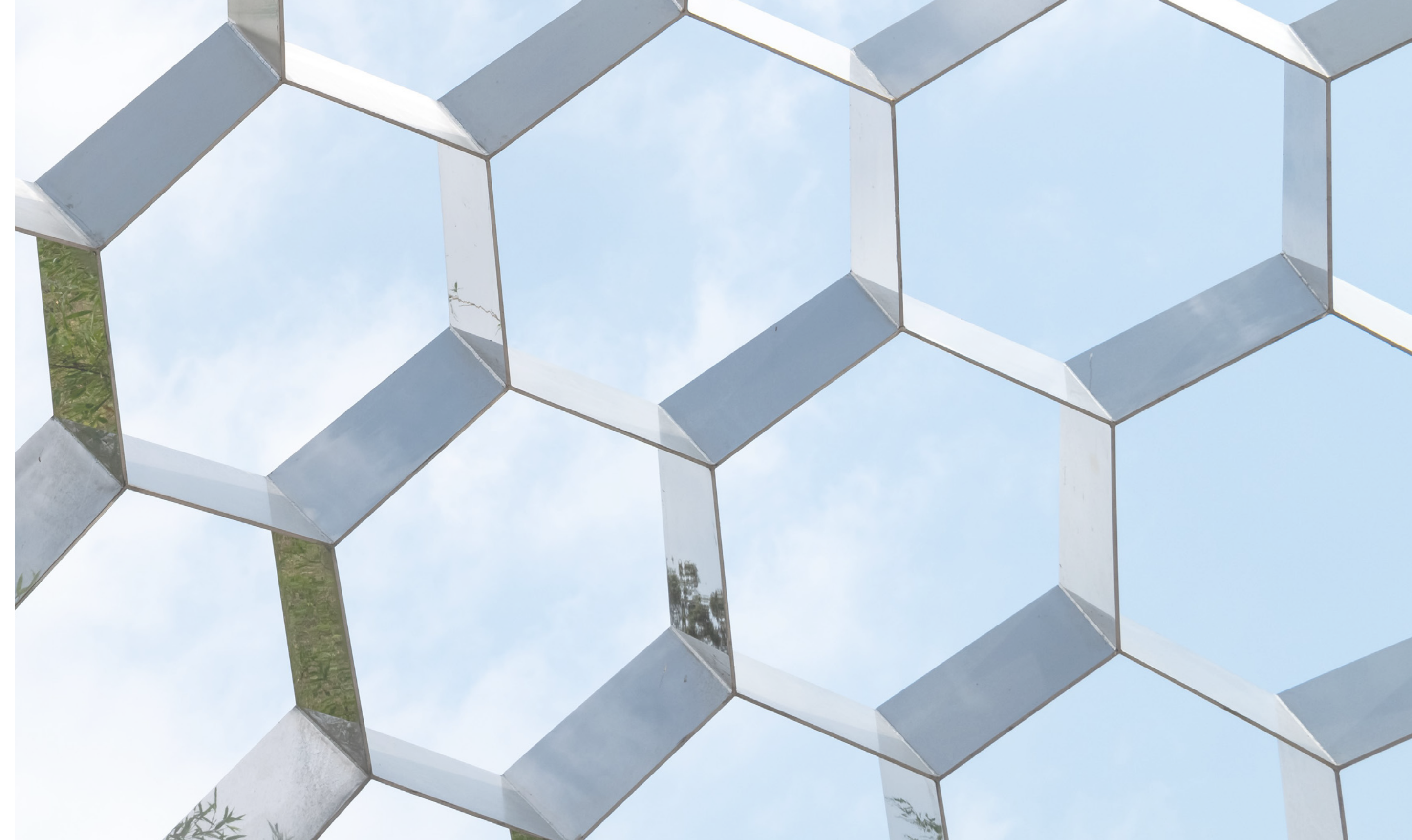
Commodities

Our outlook on agriculture remains unchanged. A robust supply picture is balanced with strong demand, therefore we believe there is limited upside potential for prices.

We have remained neutral on energy over the quarter. China's reopening was underwhelming and the market remains adequately supplied, despite production cuts from Saudi Arabia, therefore the medium-term outlook for oil markets remained balanced.

Our view on industrial metals is also unchanged. Over the quarter developed market demand has faded due to the cyclical slowdown, and China's reopening was underwhelming with moderating activity in the construction sector.

