APOLLO

Adjusting Portfolio Allocations in Times of Market Uncertainty

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Investors in the public equity markets had much to celebrate at the end of 2023. A strong run during the year was punctuated by a late-December surge after the Fed "pivot" to a more dovish policy outlook mid-month. Optimism rolled over into the New Year: As of mid-February, the S&P500 was up 19% over the past year. Meanwhile, unemployment has remained at historically low levels, GDP growth has stayed strong, and inflation—the largest economic wildcard in the past two years—has continued to track a downward trajectory.

Despite the ebullient sentiment in the markets, however, much uncertainty remains: When will the Fed start cutting rates? Will the much-talked-about soft landing actually happen, or are we in for unwanted surprises? We continue to believe that the odds of a recession in the US remain virtually split in 2024, and we're not ready to declare victory on inflation just yet. So what does that mean for markets and investors? In a nutshell, expect high market volatility in 2024.

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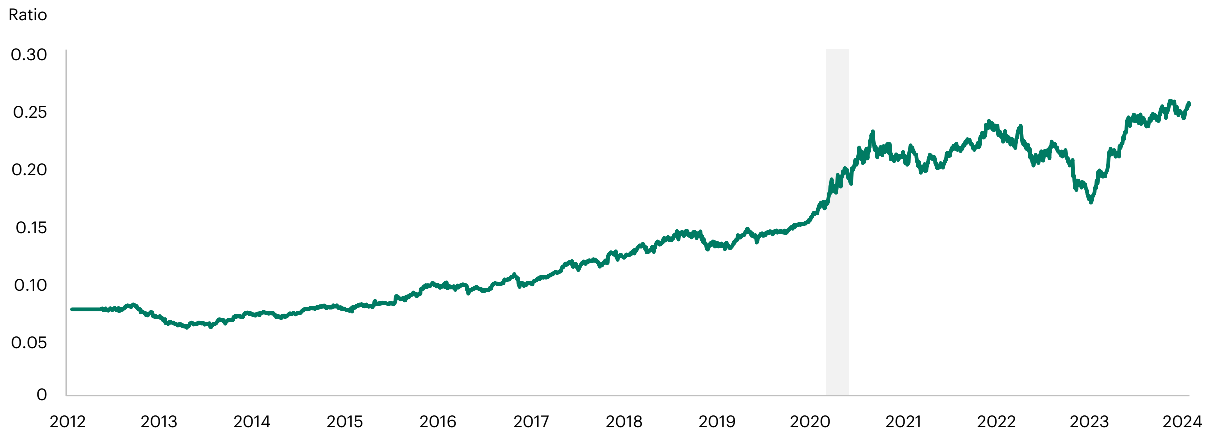
Take the equity market, for instance. Stock prices, you might say, reflect smooth sailing ahead, and are already discounting rate cuts that haven't even happened yet. But with the Magnificent 7 (Apple, Microsoft, Google, Amazon, NVIDIA, Meta, and Tesla) capturing an ever-increasing amount of investor interest (**Exhibit 1**), concentration in the public markets is at unprecedented heights, and it certainly seems as if the air is getting quite thin at these lofty levels.

As of mid-February, Wall Street analysts were calling for a 2% increase to the S&P500 in all of 2024. Given the index's 5.9% increase through February 12, and one-month Treasury yields of 5.49%, that points to a negative risk premium for investing in stocks. That is, if one believes the forecast of a 2% increase for the year, those gains are already in hand, and any buyer at these levels is both eschewing a higher risk-free return and contemplating a negative return through the end of the year from here.

Exhibit 1: The market cap of the Magnificent 7 is now roughly 25% of the entire US stock market

Ratio of Magnificent 7 market cap to Russell 3000 market cap



Data as of December 31, 2023. Sources: Bloomberg, Apollo Chief Economist

The bond market, meanwhile, is, like us, predicting a roughly 50 percent chance of recession in 2024. While it seems unlikely that we're in for a deep, hard landing, it behooves investors to consider the recessionary realities facing many pockets of the economy. The Treasury yield curve has been inverted since late 2022, meaning that it has been predicting a recession since then. It hasn't been right yet, but this could be the year the bond market is finally correct.

Also, credit spreads have tightened dramatically since the Fed pivot, and are currently sitting near all-time "tights." As of early February, US high-yield spreads were sitting around 350 basis points. Even BB bonds were trading at just 190 over par, which is an awfully tight range, arguably "priced to perfection." January also saw record amounts of investment grade issuance.

So... stocks are expensive on a relative basis and bond spreads are precariously tight. What options remain for investors to try to dampen volatility in their portfolios?

From our perspective, we are very much focused on the near-term direction of interest rates. After initially pricing in six cuts in 2024, starting as soon as March, the market has dialed back its expectations, especially after inflation, as measured by the Consumer Price Index (CPI), remained in a downward trend but receded at a slower pace than expected in January. In the 12 months through January, the CPI rose 3.1% against a 3.4% increase in December.

