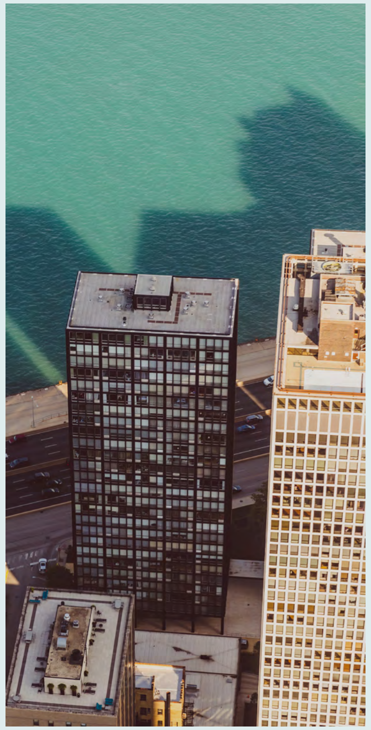
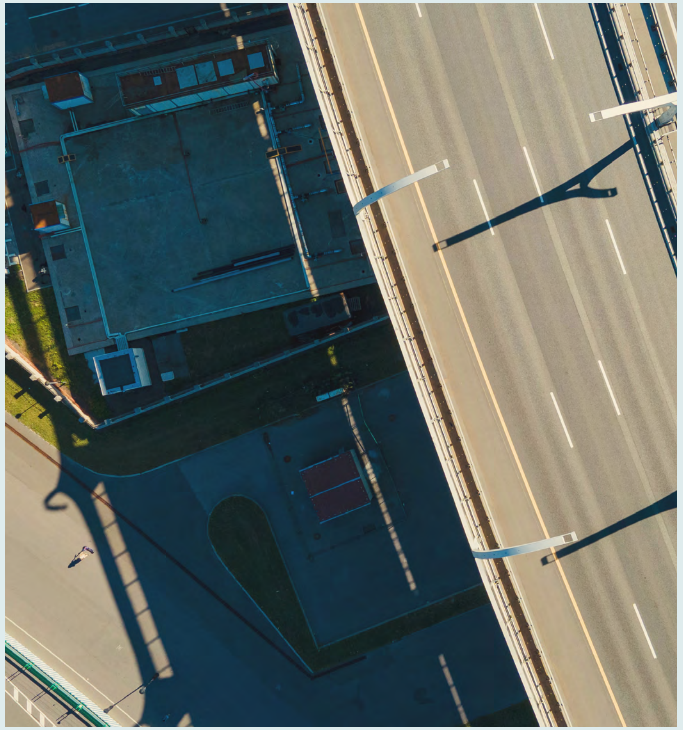
2024 MID-YEAR

Global Investment Outlook





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A letter from Steve Peacher

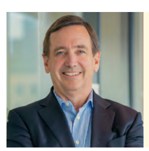
I am pleased to present the 2024 Mid-year Global Investment Outlook, during a time that is proving to be pivotal for markets and the global economy. At the midway point of this year, the central banks of Europe and Canada took careful steps to make initial cuts to rates, while noting that these were not necessarily the beginnings of a cycle. Meanwhile, eyes are fixed on the U.S. Federal Reserve and other policymaking peers who have appeared cautious toward sustained easing activity until inflation and other indicators offer clearer signals on the best time to begin rate reductions. Whether or not the data will give central banks the ability to make substantial easing moves continued to be a source of uncertainty at the mid-year point of 2024.

It's widely expected that constant discussions over inflation, central bank signals and higher-for-longer rate environments will continue to fuel market sentiment for the remainder of the year and beyond. What I find particularly notable, however, is the impact that these possible divergencies in opinions, expectations and policy have had on the risks and opportunities faced by investors.

Within this comprehensive global outlook, you will find insights into these issues from our wide range of SLC Management investment specialists. In the following pages, we cover everything from fixed income to private credit, real estate and infrastructure, as well as the overall global economic backdrop and how it might affect the insurance and pension sectors. With global markets possibly at a turning point, the range of potential opportunities spans regions, asset classes and time horizons, as do the challenges that investors need to be aware of.

The 2024 calendar year has been one of remarkable shifts already, and I hope our mid-year outlook can provide perspectives into your own positioning for the months and years ahead. This is a rare opportunity to hear all at once from our investment specialists across SLC Management, BGO, InfraRed and Crescent Capital, and I consider this a key part of our ongoing commitment to provide insightful communications, thought leadership and engaging resources to our stakeholders.

Regards,



Steve Peacher

Executive Chair, SLC Management

Macroeconomic outlook

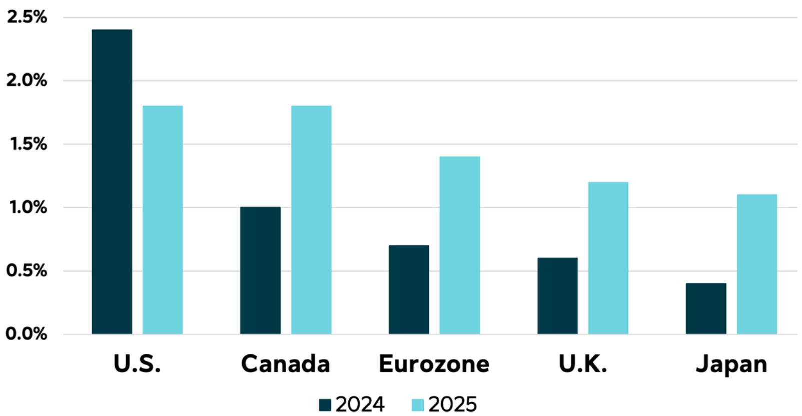
Policy pivots, moderation in consumer spending and geopolitical risk set tone for next half of 2024

Dec Mullarkey
Managing Director, Investment Strategy and Asset Allocation

U.S. growth to outperform peers

The U.S. economy has been a standout over the last several years as it leads G7 peers in real GDP growth. The resilience of the American consumer has been the key engine. Backed by a surprisingly strong labor market, which held up in the face of gloomy predictions, consumers kept spending. As inflation drops, real wages remain strong. But activity is expected to slow in the second half of this year as consumer demand looks likely to cool.

GDP growth outlook for major economies



Source: Bloomberg monthly survey, 2024. The above forecast is based on estimates and there is no guarantee that the estimate will be achieved.

The job market is also rebalancing as the number of job openings drop. And quit rates, which act as a proxy for the willingness to switch jobs, are also returning to pre-pandemic levels.

The job market has benefited from supply side gains. Immigration is up and labor participation rates for prime age workers, those 25–54 years old, are at decade highs. This has helped offset the wave of early retirements, from the over 54 crowd, that happened in the pandemic era.

U.S. consumers turning cautious

Consumers are slowly dialing back demand as prices pinch and debt loads pick up. Many of the large banks commented on their most recent earnings calls that consumer credit is generally in good shape but that delinquencies are starting to tick up, albeit starting from near record low levels. For now, most banks have characterized this shift as a normalization to pre-pandemic levels, rather than material deterioration.

