2024 Mid-Year Outlook: An Unstable Economic Equilibrium

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KEY TAKEAWAYS

- The US economy has shown more resilience and stamina than most people expected when the Federal Reserve started raising interest rates in March 2022. But now, more than two years into the Fed's tightening campaign, we find ourselves in a state of unstable equilibrium, with powerful forces pulling the economy in oppositive directions.
- On the one hand, the lagged effects of Fed rate hikes continue to reign in growth, with higher borrowing costs biting into over-levered consumers, corporates, and banks alike. The upshot? Rising consumer delinquencies, higher corporate bankruptcies, and increased pressure on some banks' balance sheets, especially smaller regional banks.
- On the other hand, the Fed "pivot" in December 2023 triggered an easing of financial conditions—bond issuance surged, M&A activity awakened, risky assets rallied, and bond spreads tightened meaningfully. These easier conditions have at least partly neutralized the effects of the Fed hikes, paving the way for a reacceleration in both economic growth and inflation.
- Which force is likely to win this economic tug of war?
- Given the current underlying strength of the US economy, we believe that easier financial conditions will continue to offset the effects of the Fed rate hikes, at least for the next three quarters, driven by strong consumer spending (particularly on services), still-high government spending (as a result of several recent spending bills), still-strong aggregate corporate earnings, and the "wealth effect" triggered by rising asset prices.
- As a result, we expect US economic growth to come in above consensus in 2024, at 2.5%, on the back of a still-strong employment picture. We expect inflation to remain above the Fed's 2% target for the foreseeable future, despite a mild reading of the consumer price index (CPI) in May. As of this writing, we remain confident in the view we've held since last year: Interest rates will remain higher for longer. We see no Fed cuts in 2024.
- We believe that private credit remains a compelling asset class. In equities, value can offer a more favorable risk-reward than growth.

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A Tale of Two Forces

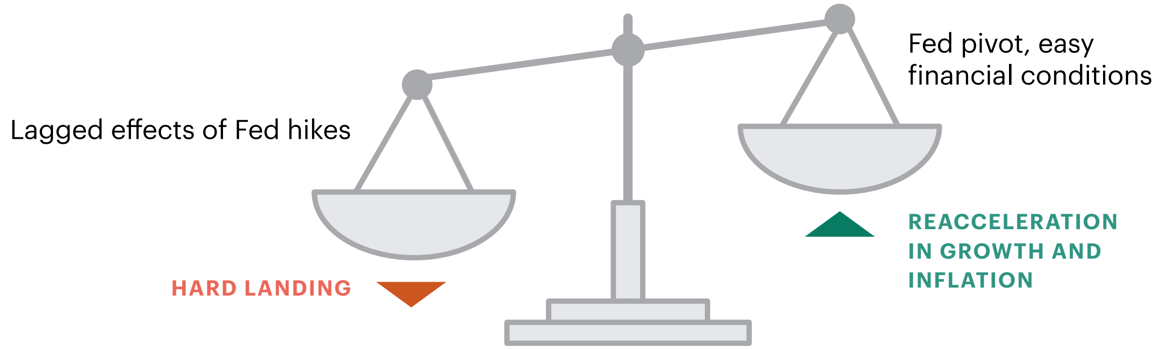
The US economy has shown incredible resilience and more stamina than most people expected when the Federal Reserve began its tightening cycle in March 2022, putting an end to almost 15 years of extremely low interest rates. At the time, many feared that a drastic and rapid increase in interest rates would "break" the economy, which had become accustomed to low borrowing costs. Further, worries about the adequacy of US corporate capital structures in a new regime of higher rates abounded. Most of those fears did not come to pass, as the economy remained strong in the face of costlier capital.

Such sturdiness, however, did not come without cost, as inflation has remained stubbornly above the Fed's 2% annual target. All-in, we now find ourselves—more than two years into the Fed's tightening campaign—in a state of unstable equilibrium, with powerful forces pulling the economy in oppositive directions (**Exhibit 1**).

In the remainder of this paper, we will discuss these individual forces in detail, explore potential outcomes, provide our views on how this economic tug-of-war will unfold, and investigate what impact can be expected on capital markets and investment portfolios.

Exhibit 1: The US economy is in a state of unstable equilibrium

The fragile US economic outlook



Source: Apollo Chief Economist

The Lagged Effects of the Fed Rate Hikes

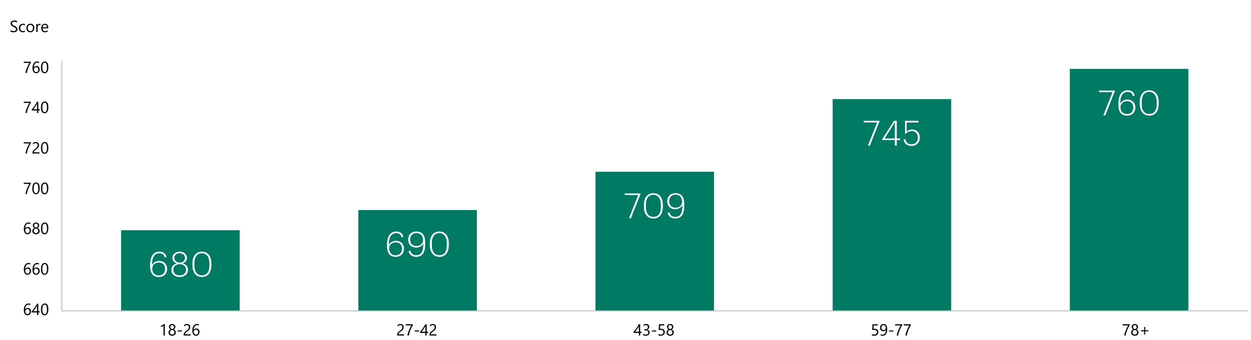
When the Fed started raising interest rates in March of 2022, we began to see impacts on the balance sheets of highly levered consumers. We also began to see impacts on the balance sheets of highly levered firms. Finally, we began to see impacts on banks' balance sheets, especially those of smaller regional banks.

Highly Levered Consumers

This is what the textbook would have predicted: When you raise interest rates, the economy should begin to slow down, with highly leveraged sectors leading the way. Since the start of the Fed's tightening campaign, younger households, which typically have three characteristics—lower incomes, more debt, and consequently, lower credit (FICO) scores (**Exhibit 2**)—have been harder hit than older ones.

Exhibit 2: Younger households have lower credit scores

Average credit score by age



Data as of 2023.
Sources: Experian, Apollo Chief Economist

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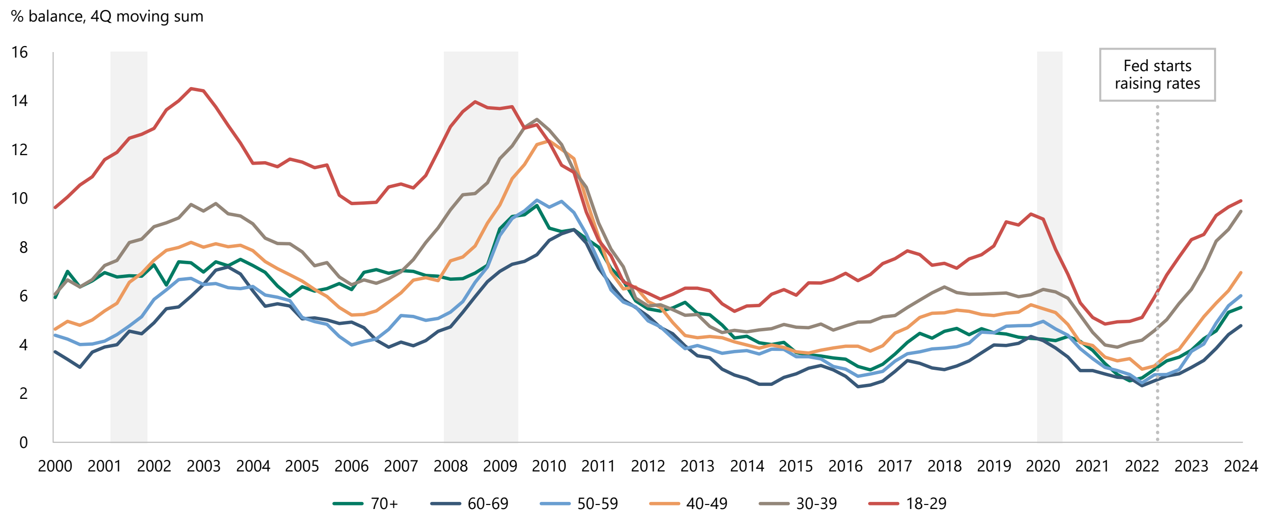
Credit card delinquencies for the youngest households have risen sharply (**Exhibit 3**) and are approaching rates last seen during the Global Financial Crisis (GFC).

The same story can be seen in auto loan delinquency rates (**Exhibit 4**). People in their 30s and below are falling behind on their auto loans at a faster pace than during the pandemic. Indeed, auto delinquencies for that cohort are almost as bad as they were at the peak in 2008.

Exhibit 3: Credit card delinquency rates are rising, especially for younger households

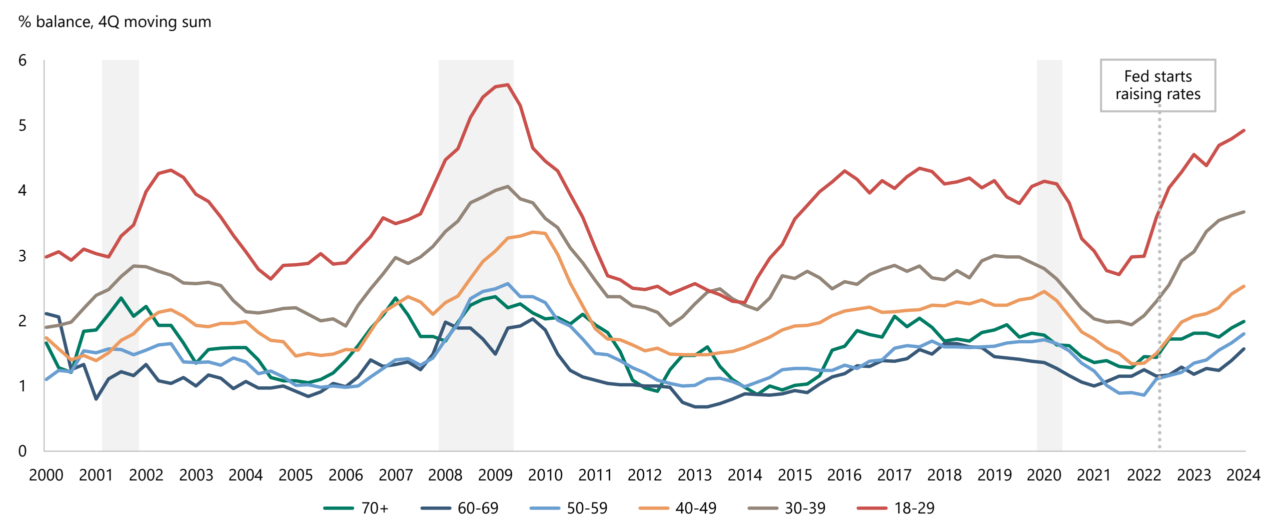
Credit card transitions to serious delinquency (90+), by age



Data as of March 2024.
Sources: New York Fed Consumer Credit Panel / Equifax, Apollo Chief Economist

Exhibit 4: Auto loan delinquency rates are rising too

Auto loan transitions to serious delinquency (90+), by age



Data as of March 2024.
Sources: New York Fed Consumer Credit Panel / Equifax, Apollo Chief Economist

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Why are these trends a cause for concern? Because the labor market is still very strong—the US economy added 272,000 jobs in May—and unemployment remains quite low. At last reading, the US unemployment rate stood at just 4.0%—well below the long-term average of 5.7%. Despite that strong employment picture, increasing numbers of people are falling behind on paying their auto loans. All of which raises a very serious question: What will happen when the economy really slows, and the labor market shows real cracks? Where will delinquencies go then?

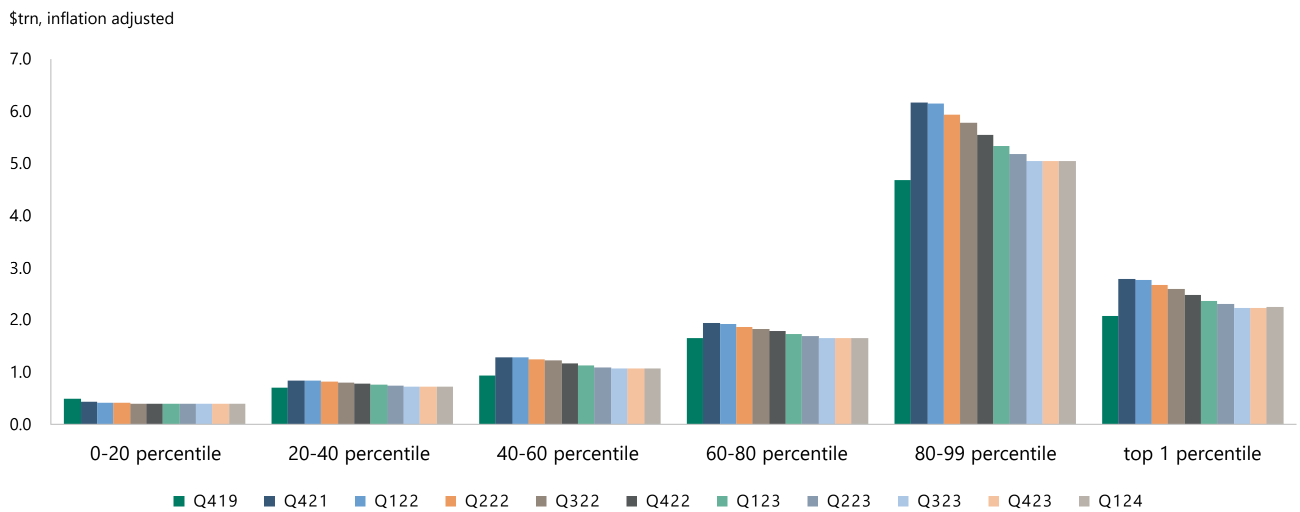
Consider, too, another window into the current health of household balance sheets, the amount of money that people have in their savings and checking accounts (**Exhibit 5**). Those in the lowest quintile—who make less than $25,000 a year—had more money before the pandemic than they do today.

In other words, low income households do not have any savings left from stimulus checks, unemployment benefits, childcare tax credits, Paycheck Protection Program (PPP) loans, and whatever amounts they might have saved during the pandemic by not going to restaurants, staying at hotels, or going to sporting events and concerts.

The same story holds for the next quintile, people who make between $25,000 and $45,000 a year. For the very middle class—the median income in the US is about $70,000 a year—current deposits are somewhat higher. But the bulk of excess savings sits with those at the top of the income distribution, those at the 80th percentile and above. Indeed, excess savings have recently started to rise again for higher income households.

Exhibit 5: Inflation-adjusted pandemic savings are concentrated at the high end of the income distribution

Deposits held by income percentile



Data as of March 2024.
Sources: FRB, Haver Analytics, Apollo Chief Economist

> The bulk of excess savings sits with those at the top of the income distribution.

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This is an important point: The top 20% of incomes account for 39% of consumer spending (**Exhibit 6**). These are the households that are still paying thousands of dollars for tickets to Taylor Swift concerts or the Super Bowl, still flying on airplanes, and eating out. Why? Because they still have some excess savings left from the pandemic.

