High Five – 2025 Outlook (Third of a Series)

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We now turn to the first of our five themes for the year ahead: *"Still higher for longer*: *What slower rate cuts mean for private capital investors."*

Let's stipulate the Fed has pulled off the trickiest of landings: cooling down inflation while keeping the economy chugging along. With reference rates sliced by 100 bps from last year, borrowers have some relief in the cost of capital and interest burden. Yet with the dawn of a new administration, the market is pricing in sustained inflation with higher Treasury yields and much slower rate cuts through 2025.

The hope is for enough positive GDP momentum to keep adding new jobs and improving productivity. December's labor report showed 256,000 job adds, and core CPI decelerating modestly to 3.2%. And while other inflation data remained stubbornly above the Fed's target, investors should draw confidence from a resilient backdrop. At a portfolio level, we have also seen companies adapt to higher-for-longer, keep cash levels robust.

Rate stability creates more certainty around valuations, which we expect to lead to meaningful pick-up in M&A activity. This builds on the trend we saw in 2024, when North American M&A reached over $1.5 trillion by the end of Q3, not far off the 2023 full-year $1.7 trillion total (see *Chart of the Week*).

For private capital investors, there are several consequences of these dynamics. First, as we discussed last week, better economic conditions ignite dry powder sitting on the sidelines. Private debt investors get more visibility into issuers' loan-to-values and debt servicing capacity. Private equity buyers can better price risk and determine enterprise value multiples. Firmer valuations in public equities should coax PE sellers to exits, helping to normalize distributions to LPs as the M&A cycle moves back to a more regular cadence.

More obviously floating rate debt investors will benefit from higher-for-longer, which, although down from the peak a year ago, are still close to historic tops. With businesses having proven they can withstand and expand even with squeezed interest and fixed charge cushions, there's real potential for favorable risk-adjusted returns in 2025.

We also expect investor focus will shift back to the fundamentals of company earnings. As has been evident in public markets for a while, with the shock of peak interest rates behind us there is greater certainty for the months ahead. Valuations will be less sensitive to interest rates than they have been over the past two years.

Finally, a favorable macro backdrop will accelerate the trends in options to monetize LP investments, such as continuation vehicles. Fund managers will be keen to capitalize on these tailwinds by holding on to their best assets and supporting them through the next stage of growth, while offering LPs the option of liquidity.