ARCAPITA

Investment Outlook 2025: The Turning of the Wheel

January 2025

Foreword

As we enter 2025, the present moment feels like a turning of a wheel. There is a widespread feeling of change in the air, yet the change is both familiar and cyclical. For instance, a new US president... who is the former US president. A downward cycle starting in worldwide interest rates... towards the macro environment seen between 2002 and 2007. Or renewed momentum in crypto... as it increasingly starts to resemble traditional finance.

For Arcapita, this change and cyclicality is nothing new. We believe the world is entering an exciting period, geopolitically and economically, and in this period we will continue our strategy: to seek investments as events unfold, with higher interest rates and value dislocations offering attractive valuations for sectors we favor, while keeping an eye toward fundamentals and durable, long-term trends.

This approach allows us to evaluate the 2025 outlook clearly and with increasing confidence. While there may be some short term turbulence arising from the new US administration, the broader investment landscape actually looks relatively predictable and balanced, in our view, an auspicious combination for investors. Interest rates globally are on a downward path, but the gradient has become shallower, giving a longer runway to acquire assets for higher cap rates or lower multiples, yet with the prospect of a medium-term lower interest rate environment on exit. Inflation has ticked up again but should remain range bound in a way that can deliver sustained income growth. Price stability is leading to a reemergence of a deeper investor and financier pool, encouraging exits, IPOs and an unclogging of the private equity pipeline. The GCC, in particular, should offer exciting growth prospects and further innovations in its investment universe and capital markets – but not eclipsing attractive investment opportunities in the US, UK and, yes, Europe.

Our strategy to seek investments as events unfold, with higher interest rates and value dislocations offering attractive valuations for sectors we favor

In Chinese astrology, 2025 is the Year of the Snake, signalling metamorphosis and intuition, and this seems fitting. The wheel turns in its reassuring cyclicality and the investment landscape evolves accordingly, while intuition and experience gives the confidence to unearth and deliver opportunities ahead of the herd.

Price stability is leading to a reemergence of a deeper investor and financier pool, encouraging exits, IPOs and an unclogging of the private equity pipeline

Global Inflation, Interest Rates, and Trends

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Overview

Despite high short-term interest rates, the U.S. economy continues to be resilient, growing at a robust pace with relatively low unemployment rates. This favorable economic environment is reflected in narrow corporate bond spreads and subdued stock market volatility.

The soft landing of the U.S. economy amidst the Federal Reserve's interest rate hikes can be attributed to three main factors.

- The widespread use of fixed-rate mortgages has shielded households from the impact of rising rates.
- Fiscal policy has remained expansionary, with the government deficit reaching 6.4% of GDP in 2023-2024.
- A stagnant active population has resulted in a persistently tight labor market.

Inflation

The recent spike in inflation has significantly influenced public perceptions of the economy. While median wages have largely kept up with overall price increases (*Figure 1*), food prices have risen steeply (*Figure* 2). Given consumers' heightened sensitivity to food prices, high food inflation is likely to have eroded consumer confidence and impacted electoral outcomes.

