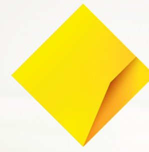

Commonwealth Private

July 2024

Macroeconomic Outlook: Better Days Ahead

Foreword

Global and domestic economies have managed to absorb higher interest rates and tighter financial conditions better than even the most optimistic forecasters could have envisaged just two years ago when inflation was hitting 40-year highs.

While there is significant pain on '*Main Street*', a unique set of factors have driven substantial gains on '*Wall Street*'. It is unusual for this dichotomy to exist, yet alone persist for so long.

As we consider what lies ahead in 2H24, there is a case for optimism. Globally, economic growth has been resilient to rate hikes, trend inflation is falling, and more than 20 central banks have started to cut policy rates. In addition, we expect the all-important US Federal Reserve (Fed) and our own Reserve Bank of Australia (RBA) to begin lowering rates sometime in 4Q. This is encouraging but remains a backdrop of gradual improvement rather than sharp recovery.

For some, this may feel a little underwhelming, but shallow downturns generally mean shallow recoveries and this means the path ahead has limited cushion for absorbing negative developments and could easily be altered as a result of a number of risks including a more significant deterioration in labour markets, deeper cut backs in consumption and sharper declines in corporate profitability and business investment.

Furthermore, geopolitical risks are on the rise, as the world moves away from the "peace dividend" period, and the pendulum swings back to towards nationalism and all things security related (i.e., defence, energy, labour, supply chains and cyber to name a few). Elections (particularly the upcoming US Presidential race) are also creating uncertainty which has the potential to manifest itself in a scale back of risk-taking behaviour and drive an even shallower recovery as we move into 2025.

While Australia finds itself somewhat insulated from many of these global threats, they nevertheless have the capacity to upend all good forecasters and forecasts.

Standing back from all the noise, our belief is that both households and businesses should look towards the next six months with cautious optimism as we travel the final few miles before policy support begins to kick in and cyclical areas of the domestic economy pick up.

Asset markets have so far absorbed the rise in bond yields spectacularly well and should benefit as cyclical tailwinds improve. For investors, fixed income is providing yields which were unimaginable just a few years ago –whether in public or private markets. Consequently, we think the outlook for multi-asset portfolios is strong. In fact, we think the risk of a "melt-up" as laggard sectors join the AI-driven leaders, is not a insignificant risk over the coming six months especially if the US election result is market positive.

We are thankful that most developed economies have avoided a hard landing and jobs have remained plentiful. However, we are cognisant of cost-of-living pressures which are causing pain at home and abroad. This pain might need to be endured for a while longer, as sticky inflation keep the RBA on hold until late in the year. But we are optimistic that incremental improvement is around the corner and that asset markets will push even higher the economic, inflation and rates begin to normalise.

Jason Todd, CFA
Chief Investment Officer
Commonwealth Private

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Key Takeaways:

Global: On a path to recovery

- Global growth is bottoming and we expect a gradual improvement led by the US, China and Japan over the coming 12 months.
- Global rate cuts have started, and alongside fiscally committed governments, underpins an improving economic outlook. However, significant political and social cross-currents are present and have the potential to disrupt the path ahead. Ultimately, we expect growth to settle at slightly below trend levels over the coming years.
- Sticky inflation will not stop central banks from cutting rates with trend inflation likely to settle back in the neighbourhood of central bank targets through 2025. We think central banks will only give back around 50% of recent rate hikes as the resting rate settles at higher levels, due to a combination of structural factors including decarbonisation, digitalisation, demographics and deglobalisation.

Australia: A painful per-capita recession underway

Australia's economy has weathered higher rates, largely thanks to strong population growth. A deep per-capita recession is underway, but we expect the economy to avoid a recession.

- Households in Australia will need to be resilient before rate relief arrives in late 2024. Sticky inflation is problematic, but we still think the RBA has finished raising rates. CBA expects the cash rate to fall back towards ~3% by late-2025.
- House prices have surprised even the most bullish of forecasters. Ongoing supply shortages and elevated demand will keep prices moving higher into 2H and beyond. Falling rates will also boost "buyer" sentiment despite reduced affordability.

Investments: Fundamentals improving

The backdrop is constructive for multi-asset portfolios. Equity markets are likely to push higher, fixed income offers the highest yields in nearly two decades, private credit offers equity-like returns without the equity-like risk while a thawing in capital markets will support private equity returns.

We think investors should be moving out of cash and into higher yielding opportunities before central banks get into their rate cut stride, as well as ensuring growth asset allocations are at least above benchmark to capture upside to cyclical improvement

- Equities have rallied strongly but valuations have not reached levels that are self-correcting, or which will prevent broad benchmarks from trading even higher into 2H24. Our regional preferences remain US and Japan.
- We expect Australian equities to lag against global markets, due to an overweight in value stocks and an underweight in growth (particularly AI-exposed technology) stocks. Resource stocks will not be the market saviour.
- We expect fixed income to deliver attractive risk-adjusted returns under a falling inflation / moderate economic growth backdrop, and even better risk adjusted returns if macro conditions deteriorate. This is a win-win scenario.

Global Outlook

Recovering despite elevated uncertainty

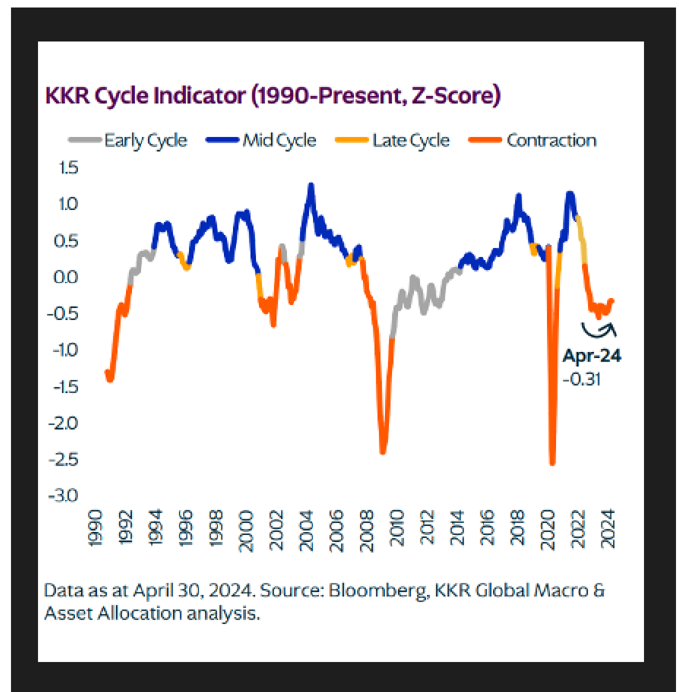
- Global growth has remained resilient in the face of high policy rates. Growth is bottoming and will improve into 2025.
- 20 central banks have already started cutting policy rates. We expect the Fed to join the party in 4Q24 although the pace of global policy easing will be gradual.
- There are fragilities within the global economy that have the potential to unsettle confidence, but the economic outlook is solid with rate cuts and a mountain of excess liquidity strong foils.

