NEUBERGER | BERMAN

Solving for 2025

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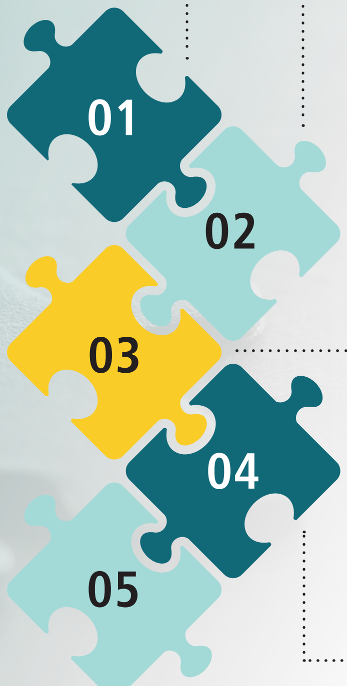
Five Investment Themes for 2025

As we transition into 2025, it's crucial to reflect on the past year's developments and prepare for the challenges and opportunities ahead. At the close of 2024, Neuberger Berman's investment leaders convened to discuss how the investing environment has evolved throughout the year and to identify the key themes they foresee for 2025. In this document, we present their insights on macroeconomics and their expectations for equities, fixed income and alternative investments. We believe there are five key themes for investors to consider as they evaluate risk and opportunity in the new year.



MACRO: GOING FOR GOLDILOCKS

A YEAR OF ABOVE-TREND GROWTH

While the politics may change, industrial policy aimed at influencing domestic production patterns will continue, whether achieved via government spending and investment, tax policy, trade policy, deregulation or other means. If inflation can be contained—and we think it can—central banks can stand aside and allow economies to run a little warm. That is a recipe for above-trend U.S. GDP growth, which could drag some of the world's other economies with it. The debt and deficit implications, and the question of whether capital is being well allocated, may surprise investors by being manageable concerns in 2025.

EXPANDING THE SOFT LANDING BY BROADENING REAL INCOME GROWTH

The detrimental impact of high inflation on lower-income consumers and small businesses has been an important driver of this year's political uncertainty. Countries and governments that deliver moderate inflation and broader participation in positive real wage growth and positive real revenue growth will increasingly come to define success, visible in data points such as higher consumer confidence, political approval ratings and GDP growth rates. While it remains to be seen whether specific policy mixes can achieve this, we see evidence that the incoming U.S. administration at least recognizes the objective, and active industrial policy is evidence of growing recognition elsewhere.

EQUITIES: THE MARKET OPPORTUNITY IS MORE THAN SEVEN STOCKS

THE STAGE IS SET FOR BROADENING EQUITY MARKET PERFORMANCE

Deregulation, business-friendly policies, moderating inflation and lower rates may allow a broadening of earnings growth and price performance. At the same time, mega-cap technology growth rates are likely to decelerate and normalize as capital expenditure ramps up. Value and small-cap stocks, and sectors such as financials and industrials, could begin to catch up with mega-cap technology. Non-U.S. markets could perform more strongly on higher global growth and lower commodity prices. Relative valuations, as well as fundamentals, should provide support for this theme.

FIXED INCOME: FED UP WITH FED-WATCHING

BOND MARKETS WILL FOCUS ON FISCAL RATHER THAN MONETARY POLICY

For more than two years, bond markets have been dominated by inflation data and the responses of central banks. We think a reacceleration of inflation can be avoided next year, and that central banks will settle into the dull routine of debating where the neutral rate sits. Bond investors will likely shift focus to the growth outlook through most of 2025, and possibly deficits and the term-premium question late in the year and into 2026. The result will be moderately steeper yield curves and a migration of bond market volatility from the short end of the curve to the intermediate and long parts.