Turning to precious metals, we upgraded gold in April, as we felt that the picture of weakening economic growth, peaking interest rates and a softer dollar would be supportive. However, growth has remained resilient and core inflation is still a problem. As such we downgraded gold towards the end of the quarter.



30 June 2023

Source: Schroders. Forward looking views and forecast may not be realised.

Private assets views
Investing during the slowdown
Q3 2023

Nils Rode
Chief Investment Officer,
Private Assets

The latest update from our private assets business includes detailed thoughts on the risks and opportunities that are emerging in each private asset class, as a broader slowdown takes hold.

Private assets were in a slowdown in the first half of 2023 in terms of fund-raising, investment activity and valuations. This slowdown could deepen during the second half of the year in the case of recession, which remains a risk.

Fund-raising numbers are a useful early indicator of investment activity and, to some extent, valuation developments in private markets. In Q1 2023, infrastructure fund-raising experienced a significant correction of almost 90% from the previous year, according to Preqin. However, other asset classes - such as private debt - only declined by 10% over the same period. Private equity buyout fund-raising remained unchanged, indicating more stability.

We have highlighted in previous quarters that, while a general slowdown and the risk of a recession may be concerning, over time they can also create opportunities for new private asset investments. Historically, attractive vintage years have emerged during times of recessions.

In the current slowdown, we recommend that investors direct their new investments towards assets that align with long-term trends and exhibit low correlation with traditional investment strategies. Additionally, investors can seize cyclical investment opportunities by maintaining a steady investment pace. Investors should be particularly selective regarding investment opportunities that continue to face headwinds, or that have not yet fully repriced, given the current market environment.

Here are some guiding principals to stick to when investing through a slowdown.

Seek tailwind from long-term trends

We see promising investment opportunities in areas such as sustainability- and impact-aligned investments, renewable energy, generative artificial intelligence (AI) and investments in India. We expect these long-term trends to continue in the coming years, presenting investors with potential for attractive returns.

Focus on less correlated investments

We see attractive opportunities in small and mid-buyouts in certain industry sectors (notably healthcare), seed and early stage venture capital investments, direct lending, insurance-linked securities and microfinance. These investments offer the potential for attractive returns while also contributing to portfolio diversification.

Seize cyclical opportunities

We view private debt and credit alternatives across various strategies as an attractive source of opportunities due to the tightening of credit conditions. Additionally, we see emerging attractive opportunities in infrastructure and real estate due to ongoing repricing.
As timing can be challenging in private assets, we recommend that investors seize cyclical opportunities by maintaining a steady investment pace.

Be particularly selective for strategies with continuing headwinds

We see a heightened risk of valuation corrections for late-stage venture and growth capital investments, the larger end of buyout markets, and commercial real estate investments that have not yet sufficiently repriced. We recommend that investors are particularly selective when considering new investment opportunities in these areas.

Our assessment of opportunities by private asset class has remained largely unchanged over recent quarters.

We provide a more detailed examination of these opportunities on the following pages.

Schroders capital

Private assets views
Investing during the slowdown
Q3 2023

Private equity

Buyout fund-raising remained unchanged in Q1 2023 versus the same quarter in the prior year, according to Preqin. Venture capital fund-raising was down nearly 70% over the same period. The correction in venture capital fund-raising follows the exuberance that late-stage / pre-IPO venture investments experienced in 2020 and 2021.

We believe that being highly selective in private equity investments is a critical success factor. Specifically, we recommend focusing on investments that align with long-term trends. We also seek opportunities with the potential to capture a complexity premium; those requiring the deployment of unique skills to drive both organic and inorganic growth in portfolio companies.

In the coming quarters, we anticipate that small and mid-sized buyouts will outperform large buyouts, driven in part by a more favourable dry powder environment for smaller transactions. Similarly, we expect seed and early-stage disruptive investments to be more resilient than later-stage or growth investments, owing to the same dynamics.

By sector, we are particularly drawn to opportunities focusing on healthcare. Regionally, we continue to see the North America, Western Europe, China and especially India as attractive.

GP-led transactions are likely to rise further in prominence. GP-leds allow favoured portfolio companies to be retained and developed further by the same management team. With IPO markets closed, we anticipate a reduction in M&A exits, so GP-leds should increase.

