Alternatives Investor Letter

February 26, 2024
Marketing material

Insights by Asset Class

Private Real Estate

Global real estate has endured an exceptionally difficult eighteen months. Despite better-than-expected economic growth and robust real estate fundamentals, rising interest rates have seen a souring of sentiment, a slump in transactions, and values falling across almost every major market. Having previously expected the U.S. and Europe to stabilize during the second half of last year, a summer run-up in global bond yields has prolonged the pain. By the end of 2023, we estimated a fall in values from peak of 10% in Asia Pacific and 20% in the U.S. and Europe.

Despite this setback, we believe the global real estate recovery is not far off. Lower real estate values, a rally in bonds and equities, and resilient occupier fundamentals all suggest the market could return to growth in 2024. In fact, we are already seeing signs of recovery in the most highly sought-after parts of the market. From U.S. logistics to Australian Build-To-Rent, a steadying of yields, coupled with strong rental growth, is once again pushing prices higher. Throughout 2024, we expect the recovery to broaden across sectors and markets and, as we go into the middle of the decade, we anticipate interest rate cuts could stimulate the global economy and increase liquidity, while also supporting the relative attractiveness of real estate pricing.

Residential and logistics remain our top calls across all three regions, while a sharp fall in new construction supports the case for active asset management, including repositioning obsolete office stock. In the U.S., our top picks include industrial and residential properties, fueled by structural tailwinds, while the retail renaissance may present additional opportunities. We generally favor U.S. markets in the Sun Belt and Mountain West, which should continue to profit from outsized population and job growth. In Asia Pacific, we expect Australian and Korea to recover strongly on the back of robust economic growth. In Europe, having experienced considerable price correction, we are increasingly positive on our outlook for the German cities, where sustained low vacancy should help support rents over the medium-term, while London and Paris stand out within their respective markets.

Private Infrastructure

Concerns over a repricing event in infrastructure were top of mind during 2023, particularly given the dramatic movements seen in Real Estate markets; however, the infrastructure market has not seen a similar market-wide downward correction and infrastructure has absorbed higher rates well in comparison to other asset classes. In the recent years of volatile macroeconomic conditions, there has continued to be an investment performance benefit for assets which have contracted revenue streams, as they typically enjoy attributes such as secured offtake and inflation-indexation.

Given strong cash generation and expectations for rates to fall to more manageable levels, we do not expect major repricing in the unlisted infrastructure market, which has begun to stabilize, and believe that 2024 should see a return to stronger fundraising and transaction activity. Though we expect some drag due to slower growth and lower inflation and as some of the higher levels of income generated by infrastructure in the recent higher inflation environment will be required to service higher debt costs, the earnings outlook for infrastructure – ultimately a long-term asset class – remains positive. As interest rates begin to fall, we expect that the negative impact on valuations and performance resulting from recent market conditions will likely prove to be transitory, although we note that scrutiny on assets with high capex strategies should keep valuations in check.

In our view, the midmarket opportunity set remains compelling given the ready pool of large cap investors needing to deploy capital into new assets, as well as the potential higher returns generally on offer from assets with growth potential. While we believe that the energy transition and digitalization will remain two of the major areas for capital deployment for infrastructure investors, we note Transport assets could be an area of increased activity in 2024 as assets kept off the market since the pandemic begin to emerge. Finally, in both the U.S. and Europe, we would note that political risk remains a key area to monitor.

Private Debt

As central banks hit peak rates, ending aggressive tightening policy, yields on private debt have remained high amid heightened risk aversion due to slower economic growth and increased geopolitical risk. This has resulted in more attractive loan investment opportunities, further fueled by a financing supply-demand imbalance in some parts of the market. In the direct lending market, pricing power has shifted in the second half of 2023, reflecting increased competition from liquid markets and an ever-increasing field of players in the private debt space, leading to moderate tightening of spreads. In real estate, the spreads remain elevated across the capital structure, particularly for less favored risk profiles, while spreads for super high-quality real estate have started to decrease from peak. Similarly, infrastructure spreads remain 25-50 bps higher compared with mid-2022.