ALTERNATIVES: THE ART OF THE DEAL

MERGERS AND ACQUISITIONS ARE SET TO SURGE

Numerous factors are aligning to release a pent-up torrent of corporate dealmaking: above-trend growth; buoyant public equity market valuations; a more stable inflation and central bank outlook; the return of banks to the leveraged lending market; declining rates and tight credit spreads; and, perhaps most importantly, an expected change in regulatory stance in the U.S. That said, private equity secondaries and co-investments will continue to flourish as liquidity is still required to work through a huge backlog of mature investments, and it will remain challenging to raise new primary funds. Event-driven hedge fund strategies will benefit from a big new opportunity set.

Solving for 2025

ROUNDTABLE DISCUSSION

GOING FOR GOLDILOCKS

As 2024 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 2025.

Erik Knutzen: As we look forward into next year, there's only one place to start: the election result from November 5. Donald Trump's surprisingly strong victory, which not only saw him carry the popular vote but looks likely to secure Republican control of Congress, potentially reshapes the economic and market outlook for 2025. It can sometimes feel as though investors have been waiting for a cyclical downturn for the past two years. We were fairly early to call for a soft landing for the U.S. economy. Does a Trump administration take us into no-landing territory?

Ashok Bhatia: All the rhetoric, all the past evidence and all that we hear about personnel being touted for this new administration suggests it will be unabashedly pro-growth—at least for the U.S. and likely for some other parts of the world. There will be debates about the impact of tariffs and immigration policies as they become clearer, but on taxes, energy prices and especially on regulation, I think we have to anticipate above-trend growth in 2025 and further momentum in 2026.

Jeffrey Blazek: Even on the issue of tariffs—let's return to the topic of their inflationary potential later, but for now, if we consider them as part of the wider ambition for U.S. reindustrialization and re-shoring, they could be an additional spur to animal spirits and capital spending, especially among smaller companies.

Brad Tank: I think that's right, and this return to industrial policy has become a truly global theme. It's been the norm in China and Europe for decades. But the U.S. joined the game with the Inflation Reduction Act (IRA), which is probably the most substantial industrial policy prescription since the Second World War. Because of some of the IRA's focus on renewables and climate-change mitigation there's speculation that a Trump administration might roll a lot of it back, or even repeal it completely. But it fits with the new administration's industrial policy ambitions and allocates money to a lot of places represented by Republicans in Congress. The likelihood is that it gets rationalized rather than repealed. Why spend so much money laying fiber-optic cables all over the U.S. when we have satellites?

"Donald Trump's surprisingly strong victory potentially reshapes the economic and market outlook for 2025."

– ERIK KNUTZEN

Joseph Amato: The concern around industrial policy is that capital gets misallocated and resources get wasted when governments try to "pick winners," prescribe suppliers to the market or crowd out private investment. We see that in some aspects of the IRA and the CHIPS and Science Act. Treating the low-carbon transition as an actual transition, rather than a flip of a switch, or supporting the industrial base within the local supply chain—these can be pro-growth initiatives if they don't devolve into ideological dogma or outright protectionism. Those risks need to be considered.

Shannon Saccocia: Those are certainly longer-term risks. Over a year-long horizon, however, it's all likely to be supportive. Realistically, this administration will want to get as much as possible done before the mid-term elections in 2026, so I think we will see a lot of spending and a consequent boost to growth. That tends to be the case in any administration's first year.

Knutzen: One shorter-term risk, as Jeff suggested, is that tariffs and other industrial policies reaccelerate inflation and force central banks to curtail this boost to growth. Is Trump inflationary or disinflationary?

Bhatia: Right now, there's a big assumption among investors that he's inflationary. We saw that in the immediate response from the dollar and Treasury yields. But there are strong crosscurrents. Aggressive, broad-based tariffs implemented immediately could push up goods prices and add perhaps 10 to 25 basis points to year-on-year inflation in the first half of next year. But the impact would be much more muted with a slower, more targeted approach.

