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2024 Allocator Outlook

Our analysts' views from an allocator's perspective on private markets in 2024 and beyond

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

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Overview

As we head into 2024, the private markets are at a particularly interesting inflection point. Discussion of a new interest-rate regime has allocators picking up their pencils again to review their portfolio construction, as compressed risk premiums that have accompanied the period of low and falling rates will likely undergo a reversal in the new environment. Long-dated US Treasury yields now ranging between 3.5% and 4.5% have led to a reset in risk assets' required rates of return, causing the portfolio optimization math to get to institutional investors' typical return targets of 7.0% to 9.0% to look decidedly different than it did when cash was metaphorically trash. At the same time, tight credit conditions have led to a slump in dealmaking, crimping the exit environment and shrinking distributions back to private fund LPs. Without cash returning from existing funds, the pace of new commitments has slowed considerably across private fund asset classes. Plus, a valuation reset is still underway in VC, hype around generative AI notwithstanding; leveraged buyout (LBO) models are dealing with the highest cost of capital in a decade-plus; and the office real estate market is in the beginning stages of recession. Combine all of that with the Federal Reserve's (Fed's) continued battle with inflation, geopolitical turmoil, fears of a coming wave of corporate bankruptcies, and downtrodden consumer sentiment, and the allocator's playbook contains a lot of question marks going into the new year.

Still, as is usually the case, the horizon is not all cloudy skies. The US economy posted a robust 5.2% annualized real GDP growth for Q3 2023, the strongest result since 2020. Inflation fighting has so far paid off, and the Fed is expected to start cutting rates next year, given the recent softening in the labor market. With the most aggressive tightening cycle in decades likely in the rearview mirror, recession odds have fallen throughout the year and public market pessimism in 2022 gave way to cautious optimism in 2023.

In our 2024 Allocator Outlook, we explore these recent macroeconomic developments; potential paths forward; the implications for private markets; and areas of risk and opportunity within buyout, VC, private credit, and real estate. From the perspective of fresh capital to deploy, our framework focuses on three factors that impact return expectations across asset classes: valuations, relative attractiveness to public market alternatives, and capital supply. Additionally, we include the relative impact of each of our three most likely economic scenarios: recession, soft landing, and reflation.

For valuations, we look at how recent deals have traded within each asset class and what that implies for private fund performance going forward. Next, looking at a private strategy's attractiveness relative to public comparables has historically been helpful to assess the trade-off that private markets represent compared with easier-to-access traditional assets. Finally, sentiment can be a helpful contrarian indicator, so an eye on the supply of capital within each asset class gives clues as to where more opportunity may arise for those with dry powder to spend.

We summarize our thoughts in the following table and dive into further detail in subsequent sections.

Summary table of allocator outlooks*

	Relative attractiveness based on:	Cross-asset relative impact of:	Commentary
Buyout	Valuations Public alternatives Capital supply	Soft landing Recession Reflation	**Valuations:** Deal multiples remain elevated despite the rise in rates and pullback in activity. Excess returns will be tough to accomplish based on the historical record. **Public alternatives:** Current public valuation multiples indicate a soft landing is fully priced. When public valuations are well above historical norms, buyout funds launched at the time tend to outperform at a higher clip. **Capital supply:** Dry powder levels remain elevated as undeployed capital piles up while waiting for narrower bid-ask spreads. However, with holding periods reaching record levels, opportunistic buyers of secondary buyouts may be in a position to target eager sellers when dealmaking starts churning faster. **Macro:** While a soft landing would lead to increased deal activity, it would also provide a high floor for entry multiples. A recession would create opportunities to deploy capital as interest rates and valuations quickly reset lower. Reflation would lead to higher debt costs and a further slowdown in deal opportunities.
Venture capital	Valuations Public alternatives Capital supply	Soft landing Recession Reflation	**Valuations:** Private valuations have yet to fully reset in the new environment as startups tighten spending in the hopes of raising follow-on capital at better prices. **Public alternatives:** Despite public markets bouncing back this year, indexes have been top heavy and much of the valuation reset that took place in 2022 remains in place. Recent VC-backed IPOs are down about 50% over the last two years, while VC fund NAVs are down only about 22% through June. **Capital supply:** Record 2022 fundraising has given way to a dismal year for new commitments in 2023. The present demand for follow-on capital across the startup landscape makes it a much more attractive time to put new dollars to work in the best opportunities. **Macro:** The current valuation reset is more structural than cyclical, so a soft landing would likely return confidence to the market without reversing this reset. While a recession may create some opportunities in the late-stage market, VC is generally more insulated from economic downturns than other asset classes, though a reflationary scenario would extend the present winter.
Private credit	Valuations Public alternatives Capital supply	Soft landing Recession Reflation	**Valuations:** Prevailing yields are the most attractive the market has seen in decades. With relatively high base rates and the pullback from traditional lenders, private credit looks well equipped to generate equity-like returns higher up the capital stack. **Public alternatives:** The rising-rate environment has lifted return outlooks across the fixed-income spectrum, making the relative attractiveness of private credit yields more in the neutral camp. **Capital supply:** The biggest risk to private credit's future return potential is the onslaught of new supply coming online. Already we are hearing anecdotes of competition compressing spreads and reducing credit quality. **Macro:** A soft landing would not only lower yields but also increase competition for deals in a crowded market. While a recession would also lower yields, it would create opportunities to be a lender of last resort to distressed companies, although competition will be higher for distressed deals than in the past. Reflation would keep yields high while strong nominal growth would support companies' ability to cover interest payments.
Real estate	Valuations Public alternatives Capital supply	Soft landing Recession Reflation	**Valuations:** Cap rates remain well below historical averages. Couple that with the higher debt service costs, and the return potential for much of the asset class is materially lower than it was a few years ago. There are likely pockets of value to be found, though, particularly in the distressed category. **Public alternatives:** The cap rate delta to the 10-year Treasury is at historically low levels, and spreads to implied cap rates in public REITs suggest the reset in private valuations has a long way to go. **Capital supply:** Given the stress in the commercial real estate market, there has been a significant pullback in new capital supply. Meanwhile, debt capital has dried up significantly, leading to potential opportunities for the careful investor with dry powder. **Macro:** A soft landing would provide reprieve for real estate investors to bring down debt costs; however, it could lengthen the time it takes for the valuation reset taking place now to crystallize. A recession would quicken the pace for new opportunities to arise. A reflationary environment would present more interest-rate-related headwinds but could translate to faster rent growth for inflation-sensitive properties.

Source: PitchBook • Geography: US • *As of December 15, 2023

Economic developments

Macro environment dashboard*

		Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023	Q3 2023	Q4 2023
Macroeconomics	Real GDP growth (annualized)	4.2%	5.2%	6.2%	3.3%	7.0%	-2.0%	-0.6%	2.7%	2.6%	2.2%	2.1%	5.2%	
	CPI (3-month annualized)	3.1%	4.5%	8.8%	5.2%	10.4%	9.7%	10.5%	2.5%	3.4%	3.8%	2.7%	4.9%	2.2%
	Core CPI (3-month annualized)	2.0%	1.9%	9.4%	3.0%	8.0%	5.5%	7.1%	6.0%	4.3%	5.1%	4.1%	3.1%	3.4%
	Job creation	2.2%	2.1%	2.5%	2.9%	3.1%	2.3%	1.5%	2.0%	1.2%	1.4%	1.6%	1.2%	1.1%
	Unemployment rate	6.7%	6.1%	5.9%	4.8%	3.9%	3.6%	3.6%	3.5%	3.5%	3.5%	3.6%	3.8%	3.7%
	Consumer sentiment	80.7	84.9	85.5	72.8	70.6	59.4	50.0	58.6	59.8	62.0	64.2	67.9	63.8
	Business confidence	101.4	102.0	101.7	101.6	101.3	100.8	100.2	99.5	98.9	98.6	98.5	98.8	98.7
Yields	Federal funds rate	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	1.2%	2.6%	4.1%	4.7%	5.1%	5.3%	5.3%
	US 10-year Treasury	0.9%	1.7%	1.5%	1.5%	1.5%	2.3%	3.0%	3.8%	3.9%	3.5%	3.8%	4.6%	4.4%
	US 2-year Treasury	0.1%	0.2%	0.3%	0.3%	0.7%	2.3%	2.9%	4.2%	4.4%	4.1%	4.9%	5.0%	4.7%
	High Yield OAS	3.9	3.4	3.0	3.2	3.1	3.4	5.9	5.4	4.8	4.6	4.1	4.0	3.8
Index returns	S&P 500	12.2%	6.2%	8.6%	0.6%	11.0%	-4.6%	-16.1%	-4.9%	7.6%	7.5%	8.7%	-3.3%	1.7%
	Russell 2000	31.4%	12.7%	4.3%	-4.4%	2.1%	-7.5%	-17.2%	-2.2%	6.2%	2.7%	5.2%	-5.1%	-4.4%
	Nasdaq Composite	15.6%	3.0%	9.7%	-0.2%	8.5%	-9.0%	-22.3%	-3.9%	-0.8%	17.1%	13.1%	-3.9%	1.6%
	Morningstar/LSTA US Leveraged Loans	3.8%	1.8%	1.5%	1.1%	0.8%	-0.1%	-4.5%	1.3%	2.6%	3.2%	3.2%	3.5%	2.2%
	Nareit All Equity REITs	8.2%	8.3%	12.0%	0.2%	16.2%	-5.3%	-14.7%	-10.8%	4.1%	1.7%	1.2%	-8.3%	0.7%
	Morningstar Infrastructure Index	10.9%	5.2%	5.6%	-2.0%	8.2%	0.9%	-10.1%	-8.5%	10.4%	1.9%	1.9%	-6.9%	1.2%

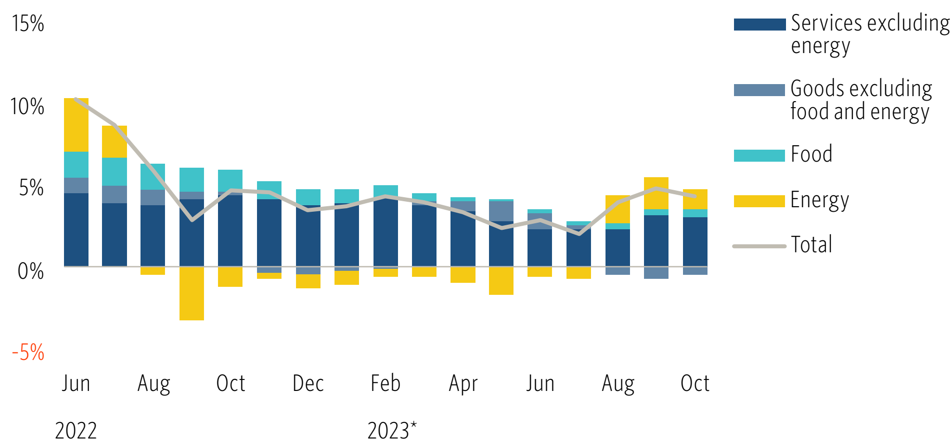
Sources: Bureau of Economic Analysis, BLS, Federal Reserve, ICE Data Indices, OECD, Morningstar, University of Michigan • Geography: US • *As of November 30, 2023

Note: For Q4 2023 representative values, data is not available for real GDP growth; consumer sentiment and business confidence data is as of October 31, 2023; CPI and Core CPI data is from three-month annualized CPI metric ended November 30, 2023; job creation data is from the three-month change in the Indexes of Aggregate Weekly Payrolls of All Employees, Total Private, ended November 30, 2023; the fed funds rate, US 10-year Treasury, US 2-year Treasury, and High Yield OAS are as of November 30, 2023; index returns are three-month returns ended November 30, 2023. Color shading reflects the relative Z-score over the last 10 years of data.

