





There is no certainty in investment, but there are areas where we can have very strong conviction about the outlook and the consequent challenges they pose to investors.

It seems clear to us that what we've got used to over the last few years is very different to what we have to get accustomed to in the future.

We have identified a number of economic drivers and disruptive forces we think will shape the investment landscape ahead of us. These encompass demographic, political, environmental and technological factors, which we believe will create both threats to and opportunities for our clients over the next 10 years. They represent our 'inescapable truths'.



Charles Prideaux
Global Head of Product and Solutions



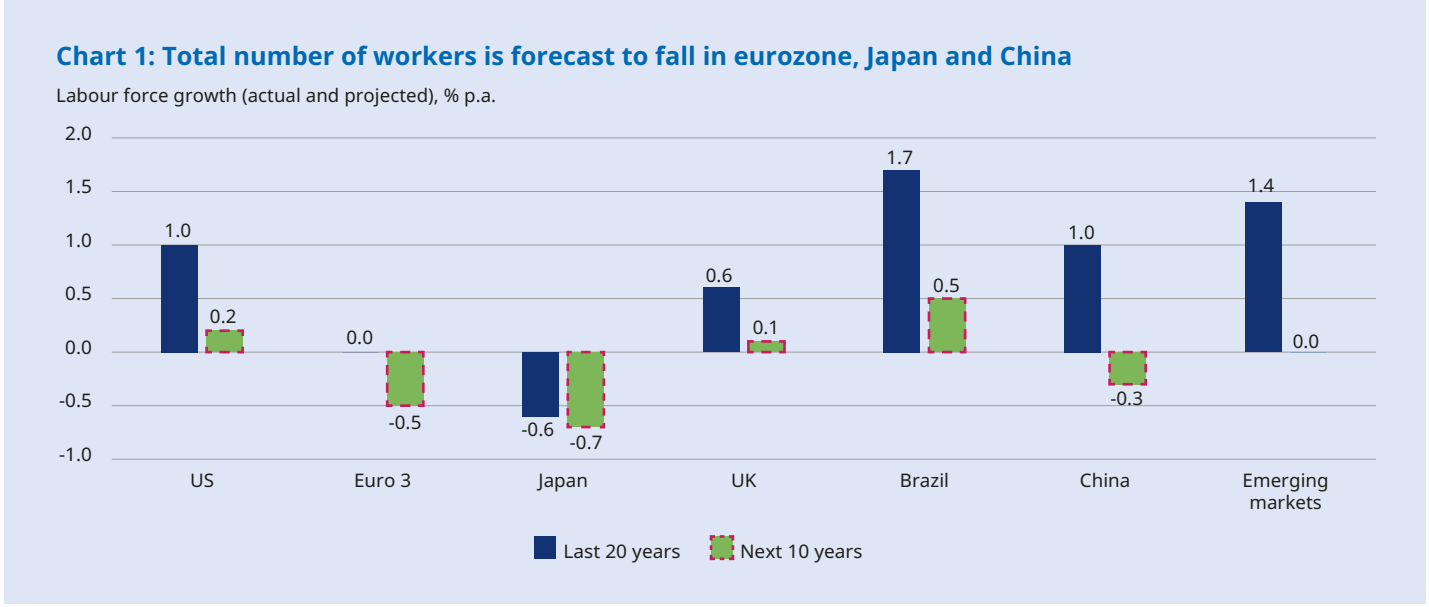
Keith Wade
Chief Economist, Global Economics

Economic forces

Looking beyond the near term, demography has a disproportionate impact on the economy. The key factors are growth in both the labour force and in productivity. They define the supply side of the economy and its ability to sustain growth without causing inflation to accelerate, or for significant imbalances to build up (factors that typically signal the end of an expansion). Actual output can and will deviate from this in the short run, for example through an easing of fiscal policy, but over longer periods growth is constrained by the supply side.

1. Global labour force growth will decline

A growing pool of employment helps push the economy along. But the labour force will grow more slowly over the next decade across all the major economies and regions. In the eurozone, Japan and China there will be an outright fall in the number of workers, as shown in chart 1. These forecasted changes are largely a result of declining global fertility rates.



Source: US Census Bureau, Oxford Economics, Schroders Economics Group.
Note: Last 20 years = 1997–2017, Next 10 years = 2018–27F. Emerging markets includes China, Brazil, Russia, India, Mexico and Korea. Euro 3 refers to Germany, France and Italy.

2. Poor productivity growth

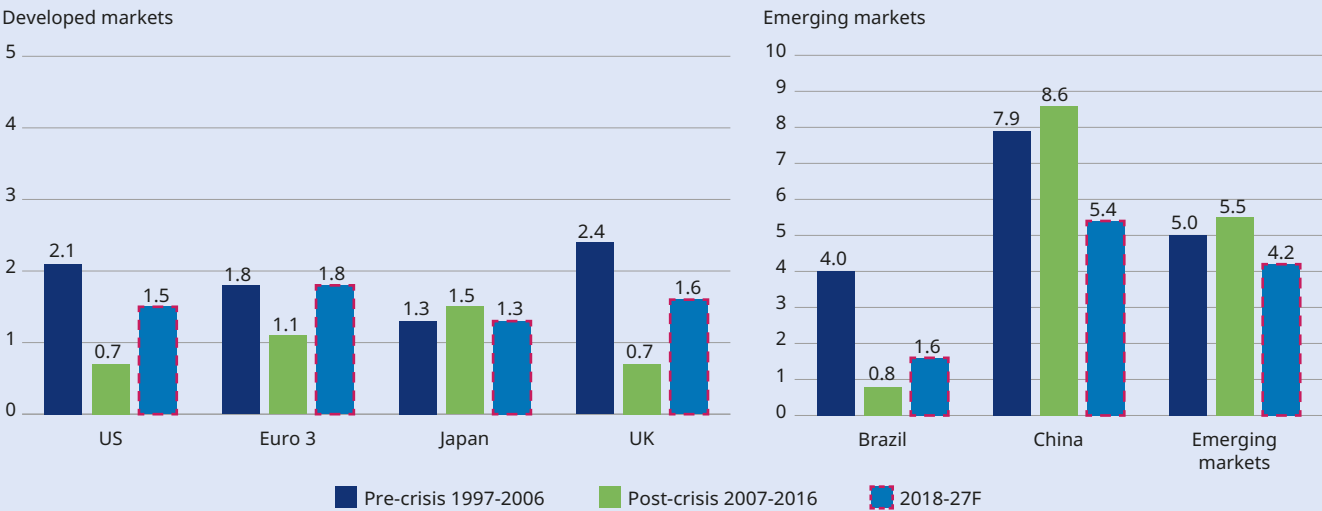
How efficiently the labour force – and other inputs – convert their efforts into economic output is also in question. Since the global financial crisis, improvements in productivity have slowed across developed economies and much of the emerging world. Looking ahead, we see some of the drags on global growth fading as the financial system normalises. Therefore, our assumption is for output-per-head to recover over the next decade towards the levels that prevailed before the crisis.

