Prospects for the economy look a little brighter but uncertainty remains

Macroeconomic update | H1 2023

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Market sentiment has improved markedly since September of last year, driven by surprisingly resilient economic activity in the US and Europe, China reopening, inflation peaking and outlooks on central bank tightening looking more market friendly.

So what do these developments mean for Partners Group's core macro views and our private markets investment strategy? Tina Jessop, Senior Economist, explains.

Given more positive economic developments recently, what is your view on economic growth and the risk of recession?

The economic backdrop looks brighter than it did just a few months ago. The energy supply disruptions in Europe that many had feared did not materialize, US private demand has so far weathered rising rates, and inflation is slowing, so there is greater visibility on how high central bank policy rates could go. As a result, we believe the risk of a more severe downturn is lower than it was.

Yet we still see plenty of uncertainty in a range of areas. Labor markets may not be as tight as they were, for example, but many sectors still face worker shortages. It is likely that the savings built up over the pandemic period will be exhausted by late summer as people dip into them to meet higher living costs. Furthermore, monetary policy acts with a lag and so higher rates will continue working their way through the system for some time to come. These could all act as headwinds to near-term real GDP growth and so we are maintaining a cautious stance in our underwriting for the time being.

Over the past two years, Partners Group has taken the view that inflation will be structurally higher as opposed to cyclical or temporary. As inflation is coming off peak levels, has this changed?

It's clear that cyclical inflationary pressures are easing now that energy and goods price rises are cooling. Yet core inflation, which excludes energy and food, and service price inflation, which tends to be stickier, currently show little signs of easing.

Many economists are predicting that inflation will follow a straight path down towards central bank targets by 2024. It's unclear where inflation will eventually bottom out over the next 12-24 months. However, we believe that this deceleration may be less smooth than these predictions suggest.

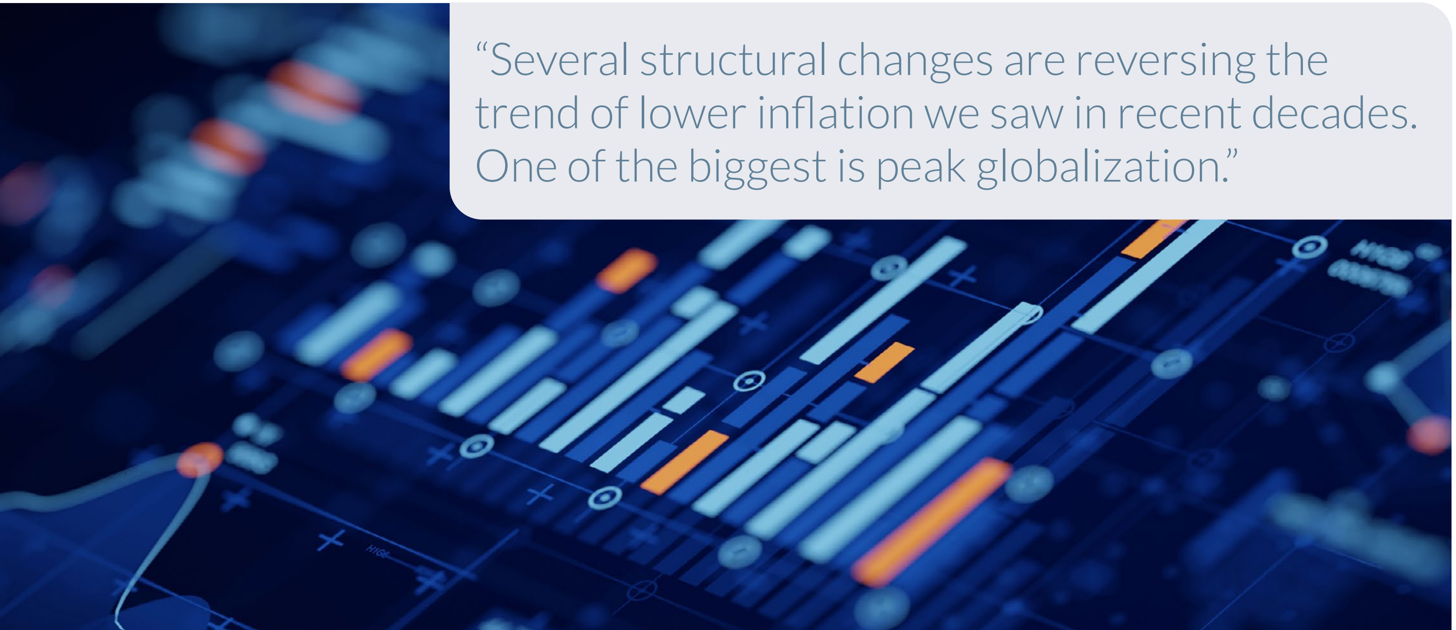
We see this in our portfolio companies. For example, input price pressures are substantially less pronounced than they were just a few months ago, but delivery times are still longer than they have historically been and hiring remains a challenge. Our discussions with portfolio companies indicate that their 2023 financial budgets include planned price increases and wage growth that are inconsistent with central bank inflation targets of 2%.

