

OVERVIEW: THE ECONOMY, PUBLIC EQUITIES, AND FIXED INCOME

2025 began with broad optimism for economic growth, particularly in the US, despite impending tariffs as well as other economic policy changes. However, optimism faded in late March and early April as the US stock market fell significantly following the “Liberation Day” tariff announcements. Additionally, global expectations for GDP growth have diminished, while inflation expectations have risen even as current inflation measures moderate.

Expectations aside, equity market performance has since recovered and reached new heights, though current geopolitical events in the Middle East and Eastern Europe, tariff policy uncertainty, the US fiscal position, and other potential risks remain. During the quarter, global equities returned 11.5%; international developed, emerging markets, and U.S. equities returned 12.0%, 12.0%, and 11.0%, respectively, driven by a 90-pause in Trump’s tariff policies to negotiate possible concessions with trading partners.

At the same time, most international central banks have lowered interest rates, working in tandem with fiscal stimulus. In comparison, interest rates in the US remain elevated while fiscal policy is accompanied by financial stability concerns. In combination, equity performance across international and emerging markets continued to exceed that of the US, albeit marginally.

The US Treasury yield curve changed shape incrementally during the quarter, largely on expectations, as near-term maturities saw yields fall anticipating future Fed rate cuts. Intermediate to longer maturities saw yields increase alongside conflicting future US GDP and inflation expectations. The now-approved budget package is set to further increase the federal deficit and debt.

Yield spreads among credit securities decreased during the second quarter across broad segments. This spread tightening was smaller across most fixed income segments, but with more notable compression among the more risk-oriented US high yield and emerging market debt segments.

PRIVATE EQUITY

Private equity exits have been lackluster. While exit value recently has trended upward, driven by the best companies exiting the market and Venture Global LNG’s outsized initial public offering inflating 1Q25 value, exit count has trended downward since the end of

2021. This was driven in part by the Federal Reserve reducing base rates, interest rate spreads narrowing on floating rate loans, dry powder (undeployed capital) being put to work, and expectation of pro-growth policies and deregulation from the incoming US administration. Halfway through 2025, these expectations have yet to pan out, extending the drought in exit activities.

Private equity inventory has swelled to 12,379 companies, with particularly high numbers among investments that are four to nine years old, which translates to a seven-to-eight-year inventory at the observed pace of exits in 2024 compared with typical holding periods of three to five years. Exit activity to corporates, sponsor-to-sponsor, continuation funds, and/or initial public offerings need to accelerate meaningfully to bring down inventory while providing much-needed liquidity to limited partners.

We would expect the difficult exit environment to continue if interest rates remain higher for longer due to higher inflation from tariffs, trade policies remaining uncertain, and/or the gap between buyers and sellers' perception of value widening. This would continue to strain liquidity for limited partners, who are more focused on distributed-to-paid capital (DPI) as opposed to internal rates of return (IRR) since the former represents actual cash returned to investors from exits as opposed to paper returns generated from unrealized gains until exit.

Despite an uncertain macroeconomic backdrop, there are still investment opportunities in private equity.

- The secondary market remains an attractive space given the discounts that are available for purchasing an individual or portfolio of assets from general partners or limited partners.
- Add-on investments in platform companies (buy-and-build) remain attractive given that these investments tend to be smaller and require less leverage.
- Co-investments have relatively lower cost structures and are attractive as they allow GPs to make larger investments with less capital.
- Growth equity is promising given deals are all equity and do not require any leverage for companies to continue to scale.
- The lower middle market continues to have exit (sponsor-to-sponsor) opportunities given the amount of dry powder among sponsors up-market.

VENTURE CAPITAL

Like its private equity cousin, the venture capital market lacks exits (buyouts, public listings, or acquisitions). This has constrained liquidity for limited partners due to the lack of distributions, which has also negatively impacted fundraising. The venture capital market has also seen an increase in flat or down rounds, with longer time frames between fundraising rounds. This has caused investors to focus more on earlier-stage startups that are profitable, with less cash burn, as opposed to the growth-at-all-cost mentality that had prevailed.

This new focus is largely due to the increased uncertainty in the market from tariffs and trade policy, which has led to greater volatility in the public equity markets. The increased volatility has caused many startups to remain on the sidelines for initial public offerings, which has been further exacerbated by the poor subsequent returns of those few startups that have gone public. Until markets stabilize, the estimated \$3 trillion backlog of “unicorns” (startups valued at over \$1 billion) will not be able to drive fund returns higher.

PRIVATE CREDIT

Broadly speaking, revenue and earnings growth remain positive for portfolio companies, leverage multiples and loan-to-value ratios are conservative, and interest coverage ratios are near 2x, providing potential downside protection.

Delinquent loans (90 days or more) remain below historical standards. While there has been an increase in covenant-lite deals in the upper middle market, this is typically reserved for larger and stronger borrower profiles in more defensive sectors. Restructuring payments-in-kind (PIKs) remain elevated—particularly in the consumer/retail and real estate sectors – but have stabilized more broadly.

The yield to maturity on loans continues to trend down toward historical levels, which is to be expected. This has been driven by a decline in base rates as well as spread narrowing from increased competition in the broadly syndicated loan (BSL) market and new capital entering the space.

Despite extreme uncertainty, potential for further slowdown, and lower deal activity levels, the maturity and growth of the private credit market has provided a high level of certainty on loan execution, meeting borrower demand. Furthermore, borrowers see private credit

as an accessible alternative compared to loans from traditional banks, where lending activities continue to tighten to meet capital requirements. Thus, we continue to see areas of opportunity that may warrant further investigation within this asset class and favor a diversified (geographic/sub asset class) private credit exposure to complement the existing middle market direct lending allocation. Further, a focus on balance sheet quality, strong covenants and documentation, and limited exposure to paid-in-kind instruments is desired.

PRIVATE INFRASTRUCTURE

Private infrastructure remains a compelling opportunity backed by strong secular demand and megatrends over the long term. Infrastructure is a bipartisan issue with a meaningful gap where private capital can fill the void. While concerns regarding the direction of fiscal policies and tariff negotiations are warranted, the fundamental demand for this asset class remains intact. In the near term, infrastructure may have an easier time weathering policy-induced inflationary pressures. The long-term trends for the AI theme in power, data centers, and critical input materials, coupled with society's critical need for infrastructure improvement and development, remains supportive of this asset class.

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