SCHRODERS CIO LENS

Q4 2023

Marketing material for professional clients only

Schroders

CONTENTS

STEERING THROUGH MARKET CROSS-CURRENTS

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

In Rome, where I grew up, people often talk about the type of wind that is blowing. There are names for all eight winds, whether it's the chilly northerly *Tramontana* or the hot southerly *Scirocco*. And the temperature and mood in the city change significantly along with the wind.

I'm reminded of this when I think about the trendless markets we've been seeing over the summer, which have blown hot and cold, affected by different forces and events.

Indeed, Federal Reserve chair Jerome Powell likened making policy decisions currently to "navigating by the stars under cloudy skies".

While inflation has been moving in the right direction, resilient growth has raised concerns that this rate hiking cycle isn't over yet.

And there's also been significant regional divergence. This is a trend I expected to see as interest rate cycles re-emerge, but it's been interesting to see the cross-currents being felt after such a long period of regions moving in unison.

The US economy is still a little too hot for comfort, while China is struggling with a weak property sector. Japan has been soaring because of the stance of the central bank, while Europe has had a decidedly soggy summer from a growth perspective.

As we've outlined in our medium-term roadmap over the last two years, we expect inflation to be higher for a given level of growth due to a number of structural trends such as labour scarcity, a shortening of supply chains, and the energy transition. We've broadly categorised these as the "3Ds" of demographics, deglobalisation and decarbonisation.

We then overlay this roadmap with a more cyclical view, based on the stage of the interest rate cycle. In this regard, we believe we are reaching a plateau – more Table Mountain than Matterhorn, as some have described it. This is as central banks observe the impact of their rate hikes so far and see signs that inflation is moving in the right direction.

As we discussed in last quarter's CIO Lens, on the multi-asset team we accepted in June that the US economy was proving to be more resilient than we had expected. As a result, we closed our underweight position in equities and have moved to a tactically positive view on US equities as we go into year-end.

As we expect bond volatility to stabilise, and given that the US economy is still generating positive growth, we believe that the soft landing narrative can allow the S&P 500 to deliver further gains. We remain positive on Japanese equities, given the Bank of Japan's stimulative stance, and we are negative on German equities where the economic slowdown is gaining some momentum. In summary, we are exploiting regional divergence in our equity views.

Equity styles are harder to discern; on the one hand, a higher interest rate environment should support value stocks, as near-term earnings tend to become more valuable at such times. But on the other, technological disruption continues to be a powerful force and supports growth stocks.

AS WE EXPECT BOND VOLATILITY TO STABILISE, AND GIVEN THAT THE US ECONOMY IS STILL GENERATING POSITIVE GROWTH, WE BELIEVE THAT THE SOFT LANDING NARRATIVE CAN ALLOW THE S&P 500 TO DELIVER FURTHER GAINS.

SCHRODERS CIO LENS
CIO QUARTERLY VIEWS

Looking at fixed income, we expect yields to stabilise as inflation subsides but given that we are not expecting a imminent recession or a Fed pivot, we prefer to own European investment grade debt as a way of increasing our sensitivity to interest rates with an attractive yield.

We have previously talked about the long-term benefit of commodity-related exposures in a world of more constrained supply and heightened geopolitical risk. We also view them as a good source of diversification if growth and inflation remain higher than expected.

In summary, we are focused on regional opportunities within equities, European investment grade debt and commodities. But we'll be keeping a close eye on which way the wind is blowing.

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

Johanna Kyrklund

Andy Howard
Global Head of
Sustainable Investment

Sustainability in the 3Ds

In August, we outlined our view of the structural forces shaping economies, markets and investment portfolios. They fall into three, helpfully alliterate, categories - demographics, deglobalisation, and decarbonisation. We believe that these forces, and the ripples they will bring, will prove instrumental in shaping returns across financial markets in the coming years and beyond.

That macro view underlines the close relationship between social and environmental trends, and business and investment drivers. Structural shifts in social and environment pressures lie at the heart of these trends:

Demographics

Healthcare advances and improved access to those services have changed the shape of the global population and will continue to do so. Over the next 20 years, the global working age population will grow at half the pace of the last two decades, while the ratio of older people to working age populations will almost double[1]. Beyond the macroeconomic implications, those shifts will raise the value of innovations able to drive workplace efficiencies and healthcare solutions.