The biggest macro story so far in 2023 has not been defined by what happened, but rather by what did not. Coming into the year, forecasts from both economists and economic models were largely aligned with their confident predictions that the US economy would fall into a recession in response to higher interest rates. Yet real annualized GDP growth through the first three quarters of 2023 was 3.1%, and the unemployment rate has remained below 4%. These developments have further shifted the consensus view among market participants toward a soft landing being the most likely economic outcome. While it remains to be seen whether the recession predictions were slightly early or just wrong, this part of the cycle has played out differently and more slowly than those in the past. In this section, we delve into current macro conditions and possible reasons the economy has been so resilient to set up a discussion about which scenarios are most likely to unfold in 2024.

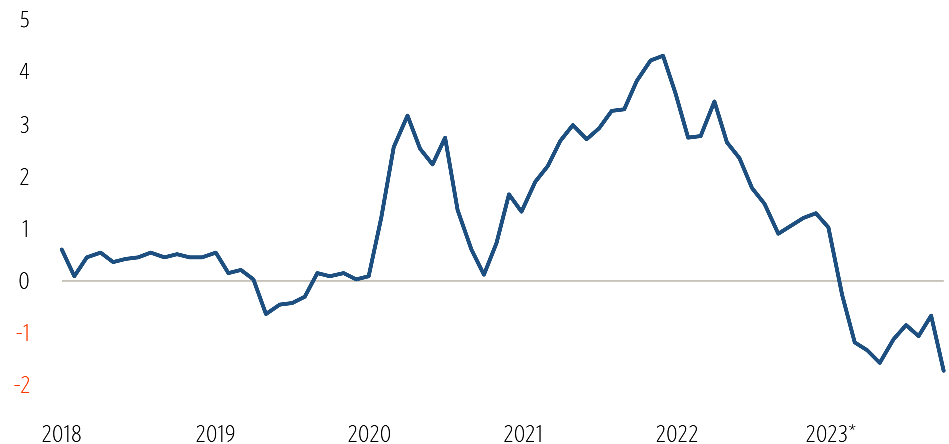
Moderating inflation without a corresponding severe weakening of the labor market has been one of the key positive developments this year, driven by improvements in supply chains leading to increased production capacity. Importantly, this has greatly reduced the left-tail risk of stagflation, which would have been a worst-case scenario for multi-asset investment portfolios. Lower inflation has also decreased the risk that the Fed will continue to tighten policy until it induces a demand-driven slowdown in which real economic growth would be collateral damage.

Contribution to annualized three-month change in CPI inflation by major category



Source: BLS • Geography: US • *As of October 31, 2023

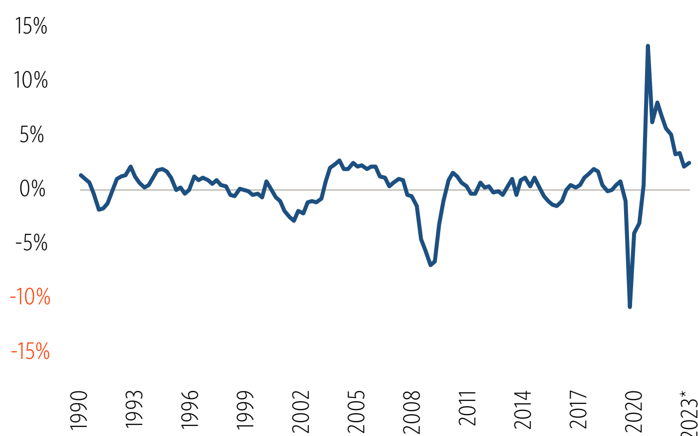
Global Supply Chain Pressure Index (Z-score)



Source: New York Federal Reserve • Geography: US • *As of October 31, 2023

While a lot of the big risks around inflation have faded, the primary concern now is that as supply-side tailwinds subside, the underlying core inflation rate will stay stubbornly above the Fed's 2% target. This concern stems from the demand-side perspective that nominal spending remains elevated relative to the potential long-run production capacity of the economy.[1] While this gap has closed recently, there is still a further slowing in nominal spending growth that is required to reach a sustainable inflation rate around 2%. As of Q3 2023, nominal GDP growth was 6.3% YoY compared with the current potential real GDP growth estimate of 1.8%. This suggests that nominal spending remains roughly 2.5% above equilibrium when considering a 2% inflation target. Even after adjusting for a higher trend rate of labor force productivity based on recent data, nominal spending is still about 1.8% above equilibrium.[2] Wage growth, a key driver of nominal spending, has also remained elevated relative to historical norms. Although it has come down recently, current measures indicate nominal wage growth is running between 4% and 5%. While the trend lower is a positive sign for more balanced supply-and-demand conditions, wage growth would still need to fall a bit further and stabilize around 3.5% to be consistent with sustainable nominal spending growth.

Nominal YoY GDP growth relative to real potential GDP growth plus 2%



Sources: Bureau of Economic Analysis and CBO • Geography: US
*As of September 30, 2023

Six-month annualized wage growth*

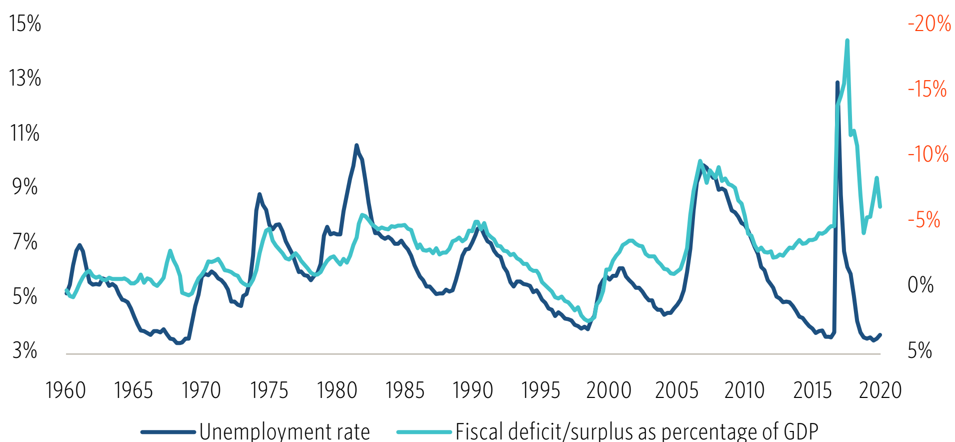
Source: BLS • Geography: US • *As of September 30, 2023

1: The long-run production capacity of the economy (also known as potential GDP) is an estimate from the Congressional Budget Office (CBO) of the economy's maximum sustainable output and is based primarily on assumptions of labor force and productivity growth rates.
2: This adjustment is made by comparing the long-run labor force productivity growth assumption in the potential GDP calculation of 1.6% to the trailing 12-month increase in observed productivity growth of 2.2%.

The most impressive aspect of moderating inflation thus far is that it has occurred without a significant deterioration in labor market conditions or real economic growth conditions. However, part of this resilience has been supported by temporary factors that have blunted the effects of monetary tightening, which are likely to fade moving forward. This comes at a time when employment growth has already slowed, thereby creating a risk of overshooting a moderation into a hard landing. Fortunately, slower employment growth until this point has been a result of slower hiring rather than a pickup in layoffs.

One of the key temporary supports to economic growth has been the unusually large fiscal spending deficit, which was 6.1% of GDP for fiscal year 2023.[3] It is quite strange to have such supportive fiscal policy during periods of good economic conditions, and this has helped offset some of the effects of tighter monetary policy. There were three key drivers of the outsized fiscal deficit: lower capital gains tax revenues, higher interest payments on federal debt, and increases in Social Security and Medicare spending that reflected one-time increases for cost-of-living adjustments. Outside of higher interest costs, which warrant less spending on discretionary spending programs given a fixed budget, the high level of deficit spending is unlikely to continue if unemployment remains low. Additionally, unsustainable Treasury funding conditions magnified the impact of fiscal stimulus on the margin. Almost all of the spending was funded through the issuance of short-term debt, which in turn came from excess liquidity parked in the Fed's overnight reverse repurchase program.

Unemployment rate versus fiscal deficit/surplus as a share of GDP*



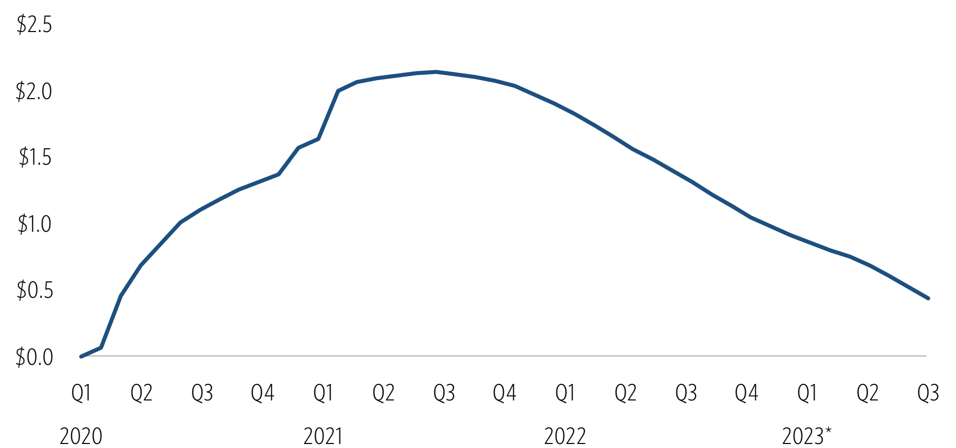
Sources: BLS and OMB • Geography: US • *As of September 30, 2023

3: If not for the strange accounting treatment of the canceled student debt forgiveness program that was recorded as an outlay in 2022 and a spending cut in 2023, the fiscal deficit would have been 7.3% of GDP.

Lagged effects from pandemic-related fiscal stimulus have also continued to support economic growth, although the benefits are likely dwindling. Since the beginning of 2022, consumers have consistently spent more of their incomes than normal as they have drawn down excess savings. While some estimates suggest that just around $400 billion of approximately $2 trillion of excess savings remain, households in aggregate are still sitting on a huge amount of liquid assets relative to the end of 2019. However, a slower drawdown of excess savings is likely to be a headwind to consumer spending growth in 2024 relative to the past two years.