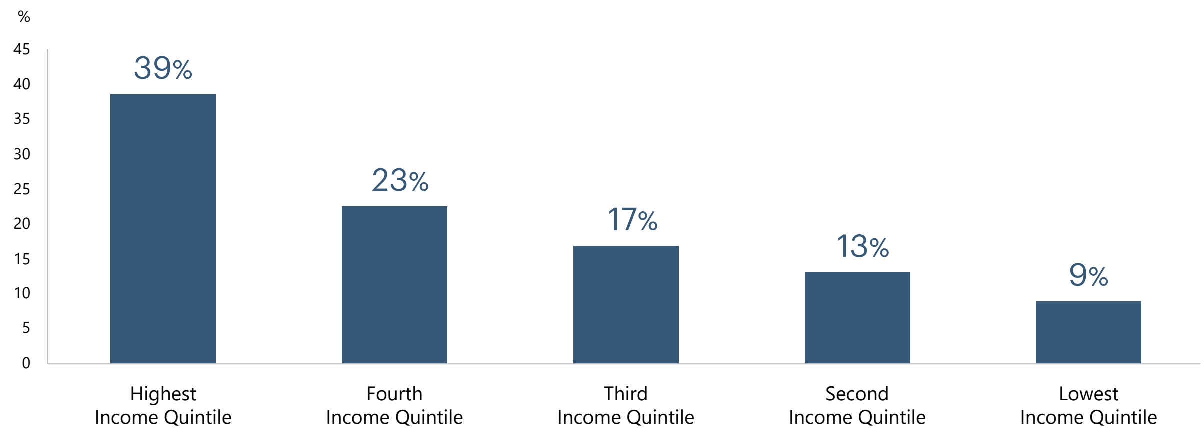
Keep in mind, too, that **Exhibit 5** only measures the amount of money people have in their bank accounts. It does not include household wealth derived from the stock market or the housing market. **Exhibit 7** shows you the growth in the market capitalization of the S&P 500 as well as that of the Bloomberg US Aggregate index since the November 2023 FOMC meeting (i.e., before the December pivot).

The market capitalization of the stock market has risen some $12.5 trillion since that time, and the bond market (including both US government and corporate bonds) has increased by $3.2 trillion, both because rates are lower than where they were in November as well due to the tightening of credit spreads. Adding these two numbers together, wealth has increased an astonishing $15.7 trillion since that time.

For comparison, US consumer spending in 2023 was $19 trillion.[1] So that means that we have added in wealth nearly 83% of last year's consumption, a significant tailwind to spending, especially for those at the top of the income distribution.

Exhibit 6: Wealthier consumers account for a disproportionate amount of spending

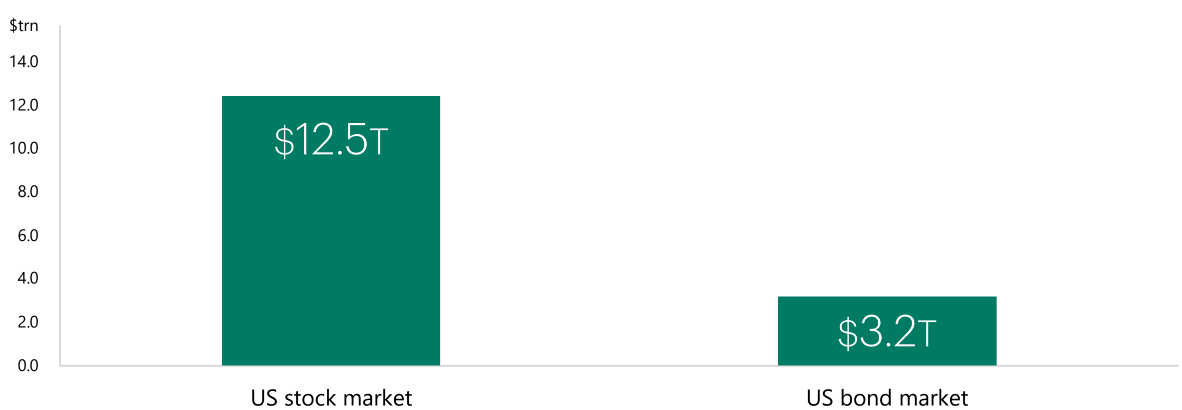
Share of consumption by income quintiles



Data as of September 2023.
Sources: BLS, Consumer Expenditure Survey, Haver Analytics, Apollo Chief Economist

Exhibit 7: Securities-related wealth has increased $15.7 trillion since the November FOMC meeting

Growth in market cap of US stock and bond markets since November 1, 2023



Data as of June 16, 2024.
Sources: Bloomberg, Apollo Chief Economist

[1] Source: Bureau of Economic Analysis

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So we have a story of two cohorts:

1. If you *owe money,* the Fed hikes have been painful. More and more households are falling behind on paying their bills. The negative effects of rising rates land most squarely on consumers who owe money on their cars and their credit cards. There's a very interesting prioritization going on in today's economy, too, in which people are unwilling to walk away from mortgages. People are very reluctant to leave their 3% or 4% fixed-rate mortgages because they know that they will have to reset and get a new loan at 7% or 8%. People are much more willing to give up on their student loans, credit card loans, and auto loans. Furthermore, some 40% of homeowners don't even have a mortgage,[2] and 95% of mortgages are 30-year fixed that are not sensitive to the Fed raising interest rates.[3] So the pain from rising rates is not particularly acute among existing homeowners. It is, of course, a different story for new household formation.
2. If you *own assets,* on the other hand, you may have never been in better shape than you are today. The stock market is up. Home prices are up. Crypto is up. Cash flows from fixed income are the highest they have been in a very long time. Higher income households, in other words, are benefitting not just because their assets are up, but because their income from investments is up as well.

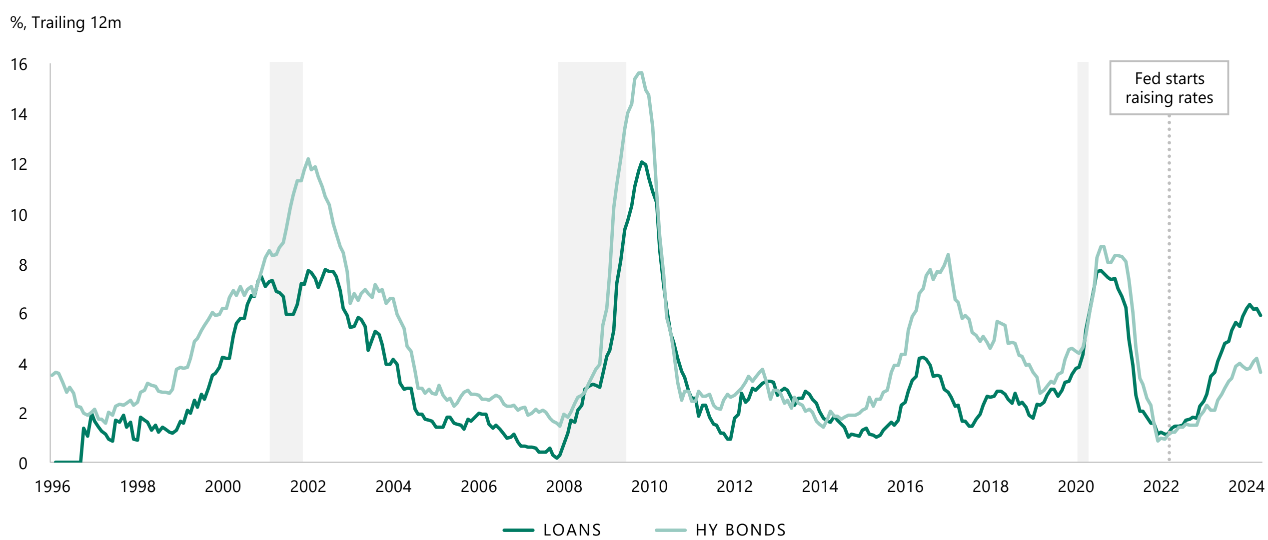
So the impact on the consumer is very bifurcated: Even though all consumers are impacted by rising rates on the liability side of the ledger, it just so happens that since the Fed turned dovish in November, risky assets have rallied strongly, providing a significant tailwind to those who own assets, particularly financial ones.

Highly Levered Firms

In the corporate realm, it's quite clear that a default cycle has started. **Exhibit 8** shows default rates for loans and high yield. Generally speaking, those who have borrowed via loans and high yield tend to be the firms with the most debt as a percentage of overall enterprise value.

Exhibit 8: A default cycle has started

US speculative grade default rates



Data as of May 31, 2024.
Sources: Moody's Analytics, Apollo Chief Economist

[2] Data as of 2022.
Source: US Census Bureau

[3] Data for 2022 Q4, as of April 2024.
Source: IMF World Economic Outlook

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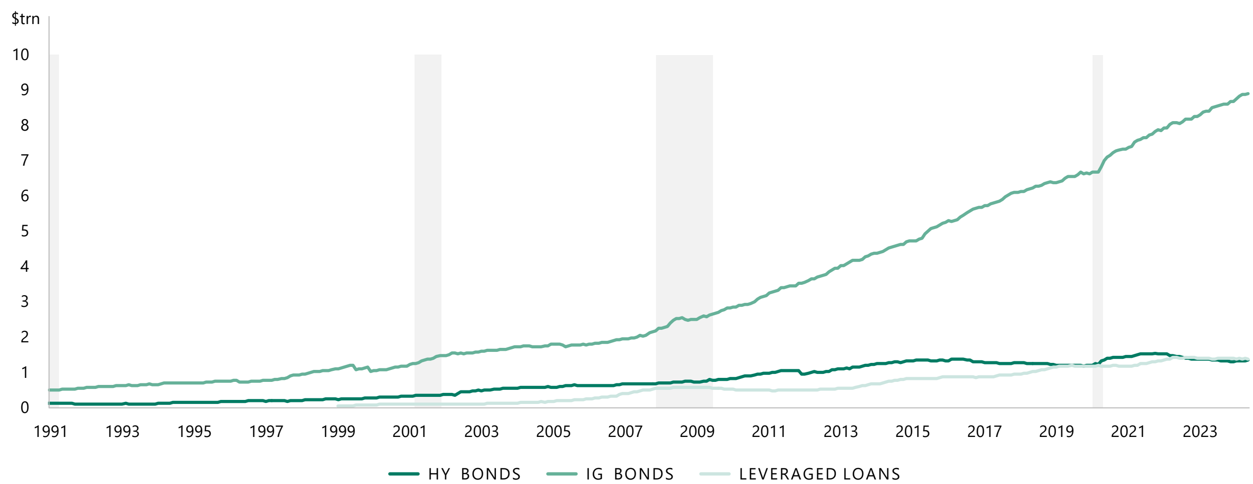
While the steepness of the rise in defaults may appear worrisome, it's important to remember that the largest credit market by far is investment grade credit (**Exhibit 9**). There are roughly $9 trillion in investment grade bonds outstanding, compared to $1.4 trillion in loans, $1.3 trillion in high yield bonds, and $1.5 trillion in private credit. So while it may seem that there is trouble brewing, there is really only trouble in that part of the credit universe—loans and high yield. During Covid, most firms termed out their debt at very low levels, and with the IG market having grown from $3 trillion in 2009 to $9 trillion today, the interest rate sensitivity of corporate America has declined.

Another interesting wrinkle can be seen when we examine the fate of companies defaulting on their debt. Typically, with a rising default rate, we would expect to see rising layoffs. In 2023/2024, that has not proven to be the case. Firms are not liquidating. Indeed, the percentage of firms liquidating in bankruptcy filings has declined to just 30%. The share of firms that are reorganizing is now 70% (**Exhibit 10**).

Exhibit 9: The investment grade market is 6x the size of both the high yield and loan markets

Market value outstanding

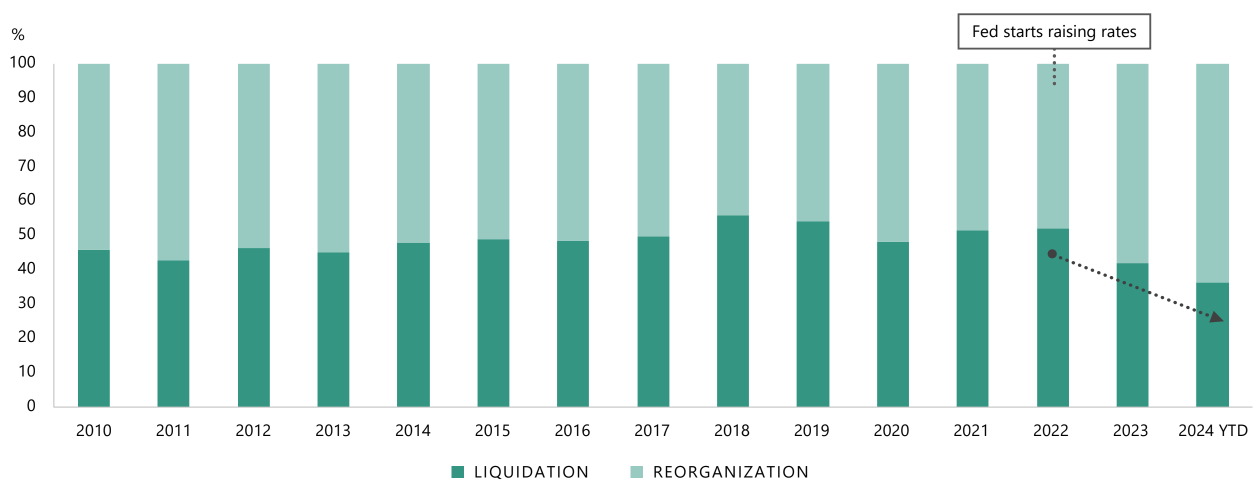


Data as of May 31, 2024.

Sources: Moody's Analytics, Apollo Chief Economist

Exhibit 10: In 2024, corporate liquidations are declining while reorganizations are rising

US bankruptcy filings by filing type



Data as of March 2024.

Bankruptcy figures include public companies or private companies with public debt with a minimum of $2 million in assets or liabilities at the time of filing, in addition to private companies with at least $10 million in assets or liabilities. Chapter 11 liquidation and Chapter 7 bankruptcy filings are categorized as liquidation and other Chapter 11 bankruptcy filings as reorganization.

Sources: S&P Capital IQ, Apollo Chief Economist.

