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M&G Investments

2023 Investment Perspectives

INVESTMENT PERSPECTIVES | FIRST EDITION | BROUGHT TO YOU BY M&G INVESTMENTS

In this issue

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Investing in a time of uncertainty

As we approach the end of an unpredictable and volatile year, the Chief Investment Officers (CIOs) of M&G Investments share their perspectives on the key themes influencing financial markets. High inflation, rising interest rates, an energy crisis and slowing economic growth are just a few of the big issues investors are having to navigate.

In this inaugural Investment Perspectives, Fabiana Fedeli, CIO Equities, Multi Asset and Sustainability; Jim Leaviss, CIO Public Fixed Income; and Will Nicoll, CIO Private & Alternative Assets, discuss the potential challenges that might lie ahead for their asset classes, while also highlighting where they see promising investment opportunities.

We begin with a brief review of 2022, a year when some long-run trends reversed and established notions of market behaviour were challenged.

2022

Nowhere to hide

Correlated falls in equities and bonds

2022 has been a tough year for investors globally as most major asset classes fell sharply. Initial optimism about a post-COVID global economic recovery quickly faded as the war in Ukraine and the subsequent energy shock reverberated through the global economy. Soaring inflation and central banks' efforts to control it became the dominant issue.

There was nowhere for investors to hide as equities and bond markets both sold off (Figure 1). Even after a strong market rebound in November, the MSCI ACWI Index had fallen 14.6% (in US dollars) in 2022 (as at end of November). US Treasuries declined 12.3% over the same period.

This correlated decline represented a painful blow for investors who sought to mitigate investment risks in a balanced portfolio containing both asset classes, so-called '60-40 strategies'.

MSCI ACWI Index has fallen

-14.6%

US Treasuries have fallen

-12.3%

as at 30 November 2022, in US dollars

Figure 1: 2022 has seen a correlated decline in equities and bonds

Year to date returns of major asset classes

Source: Bloomberg, 30 November 2022.
Past performance is not a guide to future performance.

Energy stocks and the US dollar thrived

There were a few bright spots amid the downturn. The energy sector thrived as oil and gas prices climbed after Russia's invasion of Ukraine sparked worries about global energy supplies. Global value stocks performed relatively well too as investors rotated away from some of the previously high-flying 'Growth' stocks and looked for opportunities among lowly valued, out-of-favour companies. To some extent, this shift could be seen as a reversal of pandemic-era trends, when mega-cap internet and technology stocks were in demand. In terms of currencies, the US dollar was a standout performer, supported by higher interest rates in the US.

Balanced '60-40' strategies struggled as equities and bonds both fell

A new regime:

High inflation and higher interest rates

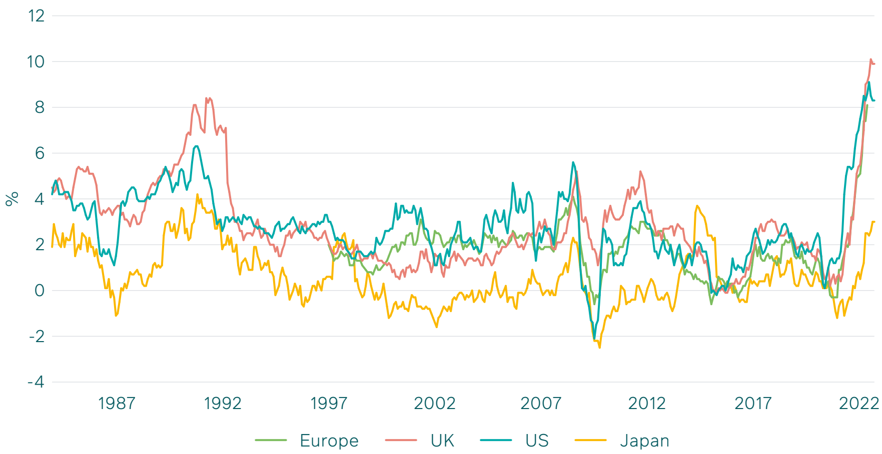
This year, investors have had to grapple with a number of macroeconomic shocks, most notably the return of inflation. At the beginning of the year, policymakers still expected inflation to be 'transitory' but prices continued to rocket across the globe. In the US and UK, the annual rate of inflation has reached 40-year highs in 2022, driven in part by soaring energy prices after Russia's invasion of Ukraine (Figure 2).

Large increases in the prices of food and energy sparked fears about a 'cost of living' crisis and falls in household disposable incomes. For businesses, investors worried that inflation would result in higher input costs (including wages) and potentially lower profit margins.

While recent data suggest that price rises in the US at least, could be slowing, inflation remains elevated and it is likely to be a primary focus for investors in the coming months. However, investors tend not to linger on the same narrative for long. While they remain fixated on inflation for now, we could see it becoming less relevant. Jim Leaviss argues below that inflationary pressures are likely to ease next year and therefore a new narrative could take hold. 2023 could be the year in which investors turn their attention to economic growth, or the lack of it, and the threat of recession.

Figure 2: Inflation has soared to 40-year highs

Consumer price inflation across developed economies year-on-year



Source: Bloomberg, 30 November 2022.

The end of ultra-low interest rates

Arguably, the most significant development in 2022, and one which may well dominate into next year, is the shift to tighter monetary policy. In an attempt to fight persistently high inflation, central banks around the world raised interest rates aggressively. While the Bank of England (BoE) was one of the first to initiate rate rises at the back end of 2021, the US Federal Reserve (the Fed) led the way in ramping up the size of rate hikes, with four consecutive 75 basis point increases since June 2022. The BoE and the European Central Bank (ECB) also became increasingly hawkish, with the Bank of Japan the notable exception, sticking with its policy of ultra-low interest rates.