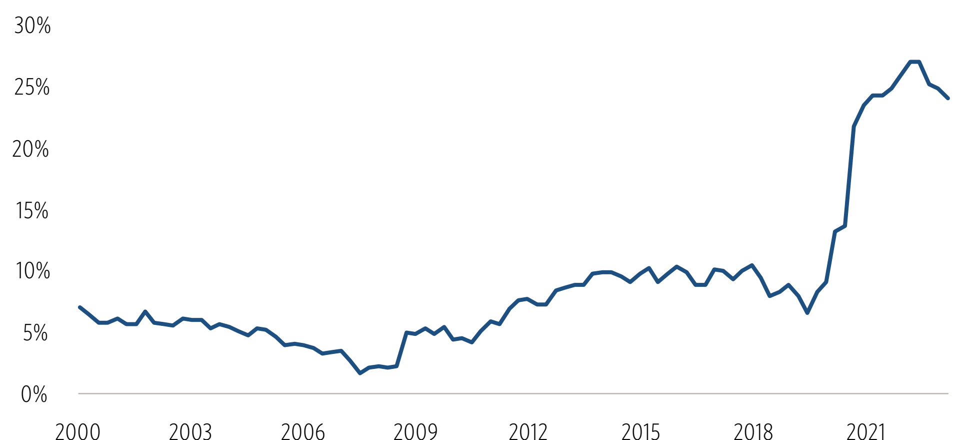
Extremely healthy aggregate corporate and household balance sheets are another key reason that higher interest rates have not yet had the expected negative impact on economic growth. Households have drastically reduced overall debt levels following the global financial crisis (GFC), and both households and corporates were able to take advantage of refinancing at record-low interest rates in late 2020 and 2021 to lock in cheap debt costs and push out maturities. At an aggregate level, net incomes are not yet being adversely impacted by higher interest rates, which has

Cumulative excess consumer savings ($B)



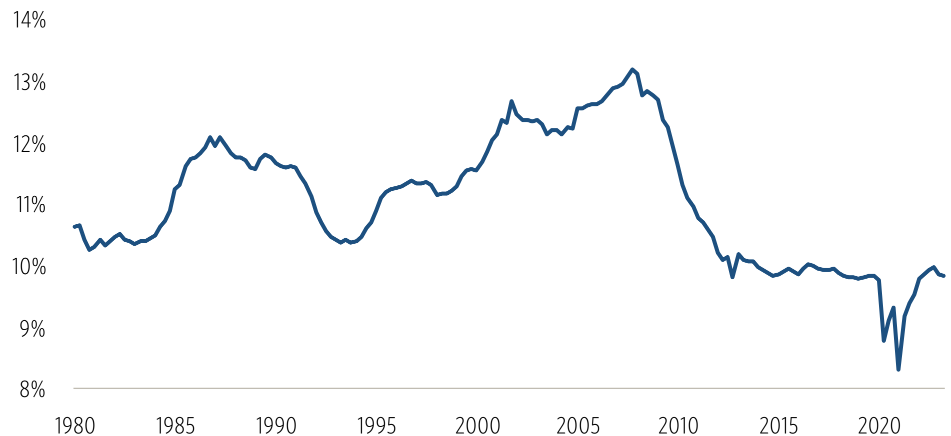
Source: San Francisco Federal Reserve • Geography: US • *As of September 30, 2023

Currency and checkable deposits held by households as a share of consumer spending*



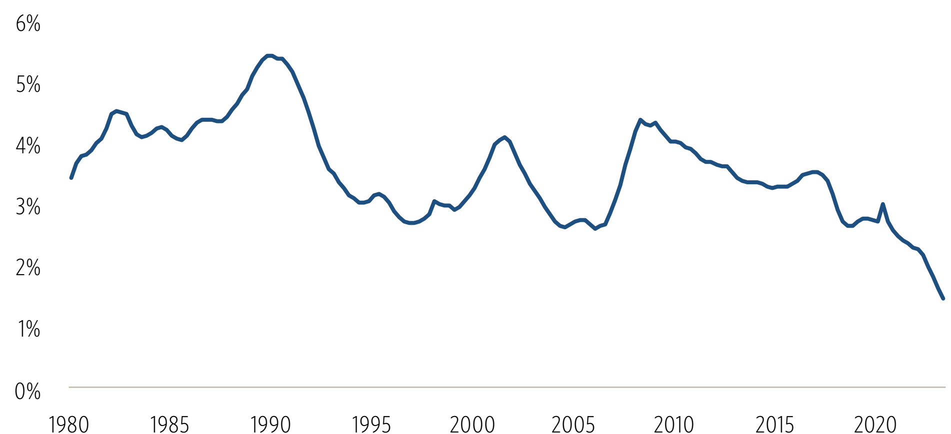
Sources: Federal Reserve and Bureau of Economic Analysis • Geography: US • *As of June 30, 2023

Household debt service payments as a share of disposable personal income*



Source: Federal Reserve • Geography: US • *As of June 30, 2023

Nonfinancial corporate net interest payments as a share of gross value added*

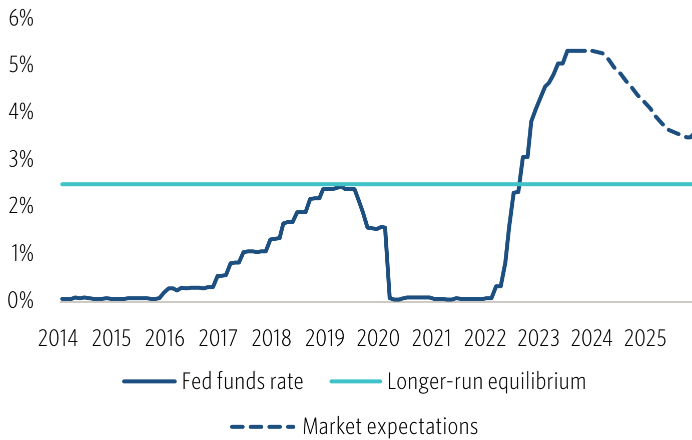


Sources: Federal Reserve and Bureau of Economic Analysis • Geography: US • *As of June 30, 2023

supported both investment and spending. While this support will slowly fade the longer interest that rates remain high, from a macro perspective, there is not much refinancing risk until at least 2025.

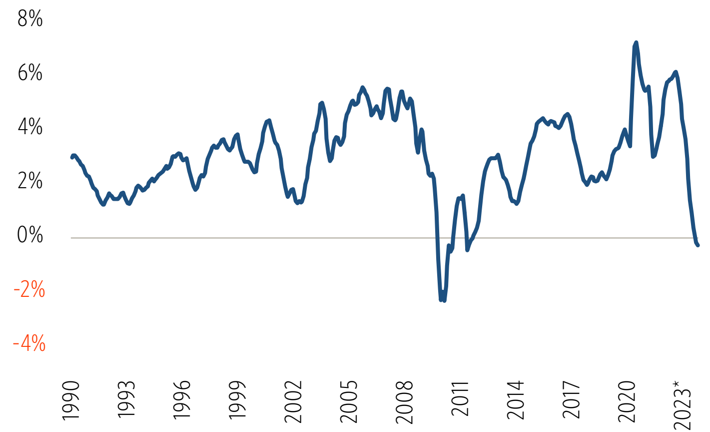
Credit has been the one channel of monetary policy transmission that has played out as expected. Higher interest rates have reduced creditworthiness of borrowers, and banks have tightened lending standards, leading to a decline in credit creation that has been a drag on growth. Total net bank credit supplied to the economy over the trailing 12 months fell for the first time since 2011, amplified by banks becoming more conservative following the failure of several regional banks in March 2023. While the degree to which lending standards tighten may slow, we expect that credit creation will continue to be a headwind to growth if interest rates remain high.

Fed funds rate with market expectations*



Sources: Federal Reserve and CME Group • Geography: US
*As of November 30, 2023

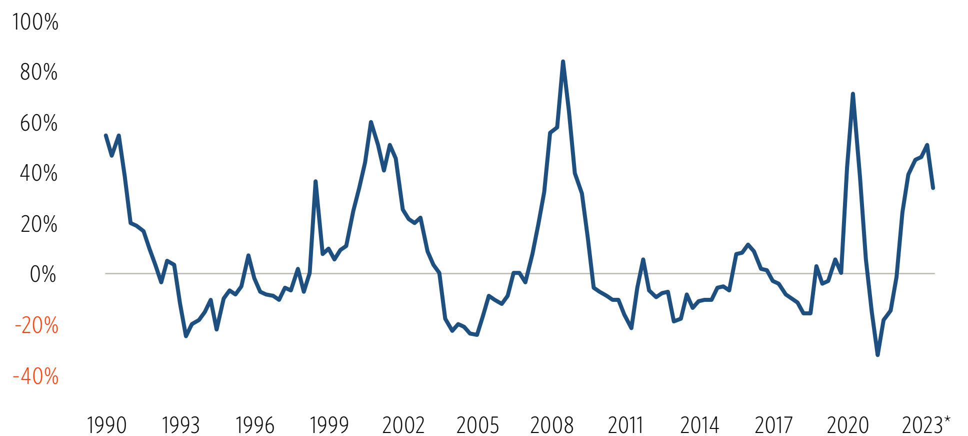
Bank credit impulse as a share of GDP



Sources: Federal Reserve and Bureau of Economic Analysis • Geography: US
*As of October 31, 2023

The throughline amid all these trends is the Fed's monetary policy. The key question has now shifted from how high rates will go to how long they will remain high. While the risk of further rate hikes is likely off the table for now, Fed officials have been adamant that inflation must return all the way to 2% before they start thinking about rate cuts. There is still a ways to go in terms of both lower realized inflation and nominal spending before this can happen, which will take time. In addition to a further moderation in inflation, real growth and the labor market may also need to weaken more before the Fed feels compelled to cut rates stemming from a concern that inflation could reaccelerate. This view contrasts with market expectations, which indicate the Fed will probably start cutting rates in the first half of 2024.

Net share of banks tightening lending standards on commercial and industrial loans



Source: Federal Reserve Senior Loan Officer Survey • Geography: US • *As of September 30, 2023

Potential paths forward

In past analyst notes,[4, 5] we have laid out the potential paths forward for the economy and their relative likelihoods in terms of a simple real growth and inflation framework. This framework yields four broad possible economic scenarios: soft landing (rising real growth with around 2% inflation), reflation (rising real growth and inflation), recession (falling real growth and inflation), and stagflation (falling real growth and rising inflation). As we mentioned in those previous notes, the goal of this exercise is not to make a precise forecast but rather to help investors think about what could occur in the next 12 to 18 months and how their portfolios could be impacted. Given the economic developments since we last published on this topic in February 2023, we have once again updated our thinking about how each of these scenarios might unfold and their relative likelihoods.