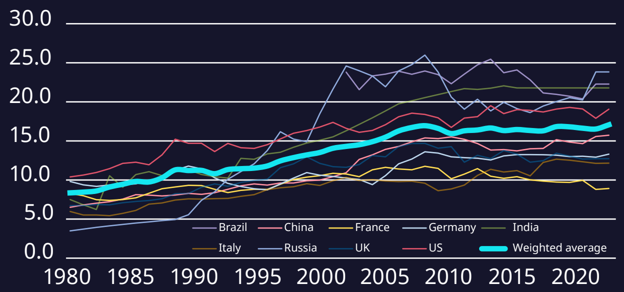
Decarbonisation

Countries representing around 90% of global economic output or greenhouse gas emissions have committed to reaching net zero in the coming decades, up from less than 10% in 2016. The policies that will deliver that transition are not yet in place, but political action is hardening, notwithstanding stutters in some economies, such as the UK recently. That shift will require a material reshaping of economies and industries, rebalancing competitive advantage and value across markets. All investors are exposed to that transition, whether consciously and proactively or not.

Deglobalisation

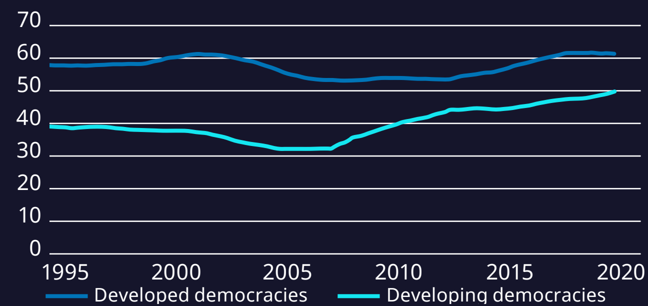
Globalisation played a critical role in lifting a large share of the global population out of poverty; inequality across the world population has dropped by more than 20% since the 1990s[2]. On the other hand, global integration has been a key contributor to rising inequality within counties, which has risen in most major economies, resulting in growing dissatisfaction with prevailing political systems (see charts below) and flip-flopping policies and political direction. Companies will have to contend with growing pressure to support the inclusion of groups that have become marginalised, amid increasingly fluid political regimes. Inclusive capitalism looks like a strategy for business success, not a slogan.

GDP-weighted average share of top 1% in total household income in G7 and BRIC countries*



Source: Inequality Database, World Bank, Schroders estimates and calculations. * Excludes Russia.

Dissatisfaction with current political system in developed and developing democracies



Source: Centre for the Future of Democracy, Schroders estimates and calculations.

Across Schroders we have long been committed to understanding the implications of those structural shifts and integrating that analysis and judgement into our investment decisions. Sustainability is a core component of that forward looking assessment, combining dedicated ESG analysis with the deep industry and company insights our investment teams have built. The future is always uncertain; understanding companies' exposures to the social and environmental trends unfolding and their management of the resulting pressures and opportunities will be increasingly important to our ability to navigate that uncertainty.

1 Based on analysis of data and projections from the UN World Population Division.
2 World Bank: Poverty and Shared Prosperity.

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Equity Analyst

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Portfolio Manager, Global Listed Real Assets

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Head of Global Unconstrained Fixed Income

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India Investment Specialist

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Overall asset allocation views

Short / negative   neutral   Long / positive   Previous score

Equities

Over the summer we continued to see encouraging developments on US inflation. With no sign of an imminent recession, our expectations of a soft landing have been supported and the probability that interest rates in the US have reached a plateau has also increased. As a result we upgrade US equities to overweight.

Government bonds

We expect yields to stabilise as inflation slides but given that we are not expecting an imminent recession or a Fed pivot, we prefer to get exposure to rates via credit where we are compensated with a better yield.

Credit

We maintain our positive view on credit as the asset class offers access to the defensive properties of duration but with some markets, notably European investment grade, generating positive carry compared to government bonds. This month we also upgrade US high yield debt as yields are attractive and a benign economic environment supports this asset class for now.

Commodities

We upgraded our view on commodities from neutral to positive in July and continue to own the asset class as a source of diversification to protect against geopolitical risks and the potential for growth remain stronger for longer.

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

Regional equity views
Q4 2023

Short / negative   neutral   Long / positive   Previous score

Equities

US

Stabilising bond yields and resilient growth in the US should support this market into year end.

UK

We upgraded our view to neutral over the quarter. While concerns around stagflation remained, valuations appeared relatively attractive as UK equities had lagged other markets. Better-than-expected fundamentals also raised prospects for the market.