Our expectation for productivity growth over the next ten years in developed markets is broadly in line with the average experienced since 1997 (chart 2). The emerging markets face a natural decline as “catch up” growth fades and the economies make fewer gains from the adoption of new technology – the so-called technological frontier. Still, emerging markets may offer greater productivity gains for the foreseeable future than their developed market counterparts.



Chart 2: Productivity hopes rest on emerging markets

Productivity growth (actual and projected), % p.a.



Source: US Census Bureau, Oxford Economics, Schroders Economics Group.

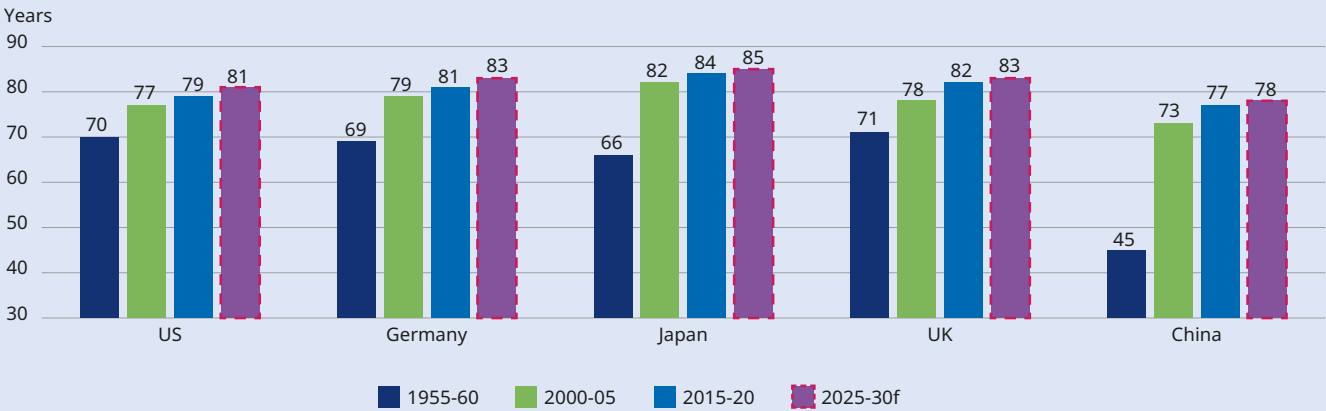
Note: Emerging markets includes China, Brazil, Russia, India, Mexico and Korea. Euro 3 refers to Germany, France and Italy. The forecasts included should not be relied upon, are not guaranteed. Our forecasts are based on our own assumptions which may change. Forecasts and assumptions may be affected by external economic or other factors.

3. Ageing populations

The slowdown in labour force growth will go hand-in-hand with an ageing of the population, a consequence of rising longevity (chart 3). Greater life expectancy will put pressure on government finances and compound the effect of slower working population growth. It will weaken per capita consumption and investment, and hence overall growth. The ageing population may also temper the recovery in productivity growth.

Chart 3: How demographics are changing

Life expectancy (actual and projected)



Source: UN 2017.

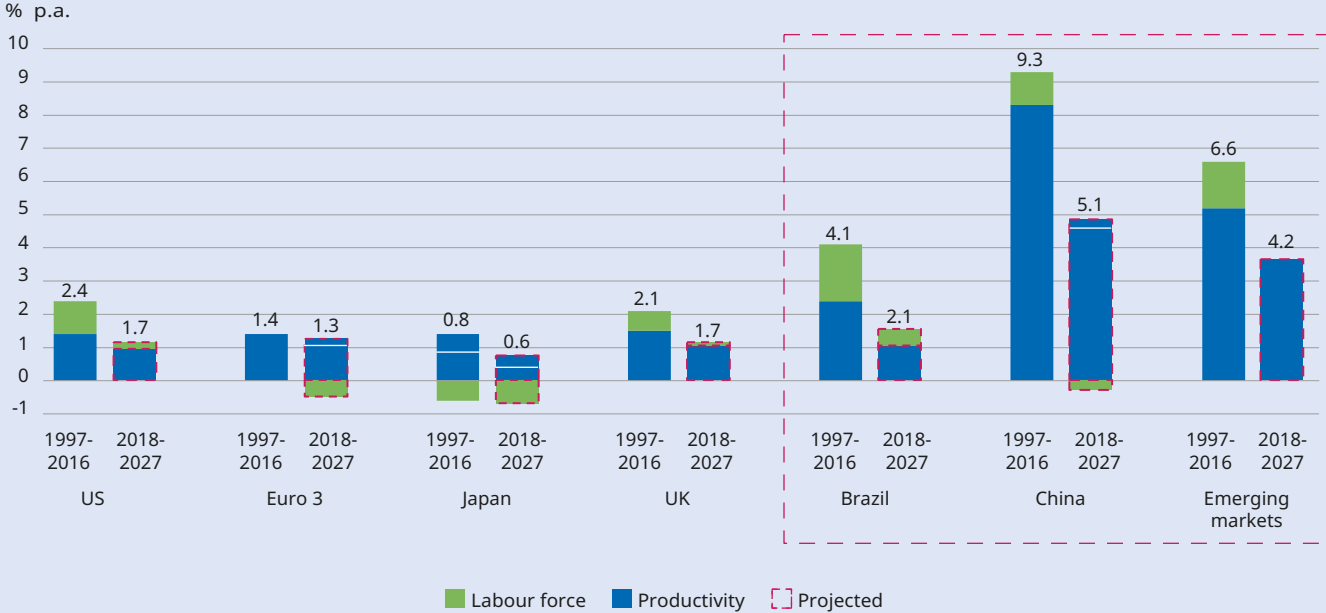
4. Gloomy global growth picture

These factors combine to give an outlook of relatively slow GDP growth for the world economy in line with the demographics (chart 4). Each of the major regions is expected to experience weaker growth over the next 10 years than the average achieved since 1996. Such a backdrop, combined with continuing social inequality, is likely to create more political uncertainty.

Emerging markets will continue to increase their share of global GDP. This is largely a consequence of the higher productivity growth associated with economies at an earlier stage of development. Higher incomes will bring a growing middle class and increasing demand for financial assets. Within this, the outlook for China will be critical, as we discuss below.

Chart 4: Global economic growth

Global GDP growth actual and projected



Source: US Census Bureau, Oxford Economics, Schroders Economics Group. Euro 3 refers to Germany, France and Italy.