Here is a high-level overview of the changes in our thinking:

- Significant progress made toward a 2% inflation rate without a severe deterioration in labor market conditions has led to a more balanced view of monetary policy in terms of growth and inflation trade-offs and has reopened the door for a true soft landing to occur. This scenario is predicated on the continued normalization in labor demand and the easing of inflation, which will allow the Fed to start cutting rates in the first half of 2024.

- The actual landing part of a soft landing (returning short-term rates to neutral) is likely going to be the most difficult. The potential for mistiming policy easing means there is still a risk of reflation, which would lead to a second round of tightening.

- Supply chain normalization, lower commodity prices, lower inflation, and a more dovish Fed have all led to a further decline in the risk of stagflation.

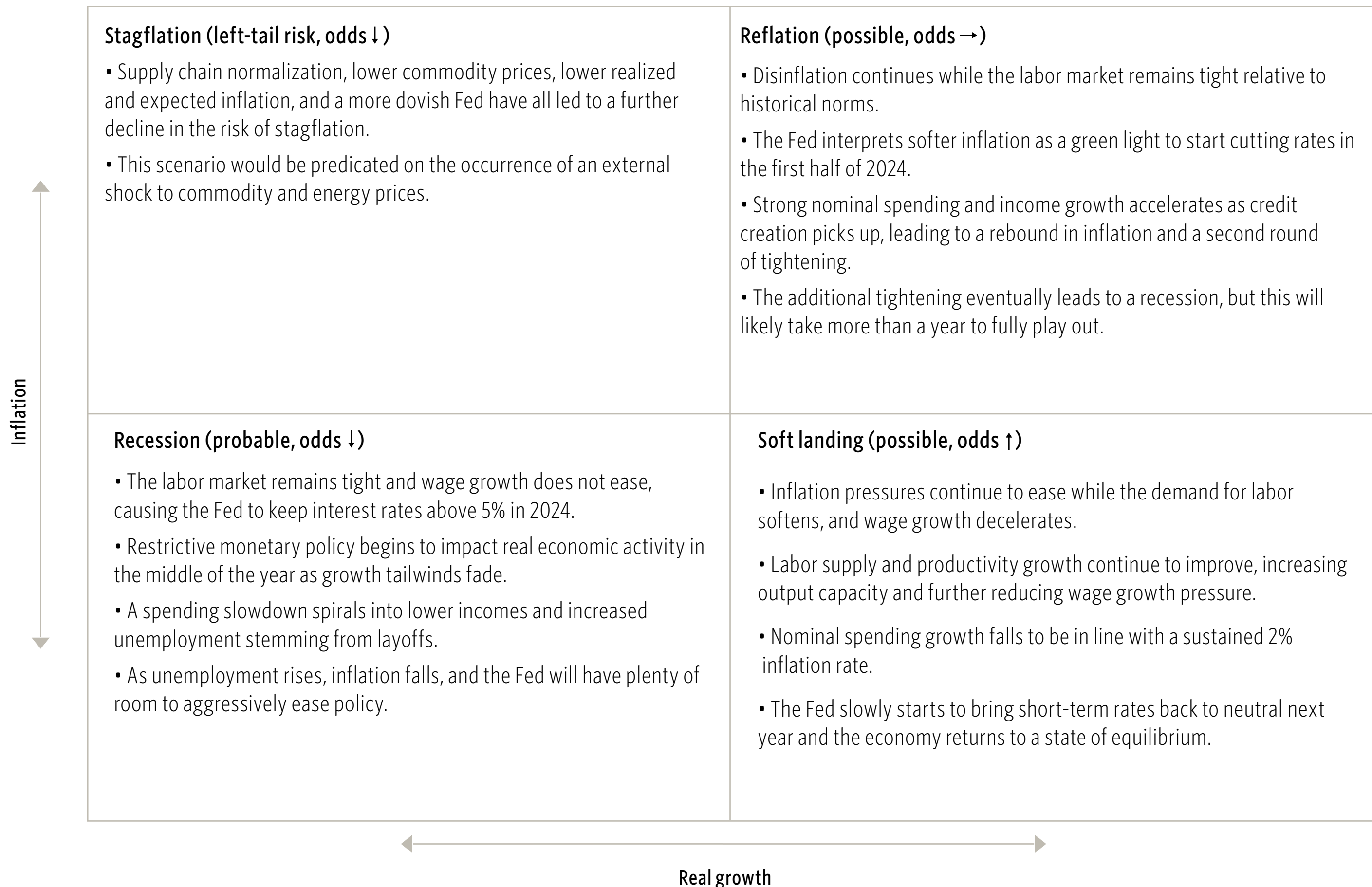
- Given that monetary policy has become more restrictive relative to previous expectations and several growth tailwinds that have offset some of the tightening are set to fade in 2024, the risk of a recession remains elevated.

- A recession is still the most likely outcome of the four scenarios despite the odds falling since our last update. However, if a recession does occur, it is likely to be less severe than previously anticipated due to the Fed facing a more balanced trade-off between growth and inflation risks.

- Despite a recession being the most likely single outcome, increasing odds of a soft landing mean that we see the scenarios with rising real growth as more likely than those with falling real growth.

4: "Q2 2022 Analyst Note: How Inflation, Monetary Tightening, and Volatility Are Impacting PE and VC," PitchBook, Andrew Akers, May 13, 2022.
5: "Q2 2023 Analyst Note: How Macro Risks Are Shaping the Outlook for US Private Markets," PitchBook, Andrew Akers, February 10, 2023.

Characteristics of possible economic scenarios in the next 12 to 18 months*



Source: PitchBook • Geography: US • *As of December 15, 2023

Implications for asset allocators

Private market dashboard

		Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023	Q3 2023	Q4 2023*
Deal value ($B)	Buyout	$95.3	$57.7	$127.7	$185.2	$123.6	$115.8	$65.8	$104.1	$159.5	$62.1	$80.7	$62.4	$32.5
	PE growth	$17.0	$23.2	$13.0	$23.5	$22.1	$25.2	$10.6	$14.5	$9.9	$12.2	$8.5	$12.8	$1.8
	Leveraged loans	$95.2	$228.0	$195.9	$203.7	$172.5	$167.4	$134.3	$78.1	$67.1	$71.9	$79.5	$103.7	$40.9
	PE exits via IPOs	$38.0	$45.0	$86.4	$76.7	$25.8	$4.3	$2.2	$0.0	$0.0	$0.9	$3.5	$0.0	$0.0
	PE exits via M&A	$40.5	$63.1	$38.6	$83.8	$89.8	$41.4	$31.9	$33.4	$22.1	$39.8	$12.7	$21.7	$18.1
	Early-stage VC	$13.6	$16.5	$21.2	$21.0	$28.4	$23.8	$20.1	$15.0	$11.3	$10.1	$11.3	$9.3	$4.5
	Late-stage VC	$17.3	$34.4	$36.5	$40.7	$40.9	$34.0	$29.3	$17.0	$14.1	$23.3	$15.7	$20.9	$10.1
	VC exits via IPOs	$104.4	$92.5	$213.9	$99.8	$127.1	$3.6	$0.7	$0.6	$1.8	$1.1	$3.4	$19.2	$0.5
	VC exits via M&A	$37.4	$15.1	$25.3	$34.6	$28.4	$11.8	$12.0	$11.1	$4.8	$7.6	$3.6	$7.8	$1.5
VC Dealmaking Indicator	Early-stage index	42.5	37.1	28.5	19.4	9.3	5.5	8.1	17.1	35	54.1	67.9	78.9	83.8
	Late-stage index	42.5	36.2	25.4	13.5	6.1	4.4	9.5	25.3	46.8	63	81.2	85.4	77.1
	Venture growth stage index	33.9	21.7	13.2	9.7	4.2	5.8	9.7	27.4	46.4	56.9	69.9	70.2	72.9
PitchBook Index returns	Private equity	8.1%	14.5%	13.5%	6.1%	6.0%	1.0%	-2.7%	-1.6%	2.3%	1.3%	2.7%		
	Venture capital	15.5%	21.9%	13.5%	8.2%	6.3%	-4.2%	-9.2%	-2.5%	-5.5%	0.2%	-0.3%		
	Private credit	3.3%	5.0%	8.0%	0.6%	2.0%	2.2%	-0.3%	-0.1%	2.4%	0.5%	0.7%		
	Infrastructure	5.5%	2.2%	4.8%	0.5%	7.2%	4.9%	1.0%	2.2%	2.7%	2.8%	1.5%		
	Real estate	1.2%	5.4%	5.4%	8.5%	7.8%	7.1%	1.4%	-0.9%	0.4%	0.7%	2.1%		
	All private capital	7.2%	11.5%	11.6%	5.6%	5.8%	1.9%	-1.8%	-1.0%	1.8%	1.3%	2.1%		

Source: PitchBook • Geography: US • *Deal value data is as of November 14, 2023. VC Dealmaking Indicator data is as of October 31, 2023
Note: Color shading reflects the relative Z-score over the last 10 years of data.

Perhaps the most important consideration for asset allocators stemming from recent macro developments is the impact of higher interest rates on strategic asset allocations. The ultraloose monetary policy over the period following the GFC, which helped push down long-term interest rates and expected return across asset classes, created significant challenges for investors. To build a portfolio that had any realistic chance of hitting their return targets—typically ranging from 7% to 9%—allocators were forced to take on more risk.

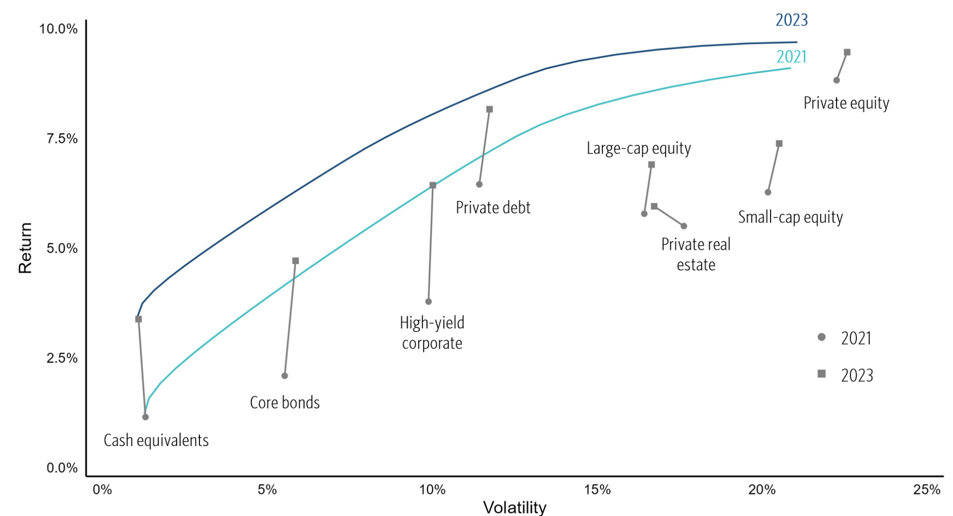
The trend of progressively lower expected returns hit a trough at the beginning of 2021. According to a survey of 39 institutions at that time, the 10-year nominal expected returns for cash equivalents, core bonds (proxied by the US Aggregate Bond Index), and US large-cap public equities were just 1.1%, 2.1%, and 5.8%, respectively.[6] Looking at a wide array of public and private assets classes from cash

6: "Survey of Capital Market Assumptions: 2021 Edition," Horizon Actuarial Services, August 2021.

to PE, the minimum risk portfolio with a 7% expected (geometric) return had a 0% allocation to core bonds. While it is unlikely that investors implemented such an extreme portfolio, it shows just how difficult it was to create a reasonable strategic asset allocation at that time.

