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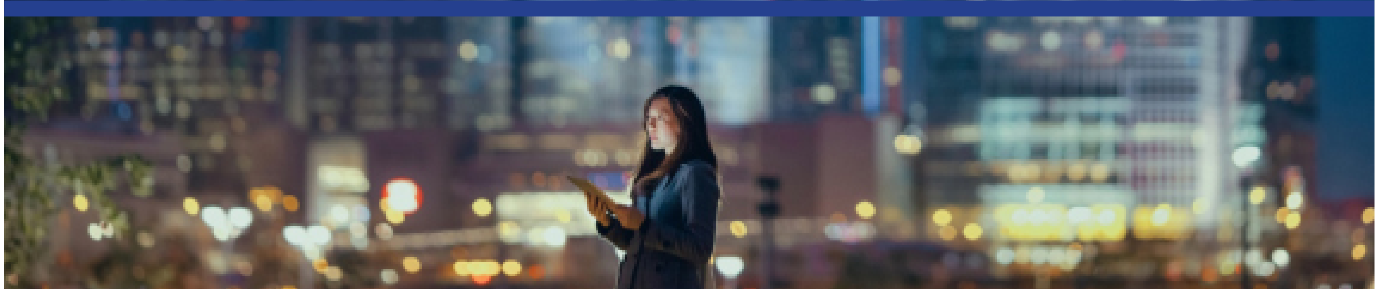

July 9, 2023

CIO Strategy Bulletin

David Bailin
Chief Investment Officer, Citi Global Wealth

Steven Wieting
Chief Investment Strategist and Chief Economist

Stefan Backhus
Head of Strategy, Alternatives

Alternative Investing Through a Slowing Economy

- There are many opportunities for alternative investment managers to take advantage of market stress, capital dislocations and asset repricings. Limitations on bank balance sheets are also changing sources of capital for transactions and major capital expenditures.
- Active management becomes a differentiator in turbulent times. Managers must tap operational resources, rather than leverage, and the high dispersion in markets provides an environment for hedge funds to demonstrate their stock and bond picking prowess.
- These conditions also provide a window for liquidity providers such as hedge funds, private credit funds and secondary private equity funds to buy assets at unusually attractive prices.
- Real estate managers must also be selective in today's environment. The attractiveness of real estate is highly differentiated by sector and geography, with continued strength in industrial and multifamily in the US relative to office. Yet the office sector has pockets of strength in Asia.
- *Despite being somewhat contradictory, recent employment reports make it clear labor markets are still outperforming the economy. When this changes, so will the outlook for US monetary policy. Setbacks in markets today – particularly for assets that have deeply underperformed the narrow leadership of 2023 – are likely to represent even stronger opportunities.*

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Alternatives have remained resilient in 2023

Our [Wealth Outlook 2023: Mid-Year Edition] emphasized the important role active asset allocation may play in driving potentially better returns over the next economic cycle. Investors should consider rotating their portfolios toward different risk assets, geographies and strategies in the second half of 2023 and in 2024. We believe alternative investments can be a key component of this. The sheer diversity of investment strategies available to fit individual risk appetites is especially appealing at turning points in markets.

Our Alternatives Research team has issued its Mid-Year Outlook: Alternative Investments through a Slowing Economy, which assesses the current market environment, identifying challenges and potential opportunities for private equity, private credit, real estate and hedge funds.

The macroeconomic climate has affected capital raising and capital market accessibility for many alternative investment managers this year. At the same time, opportunities to take advantage of market stress, capital dislocations and asset repricings are prevalent. Capital dislocations have created imbalances; securities have been mispriced and competing sources of capital have been sidelined by market dynamics. Limitations on bank balance sheets are also changing sources of capital for transactions and major capital expenditures.

