# CIO Lens Q2 2024

Marketing material for professional clients only

Schroders

# Contents

# Despite my nostalgia for the 1990s, today's market conditions are very different

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

At the start of this year market trends looked exhausted. The bond market had priced in an aggressive Fed pivot, with several rate cuts predicted for 2024. And equity gains were concentrated in the Magnificent Seven which prompted our neutral stance across equities and bonds. Where have we got to now?

**The challenge currently facing equity markets is that the very concentrated performance has left things looking lopsided. Stock markets have risen to new highs and some of the largest growth companies (such as Nvidia, up 80% in the year to date after a rise of 240% in 2023) have again powered equity markets. Understandably, there has been some concern about the direction of travel. However, a look at valuations under the surface shows that, globally, equity valuations are still quite attractive. Excluding the largest technology stocks, the S&P500 trades around 19x 2024 forecast earnings, in-line with recent history.**

Other markets outside the US are trading at a significant discount to the US and below 15-year medians on most measures. While by no means cheap as a group, even the Magnificent Seven have delivered corporate earnings to support their valuations. We are still a long way from the world of the 1990s internet bubble when investors spoke about "price to clicks" in the absence of any corporate earnings. Although I am prone to nostalgia for the 1990s, today's conditions are different, and we do not believe that equities are expensive.

Looking at relative valuations within equity markets, we are staying neutral on mega-cap stocks, because we lack the catalysts to move underweight the Magnificent Seven and, in any case, we believe that treating those seven stocks as a block under-estimates the very different business drivers between the individual companies. The dynamics behind the growth at Amazon, Google and Microsoft are very different to Apple or Tesla. We prefer to rely on our stock-pickers to cope with the idiosyncratic risks in each case. But we are now responding to the more attractive valuations outside the US by extending our equity exposure from the US to the rest of the world. We've liked Japan for some time due to its stimulative monetary policy and an ongoing cultural shift toward improved capital allocation and shareholder returns.

A global manufacturing recovery is supportive of stocks in Europe, Asia, and Emerging Markets. There is also a window where falling inflation justifies rate cuts in the US and Europe, which is helpful to valuations and many emerging economies have already started to loosen monetary policy. Pleasingly, we have seen some broadening of market performance with 44% of stocks outperforming MSCI World All Countries compared to 34% in 2023. The environment may get more challenging as the year progresses, if central banks fail to meet their inflation targets, but for now we remain positive on equities.

*We are still a long way from the world of the 1990s internet bubble when investors spoke about "price to clicks" in the absence of any corporate earnings.*

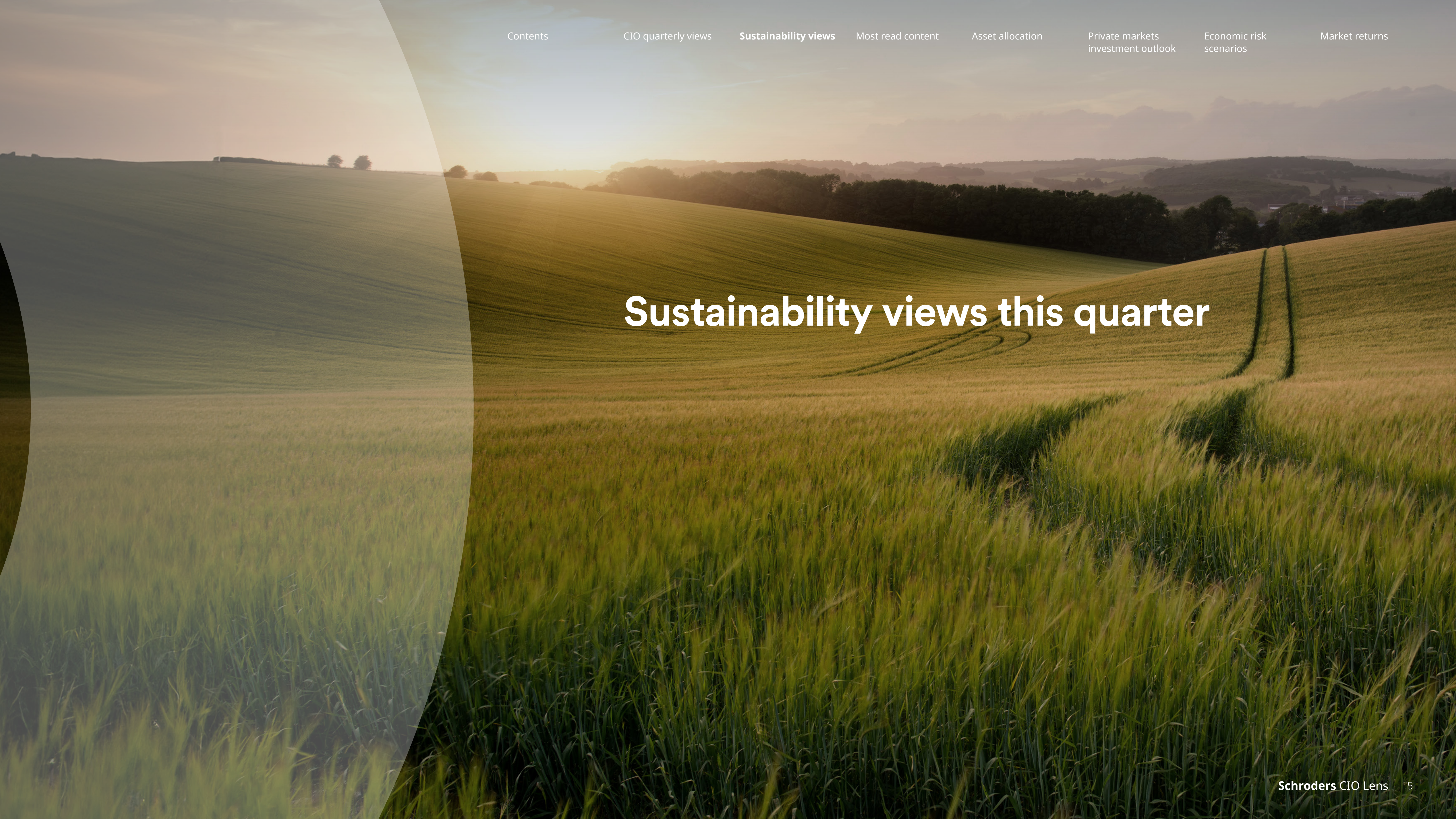
Turning to bonds, ongoing resilience in US data has led to a repricing of rate expectations in the US bond market which now more closely aligns with our view of a soft landing. Valuations have improved but given that we still don't expect an imminent recession in the US, we retain a neutral stance. Our exposure to fixed income remains focused on generating income, rather than expecting a return to a negative correlation with equities or significant price appreciation. We still like gold, in spite of recent price rises, because it should benefit as central banks start to ease and also offers protection if inflation proves to be sticker than expected.