Private Debt and Alternative Credit

In the first quarter of 2023, private debt fund-raising experienced only a slight decline – around 10% – compared to the same period in the previous year, according to Preqin.

This stability is a reflection of the attractive market conditions for private debt and credit alternatives.

The lending conditions for creditors remain favourable, offering attractive risk-adjusted yields due to spread widening, higher base rates, and more conservative deal structures with lower leverage, larger equity contributions, and tighter loan documentation.

Investments that offer variable interest rates and tangible asset backing, such as infrastructure and real estate debt, are especially attractive in our view. These asset classes provide explicit asset backing and robust downside protection, with many opportunities offering contractual or 'pass-through' links to inflation.

Floating-rate securities are also prevalent in the mortgage-backed, asset-backed, and collateralised loan obligation (CLO) sectors. These securities are backed by housing, real estate, and consumer debt as well as leveraged loans and direct lending and can provide diversification within a floating rate allocation.

The leveraged loan market has significantly repriced due to a changing economic landscape with higher rates and reduced credit availability, leading to more conservative structuring for new deals and refinancing activity.

Insurance linked securities offer valuable diversification in any fixed income portfolio due to their lack of correlation with traditional assets. Beyond this, yields are reaching historic levels due to natural catastrophes and insurance market dynamics.

Microfinance is another strategy that provides diversification and lowly correlated returns, with floating-rate portfolios delivering stable returns, making it an attractive option for investors seeking alternative sources of income.

Infrastructure

In Q1 2023, infrastructure fund-raising declined sharply - by nearly 90% - compared to the same quarter in the previous year, according to Preqin. Investment activity has also slowed down due to the repricing of markets at different speeds in a higher interest rate environment. Additionally, a material increase in capex costs has led to a slowdown in new projects. The ongoing repricing is creating attractive investment opportunities, and we expect this trend to continue throughout 2023.

We see renewables as a particularly attractive investment opportunity due to their strong link to inflation and secure income characteristics, which can help investors navigate the challenges of high inflation and tightening interest rates. The ongoing war in Ukraine has heightened concerns about energy security and spurred efforts to reduce reliance on fossil fuels. Developing the necessary infrastructure is essential for a successful transition to renewable energy, with wind and solar investments playing a vital role. Adjacent technologies such as hydrogen coupled with renewable energy sources will also play a role allowing decarbonisation of heavy industries.

We also see attractive opportunities in other infrastructure areas related to digitalisation and other essential infrastructure.

While many of the most attractive infrastructure investment opportunities can be found in Europe and in North America in our view, we also see opportunities to make sustainable infrastructure investments in emerging markets on a highly selective basis.

Real Estate

Real estate fund-raising saw a significant correction of nearly 60% in Q1 compared to the same quarter last year (Preqin). Similar to infrastructure, the higher interest rate environment has also slowed transaction activity significantly. Transaction pricing has declined by approximately 20% in Europe and the US since the third quarter of 2022. We anticipate further pricing adjustments for the remainder of 2023, especially in fringe markets and for secondary, non-sustainable, assets.

The repricing of markets is creating attractive investment opportunities, and we suggest a patient approach using a "sequential playbook" to prioritise opportunities across capital structures, sectors, and geographies. The most immediate opportunities can be found in markets that have experienced the fastest repricing, such as the UK and Nordic region, followed by regions where repricing tends to take longer, such as the US, and even more so in other Continental European markets.

The Asia Pacific region's market dynamics differ from the Western world due to varying developments during the Covid-19 pandemic. We see cyclical real estate opportunities in this region in markets that are reliant on China's post-pandemic recovery.

Logistics and urban industrial assets, convenience retail formats, mid-market multi-family housing, budget and luxury hotel formats, and self-storage are some of the sectors offering absolute and relative value. Occupational markets outside of the challenged US office sector remain well supported by tight supply conditions that we expect to persist given elevated construction and finance costs, thereby providing a conducive base for further inflation adjustment and rental growth once economies recover.

The transition to a higher interest rate regime has made financial engineering less feasible going forward, with performance centred on the delivery of efficient operational management across sectors, and on providing contractual or indirect inflation protection.

Sustainability and impact considerations should be prioritised to future proof portfolios against rapidly shifting occupier preferences and evolving regulatory requirements.

