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# Learning Insights

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Specter of stagflation haunts markets once more



## Private funds feeling the pressure

*For at least a decade, private assets – equities, credit, real estate, and other alternative assets that are not publicly traded – had been experiencing a boom, driven by the growing popularity of alternative assets after the global financial crisis of 2007-2009 and a broad bull market in asset prices, underpinned by extraordinarily low interest rates. While the relative performance of alternative assets was mixed, they did well in absolute terms, and the period was highly lucrative for alternative asset managers who charge higher fees than more traditional managers. But the private asset business is now beset by a number of headwinds set in motion by higher interest rates.*

The boom in private assets was born out of the historically low interest rate regime that prevailed for more than a decade as central banks worldwide dealt with the consequences of the global financial crisis. According to a recent report by the International Organization of Securities Commissions (IOSCO), private funds have grown fivefold since 2008, with assets under management now standing at USD 13 trillion.

The emergence of higher inflation in 2021 forced central banks to reverse course and hike rates aggressively. The bigger “surprise,” however, has been the persistence of inflation, even amid much higher rates. This has led central banks to signal their intent to hold rates “higher for longer,” dampening the prospects of a “soft landing” that many were hoping for. This combination has slashed public and private asset values and darkened the outlook for the private sector, where the impact on asset values may not yet have been fully felt.



## Higher rates to slash private asset values

Whereas publicly quoted assets – such as stocks, bonds and exchange-traded funds – can be valued instantaneously, private assets are typically valued on a quarterly basis. This lag effectively makes them less transparent, subject to sudden, sharp corrections, and regulators have frequently expressed concerns about the scope for price manipulation arising from the lack of transparency. The IOSCO report highlights potential asset value markdowns as a key risk to the private assets sector.







For private funds, interest rate “normalization” means that portfolio companies face higher rates on existing borrowing (which is typically floating rate), as well as on new and refinanced borrowing. IOSCO notes that market participants believe these risks to be “*especially stark*” over the medium to long term. While private equity firms are believed to have accumulated a significant amount of “dry powder” (capital committed by investors but not yet invested), it is unclear how much and whether this will be sufficient to cushion the blow to invested assets.

In private credit, flexible financing arrangements may help portfolio companies navigate short-term market strains, but defaults are likely to increase over the medium to long term. IOSCO expects “*significant impacts on concentrated sectors that have become reliant on a constant flow of affordable funding.*”

Meanwhile, privately held real estate assets (both equity and debt) are thought to be particularly vulnerable, with severe drawdowns in publicly quoted real estate proxies (the stocks and bonds of homebuilders, and REITs, for example) potentially signaling tough times ahead.



### Outlook for hedge funds

For hedge funds, the implications are more nuanced. Insofar as most hedge funds use leverage in their strategies, they are on aggregate vulnerable to higher borrowing costs.

However, not all hedge fund strategies are alike. The levels of leverage used, as well as the liquidity of the traded assets, vary considerably from strategy to strategy.

Those that require large amounts of leverage to exploit minor price discrepancies – fixed income arbitrage, for instance – may well suffer, as may funds that invest in illiquid assets, which they can get stuck in (a risk similar to that facing private equity funds). But strategies that trade primarily in liquid assets, with relatively low leverage, should be able to pare down risk quickly. Then there are those strategies that may even profit handsomely from the volatility that the rates turmoil generates. Global macro and directional systematic strategies are traditionally best placed to benefit from such regimes – provided, of course, that they get the direction right.





### Excess leverage the key concern

The primary concern for regulators is excess leverage and the systemic risk it might pose. Hence, the Financial Stability Board (FSB), an international body that monitors the global financial system, has developed a comprehensive work program to address the potential threat to financial stability posed by leverage in nonbank financial institutions (NBFIs). The emphasis is on hedge funds, given the potential transmission of risk through their prime brokers to the broader financial system (prime brokers, which are the main providers of leverage to hedge funds, are also typically arms of large, systemic investment banks). At a minimum, the FSB will demand greater transparency from the hedge fund sector, and is likely to recommend that banks demand more collateral from this sector.