History has not rhymed

The post-pandemic period has seen a re-write of economic history. Since the 1950's, a simple and relatively consistent relationship has existed between economic growth, inflation, interest rates and financial markets. As economies overheat, they generate too much demand, which is inflationary. In response to this, central banks raise interest rates (often aggressively because they are behind the curve), and this drives an economic slowdown usually culminating in a recession. This pushes bond yields and equity prices lower and as activity slows, demand and inflation fall and the interest rate cycle reverses.

Central banks are not dealing with a traditional overheating cycle

As we came out of the Covid pandemic, both demand and supply factors helped push inflation to multi-decade highs. Central banks responded by raising interest rates at the fastest pace since the 1990's, inflation peaked and quickly decelerated. However, most economies, while slowing, did not slip into recession, bond yields didn't fall and neither did equities (or most other risk assets for that matter). While dangerous to say, "this time is different", it really was the case. Economies were overheating but not in the traditional sense, and economic models don't handle "different" very well.



Data as at April 30, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

The global growth backdrop is solid and durable

We believe the global economic growth outlook, driven in large part by the US, is stronger than the consensus wants to believe. Economic growth estimates in the US have been consistently revised higher through 1H24 and this is feeding an improving global narrative.

In addition, China, which has been a major drag on the global outlook for the past two years, appears to have turned a corner. Recent policy announcements aimed at stabilising the housing and construction sectors have helped put a floor in GDP growth around its 5% target.

Across Europe, which has been hit hard by a combination of high energy prices and tight monetary policy, has seen inflation fall to levels that have allowed it to start its policy easing cycle. Meanwhile, Japan continues to reflate, supported by a virtuous cycle of higher wages and consumption growth, as well as the yen depreciating against the US$ by nearly 60% over the past three years.

Labour markets have remained robust and corporate profit margins are elevated

Encouragingly, unemployment rates across the developed world remain low albeit supported by deteriorating labour force participation and declining hours worked. This provides a nice foil for job losses. Corporate profit margins have been dented but remain elevated at pre-pandemic levels, while capex has also remained strong indicating that business, while cautious, have not scaled back investment intentions and are not likely to do so.

Summary of Key Global Economic Forecasts

	GDP	Interest Rate	Unemployment Rate	CPI
Aus 2024	1.40%	4.10%	4.30%	3.30%
Aus 2025	2.20%	3.35%	4.50%	2.80%
US 2024	2.40%	5.00%	3.90%	3.20%
US 2025	1.80%	4.00%	4.10%	2.40%
EU 2024	0.70%	3.25%	6.60%	2.40%
EU 2025	1.40%	2.25%	6.60%	2.10%
China 2024	4.60%	3.25%	5.10%	0.70%
China 2025	4.40%	3.20%	5.30%	1.60%

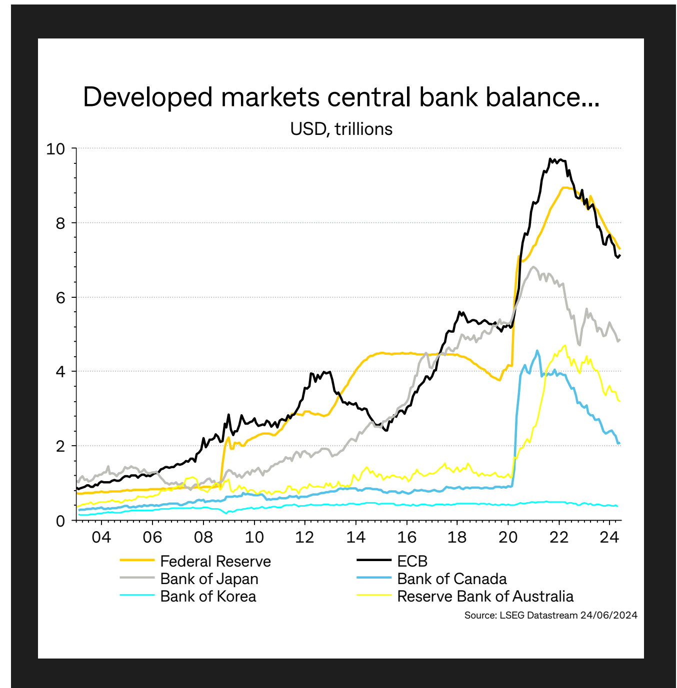
*Source: Reuters Poll

Inflation is sticky, but trend deceleration remains intact

Unfortunately, sticky inflation across the developed world means there will only be limited rate support coming from central banks, perhaps on average giving back around 50% of the rates hikes, but importantly the policy easing cycle has already begun and other key central banks (including the Fed and RBA) are likely to join in by 4Q24.

Excess liquidity has not been drained and remains an underappreciated tailwind

Perhaps one of the most underestimated tailwinds for the global economy and financial markets is the level of "excess" liquidity (largely sitting on bank balance sheets) which was built up by central banks post-GFC (Global Financial Crisis) and which has not been drained, despite tighter financial conditions.



This is the ammunition for a "buy the dip" mentality and alongside a strong willingness of policy makers to offset idiosyncratic risks (such as the US regional bank failures in early-2023), provides comfort that the global economy has the capacity to absorb a few speed bumps while continuing to gain momentum as cyclical and rate sensitive sectors bounce back.

Interest rates will not be higher forever

While interest rates are at their highest point since 2007, we believe they have peaked. We think rates will normalise back to the pre-GFC trend levels, above what we have become used to over the past decade (particularly throughout the pandemic period), but we are not nearly as hawkish on rates as the general consensus.

While the structural deflationary trend is likely reversing due to a combination of factors including deglobalisation, digitisation (AI capex), decarbonisation and demographics, we think it

is too early to tell just how much higher inflation will settle.

In our opinion, a sensible approach is to assume that inflation will fall back into the neighbourhood of long-term trend levels rather than assuming it swings from ultra-low levels to uncomfortably high levels. Our base case is for a return to normal with policy rates around 2-3% above pandemic lows and borrowing rates around 1-2% higher.

