Private Markets Outlook | H2 2023

Braving the new macro regime

Partners Group

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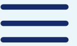


Braving the new macro regime

- Following the most aggressive rates hike cycle in decades, we anticipate a recession in the US and Europe. But the slowdown will be gradual.
- We expect increasing divergence across industries and business models during the recession – and the subsequent recovery – with impacts varying according to how they adapt to the new regime defined by higher rates, disruptive technology and a multipolar world.
- Inflation will continue to cool, but the deceleration may peter out once it gets to 3-4%, encouraging central banks to keep interest rates at peak levels into 2024.
- Going forward, capital allocation will have to consider an environment of high interest rates, downward pressures on GDP and disruptive technology. Investing in this 'brave new world', we focus on our established thematic and value creation approach, while applying asset testing scenarios to reduce downside risks.
- Our relative value assessment points to infrastructure and private credit as the asset classes benefiting the most from new and ongoing structural shifts that make up the new regime. Private equity has seen a welcome decline in entry valuations, with private equity secondaries seeing attractive discounts. There is also strong momentum behind real estate value-add strategies.

Introduction

The first half of 2023 has cemented the shift into a new macro regime. The era of cheap debt, vast credit availability, global trade integration and a US-led unipolar world has come to an end. In the near term, we expect the US and Europe to enter into a recession, while inflation and interest rates may remain higher for longer. Mid-term, we anticipate a new steady state of tepid economic growth and modestly higher inflation and nominal interest rates. Under this surface, a dynamic evolution of structural changes is brewing. These will drive a redistribution of profit pools and alter economic structures, thereby presenting compelling investment opportunities.

Tina Jessop
Senior Economist

Tina Jessop presents our near-term economic outlook and explains how it will influence decision making at the major central banks.

Stephan Schäli
Chief Investment Officer

Stephan Schäli introduces our views on the changing economic fundamentals and our approach to a "brave new world" of investing, looking into each asset class.

Nils Bartel
Global Head Capital Markets

Nils Bartel outlines the impacts of the higher interest rate environment on the financing market in a dedicated Q&A.

Tina Jessop
Senior economist

Gradual slowdown and recession expected, with varying impacts across industries as economic forces rearrange

Following the most concentrated and aggressive interest rate hiking cycle by major central banks, the Eurozone is already in a technical recession and the US could soon follow.

Over the past few months, we argued that monetary tightening, higher cost of living and the erosion of pandemic savings for many households and businesses would result in a material economic slowdown. Yet, consumption and labor markets have proven surprisingly resilient, supported predominantly by a strong services sector.

It seemed the economy had become less rate sensitive as the post-pandemic normalization was still unfolding. Now, however, higher interest rates are feeding into the real economy. Lending conditions are tightening and demand for credit is easing.

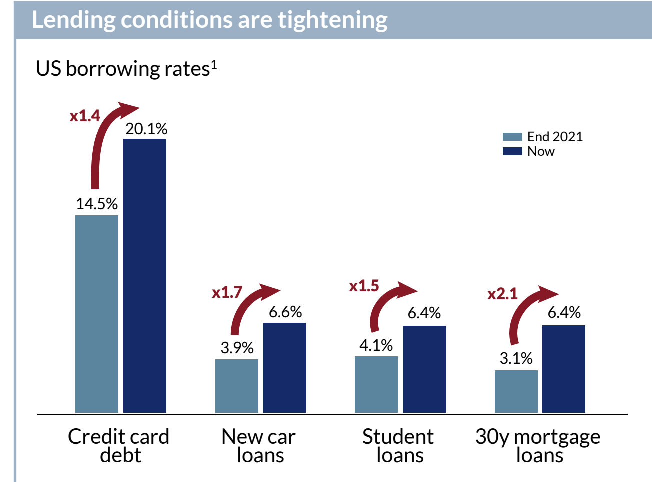
The slowdown will be gradual, we believe, and will be felt differently across industries and business models. Beyond the recession and subsequent recovery, we believe that structural forces will continue to drive changes in sectoral GDP composition.

