SOLVING
FOR 2024

NEUBERGER BERMAN

OUR INVESTMENT PLATFORM

FIRM ASSETS UNDER MANAGEMENT $439bn

MULTI-ASSET STRATEGIES

	EQUITIES	FIXED INCOME	HEDGE FUNDS & LIQUID ALTERNATIVES	PUBLIC REAL ASSETS
PUBLIC MARKETS $313bn	Global U.S. EAFE / Japan Emerging Markets – China Quantitative Thematic Custom Direct Investing	Global Investment Grade Global Non-Investment Grade Emerging Markets Debt Municipals Multi-Sector Currency	Multi-Manager Hedge Funds Long/Short Event Driven Global Macro Risk Premia Options	Commodities Diversified Real Assets Global REITs U.S. REITs
	$120bn	$167bn	$23bn	$3bn
	PRIVATE EQUITY	**PRIVATE CREDIT**	**SPECIALTY ALTERNATIVES**	**PRIVATE REAL ASSETS**
PRIVATE MARKETS $125bn	Primaries Co-Investments Secondaries Specialty Strategies	Private Debt Capital Solutions Special Situations Residential Loans Specialty Finance Private Placement European Private Loans	Hedge Fund Co-Investments Insurance-Linked Strategies Late Stage Pre-IPO SPACs	Private Real Estate – Almanac Real Estate Secondaries Real Estate Primaries & Co-Investments Infrastructure
	$88bn	$25bn	$6bn	$7bn

ESG INTEGRATION | GLOBAL RESEARCH CAPABILITIES | DATA SCIENCE

SOLVING

FOR 2024

TEN FOR 2024

Each year, our investment leaders identify 10 key themes that they believe will be prominent in the markets over the next 12 months. The themes for 2024 are summarized below. A roundtable discussion of the themes begins on page 5.

MACRO: FROM SUPPORTING THE CONSUMER TO SUPPORTING INDUSTRY

1 GROWING CHALLENGES FOR THE CONSUMER

The resilience of the many economies during 2023, particularly that of the U.S. and others that are more services- than manufacturing-led, owed much to low unemployment and the excess savings that consumers built through the pandemic. Those excess savings, which were already skewed to wealthier consumers rather than those on middle and lower incomes, are running dry—and we think inflation will likely remain above targets, rates will remain high, housing costs will remain at multi-decade highs and job markets will soften in 2024. Expect a weaker consumer to be at the heart of next year's economic slowdown.

2 STICKIER INFLATION AND SLOWER GROWTH MAY NOT BE SO BAD FOR INVESTORS

Current projections for 2024 suggest the persistence of above-target inflation and higher rates even as real growth declines. Still, we are a long way from the stagflation extremes of the 1970s, and these conditions mean relatively high nominal growth compared with much of the past decade. This could be tricky for long-dated bonds and interest rate-sensitive equities, but more neutral for quality companies—those with strong balance sheets to shelter against the rising cost of capital, and the ability to sustain margins in a low real-growth environment.

3 MORE FISCAL POLICY DISPERSION (AND DEBT SUSTAINABILITY QUESTIONS)

A renewed rise in yields and the return of term premia in both the U.S. (where growth has been resilient) and Europe (where growth has faltered) suggests growing concern about debt sustainability. After three years of near-universal agreement on deficit spending to protect workers and consumers from the impact of the pandemic, debate is likely to open up on the impact of tight monetary policy and expansionary fiscal policy on deficits, and the right balance of entitlement spending, defense and security spending, industrial-policy and energy-transition spending, and interest costs. Some countries will continue to expand fiscal policy (likely reorienting it to finance industrial policy), some will choose to reassert fiscal discipline, and some will have discipline forced upon them by newly hawkish bond markets. A packed election calendar worldwide will likely complicate the decision-making.

4 THE "AWKWARD AGE" FOR ESG

As sustainable investing and environmental, social and governance (ESG) regulation becomes more prescriptive yet increasingly fragmented, investors themselves are becoming more pragmatic and solutions-oriented. These are tensions typical of the graduation from the simplicities of childhood to the complexities of adolescence. ESG and Sustainability will remain a key regulatory focus, but confused by diverging regional approaches. However, investors on the ground will become clearer on the difference between investing for sustainable or impact outcomes on the one hand, and incorporating financially material ESG factors into investment analysis on the other. This will favor asset managers that observe these distinctions internally, bring solutions rather than labels to clients, and have made the necessary investments in personnel and data to genuinely integrate ESG factors into their research and engagement capabilities.

EQUITIES: EXHAUSTED BETA

5 EARNINGS QUALITY AND BUSINESS RESILIENCE COMES TO THE FORE

In 2022, equity markets were driven mainly by rising real rates: longer-duration growth stocks were crushed. Through much of 2023, there was a lot of sideways drift, with one huge exception: a small number of mega-cap technology stocks benefitted from excess liquidity, a "buy the 2022 losers" momentum reversal, and exuberant sentiment around the potential of artificial intelligence. In 2024, we think the earnings headwinds that began in 2023 will continue to blow. Greater recognition of rising global macroeconomic uncertainties and draining liquidity will refocus attention on valuations, earnings quality and the broader resilience of business fundamentals to slowing growth. Large performance dispersion will likely follow, not just within and across sectors, but potentially also between active and passive management.