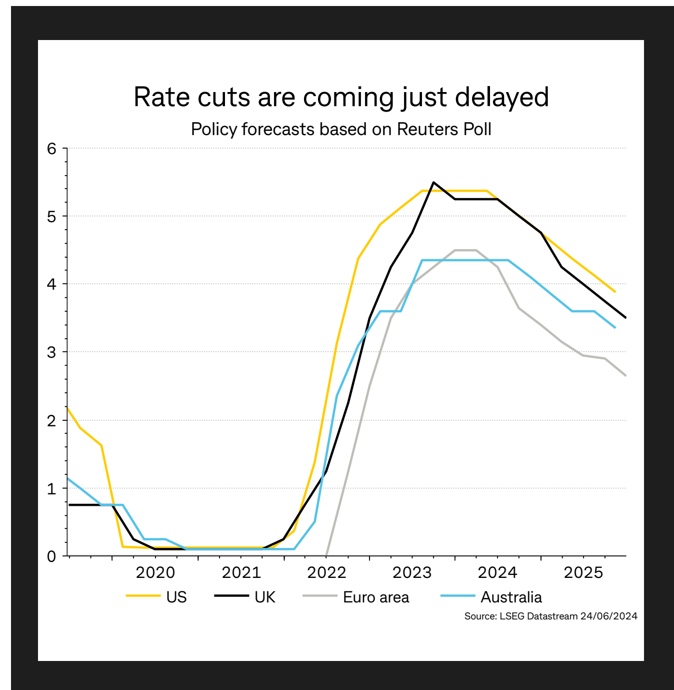
Debt growth fuelled by governments not willing to reduce the fiscal pulse

The acceleration of Government spending across the globe is not expected to experience any meaningful retracement over the medium term. The current situation of large fiscal deficits as a proportion of GDP are likely to keep long term bond yields at elevated levels as a requisite term premium is incorporated in interest rates. Even as inflationary pressures are being nullified, the fiscal debt load of governments across the Western economies are likely to act as a restraint in domestic economic growth trajectories. It is possible that economic growth remains muted as governments compete with the private sector for capital and a "crowding out" scenario eventuates.

Uncertainty remains elevated but tail risks are falling

Finally, it is expected that global growth settles below trend over the coming few years despite picking up from trough levels, which means there is a risk we could be wrong in our upbeat assessment of the global economic outlook.

Real incomes are weak, business bankruptcies have spiked, credit card debt has exploded (particularly in the US), discretionary spending in many areas has collapsed, housing prices (outside of Australia) have fallen and it's possible that unemployment will rise more than gradual predictions.



On top of this, the root of all evil – inflation – might not decline in a way that allows central banks to continue their policy easing path and elections could easily through a spanner in the works via threatening the extent of fiscal policy support in coming years.

Pockets of stress are unlikely to become systemic and the outlook is durable

However, despite pockets of stress we think global growth will gradually pick up, inflation will continue its trend deceleration and policy rates will begin a staggered fall from peak levels. We don't think this is a goldilocks backdrop, but if inflation falls back into the neighbourhood of central bank targets within the next 6-12 months and this allows less restrictive monetary settings, then policy makers should get their just rewards. They would have successfully navigated through a global pandemic and tamed an unintended inflationary spike without causing significant collateral damage to the labour market or the economic backdrop – an impressive outcome if it eventuates.

Australian Economic Outlook

Muddling its way out of a policy induced slowdown

- Australia's economic outlook remains relatively robust despite pockets of household and business stress. We expect growth to slow through 2H24 but gradually recover thereafter.
- Australia's inflation path is lagging most other developed economies by a few quarters. This will likely see the RBA keep rates on hold until late-2024. Subsequently, CBA expects rates to glide down to 3.10%.
- House prices are expected to inch higher as rate cuts get closer and supply-side conditions remain tight.

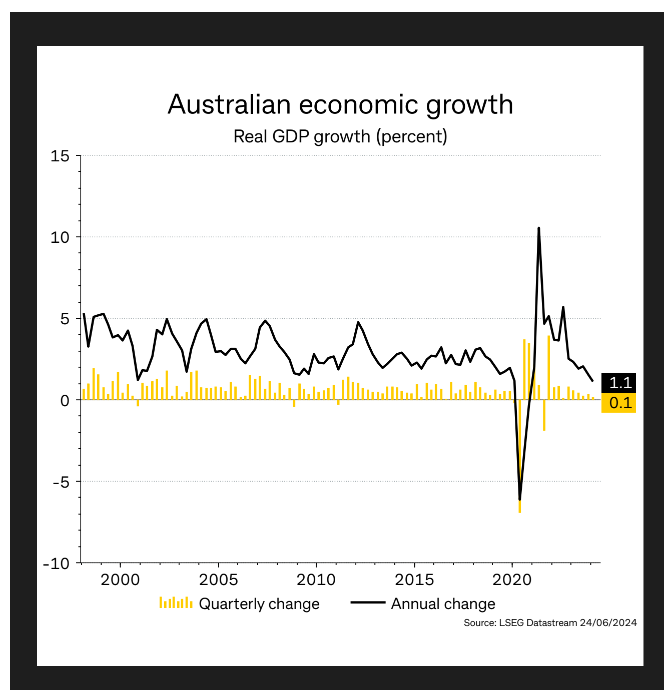
Pockets of weakness will persist, but should remain idiosyncratic

Herein lies the dichotomy for the Australian economy. You get two different views on the economic backdrop depending on who you ask; those with less income are more likely to be struggling, while those on higher income, with less debt not so much. Given we're in a real GDP per capita recession (so far five quarters long) and more than half the country is not positive about their own personal circumstances, suggesting the backdrop is solid is an unfortunate part of focusing on the 'whole' instead of the 'parts'.

To date, the Australian economy has so far absorbed the impact of higher policy rates which has driven a sharp slowdown in fortunes of the household sector, . Real incomes have collapsed, retail spending is in contraction due to severe cost of living pressures, the debt servicing burden has exploded, and consumer confidence has been mired at recession levels for the past two years.

Economic growth has stalled but not collapsed

However, while economic growth has fallen to stall speed (1.1% YoY – the lowest level in 32 years outside of the pandemic), it has been resilient to any softness in the global economy and a rapid deterioration in incomes and spending. Although the labour market is likely to weaken further (with unemployment presently 4%), this is a lagging indicator for the health of the economy, and we think the worst of the deterioration has now been seen.



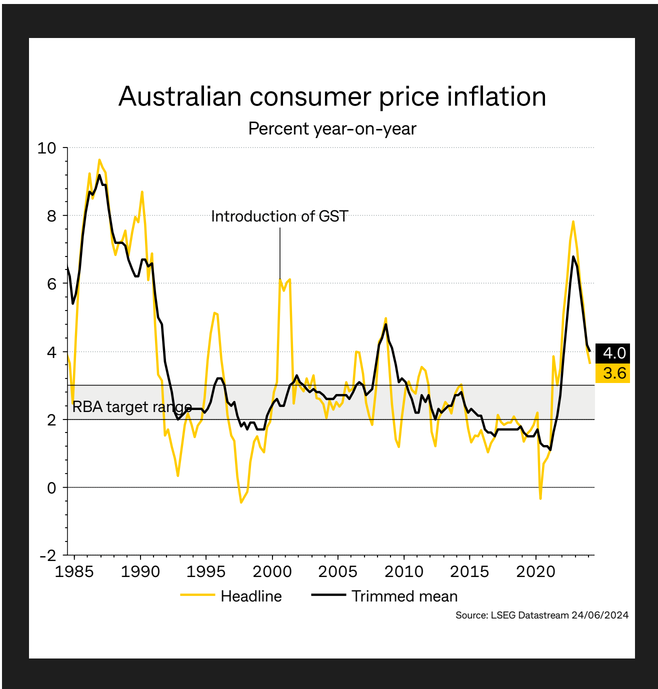
Inflation is not at levels that will allow the RBA to loosen monetary conditions

Unfortunately, inflation is not yet at levels that would push the RBA into early rate cuts. While this would provide support for the hardest hit households and businesses, the trend deceleration is likely to continue through 2H24, allowing the RBA to begin a modest rate cut path by year end. CBA economics is forecasting the cash rate to settle at 3.10% by the end of 2025 – a level they believe is just above neutral.

