# CIO Lens Q3 2024

Marketing material for professional clients only

Schroders

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# In a complex world, it can pay to keep things simple

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

Investors have found plenty to worry about in recent newspaper headlines. From surprise elections to sticky inflation, plus "known unknowns" like the US Presidential election, it all adds up to a complex environment to negotiate. Being able to cut through the noise, and focus on what's most material for markets, is essential.

**Over the second quarter, economic data continued to confirm our expectations of a soft landing, with activity remaining positive and inflation moving in the right direction.**

A number of major central banks have started to cut rates – Swiss National Bank, Bank of Canada and European Central Bank. We expect the Bank of England to join them this summer while the US Federal Reserve will likely wait until the autumn.

This supports our positive view on equities, particularly as corporate earnings are also coming through. The narrowness of equity market performance, with technology stocks powering this year's gains, is a source of concern, as are relatively elevated valuations (particularly in the US).

However, valuations in the technology sector continue to be supported by strong revenue momentum and positive operating leverage (i.e. revenue growth outstripping cost growth).

With interest rates starting to fall, emerging market equities are looking more compelling. Many emerging economies have brought inflation under control, are running prudent fiscal policy and benefit from the manufacturing recovery that is currently under way.

As we came into the year, there was a lot of concern about elections. We have stated before that politics matter but they tend to play over months and years rather than days. In many cases, the results have indicated frustration with the incumbents – think of South Africa, India, France and, of course the UK. This is consistent with an environment where the political consensus is being challenged.

And as a consequence, as we have highlighted before, we think this will lead to fiscal policy being looser and monetary policy being tighter. This is a shift from the regime of the past decade which was characterised by tight fiscal policy and loose monetary policy.

> My teenage son typically accuses me of over-thinking but this year we have kept it simple and, so far, it has paid off; a benign environment for growth is supportive of equities. And inverted yield curves, where shorter-term rates are higher than longer-term, mean that in bonds it still pays to wait for better levels or more tangible signs of recession risk.

Of course, the most important election is still ahead of us with the US heading to the polls in November. Protectionism is likely to remain a feature of US policy whoever wins. Immigration policy could be important in the context of wage growth, particularly because labour markets are still buoyant.

The possibility of a Republican clean sweep (winning both houses of Congress as well as the presidency) does raise concerns about more expansionary fiscal policy which could point to higher yields at the longer end of the yield curve as investors worry about the sustainability of the fiscal deficit.

This is one of the reasons why we do not view government bonds as offering the same diversification benefits that they used to.

However, interest rate cuts should underpin yield curves and there is still a significant role for fixed income as a source of yield in portfolios - what I call the old-fashioned reason for owning bonds.

**Watch Johanna's video update using this QR code or click here**

"As ever, it's important to focus on the fundamentals, not the newspaper headlines.

# Sustainability views this quarter

# Distinguishing noise from trends in sustainable investment

**Andy Howard**
Global Head of Sustainable Investment

> At Schroders, we take a long term view, focusing on trends that will shape the years ahead rather than shorter term noise. Future demands will look different to those we have seen in the past – less focus on commitments and aspirations and more on practical implementation and delivery – but the importance of sustainability to effective investment decisions and our clients' interests is unchanging.

**Headlines surrounding sustainability and sustainable investment have clearly shifted. During 2021–22, coverage was almost universally positive, sustainable investment fund performance had been strong across the market and inflows into sustainable products outpaced a wobbling market for fund investments.**

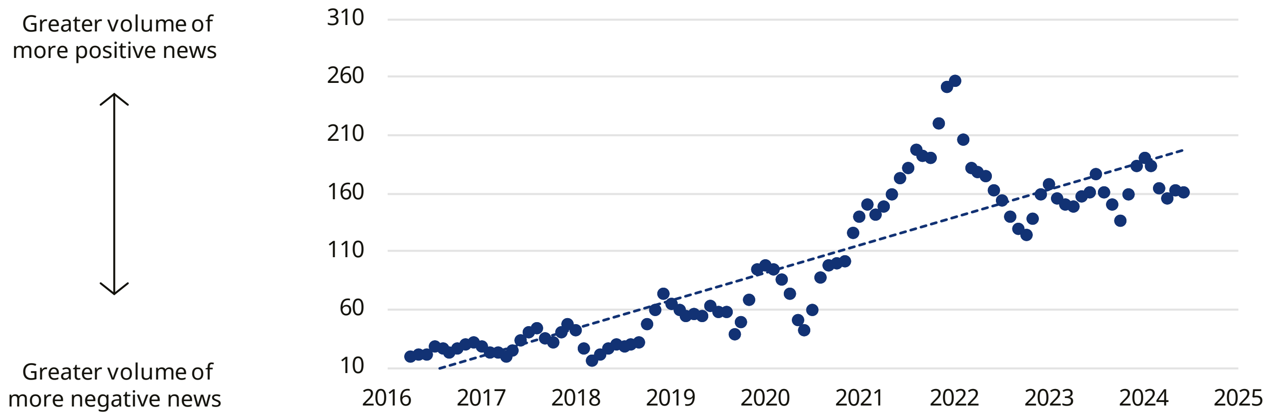
Since then, coverage has turned. Typical sustainable investment fund performances have wavered, inflows into those funds have softened, political rhetoric has become more critical and media headlines have become more negative.

In practice, neither the highs nor the lows are representative of the trends, or the fundamental importance of sustainability to the investment industry. The underlying trend is more important than the fluctuations around it.

The chart below plots sentiment toward sustainable investment over recent years. We have used a news aggregation service to extract all stories featuring "sustainable investment" since 2016 and a sentiment classification service to determine the positive or negative tone of those stories. By multiplying the volume of stories by the average sentiment in each month, we can gauge fluctuations in media views of the field.

