SCHRODERS CIO LENS

Q1 2024

Schroders

CONTENTS

CIO LENS Q1 2024:

FLEXIBLE APPROACHES NEEDED AS FRESH OPPORTUNITIES ARISE

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

After the strong rally in markets into year end, valuations look a bit stretched across asset classes. Our base case is still for a soft landing in the US but this is now very much reflected in the level of equities, credit spreads and the extent of rate cuts priced into the bond market.

The pack of cards needs to be reshuffled to provide fresh opportunities (as you can see, my memories of all the board games I played over Christmas are still dominating my thinking!).

The challenge of course is that markets can move quite quickly - we have elections in 40 countries this year, a tense geopolitical environment and central banks are in the middle of "landing the economy" which can always create volatility.

With cash rates starting to fall, we would advocate being invested. But you need flexible approaches which can navigate these markets for you and take advantage of buying opportunities as they arise. After all, the next card to be dealt can significantly change the hand you hold.

Last quarter, investors were concerned about further rate hikes from the Federal Reserve (Fed) while we were firmly of the opinion that rates had reached a plateau. Well, three months is a long time in the bond markets as we now have a situation where investors are itching to price a Fed pivot.

We are not predicting significant rate cuts given the backdrop of high levels of employment. Although inflation continues to move in the right direction and wage growth has peaked, it feels premature for the Fed to cut so aggressively. As a result, we have closed our long duration positions and favour steepeners to benefit from lower rates.

To the extent that the Fed may choose to emphasise falling inflation rather than tight employment conditions, we would view this as being more bullish for equities than for bonds because we still view the risk of an imminent recession in the US as being low.

More broadly, and in the context of the 3D Reset, the next phase is really to think about what policies emerge from the reset. This is partly a function of the different conditions that each economy faces and the hand of cards that each policymaker has been dealt. As mentioned before in the CIO Lens, this economic divergence is a source of investment opportunity:

- Many emerging market (EM) countries have run more orthodox policies which now leave their debt markets in a good place, with room to ease rates further, leaving us positive on local currency EM debt.
- China faces a deflationary environment as it copes with the ramifications of its property crisis and, although we see some upside to the export cycle, it cannot rely on mercantilism given the size of its economy and the protectionist backlash in the West.
- Japan is still running stimulative policies because of its deflationary history and its high level of government debt might be an obstacle to tightening.
- Europe has a growth problem given an ageing demographic and higher energy costs than its competitors, but it also has a relatively stable political system and its conservative fiscal policies are supportive of European bonds.

WITH CASH RATES STARTING TO FALL, WE WOULD ADVOCATE BEING INVESTED. BUT YOU NEED FLEXIBLE APPROACHES THAT CAN NAVIGATE THESE MARKETS FOR YOU AND TAKE ADVANTAGE OF BUYING OPPORTUNITIES AS THEY ARISE.

- The US has been able to run more stimulative policies because of the dollar's position as reserve currency of the world. As Reagan once said "I'm not worried about the deficit. It's big enough to take care of itself". A Trump election might push the patience of investors too far though if it resulted in more fiscal profligacy.

Economics is an art, not a science because of the role of human behaviour. We continue to live in a world that is dealing with the aftermath of the pandemic and is facing unrelenting technological disruption. The 3Ds (demographics, deglobalisation and decarbonisation) have also impacted the relationship between growth and inflation.

Taking all this together, the economic consensus forged over many years is being challenged. We need to fight the tendency to rely on the investment "maps" that served us well over the last decade. Instead we need to focus on the divergences now occurring, and the fresh opportunities these are creating.

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

Johanna Kyrklund

Why sustainable investing is far from a “one size fits all” approach

Andy Howard
Global Head of
Sustainable Investment

Sustainable investment has been on a rollercoaster ride in recent years. From unbridled – and relatively uncontested – enthusiasm a few years ago, the picture has become more balanced by scepticism over the last 12-18 months amid a rise in anti-ESG sentiment in parts of the US political spectrum.

In all of this, one of our biggest frustrations has been the tendency to treat sustainable investment strategies as a homogenous group, or a set of criteria with which funds must comply. Whether criticising sustainable investment as “woke” do-gooders pursuing a quasi-political agenda, or for its failure to tackle the world’s ills, it is no more logical to level a critique at a field as diverse as sustainable investment than it is to extoll its virtues.

Sustainable investment is defined by its consideration of social and environmental performance in decision making, which encompasses numerous approaches to measurement, myriad factors and many ways of incorporating sustainability factors into investment strategies.