GDP growth is important for determining the overall size and income levels of economies, but for equity markets a key driver of returns over the medium term is productivity growth. The latter relates more closely to earnings per share as it adjusts for the increased input of labour and capital ¹. On this basis, if productivity growth improves compared to the

¹ As it does not allow for investment/ shareholder dilution, GDP growth does not relate well to equity market returns.

recent past it should support better corporate earnings and equity returns.

5. China will be critical

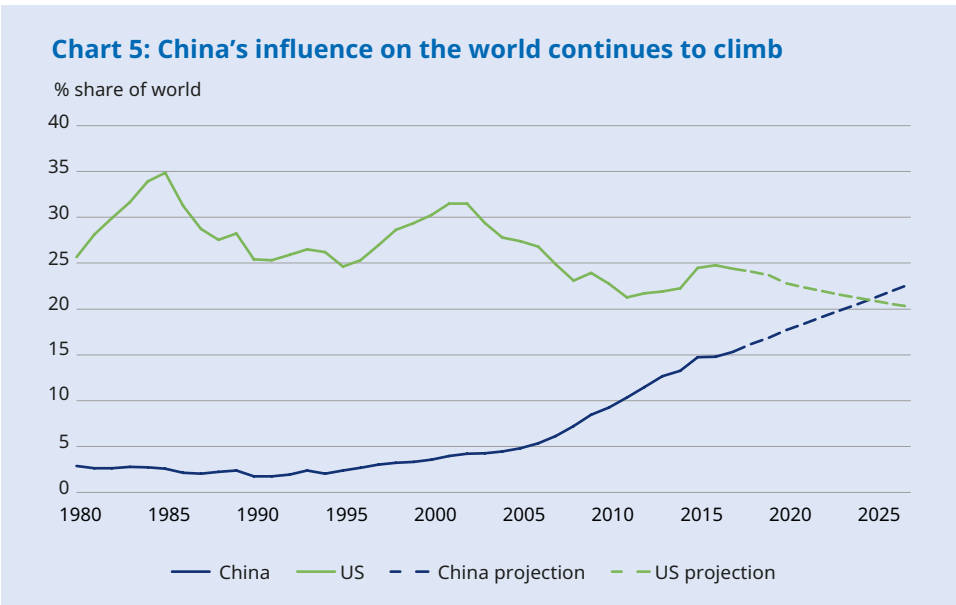
China’s rise has been astonishing and the key driver behind emerging markets’ growing share of global GDP, more than tripling its share since joining the WTO in 2001. However, China now faces a decisive transition period. Demographic challenges lie on the horizon as its working age population enters decline. More immediately, policymakers must find a way to address excessive borrowing and poor asset quality in the banking system while also reducing the reliance on investment and heavy industry.

Complicating matters further, part of this effort, “Made in China 2025”, has roused the ire of the US. China’s plan to dominate the global market in new technology industries – robotics, new energy vehicles and artificial intelligence (AI) among them – poses a clear competitive threat to the US and a challenge for the global economy.

This helps explain the stance taken by the US, and means that tensions are unlikely to subside. The existential fear in the US over China’s growing high-tech competitiveness will probably result in more localisation, or even a “splinternet” that divides trade in high tech goods and services along regional lines. In April, the Federal Communications Commission passed rules making it difficult for US firms to buy Huawei equipment, and China’s ZTE was temporarily shut down by US export restrictions, which cut off supply of key components not available elsewhere.

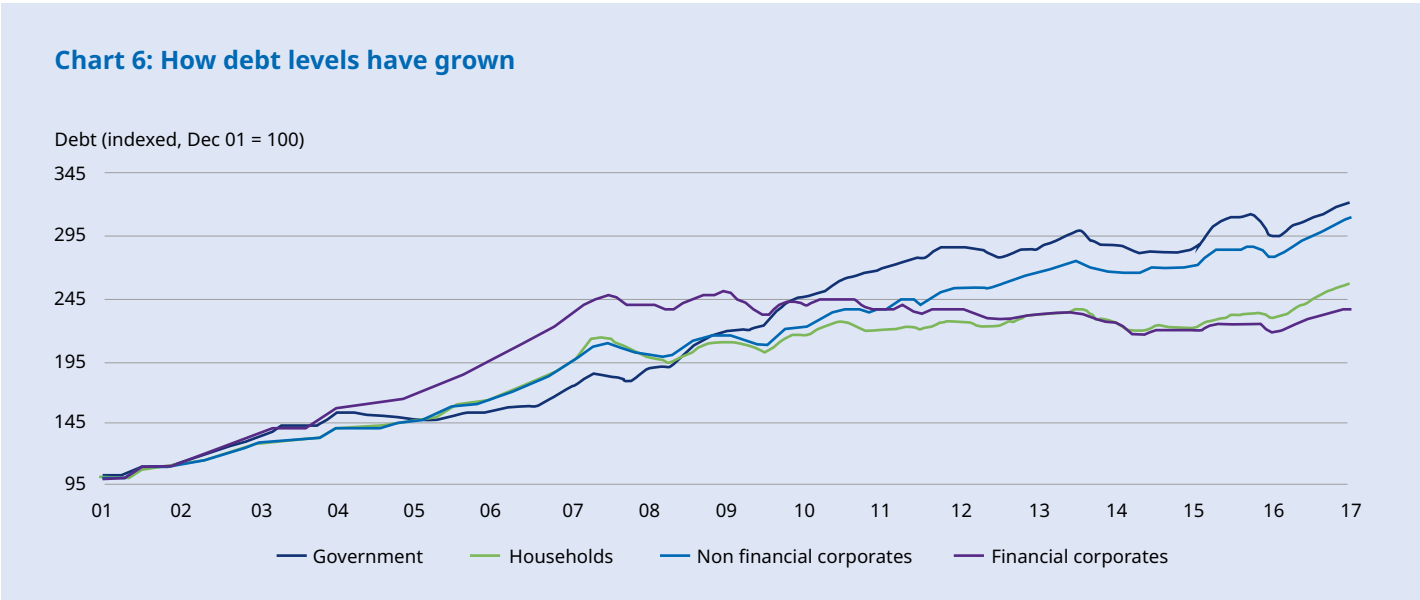
Beyond this, China’s efforts to reduce debt levels, or at least slow the rate of borrowing, has implications for global growth. The Chinese stimulus response to the global financial crisis was worth some 20% of GDP. A similar effort simply looks unaffordable today. That China has also accounted for the lion’s share of the growth in global debt would also suggest that, even absent a crisis, global growth would struggle unless another similarly willing debtor can be found as China retrenches.

Source: Thomson Datastream, Oxford Economics, Schrodgers Economics Group. Economist Magazine, March 2018.



