

# BEWARE THE CONSENSUS



**A THAWING ON THE HORIZON?**  
*PRIVATE EQUITY*

**SETTING THE TABLE FOR 2024**  
*INVESTMENT GRADE*

**GOOD NEWS IS GOOD FOR CREDITS**  
*HIGH YIELD*

# Letter From The CIO

Both experience and history suggest that consensus expectations are often not realized.<sup>1</sup> For example, in January 2022, the market projected a modest number of rate hikes for the year. Instead, the Federal Reserve (Fed) hiked at seven meetings in 2022, increasing the Fed Funds Rate by 425 bps due to sharply higher and sustained inflation.<sup>2</sup> Again, in January 2023, the consensus view was for a significant slowdown in US GDP growth, with worries of a recession. Instead, continued post-COVID demand for services in 2023 boosted both the US economy and risk assets.<sup>3</sup> The S&P 500 Index produced a total return of 26.3% while economic strength allowed riskier segments of the market to perform strongly (Russell 2000 16.9%, CCC & Lower bonds 20.4%).<sup>3</sup>

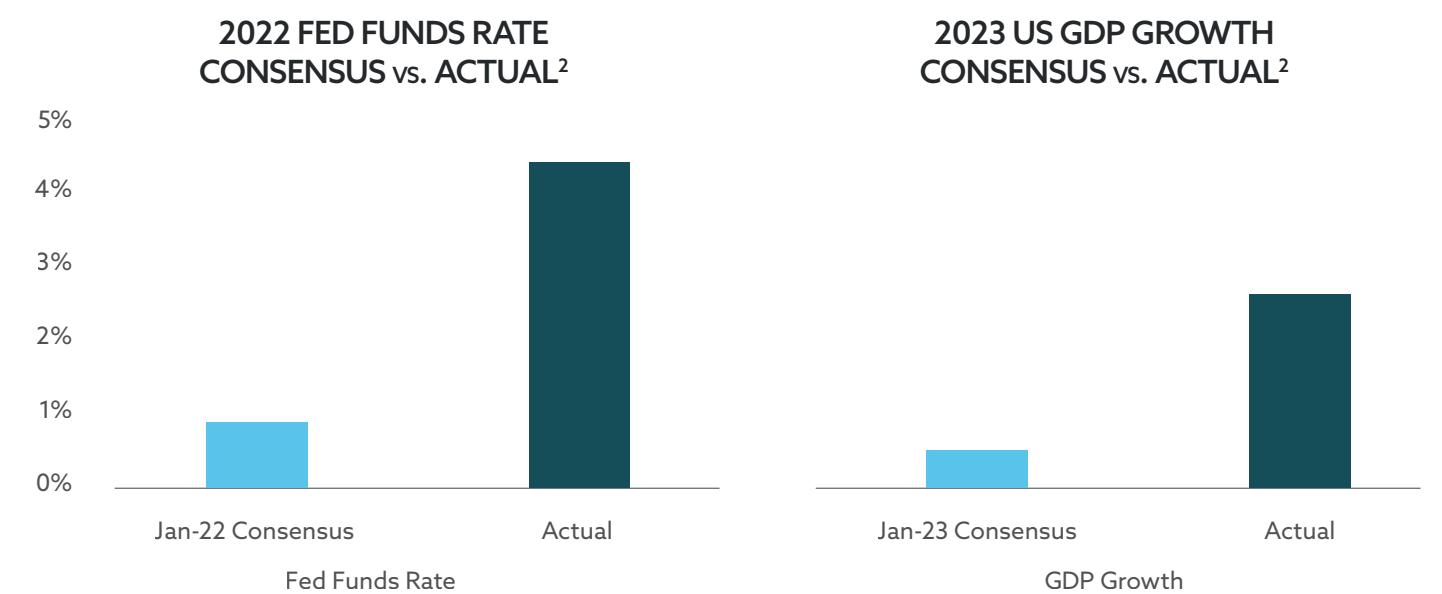
What the examples above demonstrate is that market participants often struggle to correctly predict macro outcomes when looking a year ahead. We believe this lesson is especially relevant in the current environment, in which the consensus has moved toward a soft-landing expectation for the US economy in 2024. To be clear, a soft landing – characterized by the combination of low but positive growth and low inflation – looks like a plausible base case. Consistent with this, the Fed’s “dot plot” has signaled to the market that rate cuts will begin this year.<sup>4</sup> As a result, 2024 seems to be shaping up to be a solid year for risk assets.