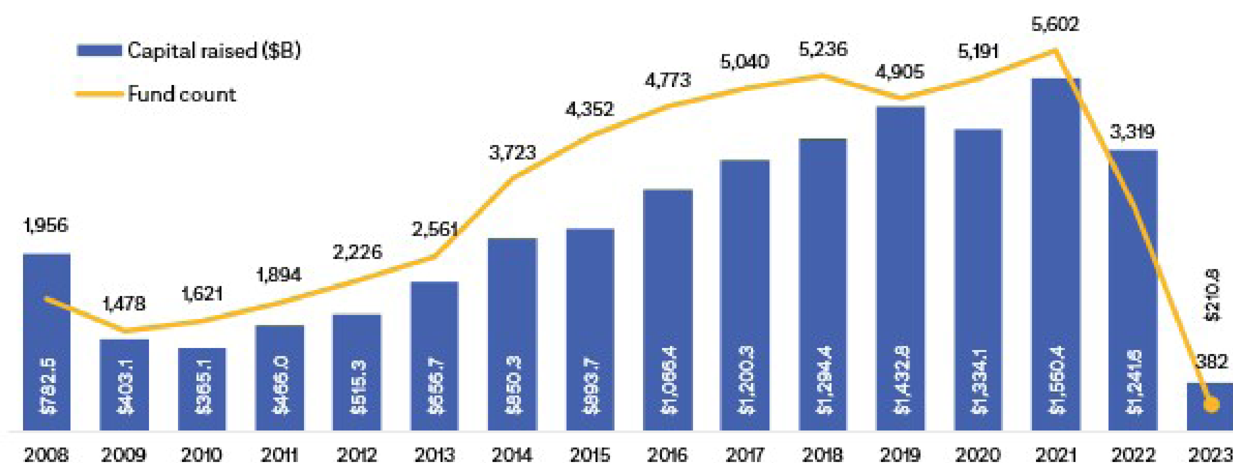
Less capital to fund better opportunities

From a global private capital fundraising perspective, $318.8 billion less was raised in 2022, although commitments of $1.2 trillion was still the fifth-highest amount raised in any year (**Figure 1**). The fundraising trendline saw a further 42% decline year over year in Q1 2023. Early fundraising data for Q2 indicates that capital raised will be flat relative to Q1.[1] There was also emphasis on secondary, private debt and buyout offerings, while venture capital (VC) and real estate fundraising lagged.[2]

The continued fundraising slowdown is in part driven by investor asset allocation. As public markets declined and exits for alternatives became harder, their exposure to alternatives as a percentage of their portfolios went up. Investors attempting to pursue a steady commitment pace have pulled back on the number of managers and strategies they support, rather than ceasing commitments altogether. This consistency of commitments across vintage years is something we continue to advocate. Market timing is never advisable, particularly in illiquid investments.

Notably, funds greater than $1 billion in size secured 75% of all fundraising in 2022 and through Q1 2023. Typically, only the most well-regarded managers are able to raise larger funds. Despite a slower fundraising environment, a subset of the most experienced managers has a significant amount of dry powder available to execute their investment strategies and take advantage of potentially more attractive valuations and/or market dislocations.

Figure 1: Global private capital fundraising is down



Source: Pitchbook as of March 31, 2023. Pitchbook Private Capital includes all global private equity, venture capital, real estate, private credit and infrastructure funds tracked by Pitchbook. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