Europe ex. UK

The eurozone purchasing managers' index (PMI) continued to decline, with manufacturing activity being particularly weak. This, combined with relatively high inflation, was expected to weigh on the performance of the region and so we kept our negative view.

Japan

We upgraded our outlook on the region to positive over the quarter. Strong corporate fundamentals coupled with good domestic demand should allow the equity market to grind higher and outperform other regions.

China

On the one hand, valuations during the quarter appeared relatively attractive, but momentum slowed as doubts over economic growth increased. The market also faces meaningful challenges in the economically significant property sector and so we chose to remain neutral.

Asia ex. Japan

We upgraded to neutral as there was some evidence to show that the global manufacturing cycle had started to rebound, particularly in the tech sector where enthusiasm over artificial intelligence boosted sentiment. This provided a better outlook for countries such as Taiwan and South Korea where tech exports are a major contributor to GDP.

Emerging markets

We retained our neutral stance. The relatively weak global goods cycle remains a headwind; however, the asset class is likely to be supported by central bank policy easing, given inflation in EM markets is generally lower than in developed markets.

30 September 2023

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

Fixed income views
Q4 2023

Short / negative · neutral · Long / positive · Previous score

Bond and credit

Government

We closed our overweight position in the 5 year as, with the Fed on hold, we lack catalysts for that part of the curve to rally. Longer-dated bonds are unattractive due to the yield curve being inverted, and concerns surrounding debt levels and inflation.

In the UK, for most of the quarter we were negative on gilts but upgraded our view to neutral in September, mainly as a result of inflation falling more than expected.

At the outset of the period, we were neutral on German Bunds, but then upgraded our view to positive due to lower inflation and the deteriorating growth outlook.

We remained neutral on Japanese bonds as absolute yields have remained unattractive.

Inflation-linked

We remain neutral inflation-linked bonds because of the Federal Reserve's commitment to curbing inflation and because we see some tentative signs of softening wage trends.

EMD

Denominated in USD:
Valuations for USD emerging market debt are expensive. Although fundamentals remain resilient, these markets are exposed to Chinese growth and the global commodity cycle. Additionally, the light supply of bonds kept technical conditions tight, therefore we maintained our neutral score over the period.

Denominated in local currency:
In July, we were positive on emerging market debt, as declining inflation meant emerging market economies were approaching their inflation targets. Within the asset class, we preferred Latin America due to positive real yields. We maintained this view in August, but switched to neutral in September as we were concerned about the risks to the asset class should the US dollar strengthen.

High yield (HY)

US

EU

We have upgraded US high yield because the sell-off in yields provides us with a compelling carry opportunity. Corporate and household balance sheets remain strong, standing them in good stead to digest tightening financial conditions and moderate growth without a significant pick up in defaults. In Europe, defaults are starting to increase, albeit from a very low base, so we remain neutral.

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

Investment grade (IG) corporate

US

EU

We kept our scores unchanged for US and European investment grade credit. We retained our preference for European investment grade as we expected it to benefit from the ECB nearing the end of its hiking cycle and from the positive carry. In the US investment grade sector, although corporate fundamentals remained strong over the period, yields looked unattractive relative to cash rates and valuations remained expensive.

30 September 2023

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

Commodities views
Q4 2023

Short / negative · neutral · Long / positive · Previous score

Commodities

We are neutral on agriculture as crop conditions have improved significantly, providing a buffer on the supply side. El Nino remains a risk but higher yields and good progress in this planting season leave us neutral.

In the case of energy, supply cuts from Saudi/Russia are still feeding into the market but we believe the impact is largely priced , and the outlook for 2024 is for more muted demand growth. However, energy is diversifying in the context of a tense geopolitical situation.

We maintained a neutral score on industrial metals over the quarter. Supply remained tight, with the outlook for growth muted, it is unclear as to where an increase in demand could come from.

We have upgraded gold as strong Central bank and Chinese domestic demand is supportive and it could perform well if real yield speak.

30 September 2023

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

Private Assets Investment Outlook

Rethink the Re-up – selectivity is key

Q4 2023

Nils Rode
Chief Investment Officer,
Private Assets

The global themes of decarbonisation, increasing deglobalisation trends, evolving demographics and the ongoing AI revolution continue to create new opportunities across the spectrum of private asset investments. At the same time, we are witnessing a general slowdown in the fundraising cycle across private asset strategies. Likewise, transaction activity is also slowing down and valuations are adjusting to varying degrees across strategies.