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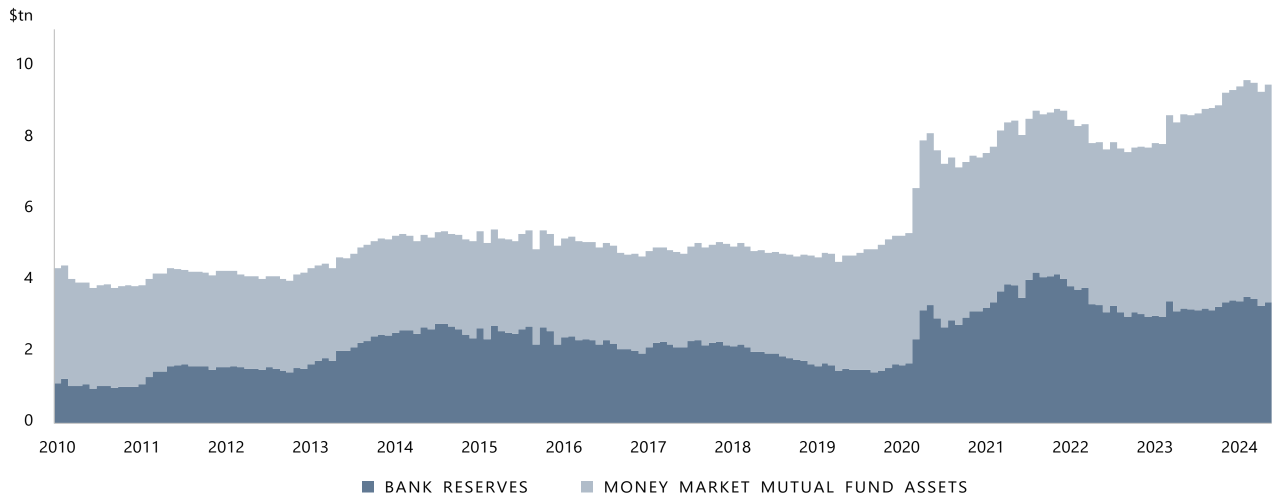
Why is that the case? Because of a phenomenon known as *equitization*. Debt is being written down and exchanged for equity, and that is keeping firms alive. Why is that happening? Because there's a lot of dry powder sitting on the sidelines—at least $1 trillion in private equity and another $400 billion in private credit.[4] There's also willingness to lend, broadly speaking, in the public markets, because credit spreads are very tight, and equities are very high (**Exhibit 11**).

That provides a willingness to refinance companies without shutting them down. This is one of the reasons why we did not see a recession last year: Because companies were able to wiggle through the difficulties caused by rising rates by reorganizing.

Exhibit 12 shows that between 50% and 60% of leveraged loan defaults today are distressed exchanges where debt is being written down and exchanged for equity. While we consider this a positive for the companies, employees, and other stakeholders involved, it's important to note that these exchange transactions also represent a gamble by those taking equity positions.

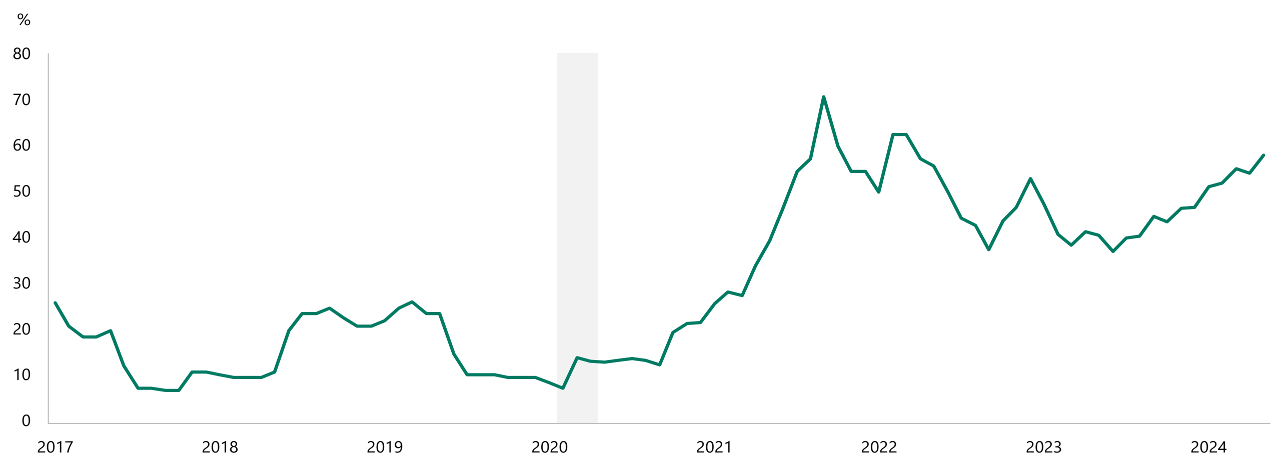
Exhibit 11: There is record-high liquidity to support equity and credit markets



Data as of May 2024.
Sources: ICI, FRB, Haver Analytics, Apollo Chief Economist

Exhibit 12: Distressed liability exchange transactions as a share of total defaults are on the rise

Distressed exchange as a share of leveraged loan defaults



Data as of May 31, 2024.
Sources: S&P, PitchBook LCD, Apollo Chief Economist

[4] Source: PitchBook LCD

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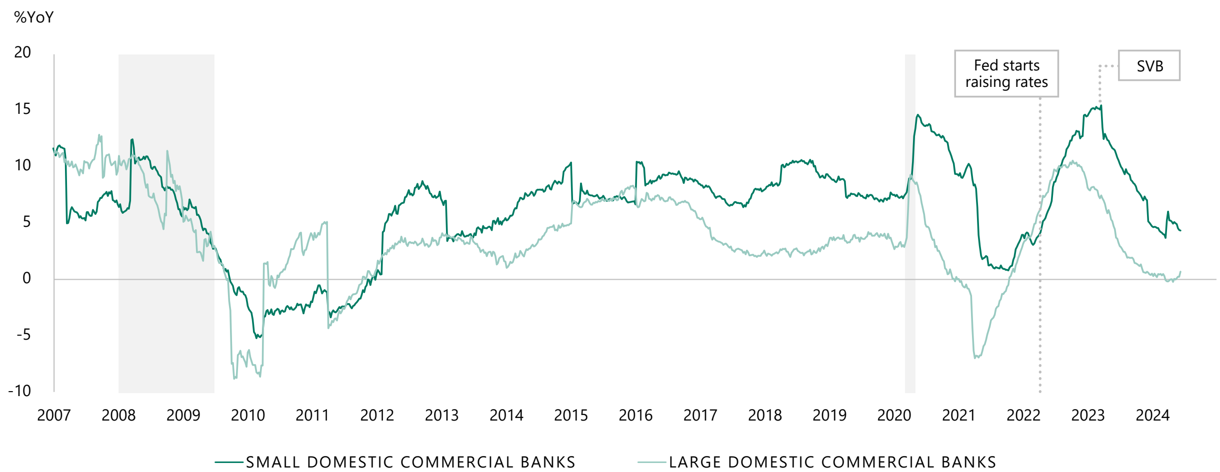
If rates do indeed stay higher for longer, as we expect, there is a real likelihood that many of the companies reorganized today will burn through their remaining cash without the ability to refinance again, leaving them in worse shape a year from now than they are today. It's already crunch time for those companies that have a lot of debt. If rates stay high, some companies that have reorganized today will find themselves facing another reorganization tomorrow. Complicating matters is the fact that small companies generally don't have pricing power in any shape or form, which means that they won't have recourse to the option of passing the higher costs of servicing their debt onto consumers.

Highly Levered Banks

What has higher rates for longer meant for the banking sector? The first trail of breadcrumbs we can follow is that of weekly lending data from the banking sector, where we have seen a dramatic decline since the Fed started raising rates (**Exhibit 13**).

There is, mind you, some good news for the banking sector: Commercial real estate (CRE) prices are starting to rebound (**Exhibit 14**). That's particularly good news for regional banks, which have a lot of CRE on their books. Except for office prices, the nationwide CRE crisis is beginning to abate, with national CRE prices looking good, as well as apartments, retail, and industrial.

Exhibit 13: Weekly Fed data shows small and large bank lending growth slowing rapidly

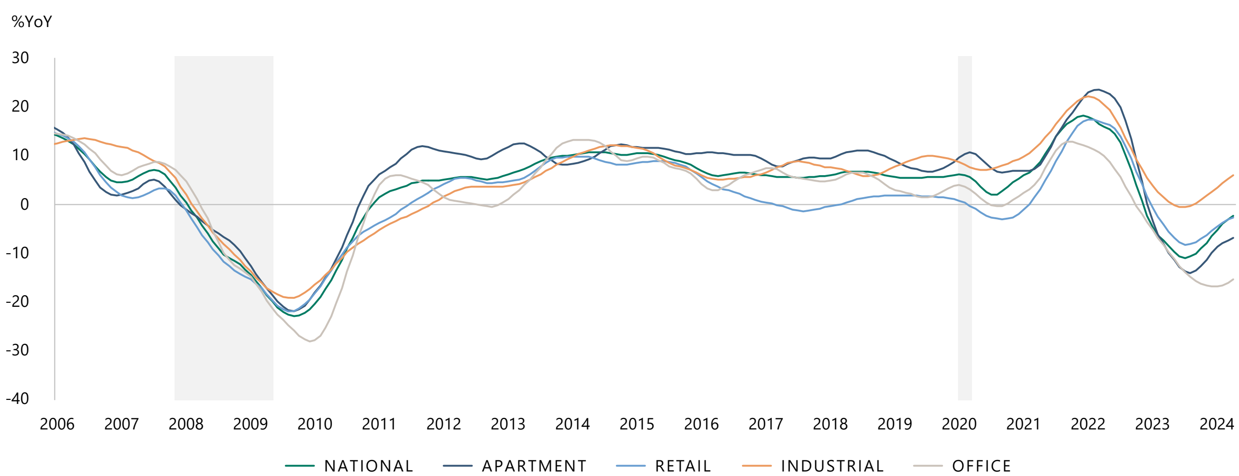


Data as of June 5, 2024.

Sources: Federal Reserve Board, Haver Analytics, Apollo Chief Economist

Exhibit 14: CRE prices have begun to rebound, which is particularly good news for regional banks

Commercial property price index



Data as of April 30, 2024.

Real Capital Analytics Commercial Property Price Index, retrieved from Bloomberg for National All Properties ticker MOCICINP, National Office ticker MOCICIOE, National Apartment ticker MOCICIAP, National Industrial ticker MOCICIIN, and National Retail ticker MOCICIRL.

Sources: Federal Reserve Board, Haver Analytics, Apollo Chief Economist

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So, what does this all mean for the broader economy?

The Fed raising rates has hurt those consumers with weaker balance sheets. It's been difficult for firms with weaker balance sheets as well. It's also been tough for some banks. But the pain suffered by those three groups has simply not been big enough to create the hard landing that everyone expected in 2023.

Indeed, the incoming data continues to be strong. Growth remains solid, labor costs are elevated, and inflation is higher than the Fed's 2% target. The sources of growth are fiscal policy (which we will return to later) and easy financial conditions. Specifically, the Fed's pivot in December has had a very positive impact on financial markets.

When the Fed signaled an imminent easing of financial conditions, everything changed. Desperate for fresh liquidity, the market effectively provided it to itself even before the Fed had begun to do so. The result? The Fed is now caught between tightening and easing, in an unstable equilibrium of its own making.

At the conclusion of their two-day policy meeting on June 12, central bankers held the target range for the fed funds rate steady for the seventh straight meeting, at 5.25% to 5.5%, pointing out that "We do not expect it will be appropriate to reduce the target range for the federal funds rate until we have gained greater confidence that inflation is moving sustainably toward 2%."

Regarding the future direction of rates, Fed Chairman Jerome Powell said during a press conference, "If the economy remains solid and inflation persists, we're prepared to maintain the current target range for the federal funds rate as long as appropriate." So while it's likely that an easing bias remains in place, it seems quite clear that rates will stay higher for longer. Our view, in fact, is that the Fed will not lower rates at all in 2024.

The Fed Pivot and the Easing of Financial Conditions

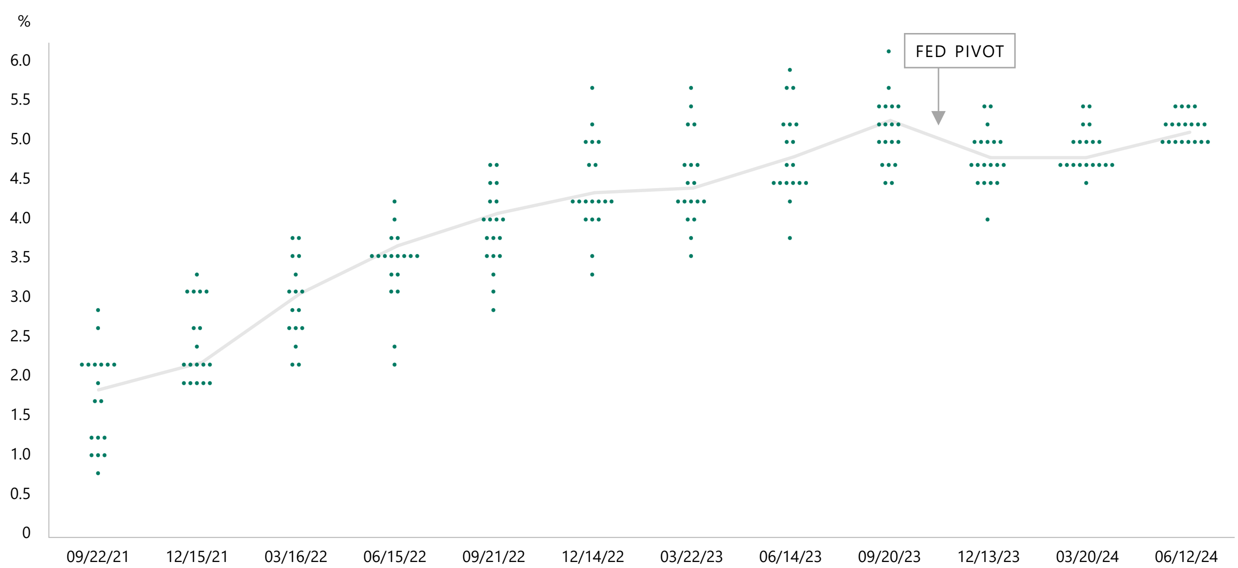
At the center of the economic story over the past several years has been the pathway of inflation. At first, it went up, so sharply that the Fed was spurred into quick and dramatic action. Then, after the Fed hikes, it came down. By late 2023, the way the Fed saw things, everything was normalizing. That was good news, and it signaled as much to the market in December 2023. And then, new inflation data was released and showed that, suddenly, we were no longer normalizing. The picture still holds: In mid-June, inflation readings showed a May CPI increase of 3.3% over the previous year, a moderation from April, but still well above the Fed's target of 2%.

For two years, the Fed had been saying, "interest rates are going higher." That message resulted in very little activity in capital markets, with low levels of initial public offerings (IPOs), mergers and acquisitions (M&A), sponsor-to-sponsor deals, and sponsor-to-strategic deals. Private equity deal flow slowed to a crawl, as managers sought to delay exits as interest rates moved higher.

That changed at the December 2023 meeting when, with a few exceptions, all FOMC members began forecasting moderately lower interest rates at year-end 2024 (**Exhibit 15**). In other words, "interest rates are expected to decline from now on."

