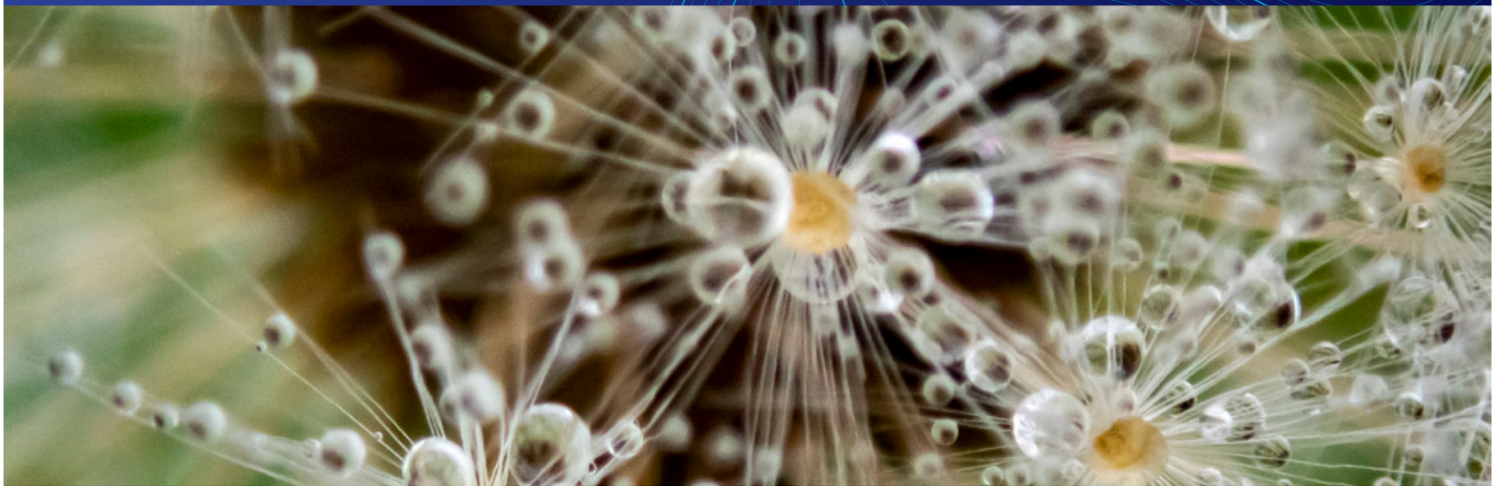

Alternative Credit Review: 1Q24

The year began on a positive note across a range of alternative credit assets—both public and private—as many of the dynamics that buoyed very strong performance for much of 2023 persisted into the first quarter of 2024.

While traders have recalibrated their expectations for the number and magnitude of federal funds rate cuts in 2024—from six cuts totaling 150 basis points in January to only three for 75 basis points by quarter end—the combination of robust economic activity and manageable if elevated inflation fueled hopes that a soft landing not only was possible but likely.[1] The third and final estimate of fourth quarter GDP growth came in at 3.4% to bring full-year 2023 output to 2.5%, up from 2022's 1.9%, while readings of headline and core PCE came in at 2.5% and 2.8%, respectively.[2] Employment data remained strong—the economy added an above-consensus 303,000 jobs in March, pushing the unemployment rate down to 3.8%—but softening hourly earnings growth eased the potentially hawkish sting.[3]

First Eagle's quarterly Alternative Credit Review provides an update on the investment environment for alternatives and a closer look at how the First Eagle Alternative Credit and Napier Park teams view key asset classes.

For its part, the Fed appears comfortable with a wait-and-see approach at this stage. The central bank left rates unchanged at its mid-March policy meeting, with Chair Powell noting that stubborn inflation readings in recent months hadn't changed his expectations that inflation would continue to gradually retreat to target levels, if perhaps along a circuitous route.[4] Interest rates moved higher across the yield curve during the quarter, leaving its slope little changed from the start of the year.

Monetary policy is likely to continue dominating the financial headlines, with investors dissecting every data release and Fed governor utterance for clues to its direction. As we have seen over the past several years, volatility is one potential outcome of this dynamic; in fact, we recently saw 10-year Treasuries quickly back up around 30 basis points following the April 10 release of an above-expectations inflation print. The evolution of market sentiment is something to watch closely, as it often creates opportunities to selectively participate in credit risk we view as mispriced.

1. Source: Bloomberg World Interest Rate Probabilities; data as of April 3, 2024.
2. Source: Bureau of Economic Analysis; data as of March 28, 2024.
3. Source: Bureau of Labor Statistics; data as of April 5, 2024.
4. Source: *The Wall Street Journal*; data as of March 20, 2024.

Broadly Syndicated Loans: Technicals Favored Lower-Quality Paper

Demand for loans—historically driven by a combination of CLO formation and retail mutual fund/exchange-traded funds (ETF) flows, with the former typically the much larger contributor—was consistent throughout the period as sentiment around credit fundamentals remained constructive. Net CLO creation topped $48 billion in the first quarter, the best-ever start to a calendar year.[5] Mutual fund/ETF inflows added another $2.8 billion; while retail demand for loans historically has been a function of duration-risk management, year-to-date inflows seem to indicate that retail investors may be looking more holistically at the relative value in loans.[6]

Though green shoots were evident in mergers and acquisition (M&A) activity, a mere $38 billion of loan net supply was brought to the market during the quarter. The vast majority of the $300 billion of new-issue volume in the period was attributable to repricing and refinancing.[7] Net supply that continues to be well short of demand should provide a strong technical for loans going forward.