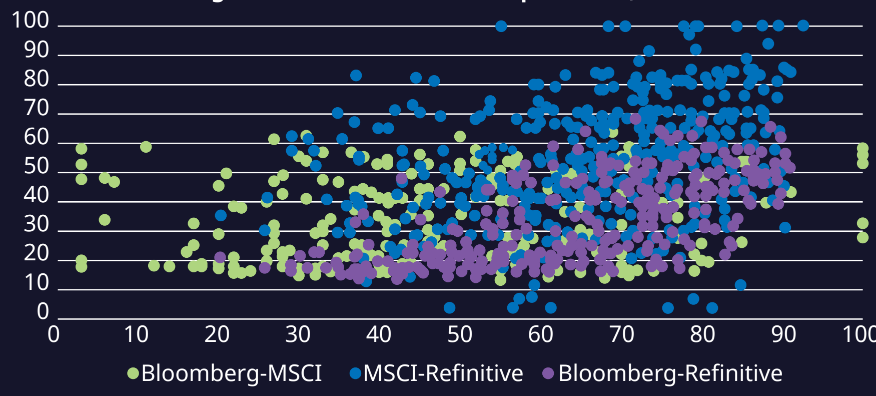
Illustrating the first of those points, the chart above shows the OECD’s analysis of the (limited) correlation between ESG ratings provided by three of the most widely-used providers, consistent with our own analysis.

Similarly, ESG trends encompass areas as diverse as climate change, human rights, labour standards or governance integrity. Strategies focused on specific areas often will not demonstrate leadership in others.

The differences between focusing on today’s leaders rather than investments that have the greatest prospect of improvement, or strategies focused solely on identifying alpha opportunities versus those which also prioritise positive impacts, can also be significant.

The industry’s focus on compliance with regulation, particularly in the EU, has not helped in recent years. Although its Sustainable Finance Disclosure Regulation has left a fair bit of discretion to investment managers to determine the best ways to approach sustainability analysis and measurement, it has created a focus on compliance with criteria. Although regulation is going to remain a theme in sustainability for several years, the industry should have established clearer operating procedures by now,

S&P 500 ESG ratings correlation for different providers, 2019



Taken from OECD report “ESG Investing: Practices, Progress and Challenges”.
Source: Bloomberg, MSCI, Refinitiv, OECD Staff calculations.

allowing more focus to return to developing and delivering thoughtful investment goals.

In our view, sustainability analysis is firstly about understanding the strength of companies’ relationships with the stakeholders on which their business models rely, their exposure to emerging social and environmental pressures and their readiness to adapt to them. Secondly, it is about understanding how to best incorporate the conclusions of that assessment into investment decisions. Insofar as those trends are themselves becoming more powerful competitive drivers, this is effectively no more than expanding the scope of investment analysis to reflect the environment in which companies today compete.

To do so, we have invested heavily in developing proprietary insights in conjunction with investment teams across the firm, rather than relying on third party measures. We’re well aware that tools like SustainEx* – which estimates the net social and environmental “cost” or “benefit” of an investment portfolio with regard to certain sustainability measures – exacerbate the lack of consistency. But one wouldn’t expect investment managers to reach the same conclusions in other areas and sustainability is no different.

To provide the greatest benefit, sustainable investment must influence investment decisions and judgements alongside other considerations, rather than simply act as a screen on investment universes or a constraint on portfolio construction. How we use analysis to make investment decisions, or seek to engage with portfolio management teams, alongside many other factors, is as important as the conclusions our analysis reaches.

At Schroders, we view our focus on ESG integration as a foundation of our approach. More than five years ago, we began a journey toward ensuring that environmental, social and governance factors were considered in the investment decision making processes of the strategies we manage across Schroders. In 2021 we reached the milestone of confirming that all Schroders-managed strategies had demonstrated how material sustainability factors are identified and examined, and how the results of that analysis are incorporated into investment decisions and active ownership efforts.

We have continued that journey, refining the accreditation framework we apply to assess the rigour of investment teams’ integration. In 2023, we included a greater focus on climate change risks and opportunities, as well as more emphasis on sustainability-focused engagement, and in 2024 we will continue to deepen that framework and the foundation it provides.

Most read content this quarter

Remi Olu-Pitan, CFA
Head of Multi-Asset Growth and Income

Peak rates? Options for investors

“With inflation declining in many parts of the world and the US Federal Reserve signalling it may cut rates, now is the time to consider what to do when rates peak.”

Read the full article here

Alex Tedder
Head of Global & Thematic Equities

Is the future still bright for the Super-7?

“While it may be tempting to move on from the Super-7 after such a strong year, we believe a more nuanced approach is the right one. The group is heterogeneous but united by the common denominator of strong business franchises in growing areas.”

Read the full article here

Duncan Lamont, CFA
Head of Strategic Research

Active vs. passive: concentrated markets swing the pendulum back in favour of active

“When the market has become very concentrated in a few stocks, investors have done better by allocating away from those stocks. The tables could be set to turn in favour of more actively managed strategies at last.”

Read the full article here

George Brown
Economist

US election countdown: what investors need to know

“American voters look set to see a rematch of Biden versus Trump next year. We explore how the economy and various asset classes could perform under the possible scenarios.”

Read the full article here

Overall asset allocation views

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

Equities

We held a positive view on equities for most of the quarter as lower bond volatility and an absence of recessionary risks remained supportive of the asset class. Most recently, our expectations of a peak in US interest rates and a soft landing were corroborated by Federal Reserve chairman Jerome Powell. However, strong returns across equity and bond markets mean our soft-landing view has now been priced in, and so we move to neutral.