6 LAGGARDS FIND (RELATIVE) FAVOR

We have seen wide dispersion in the optimism being priced into regions (favoring developed over emerging markets), countries (India over China), styles (growth versus value) sectors (technology preferred to financials) and size (large caps over small caps). We believe markets with a greater degree of pessimism priced in are likely to perform better than those priced for perfection, should growth disappoint or the cost of capital continue to rise. The lurching back and forth between these investment categories that we have seen in 2022 and 2023 could be set to continue.

FIXED INCOME: THE LONG AND GRINDING ROAD

7 SUPPLY AND DEMAND OUTWEIGHS FUNDAMENTALS

Marginal changes in spreads and yields will continue to owe more to supply-and-demand technicals than fundamentals, much like they have in 2023. Modest issuance and keen appetite for higher yields kept credit spreads tight and range-bound through much of 2023. Rising supply of government bonds is impacting risk free yields, and the shape of yield curves. Similarly, high cash yields created strong technical demand for cash and short maturity investments, which is beginning to push the most attractive point for relative value out into intermediate maturities. These technical factors are unlikely to change significantly in 2024.

8 A SLOW RISE IN IDIOSYNCRATIC DEFAULTS, BUT ELEVATED TAIL RISK

As higher rates bite into the real economy, credit defaults are beginning to rise and will be a feature of 2024's credit landscape. We expect credit stresses to be idiosyncratic: companies with longer-dated fixed-rate debt and high-yielding cash on stronger balance sheets, and the ability to sustain and grow margins, are unlikely to experience substantial spread-widening. We also expect the default rate to be low relative to past cycles. But there are caveats. A significant amount of corporate lending has moved into private markets since 2008, and deteriorating credit metrics stretch broadly across real estate and consumer debt, so a low visible corporate default rate may not tell the whole story. And systemic tail risk will be high, given the scale and rapidity of the tightening cycle—as we saw in the mini-banking crisis in 2023.

ALTERNATIVES: DISRUPTION BRINGS OPPORTUNITY

9 WHERE CAPITAL IS CONSTRAINED, CAPITAL PROVIDERS CAN BE REWARDED

Even though fundraising is down, there is still a lot of dry powder in private markets, just not in all the right places. Exit bottlenecks mean that private equity firms are seeking to squeeze more growth out of their best existing companies, while also providing liquidity for investors that need it. That has led to a rise in demand for investor capital, not for new deals, but for secondaries, co-investments, private credit and capital solutions such as preferred or structured equity. We think these will continue to be the most attractive corners of private markets through 2024.

10 REAL ESTATE DIVIDES INTO THE HAVES AND HAVE-NOTS

Real estate owners and operators face historic increases in the cost of capital, structural changes in demand for office, industrial, residential and retail properties, and growing geographic dispersion of economic well-being. This will divide owners into the strong and the weak, and compound the advantages and disadvantages. Those experienced players with strong performance and robust balance sheets will be able to continue to cement their market leadership positions. In addition, we think haves, have-nots and volatility will combine to create opportunity in the real estate credit markets.

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Chief Investment Officer—Private Wealth

ANTHONY D. TUTRONE
Global Head of Alternatives

ROUNDTABLE DISCUSSION

STICKIER INFLATION AND SLOWER GROWTH

As 2023 ended, the leaders of our investment platforms gathered to talk about the evolution of the investment environment over the past 12 months and the key themes they anticipate for 2024.

Erik Knutzen: Last year, we expected the economic slowdown to trough in 2023. The eurozone, whose manufacturing-led economy is more sensitive to high rates and highly exposed to China, entered recession—but it now seems too early to call that the trough. U.S. GDP growth has strengthened through much of the year, but some indicators are now weakening. In both cases, the slowdown seems to have been elongated or delayed. We and many other market participants perhaps underestimated the persistent strength of the fiscal impulse and the consumer, especially in the U.S.

Shannon Saccocia: The cushion we all built for ourselves in the preceding years enabled us to digest the challenging inflation and interest-rate environment. Governments stepped in with support through the pandemic. Corporations termed out debt and held a lot of high-yielding cash. Households held record savings. That's why the U.S. consumer didn't tire as expected. This could be a decisive theme for 2024, however, as those excess savings begin to run dry. Delaying the slowdown is likely to make it milder, but I still think a slowdown is on the way and the weakening consumer will be at the center of it.

Ashok Bhatia: I agree this is going to be a consumption slowdown rather than a substantial corporate-investment, jobs-market or housing-market slowdown. After three years of pandemic payments and high wage growth, we will look back on 2023 as peak consumer.

Brad Tank: They're going to be left exposed to inflation, high rates and the least affordable housing market for decades.