Economic forecasts have altered significantly over the course of 2023 with growth more resilient than expected. However, fears of recession going into 2024 in combination with the aforementioned financing supply-demand imbalance should help retain attractive opportunities for alternative lenders across the risk spectrum, while fundamentals have shown improvement year-on-year. Prospects for private debt continue to be favorable in our view. Higher base rates, coupled with healthy spreads, are expected to deliver competitive returns for lower-risk investments. While high-yield strategies carry greater risks, these are in many cases mitigated by the defensive characteristics of the collateral or industry (e.g., contract utilities, health care, logistics and residential) or otherwise compensated for through elevated spreads (e.g., real estate construction, secondary office).

We continue to see notable opportunities in digital and energy transition and note that transport assets could be an area of increased activity in 2024 as assets reemerge post the pandemic. In real estate, we believe the logistics and residential sectors still may offer attractive risk-adjusted returns for both senior and junior debt, although offices and retail could also offer interesting lending opportunities on a more selective basis. Turning to private credit, as the asset class has grown rapidly, competition to lend has followed and, for the first time in a while, private equity leveraged buyout (LBO) supply has fallen. So, while we see compelling value in direct lending, we prefer senior, unlevered, geographically diversified exposure. We also favor creditor-friendly jurisdictions where we see better risk/reward from reduced competition, more stable lender protections and better choice which, in turn, enables both selectivity and diversification. Higher on the return spectrum, we dislike synthetic methods (i.e. high leverage or structurally junior tranches) as we believe this is not the moment to amplify risk exposure. Instead, we favor idiosyncratic credit where the borrower has an identifiable need to pay a complexity or customization premia – an opportunity set that continues to grow under more volatile capital allocation conditions.

Liquid Real Assets

After strong relative performance during the latter half of 2021 and early 2022, Real Assets faced two primary headwinds in 2023 – disinflation and rising interest rates – which weighed on valuations. Pressure began to abate late in the year as inflation continued decelerating and expectations arose that major central banks were finished hiking this cycle. As longer-term rates interest rates relented, a goldilocks rally materialized into year-end. Global real estate securities ended the year strong, led by European and U.S. property stocks. Global listed infrastructure saw mixed sector results, but was assisted by solid gains across Europe and broader transports. While pockets of strength lent support for natural resource equities (e.g. steel, emerging oil & gas), commodities succumbed to widespread price pressures on concerns over China's economic recovery and weak global demand prospects, though gold was a lone bright spot.

The outlook for commercial real estate has stabilized – the end of the Fed tightening cycle and an improving earnings outlook are serving as compelling catalysts while moderating fundamentals should improve as cost pressures and revenue comps ease and supply deliveries shrink. Bank lending remains tight, but public REITs retain access to the capital markets, with unsecured debt proving to be a competitive advantage. Listed infrastructure should benefit given their inflation passthrough traits and necessity-based assets while a lower cost of capital in the form of lower long-duration bond yields would also be a positive. For commodities, demand expectations are exhibiting signs of improvement as market participants have drawn confidence from additional Chinese stimulus and government rhetoric as well as improved transportation demand. On the supply side, intervention by OPEC+, war and weather factors are helping to keep conditions tight.

Overall, we expect performance dispersion to remain pronounced at a stock and sector level, affording experienced active managers opportunities to create alpha on behalf of clients. We favor property sectors such as data centers, industrial, and malls where fundamentals remain robust or appear poised to strengthen. Within infrastructure, we prefer exposure to companies with stable growth rates and valuations have already adjusted to higher interest rates. Despite their lackluster performance over the past 2 years, many utilities have continued to deliver stable cash flows and a have a sound fundamental outlook based on policy-driven CAPEX spend on renewable energy projects and broader energy transition, in our view. Within commodities, opportunities exist, though we expect elevated volatility as various drivers are subject to evolve quickly with changes in prices, geopolitics, policy, and economic growth prospects. Gold appears fairly priced given the expected path of interest rates, however, clarity on next steps on interest rate cuts from central banks will be an important factor driving prices from here. On the energy side, supportive indications from the Chinese government, stabilizing manufacturing data in the U.S. and Germany, and an increased likelihood of supply disruption due to geopolitical events are supporting our positive view on oil. We maintain that a holistically managed real assets allocation can offer an attractive combination of growth and defensiveness and a strong income and liquidity profile – all powerful tools for managing aggregate portfolio risk.

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as of 1/31/24; 099774_1 (02/2024)

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