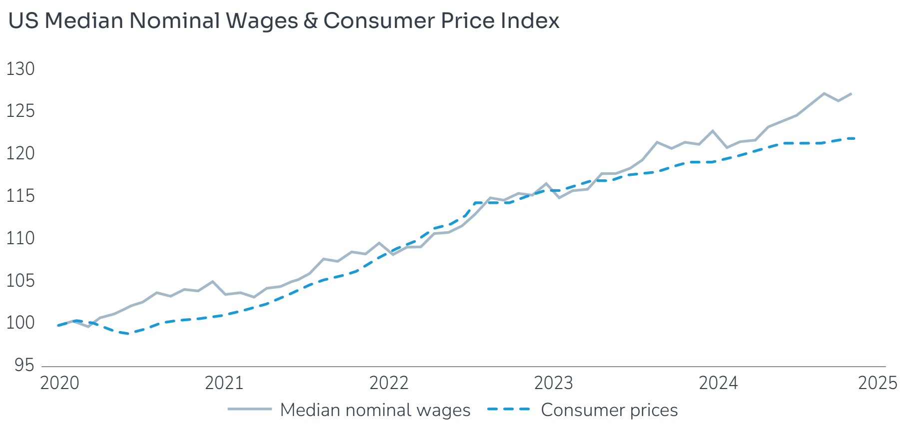

Figure 1

US Median Nominal Wages & Food Price Index

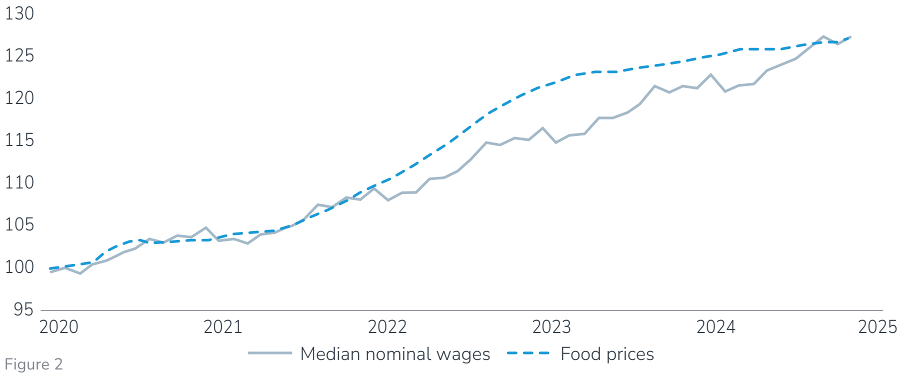

Figure 2

Inflation is declining, but several factors could reignite inflationary pressures.

- The tariffs proposed by the Trump administration could drive up prices, triggering a period of above-average inflation.
- Geopolitical tensions may increase the costs of critical resources like rare earth minerals, fertilizers, and semiconductors.
- Potential large-scale deportations of U.S. undocumented workers could increase costs in industries such as construction and hospitality.
- Climate change continues to pressure food prices, while the growing unpredictability of weather patterns has prompted insurance companies to raise the costs of insuring against natural catastrophes such as storms, wildfires, and flooding.

US Five-Year Break-Even Inflation Implicit in Bond Prices

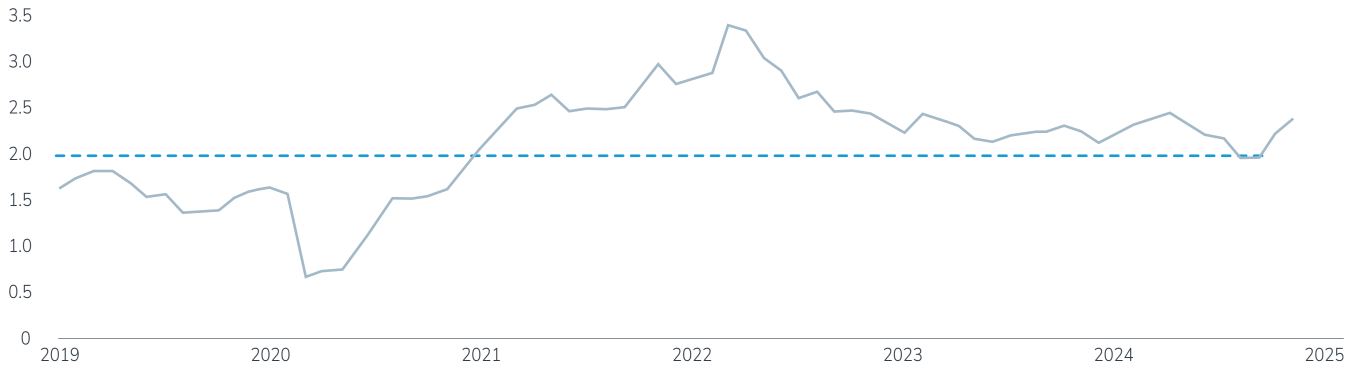

Figure 3

Interestingly, the five-year, break-even inflation rate calculated from differences between indexed (which promises a real return over the rate of inflation) and non-indexed (which promises a nominal return regardless of rate of inflation) U.S. government bonds, converged to 2% in September but has since begun to rise, indicating the market is pricing in some inflation above the Fed's target 2% (*Figure 3*).