However, we believe the market effectively pulled forward a lot of the expected returns from a soft-landing scenario and attendant rate cuts with the rally that took place Q4 2023. As a result, equities began 2024 trading at high price-to-earnings ratios while bonds began the

year trading at tight spreads. The macro consensus of a soft-landing could prove correct, but we believe additional upside in risk assets is limited. Conversely, the macro consensus could prove inaccurate once more, with the potential for a painful downward move in asset prices given starting valuations. This risk is especially pertinent given that current valuations are driven in large part by the market’s more aggressive pricing of rate cuts than are indicated by the median of the Fed “dot plot.”<sup>4,5</sup>

Much of the market’s current view on what the Fed will likely do has been shaped by comments from Chair Powell and other Fed members. During his press conference in December, Powell stated the Fed had already started discussing rate cuts, even though other members later walked back (or attempted to walk back) that point. This was a market-moving comment that had a profound impact on market pricing of Fed cuts and, by derivation, risk assets. Why did Chair Powell make this comment and did he mean to or was it simply a gaffe? It is difficult to say but, among recent Fed Chairs, Powell has had an uneven record in communicating with the markets.

Gorodnichenko, Pham and Talavera (2021) published a detailed study of the influence of Fed Chair speeches on financial markets. They found that Powell’s speeches had more negative impacts than his predecessors Ben Bernanke and Janet Yellen, with Powell also exhibiting the largest variations in tone.<sup>6</sup> In another research paper, Narain and Sangani (2023) examined the market impacts of Powell’s press conferences. They found that: 1) the market tended to move in the opposite direction during Powell’s press conferences compared to its movement



(1) As of 24 January 2024. Unless otherwise stated, the information presented has been prepared from market observations and other sources believed in good faith to be reliable. Information and opinions expressed by PPM are current as of the date indicated and are subject to change without notice. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (2) Bloomberg, Federal Reserve. 17 January 2024. “Actual” 2023 GDP growth includes projections for the fourth quarter. (3) Morningstar, ICE Data Services. 2 January 2024. (4) Federal Reserve. 13 December 2023. (5) Bloomberg. 9 January 2024. (6) Gorodnichenko, Yuriy, Pham, Tho and Talavera, Oleksandr. “The Voice of Monetary Policy.” National Bureau of Economic Research. March 2021.

following the policy statement; 2) Powell's choice of language correlated with these market movements; 3) Powell's predecessors in contrast tended to reinforce the market's initial reaction; and 4) communications during Powell's tenure have been less effective in reducing forward-looking interest rate uncertainty.<sup>7</sup>

Given this record, one can be forgiven for some skepticism regarding any market rally based largely on Chair Powell's comments. This is especially the case given the contents of the Fed minutes released on 3 January. While the minutes noted some progress on inflation, they emphasized multiple times that the job was not yet done, with risks to inflation remaining to the upside.<sup>8</sup> We believe the Fed would not want to repeat the mistake of the mid-1970s when it cut rates too early, resulting in inflation reaccelerating and ultimately requiring more painful rate hikes in the late 1970s and early 1980s.<sup>9</sup> This leads us to conclude that rate cuts may not come as early or be as steep as the markets currently expects.

From our point of view, complacency with respect to economic outcomes and the Fed's actions is one of the biggest dangers for market participants. We believe that market prices reflect the most benign outcome, exposing portfolios to the significant downside risk inherent in today's high, consensus-driven valuations. This complacency is an important reason why we prefer to approach investing from a bottom-up, fundamental standpoint. Researching investments on a security-level basis is an approach that allows a manager to meet client objectives quietly and consistently without requiring more unreliable assumptions on economic outcomes or the Fed's actions.