Meanwhile consumer-facing companies are starting to see a more discerning consumer hunting for value. In particular, some large food retailers have cut prices, looking to win back customers who switched to more affordable brands.

High prices have certainly made consumers cautious. And that pullback is a critical reason U.S. growth is expected to drop from 3% in the first half of this year to 2% in the second half.

Central banks have shifted to cuts

While the U.S. Federal Reserve is still on hold at the mid-year point, other key central banks have already started cutting rates. The Bank of Canada (BoC) broke the ice in June with a 25 basis point rate cut, and right after that the European Central Bank (ECB) followed with the same move. But do not expect the flood gates to open. While both central banks feel inflation is heading in the right direction, they stressed they will continue to be data dependent and not commit to a prescribed pace of cuts.

Both banks needed to move ahead of the Fed as Canada and the eurozone are expected to deliver around 1% GDP growth this year, less than half of U.S. expectations. Fortunately, after months of plateauing, U.S. inflation is showing some renewed cooling, which has revived the prospects that the Fed will respond with rate cuts later this year.

Historically, when central banks end a long tightening cycle they have rushed to cut rates – mainly because they have waited too long, and a recession is in the works. But this has not been a typical cycle. The Fed in particular promised to learn from the past and looked to engineer a soft landing. With a reasonable combination of skill and luck that quest continues at a measured, data dependent pace.

Macroeconomic outlook (cont.)

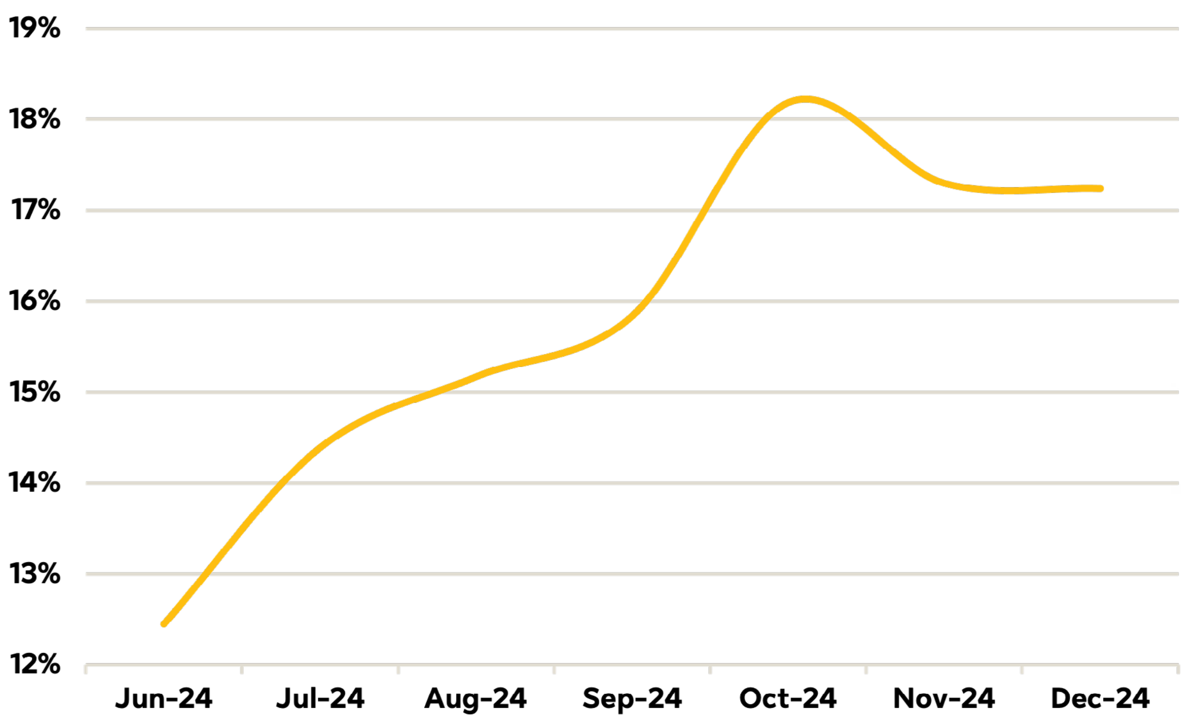
Dec Mullarkey

Managing Director, Investment Strategy and Asset Allocation

Geopolitical risk is ticking up

Markets generally pay little heed to U.S. presidential elections until about three months in advance of the vote. As can be seen from the implied option volatility chart, markets are expecting volatility to peak right before the election but remain high through the end of the year.

S&P 500 Chicago Board Options Exchange Volatility Index (VIX Index), implied forward volatility



Source: Bloomberg, 2024.

This time, the big issues are likely to be taxes, tariffs and immigration. But regardless of what disruption the potential presidents promise, they can only deliver if they have agreement from the other two branches of government. And on that note markets generally like a divided government, which most forecasters expect to be the outcome, of a single party not controlling all branches of government and allowing for more checks and balances.

One area where there is bipartisan agreement is strategic tariffs and sanctions on China. And as election promises start to ramp up, markets will look to assess their impact. So, volatility around trade and geopolitical risk will likely increase. That type of uncertainty tends to support a stronger dollar, as the U.S. is perceived as a safe haven even if it is the cause of the geopolitical risk.

Higher for longer

The Fed has also been upping its forecast of the eventual Federal Funds Rate, the short-term rate needed to keep the economy humming at a stable pace. In the past, 2.5% seemed about right. But recently the Fed has been nudging up its estimate and has it now close to 2.8%.

Persistent fiscal deficits, secular demand for capital and financial conditions that seem less sensitive to Fed rates have led to a rethink of the target or neutral rate. And varying research suggests something in the 3.25%–3.5% range may be needed.

Fed Chairman Jerome Powell has also commented that “rates will not go back down to the very low levels that we saw” over the last cycle. So, beyond rate cuts, the neutral rate is another important piece of the Fed picture, as this rate is a basic building block in deriving market yields and the cost of capital.

Sources: Bloomberg, U.S. Federal Reserve, 2024.

Fixed income: investment grade

Rich Familetti
CIO
U.S. Total Return Fixed Income

Linda Kong Ting
Senior Director and Credit Analyst,
Asset Management

Perceptions versus reality in economic sentiment alludes to potential risks down the road

Important signals from divergence in sentiment

The first half of 2024 has been a period of exceptional cognitive dissonance, in which expectations waver on changing sentiment and perceptions often don't match the metrics. Taking rate expectations as an example, early 2024 markets appeared to price in as many as six rate cuts throughout year from the U.S. Federal Reserve. In June, expectations settled to just one rate cut, with some credible prognosticators even making a call for zero. As for public sentiment, a Harris poll indicated a majority of Americans believed the stock market was down for the year and their country was in a recession, at a time when the S&P 500 Index hit double-digit gains at its highs and the U.S. economy continued its four-year-long expansion.