The deregulation of oil exploration could expand U.S. oil production, alleviating inflationary pressures through lower oil prices. However, much of the production growth would come from fracking, which is unlikely to expand at the current oil price of $70 per barrel. According to a Federal Reserve Bank of Kansas City survey conducted in October, fracking operators require oil prices to reach $89 per barrel to justify a medium-run expansion in production capacity.

Interest Rates

The yield curve exhibits an unusual U-shape, characterized by high short-term rates, low medium-term rates, and elevated long-term rates. This pattern reflects market expectations of declining interest rates as inflation subsides and unemployment rises. Elevated long-term yields reflect the end of the Federal Reserve's quantitative easing policy and growing concerns about the rising levels of U.S. government debt.

Higher interest rates have eroded the value of U.S. banks' bond portfolios. Banks with stable depositors who maintain funds in low-interest accounts can mitigate capital losses through higher net interest margins. In contrast, banks with more volatile deposit bases, such as Silicon Valley Bank had, lack this flexibility, leaving them vulnerable

Fiscal sustainability

Country	Long-run nominal GDP growth rate (%)	Yield on 10-year govt bond (%)	Long-run growth rate minus 10-year yield (%)
China	5.3	1.8	3.5
France	3.1	3.0	0.1
Germany	2.8	2.3	0.5
Greece	3.4	3.0	0.4
Italy	2.7	3.4	(0.7)
Japan	2.4	1.0	1.4
Poland	5.4	5.8	(0.4)
Portugal	3.9	2.7	1.2
Spain	4.0	2.9	1.1
United Kingdom	3.4	4.4	(1.0)
United States	4.0	4.4	(0.4)

Table 1

The U.S. debt-to-GDP ratio has soared to levels not seen since the aftermath of World War II. While concerns about the dollar losing its status as the global reserve currency are premature and foreign holdings of U.S. debt are diversified, the current debt trajectory is likely to be unsustainable. Possible resolutions include:

- Advancements in AI boost productivity, enabling nominal GDP to grow faster than government bond yields. In this scenario the debt-to-GDP ratio can gradually decline without drastic policy changes.
- A crisis-driven adjustment involving unpopular measures such as spending cuts or higher taxes.
- Partial monetization of the debt through increased dollar printing could reduce debt burdens in the short term but risks undermining the dollar's role as a global reserve currency.

Table 1 shows that in addition to the U.S., Italy, Poland, and the U.K. currently have less stable public debt dynamics, with 10-year government bond yields exceeding the IMF's forecasts for long-term nominal GDP growth.

Equities & Crypto

U.S. equity markets continue to climb, led by the seven largest companies quoted in the stock market. Valuations are lofty, Robert Shiller's price-to-long-term earnings ratio stands at 38 well above its historical median of 16.5. The exuberance about AI mirrors the late 1990s dotcom boom, where a few winners like Amazon emerged amidst many losers.

Price-earnings ratios for European stocks are relatively low, reflecting subdued growth prospects due to a declining active population and a restrictive regulatory environment. While the ECB has lowered short-term interest rates, it has simultaneously ceased its asset purchase program, increasing pressure on public finances in countries like Italy.