Exhibit 15: The Fed pivoted in December 2023 from rates going higher to rates going lower

FOMC members' end-2024 forecast for the fed funds rate



Data as of June 12, 2024.
Sources: Bloomberg, Apollo Chief Economist

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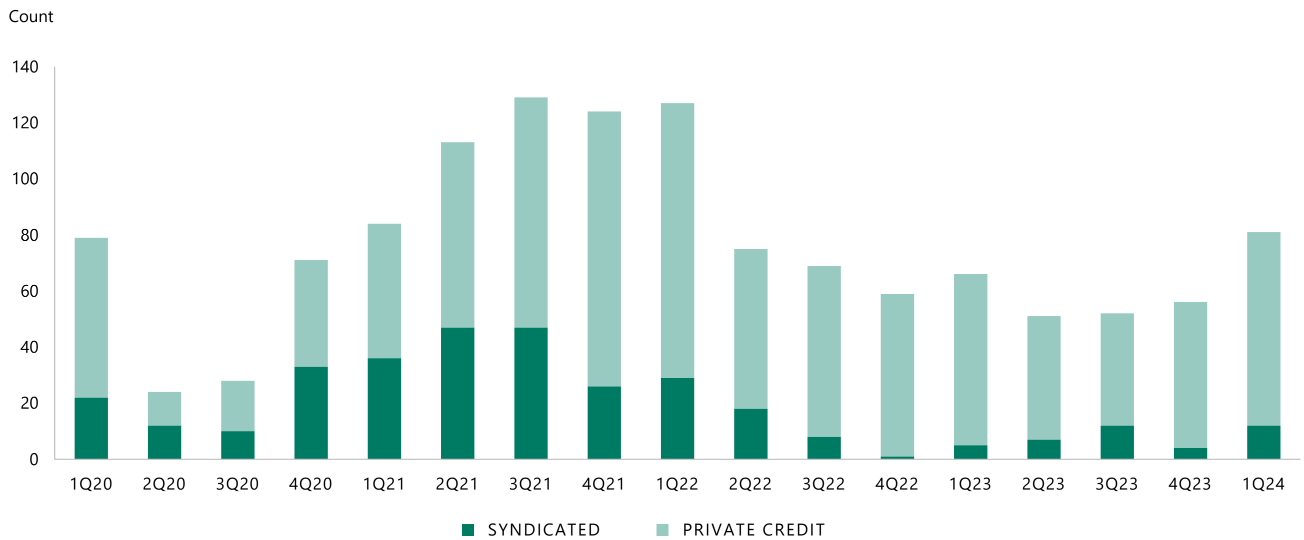
The impact of that signal change from the FOMC was profound. Private equity firms "jumped off the fence" and began to transact. The M&A market opened up. The IPO market opened up. Leveraged buyout (LBO) financings rebounded significantly (**Exhibit 16**). The Fed pivot also triggered a significant rally in the S&P 500 (**Exhibit 17**).

Exhibit 16: LBO financings have come back strongly since the Fed pivot

Number of LBOs financed in BSL and private credit market

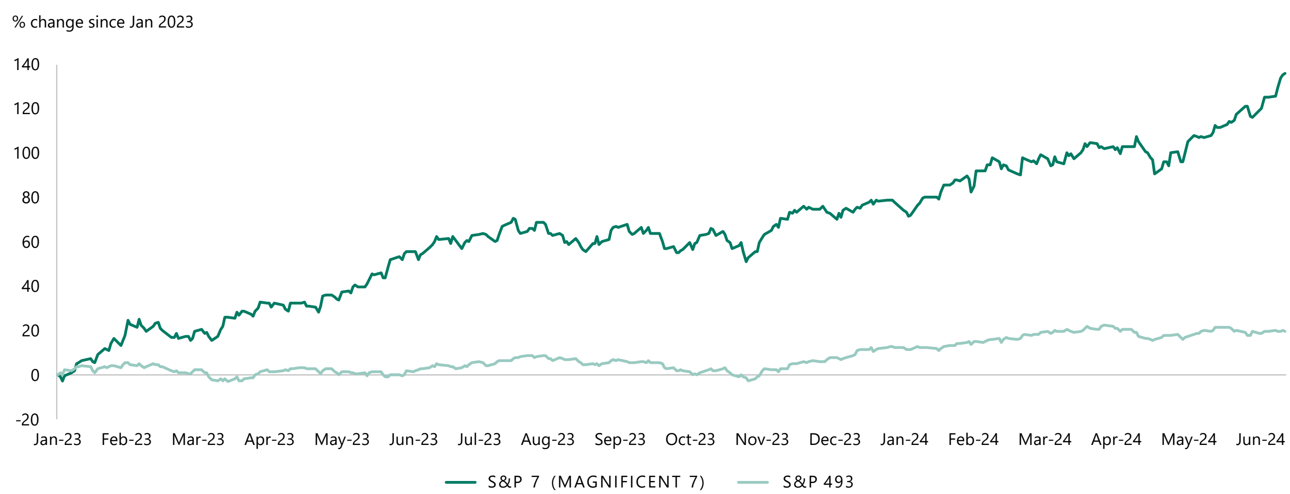


Data as of March 31, 2024.

Sources: PitchBook LCD, Apollo Chief Economist. Note: Private credit count is based on transactions covered by LCD News

Exhibit 17: The market cap of the S&P 500 has risen sharply, in large part due to the performance of the Magnificent 7

S&P 500 index performance



Data as of June 14, 2024.

Note: The S&P 7 is the Magnificent 7: Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta, and Tesla.

Sources: Bloomberg, Apollo Chief Economist

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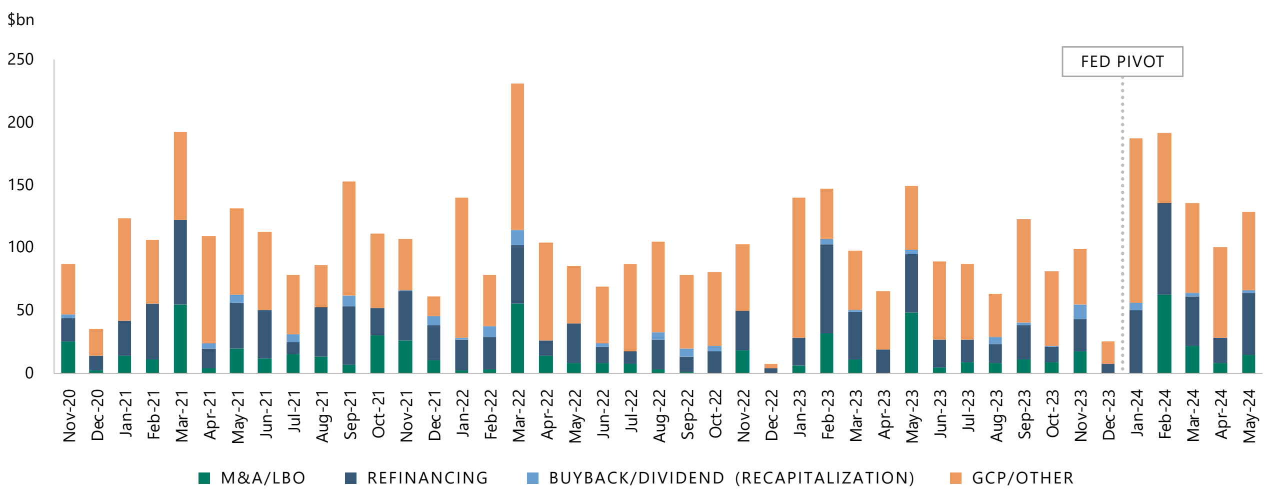
Buoyant demand for corporate debt permeated all corners of the credit market with investment grade (**Exhibit 18**), high yield (**Exhibit 19**), and leveraged loan issuance capping the busiest start for primary markets in at least two years. US high yield debt issuance hit its highest quarterly mark since the third quarter of 2021 while investment-grade issuance soared to $530 billion in the first three months of the year, its highest first quarter level ever. Leveraged-loan issuance posted its second most active quarter on record although most of the activity was driven by repricing and refinancing as issuers looked to extend maturities and lock in tighter spreads. M&A activity also came alive in the first quarter, rising 70% versus the same period last year alongside a flurry of rumored M&A headlines. In short, since the Fed pivot, we have seen issuance in all purposes and all proceeds up dramatically. In February, in particular, M&A and LBO activity were quite strong.

On the Fed's cue, the capital markets reopened. And with the Fed *still* saying that the next move in rates is lower, we should expect capital-market activity to remain vibrant.

Exhibit 18: Investment-grade issuance has risen sharply...

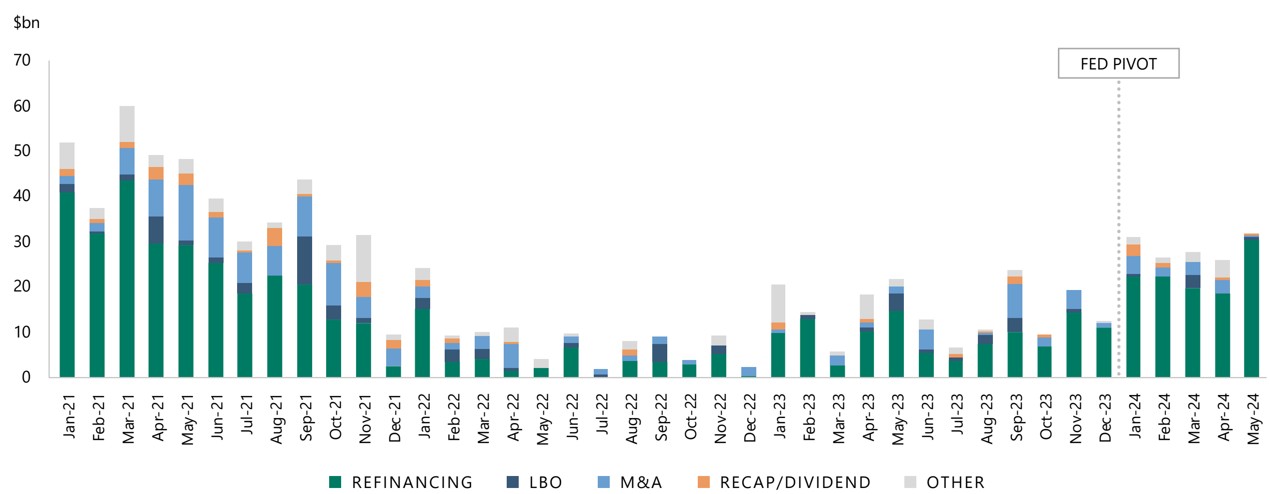
High grade volume by proceeds



Data as of May 2024.
Note: GCP means general corporate purpose.
Sources: PitchBook LCD, Apollo Chief Economist

Exhibit 19: ...along with high-yield issuance

HY issuance volume by proceeds



Data as of May 2024.
Sources: PitchBook LCD, Apollo Chief Economist

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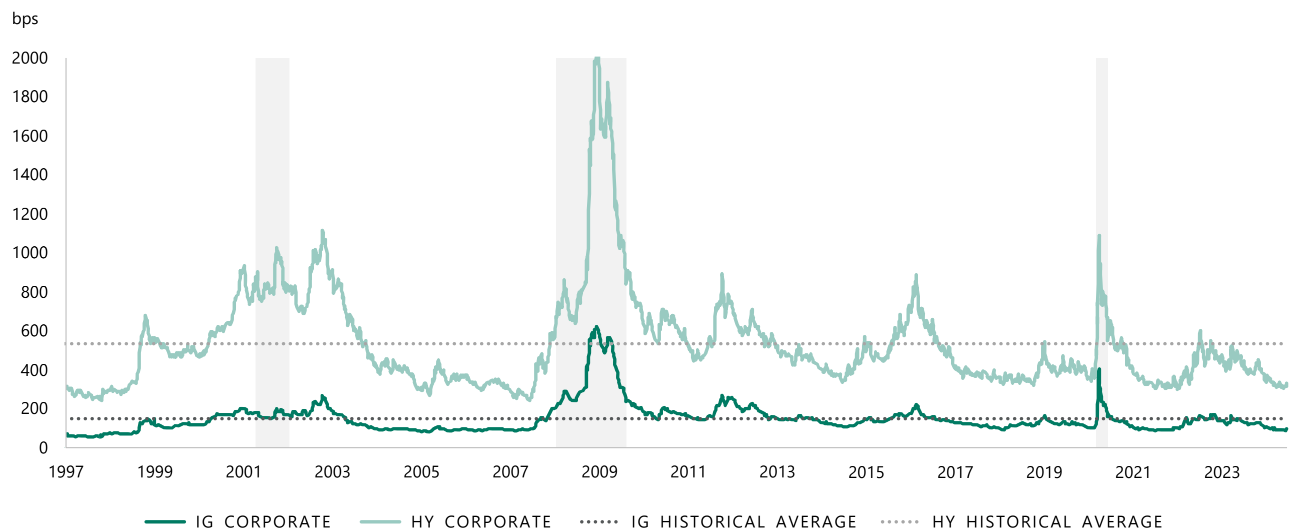
A look at the path credit spreads have taken over the past few years shows quite clearly how the Fed rate hikes have been neutralized by the easing in financial conditions (**Exhibit 20**). The Fed began to raise rates in March of 2022. Initially, markets reacted exactly as one might expect: When the Fed raises rates, people get worried about a slowdown, and credit spreads start widening. But today, the IG credit spread is at an incredibly tight 95 basis points (bps), with the high yield index at 329 bps. All-told, credit spreads have tightened to levels that are close to when the Fed began to hike rates in the first place.

The Fed reopened the market just by *talking* about lowering rates. With its signal change, the Fed created a *pivot party* whereby everyone in financial markets who was hiding under the table for years was able to stick their head out and say, "We see a green light to take on some risk!" All of this has generated nothing short of a dramatic tailwind to the US economy. We can call this the *Fed Cut Reflexivity Paradox*: The more the Fed insists that the next move in interest rates is a cut, the more financial conditions will ease, making it more difficult for the Fed to cut.

Exhibit 20: Credit spreads have tightened significantly

US investment grade and high yield spreads



Data as of June 14, 2024.
Sources: Bloomberg, Apollo Chief Economist

> The Fed is now caught between tightening and easing, in an unstable equilibrium of its own making.

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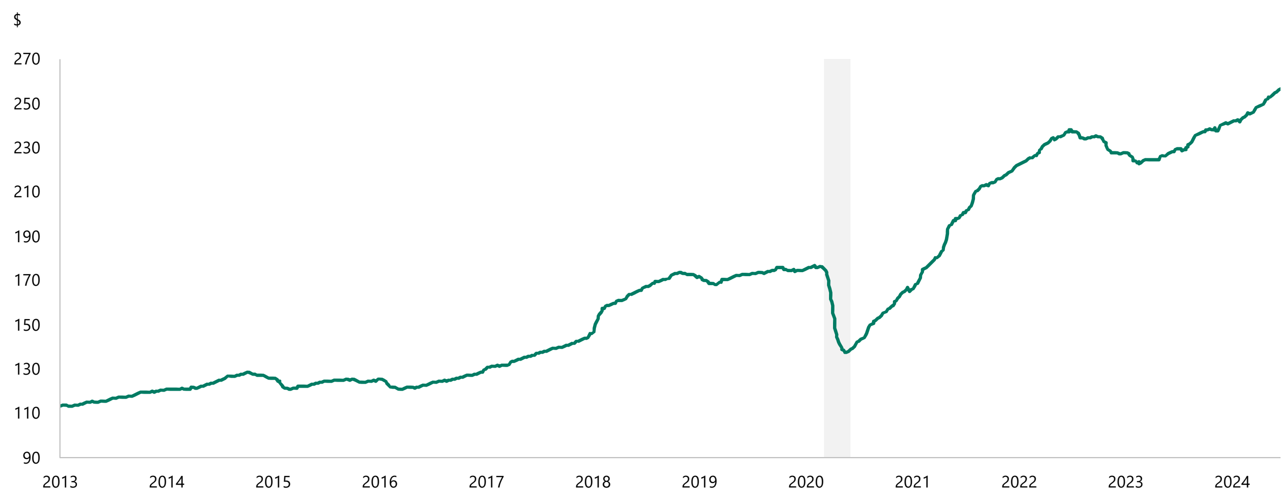
Outlook for corporate performance: Stronger for longer

Equity analysts continue to increase their earnings expectations for the S&P 500 because there are simply no signs of a slowdown in corporate earnings (**Exhibit 21**). This presents an obvious upside risk to inflation over the coming months.

The economy continues to power ahead fueled by easy financial conditions, as shown by the Bloomberg US Financial Conditions index (**Exhibit 22**). The index has risen since the Fed pivot in November and December, boding well for both corporate profit and overall GDP growth.