6.Global inflationary pressure will be limited

The outlook for inflation will depend on how supply in the world economy grows relative to demand. All things being equal, a weaker supply side should mean more capacity constraints and hence higher and more volatile inflation. However, the same factors that will constrain future supply will also weigh on demand, with spending likely to slow in line with weaker labour force growth and an ageing population. High levels of debt and a more tightly regulated banking sector will also constrain the willingness and ability of individuals and firms (particularly small and medium sized enterprises/SMEs) to take on more credit.



Source: BIS Data.

These factors suggest that demand, like supply, will grow moderately in future. This would reduce both the likelihood of inflation accelerating above target and the need for aggressive rate hikes by central banks. Inflation is also likely to be contained by ongoing structural factors such as the disinflationary effect of international competition on prices and wages and the deflationary impact of disruptive new technology.

These effects may be tempered by populist politics, with measures such as tariffs and restrictions on immigration. It is likely that we have passed the peak in terms of pressure from globalisation, but the overall impact of these structural factors is still likely to be disinflationary.

For example, the effect of robotics and artificial intelligence (AI) on the labour market is only just beginning to be felt and will create a new deflationary wave as the effect of globalisation ebbs.

Overall, we would see the low growth environment going alongside low inflation and interest rates.

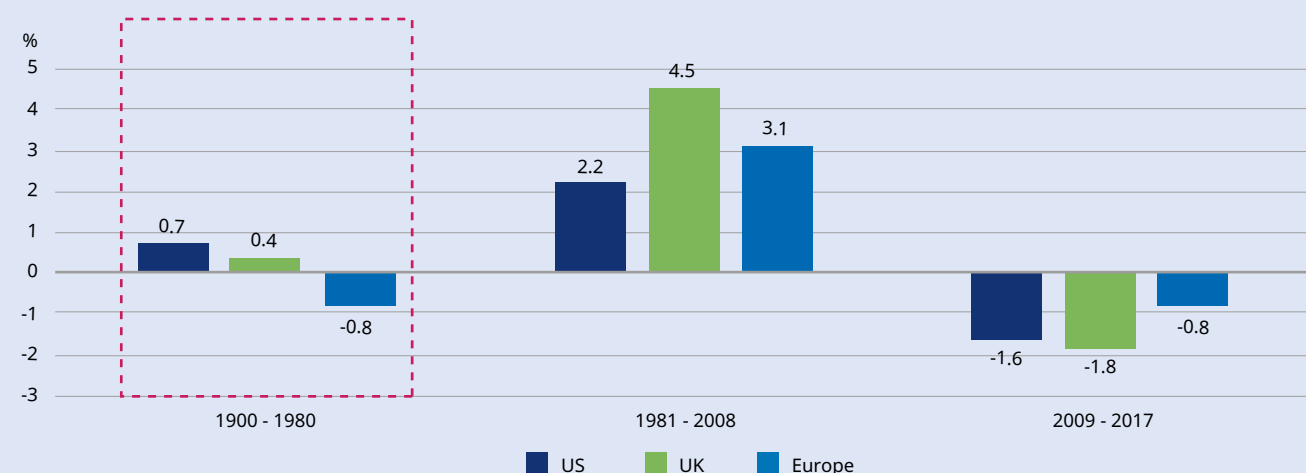
7. Interest rates will likely remain low



Interest rates will be higher than today’s exceptionally low levels, but are still likely to be relatively low by the standards of pre-crisis levels. Quantitative estimates of where interest rates will settle in the long run vary, but recent comments from policymakers² suggest the equilibrium level³ for the US and UK is around 0.5% in real terms, meaning 0.5% above the rate of inflation. This would be higher than today’s levels where interest rates are below inflation, but below the levels that prevailed before the financial crisis. The equilibrium rate will vary from market to market but taking a longer run perspective, the new level would be similar in our view to the average between 1900 and 1981, some 1% to 3% below pre-crisis levels (chart 7).

² See: The future fortunes of R-star: are they really rising? John C. Williams FRBSF, 21 May 2018 and the Bank of England Inflation report, August 2018.
³ The equilibrium rate is the interest rate that would pertain when the economy is at equilibrium, meaning that unemployment is at the natural rate and inflation is at the 2% target.

Chart 7: What is the new normal for interest rates?
Average annual % real interest rate (short-term interest rate minus inflation)



Source: Dimson, Marsh & Staunton, Credit Suisse Global Investment returns Yearbook 2018.

Economic forces: the investment implications

The broad macro-economic environment we have described is not unlike that experienced since the global financial crisis, where equity and bond markets have performed well despite low growth and inflation. However, during that period markets had the tailwind of very loose monetary policy as central banks kept interest rates well below inflation, a factor that has supported higher valuations.

As discussed above, we expect a normalisation of monetary policy with interest rates moving back above inflation and bond yields experiencing upward pressure as quantitative easing (QE) unwinds. Cash and government bonds will become more attractive, but will still offer limited real returns and consequently income-seeking investors will continue to search for yield.



1. Greater focus on corporate earnings as volatility rises

Looking at stock markets, as interest rates rise investors will be less willing to pay high valuations for stocks. Stock market returns will increasingly be driven by earnings growth and by payouts to shareholders (via dividends and buybacks). Volatility in financial markets is also likely to be higher as interest rates normalise and official asset purchases are unwound. Although the macro backdrop may be subdued, central banks will not be as active in suppressing market volatility through highly responsive policy responses, i.e. the so-called central bank 'put' is likely to fade.

Increased political risk will also create bouts of higher volatility, as we have seen recently with the US administration's trade policy.

Against this backdrop, equity and bond markets will put greater focus on corporate profitability. Low GDP growth does not necessarily imply weak profits growth. As noted above, productivity is a better indicator of profitability and the anticipated improvement in developed markets will help in this respect. The continuation of relatively high productivity growth in the emerging world will also support earnings in these markets.

Alongside productivity, corporate earnings performance will also depend on the ability of business to maintain the level of profits as a share of GDP or national income. These have risen significantly in recent years and are now under pressure from growing economic and political factors, which point to a greater proportion of GDP going to labour in the form of higher wages and compensation.

