



INVESTMENT OUTLOOK 2025

**BORDER TO COAST
PENSIONS PARTNERSHIP**

INTRODUCTION



Joe McDonnell

Chief Investment Officer

At Border to Coast, we believe the big ‘top-down’ issues should be debated and examined to understand how they could affect capital allocation decisions of our Partner Funds. We see our thinking here as complementary to our primary focus – bottom-up stock selection and investment due-diligence.

LGPS Partner Funds are long-term investors with a strategic emphasis on growth and income strategies so we explore how these common themes will play out across both public and private markets. High level questions we look to tackle include: Will AI continue to dominate? How will this theme develop in both listed and private markets? How will credit fare and what parts of the market are attractive? Will the growing demand for energy continue to underpin clean energy demand? And will the new UK government policy initiatives be a tail wind for energy and housing?

In this Investment Outlook, our Portfolio Managers and Strategists examine each of these questions, and identify some of the key considerations for investors in 2025.

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OVERVIEW

MANAGING RISK: A NEW REGIME AND DEEPENING FRAGMENTATION



Anthony Petalas
Portfolio Manager

As investors, we were somewhat spoiled in 2024. Markets rose as inflation fell, and global economies breathed a sigh of collective relief as the risk of global recession faded. Looking ahead, central banks have started cutting policy rates that can further support global growth and corporate profitability. But, will this relative steadiness last throughout 2025? We suspect not. With a new (but also returning) President entering the White House, we are stepping into a known unknown. Volatility over stability could be the order of the day. In this report, we examine what is in store for global markets across key themes for equities, fixed income, and private markets.

An economic makeover

As we step further into 2025, economies are undergoing something of a makeover. Protectionist policies look set to reconfigure established trade partnerships and supply chains. Most developed economies are constrained by inflation, low growth, and political extremism. The re-election of Donald Trump and the Republican sweep of Congress could lead to measures that add to volatility rather than stability. While the specifics on

potential policy shifts remain uncertain, President-elect Trump has stated that he will use extreme tariffs to protect US interests. For decades the benefits of global trade were widely accepted, however, tariffs are now being used as negotiating tactics that could instigate trade wars. The geopolitical environment is extremely fragile, and macro policy has the potential to be a source of disruption.

This lose-lose combination of greater strategic rivalry and reduced economic cooperation risks putting the brakes on any potential for global economic growth, while paving the way for future inflationary shocks. This fundamentally changes the investment landscape. The long-held tenet of diversification – blending stocks and bonds – may not be applicable under this new regime. Investors must look for a new way.

At Border to Coast, we believe investors can find opportunities by tapping into secular growth themes that can withstand the deepening fragmentation in the global economy. Looking at asset allocation through a more thematic lens can, in our opinion, help investors position portfolios in this new era of shorter and less predictable cycles. Disruptive trends with secular growth potential can help investors navigate this uncertainty by removing the need to rely on traditional metrics of economic progress to deliver returns.

What next for artificial intelligence?

Despite the meteoric rates of adaptation in artificial intelligence (“AI”), it looks set for further acceleration in 2025 as processing power increases and efficiencies improve. To date, tech giants have driven record levels of capital expenditures to data centres that can power these systems. Big cloud providers and chip producers are currently benefitting from this wave and as the adaptation continues it could unlock new revenue streams across the global economy.

“While today’s enablers dominate headlines, the next wave of market leaders will likely arise from businesses applying AI to revolutionise specific industries...”

History shows that transformative technologies often yield unexpected winners. While today’s enablers dominate headlines, the next wave of market leaders will likely arise from businesses applying AI to revolutionise specific industries. Sectors such as healthcare, finance, and logistics stand poised for disruption with emerging players using AI to deliver precision medicine, automate operations, or create personalised customer experiences.

Moreover, diversifying across the AI value chain including enablers, adopters, and innovators can help mitigate risks tied to current market concentration. Focusing on

long-term structural trends rather than short term hype, investors can position themselves to capture AI’s transformative potential while avoiding overexposures to crowded winners.

For more on the AI boom, see page 7.

The net zero investment opportunity

Energy consumption is the often-overlooked elephant in the room when it comes to AI and the associated data centre expansion. Both demand vast amounts of power. When coupled with the global push to decarbonise economies, there is a clear need to expand renewable energy capacity, improve storage efficiency, and upgrade related infrastructure.

The convergence of decarbonisation and digitalisation are structural shifts that will continue to unfold over the longer term regardless of who sits in the White House. Alternative investments in private markets, particularly infrastructure, are well positioned to capture this trend. Renewable energy projects such as wind farms, solar panels, and hydrogen plants offer stable long-term cash flows and direct exposure to decarbonisation efforts.

Investment in electrification, grid modernisation, and electric vehicle charging networks are essential for enabling the effective use of the energy generated by renewables and supporting the energy transition. Private markets also provide unique opportunities to fund innovative startups and technologies that are yet to go mainstream.

The shift to a low-carbon economy is not just about mitigating risks – it represents a paradigm shift in how energy is produced, consumed and optimised. Investors who

position themselves at the forefront of this transition can capture both the potential for sustainable growth and meaningful impact, positioning the energy transition a cornerstone theme for portfolios.

For more on the opportunity to invest in the energy transition see page 19.

Finding a new equilibrium

The period between the end of the Global Financial crisis and the onset of the Covid pandemic was marked by ultra-low interest rates. In fact, Europe had a decade-long experience with negative interest rates to encourage bank lending to kick-start growth and fend off disinflation. This led to the acceptance of TINA (There Is No Alternative), a phenomenon in which stocks and shares were the only option if you were looking for returns.

However, as inflation began to rear its head in early 2021 and central banks came to terms with the fact that inflation was not “transitory”, they kicked off one of the quickest rate hiking cycles on record from early 2022 onwards. Investors experienced significant losses and traditional stock/bond portfolios offered no protection.

As major economies have adjusted to this new interest rate equilibrium, the balance of risks have changed for global investors. Credit investments now offer equity-like returns with significantly less volatility. With inflation and interest rates likely to remain structurally higher than they were in pre-pandemic, investors do not need to rely as heavily on riskier investment to achieve overall returns targets.

For more on fixed income see page 16.

Hidden risks of passive investment

Passive investing has grown immensely popular over the past decade, driven by low fees and simplicity. Yet, as equity markets become increasingly concentrated in a handful of mega-cap names, the hidden risks of a purely passive play have been exposed.

This concentration poses significant risks for investors whose portfolios mirror market cap weightings, leaving them disproportionately exposed to these mega-cap stocks. Any downturn in these companies, whether due to regulatory pressures, intensifying competition, or market corrections could amplify portfolio losses.

This dynamic is reminiscent of the “Nifty 50” era of the 1970s, when a small number of “bulletproof” stocks dominated the market. Over time, many of these companies underperformed as they struggled to meet the hefty valuation expectations, dragging down portfolios overly reliant on them. In this case, the risks of market concentration became painfully clear, exposing the limitations of passive strategies during periods of market dislocation.