It's too late to be bearish on growth. The economy has absorbed the hits

Overall, this is an encouraging picture for Australia's economy. The business backdrop has softened but input cost pressures have abated

from Covid-induced highs and profit margins remain high. Wage growth (now sitting a little over 4%) will moderate as the labour market softens but businesses should not expect to see labour costs fall with any pace, and it will be a slow grind to better conditions.



No recession means no recovery. Expect a gradual path of economic improvement

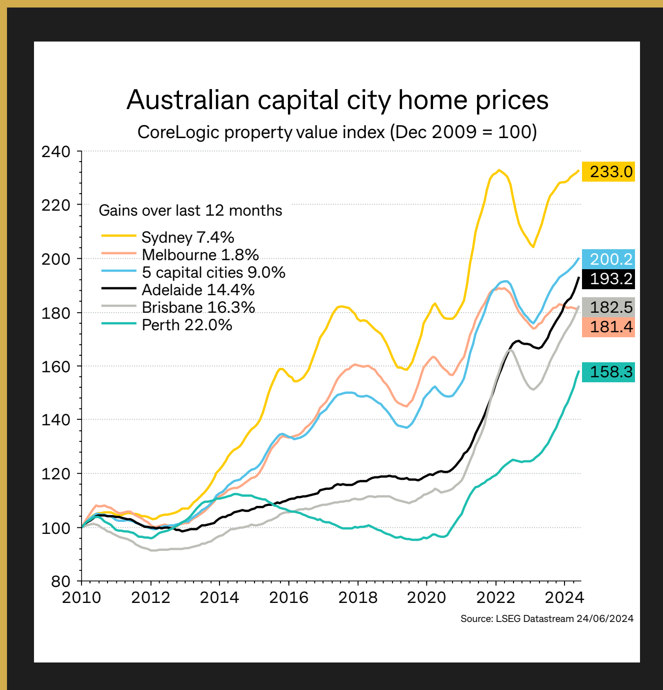
Encouragingly, we think the worst of the hit to households has been seen with some budget relief and Stage 3 tax cuts on the way. While the housing shortage is a concern, rising collateral values does support confidence and home equity levels even if debt service relief is some way off. Relative to expectations, the Australian economy has performed markedly better than expectations and while it is running well below trend, with cost of living pressure likely to persist, we do not foresee a collapse from current levels. But no recession means no recovery and so the path higher will be gradual rather than sharp.

Australian Housing

Further upside coming

House prices across Australia's eight capital cities have now risen for 15-consecutive months and are up 12% from the lows of 2023, with the national average home price back to a record high level.

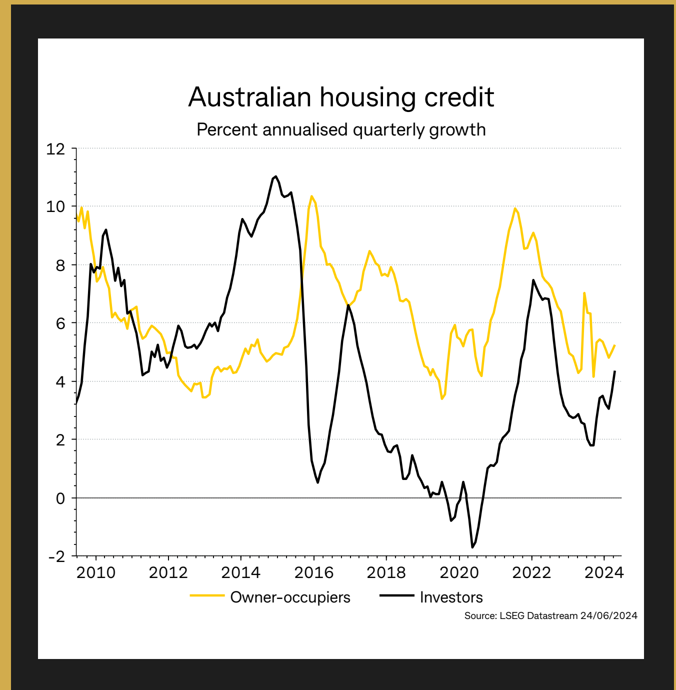
Despite the average mortgage rising 3.5% since the RBA first began raising rates, and the average Australian household being more indebted than any other on the planet, this is a phenomenal achievement.



Regardless of regional and sub-sector disparities or whether housing is considered a physical or financial asset, it is hostage to supply and demand dynamics and there has simply been too much of one (demand) and not enough of the other (supply).

We think many of the trends that have driven house prices higher will remain intact, albeit some with less potency. Under normal conditions, the significant decline in affordability and borrowing limits due to higher lending rates would have been a significant headwind for house prices. However, record immigration levels (reaching ~600k in the 12 months to Oct-23), a structural shortage of supply, a reversal of Covid driven intrastate migration trends, a dramatic decline in listing (boosting sales to new listing ratios) and a very supportive "bank of mum and dad" has driven a consistent rise in prices that doesn't appear to be at risk of ending.

For many households, lower borrowing capacity and rising affordability challenges are preventing a return to the housing market. There is however, a significant cohort where these challenges are less relevant and fear of missing out (FOMO) is driving a willingness to stretch borrowing limits. Similarly, while the cost of credit has risen, it remains available to strong borrowers.



CBA economics believe a shallower easing cycle could slow the rate of house price growth in late-2024, but this is only likely to reduce the gains that will likely exceed its 2024 price growth projection of 5%, as opposed to reverse any upward momentum.

The strong gains in Perth, Adelaide and Brisbane are in part due to a normalisation of conditions around the pandemic period and are likely to fall back into line with broader aggregates as we move into 2H24. Any reprieve from strong home price growth will have to come from the supply side.

A rise in listings, as well as new housing supply will help, but new building approvals are constrained due to challenges in the construction space and crowding out from government and other forms of private investment. It is likely house prices are moving higher, just at a slower pace form here.