Shiller PE Ratio

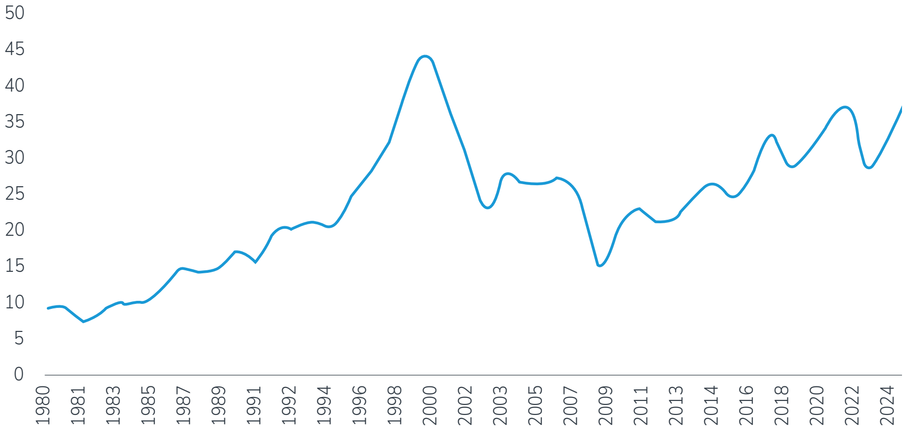

Figure 4

Cryptocurrencies have experienced a sharp increase in value, driven by expectations of a favorable regulatory environment. Although blockchains have demonstrated resilience against hacking, using cryptocurrencies to purchase goods and services remains challenging. These assets continue to be highly speculative investments. Meanwhile, central bank digital currencies remain in the testing phase because central banks are concerned that cybersecurity risks outweigh potential efficiency gains.

Emerging Trends in AI

High interest rates and the allure of AI investments have attracted large capital flows into the U.S., strengthening the U.S. dollar.

The past decade has witnessed remarkable advancements in AI, a fact recognized in this year's Nobel Prize awards. The Nobel Prize in Chemistry was awarded to David Baker, Demis Hassabis, and John Jumper for their application of AI to the problem of folding proteins. In Physics, John Hopfield and Geoffrey Hinton were honored for their foundational work on neural networks.

Large Language Models (LLMs) like ChatGPT have demonstrated the ability to produce coherent text on numerous topics and have successfully passed advanced high school exams. However, there is uncertainty about whether the continued scaling of data and computational power, which has driven these advancements, will continue to produce results.

AI's impact on the labor market, especially on non-routine cognitive jobs, remains uncertain. So far, productivity gains driven by AI are likely to have contributed to the 70 percent decline in the demand for software developers between March 2022 and November 2024.

Although blockchains have demonstrated resilience against hacking, using cryptocurrencies to purchase goods and services remains challenging

The GCC: An Economic Transformation

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The decline in hydrocarbon revenues in 2024, driven mainly by the OPEC+ voluntary curbs on oil production, is expected to have a negative impact on the region's overall GDP. However, the continued commitment towards diversifying away from hydrocarbons led to robust growth in the GCC's non-oil sectors, which are expected to grow by 3.7% in 2024. The Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE) are the largest contributors to this growth.

This has been coupled with the execution of transformative long-term plans, which led to growth in employment opportunities and enhancements in labor market dynamics. KSA's unemployment rate dropped in 2024 to a historical low of 7.1%, which is close to Saudi Vision 2030's target, while Saudi women's labor force participation rate has exceeded Vision 2030's target of 30%, further promoting economic growth and productivity.

Prudent policy-making in the GCC, along with subsidies given on essential items like food and energy, has also helped in maintaining relatively low inflation rates, forecast to average around 2.1% in 2024, while the global economy has been battling high inflation rates, with a forecast of 5.8% globally.

The continued commitment towards diversifying away from hydrocarbons led to robust growth in the GCC's non-oil sectors

2.1%
Inflation in Saudi Arabia

5.8%
Inflation in global economy

↓7.1%
KSA's unemployment rate in 2024

>30%
Saudi women's labor force participation

The economic, social and political stability offered by the GCC region, coupled with the ongoing implementation of focused national visionary strategies, have boosted local and international investor confidence, leading to higher investment flows into the region. IPO momentum is expected to continue being a key driver for the region, with a robust pipeline of upcoming IPOs, which indicates a healthy market for fundraising, given more visible and reliable exit paths.

GCC's GDP is forecast to grow at 4.2% in 2025, compared to the forecast global GDP growth of 3.2%, which clearly demonstrates that the GCC region, particularly KSA and UAE, are well placed to outperform the global average, driven by the robustness and sustained momentum in growth of the non-oil sector of the economy.

As the transformative plans are implemented and the drive towards economic diversification and growth continues, we will remain focused on investment opportunities in areas where we have built a successful track record of achieving above-market returns, are supported by favorable long-term fundamentals and are aligned with the region's long-term priorities.