With uncertainty and change, investors face changes in actual portfolio allocations, required returns or liquidity needs and are now reviewing their allocation and commitment plans. While the potential for economic slowdown or a recession may be a concern, cycles bring opportunity. Historically, attractive opportunities for equity owners and lenders have emerged during times of recession. Likewise, policy changes, and implementation of new regulation for traditional capital providers, like banks, also creates inefficiencies that can benefit alternative capital investors.

We believe that the confluence of new thematic tailwinds, the current cyclical slowdown, and limitations on traditional capital providers present an attractive opportunity for investors who apply a forward-looking approach. Below are some guiding principles we consider important to navigating investments through this cycle.

Seek tailwind from the 3D Reset and the AI Revolution

Powerful long-term trends such as decarbonisation, deglobalisation, and demographics (the “3 Ds”), alongside the ongoing AI revolution, will drive a markedly different economic and geopolitical environment over the next decade and beyond. Considering the importance of longer-term trends to many private assets investments, these themes are particularly significant. We see attractive investment opportunities in areas such as sustainability- and impact-aligned investments, renewable energy, generative AI, and investments in India.

Focus on less correlated investments

With uncertainty, volatility, and new market dynamics, the benefit of diversification is significant. In this context, identifying less correlated strategies can be a risk mitigating advantage. We see attractive opportunities in less volatile or less correlated assets, as well as investments in sectors where capital provision is inefficient. Real assets offer protection from inflation, insurance linked securities are uncorrelated to macro-economic risks, microfinance and private credit offer income with lower volatility with additional opportunity present in small and mid-buyouts (particularly in certain industry sectors such as healthcare) and also in seed and early stage venture capital investments.

Rethink the re-up – selectivity is key

Many new investments involve re-ups with general partners (GPs), with whom investors have existing relationships. In this dynamic environment we advise investors to question whether past success will continue. Assessment of partners and strategies in light of the impact of key trends of decarbonisation, deglobalisation, demographics, and the AI revolution, are critical. Rather than automatically re-upping into similar strategies, we recommend that investors broaden their new investments into opportunities that benefit from these transformative trends, that offer diversification and/or that capture the benefits of inefficiencies.

Our assessment of opportunities by private asset class has remained largely unchanged over recent quarters. We provide a more detailed examination of these opportunities below.

Schroders capital

SCHRODERS CIO LENS
PRIVATE ASSETS INVESTMENT OUTLOOK

Private Assets Investment Outlook

Rethink the Re-up – selectivity is key

Q4 2023

Private equity

We believe that being highly selective in private equity investments is a critical success factor. We focus on opportunities that are aligned with the trends mentioned already and that have the potential to capture a complexity premium. That is, 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 resulting in lower and more stable entry valuations 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 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 Credit Alternatives

Income is now very attractive in most markets. Rising interest rates have combined with a pullback of some traditional capital providers to create a combination of attractive coupon, lower leverage and more favourable terms.

Investments that offer variable interest rates and strong security are especially attractive in our view. For example through tangible asset backing, combined with contractual or 'pass-through' links to inflation. Some sectors offer structural opportunities, such as infrastructure debt, while other sectors offer more selective opportunities, like commercial real estate. We remain cautious with regard to real estate debt, and focus our lending where fundamentals are strong. For example, we believe that the deterioration of fundamentals in offices has not yet fully played out, while areas like rental housing and student housing remain attractive from a lender's perspective.

Floating-rate securities are the majority of the asset-backed (ABS), and collateralised loan obligation (CLO) sectors. Over the last decade, for these sectors and for MBS, the Federal Reserve and US banks have been among the largest buyers. Their withdrawal has created a very attractive opportunity in the highest quality securities. These investments offer diversification to tradition corporate credit. As well, the increase in regulatory capital requirements for banks will fuel growth in this segment.

The leveraged loan markets have shown resilience. Yields benefit from higher base rates, and considerable yield spread; however, loan prices are high. In general, default rates remain low and risk has been more idiosyncratic, but default levels have begun to rise and recoveries on defaulted loans have historically been low. With the uncertain macro backdrop and the risk of an upcoming default cycle, high selectivity is key.

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 also offers diversification and lowly correlated returns, making it an attractive option for investors seeking alternative sources of income.

Infrastructure

Within infrastructure, we see renewables as a particularly attractive due to their strong link to inflation and secure income characteristics. They also contribute to diversification, through their exposure to differentiated risk premia (such as energy prices and weather).