Joseph Amato: People are starting to talk about stagflation. Is that where we are headed in 2024? Today's conditions don't feel like the extreme stagflation of the 1970s, which were characterized by high rates, slow growth but also high unemployment.

Knutzen: We've been discussing the growing structural forces of inflation for a long time now. Structural forces persist through all stages of the growth cycle, by definition, so that suggests slowdowns are now more likely to feel like stagflation. But, as Joe suggests, that term evokes the extremes of the 1970s. As my colleague Bob Surgent points out, the stagflation we are talking about could equally be characterized as structurally higher nominal GDP growth.

Amato: Right, and that's an important point. If real growth declines to 1% but inflation is at 3%, you get 4% nominal GDP growth, which is arguably better for investors than the 1 – 2% real growth, zero inflation and zero rates that we've had for much of the past decade.

Knutzen: It would be a difficult environment for government bonds, particularly at the long end of the curve, but it could take some of the sting out of high policy rates and high real rates in equity markets by helping to sustain earnings and valuations. An additional "long-the-strong" focus on quality companies is likely to be important, however, as investors begin to seek out businesses that can sustain margins in the face of these rising labor, resource, interest and capital costs. How does the fiscal policy outlook affect our view here? A bias to fiscal expansion is one of the forces we've identified behind structurally higher inflation, but on the other hand, there's been an immense transfer of wealth from the public to the private sector that will ultimately need to be rebalanced, presumably by fiscal consolidation.

> ***"The stagflation we are talking about could equally be characterized as structurally higher nominal GDP growth."***
>
> **– ERIK KNUTZEN**

Saccocia: My view is that, rather than meaningful fiscal consolidation, we will see a shift from fiscal spending directed at supporting the consumer toward fiscal spending directed at industry—and specifically security-related spending, in the light of the conflicts in Ukraine and the Middle East and tense U.S.-China relations. Food security, energy security, military security, supply-chain security. We have seen the beginnings of that in policies and legislation aimed at securing strategic industries in the U.S., Europe and China, and globally in policies designed to improve power transmission grids and ready them for renewable energy. The growing dominance of China in areas like electric vehicles, semiconductors and critical pharmaceuticals is beginning to feed into policy choices elsewhere. There will be positives out of this, but will running the necessary deficits come back to bite us?

Tank: I certainly think this is the year when debt sustainability comes into focus, as expansionary industrial policies and rising interest payments really start to widen deficits. The evidence suggests that it's this driving recent moves on yield curves, rather than rising inflation expectations.

Knutzen: We could see the concept of fiscal dominance enter the discussion, and sharper debates about the appropriate balance in the fiscal and monetary policy mix. Fiscal expansion combined with high rates is a recipe for ballooning interest costs and potentially unsustainable deficits.

Niall O'Sullivan: Politics and geopolitics are going to complicate this fiscal monetary-inflation picture. The election calendar is packed in 2024. It kicks off with Taiwan in January and ends with the U.S. and possibly the U.K. In between, we'll get elections in Russia, India, Pakistan, Mexico, South Africa, South Korea and many other countries, including elections to the European Parliament—there's even a vote planned in Ukraine. On the whole, I think the populist background supports fiscal expansion in pursuit of the security objectives outlined by Shannon. That is inflationary, all else being equal. Investors need to think about these geostrategic issues more and more, especially in industries like technology, materials and energy; they need to think about exposure to growing levels of intra-emerging markets trade; and they need to think about supply-chain resilience as an important aspect of quality.

Knutzen: A subject that comes up a lot in conversations with clients that we haven't addressed yet is ESG, sustainable and impact investing. Last year we said there would be more effort within the industry to clarify the terminology, and especially the distinction between investing processes, such as ESG integration, and investing outcomes, such as impact.

"As central banks drain liquidity from the market, above-target inflation meets slowing growth and the high cost of capital and labor starts to bite, earnings more than anything will drive stock price performance."

– JOSEPH AMATO

Amato: It's easy to be distracted by the politics and sometimes conflicting regulation, but behind all of that, investors and corporations have been moving in the direction we outlined. ESG is growing up, and that means growing pains, but the trend is increasingly to focus on financially material ESG factors as part of a broader effort to integrate them into the analytical process. If this trend persists, eventually we might be able to retire the term "ESG," talk about impact and sustainable investing on their own terms, and avoid much of the current confusion.

"Politics and geopolitics are going to complicate this fiscal monetary-inflation picture, and the election calendar is packed in 2024."

– NIALL O'SULLIVAN

O'Sullivan: I agree. I'd describe it as a turn to pragmatism, in general. Clients don't tend to come to us looking for "ESG" or "impact," they come looking for solutions. "The world looks to be on a path to net-zero emissions, and my board not only wants to know what our portfolio exposure is, but also wants to get that portfolio on its own path to net-zero." Sure, that's why we've integrated a Climate Value-at-Risk measure into the strategic asset allocation process, so you can adjust all your return estimates based on several global-warming scenarios. And we've developed a Net Zero Alignment Indicator to help assess whether individual companies are on a credible pathway: you can use this tool to adjust portfolio exposures or direct your engagement efforts. Those are the conversations happening on the ground.