The market rally and the combination of higher risk-free yields and tight bond spreads reduces the opportunity cost of more defensive positioning across public and private credit markets. Entering 2024, we have taken advantage of this opportunity to express a [higher-quality theme](#) across our clients' portfolios, where the mandates allow. This positioning allows flexibility in what is expected to be a still robust new issue market for asset classes like investment grade corporate bonds and CLOs.

Our higher-quality focus also generally avoids current areas of stress in the market (e.g., rising auto and credit card delinquencies). With respect to the Office sub-sector of commercial real estate (CRE), we expect occupancy will continue to decline and rent growth to remain negative in 2024. However, assets are more likely to change hands, which we believe will bring much needed transparency and potentially unclog the CRE transaction pipeline, creating opportunities in higher-quality and less-distressed parts of the market. Finally, in private equity, we expect co-investment deal activity to remain robust and are hopeful that the lull in exit activity will begin to abate.



**CRAIG SMITH, CFA**  
President, CEO & CIO



**OGECHI NWACHUKWU**  
Deputy CIO

## TO MAINTAIN CREDIBILITY, FED WANTS SUSTAINED LOW INFLATION<sup>9</sup>



(7) Narain, Namrata and Sangani, Kunal. "The Market Impact of Fed Communications: The Role of the Press Conference." 10 February 2023. (8) Federal Reserve. 3 January 2024. (9) FactSet. 18 January 2024



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### KEY TAKEAWAYS

- > Private equity investors endured a difficult 2023, with deal activity declining
- > However, record dry powder could underpin a rebound in investment activity while economic clarity may lead to a rebound in exit activity
- > We expect a fairly busy year for PPM Private Equity, across both primary and co-investments

### A CHANGING NARRATIVE

Investors may encounter many of the same themes in US private equity (PE) in 2024 compared to last year, but we are hopeful the market will see improvement across a number of areas.

At a macro level, higher interest rates dominate the market. The low interest rate environment of the previous cycle supported the entire PE market and encouraged new entries. Even if the Federal Reserve cuts policy rates, market rates are expected to remain much higher than the previous cycle. As a result, we believe manager selection is critical. With tighter capital and less leverage in the market, we expect to see the best managers outperforming.

PE fundraising is likely to remain challenged in 2024 (see next page). However, we expect investment activity to pick up this year. PitchBook recently noted that capital deployed declined 29% in 2023, but that led to another increase in dry powder that could lead to more investment activity this year.<sup>1</sup> For co-investments in particular,

the investment outlook is robust, in our opinion. Given higher rates and lower availability of debt capital, some general partners (GPs) will likely look to limited partner co-investments to complete transactions.

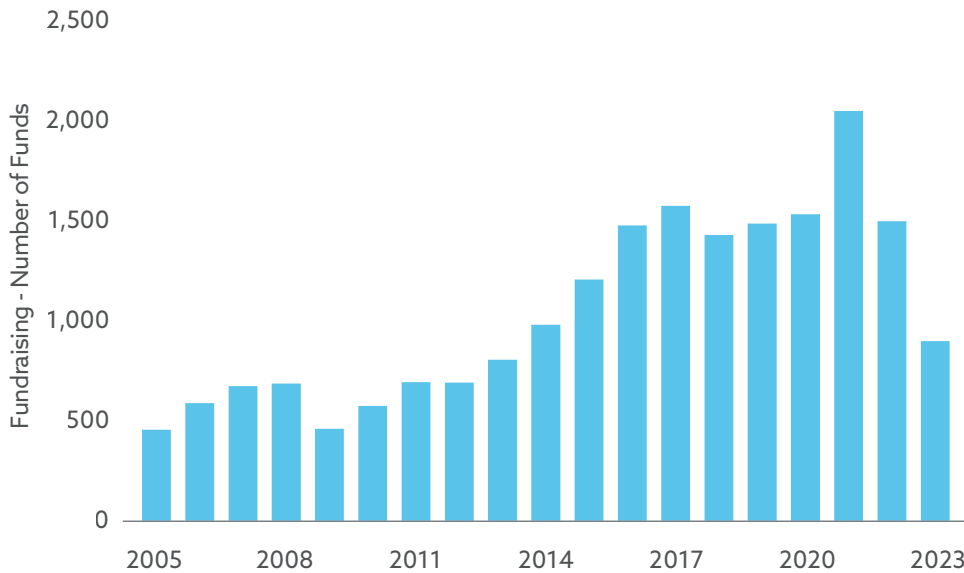
Our expectation is for the lull in exit activity to continue at first, but eventually abate. Exit value fell 26% in 2023, but economic clarity, even if it means slower growth, should help line up buyers and sellers.<sup>1</sup> In the meantime, we expect the secondary PE market to remain robust in 2024. Secondaries are a way for investors to enter the market without hurdles such as the J curve and provide GPs another avenue to exit portfolio company investments. We also expect continuation vehicles to see a robust market in 2024. In fact, PE participants have found ways to put all of these themes together. FundFire recently reported that continuation funds are increasingly tapping capital from co-investors coming in alongside an anchor secondaries manager.<sup>2</sup>