There are genuine reasons for this divergence. A mortgage backdrop benefiting many homeowners while presenting barriers to lower-income, younger renters, plus inflation, consumer debt, high fuel prices and strong headline employment numbers masking pockets of labor market weakness, all contribute to an economy that feels more challenging than the numbers by themselves suggest. Higher U.S. immigration levels compared to the pre-COVID era have provided both a boost to overall growth but also to housing-related inflation, which may not subside until immigration returns to baseline levels of approximately one million new residents a year (current levels being approximately 2.5 million annually).

In this context, the continued fixation on the mirage of recession by individual consumers makes a lot more sense. The average consumer is indeed treading water in the sense that inflation has eaten away at more recent wage gains, and it is unclear where growth in personal balance sheets may come from in the future.

Population growth may steer policy

So, what are the implications of these economic factors? While stagflation remains a possibility, it still appears more likely that the U.S. economy will continue to grow, albeit much more slowly, in the near term. Given that the drivers of inflation are largely in housing and services, the path of rates may depend more on raw population growth than we might have expected in prior cycles.

Since large corporates are likely to benefit more from immigration than small companies, we see continued scope for tight investment grade (IG) spreads until above-trend immigration stops providing meaningful uplift to GDP and there is more scope for the Fed to become dovish. Following such a point, the potential path for rate cuts and inflation will determine whether markets can regain momentum. From this perspective, U.S. elections may seem more consequential than they have been in previous cycles, as policy choices resulting in sharply lower immigration could be a contributor to a potential recession. However, if slowing inflation results from a pressured labor market, we see scope for large companies to cut expenses even if pricing growth moderates. While this might initially involve employee redundancy to reverse higher staffing levels following the tight labor markets of 2021–22, we see potential for additional pressures on commercial real estate as the return-to-office rally dissipates. Looking further out, we are more cautious on the medium-term prospects for supposedly noncyclical software-as-a-service products, as recurring expenses of this nature may receive more scrutiny as the economy softens – on top of the potential for consolidation due to advances in artificial intelligence.

Encouraging signs from ratings activity

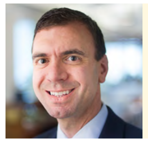
In credit, we observe some counterintuitive reasons to remain sanguine on corporate health. IG revenue growth excluding commodities was positive in the second quarter of 2024, though lagging GDP growth, implying some room for catching up and possibly stabilization in headwinds from foreign exchange due to the strong U.S. dollar. Corporate earnings growth excluding commodities with continuing margin pressures suggest companies in good health that may still be vulnerable to rising costs. Leverage has also ticked up, although at least some of this is due to interest expenses.

Although we are slightly more apprehensive on the direction of the economy, we believe there is scope for cost savings if inflation becomes more contained in either commodities or labor. We also note that despite some measured deterioration in both interest coverage and leverage ratios across IG credit, the ratio of upgrades to downgrades was extremely positive in Q1 2024 at 3.8-times, compared to 3.5-times in the full year 2023 and the 15-year average of 1.1-times.

Rating momentum accelerated in April and May. We are also encouraged by the fact that from 2023 to mid-year 2024, upgrades have been strong in traditionally cyclical sectors such as energy and banks, and increasing even in rates-challenged sectors such as utilities. Negative watches and outlooks have also declined as a proportion of IG corporate bonds, while fallen angel volumes have been very low, suggesting overall ratings stability.

Sources: Bloomberg, Goldman Sachs, The Harris Poll, 2024.

Fixed income: non-investment grade



John Fekete
Managing Director and Head of Capital Markets

A possible pivot in monetary policy could further strengthen non-IG opportunities

Credit returns robust irrespective of rate moves

As investors enter the second half of 2024, much of the focus continues to be on the possibility of rate cuts, a focus that we believe is myopic. With high base rates resulting in high-single-digit coupons in credit as of June 2024, investors don't need rate cuts to generate attractive returns, in our view. Recent U.S. economic data have been resilient. The Organisation for Economic Co-operation and Development forecasts U.S. GDP growth to be 2.6% in 2024, the highest of G7 economies and well above the 2.1% 20-year U.S. average. We believe we are in an environment in which clipping coupon income is sufficient for most investors to meet or exceed return requirements.

A strong labor market, combined with healthy consumer spending, underpins the U.S. economy. Post-pandemic earnings growth has helped to mitigate the impact of higher debt servicing costs. In the first quarter of 2024, leveraged loan issuer earnings before interest, taxes, depreciation and amortization (EBITDA) grew by 3%, according to Pitchbook/LCD. This was the 14th consecutive positive reading dating to the fourth quarter of 2020. Interest rates have stabilized while EBITDA continues to grow, resulting in 0.2-times improvement in the interest coverage ratio since Q3 2023. The ratio is at approximately 4.4-times as of June 2024.

Inexpensive valuations in CCC-rated space

Credit stress and default activity have been modest, but there are pockets of the market in which the dominant sentiment is less than rosy. For example, CCC-rated bonds in the U.S. high yield bond market trade at a significant relative discount to BB- and B-rated bonds. According to Goldman Sachs, the spread ratio of the CCC index to the broader index, a measure of relative cheapness, stands at the 98th percentile rank as of June 2024, using a 20-year lookback window. The expensive cost of capital for CCC-rated borrowers has caused this current gap, which is wider than 98% of the time in the past 20 years.

A recent surge in primary issuance has reduced the once looming debt maturity wall, pushing out maturities and making it less likely borrowers will stumble. This wall is often spoken about and makes for good headlines, but is rarely a driving factor for markets.

The U.S. Federal Reserve's signaling of no further rate hikes provides a green light for investors to take advantage of the carry trade in fixed income. We believe there may be select opportunities in floating rate assets. In addition, syndicated loans and collateralized loan obligation (CLO) debt might be in a "sweet spot," with yields high enough to attract capital but low enough to facilitate refinancing in a robust new issue market. Based on our analysis, a blended portfolio of high yield bonds, syndicated loans and CLO mezzanine debt currently could yield approximately 9%–11%, according to the expected returns of corresponding indices.*

An inflection point for fixed income

We appear to be in the midst of a great monetary pivot, in which interest rate policy could go from being a headwind to a tailwind at a time when recession risk is relatively low, leading allocators to find value across fixed income again. High base rates mean fixed income instruments can cushion portfolios against equity and growth volatility, something that couldn't be counted on when rates were near zero. There's room for growth for most allocators. According to Pensions & Investments, the allocation to traditional fixed income by the largest U.S. public pension plans was 20.3% of their total portfolio in 2023, down from 27.1% in 2008.

Market views on economic growth, inflation and interest rates have shifted over the past six months. However, we have observed revenue and EBITDA growth among the stronger issuers. Against this backdrop, we believe investors could benefit from disciplined sourcing, underwriting and portfolio construction processes that remain consistent and that can therefore help reduce costly errors. This can help position investors for more durable portfolios that generate high income with minimal default risk.

Sources: Bloomberg, Pitchbook/LCD, Pensions & Investments 2024.