EQUITIES: EXHAUSTED BETA

Amato: We've always considered ESG factors to be an integral part of active management. Which brings us to our market themes for the year ahead. It's been a frustrating year for active managers. We've had essentially flatlining earnings, but watched the S&P 500 Index rally strongly. And that rally was incredibly concentrated in the biggest stocks in the index. Earnings and business fundamentals seemed irrelevant next to excess liquidity, buying the big losers from 2022, and a sense that mega-cap tech stocks are defensive and beneficiaries of the artificial intelligence theme. I think that becomes more difficult to sustain as central banks drain liquidity from the market, above-target inflation meets slowing growth, and the high cost of capital and labor starts to bite. Earnings more than anything will drive stock price performance and investors will become more discerning and selective, in my view.

Saccocia: I call this the theme of "margin recapture." Do certain industries and companies have more profitability levers to pull than others? If artificial intelligence is the new productivity and profitability lever, and 2023 was the year when every business needed to show that AI was on its Vision Board, 2024 will be the year to set out AI-related capex and hiring programs. It's time to walk the walk on deploying AI to enhance productivity, rather simply talking the talk.

O'Sullivan: This informs our "long-the-strong" theme. Strong balance sheets shelter from rising interest costs, while low operational leverage, the ability to deploy technology and pricing power all help minimize and absorb high labor and input costs. By implication, we are short the weak: those with high financial or operating leverage, those less able to protect margins—but also those who benefited disproportionately from pandemic measures, those whose valuations are most dependent on a rapid reduction in rates, and those who are priced for perfection and fail to deliver.

Amato: The risk embedded in anything that's priced for perfection is likely to be an important theme across regions, countries, sectors and styles. Look for the laggards to find favor—at least on a relative basis. Have developed markets become expensive relative to emerging? Have investors become too pessimistic on China and too optimistic about India? Are financials now more attractive than tech stocks, is value going to reassert itself against growth? Small caps may not perform particularly strongly in the kind of environment we've described, but are large caps due a pullback after such dominant outperformance in 2023? Having pessimism already priced in can be a protective buffer in a downturn.

FIXED INCOME: THE LONG AND GRINDING ROAD

Tank: Turning to fixed income themes, it's notable that we tentatively mentioned bond vigilantes last year, which makes it tempting to announce their full return this year. But I think that is over-dramatic. Really, what we've been seeing recently is an extension of a theme we've seen through much of 2023: the ebbs and flows of spreads and nominal Treasury rates have been about shifts in supply and demand rather than fundamentals. For example, at the start of the year, credit spreads tightened even though virtually every strategist was forecasting a recession during 2023, simply because corporates that locked in lower rates a year earlier were no longer coming to market. In rates markets, government bond market yields broke out of their trading range when investors realized just how much and how quickly U.S. Treasury issuance was accelerating. That was a reaction to a higher-than-expected rise in government interest costs, lower-than-expected tax receipts and a resulting explosion of the deficit—as I mentioned earlier, it's not really about growth and inflation, it's about a flood of Treasury market supply. With many buyers of longer-dated bonds pulling back—including central banks, commercial banks and offshore buyers facing high currency-hedging costs—it's no wonder we have seen the return of some term premia in yield curves.

> ***"One can talk about 'bond vigilantes,' but really it's just that the ebbs and flows of spreads and nominal Treasury rates have been about shifts in supply and demand rather than fundamentals."***
>
> **– BRAD TANK**

Knutzen: We should mention Japan, in the context of these technical forces. If inflation proves sticky there, the Bank of Japan may have to abandon its yield-curve control policy—it has already signaled that it is gradually preparing to do so. That could set off a substantial re-allocation of capital out of international bond markets and back to Japan.

Bhatia: I think we have rightly drawn attention to the probability that term premia will go on being priced back into yield curves through 2024, but it's also worth noting that these technical forces can switch rapidly. What if some of the mountain of cash that investors are sitting on starts to find its way further out onto the curve? What if liability-driven investors start to move out on the corporate curve to lock in higher yields? Focus is on supply overwhelming demand now, but there is potential demand out there.

Knutzen: How does the dominance of technical forces inform our outlook for credit markets?

Bhatia: We think low supply in corporate credit markets will persist into 2024, and it will be relevant both for spread volatility and for the shape of the default cycle. There is little issuance because so many companies issued more than they needed to when rates were low back in 2021 and 2022, and that has also set back the date at which many will need to raise more debt, and lowered the amount of debt they are likely to have to raise. The longer rates remain high, the more those issuers get dragged into the same refinancing net as everyone else, but those cash holdings still provide a meaningful buffer. We expect defaults to rise, but these dynamics coming into the downturn are likely to make this default cycle longer than usual, and also more idiosyncratic. A relatively high proportion of defaulters are likely to be serial defaulters—they will have been less able to raise abundant cheap capital in 2021 and 2022, and that will now compound their fundamental weaknesses relative to the higher quality issuers. That said, the tail risk remains elevated, as the mini-banking crisis demonstrated earlier this year. Big moves in Treasury markets, like the one that occurred over recent weeks, raise those risks.