Wage pressures will sustain core inflation above central banks' targets

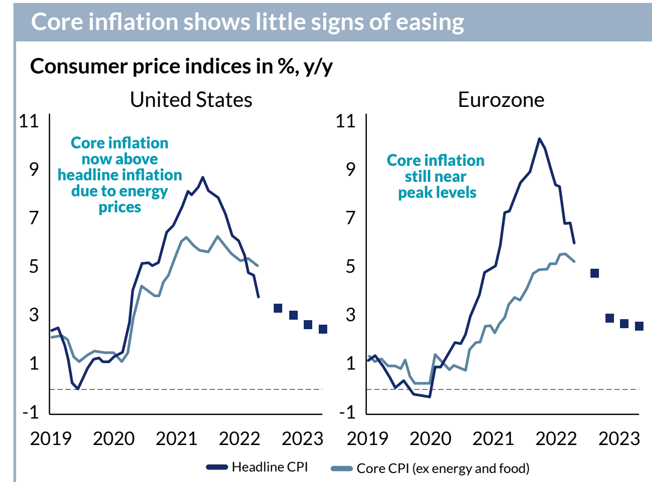
Many of the supply bottlenecks that caused the sharp spike in consumer price inflation have abated. Goods demand has normalized. This is evidenced in cooling energy and goods price pressures, the major drivers behind the recent deceleration of inflation rates. Meanwhile, core and services inflation remain persistently high.

Going forward, we view wage growth as being a key determinant of core inflation. Labor markets in the US and Europe remain tight, with job creation still up and wage growth above past decade averages. But we expect moderation. Evidence from our portfolio assets indicates that hiring intentions are being revisited. Employees are also less likely to switch jobs, softening wage pressure.

Still, we are not yet at a stage where businesses will cut work forces on a large scale. Businesses do not want to be caught in a 2021/2022-like situation where labor shortages restrained output. Furthermore, the demographic decline in the workforce and structural talent shortages in certain industries, like healthcare, should help sustain wage growth for longer.



Source: Partners Group, Federal Reserve (May 2023).
[1] Student loans are the average interest rate for all federal loans, and the mortgage rate is for fixed mortgages.



For illustrative purposes only. Dots show quarterly consensus forecasts for headline CPI. Source: Partners Group, Bloomberg (2023).

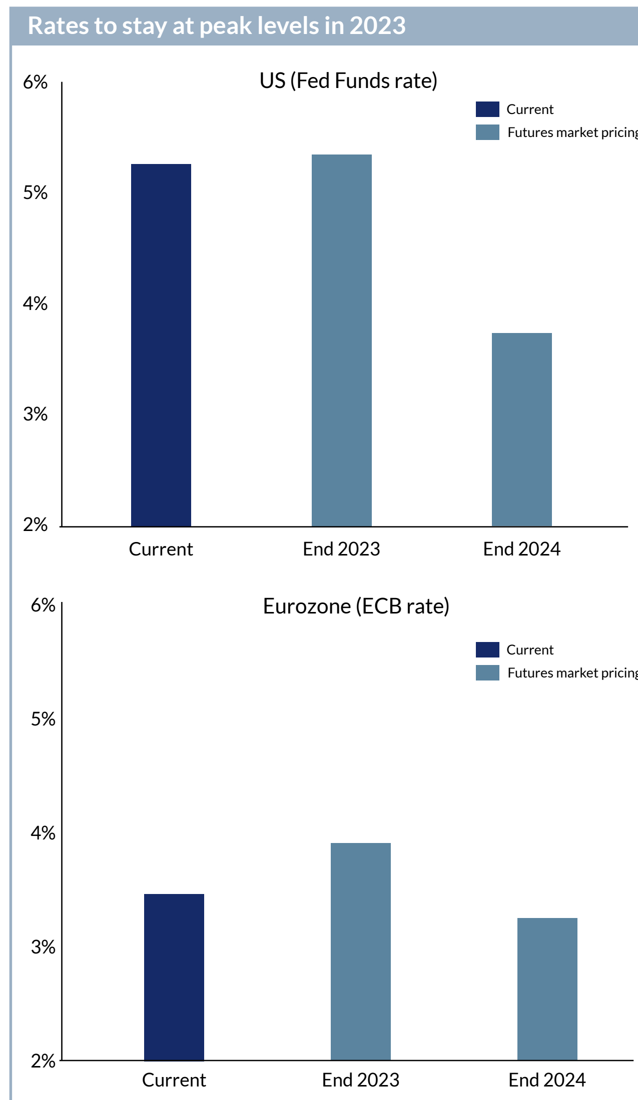
In addition, companies will aim to continue passing on higher costs to protect margins, but this will clearly become more difficult as top-line growth slows further. As a result, we believe inflation will continue to cool but this deceleration may peter out once the 3-4% mark is reached.