“This dynamic is reminiscent of the ‘Nifty 50’ era of the 1970s when a small number of ‘bulletproof’ stocks dominated the market...”

Active strategies can help identify undervalued opportunities in overlooked sectors or regions and mitigate the concentration risk. Fundamentally weighted indices can also offer a compelling alternative to traditional market cap weighted indices. By emphasising factors such as valuations and profitability, these indices can provide a more balanced exposure across sectors and market capitalisations. This approach helps investors align with long-term fundamentals rather than chasing momentum-driven trends. While passive investing remains a powerful tool, investors must recognise its limitations in a concentrated market. A more dynamic approach, blending active strategies and alternative exposures, may help manage risk and capture opportunities in this uncertain environment.

For more on past market boom and bust, see page 10.

Regime Change

The pre-pandemic era, often referred to as the “Great Moderation”, was characterised by stable economic growth, low inflation, and low market volatility. Central banks maintained accommodative policies, while globalisation fostered efficiency and price stability for over four decades. This environment provided a fertile ground for the success of the traditional equity-bond portfolios, which benefited from muted macroeconomic volatility and consistent diversification between asset classes. This stability encouraged robust economic expansion while fostering favourable conditions for equities. Meanwhile, bonds served as a reliable hedge, offering steady income and downside protection during periods of equity market turbulence.

This came to a sudden halt in 2020. Inflation, geopolitical fragmentation, and supply chain realignments in the post pandemic world have disrupted the equilibrium of the Great Moderation era. Secular forces such as energy transitions, demographic changes, and reshoring of industries are introducing structural pressures that amplify volatility in the economic and market cycles.

In this new regime, traditional investment strategies may no longer suffice. Alternative strategies can provide exposures to asset classes that are less correlated with traditional equities and bonds. Strategies like private credit, infrastructure, and real estate can generate returns independent of broad market trends. For example, private credit assets are floating rate instruments providing income that is adjusted with higher interest rates. This feature helps preserve real returns in inflationary environments as central banks raise interest rates to combat inflation.

For more on private credit see page 23.

Investors also need to adapt to a more dynamic approach to actively adjust portfolio exposures in response to evolving market conditions. Actively adjusting allocations across asset classes can help manage correlations that may shift unpredictably during macroeconomic shocks reducing the overall portfolio risk.

Adapting to this era of higher volatility will require flexibility, discipline, and a forward-looking perspective. By embracing a more dynamic approach, investors can position themselves to manage risks and capture opportunities in a post-pandemic world that has bade farewell to the Great Moderation.

EQUITIES

WILL AI CONTINUE TO DOMINATE GLOBAL EQUITY MARKETS?



Paul Allison
Portfolio Manager

Prior to Microsoft's \$10bn cash injection into ChatGPT's creator OpenAI in January 2023, most people's views on AI had been limited to Hollywood's dystopian interpretations. But everything changed when the then-second biggest company in the world double-knotted its future to AI's development, committing to weave the technology into its ubiquitous software products. That caught the attention of average investors, many of whom had already profited handsomely from Microsoft's stunning transformation from a slow-growing software business to a rapidly growing cloud services provider. Microsoft's backing dropped AI into the mainstream and sparked an investor frenzy. The explosion of AI, and its ripple effect across companies from Nvidia to semiconductor firms, has been among the biggest stories in global equity markets in recent years, but how long will it last?

What's driving the AI boom?

Since 2020, AI's development has been dramatic. At the centre of it all are facilitating

technologies - the picks and shovels – like graphics processing units (GPUs) and data centres. Ironically, neither of these technologies were advanced with AI primarily in mind. But rapidly increasing computing capacity, along with faster and more powerful GPUs, have been the key ingredients that brought software like ChatGPT to the boil. Said another way, AI's models needed powerful GPUs to make them useful, but they'd be pointless without the massive data centres providing the capacity to run them. It's noteworthy too that advancements in the reduction of computing costs have been running out of steam - other options are needed to lower the cost of computing enough so that major technological breakthroughs like AI can happen. That's where GPUs come in.

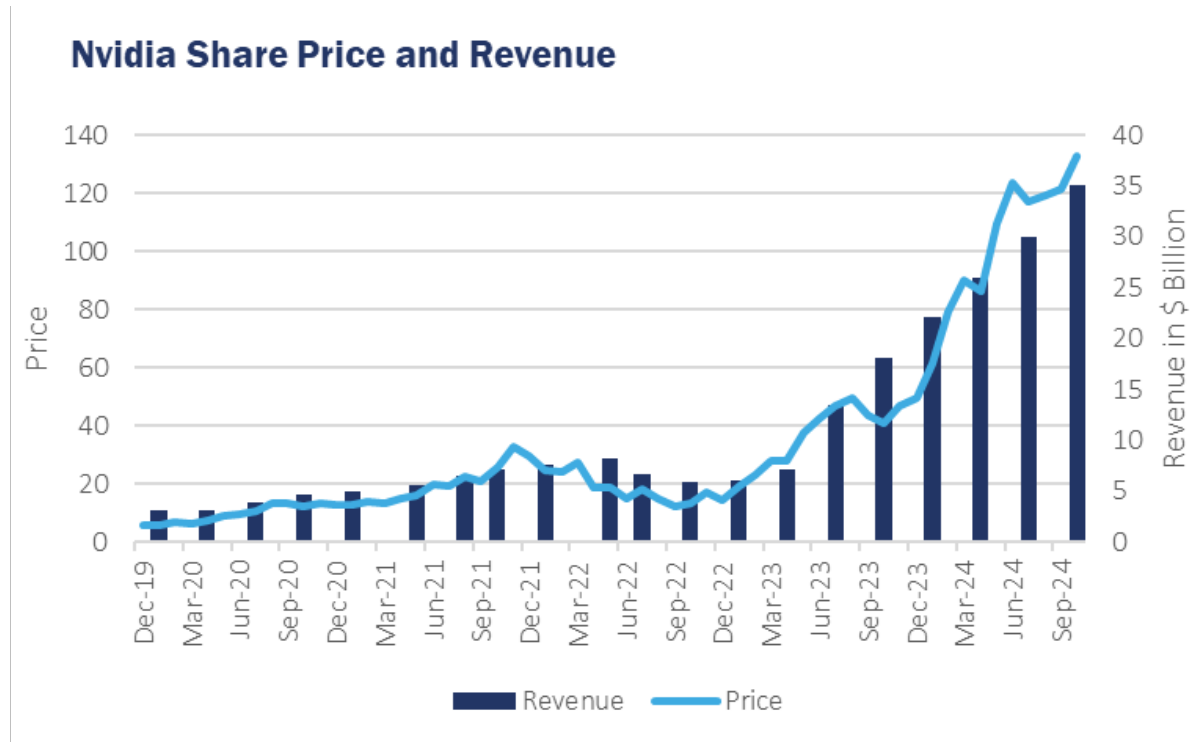
Since ChatGPT 3 burst onto the stage, there's been several new and improved iterations, more than a few lookalikes, as well as a load of startup AI-native applications. All of that requires exponentially more GPUs and data

“The explosion of AI and its ripple effect has been among the biggest stories in global equity markets in recent years...”

centres. Unsurprisingly, then, it's been the stock prices of Nvidia, Microsoft and other cloud providers, as well as a range of other and semiconductor firms riding on the theme's coattails that have soared.

investor I still build plenty of spreadsheets, and I can't wait for AI to do it all for me.