### TECH BACK AT THE FOREFRONT

The Technology sector could see strong momentum in 2024. Public market technology firms led equity market declines in 2022 but also led the rebound in 2023. In PE, however, we observed that private technology companies (especially growth equity) experienced additional repricing in 2023. However, we expect the sector to be a leader in 2024, driven by artificial intelligence, automation, an abundance of data and data analytics, and the continued focus on cybersecurity. In addition, technology adoption has been widespread across sectors and sub-sectors, which should continue to drive transaction volume across private equity.

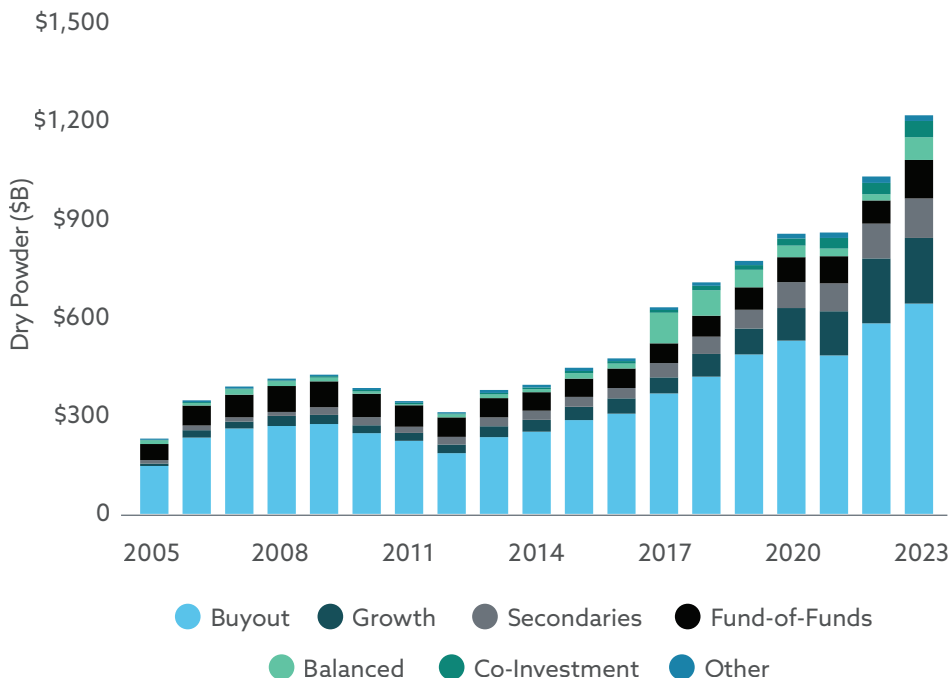
(1) PitchBook. "PE heads deeper into the storm." 4 January 2024. (2) FundFire. "Co-Investments Emerge as Vital Tool for Continuation Deal Funds." 6 December 2023.  
Past performance is no guarantee of future results.

## PE FUNDRAISING SHOULD REMAIN CHALLENGED IN 2024<sup>3</sup>



PE fundraising ran into a number of headwinds in 2023, led by higher interest rates. The overall amount of fundraising in North America held relatively steady last year at \$677B, though that remained down from 2021's record of \$746B.<sup>3</sup> But that was driven by the very largest PE funds, as the number of funds raised plunged from 2,011 in 2021, to 1,470 in 2022 and just 881 in 2023. We expect fundraising to remain challenged in 2024, with managers likely launching funds earlier and taking longer to raise capital. Indeed, the average number of months to final close held steady at a record 21 months in 2023. Co-investment fundraising, while not immune to these headwinds, have some mitigating factors including lower fees and diversification.