As a result, we continue to believe that inflation over the medium to long-term will trend to a 3-4% range in the US and to a slightly lower range in the Eurozone.

What is behind structurally higher inflation?
Several structural changes are reversing the trend of lower inflation we saw in recent decades. One of the biggest is peak globalization. After years of global integration, the world is becoming multi-polar, as companies move critical supply chains closer to home in a bid to build resilience. In response to geopolitical tensions, we are seeing restrictions on the free movement of goods, capital, technological knowhow and energy supply.

All this will increase company operating and production costs, while the energy transition will further strain energy and certain commodity prices.

Wages are another area of structurally higher inflation. The pandemic exacerbated already tight labor markets and demographic decline will only make this worse. Certain segments in the healthcare sector, for example, face a structural shortage of professionals as more people retire than newly qualified staff join the labor force.



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We also believe there is a strong political incentive to keep inflation at moderately high levels. This is because higher inflation leads to higher nominal growth, and this alleviates record high government debt levels and persistent fiscal deficits.

With inflation reducing, the market now expects central bank rates to peak in H1, followed by rate cuts towards end 2023 and in 2024. What is your assessment?
As inflation decelerates, we think that central bank rates will likely reach peak levels over the course of H1.

After that, though, the rate path is much more uncertain. Much will depend on how economic growth and labor markets hold up. As highlighted earlier, we are skeptical that the disinflation path will be as rapid and straightforward as consensus anticipates.

As a result, we believe it may be premature to price in central bank rate cuts for the second half of the year. Instead, we think that central banks will increase rates in H1 2023 and this may be followed by a pause, leaving rates at elevated levels into 2024.

Over the mid-term, structurally higher inflation rates will also mean higher central bank target rates than those set since the Financial Crisis. We expect real rates to level out at close to zero percent.

What does this mean for private markets in 2023 and how is this impacting our investment strategy?
A more positive market environment bodes well for private markets as price expectations between sellers and buyers converge and credit becomes more available. And when private market investment activity picks up after an economic downturn or a severe market correction, there is typically an interesting period where private market investors can acquire attractive assets at lower valuations.

Until this happens, we remain cognizant of near-term macro risks and we are actively building out our pipeline of thematically oriented target assets. We will continue to focus on investment opportunities where we have high conviction in the underlying theme and on the potential for transformational future growth.

Across all asset classes, we also continue to place great importance on demand resilience, where assets can pass on potential pricing pressures and mitigate near-term risks to growth and inflation. Geographical exposure across the full supply value chain is also an important consideration.

From a relative value perspective, private debt, with its high single-digit to low double-digit return potential, remains attractive in this environment. Private infrastructure is also attractive because it is well positioned to benefit from the green energy transition, stretched government budgets and because of its inherent inflation link.

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