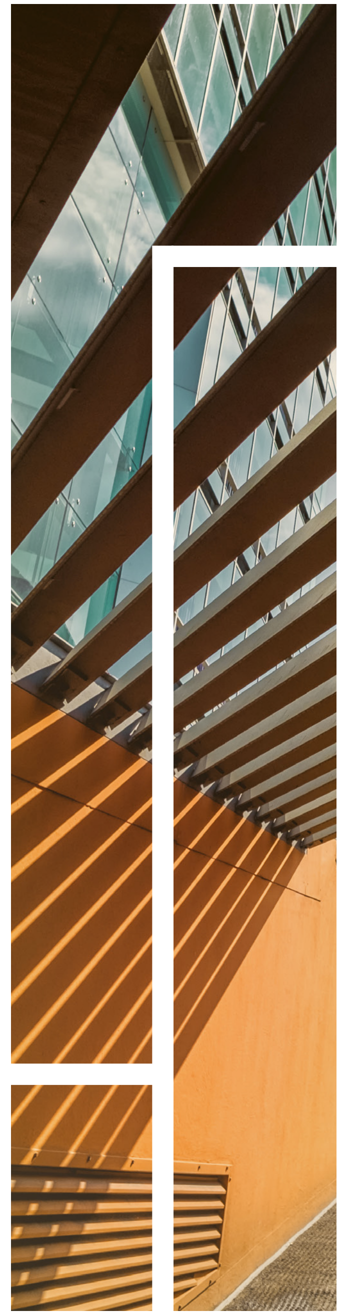
Midterm Elections Are Imminent, But Investor Eyes Remain Trained on the Fed and Inflation

The term "uncertainty" has dominated headlines much of this year. Election season exacerbates that sense of uncertainty, leaving investors and company executives to weigh the different scenarios each outcome might bring.



That said, monetary policy is unlikely to change based on the results of U.S. Congressional elections. This November, while dealmakers may be tracking races in the Senate and House of Representatives, their true focus lies on the Federal Reserve as officials attempt to control the inflationary environment. Just this week, they announced a 0.75 percentage point increase—the fourth consecutive hike at that rate.

The most critical factor impacting today's private capital markets is the threat of a recession. Two to three months ago, there was more talk of the possibility of a soft landing. Today, that result seems less and less likely as investors brace for additional interest rate hikes and the impacts that may have on wages and unemployment. Many questions remain: Will we enter a recession? When will this happen? Are we already in one? And if so, what will the duration and shape be – V, U, W?

The uncertainty around whether a recession will come to fruition has caused a bit of paralysis in mergers and acquisitions (M&A) markets as sellers grapple with the appropriate timing to take companies to market. Many private equity (PE) sponsors are sitting on several quality assets that they would like to sell, but the last thing they want to risk is a failed process.

At the same time, valuations have come down somewhat, but seller expectations in many instances have not followed suit. As sellers navigate the market conditions and possibility of a recession, we may see more "quiet" sale processes as sellers forgo broad market outreaches and engage advisors to discreetly bring the right acquirers and investors to the table.

Conventional wisdom also tells us that in times of uncertainty, limited partners look to harbor cash. Fundraising can become more difficult as institutional investors become increasingly discerning about where they allocate their capital. For PE, fund dynamics can come into play as some firms face pressure to put capital to work depending on the level of dry powder relative to the fund life.

The combination of these factors means that we will continue to see capital deployed and deals closing, but the capital will most likely flow to those business that have business models or serve end markets that are very credibly less cyclical.

As for the Congressional elections, the latest polling suggests we will likely see a Republican majority House while the Senate race remains too close to call. If current projections stand, it is increasingly likely we will see more gridlock on key policy initiatives. Regardless of the outcome, economic forces are sure to take center stage as monetary policy continues to be the primary shaper of M&A in the private capital markets over the coming months.

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