* Indices used as asset class proxies: Credit Suisse Leveraged Loan Index & JPMorgan CLOIE Index as of May 31, 2024. This information is based on combining 50% Credit Suisse Leveraged Loan Index and 50% JPM CLOIE yield. Public and private credit indices shown are widely used market benchmarks to generally assess the relevant risk profile of a particular investment strategy. Future fluctuations in valuations and performance may occur as a result of changing market conditions, among other variables. The comparison indices and asset classes presented set forth herein are provided for informational purposes only and should not be relied upon as an indication of Crescent's investment strategy or as an accurate measure of comparison, as there may be differences between the relevant Crescent fund and such indices due to varying fund vintages and strategies. The comparisons contained herein have inherent limitations and qualifications, such as limited sample size, imperfect access to information and other considerations. There are significant differences between the types of securities and assets typically acquired by a Crescent fund and the investments covered by the applicable index or benchmark. Certain indices may or may not reflect the reinvestment of dividends, interest or capital gains. Moreover, indices are unmanaged and are not subject to fees and expenses.

Private credit: investment grade

Andrew Kleeman
Senior Managing Director,
Co-Head of Private Fixed Income

Elaad Keren
Senior Managing Director,
Co-Head of Private Fixed Income

Nushi Kazemian
Managing Director,
Private Fixed Income

Market could be primed for steady growth in a competitive environment

Increased certainty could strengthen volumes

Year-to-date volume for investment grade (IG) private credit issuances at June 2024 has shown a modest but steady growth compared to the similar period last year. Market activity started at a slower pace in January and February of 2024 but by March the number of issuances picked up materially and has continued since. With a backdrop of more stability in the economy, retreating fears of a material recession and now a firmer consensus that interest rates are likely to stay higher for longer than previously predicted, we are seeing an uptick in market activity versus last year.

Shifts from previous year, and possible signals for 2024

At this mid-year point of 2024, we have identified a series of evolving trends that could impact IG private credit markets for the remainder of the year and beyond:

Number of issuers – A higher volume of issuers came to the market versus last year, with several financings and projects that were put on hold in 2023 due to an expectation of interest rate drops now moving forward.

Deal size – Several substantially sized deals (greater than US$1 billion) were completed so far this year, an increasing trend since 2023, with the two largest issuances represented by an over US$7 billion deal in the infrastructure-energy pipeline sector and US$2.3 billion in a structured credit tenant lease financing in the industrial-manufacturing sector. We consider these illustrative of the growing demand in IG private credit markets, with a large diversified and ever-expanding investor base. It also underscores the ability of the market to execute complex large transactions. This is a trend we expect to continue in the near term.

Currency – So far in 2024, there has been a significant increase in non-USD volume compared with the same period in 2023, with nearly 50% more issuances from outside of North America; this highlights the diversification, flexibility and depth of current markets, in our view.

Spreads – Often the advantage of larger-sized deals for investors is that spread expectations are sustained without bids materially outpacing the available volume, providing attractive relative value opportunities. Notwithstanding the larger deals, we have seen material oversubscriptions on average- and smaller-sized deals this year, leading to more competition and at times putting downward pressure on spreads. Overall, the weighted average spreads have seen a compression so far compared to last year, following a similar trend seen in the public IG corporate bond markets. We believe relative value compared to the public market remains solid.

Term – Year-to-date new volume for 2024 has been more equally distributed along the duration curve with a material portion in the 20-plus year term bucket. This is in contrast to last year where we saw more shorter-term issuances and very little beyond 10–15 years. As more consensus has formed around higher interest rates in the short term and with the economy showing growth, we are seeing a slow gradual move to issuers locking in rates over longer terms where it makes sense, albeit still at lower levels than pre-interest rate hikes.

Credit quality – So far in 2024, IG private credit volume has seen a shift to the lower end of the IG curve (i.e., the BBB range), rather than the same period last year where the volume was more equally distributed across the risk curve (i.e., the BBB to A range). This shift in 2024 can provide attractive spread and relative value opportunities on good quality transactions, but also requires more diligence, plus discipline in credit underwriting.

Sectors — Volume has been anchored by issuance in the industrial sector followed by financials, utilities and transportation. Real estate investment trusts and utilities saw an uptick compared to the previous year, though spreads and relative value remain constrained for these sectors. We have seen a general slowing in the pace of financials compared to the growth seen a couple of years ago. Infrastructure volume has been robust so far this year with a number of energy, transportation and digital infrastructure (mainly data center) transactions anchoring the volume. Real estate continues to face major headwinds resulting from sustained high interest rates and inflation, lower investment activity and fundamental shifts in sectors such as office after the pandemic. However, we see robust volume activity in more niche commercial real estate sectors, such as credit tenant lease financings and government-funded housing (e.g., social housing, homeless shelters and seniors' care). In addition, fund financing and private asset-back securities are two of the growing segments of the IG private credit market that continue to provide solid volume and robust relative value and quality, further diversifying the IG private credit portfolio for investors who have the asset class expertise and a wide origination platform.

Private credit: investment grade (cont.)


Andrew Kleeman
Senior Managing Director,
Co-Head of Private Fixed Income


Elaad Keren
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Nushi Kazemian
Managing Director,
Private Fixed Income

Volatility could create opportunities

The evolving trends we've seen thus far keep us optimistic for a solid investment year in 2024, with the caveat that the last quarter of the year remains uncertain as U.S. elections take place. While we expect the market to be resilient, it remains to be seen whether it would experience significant volatility in price and/or investor liquidity. It is worth noting that such periods of volatility could also serve as fertile ground for larger experienced investors who are well-positioned to take advantage of favorable pricing dislocation or to undertake attractive bilateral or smaller club transactions.

Source: Private Placement Monitor, 2024. Investment grade credit ratings of our private placements portfolio assets are based on a proprietary, internal credit rating methodology that was developed using both externally purchased and internally developed models. This methodology is reviewed regularly. More details can be shared upon request. There is no guarantee that the same rating(s) would be assigned to portfolio asset(s) if they were independently rated by a major credit ratings organization.

Private credit: non-investment grade

Chris Wright
President and Head of Private Markets

Chris Wang
Managing Director

Capitalizing on compelling private credit opportunities in a high interest rate environment

Attractive market conditions for cycle-tested investors

While headlines this year have been dominated by the talk of the revival of banks, the reality is that yields, structures and documentation in private credit continue to offer what we view as compelling opportunities for a proven, cycle-tested manager to capitalize on in this high interest rate environment.

We believe the ingredients for a return of merger and acquisition activity are in place: there is a significant amount of private equity dry powder waiting to be invested, pressure from limited partners to return capital, a deep private credit financing market and the expectation of eventual rate cuts. While we expect some continued choppiness in the market for the remainder of this year due to the U.S. election, geopolitical concerns and the wait for the U.S. Federal Reserve to pivot, pressure is building to deploy capital and realize investments. We have already seen a pickup in activity this year as leveraged buyout activity grew year over year for the first time since Q1 2022.

Private credit continues to be the financing choice for companies and sponsors with private credit accounting for an 85% share of buyout and M&A activity this year. Even if this elevated level of private credit financing is not sustained, private credit's value proposition and permanent role are clear, and we look at this as the new era of capital delivery to companies.

