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2024 Real Assets outlook: A brave new world?

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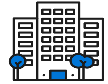
Executive summary

- We are as focused on the implications of high interest rates for economic growth and user demand as we are on their impacts on asset pricing.
- We see strong prospects in 2024 for less cyclical, needs-based assets and businesses. While debt yields are high in a historic context, we believe investors should monitor credit quality and risk-adjusted returns.
- We caution against narratives that position debt and equity separately. Ultimately, we see them as two sides of the same coin.
- In private credit, more cyclical businesses with significant leverage may come under greater pressure, translating into credit issues for investors.
- Capital structures created in a very different rate environment could be challenged by refinancing schedules, particularly in commercial real estate. This may create potential opportunities for long-term investors with flexible capital.
- Marrying cyclical opportunities with structural tailwinds are likely the two key ingredients in generating long-term performance, in our view.
- We see lasting opportunities arising from four key megatrends:

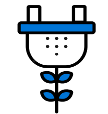
1. Demographics
2. Deglobalisation
3. Digitalisation
4. Decarbonisation

Introduction

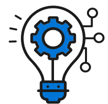
In our outlook for 2023, we highlighted several themes:



Residential and industrial property as sources of relative resilience within real estate.



The growing role for clean energy and natural resource allocations in real asset portfolios.



The wide spectrum of strategies spanning private credit, from growth-oriented sub-investment grade debt to fixed-rate investment grade lending.

The role of private markets in providing diversification and contributing to ESG outcomes in a multi-asset portfolio.

In 2024, we are again highlighting the growing role we expect (clean) energy-related assets to play in real asset portfolios in the coming decade, alongside residential and industrial property.

We also flag the material impact of digitalisation, with positive benefits for assets such as data centres and digital infrastructure networks. Private market allocations remain as important as ever in potentially reducing overall portfolio risk.

For private credit, we believe a weaker economic environment could put pressure on credit quality and investment performance for the growth-oriented end of the spectrum. While 2023 saw an increase in delinquencies, the various indicators don't point to a material deterioration.

In our view, however, this largely reflects lags in the transmission of market interest rates into what borrowers actually pay. We still believe that rates remaining high will lead to a growing number of either non-performing loans or lending that cannot be refinanced under existing capital structures potentially. This is likely to create problems for higher-risk legacy positions – but also opportunities for fresh capital to generate strong risk-adjusted returns.

While near-term macro dynamics remain relatively uncertain, we maintain a high level of conviction around the continued impact of long-term megatrends, which we expect to continue to drive capital allocation decisions over the short, medium and long term.

Looking to the long term, we see four key megatrends as being most influential for the private markets universe: **demographics, decarbonisation, digitalisation and decoupling**.

We believe the consequences of these megatrends are particularly positive for a selection of key private market sectors, notably energy transition infrastructure, residential, urban logistics and digital assets. We will discuss these further in the second half of the report.

Macro outlook

We have reached a transitional stage. Policy rates appear to have peaked and the world economy has proven much more resilient in this tightening cycle than anticipated, in particular the US. This has created the impression that we may already have reached the so-called 'soft landing'.

While this is plausible, we believe it is too early to draw this conclusion.

As we came out of the pandemic and entered the tightening cycle that followed, the global economy was supported by extraordinarily high consumer cash savings, low corporate and mortgage debt costs, the unwinding of supply chain disruptions and ample fiscal stimulus. It now appears that the scale of consumer cash buffers and fiscal stimulus had been significantly underestimated; these buffers temporarily shielded the economy from the impact of higher rates.

The term structure of debt has been equally important. Market rates take time to convert into higher interest payments for many borrowers: the coupon payments on JP Morgan's index of floating rate US syndicated loans, have risen sharply, while those on fixed rate bonds have only started to edge up.

However, it is only a matter of time before the buffers run down and the lagging impacts kick in. Signs of weakness are emerging: for example, rising delinquencies and bankruptcies have risen, and, despite still elevated inflation, earnings growth fell in the third quarter of 2023.