Central bankers' determination to curb inflation by raising interest rates brought to an end a trend that has dominated financial markets for more than a decade: ultra-low interest rates and cheap money. These factors have arguably bolstered asset prices in recent years and the reversal could well have an equally dramatic effect. As Fabiana Fedeli notes, even if inflation comes down, higher costs of funding may continue to put pressure on businesses' balance sheets and create difficulties for weaker companies. Adapting to this new regime will clearly be one of the biggest challenges for investors in 2023, particularly as rapid monetary tightening could be a risk to economic growth.

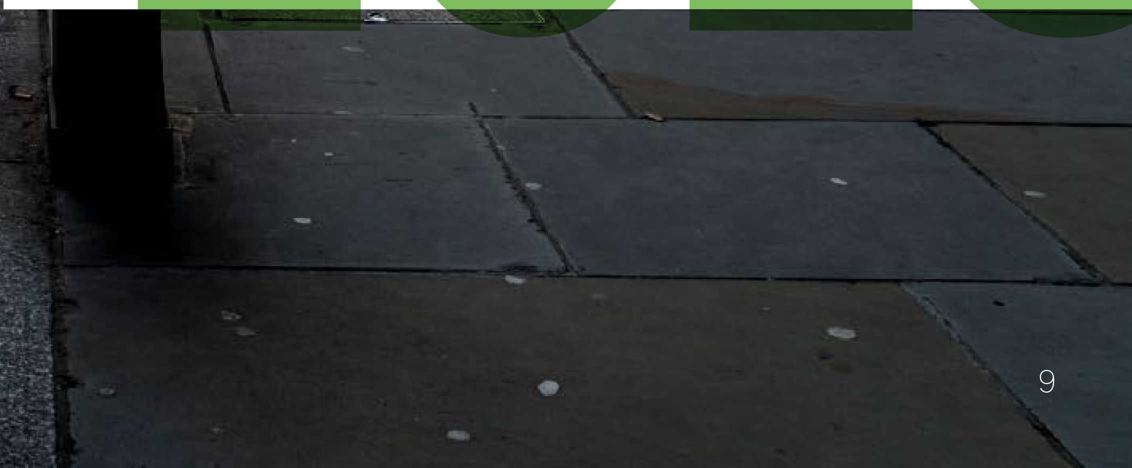
News-driven markets

Financial markets were heavily driven by news and macroeconomic events in 2022. For instance, investors fixated on each inflation print and the subsequent impact on the Fed's rate policy, in particular whether it would reverse course, or 'pivot'. Given the current uncertainty about the global economic outlook and ongoing tensions, it is likely that markets will continue to be volatile in the months ahead. We may well see businesses struggle given this challenging economic backdrop. However, as Will Nicoll notes, tough times could also result in some interesting opportunities for patient focused investors.

In the following pages, our CIOs provide their thoughts on the main issues facing investors today. After a difficult year, there could be further challenges, not least the risk of recession. But there may also be grounds for optimism, with some potentially interesting opportunities appearing across markets.

We hope you enjoy reading the document and find the views stimulating.

2023



No time for broad strokes investing

Fabiana Fedeli,
CIO, Equities, Multi Asset and Sustainability

We've seen equity markets remain volatile and range bound in 2022, particularly sensitive to newsflow and influenced by multiple exogenous forces. To move beyond this in the months ahead we'll need a positive jolt of some description, whether that be confirmation of inflation peaking or central banks no longer hiking rates or, indeed, a resolution to the tragic war in Ukraine, and – of course – a milder-than-anticipated recession.

Investors will be looking for companies that have the financial strength and business strategy to withstand the potential downturn.

Light at the end of the ‘rate hike tunnel’

For now, inflation remains a principal concern for investors. Recent US inflation data have shown initial signs of inflation peaking there, as higher interest rates dampen demand and supply chains recover. But with spending rotating back to labour-intensive services and the jobs market still tight, we’re unlikely to see a pronounced pivot from the Fed, so rates could remain elevated for some time.

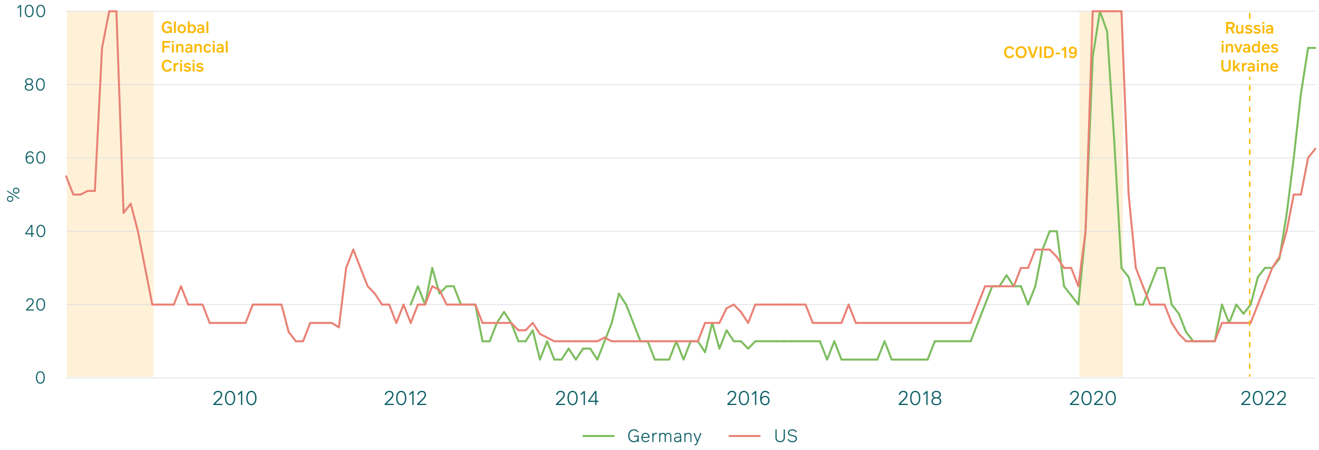
Meanwhile, we are yet to see signs of peak inflation in other developed markets, with higher food and energy costs still putting upward pressure on prices and inflation across Europe and the UK.