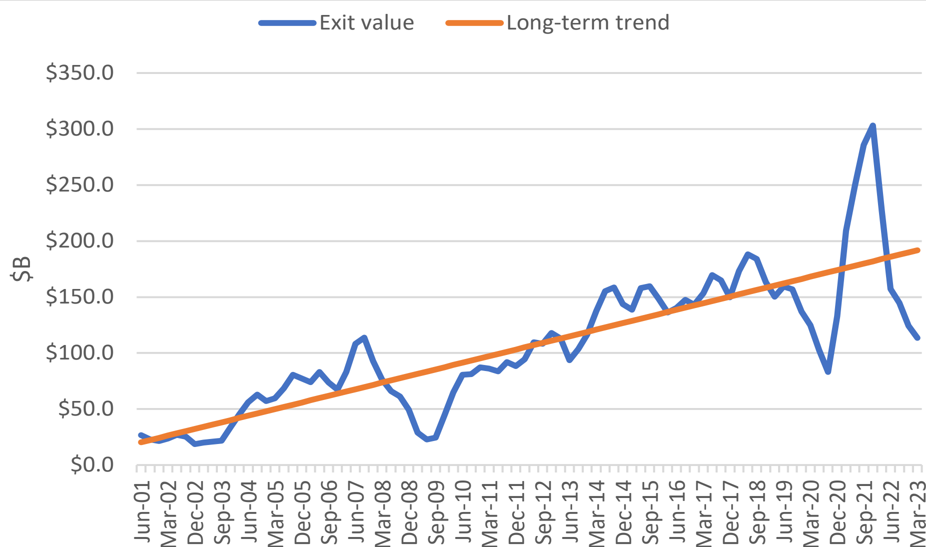
1 Source: Preqin, as of June 29, 2023

2 Source: Pitchbook, as of March 31, 2023

Private equity

For private equity, exit transaction volumes in the first quarter of 2023 continued to decline. Year-over-year exits are down 63% (**Figure 2**). This data is comparable to slowdowns seen in 2008 and 2020. Initial public offering (IPO) markets continue to be effectively closed, with only four US private equity-backed IPOs coming to market in the first quarter of 2023, vs. an average of 17 IPOs per quarter for 2016 through 2021. In addition, M&A markets have been deeply impacted by the uncertain macro environment, increased debt costs and an overall disconnect between buyers and sellers on valuation.[3]

Figure 2: Rolling 6-month private equity exit value ($B) trends



Source: Pitchbook as of March 31, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

General partners (GPs) have adapted to this environment by looking to GP-led secondary transactions to provide liquidity to limited partners (LP). GP-led secondaries have represented 50% of all secondary transactions for the last three years.[4] In a GP-led secondary transaction, a fund manager decides to sell one or more existing portfolio companies into a new investment vehicle which is overseen by the same manager. The GP utilizes a third party (the secondary firm) to anchor the acquisition and negotiate an arms-length transaction for the assets. GP-led secondary transactions are not dependent on the capital markets for execution because they're typically able to leverage the existing credit facilities rather than obtain new debt, as there's no substantial change of control.

Secondary sales of limited partnership interests are an option for qualified investors, however, transaction complexity and steep discounts to net asset value keep many away. In contrast, GP-led secondaries offer upside to their investors via recapitalization and an extension of time for further business growth.

Buyout financing: More equity, less debt

While the ability of companies to access the capital markets has seen periodic relief in 2023 relative to the latter half of 2022[5], 63% of the new bond volume has been for refinancings, rather than acquisitions. Given the rapid rise in yields and the uncertain outlook for corporate profits, credit markets have largely remained closed to companies with weaker balance sheets. Given this lack of liquidity in public markets for new issues, those that did come to market saw 1.0x to 2.0x lower debt multiples than in 2020 and 2021.[6]

[3] Source: Pitchbook, as of March 31, 2023

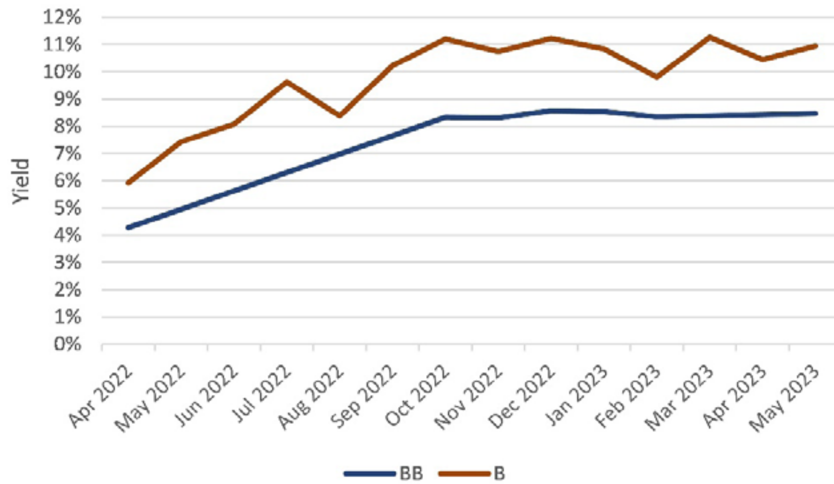
[4] Source: Jefferies & Co. as of December 31, 2022.