Lastly, a word on political risk. Geopolitical tension is an unfortunate constant and there is a lot of talk of all the political elections this year. Geopolitical events are very difficult to position for because their timing is almost impossible to predict. The only true defence is to be diversified in your allocations by geography and asset class and, from a corporate perspective, to review the resilience of global supply chains.

The timing of elections is obviously known but I would argue that we can over-emphasize their importance. We have already seen a shift in the political consensus, towards greater fiscal intervention and protectionism which will remain in place irrespective of electoral outcomes. As mentioned in our 3D reset, this contributes to a deterioration in the growth and inflation trade-off which means that we are very unlikely to go back to a world of zero interest rates. It also means that we need to reconsider sovereign risk as bond investors react to more fiscal spending. This again is very different to the 1990s when a focus on fiscal rectitude structurally reduced bond market risks. Politics matter but they tend to play out over months and years rather than days.

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

*Politics matter but they tend to play out over months and years rather than days.*



# Sustainability views this quarter

# The value of climate collaboration: our approach to industry initiatives

**Andy Howard**
Global Head of Sustainable Investment

**We have long argued that climate change represents an inevitable and unavoidable challenge and opportunity that will disrupt economies, industries, and investment portfolios. It is a systemic risk that requires – and is receiving – significant attention. Countries representing around 90% of the global economy and companies comprising around half of the value of the MSCI ACWI global benchmark have committed to reaching net zero in coming decades.**

In tandem, the number and membership of investment industry initiatives focused on climate change have grown in recent years, as the issue has moved firmly into the mainstream of the investment agenda.

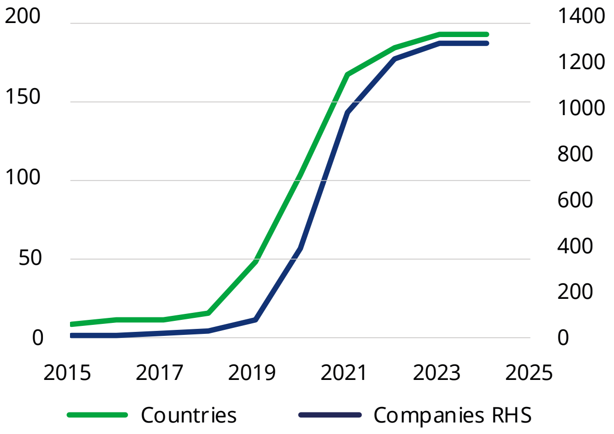
In recent weeks, those industry groups have come under renewed scrutiny. Most recently, several large institutions have left or limited their engagement in Climate Action 100+ (CA100+), an initiative launched in 2017 that had reached 700 members responsible for $68 trillion at the end of 2023 – equal to roughly two-thirds of the asset management industry's total AUM[1] – according to its website.

Schroders is a member of CA100+ and we have no plans to exit. In general, we apply simple principles to our decisions over the initiatives we join:

- Our investment views drive the actions we take, including joining and remaining members of industry initiatives. Those initiatives do not determine either our views or actions; we do not sacrifice investment integrity to any external initiative.
- We join groups if their objectives and actions are aligned with our fiduciary duty and view of how we can most effectively manage the assets our clients entrust to us, and where we believe membership lawfully enhances our ability to meet our clients' long-term financial objectives.
- If initiatives' priorities become inconsistent with our goals, we will reconsider our membership.

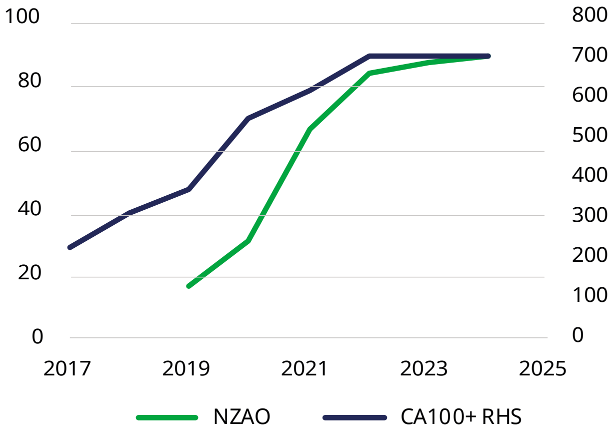
We believe strong financial returns and meeting climate commitments go hand-in-hand. Our own climate transition plan[2] plots our firm's path to aligning our business and the portfolios we manage toward the net zero global economy to which the large majority of the global economy has committed, in our pursuit of maximising long-term value for our clients. Our emphasis is on supporting and encouraging transition by the companies and assets we invest in, supported by our firmwide commitment to engagement, and enabling our clients to benefit from the enhanced value that can be unlocked by such activity.