Blazek: During Trump's first term, the eventual size and breadth of his tariffs were reduced via negotiation. I think we'll see something similar this time, with country-specific or regional trade deals in which key sectors are delineated. That level of negotiation also pushes out the time horizon for implementation.

"This election result surely makes the Fed's task in 2025 more complex, but we think Trump's program will be more aligned with the central bank's objectives than many investors currently anticipate."

– ASHOK BHATIA

Saccocia: I see a similar crosscurrent with immigration policy. It remains to be seen how much tighter the new policy will be, but lower immigration would mean higher wages and tighter supply in some key areas, but also less demand for the goods and services that make up a large proportion of the lower-income consumer's shopping basket.

Bhatia: I agree that the inflationary effect of tighter immigration is likely to be a wash. And let's not forget, one of the reasons Trump performed so strongly in this election, and why so many other incumbents around the world have been shown the door this year, is that voters are really angry about inflation. We expect this administration to focus on containing consumer prices, and some of its core principles feed into that, such as lower taxes, more oil and gas supply and lighter regulation. This election result surely makes the Fed's task in 2025 more complex, but we think Trump's program will be more aligned with the central bank's objectives than many investors currently anticipate.

Amato: We're touching on an important point here that's been at the heart of a lot of our commentary through 2023 and 2024. The headline U.S. economic data looks great. Resilient growth, falling inflation, low unemployment, positive real wage growth, robust consumer confidence, a record high for the S&P 500 Index. But those with lower incomes have been feeling the squeeze in terms of higher-than-average inflation and high interest rates. We can see it in the rising rate of auto and credit card debt delinquencies. We can see it in the underlying data from consumer confidence surveys, especially among those in the very lowest income bracket. And many smaller companies—which you don't see in the S&P 500, but employ some 80% of the U.S. workforce—have been struggling. That's what leads to results like November 5.

"The policy objective is very clear. You want stronger nominal wage growth, especially for middle- and lower-income consumers, and stronger nominal revenue growth, especially for smaller businesses. And you need to achieve that while keeping inflation under control."

– BRAD TANK

Tank: The policy objective is very clear. You want stronger nominal wage growth, especially for middle- and lower-income consumers, and stronger nominal revenue growth, especially for smaller businesses. And you need to achieve that while keeping inflation under control. That's not only important for the coming year—it's the mix that is most likely to take the force out of populism. We started to see that mix after 2017, until the pandemic blew us off course. Since then we've seen some progress on rising real wages and had started to achieve lower inflation in 2024—but slowing inflation doesn't reset to the consumer prices of three years ago, and that's the distress voters feel. It remains to be seen whether the incoming administration delivers the required policy mix, but there is at least some evidence, from the people likely to play a part in Trump's administration, that they understand the objective. If inflation can be kept below 3%, the policy mix we've been describing has the potential to deliver.

"During Trump's first term, the eventual size and breadth of his tariffs were reduced via negotiation. I think we'll see something similar this time."

– JEFFREY BLAZEK

Knutzen: We see this policy debate all around the world now. It's the debate that broke Germany's governing coalition; it animates Mario Draghi's report on competitiveness for the European Union; it's the challenge that the U.K.'s new administration has set itself; it lies behind Abenomics and its successors in Japan; and also behind China's attempt to sustain growth while shifting its engine from debt-financed investment to consumption. After a year of elections in which many incumbents lost power, the extent to which any government achieves that balance between broader participation in strong nominal income growth and moderate inflation will define policy success in 2025.

EQUITIES: THE WORLD HAS MORE THAN SEVEN STOCKS

Anthony Tutrone: I think we are describing a positive backdrop for risk assets in general, but for smaller U.S. companies in particular. That's our initial take in private markets, given the likely change in regulatory stance, especially around anti-trust and mergers.