Most of this, though, is just an extension of what's already happened, and will simply require more and better versions of what we



Source: Copyright. Bloomberg Finance L.P.

Will AI continue to soar?

As far as the next couple of years are concerned, it doesn't take a lot of imagination to conjure a scenario where agents on our phones are booking hotels, flights, dinner reservations and doing the shopping, all with minimal human input. In the office, our AI agents will literally be our assistants, grabbing data from here, dropping it into a chart over there, and making sure the latest presentation has been sent to everyone's inbox, again with limited human number crunching. As an

already have. That gives me confidence that the picks and shovels part of the journey isn't

“The picks and shovels part of the journey isn't over...”

over. After all, stock frenzies tend to get completely out of hand before things really go south, and with Nvidia's stock on 30x price to expected earnings, its valuation is hardly

incomprehensible – especially when you consider that Walmart (not exactly a technology company) traded on 55x price to earnings in 1999 at the peak of the last craze.

Looking further out, it's just too tough to know how AI will change our worlds, so I don't think it makes a lot of sense trying to figure out – and invest behind – the next big thing. There's time to sit back and wait. Revisiting the arrival of the internet comparison, in 2000 very few invested in Apple based on an anticipated explosion in smartphones, or Microsoft because it would become the second largest data centre provider in the world – both of which wouldn't have been possible without the internet. The point is that the real impact of any major technology adoption often takes years to surface.

“The point is that the real impact of any major technology adoption often takes years to surface...”

So, in the Border to Coast view, a positive medium-term outlook on AI isn't down to any tomorrow's-world-like predictions.

Instead, it's based on a belief that every company, in every sector, will reap some sort of gain from the technology. That could be a bit of productivity-driven cost saving, or some incremental revenue opportunity. But when taken together, the impact could be big enough to point to profits in the overall market that are likely to be better than most expect.

“A positive medium-term outlook on AI isn't down to any tomorrow's-world-like predictions. Instead, it's based on a belief that every company, in every sector, will reap some sort of gain from the technology...”

There's plenty of risks to that view, of course. Global economies could plunge and throw a spanner in the works. Geopolitics is a wildcard which could upend any reasonable profit outlook. But all other things equal, I think there's enough wind in the AI sails to keep the market drifting higher. And that's a comfortable place to be while waiting for the next life-changing impact the technology is bound to serve up.

LESSONS FROM THE PAST: WHAT THE NIFTY FIFTY AND THE DOT.COM BUBBLES TAUGHT US



Will Ballard

Head of Equities

With the US equity market hitting a new high and the “Magnificent 7” continuing to grow in importance, we wonder whether history has any lessons for us. The 1970’s and 2000’s teach us that concentration in equity markets should not be ignored, and today’s technological leaders might not always be the best investments for the long term. Balancing the opportunity these investment offer with the risks they present is the challenge we currently face.

In 1932 Edwin Land established Land-Wheelwright Laboratories to commercialise his groundbreaking technology, a filter that could polarise light. A few years later it was renamed Polaroid Corporation and it became a poster child for technological innovation.

Throughout the 1950’s and 60’s, household names like McDonald’s, Johnson & Johnson, PepsiCo and Gillette saw their share prices soar. Investors fell in love with a small group of stocks that they believed were so attractive they only had to make one decision, to buy and then hold. The hubris that drove Polaroid’s share price to over 90x earnings and the S&P500 to a peak of 19x in 1972 were testament to the times. Polaroid’s popularity only peaked in 1977 when it dominated the

instant camera market with nearly two thirds of all sales, and yet in 1974 its share price collapsed by over 90%.

Polaroid’s story is far from unique. Its collapse in share price was more closely linked to its high valuation, investor concentration and a seismic shift in the market environment. As evidenced by its continued revenue growth, it was only three years later that its revenue peaked and started its gradual decline as its technology and competitive position were surpassed. The 1970’s were marked by high inflation, the collapse of Bretton Woods, the 1973 Opec oil embargo, and then Federal Reserve Chairman Arthur Burns hiking rates from 5% to 13%. These factors, combined with the high valuation and concentration in the stock market, all compounded to create the stock market crash of 1973.

Fast-forward twenty years

In the 1990’s the market was gripped by a different fever. This was the time of the internet, the dot.com bubble, financial deregulation and Federal Reserve Chairman Alan Greenspan’s “easy-money” policies. We have different protagonists, but a very similar story. In this case, the poster child was Cisco Systems Inc, a US giant that made network systems and switches, the backbone to the internet. They didn’t achieve Polaroid’s 2/3rds market share, but 40% of such a high growth market and a technological leader had afforded it an iconic status in the eyes of investors. Its market capitalisation overtook that of General

Electric at half a trillion dollars and at its peak it traded on 272x earnings. From its peak in 2000, to its trough in 2002, as the dot.com bubble burst, it declined 90%.

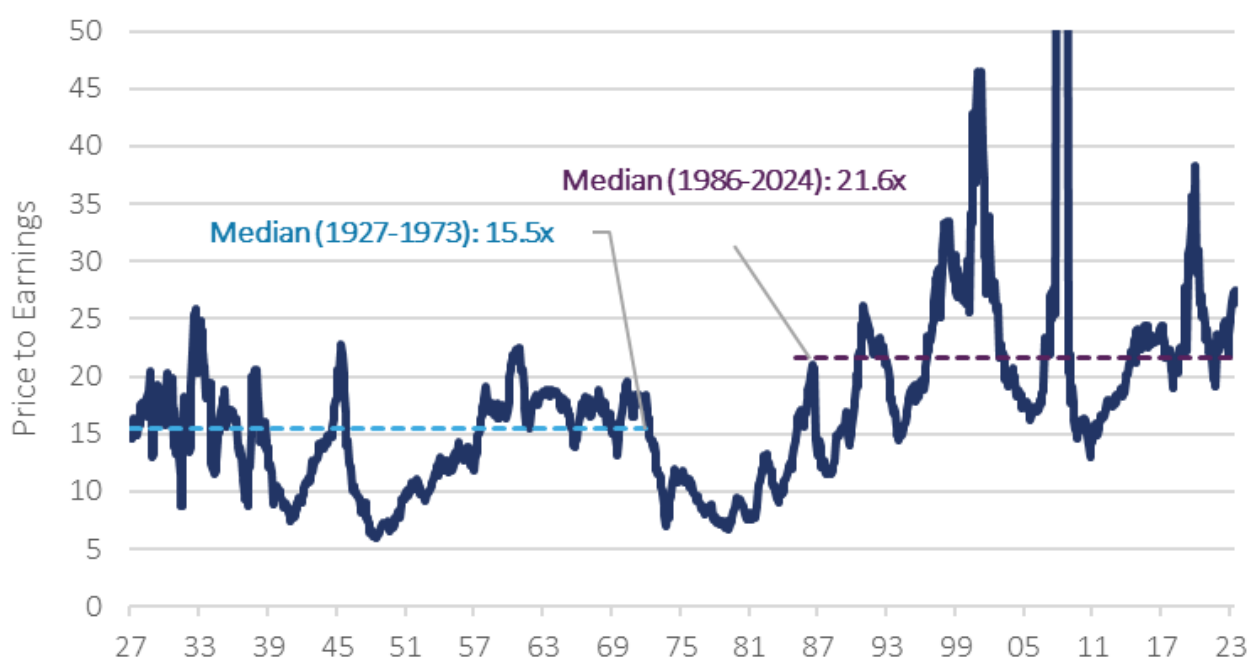
A sign of our times

Our aim is not just to illustrate the parallel between these two historical examples and Nvidia – the modern-day equivalent – but also to try and provide a framework to analyse our current market environment and what these companies might tell us. They are, after all, a sign of their times.