Economic risk scenarios

Banking crisis risk added

In thinking about risk scenarios, the US debt ceiling issue remains at the forefront of investors' minds. The baseline assumes that a last-minute deal is struck which includes some austerity in the outer years, and as a result, there is minimal impact on financial markets. However, because fears of an actual or near default remain very live, we have retained the **Bond Vigilantes Return** scenario.

The polarised political landscape in Washington raises a clear risk of government shutdown, ratings downgrades and even default as the US government approaches its debt ceiling. A buyers' strike in the Treasury market could cause huge volatility in global financial markets and see bond vigilantes go after other governments around the world that are running unsustainable fiscal policies. Governments may be forced to retrench, while an abrupt tightening of financial conditions would be bad news for those emerging markets that rely on capital flows.

We continue to place a higher probability on and have retained the **Supply-Side Inflation** scenario, where the labour market remains buoyant, causing wage inflation to remain high, pushing up costs for companies that in turn continue to raise their prices. This stagflationary scenario requires even more aggressive monetary tightening to reverse inflation pressures.

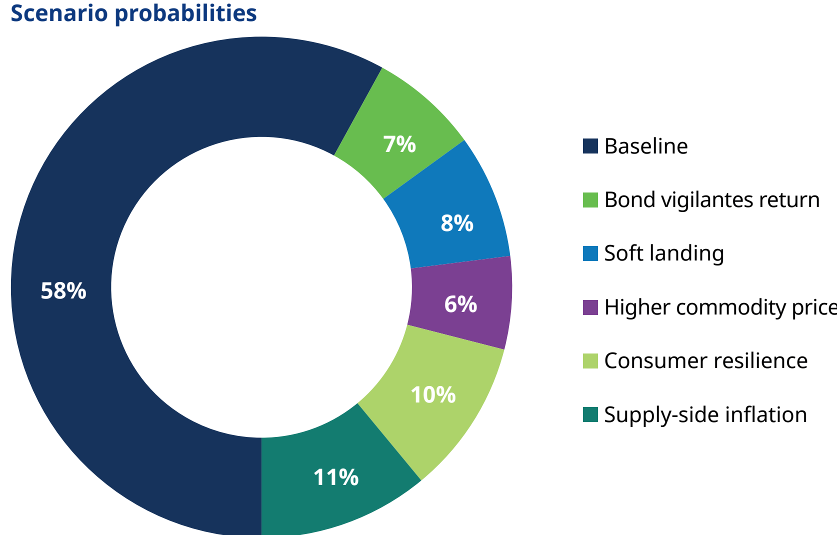
On a more positive note, we have also kept both the **Consumer Resilience** and the **Soft Landing** scenarios. The former sees households spend more of the savings that had been accumulated through the pandemic, leading to a reflationary scenario, while the latter has a more positive response from the labour market. Missing workers return to boost output, but also to cool the labour market as supply improves. This is a productivity boosting scenario.

Lastly, we have decided to drop the previous **Higher Commodity Prices** scenario as the recent announcement by OPEC to cut production only had a small impact on energy prices compared to the start of this year. While a risk of rising commodity prices remains, we preferred to replace the scenario with one that captures the rising risk of a problem with the banking system – the **Banking Crisis Deepens** scenario.

This scenario has been added in response to the events in the regional US banks. The scenario assumes more regional banks face runs and fail. As they do, the rest of the banking system tightens credit conditions further, leading to reduced lending and demand. This spreads to other countries given the linkages through dollar financing. The scenario is deflationary and would prompt the Fed to halt QT and cut interest rates. Outside of the baseline, the Supply Side Inflation scenario has the largest probability amongst the scenarios, closely followed by Consumer Resilience.