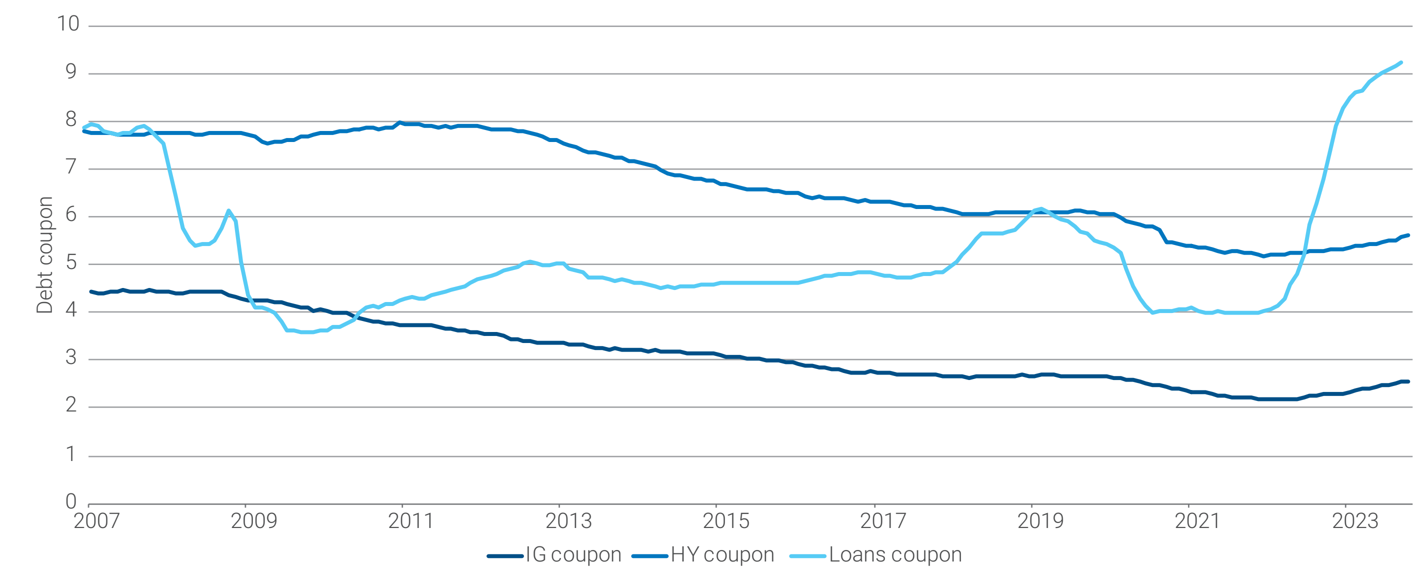
Our central case remains a recession for the US, Europe and UK in the first half of 2024, as higher interest rates start squeezing disposable incomes and corporate margins. Our conviction is strengthened by the constraints on central banks of high inflation and the current strength of the labour market; we see a dovish pivot as requiring more than a mild recession.

Weaker GDP growth is likely to lead to lower demand for cyclical businesses and the more economically sensitive areas of real estate and infrastructure, such as offices and transportation. Conversely, residential property, utilities and social infrastructure are relatively uncorrelated to the economic cycle.

We can connect this relative resilience to the ongoingmegatrend of urbanisation and population growth, particularly in developing markets. In short: demand for residential spaces is likely to remain ahead of supply, a tailwind remaining supportive of rental growth.

The flip side of higher rates is attractive debt returns. With interest rates at their highest levels for more than a decade, public credit yields are currently trading around the 80-90th percentile versus their 20-year histories; we can see a similar pattern in private credit. In real estate and infrastructure, debt yields are higher than valuation-based asset yields in several markets.

Rising debt cost has not yet fed through to most corporates



Source: Bloomberg, JP Morgan as at October 2023.

The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

But debt investments are clearly not immune to economic conditions.