ALTERNATIVES: DISRUPTION BRINGS OPPORTUNITY

Tank: There has been a lot more corporate lending in private markets since the financial crisis, and in the private-equity and private-debt world, these stresses get fixed behind the scenes between a small number of parties. That could mean that a lot of defaults don't make it into the public eye, while some defaults will be avoided, in exchange for some parties having their returns suppressed through restructurings and recapitalizations.

Anthony Tutrone: It's certainly a real issue, although investors should note that equity is generally a bigger part of the capital structure of private equity transactions done since the Global Financial Crisis. That makes the ecosystem less vulnerable to rising rates. That said, higher rates could present issues for legacy portfolio companies with high leverage or weak operating performance. Secondary buyers need to be highly selective, and private credit investors looking to take advantage of these higher rates should be very selective when it comes to funds with existing investments.

O'Sullivan: Some of these stresses in legacy assets will be opportunities for liquidity and capital providers. As Brad implies, returns for equity holders become suppressed after these restructurings because they have to pay for the capital being provided by private credit or preferred stock investors. But these opportunities are not only about balance sheet stresses; in fact, for the most part, we are talking about growth capital for high-quality companies.

Tutrone: Yes, this is the issue of IPO and M&A activity being so constrained. When these exit routes are closed, investors who need liquidity have to find another way to sell assets, and investors who don't need liquidity will often want to raise new capital to finance the next stage of growth for their best companies—companies that they didn't plan to be owning at this stage. Investors who need liquidity may simply sell into the private equity secondaries market, where we are currently seeing very attractive value because there is a lot of demand for liquidity versus the available capital. We're seeing more and more "GP-led" secondaries, too, where the fund manager will put companies into a "continuation fund," take new investment from the secondary market to provide capital for portfolio companies and liquidity for exiting Limited Partners. Investors looking for growth capital to inject into companies are seeking out several types of provider: it might be a private debt fund; if they are up against their debt limits, they might offer a "mid-life" co-investment, where a new investor provides equity for an existing portfolio company; and if they are up against debt limits and don't want to dilute the equity, they may go to a specialist capital solutions provider for preferred or structured equity. For investors looking for tactical opportunities in this market, these areas have been very attractive over the past 18 months. We think they will continue to be so in 2024.

O'Sullivan: You mentioned the potential challenges that higher rates pose for legacy deals that were financed with floating rates when interest costs were low. But how do higher rates affect new transactions?

Tutrone: The main challenge is that private equity managers can no longer rely on cheap leverage and increasing valuation multiples to generate returns. Since the financial crisis, however, private equity firms have invested in the expertise and resources required to help portfolio companies accelerate revenue and earnings growth through effective strategic and operational-improvement plans. We think that means the returns that the best managers generate will be more idiosyncratic and less likely to be correlated with the wider market, which means more rides on selecting and having access to those managers. In short, higher rates will start to separate the best from the mediocre in terms of performance.

"Higher rates will start to separate the best private equity managers from the mediocre, in terms of performance."

– ANTHONY TUTRONE

Amato: Our colleagues on the Almanac Realty team have been making a similar point about the private real estate outlook, albeit compounded by the extraordinary cross-currents in that asset class. They point to the supportive long-term trends: structurally higher inflation and nominal growth is a positive because rent is paid in nominal dollars and nominal replacement costs are likely to limit new supply; and the industry is consolidating and institutionalizing, bringing more real estate under the control of operating companies. But you've got to survive long enough to benefit from those trends. With rates going up, valuations are coming down, refinancings are becoming more expensive, and so anyone with a weak balance sheet is under a lot of pressure. That means dividend cuts, or worse. And on the operational side, while industrial, residential, storage and other specialty assets are often benefitting from tailwinds, offices are struggling and it's difficult to know how that sector will look once the dust has settled. Retail and senior housing are going to be heavily affected by local economics, and regional divergence in economic well-being is widening. So, as in private equity, you need the right assets of the right quality in the right places to succeed, and you need to select operating companies with the skills and the balance sheets to deal with these complex market dynamics and higher rates.

Knutzen: I think that's a great place to wrap up. Long the strong in an environment of higher rates for longer is certainly a unifying theme across our 10 for 2024. While in many ways I'd say our economic outlook for the year ahead is less pessimistic than it was 12 months ago, the potential for volatility is just as high, and the full impact of monetary policy tightening still appears to be ahead of us.

SOLVING

FOR 2024

LOOKING BACK

Last November, our investment leaders identified their 10 key themes for 2023. As 2023 ends, we look back to see how well they anticipated the events of the year.