That said, we are closer to the light at the end of the ‘rate hike tunnel’, with central banks likely to stop hiking sometime in the first half of 2023. Following 75 basis point rate hikes from the Fed, ECB and BoE at the last meetings, we could well see a unified reduction (data dependent) in the size of hikes at the December meetings.

Importantly though, I don’t see any room for central banks to adopt a less hawkish rhetoric as they risk *de facto* loosening monetary conditions by lowering rate expectations, which in turn would make their job more difficult and potentially force them to tighten more, and for longer.

Figure 3: Tough economic times ahead?

Median forecast probability of recession in next 12 months



Source: Bloomberg, 30 November 2022.

Probability of recession

While confirmation that we are over peak inflation would support an improvement in market sentiment, at the same time as markets become less concerned about inflation, it is likely to start diverting its attention to the probability and scale of a recession.

So, the extent of the global economic slowdown will also be front of mind in the coming months. Expectations of a recession are relatively high, particularly in Europe where high energy prices, persistent inflation and rising borrowing costs are likely to dampen activity (Figure 3). Equity markets, generally speaking, do not like recessions.

While a fall in inflation may help companies' profit margins at one end, two other opposing forces will be working at the same time: higher cost of funding, as a result of higher interest rates, and companies not being able to increase prices any further in a recessionary environment. For weaker companies, higher borrowing costs could create real difficulties from a balance-sheet perspective.

Investors will be looking for companies that have the financial strength and business strategy to withstand the potential downturn.

Another element we are watching closely is geopolitical risk. If there were a satisfactory resolution to the war in Ukraine, which involved an agreement and the lifting of sanctions, that would likely provide a significant boost to investor sentiment. The more constructive relationship following the November meeting between Presidents Joe Biden and Xi Jinping improved sentiment recently, but doesn't mean that we have blue skies. US-China tensions are likely to continue and we are still expecting China to respond to the technology curbs introduced by the US.

Selectivity will be key

So how can equity investors navigate this challenging environment of elevated interest rates, weaker earnings, slowing growth and likely recession? As **we noted earlier this year**, we think this is not a market for ‘broad strokes investing’, meaning it’s not a market for big sweeping sector or country calls.

However, this is still a market in which active investors can harvest alpha, in our view, but selectivity will be key: identifying those companies with robust balance sheets and strong pricing power. We’ve seen from the recent earnings season that companies in the same sector have managed to deliver very different earnings results based on tilts in exposure, cost control, product mix and, generally, also the quality of management.

So, in my view, this remains a market in which to seek selective opportunities as the baby gets thrown out with the bathwater, looking for healthy companies with solid fundamentals, where the level of price action is unwarranted given the strength of the underlying business.

At a country level, we are finding selective opportunities across all markets but in Japan, where corporate reform and restructuring continues to gather pace, we believe there is ample chance to harvest stock-specific opportunities. We’ve also been finding attractive opportunities in China. While we’ve had one of the best runs on record, we think valuations still remain inexpensive, with stocks trading at distressed levels that do not reflect the underlying fundamentals, in our view.

In Japan corporate reform and restructuring continues to gather pace.

We continue to like longer-term themes such as renewables (along with suppliers as well as users of low-carbon technology) and infrastructure (inflation-linked, higher and growing dividends, which counteract inflation), as these are areas where capital expenditure will continue to rise independent of the prevailing market conditions.

In our multi asset strategies, we've added to duration at the long end of the yield curve and are now overweight duration. In terms of equities exposure, while we are some way off the October market lows, we still maintain a small tactical overweight; reflecting the balance between the improvement in some of the recent newsflow (ie geopolitical risk and inflation) and, on the other hand, the fact that the upside move has been quite rapid and the macro direction is still too uncertain.

Sustainable investing is here to stay

From a sustainability perspective, the past couple of years have been challenging. The COVID-19 pandemic had a significant impact on development areas such as health, education and poverty. More recently, the energy crisis and the intensifying cost of living crisis have created further setbacks to near-term sustainability commitments. For example, soaring gas prices after Russia's invasion of Ukraine has seen demand for coal increase this year in Europe.

Although this is likely to be a short-term phenomenon, it represents a departure from the longer-term global ambition of phasing out coal use. In light of the disruption to the energy market caused by the war in Ukraine, many investments aligned to the United Nations Sustainable Development Goals (SDGs) or tied to the low-carbon ecosystem, have underperformed their carbon-intensive peers this year.

Despite these challenges, I believe sustainable investing is here to stay. So much so, I think that five years from now we will not make a distinction anymore between sustainable and non-sustainable products. Embedding sustainability criteria in the way we invest will simply become mainstream.

The war in Ukraine has also highlighted the need to improve energy security and diversify energy sources, which puts renewable power centre stage. Government initiatives such as REPowerEU in Europe and the Inflation Reduction Act in the US are directing billions of dollars to support the energy transition.

And it is not just governments taking these steps; we are seeing companies push ahead with sustainable investments as they recognise the importance of focusing on the longer-term carbon-reduction goals. And where there is capital flowing, there are likely to be investment opportunities. As I mentioned in a **recent COP27 article**, greater collaboration between the public and private sectors will also help to unlock opportunities for investment.

