Women in Alternative Investments

Macro and Industry Outlook Report

February 2019

kpmg.com

Introduction

The Sixth Edition of the Women in Alternative Investments Report incorporated insights from an online survey of 886 alternative investment professionals globally. This supplementary Macro and Industry Outlook Report showcases the views of our female fund respondents. When an investor perspective is included, those responses are gender agnostic as has been the case in prior years.

Macro outlook

At the beginning of 2018, the catch phrase was synchronized global growth. In 2019, the picture is quite different. 2019 will be all about recession watch. The United States' fiscal stimulus from tax cuts and increased spending will wane in the later part of 2019 which puts downward pressure on growth. Furthermore, the lagged impact of four rate hikes in 2018 will begin to take a bite out of growth this year. While the tight labor market is lifting wages and increasing household consumption capacity, in 2019, we expect it will also begin to constrain growth as firms struggle to find workers to match expansion plans. Finally, investment in the housing market fell in the first three quarters of 2018, and a continued decline in that area would also dampen growth.

Meanwhile Europe, the United Kingdom, Japan, and many emerging markets are seeing substantially slower growth. Emerging markets in particular are experiencing tighter liquidity conditions as many economies have raised rates at a faster rate than U.S. policy makers in order to stem currency declines in the wake of a stronger U.S. dollar. Finally, slowing growth in China is a substantial concern as China is the largest contributor to global growth. Slower growth in China in 2019 will have an impact on the world economy, including the United States.

All of this combines to paint a picture with storm clouds on the horizon. The difficulty is not in predicting the arrival of inclement economic weather, but in pinpointing when it will arise. Consequently, both bottom-up fundamentals and macro considerations will be key determinants of performance for alternative investments.

> Rising interest rates and tighter monetary policy are seen as the greatest threats to the global economy through 2019, according to slightly over a third of our female respondents. Trade conflicts and China's imbalances were also cited as significant threats.

Europe – The risks of uncertainty

A disorderly exit from the EU remains one of the major risks of 2019.

"If there's disorderly exit, we are likely to see further falls in the pound and a rise in inflation, thus squeezing households' spending power," said Yael Selfin, Chief Economist, KPMG in the U.K. "However, the Bank of England may pursue an accommodative stance in the short term and investment is expected to pick up as companies adjust to a new trading relationship."

But there are limits to growth. Even under a "soft" Brexit, growth in the U.K. is currently constrained by relatively poor productivity performance and is expected to be relatively unremarkable at around 1.5 percent.

In a no-deal scenario, longer-term growth estimates by the U.K. government suggest that within 15 years, the U.K. economy would be between 7.7 and 9.3 percent smaller than it would have otherwise been. Outside the U.K., other European countries would suffer as well in a no-deal scenario, but the effects would be less significant than on the U.K.

> "The U.K. economy is about to experience a significant structural transformation triggered by Brexit, and other long-term trends such as aging population and advances in artificial intelligence. Rethinking of supply chains and the impact of a tight labour market with fewer EU workers have the potential to change how many companies do business. This should lead to new winners and losers."
>
> —**Yael Selfin**, KPMG

United States – Slowdown forecasted

When assessing the U.S. economy's risk of recession, a key measure is the number of quarters the economy spends below full employment. Historically, unemployment spends an average of 12 quarters below the natural rate before a recession. By this measure a recession would occur in the end of 2019.

The other main measure is the shape of the yield curve. As the Federal Reserve tightens rates, the cost of capital for banks goes up. If rates at the longer end of the yield curve go up by equal amounts, this is not an issue. However, this rarely happens. As the Fed's rate hikes begin to slow growth by raising the cost of borrowing money for purchases and investment, the long end of the yield curve usually goes up by diminishing amounts. Eventually the long end of the curve falls below the short end on prospects for weaker growth and inflation, known as an inversion of the yield curve. This is a signal recession is coming. At this point in the current expansion, the yield curve has yet to fully invert but it is close.