The environment that allocators are facing today looks a lot different than the one they were faced with for the past 10-plus years and especially the one in 2021. Rate hikes from the Fed have pushed the yield on the three-month Treasury bill to over 5%, and the 10-year Treasury is yielding around 4.0%. Meanwhile, prices on risky assets have not similarly adjusted downward. This has caused cash and core bonds to become more attractive on a relative basis.

10-year expected risk and return for select asset classes with efficient frontiers*



Sources: Horizon Actuarial and PitchBook • Geography: US • *As of August 31, 2023

Returning to the example of the minimum risk portfolio that is expected to achieve a 7% return, the allocations look starkly different when using the most recent expected returns.[7] Most importantly, the allocation to core bonds increases from 0% to 45%. This analysis suggests that allocators should be motivated to de-risk their portfolios from a strategic perspective and potentially wait for more attractive entry points for riskier assets from a tactical perspective.

In addition to their ramifications for risk allocation across the portfolio, changes in market pricing and the macro backdrop also warrant that allocators take an earnest look at their exposures within private markets. We approach the implications of the present environment from the perspective of new capital deployment in 2024: What are the risk/reward drivers that investors should be considering for new commitments to buyout, VC, private credit, and private real estate strategies? We focus on each asset class's valuations, relative attractiveness to public market alternatives, and capital supply, and we include views on how the macroeconomic outlook may play a role in the opportunities and risks.

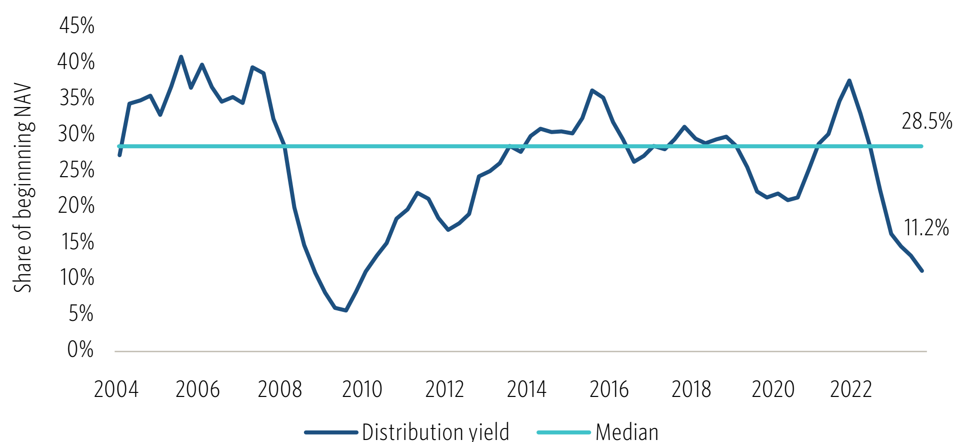
7: "Survey of Capital Market Assumptions: 2023 Edition," Horizon Actuarial Services, August 2023.

Buyout

Relative attractiveness based on:		Cross-asset relative impact of:	
Valuations	🔴	Soft landing	🔴
Public alternatives	🟢	Recession	🟢
Capital supply	🟡	Reflation	🔴

PE buyout funds have been a staple of private market allocations for decades, driven by strong returns and perceived understated volatility relative to public markets.[8] With near-zero long-term rates seemingly a thing of the past, buyout firms face new challenges to creating outsized returns. Since mid-2022, US PE has been characterized by questionable valuations of portfolio companies as discount rates have risen along with a dried-up exit environment. Despite a rebound in public markets and economic sentiment, 2023 has gone down as one of the worst years on record for fund distributions. Only about 11% of net asset value (NAV) has been distributed over the last year through Q3, down significantly from the median 12-month distribution yield of 28.5%. Low distribution yields are a product of historically long holding periods of portfolio companies—nearly one-third of current buyout-backed companies have been held at least five years. The lack of exit activity has translated to a slower capital recycling wheel only partially offset by innovations in GP-led secondaries and NAV lending.

Aggregate buyout fund one-year distributions as a share of beginning NAV*

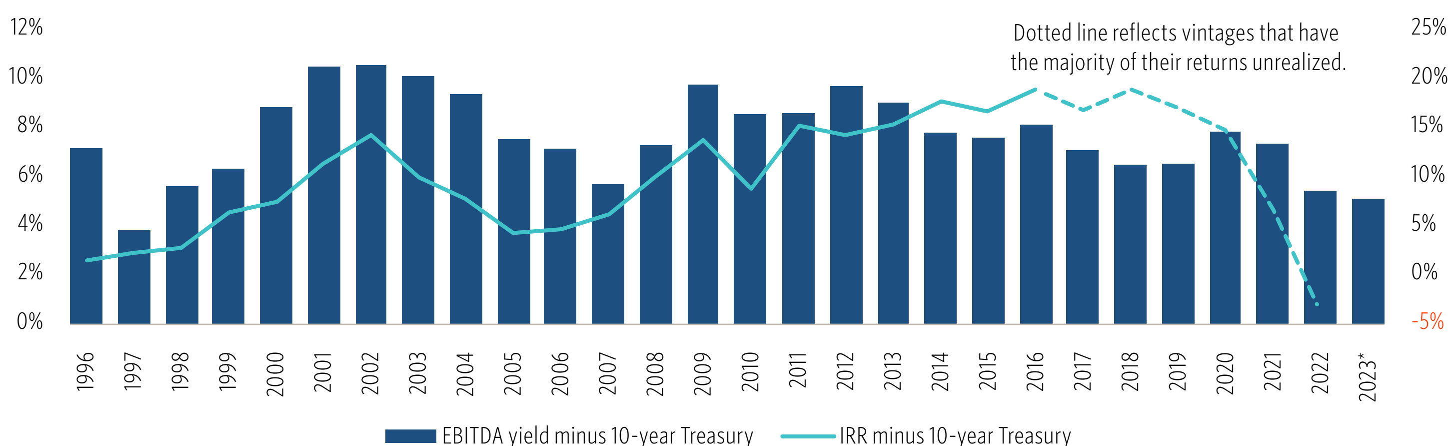


Source: PitchBook • Geography: US • *As of September 30, 2023
Note: Data for the two most recent quarters was estimated based on exit value.

8: "Q2 2023 PitchBook Private Capital Indexes," PitchBook, Zane Carmean, CFA, CAIA, November 7, 2023.

Another issue is that higher discount rates and a slowdown in deal activity have yet to cause a meaningful shift in LBO entry prices. The average EV/EBITDA transaction multiple sits at 11.4x in 2023, down only slightly from 2022's all-time high of 11.9x. If history is any indication, these elevated valuations are not promising for buyout funds to return a meaningful premium to US bonds. When buyout valuations are rich relative to the 10-year Treasury yield, as they are today, the median fund excess IRR has been below average. And a soft-landing scenario would likely keep entry multiples elevated, thereby hurting return expectations if rates settle at a higher base compared with the 2010s.

Median EBITDA yield minus average 10-year Treasury versus median fund vintage IRR minus average 10-year Treasury



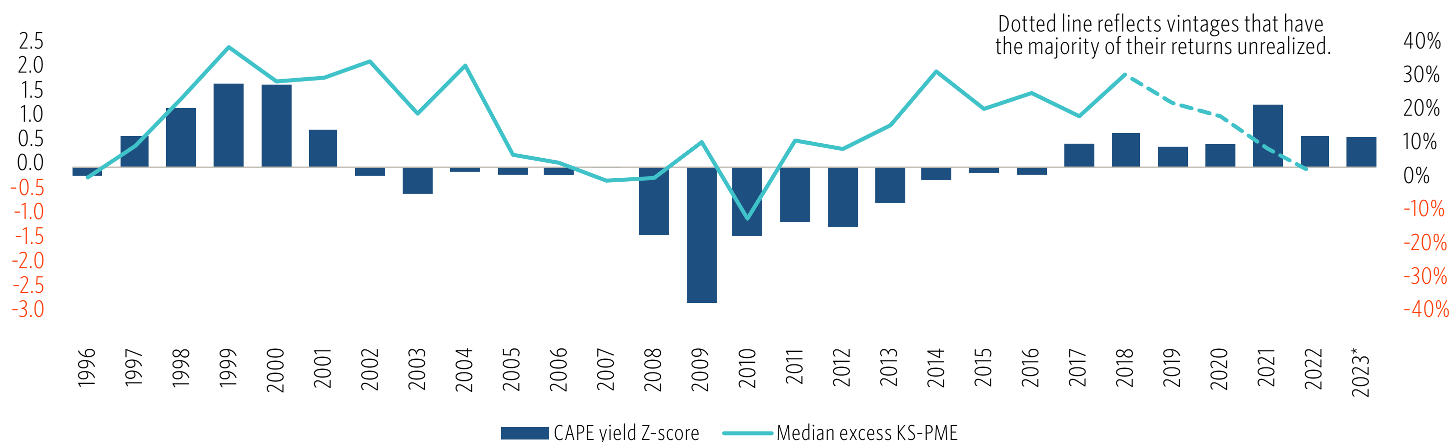
Sources: PitchBook | LCD, FRED • Geography: US • *Returns as of March 31, 2023. EBITDA and Treasury data as of October 31, 2023
Note: EBITDA yield is the inverse of EV/EBITDA transaction multiples.

With relatively unattractive entry multiples, we look at public markets for clues on the relative value trade-off. Historically, US buyout funds have achieved an average vintage year median Kaplan Schoar public market equivalent (KS-PME) of 1.17 against the S&P 500 from 1996 to 2018.[9, 10] However, that relative outperformance has not been steady across vintages, or across funds in those vintages. Valuation levels in public equities have provided a useful indicator on a given buyout vintage's likelihood of outperforming stocks. We look at CAPE yields historically against buyout fund PMEs,[11] specifically the degree to which the CAPE yield during the year is above or below historical averages.

9: "PME Introduction: Benchmarking Methods," PitchBook, Samuel Henly, November 1, 2013.
10: Performance of young funds is a notoriously unreliable measure of eventual returns when funds fully liquidate. Therefore, we require the buyout fund vintages to be at least 5 years old.
11: CAPE yield is the inverse of Robert Shiller's cyclically adjusted price/earnings ratio (CAPE). Low CAPE yield indicates high valuations, while high yields indicate low public equity valuations.