Market segmentation matters

Significant amounts of capital have been raised by asset gatherers in private credit, creating an immense pressure to deploy capital in upper middle market and large cap financings where it can be done so in size and scale. Due to this dynamic and competition with the newly reinvigorated banks, we have increasingly seen a convergence in this market segment with the broadly syndicated markets. Terms increasingly look alike with tighter yields, looser documentation, lax covenants and decreased access to information. Furthermore, portfolios focusing on the upper middle market and large cap financings typically look similar and lack differentiation as they are pressured to participate in every jumbo transaction that comes to market, lest they fall behind in their deployment targets.

While larger managers have moved upmarket to replace banks, the core middle market and lower middle market remain less competitive where financings are satisfied by one or a small number of lenders and borrowers are relying on a value-added partner to help grow their businesses. Here, lenders have more influence and control over structure, pricing and a greater ability to build protections and rights into documentation.

Value of incumbency and rise of portability

Incumbency provides a proprietary pipeline of investment opportunities, as the incumbent lender is typically the first call for any additional capital needs. The incumbent lender also has unique insights into the historical performance of the company and capabilities of the management team, and as such can efficiently re-underwrite the business with speed and conviction.

Today, incumbency may be hardwired into transactions for the highest quality credits, due to the growing use of portability provisions. Portability allows the existing debt package to remain in place through a change of control transaction and leaves the incumbent lender invested in a well-known credit. Portability provisions have increased in prevalence as borrowers refinance or amend their existing debt structures in advance of upcoming maturities but are planning for a short-to-medium term exit.

The importance of staying disciplined

There are many compelling opportunities in private credit today for those who have the experience and know-how of investing through multiple cycles and a track record of staying disciplined. Yet there are also many pitfalls waiting for less-experienced and less-disciplined managers who may not have the experience of investing through cycles or who may simply be prioritizing gathering and deploying assets.

We expect today's higher-for-longer rate environment to reveal which managers have been doing the hard work of staying disciplined in underwriting, negotiating stringent documentation and actively monitoring their portfolio, and which managers have not. This is a market environment where manager selection is vital, and we should see a growing dispersion of returns among asset gatherers and true credit investors in private credit.

Sources: Leveraged Commentary & Data (LCD), PC & MM Q1 2024 Quarterly Stats, as of March 31, 2024.

Real estate

Outlook is robust for CRE market, but interest rate environment remains a source of concern

Ryan Severino
Chief Economist, Head of U.S. Research

Macro environment promising amid policy challenges

With the first half of 2024 behind us, the narrative for the U.S. commercial real estate (CRE) market remains largely unchanged. The economy continues to expand, supporting generally healthy space market fundamentals, which are maintaining their general trajectory, both overall and within each property type. But capital markets remain largely stymied by relatively high interest rates. Consequently, many participants in the CRE market are growing increasingly frustrated with the U.S. Federal Reserve and monetary policy. Despite these challenges, the balance of risks still skews positive for CRE over the next 12–18 months. We remain broadly positive on the outlook and continue to foresee better overall performance for CRE over the balance of the year.

CRE market outlooks by sector

Industrial – This sector remains the darling of CRE and now stakes a claim as the bellwether property sector, a title formerly held by office properties. Because of this, many observers look to industrial as a gauge for the overall health of the CRE market. Though normalizing, industrial still looks broadly favorable, in our view. While we project excess supply and vacancy rate increases roughly through year end, we maintain a positive outlook for industrial over the five-year forecast period and do not foresee industrial relinquishing its crown as the strongest property sector.

Retail – Continuing its strong performance during the first quarter, retail quietly benefited from a combination of low vacancy and healthy rent growth. Consumption remains the dominant force driving the U.S. economy and retail centers – critical sources for both goods and services – remain the dominant avenue of access for consumers. Our outlook remains positive: while we foresee relatively little upward pressure on vacancy rates over the forecast horizon, the sector will struggle to maintain the outsized rent growth of the last few years.

Multifamily – The sector surrendered its title as the darling of CRE to industrial during the latter stages of the prior business cycle. Multifamily had been on a strong run since the 2007–2009 Global Financial Crisis and some slowdown proved inevitable. But one should not read too much into that. Although new construction currently exceeds demand, that should reverse by roughly year end. We maintain a positive outlook for multifamily over our forecast horizon – vacancy rates should stabilize toward the end of this year before beginning another down cycle while rent growth should slowly reaccelerate.

Office – Remaining the most challenged of the major property types, the market is gradually adjusting to excess supply in office, particularly of older obsolete space. That inventory adjustment process will likely unfold over a number of years. But as is often the case, it appears to us that CRE market participants may have overreacted to office's plight. While we don't expect the fortunes of office to swing wildly back toward pre-pandemic norms, the market is not completely imploding either. And moving forward, a number of individual office markets will almost surely outperform many markets in other property types.

Emerging Sectors – These growing sectors are increasingly playing a more important role in investment portfolios. **Cold storage** boasts strong performance in market fundamentals as an integral part of the global food supply chain, especially as its inventory ages. **Data centers** also offer strong fundamentals as a critical component of the digital infrastructure. Furthermore, only modern data centers can meet the increased demand for storage and brute-force mathematics capabilities. **Build-to-rent communities** (**BTRC**) are offering opportunities to invest in single-family dwellings at scale. Fundamentals are preforming well as demand for housing inexorably increases and supply growth badly lags.

Capital markets – Investment activity showed additional signs of stabilizing during the first half of the year. Total transaction volume remained effectively flat and cap rates ticked higher, but at a slower pace than during the last two years. Income returns have maintained consistency over the last couple of years. The main drag on total returns – appreciation returns – remain negative, but less so in recent periods. And higher frequency measures of return, such as monthly measures, are tentatively showing that the overall CRE total return is already reverting to positive territory.

CRE credit markets remain largely shut down due to elevated interest rates, but performance largely reflects the performance of specific property sectors. Retail, industrial and multifamily loans are faring relatively well, while office and hospitality loans are coming under pressure. Over time, we expect this pattern to roughly persist, even as overall performance should improve as interest rates ultimately decline.

Monetary policy remains key

At this midyear point, the main risks to the CRE investment market remain exogenous, namely monetary policy. Endogenous risks remain limited, in our view. Market fundamentals are faring well amidst ongoing demand and subdued construction activity. Valuations have already been marked down considerably from cycle highs, and we expect that they are nearing, or are possibly at, a bottom. That offers better opportunities for appreciation returns over the medium term. Increased transaction volume and liquidity should help facilitate such returns.

And we expect that debt markets, limited by the interest rate environment of the last two years, should thaw and become more active. But the key to all of this remains monetary policy. Until the Fed begins cutting rates, the CRE market will only make incremental progress. We foresee monetary policy turning sooner than later, but not just yet.

Sources: CoStar, Jones Lang LaSalle (JLL), 2024.