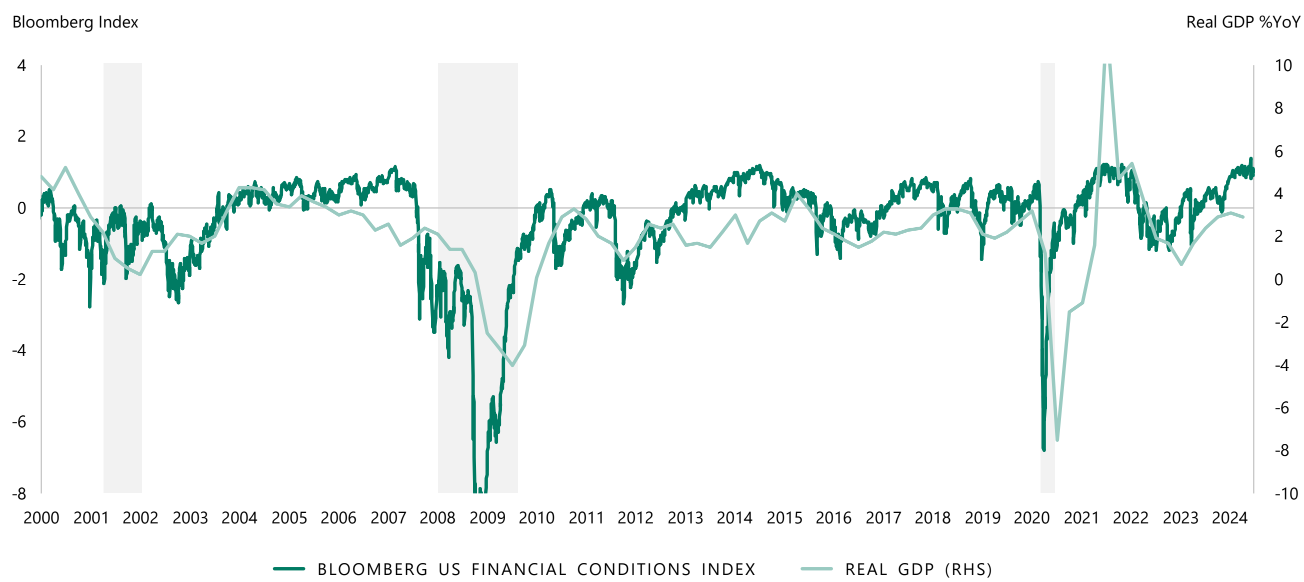
Exhibit 21: There are no signs of a slowdown in S&P 500 earnings expectations

S&P 500 12-month forward EPS



Data as of June 14, 2024.
Sources: Bloomberg, Apollo Chief Economist

Exhibit 22: Easier financial conditions point to a rebound in GDP growth



Data as of June 14, 2024.
Sources: BEA, Bloomberg, Apollo Chief Economist

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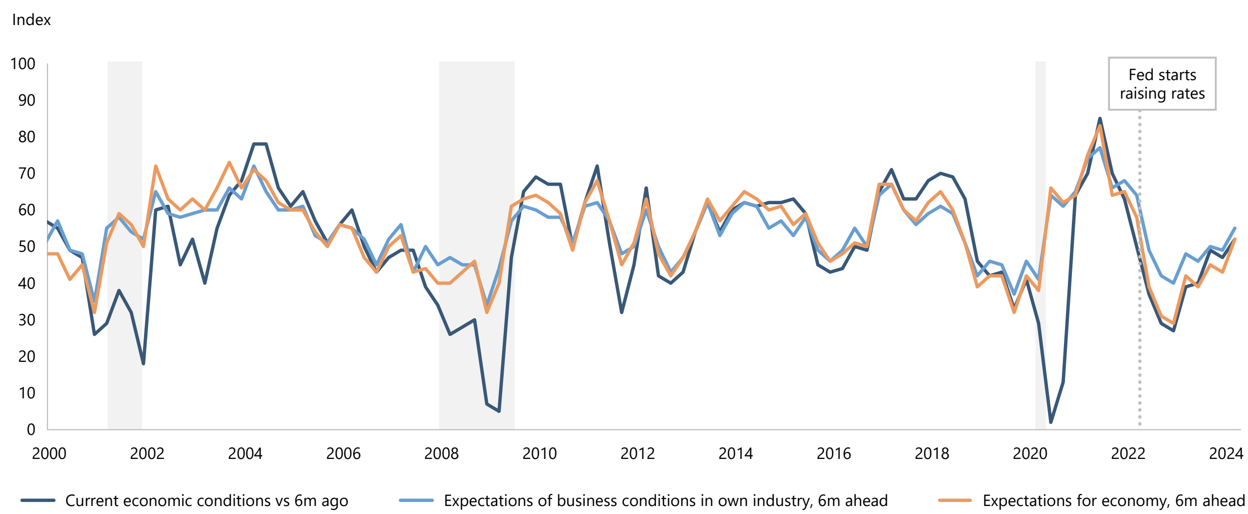
In fact, CEOs are increasingly bullish, despite the Fed's rate hikes (**Exhibit 23**). Confidence continues to rebound among that cohort, and CEOs' view of current and future conditions remains optimistic.

We should not be surprised that the labor market is still strong. We should not be surprised that inflation is still strong. And we should not, therefore, be surprised if the economy continues to do well (**Exhibit 24**).

At this stage, given the current underlying strength of the US economy, we believe that easier financial conditions will continue to offset the effects of the Fed rate hikes. As such, we disagree the consensus outlook for the economy. We think US GDP growth will be 2.5% in 2024, higher than the consensus view of 2%. The joint tailwind from easy financial conditions and continued strength in consumer spending, which we will discuss next, can overwhelm the consensus estimates over the next three quarters.

Exhibit 23: CEOs are increasingly bullish, despite the Fed's rate hikes

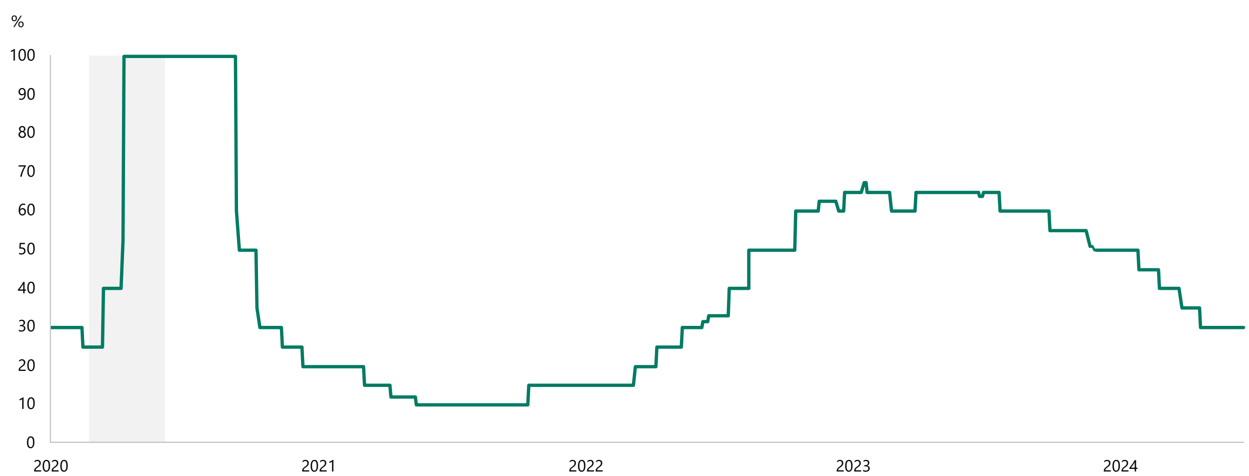
CEO business confidence



Data as of March 2024.
Sources: Conference Board, Haver Analytics, Apollo Chief Economist

Exhibit 24: The consensus view of the likelihood of a US recession over the next year continues to fall

Consensus: Probability of US recession in the next 12 months



Data as of June 17, 2024.
Sources: Bloomberg, Apollo Chief Economist

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With the backdrop of rallying markets, strong investment-grade and high-yield issuance, and more IPO and M&A activity, hiring and inflation will likely remain strong.

With financial conditions easing, we expect the economic data to continue to remain robust. As shown previously, Fed hikes are biting on highly leveraged consumers and firms. But not at the macro level. The interest-rate sensitive parts of the economy are responding to higher costs of capital, but the impact is not yet visible in the macro data.

The ongoing rebound in capital market activity combined with a low inventory of homes for sale is boosting employment and the housing market, increasing the risk of a rebound in inflation. The Fed's inflation target is 2% and inflation has started to move sideways at 3%, which is a problem for the FOMC. The US economy is simply not slowing down, and the Fed pivot has provided a strong tailwind to consumer spending and capex spending since December.

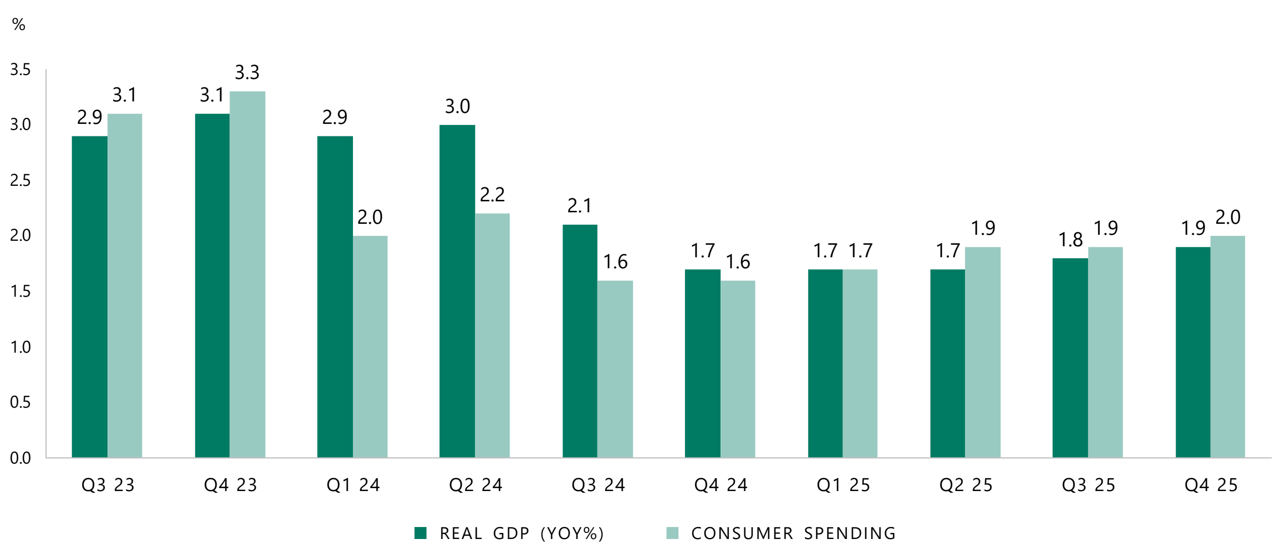
Outlook for consumer spending: Stronger than everybody expects

We know that rate hikes are having an impact on various borrowers. They have had an impact on highly levered households, highly levered firms, and highly levered banks. While the risks of a hard landing remain—more people not able to pay their credit cards bills and auto loans, and still at risk of losing their jobs—those households at risk do not account for a significant enough share of consumer spending to tilt the balance at the macro level.

From a holistic perspective, we believe that the consensus outlook for consumer spending is too low (**Exhibit 25**). Why? Because even though consumers with a lot of debt are being negatively impacted by higher interest rates, the dramatic increase in the wealth of middle and high income households is more than compensating for the negative effects of rising rates. As we said before: The stock market is up, house prices are going up, even crypto prices are going up. Fixed income cash flows have also improved. This significant increase in household wealth, combined with still-strong home prices, will be a solid tailwind to consumer spending over the coming quarters, in our view.

Exhibit 25: We believe that the consensus forecasts for consumer spending are too low

Consensus forecasts for consumer spending and GDP growth



Data as of June 17, 2024.
Source: Bloomberg

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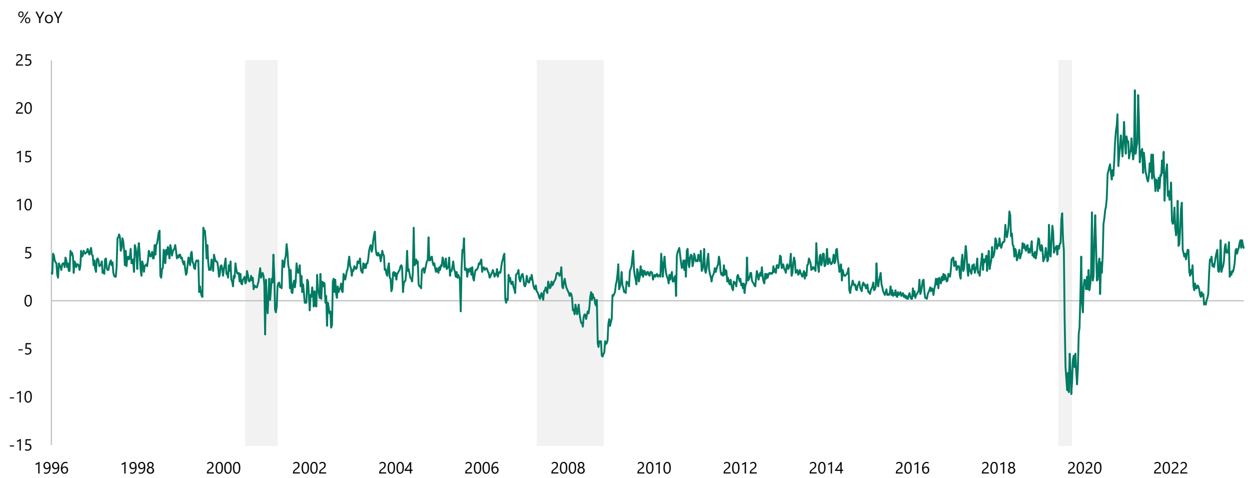
Because of the significant rise in the stock market and significant cash flows from fixed income, US households still have discretionary spending power (**Exhibit 26**), and that is why inflation in non-housing service sectors continues to be so high and consumers are still making plans to spend more money in the year ahead (**Exhibit 27**).

In summary, we believe that, over the next several quarters, those lagged effects of the Fed rate hikes will be overtaken by the dramatic tailwind coming as a result of the easing of financial conditions (stock market up, credit spreads tighter, Bloomberg Financial Conditions index, investment-grade and high-yield issuance up). The US consumer has too much gas left in the tank to expect that she will take her foot off the spending pedal anytime soon.