2. Returns from market indices may be limited

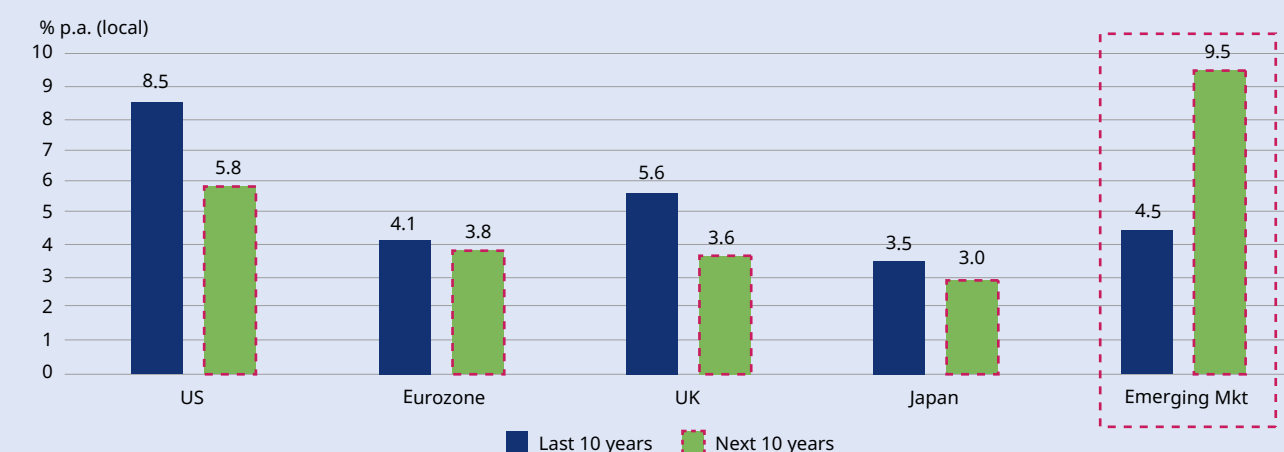
The net result of these cross currents is likely to be lower returns on stock market indices, or beta, compared to the recent past. Our return expectations for the next ten years are summarised in table 4 and show that with the exception of the emerging markets, all equity regions are expected to deliver lower returns over the next ten years than in the previous ten-year span.

Our research also shows investors are hoping for far greater returns, shown in chart 9. The Schroders 2017 Global Investor Study⁴ surveyed more than 22,000 investors in 30 countries. It found the typical investor expecting annual average returns of 10.2% over the next five years.

The gap between forecast returns and history is even more dramatic for sovereign bond markets, shown in chart 10, than for equities. In the words of the London Underground: mind the gap.

The implication is simple: there will be greater need for active fund managers who can generate alpha – i.e. who can beat the market – in the period to come.

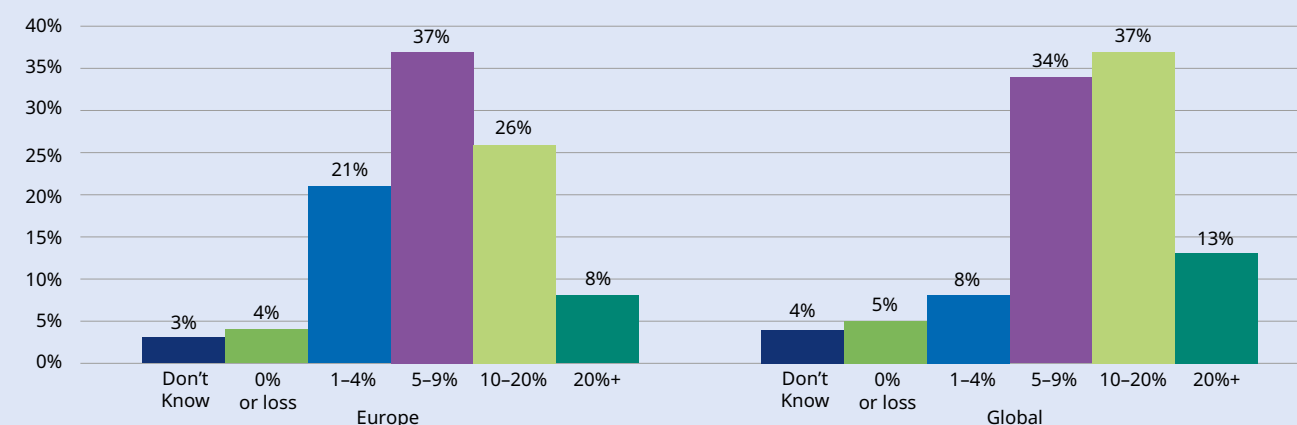
Chart 8: Schroders' forecasts for stock market returns
Historical (2007–2017) vs. future 10 year Equities return expectations (2018–27)



Source: Schroders, June 2018. The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. Forecasts and assumptions may be affected by external economic or other factors.

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

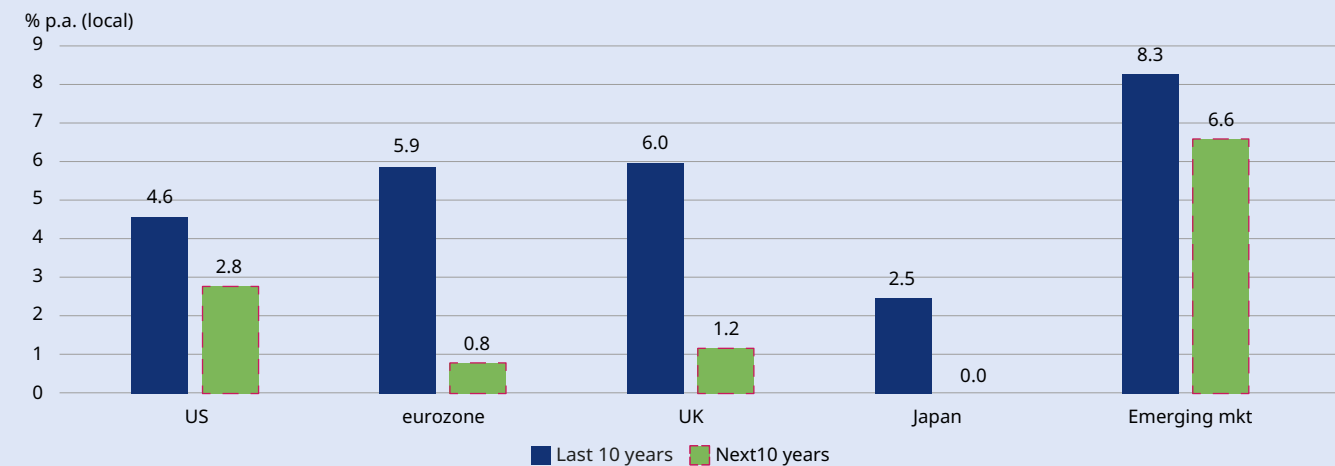
Chart 9: Investors' expectations for returns
The 2017 Global Investor Study highlighted high annual return expectations for the next five years



Source: Schroders' 2017 Global Investor Study 22,000 investors in 30 countries.

4 >20K investors with >EUR10K invested savings.