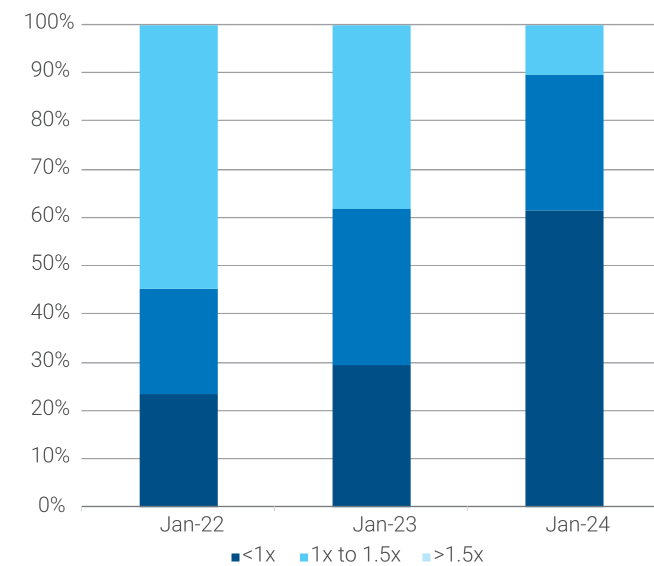
We think the lower-rated segment of the private credit market (B rated or below) will come under increasing debt servicing pressure. Recent research by Moody's showed that, assuming a federal funds rate of 5.25%-5.50%, the proportion of North American B3-rated issuers where EBITDA no longer covers interest cost would jump from 29% at end-22 to 62% at end-23.[1]

A further year of weak earnings growth and continued high funding costs is likely to push coverage ratios down further; pressure on credit metrics is likely to ripple up the sub-investment grade end of the rating scale.

As such, we expect rising defaults, restructurings and writedowns (although not a GFC-style crisis). From a debt investor's perspective, we continue to believe that the tactical opportunity lies in the investment grade and resilient BB space, where returns are driven by interest rates more than as compensation for credit risk.

Capital structures created in a very different interest rate environment could be challenged by refinancing schedules. This is particularly the case in commercial real estate, where lending is typically shorter-term than most corporate or infrastructure lending.

B3 rated issuers interest coverage breakdown



Source: Moody's as at July 2023. January 2024 is based on Moody's projection.

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1. Source: Moody's, July 2023
2. Source: MSCI as at 27 October 2023

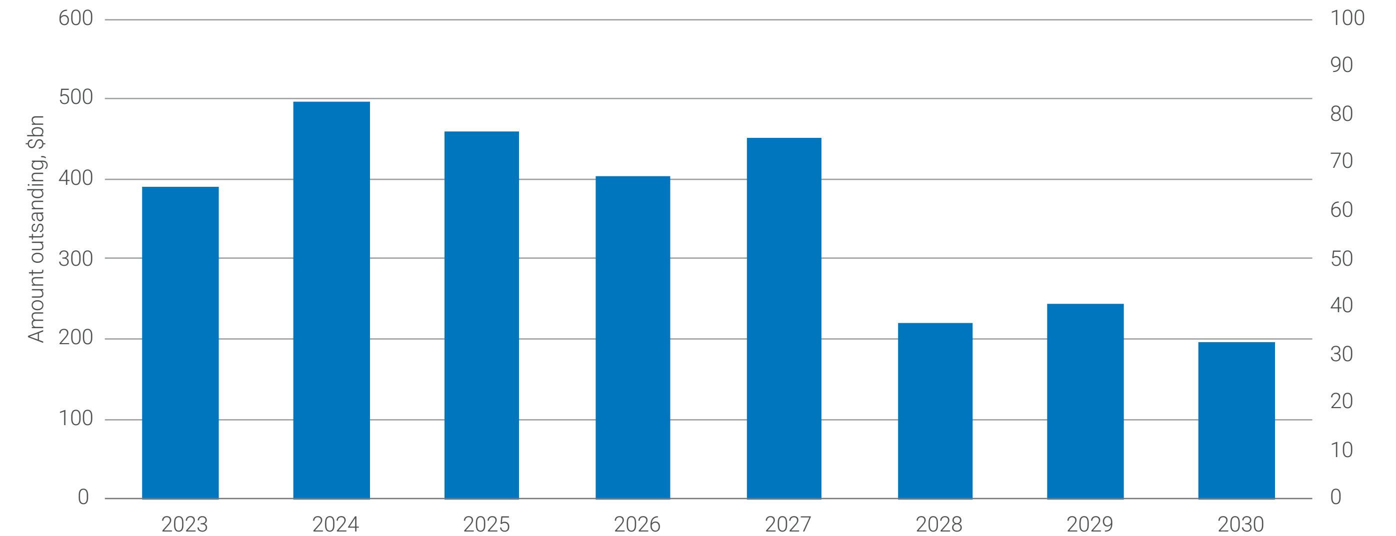
There is an estimated £130 billion of commercial mortgages maturing in the UK during 2024-26. The equivalent figure for the US is $1.4 trillion.[2] Even for assets where cashflows have remained stable or grown, the material increase in rates since many of these loans were originated means that many loans cannot be refinanced on terms acceptable to lenders without injections of fresh equity. This is likely to drive asset disposals from borrowers without access to equity, as well as demand for preferred equity to bridge. We believe either avenue could open opportunities for long-term investors with flexible capital.