[5] Source: LCD, as of May 31, 2023

[6] Source: Leveraged Commentary and Data (LCD), as of May 31, 2023

Borrowers who cannot access public markets are looking to private credit managers and Business Development Companies (BDCs). Lenders are able to get far better terms from these borrowers in 2023, who must sacrifice on structure and price to stimulate interest, providing loan investors better protection and higher yields on performing credit. The average cost for a unitranche middle market loan has risen to 680 bps over the Secured Overnight Financing Rate (SOFR), driving new issue rates near 12% (**Figure 3**).[7]

Figure 3: New issue yields continue to rise



Source: LCD as of May 31, 2023. For illustrative purposes only. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

From a new investment perspective, US private equity deal volume in Q1 2023 was up 11.4% from Q4 2022 at $261.4 billion. This remains above the pre-Covid average of $180.3 billion per quarter. However, 73.5% of this activity is for growth and add-on transactions. Add-ons allow managers to utilize existing credit facilities to complete deals. The cost and limited availability of credit capital means managers must finance deals with equity and less debt, and have high confidence in their ability to drive improved financial performance at the company level.

We expect buyout managers will continue to structure transactions with a higher equity participation and subsequently look to refinance these transactions when debt capital becomes more available and less expensive. A prominent example of this would be the recently completed take-private of Qualtrics by Silver Lake and the Canadian Pension Plan, where the $18.5 billion transaction only utilized $1 billion of debt.[8]

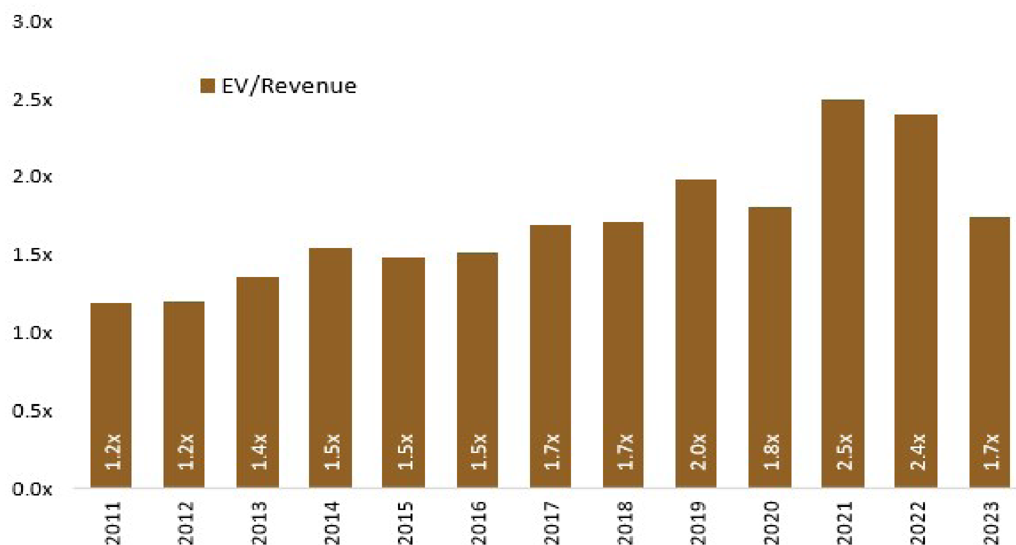
We also expect that valuations will come down to reflect these new realities. This often takes several quarters to occur, as buyers and sellers adjust to the new deal environment. For example, the median enterprise value to revenue multiple for the quarter ending March 31, 2023, was 1.7x for buyout deals in North America and Europe (**Figure 4**). This is down 32%, from a peak of 2.5x in 2021.[9]

[7] Source: LCD, as of May 31, 2023

[8] Source: Seeking Alpha; Qualtrics agrees to $12.5B sale to Silver Lake, March 13, 2023

[9] Source: Pitchbook, as of March 31, 2023

Figure 4: North America and Europe private equity enterprise value/revenue multiples declined in Q1 2023



Source: Pitchbook as of March 31, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Hedge funds