Infrastructure

Monetary policy at an inflection point, as longer-term megatrends continue to shape this growing market

Jack Paris
Chief Executive Officer

Richard Crawford
Partner, Head of Energy Income Funds

Edward Hunt
Partner, Head of Core Income Funds

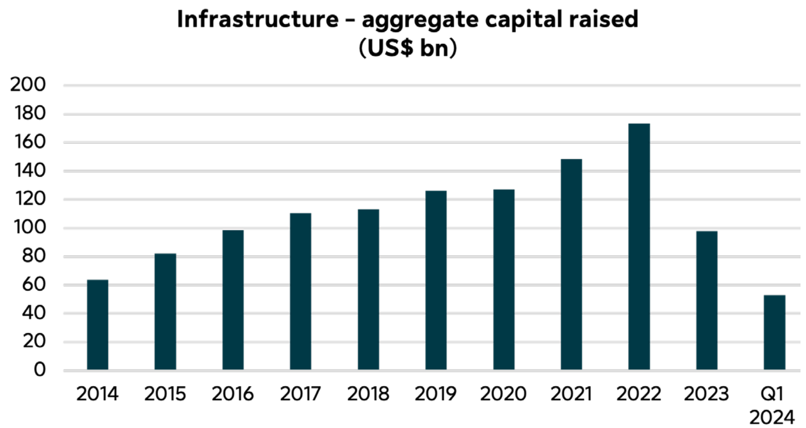
Stephane Kofman
Partner, Head of Capital Gain Funds

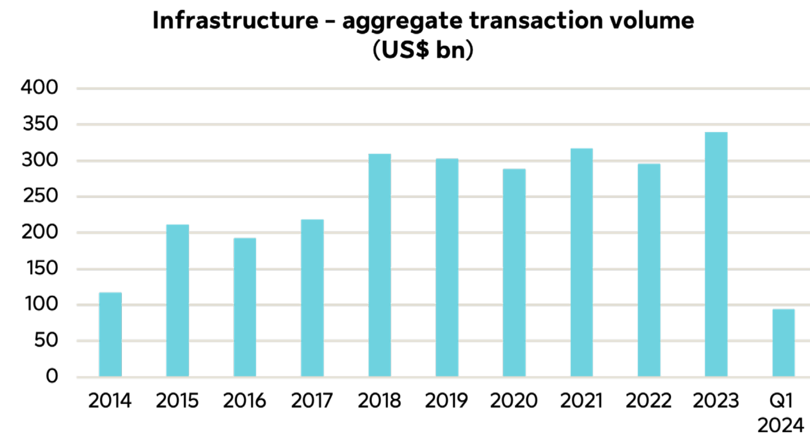
Rate pressures continue as near-term influences on infrastructure

The dominant short-term theme in infrastructure has been a degree of price adjustment and dislocation in the market, largely driven by the sharp increases in interest rates of the recent past. While there were some policy pivots in June 2024, with the central banks of Europe and Canada taking tentative steps toward rate easing, continued pressures from high rates in the United States and United Kingdom still have the capacity to affect asset valuations and deal flow. Having said that, infrastructure continued to prove resilient compared to other alternative asset classes, particularly with GDP-linked sectors such as energy and transport – supported by the resilient growth environment – and with digital infrastructure thriving as well amid an unprecedented acceleration in data demand driven by AI.

In terms of deals flow, higher rates led to a greater investor focus on value-add strategies over core. With investors already receiving higher income from traditional bonds amid elevated rates, interest in infrastructure has gravitated toward the higher end of the risk/reward spectrum. Furthermore, the short-term uncertainty on policy has led to a widening in bid–ask spreads, with a discerning buy-side, placing a greater emphasis on testing asset prices, coupled with a sell-side less incentivized to put assets on the market. At the mid-year point of 2024, the volume of infrastructure transactions, particularly for core assets, had moderated somewhat when compared with recent years, with certain deal processes also taking longer as well.

Capital raises, transaction volumes moderating in early 2024





Source: Preqin, InfraLogic, as of June 2024. Aggregate transaction volume includes deals labeled as "Greenfield" and "M&A."

However, it is important to note that the pricing environment for high quality assets continues to be strong, supporting transaction volumes. Similarly, after a very challenging past 18 months in terms of the fundraising environment, positive momentum can now be observed for established managers with a differentiated and proven investment proposition.

Infrastructure (cont.)

Jack Paris
Chief Executive Officer

Richard Crawford
Partner, Head of Energy Income Funds

Edward Hunt
Partner, Head of Core Income Funds

Stephane Kofman
Partner, Head of Capital Gain Funds

Global monetary policy at the crossroads

While high rates continue to be a potentially disruptive market force, we may also be at a possible inflection point in monetary policy. As previously mentioned, some central banks, such as the European Central Bank, have enacted rate cuts, and policymakers in the U.S. and U.K. have also signaled greater confidence that inflation is increasingly under control. This suggests that these two major economies could now be beyond peak interest rate levels and could possibly move to easing mode in the second half of 2024.

This could serve as a catalyst for infrastructure investment, as increased macroeconomic confidence could help move investment capital off the sidelines. We expect this to also provide stronger structural support to valuations in the sector.

Investing in "4-D" megatrends

The longer-term picture for infrastructure continues to be promising, in our view, with the capacity for growth driven by the "3-Ds" of thematic megatrends we have discussed in our previous outlook statements:

Decarbonization – with continued efforts to decrease fossil fuel reliance and support electrification of heat and transport in addition to pushing for increased roll out of renewables.

Digitalization – including the expanded development of AI and the significance of cloud computing and other technological initiatives, boosting the volume of data and demand for digital infrastructure and data centers in particular.

Demographic changes – with ageing populations in major developed economies and increased migration to urban areas reshaping infrastructure demand patterns and investment needs.

We would note, however, the emerging importance of a "4th D" in the equation, that of "deglobalization," with rising trade barriers leading to a reshuffle of supply chains and a reshoring of production capacity, and policy, such as the Inflation Reduction Act (IRA), aimed at stimulating investment in new infrastructure in the areas of clean energy, transportation and the environment to drive economic growth, job creation and a modernization of ageing infrastructure, which in many cases has been in decay for some time and is in urgent need of reinvestment. That these four megatrends continue to grow in importance, along with the capital outlays needed to fund them, means greater opportunities for infrastructure investors to participate in a long-term secular growth story. The opportunity set becomes more pronounced in the post-COVID era, in which government balance sheets have become strained due to increased public spending, which in turn opens the door wider for private investors.

Risks remain in the infrastructure space, from uncertainty around the growth outlook, to the possibility of greater geopolitical turmoil in the Middle East, Ukraine and other regions leading to increased market volatility and supply chain disruptions leading to construction delays and cost overruns for new infrastructure projects. However, given the pivotal role that the asset class plays for the energy transition and a widening investment gap, we anticipate continued support from policymakers and interest from investors in this rapidly evolving asset class.

Sources: Preqin, InfraLogic, 2024.