## GROWING DRY POWDER HAS RAMIFICATIONS FOR FUNDRAISING, VALUATIONS<sup>4</sup>



PE dry powder continued to increase in 2023, rising to \$1.2T in North America, with half of that coming from Buyout.<sup>4</sup> This is one factor that could allow investment activity to pick up in 2024 for the broader market, as we anticipate, despite fundraising headwinds. Separately, record dry powder has helped valuations for the top-rated portfolio companies, even as lower-rated assets have seen notable declines. There is an increasing amount of money chasing a smaller bucket of top deals, a trend that we expect to continue.

(3) Source: Preqin, Ltd. Number of funds and dollar amount raised per year for North American PE ex. venture capital. As generated on 5 January 2024.

(4) Source: Preqin, Ltd. As generated on 5 January 2024.

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Portfolio Manager**CALVIN WALKER**Managing Director,  
Portfolio Manager**KEY TAKEAWAYS**

- > A strong rally in Q4 2023 may have pulled forward positive performance from 2024 that could impact the investment grade (IG) market in the new year, but we expect demand for IG bonds to persist
- > Investor expectations for rate cuts beginning in May versus our conviction for a shallower easing cycle beginning in H2 2024 could create bouts of volatility and opportunities for tactical shifts in portfolios
- > We see investment opportunities for our clients brought about by increased M&A activity in 2024

**A RALLY TO END THE YEAR**

The US investment grade market surged into year-end as participants reacted favorably to economic data pointing to cooling inflation and dovish commentary from Fed members. On the strength of this rally, the Bloomberg US Credit Index (Index) produced an excess return of 181 bps for the quarter, increasing the annual excess return to 420 bps.<sup>1</sup> On a total return basis, the Index surged 8.15% in the quarter, driven by both spread tightening (19 bps in Q4 to 93 bps) and a rally in US Treasuries (10-year yield fell 71 bps to 3.88%). The Index returned 8.18% in 2023.

**POTENTIAL IMPACT FOR 2024**

The positive returns seen in Q4 may have pulled forward some positive performance from 2024, which can affect the IG marketplace in the new year. Historically high yields led to an increase in demand in the asset class, resulting in net inflows of

\$123B for 2023.<sup>2</sup> As a result of the decline in US Treasury yields, Index yields have now fallen to 5.16% from a recent high of 6.32% in October 2023.<sup>3</sup> However, as the chart on the next page indicates, these current yields are still quite attractive from a historical perspective, which we believe should entice investors to continue to add fixed income exposure in 2024.

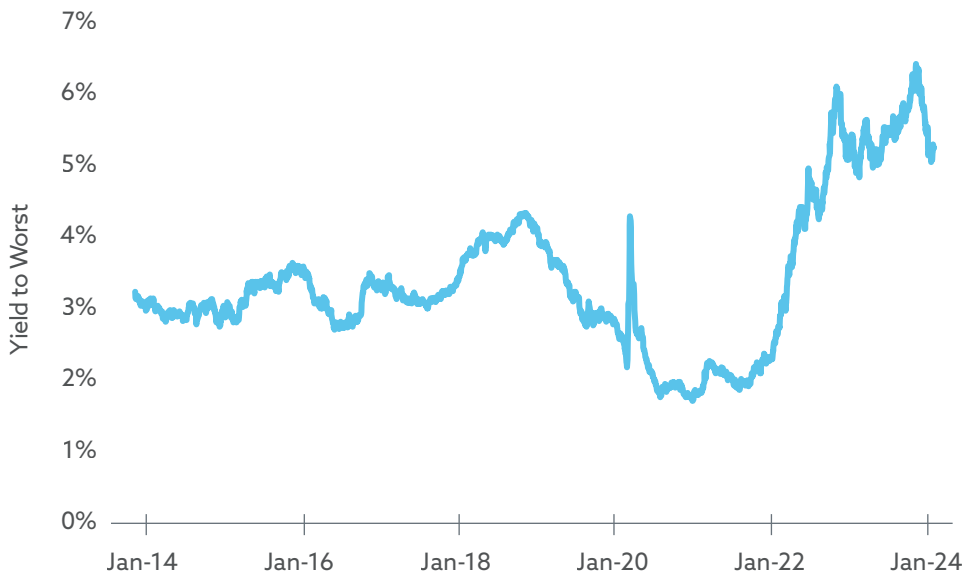
The market's current expectation is for an economic soft standing and for a total of five rate cuts in 2024 to begin in May.<sup>4</sup> However, we believe this final round of the fight against inflation will be the most difficult and envision a shallower easing cycle that begins later in H2 2024. This disconnect, in our opinion, will likely drive bouts of volatility, which could create opportunities for tactical shifts in portfolios. We believe this environment favors investment managers that drive alpha generation through an extensive security selection process.