**Number of countries and companies committed to reaching net zero emissions**




Source: Net Zero Tracker, Schroders analysis

**Number of signatories to Net Zero Asset Owner Alliance and CA100+**



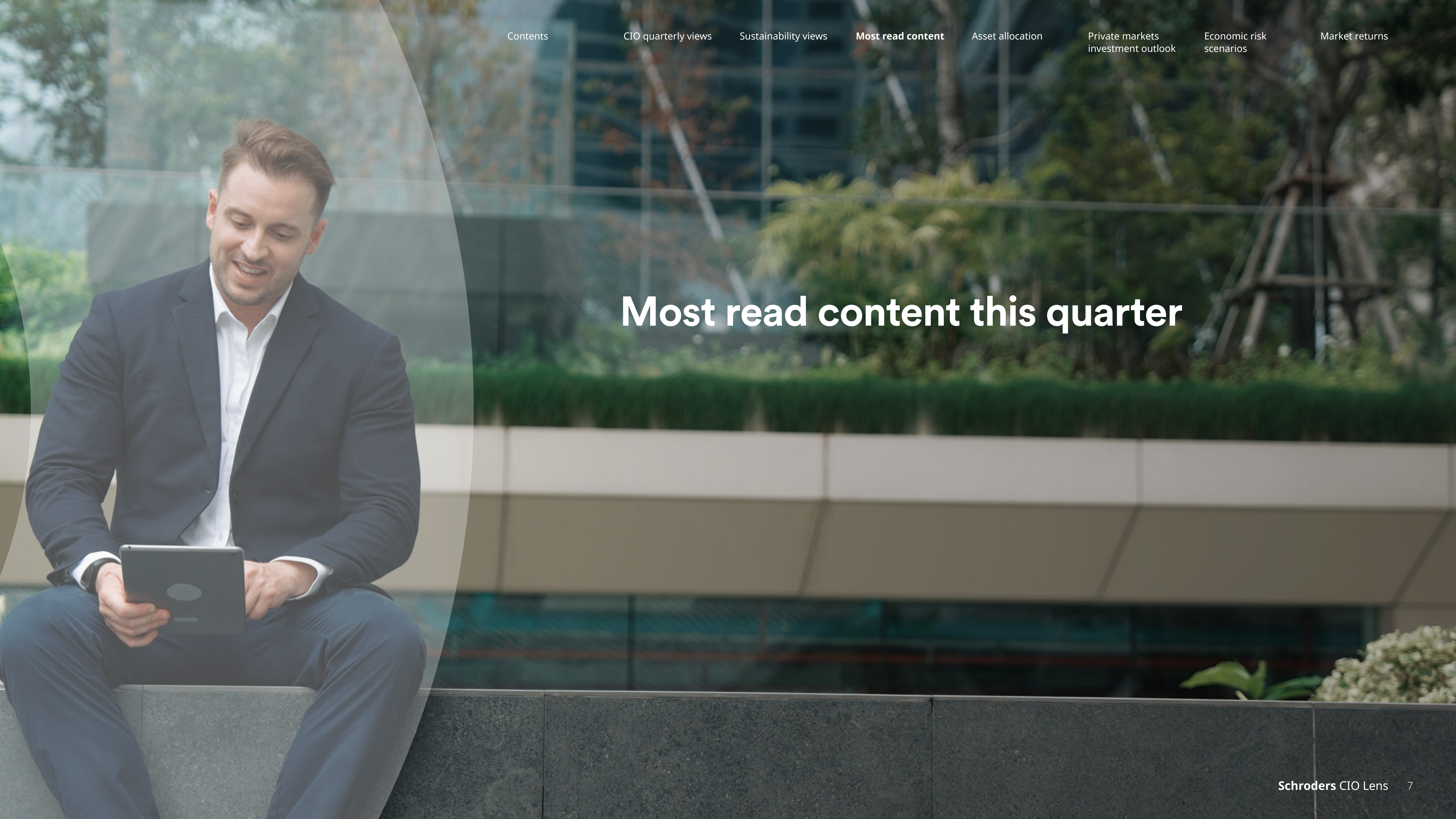

Source: Net Zero Asset Owner Alliance website, CA100+ website, Schroders analysis of archived web pages and historical CA100+ annual reports

We have found that companies able to cut their emissions most quickly have outperformed over the last five years[3], and against a backdrop of increasingly visible physical threats and growing pressure for action, see no reason to expect those drivers to change.

Our own engagement has proven rewarding[4], but we also believe we can help serve the interests of our clients by considering policy developments, broader societal expectations and physical risks and economic costs associated with climate change through participation in industry initiatives. We will not agree with fellow members on every issue, or on the appropriate steps to take where engagement does not yield the results we hope for, which is inevitable in an organisation as diverse as CA100+. We will determine our own actions independently in those cases.

Similar principles apply to other initiatives of which we are members, while we have declined to join groups which fall short of those requirements.

1. Total asset management industry AUM from BCG, 2023
2. Schroders Climate Transition Action Plan
3. Companies which have reduced carbon intensity in the top quintile of their sector over the last five years have outperformed those in the worst quintile of change by c4% pa
4. See Schroders Climate Report, which includes a summary analysis of our engagement experience including the finding that companies we have engaged in the MSCI ACWI IMI index since 2021 have proven twice as likely set new emissions targets, have cut emissions twice as quickly and have outperformed by 4% annually compared to companies in that index we did not engage on climate topics.



# Most read content this quarter

# Most read content this quarter

**Masaki Taketsume**
Fund Manager, Japanese Equities

## Where next for Japanese equities after record high?

*Robust corporate fundamentals, improved governance standards and increasing demand from foreign investors have all contributed to the stock market's robust performance. A key question for investors now must be whether the market can continue to advance.*

**Read the full article here.**

**Duncan Lamont**
Head of Strategic Research

## Scared of investing when the stock market is at an all-time high? You shouldn't be.

*While many investors may feel nervous about the potential for a fall, our analysis of stock market returns since 1926 shows that investing at a new high can be profitable.*

**Read the full article here.**

**Tim Goodman**
Head of Corporate Governance

## Annual shareholder meetings need a shake-up, but how?

*Shareholder meetings are often uninspiring, but they are essential for shareholder democracy. We consider how they could be revamped to better serve the needs of all stakeholders.*

**Read the full article here.**

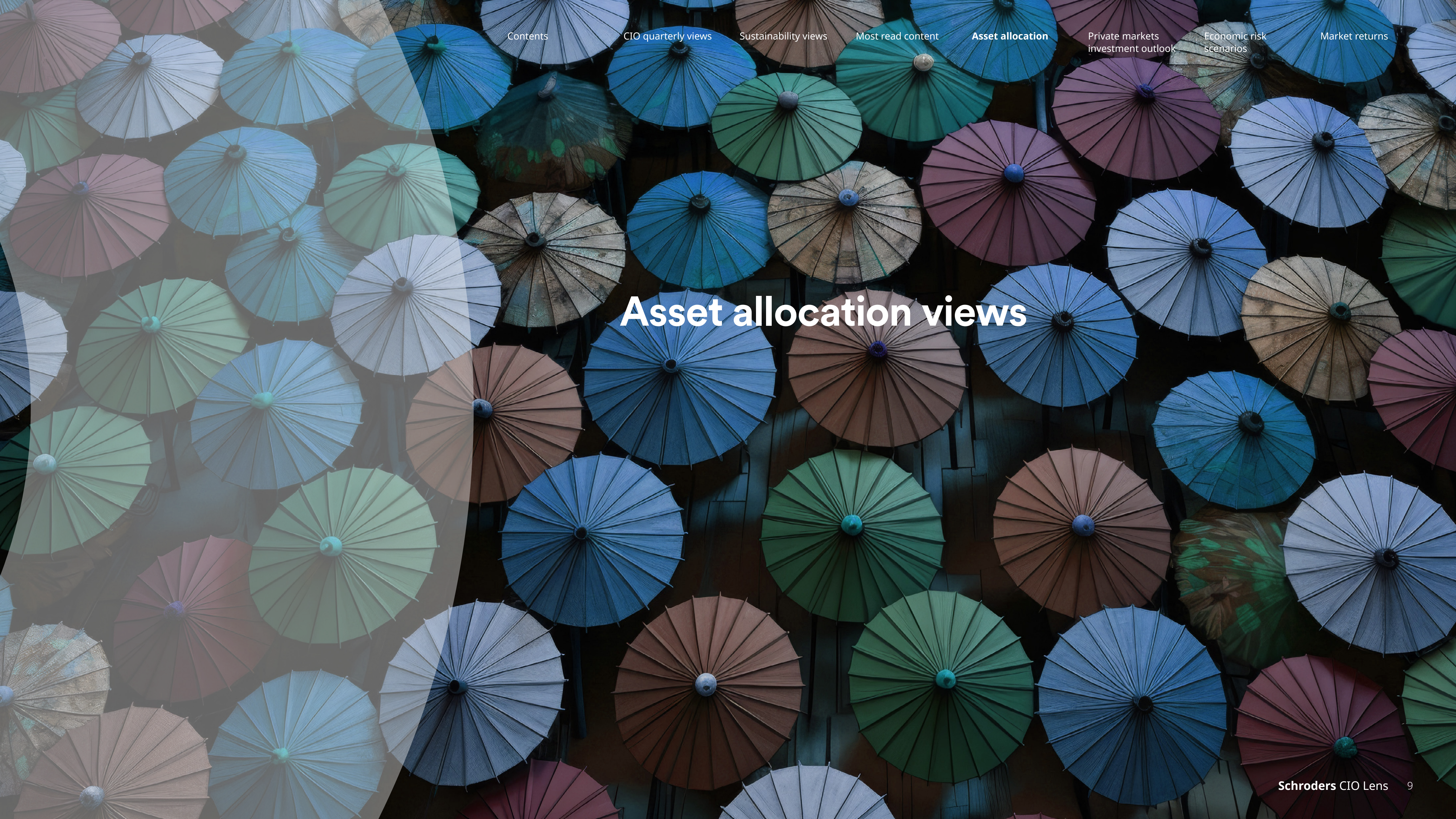
**Karen Wright**
Associate Investment Director, Global Unconstrained Fixed Income