Exhibit 26: The weekly data for same-store retail sales is still strong

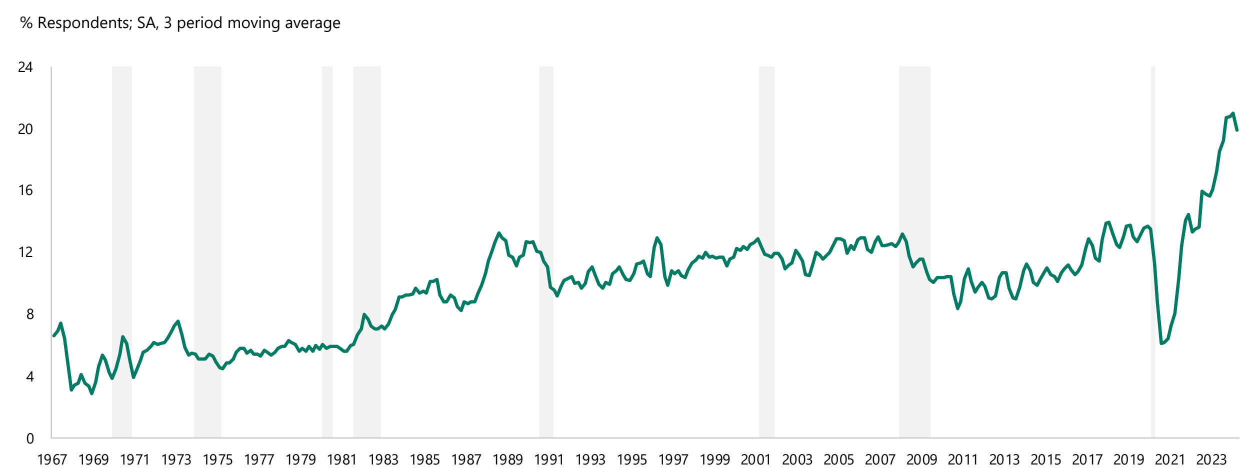
Redbook Research: Same-store, retail sales



Data as of June 2024.
Sources: Redbook, Bloomberg, Apollo Chief Economist

Exhibit 27: A record-high share of the population is planning to go on vacation to a foreign country within the next six months

Vacation intended within 6 months: foreign country



Data as of April 2024.
Sources: The Conference Board, Haver Analytics, Apollo Chief Economist

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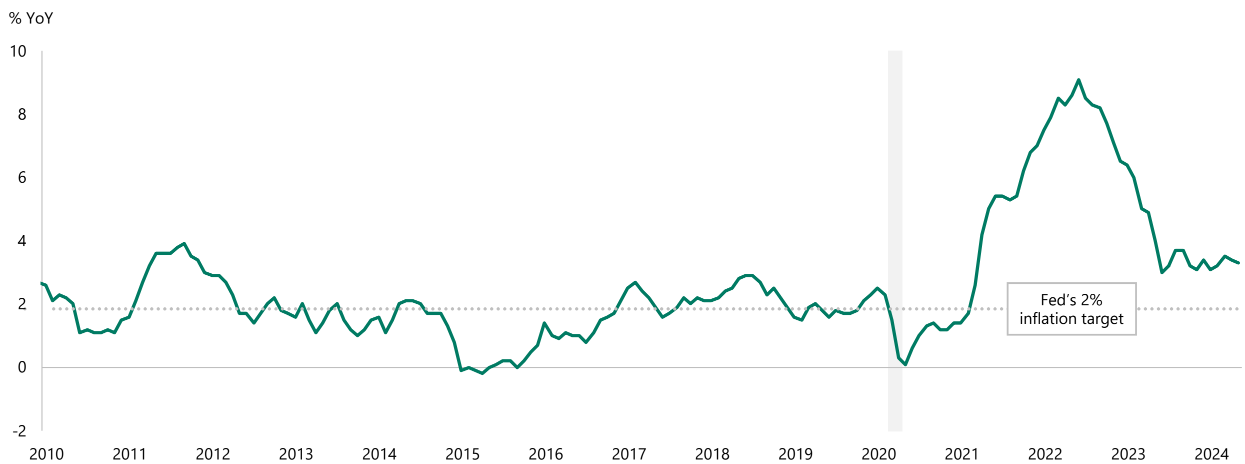
Outlook for inflation: Still too early to declare victory

Inflation is stuck between 3% and 3.5% (**Exhibit 28**). A casual market observer might ask whether there is any real difference between 2% and 3%. The answer? There is a *huge* difference. The Fed has publicly committed to a 2% target, and it is going to do all that it can to achieve it. And what's their main weapon to do so? Keeping interest rates higher for longer.

What if inflation starts falling again? What then? That would be good news for the Fed and indeed pave the way for rate cuts. But the data isn't pointing that way. Indeed, there has been an uptrend in inflation in the last three to six months—not just in the consumer price index (CPI) (**Exhibit 29**) but in the personal consumption expenditure (PCE) index (**Exhibit 30**, following page) as well.

Exhibit 28: Inflation is sticky above the Fed's 2% inflation target

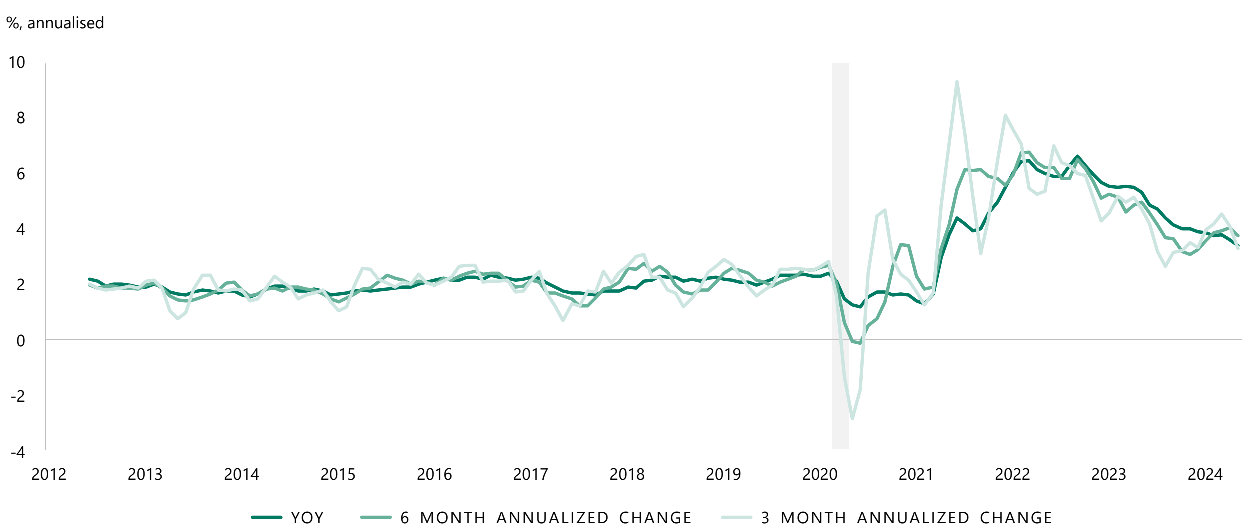
Headline consumer price index (CPI)



Data as of May 2024.
Sources: BLS, Haver Analytics, Apollo Chief Economist

Exhibit 29: Core CPI has been stubborn both in terms of 3- and 6-month changes

Core consumer price index (Core CPI)



Data as of May 2024.
Sources: BEA, Haver Analytics, Apollo Chief Economist

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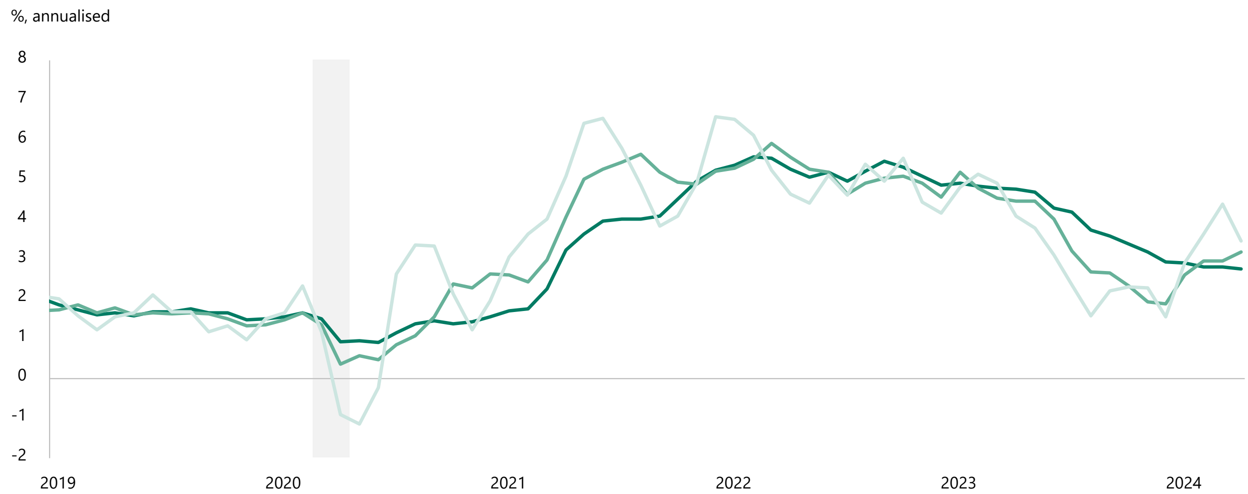
Exhibit 30: Core PCE is proving sticky as well

Core personal consumption expenditures (Core PCE) price index

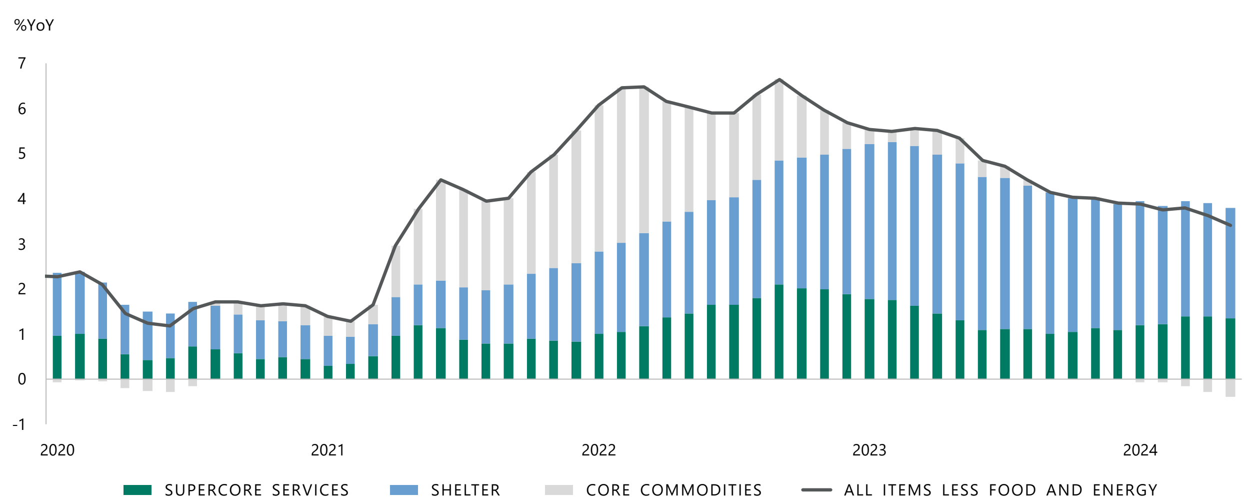


Data as of May 2024.
Sources: BEA, Haver Analytics, Apollo Chief Economist

Looking more granularly, we can see that the sources of inflation have shifted over time (**Exhibit 31**). At first, the prices of goods were the main cause of inflation due to supply-chain issues caused by the business disruptions triggered by the onset of Covid. The upshot? Goods inflation went up 12%.

Exhibit 31: Inflation: First goods, then services

US core inflation



Data as of May 2024.
Chart shows contribution analysis of the three main components of the core consumer price index (core CPI): supercore services (services less energy, rent of primary residence and owners' equivalent rent), shelter, and commodities (less food and energy).
Sources: BLS, Haver Analytics, Apollo Chief Economist

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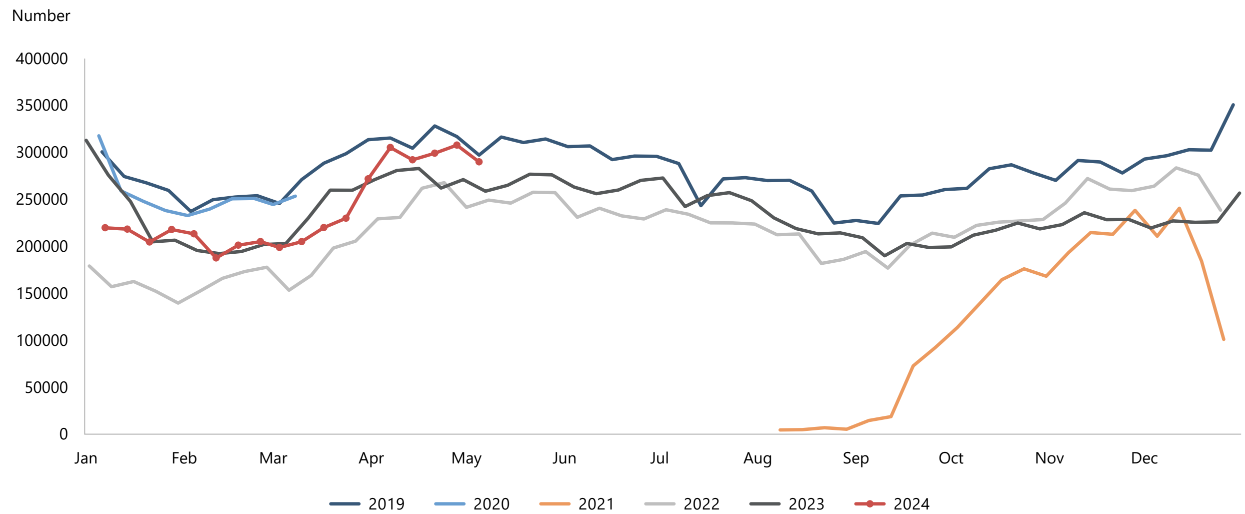
Fast forward to today, with goods inflation down significantly as supply-chain issues were resolved, the big driver of inflation of late has been services, along with housing. Supercore services—e.g., Broadway shows (**Exhibit 32**), restaurants, hotels, airlines, concerts, sporting events, cruise lines—have remained particularly robust.

Everything that has to do with a service on consumption is still strong. And that's exactly why we're still seeing above-target inflation. Making matters even more complicated, rising energy prices, combined with the ongoing rebound in the manufacturing sector, increase the likelihood that we may even see another increase in goods inflation over the coming months (**Exhibit 33**).