**MITIGATING RISK, FINDING OPPORTUNITY**

In terms of positioning, our low-growth economic outlook merits a higher-quality focus in our Investment Grade Credit strategy. In Crossover and Core Plus, we remain long at both the front-end and back-end of the corporate curve to barbell risk. Across strategies, we prefer US money center banks and see better value in their short maturity bonds. Finally, we anticipate increased levels of M&A activity in 2024 as companies with stronger balance sheets attempt to grow and take advantage of any valuation dislocations. We believe transactions should include less leverage than recent years, and we will look to identify deleveraging stories in which to invest.

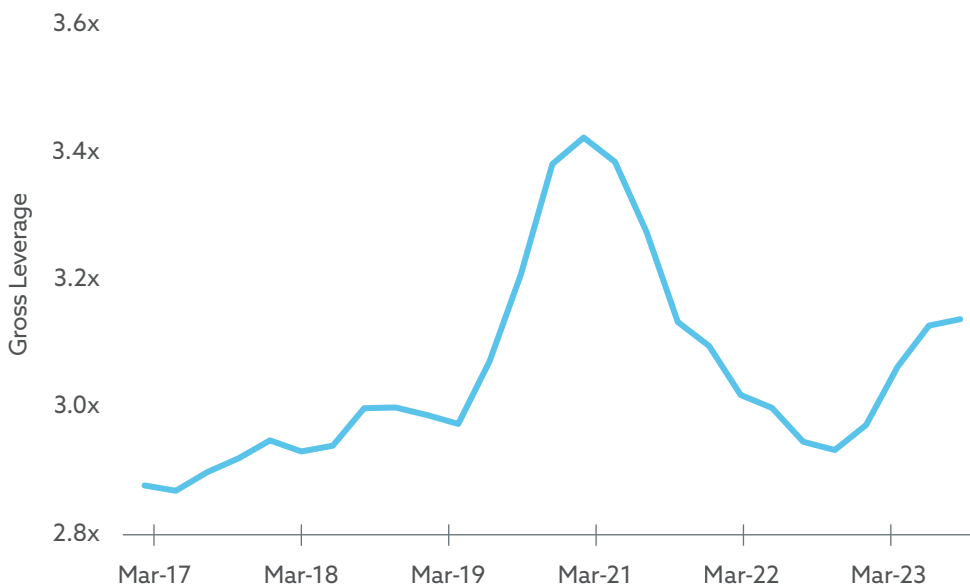
(1) Unless indicated, data sourced from Barclays. 2 January 2024. (2) Morningstar. Based on monthly flows for the US OE Intermediate Core Bond category (including ETFs) through 31 December 2023. (3) FactSet. Daily Bloomberg US Credit Index yield to worst from 9 January 2014 to 9 January 2024. (4) Bloomberg. 9 January 2024. Past performance is no guarantee of future results.

### YIELDS STILL ELEVATED DESPITE RECENT PULLBACK<sup>3</sup>



With the end of year rally, yields in IG bonds receded from their recent highs. However, when taking the long view, 5.16% is in the top decile of yields over the last 10 years, so participants can still take advantage of elevated yields.<sup>3</sup> Since yields at the time of investment are typically long-term drivers of total return in bonds, we expect demand for IG to continue in 2024.