Bad news was good news for hedge funds. Hedge funds saw an uptick in net capital flows of $9.1 billion in the first quarter of 2023 as macroeconomic and financial risks and volatility increased significantly on the back of regional bank failures and other dislocations. Through this volatile backdrop, hedge funds were able to deliver positive performance. The HFRI Fund Weighted Composite Index gained 1.2% in the first quarter, led by both equity hedge and event-driven strategies. From a strategy perspective, macro and relative value, including multi-strategy funds, remained in focus, while equity hedge strategies also saw notable net asset inflows after being out of favor in 2022 amid declines in the broader equity markets.[10]

Equity-oriented hedge funds benefit from dispersion in market performance. Mega-cap technology stocks have been surging in 2023 while most other stocks and sectors were flat or declining.

In May 2023, the S&P 500 Index dispersion rose to its highest level since March 2020, reaching an annualized 36% and bringing the trailing 12-month average to its highest level since 2010. Dispersion was also at or above average for most global equity markets in May, with S&P's Emerging, Developed ex-US and US small- and mid-cap indices in the top quartile of historical observations.[11] Dispersion gives us a way to measure the potential value of stock picking ability, and periods of high dispersion, where stocks trade more independently, should present a greater opportunity for stock picking.

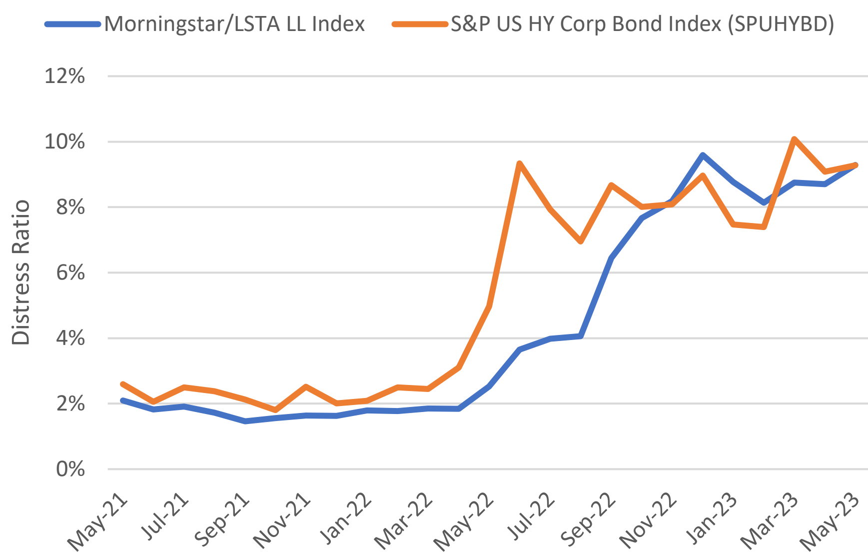
Equity returns in credit markets

The current limited access to capital markets for public and private companies provides a wide set of opportunities for credit-oriented hedge funds. Distressed investors can buy debt at discounted prices and take an active approach to capture higher recovery values. As of May 31, 2023, the number of bonds trading at or above an option adjusted spread of 1000bps represented 9.3% of all bonds outstanding, while 9.3% of leveraged loans were trading at 80% of par, or below. The expanded universe of debt trading at discounted prices also enables managers adept at credit selection to capture elevated yields for stressed bonds and loans that will ultimately remain performing.

[10] Source: HFR, as of March 31, 2023

[11] Source: S&P Global, as of May 31, 2023

Figure 5: Distressed ratio by count for US high yield and leveraged loans



Source: LCD and Morningstar LSTA Leveraged Loan Index as of May 31, 2023. Distressed ratio represents the percentage of bonds in the S&P US High Yield Corporate Bond Index (by count) that are trading at option adjusted spreads at or above 1000bps and the percentage of loans in the Morningstar/LSTA Leveraged Loan Index that are priced at or below 80% of par. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Real estate

Real estate markets are very differentiated by sector. Despite new supply, US industrial vacancy was just 3.5% as of Q1 2023 and remains below the 5.0% historical average.[12] For the multifamily sector, while rental growth is moderating from pandemic highs, net effective rent increased 4.5% year over year in Q1 2023, which remains above the pre-Covid average of 2.7%.[13]

In contrast, post-pandemic global office utilization is at 50% of inventory and the sector faces additional headwinds from volatile capital markets and a slowdown in the economy, particularly in the United States.[14] In particular, “return to office” in the US is lagging Europe and Asia, since in the US there are larger living spaces, affording more in home flexibility, generally longer commutes and a tighter labor market.