Chart 10: Schroders' forecasts for government bond returns
Historical (2007–2017) vs. future 10 year return government bond expectations (2018–27)



Source: Schroders, June 2018. The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. Forecasts and assumptions may be affected by external economic or other factors.

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This analysis describes our central view of markets over the medium to long term, but we recognise that the world economy faces a series of challenges which could lead to significantly different outcomes.

In the next section we look at four disruptive forces which are prevalent and are not going away. They are likely to affect the investment landscape over the next decade and we examine the associated opportunities and threats.

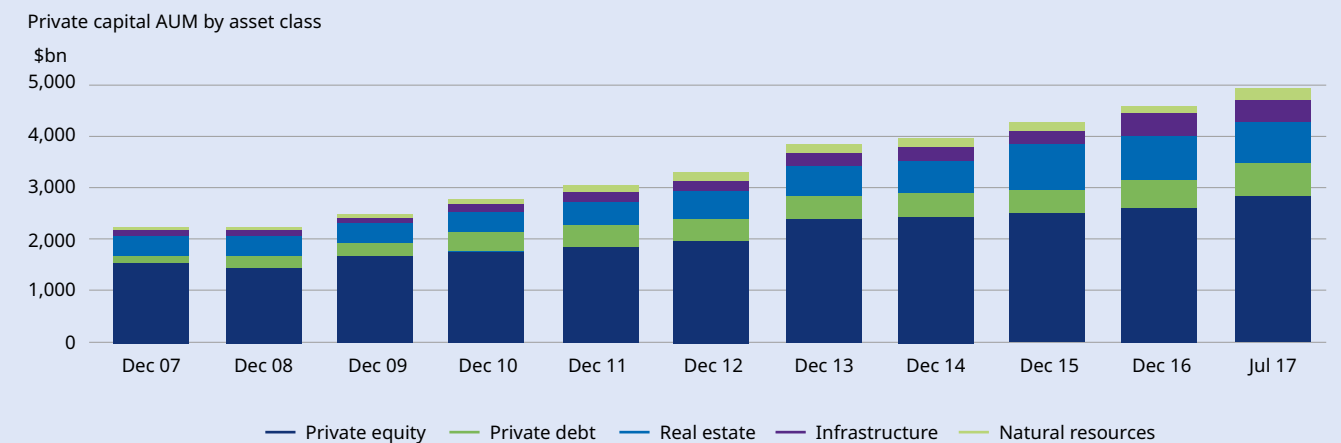
Disruptive forces

1. Market disruption

Changing patterns of finance

One factor which is likely to present opportunities for investors is that banks are likely to play a reduced role in financing economic activity, as the sector operates under stricter regulatory constraints. While this is one of the potential checks on future growth, it will encourage the provision of alternative sources of funding. This may be in the form of debt or equity, but may create opportunities for private capital. Private capital refers to money provided to a business that does not come from an institutional source, such as a bank or government entity, nor through selling on a stock exchange.

Chart 11: Rising alternative sources of funding



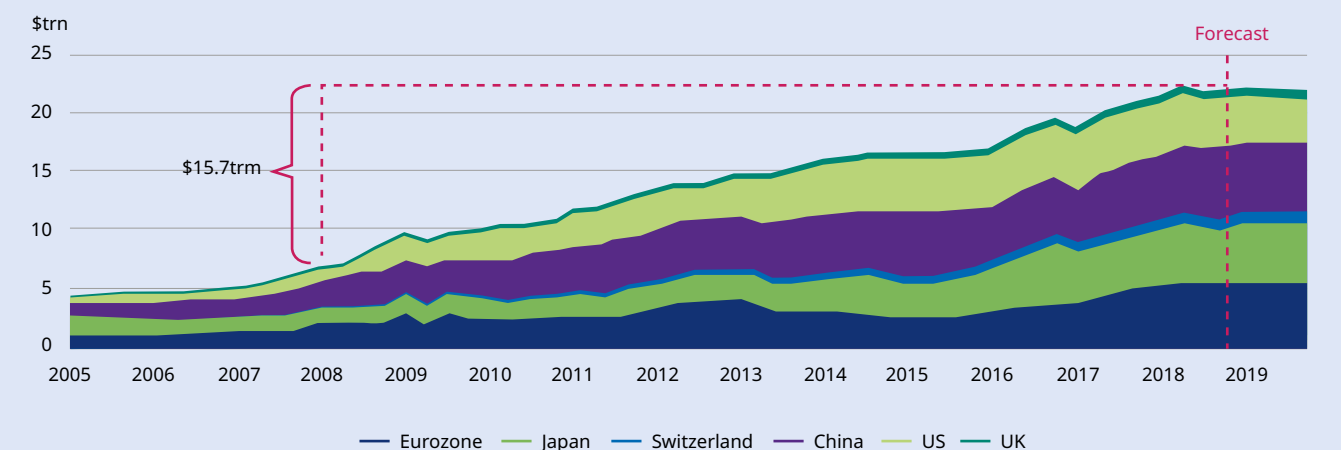
Source: Prequin Global Private Debt Report 2018, data from 2007–2017.

Economies and regions that have been particularly dependent on banks for funding, such as the EU, will shift toward other forms of funding. We expect the corporate bond market to expand along with private equity and alternatives such as peer-to-peer lending (loans provided by individuals) and crowdfunding. Indeed, there's nothing alternative now about alternatives. They're now the norm.

The end of QE

The US Federal Reserve is already in the process of reducing the assets on its balance sheet, which were acquired through QE.

Chart 12: Value of assets in central banks' balance sheets



Source: Thomson Datastream, Schroders Economics Group. 15 August 2018. Full data to Q2 2018.

We expect central banks in the UK, Japan and the eurozone to move in the same direction in coming years, to begin selling the assets they bought. This will increase the supply of government and high-quality corporate bonds to the private sector, as these have been the principal assets purchased during these programmes.

The process of unwinding QE will be slow and gradual, but will be welcome given the present shortage of these less risky assets and future demographic profile (with more retiring savers seeking financial security). As mentioned previously, rising rates will likely push up bond yields and weigh on stock markets, as the interest rates available on bonds increase, stocks generally become less attractive. Such pressures may be particularly acute in the eurozone, where official asset purchases (QE) have significantly depressed yields.

2. Technological disruption

Changing business models



Technological progress is already a feature of our projections in driving productivity and long run growth. However, technology also creates unique challenges for investors through its tendency to disrupt existing businesses and create winners and losers. By breaking down barriers to entry, new opportunities can be created.

Mark Carney, Governor of the Bank of England, recently commented: “In a hyper-connected, capital-light world, the future may increasingly belong to small and medium sized firms with platforms....giving them direct stakes in local and global markets. Connections can be made between small businesses in Scunthorpe and their clients in Shanghai, and between households in Bassetlaw and Bangalore⁵”.