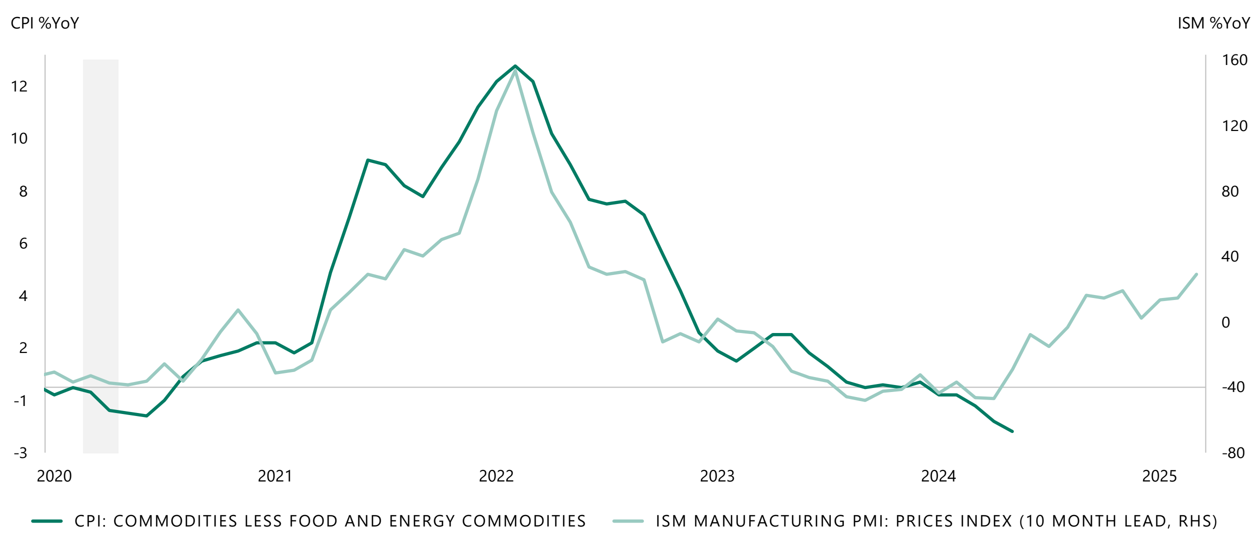
Exhibit 32: Broadway show attendance has been accelerating in recent weeks

Broadway attendance



Data as of April 2024.
Sources: Internet Broadway Database, Apollo Chief Economist

Exhibit 33: There are signs of a rebound in goods inflation



Data as of May 2024.
Sources: BLS, ISM, Haver Analytics, Apollo Chief Economist

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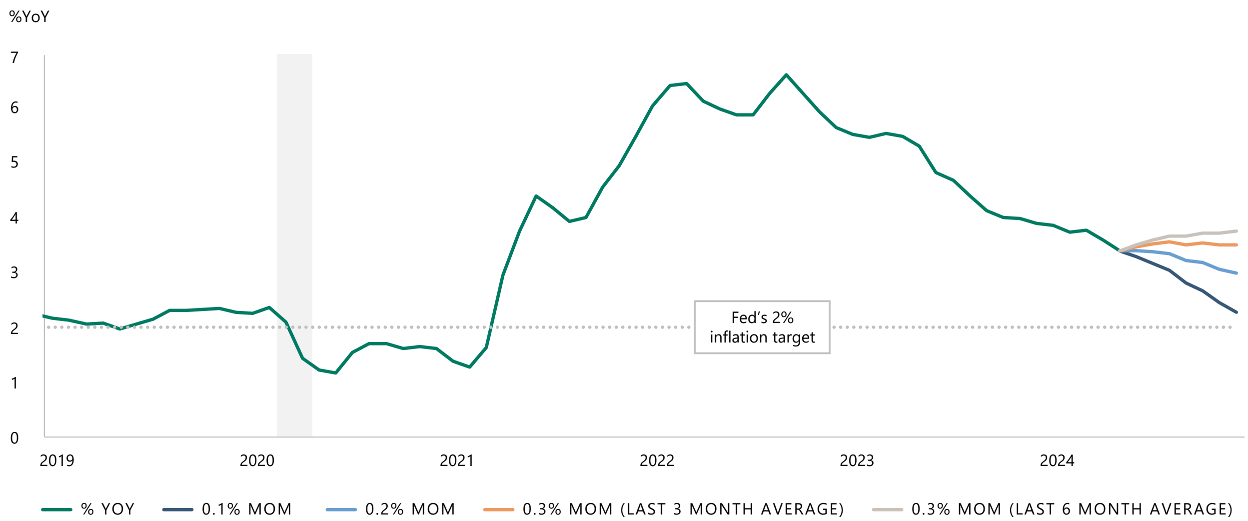
So yes, inflation has come down from the peak levels we saw in 2022, but no, we are not where we need to be quite yet (**Exhibit 34**). In fact, month-over-month inflation has been rising on average 0.3% for the last three months and 0.3% for the last six months. If inflation continues to rise as this pace for the rest of the year, then year-over-year core CPI inflation will increase from currently 3.4% to 3.5% to 3.8%.

Even if month-over-month core CPI comes in at the historical average 0.2% for the rest of the year, then year-over-year inflation will still end the year at 3%. To get inflation back to the Fed's 2% inflation target, core CPI will have to come in at an unprecedented 0.1% month-over-month for the rest of the year.

Base effects and strong recent readings complicate the Fed's efforts to get inflation back to its 2% inflation target. Put differently, it will require a sharp, immediate slowdown in consumer spending and capex spending for the Fed to be able to cut rates by the end of this year. We simply do not see that happening in the near future.

Exhibit 34: Inflation will likely be above the Fed's 2% target for the rest of 2024

Core PCE



Data as of May 2024.
Sources: BEA, Haver Analytics, Apollo Chief Economist

> It will require a sharp slowdown in spending for the Fed to be able to cut rates by the end of this year.

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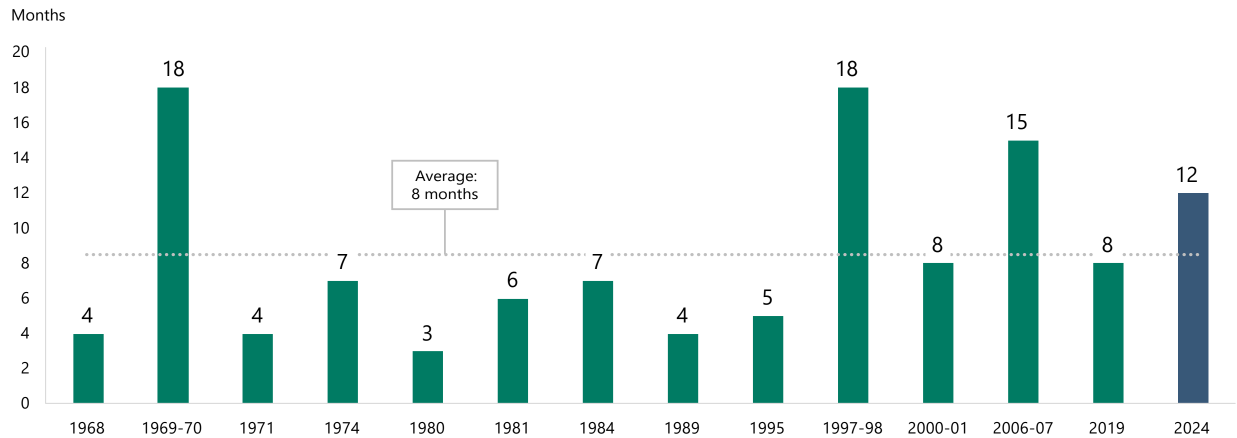
Outlook for rates: Still higher for longer than the market expects

Rates will likely stay higher for longer because we're simply not done fighting inflation. It normally takes eight months from the last Fed hike until the Fed starts cutting, but during this cycle, the Fed has kept interest rates constant for eleven months since the last hike in July 2023 (as of this writing). With easy financial conditions still giving a significant boost to inflation and growth over the coming quarters, the risks are rising that we could see a Fed cycle that is very different, with the Fed keeping rates higher for much longer than we usually see (**Exhibit 35**). Recall, too, our notion of the Fed Cut Reflexivity Paradox: With the Fed still signaling the possibility of future rate cuts, financial conditions have remained easier than when the Fed started raising rates in March 2022, fueling both strong economic results and capital markets performance. All of which may make it more difficult for the Fed to *actually* cut rates.

Over the longer term, the fed funds rate is expected to stay at 4% not only for the next several quarters, but for the next three to five years (**Exhibit 36**).

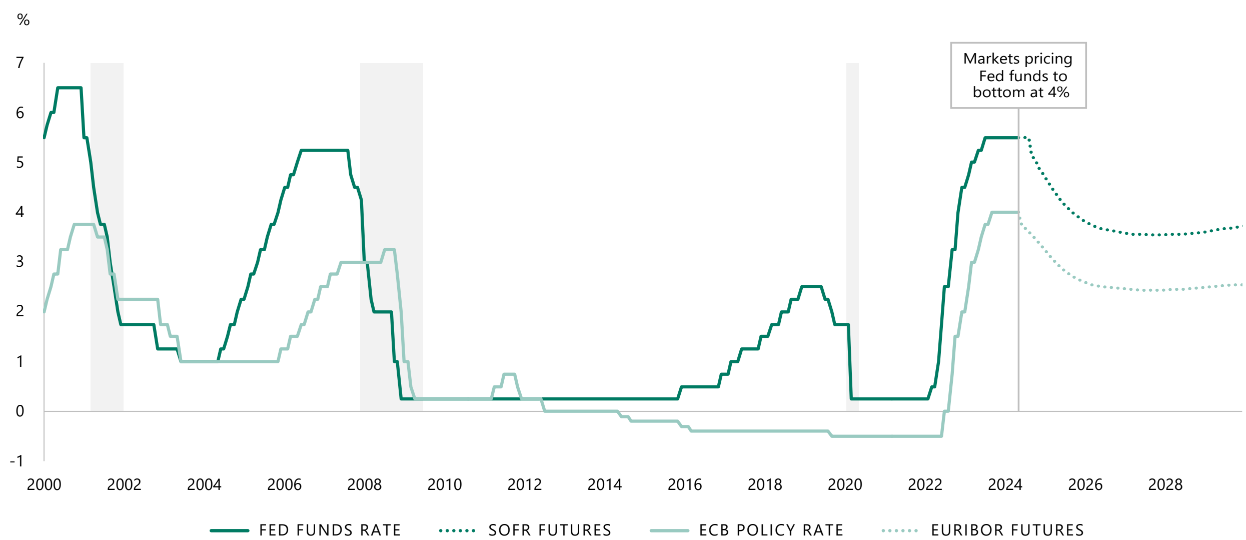
Exhibit 35: The Fed is keeping interest rates higher for longer than normal

Length of time from last hike to first cut



Data as of June 2024.
Sources: FRB, Haver Analytics, Apollo Chief Economist

Exhibit 36: Interest rates will likely remain higher for a long time



Data as of June 2024.
Sources: Bloomberg, Apollo Chief Economist

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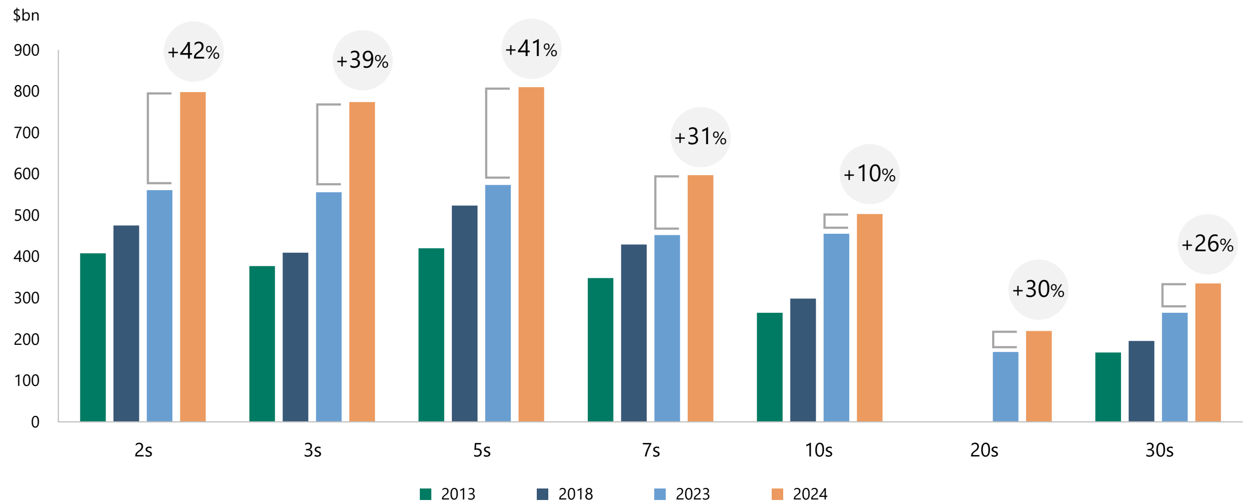
Why is that the case? There are five main reasons:

- **Deglobalization:** The global trend toward reshoring is inflationary. Any potential future tariffs or trade wars will likely only exacerbate the situation.
- **Energy transition:** Energy transition is costly. In addition to spending on new technologies, we must also rewire the existing grid. Both are inflationary.
- **Increased defense spending:** Defense spending is inflationary because it is not very productive. It's just money that we need to spend to protect ourselves.
- **The debt pipeline:** There's significant issuance of debt still in the pipeline (**Exhibits 37**, **38**) that will likely prompt upward pressure on rates at the long end.
- **The US fiscal deficit:** Higher fiscal deficits mean higher borrowing needs to finance them.

Exhibit 37: Treasury auction sizes expected to increase on average 35% across the yield curve in 2024

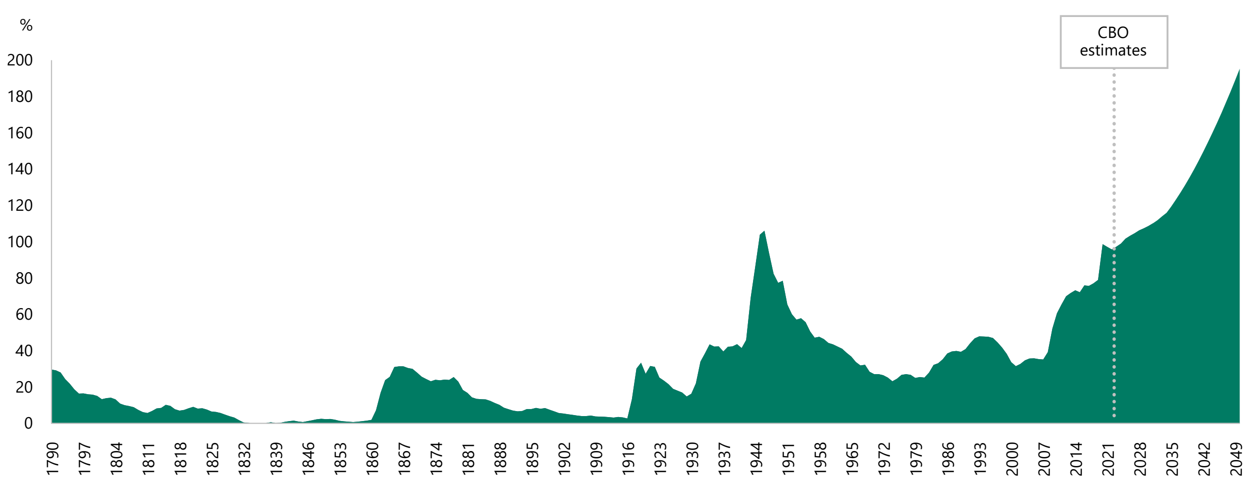
Treasury issuance across tenors



Note: Estimates from September 2023 to Dec 2024 from the TBAC neutral issuance scenario.
Sources: SIFMA, TBAC, Haver Analytics, Apollo Chief Economist

Exhibit 38: Under current policies, government debt outstanding will likely grow from 100% to 200% of GDP

US federal debt held by public (% GDP)



Sources: CBO, Haver Analytics, Apollo Chief Economist

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In short, interest rates will likely remain higher for longer because of cyclical reasons: The economy is strong, fueled in large part by the overwhelming effect of the tailwind from financial conditions being easy. Interest rates will likely also remain higher for longer because of structural reasons: Namely deglobalization, energy transition, more defense spending, and higher debt levels that require more financing and more issuance of Treasuries. We remain of the view that the Fed will not cut rates this year, and rates will stay higher for longer.