Amato: I think any broadening of the benefits of economic growth is likely to be reflected in a similar broadening of performance among companies. So that's not just better performance from small caps, in our view, but also from cyclical sectors like financials, industrials and energy, and value stocks more generally. Lower taxes and a reversal of the anti-trust focus are tailwinds for mega-cap technology, as well, and there appear to be a lot of tech-friendly people around Trump, but tech earnings growth is likely to moderate from here and valuations are already full.

Saccocia: The capital expenditure that brought us recent advances in artificial intelligence could start to weigh on the tech sector, while the benefits begin to spread through the economy, increasingly accruing to its users. And there is still a lot of pent-up infrastructure build-out that, as we've discussed, is unlikely to be rolled back by Trump. That points to a broadening of market performance within the U.S., but what about outside the U.S.? At least until new tariffs are implemented, and especially if they turn out to be more considered than expected, I could see a situation where a stronger dollar and China's stimulus helps Japan while lower energy prices give Europe an additional boost.

Bhatia: If the U.S. does achieve above-trend growth and low inflation, it is likely to lift all boats, with those adopting that similar policy mix benefiting the most, as we've discussed. Dollar strength may be a headwind for emerging markets, but we don't see it causing major challenges. But the outlook outside the U.S. depends on the trajectory of trade policy, capital flows, energy prices and the geopolitical flashpoints—the positives are less clear-cut.

Knutzen: It's also worth noting that the cost of capital will remain high even if we do manage to avoid reaccelerating inflation. That's something we monitor closely. Once the immediate post-election rotation into risky assets has run its course, investors will need to assess whether the positives of lower taxes and looser regulation outweigh the negative of high, and potentially rising, longer-date financing rates. That leaves the Multi-Asset team bullish into year-end and cautiously optimistic thereafter, but there is a lot of uncertainty to come through 2025.

Amato: Agreed: this may be a "buy beta" story until the end of 2024, but thereafter dispersion should be higher and active management will be critical, however 2025 turns out.

FIXED INCOME: FED UP WITH FED-WATCHING

Tutrone: I do agree that investors and business owners will be watching the Fed. They want lower rates. Will they get that?

Bhatia: We came into the election with the view that an improving growth outlook and a more stubborn level of inflation would cause the Fed to pause rate cuts early in 2025. We thought the market was about right in pricing for a terminal rate of around 3.75%, we just didn't agree we'd get there in a straight line, as futures were suggesting. That view hasn't changed, and the market is aligning with our terminal-rate target of 4% and starting to price for a pause in January.

Amato: We've talked about how the Trump administration might be more neutral on inflation than many anticipate. The other discussion point has been on the fiscal side—how his policy proposals could spark concerns about debt sustainability.

Blazek: Look at the rise in long-dated yields since the election. For sure, a good portion of this is a repricing of the Fed's path to the terminal rate, which was happening before November, but does it also reflect concerns about excessive future borrowing?

"Any broadening of the benefits of economic growth is likely to be reflected in a similar broadening of performance among companies."

– JOSEPH AMATO

Bhatia: This is really our main theme for 2025: a shift, in the bond markets, from focusing on inflation and the Fed to focusing on fiscal policy. If disinflation is sustained and the resulting Fed path is now priced into the curve, that suggests a fair value of around 4.25% for the 10-year Treasury yield. But as the attention turns to the fiscal backdrop, the volatility that has been concentrated in the short end of the curve is likely to migrate into longer-dated bonds, so the trading range around 4.25% at 10 years is likely to be wide. It is important to note that, at least for 2025, we think fixed income investors will focus on the growth implications of fiscal policy rather than the deficit implications, especially if we start to see our base case of spending cuts largely balancing out tax cuts. This administration can't blow the budget if it wants to avoid re-igniting inflation. Debt concerns may surface later in 2025 and beyond, but we think this will be manageable for the foreseeable future.

"The capital expenditure that brought us recent advances in artificial intelligence could start to weigh on the tech sector, while the benefits increasingly accrue to its users."