**Michael Lake**
Investment Director, Fixed Income

## Could short-dated bonds provide an attractive alternative to cash?

*Is it time to trade your cash for short-dated fixed income? The shift could be a multi-decade opportunity for savvy investors.*

**Read the full article here.**



# Asset allocation views

# Overall asset allocation views

## 31 March 2024

Short/negative    Neutral    Long/positive    Previous score

### Equities

**Overall view:** Although we continued to anticipate a soft-landing, we began the period neutral on equities because we believed that the markets were already accurately pricing in a soft-landing. As the quarter progressed the continued upside surprises to US growth without any spikes in inflation meant there was the potential for equity prices to rise further and so we upgraded our view to positive. This sentiment continued into quarter end, with our preference being to hold a broadly diversified mix of global equities.

### Credit

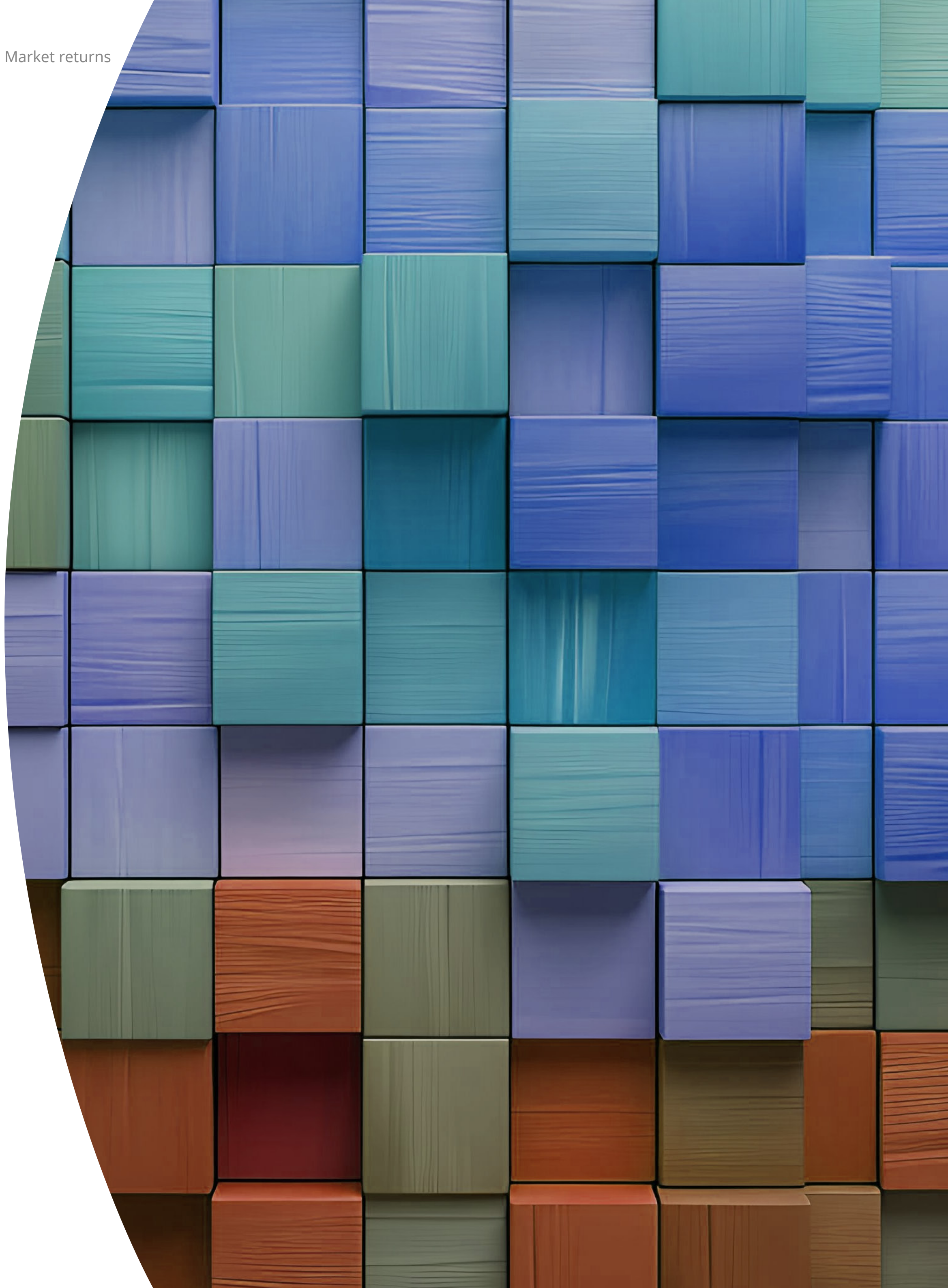
**Overall view:** We remained neutral over the quarter, during which we saw a tightening in spreads that left valuations looking extremely stretched. In the US in particular, the flattening of the curve means US investment grade bonds now offer little value relative to cash. However, supportive supply and demand dynamics allied with strong fundamentals broadly offset the expensive valuations, keeping us neutral.

### Government

**Overall view:** We maintained a neutral score over the quarter. Expectations of the timing of rate cuts are now more realistic compared to the beginning of the year but, in the case of US bonds in particular, valuations are not cheap enough to offset the negative carry.

### Commodities

**Overall view:** We maintained a neutral view over the quarter due to strong supply side dynamics and moderate levels of growth. We did, however, upgrade our outlook on gold to positive at the start of the quarter, on the anticipation of a normalisation in real rates when central banks start to ease. Additionally, continuing strong demand from Asian central banks and households more than offsetting sales from other regions supports our positive view.