Government bonds

Following an upgrade mid-quarter, we have moved back to neutral as bonds have rallied alongside risk assets, with the market now pricing in significant rate cuts. We think that for yields to fall further, we need to see evidence of an increased risk of a hard landing.

Credit

We have turned neutral on credit following the significant tightening of credit spreads towards the end of the quarter. Valuations in US investment grade bonds now reflect an optimistic outlook for 2024 and have become more expensive. Default rates have started to increase in both US and European high yield without reflecting significant credit stress. However, fundamentals have started to turn and may deteriorate going forwards.

Commodities

We have owned commodities as a hedge against stagflation and geopolitical risks. However, we downgraded our view to neutral in December given a lack of discipline on quotas among oil producers, and minimal signs that demand across the spectrum will pick up and support higher prices in the new year.

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

Regional equity views
Q1 2024

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

Equities

US

Despite holding a positive view at the start of the quarter, we have moved to neutral as the market has now priced in our expectations that US interest rates have peaked and that there will be a soft landing. Within the market we prefer the equal-weighted S&P 500 index as we expect a broadening out of performance away from the "Magnificent Seven".

UK

We are maintaining our neutral view on UK equities where, despite a slight reversal in the dire economic outlook, the Bank of England must move cautiously to mitigate the risk of stagflation.

Europe ex. UK

We were negative on Europe at the start of the quarter predicated on high inflation and the decline in manufacturing. We have since moved to neutral as the economic data has started to surprise to the upside, and as cheap valuations resulting from excessive pessimism mean we believe Europe is less likely to underperform other markets.

Japan

We downgraded our outlook on Japanese equities to neutral at the end of the quarter. While we still like Japan for its structural growth story, we believe that the Bank of Japan could push ahead with normalising monetary policy, which would likely put upward pressure on the yen.

China

We are maintaining our neutral view on China as the elimination of speculative demand for housing continues to weigh on the economy. We do, however, see early signs of life in the export cycle and are mindful of the possibility of more stimulus measures.

Asia ex. Japan

We have kept our neutral view as overall signs of life in the global manufacturing cycle are modest. However, we favour Korea and Taiwan relative to other markets as they should be supported by positive demand for semiconductors.

Emerging markets

Given that the manufacturing recovery will impact emerging markets unevenly, we retain our neutral view.

31 December 2023

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

Fixed income views

Q1 2024

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

Bond and credit

Government

With our cyclical model firmly in slowdown mode, we upgraded duration in November. At the time, the steepening of the yield curve also made owning the US 10-year less punitive. As our expectations of a peak in US interest rates and a soft landing were later corroborated by comments from Jerome Powell, we moved back to neutral. Strong returns across bond markets mean that our soft landing view is now priced in, making it difficult for us to keep a positive view. Looking to regions outside the US, we have remained neutral throughout the quarter. Despite cooling inflation in the UK, concerns surrounding persistently strong wage growth and supply-side issues keep us neutral. In Germany, markets look to have priced rate cuts too aggressively at the short end of the curve, whilst more medium-term tenures should be supported by inflation undershooting on the downside. This mixed picture keeps us on the sidelines.

Inflation-linked

We remain neutral. Although there is a risk of inflation returning, we believe the Fed's hiking cycle has brought inflation under control in the short to medium term.

EMD

Local
Our bullish outlook on the US dollar and its potential to weigh on local emerging market bonds kept us neutral in November. More recently, however, a dovish Fed could indicate a softening of the US dollar, which would be supportive for emerging market rates. However, while there is a risk of a hard landing, we remain neutral.

Denominated in USD:
Although the light supply of bonds remains favourable, continued expensive valuations have kept us neutral overall.

High yield (HY)

US

EU

We upgraded our outlook on US high yield debt at the start of the quarter as absolute yield levels became very attractive. Corporate and household balance sheets also remain relatively strong, leaving them in good stead to digest tightening financial conditions and any moderation in growth. We retained our neutral score on European high yield debt as default rates have started to rise steadily albeit from a low base.

Investment grade (IG) corporate

US

EU

We are neutral on both US and European investment grade debt. Credit spreads tightened towards the end of the quarter amid growing speculation that interest rates have peaked. This narrative provided a powerful technical tailwind leaving investment grade valuations constrained by cash once again.

31 December 2023

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

Commodities views

Q1 2024

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

Commodities

We downgraded energy to neutral at the end of the quarter. Despite OPEC members recently agreeing on further cuts, many are failing to comply with pre-existing quotas, undermining the threat of a squeeze on supplies. Meanwhile, US oil productivity continues to improve, further reducing the risk of prices rising.

We have downgraded gold to neutral as despite buoyant central bank and Chinese domestic demand, the recent rally has left the price looking overbought.

We remain neutral on agriculture as despite poor weather putting upwards pressure on wheat prices, the general outlook remains balanced.