Two things stand out. Firstly, that during 2021–22, sentiment was far stronger than is the case today, reflected in our anecdotal experiences and the "hotness" of hiring into sustainable investment roles at that time. Second, and more importantly, the trend is firmly upward over the period we have been able to examine.

**Strength of sentiment toward sustainable investment, indexed**




Source: Schroders calculations. We extract news stories from a wide range of sources based on the "sustainable investment" search term and use a sentiment classifier to determine the strength of sentiment toward that topic in each story. We then multiple the number of stories in each month by the average sentiment in that month to calculate the above index. Chart is rebased so that the average "strength of sentiment" is 100 over the period shown.

Sustainable investment will again become a "hot topic". The areas of focus, the investments that benefit and the acronyms used may look different but we believe the focus will return. The forces that shape our conviction in the importance of sustainability to the investment industry and our clients are only intensifying. Climate change, nature loss, social unrest are growing challenges over which the investment industry's awareness – and ability to analyse – are rising with increased corporate recognition[1] and disclosure[2].

[1] For example, the WEF Global Risks Report plots a growing corporate focus on sustainability related risks.
[2] Global regulators have introduced growing disclosure requirements, for example see KPMG's analysis.

# Most read content this quarter

# Most read content this quarter

**Irene Lauro**
Environmental Economist

## Are we underestimating the impact of climate change?

Concerns around the growing impact of physical risks associated with global warming call for a more in-depth analysis of their potential economic consequences.

**Read the full article here.**

**James Lowe**
Sales Director, Private Assets and Investment Trusts

## Private assets for wealth management clients: why, and why now?

Allocations to private assets are typically made in pursuit of enhanced performance and diversification, arguments that historic data continues to support. But other factors, such as the emergence of new vehicles for private asset investments, and the declining number of publicly quoted companies, are also driving the trend.

**Read the full article here.**

**Mannat Chopra**
Equity Analyst,
Global Resource Equities

**Alex Monk**
Portfolio Manager,
Global Resource Equities

## Power-hungry AI applications are demanding a significant expansion in global energy capacity

The increased use of AI will demand a major build-out of data centres and greatly increase electricity consumption. Renewables can provide much of the required power, but on-demand sources like natural gas will still be needed, given the intermittence of wind and solar energy.

**Read the full article here.**

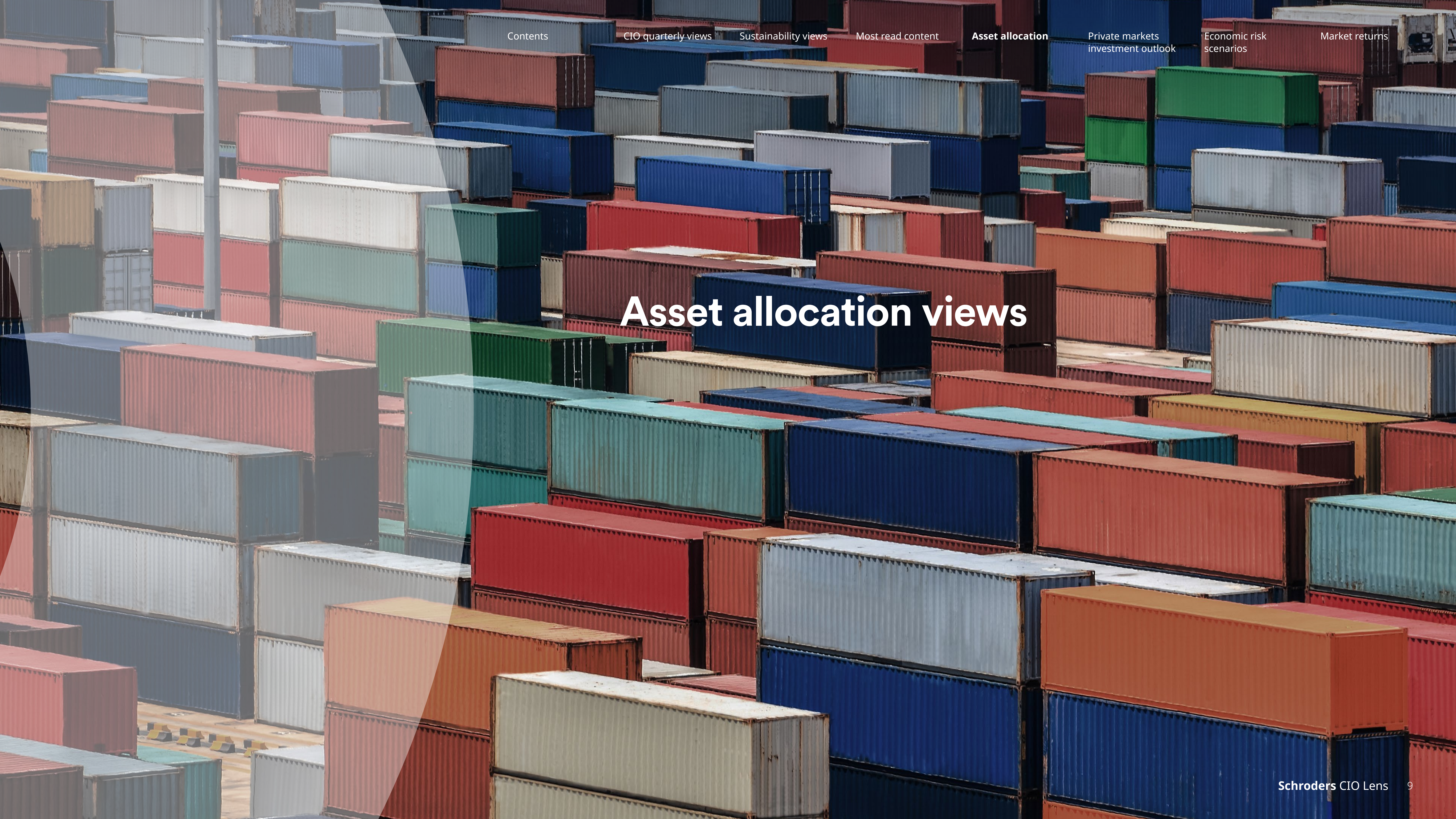
**Viswanathan Parameswar**
Head of Private Equity Investments Asia

**Verity Howells**
Investment Research Manager Private Equity

## The attractions of the small-mid private equity segment

New empirical research from Schroders Capital reveals that small and mid-sized private equity funds have outperformed large funds with greater resilience through economic cycles.

