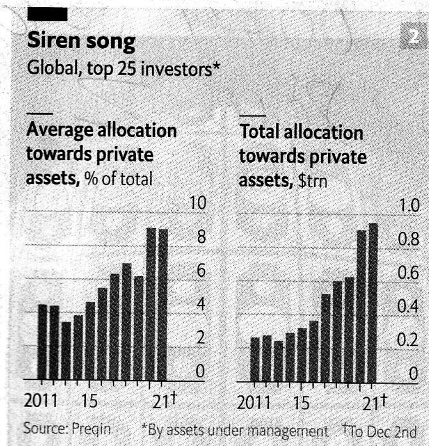
markets such funds to end-investors.

The belief that private returns will be superior reflects a variety of contestable arguments: that investors can earn an "illiquidity premium" for having money locked up in assets that do not trade freely, say, or that private markets are less efficient than public ones, allowing skilled managers to exhibit consistent outperformance. Sceptics think that opaque private markets allow managers to mask high leverage and volatility. For now, the magic formula is working. Some big investors report annual returns in the mid-teens across private-asset classes this year, with those on PE above 50%. By comparison, the S&P 500, an index of American stocks, has produced a return of 24%.

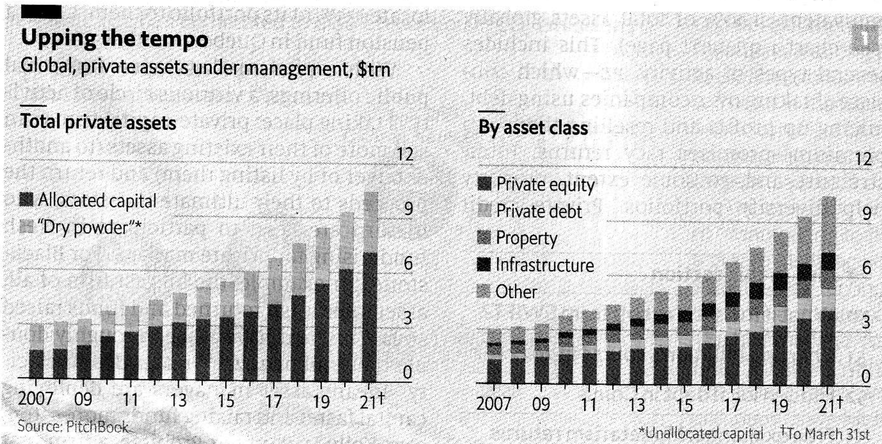
Lured by high returns, some investors are keen to be more directly involved in running private assets, rather than being passive customers of the big private-capital managers. APG, a Dutch pension manager that oversees $703bn, aims to own at least 10-15% of every fund it backs, so as to negotiate veto rights over strategic matters, says Patrick Kanters, its private-markets boss. Many big limited partners also "co-invest" alongside funds directly in portfolio companies, which allows them more discretion over the size of their exposure, and lowers overall fees. Some bypass managers entirely. Co- and direct investments are set to reach $265bn this year, the highest-ever amount by far. Large investors in "real" assets, which include property and infrastructure, have become full-fledged developers, enabling them to create their own pipeline of deals—whether for student housing or hospitals—and pocket a fat margin.

Changing the tune

Yet the scale of the boom is also a source of unease. Valuations are creeping up. In a survey of 71 global institutions carried out by Probitas this autumn, 65% ranked unhealthy competition for deals as the biggest risk, up from 55% last year. Frenetic activity means less due diligence. Limited partners (as the ultimate investors in funds are known) have little time to forge relationships with new managers and diversify their bets. Some are recruiting more staff, triggering what Maxime Aucoin of CDPQ calls a "war for talent". Meanwhile managers are feeling rushed, too. "Decisions are being made on bigger dollars in fewer days," notes Steve Moseley of APFC. The amount of "dry power", the total committed to funds but not yet spent, stands at a record $3.3trn. The pressure to deploy capital means fund managers have less incentive to evaluate potential targets strictly, or to turn down deals.



Alongside frothy behaviour, the other risks are the economy and interest rates. For now a roaring American recovery means that the underlying performance of the firms and assets that private managers own is decent. In November, for example, Blackstone told investors that, for the first time ever, every one of the companies that it owned was experiencing growing revenues. Rising interest rates are a concern, however, as they can deflate asset prices, impose stress on indebted companies and make it harder to raise debt to finance deals. So far the Federal Reserve's pivot towards tightening monetary policy has not roiled credit markets: junk-bond yields (a proxy for interest rates on riskier debt) have risen from 4% in September to 4.5% now. But there could be more to come.



Flush with cash amid a deal frenzy, what is the industry to do? One option would be to liquidate portfolios, that is, to sell more assets than it buys, in effect trying to cash in some chips when prices are high. As yet, however, this does not seem to be happening. Take the figures for three big managers, Blackstone, Carlyle and KKR. So far this year for every $1 of assets, in aggregate, that they have sold, they have bought $1.30. Although Carlyle is being more cautious than the other two firms, these figures indicate that the industry overall thinks the good times will roll on.

That suggests that if there is any restraining force in the industry it is the ultimate investors. Some are hedging risks. Australia's Future Fund is rebalancing its real-asset portfolio towards "defensive" assets, such as housing blocks with a diverse set of tenants that it can "build and hold for ever", says Wendy Norris, its deputy investment chief. But few investors think there is an alternative to alternatives. All those canvassed by *The Economist* said their allocations would continue to edge up. Some have sour memories from the financial crisis, when they rushed to dump private assets at a loss, instead of snapping up bargains. This time, even if the music stops, they will keep dancing. ■

Economic sanctions

SWIFT thinking

The consequences of excluding Russia from the global payments system

FOR WEEKS Russia has been massing troops and tanks near the Ukrainian border. Neither talks with nor threats from the West have stemmed the flow. With America and its allies loth to commit forces, another option is gaining prominence: cutting Russia off from SWIFT, the messaging network used by 11,000 banks in 200 countries to make cross-border payments. Flicking a switch seems safer than putting boots on the ground. But it could have dangerous consequences.