Rate cuts not to be expected until 2024, unless precipitated by severe credit events

The Fed is likely to move first in any future rate cuts, with it being ahead in the hiking cycle compared to the ECB and the Bank of England. But given the current economic environment – and even considering the Eurozone's modest contraction – we do not anticipate any cuts before 2024. There's also a high degree of uncertainty around the timing and scale of future rate cuts.

Central banks will likely want to see a sustained cooling of the labor market to prevent a potential wage-price spiral and unanchored inflation. This is the key lesson learned from the Great Inflation crisis of the 1970s. The US official 'non-cyclical' unemployment is at 4.2%, with the current actual unemployment rate at 3.7%. The Fed will likely accept some overshoot above the 4% mark before turning more dovish and we expect this to take us into next year.

Financial stability is another factor to be considered. The recent turmoil in the banking sector implies that rates likely cannot go much higher. Therefore, cuts could happen earlier if we were to see the emergence of more severe credit events that cannot be mitigated with targeted liquidity injections.



For illustrative purposes only.
Source: Partners Group, Bloomberg (2023).

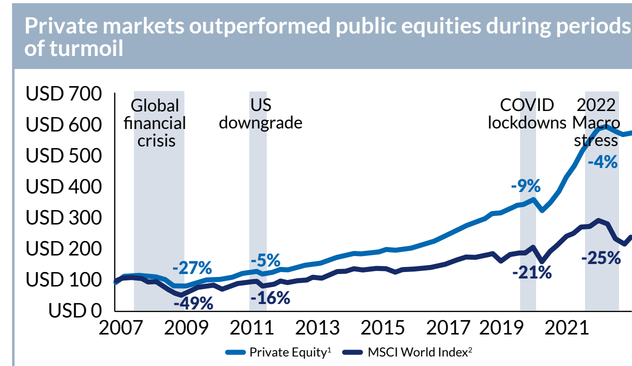
Stephan Schäli
Chief Investment Officer

Braving a world redefined by technology, changing demographics and multipolar competition

The recent events advances around artificial intelligence (AI) and ongoing geopolitical tensions are perfect examples of what is giving rise to a 'brave new world' of investing. The era of declining interest rates, cheap credit and a US-led unified global economy is in the past. A new macro regime is emerging. We believe it will be defined by disruptive technology, downward growth pressures from changing demographics amid already elevated fiscal debt levels, and an increasingly multipolar world. In this environment, passive investing and the traditional 60/40 portfolio will be challenged.

We have identified three giga themes – Digitization & Automation, New Living and Decarbonization & Sustainability – that we believe will drive a substantial reordering of sector compositions and create ample investment opportunities over the years to come. The impacts will be felt on the way people live and work, and on industries and economies. Profit pools will be rediverted as some business models become obsolete while others are newly created or innovated. In many cases, public markets will not be able to capture this transformation. The most resilient and sustainable businesses can be several layers down in the value chain and operate in less obvious underlying sub-sectors.

Private markets outperformed public equities during periods of turmoil



For illustrative purposes only. Figures as of 31 December 2022. Drawdowns correspond to quarter end index values. [1] Private Equity returns represented by the Bloomberg PE Buyout Index (PEBUY) through 31 December 2022. Benchmark is used for comparison purposes only. [2] MSCI World total return in USD.
Source: Partners Group (2023).