**Read the full article here.**



# Asset allocation views

# Overall asset allocation views

## 30 June 2024

Short/negative Neutral Long/positive Previous score

### Equities

**Overall view:** We began the second quarter with a positive view on equities as economic growth remained solid both inside and outside of the US, and the cyclical backdrop was supportive. Our view remains unchanged as economic data continues to confirm our expectations of a soft landing, with activity remaining positive and inflation moving slowly in the right direction. Given this backdrop, we believe there is still potential for further growth in equities.

### Credit

**Overall view:** Valuations appeared expensive throughout the second quarter. However, yields on corporate bonds rose modestly as credit spreads widened. This led us to retain a neutral score because liquidity is abundant, growth robust and carry supportive. In terms of regional preference, we prefer European credit as valuations are less extreme compared to the US.

### Government

**Overall view:** We downgraded our score from neutral to negative in April as valuations were expensive, carry was negative and there was a potential for rate cuts to be pushed back as the downward trend in inflation had stalled. However, in May we upgraded our view to neutral. While sticky inflation remained a concern, we felt valuations were attractive for the US two-year, US Tips and UK gilts. We maintained this overall neutral score through June because even though the inflation numbers surprised on the downside, our models indicated that valuations were no more than fair.

### Commodities

**Overall view:** Our view on commodities has been mixed this quarter. Robust demand for gold kept us positive on the precious metal throughout the period, and flickers of life in the manufacturing cycle combined with tight supply dynamics turned us temporarily positive on industrial metals. However, balanced energy markets and mixed agricultural conditions mean we are now neutral overall.

# Regional equity views

## Equities

Short/negative Neutral Long/positive Previous score

### US

We began the quarter positive on US equities as economic growth looked healthy, the labour market was growing, and US consumer confidence was strong. As the quarter progressed, we maintained this view as the economic environment remained favourable and the outlook for earnings was positive. US equities continue to lead global markets.

### Europe

A positive outlook on the European economy and the understanding that this would act as a significant driver for European equities kept us positive during April and May. In June, equity market performance began to narrow, and weaker data started to affect prices. Consequently, we moved back to neutral.

### China

While we expect to see a stabilisation in Chinese markets after the recent recovery in exports, we prefer other emerging markets (EM) such as Latin America, Taiwan, and South Korea.

### Emerging Markets

We have upgraded our view on emerging markets to positive. Many emerging economies have brought inflation under control, are running more prudent fiscal policies, and stand to benefit from the manufacturing recovery that is currently under way.

### UK

May saw us upgrade UK equities from neutral to positive after earnings expectations trended upwards in an environment where valuations were already cheap relative to history. Towards the end of the period, we moved back to neutral. Although valuations remain cheap and fundamentals are improving in the UK, other regions are more attractive.

### Japan

We started Q2 with a positive outlook on Japan due to robust fundamentals and a favourable macro-economic environment. In June, the positive impact of the weaker yen on Japanese equities began to fade due to rising import costs. Signs of a deterioration in consumer and business sentiment have also emerged, causing us to turn neutral.

### Asia ex. Japan

We downgraded the region to neutral at the beginning of the second quarter as any delay in cuts to US rates would likely have a negative impact. Later in the period when global manufacturing PMIs improved, we moved to positive. This improvement in activity should continue to drive the export recovery.

# Fixed income views

## Bonds and Credit

Short/negative | Neutral | Long/positive | Previous score

### Government

We downgraded our view on US government bonds from neutral to negative, as inflationary risks re-emerged, and the Federal Reserve (Fed) indicated that rate cuts were likely to be pushed back to later in the year. Even though inflation in May surprised on the downside, our models indicated that valuations were fair. Hence, with the labour market also strong, we remain on the sidelines.

In the UK, we held a positive view on gilts as we felt they were unduly caught up in the sell-off in US treasuries. We believed that UK inflation should soften and help support the case for rate cuts. However, service inflation remained sticky, offsetting the effects of a softening labour market, and so we downgraded our score to neutral in June.

In Europe, we maintained a neutral score over the quarter as the European Central Bank (ECB) indicated that it would cut rates in June, which was reflected in market pricing. Despite inflation edging up in May, the first rate cut was announced in June, but it does mean that the ECB may decide to slow the pace at which it makes further cuts.

### Inflation linked

We remained positive over the quarter. While headline measures suggest inflation is easing, the sector has continued to offer a useful hedge against sticky inflation.

### EMD Local

We maintained a neutral view on EM local bonds over the quarter. While we felt that a US soft landing would be supportive, the stickiness of US inflation and its impact on the Fed's policy kept us on the sidelines. In June, although spreads and valuations were attractive, and carry was compelling, we preferred to express our views through currency positions and maintained our neutral score.

### EMD Denominated in USD

As fundamentals are robust and yields attractive, EM corporates should be poised to gain from technical tailwinds. However, expensive valuations mean we remained neutral over the quarter.