In addition to the decarbonisation trend, renewable energy is benefiting from heightened concerns about energy security and the need to reduce reliance on fossil fuels, which were reinforced by the ongoing war in Ukraine. Furthermore, the cost of living crisis has also brought focus to energy affordability, and in many areas around the world renewables are now the cheapest source of electricity production that can be built.

We also see opportunities in adjacent technologies such as hydrogen, heat-pumps, batteries and electric vehicle charging, which will play an important role in enabling the decarbonisation of industries such as transport, heat and heavy industries.

We also see attractive opportunities in other infrastructure areas related to digitalisation and other essential infrastructure. These investments offer similar opportunities around the ability to generate inflation-linked and often stable returns.

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

Real Estate

Real estate markets have repriced significantly as a consequence of the new higher interest rate regime, inflationary pressures, geopolitical shifts, equity and debt market movements impacting investor allocations, and ever-growing sustainability considerations.

Occupational markets continue to show resilience and while demand has softened, tight supply conditions (given elevated construction and debt finance costs) and the scarcity of high-quality sustainability-compliant space is likely to fuel renewed growth into the medium-term.

Given the extent and uneven pattern of the repricing so far, we view the real estate asset class to be in the early phase of a broader cyclical buying opportunity, alongside existing and newly emerging opportunities from structural change. The most immediate opportunities can be found in markets that have experienced the fastest repricing, such as the UK and Nordic region, followed by the US and other Continental European markets. In Asia Pacific, cyclical opportunities are centred on markets most reliant upon China's recovery.

Logistics and urban industrial assets, convenience retail formats, mid-market multi-family housing, budget and luxury hotel formats, and self-storage are the sectors offering absolute and relative value.

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 which will mean capital expenditure will also have to increase to meet evolving regulatory and shifting tenant requirements.

Economic risk scenarios

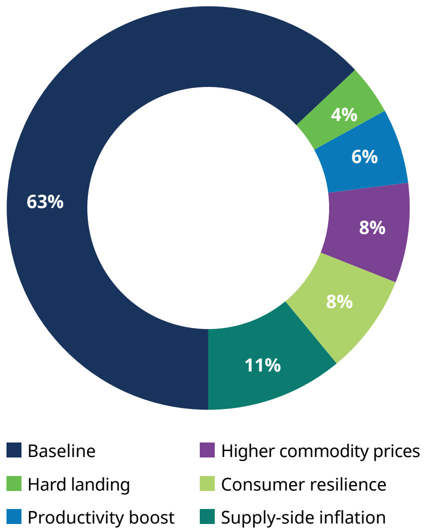
Hard landing and higher commodity prices scenarios added.

We have moved the baseline in a more reflationary direction by raising our projections for both growth and inflation. The existing scenario which best captures such a move is consumer resilience where households continue to spend at a faster pace than in the baseline. We retain this scenario as, despite incorporating greater spending into our forecast, we recognise that this could persist for longer, posing a risk of stronger growth and inflation as well as interest rates.

However, this is not the whole story. As noted above, markets have been driven by the rising probability of a soft landing. Our new forecasts reflect this as we now assume inflation can decline at less cost in terms of slower growth and higher unemployment than in our previous forecast. The increase in our inflation forecast is marginal compared to the rise in expected growth and can largely be accounted for by a higher assumption for oil prices. Hence, the move in our forecasts is largely driven by a more positive view on underlying productivity – a clear step in the soft landing direction.

As with Consumer resilience we choose to retain a scenario where this goes further than in the baseline which we have termed Productivity boost. This has a similar outcome in terms of a better growth/ inflation trade off as our previous soft landing scenario, but is more driven by stronger capital spending, largely supported by fiscal measures. It also recognises the potential for faster productivity gains as a result of the break throughs in artificial intelligence (AI).

Scenario probabilities



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

Two risk scenarios from our previous forecast are dropped as the probability of their occurrence has fallen significantly over the past three months: "bond market vigilantes" and "banking crisis deepens".

Both these scenarios were deflationary in that they led to weaker growth and lower inflation than the baseline. We do, however, still see a risk in this direction and have a new Hard Landing scenario where central banks overtighten monetary policy and plunge the world economy into recession.