When looking at Sustainable investing through the lens of the SDGs, the annual SDG financing gap is estimated to be more than US$4 trillion. The M&G SDG Reckoning report, produced annually by our Impact team since 2020, shows that the current scale of financial flows addressing the SDGs is insufficient. The only way to overcome this gap is for both the public and private sectors to increase action, and direct capital towards addressing global sustainability problems such as food security, health inequality, social inclusion, biodiversity loss, and excessive waste. The outcome of the recent COP27 highlighted the relevance of all of these issues and more.

In future, embedding sustainability criteria in the way we invest will simply become mainstream.

View M&G's SDG Reckoning Report here.

While we support the UN SDGs, we are not associated with the UN and our funds are not endorsed by them.

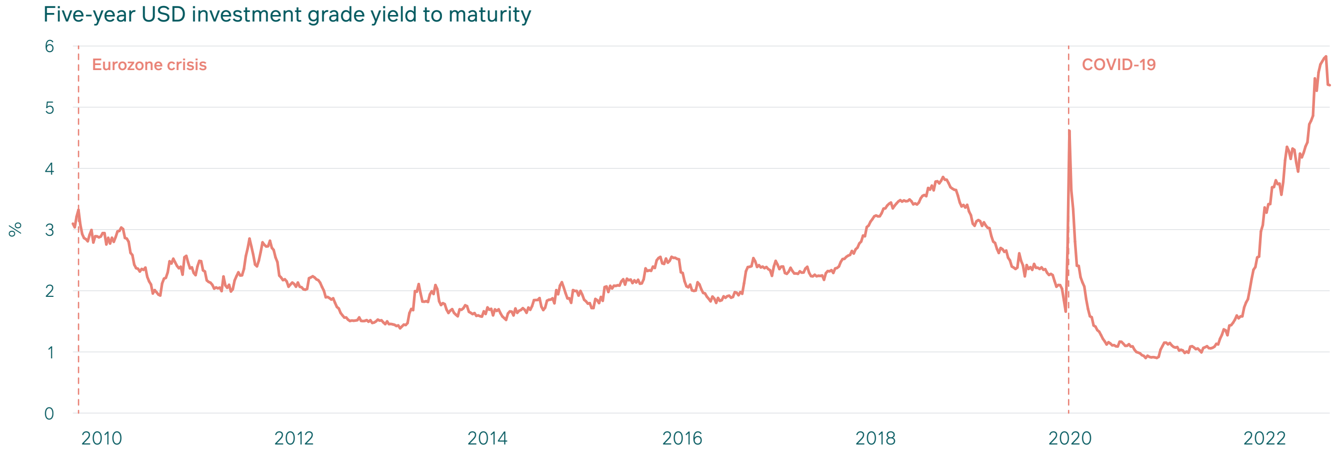
Value restored in bond markets?

Jim Leaviss,
CIO, Public Fixed Income

Bond markets experienced one of the sharpest sell-offs on record in 2022, as concerns over persistently high inflation and an aggressive tightening in monetary policy pushed government bond yields to their highest levels in over a decade. Credit valuations have also come under severe pressure as markets started to factor in the impact of slowing economic growth and higher borrowing costs on corporate earnings.

This has led to a significant re-pricing in both credit spreads and the 'risk-free' rate (as represented by government bond yields). Investment grade bond yields are now at multi-year highs, with five-year US investment grade corporate bonds yielding above 4% (figure 4). While mindful of the challenges facing the global economy, we believe corporate fundamentals remain sound and that current yields represent highly attractive value for investors. Base effects alone should mean that headline annual inflation figures start to come down throughout 2023, which should be positive news for bond markets, particularly as a US-led hiking cycle now appears be largely fully priced-in.

Figure 4: Bond yields over time – five-year USD investment grade yield to maturity



Source: Bloomberg, Deutsche Bank, ICE indices, S&P Global. As of 28 November 2022.
Past performance is not a guide to future performance.

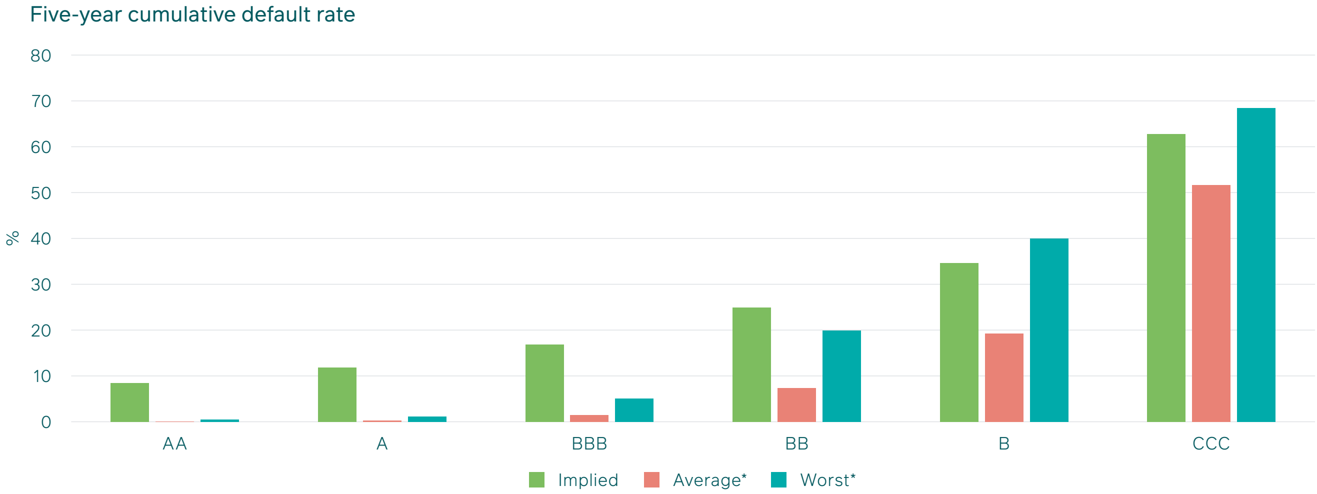
Inflation to gradually ease, but no signs of a Fed pivot just yet