It’s a different story in certain Asian developed markets. For example, Covid did not have a material disruption on office occupancy rates in the commercial real estate market in Japan’s major cities. Higher return-to-office rates have been driven by cultural preferences and demographic factors such as age, childcare needs, and relatively small residential space than other global markets such as the US or Europe.

[12] Source: CBRE Industrial Report Q1 2023

[13] Source: CBRE Multifamily Report Q1 2023

[14] Source: UBS as of December 31, 2022

Alternative areas of focus

We believe investors should maintain a disciplined cross-cycle approach to investing in alternatives. Uncertain times can often test that discipline. However, at an asset class level, the long-term outlook for private equity, real estate and hedge funds now looks much brighter than it did during the bull markets of 2021. Based on our Adaptive Valuation Strategies methodology[15], the forecasted annualized 10-year Strategic Return Estimates (SREs)[16] for private equity, real estate and hedge funds are 17.6%, 10.6% and 9.1% respectively. These SREs stood at 11.6%, 8.8% and 4.1% a year ago. The 2022 sell-off and continued broad market weakness has led to valuations becoming more normalized. These cheaper valuations were among the factors that improved the SREs and can potentially help lead to improved return estimates in the future. Specific areas of focus we're identifying over the balance of 2023 and into 2024 include:

- ***Active management via buyouts and hedge funds*** – As highlighted above, pricing dislocations, the high degree of dispersion in equities and less liquid credit markets combine to create an environment where active managers are well positioned to identify interesting companies and acquire them at attractive valuations. This should be seen in operationally focused buyout funds, activist equity hedge fund managers and through the security selection skills of equity and credit hedge fund managers.
- ***The liquidity opportunity for private credit and distressed managers*** - Alternative fixed income managers can be rewarded for providing liquidity in times of limited capital markets availability, allowing them to evaluate financing strategies across the risk continuum while patiently awaiting the emergence of potential stressed/distressed opportunities. In particular, funds that specialize in credit underwriting, capital strategies and distressed restructuring may be well-placed to add value for investors in 2023 and 2024.
- ***GP-led secondaries to add liquidity to illiquid markets*** - GP-led transactions are the fastest growing segment of the secondaries market, because they can facilitate providing needed liquidity to certain investors while also maintaining the current debt capital structures and allowing GPs to retain control of their key investments.
- ***Tech carries on*** – As one of our "unstoppable trends" the disruption and digitization of the world across almost every sector continues unabated. The venture capital and growth equity ecosystem has been the engine of innovation for decades, creating and enabling the fastest-growing companies in the world to mature prior to going public. With IPO markets effectively closed, private investors can acquire positions in tomorrow's disruptors at less lofty valuations than seen at the peaks of 2021. This unstoppable drive to digitization also illustrates the continued need for digital infrastructure investment in things such as data centers, wired infrastructure and mobile facilities.

Confusing signals get louder in the rolling recession

Cues from economic data didn't make the outlook for markets any clearer in the past week. At midweek, payroll processor ADP reported a private sector US hiring boom, saying 497,000 new jobs were added in the past month. In response, financial markets lurched to price in greater Fed tightening, with equities and bonds falling and the US dollar rising. Subsequently, the US Bureau of labor statistics released its own set of "dueling employment reports." The comparable figure for private hiring showed a 149,000 rise, the smallest gain since the Covid-induced recession of 2020.

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[15] Adaptive Valuation Strategies (AVS) is the Citi Global Wealth Investment's proprietary strategic asset allocation methodology. It determines the suitable long–term mix of assets for each client's investment portfolio.