Clearly, picking those who are on the right side of technological progress will continue to be key for portfolio performance.

Displacement of jobs

More generally, new technology can also be a double-edged sword. It can bring greater efficiencies in production, but also increase displacement in the labour market as traditional occupations become obsolete. The future for the three million drivers of long-distance vehicles in the US, for instance, looks bleak.

While increased international trade has received much of the blame for job losses, new technology has been just as powerful in terms of its labour market impact. As the fourth industrial revolution gathers pace, the increased use of robotics and AI will affect a wider range of professions.

The problems of inequality may worsen as a consequence, with the potential to bring even greater political disruption.



3. Environmental disruption

Rapid action needed

Our views of the future are complicated by growing tensions between the real economy and the natural environment, and climate change in particular. The challenge has been centuries in the making, but remedial action will have to be far faster to avoid its worst impacts.

Larger, wealthier populations put more pressure on Earth’s finite capacity to meet expanding consumption or to absorb the damage it creates. As one measure, the Global Footprint Network tracks the world’s use of ecological resources, relative to its capacity to supply those resources⁶. That analysis implies the world has a consumption footprint more than 50% larger than its capacity, an environmental deficit that has been widening for around half a century.

Carbon emissions and the challenges climate change poses are the largest component of that footprint, and have escalated social and political agendas. Since the industrial revolution, the world economy has grown in lockstep with rising energy demand and fossil fuels in particular. That growth in turn has pushed up concentrations of greenhouse gases in the atmosphere by around 50%. Global temperatures have risen by one degree Celsius over the same period, with a further 0.6 degrees almost assured⁷. Global leaders have committed to keep long run temperature rises below two degrees⁸, which means rebuilding the energy infrastructure underpinning the world economy.

Unchecked environmental damage will have severe economic and social consequences

Current efforts fall far short of that goal. In 2017, we introduced the Climate Progress Dashboard to track climate action across a wide range of indicators. It currently points to long run temperature rises around 4 degrees⁹. Should that continue, sea levels would rise by around one metre. Some regions would see 50% declines in water availability, while others become flooded. Oceans would become 150% more acidic, devastating marine life.

The social and economic impacts of that disruption would be unavoidably huge. Our own analysis has estimated the impact on global output at anywhere from a few percentage points of loss to 50% or more by the end of the century.



While inaction implies significant long-term risks, steps to avoid the worst effects of climate change will also prove necessarily disruptive. Cutting global per-capita emissions by four-fifths by 2050 will require far tougher policy intervention than we have seen to date. Our modelling of the financial implications of policies tough enough to contain temperature rises below two degrees implies 10-15% of the value of global companies could be lost¹⁰.

It seems unavoidable that a combination of the physical damage climate change creates and the impact of steps to mitigate its impacts presents a complication to future economic or investment views. We have invested in analysis and tools to monitor, measure and manage that risk; there are no simple shortcuts or established models, but recognising a new source of risk seems unavoidable.

Investors increasingly care about environmental issues

Results from Schroders’ 2018 Global Investor Study¹¹ revealed that consumers have become more aware of sustainability in their investment choices. Across the globe 76% of investors felt that sustainable investment was more important than five years ago. In tandem with this, 64% of all investors and 75% of millennials have revealed that they have increased their sustainable investments within the past five years.

Behind these headline figures, the study also revealed individual motivations for sustainable investing, highlighting the specific factors where they wanted fund managers to make a difference (chart 13).

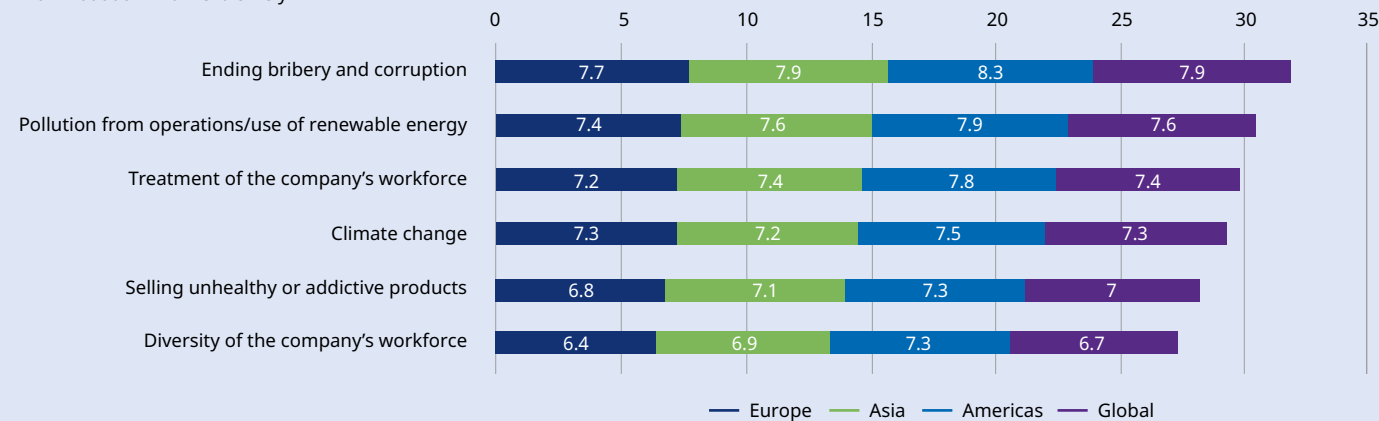
5 From Protectionism to Prosperity, 5 July 2018 [here](#).
6 <https://www.footprintnetwork.org/resources/data/>

7 The approximately 40 year lag between emission release and temperature changes mean further temperature rises can be effectively predicted based on emissions already released
8 The agreement reached in Paris in December 2015: <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>. This is not a stretch goal; it's the level at which there is a 50/50 chance of “catastrophic climate change” according to analyses summarised by the OECD, IIPPC and others.
9 <https://www.schroders.com/en/about-us/corporate-responsibility/sustainability/climate-progress-dashboard/>
10 <https://www.schroders.com/en/about-us/corporate-responsibility/sustainability/climate-progress-dashboard/carbon-var/>
11 >20K investors across 30 countries with >EUR10K invested savings.

Chart 13: Investors' sustainability priorities

How investors rate the importance of the issues that they want fund managers to act on

0 = not at all - 10 = extremely



4. Political disruptions

Government finances will come under pressure



The rise of populist political parties and leaders has become a key feature in Europe, the US and parts of Asia recently. The economic outlook described above would reinforce this populist trend, as we will see government finances undermined as slow growth cuts tax revenues and boosts expenditure on benefits. Ageing populations will increase pension spending and demand for healthcare, adding to the pressure on government borrowing as dependency ratios rise. Consequently the ability of governments to meet voter expectations will become increasingly challenged, thus further feeding populist unrest.