Presently, we find US public equities to be in a poor starting position to outperform buyout funds raising capital now. From 1996 to Q3 2023, we measure the Z-score of the CAPE yield metric and compare it against excess KS-PMEs of the respective buyout vintages through 2018.[12] We find that US buyout funds launched during periods of high public market valuations tend to outperform the S&P 500 significantly more than when starting public market valuations are low. For example, for vintages launched during a year in which the CAPE yield was below average, median KS-PMEs were 1.21, suggesting healthy outperformance by buyout funds. Compare that against PMEs when CAPE yields were above average, and the relative median performance measure drops to 1.08. The delta increases the further the CAPE yield deviates from the average. While this is just a simple exercise looking at historical perspectives, it suggests that US public equities pricing in a soft landing are at a disadvantage relative to buyout funds launching now. Still, about one-third of buyout funds have underperformed the S&P 500 historically, and many now are relatively untested in dealing with higher interest rates and a less-accommodating Fed policy.

Z-score of average CAPE yield versus buyout fund median excess KS-PME



Sources: PitchBook and Robert Shiller • Geography: US • *Returns as of March 31, 2023. CAPE data as of October 31, 2023

On the capital supply front, the availability of capital has helped keep transaction multiples elevated despite the pullback in dealmaking. The nearly $750 billion in dry powder sitting in US buyout funds has made pricing competition ever-present. Although dry powder has fallen in 2023, over one-fifth of that undeployed capital is at least 3 years old—the highest proportion since 2012. In a soft-landing scenario, a valuation reset will be slow moving, while the strong incentives to put capital to work remain. However, should a recession hit in the next few quarters, valuations will likely come down quickly. That scenario presents an environment wherein portfolio company earnings take a significant hit precisely at the time their interest coverage ratios are thin. That should open up more attractive opportunities for adaptable buyers with cash on hand.

12: Excess KS-PME is calculated by subtracting 1.0 from the multiple. A PME less than one will have a negative excess, representing underperformance against the S&P 500, and vice versa for PMEs that are above one.

What has worked for PE in years past may not work going forward. In diligencing a manager's ability to generate durable returns, extra scrutiny must be placed on the source of performance. All else equal, managers that lean on leverage should be expected to face more headwinds in a higher-rate environment. Low and falling base rates throughout the 2010s and early 2020s meant that managers that took on an extra turn or two of debt on their buyout transactions benefited greatly from dividend recapitalizations and asset appreciation. Underwritten debt became cheaper for portfolio companies as three-month LIBOR crested at 2.8% in 2018—down significantly from prior cycle peaks of 5.6% and 6.9% before the GFC and dot-com bust, respectively. And an accommodating Fed led to much of the post-GFC era seeing rates anchored below 1%, culminating in historically cheap money during the COVID-19 pandemic. On top of cheap leverage, steadily expanding valuation multiples throughout the decade meant rising tides for flagship funds of all ilk. Now, with a cautious Fed and the secured overnight financing rate showing a five handle, managers must be able to demonstrate value creation outside of financial engineering and can no longer rely on multiple expansion to generate returns. Falling debt/EV ratios are an encouraging sign that many GPs have received the message.[13] The ability to produce fundamental business improvements and having differentiated access to targets are increasingly important qualities in buyout managers.

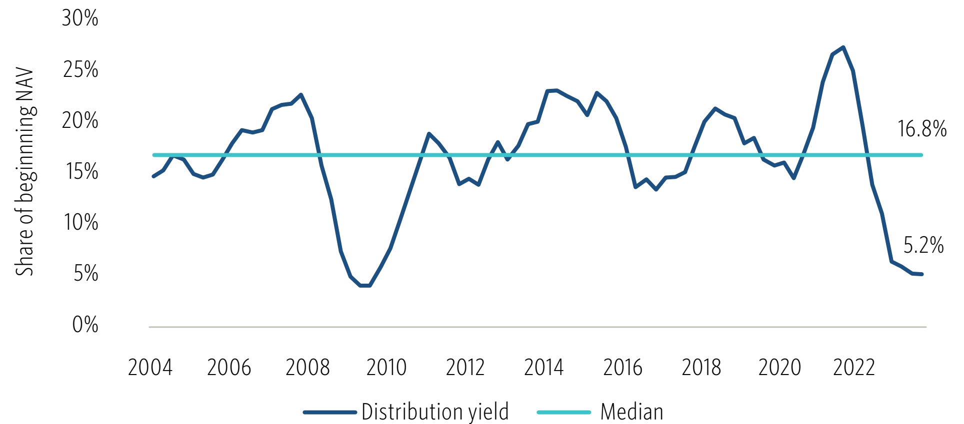
Venture capital

Relative attractiveness based on:		Cross-asset relative impact of:	
Valuations	🔴	Soft landing	🟢
Public alternatives	🔴	Recession	🟡
Capital supply	🟢	Reflation	🔴

As kind as the low-interest-rate world was for VC before 2022, the new regime has been a shock for the asset class for the past two years. High-flying valuations of loss-generating startups have come under pressure throughout 2022 and 2023. As of October 2023, about 900 unicorns are headquartered in North America, with a cumulative valuation of $3.2 trillion on paper. Marked-up holdings have led to the majority of total value to paid-in capital (TVPI) sitting in unrealized NAV for every vintage from 2014 onward. For funds that deployed heavily in the 2020 and 2021 runup, many will struggle to generate distributions to paid-in capital for LPs in line with current TVPIs. Similar to buyout funds, distribution yields have run into a wall as the IPO market and other exit avenues have shriveled up. Cumulative fund returns, as measured by our US Venture Capital Index, sit at -22.4% from the start of 2022 through Q2 2023. However, VC-backed IPO performance has been an abysmal -52.0% over the same period, suggesting that NAV markdowns in private funds are still yet to fully reflect the new environment. Keeping NAVs afloat is the fact that down rounds are still relatively rare. However, 17.1% of deals transacted at lower valuations in Q3 2023—the highest rate since 2013.[14]

13: "Q3 2023 US PE Breakdown," PitchBook, Tim Clarke, et al., October 10, 2023.
14: "Q3 2023 PitchBook-NVCA Venture Monitor," PitchBook and NVCA, Kyle Stanford, CAIA, et al., n.d., accessed November 28, 2023.

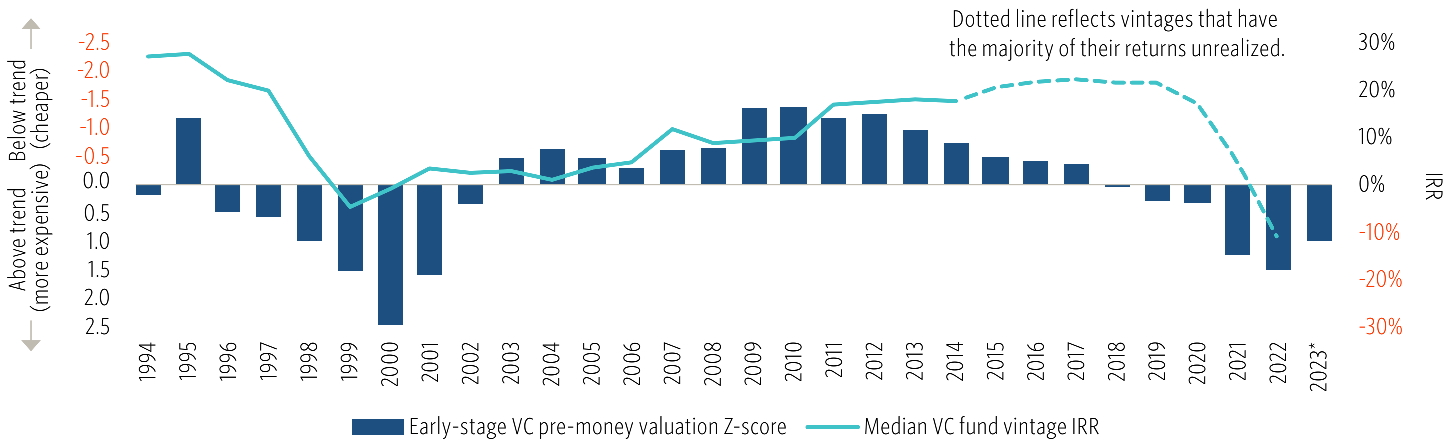
Aggregate VC fund one-year distributions as a share of beginning NAV*



Source: PitchBook • Geography: US • *As of September 30, 2023
Note: Data for the two most recent quarters was estimated from exit value.

At the same time, the present state of startup valuations leaves much to be desired from an investor's perspective. Pre-money valuations are still a full standard deviation above expectations, based on normalized trend growth, which reflects a still-rich dealmaking environment that has been buoyed by AI & machine learning startups. Historically, overpriced periods have led to underperformance of funds, as exhibited in the dot-com bubble, which is the closest comparison we have for the recent environment. A potential counter to this analysis is that there may be a quality bias at play for recent deals, evidenced by the lack of down rounds mentioned above. The pullback in dealmaking theoretically has led to only the best startups being able to receive funding, while lower-valued firms wait in hopes of a more receptive climate.

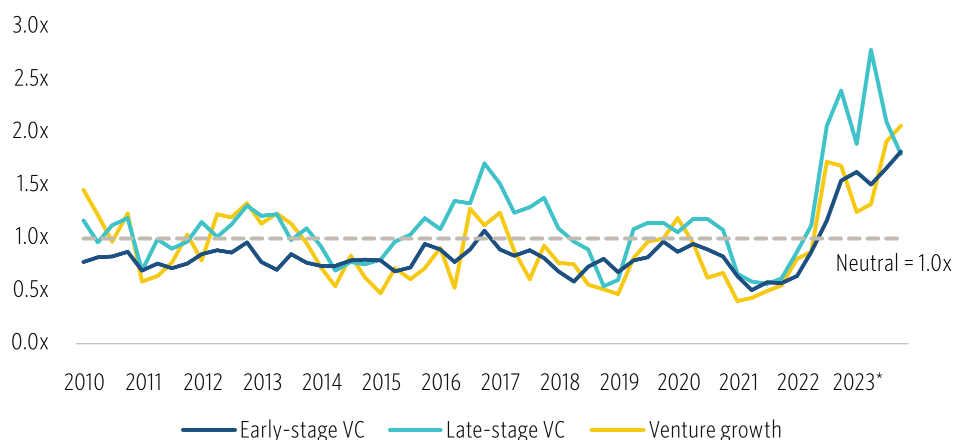
Early-stage VC pre-money valuation Z-score versus median VC fund vintage IRR



Source: PitchBook • Geography: US • *Returns as of March 31, 2023. Pre-money valuation Z-scores as of November 10, 2023
Note: Annual pre-money median valuations were first log-transformed and then compared to a linear trend. The percentage deviation from trend was then transformed to a Z-score to get a relative valuation measure.