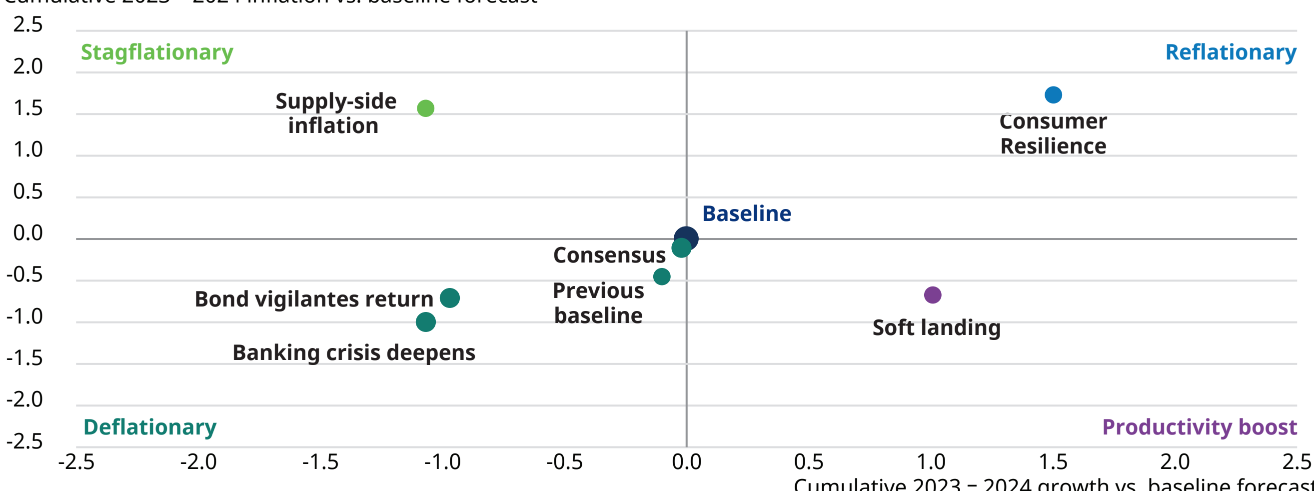
Overall, the evolution of the baseline forecast and risk scenarios means that the balance of risks for growth remains skewed to the downside, but it is at its highest level since May 2021. The risk to the inflation forecast has fallen and is now balanced, falling to its lowest level since November 2020.

Scenario probabilities



Source: Schroders Economics Group. 24 May 2023. Please note the forecast warning at the back of the document.

Scenario grid – growth and inflation deviations from baseline



Source: Schroders Economics Group. 24 May 2023. Please note the forecast warning at the back of the document.

Deviations from Baseline: Summary of risk scenarios

	Summary	Macro impact
Bond vigilantes return	Negotiations to lift the debt ceiling hit an impasse as both sides dig their heels in. As investors fret about the risk of a US default, contagion spreads to other vulnerable debt markets which see higher yields and a greater probability of default being priced in. After some time, an agreement is reached to raise the debt ceiling, but the damage to the US's reputation is done, and a risk premium remains going forward.	**Deflationary:** Higher term premiums across the global economy raises the cost of financing debt, and reduced disposable income. The volatility in markets and currencies also reduce corporate and consumer confidence. The Fed is forced to stop QT and cut rates in an effort to lower yields, which is replicated by its peers in many advanced economies. However, policy rates in most of EM remain elevated to defend their currencies, with some even forced into large emergency rate hikes to stem capital outflows.
Soft landing	The trade-off between growth and inflation improves as companies see costs fall back. Higher living costs encourage more workers to return to the labour force, boosting the participation rate. This helps ease wage pressures, and provides firms more resources to generate growth, with less inflation.	**Productivity boost:** Economies that have been hampered by supply constraints – notably the US, Europe and UK – see an increase in growth while inflation pressures subside a little. This relieves some of the pressure on the central banks in the fight against inflation, allowing them to cut interest rates sooner and to lower levels by the end of the forecast period.
Banking crisis deepens	Fears about the fragility of the US financial system spur successive bank runs, causing a number of regional lenders to fail. Whilst deposits are protected, lending standards for households and businesses are tightened further across a consolidated banking landscape. As credit dries up and confidence is hit, consumers rein in their spending, whereas firms are forced to retrench as well as cut costs by laying off workers.	**Deflationary:** Activity is hit by the deterioration in credit conditions, tipping the US economy into a recession which sees GDP suffer a peak-to-trough fall of around 2% and the unemployment rate climb to a peak of 6%. In response, the Fed cuts rates and reins in the pace of quantitative tightening. Weaker activity and confidence spreads to the rest of the world, prompting other central banks to cut rates more aggressively than under the baseline.
Consumer resilience	Thanks to the build-up of savings during the Covid-19 pandemic, households maintain regular spending patterns, despite rising cost pressures and interest rates. This in-turn bolsters the outlook for corporate profitability, encouraging greater CAPEX and the passing on of costs through higher prices.	**Reflationary:** Demand remains robust through 2023, leading to higher core inflation, and headline inflation falling back more slowly than in the baseline. Central banks respond by raising interest rates more aggressively. The Fed funds rate reaches a peak of 6.5%, while the ECB refinancing rate reaches 5.5%. Eventually, higher interest rates cause activity to slow, and the US experiences a technical recession in the second half of 2024. At that stage, central banks start to cut rates again, but over the two-year horizon, growth and inflation are both higher than the baseline.
Supply side inflation	Bottlenecks in the industrial sector re-emerge and prevent goods inflation from falling back, while commodity markets also struggle with supply shortages. Meanwhile, wages accelerate by more than in the baseline in response to tight labour markets. The labour participation rate in the US does not improve, whilst mismatch between worker skills and jobs in the post covid economy means the non-accelerating inflation rate of unemployment (NAIRU) rises and available slack is less than in the baseline.	**Stagflationary:** Supply shortages cause commodity prices to climb further, pushing food and energy inflation higher. Supply constraints and higher commodity prices see goods inflation increase again and tight labour markets ensure that price pressures endure as wages increase. This results in persistent inflation, which does not get back down to target over the forecast horizon. This forces the Fed to raise rates all the way to 6.5%. Other central banks also step up the pace of tightening. Higher inflation, along with tighter monetary policy, chokes off demand leading to shallower recoveries from deeper recessions in 2023.