These opportunities will need to be assessed with a robust approach to underwriting long-term free cashflows. A number of areas of real estate, with offices the most prominent example, are experiencing both changing occupier requirements and high future capital expenditure liabilities, including those associated with energy efficiency.

Conversely, residential and industrial assets are seeing more consistent demand with less risk on future capital liabilities. Those investing fresh equity, or originating new loans, need asset profiles and business plans that support long-term investment performance.

This macro outlook considers private markets in the short to medium term – but we must also take into account the longer-term narratives that will underpin and inform performance over the coming years. Many are clearly visible today; next, we will outline the four we see as most important to investors in real assets.

US CRE debt maturing between 2023 and 2030



Source: MSCI as at October 2023.

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The 4 D's: Connecting megatrends to portfolio strategy

The tectonic plates under the global economy are shifting. Advances in technology, population changes, geopolitics and environmental considerations are simultaneously catalysing the development of new industries and rendering some traditional assets obsolete.

While it is always challenging to boil a complex picture down into a small number of factors, in our view many of the most pressing trends that will influence the investment environment over the short, medium and long terms can be traced back to one of four megatrends:

1. **Demographics** – developed economies face ageing labour forces and a growing proportion of elderly households, an issue increasingly entrenched by declining fertility rates. Meanwhile, population and wealth growth in many emerging markets continues at pace.

2. **Decarbonisation** – this remains a global policy priority, creating both vast capital demand for new asset creation and initiatives to support climate adaptation and energy efficiency.

3. **Digitalisation** – the benefits and challenges of embedding digital technologies in both existing and new business models continues to create new winners and increased obsolescence risk among incumbents.

4. **Deglobalisation** – growth in global trade has stagnated. While we do not expect globalisation to reverse outright, we do anticipate the barriers to flows in goods, services, capital, people and information are likely to trend higher.

We will publish a more in-depth piece in the new year covering these megatrends' key implications for private market investors. This is a preview of our conclusions:

1. Energy transition infrastructure

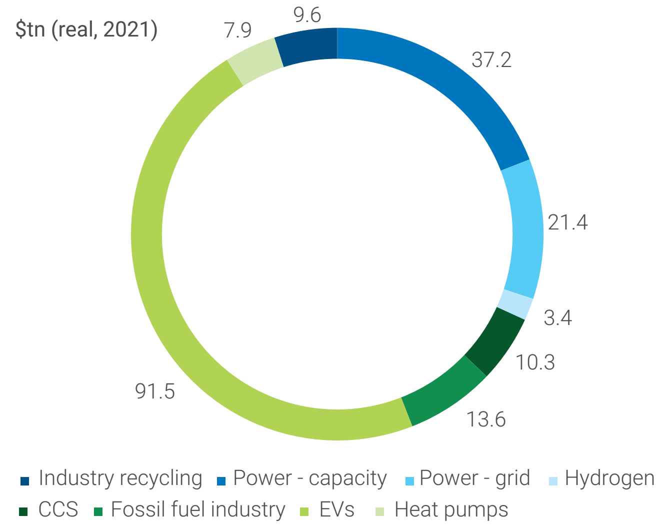
Countries representing almost 90% of the world's population have adopted net-zero targets.[3] Considerable subsidies are being implemented in the EU and the US to accelerate decarbonisation. These have been lent a greater urgency by the greater awareness of energy security driven by the war in Ukraine.