### LEVERAGE NEAR PRE-COVID LEVELS<sup>5</sup>



Corporate fundamentals, in our view, are at [reasonable levels](#) despite a tumultuous 2023. The most recent reading for gross leverage at 3.1x was only slightly above the pre-COVID average of 3.0x and well off the peak of 3.4x in September 2020.<sup>5</sup> As long as IG companies can maintain these leverage levels by managing their balance sheet and cash flows, bond prices should remain supported.

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### KEY TAKEAWAYS

- > The US high yield market ended 2023 with a strong rally as investors reacted favorably to economic data pointing to decelerating inflation and dovish comments from Fed members
- > The "slow burn" cycle continued in the quarter, which saw a resumption in overall downgrades, improvement in the distress ratio and a measured increase in defaults
- > We expect economic growth to be good enough in 2024 for most high yield credits and believe the yield and discounted dollar price make the asset class attractive for income oriented investors

### A YEAR-END RUN-UP

Following a weak October, the US high yield market surged into year-end as investors cheered decelerating inflation growth and dovish talk from Fed members, emboldening hopes for an economic soft landing. The ICE BofA US High Yield Constrained Index (Index) posted a quarterly total return of 7.07%, resulting in an annual total return of 13.47%.<sup>1</sup> Higher-rated bonds led during the quarter amid a rally in US Treasuries: BB 7.34%, B 6.78%, CCC & Lower 6.60%. However, lower-rated bonds led over the year: BB 11.44%, B 13.96%, CCC & Lower 20.36%.

The end of the year saw a continuation of the "slow burn" credit cycle. The Index default rate increased for the seventh quarter in a row, albeit gradually, rising 43 bps to 3.77% but remaining below the average since 2006 of 4.11%.<sup>2,3</sup> The distress ratio, a predictor of future defaults, decreased 41 bps during the quarter to

6.29% and remained below its historical average of 11.16%.<sup>3</sup> The Index saw more bonds downgraded (-\$80B) than upgraded (\$60B), continuing the trend over 2023 where \$315B in bonds were downgraded and \$241B in bonds were upgraded.

We modestly increased overall portfolio risk in the fourth quarter. We expect economic growth to be good enough in 2024 for most of the high yield market, but are watching for weakness in the labor market. When looking for value, we see opportunities across the ratings spectrum and favor core income names – performing credits with spreads in the range of 300-600 bps.

### SECTORS IN FOCUS

All sectors finished the quarter positive, led by Banking (9.30%), while Transportation trailed (3.80%). Over 2023, Retail led (17.43%), spurred on by the resiliency of the US consumer, and Transportation lagged (9.19%).

We increased exposure to the Telecommunications and Transportation sectors during the quarter and reduced exposure to Energy and Technology. At quarter-end, Energy still remained our largest overweight sector along with Automotive, while Real Estate and Basic Industry were the largest underweight sectors.