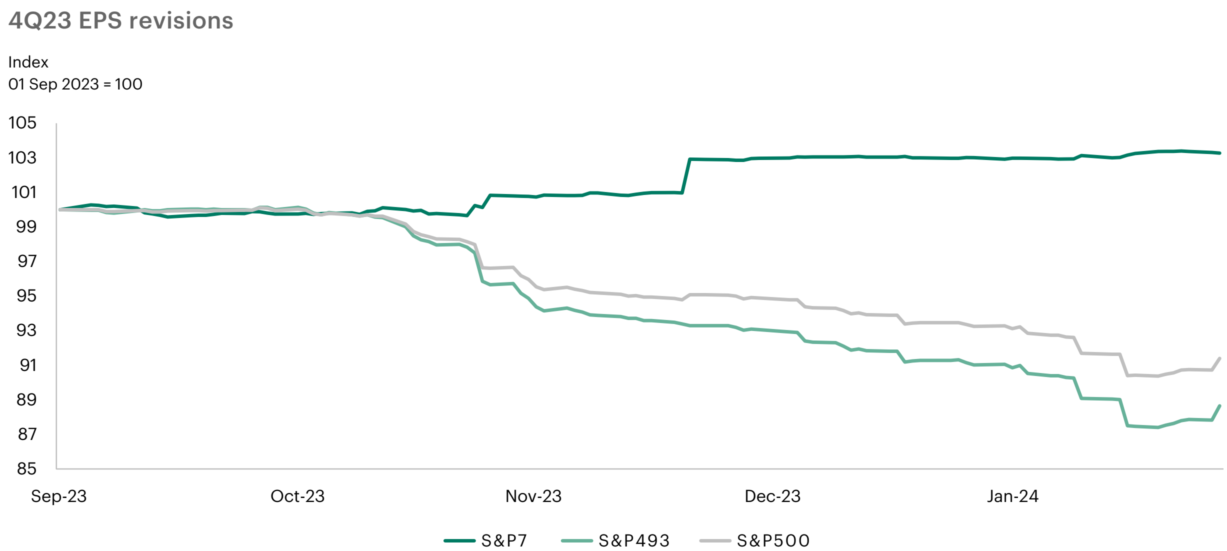
As of this writing, just four cuts are priced in for 2024, with a 40 percent probability of five. The first cut is now estimated to come not in March but in July, a material change to previous forecasts. The result? All levels of the interest rate curve have widened, but especially at the short end. Our chief economist Torsten Slok has been calling for higher rates for longer, and the data have been corroborating his forecast: Any cuts will come later in the year, as more and more evidence suggests that the economy is not slowing enough.

The move from 9% inflation down to 4% inflation was straightforward enough, with supply chain rationalization a large part of that correction. But the path from 4% to 2% is going to be a bit more challenging, and we think it will take more time. As a result, we anticipate some volatility in the weeks and months ahead. All of that, too, before the November election picks up steam, which will surely bring its own attendant volatility in its wake.

This is one of those times where we will advocate a back-to-the-basics concept, the capital asset pricing model, or CAPM. The whole point of the CAPM is to try to understand where the risk-free rate is and where it might be going. That way, when investors add risk to a portfolio, they can try to make sure that they're getting the premium they deserve, whether that's a liquidity premium, an equity risk premium, or otherwise.

Our key takeaway: At this point, we do not see sufficient premiums in the public markets. Public equities are overly concentrated and continuously volatile, despite the recent surge. Additionally, earnings growth is also very concentrated (**Exhibit 2**). As discussed previously, public bond markets, particularly corporates, are trading at very tight spreads.

Exhibit 2: Earnings expectations have been moving sideways for the S&P7 and down for the S&P493



Sources: FactSet, Apollo Chief Economist

So where does opportunity lie? We believe that private markets—both equity and debt—can offer an alternative to publicly traded securities as well as a level of diversification that might help mitigate expected volatility in public markets.

Despite the maturation of the alternatives industry, many investors still consider "alts" to be a "riskier corner" of the markets, restricted to hedge funds, leveraged loans, and the like. However, we define "alternatives" as simply an alternative to publicly traded stocks and bonds that seeks excess returns per unit of risk at every point along the risk-reward spectrum, from investment-grade credit to equity. Today, the largest providers of alternative capital are acting as viable replacements to historical providers of both debt and equity to some of the largest companies in the world.

Private credit has grown a lot from its origins as a provider of credit to middle-market companies and sponsor finance. The largest providers of alternative credit today lend directly to not only middle market but also large investment-grade type borrowers. Also, unlike the banking system, providers of private credit tend to hold loans to maturity. In other words, while banks represent a lend-to-syndicate model, private credit is a lend-to-hold model, one that, we believe, offers both better downside protection as well as more stability.