Similarly, we remain neutral on industrial metals. Although the supply-side remains tight, there is currently no indication of an increase in demand.

31 December 2023

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

SCHRODERS CIO LENS
PRIVATE ASSETS INVESTMENT OUTLOOK

Private markets investment outlook

New year, new opportunities

Q1 2024

Nils Rode
Chief Investment Officer,
Private Assets

As developed market interest rates show signs of peaking and private market activity has been in a slowdown phase in recent quarters, we see attractive new investment opportunities across private markets. These are particularly appealing when they align with the global 3D Reset theme and the artificial intelligence (AI) revolution.

Following a phase of very strong fundraising during the pandemic, 2023 marked a period of slower capital raising for many private asset classes. We now see private markets having largely reverted to pre-pandemic levels in terms of fundraising, investment activity, and valuations. However, noteworthy exceptions include large buyouts in private equity, where fundraising has remained vigorous - a concern as it results in higher dry powder and entry valuations. Moreover, fundraising for infrastructure and venture capital has seen a significant downturn, and real estate valuations have undergone strong corrections in some regions and market segments.

It is time for optimism

Developed markets have made remarkable strides in bringing inflation closer to policy goals, with a considerably lesser impact on growth, notably in the US, than markets had anticipated. While potential uncertainties arise from geopolitical risks and muted growth expectations for 2024, we believe it's time to be optimistic about the potential for private market investments, given that private market conditions have largely normalized (with a few exceptions).

Private markets offer the advantage of diversification across risk premia, access to investments with defensive characteristics, and exposure to the global 3D Reset themes, such as decarbonization, deglobalization, and demographics, as well as the AI revolution. Many of these trends will favour specific investment categories, including sustainability and impact-aligned investments, renewable energy, generative AI, and investments in India. Simultaneously, some of these themes are inflationary, contributing to higher interest rates. Coupled with funding gaps created by regulatory capital limitations on banks, we anticipate this will generate appealing lending opportunities.

Capital flows: A contrarian indicator

Many private market strategies operate as closed systems where fundraising determines the amount of available dry powder, which subsequently influences entry valuations and ultimately investment returns. Therefore, we favour strategies with stable fundraising dynamics, such as small/mid buyouts and see potential in strategies where fundraising has significantly deviated below its long-term trend, like infrastructure equity and venture capital. We're also drawn to strategies with higher capital needs due to the retreat of traditional capital providers, such as real estate debt, insurance-linked securities, specialty finance, microfinance, and private credit.

Selectivity remains key

Many current private investments involve "re-ups", or reinvestments with existing partners. The pandemic has amplified this trend as due diligence on new strategies and meeting new managers posed a challenge.

Considering the new market dynamics driven by the 3D Reset and the AI revolution, we believe it's crucial to question whether past successes can be replicated. Are existing partners and strategies well-positioned for today's trends (decarbonization, deglobalization, demographics, and the AI revolution)? Are the fundraising and dry powder dynamics within the sub-sector healthy? Given the changes in market dynamics, it's likely that opportunity sets should also evolve.

Now, more than ever, it's vital to expand investments into opportunities that benefit from these transformative trends and policy changes, diversify a private allocation as it matures, and concentrate on areas with healthy fundraising dynamics that provide access to less efficient markets and opportunities.

Subsequently, we summarize where we see the most attractive opportunities within each private asset class based on these criteria.

Schroders
capital

Private equity

In our view, a critical success factor in private equity investments is a highly selective approach, focusing on opportunities that align with previously mentioned trends and can capture a complexity premium. These opportunities require unique skills for driving both organic and inorganic growth in portfolio companies.

We expect that small and mid-buyouts will outperform large ones in the coming quarters, due to a favourable dry powder environment and an added exit strategy: selling their portfolio companies to large buyout funds, facilitated by strong fundraising activity among large buyout funds, which typically acquire most of their companies from other funds.

We also expect disruptive seed and early-stage investments to show more resilience than later-stage or growth investments, due to similar dynamics. Early-stage investments have the advantage of a new set of investment opportunities, particularly in artificial intelligence, while a tight fundraising environment enforces discipline regarding entry valuations. Meanwhile, late-stage or growth investments face increased refinancing and valuation risks due to a drop in venture capital fundraising and a yet-to-reopen IPO window.

We find the healthcare and technology sectors particularly promising. Regionally, North America, Western Europe, China, and especially India remain attractive. In China, we see the most attractive opportunities in the onshore, RMB-denominated market.

We foresee a further rise in GP-led transactions, allowing favoured portfolio companies to be further developed by the same manager.

Private Debt and Credit Alternatives

Income is now highly attractive across most markets. Interest rates in developed markets have likely peaked or are nearing their peak, offering higher income. Additionally, leverage is lower and terms are more favourable.

We like investments offering variable interest rates, robust security through tangible asset backing, and debt with contractual or ‘pass-through’ links to inflation. Some sectors, such as infrastructure debt, provide defensive opportunities, while others, like commercial real estate, offer selective opportunities driven by significant fundamental changes.