Risks to the Outlook

We have conviction about our views of the paths of the US economy, consumer spending, inflation, and interest rates. But that is not to say that the outlook is void of risks, of course. In fact, we are closely monitoring several fronts in which developments could lead to an amplification of our base case or could, in fact, derail some of our expectations. The two main ones are:

- **Geopolitical risk:** Although always hard to quantify, geopolitical risk is relatively high in the current environment. The war in Ukraine continues to drag on with no particular end in sight, adding to both political and financial tensions. As of this writing, Western European countries have managed to navigate disruptions in energy supplies without much economic fallout, but the situation could change if the conflict intensifies or changes direction. Meanwhile, the ongoing war in the Middle East is also a source of concern, as any escalation in the conflict could have myriad implications. Lastly, the sheer number of elections taking place around the world in 2024—polls are taking place in 40 countries that represent half of global GDP—also poses a variety of risks to our outlook.
- **China:** The Chinese economy has been facing a post-Covid period of slowdown, with slowing exports, deflation in its highly leveraged housing sector, and demographic deterioration (which can erode consumer spending over time). Additionally, trade conflicts with its global trading partners (especially the United States) have revived fears of tit-for-tat restrictions on imports, which could lead to an aggregate slowdown in both global commerce as well as the flow of capital, both in foreign-direct investments (FDI) and capital markets.

In Summary

- We expect economic growth to be above trend, and more than the market expects. We do not see a slowdown anytime soon.
- We see consumer spending remaining strong due to continued strong employment gains as well as the wealth effect of an easing of financial conditions.
- We think inflation is going to remain stubborn.
- We continue to think rates are going to be higher for longer than the market expects.
- All in all, the state of the economy, as of this writing, remains strong. But that strength sits atop an unstable state of equilibrium, as higher rates for longer and persistent inflation against the backdrop of a still-tight monetary policy represent strong forces that can quickly upset this balance.

Investment Implications

Higher rates for longer—not only for short rates, also for long rates—has some important consequences across the board for thinking about asset allocation. We believe the combination of higher yields and continued solid earnings will be good for private credit yields and credit fundamentals.

Private Credit

Rates higher for longer with a strong economic backdrop is favorable for high-quality private credit, i.e., large-cap companies with diversified earnings and high coverage ratios. The ongoing rally in credit is likely to continue, driven by attractive all-in yields with strong demand from retail, insurance, and pensions. Indeed, high base rates are keeping yields well above their historic average (**Exhibit 39**, following page). Robust technicals and a strong macroeconomic backdrop can support valuations even though credit spreads are near the tight end of recent trading ranges.

Higher-rated, senior-secured, first-lien loans, and bonds with high coverage ratios can yield attractive risk-adjusted returns in a high interest rate environment. In particular, large-cap companies with low leverage and solid cash flows are particularly attractive. On the other hand, higher-for-longer rates pose risk for funding-cost sensitive parts of the credit market. Companies with low interest coverage ratios, especially those with loan-heavy capital structures and/or near-term maturity walls, could come under pressure, as could the CRE market.

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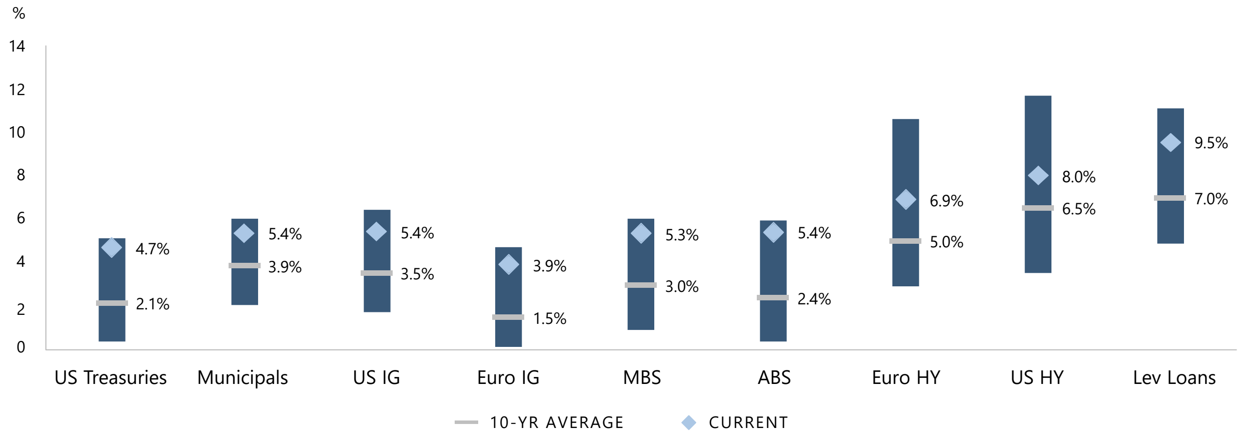
Exhibit 39: Yields are attractive across the board, even if valuations appear rich

Current yields are above 10-year historical averages for all categories



Data as of May 31, 2024.

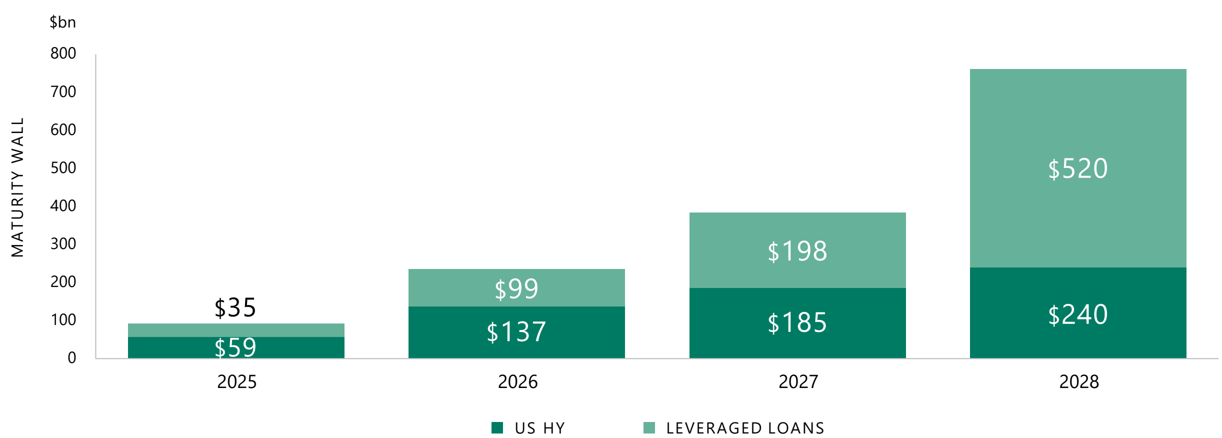
All sectors shown are yield-to-worst except for municipals, which are based on the tax-equivalent yield-to-worst, and leveraged loans, which are based on YTM. Dark blue bar represents min/max yield-to-worst over trailing 10-year period ending May 31, 2024. Orange triangle represents current YTW as of May 31, 2024. US Treasuries represented by Bloomberg US Treasury Index (LUATYW). Municipals represented by Bloomberg US Municipal Index (BTXMYW). US IG represented by Bloomberg US Corporate Bond Index (LUACTRUU). Euro IG represented by Bloomberg Euro Aggregate Corporate Index (LECPYW). MBS represented by Bloomberg US MBS Index (LUMSYW). ABS represented by Bloomberg US Agg ABS Index (LUABYW). Euro HY represented by Bloomberg Pan-European High Yield Index (LP01YW). US HY represented by Bloomberg US Corporate High Yield Index (LF98YW). Lev Loans represented by Credit Suisse Leveraged Loan Index (CSLLLTOZ).

Source: Bloomberg

We do, however, see an opportunity set in private credit for those lenders able to take advantage of the market-wide "maturity wall." As shown in **Exhibit 40**, about $1.5 trillion of US high yield and leveraged loan volume is scheduled to come due between 2025 and 2028. This widespread rolling over of debt will likely provide new opportunity to lend to companies at attractive rates of return while simultaneously de-risking the investment through an injection of fresh capital, enhancing lender protections, and optimizing the capital structure. Done correctly, such a process can benefit the company, the lender, and bondholders.[5]

Exhibit 40: A $1.5 trillion maturity wall can create opportunities for private lenders

Companies are expected to roll over debt in coming years



Data as of June 2024.

Leveraged Loans data excludes defaulted facilities and are based on par amount outstanding. High yield data based on February 2024 universe of ICE BofA US High Yield Index (H0A0) and ICE BofA 0-1 Year US High Yield Index (H544) and is based on face value.

Sources: Bloomberg, PitchBook LCD

[5] For more on the opportunity in credit markets, see "What Does a 'Higher for Longer' Rate Environment Mean for Credit Markets?," Jim Vanek, Co-Head of Global Performing Credit at Apollo, April 26, 2024.

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One consideration: the December Fed pivot triggered a reversal to the long-term trend of deteriorating coverage ratios in both public and private credit. However, if rates do remain higher for longer, it's possible that coverage ratios could return to a downward course, placing more companies at risk of default. In such a scenario, we believe that the best investments will be high up in the capital structure, with significant amounts of equity support.

Finally, it is quite clear that solutions that would have been possible only in public markets just five or 10 years ago are migrating to private markets. The expanded opportunity extends beyond direct lending to corporates on a private basis. Going forward, private lenders can have an opportunity to be providers of liquidity, and to structure and create assets that can play specific, beneficial roles in fixed-income portfolios.

Private Equity

We continue to view the opportunities in private equity in much the same way as we did in our December 2023 outlook.[6] Opportunities will likely continue to emerge among potential distressed companies in the context of slowing growth and higher-for-longer rates. We also continue to believe that the ongoing uncertainty and volatility in the broader market call for a flexible, value-oriented strategy in private equity. We believe strategies with the ability to invest opportunistically across the capital stack are well-positioned to capitalize on the shifting fortunes of companies seeking financing in these turbulent times. We also continue to see the potential for opportunistic buyouts and corporate carve-outs as sponsors seek solutions and corporates review their non-core assets.

Despite the easing of financial conditions that have come in the wake of the Fed pivot, we also see opportunity to capitalize on the desire for exits and intra-LP transactions via secondary funds. Indeed, the secondary market has developed into a core allocation for many sophisticated investors. Even as traditional exit avenues (M&A, IPO) have recently become more viable for sponsors, we believe GP-led secondaries are now part of the "exit toolkit" given the ability to hold on to trophy assets for longer and as an attractive portfolio management tool for GPs. We believe the secondary market could double or even triple in size by 2027, with much of that growth fueled by the growth of private market AUM.[7]

Real Assets

As we have discussed both above and at length in our previous economic outlooks, the sharp rise in interest rates after almost 15 years at ultra-low levels has had dramatic effects on the commercial real estate industry, depressing valuations and market liquidity. That being said, we believe that the negative headlines painting the entire CRE space as in turmoil represent an overgeneralization that does not correspond to reality.

While office remains particularly weak for a variety of reasons, including work-from-home, other sectors are showing resiliency. Even though valuations have reset across property types, operating fundamentals in many sectors remain sound. Additionally, secular growth trends continue to persist for sectors including industrial, multifamily, as well as specialty areas such as data centers, cold storage, self-storage, and student housing.

We believe that, at this stage of the economic cycle, the opportunity remains more compelling towards real estate debt than equity on a risk-adjusted basis. Real estate credit can offer a more attractive proposition due to high base interest rates, widening spreads, more protective loan structures, as well as expectations of higher-for-longer rates. We also see the opportunity to originate real estate loans as key sources of funding (e.g., banks and commercial mortgage-backed securities, or CMBS) have stepped back, leaving a void for alternative lenders to fill. We see this opportunity not only in the US but also in Europe, where the potential for diversification and the opportunity to capitalize on region-specific differences exist. Finally, tremendous amounts of real estate loans are set to mature over the next few years in the US and Europe, which can provide significant refinancing opportunities at today's valuations and higher interest rates.[8]

Public Markets

Liquidity risk premia in public credit markets have declined, especially in high yield. There is a compelling argument to allocate away from illiquid parts of public credit to either liquid public credit or private markets, which still can offer elevated liquidity premia.

[6] "2024 Outlook: What's Next After the 'Fed Pivot'?," Torsten Sløk, Apollo Chief Economist, December 19, 2023.

[7] For more on our views regarding the secondary market, see "PE Secondaries: Evolving Landscape Can Expand Opportunities," Steve Lessar, Veena Isaac, Konnin Tam, Co-Heads of Apollo Sponsored and Secondary Solutions (S3), April 23, 2024.

[8] For more on our views on real estate debt, see "Mind the (Finding) Gap: Finding Opportunities in Real Estate Debt Amid Dislocation," Scott Weiner, Global Head of RE Credit, and Ben Eppley, Head of RE Credit Europe, March 27, 2024.

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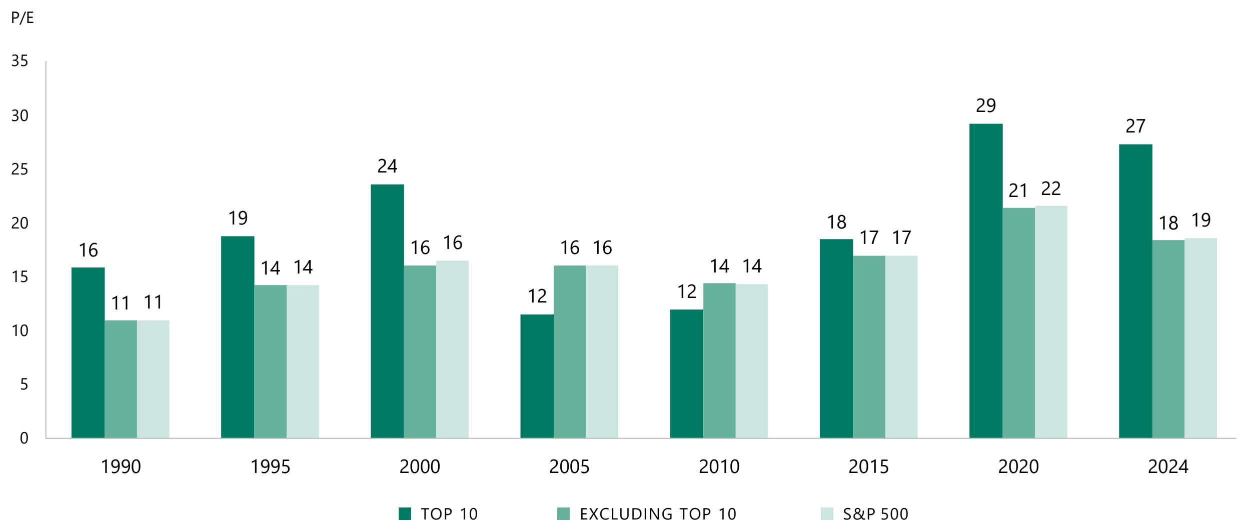
On the equity front, rates higher for longer is negative for technology, growth, and venture capital, and the artificial-intelligence (AI) bubble remains a major risk for equity investors. The crowding into the AI trade (**Exhibit 41**) marks a frenzy rivaled only by previous tech manias such as the 1990s tech bubble. In recent months there has been more divergent performance among the Magnificent 7, and this can be a sign of weakness for the AI story. In addition, the continued growth in passive investing is also artificially boosting stock prices of the mega-cap tech stocks as more passive inflows move into the largest stocks in the index.

Uncertainty about the ongoing soft landing will keep volatility elevated. A hard landing or a reacceleration in growth and inflation remain quite possible. Stock picking is key. Rates higher for longer will continue to weigh on small-cap companies with high leverage and low coverage ratios. In this environment, especially in light of recent price gains, public market equities do not look attractive compared to most other asset classes, including cash.

Exhibit 41: The current AI bubble is bigger than the 1990s tech bubble

12-month forward P/E



Data as of May 31, 2024.
Sources: Bloomberg, Apollo Chief Economist

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