However, a shock or a cluster of shocks, domestic or international, is the area of most concern for 2019. Heading into 2019, the largest concern is international shocks. China's economy is slowing and could morph into a shock to the global financial system if Chinese authorities make any missteps while trying to reign in excessive corporate credit, now over 170 percent of GDP, while also trying to stimulate consumer spending.

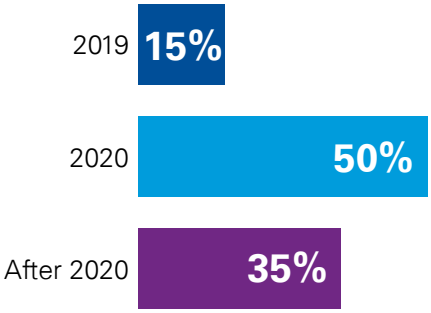
China represents approximately 15 percent of global GDP, but its marginal contribution to global GDP is closer to 25 percent. Thus a slowdown in China would impact the rest of the world economy as lower commodity consumption would also transmit through financial channels to commodity exporting economies. In addition, slowing growth in Europe and other emerging markets would also contribute to slower world growth, which would impact the U.S.

"Looking ahead, the Fed is in the driver's seat insomuch as their response to any shock would have a mitigating effect," said Constance Hunter, Chief Economist, KPMG LLP. "It should be noted, however, that the Fed's track record in achieving a soft landing is poor; the Fed has rarely been able to engineer a soft landing once the unemployment rate falls below the natural rate. Tighten too much and the economy slows due to higher rates; tighten not enough and the economy slows due to higher inflation. It is the Fed's intention to walk the tight rope between steady growth, low unemployment and low inflation, but the trick is that it is a very difficult tight rope to walk."

For all of these reasons, survey respondents do eventually expect a recession although exact timing is difficult to predict

When do you expect a U.S. recession to occur?

Among female respondents



Implications for expected slowdown

Should China and the rest of the world reverse their slowing growth rates, it is possible a recession could be put off into 2020. If this happens and if the U.S. is the genesis of a global recession, it still would have a global impact. As the largest consumer and importer in the world, slower growth in the U.S. will mean slower imports from other countries.

"In addition, the U.S. generally enters a recession as a result of rising U.S. interest rates and because treasuries are the reference rate for many other rates around the world, tighter liquidity conditions in the U.S. mean tighter liquidity conditions globally," noted Ms. Hunter.

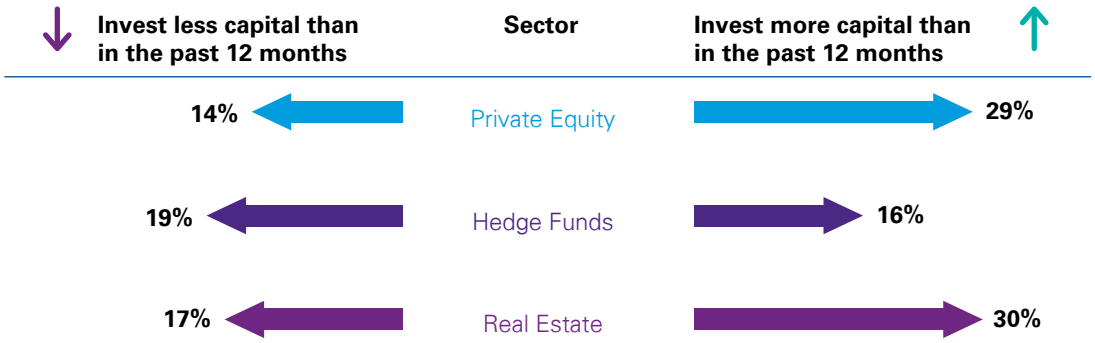
Finally, the slowing of U.S. and global growth due to the combination of slower or declining growth of working age populations and low productivity growth means that potential GDP is lower than in the past. As a result, central bank rates are lower than in the past. Additionally, many countries are facing fiscal challenges from increased longevity of retirees who are drawing on state sponsored health and social security systems.