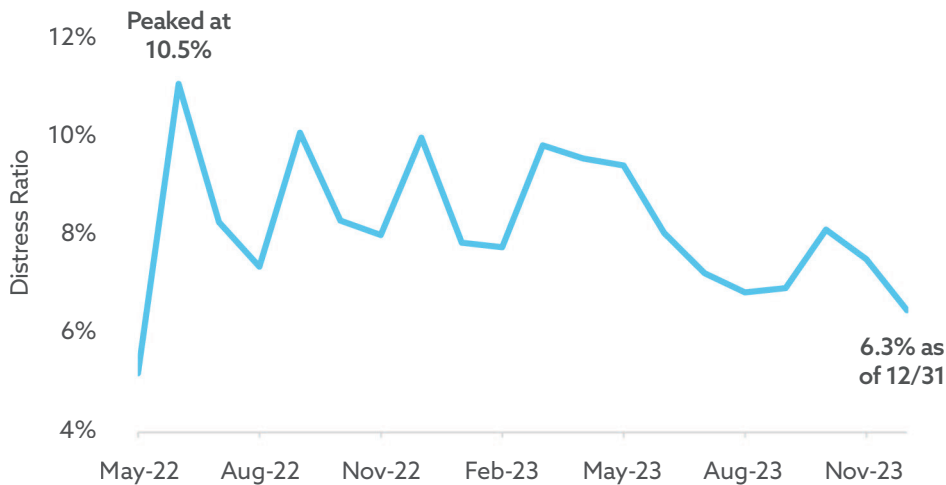
### DEMAND FOR HIGH YIELD RETURNS

High yield technicals improved in Q4 2023. The asset class experienced \$9B of inflows during the quarter, improving net flows to flat for the year.<sup>4</sup> Gross issuance totaled \$42B for the quarter, considerably higher than the \$15B seen in Q4 2022. Issuance for the year was \$175B, up from the \$106B issued in 2022 but well below the levels seen in 2021 (\$455B) and 2020 (\$433B).<sup>2</sup>

(1) Unless indicated, data sourced from ICE Data Services. 2 January 2024. (2) Data in this paragraph, including defaults, distress and upgrades/downgrades, from BofA Global Research. 2 January 2024. (3) Default rate calculated at the issuer level for the last 12 months. Distress defined as bonds with spreads above 1,000 bps on a par basis. (4) Morningstar. Based on monthly flows for the US OE High Yield Bond category (including ETFs) through 31 December 2023. Past performance is no guarantee of future results.

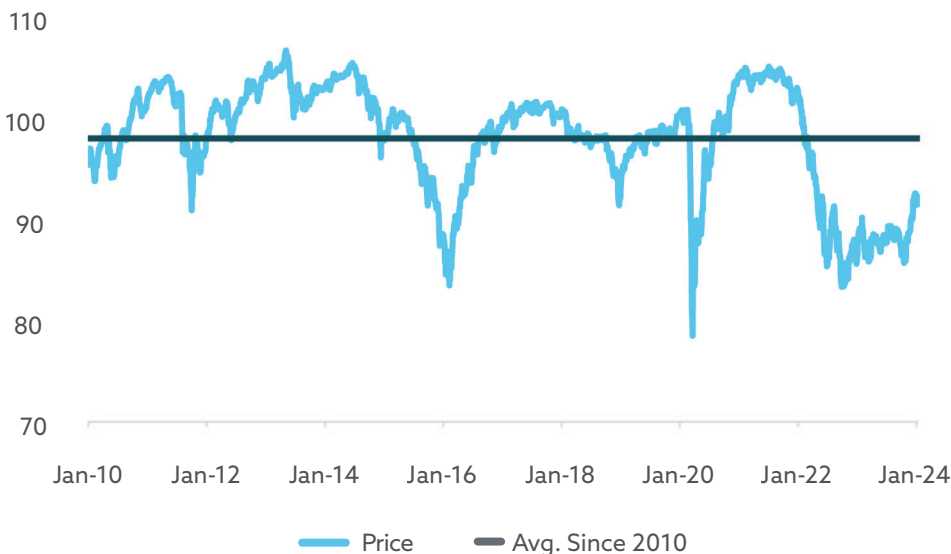


## DISTRESS RATIO IMPROVING FROM RECENT HIGHS<sup>5</sup>



At the end of 2022, we made the call that high yield would enter into a “slow burn” credit cycle. That scenario played out through 2023, as the asset class has seen a measured rise in defaults and an increase in downgrades. One positive has been the distress ratio, which has trended lower after peaking at 10.5% in June 2022 and reaching 9.4% in March 2023.<sup>5</sup>

## HIGH YIELD PRICES STILL DISCOUNTED DESPITE RECENT INCREASE<sup>6</sup>



Since mid-October, the price of high yield bonds has increased nearly \$6 to \$91.83.<sup>6</sup> Even with that rise, prices are still below the average since 2010 of \$98.41. From a valuation perspective, these discounted dollar prices along with elevated yields help offset the current mediocre spread levels. We view having two out of three factors positive as attractive for the market.

(5) BofA Global Research. 2 January 2024. The distress ratio is defined as the percentage of bonds with spreads above 1,000 bps on a par basis. (6) ICE Data Services. Daily price of the ICE BofA US High Yield Index. 18 January 2024.

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