### Investment Grade

(US) (EU)

We maintained a neutral score over the quarter. Cash offers higher yields than US investment grade (IG) and valuations for US IG are notably expensive across the rating spectrum. However, the higher carry offered in the current benign economic environment meant that, on balance, we remained neutral. While valuations in Europe are also elevated, the less inverted shape of the European yield curve means the issue is less prevalent. We remained neutral over the period.

### High Yield

(US) (EU)

We remained neutral over the quarter. Despite valuations being stretched, we think it is too early to turn negative given ample liquidity and attractive levels of carry. In Europe, we downgraded the sector to neutral in June. European HY spreads have tightened and are still better value than the US, but we prefer taking risk exposure elsewhere in our portfolios.

# Commodities views

Short/negative Neutral Long/positive Previous score

## Commodities

Early in the second quarter, we turned positive on commodities. We retained our positive view on gold from last quarter but moved positive overall as we also decided to upgrade our outlook on industrial metals. The catalyst for our change in view was increased demand generated by the recovery in manufacturing activity in the US and Europe. In the precious metals sector, gold continued to be supported by strong demand in the physical market.

However, as the quarter drew to a close, we returned to our neutral view. While we continue to like gold as real rates decline and as a hedge against inflation and geopolitical risk, we took profits on our industrial metals position following a strong rally in prices.

Elsewhere, our neutral views on energy and agriculture were unchanged throughout the quarter. Energy inventories trended in line with historical norms, and despite recent production cuts from OPEC+, supply is expected to rise later in the year. In agriculture, localised weather conditions have led to disparate markets. While some prices have drifted upwards more recently, for the moment, we see no clear trends emerging.

# Private markets investment outlook

# Private markets investment outlook Q3 2024

## An attractive investment environment

**Nils Rode**
Chief Investment Officer, Private Assets

*As we enter Q3 2024, private markets have largely reverted to pre-pandemic levels in terms of fundraising, investment activity, and valuations, creating a favourable environment for new investments. Some areas have even corrected beyond 2019 levels.*

**A normalisation in fundraising and valuation adjustments create promising investment opportunities. The Artificial Intelligence (AI) revolution and other long-term trends make certain private market strategies especially appealing. Furthermore, a potential easing of inflation and anticipated interest rate cuts could provide short- to mid-term tailwinds. However, due to ongoing political tensions within and between countries, and escalation risks for ongoing conflicts, diversification within private market allocations is crucial.**

In 2023, fundraising was concentrated on large funds, making small and mid-sized private market strategies particularly attractive. This is evident in private equity, where buyout fundraising for large funds reached record levels, while the rest of the market remained healthy.

Historically, fundraising has been a valuable contrarian indicator. In many private market strategies, fundraising levels and dry powder directly influence entry valuations and impact vintage year return expectations.

We find private market investments aligned with the AI Revolution and the 3D Reset (decarbonisation, deglobalisation, demographics) particularly attractive. AI is driving investment activity across private market strategies, notably in venture and growth capital for innovation, as well as in data centres and renewable energy, addressing increasing energy needs in a sustainable way.

Income has become particularly appealing across most markets, with private debt and credit standing out. We favour investments that benefit from market inefficiencies, focusing on fundamentals over distressed assets.

Although interest rates are likely to remain higher for longer, we anticipate that easing inflation and potential interest rate cuts will provide a tailwind for private market investments in the short to mid-term. This is especially true for real estate, where significant valuation corrections have occurred, and our proprietary valuation frameworks suggest that 2024 and 2025 will be attractive years for new investments.

While our private market investment outlook is generally positive and has not changed materially from prior quarters, we believe that given ongoing geopolitical risks and domestic political tensions as well as escalation risks from ongoing conflicts, it's essential to maintain high selectivity and robust diversification within private market allocations. In the following, we highlight the most attractive opportunities within each private asset class.

# Private Markets Investment Outlook Q3 2024

## Private equity

Private equity has broadly normalised with fundraising and deal volumes back to pre-Covid levels. Larger exits, however, remain especially slow relative to 2019, while smaller exits have been more stable.

We advocate for a highly selective approach to private equity investments, focusing on opportunities that resonate with global trends and can capture a complexity premium.

We prefer small to mid-sized buyouts over larger ones due to a more favourable dry powder environment and a valuation discount of around 6x EV/EBITDA. Furthermore, there are attractive exit opportunities for small buyouts as around 60% of dry powder currently sits with large buyout funds.

Co-investments are attractive as banks have withdrawn from the lending market and credit funds have been more cautious. The equity requirement in deals has increased, resulting in a capital gap that active co-investors can step into.

GP-led transactions are compelling due to the lack of traditional private equity exit routes and demand for distributions. We find both single-asset and multi-asset GP-led investments attractive. Single-assets can provide runway for star assets while multi-assets provide an efficient end of fund-life solution.

We believe the innovation in AI, disruptive energy technology, and biotechnology will be driven by seed and early-stage ventures. Early-stage investments benefit from a disciplined fundraising environment, leading to more conservative entry valuations. Conversely, late-stage or growth investments face higher refinancing and valuation risks due to decreased venture capital fundraising and a still-closed IPO window. In terms of sectors, generative AI investments have surged across private assets, with venture funding for generative AI projected to reach nearly 15% of total venture investments in 2024, up from just 2% in 2022.

From a geographic perspective, we find North America, Western Europe, China and India attractive. China remains the second-largest private equity market globally, with the RMB market playing a pivotal role in driving growth. India's private equity market is promising due to its robust long-term economic growth prospects, a rapidly growing private equity industry, and a broad spectrum of high-growth private companies.

## Private Debt and Credit Alternatives

Income remains highly attractive across most markets. Despite peaking interest rates in developed markets, we anticipate they'll remain higher than levels seen in the past two decades, suggesting an opportunity to reallocate to income.