Insurance asset management

Peter Cramer
Senior Managing Director, Head of Insurance Portfolio Management & Trading

Nitin Chhabra
Managing Director, Head of Insurance Solutions

Louis Pelosi
Managing Director, Client Solutions

"Higher for longer" creating considerable opportunities for insurers to add yield

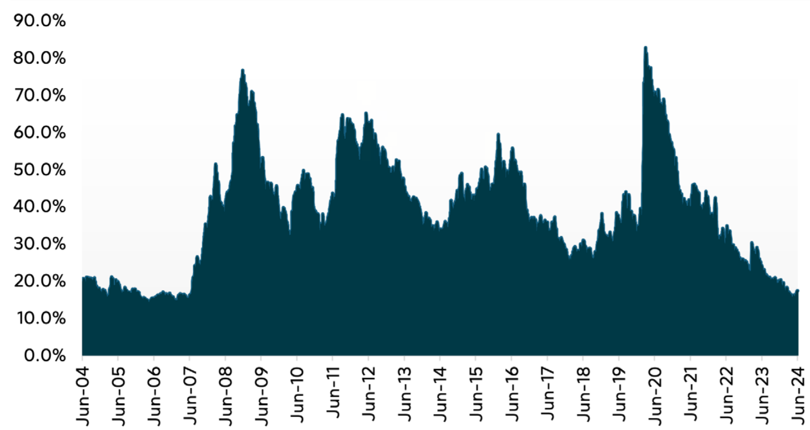
Shifting market expectations prolong higher reinvestment yield environment

Macroeconomic conditions and a shift in market outlooks have created considerable opportunity at the mid-year point for insurers to increase income generation. Such opportunities might encompass both the public and private markets – with the latter including investment grade (IG) private credit, direct lending and real estate debt.

Strong growth, persistent inflation and a cautious U.S. Federal Reserve have all contributed to the market walking back its expectation for aggressive rate cuts in 2024. This has resulted in a higher-for-longer interest rate environment and prolonged the opportunity for insurers to add attractive yields to their portfolios in both public and private markets across the curve. Despite the inverted yield curve, given the high absolute level of rates we've increasingly seen clients thinking about extending duration on the margin within their public fixed income portfolio, enabling them to lock in higher yields for longer. While there is much uncertainty surrounding the future path of interest rates, what is certain is that any such move to extend duration should include careful consideration of the amount of liquidity needed to be held in adverse scenarios – be it a natural catastrophe for property and casualty insurers or a mass lapse event for life insurers – along with the available sources of liquidity including operating cash, investment income and lines of credit.

While rates have increased, spreads have continued to tighten on strong corporate fundamentals and technical tailwinds as the demand for income remains high from all types of investors in this space. The opposing moves of rates and spreads have created a dynamic where spreads as a percentage of all-in yields are at historical lows, even with record IG corporate bond issuance in Q1 2024. As a result, we generally remain cautious on credit exposure as spreads do not appear to be pricing in potential risks and headwinds of a slowing consumer in the coming year, as evidenced by the diminishing ratio of option-adjusted spreads to yield-to-worst.

Option-adjusted spread/yield-to-worst ratio for U.S. corporates at historic lows



Source: Bloomberg, as of June 2024.

Current opportunities to increase investment income

We see areas of opportunity for insurers across the spectrum to maintain quality positioning while providing attractive levels of investment income not seen in many years:

- Within public fixed income, securitized assets (mortgage-backed securities, asset-backed securities, collateralized loan obligations) offer potential relative value opportunities in the IG part of the market. Meanwhile, narrowly syndicated credit continues to offer a significant yield advantage above high yield bonds and broadly syndicated loans in the non-IG space.
- We continue to see strong relative value in IG private credit, particularly in the intermediate part of the curve, due to the inverted yield curve and lower competition for intermediate duration bonds. As these bonds primarily come with fixed rates, the opportunity to "lock in" these yields is compelling for all types of insurers. Within the IG private space, we note specific interest in private structured credit, specifically asset-backed finance and fund finance/net asset value (NAV) lending.
- Also on the private credit side, we are seeing increasing levels of interest and allocation to direct lending as a result of double digit yields and the potential for downside protection in this space, given strong levels of collateralization and direct lending's senior position within capital structures.
- Finally, while real estate headwinds in certain sectors have kept some investors at bay, we're observing more activity with insurers on the real estate debt side as a result of the yield profile of the asset class and capital efficiency in many regulatory regimes.

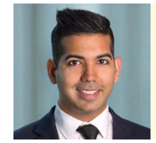
The remainder of 2024 is likely to bring surprises stemming from any number areas, including the degree of success of central banks to curb inflation while increasing growth, the upcoming U.S. elections and, perhaps, even from updates on the insurance regulatory front. These surprises have the potential to negatively impact insurer investment portfolios. Fortunately, notable opportunities exist for insurers to meet their income and total return objectives while minimizing the negative impact of adverse market events.

Source: Bloomberg, 2024. Investment grade credit ratings of our private placements portfolio assets are based on a proprietary, internal credit rating methodology that was developed using both externally purchased and internally developed models. This methodology is reviewed regularly. More details can be shared upon request. There is no guarantee that the same rating(s) would be assigned to portfolio asset(s) if they were independently rated by a major credit ratings organization.

Retirement plan solutions

Plan sponsors look to lock in higher rates as funded statuses remain strong and markets stabilize