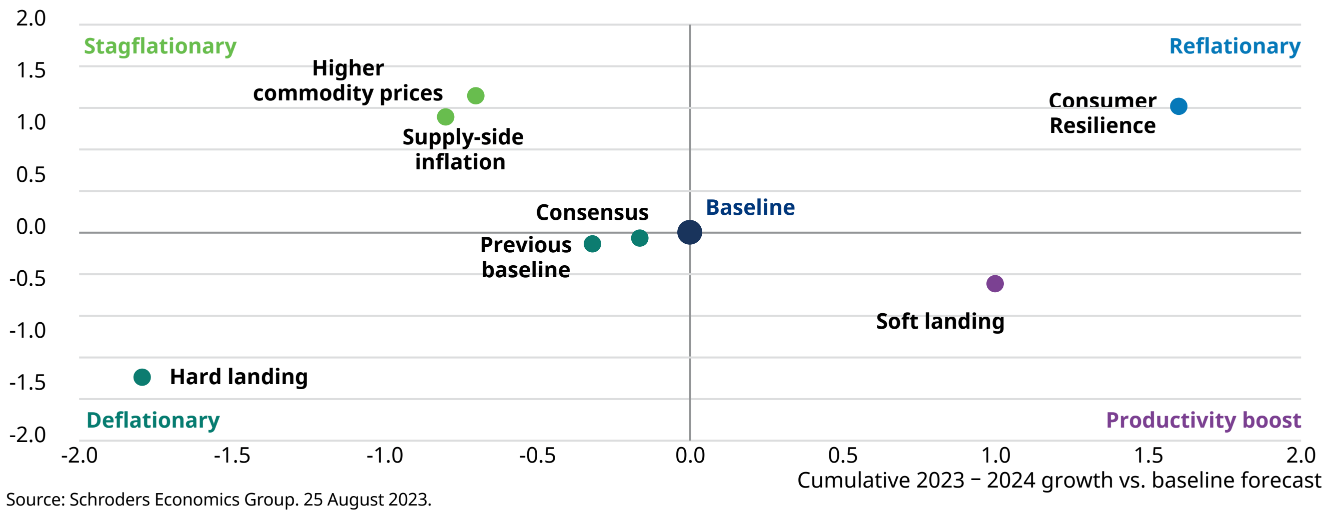
The other new scenario is Higher commodity prices. The main driver is on the supply side where restriction by OPEC+ in energy markets drives oil prices to $120/ barrel. Meanwhile, an intensification of fighting in Ukraine causes the Black Sea trade corridor to collapse, sending grain prices sharply higher. Other foods are also affected by extreme weather events. Lastly, a severe 2023/24 European winter coincides with an intensification in global competition for LNG shipments and industrial action among some producers. This causes the price of natural gas in Europe to return to the highs not seen since autumn 2022. As in the Hard landing, this scenario is negative for growth, but the rise in commodity prices boosts inflation sending the world economy in a stagflationary direction compared to the baseline (chart 7).

This new scenario allows us to retain, but redefine, the Supply side inflation scenario to one where the source of inflationary pressure is solely due to the labour market. In this scenario wage pressure is greater at any given level of unemployment and productivity is weaker as shortages cause firms to hoard workers. As with the higher commodity price scenario this has stagflationary consequences for the world economy compared to the baseline.

In terms of probabilities, the economics team believes that the balance of risks is skewed toward stagflation reflecting the Supply side inflation and higher commodity prices scenarios (charts 8 & 9). This would tie in with our view that we are entering a more difficult phase in the inflation reduction process. One which will challenge support for central bank's anti-inflation policies as social unrest is likely to rise in the wake of higher unemployment.

Scenario grid – growth and inflation deviations from baseline

Cumulative 2023 – 2024 inflation vs. baseline forecast



Source: Schroders Economics Group. 25 August 2023.