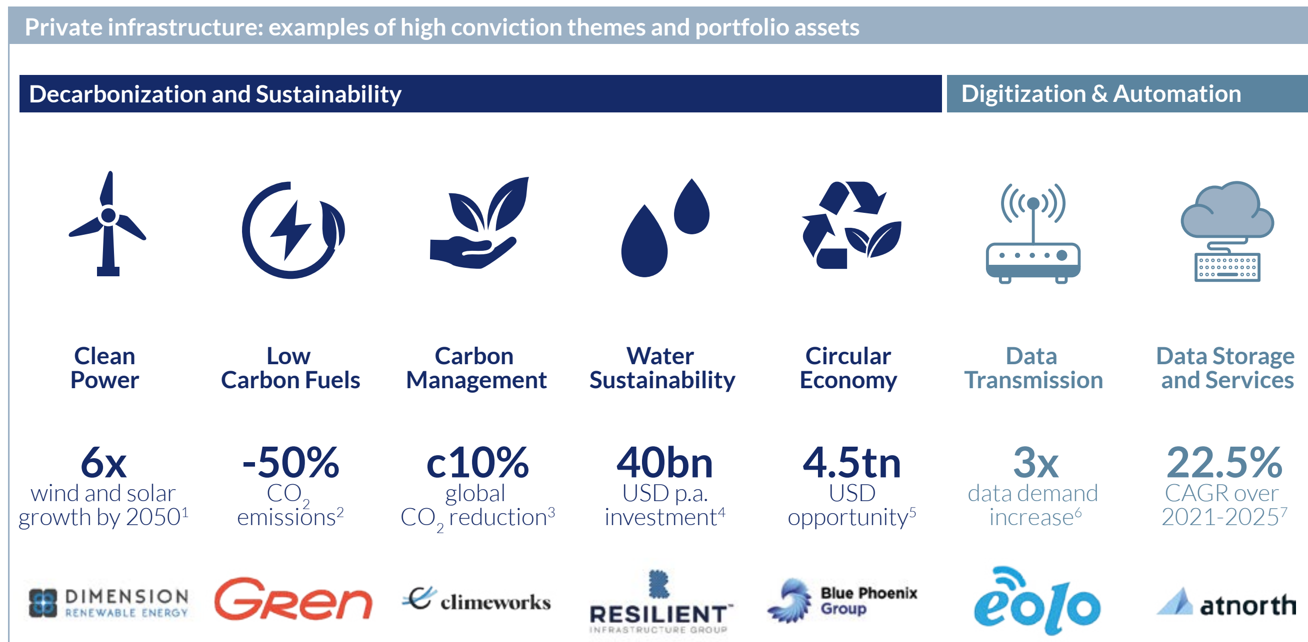
For example, within carbon capture, direct air capture is a new technology that will play an important role in achieving net zero carbon emission goals. In healthcare, the next wave of innovation will be highly data centric. Big data and digitized monitoring will help inform medical diagnosis, treatment plans, and the health status of patients. Supply chain transformation is another example where companies must prepare for a multipolar world by securing and diversifying supplier relationships and using the opportunity to digitize part of the monitoring process.

A proactive and dynamic approach to investment is required to build a new type of defensiveness and drive growth. We believe private markets managers have the operational and strategic expertise, long-term discipline and the capital needed to steer assets through this transition.

Keeping a thematic investment approach with thorough asset testing to reduce downside risks

The core of our investment strategy is unchanged: we apply our established thematic approach and focus on value creation. This may entail helping a leading company to adopt new technologies to enhance operational efficiency or reach new markets, as well as working on asset repositioning. Compared to the recent past, we place greater emphasis on organic growth and real asset transformation. Inorganic platform expansion is still appealing if it can be achieved through cash flow generation instead of expensive debt financing facilities.

With our approach, we aim to smooth exposure to GDP growth in our portfolio. For instance, we like logistics properties in strategic locations, with purpose-built features and tenant-specific capex, which are supported by secular shifts towards e-commerce and supply chain optimization. In infrastructure, big data and AI are driving an increase in data storage and data center demand. As a safeguarding measure, our base case scenario already incorporates more cyclical risks, a recession, and margin headwinds. We will maintain this discipline for the foreseeable future in both our assessment of new investments and in the steering of our portfolio assets as we continue to monitor the macroeconomic and capital market backdrop in which we operate.