exception, performed the worst. Furthermore, the top half of the Nifty Fifty materially underperformed the broader S&P500 index over the following 30-year period (ref: Jeff Fesenmaier and Gary Smith 2002). This parallel can also be drawn in 2000 when the top 10 companies in the S&P500 index represented 27% of the total market capitalisation and the S&P500 reached a non-recessionary peak of over 30x earnings.

The impact of the combination of high valuations and concentrated equity positioning

S&P 500 Price to Earnings



Source: Data from [Macrotrends.net](https://www.macrotrends.net)

There are two interlinking points that we wish to highlight – those of the inter-relationship between market concentration and valuation. When Polaroid soared, the Nifty-Fifty traded on 42x compared to the S&P500 on a more manageable 19x. Over the subsequent years, the highest valued companies, almost without

can be seen clearly from change in leadership in the equity market following the burst of the dot.com bubble. From 1999 through to 2014 the Russell 2000, an index of small and mid-sized companies in the US, outperformed the large cap S&P500 by 5% per annum.

Will history repeat itself?

When we look at the current market conditions, history's warning signs are starting to flash amber. Market concentration is at an all-time high and darling stocks such as Nvidia are trading on expensive valuations (120x price to last year's earnings) with optimistic expectations. We do not doubt that Nvidia is truly unique and an essential part of the

Jerome Powell's commitment to the dual mandate of maximising employment whilst maintaining price stability. Though it remains too early to tell, it is plausible to suggest President Trump's focus will encourage deregulation and lower taxes, all of which are likely to be supportive of small and mid-sized companies.

As long-term investors, we look for a nuanced approach and seek to balance the

S&P 500 relative to Russell 2000



Source: Copyright. Bloomberg Finance L.P

current artificial intelligence boom. Its future growth will rapidly make its valuation appear more palatable (35x next year's earnings). It is also highly unlikely that the mistakes made by Alan Greenspan or Arthur Burns are to be repeated. When looking at the S&P as a whole, the valuation appears high but not unreasonable. The strength of the US economy is supportive of earnings growth as is the current Chairman of the Federal Reserve

opportunities available in markets with the risks that they entail. We remain optimistic for the outlook for US equities and, by default, global equities - but within that, we have tempered our enthusiasm for the largest companies that have been moving markets higher. We believe better opportunities may lie in other smaller, lower profile and less loved parts of the market.

STABILITY AND RECOVERY IN THE UK: WHAT A NEW GOVERNMENT COULD MEAN FOR UK EQUITIES



Simon Kirton

Portfolio Manager

On 4 July 2024, after 14 years watching and waiting on the sidelines, the Labour Party returned to Government with a significant majority in the House of Commons. While this marked a sea change in politics, the UK stock market's reaction to the news was muted. It remained broadly neutral and moves in currency markets were minimal. Yet, change is afoot, so what could this new administration mean for UK equities going forward?

Firstly, in terms of context, it is important to note that around 76% of earnings from the UK equity market are derived internationally. The FTSE 100 Index is dominated by multinational companies trading in global sectors (oil and gas, mining, healthcare, consumer staples) across numerous international markets. Arguably, for many of these companies the occupant of the White House, not 10 Downing Street, is of far more relevance.

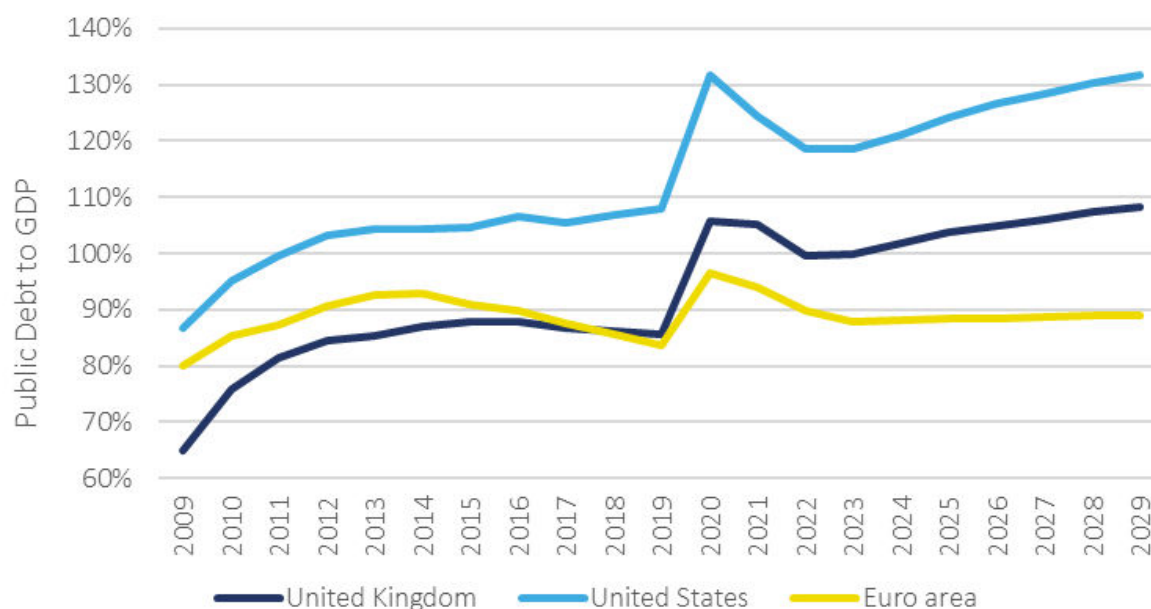
Secondly, the performance of UK equities is largely driven by its sectoral composition. The prevalence of energy and materials companies has been a drag relative to the US, which has benefitted from the stellar

performance from technology companies (and its economy as a whole). Technology makes up 26% of the S&P 500 Index (US stock market) compared to only 1% in the UK All Share Index. Thirdly, interest rates and inflation are heavily influenced by global economics and world events. For example, tightness in post-Covid supply chains and, more recently the war in Ukraine, helped to generate high inflation across international economies. With few exceptions, local governments were impotent in the face of these powerful global forces.

“All governments want to achieve faster economic growth...however it is hard to do...”