MACRO: BACK TO THE "OLD NORMAL"

1. A YEAR OF PEAKS AND TROUGHS WITH A RETURN TO THE "OLD NORMAL"

What we said: We think the next 12 months are likely to see this cycle's peaks in global inflation, central bank policy tightening, core government bond yields and market volatility, as well as troughs in GDP growth, corporate earnings growth and global equity market valuations. But we do not believe this will mark a reversion to the post-2008 "new normal". We see structural forces behind persistently higher inflation—and therefore a persistently higher neutral interest rate, a higher cost of capital and lower asset valuations.

What we've seen: Headline and core inflation rates in the U.S., Europe, China and Japan appear to have peaked between June 2022 and March 2023, but rising prices have been more persistent than many anticipated, supporting our structural view that we are returning to an "old normal." The U.S. Federal Reserve and European Central Bank have maintained their hawkish messaging even as inflation has declined: policy rates may hit their peaks before year-end, but further tightening into 2024 is a higher probability than we envisaged at the start of the year. In addition, the recent market sell-off raises doubts about whether 2023 will see the peaks in bond yields and market volatility. U.S. GDP growth has been strong this year, and while eurozone growth has weakened, it has avoided recession so far—the trough of the slowdown now looks likely to occur next year. Consensus estimates suggest that U.S. and European large-cap earnings troughed in the first quarter of 2023; however, given what we see as the delayed economic slowdown, we now think there is a further decline to come, potentially stretching into next year. Despite the recent correction, equity markets remain well above the lows of late 2023. We and many other market participants perhaps underestimated the persistent strength of the fiscal impulse and the consumer in 2023, especially in the U.S.

GRADE: ★★★☆☆

While our "old normal" call has been playing out, the economic slowdown is taking longer to manifest than we expected.

2. ADJUSTING TO HIGHER RATES CONTINUES TO DISRUPT

What we said: As rates rise and investors demand higher risk premia, the cost of capital goes up. This happens at some point in most cycles, but we believe the current adjustment is structural, and it is proving unusually large and rapid—raising the risk that it is disruptive. Many mortgage borrowers could be shocked when they refinance at 2023 rates. Many corporate capital structures built for a low-rate environment are in for a similar sharp adjustment. And with government debt exploding during the pandemic and "bond vigilantes" back on watch, some sovereigns may be forced into the kind of uncomfortable re-think recently forced upon the U.K. We think investors should be watchful for weak points that could cause broader disruption.

What we've seen: So far, the highest-profile examples of vulnerable businesses getting into difficulty because they were built for a low-rate environment have been Credit Suisse, Silicon Valley Bank and First Republic Bank. They failed after suffering deposit flight, compounded by having to crystalize steep losses in large holdings of Treasury bonds. Authorities appear to have acted swiftly to contain the fallout. While high yield issuers have so far been relatively resilient due to limited current refinancing pressures, defaults have been rising, and we are seeing considerable pressure in U.S. commercial real estate loans and floating-rate structures, in general—at a time when overall U.S. financial conditions have actually been easing, not tightening.

GRADE: ★★★★☆

The mini-banking crisis confirmed our fears.

3. MORE DEGLOBALIZATION

What we said: Manufacturing supply chains, commodity markets, financial systems, regulatory regimes, fiscal and monetary policy frameworks—we have seen them all become more integrated between 1980 and 2008, and more fragmented since. We see many and varied reasons, including the political backlash against the unequal outcomes of globalization; the shocks of the Great Financial Crisis and the pandemic; the waning internationalism of the U.S.; and increasing tensions as geopolitical blocs realign. We anticipate more landmarks on this journey in 2023, as it is driven by strong political, security and risk management imperatives.

What we've seen: Relations between the U.S. and China, in particular, have been strained, and those strains appear increasingly to coalesce around the emerging "Semiconductor Cold War." The ongoing war in Ukraine continues to complicate that relationship, as well as re-align relations between the U.S., Western Europe and the "Global South." Moreover, these are not issues solely among geopolitical competitors, but also among allies: witness the controversy in Europe over the U.S.'s Inflation Reduction Act, for example; and the beginnings of divergence within Europe, but also between Europe and the U.S., on the question of how to balance political and commercial relations with China. While the supply-chain shocks of the pandemic and the war in Ukraine have waned significantly, the underlying geopolitics continue to deteriorate.

GRADE: ★★★★☆

While Covid constraints continue to ease, geopolitical and protectionist stresses continue to accumulate.

4. REDOUBLED EFFORTS TO CLARIFY "ESG"

What we said: Environmental, social and governance (ESG) investing became increasingly politicized in 2022 as the crisis in Ukraine triggered strong outperformance from fossil fuel assets, and stoked fears that ESG investors were starving domestic energy providers of capital. To counter this politicization, we believe more clarity is needed on the distinction between investing processes and investing outcomes. ESG integration is a process designed to ensure that financially material ESG factors are considered, alongside others, in traditional investment analysis. Exclusions, sustainable investing and impact investing pursue a specific non-financial outcome, in a portfolio or in the real world, alongside managing financial return. We anticipate focus on this clarification from the industry and its regulators in 2023.