– SHANNON SACCOCIA

Saccocia: This could be positive for credit, if investors start to see high-grade corporate balance sheets as a safer haven than the U.S. government's.

Bhatia: Credit fundamentals are strong, justifying current tight spreads, but those spreads suggest much of the safe-haven idea is priced in. The other big thing for fixed income investors to look out for is the impact on municipal bonds of potential changes to the State and Local Tax (SALT) deductions contained in the 2017 Tax Cuts and Jobs Act (TCJA). The TCJA capped SALT reductions at $10,000, making the tax advantages of munis very attractive. That cap is set to expire at the end of 2025, and the Trump administration is expected to allow that expiration. That could be negative for munis and is worth watching. And maybe I'll end by noting that a more favorable regulatory regime for M&A and rising takeover speculation could help sustain weaker credits in high yield and loans—just to tee up Tony on private markets.

ALTERNATIVES: THE ART OF THE DEAL

Tutrone: An easing of the anti-trust stance of the previous administration, which was arguably among the toughest in recent U.S. history, would be an unalloyed positive for private markets. If our outlook is correct, we are looking at above-trend growth, sustained public equity market valuations and a stabilizing interest-rate environment next year. Banks have returned to the syndicated loan market, and private credit funds have raised significant capital. This should result in accommodative financing markets and continued tight credit spreads, in our view. It is an almost perfect backdrop for dealmaking, and our conversations with M&A bankers suggest that there is indeed a huge and growing pipeline of transactions. I don't think it's a coincidence that the stocks of private market asset managers were among the best performers in the days after November 5. Some of the exit backlog of the past two years will start to be cleared through 2025, as a result. That said, there are still a lot of mature private equity portfolios to work through and still a lot of investors who are overallocated to private markets, so we expect to see continued demand for liquidity from the secondary market and co-investment partners, and primary fundraising will remain challenging, especially for first-timers or General Partners with weaker stories.

Saccocia: We might say that private equity is at the heart of many of our themes for 2025. We see smaller companies, and businesses in the technology, consumer and industrial sectors, benefiting the most from the anticipated fiscal and regulatory shifts. And private companies are also likely to gain an outsized benefit from more M&A, and broadening implementation of technological advances like artificial intelligence.

"An easing of the anti-trust stance of the previous administration would be an unalloyed positive for private markets."

– ANTHONY TUTRONE

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LOOKING BACK

Last November, our investment leaders identified their key themes for 2024. We look back to see how well they anticipated the events of the year.

MACRO: FROM SUPPORTING THE CONSUMER TO SUPPORTING INDUSTRY

1. GROWING CHALLENGES FOR THE CONSUMER

What we said: 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 multidecade highs and job markets will soften in 2024. Expect a weaker consumer to be at the heart of next year's economic slowdown.

What we've seen: According to the Federal Reserve Bank of San Francisco, pandemic-era excess savings did indeed run out around March of 2024. Inflation and rates stayed higher than expected and housing grew more expensive. That said, the wealth effect of rising financial markets was an offset to dwindling savings, consumer spending remained strong, reaching an all-time high in the third quarter of 2024, and most measures of U.S. consumer confidence regained strength after softening a little over the summer months. Unlike many other developed economies and especially China, the U.S. GDP growth rate strengthened in the first half of the year and looks set to be around 2.5% for 2025 as a whole.

GRADE: ★★☆☆☆

The past year was yet another reminder never to bet against the U.S. consumer.

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

What we said: 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.

What we've seen: While growth did not slow as much as we expected, inflation did prove more stubborn, especially in the U.S. That was tricky for bond investors, but U.S. large- and mega-cap growth stocks benefitted from another year in which its overall quality outweighed the longer duration of their cash flows.

GRADE: ★★★★☆

Growth continued to support equity markets despite stickier-than-expected rates.

3. MORE FISCAL POLICY DISPERSION (AND DEBT SUSTAINABILITY QUESTIONS)

What we said: 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, 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.