We expect inflation to remain a pressing issue for investors, although we are starting to see evidence that price rises in the US at least are starting to ease – the US Consumer Price Index (CPI) increased 7.7% year-on-year in October, down from 9.1% in June. We think inflation will continue to slow in 2023, partly due to base effects and lower commodity prices, but also because financial conditions have tightened quite meaningfully over the past year. Monetary policy typically works with a 12-18 month lag, so we think the full impact of higher interest rates will only really start to be felt next year.

However, while we have already seen a dip in goods inflation, we expect services inflation to remain elevated for some time, with the very tight US labour market expected to put continued pressure on wages. Wage cycles tend to last for years rather than months, and the Fed will be very mindful of the risk of triggering a wage/price spiral. Therefore while the Fed should be able to slow its pace of hiking as headline inflation cools, it will probably want to keep policy in restrictive territory for a little while longer, and it is perhaps premature to be talking about an outright pivot at this stage.

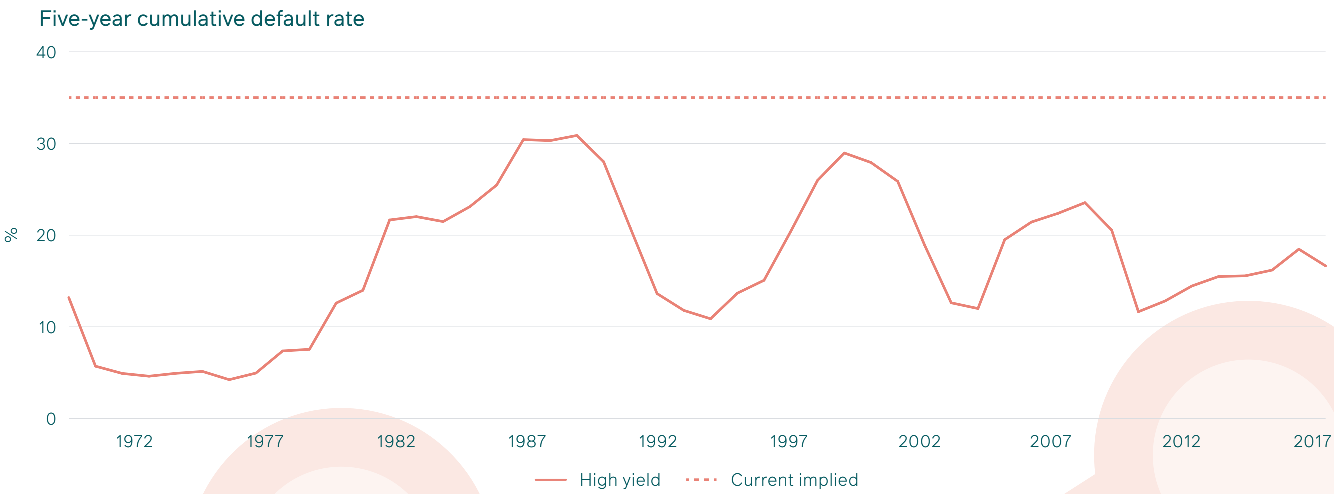
Looking beyond 2023, we think the Fed may have a more difficult job keeping inflation below 2% than has previously been the case. This is due to the fact that many of the forces that kept inflation so low for so many years could start to unwind. In particular, globalisation is likely to be a less powerful force going forward, reflected by issues such as the onshoring of supply chains and increased use of tariffs and other restrictive trade measures.

Figure 5: Market implied default rates versus historic default rates



Source: Bloomberg, Deutsche Bank, ICE indices, S&P Global. As of 31 October 2022.
*Assuming 40% recovery rate for IG and 30% recovery rate for HY.
Past performance is not a guide to future performance.

Figure 6: What level of default is currently priced in the high yield market



Source: Bloomberg, Deutsche Bank, ICE indices, S&P Global. As of 30 September 2022.
Past performance is not a guide to future performance.

> **EVEN AS INFLATION COOLS, THE FED WILL PROBABLY WANT TO KEEP POLICY IN RESTRICTIVE TERRITORY**

A challenge central banks face is that if they start talking too early about changing course then it could lead to a renewed rally in equity markets and a fall in bond yields – this would effectively loosen financial conditions and potentially create more inflation. It could be the case that central banks feel they need to stand firm now in order to avoid having to tighten policy again, and potentially cause greater damage, further down the line.

Against this backdrop we remain somewhat cautious on rates, while acknowledging that valuations look a lot more attractive than this time last year. Although we have been gradually increasing duration as yields have risen this year, we think it is too soon to be aggressively adding duration. Until we see clear signs of a Fed pivot, we think rates are most likely to remain rangebound, albeit with intermittent volatility as markets react to the latest Fed pronouncements.

Credit spreads pricing in a sharp downturn

We believe there is now significant value in credit, with investors being well paid to take credit risk. While further volatility is likely in the short term, from a long term perspective we think credit offers very attractive risk/return dynamics. Defaults are expected to stay low due to strong company fundamentals and robust balance sheets, while many businesses have taken the opportunity to refinance their debt for several years at cheap levels.

We believe that markets are more than pricing in the bad news, with credit spreads reflecting an implied default rate well in excess not only of average default rates, but also of the worst default rates (Figure 5). For instance, corporate bonds rated BBB are pricing in a five-year cumulative default rate of 16.9%, which compares with an average default rate of 1.5% and a worst default rate of 5.1% (as at 31 October 2022).