The silver lining for allocators with capital to put to work is that we have entered a new period of relative investor friendliness, which should quicken the pace for opportunities to arise in 2024. Our estimates for the amount of capital being sought by startups has hovered around 2.0x to 3.0x more than actual deal value in 2023. Despite 2022's record fundraising of $172.5 billion, capital has been slow to deploy, likely as VCs anticipate lower valuations to come. Meanwhile, corporate VCs and nontraditional investors have pulled back considerably from the market in 2023, which has notably impacted capital availability for late-stage and venture-growth-stage startups.[15] Combine that with a near-decade-low fundraising environment in 2023, and the scales have tilted toward investors to be more selective in their targets. Ultimately, a more investor-friendly environment, coupled with a more accommodative interest rate environment in our soft-landing scenario, ought to translate to better returns for vintages investing heavily in the valuation lull. Should our recessionary scenario play out, the valuation reset will come faster and offer a clearer signal to deploy capital, though with a heightened risk of startup failures. For LPs allocating to new commitments today, the due diligence process should focus in on the GP's expected deployment schedule and their demonstrable edge in the sectors in which they invest. A GP eager to take advantage of the market sentiment may find themselves still overpaying relative to where pricing may be by the end of 2024 or 2025. Patience is likely a virtue until the release valve fully lets out.

VC capital demand/supply ratio



Source: PitchBook • Geography: US • *As of October 31, 2023

Private credit

Relative attractiveness based on:		Cross-asset relative impact of:	
Valuations	●	Soft landing	●
Public alternatives	●	Recession	●
Capital supply	●	Reflation	●

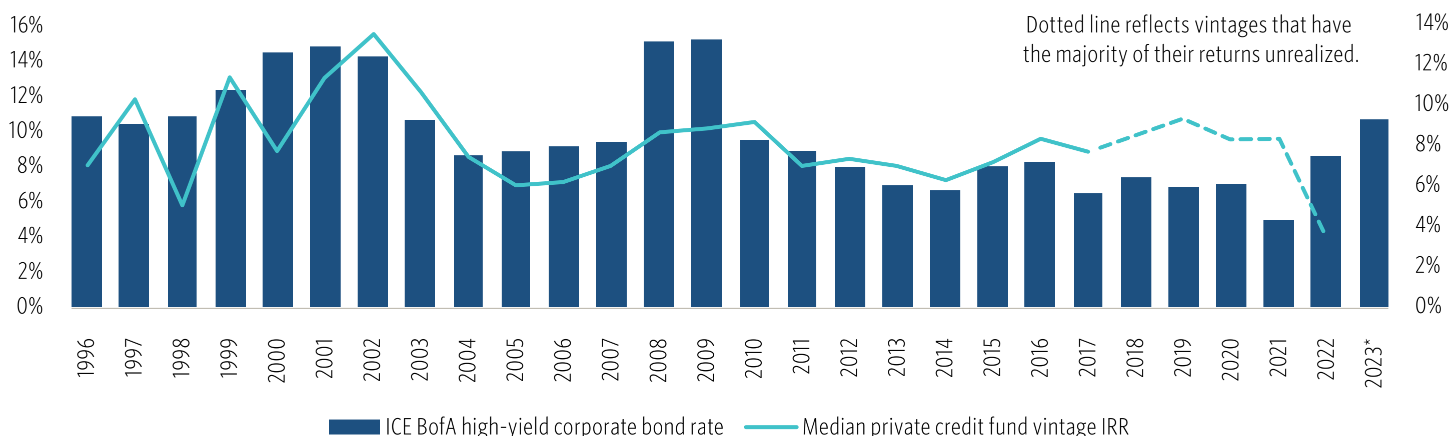
15: "Q3 2023 PitchBook-NVCA Venture Monitor," PitchBook and NVCA, Kyle Stanford, CAIA, et al., n.d., accessed November 28, 2023.

At recent private market investor conferences, private credit has dominated conversations. Direct lending funds have hit pay dirt for their LPs after rising from relative obscurity following the GFC and being hamstrung in the world of low interest rates. As inflation picked up and central banks began stepping in to raise short-term rates, floating-rate loans originated by these funds have benefited greatly. The traditional syndicated loan market suffered setbacks from hung debt starting in 2022 as would-be buyers balked at taking on leveraged loans issued just as rates started their rapid rise. Loans tied to LBOs of Citrix Systems, Nielsen Holdings, and others have left the traditional lenders wary of underwriting new deals. Silicon Valley Bank's swift failure in early 2023 has not helped sentiment among the banking community, nor has the resulting capital requirement proposal from the Fed.[16]

The bank pullback from the leveraged loan market has allowed alternative lending platforms to fill a large void for credit-hungry private equity firms and middle-market businesses. Of the LBOs tracked by PitchBook-LCD, more than 80% have been financed by the private credit market since the start of 2022. And benchmark base rates are more than double their highest point of the 2010s, allowing all-in yields of low double digits after factoring in credit spreads. In short, debt funds have been able to offer contractual, equity-like yields higher up portfolio companies' capital stacks. When including all private debt strategies going back to the 1990s, private credit tends to offer high future IRRs when yields are at an attractive starting position. Proxying with high-yield bonds, an effective yield of over 8.0% in December 2023 indicates a strong position across the debt markets—of which private credit is now a key player.

There are risks to the upside that private credit funds are currently advertising, though. Direct lending funds have yet to be truly tested by an economic slowdown, so a recession over the next 12 to 18 months will likely shake out a wide dispersion of performance. Losses on bad debt would undoubtedly dampen the market. Plus, a recession in 2024 will likely result in even lower buyout dealmaking activity than

Average high-yield bond rate versus median private credit fund vintage IRR



Sources: ICE Data Indices and PitchBook • Geography: US • *Returns as of March 31, 2023. High-yield bond rates as of October 31, 2023

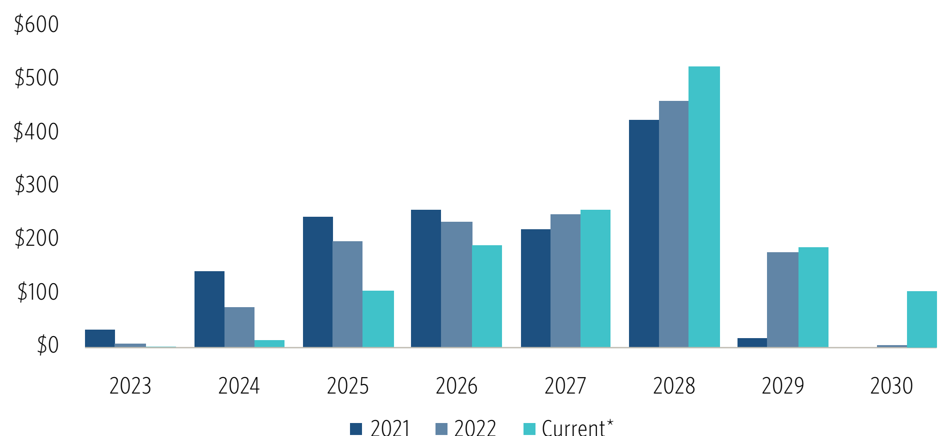
16: "Fact Sheet on Proposed Rules to Strengthen Capital Requirements for Large Banks," Federal Reserve, July 27, 2023.

today, and base rates will come down as the Fed reintroduces accommodative policy. Both would negatively impact return expectations. However, a recession would reduce competition and provide opportunistic and distressed funds a chance to be a lender of last resort at attractive spreads.

For yield-focused investors, plenty of opportunities exist across fixed-income assets to deploy capital. One does not need to venture into riskier private markets to earn yields above many institutional investors' 7.0% total return target. Locking in yields of nearly 9.0% could be an attractive strategy for deploying capital in an allocator's fixed-income bucket, considering the higher credit quality one can find in bonds relative to leveraged loans and private credit.[17] Earning high-single-digit returns in bond markets also comes with the protection of the borrowers' cost remaining fixed—returns will come from attractive entry pricing below par. The tailwind of higher floating rates in private credit and leveraged loans could also translate to higher default rates should a downturn in corporate earnings take place with coverage ratios already thin, making the risk-reward worth a second look.

A soft-landing scenario perhaps comes with the greatest risks as capital flowing into the space has created a lot of competition just as base rates are expected to stabilize lower. Both would have a material negative impact on yields and covenant protections.[18] The nadir in dealmaking has slowed the flow of opportunities for private credit to spend down its dry powder. The much-touted wall of maturity could theoretically offer opportunities for private credit lenders to continue to replace high-yield bond and syndicated bank loans; however, the bulk of debt has been refinanced out past 2025. That means dry powder sitting in coffers may have difficulty finding a home. Already, market participants are struggling to put capital to work, with new originations dropping in 2023 relative to 2022, along with about a 100-basis-point compression in spreads from the start of 2022.[19] The top six US listed alternatives managers have also reported an average decline of 33% in 12-month deployment as of Q3 2023.[20] Add to that the potential for the syndicated loan market to bounce back, and capital supply relative to borrower appetite may be starting to turn into a headwind.

Maturity breakdown of performing loans ($B)



Source: PitchBook | LCD • Geography: US • *As of November 10, 2023

17: "Performing Credit Quarterly," Oaktree Capital, Q3 2023.
18: "Private Credit Competition Raises Questions About Risk," Bloomberg, Sonali Basak, September 29, 2023.
19: "US Private Credit & Middle Market Quarterly Wrap," PitchBook-LCD, Q3 2023.
20: "Q3 2023 US Public PE and GP Deal Roundup," PitchBook, Tim Clarke, et al., November 29, 2023.