We will be seeking to invest in scalable technology-enabled private companies that provide essential services that are non-discretionary and mission critical in nature. Given the current economic landscape, the number of firms that outsource their non-core and support activities to improve efficiency and accelerate growth is expected to continue increasing. This is expected to provide investors with downside protection while benefiting from strong tailwinds.

Investments in industrial real estate will continue to be an area of focus, given the sector's growth prospects, the prevailing supply-demand mismatch, its alignment with the region's objectives and the proven defensiveness the sector has demonstrated during challenging macroeconomic environments.

These are exciting times for the GCC region, and we want to continue to provide our investors with access to investments that capitalize on and benefit from the expected growth and stability provided by the regional environment.

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The US: Cutting Through the Noise

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↑2.4%

Projected economical growth

The U.S. economy in 2025 will be navigating through a complex landscape shaped by global interest rates, inflation control, and geopolitical influences. The economy is projected to grow at an annual rate of 2.4% in 2025. This growth is expected to be driven by robust consumer spending, bolstered by solid income growth and easing financial conditions. The influence of new tariffs and potential tax policy

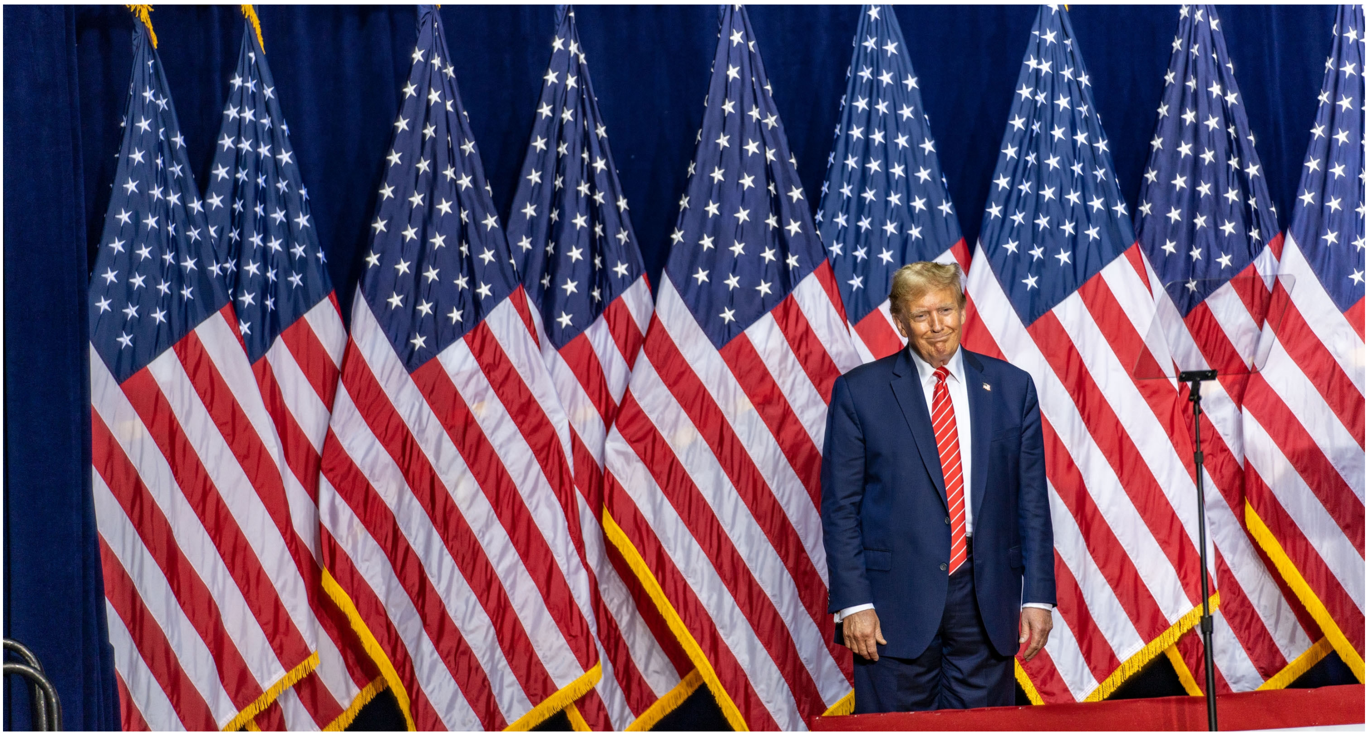
changes under a Trump administration could introduce volatility; however, those are expected to have a modest net impact on GDP growth. Inflation is anticipated to stabilize, with core Personal Consumption Expenditure (PCE) expected around 2.4%, potentially rising to 3% if broad tariffs are implemented. The Federal Reserve's (The Fed) commitment to price stability might lead to a pause in rate cuts if inflation spikes. The Fed is forecasted to continue reducing rates towards a terminal rate of 3.25-3.5% by year-end, though this might be adjusted based on inflation and growth dynamics. Rate cuts are expected to be more gradual as the economy reaccelerates.