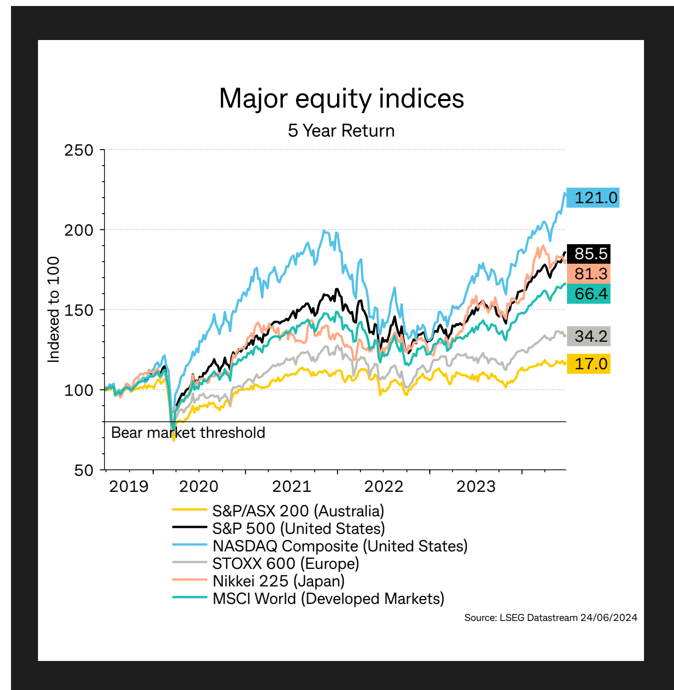
Global Equities

Structural tailwinds offset cyclical headwinds

- We like the outlook for equities. Rate cuts alongside falling (trend) inflation and improving economic growth should see the equity rally broaden into 2H24.
- Transformational changes across the technology sector (AI) are enough to offset cyclical weakness and higher bond yields until fundamentals catch up with the market.
- Valuation concerns are idiosyncratic and not systemic. We are less worried about a deep and/or prolonged correction, but shallow downturns mean shallow recoveries. Don't expect a prolonged period of value stock and/or small cap relative outperformance.
- Australia is overweight value and underweight growth stocks (technology in particular). Without these drivers, we see limited chance of sustained outperformance versus US/Global Equities.

Equity valuations not a constraint to further gains

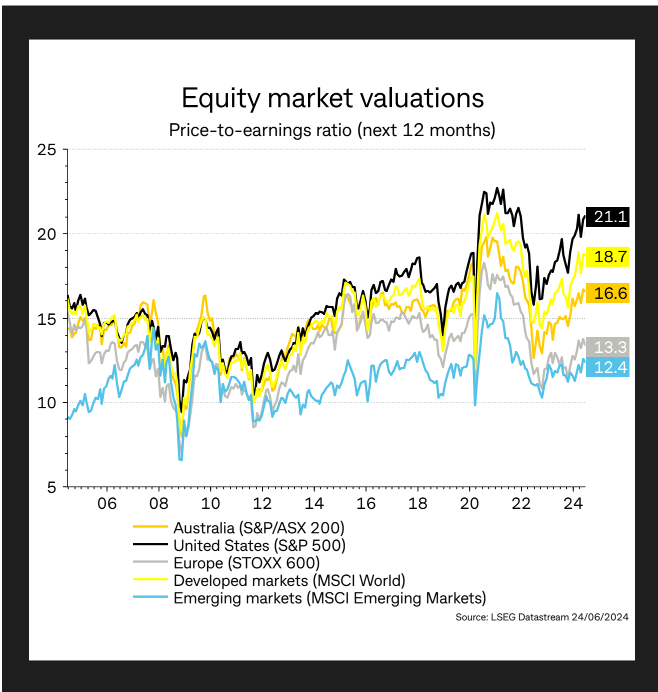
While the post-pandemic rebound has pushed valuations to levels that are likely to slow the pace of gains as we move into 2H24, we think structural tailwinds (AI) and an improving cyclical outlook will be enough push key benchmark indices higher and with price gains to move further down the market cap spectrum into areas that have lagged broader index returns.

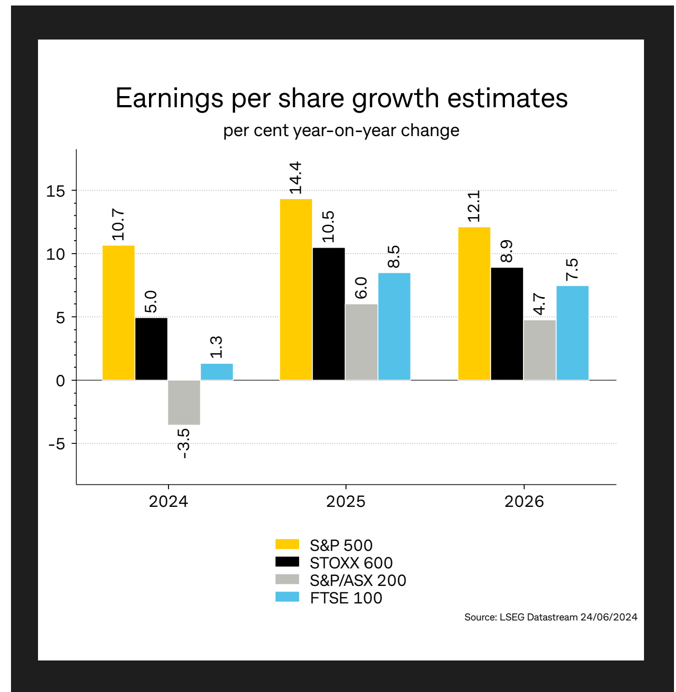


The consensus will continue to chase the market higher

We sit on the positive side of consensus expectations and think the risk of a deep and/ or sustained correction has now been largely removed due to confidence in an economic soft landing and with rate cuts on the horizon. We believe equities can push higher for a number of reasons, including:

- Corporate profits have remained strong despite a plethora of cost pressures (including raw materials and wages) and mixed pricing power. We don't envision a strong springboard for profits given expectations for a muted global recovery, but we do believe profit momentum will rise due to cyclical leverage and strong profit margins.
- In our opinion, the start of the rate cut cycle alongside a stabilisation in activity indicators will support more broad-based performance within equity markets. Small and mid-cap stocks alongside domestic cyclicals which have lagged the performance of large, liquid and often technology sensitive large caps should pick up as confidence in the recovery improves.





- Valuations are lofty in certain areas, but these headwinds are not universal, and there are sufficient offsets within and across equity markets to protect against valuation risk, such as moving down the market cap spectrum, tilting to value and laggard industries or via regional exposures (such as Europe, Asia, Japan or Australia).
- Finally, we feel inflation is on the verge of falling back into the neighbourhood where equities have traditionally performed well. Historically the best regime for US equities is when inflation is sitting between 2-3% (averaging 14% pa since 1950).

Geopolitics will keep uncertainty elevated but will not derail equities

We do have some concerns around the equity backdrop. There is clearly a bifurcation within markets between large, liquid and well capitalised corporates, and those that are more reliant on debt capital markets. Similarly, negative developments around elections and geopolitics could cause more lasting problems for equity investors and risk assets if it were to drive a (semi) permanent spike in volatility and risk aversion. However, we believe high levels of cash sitting in money market funds (currently around US$6.1tn) and underweight equity allocations is a substantial cushion against getting overly bearish.