Deviations from Baseline: Summary of risk scenarios

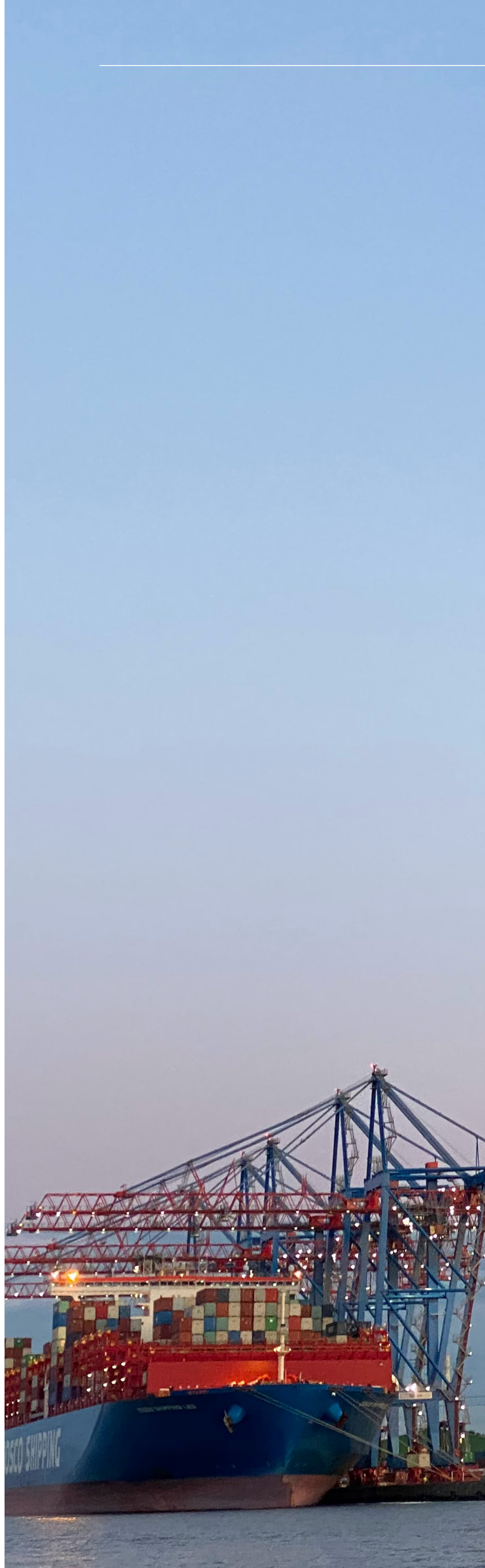
	Summary	Macro impact
Hard landing	Developed market central banks continue to tighten monetary policy in order to stamp out inflation. The Fed hikes to a terminal rate of 6.50%, with the ECB and BoE reaching 5% and 6.75% respectively. But the cumulative effect of further interest rate hikes, along with the eventual lagged impact of past aggressive tightening, hit domestic demand hard. Rate cuts eventually follow, but too late to prevent all major economies from tipping into recession. Meanwhile in China, problems in the housing market go from bad to worse as a further collapse in new home sales causes more developers to default on their debt obligations, raising concerns about a financial crisis and further denting confidence. With Beijing still reluctant to deliver significant stimulus, economic growth slows markedly.	**Deflationary:** Overtightening of monetary policy, demand destruction and subsequent recessions cause negative output gaps to open up. At the same time, commodity prices tumble as the outlook for demand deteriorates, with Brent crude falling to a trough of just $50/bbl in early-2024. 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 continues to flirt with a prolonged period of deflation.
Productivity boost	Initiatives such as the Inflation Reductaion Act (IRA) and CHIPS Act by the Biden administration continue to support strong US business investment, increasingly among non-US domiciled corporates. Other countries seek to replicate this, either through co-operation agreements (e.g. Japan's critical minerals deal, the UK's Atlantic Declaration) or by funding their own incentive schemes. This proliferation of subsidies results in a sharp rise in capital expenditure that delivers immediate productivity gains. Alongside this, the adoption of artificial intelligence is more rapid and widespread than expected, resulting in significant efficiency gains across economies but without significant displacement of labour.	**Productivity boost:** Economic growth is initially bolstered by higher capital expenditure, which is then sustained as projects come onstream and new industries are created. The resulting net productivity gains 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, aided by a weaker USD which serves to offset modestly higher crude oil prices. Central banks are able to cut rates more aggressively in 2024 and step up the pace of quantitative tightening as a consequence.
Higher commodity prices	A perfect storm of events lead to a broad-based and sustained rise in the price of various key commodities. Brent crude oil climbs above $120/bbl owing to further output cuts by OPEC+, Meanwhile, an intensification of fighting in Ukraine causes the Black Sea trade corridor to collapse, sending grain prices sharply higher. Other foods are also affected by extreme weather events, such as wildfires and flooding, alongside a strong El Niño. Lastly, a severe 2023/24 European winter coincides with an intensification in global competition for LNG shipments and industrial action among some producers. This causes the price of natural gas in Europe to return to the highs not seen since autumn 2022.	**Stagflationary:** Higher food and energy prices push up inflation, with global CPI averaging 1.1 percentage points higher than the baseline in 2024. Both the eurozone and UK are among the worst affected, owing to the significance of natural gas in their energy mix. Global growth is weaker as a consequence, with the exogenous energy shock sending several developing countries into a technical recession. Still, central banks respond by raising rates more this year. Although they then begin to loosen policy in 2024, it remains more restrictive than the baseline so as to ward against the risk of second-round effects.
Consumer resilience	While excess savings built up during the pandemic have now been mostly drawn down, household spending continues to grow strongly as saving rates do not normalise, real income growth turns positive and consumer credit lines are tapped. At the same time, higher rates struggle to gain traction owing to deleveraging efforts since the financial crisis and because rock bottom interest rates were locked in during previous years across long time horizons. This strong consumer backdrop in-turn bolsters the outlook for corporate profitability, encouraging greater capex and the passing on of costs through higher prices.	**Reflationary:** Robust consumer demand causes core inflation to remain stickier than in the baseline, whereas headline inflation falls back more slowly. Also, strong growth results in a further tightening of labour markets, with the US unemployment rate falling below 3%. Central banks respond by raising interest rates more aggressively. The Fed funds rate rises to a peak of 6.50% in early 2024, while the ECB main refinancing rate reaches 5.75%. Eventually, higher interest rates cause activity to slow, prompting central banks to start cutting rates. Over the two-year horizon, global growth and inflation are both higher than the baseline.
Supply side inflation	Despite an economic downturn, companies choose to hoard workers after the hiring difficulties experienced over recent years. With the labour market remaining tight as a consequence, companies are forced to offer higher pay awards to attract and retain staff, causing wage growth to accelerate further still. These factors weigh on productivity and push up unit labour costs, which are then passed on through price rises, keeping inflation sticky at elevated levels. All the while, the mismatch between worker skills and jobs in the post-pandemic economy means the 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 September 2023. Scenarios are hypothetical. There is no guarantee these events and outcomes will occur.