That said, the UK economy, where a proportion of the UK equity market is directly exposed, is clearly one area in which the new government, setting aside global inputs, would wish to exert influence. All governments want to achieve faster economic growth. Delivery of this goal allows them to cut taxes or spend more on public services therefore increasing their hopes of re-election. However, it is hard to do. In theory, the Labour government wishes to create the conditions for firms and individuals to generate wealth. Those

IMF Public Debt to GDP Projections



Source: Berenberg. IMF, World Economic Outlook Database

conditions are macroeconomic stability, low and stable inflation and a taxation system that is constant, on a wide tax base and not too burdensome. This climate would encourage private investment where the UK lags its competitors in certain areas. Government investment will also be important in creating the necessary infrastructure and public services.

“It is fair to assume that Labour will want to avoid missteps and build a reputation for economic competence...”

However, fiscally Labour has little room to manoeuvre with public debt to GDP at multi-decade highs of >100% (see table above).

History shows that radical policies can prompt exaggerated and harmful reactions in fragile markets. It is fair to assume that Labour will want to avoid missteps and build a reputation for economic competence. Stability, growth and recovery will be prioritised.

While in general terms the new government’s impact may be limited, there are some specific areas where its policies can make a difference. Some changes planned by Labour are of particular relevance to certain sectors and stocks rather than the whole stock market. For example, two of the areas of influence in the

UK equity market where Labour policies may make a difference are housing and energy.

Firstly, in housing, the election of a Labour government has been seen as a positive. Housing affordability should improve as rates fall, and this should unlock pent up customer demand. Pro-housing rhetoric from Labour could signal a new generation of housebuilding (although there have been numerous false dawns over the years). Planning reform as promised by the government will be the key to driving any progress on this front. The political will to make an impact is undoubtedly there.

“Planning reform as promised by the government will be the key to driving any progress on housing...”

Secondly, energy and utilities companies will be impacted by Labour’s strategy in the years to come. The government has ambitious goals to ease planning conditions and increase renewable energy. There is also support for nuclear as part of the solution to energy security.

Clean energy producers and network companies should benefit from these policies although the potential for further taxation and regulation in some specific areas may moderate levels of excitement. For example, investment in the North Sea will be hit by Labour’s decision not to issue new oil and gas licences. As always, the devil will lie in the detail.

“Two of the areas of influence in the UK equity market where Labour policies may make a difference are housing and energy...”

Successive governments have failed to deliver sustained growth through long term strategic planning beyond the political cycle.

As a starting point, if the new government can provide a level of political and economic stability to the UK, this could build a foundation for recovery both in the UK economy and parts of the UK equity market. However, the ultimate direction of the UK Equity market will be largely determined by external factors.

FIXED INCOME

NOT TOO HOT, NOT TOO COLD: CREDIT LIKES GOLDBLOCKS



Steve Holmes
Credit Strategist

Goldilocks may have been more focused on porridge and a comfortable nap, but credit assets such as investment grade and high yield bonds as well as private credit loans also tend to perform best in a ‘just right’ environment, namely moderate economic growth and low/falling inflation. Happily this type of environment looks likely to persist into 2025. In this article, we explore the solid fundamentals behind credit assets and the impact easing interest rates could have on company managers’ ‘animal spirits’, to explain what could be in store for the asset class.

Credit markets have benefitted from historically high and relatively stable yields for the last two years, with credit risk spreads also remarkably stable. Falling yields helped fixed coupon and high duration bonds to deliver a second consecutive year of solid returns, for instance the Sterling Investment Grade bond index returned 8.6% in 2023 and 2.3% in 2024.

While there is some uncertainty about the timing of further central bank policy rate cuts, inflation concerns have reduced. Further cuts

seem likely. In previous episodes where rate cuts have been delivered in a non-recessionary environment, credit spreads were largely unchanged 12 months later, suggesting another year of stability is in store.

Investment in credit assets in 2025 should continue to benefit from stable credit spreads, attractive starting yields and for fixed-rate bonds, the prospect of capital appreciation as base-rates are lowered over the course of the year.

Solid fundamentals

The financial buffers built up by many companies during the COVID shock have not yet been depleted so even though credit risk premia (the return over the risk-free yields of government bonds that investors demand for taking on credit risk) is close to 25-year lows they reflect better-than-average resilient balance sheets. Overall leverage metrics have remained well below historical norms across investment grade (IG) and high yield (HY) issuers. Meanwhile, earnings have been gradually improving, so even though interest expenses have picked up over the past year, interest coverage ratios have stabilised.

With central banks beginning to cut interest rates, funding costs are now declining, making refinancings less costly for issuers. Consumers will also benefit from lower mortgage costs as well as more affordable loans that could

benefit issuers in retail and durable goods sectors.

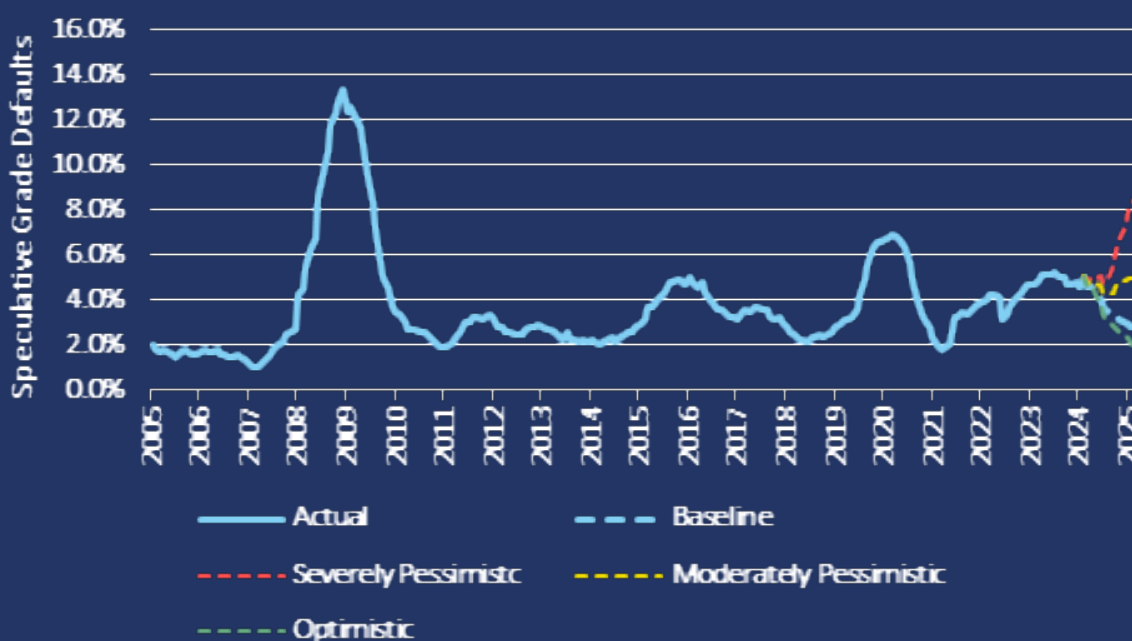
This resilience is reflected in rating agency actions and in default rate expectations. Generally, corporates have enjoyed net ratings upgrades so far this year across IG and HY markets.