We believe this reflects an excessively gloomy outlook for default rates, and we have been taking the opportunity to add credit risk across many of our portfolios. However, given the uncertain economic environment, it is important to remain selective, and we generally favour higher-quality, more defensive names which should hold up better if we do see a more recessionary scenario. In contrast, we remain much more cautious on more speculative areas, such as high yield bonds rated CCC, where we think defaults could rise quite significantly.

We are also seeing significant spread dispersion across corporate bond markets – this is where bonds with the same credit rating trade at a different credit spread over government bond markets. We think spread dispersion could increase further as we move towards a Fed pivot, and this could provide a rich source of opportunities for active managers who are able to identify mispriced securities.

By providing exposure to both interest rates and credit, we believe corporate bonds can offer a source of resilience in uncertain market conditions. While 2022 was an exception, credit spreads and interest rates typically move in opposite directions to one another, and we believe this inverse correlation can help provide a valuable cushion for corporate bond investors during periods of market turbulence.

Selective opportunities in emerging markets

Another area where we see attractive medium-term value is in emerging markets, although a highly selective approach is needed when investing in this area. Emerging market bonds have seen significant drawdowns this year, with yields now at very elevated levels. The relentless rise in the US dollar against other currencies has clearly been a major headwind for the asset class, although we think the bulk of this rally is likely to be behind us, and expect a further softening from here as a result of the worsening US trade deficit.

Some of the larger emerging countries in particular have better fundamentals now than in 2013, with current account surpluses, smaller budget deficits, higher foreign exchange reserves and cheaper currencies. Moreover, unlike in previous hiking cycles, many emerging market central banks have pre-empted the Fed and have moved to hike rates aggressively since 2021, helping to boost the very attractive yields available to investors.

While the different parts of the asset class tend to get lumped together, there is a great deal of dispersion between emerging market issuers, both in terms of valuations and growth trajectories of individual countries. For instance, many Latin American countries have remained relatively well insulated from the effects of the war in Ukraine, with several having benefited from elevated commodity prices. ■

> **WE BELIEIVE THE MAJORITY OF LARGE BANKS ARE IN GOOD SHAPE AND HIGHER INTEREST RATES SHOULD IMPROVE THEIR PROFITABILITY**

Spotlight on high yield

Stefan Isaacs,
Deputy CIO of Public Fixed Income

Attractive income to help cushion downside risks

At the end of November, global high yield spreads were at the 508 basis point level, which we believe prices in a lot of the bad economic news and provides a fairly attractive entry point for the asset class.

Current spread levels translate to an implied five-year default rate of around 30%, which is much higher than our expectation, and would be more extreme that the worst-ever default experience (Figure 6). We believe that corporate fundamentals are in generally good shape and expect company revenues to prove fairly resilient overall. Leverage across the asset class remains relatively modest, with many companies having taken the opportunity to reduce their debt or extend its maturity following the pandemic, which should significantly reduce re-financing risk.

As a result, we believe high yield indices now represent a higher-quality universe compared to before the pandemic. While we expect default rates to rise from current very low levels, we do not expect to see a sharp spike in defaults. With all-in yields just under 9%, we believe the asset class offers an attractive income stream, which should provide a significant cushion against any further widening in spreads or a rise in defaults.

Sector views – constructive on banks, cautious on the consumer

From a sector perspective, we think banks look well-placed to benefit in a rising rate environment as they are able to capture higher lending margins, while their robust capital positions should provide a significant buffer in the event of a sharper-than-expected downturn. Current valuations indicate heavy losses in the banking sector, although we believe that market

> **WE BELIEVE INVESTORS ARE BEING WELL PAID TO TAKE CREDIT RISK...**
>
> **BUT IT IS IMPORTANT TO REMAIN SELECTIVE**

perception is some distance from the fundamental picture. While some losses will clearly occur, we believe that the vast majority of large banks are in good shape to weather the storms, while the increase in interest rates should significantly improve their profitability.

We think there is also value to be found in the real estate sector. Given its sensitivity to bond yields and its long-dated nature, the sector's valuations have fallen very sharply this year. There has also been a lot of issuance in this space over the past few years, which will have acted as a technical headwind. This is an area where it is important to be selective and to thoroughly assess underlying property valuations, although we believe the sector looks cheap overall, with many real estate bonds pricing well below par.

We are more cautious on sectors exposed to the consumer, although given the very strong US labour market we are expecting a modest fall in demand rather than an outright collapse, and we think that all but the most highly leveraged names should be able to navigate their way through a period of slowing growth. ■

Investing in a higher rate environment

Will Nicoll,
CIO, Private and Alternative Assets

The impact of rising rates

At the outset, it is worth highlighting that private markets are a broad and versatile collection of asset classes, spanning a wide spectrum of investment opportunities including private credit, structured and consumer finance, real estate, infrastructure and private equity.

Given this diversity, the impact of rising rates has been different for the different parts of the market. Some have reacted aggressively, driven by the same credit concerns that have influenced public fixed income markets. Other parts have been slower to respond and are only just starting to price in the likely possibility of recessionary headwinds and there are others that are more defensive in nature and have the potential to withstand even the toughest of economic outlooks.

Rising interest rates have actually proved supportive for the investment thesis for much of the private and illiquid credit investable universe, given the typically low duration, floating-rate nature of these assets. As a result, price declines in this area have typically been more limited than for traditional fixed income.

The direct (and indirect) hedging abilities of alternative assets are likely to appeal to wary investors looking to insulate their portfolios.