# Regional equity views

## Equities

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

### US

Even though we started the period with a neutral view, we did recognise that the macro environment was favourable. We upgraded our view to positive in February, with the continued buoyancy of the labour market and positive inflation news motivating the change. We maintained this view through to the end of the quarter as sentiment further improved with the Federal Reserve confirming its intention to implement three rate cuts this year.

### Europe

Although equity prices appeared attractive at the start of the year, we remained concerned about the prospects for European growth. This meant we started with a neutral view, but in February we upgraded that view to positive as manufacturing data showed signs of bouncing off its 2023 lows. We maintained this view for the remainder of the quarter.

### China

We have maintained a neutral standpoint as a fragile property sector and insufficient stimulus from the People's Bank of China have been counter-balanced by cheap valuations and some signs of recovery in the global goods cycle.

### Emerging Markets

With no obvious catalyst to mitigate the weak outlook on China, we have remained neutral.

### UK

Despite acknowledging the marginally improving economic conditions in the UK, the difficult balance facing the MPC between managing inflation and not stunting growth meant we started the period with a neutral view. We have maintained this position throughout the quarter, with the rationale largely unchanged and a view that there were more attractive opportunities in other equity markets.

### Japan

Early in the new year, the backdrop in Japan was one of strong economic fundamentals and positive earnings growth. However, concerns about the impact of any strengthening in the yen meant we were neutral. Nevertheless, we did upgrade this view to positive in February in line with our more positive view on equities globally.

### Asia ex. Japan

The recovery in the global manufacturing sector should benefit Taiwan and Korea, which when coupled with AI and semi-conductor demand resulted in us upgrading our view to positive in February, which was unchanged through quarter end.

# Fixed income views

## Bonds and Credit

Short/negative Neutral Long/positive Previous score

### Government

Since the beginning of 2024, we have seen ongoing resilience in US data as the labour market has remained buoyant, which has led to a repricing of rate expectations in the US bond market. This is now more closely aligned with our view of a soft landing. We continue to expect further modest softening in growth and inflation over the coming few months. Despite US 10-year bonds now yielding 4.33% and starting to approach more attractive levels, we decided to stay neutral through the end of the quarter as valuations are not cheap enough to offset the negative carry.

In the UK, we upgraded our view to positive in March as Gilts appeared to have been unduly caught up in the sell-off in US Treasuries. UK services inflation is expected to soften, which should further support the case for rate cuts.

In Europe, despite a fall in inflation, wage pressures have remained elevated. We remain neutral on Bunds, mainly because the European Central Bank (ECB) has provided clear guidance that it expects to start cutting rates in June, which is already reflected in market pricing.

### Inflation linked

We upgraded to positive in January. This sector has continued to offer a hedge against the risk of an uptick in inflation later in the year when favourable base effects are expected to subside.

### EMD Local

Our view remained unchanged over the quarter as we continued to believe that a soft landing would be supportive of a weaker US dollar and therefore EM bonds. However, given the resilient US data and the risk of delayed rate cuts, we prefer to remain neutral.

### EMD Denominated in USD

Valuations have continued to appear expensive. However, during the quarter, fundamentals have been strong and all-in yields attractive, meaning we are now positive.

### Investment Grade

(US) (EU)

We maintained a neutral score over the period. Further spread tightening at the beginning of the year following dovish comments from the Federal Open Market Committee left US IG valuations expensive. In Europe, we believed that investors were not being adequately compensated for the credit risk as a soft-landing scenario was already priced in. As the quarter has progressed, we recognised that European credit offered slightly better value compared to the US, but investors are currently more focused on all-in yields rather than spreads and so we have remained neutral.

### High Yield

(US) (EU)

We downgraded US high yield in January as spread levels at that time implied that valuations were extremely stretched. This score has remained unchanged over the quarter. Towards the end of the period, we upgraded European high yield debt to positive. While European valuations have been relatively attractive for a while, concerns about the economic outlook had previously kept us neutral.

# Commodities views

Short/negative Neutral Long/positive Previous score

## Commodities

We maintained a neutral view over the quarter due to strong supply side dynamics and moderate levels of growth. We did however upgrade our outlook on gold to positive at the start of the quarter, on the anticipation of a normalisation in real rates when central banks start to ease. Additionally, continuing strong demand from Asian central banks and households more than offsetting sales from other regions supports our positive view.

During the quarter, we maintained a neutral stance on energy. Although OPEC+ renewed their commitment to extend production cuts into the second quarter, compliance with these cuts has been tenuous to date. Additionally, there has been an increase in non-OPEC supply to the market.

We upgraded our outlook on gold to positive at the start of the quarter as we expected real interest rates to normalise when central banks begin to ease monetary policy later this year. Additionally, gold provides some protection against the risk of inflation picking up again towards the end of 2024, and prices should be well supported given the strong demand from investors in Asia.

The agriculture sector has been experiencing a growing divide. On the one hand, Brazil's abundant grain harvests have resulted in high stock-to-use ratios, while the prices of soft commodities such as cocoa have increased due to supply constraints caused by heavier-than-anticipated rainfall. We therefore retain our neutral score. Similarly, we have remained neutral on industrial metals. Supply has continued to be tight with further downgrades to copper production this year. But the lack of demand growth, primarily from weakness in China, has offset the supply constraints leaving us with no reason to be positive or negative.

# Private markets investment outlook

# Private Markets Investment Outlook Q2 2024

## A new investment environment

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

*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.*

**Private markets are entering Q2 2024 with a reshaped investment landscape. The normalisation of fundraising and valuation adjustments for specific strategies have set the stage for promising investment opportunities. Investments that align with the global 3D Reset theme and the ongoing AI revolution are particularly appealing. Additionally, the potential further easing of inflation and anticipated interest rate cuts can create short to mid-term tailwinds. Yet, with continuing political tensions both within and between countries and escalation risks for ongoing conflicts, diversification within private market allocations remains key.**

As we approach Q2 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. However, in 2023, fundraising remained concentrated on large funds, which is one of the reasons why we see more attractive opportunities for small and mid-sized private market strategies. This is especially the case for private equity, where buyout fundraising for large funds reached record levels while the rest of the market stayed at healthy levels.

Historically, fundraising has served as a valuable contrarian indicator. This is because most private market strategies are closed systems where fundraising levels and dry powder directly influence entry valuations and, in turn, impact vintage year return expectations.

We find private market investments that align with the 3D Reset (decarbonisation, deglobalisation, demographics) and the AI revolution particularly attractive. For instance, in infrastructure, the energy transition segment stands out due to the push for decarbonisation and concerns about energy security. Its strong correlation with inflation and secure income traits further contribute to this asset class's growth.

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 may be attractive years for new investments.