Banks in the US and Europe continue to reduce their lending volumes as they attend to increasing regulatory pressure as well as distress in their commercial real estate loan portfolios. The result is a significant risk premium available beyond rates for alternative, non-bank lenders. As risk premiums in the liquid debt market have collapsed, private debt and credit appear very attractive.

We favour investments offering high income and benefiting from capital provision inefficiencies. These include:

- Defensive income from infrastructure debt with stable, low-volatility cash flows.
- Opportunistic income from sectors with distress that causes emotional bias, like real estate debt.
- Uncorrelated income from sectors such as insurance-linked securities.
- Diversifying income capitalising on changes in bank regulation, like asset-based finance, or sectors with limited capital access, like microfinance.

Our focus is on fundamentals rather than distressed assets. We target areas with emotional bias due to distress but avoid those with unresolved fundamental issues. For example, while commercial real estate debt faces fundamental distress in the office sector, this has unfairly impacted investor sentiment towards healthy sectors like apartments. Local apartment markets with recent inventory spikes will see rent growth recovery due to reduced future supply from higher financing costs. Unlike offices with excess space, the US still faces a housing shortage.

Today, most liquid markets have historically tight risk premiums. Value remains in agency mortgage-backed securities (MBS), non-syndicated MBS/asset-backed securities (ABS), and specialised sectors such as insurance-linked securities.

Insurance-linked securities provide valuable portfolio diversification due to their lack of correlation with macroeconomic conditions and offer attractive returns due to higher yields driven by reinsurance limitations.

The growing interest in income allocations and maturity of private debt allocations have created a need for diversification. Asset-based finance is a key area of inquiry due to its diversity and the benefits of Basel III impacts in the US. Opportunities within this sector span equipment, consumer, and housing, and can be accessed directly, via financing, or through risk transfer mechanisms such as bank capital relief.

As investors face extensions in their traditional private debt book's maturity, strategies generating cash flow, particularly with near-term income or capital return – as is the norm in asset-based finance – are in greater demand.

# Private Markets Investment Outlook Q3 2024

## Infrastructure

The energy transition segment in infrastructure is particularly compelling due to its strong inflation correlation and secure income traits. It also diversifies portfolios through exposure to distinct risk premiums like energy prices.

The push for decarbonisation, coupled with energy security concerns, which are amplified by the conflict in Ukraine, continues to benefit renewable energy. The cost-of-living crisis has also spotlighted the issue of energy affordability. In many regions globally, renewables have become the most cost-effective option for new electricity production.

Currently, renewable energy in Europe has a €600 billion base, representing 45% of infrastructure transactions. By the early 2030s, this is forecast to more than double to €1.3 trillion, potentially making renewables and energy transition infrastructure the majority of investable assets in the sector.

Renewable-related technologies, such as hydrogen, heat pumps, batteries, and electric vehicle charging, will play a crucial role in facilitating the decarbonisation of sectors like transport, heating, and heavy industries.

The market has shifted to a buyer's market, recalibrating expected equity returns due to rising interest rates and reduced dry powder, creating a gap between renewable projects and limited capital investment. This makes the current environment attractive for core/core+ strategies, with equity returns rising over 200bps in the last 18 months.

We favour core/core+ strategies that benefit from strong asset performance and enhanced cash generation via active management. Selectively, there are higher return opportunities in infrastructure projects like hydrogen, although we remain cautious on early-stage developments due to capex volatility.

We see a return dislocation between listed and private markets, with listed assets trading at a discount, leading to significant take-private transactions.

AI advances are boosting renewable sector demand, notably increasing electricity consumption for data centres (e.g. Ireland's electricity consumption is expected to increase by 32% in the next 10 years, driven by an expansion of data centre capacity). This demand shift supports long-term green electricity pricing, underpinned by corporates' net-zero ambitions.

In terms of geography, Europe and North America benefit from these dynamics, where energy security concerns mitigate short-term political impacts.

## Real Estate

The real estate market has been experiencing value corrections across the globe, albeit with varying degrees of progress made across regions, sectors, and investment structures. This presents a live sequential opportunity to access the asset class on an attractive basis. Indeed, our proprietary valuation framework suggests that 2024 and 2025 will be opportune years for real estate investments, with some market segments likely to have already fully rebased.

