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The Carlyle Compass

By Peter Cornelius

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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition features guest author Peter Cornelius, Chief Economist at AlpInvest. Received this email as a forward? Subscribe here.*

2025 – The Beginning of a New Private Equity Cycle?

Exceptionally Good Returns across Risk Assets in 2024

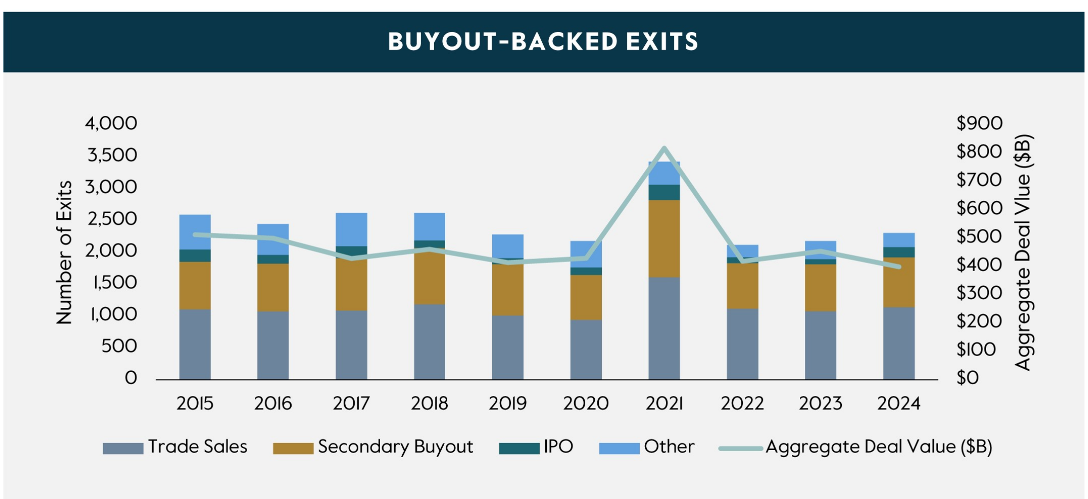
Financial markets continued to perform well in the final quarter of 2024, as many central banks continued to ease monetary policy. In this environment, most major risk assets extended their gains, with the MSCI World index ending 2024 17% higher than at the beginning of the year. While the S&P 500 index rose more than 23% in 2024, European stocks, proxied by the Euro Stoxx 50 index, gained approximately 8%. Meanwhile, investors in U.S. single-B-rated corporate bonds enjoyed an annual return of 7.5%, and investment in U.S. leveraged loans generated a return of almost 9% in 2024.

At the time of writing, private equity returns in Q4 have not yet been reported, but data through Q3 suggest that appreciation roughly kept pace with public equities on a public market equivalent (PME) basis. While it remains to be seen whether private equity returns outperformed public equities for full-year 2024, the result may depend on the benchmark. As far as the U.S. market is concerned, the small-cap Russell 2000 gained 11.3%, a still significant but less impressive return than the large-cap S&P 500 whose outstanding performance (+23.3%) was largely driven by a small number of large tech companies.

Headwinds Turn into Tailwinds

2024 might prove to have been the turning point in the private equity cycle. Private equity cycles typically lose momentum when exits slow and diminished cash flows impact investors' models, causing new commitments to fall progressively. The most recent cycle is no different. But exit markets have already begun to stabilize (Figure 1), and buyout distributions have logged two consecutive quarters of net positive cash flow thanks in large part to a boom in dividend recapitalizations against a backdrop of easier financing conditions.

Figure 1: Buyout-Backed Exits



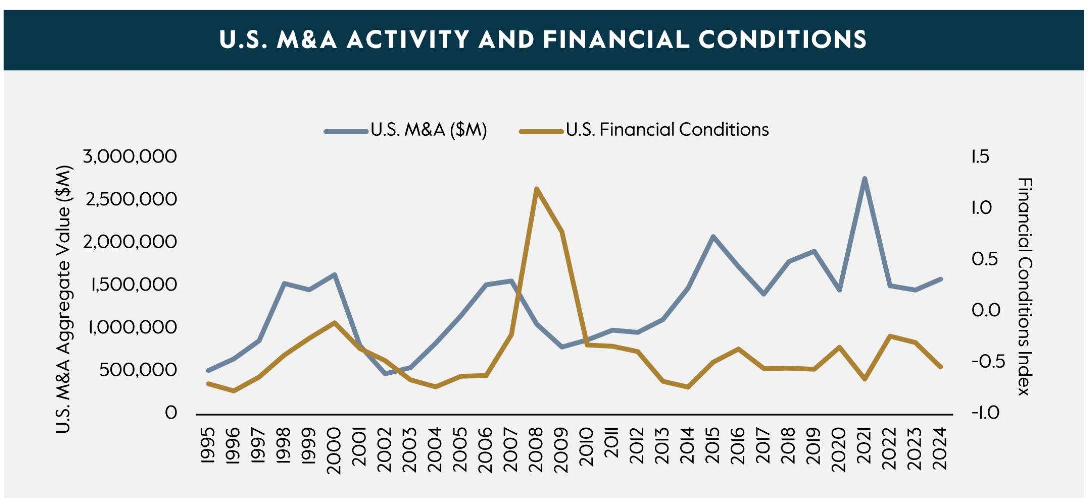
Source: Preqin, accessed 1/13/25. For illustrative purposes only. There is no guarantee any trends will continue.

2024 saw a very heavy election calendar around the world, including the US presidential election. Throughout 2024, market participants' expectations for future policy rates also fluctuated widely. With elections out of the way and greater clarity on the probable future path of interest rates, broader uncertainty has receded, which may help to stabilize investors' expectations and facilitate greater deal activity.

The need for patient capital to restructure fundamentally sound, but undermanaged businesses remains large. Additionally, major advances in new technology, such as AI, require huge investments to enhance competitiveness. On the supply side, the availability of patient capital should improve as the expected recovery in exits and distributions may support a recovery in fundraising.

Overall, as we enter 2025, we see improved conditions for a self-sustained new private equity cycle, which could bring about new investment opportunities, regardless of the amount of future monetary easing by the Fed and other major central banks, with deal activity and financial conditions found to be only relatively loosely correlated (Figure 2)

Figure 2: U.S. M&A Activity and Financial Conditions



For illustrative purposes only. No assurance that trends depicted will continue. Financial Conditions Index as calculated by the Chicago Fed. The Chicago Fed's Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average. Downloaded from Fred database, 1/13/25. M&A data as reported by Dealogic, accessed 1/13/25.

Despite these early signs of a normalization in capital markets, it is important to note that the private equity ecosystem is still working through a correction. Cumulatively across private market asset classes (not just buyouts), contributions have exceeded distributions by roughly $490 billion since early 2021. This dynamic has contributed to the strong secondary volumes observed in 2024, as both LPs and GPs have sought solutions to address liquidity challenges. Indeed, as we entered the fourth quarter of 2024, the secondary market was on track to achieve record transaction volumes of nearly $150 billion, eclipsing previous highs set in 2021. Looking ahead, we anticipate elevated secondary market activity to continue over the medium-term as LPs work through significant overexposure. Even if exit volumes in 2025 improve, the backlog of unrealized assets suggests that a full normalization of portfolio allocations may not occur until 2027.

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