What we've seen: An otherwise contentious U.S. election campaign saw almost no debate over debt sustainability, with both candidates promoting programs that would meaningfully raise deficits. By contrast, weak growth has made Germany's "debt brake" a stress point within its governing coalition. A dramatic election in France ultimately led to a more hawkish take on the public finances, while China launched a bold series of stimuli and Japan's ruling party lost its majority attempting to double-down on its hawkish normalization of fiscal and monetary policy. The U.K.'s new government set out a budget that seeks to contain entitlement spending, repair public services and support industrial policy, with day-to-day spending funded with tax hikes and investment with new borrowing.

GRADE: ★★★★☆

After the pandemic consensus, a hundred fiscal-policy flowers are blooming.

4. THE "AWKWARD AGE" FOR ESG

What we said: As sustainable investing and environmental, social and governance (ESG) regulation becomes more restrictive and complex, 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 differing regional priorities. However, investors on the ground will become clearer on the difference between investing for impact on the one hand, and incorporating 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.

What we've seen: The past year has generated more questions than answers on sustainable investing and ESG regulation. Europe has acknowledged that its Sustainable Financial Disclosure Regulation (SFDR) requires further improvements and is working on both short- and longer-term changes. Regulators globally have recognized that the quality and availability of ESG data disclosed by companies is one of the main causes of lack of transparency for investors, greenwashing and capital misallocation; however, their efforts to introduce sustainability-related reporting rules for companies across the world have not been welcomed by the U.S., and after the elections across Europe and the U.S., certain areas of activity are undoubtedly more vulnerable to political change. We believe this environment increasingly favors asset managers that observe the distinctions between using financially material ESG factors for investment analysis and engagement on the one hand, and investing to achieve specific sustainability outcomes on the other.

GRADE: ★★★☆☆

In an environment of more questions than answers, defining terms and objectives clearly is critical.

EQUITIES: EXHAUSTED BETA

5. EARNINGS QUALITY AND BUSINESS RESILIENCE COMES TO THE FORE

What we said: 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 2023 losers" momentum reversal, and exuberant sentiment around the potential of artificial intelligence. Sentiment has already shifted, and we think above-target inflation, slowing growth and draining liquidity will refocus attention on the quality of earnings and the resilience of business fundamentals to these conditions: S&P 500 topline growth has fallen below the fed funds rate, and we think the earnings write-off cycle that began in 2023 will gather pace. Performance dispersion will likely follow, favoring sectors and companies that have more productivity levers to pull, and show evidence of implementation as well as just ideas—especially on the use of AI and other technologies.

What we've seen: Fundamental performance among U.S. equities has been broadening. The number of S&P 500 Index industries outperforming the broad Index jumped from 17 last year to 28 by the end of October 2024. This reflects a rise in the number of industries that grew their earnings over the past 12 months, and an even larger rise in the number that analysts project to grow earnings over the next 12 months, from 40 to 56 (out of 67). Nonetheless, alongside this broad uplift has also been dispersion of stock price performance in favor of higher quality stocks. On a sector-neutral basis, factors such as faster-growing gross, operating and net income margins, higher return on equity and lower sales and earnings variance have outperformed by between five and 10 percentage points so far this year. We anticipated both trends to be stronger in 2024, and expect them to continue into 2025.

GRADE: ★★★☆☆

Equity market performance has reflected broad economic strength.

6. LAGGARDS FIND (RELATIVE) FAVOR

What we said: 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.