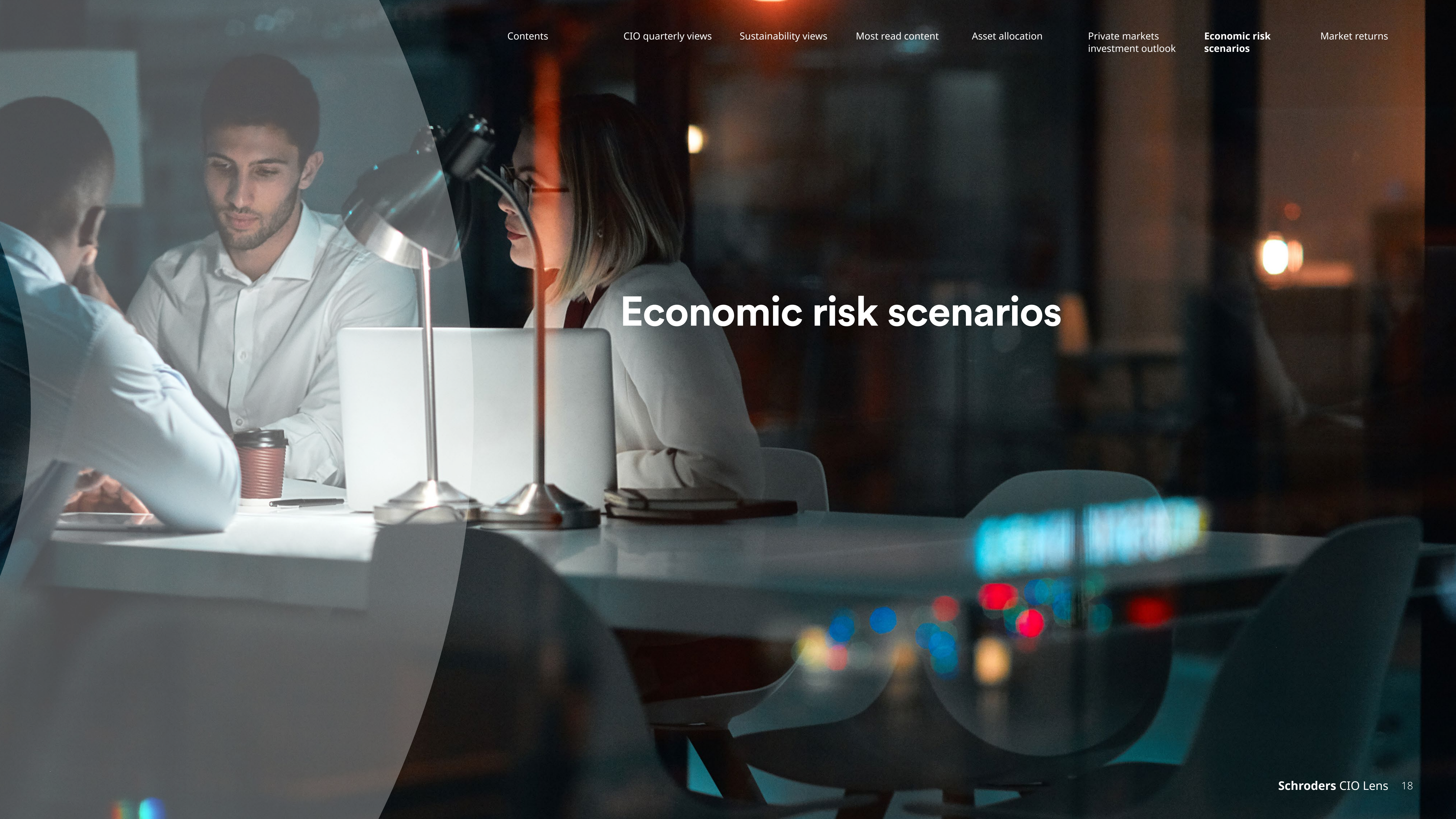
Occupational markets remain robust, with expected growth in most real estate sectors, particularly those driven by favourable structural trends. Tight supply conditions due to increased construction and debt finance costs, continue to support rental income levels. The lack of high-quality ESG-compliant spaces will also help stimulate rental growth post-economic recovery.

Opportunities are emerging from ongoing constraints in the debt capital markets. Refinancing waves, including platforms seeking capital solutions to shore up balance sheets, are anticipated to accelerate these opportunities amid further price discovery in 2024.

Despite more volatile geopolitical conditions, we believe that interesting investment opportunities are starting to arise in selected parts of the markets where strong fundamentals prevail. Immediate opportunities are present in markets where rapid repricing has occurred, such as the UK and Nordic region.

In Asia-Pacific, opportunities that align with China's delayed recovery or support nearshoring/friend shoring of supply chains are favoured. Industrial and logistics assets have rebased to attractive price points in most submarkets. We prefer operational properties with strong demand-side tailwinds and direct or indirect inflation-linked income potential.

The current environment reinforces our focus on operational excellence to ensure long-term, sustainable income and investment outperformance. We believe all real estate has become operational, aligning the financial outcome of investments with the success of tenants' businesses within these assets.



# Economic risk scenarios

# Economic risk scenarios: still worried about inflation

**The uncertain global backdrop and less synchronised economic growth mean that the risks around our baseline forecast remain high.**

We continue to believe that biggest risk to our baseline forecast is a **consumer boom**. We assign an 11% probability to even stronger consumer spending, predominately in the US. As the grid below shows, while strong demand boosts growth, it also leads to higher inflation to move our forecast in a reflationary direction that ultimately forces central banks to raise interest rates further.

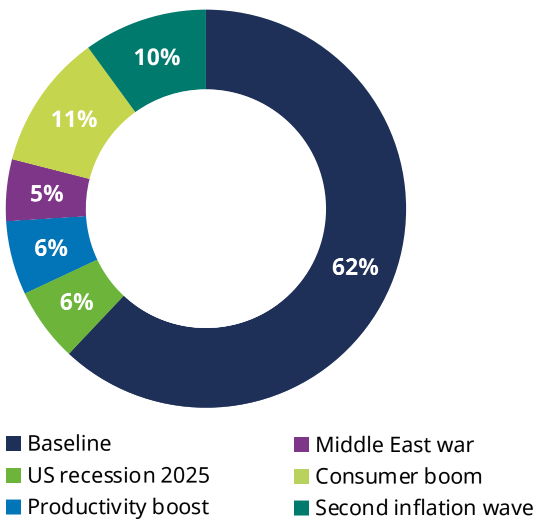
At the same time, though, we see an almost equal chance (10%) that resilient global growth, coupled with interest rate cuts, sow the seeds for a **second wave of inflation** that chokes off activity and moves the world in a stagflationary direction. This scenario sees central banks forced to reverse initial rate cuts in 2025.

Alternatively, there is a risk of a **US recession in 2025** if the long and variable lags in monetary policy finally come to the fore. This relatively high impact but low probability (6%) scenario would tilt the global economy in a deflationary direction, making space for central banks to deliver much larger interest rate cuts.

There is also a risk that supply side scenarios could impact the global economy. While we assign a relatively low 5% probability, the risk of a broader **Middle East war** cannot be dismissed. Concerns over the supply of energy could push oil prices towards $150 per barrel, taking the world in a stagflationary direction and leaving less room for interest rate cuts.