The political landscape post-election might introduce legislative changes affecting sectors like energy, healthcare, and technology. Additionally, new tariffs threatened by the incoming Trump administration could lead to short-term inflation but might also encourage domestic production in the longer term. The impact on international relations and global supply chains remains a wildcard.

For US investments, expectations are set for a significant increase in deal flow. This is influenced by improved economic conditions, lower interest rates, and a strong investor sentiment post-election.

For Private Equity, there's a particular focus on carve-outs and take-private deals, with sectors like business services that provide essential services experiencing continued tailwinds. The pressure on fund managers to exit long-held investments has intensified, leading to a predicted uptick in both IPOs and mergers and acquisitions

2025 is poised to be a pivotal year for private equity



(M&A). However, the pace might be tempered by the ongoing need to narrow valuation gaps between buyers and sellers. The political shift might lead to less stringent regulatory scrutiny, potentially boosting M&A activity. However, this could also introduce complexities, as new policies might affect specific industries, influencing deal structures and market dynamics. With traditional leverage currently less effective due to higher interest rates, PE firms are doubling down on operational improvements and value creation strategies. This involves enhancing EBITDA through operational efficiencies, strategic acquisitions, and managing working capital more effectively. There's a cautious optimism with potential risks like inflation, interest rate fluctuations, and geopolitical tensions playing roles. Overall, 2025 is poised to be a pivotal year for private equity, with opportunities for growth but also significant challenges in navigating the evolving economic and regulatory landscape.

For Real Estate, we view 2025 as effectively a continuation of trends that began in 2024 but are taking longer to bear fruit, in part because of interest rate policy. Coinciding with the increased debt and equity capital inflows seen in 2024, we see the US real estate market entering a new cycle, making investing in new construction projects more opportune than it has looked for many years. And asset repricing over the past 18 to 24 months has created buying opportunities, even amongst out of favor property types in certain cases. We expect this to continue due to interest rate policy dynamics. For example, office will see some value creation and targeted opportunities because of moderating tenant trends such as return to office having the potential to provide relief to the sector.

We see the US real estate market entering a new cycle, making investing in new construction projects more opportune than it has looked for many years

The UK: Steady as She Goes

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We expect many of the UK trends from 2024 to continue

This time last year, we were forecasting lower (but also fluctuating) inflation, solid-if-unspectacular economic performance, and slowly falling interest rates for the UK for 2024, all of which would combine to create an attractive investment window, as rebased asset values presented compelling opportunities.

As we near the end of 2024, our forecast has indeed come to pass. Inflation has halved compared to a year ago. Meanwhile, the Bank of England has cut interest rates by a gradual 50 basis points over the course of the year, from 5.25% in December 2023 to 4.75% in December 2024, and UK GDP is expected to have grown by ~1% this year.