We exercise caution where significant change, like the work-from-home trend in the US, has occurred. In real estate debt, we focus on sectors with strong fundamentals, such as rental and student housing. Offices may become an opportunity once supply and demand changes are fully appreciated.

Asset-backed and mortgage-backed securities and collateralised loan obligations offer diversification from traditional corporate credit or loans. The retreat of key buyers such as the Federal Reserve, influenced by quantitative tightening, and US banks, guided by Basel III regulations, has opened up appealing opportunities in these high-grade securities.

The corporate loan markets, both syndicated and private, have seen significant capital inflow, which we approach with caution. While loans have shown resilience, and while yields benefit from higher base rates, and considerable yield spread, loan prices are high, there is no call protection in a par loan and there is considerable re-pricing of loans today. In our view, high selectivity is key.

Insurance-linked securities offer valuable portfolio diversification due to their lack of correlation with traditional assets. Additionally, high risk spreads yield attractive portfolio returns. Microfinance is also attractive due to diversification and less correlated returns.

Infrastructure

Within infrastructure, we see renewables as 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.

Technologies related to renewables, such as hydrogen, heat-pumps, batteries and electric vehicle charging will play an important role in enabling the decarbonisation of industries such as transport, heat and heavy industries.

There is currently a notable disparity between the high number of renewable projects and the limited capital investment, leading to higher returns and making now an enticing entry point, particularly for core/core+ strategies.

Additionally, we see potential in other infrastructure sectors connected to digitalisation and essential services, offering opportunities for 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 undergone significant repricing due to the new higher interest rate environment, inflation, geopolitical changes, and market fluctuations affecting investor allocations.

Despite a slight softening in demand, occupational markets remain resilient due to tight supply conditions caused by high construction and debt financing costs, and a shortage of sustainability-compliant spaces. This situation is likely to spur growth in the medium term.
To meet evolving regulatory and tenant demands, it is crucial to prioritize sustainability and impact considerations, which will necessitate increased capital expenditure.

We believe the real estate sector is in the early stages of a broader cyclical buying opportunity due to the extent and uneven pattern of the repricing so far. We advise investors to be patient as opportunities emerge over time across capital structures, property types, and regions.

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 the Asia Pacific region, cyclical opportunities are focused on markets that align with China's recovery or offer alternatives in the nearshoring/friendshoring of supply chains.

Industrial and logistics assets have significantly repriced but remain supported by strong structural fundamentals. We favour operational property types that have strong demand-side tailwinds and can deliver direct or indirectly inflation-linked income. These include self-storage, hotels, senior housing, select residential segments, and healthcare-related real estate.

Economic risk scenarios

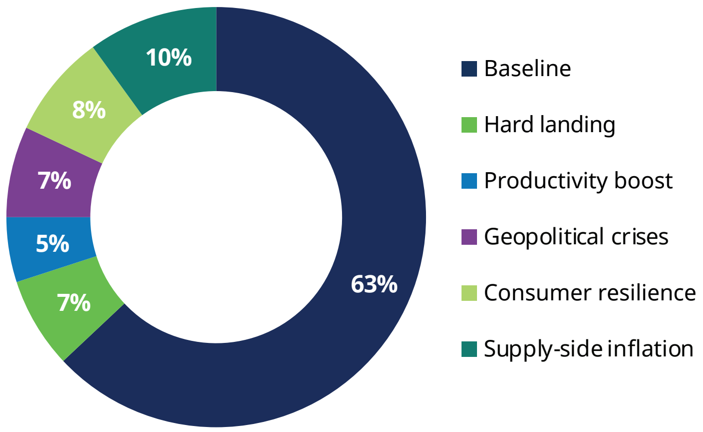
The balance of risks is still skewed in a stagflationary direction.

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

As shown by recent resilient spending data, there is a risk that monetary policy has become less effective and that consumption will remain buoyant, preventing a smooth decline in inflation and even forcing interest rates higher. Our analysis suggests that while this consumer resilience scenario could add a cumulative 1.3 percentage points (pp) of additional growth to our global forecast, it would also add 1.3 pp to inflation and delay reductions in interest rates. Indeed, resurgent demand and inflation could force a further tightening of monetary policy. At the same time, though, there is also a clear risk that the long and variable lags in policy transmission come to the fore more quickly than anticipated, leading to a hard landing in the global economy.

However, there also remains a lot of uncertainty about the supply side of the global economy. Euphoria about new technologies such as artificial intelligence (AI) could translate more quickly into an investment boom that results in a **productivity boost** that supports a softer landing than we assume in our baseline forecast.