For illustrative purposes only. Selected investments represent a sample of infrastructure directs and co-investments that Partners Group made on behalf of its investors. The examples shown represent transactions made between 2021 and 2022 and may be part of several infrastructure and open-ended products, managed by Partners Group. 1 Increase in share of wind and solar in total generation. Source: Bloomberg New Energy Finance – New Energy Outlook 2022 (2023). 2 Source: Intergovernmental Panel on Climate Change, Goldman Sachs. 3 Contribution of carbon capture and sequestration in carbon emission reduction needed by 2050 to achieve Sustainable Development Scenario of the International Energy Agency. Source: IEA. 4 To maintain US current supply. Sourced from: American Society of Civil Engineers. 5 Sourced from: Accenture Strategy publication, Waste to Wealth. 6 Global growth from 2020 to 2028. Sourced from: AV&Co, Cisco. 7 In the Nordic data center market. Source: Altman Solon 2021. Rationale: examples reflect recent investment in a company benefitting from transformative trends in sub-sectors with high relative value attractiveness. Source: Partners Group (2023).

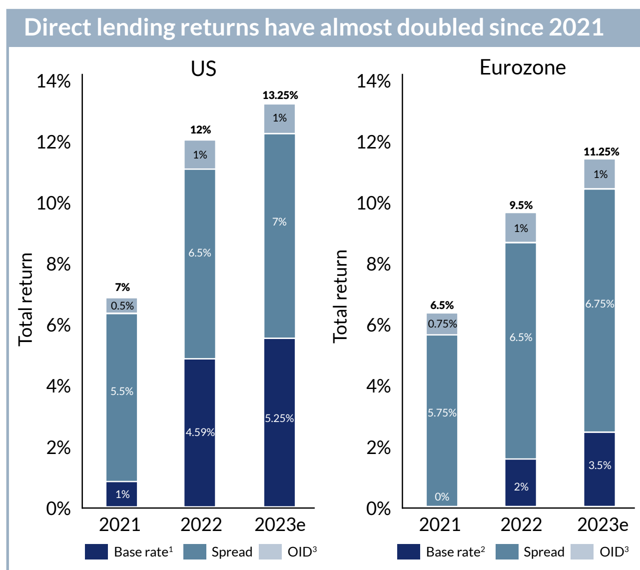
For new opportunities, we carry out comprehensive asset testing against adverse economic scenarios and do not compromise on price. We also continue to place emphasis on assets' pricing power, product differentiation and cash flow generation to ensure margin stability amid lower GDP growth, higher interest rates and elevated wages.

Our relative value views across private markets asset classes

Bifurcation is the overarching theme across private markets today. Quality assets are garnering investor interest from an equity and credit perspective. More cyclical or underperforming assets, on the other hand, often have their sales pulled or do not even come to the market in the first place.

Private equity and private real estate have seen a welcome decline in entry valuations, between 5% to 15% depending on the sector and industry. With a notable gap in bid-ask spreads, transaction volumes in general remain subdued. We believe volumes may

bounce back quickly once the timing and depth of the economic slowdown and the path for interest rates become clearer. This should be followed by a period in which capital can be deployed at more attractive entry valuations for private equity. In private equity secondaries, momentum is strong with high-quality LP portfolios and continuation funds coming to market at attractive discounts. In real estate, we see the new macro environment as even more conducive to our value-add strategy focused on asset transformation and thematic sourcing.



[1] Base Rate = ICE LIBOR USD 3 Month. [2] Base Rate = CME Term SOFR 3 Month. Spread and OID are observations by Partners Group as of December 30, 2022. [3] Original issue discount (OID) is a form of interest equal to the excess of a debt instrument's stated redemption price at maturity over its issue price. For illustrative purposes only. There is no assurance that similar results will be achieved. Actual figures may differ and may vary significantly. Source: Partners Group (2023).

Private infrastructure is one of the standout asset classes, supported by structural tailwinds, such as digitization, decarbonization and clear alignments with governments seeking to compensate historical underinvestment. The most attractive value proposition in this macro backdrop consists of a mostly equity-financed platform strategy. Private infrastructure valuations for core assets and market leaders remain at lofty levels. We focus instead on the next top-three assets. We then make tuck-in acquisitions at lower valuations, thereby further diluting the average valuation. We avoid GDP-sensitive segments and look for direct or indirect inflation correlation of revenues.