Market returns

	Total returns	Currency	September	QTD	YTD
Equity	US S&P 500	USD	-4.8	-3.3	13.1
	US Nasdaq 100	USD	-5.0	-2.9	35.4
	UK FTSE 100	GBP	2.4	2.2	5.5
	EURO STOXX 50	EUR	-2.8	-4.8	13.4
	German DAX	EUR	-3.5	-4.7	10.5
	Spain IBEX	EUR	-0.8	-0.8	18.3
	Italy FTSE MIB	EUR	-1.9	0.6	24.0
	Japan TOPIX	JPY	0.5	2.5	25.7
	Australia S&P/ ASX 200	AUD	-2.8	-0.8	3.7
	HK HANG SENG	HKD	-2.6	-4.2	-6.8
EM equity	MSCI EM	LOCAL	-1.8	-1.3	4.4
	MSCI China	CNY	-2.8	-1.9	-6.1
	MSCI Russia	RUB	-	-	-
	MSCI India	INR	2.0	4.1	8.7
	MSCI Brazil	BRL	1.3	0.1	7.1
Governments (10-year)	US Treasuries	USD	-3.4	-5.1	-2.9
	UK Gilts	GBP	-0.3	0.6	-2.5
	German Bunds	EUR	-2.8	-2.8	0.2
	Japan JGBs	JPY	-1.0	-3.0	0.3
	Australia bonds	AUD	-3.4	-3.0	-1.0
	Canada bonds	CAD	-3.5	-5.3	-3.7
Commodity	GSCI Commodity	USD	4.1	16.0	7.2
	GSCI Precious metals	USD	-5.1	-3.8	0.5
	GSCI Industrial metals	USD	1.5	3.5	-5.2
	GSCI Agriculture	USD	-3.3	-4.3	-7.6
	GSCI Energy	USD	7.8	28.8	13.9
	Oil (Brent)	USD	9.8	28.0	12.4
	Gold	USD	-4.4	-3.1	2.3
Credit	Bank of America/ Merrill Lynch US high yield master	USD	-1.2	0.5	6.0
	Bank of America/ Merrill Lynch US corporate master	USD	-2.5	-2.7	0.4
EMD	JP Morgan Global EMBI	USD	-2.8	-2.6	1.1
	JP Morgan EMBI+	USD	-3.7	-3.4	-0.2
	JP Morgan ELMI+	LOCAL	0.6	1.8	6.1
	Spot returns	**Currency**	**September**	**QTD**	**YTD**
Currencies	EUR/USD		-2.5	-3.0	-0.8
	EUR/JPY		0.0	0.2	12.2
	USD/JPY		2.5	3.2	13.1
	GBP/USD		-3.7	-4.0	1.5
	USD/CNY		0.1	0.2	5.3
	USD/AUD		0.3	3.1	5.1
	USD/CAD		-0.1	2.2	-0.2

Source: Refinitiv Datastream, Schroders Economics Group. 30 September 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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