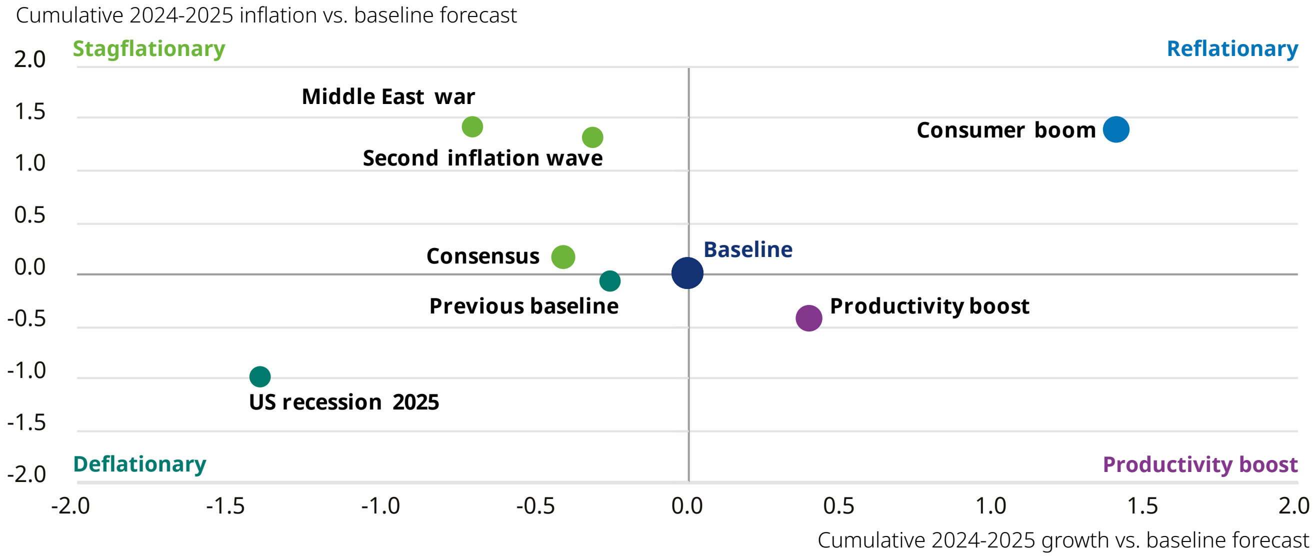
By contrast, we see an almost equal 6% chance of a **productivity boost** as the rapid adoption of technology boosts growth, while also shaving a bit off inflation to make space for additional monetary easing through the forecast horizon.

### Scenario probabilities




Source: Schroders 2024.

### Scenarios grid – growth and inflation deviations from baseline




Source: Schroders 2024.

## Summary of baseline and risk scenarios

| | Summary | Macro impact |
|---|---|---|
| **Baseline** | Our 2024 forecast for global GDP growth has been raised from 2.6% to 2.8%. This momentum is expected to be maintained in 2025, with our new 2.8% forecast marginally higher than the 2.7% we previously pencilled in. Among the advanced economies, the US economy is still expected to expand 2.7% this year before a modest easing in growth to 2.1%. Meanwhile, the eurozone growth forecast for this year has been raised to 0.9%, whilst next year's expansion is still expected to be 1.8%. But the biggest upgrade has been to the UK, which is now expected to grow 0.7% this year rather than contract 0.2% as previously expected, before growing 1.3% next year. Overall, developing economies are expected to expand 4.3% in 2024 and by 4.0% in 2025. This upgrade has been driven by China, which is now expected to grow 5.2% this year, but we maintain our expectation that it will slow to 4.5% next year. | Global CPI inflation is now expected to be 3.1% in 2024, firmer than the 2.9% we previously expected. Both advanced and emerging market economies are now expected to witness higher inflation this year. But we have marginally lowered our inflation forecast for 2025 from 2.5% to 2.4%. Falling inflation should allow central banks to gradually ease policy over our forecast horizon. We now expect the ECB will start cutting rates in June by 25 bps, followed by a further three cuts by year-end and two more in 2025. Meanwhile, we expect the BoE to cut rates by 25 bps in August and another two times before the end of the year, followed by just one further reduction in 2025. The Federal Reserve, on the other hand, is unlikely to have sufficient confidence to ease policy until September, if at all before the end of this year. It is a close call, but the baseline forecast has two 25 bps reductions this year and one further cut in March 2025. |
| **US recession 2025** | In the US, the long and variable lags of monetary policy finally come to the fore as the cumulative effect of past aggressive interest rate hikes and quantitative tightening (QT) tip the US economy into recession in early 2025. GDP suffers a peak-to-trough decline of 1.5% and the unemployment rate climbs to 6%. This soon spreads to other advanced and developing economies. Central banks ease policy in response, with the Fed being the most aggressive in cutting rates to 2%. | **Deflationary:** Declines in domestic demand cause negative output gaps to open up, leading to some deterioration in labour markets and easing inflationary pressures. At the same time, commodity prices tumble as the outlook for demand deteriorates, with Brent crude falling to a trough of just $40/bbl in Q1 2025. As a result, headline rates of inflation fall further than in the baseline, with calendar year averages about 1 percentage point below target in most developed markets in 2024, while China slips into outright deflation. |
| **Productivity boost** | Labour recruitment and retention difficulties prompt firms to squeeze additional productivity out of their existing workforces and iron out supply chain inefficiencies. Initiatives taken vary by firm and sector, but it includes an acceleration in robotics usage and artificial intelligence (AI) being adopted at a more rapid and widespread pace than expected. This results in significant efficiency gains across economies but without significant displacement of labour. | **Productivity boost:** Economic growth is initially bolstered by higher capital expenditure. The resulting net productivity gains foster greater competition and enable corporates to rein in price increases, with some sectors even seeing outright deflation. This sees inflation fall back more sharply across developed and emerging economies in 2025, which enables central banks to cut rates more aggressively. |
| **Middle East war** | The ongoing war in the Middle East spreads across the region and also drags Western nations into the conflict. This causes wholesale oil prices to spike towards $150/bbl in the second half of 2024 and remain above $100/bbl througout the forecast period. Conflict in the region means that disruption to shipping routes worsens and delivers a general shock to confidence. Flight to safety causes the US dollar to appreciate. | **Stagflationary:** The surge in oil prices immediately pushes inflation higher. While the squeeze on real incomes has a negative impact on growth, concerns about tight labour markets and second round effects on wages force central banks to push back the start of easing, meaning that rates end 2024 around 50bps higher than in the baseline forecast. Delayed easing cycles weigh on growth in 2025. |
| **Consumer boom** | Higher interest rates struggle to gain traction as buoyant labour market conditions and real income growth drive continued strong consumer spending. Greater loan availability and demand clears the way for a credit cycle to further support demand. Booming consumption bolsters the outlook for corporate profitability, encouraging greater capex and the passing on of costs through higher prices. | **Reflationary:** Robust consumer demand ensures that growth is far stronger than in our baseline forecast, but also causes price pressures to remain sticky and leads to higher commodity prices. As a result, inflation remains significantly above target throughout the forecast horizon, forcing central banks to abandon plans to cut interest rates in 2024 and eventually restart hiking cycles as underlying price pressures re-emerge. |
| **Second inflation wave** | While inflation initially continues to ease, tight labour markets mean that companies continue to offer substantial wage increases to attract and retain staff. This persistence of elevated wage growth hurts productivity and raises unit labour costs. This leads to a second wave of inflation in 2025, that forces central banks to have to change course and tighten policy after cutting rates in 2024. | **Stagflationary:** Across much of the global economy, inflation is on average about 1 percentage point higher than the baselline in 2025, which forces central banks to raise interest rates. Higher inflation, along with tighter monetary policy, hits demand leading to economies experiencing weaker growth next year. |