Default rates had been climbing in 2023 and into the early months of 2024 but peaked mid-year. In its 2025 forecast, Moody's expects further gradual improvement, with HY loan and bond defaults dropping to 4.3% by the end of 2024 before declining further to below 3% by the end of 2025.

valuations improve we are beginning to see "animal spirits" return. Companies are increasingly willing to prioritise actions that boost shareholder returns over balance sheet resilience.

We may see companies borrowing to pay a dividend which would limit upward rating momentum. For instance, for private equity funds looking to boost returns where it may be too early to IPO, a distribution is a good alternative for investments that have made good progress deleveraging or that feel confident enough in the economic outlook to reduce their resilience buffer.

Speculative Grade Default Expectations



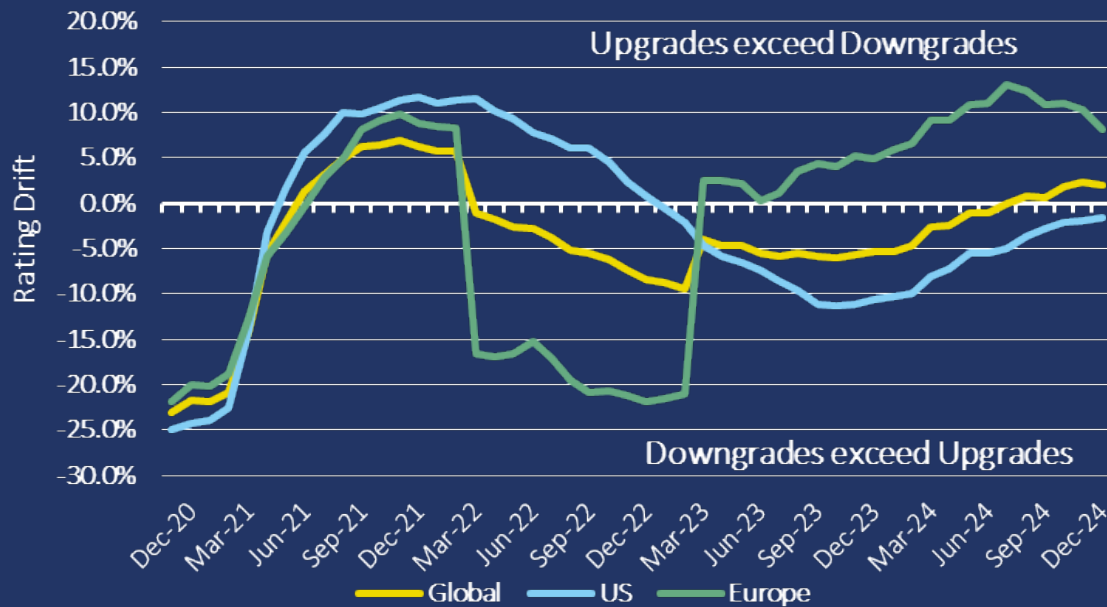
Source: Moody's

Animal spirits rising

While some risks have faded with the growing conviction of an economic soft-landing, new risks are emerging. As borrowers gain more confidence that interest rates are easing and as

Another "animal spirits" risk we are watching is a more broad-based mergers and acquisitions (M&A) cycle, which could weigh on credit metrics as benign markets can make

Moody's 12-month Trailing Rating Drift



Source: Moody's Note: Rating

Drift Calculation = (Notches upgrades – Notches downgrades) / Rated Issuers

companies more willing to sacrifice their credit rating to achieve a strategic goal.

If President Trump enacts all the policies he talked about while campaigning, further disruption is likely in 2025. We do not yet know the exact timing and scope of the policy measures to be adopted but the risk is that if large tariffs and mass deportations are implemented as described during the election campaign, they could weaken growth in the US and globally. By contrast a focus on lower taxes and less regulation may be favourable for growth and credit quality. While some proposed policies could stoke inflation, others are deflationary; some policies should boost growth, others could be negative. The timing, scale, and rhetoric of policy announcements

could trigger numerous periods of market volatility.

Tactical risks and opportunities

While high yields and stable economics favour a strategic allocation to credit markets, most sectors are already “priced to perfection” which limits the potential for further tightening of credit spreads. In this environment it will be important to maintain the ability to be tactical (keep an allocation to high quality liquid credit assets) because opportunities will arise to take advantage of volatile periods.

PRIVATE MARKETS

INVESTING IN CLIMATE SOLUTIONS: THE IMPORTANCE OF INFRASTRUCTURE INVESTMENT IN THE ENERGY CRISIS



Nick Livingstone

Portfolio Manager

Keeping the lights on, powering factories, heating homes, driving cars: as development picks up pace around the world, so too has demand for oil and gas. With the success of the energy transition hanging in the balance, we examine the outlook for infrastructure in the context of renewable solutions to the climate crisis.

Global energy consumption has increased by at least 1% every year since 1966. Between 1990 and 2020, global energy consumption jumped 60%, and, if predictions prove to be right, by 2050 it will rise a further 50%.

To date, most of the energy we have used has come from relatively cheap and abundant fossil fuels which are also the largest contributors to greenhouse gas emissions and a leading contributor of climate change. Despite the recent withdrawal of the US from its climate commitments, most Governments worldwide remain focussed on reducing carbon emissions whilst meeting the energy requirements of their citizens. As a result, there needs to be a change in the way the world produces, distributes and consumes its energy.

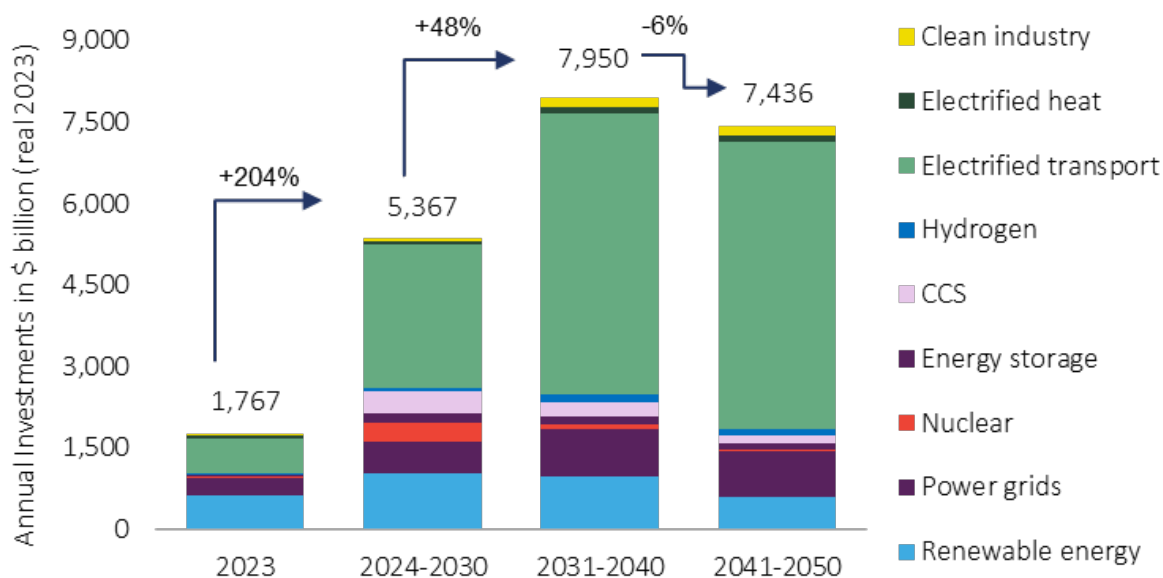
This shift cannot happen without crucial investment in infrastructure. As the backbone that enables the development of technology to support the production, integration and storage of renewable resources and the transmission of clean energy, such investment is crucial in the battle to contain the worst effects of climate change.