Real estate

Relative attractiveness based on:		Cross-asset relative impact of:	
Valuations		Soft landing	
Public alternatives		Recession	
Capital supply		Reflation	

The impact from COVID-19 lockdowns may have had the most lasting impact on commercial real estate than any other investment asset. Shrinking office demand due to a possibly permanent move to hybrid work, coupled with decade-plus high borrowing costs, has put tremendous pressure on institutional real estate portfolios. Coming out of the leverage-induced real estate crisis in 2008, investment-grade real estate has enjoyed a long stretch of rising valuations (falling cap rates) and steady rent growth outside of large pockets of retail. Then inflationary pressure led to the rapid rate hikes of 2022, and suddenly a slow-moving train wreck in commercial real estate loans has been underway. Valuations in US office have fallen by nearly one-third from their prior peak,[21] and delinquency rates on office properties hit 6.1% in November 2023.[22]

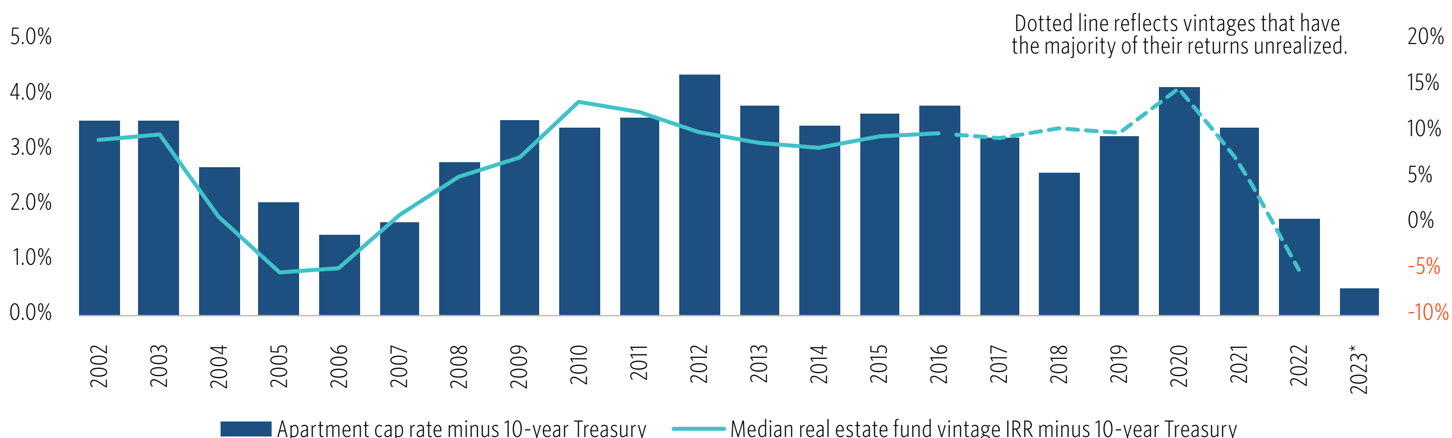
Given where rates stand today, the prospect for the future paints a grim picture for valuation repricing still to come. Outside of office, cap rates across private real estate remain near all-time lows but have started creeping up.[23] National Council of Real Estate Investment Fiduciaries (NCREIF)-reported real estate pricing shows appraisal-based cap rates expanding to just above 4.0% through Q3 2023, with gaps to BAA yields and Treasury rates the widest since the GFC and in the wrong direction.[24] When those spreads are tight, performance of real estate funds tends to be quite poor on a relative basis. And 2023 pricing is screening as the least attractive compared to the 10-year Treasury measure since at least 2002, which means a significant amount of rent growth is needed to justify the entry pricing.

The sell-off in public REITs may offer a glimpse into how private valuations will reset over the coming quarters. The spread between public implied cap rates and NCREIF's appraisal cap rates was nearly 200 basis points at the end of Q2 2023. At the end of 2021, it was less than 100 basis points. We would expect private real estate to do much of the value resetting to close the gap. In a recessionary path, there would be an additional downside to real estate's value proposition across

21: "Property Prices Decline on Higher Rates," Green Street, November 6, 2023.
22: "CMBS Delinquency Rate Dips in November 2023, But Office Delinquency Rate Tops 6%," Trepp, December 1, 2023.
23: "Briefing: Behind the Cap Rate Expansion," Connect CRE, Amy Wolff Sorter, November 16, 2023.
24: "Third Quarter 2023 NCREIF Indices Review," NCREIF, Jeff Fisher, Ph.D., and Will McIntosh, November 16, 2023.

most sectors. Ironically, a recession may present opportunities in office, though, as it will lead to a faster unwinding of underwater properties and a resetting of valuations that will favor the careful opportunistic buyer. It may also put more power in the hands of employers to get their employees back in office. Should a soft landing occur, base rates are likely to remain elevated relative to the 2010s, which means the property sector will probably contend with a slow escalator down to more reasonable buyer entry points.

Apartment cap rate minus average 10-year Treasury versus median real estate fund vintage IRR minus average 10-year Treasury



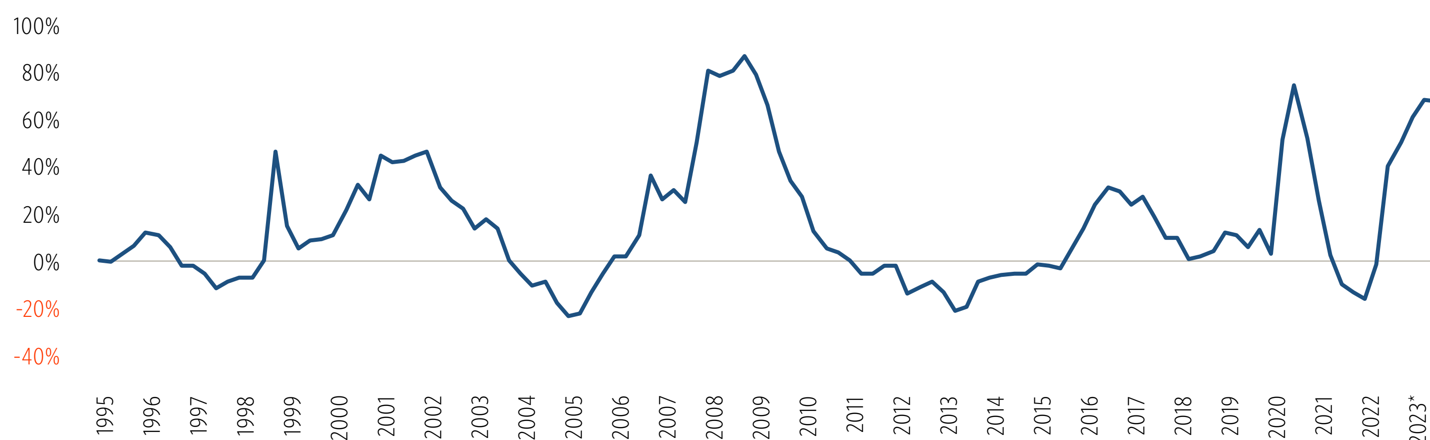
Sources: National Multi-Family Housing Council and PitchBook • Geography: US • *Returns as of March 31, 2023. Cap rate and Treasury rates as of October 31, 2023

Potentially accelerating the unwinding in valuations going into 2024 is the dearth of capital available—both debt and equity. Real estate fund dry powder has shrunk to $211.5 billion as of the most recent available data in Q1 2023 and has decreased during each of the last three years. Private fund capital calls are on pace for only $65.8 billion in 2023—the slowest in nominal terms since 2012. Public REIT capital deployment has also been pared back. Acquisition activity has reached only $28.7 billion through the first three quarters of 2023—down significantly from 2022's full-year total of $109.5 billion.[25] Redemption queues reported by some NCREIF funds and private REITs earlier this year suggest the pullback in capital has hit evergreen vehicles as well.[26] For those with dry powder, pricing competition should continue to ease in a soft-landing scenario, but a recession would quicken the pace for new opportunities to arise.

25: "REITs Raised $4.1 Billion Through Secondary Offerings in 2023: Q3," Nareit, John Barwick, October 6, 2023.
26: "Redemptions at US Property Fund Rise to $5.6bn as Investors Seek to Exit Sector," IPE Real Assets, Jon Peterson, September 20, 2023.

The bank pullback has not hurt only the leveraged loan world but also commercial real estate lending. The net percentage of banks tightening credit standards on commercial real estate loans has hit its highest level since Q1 2020 and the GFC before that. The best real estate vintages for US funds have historically come around the peaks of these tightening cycles and in recessionary environments. Real estate is also not at all homogeneous. For an opportunistic allocator, identifying GPs with patience and an edge in distressed property underwriting may offer some of the better risk-adjusted return potential in private markets going into 2024. Structural opportunities may exist for specific property types, such as data centers (digital transformation), senior housing (demographic trends), and logistics (e-commerce).[27]

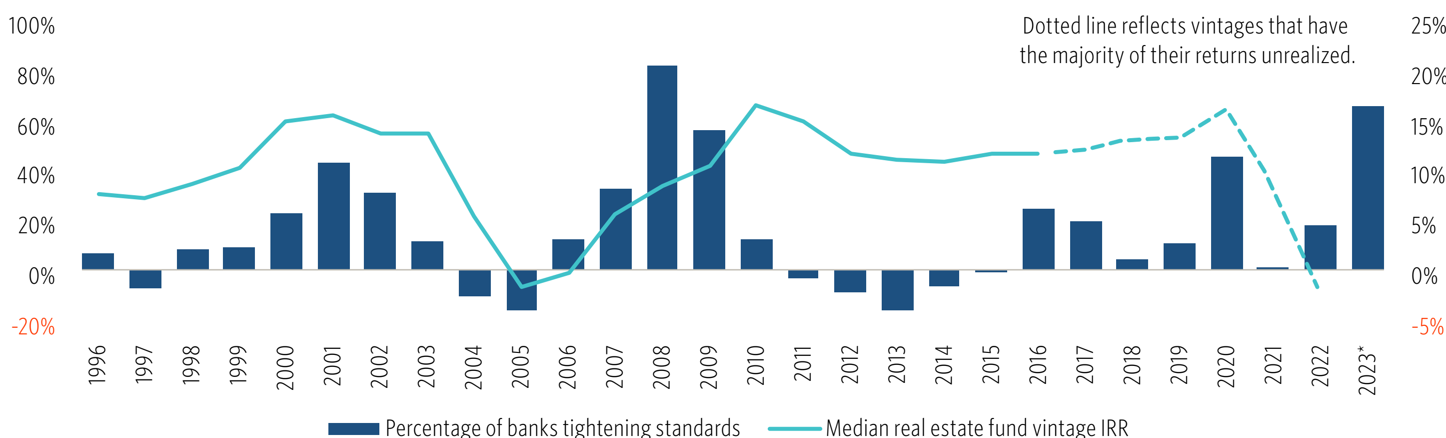
Average net share of banks tightening credit standards on commercial real estate loans



Source: FRED • Geography: US • *As of September 30, 2023

Note: Beginning in 2013, the Senior Loan Officer Survey split the questionnaire on credit standard tightening for real estate into multi-family, commercial, and construction. We combined the three series into a simple average to have a comparison with prior years.

Average net share of banks tightening credit standards on commercial real estate loans versus median real estate fund vintage IRR



Sources: FRED and PitchBook • Geography: US • *Returns as of March 31, 2023. Senior Loan Officer Survey as of September 30, 2023

27: "2024 Real Estate Outlook," PGIM Real Estate, November 2023.

Concluding remarks

As we head into the new year, navigating the new regime of higher rates will require a significant rethinking of portfolio construction for allocators. The macroeconomic environment has yet to offer a definitive path forward, with recession odds still high but a soft landing seemingly in sight. No matter the outcome, it appears we have officially closed the book on a long stretch of low and falling yields.

Across all asset classes, the key takeaway for allocators is the importance of diversification, rigorous due diligence, and adaptability to market changes. In this complex and rapidly changing market, the ability to identify and capitalize on emerging trends while maintaining a resilient and well-balanced portfolio will be crucial for achieving long-term investment success. As we head into 2024, staying informed, agile, and open to new investment paradigms will be paramount in navigating the uncertainties and seizing the opportunities that lie ahead. We do not advocate timing markets, but we hope that our 2024 Allocator Outlook presents a differentiated view of private markets, their place in strategic allocations today, and the risks and opportunities they present going forward.

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