Equities are supported by both structural and cyclical tailwinds

It's our opinion that equities will be propelled higher by a combination of structural AI-related tailwinds and an improving cyclical outlook. The pace of gains is likely to slow as the hype around the technology sector fades and leadership begins to deepen, but we do not believe equities will undergo a large-scale valuation correction outside of sustained negative inflation-rates developments.

Technology is a durable thematic but value and small caps are not

We still like the technology as our preferred structural thematic. We think this tailwind continues to benefit tech sensitive markets like the US and parts of Asia, including Japan which is in a multi-year reflationary cycle supported by rising wage growth, consumption spending and a weaker yen.

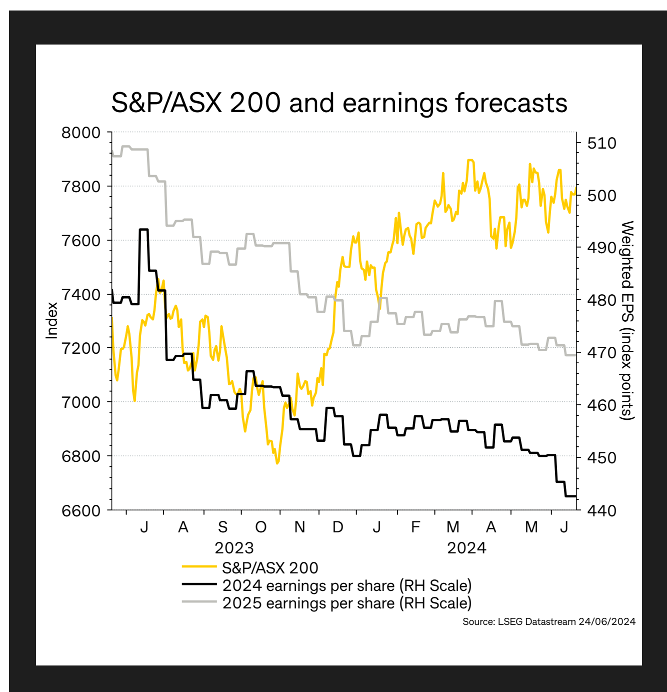
Rate cuts and improving economic growth momentum should help small cap and value stocks close some of the valuation discount to large caps and value stocks but unlike the consensus, we don't see a sustained multi-year trend of outperformance due to expectations for a modest economic recovery.

Australian Equities

Average returns but at lower risk and volatility

For investors in the domestic market, the outlook is solid but far from spectacular. Corporate Australia is well run and has come through the economic slowdown in good shape with profit margins remaining elevated.

While some may see valuations at 17x forward earnings as a constraint, we are less worried and don't believe it prohibit further upside once investors drill further down into the market where there is more valuation appeal.

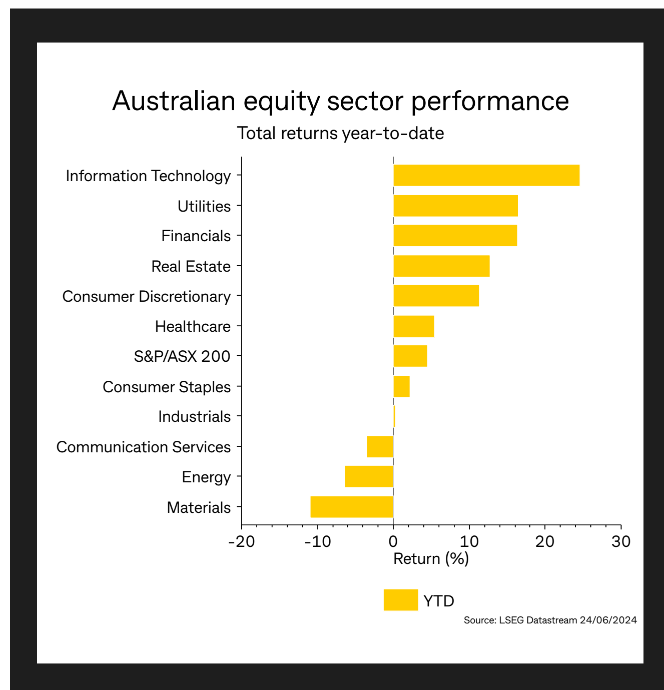


Banks will not provide leadership for the next leg higher in equities

With the earnings outlook relatively muted (~3-4% EPS growth expected for the S&P/ASX 200 Index over the next two years), we think the start of rate cuts could push valuations even higher with earnings only gradually growing into more elevated PE's. In addition, with banks strongly outperforming over the past six to nine months off the back of better-than-expected earnings (less intense competition in the lending and deposit-taking markets, benign credit conditions), leadership for the broader index will not be there as we move into 2H24.

Australia doesn't have an AI driven technology sector

Australia doesn't have many companies directly exposed to AI, and while investors are chasing anything with links to this theme (including data centres), these are not large cap stocks that can propel the market higher.



On this note, it has historically been the case that as the global growth backdrop has picked up, Australia has performed due to the heavy allocation towards resources. But China is in its own "domestic" cycle and while industrial demand will rise as growth improves, we think areas of structural undersupply (such as copper) will remain key upside drivers rather than iron ore.

Low double-digit growth at lower risk remains appealing for Australian investors

We think Australia can post returns in the high single-digit to low double-digit range over the coming year as capital growth is supplemented by a 4-5% dividend yield. While far from the lofty levels the more cyclical and tech laden benchmarks may provide, this is about average and sometimes average is good enough, particularly with lower volatility.

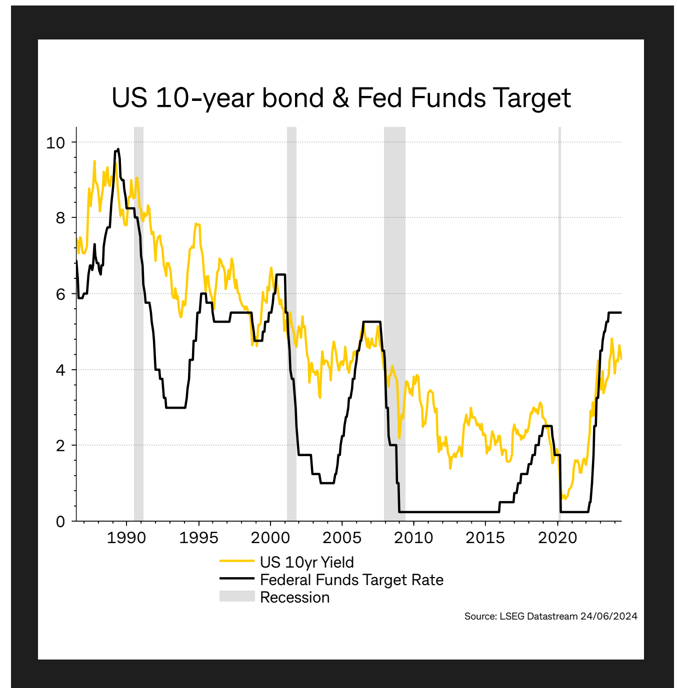
Fixed Income Outlook

The stars are aligning

- We expect fixed income to deliver attractive risk-adjusted returns under a falling inflation / moderate economic growth backdrop, and even better risk adjusted returns if macro conditions deteriorate. This is a win-win scenario.
- Central bank rate cuts have started but de-synchronised business cycles mean they will proceed at an uneven rate. Investors should be looking to move out of cash to lock in peak bond yields. A flattish yield curve means there is limited need to move too far out the curve or take on a lot of interest rate risk.
- Private credit, despite the hype, should be a part of every well diversified portfolio. Investors should require a high hurdle rate alongside strong lender covenants to make up for illiquidity with diversification across issuer, exposure and country which are solid offsets to asset class risks.