A successful energy transition hinges on the infrastructure that enables the transportation, storage and distribution of transition solutions and ultimately clean energy. Energy system operators are likely to lead the way, collaborating with private and public stakeholders to address concerns about resource intermittence, energy security, and sustainability.

“The energy transition is probably the most important theme for private infrastructure investors today..”

They will also develop energy and capacity solutions that meet the rising demand for transition solutions and clean energy. Many market commentators believe that most of

Energy Transition Investments Net Zero Scenario



Source: Copyright. Bloomberg Finance L.P. Note: 2023 shows actuals. Excludes investment in fossil-fuel processes and power and conventional energy, and spending on ICE vehicles. CCS is carbon capture and storage

the capital required to build the energy system of the future will come from private markets.

The energy transition is probably the most important theme for private infrastructure investors today, who find themselves with a long-term opportunity to deploy significant capital into sustainable assets across the risk-return spectrum. However, the market is dynamic, so choosing the right technologies, geographies and tariff regimes to invest in at the right time will be critical.

Recent market developments such as Brookfield and Microsoft's framework agreement to deliver 10.5 gigawatts of new

renewable energy capacity highlights the opportunity, with large corporates increasingly focused on securing green energy supply to address their own net zero ambitions.

Infrastructure strategies provide a range of investment opportunities within the renewables and energy transition market, from the acquisition of existing assets, development, construction and repowering opportunities, through to the development of vertically integrated independent power producers.

THE TECHNOLOGY STACK: ASSESSING THE BIG OPPORTUNITY IN PRIVATE EQUITY



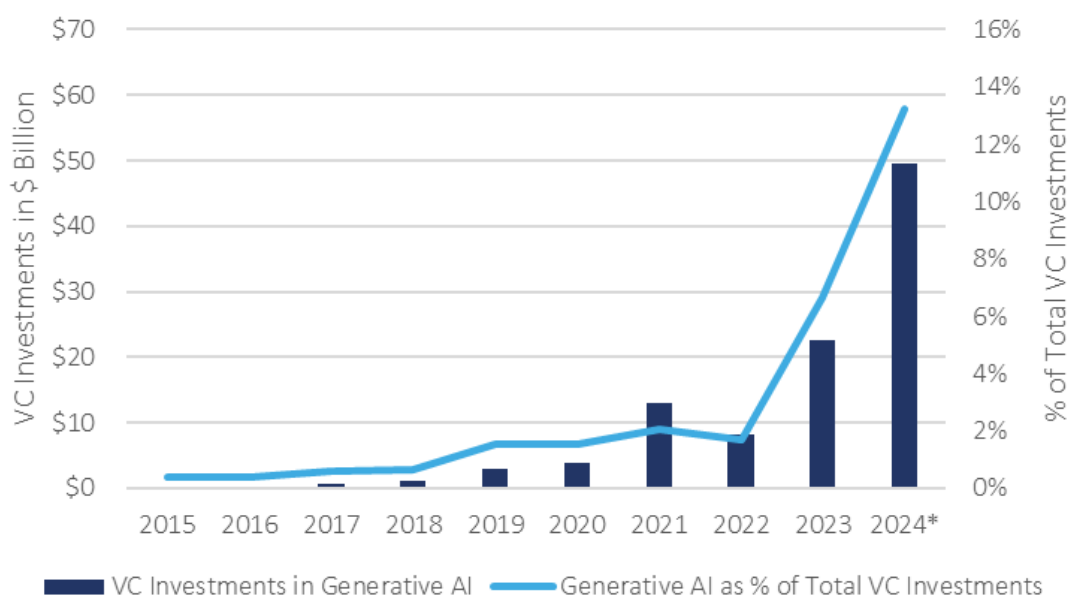
Keith Angood
Portfolio Manager

The dominance of the technology sector stretches beyond public markets, with nearly a third (30%) of the value of the private equity market made up of tech firms. A winning combination of growth, scalability, and profitability has put software and Software-as-a-Service (SaaS) at the top of the tree in terms of investment opportunities for private market investors. Here, we discuss the development and utilisation of Artificial

Intelligence (AI), and how private equity can offer alternative ways to tap into growth.

AI is rapidly reshaping industries throughout the world. Generative AI (Gen AI) is one type of artificial intelligence in which models are trained using existing content and are able to learn to create new content by identifying patterns, relationships and underlying structures within the data. Driven by advancement in machine learning, deep learning and natural language processing, an inflection point was reached in 2022 and advances from here seem likely to accelerate. We can see clearly how AI and Gen AI experienced a boom in interest and

Venture Capital investments in AI and Gen AI



Source: Schroders Capital. Note: 2024* is until May 2024 Annualised

attention in 2024 with the rates of venture capital investment near tripling on 2023 (see chart above).

What is the scale of opportunity?

Gen AI possesses the capability to revolutionise many industries, with the potential benefits for businesses being vast. Productivity gains, streamlined operations, personalised services, cost reduction, informed decision-making and increased revenue generation all widely apply. More industry-specific applications range from the potential to create art and fashion, through to medical diagnostics and drug discovery.

So, how do investors assess the opportunities on offer? The technology stack below offers a roadmap:

- Infrastructure – these are the building blocks for AI. This layer consists of all the resources and services for developing and deploying Gen AI applications such as chips and semiconductors as well as cloud infrastructure.
- Model – this is where the Gen AI models are developed and trained. This layer includes the storage, management and manipulation of the huge data sets being used, as well as the data itself.
- Application – at the top is where Gen AI applications are built and deployed. This layer comprises apps which are open to thousands of companies and are used to easily harness the innovation enabled by the infrastructure and models.

Currently, development of Gen AI sits between the first and second layers of the ‘tech stack’, between infrastructure and models, suggesting there is much more to come as the technology evolves. The potential as the tech moves up the ladder towards ever greater application in everyday life is significant, and an area of huge potential opportunity for the innovators and investors who are able to lead the way.

Private equity investors can tap into this growth in a number of ways. Venture capital and growth strategies present opportunities to invest in new developments at the infrastructure level, supporting the ‘enabling’ tech that means AI can succeed at the model and application layer. Meanwhile, scaled software businesses with sticky customers and strong pricing power can present attractive buy-out opportunities.