> Net supply that continues to lag demand should provide a tailwind for loans going forward.

Fundamentals and operating results for loan issuers have been mixed, but balance sheets remain in a relatively good position. Revenue and EBITDA increased year over year, and EBITDA margins remained at the highest level in recent years. While interest coverage has come down amid higher interest expenses, leverage has receded to a post-pandemic low. Default rates, perhaps not surprisingly, have moved moderately higher in recent months, though they remain only slightly above average.[8]

Lower-quality assets outperformed during the quarter, as the broad technical lift in prices had a larger impact on loans trading at material discounts to par, which in many cases are of lower quality. For the quarter, loans rated CCC rose nearly 1.5%, while BB rated loans lost 0.1% and B rated loans gained 0.1%.[9] While upside in the loan market appears limited today, especially among the lower-rated paper that participated in the first quarter's rally, corporate loan yields are currently attractive at levels that are slightly higher than they began the year.

Middle-Market Direct Lending: Supply Remained Sluggish

As it has in the broadly syndicated loan market, the supply of direct lending opportunities in general has lagged demand. That said, the lower middle market appears to have a more balanced supply/demand dynamic, from our perspective, as rising private company valuations over the years prompted private equity sponsors to look toward the smaller end of the middle market for more cost-effective platform opportunities.

There are signs that M&A volumes may normalize as the year progresses, creating more opportunities for lenders across the middle market going forward. In our view, the release of pent-up M&A energy depends on lower interest rates and the ability of buyers and sellers to agree on enterprise value, which should be easier should rates pull back somewhat. Putting more than $2.5 trillion of private equity dry powder to work on acquisitions at a conservative loan-to-value ratio of 50% would require $1.25 trillion of private credit capital.[10] Separately, asset-based lending should benefit from rates that seem likely to remain elevated, even if a bit below current levels.

Private credit fundamentals, particularly in the sponsor-backed middle market segment, have been stable, in our observation, due in large part to these borrowers' more conservative capital structures.

5,6,7,8. Source: JPMorgan; data as of March 31, 2024.
9. Source: Credit Suisse Plus; data as of March 31, 2024.
10. Source: Preqin; data as of December 13, 2023.

Real Assets: Realizing Value through Active Management

While a dependable, predictable stream of income is among the key reasons to consider a portfolio of real assets, active management of these assets, in our view, is essential to realizing their full value. Opportunistically selling select assets over time may crystallize returns and helps support the portfolio's performance—including its internal rate of return (IRR), multiple on invested capital (MOIC) and distributions to paid-in capital (DPI)—across market conditions.

As a general rule of thumb, realizations in the real asset space come in three forms:

> We believe active management of real assets holdings is essential to realizing their full value.

- **Asset sales.** The assets that comprise the real assets space tend to be homogenous—one Airbus A320 aircraft is pretty much the same as another—and the markets for selling them to other asset owners and/or operators tend to be broad and liquid as a result. As with any asset, the relative valuation of real assets fluctuates over time, providing owners with an opportunity to boost performance through well-timed purchases and sales.
- **Distributions from income.** Many real assets—including transportation and energy equipment—have long but finite lifespans, and the lease rates charged to counterparties for the use of these assets implicitly includes compensation for depreciation. In effect, these assets are self-liquidating; every lease payment to the owner of the asset reflects a partial exit from the asset, enabling the owner to extract a substantial portion of its basis while holding the asset for only a portion of its useful life.
- **Distribution from recapitalizations.** By taking advantage of changing credit market conditions and the strong cash flows potentially generated by real assets, an asset owner may be able to opportunistically refinance debt to extract an equity distribution from its asset and refine its capital structure.

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All investments involve the risk of loss of principal.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments than would be the case in absence of such arrangements; and
- Below-investment-grade loans, which may default and adversely affect returns.

Definitions

Asset-based lending (ABL) facilities are corporate loans secured by specific assets of the borrower.

Broadly syndicated loans (BSLs) are loans extended by a group of financial institutions (a loan syndicate) to a single borrower. Syndicates often include both banks and nonbank financial institutions, such as collateralized loan obligation structures, insurance companies, pension funds or mutual funds.

Collateralized loan obligations (CLOs) are financial instruments collateralized by a pool of corporate loans.

Credit ratings as represented here are assessments provided by nationally recognized statistical rating organizations (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. The grades referred to here are from S&P and Fitch**.** A '**BB' credit rating** means that there is a higher probability for default of a debt issuer or a debt instrument. BB is the second-best non-investment grade rating. An **obligation rated** '**B**' is considered more vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments. An **obligation rated** '**CCC**' is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

Dry powder refers to cash on hand by a venture capital or private equity firm to purchase assets or make acquisitions.

Exchange-traded funds (ETFs) are a basket of securities that tracks an underlying index. ETFs can contain investments such as stocks and bonds.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

10-year Treasuries are debt obligations issued by the United States government with a maturity of 10 years upon initial issuance that pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

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