However, it is important to consider the potential effect of such significant and rapid interest rate increases. Rising coupon rates for a piece of private debt, which might have been 3% or 4% and could climb to 5% or 6%, are positive for investors but that increase in funding costs can make an extraordinary difference for the balance sheet for that company. So, in my view, this issue of higher borrowing costs, particularly combined with elevated inflation levels, is going to be the enduring theme through 2023 and speaks to the need for selectivity and flexibility of investing.

Beyond traditional financial assets, the direct (and indirect) hedging abilities of alternative assets are likely to appeal to wary investors looking to insulate their portfolios. For investors in areas like private equity, infrastructure and property, it remains extremely important to focus on high-quality companies or buildings that are going to survive, whatever economic environment they are in. This means always looking at the underlying assets and their quality to try and ensure that they can withstand challenging conditions – again selectivity and pricing discipline is key.

While the prospect of a recession is arguably one of investors' key concerns for the year ahead, an economic slowdown could create opportunities for investment strategies that focus on struggling companies. For example, 'distressed funds' that can look through the negative headlines and work with companies as they recover may be seeing an opportunity to fund raise as the dearth of defaults in recent years looks set to change.

Looking beyond the near-term macroeconomic situation, infrastructure is an important long-term theme that we see across private markets. This is a particularly exciting time for infrastructure as we embark on energy transition and shift to a digital economy: we need to completely re-do the world's infrastructure in the coming years, and a lot of it will be done through emerging technology, which will be backed by private equity, venture capital (VC) and private lending.

The end of ultra-low rates

Another observation is that the landscape has clearly changed. Even though inflation may well come down in 2023, we don't expect to see things return to the way they were before. We've had such an extraordinary period of ultra-low, and even negative, interest rates and people have got used to the abundant liquidity that has resulted from that (Figure 7).

But even when inflation eventually comes down, there is a risk that investors expect to go back to what they think is normal, but in reality negative interest rates weren't normal. Excess liquidity available everywhere is not normal and investors arguably still have to adjust to this.

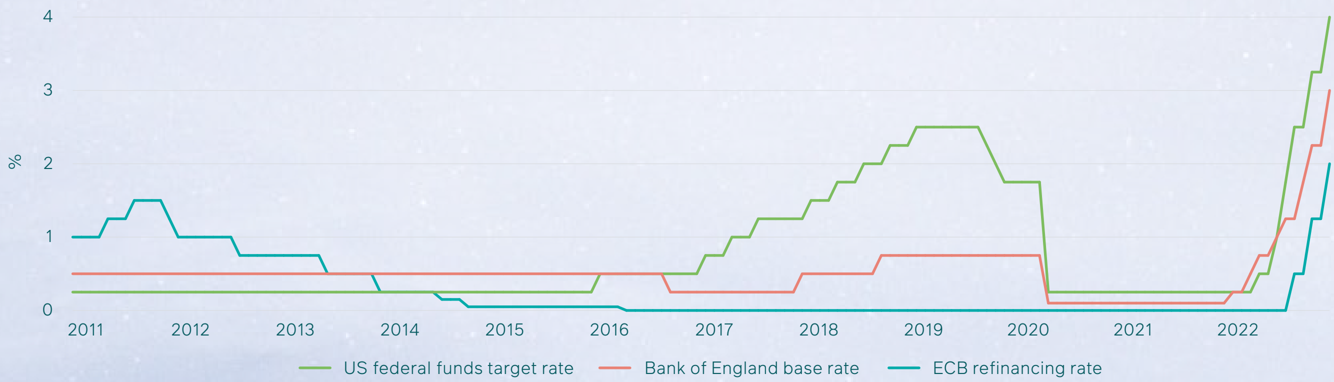
Longer term, we are moving from a position of ultra-low rates into an environment that is more in line with historical trends. This could mean that the parts of the private markets that may have grown very strongly, in part because of the recent low-rate conditions, could come under a bit of pressure.

Real estate in a rising rate environment

With bond yields significantly higher, real estate's risk premium has narrowed, making low property yields in some sectors more challenging to justify.