2024 also brought the first change in UK government leadership in 14 years, with Labour winning a large majority in the July general election. Despite campaign trail rhetoric highlighting a large legislative agenda, the reality has been more of a nip-and-tuck approach than drastic changes. Even the new Budget,

UK Inflation & Consensus Forecast vs. Bank of England Target Inflation Rate

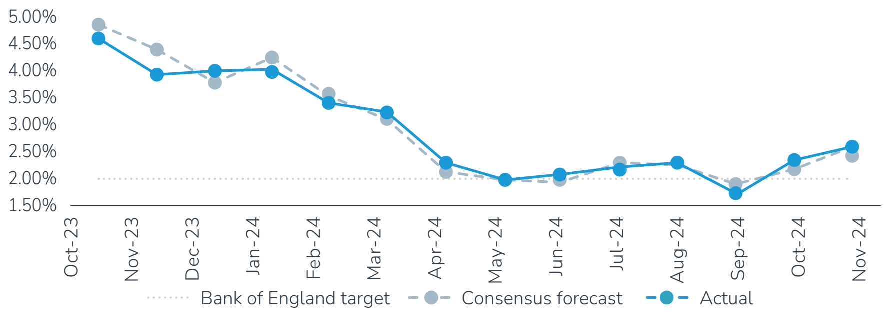


Figure 5

which was introduced in October and outlined a new tax regime was ultimately less far reaching than many anticipated and is now considered expansionary by many businesses and economists, despite headlines in the media. As businesses continue to adapt to the new government and digest policy changes, we expect the pause around the Budget that caused the current fourth quarter economic slowdown to subside.

As we look ahead to 2025, we expect many of the UK trends from 2024 to continue. We continue to forecast fluctuations in rates of inflation, and we are preparing our investment portfolios accordingly. Despite political pressures to stimulate the economy and a desire to maintain policy harmony with the Fed (which is easing, despite their economy needing little stimulus) and the ECB (which is easing to stimulate the core Eurozone economy), fluctuations in inflation will put pressure on the Bank of England to ease interest rate policy more cautiously, creating a higher-for-longer environment that provides a longer runway than other geographies to acquire higher assets at attractive valuations. Equally, we anticipate slow but steady GDP growth that provides a predictable, if somewhat unexciting, context for investment.

Geopolitically, 2024 saw the UK largely regain its status as a political safe haven as its clear political majority stood out in contrast to other developed countries' elections. As we look ahead to 2025, we view the UK economy as relatively insulated from major geopolitical risks, including threats of tariffs from President Trump. The UK economy being highly service oriented, especially when viewed through the lens of international trade, should keep it largely off the radar of a Trump administration that is primarily focused on manufacturing and hard goods, more broadly.

With markets calming, political uncertainty receding, the Pound at historically attractive levels, and asset pricing rebased, the attractive investment window that characterized 2024 looks to continue into 2025. The consensus expectation is that economic growth should gradually gather momentum as we work through 2025, and you can expect Arcapita to position our investors to benefit from that growth.