Lower policy rates mean falling cash returns

Higher interest rates have been a boon for cash heavy investors in recent years. However, the global rate cut cycle is now underway and declining short end returns are likely to be a catalyst for some of this cash to begin moving into fixed income and/or more risky assets. Bond returns have lagged behind other asset classes as central banks have raised policy rates and inflation fears have driven the "higher for longer" narrative. In our opinion, investors should look to raise fixed income exposure in order to lock in peak rates as the easing cycle marks an inflection point for bond yields.



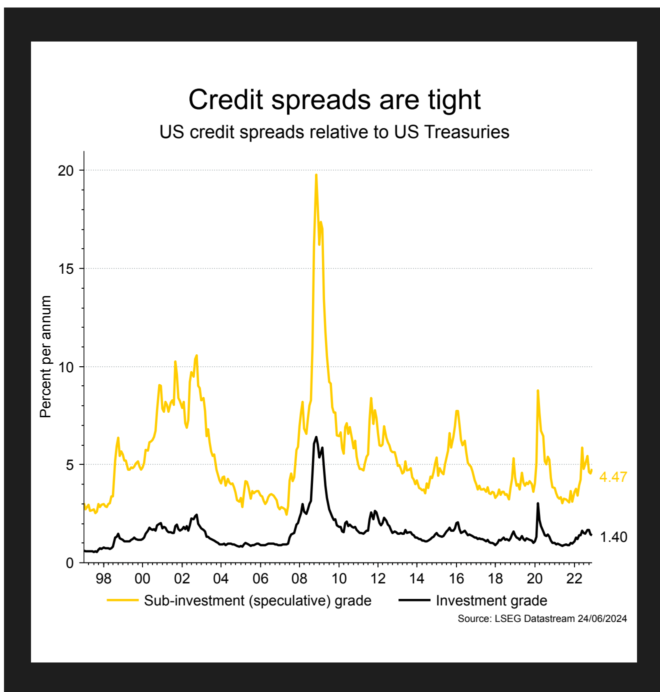
Long bond yields will not remain at peak levels once cash rates begin to fall

While there is a view that long bond yields will remain elevated due to structural inflationary concerns and the need for a reasonable spread to short rates (the term premium), we think investors have an opportunity to lock in long bond yields in the range of 4-5%, while also picking up some capital appreciation as they move lower over the coming year. Historically, long yields have fallen as central banks have cut short rates and we expect the same to occur this time around, albeit with yields to settle at moderately higher levels.

Bonds are back – providing yield, capital upside potential and diversification benefits

Higher starting yields, the potential for capital upside and greater downside portfolio protection via a lower correlation with equities underpins our positive view on fixed income, particularly on a risk adjusted basis versus other asset classes.

In addition, the divergence in the speed at which inflation is decelerating across the developed world should provide attractive fixed income opportunities at a security and country level without the need to take on significant interest rate, credit or illiquidity risk.



Credit spreads are already tight – stick to higher quality issuers

Credit spreads have remained exceptionally tight throughout the past 18 months as corporate fundamentals remained resilient to tighter monetary conditions. While surprising, this trend has mirrored that for most economies which have performed far better than expected given the pace and magnitude of policy rate hikes.

However, a two-tiered backdrop has developed with many large cap well financed corporates powering on through the slowdown while many cash short, finance reliant corporates have suffered from deteriorating economic conditions. While the macro economy remains tough for many businesses, we don't expect to see systemic concerns emerge across the credit spectrum and do not foresee a meaningful rise in spreads coming.

Private credit is not a bubble. The illiquidity premium remains intact

The withdrawal of banks from some non-core lending (deleveraging) is driving strong growth within private credit with demand also being fuelled by more innovative ways to access higher yielding and more diversified credit products.

While the hype surrounding credit is a reason for caution, we believe that a sensible allocation – diversified across issuer, exposure and country – with high hurdle requirements and strong lender covenants to make up for illiquidity, will enhance the risk-reward characteristics of a diversified multi-asset portfolio and provide investors with a yield that in the past was not possible to achieve without going further out the risk curve.

In other words, we think fixed income investors can now approximate equity like returns with an attractive risk-adjusted outlook given the yield available within private markets. In addition, this becomes even more appealing for those who are concerned about valuation risk within equities vis-à-vis bonds.

Fixed income is a crucial component of multi-asset portfolio construction

We think the stars have aligned for fixed income and that it offers investors a combination of yield, capital upside and diversification benefits that have been lacking for many years. While rate cuts send a signal that risk taking behaviour may be about to increase, we still like the higher quality credit segments.
We think investors should be moving out of cash to lock in peak yields and extending duration out past benchmark. We think private credit still provides highly appealing return opportunities and should be a key part of any fixed income allocation over the coming 12 months.

Alternative Assets

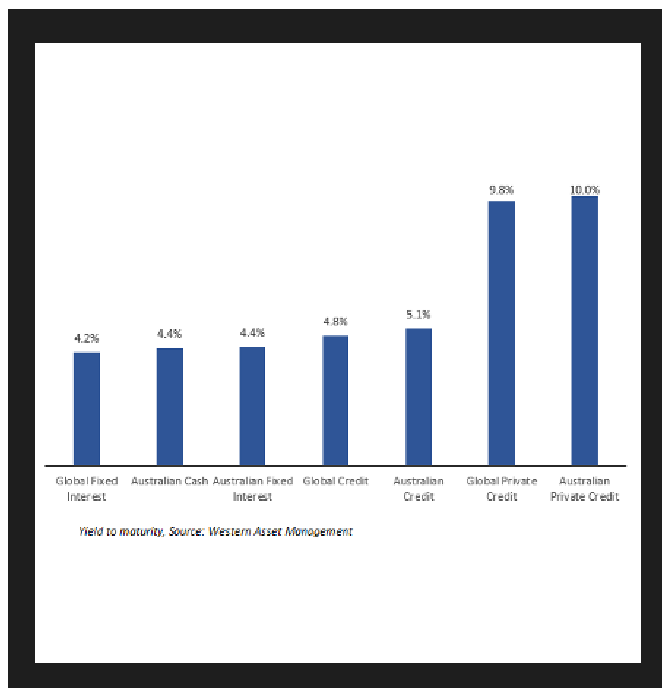
A meaningful addition to investment portfolios

- Alternative assets are a must have either as stand-alone investments or as part of a multi-asset portfolio.
- Hedge funds offer strong diversification benefits against traditional assets, but manager selection is key. We like long-short and macro funds.
- We like private credit for its yield enhancement and limited market risk exposure while we think PE should hold a structural allocation in portfolios.
- Real assets provide an inflation hedge as well as a predictable income stream. Strong structural tailwinds raise the appeal of infrastructure (decarbonization) and selected areas of property (healthcare, logistics & data centres).