Tim Boomer
Senior Managing Director, Head of Client Solutions

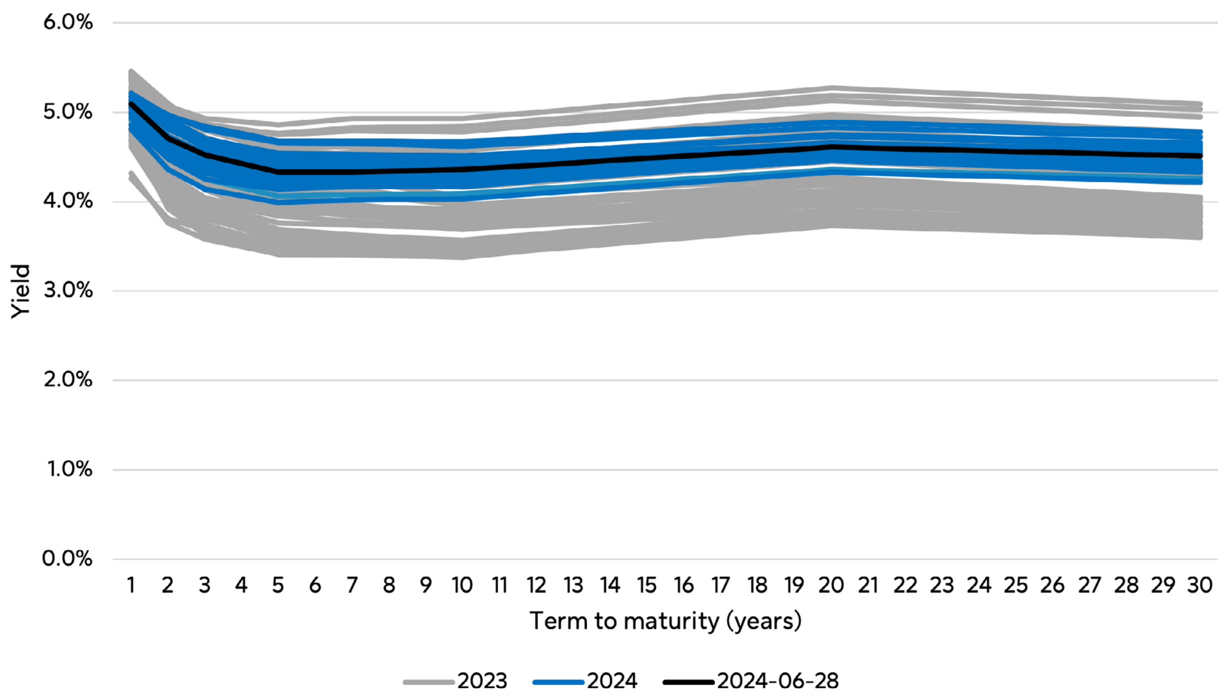


Ashwin Gopwani
Managing Director, Head of Retirement Solutions

Rate markets stabilize, plan sponsors reassess LDI portfolios

The 2024 calendar year thus far has exhibited much more stability in rate markets compared to 2023. With inflation easing, central bank rate cuts are anticipated later this year in the U.S, and have begun in Canada and Europe. While rates were at historic highs in 2023, the volatility of rates and their potential continued upward movement, coupled with a hot equity market, made it difficult for plan sponsors to adopt a change in their pension plan strategy. As rates stabilize, the potential of a drop in rates becomes more likely and consensus builds that the stock market rally can't continue, we've seen heightened interest from plan sponsors in de-risking to lock in the higher yields while they last. As long as these economic factors continue to hold sway, we expect this trend to persist.

Yield curve volatility has eased, although inversion persists



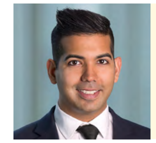
Source: Bank of Canada, weekly yield curve data for zero-coupon bonds, as of May 22, 2024. Dispersion between curves within each data series reflects the degree of yield curve volatility in the corresponding year.

Continuing from trends seen in 2023, plan funded statuses have improved in 2024 to date, driven by yield increases combined with strong equity performance. Furthermore, as of the end of June, corporate discount rates have fallen due to tightening credit spreads, but remain near 10-year highs, according to the Society of Actuaries' FTSE Pension Liability Index – Short. As a result, based on our observations plan sponsors have shown increased appetite for either increasing allocation to liability-hedging fixed income or for lengthening duration of existing fixed income portfolios to protect funded status gains and capitalize on the higher-yield environment.

Retirement plan solutions (cont.)

Tim Boomer

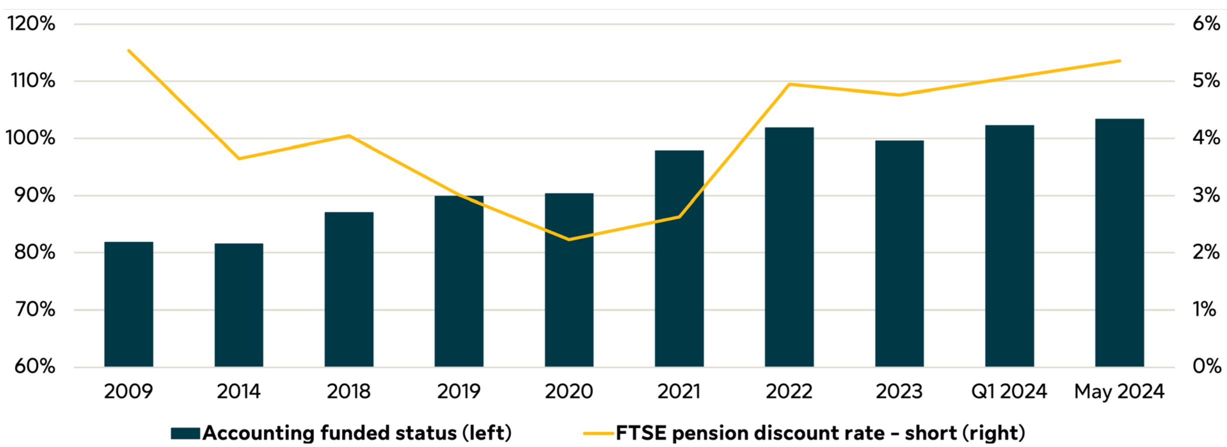
Senior Managing Director, Head of Client Solutions



Ashwin Gopwani

Managing Director, Head of Retirement Solutions

Strong financial positions and high discount rates suggest an opportune time to reduce risk



Sources: Accounting funded status based on Milliman Pension Funding Index (as of May 2024), which tracks the average accounting ratio of the 100 largest defined benefit pension plans sponsored by U.S. public companies. FTSE pension liability discount rate based on the FTSE Russell methodology and shown for the short (10–12 year) duration liabilities.

Diversification and yield enhancement in focus for fixed income portfolios

As fixed income portfolios grow in defined benefit plans, we expect plan sponsors to look for ways to generate higher yields to keep pace with liability growth, and to sufficiently diversify exposure to credit downgrades and defaults. Consequently, plan sponsors are increasingly looking outside of traditional credit to help meet these needs.

Structured product and private credit (both traditional and investment grade [IG]) can fit the bill and have garnered interest among many plan sponsors. Such investments can provide spreads that outpace comparably rated corporates. In our view, skilled managers can incorporate structured products into a liability-driven investing (LDI) portfolio in a way that continues to maintain a high correlation to corporate credit without gaining direct name exposure.

IG private credit can be used to improve a plan's fixed income diversification profile without detracting from interest rate hedging by introducing medium- and long-dated fixed exposure to issuers and sectors not found in public corporate markets, in addition to potentially higher yield due to complexity and illiquidity. Traditional private credit has surged in popularity as a return enhancer for less liability-oriented investors such as public pension plans, some of whom have recently introduced new long-term strategic allocations to the asset class within their portfolios, or as a component within an LDI strategy to generate additional yield and income with reduced volatility compared to equity.

Seeking duration extension through U.S. 20+ STRIPS

For plan sponsors interested in extending duration without reducing the allocation to return-seeking assets, leverage is traditionally a good candidate. However, yield curve inversion has made leveraged strategies more costly to employ, as the embedded short-term financing costs currently exceed long-term yields. As such, we have seen some resistance to the use of leverage, and we have seen plan sponsors consider options for mitigating this impact, such as lengthening duration through the use of U.S. 20+ STRIPS. Until rate cuts commence and financing costs fall, we expect to see plans continue to pursue duration extension through physical instruments and to only consider leverage when the opportunity for extension through physicals has been exhausted.

Troubled waters ahead?

There are no guarantees that the balance of 2024 will herald the same good fortunes seen in the first six months, and the potential headwinds are numerous. From ongoing global conflicts and the upcoming U.S. election to the success of central banks, particularly the U.S. Federal Reserve, at curbing inflation while staving off a recession, there are number of pitfalls that market actors will need to manage carefully. In times of higher risk, the benefits of derisking and diversification are at a premium, and we expect increased activity in areas that support plan sponsors in these objectives, such as LDI and real assets.

Sources: Bloomberg, Society of Actuaries, Milliman, 2024.

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All data are subject to change.

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