What we've seen: Despite some dramatic rotations in July, large-cap growth continued to outperform in 2024. U.S. smaller companies have outperformed non-U.S. large caps and even the S&P 500 Equal Weighted Index, but couldn't keep up with the cap-weighted U.S. large-cap indices. Emerging markets have not kept pace with developed markets, again due largely to the performance of U.S. stocks, but China did surge ahead of India in September, following new stimulus measures. Financials still slightly lag technology, year to date—but they remain the best-performing sector outside of tech and communication services and, along with small caps and other value stocks, they could make up more ground in the post-election rally to the end of the year. The gap between the estimated next 12 months' earnings for the largest seven S&P 500 stocks and the rest of the Index started to close through 2024: having started the year at over 40% it is now 33%, and we believe there is room for growth to further narrow that gap.

GRADE: ★★☆☆☆

The winners of 2023 haven't had such a smooth ride in 2024, but they remained the strongest investments.

FIXED INCOME: THE LONG AND GRINDING ROAD

7. SUPPLY AND DEMAND OUTWEIGHS FUNDAMENTALS

What we said: 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.

What we've seen: After a slow start, companies have been on a record-breaking rush to issue bonds in 2024. Even so, spreads have become historically tight in both investment grade and high yield markets. This has partly reflected technical appetite for the relatively high yields offered even at these tight spreads, but also the fundamental resilience of borrowers' balance sheets, two and a half years after rates began to rise. We believe there has been a greater breach between technicals and fundamentals in the Treasury market, where appetite for relatively high yields has, in our view, delayed the emergence of an appropriate term premium in intermediate and longer-dated bonds.

GRADE: ★★★☆☆

Bond market pricing may reflect corporate fundamentals, but it appears to be understating government bond risk.

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

What we said: 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—with some caveats: A significant amount of corporate lending has moved into private markets since 2008, and deteriorating credit metrics also 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.

What we've seen: Default rates have remained low this year. That said, we have seen increased credit pressure in some household names, such as Warner Brothers and Boeing, and the first half of the year saw a rise in liability management exercises that resulted in some defaults. Overall, idiosyncratic risk did become elevated, but borrowers tended to succeed in "muddling through" their difficulties rather than blowing up.

GRADE: ★★★☆☆

The default rate has been slow, overall, but risk does appear to have migrated to the private markets.

ALTERNATIVES: DISRUPTION BRINGS OPPORTUNITY

9. WHERE CAPITAL IS CONSTRAINED, CAPITAL PROVIDERS CAN BE REWARDED

What we said: 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.

What we've seen: While private equity activity has started to recover in 2024, portfolio company exits remain on par with the low levels of 2023 due to continued weakness in M&A and IPOs. As a result, private equity firms and investors did look to alternative sources of liquidity in 2024. Secondary transactions are on pace for a record year in 2024. Although M&A activity is down significantly from its peak in 2021, we have seen co-investment and capital solutions activity increase substantially, driven by private equity firms looking to sell minority interests or issue preferred stock in existing portfolio companies as a way to deliver liquidity to their investors.

GRADE: ★★★★★

Traditional exit routes have remained blocked, and investors moved more decisively toward alternative routes.

10. REAL ESTATE DIVIDES INTO THE HAVES AND HAVE-NOTS

What we said: 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 wellbeing. 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.

What we've seen: The real estate market backdrop has improved, with rates coming down and an uptick in transactions in certain markets. A Deloitte survey of 880 real estate CEOs, CFOs and COOs taken in June and July suggests a major shift: 60% had expected declining revenues in 2024, but almost 90% expect rising revenues in 2025; and only 7% now expect to focus on cost-cutting, compared with 40% last year. That said, the top risks cited still include the cost and availability of capital, with respondents concerned about refinancing loans that were not only underwritten at a time of lower rates, but often extended because rates were expected to decline faster than they have. This has been causing some stress for the highly leveraged "have-nots" and opportunity for the less-leveraged "haves." While property transaction activity remains slow, M&A among operating companies has rebounded this year, with a focus on adding new technology capabilities, increasing scale and acquiring new talent rather than expanding property portfolios.

GRADE: ★★★★★

With a recovery underway, strong companies have been acquiring operational capacity to cement their market leadership.

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