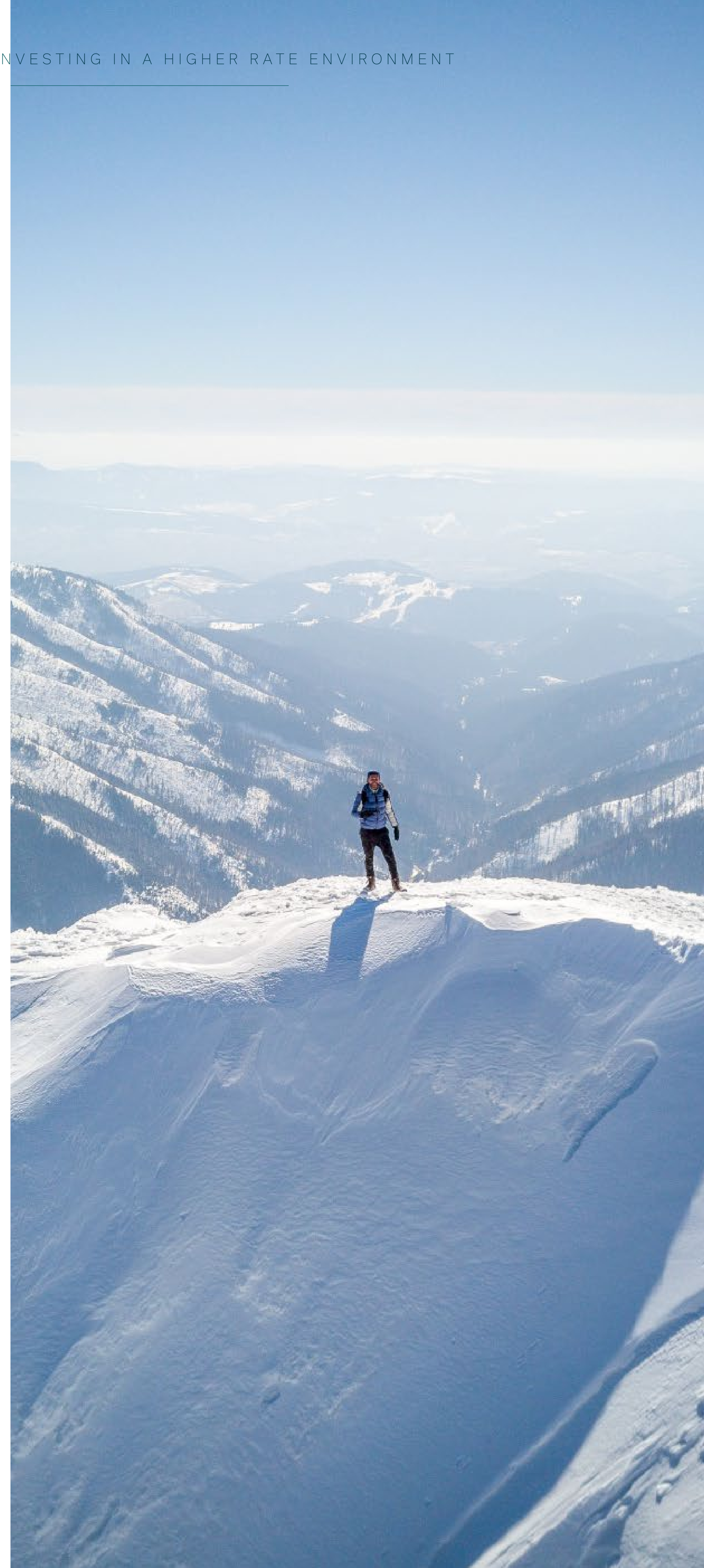
We believe a price correction across global real estate markets will drive variation in performance of existing portfolios, depending on quality of assets. Increasingly stringent occupier requirements mean buildings without green credentials are at risk of lower occupancy, and 'brown' discounts for older property look set to accelerate. Despite the high cost of heavy retrofitting, delaying works could be a false economy, in our view.

Figure 7: Moving on from an era of ultra-low rates



Source: Refinitiv Datastream, 30 November 2022.
Past performance is not a guide to future performance.

We think private markets will throw up some very interesting and attractively valued ideas.



Portfolio allocations are also likely to shift, given that traditional property sectors such as offices are facing structural and cyclical challenges. The living sector looks more resilient, in our opinion, as housing is in high need. Helping to bridge the supply gap could therefore mitigate the current upwards pressure on yields through attractive income and growth prospects, while enabling institutions to create a positive social impact.

Property revaluations will naturally take time to play out, but as yields reach stabilisation, we believe assets are likely to reflect an attractive long-term value opportunity, with improved performance prospects.

With economic headwinds rising, steering through market volatility will require skill and perspective. History shows that it is often in the years after recession that real estate delivers, with the potential for repricing to create the next best vintage of investments, in our view.

Interesting value opportunities

We think 2023 is going to be very interesting for several reasons. Firstly, when you look at the private markets as a whole, they are reacting so differently at the moment and with vastly different time lags to the events and developments we have seen in 2022. We think that there are places that offer very interesting value opportunities at the moment and there are places where there is much less value. In some cases, we're waiting for the markets to react. So, looking ahead to 2023, we think private markets will throw up some very interesting and attractively valued ideas.

Given we are in a credit cycle, and it is likely the current cycle of interest rate rises hasn't finished, we could see investors pull back to 'duller' assets. So, although great opportunities could turn up over the next couple of years, the chance of getting lots of new investors to consider private assets will be quite difficult. But for the actual structure of the private assets and private equity markets, we believe there are some good long-term tailwinds.

Democratisation of private assets

The "democratisation" of private assets – that is extending these investments to a wider audience than the traditional institutional investor base – is a much-discussed trend.

Institutional investors have grown up with the idea of the J-curve in private equity, whereby returns are negative in the early years of an investment before generating a payback later in the fund's life. There is less comfort with this structure in wholesale or retail client bases and investment in private assets from these clients has been much lower.

The advent and growth of a secondary market could help democratise the asset class as people can invest and start getting immediate returns, even if they're slightly lower than those for investors who are able to hold a fund through its whole life cycle.

One of the main challenges to this process is education. Wholesale investors as a whole are not au fait with private markets yet as there haven't been easily available products that they can talk and think about. Regimes such as EU LTIFs (Long-term investment funds) and UK LTAFs (Long Term Asset Funds) are gradually changing this and are helping clients to invest in products which don't have daily liquidity and can therefore access private assets without creating a liquidity mismatch. New semi-liquid funds investing in private assets are emerging and seem likely to create a larger demand for these assets, which in turn could drive the growth of the market overall.

Sustainability and Impact investing

Another tailwind that we think is significant for private markets is the increasing interest in sustainable and impact investing. There are a raft of opportunities for investment which fulfils positive climate or social objectives within private markets as investments are often targeted at a particular project or activity. Opportunities for investment are wide ranging, from renewable energy and digital transformation through student and affordable housing and urban regeneration to forestry or financial inclusion. The range of interesting assets offering attractive returns that we see is extremely broad.

> **The advent and growth of a secondary market could help democratise the asset class.**

Weather the challenge

Given the new investment landscape that we are entering, it is likely that financial markets will be somewhat volatile in the coming months. However, we believe that within private markets there is a diverse range of investment strategies and assets that are well placed to weather a challenging environment of higher rates, as well as offering exciting long-term opportunities.

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