Source: Schroders Economics Group. 30 June 2023. Scenarios are hypothetical. There is no guarantee these events and outcomes will occur.

Market returns

	Total returns	Currency	June	Q2	YTD
Equity	US S&P 500	USD	6.6	8.7	16.9
	US Nasdaq 100	USD	6.5	15.4	39.4
	UK FTSE 100	GBP	1.4	-0.3	3.2
	EURO STOXX 50	EUR	4.4	4.2	19.2
	German DAX	EUR	3.1	3.3	16.0
	Spain IBEX	EUR	6.5	5.8	19.3
	Italy FTSE MIB	EUR	8.6	7.2	23.3
	Japan TOPIX	JPY	7.5	14.4	22.7
	Australia S&P/ ASX 200	AUD	1.8	1.0	4.5
	HK HANG SENG	HKD	4.5	-6.0	-2.7
EM equity	MSCI EM	LOCAL	3.5	1.8	5.8
	MSCI China	CNY	4.5	-8.9	-4.3
	MSCI Russia	RUB	-	-	-
	MSCI India	INR	3.9	12.2	4.4
	MSCI Brazil	BRL	9.3	14.9	7.0
Governments (10-year)	US Treasuries	USD	-1.1	-1.9	2.3
	UK Gilts	GBP	-1.3	-6.1	-3.1
	German Bunds	EUR	-0.8	-0.2	3.1
	Japan JGBs	JPY	0.4	-0.1	3.4
	Australia bonds	AUD	-3.1	-4.9	2.1
	Canada bonds	CAD	-0.4	-2.2	1.8
Commodity	GSCI Commodity	USD	4.4	-2.7	-7.5
	GSCI Precious metals	USD	-2.3	-2.8	4.4
	GSCI Industrial metals	USD	0.5	-9.1	-8.5
	GSCI Agriculture	USD	2.1	-3.0	-3.4
	GSCI Energy	USD	6.0	-3.2	-11.6
	Oil (Brent)	USD	1.3	-6.6	-12.3
	Gold	USD	-2.8	-3.1	5.5
Credit	Bank of America/ Merrill Lynch US high yield master	USD	1.6	1.6	5.4
	Bank of America/ Merrill Lynch US corporate master	USD	0.3	-0.2	3.2
EMD	JP Morgan Global EMBI	USD	1.9	1.5	3.8
	JP Morgan EMBI+	USD	2.3	1.4	3.3
	JP Morgan ELMI+	LOCAL	1.2	2.5	4.2
	Spot returns	**Currency**	**June**	**Q2**	**YTD**
Currencies	EUR/USD		2.3	0.4	2.2
	EUR/JPY		5.9	9.1	12.0
	USD/JPY		3.4	8.6	9.5
	GBP/USD		2.6	2.8	5.7
	USD/CNY		2.1	5.9	5.1
	USD/AUD		-2.8	0.6	1.9
	USD/CAD		-2.7	-2.2	-2.3

Source: Refinitiv Datastream, Schroders Economics Group. 30 June 2023.
Note: Blue to red shading represents highest to lowest performance in each time period. Past performance provides no guarantee of future results.

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