Unfortunately, a failure to deal with the pressures on public finances will mean an increasing risk of crisis in countries with high public debt and poor demographics. Governments are pursuing policies to mitigate these effects (such as raising retirement ages), but such pressures are already attracting the attention of sovereign ratings agencies.

It is possible that such trends will open up opportunities for investors. For example, the need to finance public infrastructure spending could allow the creation of long-

dated bonds with a secure income stream – an attractive investment for ageing populations. Innovation is needed to meet rising healthcare demands and, as people extend and shift careers, there will be greater demand for education and training. Technology will play an increasing role and private sector involvement in all these areas could be key.

Growing pressure on individuals

On an individual basis, pressures on government funding of healthcare and pensions means that people will have to take greater individual responsibility. Against this backdrop, people living longer should result in growth assets being held for longer periods to support retirement. There are likely to be more demands on the retirement account as people have to fund old age care as well as their income. There is also a potential knock-on impact from lower returns as pensions are more likely to be underfunded at retirement, meaning people are likely to have to work for longer.

However, none of these are particularly palatable options and we recognise that greater private sector involvement may not occur as the increase in populism leads governments to pursue alternative solutions.



The rise of populism will increase political complexity

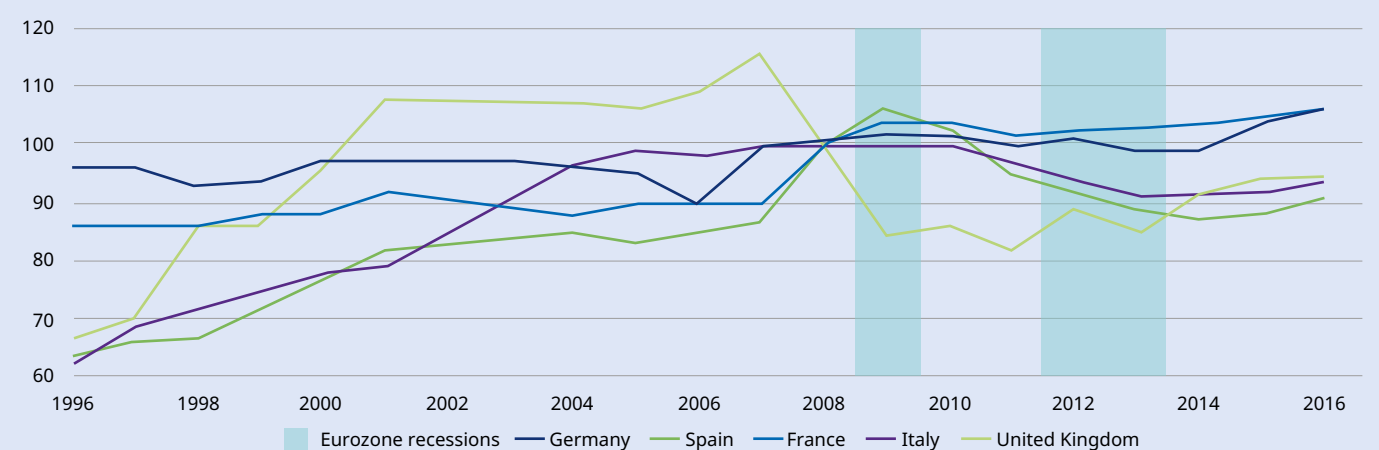
Populism has been fuelled by stagnating living standards for a large proportion of the population and, although we expect national incomes to rise, it is likely that median incomes will continue to struggle.

In real terms, the median household income in the US was the same in 2016 as in 2000, despite an increase in real GDP over this period of 38%.

Gains have been skewed toward the upper end of the income distribution (i.e. the wealthiest), while the lowest earners (those in the lower quintile) have experienced absolute declines in real income. The picture is similar for Europe (see chart 14), although less pronounced due to the more redistributive tax systems.

Chart 14: No progress in European living standards since 2008

Net real median incomes (2016 prices in euros), Index (100 = 2008)



Source: Thomson Datastream, Schroders Economics Group.

Globalisation is seen as one of the culprits here, along with technology and the effects of central bank policy on asset prices. The spotlight has also fallen on the ability of multi-national companies to divert income to favourable tax regimes, thus putting more pressure on government finances whilst boosting corporate earnings¹².

Policies to temper the impact of globalisation through restrictions on trade, immigration and capital flows are increasingly likely to emerge. Greater redistribution through taxation and other policies such as increased state control of industry are also probable. The only certainty is that political risk will be a much more significant part of the investment landscape.

¹² For more on this see [here](#).

Disruptive forces: the investment implications

Our central analysis suggests that we are moving to a world of lower growth and lower returns, consistent with the demographics and productivity trends. Equities are still expected to outperform bonds and emerging markets outperform developed, but the absolute level of returns is likely to be lower than in the recent past. In addition, we would expect volatility to be higher as monetary policy normalises and the central bank “put” on markets (mentioned above) expires.

Forecasts included should not be relied upon, and are not guaranteed. References to sectors are for illustrative purposes only and are not a recommendation to buy and/or sell. Sectors that offer higher levels of returns generally carry higher risk, no investment is risk free.

Expect a greater range of market drivers

The shift toward monetary policy normalisation, particularly the end of QE, will also create a greater range of market drivers. It has always been the case that macro factors alone do not drive all markets. Many bourses are skewed toward particular sectors, or have significant overseas exposure and do not reflect the domestic economy. As central bank influence wanes, such factors will come to the fore.

Consequently, there will be a greater focus on profitability and earnings growth rather than valuation shifts as drivers of returns. Within markets, profitability will be determined by the ability of a firm to maintain its market position amid increasingly disruptive trends. Shifts in politics, markets, technology and the environment are four we have focused on here and stock performance will be determined by the ability of firms to reap the benefits and anticipate these changes.

All of this analysis suggests we can expect greater divergence in performance across asset classes and within markets, with greater focus on individual or idiosyncratic drivers. While financial markets may offer more subdued returns and become more volatile, the scope for alpha generation – to beat the market – and diversification should remain significant. Being aware of these trends is important and highlights the advantages which active asset management can provide to investors¹³.

Conclusion

After almost a decade of strong returns many investors have become complacent about the outlook. This assessment suggests that in a more challenging future environment factors such as asset allocation, access to multiple sources of return, active stock selection and risk management will be critical in meeting the goals of investors over the next decade.

As we enter the next phase of the post-global financial crisis era, these “inescapable truths” can help guide investors through a time of unprecedented disruption.

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.

13 For more on the case for active management see <https://www.schroders.com/en/insights/economics/the-case-for-active-investing/>





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