We see alternative and real assets as providing three key attributes for portfolios. First, hedge funds are a strong ballast for financial market volatility and uncertainty given low correlation with traditional assets (equities and bonds); Second, high quality private credit can provide significant yield enhancement versus traditional fixed income assets; and third, selected areas of infrastructure (decarbonisation) and property (logistics, data centres) provides access to strong structural thematics which are increasingly important when cyclical tailwinds are less pervasive.

Hedge funds are a strong source of idiosyncratic return

The idiosyncratic nature of alternatives and in particular hedge funds provide an important risk diversifier for portfolios when macro uncertainty and two-way volatility is high. However, returns to hedge funds as an asset class have been steadily declining over the past two decades with significant performance dispersion amongst managers. This means manager selection and fund diversification are important considerations when selecting hedge funds with the intention of reducing market (systematic) risks.



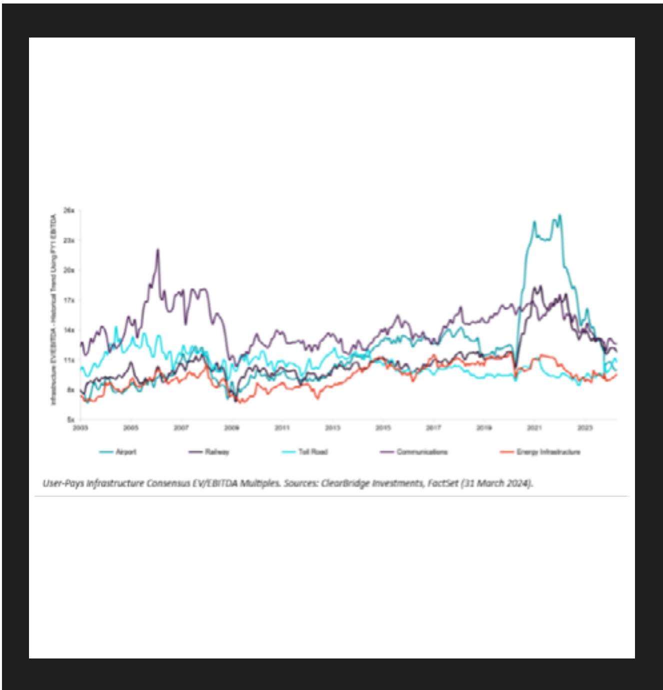
Yield to maturity, Source: Western Asset Management

Private Markets (credit) are an appealing destination for cash heavy investors

Private markets continue to offer attractive diversification benefits. While a higher cost of debt and lower capital market activity present some challenges, the overall picture is more nuanced, with 2023 the seventh-largest fundraising year in history.

Private equity has seen a welcome decline in entry valuations, with secondaries seeing attractive discounts as markets become more challenging and some existing investors require liquidity. Venture Capital continues to struggle as more companies are now approaching the stage where they can no longer delay new funding rounds which is creating a reset of valuations.

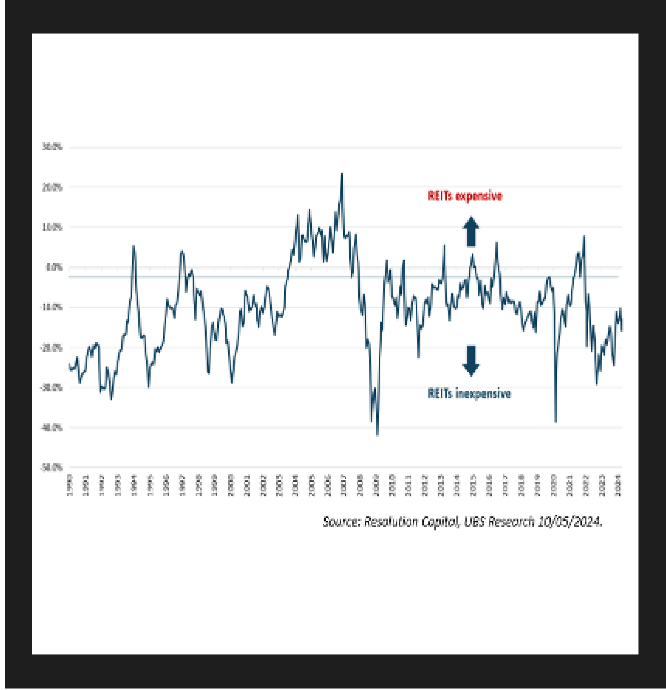
Selective private debt, especially senior debt opportunities, look attractive given the higher interest rate environment with floating rate yields rising. Uncertainty and tighter credit conditions have caused traditional lenders, like banks, to retreat, thereby creating better opportunities for private lenders.



User-Pays Infrastructure Consensus EV/EBITDA Multiples. Sources: ClearBridge Investments, FactSet (31 March 2024).

Infrastructure provides exposure to structural investment tailwinds

For a significant part of 2023 and into 2024, global listed infrastructure has had a difficult period keeping pace with the risk-on sentiment of the broader equity market. Rising interest rates and the more defensive characteristics of infrastructure have been head winds. However, there is a rising structural tailwind for infrastructure via strong and stable earnings growth, attractive valuations and a demonstrable dividend stream.

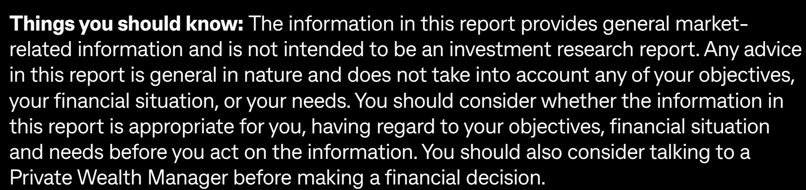


Source: Resolution Capital, UBS Research 10/05/2024.

Property comes with cyclical headwinds and structural tailwinds

In the past few years, global listed property returns have been diluted by rising interest rates and structural overhangs afflicting retail (bricks and mortar), office (high vacancy rates) and commercial). Added to this has been more hawkish interest rate expectations by major central banks.

Since the GFC, the asset class has shifted to lower financial leverage, well staggered debt maturities and diversified sources of debt. With this backdrop, asset class valuations are relatively attractive, trading at a discount to private market real estate values and, in some cases, below replacement costs. An allocation to global listed property remains warranted in a diversified portfolio.



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