[16] Source: CGW Global Asset Allocation Team data as of Oct. 31, 2022. Strategic Return Estimates (SRE) based on indices are Citi Global Wealth's forecast of returns over a 10-year time horizon for specific asset classes (to which the index belongs). Indices are used to proxy for each asset class. Cash refers to the US Cash SRE. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes use proprietary forecasting methodology based on the assumption that equity valuations revert to their long-term trend over time. The methodology is built around specific valuation measures that require several stages of calculation. Assumptions on the projected growth of earnings and dividends are additionally applied to calculate the SRE of the equity asset class. Hedge Fund and Private Equity SREs are linked to equity SREs. Fixed Income asset class forecasts use a proprietary forecasting methodology that is based on current yield levels. Other asset classes use other specific forecasting methodologies. SREs are in US dollars. SREs are generally updated on an annual basis, however they may be updated off cycle based on market conditions or methodology adjustments. Strategic Return Estimates are no guarantee of future performance. SREs do not reflect the deduction of client fees and expenses. Future rates of return cannot be predicted with certainty. Investments that pay higher rates of return are often subject to higher risk and greater potential loss in an extreme scenario. The actual rate of return on investments can vary widely. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index. All SRE information shown above is hypothetical not the actual performance of any client account. Hypothetical information reflects the application of a model methodology and selection of securities in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading.

With numerous other contradictory reports in mind, it's clear that labor markets are still outperforming the economy. When this changes, so will the outlook for US monetary policy. Setbacks in markets today – particularly for those assets that have deeply underperformed the narrow leadership of 2023 – are likely to represent even stronger opportunities.

Gains in the future for today's losers

Covid distortions of 2020 are still influencing labor markets. As **Figure 6** shows, even the deepest of past recessions barely dented employment in key services industries. Yet in 2020, private services suffered a short depression, an unprecedented 17% drop in employment overall. After losses that have still to be fully recovered in some services areas, there is no reason to expect any drop in headcount near term.

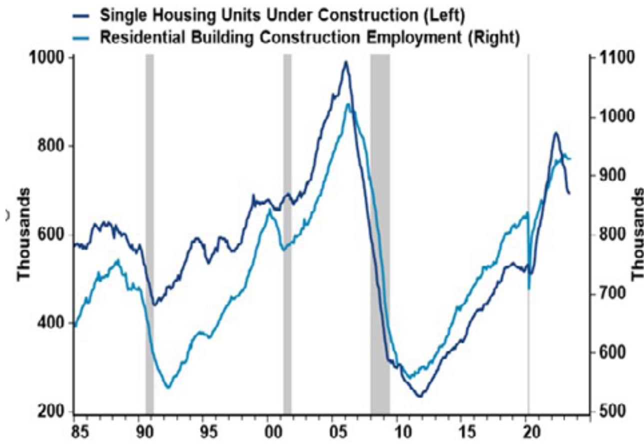
Employment in cyclical industries such as homebuilding has also outperformed expectations. Yet signs of cracks are emerging. Homebuilders are trying to shed inventories despite gaining share of the overall housing market (**Figure 7**). We expect the multi-family home construction market will follow the single-family industry with a lag given a longer construction cycle.

While services spending across most of the world isn't about to buckle, for single-family homebuilders and manufacturing firms, recession is already quite progressed. US manufacturing order surveys have been contracting for 10 months. As **Figure 3** shows, the pace of decline is already subsiding. Customer inventories are beginning to clear in the usual recessionary pattern that leads to recovery, which we expect in 2024.

By 2024, the "pent-up" demand for services will be significantly less. As such, no one should expect a repeat of the broad-base economic boom seen in 2021. But as we noted in last week's reports (see CIO Bulletin and Quadrant), some of the financial assets now priced for recession – such as profitable mid- and small-cap shares – will be poised for recovery instead (**Figure 8**). As we discuss above, this provides a fertile investment environment for active managers.

Figure 6: US employment – leisure and hospitality

Figure 7: US single-family homes under construction vs residential construction employment



Source Haver Analytics as of July 7, 2023.

Figure 8: US ISM manufacturing new orders and customer inventories

Figure 9: S&P 600 Forward P/E Relative to S&P 500

Source Fig 8: Haver Analytics as of July 7, 2023. **Figure 9**: Factset as of July 7, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

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Bond rating equivalence

Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's**[1]	**Standard and Poor's**[2]	**Fitch Ratings**[2]
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
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