While our private market investment outlook is generally positive, 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 Q2 2024

## A new investment environment

### Private equity

In 2023, buyout fundraising, propelled by larger funds, reached a record high, while growth and venture fundraising have not yet recovered to pre-Covid levels. A sustained decline in deals and exits led to lower buyout valuations.

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 favour 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. Small and mid-sized buyouts also have an additional exit strategy — selling their portfolio companies to larger buyout funds.

Co-investments are attractive as they address a critical need in capital structures, especially as banks have withdrawn from the lending market and deal leverage has reduced. Deals involving structured equity and preferred equity can present particularly beneficial risk-return profiles.

We anticipate GP-led transactions will excel in the current exit-stressed market. Single-asset GP-led investments, often centred on standout portfolio companies, are particularly intriguing. These transactions can offer shorter holding periods and higher upside potential with lower loss ratios than traditional LP-led secondaries.

We believe seed and early-stage venture will be a driver of the current wave of AI innovation, disruptive energy technology, and biotechnology. Early-stage investments benefit from a disciplined fundraising environment, which results in more conservative entry valuations. Late-stage or growth investments face higher refinancing and valuation risks due to a drop in venture capital fundraising and a yet-to-reopen IPO window.

Regionally, North America, Western Europe, China, and India are appealing. We view India's private equity market as particularly 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 has become 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.

With banks, especially in the US and Europe, retreating, there's a significant risk premium available beyond rates. 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, such as 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, such as microfinance.

Our focus is on fundamentals rather than distressed assets. We prefer areas where distress has created emotional bias in otherwise healthy asset sub-sectors, avoiding areas with unresolved fundamental challenges.

With many syndicated markets rallying in Q4, yield spread premiums have significantly reduced, even in previously cheaper liquid markets like CLOs (collateralised loan obligations) and ABS (asset-backed securities). Today, most liquid markets are historically tight in terms of risk premium. Only Agency MBS (mortgaged-backed securities) and non-syndicated MBS/ABS as well as specialized sectors, such as insurance-linked securities, offer value.

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

## Infrastructure

In the realm of infrastructure, we find the energy transition segment particularly compelling due to its strong correlation with inflation and secure income traits. It also aids in diversification through its exposure to distinct risk premiums, such as energy prices.

The push for decarbonisation, coupled with growing concerns about energy security and the need to reduce dependency on fossil fuels, further amplified by the ongoing conflict in Ukraine, benefits 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. These macro trends support the future growth of this asset class.

Currently, with a base of approximately €600 billion installed in Europe, renewable energy accounts for 40 – 45% of infrastructure transactions. Projections suggest that by the early 2030s, renewables could more than double to €1.3 trillion. This suggests that in the future, renewables, and more broadly, infrastructure related to the energy transition, could make up the majority of investable assets within the infrastructure 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.

At present, there is a significant gap between the high volume of renewable projects and the limited capital investment. This, combined with rising interest rates, has led to a re-evaluation of expected returns, rendering the current market environment an attractive entry point, especially for core/core+ strategies. Simultaneously, the asset class has demonstrated resilience as the link to inflation and exposure to merchant price have bolstered the strong performance of existing portfolios in 2023.

## Real Estate

The real estate market has been experiencing value corrections, with varying degrees of adjustment across different regions, sectors, and investment structures. This presents an opportunity for sequential access to attractive repricing. Our proprietary valuation framework suggests that 2024 and 2025 will be opportune years for real estate investment.

Occupational markets remain robust, with expected growth in most real estate sectors, particularly those with structural support. Despite softer demand, tight supply conditions due to increased construction and debt finance costs maintain sustainable rental income levels. The lack of high-quality ESG-compliant spaces will stimulate rental growth post-economic recovery.

Opportunities are emerging from debt capital market illiquidity, including those requiring capital solutions for balance sheet adjustments. Refinancing waves are anticipated to accelerate these opportunities amid further price discovery in 2024.

Immediate opportunities are present in markets with rapid repricing, such as the UK and Nordic region, followed by the US and other Continental European markets. In Asia-Pacific, cyclical opportunities are attractive that align with China's delayed recovery or nearshoring/friendshoring of supply chains.

Industrial and logistics assets have rebased to attractive price points in most submarkets, backed by strong fundamentals. We favour operational properties with strong demand-side tailwinds and direct or indirect inflation-linked income potential.

The current environment reinforces our focus on operational excellence for 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: rising geopolitical risk

**In addition to the baseline forecast, the Schroders Economics Group produces a set of risk scenarios designed to examine the impact of potential events and risks around some of the underlying assumptions made in the forecast. The criteria for inclusion is that the risk must be expected to at least become a concern to investors, and therefore is reflected in financial markets in the next six months.**

The scenarios are summarised in the chart below, where the cumulative difference in GDP growth between now and the end of the forecast horizon is shown for each scenario along the horizontal axis, and the cumulative difference in CPI inflation is shown on the vertical axis. Therefore, scenarios in the top right quadrant are classified as reflationary versus the baseline forecast owing to higher growth and inflation, whereas scenarios in the bottom left quadrant are deflationary, and so on.

In this quarter's update, we have attempted to capture the growing concerns over geopolitical risk.

Previously, the stagflationary **'Geopolitical crises'** scenario attempted to model several potential flare-ups, including an escalation of the conflict in the Middle East as well as rising tensions between the West and China. This scenario has been replaced with one that exclusively focuses on the former, and two more that target other concerns.

The new **'Middle East war'** scenario assumes that the localised fighting in Israel spreads across the region, which also drags Western nations into the conflict. The war is assumed to not only disrupt key shipping channels but also the supply of oil, causing wholesale prices to spike towards $150 per barrel.

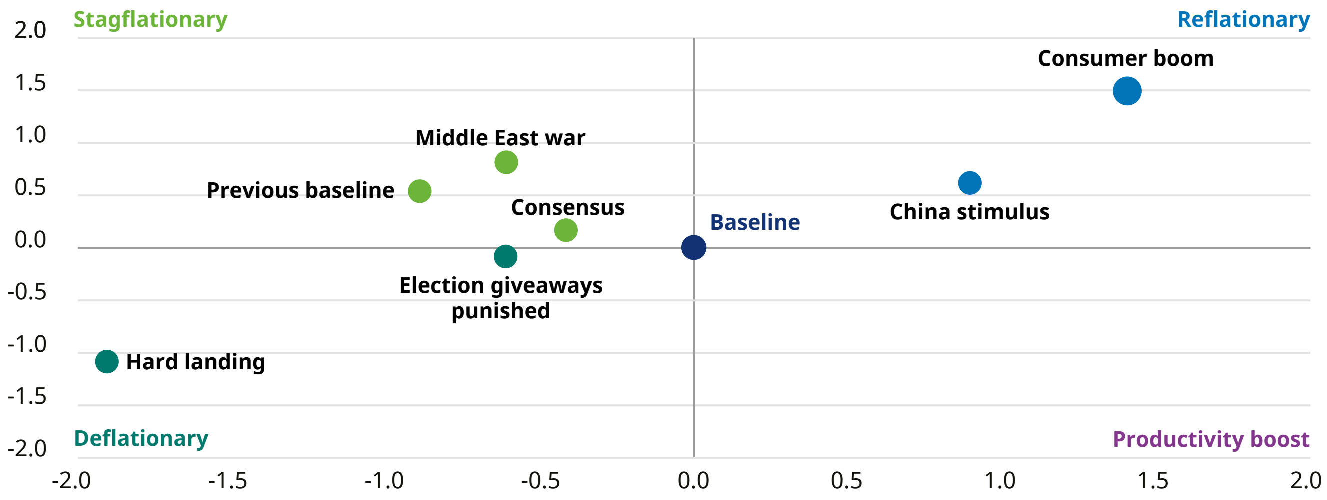
The macroeconomic impact is likely to be stagflationary for the global economy.