What we've seen: Continued noise, but not much more clarity. In the U.S., hearings in the House of Representatives in May and June confirmed that some are still muddying the debate for political ends. We do not expect the Security and Exchange Commission's forthcoming rules on ESG fund disclosures to fix that. As the rules proliferate, we also see growing divergence in regulation, enforcement and guidance across different jurisdictions. By contrast, we see a general convergence in attitudes and aims among both corporations and investors. Corporates are adopting either mandatory or voluntary disclosures in growing numbers, improving our ability to price for financially material ESG considerations. And the reason Neuberger Berman continues to invest to improve our ESG integration and sustainable investing is that our clients increasingly prioritize these capabilities in their manager selection.

GRADE: ★★★☆☆

The debate remains noisy and not much clearer, although corporations and investors continue to press forward.

FIXED INCOME: THE RETURN OF MARKET DISCIPLINE

5. PERSISTENT INFLATION SUGGESTS PERSISTENT BOND MARKET VIGILANCE

What we said: We enter 2023 with high inflation and extreme levels of government debt. Against this background, we see bond investors standing up more strongly for their interests against policymakers. Markets are punishing policy inconsistencies between fiscal and monetary authorities within sovereigns, and excessive fiscal or monetary policy divergences between sovereigns. We think core government bond yields may be range-bound where policies are consistent, but potentially higher and more volatile where policies are inconsistent. Despite the pace of policy adjustment and attendant market rate moves, outside the U.K. central banks have so far not had to intervene to maintain market liquidity—but an emergent policy conflict remains a tail risk for bond markets in 2023.

What we've seen: For much of 2023, bond yields traded in a range, with the top set by the volatility around the collapse of Silicon Valley Bank in March. When they broke out of that range in September, it appeared to be because investors became more worried about U.S. deficits and debt sustainability, as interest costs rose more than expected and tax revenues rose less than expected. This is what we meant by markets "punishing policy inconsistencies between fiscal and monetary authorities." Combined with the prospect of ongoing fiscal expansion, continued central bank hawkishness, despite declining inflation, is a real concern for deficit-watchers.

GRADE: ★★★★☆

The recent dramatic bond market sell-off has made this theme even more prominent and widespread than we anticipated.

6. ABILITY TO ABSORB HIGHER RATES LIKELY TO DOMINATE CREDIT

What we said: Over the course of a decade, many financial structures have been built around falling and ultimately near-zero rates, including a lot of debt structures. Floating-rate borrowers will need to adjust right away, but because we see structurally higher rates ahead, we think fixed-rate borrowers will eventually need to adjust, too. We do not anticipate a major uptick in defaults: the economy has historically been able to generate healthy growth with rates at these levels, balance sheets are generally strong and maturities are generally several years away, supporting a range of fixed income credit markets. That said, in our view, the sooner investors work higher-rates-for-longer into their credit analyses, the sooner they are likely to make what we regard as the necessary portfolio adjustments.

What we've seen: Despite an increasingly hawkish rates outlook through the year, index-level credit spreads have tightened. But that disguises substantial dispersion at the industry and issuer levels. Floating-rate structures are generally under pressure. Some sectors, such as U.S. regional banks and commercial mortgage-backed securities (CMBS), have struggled very publicly with higher rates, but trouble in industries like telecommunications suggests the challenges are more widespread. In high yield, the majority of industries are now experiencing deteriorating cash flow.

GRADE: ★★★★☆

We have seen the beginnings of dispersion based on creditworthiness.

EQUITIES: WINNERS AND LOSERS

7. EARNINGS ESTIMATES RECALIBRATE AND FAVOR THE FITTEST

What we said: Much of the equity bear market of the first half of 2022 appeared to be due to the application of higher discount rates to largely unchanged future earnings estimates. Consensus earnings growth estimates for 2023 did not fall in the same way as real GDP growth estimates, perhaps because high inflation has supported nominal GDP growth. As inflation turns downward but remains relatively high as the economy slows, we think earnings estimates are likely to be revised down. We also think dispersion will increase, favoring companies that are less exposed to labor and commodity costs, have more pricing power to maintain margins, and use less aggressive earnings accounting. We believe this will translate into greater dispersion of stock performance.

What we've seen: We have seen earnings estimates recalibrate. Consensus estimates for 2023 S&P 500 Index earnings have declined this year, but more modestly than we anticipated or believe is justified: they still project 1.8% growth over 2022 earnings. For the STOXX 600 Europe Index, the consensus estimate for 2023 earnings has actually increased since December, and would represent a 0.3% gain on 2022 earnings. Excluding the volatile energy sector, there was a 48-point range between the top and bottom S&P 500 sector for first-quarter earnings growth, and a full 85-point range in the second quarter. That range is typically 30 points. For the most part, however, the impact of earnings on market performance and dispersion has been muted by excess liquidity, and a sense that mega-cap tech stocks are defensive and beneficiaries of the artificial intelligence theme.