Scenario probabilities



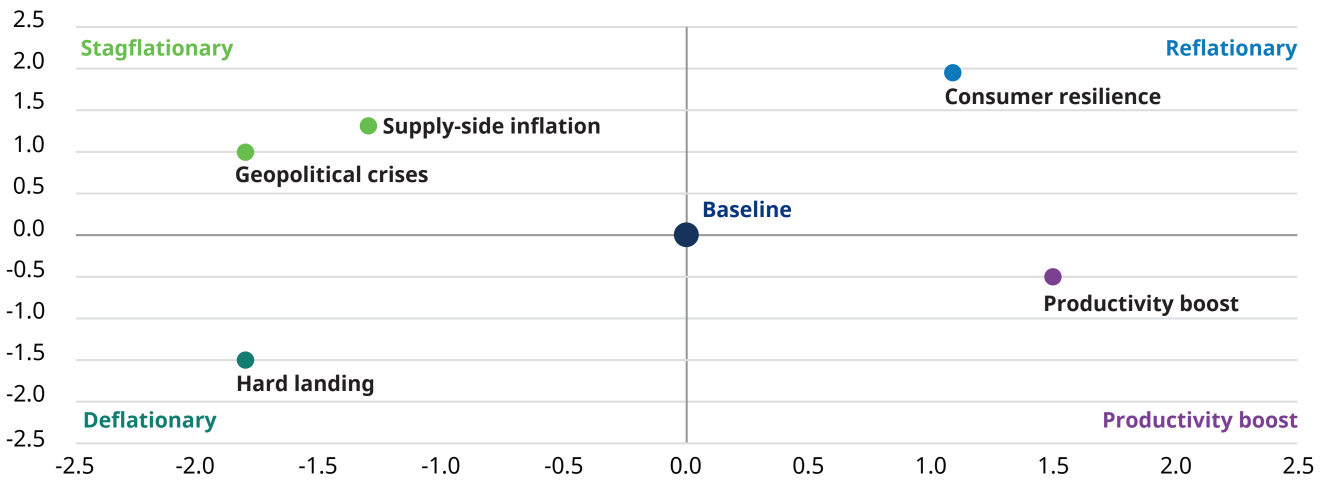
Source: Schroder Economics Group. 21 November 2023.
Please note the forecast warning at the back of the document.

Equally, though, there is a risk that negative supply shocks move the global economy in a more stagflationary direction as tracked by a **supply side inflation** scenario. Recent signs of moderation in labour markets such as the US could prove to be a false dawn and persistently elevated wage growth may cause higher rates of inflation to become ingrained. Finally, **geopolitical crises** could disrupt commodity supplies – particularly of oil – hinder international trade and investment and lead to resurgent inflation. Both scenarios would leave central banks in advanced economies with little or no room to cut interest rates.

Our long-running supply side inflation scenario continues to be assigned a relatively high probability of 10%. This, along with the 7% assigned to the geopolitical crises scenario, means that stagflationary outcomes remain the biggest risk to our baseline forecast.

Scenario grid – growth and inflation deviations from baseline

Cumulative 2023 – 2025 inflation vs. baseline forecast



Cumulative 2023 – 2025 growth vs. baseline forecast

Source: Schroder Economics Group. 21 November 2023. Please note the forecast warning at the back of the document.