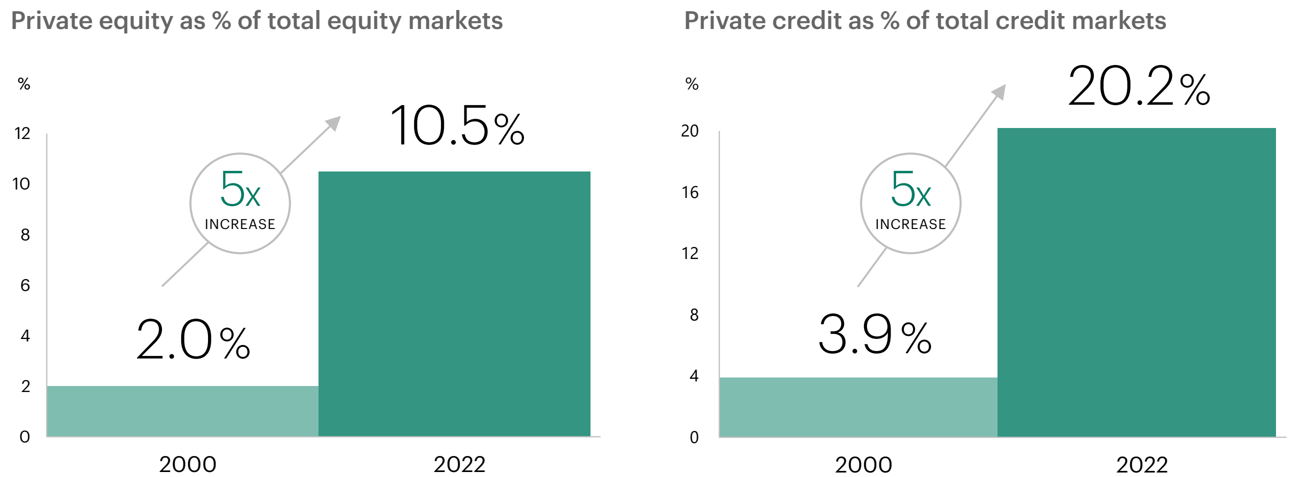
Significant downside mitigation includes first-lien protections, strong documentation, strong covenants, and lower loan-to-values. We find it difficult to argue against the 11% to 12% floating rates we're seeing on first-lien loans in private credit as of this writing.

Further, recent innovations have also made these private-market strategies available to investors in semi-liquid structures, meaning that individual investors can now consider using private credit as a replacement to at least some portion of their fixed-income portfolio holdings.

In other words, we see private markets as an integral part of wealth portfolios, deployed alongside public equity and fixed income. Given the growth of the market and the high credit quality of available assets, we do not see private credit just as a candidate for an "alts" bucket, or some exotic portion of one's portfolio, but as a replacement for some of the core portion of the typical 60/40 asset mix (**Exhibit 3**).

As far as the equity markets are concerned, it's a fair question to ask why investors need to consider private equity when the public markets have been performing so well. But with lofty valuations, strong concentration, and flat(ish) earnings growth revisions for most public companies, we believe that private equity can offer a potentially better value on a relative basis today, especially with the Magnificent 7, the key driver of public equities these days, now sporting an almost 50x price-earnings ratio.[1]

Exhibit 3: Investors are turning to private assets as a means of diversifying portfolios



Sources: Preqin, Bloomberg, Apollo Chief Economist. Private equity data as of December 2022.

Additionally, public stocks have experienced volatility greater than 20 (as measured by the VIX Index) over the past couple of years. And, as discussed previously, with the consensus among Wall Street equity analysts that the S&P00 will return 2% in 2024, we see no equity risk premium left in the stock market.

Investors looking to "recreate" equity-like returns can consider shifting a portion of their equity allocation to the private markets, which we believe can offer–when deployed in a diversified strategy–a similar long-term equity return profile, with substantially lower volatility, better downside protection, and exposure to a wider swath of the US economy.

For more on this, see our white paper, *"Beyond Beta: How to Use Alternatives to Replace Public Equity."*

Diversification is always the watchword of prudent portfolio management. Public markets are simply not offering as much of that crucial ingredient at the moment, as the performance of both equities and bonds remain highly correlated. In that light, as we expect more, not less, volatility in the public space, we see an allocation to private markets as a compelling means to mitigate portfolio risk during uncertain times.

[1] As of February 13, 2024

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Alexander Wright is Partner, Global Wealth Strategist in the Client and Product Solutions group at Apollo. Previously, Alexander was the Co-Head of Yield Products and a portfolio manager for Apollo's closed-end funds, CLOs, and private BDC. Prior to joining in 2011, he was with GSC Group where he served in a variety of different roles, most recently as Chief Administrative Officer, Chief Financial Officer, and Head of US Corporate Debt. Before that, Alexander was with IBJ Whitehall Bank & Trust Corporation and Chemical Banking Corporation.

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