The inflationary bout that has led to higher interest rates across much of the developed world can't be attributed to the conflict alone, but it did markedly exacerbate an already challenging picture. These challenges are very likely to have added to policymakers' resolution to decarbonise as a strategy for restoring energy security in the long term.

In Europe, the energy transition represents an €840 billion opportunity for investors looking to deploy capital into sustainable infrastructure.[4] We see strong investment opportunities for wind and solar farms, battery storage and, in time, the power network infrastructure required to ensure increased renewable capacity is effectively integrated into the energy system.

3. Net Zero Tracker (2023) Net Zero Stocktake 2023: NewClimate Institute, Oxford Net Zero, Energy and Climate Intelligence Unit and Data-Driven EnviroLab
4. https://www.lgim.com/lu/en/responsible-investing/clean-power/

Cumulative investment by sector 2022-2050 (net-zero scenario)



Cumulative investment by sector/type, 2022-2050 (Net Zero Scenario). Source: BNEF

It should be noted that diversification is no guarantee against a loss in a declining market. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

We believe the acceleration of global decarbonisation will expand the investment universe in infrastructure, creating a diverse set of assets with varying fundamental investment characteristics. This should improve the diversification benefits of infrastructure portfolios as exposure to new risk factors is added. Equally, we see a growing role for 'natural capital' such as forestry to be incorporated alongside other 'real' assets.

2. Residential

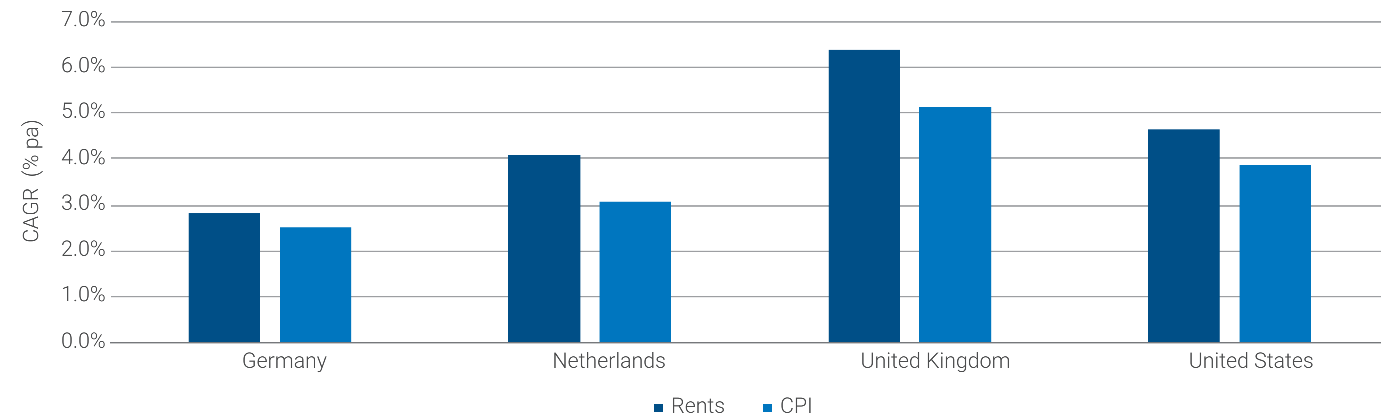
An increasingly volatile macroeconomic and geopolitical environment, with inflation potentially remaining a persistent issue, supports more needs-based, counter-cyclical, inflation-hedging assets.

On a long-term basis, residential rents have outstripped inflation across several key western markets, while also exhibiting lower volatility than seen in other commercial property sectors.