Bank of England Base Rate

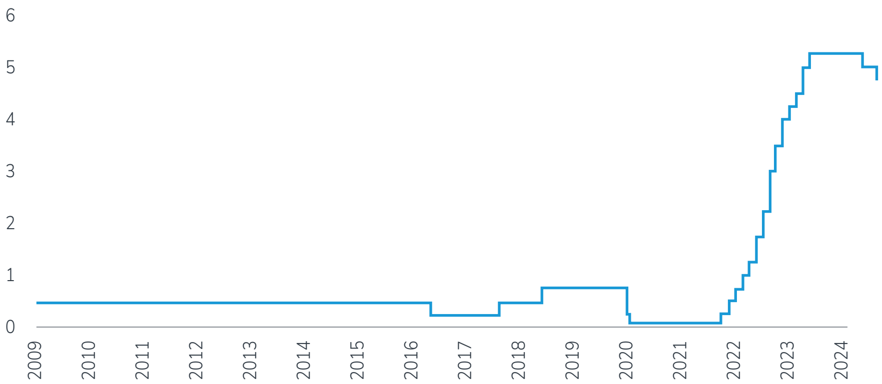


Figure 6

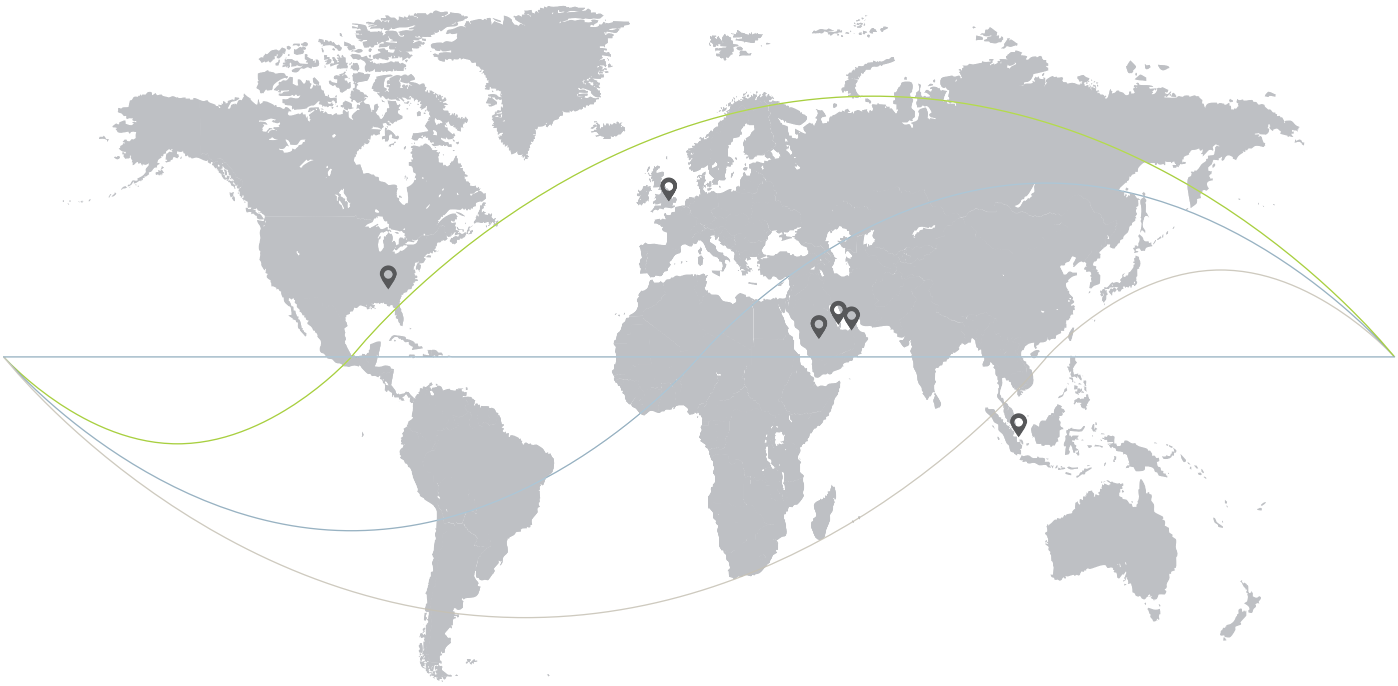
[1] https://www.worldbank.org/en/news/press-release/2024/12/01/non-oil-sectors-drive-robust-growth-in-gcc-countries
[2] https://www.argaam.com/en/article/articledetail/id/1772066
[3] https://www.agbi.com/economy/2024/12/gcc-growth-to-surge-to-4-2-in-2025-26-says-world-bank/
[4] https://edition.cnn.com/2024/10/22/economy/weo-imf-global-inflation/index.html
[5] https://www.worldbank.org/en/news/press-release/2024/12/01/non-oil-sectors-drive-robust-growth-in-gcc-countries
[6] https://mediacenter.imf.org/news/imf-world-economic-outlook-update/s/396fed6d-7b53-4e82-8a37-626cbcc83d69

ARCAPITA

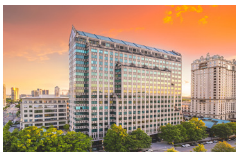
Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, US, UK, Saudi Arabia, UAE, and Singapore, Arcapita's management team has completed transactions worth a total value of approximately $30 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.



United States



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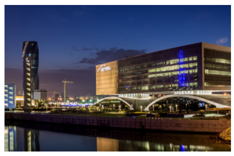

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