Ultimately, AI developments represent a significant opportunity to invest in disruptive business models, but also for companies more broadly to develop market advantage and cost efficiencies. With \$100bn spent by tech giants including Alphabet, Amazon, Meta and Microsoft in the year to June 2024 – a 47% year-on-year increase – it is clear that this is where the opportunity lies, and where all eyes are focused, for the foreseeable future. Identifying the investment managers and strategies with the capabilities to identify and utilise these emerging technologies, harnessing the opportunity set on offer, should form part of a wider private equity portfolio.

WHAT IS THE IMPACT OF RATE CUTS ON PRIVATE CREDIT?



Victoria Hall

Assistant Portfolio
Manager

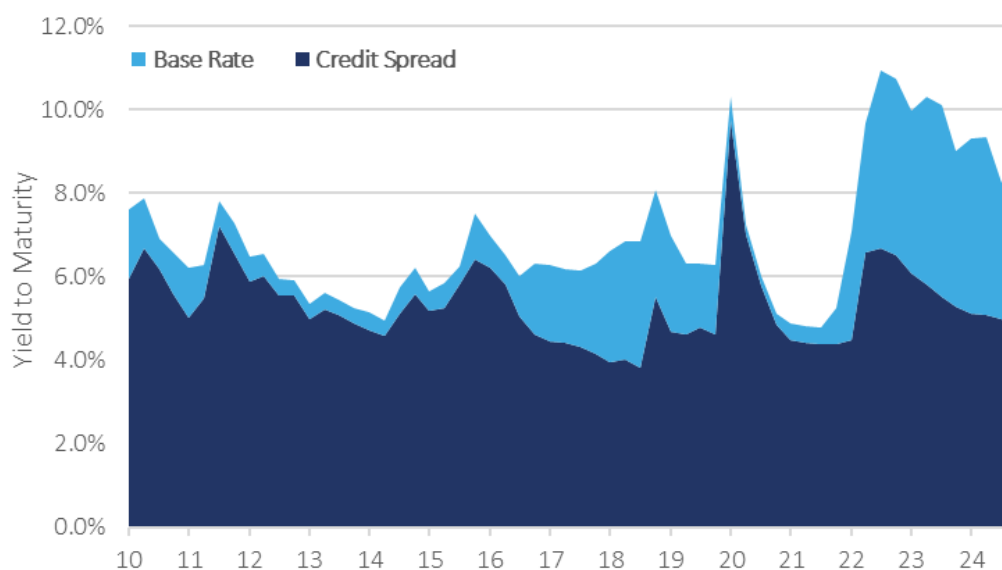
The ‘new normal’ of near-zero base rates came to an end almost two years ago, with a surge in rates since supporting compelling all-in gross yields in the private credit market. Spreads have compressed somewhat since rates peaked, with the upper end of the middle market private loan space being most impacted (see chart below), and gross yields are now down from ~12.5% closer to ~10.5% on senior secured unitranche loans. So, what is the outlook? In this piece we examine expectations and the opportunity as we move into 2025.

What are expectations?

Expectations are for lower base rates in the years ahead and neutral rates are currently considered to be around 3% and 2% for the US and Europe respectively. These levels are considerably higher than the near zero-base rates experienced through the decade to the beginning of 2022, and is currently delivering attractive all-in yields of between 8 – 10% for senior lending transactions, assuming that spreads remain unchanged from today’s levels.

The lower spreads and more stable interest rate environment have given borrowers more breathing room to opportunistically consider refinancing – given the typically floating rate nature of the asset class – helping to buoy up deal activity. Market

Leveraged Loans Return Decomposition



Source: Copyright. Bloomberg Finance L.P.

activity has therefore seen elevated refinancings as a share of total deal activity, although M&A is picking up YTD as well (see chart above).

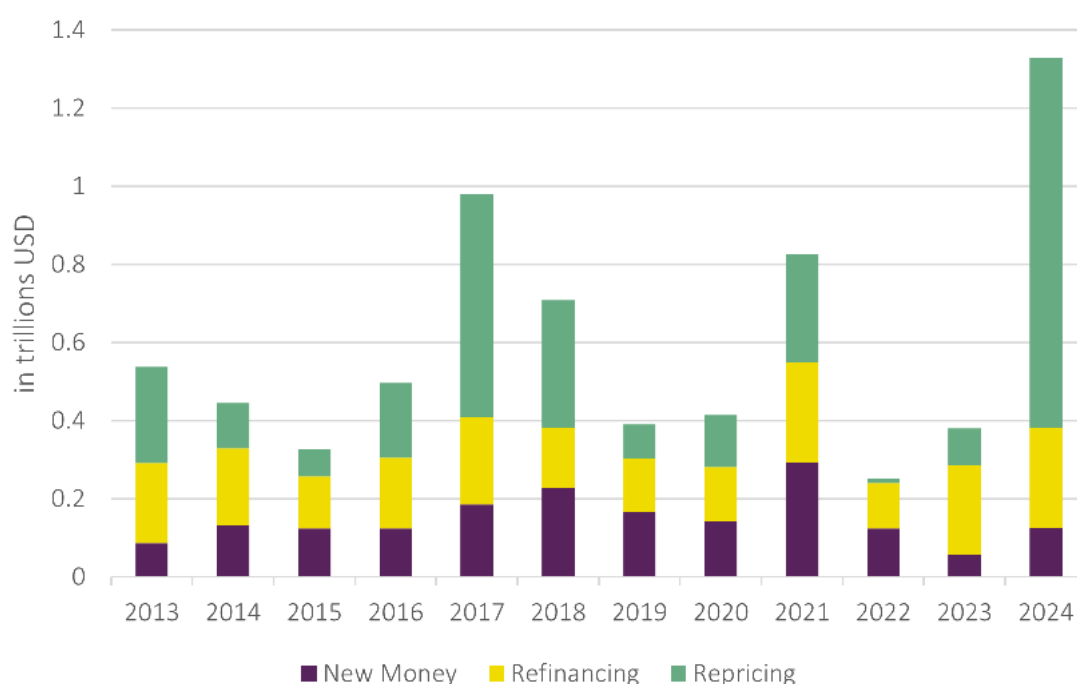
Refinancings often provide an incumbency advantage to the existing lender, as sponsors and borrowers seek to minimise the complexity of switching provider. The incumbent lender's deep insight into the borrower's existing credit health can also help to derisk the follow-on transaction from the lender's perspective.

deal activity and relationship building during the significant bank retrenchment seen from 2021 through 2023.

What is the opportunity?

The market opportunity therefore remains compelling across the private credit spectrum. Attractive rates in the senior space allow for a focus on quality via large, market leading managers. These managers are also well positioned to benefit from the highlighted incumbency advantage where they have existing loans in place with the

US Leveraged Loan Volume



Source: Copyright. Bloomberg Finance L.P

While banks have been re-entering the market to again compete with private lenders, they have not been able to fully regain old ground. Speed, flexibility and certainty of execution remain highly valued criteria in lender selection and these attributes have served direct lenders well in

best quality private equity managers. The bottom line? Private equity dry powder remains at high levels and private lenders are in a strong position to be able to capitalise on this market opportunity going forward.

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