Within private debt, senior debt is exceptionally well positioned to benefit from the high rates environment. Floating-rate yields have doubled to 10% over the past 15 months, mostly driven by base rate increases. We see compelling returns

Economic and market scenarios: main parameters

Our base case scenario guides our overall strategy, while three other test scenarios help us assess the robustness of an asset, sector, or portfolio of assets against different economic and market outcomes.

	Base case	Asset testing scenarios		
	Modest growth & higher inflation	Stagflation	Severe recession	Market rally
Real GDP growth¹ *Next 5-year average*	**1.5-2.5%** *US: 1-2%* *EU: 1-1.5%*	0-1%	1-1.5%	2-2.5%
Inflation¹ *Next 5-year average*	**2.5-3.5%** *US: 3-3.5%* *EU: c.2-3%*	4-5%	1.2%	2.2.5%
Fed funds rate *In 5 years' time (5-year average)*	**3-4%** *(c.3.5-3.75%)*	**4-6%** *(c.4-4.5%)*	**1-2%** *(c.1.5-2%)*	**2-3%** *(c.3-3.5%)*
Market valuations² *In 5 years' time*	**0-10% lower**	**10-20% lower**	**5-10% lower**	**5-15% lower**

Base case scenario
The US and Europe enter a recession in 2023/2024 as tighter financial conditions slow demand and hiring. Despite easing growth, sticky core inflation keeps rates elevated into 2024, with gradual easing thereafter. In the mid-term, structural headwinds (debt, demographics) drive modest trend growth. Structural factors (peak globalization, energy transition) keep inflation above 2% targets. Central bank target rates stay higher compared to the past decade. Valuations remain broadly unchanged, having already repriced to margin headwinds and higher rates.

Stagflation
As the economy enters a recession, monetary policy is relaxed prematurely. Inflation remains elevated/eases only temporarily before inflation and inflation expectations pick up again (wage-price spiral). Eventually (2025/2026), central banks react aggressively, durably lifting real rates into positive territory. Valuations correct materially.

Severe recession
Tighter financial conditions result in a substantial rise in default rates and/or financial instability. Governments have little room to step in. Disinflationary demand destruction requires drastic rate cuts back towards past lows. After a sharp correction, valuations recover somewhat.

Market rally
Growth proves more resilient (strong employment), and core inflation gradually returns towards central bank targets, allowing central banks to lower rates. Real rates remain at the neutral level. Capital availability and valuations rise.

[1] NAV-weighted as per Partners Group's asset split across US, Europe, other advanced and emerging markets. [2] Market valuations refer to price-to-earnings ratios for public equities, enterprise value to earnings before interest, tax, depreciation and amortization for private equity, capitalization rates for private real estate and underwriting internal rate of return for private infrastructure. For illustrative purposes only. Source: Partners Group (June 2023).

across the quality spectrum, including for high-quality companies. Moreover, choppy markets have led traditional lenders like banks to rein in their offerings, leaving space for private lenders to fill the gap. With a recession approaching, however, we remain selective. Weaker companies may struggle, as profit margins narrow. Although we don't anticipate a return to past recession highs, default rates could slowly tick higher from today's suppressed levels of c. 2%.

While higher rates constitute a tailwind for private credit, questions have been raised about the future of the leveraged buyout model amid increasing debt costs. We believe these concerns to be overdone for two reasons. First, history has shown the buyout model can weather volatile environments: the high rates of the 2004-2007 period and the 2008-2010 recession yielded solid multiples for buyout investors. Second, our analysis indicates that, for companies that can maintain margin stability, the recent entry valuation compression largely compensates for lower leverage and higher interest rate payments. But it is also true that macro volatility often lays bare operational expertise and adaptability to changing economic fundamentals.

Return dispersion typically widens substantially in challenging investment backdrops, so manager selection is crucial.

Nils Bartel
Global Head Capital Markets

Living with higher interest rates: a capital markets perspective

Interest rates on buyout debt have doubled over the past year. What is Partners Group's Capital Markets team doing to prepare portfolio assets for this regime of higher rates?