With 59% of democratic populations going to the polls this year, representing 43% of world GDP, the political risk brought about by elections is also high on the list of concerns. The most important of all will be the US election this November, where a return of former president Donald Trump is expected by many investors to lead to renewed fiscal stimulus.

The US's large fiscal deficit would probably make this difficult, but what if the two candidates throw caution to the wind and engage in an ever-escalating bidding war of fiscal giveaways? To explore this, we have introduced the **'Elections giveaways punished'** scenario, where the current administration finds a way to increase spending just before the next election (temporarily boosting growth), but further promises of giveaways from both sides scare investors over the increase in future indebtedness. Bond vigilantes return in force worldwide, punishing profligate governments, and those that had been vulnerable in the past. Yields rise sharply, causing future borrowing costs to explode.

The third government driven scenario is more positive for investors. This is the new **'China stimulus'** scenario. Weaker activity data at the start of this year coupled China's annual rate of inflation falling below zero prompts authorities to inject substantial fiscal stimulus in order to boost demand. Higher growth in the region follows, although the spillover to advanced economies is limited. Commodity prices rise in response to stronger demand, contributing to higher global inflation.

**Scenarios grid – growth and inflation deviations from baseline Cumulative 2024–2025 inflation vs. baseline forecast**



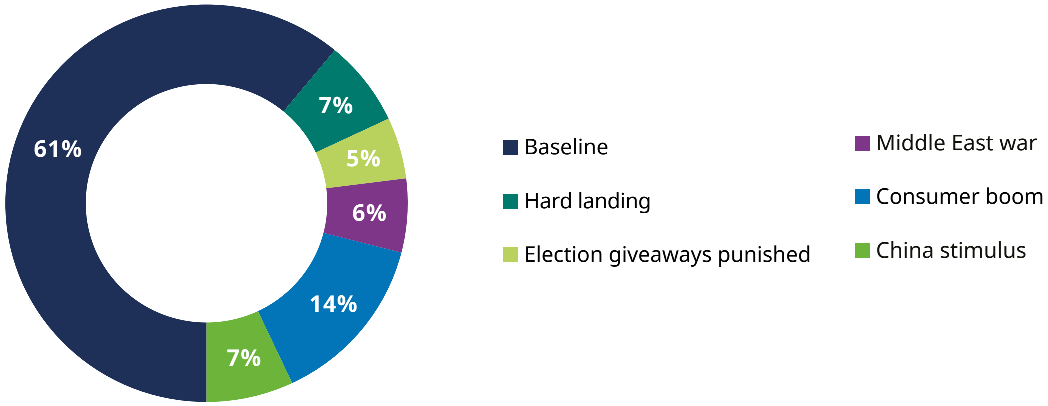

Source: Schroders Economics Group. 23 February 2024. Please note the forecast warning at the back of the document.

# Economic risk scenarios: rising geopolitical risk

The remaining two scenarios focus more on uncertainties around the impact of monetary policy, and the behaviour of households. The **'hard landing scenario'** has been retained and reflects the risk that monetary policy typically works with long and variable lags. The cumulative effect of tighter monetary policy has a larger impact in this scenario compared to the baseline, prompting households and firms to cut back spending aggressively, tipping many economies into recession (and deepening those already in one).

The final scenario is an update of our previous 'consumer resilience' scenario, where households continue to use excess savings built-up during the pandemic to grow their spending. Despite the upgrade to the baseline forecast, we feel there is still room for household consumption to surprise to the upside, especially in Europe where those pandemic savings are mostly still intact. Therefore, to better reflect the status and risk to the baseline, we have renamed the scenario **'Consumer boom'**.

### Scenario probabilities




Source: Schroders Economics Group. 23 February 2024. Probabilities are mutually exclusive.