### New SEC regulations addressing private funds

Amid these gathering storm clouds, the US Securities and Exchange Commission (SEC) has announced a set of new requirements aimed at increasing transparency, fairness, and accountability for the private funds industry. The new SEC regulations include rules that oblige private fund advisors to:

- Provide investors with quarterly fees and performance reports
- Obtain an annual financial statement audit for each private fund they advise
- Obtain a "fairness opinion" or "valuation opinion" regarding any advisor-led secondary transactions
- Prevent preferential treatment toward some investors – when it comes to fund redemptions, for example
- Restrict various types of activity contrary to the public interest and the protection of investors, such as the charging of any fees and expenses that do not fall within the fund's specified fee structure (for example, fees relating to an investigation of the advisor)







These measures are echoed by comments from IOSCO regarding conflicts of interest in private finance, such as those that can arise between the investors in a single asset manager's separate investment products – if, for example, the firm's debt fund lends to portfolio companies in one of its equity funds. IOSCO also points to conflicts of interest in some aspects of valuations, transaction negotiation practices, and general partner-led secondary markets.

Given the challenges posed by the increased cost of debt, some funds may be required to seek equity financing, at potentially unfavorable valuations given the stress already seen in public equity markets.

**Intuition Know-How has a number of tutorials relevant to the content of this article:**

- Private Equity – An Introduction
- Private Equity – Investing
- Private Debt
- Hedge Fund – An Introduction
- Hedge Funds – Strategies
- Hedge Funds – Investing
- Real Estate – An Introduction
- Real Estate – Investing
- Real Estate – Valuation
- REITs
- Monetary Policy
- Financial Authorities (US) – SEC

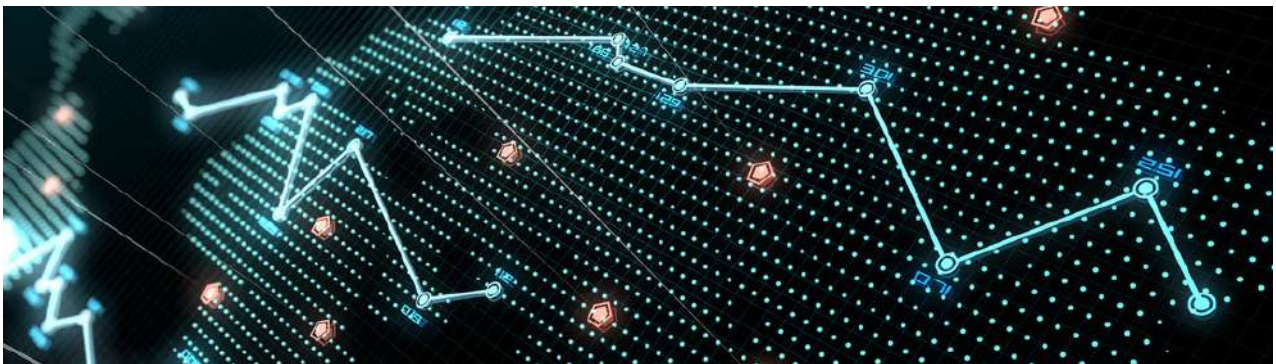




## Specter of stagflation haunts markets

*The response of central authorities to the pandemic was decisive – reflationary policies that injected massive amounts of money into both the financial system and the real economy, turbocharging credit growth and asset valuations. However, the unintended consequence of all this stimulus was an unwelcome surge in inflation, exacerbated by the energy price shock caused by Russia's invasion of Ukraine in February 2022. High and persistent inflation forced a sharp shift from a highly accommodative monetary policy stance to aggressive monetary tightening. These measures have already caused considerable stress in markets, with potentially much more to come.*

Inflation remains persistent throughout the globe, while growth has stalled in many regions, having proven far more resilient than anticipated. This combination has raised the specter of a phenomenon not seen since the 1970s – stagflation, which is a combination of low economic growth, rising prices, and high unemployment.



### Echoes of the 1970s

The echoes of the 1970s are clear. The shockwaves that Russia's invasion of Ukraine in February 2022 sent through energy markets were starkly reminiscent of the oil price shock of 1973, when Arab nations imposed an oil embargo on the US and other countries that supported Israel in the Yom Kippur War. The alarming recent breakout of violence in the Israel-Gaza conflict has clear resonance too. A common feature of both energy price shocks is that they made an existing inflation problem worse.

The policy responses to the inflation shocks were also similar. In 2022, as in the 1970s, the US Federal Reserve was forced to maintain an aggressive monetary tightening stance – the rate hiking cycle that began in early 2022 may not yet have run its course.

### Important differences

However, there are important differences. While the 1970s oil price shock and the subsequent policy response plunged the US and much of the world into recession, developed economies have so far proven much more resilient to the more recent shock.

There are several likely reasons for this resilience.



First, unlike in the 1970s, the US today is a net exporter of oil, and therefore much less sensitive to global supply shocks.