GRADE: ★★★☆☆

Earnings performance has dispersed, but sentiment and liquidity outweighed fundamentals in market performance.

8. MANAGEMENT TEAMS REFOCUS ON SHAREHOLDER VALUE

What we said: When equity investors demand higher risk premia and bond yields present a meaningfully higher return hurdle, one way to keep the cost of capital down is to re-focus on delivering tangible, near-term shareholder value. When the economic going gets tough, effective management teams typically start improving capital structures and balance sheets, spinning out lower-return divisions, acquiring strategic targets finding efficiencies, and engaging creatively with shareholders. In these conditions we tend to see the true potential of alignment between active shareholders and company management: 2023 could be a lively year in the boardroom.

What we've seen: While much of the outperformance of the "Magnificent Seven" appears to have been due to liquidity, technical flows and artificial intelligence, part of it was also due to management teams "getting religion" on shareholder value: these mega-cap enterprises have a lot of levers to pull, including redirecting capital from some ambitious investment plans and vanity projects—and the market rewarded them for doing so. U.S. regional banks, for example, face much tougher decisions, such as how much of their loan book to liquidate. In addition, it is notable that, while the Event-Driven family has been a mixed bag in the HFRI Hedge Fund Indices, the Event-Driven Activist Index has been one of the best performers. Many merger transactions are failing under the current uncertainty, but a pick-up in discussions underlines the urgency that management teams feel to make strategic changes when they lack confidence in simple multiple expansion.

GRADE: ★★★☆☆

We see the beginnings of this focus on shareholder value, but may have to wait to see it translate into broader corporate strategy.

ALTERNATIVES: CHALLENGES AHEAD, BUT OPPORTUNITIES FOR THE NIMBLE

9. MORE DISPERSION IN PRIVATE MARKETS PERFORMANCE

What we said: Private markets won't be impervious to the ongoing slowdown. Exits are more difficult in volatile public markets, and while private company valuations tend not to fall as far as public market valuations, we do think they are likely to decline. Such a challenging environment is likely to result in performance dispersion that tends to favor higher quality companies, especially where management has well-defined growth plans as opposed to relying on leverage and multiple expansion. It's also important to remember that private equity funds generally invest over multi-year periods, typically enabling new and recent-vintage funds with "dry powder" to seek opportunities as valuations decline through the slowdown.

What we've seen: Exits, which were already down more than 50% in the second half of 2022, have continued to decline through 2023. Where transactions are completing, we see valuations down 15 – 20% on comparable deals of recent years—and it is worth noting that, with private equity managers increasingly willing to walk away from deals that are not attractively priced, only higher-quality companies are currently being bought and sold. On average, we see private equity managers forecasting lower earnings multiples on exit for new deals, indicating that they think all their net return will come from growing earnings via acquisitions and business improvements. As such, we believe we will see the relative quality of the companies, company management and of private equity managers involved in current transactions reflected in greater valuation dispersion as those transactions mature.

GRADE: ★★★★☆

At this stage in the cycle, the highest-quality companies are almost the only ones being transacted.

10. A GROWING OPPORTUNITY SET FOR OPPORTUNISTIC INVESTORS

What we said: In a market downturn, liquidity providers can be selective across liquid and illiquid alternatives and niche opportunistic strategies as valuations decline—or even dislocate. Among liquid alternatives, we think global macro and other trading-oriented hedged strategies can continue to find opportunity amid volatility. We anticipate increasing opportunities to provide niche capital solutions at attractive or even stressed yields as debt structures are reworked. And on the illiquid side, we think private equity secondaries has become a buyers' market. Economic strains could also open up long-term value opportunities in inflation-sensitive real assets, in markets both liquid (e.g., certain commodities) and illiquid (e.g., real estate).

What we've seen: Returns data to the end of September suggest that 2023 has so far been a lackluster year for hedge funds. Among the major strategy families, according to HFR, Macro has struggled in an environment with range-bound bond markets and generally declining volatility—with currency-focused and short-term trading strategies bucking the trend. Equity Hedge has delivered positive returns, in general, but lagged the market as outperformance came from the mega-cap growth stocks that these strategies tend not to favor. Bearish trends in bonds and equities since September may enable some catch-up. Event-Driven has been a mixed bag, with Activist, Special Situations and Credit Arbitrage doing well, but Merger Arbitrage struggling. Insurance-Linked Strategies have been a bright spot within liquid alternatives, as premiums have been rising. We have been seeing a more opportunistic landscape in illiquid and semi-liquid markets, however. Yields on niche capital solutions have generally risen from low teens to high teens. As private equity and especially private real estate investors seek liquidity in the secondary market, attractive discounts have become common. Overall, however, the story of much of 2023 has been about liquid-market "beta," whether that be the currency carry trade or equity indices driven by high-quality, mega-cap technology stocks.

GRADE: ★★★☆☆

Trading-oriented strategies in liquid markets have disappointed, but providers of opportunistic capital have been well rewarded in illiquid and semi-liquid markets.

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