A first hurdle would be getting SWIFT to comply. The co-operative of banks, based in Belgium, vows to be politically neutral. Many European countries, such as Germany, do a lot of business with Russia, and may oppose the plan. But there is a precedent. In 2018 America managed to force SWIFT to ditch Iranian banks even in the face of European resistance. America would probably have its way again. It could threaten to pull its own banks from SWIFT, ▶▶

or to seize infrastructure vital to the network, such as a data centre in Virginia. In 2020 it used similar threats to force SITA, a network of global airlines based in Switzerland, to disconnect carriers from countries facing American sanctions.

But would excluding Russia from SWIFT actually be worthwhile? There are three reasons to think that it might not. It would harm but not cripple Russia; it would impose costs on the West; and it would be counterproductive in the long run.

Start with the impact on Russia. The no-SWIFT scenario is not new to Moscow. It has been bracing itself since 2014, when America first raised the idea of unplugging it from the network to punish it for invading Crimea (cooler heads eventually prevailed). If Russia were excluded today, capital flight and a run on firms and banks reliant on foreign funding would ensue. But coping mechanisms would then kick in. Russian banks and their foreign partners would use other means of communication, such as telex, phone and email. Transactions would migrate en masse to SPFS, a Russian alternative to SWIFT that is not nearly as ubiquitous and sophisticated, but still usable. As the payments infrastructure struggled at first to cope, Russia would suffer some disruption—but not disaster. Over time, investment in SPFS would make the system speedier.

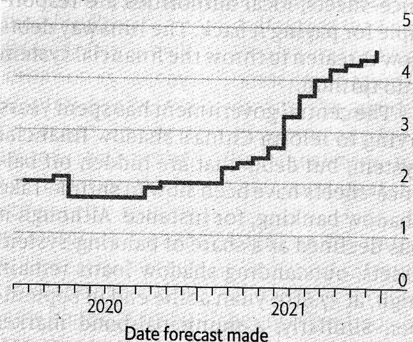
Meanwhile, the West would suffer blowback. Until now America has aimed its financial firepower at small or isolated countries such as Cuba, Iran and Myanmar. Russia is twice the combined size of any economy America has ever embargoed. Any disruption in Russia would spill over to the countries that have business dealings with it. It is the EU's fifth-largest trading partner, for instance. And European banks have $56bn-worth of claims on Russian residents. There would also be indirect damage through retaliation. Iran in 2018 had a weak hand. But Russia is the source of 35% of Europe's gas supply and is home to €310bn ($350bn) of EU assets.

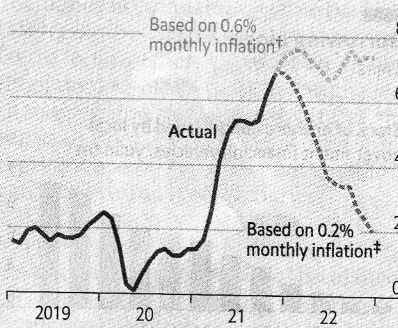
In the long run America, too, would bear costs. It holds sway over international finance thanks to the dollar's dominance and its pre-eminent role in global settlement systems. Any country with uneasy relations with America would seek alternatives to SWIFT, while Europe might redouble its efforts to develop a more independent payments network. Weaponising SWIFT against Russia would be seen by China as a "dress rehearsal", says Adam Smith, a former American sanctions official now at Gibson Dunn, a law firm. It would provide China with the impetus to bolster CIPS, its rival to SWIFT, just as America's other foes look for alternatives. The network, which already counts some big foreign banks as members, allows messages to be transmitted in both Chinese and English. Its daily average volume of transactions of 310bn yuan ($50bn) remains well behind SWIFT's estimated $400bn, but it has nearly doubled in the past year. Should it reach scale, America's financial dominance would be threatened.

Caught in the cross-border cross-fire

Other weapons of economic disruption exist. America could, for example, blacklist big Russian financial institutions, preventing its own banks from dealing with them. That would probably be as disruptive for Russia as a disconnection from SWIFT, without undermining the global financial architecture as much. Yet the risk of immediate blowback would remain. That highlights a long-standing dilemma of wielding economic sanctions: although they are cheap when aimed at puny states, bigger targets can hit back, says Tom Keatinge of the Royal United Services Institute, a think-tank. The West still has powder left. But it must choose its battles wisely. ■

Price surprise
United States





Sources: Wolters Kluwer; Bureau of Labour Statistics; *The Economist*

*Average of top analysts' forecasts for consumer-price inflation †Average rate during Jan-Nov 2021 ‡Average rate in 2019

Follow the money

The only thing that proved transitory about inflation in America in 2021 was the consensus that it would subside. The left-hand chart shows that analysts consistently revised up their predictions, trailing reality. Consumer prices are now rising by nearly 7% compared with a year earlier, the fastest pace since 1982. What does the future hold? The right-hand chart presents two scenarios. In the first, month-on-month inflation immediately falls back to its pre-pandemic trajectory. Even so, it would take until the end of 2022 for annual inflation to slow to the 2% pace that used to be the norm. In the second case, consumer prices rise at the same monthly clip seen over the past year. Annual inflation would soar to nearly 8% in February, and stay elevated. Either way, one prediction seems rock-solid: the Federal Reserve will start raising interest rates in 2022, as the central bank itself indicated on December 15th.