Summary of baseline and risk scenarios

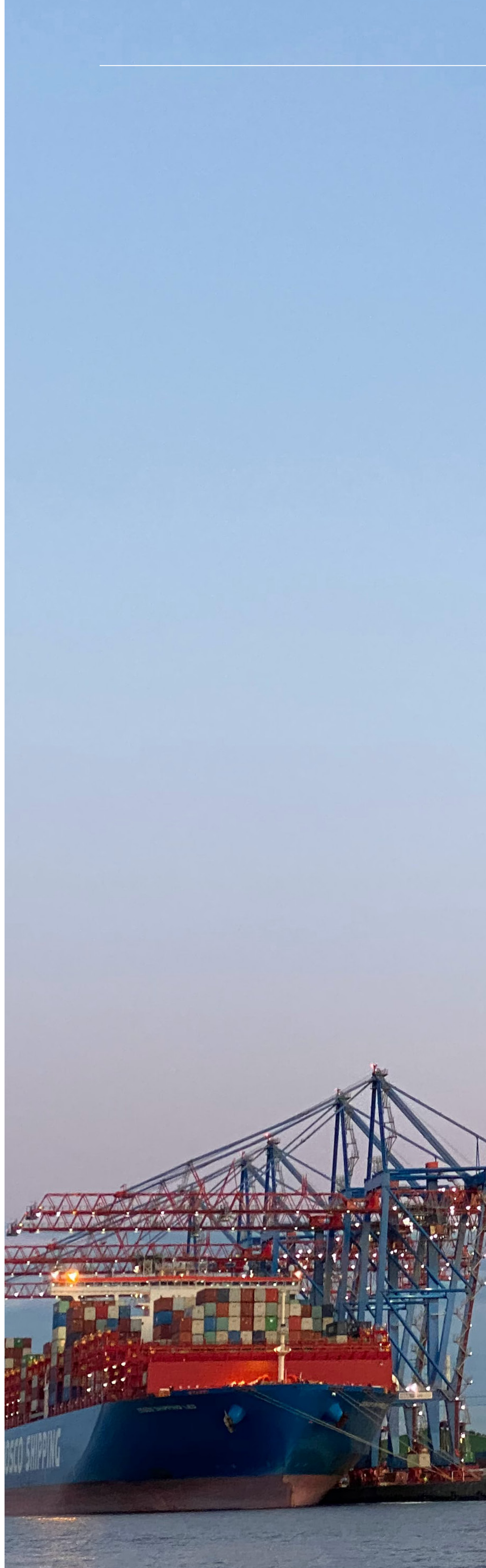
	Summary	Macro impact
Baseline	Global GDP growth is expected to ease from 2.7% in 2023 to 2.2% in both 2024 and 2025. Among advanced economies, growth is forecast to fall from 1.6% in 2023 to 1.0% in 2024 before ticking up to 1.1% in 2025. For the time being, the US economy continues to defy gravity, but we do expect growth to slow as higher interest rates gradually feed through to activity. We also expect the eurozone to have fallen into recession before the end of 2023, with the UK economy probably following suit in the first half of 2024. Meanwhile, emerging market growth is forecast to slow from 4.2% in 2023 to 3.9% in 2024 and 3.8% in 2025. In China, the ongoing bust in the housing market continues to hang over the economy. The authorities have been in loosening mode for some time and further easing is likely as Beijing attempts to manage the end of its housing-led economic model.	We expect global CPI inflation to moderate from 4.4% in 2023 to 2.9% in 2024 before edging up to 3.0% in 2025. Even so, disinflation up until this point has in large part been due to fading commodity price effects rather than a significant easing in underlying, core price pressures. And so the hard yards in getting inflation down to target are still to come. We expect the ECB will be the first major developed market central bank to start cutting rates. We forecast 150bp of rate cuts, starting in Q1 2024, taking the deposit rate down to 2.5% by the middle of 2025. Following not far behind should be the BoE, for which we have pencilled 125bp of easing to 4% by mid-2025. By contrast, we think the Fed will be the last to cut rates. We have pushed back our expectations for the Fed pivot and now expect a first cut in September 2024, with rates eventually falling by 200bp to 3.5% in 2025.
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 5.75% 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 and the consquential 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 below $50/bbl in mid-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 Reduction 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 and step up the pace of quantitative tightening as a consequence.
Geopolitical crises	An escalation of the conflict in the Middle East resulting in higher oil prices as Iran initiates a blockade of the Strait of Hormuz. Brent crude oil climbs above $120/bbl and hovers around that level until the end of 2025. Meanwhile, tensions between the West and China intensify as frustration over the latter's support for Russia's war with Ukraine brings a renewed bout of trade sanctions and tariffs from the US and Europe. The impact is felt directly through higher energy prices and inflation globally and indirectly through its impact on trade and international investment. Capital spending is expected to be weaker as firms reassess supply chains in the light of a deteriorating geopolitical situation.	**Stagflationary:** The result is a more stagflationary outcome for the world economy as higher oil prices push up inflation and weigh on activity. Central banks respond by keeping rates more restrictive relative to the baseline, such that the Fed keeps rates on hold through 2024. However, China is the deflationary exception, with the imposition of trade barriers from the West weighing on growth and domestic inflation. This prompts Beijing to respond by cutting the loan prime rate and the reserve requirement ratio.
Consumer resilience	Excess savings built up during the pandemic continue to be drawn down, such that 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 7% in Q3 2024, while the ECB main refinancing rate reaches 6%. Eventually, higher interest rates cause activity to slow, prompting central banks to start cutting rates.
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:** With companies clinging on to workers, tight labour markets ensure that price pressures endure as wages increase and productivity stagnates. These factors result in inflation proving persistent at above-target rates across much of the global economy. This forces the Fed to raise rates to 6.50%. Other central banks also step up the pace of tightening. Higher inflation, along with tighter monetary policy, chokes off demand leading to economies witnessing below-trend growth and flirting with recessions.