## Summary of baseline and risk scenarios

| | Summary | Macro impact |
|---|---|---|
| **Baseline** | Global GDP growth has been revised higher this year from 2.2% to 2.6%. Most regions have seen some upgrades, but the biggest contributor came from the US economy. The global forecast for 2025 has also been revised up, from 2.2% to 2.7%, again, mostly on the back of upgrades to the US outlook. US GDP growth for 2024 has been upgraded from 1.3% to 2.7%. Growth in the US is then expected to slow to 1.9% over 2025. Meanwhile, growth in the eurozone is forecast to rise from 0.5% in 2023 to 0.7% in 2024 and 1.8% in 2025. By comparison, UK GDP growth for this year has been lowered to -0.2% but raised from 0.7% to 1% for 2025. Stronger growth in developed markets, particularly the US, is likely to have some positive spill over to the emerging markets. We now expect EM GDP growth of 4% both this year and next, up from 3.9% and 3.8% respectively. The outlook for the global economy is looking brighter. Global GDP growth in the new Schroders forecast has been revised up from 2.2% to 2.6% for 2024 and from 2.2% to 2.7% for 2025. Meanwhile, global inflation is forecast to slow from 4.4% in 2023 to 2.9% in 2024 (unrevised) and to 2.5% in 2025 (revised down from 3%). | The global inflation forecast for 2024 remains unchanged. Inflation is projected to moderate further from 4.4% in 2023 to 2.9% for this year. The reduction to the emerging markets inflation forecast has been offset with a small upward revision for advanced economies. Inflation is forecast fall further to 2.5% in 2025 driven mainly from the emerging markets. We still expect the ECB will be the first major developed market central bank to start cutting rates as soon as March by 25bps, with a further three cuts to follow this year. Meanwhile, the first cut in UK interest rates is forecast for May followed by another in June with rates falling to 4.25% by the end of 2025. In the US, the Federal Reserve is expected to start cutting rates from June. The baseline forecast has a total of three 25bps cuts this year, and one further cut in March 2025, As inflation continues to fall, central banks have started to change the tone of their communication. References to upside risks for interest rates have largely been removed, while discussions of downside risks have remained. Expectations are building that interest rates will be lowered as we progress through this year, but there are still questions over how much easing will follow. |
| **Hard landing** | The long and variable lags of monetary policy finally come to the fore as the cumulative effect of past aggressive interest rate hikes hit domestic demand hard across developed markets from Q2 onwards, particularly in the US where GDP falls by a cumulative 2%. Evidence of deep recessions that will alleviate labour market and price pressures see central banks pivot quickly to easing mode, front-loading cuts in interest rates to expansionary levels. The Fed cuts to 2%, with rates in the eurozone and UK falling to 2% and 1.75% respectively, leading to some recovery towards the end of the forecast horizon. Weaker global growth snuffs out any recovery in China's manufacturing sector, adding to problems in the housing market. | **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 Q3 2024. As a result, headline rates of inflation fall further than in the baseline, with calendar year averages about 0.5 percentage points below target in most developed markets in 2024, while China slips into outright deflation. |
| **Election giveaways punished** | Bond market investors take umbrage at pre-election give-aways ahead of elections in the US and UK, at a time when leading candidates fail to deliver credible plans to tackle dreadful fiscal positions further down the line. Bond yields spike in the third quarter as elections near. Tighter financial conditions, that are buttressed by central banks being forced into rate hikes to calm financial markets, deliver an immediate hit to growth in late-2023. Central banks are also forced to restart QE. Market pressures force newly-elected governments to deliver austere budgets in 2024, resulting in a significant decline in growth that eventually allows some rate cuts later in the year. | **Deflationary:** Pre-election sweeteners initially push the global economy in a reflationary direction, notably in the US. However, tighter financial conditions and austere financial conditions reverse those trends, resulting in both growth and inflation falling below our baseline projections in 2025. |
| **Middle East war** | The outbreak of war in the Middle East where localised fighting in Israel spreads across the region, which 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 until late-2025. Conflict in the region means that disruption to shipping routes through the Red Sea continues and delivers a general shock to confidence. Flight to safety causes the US-dollar to appreciate. | **Stagflationary:** The surge in oil prices passes 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 50bp higher than in the baseline forecast before falling more significantly in 2025. 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. Meanwhile, the fading effects of the regional banking crisis clear 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 prices 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. |
| **China stimulus** | A weak start to 2024 that causes China to slip deeper into deflation forces the authorities to change tack and deliver a substantial fiscal stimulus in order to boost demand. The proceeds of large government bond issuance are used to fund infrastructure projects, investment in green technology and high-tech manufacturing along with some support for consumption. Beijing also delivers some measures to stabilise the housing market but resists the temptation to restart mass real estate construction. | **Reflationary:** Stimulus measures lead to significantly faster growth in China's economy, but the spill-overs to the rest of the world are fairly narrow. Expectations of stronger demand lift commodity prices, supporting those (largely emerging market) economies that export natural resources. But while other economies receive some benefit from stronger Chinese demand, higher commodity prices also cause inflation to be a bit higher than in our baseline meaning that interest rate cuts are marginally less aggressive than in the baseline. |

*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 | March | QTD | YTD |
|---|---|---|---|---|---|
| Equity | US S&P 500 | USD | 3.2 | 10.6 | 10.6 |
| | US Nasdaq 100 | USD | 1.2 | 8.7 | 8.7 |
| | UK FTSE 100 | GBP | 4.8 | 4.0 | 4.0 |
| | EURO STOXX 50 | EUR | 4.4 | 12.9 | 12.9 |
| | German DAX | EUR | 4.6 | 10.4 | 10.4 |
| | Spain IBEX | EUR | 11.2 | 10.6 | 10.6 |
| | Italy FTSE MIB | EUR | 6.8 | 15.1 | 15.1 |
| | Japan TOPIX | JPY | 4.4 | 18.1 | 18.1 |
| | Australia S&P/ ASX 200 | AUD | 3.3 | 5.3 | 5.3 |
| | HK HANG SENG | HKD | 0.6 | -2.5 | -2.5 |
| EM equity | MSCI EM | LOCAL | 3.1 | 4.6 | 4.6 |
| | MSCI China | CNY | 1.1 | -1.7 | -1.7 |
| | MSCI Russia | RUB | - | - | - |
| | MSCI India | INR | 1.4 | 6.4 | 6.4 |
| | MSCI Brazil | BRL | -1.1 | -4.5 | -4.5 |
| Governments (10-year) | US Treasuries | USD | 0.7 | -1.7 | -1.7 |
| | UK Gilts | GBP | 1.8 | -1.7 | -1.7 |
| | German Bunds | EUR | 1.1 | -1.5 | -1.5 |
| | Japan JGBs | JPY | -0.1 | -0.5 | -0.5 |
| | Australia bonds | AUD | 1.7 | 0.9 | 0.9 |
| | Canada bonds | CAD | 0.4 | -2.2 | -2.2 |

| | Total returns | Currency | March | QTD | YTD |
|---|---|---|---|---|---|
| Commodity | GSCI Commodity | USD | 4.7 | 10.4 | 10.4 |
| | GSCI Precious metals | USD | 8.4 | 7.1 | 7.1 |
| | GSCI Industrial metals | USD | 3.1 | 0.3 | 0.3 |
| | GSCI Agriculture | USD | 4.4 | 0.9 | 0.9 |
| | GSCI Energy | USD | 5.7 | 15.7 | 15.7 |
| | Oil (Brent) | USD | 4.3 | 12.5 | 12.5 |
| | Gold | USD | 8.3 | 7.2 | 7.2 |
| Credit | Bank of America/ Merrill Lynch US high yield master | USD | 1.2 | 1.5 | 1.5 |
| | Bank of America/ Merrill Lynch US corporate master | USD | 1.2 | -0.1 | -0.1 |
| EMD | JP Morgan Global EMBI | USD | 1.9 | 1.4 | 1.4 |
| | JP Morgan EMBI+ | USD | 2.2 | 2.3 | 2.3 |
| | JP Morgan ELMI+ | LOCAL | 0.3 | 1.7 | 1.7 |
| | **Spot returns** | **Currency** | **March** | **QTD** | **YTD** |
| Currencies | EUR/USD | | -0.2 | -2.2 | -2.2 |
| | EUR/JPY | | 0.9 | 5.0 | 5.0 |
| | USD/JPY | | 1.1 | 7.4 | 7.4 |
| | GBP/USD | | -0.1 | -0.9 | -0.9 |
| | USD/CNY | | 0.8 | 2.0 | 2.0 |
| | USD/AUD | | -0.2 | 4.6 | 4.6 |
| | USD/CAD | | -0.2 | 2.6 | 2.6 |

## Important information

EST. 1804

Schroders plc 1 London Wall Place, London EC2Y 5AU,
United Kingdom T +44 (0) 20 7658 6000

schroders.com
@schroders