"There is also a growing concern among economists that, during the next downturn, not only will the Fed not be able to cut rates by the magnitude of its historic average (550 basis points) to stimulate growth, but fiscal coffers will likely not have the capacity to conduct stimulative fiscal measures," she added. "This could well mean longer more 'u' shaped recoveries rather than 'v' shaped recoveries seen in the two decades before the financial crisis."

Industry outlook

Institutional investors remain committed to alternative assets, both in a quest for absolute returns and to increase diversification of their portfolios in preparation for geopolitical uncertainty and late cycle market volatility. With many believing equity markets are at or near their peak, investors are expecting more modest returns across most asset classes going forward and are looking to minimize their downside risk. Allocation plans reflect these considerations.

Investor plans for allocations in the next year



Source: Preqin Investor Update: Alternative Assets H2 2018

Hedge funds

Although many investors have been disappointed by overall returns for hedge funds in recent history, outlook for the asset class is beginning to improve.

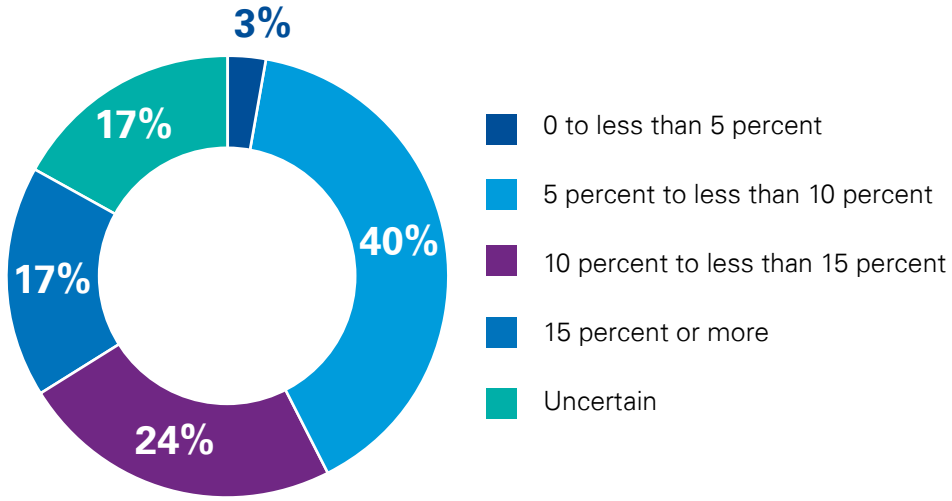
Both our hedge fund and investor respondents are decidedly optimistic about expected performance, with 51 percent of hedge fund respondents and 44 percent of investor respondents expecting improved performance for hedge funds in 2019.

Investment outlook is also strong, with 51 percent of hedge fund respondents expecting that investment opportunities will improve in 2019.

Investor commitment to the sector remains relatively steady, though down relative to other asset classes according to Preqin research. This steady commitment to hedge funds is not surprising given that many believe equity markets are approaching a peak and there is increasing uncertainty regarding the geopolitical and macroeconomic climate.

Not surprisingly, hedge fund respondents' expected returns have improved since our 2016 Report, with 40 percent of this year's respondents expecting returns of 10 percent or more through 2019. In 2016, only 31 percent of hedge fund respondents expected returns of 10 percent or more.

Hedge fund respondents' expected returns through 2019



Does not equal 100% due to rounding

Private equity and venture capital

"The size of the private equity industry has continued to grow, with assets under management reaching $3.41tn as of June 2018. This growth is set to continue and our survey results clearly show that investor appetite has not been sated yet—the majority report that they intend to commit as much or more to the asset class in 2019 than they did in 2018. In fact, we project that the industry will grow to $4.9 trillion by 2023, overtaking hedge funds to become the largest alternative asset class. However, the road ahead will not all be plain sailing: concern over the impact of high pricing on future returns persists, the gap between the largest managers and the rest continues to widen, and many believe a market correction looms ever nearer. Nonetheless, private equity has a proven track record for weathering times of economic downturn and delivering superior returns. Provided the industry continues to evolve and adjust, the future remains very bright"

—**Christopher Elvin**, Head of Private Equity Products, Preqin

The outlook for private equity remains solid through 2019. The asset class continues to deliver strong returns, and investors remain committed to it. However, fundraising will remain competitive. And, with a lot of dry powder on the sidelines, steep competition for transactions will continue, at least until the equity markets turn.