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

# Market returns

# Market returns

| | Total returns | Currency | June | QTD | YTD |
|---|---|---|---|---|---|
| Equity | US S&P 500 | USD | 3.6 | 4.3 | 15.3 |
| | US Nasdaq 100 | USD | 6.3 | 8.0 | 17.5 |
| | UK FTSE 100 | GBP | -1.1 | 3.7 | 7.9 |
| | EURO STOXX 50 | EUR | -1.7 | -1.6 | 11.1 |
| | German DAX | EUR | -1.4 | -1.4 | 8.9 |
| | Spain IBEX | EUR | -3.1 | 0.3 | 11.0 |
| | Italy FTSE MIB | EUR | -3.6 | -1.5 | 13.4 |
| | Japan TOPIX | JPY | 1.5 | 2.3 | 20.1 |
| | Australia S&P/ASX 200 | AUD | 1.0 | -1.1 | 4.2 |
| | HK HANG SENG | HKD | -1.1 | 9.0 | 6.2 |
| EM equity | MSCI EM | LOCAL | 4.3 | 6.6 | 11.2 |
| | MSCI China | CNY | -1.9 | 7.2 | 5.2 |
| | MSCI Russia | RUB | - | - | - |
| | MSCI India | INR | 6.9 | 10.3 | 17.4 |
| | MSCI Brazil | BRL | 1.9 | -2.5 | -6.9 |
| Governments (10-year) | US Treasuries | USD | 1.3 | -0.2 | -2.0 |
| | UK Gilts | GBP | 1.6 | -0.7 | -2.4 |
| | German Bunds | EUR | 1.6 | -0.9 | -2.4 |
| | Japan JGBs | JPY | 0.3 | -2.6 | -2.9 |
| | Australia bonds | AUD | 0.9 | -1.8 | -0.9 |
| | Canada bonds | CAD | 1.4 | 0.7 | -1.5 |

| | Total returns | Currency | June | QTD | YTD |
|---|---|---|---|---|---|
| Commodity | GSCI Commodity | USD | 1.4 | 0.7 | 11.1 |
| | GSCI Precious metals | USD | -0.2 | 6.0 | 13.5 |
| | GSCI Industrial metals | USD | -5.1 | 8.2 | 8.5 |
| | GSCI Agriculture | USD | -7.8 | -5.6 | -4.8 |
| | GSCI Energy | USD | 5.8 | 0.7 | 16.5 |
| | Oil (Brent) | USD | 5.7 | -1.1 | 11.2 |
| | Gold | USD | -0.2 | 5.1 | 12.6 |
| Credit | Bank of America/Merrill Lynch US high yield master | USD | 0.9 | 1.1 | 2.6 |
| | Bank of America/Merrill Lynch US corporate master | USD | 0.6 | 0.1 | 0.0 |
| EMD | JP Morgan Global EMBI | USD | 0.7 | 0.4 | 1.8 |
| | JP Morgan EMBI+ | USD | 0.6 | 0.1 | 2.4 |
| | JP Morgan ELMI+ | LOCAL | 0.6 | 2.0 | 3.7 |
| | **Spot returns** | **Currency** | **June** | **QTD** | **YTD** |
| Currencies | EUR/USD | | -1.3 | -0.8 | -3.0 |
| | EUR/JPY | | 1.1 | 5.5 | 10.7 |
| | USD/JPY | | 2.4 | 6.3 | 14.1 |
| | GBP/USD | | -0.7 | 0.1 | -0.8 |
| | USD/CNY | | 0.5 | 0.6 | 2.5 |
| | USD/AUD | | -0.4 | -2.3 | 2.2 |
| | USD/CAD | | 0.4 | 1.1 | 3.8 |

Source: LSEG Refinitiv, as at 30 June 2024.

## Important information

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