We are closely monitoring market conditions in terms of capital, rates and the financing requirements of our assets. This allows us to actively manage capital structures and interest rate hedging, especially for direct private equity and infrastructure investments. We have always partially hedged floating-rate debt at the asset level The level of hedging has varied depending on factors such as the asset class, capital structure, the asset's characteristics and investment case, among others.

In Q3 2021, expecting a significant increase in inflation, we decided to increase hedge ratios for the large majority of our private equity and private infrastructure direct portfolio to 90%. Therefore, these portfolios are well protected against the current environment. More recently, with floating rates likely close to peak levels, we have reverted to a partial hedging strategy. From a debt maturity perspective, we have been pro-actively refinancing or extending maturities. In our private equity portfolio, for example, more than 90% of debt matures in 2025 or later.

How have capital markets been impacted by this new regime and what are conditions like today?

Rapidly rising rates, financial tightening, the stress in the banking sector, and macro and geopolitical uncertainty have all had an impact on capital markets. Since the first

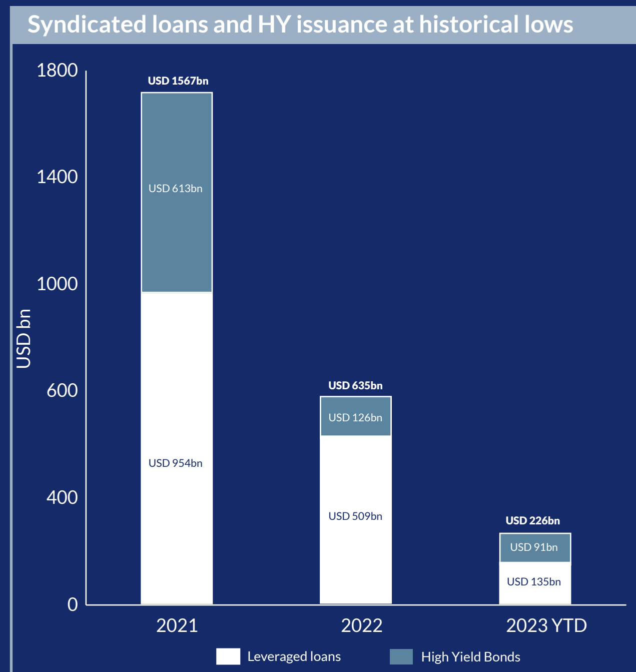
half of 2021, borrowing costs in leveraged buyouts rose two-to-three-fold, peaking in the third quarter of 2022. This was caused by the increase in base rates as well as spread widening. Volatility also rose, and markets were effectively shut for parts of 2022.

With banks unable to syndicate underwritten financings without significant losses, their appetite for new financing evaporated. Private credit providers remained active and gained market share. However, they also became very selective, and commitment levels per transaction reduced meaningfully. Overall leverage levels declined.

But apart from the weeks surrounding the collapse of Silicon Valley Bank, market conditions have been improving so far this year and banks have started cautiously underwriting again. Still, primary market activity remains low – year-to-date, 72% of institutional loan and high yield issuance in the US market has been related to refinancings. The infrastructure financing market has been more stable, while in real estate financing appetite strongly depends on the sector.

How can managers finance new transactions in the current environment?

The time and effort it takes to secure a committed financing package have increased meaningfully in the current environment. With reduced commitment sizes from private credit providers, banks still cautious on underwriting and bifurcation high, it is important to explore every source of liquidity. Contrary to a fully functioning market, views can vary significantly by lender. It is therefore important to approach many potential financing providers. We have had situations where we spoke to more than 60 lenders. Also, there is rarely the option of a standard financing solution in the current market – they tend to be bespoke. For example, for larger financings, a sponsor might need to combine a range of sources, from private credit providers and commercial banks to institutional loans and/or high yield bonds. This is typically unusual in the same financing structure. Our Capital Markets team is well-positioned and has the experience to navigate these uncertain times and seek these bespoke solutions for our assets.



For illustrative purposes only.[1] Source: 1 LCD as of April 2023

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