In light of these forces, it's not surprising that private equity fund respondents are closely split on expected performance for their asset class through next year, with 33 percent expecting it to worsen and 32 percent expecting an improvement.

Investors have also revised downward their performance expectations for the asset class going forward, with 34 percent of investors expecting performance to worsen in 2019.

Venture capital performance outlook is only slightly better with 35 percent of venture capital fund respondents expecting improved performance through 2019. Investor respondents are less optimistic, with only 29 percent expecting improved performance for the asset class over the same timeframe.

Expectations for investment opportunities for both sectors are a bit more optimistic, with 40 percent of private equity fund respondents and 42 percent of venture capital respondents expecting investment opportunities for their sector will improve through 2019.

Valuations will continue to weigh on general partners, as many expect entry prices for assets will remain high, at least over the near term. In addition, intense competition for larger transactions has caused more players to come downstream to bid for lower middle-market companies. Given this trend, it's not surprising that a recent study of institutional investors by Preqin found that small to mid-market buyout funds are seen as the best investment opportunities within the asset class. Venture capital is also expected to see increased investor interest through 2019.

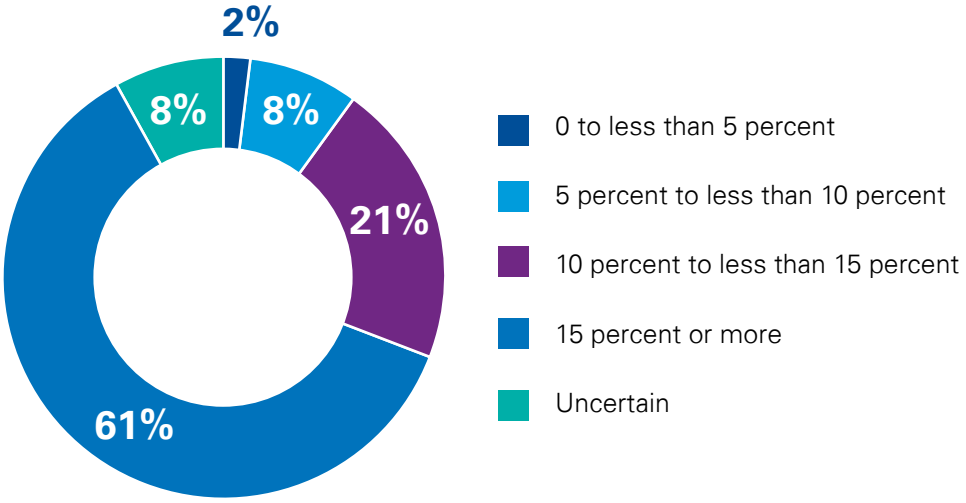
While many expect investment opportunities to remain strong in North America and Europe, more investors are looking to opportunities in Asia and emerging markets according to Preqin, given that many expect valuations to remain high in developed markets through 2019.

"The greatest risk from a tech perspective is that the bubble will burst when money starts to dry up for some of these unprofitable unicorns and the rest of the overvalued unprofitable companies realize they are Emperors without clothes. United States valuations are already at overheated multiples for P/E and leverage multiples."