We believe ongoing urbanisation and population growth, combined with continued shortages of housing supply across many markets, will propel new asset creation and comparatively stable rental growth over the long term.

We see continued debt and equity investment opportunities for multi-family and single-family residential, including affordable housing, and we anticipate purpose-built student accommodation will remain attractive.

Residential rental growth versus inflation. 1973-2022



Source: OECD as at March 2021.

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3. Urban logistics

The digital revolution has already had a disruptive impact on the retail and industrial real estate sectors, where the impact of e-commerce and social media has transformed business models. A cultural shift in shopping behaviours has diminished the need for traditional bricks and mortar shops and accelerated the growth in urban logistics and multi-let industrial estates. These sectors could benefit in the future from increased decoupling of global economies through selective onshoring in nationally critical industries and higher inventory levels.

The growth of industrial real estate portfolios is not new: over the past twenty years, industrials have grown from 16% to 32% of real estate portfolios in the UK[5] and 23% to 39% in the US.[6] The strength of the structural forces underpinning the sector means that we expect this sector to retain its significant role in portfolios, with significant scope for expansion amongst higher-growth subsectors including cold storage and self-storage.

4. Digital and tech

The computing power and volume of data required to support the digital revolution, turbocharged by the uptake of generative AI, requires a rapid increase in data processing and storage facilities (i.e. data centres), along with substantial additions to digital infrastructure networks (5G, mobile and fibre networks etc). This could in turn, grow the volume of investment opportunities in these sectors.

The structural tailwinds supporting the growth in data centres are, in our view, compelling. While their environmental impacts need to be reduced over time, we anticipate that continued strong growth in demand, combined with increasing challenges to new supply rollout due to both planning and power requirements, would be conducive to strong rental growth.

We believe life sciences industries and companies are well placed to benefit from these megatrends, representing an important source of innovative technologies and medical breakthroughs.

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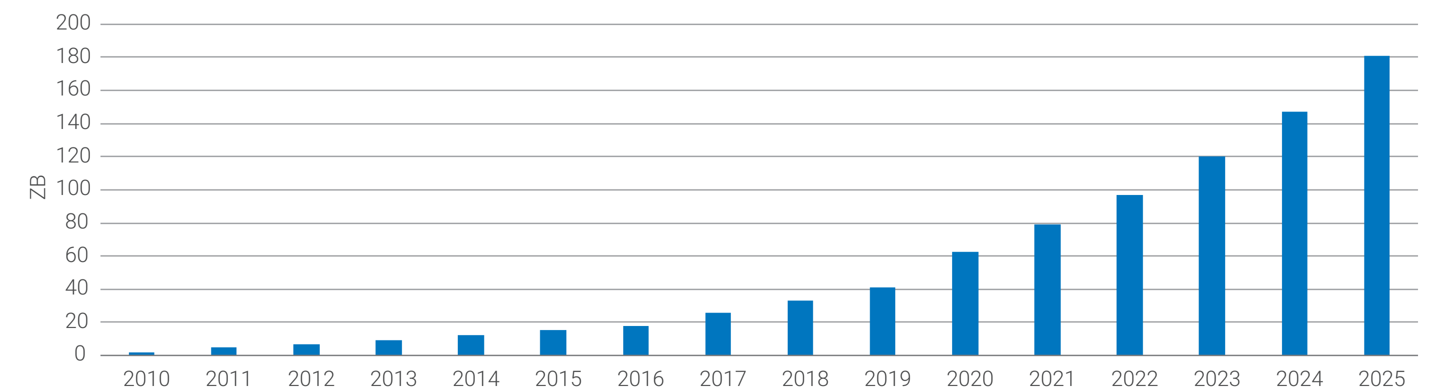
Data generated annually (zettabytes)



Source: Statista, Bernard Marr & Co. One zettabyte = one trillion gigabytes 2023.

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5. MSCI UK Quarterly Index: Q4 2003 versus Q3 2023.
6. MSCI US Quarterly Index: Q3 2003 versus Q2 2023.

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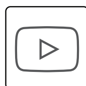

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