A second factor was a raft of stimulus measures implemented by Western governments aimed at countering the effects of the Russia-Ukraine energy market shock. The US government passed the so-called Inflation Reduction Act, which included (among other measures) a release of the US strategic petroleum reserves (SPR), helping to alleviate supply shortages and drive oil prices lower. Meanwhile, energy price caps imposed by European governments helped to cushion the blow of soaring European natural gas prices, with the Russian gas tap effectively turned off.

A third development that may have buoyed growth and helped to avert recession was a pronounced yield curve inversion (short-term interest rates rising well above long-term rates), which helped to anchor long-term borrowing costs.

The upshot of these various measures was that unlike in the 1970s, recession was avoided. Growth across developed markets even surprised to the upside heading into 2023, as inflation abated and, crucially, the labor market in the US showed no signs of weakness. This backdrop set the stage for strong gains in risk assets through to July 2023.



### Renewed storm clouds

However, clouds soon started to gather again. Following sharp declines, oil prices found a footing in July-August and have been rallying since, driven by a combination of buoyant demand, OPEC production cuts, and the US government buying oil to replenish the depleted SPR.

This pick-up in the oil price has coincided with inflation creeping higher again, with successive CPI readings above 3.5% in recent months – the first negative surprises since 2022. The stubbornness of inflation was one of a handful of factors (another being heavy supply from the US Treasury) contributing to a bond market rout over the summer, in which long-dated bonds bore the brunt of the selling. The resultant yield curve steepening has undone much of the prior inversion, causing ructions in bond markets as markets priced in “higher for longer” interest rates.

Meanwhile, growth has shown signs of slowing. This current backdrop – a weakening economy amid stubborn inflation, with rising oil prices, and a steepening yield curve – is exactly what stagflation looks like.







### Countervailing deflationary forces

Before we get to what a new era of stagflation might mean for financial markets, it's important to note some powerful forces acting against it. A big one is China, which is currently in the process of unwinding its real estate bubble built over decades. This has caused debt deflation, with echoes of post-bubble Japan of the 1990s.

Another is the outsized national debts and deficits in the developed world – most importantly, the US. An adjustment needs to happen, and the IMF, among others, has been urging governments to rein in their deficits. It's hard to imagine inflationary pressures persisting in a world where China exports deflation while the US and other governments get serious about reducing their deficits, effectively reversing the various stimulus measures that drove much of the inflation in the first place. And even if governments don't get serious about deficit reduction, this may only force central banks to hold rates even higher for even longer, which should then keep a lid on inflation.



### Market implications

Assuming stagflation were to prevail, despite the deflationary winds described, what might the implications be for financial markets?

Stagflation is generally bad for bonds and most financial assets, but good for real assets, such as commodities. On the face of it, then, investors should shun bonds and buy commodities, commodity-related equities (oil and mining stocks, for example), and the equity markets of commodity exporters, such as Brazil, South Africa, and Australia.

However, starting valuations must also be considered – what are these different assets pricing in? Having taken a severe beating since the end of 2021, bonds have priced in a lot of the bad news. US Treasuries are now offering positive real yields (nominal yields minus inflation – compare 4.8% on 10-year USTs, for example, to current CPI around 3%). In other words, inflation would have to rise almost two percentage points from here to erode this positive real yield, leaving a decent margin of safety for bonds. The same cannot be said for US equities, which are looking expensive in most scenarios, pricing in decent earnings growth over the next two years, and therefore highly vulnerable to negative growth surprises.







What about those inflation/stagflation beneficiaries – commodities, Brazil, and so on? While these markets have outperformed over the past two years, they are still a long way from undoing their dramatic underperformance versus US equities experienced during the disinflationary post-financial crisis period. This leaves them looking relatively cheap, at steep discounts to US equities, with plenty of catch-up potential should inflation/stagflation persist.

A Deutsche Bank report from last year on those parallels between the current environment and the 1970s sums up as follows.

*Overall, the main takeaway should be that if inflation stays high for many years, both history and today's high starting valuations suggest it will be very difficult to generate positive real returns in most traditional financial asset classes. Nominal returns will also likely notably underperform their long-term trend. Commodities could be the exception.*

*-“Investing during Stagflation: What happened in the 1970s,” Deutsche Bank Research*

To sum up, then, this is a complicated environment with all sorts of variables. Nobody knows what sort of regime will prevail. However, whether it's stagflation or something else, the unusual mix of ingredients in play means there's a decent chance it will be one most market participants are unaccustomed to.

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- Bond Markets – An Introduction
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- Equity Markets – An Introduction
- Equity Valuation – An Introduction