—Female fund respondent

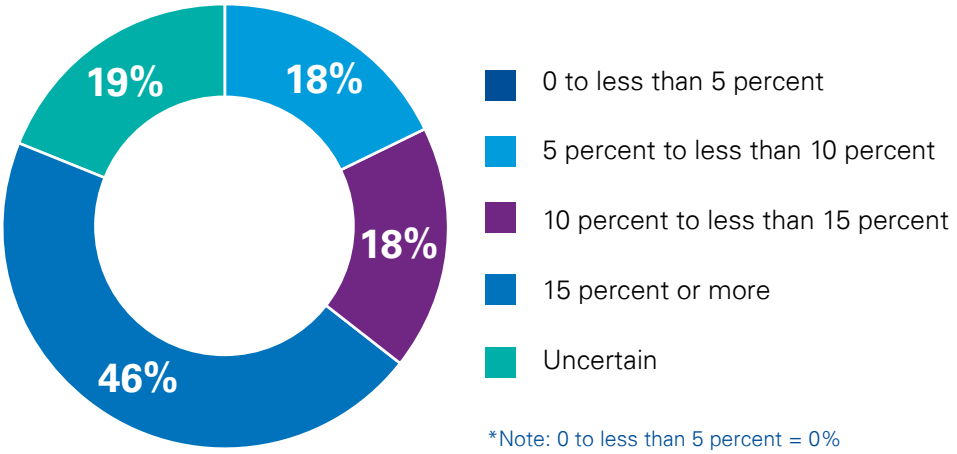
As in years past, private equity respondents' expected returns remain the highest of all sectors surveyed, with 60 percent expecting returns of 15 percent or more through 2019.

Private equity respondents' expected return range through 2019



Venture capital respondents' expected returns were also strong, with 46 percent expecting returns of 15 percent or more.

Venture capital fund respondents' expected return range through 2019



*Note: 0 to less than 5 percent = 0%

Real estate

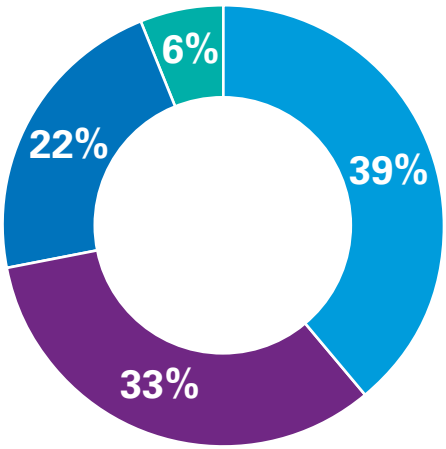
Of all asset classes surveyed, performance expectations for real estate are the least optimistic, with only 25 percent of real estate fund respondents and 23 percent of investor respondents expecting improved performance for the sector in 2019. The challenge for the asset class is how to maintain attractive returns given current high valuations.

Despite a challenging horizon, 32 percent of real estate fund respondents expect investment opportunities for the sector will improve in 2019.

Concerns over cycle risk have led many investors to see to de-risk their real estate portfolios, with strategies such as value-added, core, and core-plus becoming more popular, according to recent research by Preqin.

Not surprisingly, real estate fund respondents' expected returns have weakened since our 2016 Report when the asset class was at its most recent peak, with 55 percent of this year's respondents expecting returns of 10 percent or more through 2019. In 2016, 65 percent of real estate fund respondents were targeting returns of 10 percent or more.

Real estate fund respondents' expected returns through 2019



- 0 to less than 5 percent
- 5 percent to less than 10 percent
- 10 percent to less than 15 percent
- 15 percent or more
- Uncertain

*Note: 0 to less than 5 percent = 0%

Does not equal 100% due to rounding

Contact us

Camille Asaro
Partner, Audit – Alternative Investments,
KPMG in the U.S.
T: 212-954-4610
E: casaro@kpmg.com

Kelly Rau
Partner, Audit – Alternative Investments,
KPMG in the U.S.
T: 212-872-3455
E: krau@kpmg.com

Constance Hunter
Chief Economist,
KPMG in the U.S.
T: 212 954 3396
E: constancehunter@kpmg.com

Yael Selfin
Chief Economist,
KPMG in the U.K
T: +44 20 73112074
E: yael.selfin@kpmg.co.uk

kpmg.com/socialmedia