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

Market returns

	Total returns	Currency	December	QTD	YTD
Equity	US S&P 500	USD	4.5	11.7	26.3
	US Nasdaq 100	USD	5.6	14.6	55.1
	UK FTSE 100	GBP	3.9	2.3	7.9
	EURO STOXX 50	EUR	3.2	8.6	23.2
	German DAX	EUR	3.3	8.9	20.3
	Spain IBEX	EUR	0.7	8.2	28.0
	Italy FTSE MIB	EUR	2.1	8.4	34.4
	Japan TOPIX	JPY	-0.2	2.0	28.3
	Australia S&P/ ASX 200	AUD	7.3	8.4	12.4
	HK HANG SENG	HKD	0.2	-3.9	-10.5
EM equity	MSCI EM	LOCAL	3.2	5.6	10.3
	MSCI China	CNY	-2.5	-4.8	-10.6
	MSCI Russia	RUB	-	-	-
	MSCI India	INR	7.9	12.2	22.0
	MSCI Brazil	BRL	5.7	14.6	22.7
Governments (10-year)	US Treasuries	USD	4.2	6.8	3.6
	UK Gilts	GBP	5.7	8.9	6.2
	German Bunds	EUR	3.6	7.4	7.6
	Japan JGBs	JPY	0.6	1.5	1.8
	Australia bonds	AUD	4.0	5.7	4.7
	Canada bonds	CAD	4.2	9.0	5.0
Commodity	GSCI Commodity	USD	-3.3	-10.7	-4.3
	GSCI Precious metals	USD	0.5	11.0	11.5
	GSCI Industrial metals	USD	3.8	0.8	-4.5
	GSCI Agriculture	USD	-3.3	-0.7	-8.3
	GSCI Energy	USD	-5.2	-16.7	-5.2
	Oil (Brent)	USD	-3.7	-18.6	-8.5
	Gold	USD	1.4	11.2	13.8
Credit	Bank of America/ Merrill Lynch US high yield master	USD	3.7	7.1	13.4
	Bank of America/ Merrill Lynch US corporate master	USD	4.0	7.9	8.4
EMD	JP Morgan Global EMBI	USD	4.8	9.3	10.5
	JP Morgan EMBI+	USD	5.2	10.5	10.3
	JP Morgan ELMI+	LOCAL	0.6	2.0	8.2
	Spot returns	**Currency**	**December**	**QTD**	**YTD**
Currencies	EUR/USD		1.2	4.3	3.5
	EUR/JPY		-3.5	-1.4	10.6
	USD/JPY		-4.6	-5.5	6.8
	GBP/USD		0.7	4.4	6.0
	USD/CNY		-0.3	-2.3	2.9
	USD/AUD		-2.8	-5.4	-0.6
	USD/CAD		-2.7	-2.5	-2.7

Source: Refinitiv Datastream, Schroders Economics Group. 31 December 2023.
Note: Blue to red shading represents highest to lowest performance in each time period. Past performance provides no guarantee of future results.



SCHRODERS CIO LENS

Important information

Marketing material for professional clients only. Investment involves risk. This material is for professional investors or advisers only. It is not to be provided to retail clients. Investment involves risk.

Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy.

The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Reliance should not be placed on any views or information in the material when taking individual investment and/or strategic decisions.

Past Performance is not a guide to future performance and may not be repeated.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of investments to fall as well as rise.

Schroders has expressed its own views and opinions in this document and these may change. Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy

Insofar as liability under relevant laws cannot be excluded, no Schroders entity accepts any liability for any error or omission in this material or for any resulting loss or damage (whether direct, indirect, consequential or otherwise).

This document may contain "forward-looking" information, such as forecasts or projections. Please note that any such information is not a guarantee of any future performance and there is no assurance that any forecast or projection will be realised.

This material has not been reviewed by any regulator.

Not all strategies are available in all jurisdictions.

Schroders may record and monitor telephone calls for security, training and compliance purposes.

For readers/viewers in Argentina: Schroder Investment Management S.A., Ing. Enrique Butty 220, Piso 12, C1001AFB - Buenos Aires, Argentina. Registered/Company Number 15. Registered as Distributor of Investment Funds with the CNV (Comisión Nacional de Valores). Nota para los lectores en Argentina: Schroder Investment Management S.A., Ing. Enrique. Butty 220, Piso 12, C1001AFB - Buenos Aires, Argentina. Inscripto en el Registro de Agentes de Colocación y Distribución de PIC de FCI de la Comisión Nacional de Valores con el número 15.

For readers/viewers in Brazil: Schroder Investment Management Brasil Ltda., Rua Joaquim Floriano, 100 – cj. 142 Itaim Bibi, São Paulo, 04534-000 Brasil. Registered/Company Number 92.886.662/0001-29. Authorised as an asset manager by the Securities and Exchange Commission of Brazil/Comissão de Valores Mobiliários ("CVM") according to the Declaratory Act number 6816. This document is intended for professional investors only as defined by the CVM rules which can be accessed from their website www.cvm.gov.br.

For readers/viewers in Switzerland: Marketing material for professional clients and qualified investors only. This document has been issued by Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zurich, Switzerland a fund management company authorised and supervised by the Swiss Financial Market Supervisory Authority FINMA, Laupenstrasse 27, CH-3003 Bern.

For readers/viewers in the European Union/European Economic Area: Schroders will be a data controller in respect of your personal data. For information on how Schroders might process your personal data, please view our Privacy Policy available at www.schroders.com/en/privacy-policy or on request should you not have access to this webpage. Issued by Schroder Investment Management (Europe) S.A., 5, rue Höhenhof, L-1736 Senningerberg, Luxembourg. Registered No. B 37.799.

*Schroders uses SustainEx™ to estimate the net social and environmental "cost" or "benefit" of an investment portfolio having regard to certain sustainability measures in comparison to a product's benchmark where relevant. It does this using third party data as well as Schroders own estimates and assumptions and the outcome may differ from other sustainability tools and measures.

611247

EST. 1804

Schroder Investment Management Limited

1 London Wall Place, London EC2Y 5AU, United Kingdom

T +44 (0) 20 7658 6000

schroders.com

@schroders