Alternative Credit Review: 2Q24

The behavior of financial assets in the second quarter continued to reflect an environment in which investor risk perception generally is low despite the many seeming hazards on the road ahead.

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.

As suggested by narrowing credit spreads and expanding equity multiples, investors for the most part continued to appear comfortable in an environment marked by easing inflation, positive if slowing economic growth and the potential for rate cuts in the not-too-distant future. Following its June policy meeting, the Federal Reserve's "dot plot" of federal funds rate projections now calls for one 25 basis point cut by year-end—down from three cuts in its March report—and the central bank continued to offer a cautious outlook for loosening despite "modest further progress" toward its inflation goals.[1]

While markets have appeared to view rate cuts as the answer to their collective prayers for nearly a year now, they may want to be careful about what they wish for. Both employment conditions and business sentiment remain at relatively healthy levels for now, and goosing an economy with no obvious slack risks triggering an unwelcome asymmetric inflationary response. The risks seem particularly high given the country's troubling fiscal dynamics; in fact, the Congressional Budget Office recently updated its estimate of the fiscal 2024 budget deficit to $2.0 trillion, or 7% of GDP.[2] Fiscal discipline is not a term associated with either major US political party today, and the prospects for fiscal consolidation in the foreseeable future are dim regardless of how November's elections play out.

On the other hand, there also exists the possibility that the country is closer to entering an economic stall zone than the beginning of a durable re-expansion. For example, the latest PMI reading for the services sector—which comprises more than 70% of the economy[3] —slipped into contraction, suggesting some lost momentum in June. We've also seen signs of a slowly weakening unemployment picture. While still near multidecade lows, the U-3 unemployment rate increased from 3.7% to 4.1% year to date, while the number of full-time employees declined.[4] It's worth noting that while the US federal deficit remains elevated, it's down year over year, depriving the economy of the same fiscal boost it was benefitting from in 2023.

1. Source: Board of Governors of the Federal Reserve System; data as of June 12, 2024.
2. Source: Congressional Budget Office; data as of June 18, 2024.
3. Source: Bureau of Economic Analysis; data as of June 27, 2024.
4. Source: Bureau of Labor Statistics, Federal Reserve Bank of St. Louis; data as of July 5, 2024.

Though well off late April peaks, yields on the long end of the Treasury curve finished the second quarter slightly higher from where it began and served as a small headwind to longer-duration assets.[5] In contrast, more credit-sensitive parts of the market were bolstered by a supportive fundamental backdrop. Overall, the fixed income market continues to be marked by limited term premia for government paper and very tight spreads on vanilla credit, suggesting risk compensation in traditional fixed income markets is for the most part underwhelming.

Broadly Syndicated Loans: Quality Returns to the Fore

While lower-quality, more deeply discounted names benefitted from the prevailing dynamics of the first quarter, this trend reversed in the second as mounting concerns that US economic growth was beginning to wane prompted investors to adopt a more defensive stance. Over the past few months, many issuers perceived to be of higher risk or that had any type of negative headline attached to them saw significant secondary market pressure on their loans. This risk-off posturing was particularly notable among collateralized loan obligations (CLOs).

> Mounting concerns that US economic growth was beginning to wane prompted loan investors in general to adopt a more defensive stance in the second quarter.

Despite a bit more selectivity among managers, investor demand for credit remained strong. Net CLO creation totaled a robust $50.5 billion in the second quarter after the first quarter's strong $48.1 billion, resulting in nearly $100 billion of net creation in the first half of 2024; for context, net CLO creation totaled $115 billion in all of 2023. Meanwhile, inflows into loan mutual funds and exchange-traded funds (ETFs) were fairly consistent throughout the second quarter, totaling nearly $8 billion. Against that backdrop, the market saw just $32.7 billion of net new loan supply during the quarter, as activity was concentrated in refinancings and repricings.[6]

Although lower expectations for growth and inflation could create some renewed interest in longer-duration assets, we believe the alternative credit market is likely to continue to see demand not only from fixed income investors but also from equity investors who view the risk/return of credit as more attractive relative to the higher volatility and lower returns possible in the equity market going forward.

Middle-Market Direct Lending: Overall Activity Strong Despite Sluggish M&A

Direct lending in the second quarter was the swiftest it has been in several years thanks to robust refinancing and recapitalization activity. While the great wave of mergers and acquisitions (M&A) activity many are anticipating has yet to materialize, direct lending volumes to finance buyouts in 2024 remain higher than they were during the period of Fed rate hikes.[7] Meanwhile, the lower middle market appears to have a more balanced supply/demand dynamic overall, 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.

Furthermore, there have been signs buyout volumes across the middle market may normalize as the year progresses, creating more opportunities for lenders 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 likely will be easier should rates pull back somewhat. Separately, asset-based lending is expected to benefit from rates that seem likely to remain elevated, even if a bit below current levels.

5. Source: Board of Governors of the Federal Reserve System; data as of June 30, 2024.
6. Source: JPMorgan; data as of July 1, 2024.
7. Source: Pitchbook | LCD; data as of July 1, 2024.

While economic growth may be slowing, it continues to provide a supportive environment for credit. Given the relatively strong fundamental position of many borrowers, a relatively benign maturity schedule, and open access to capital via both the syndicated and private credit markets, we would not expect default rates to rise dramatically from current levels barring a major breakdown in economy. This is particularly true in the sponsor-backed middle market segment, in our view, due in large part to these borrowers' more conservative capital structures.

Structured Credit: Compelling Potential in a Specialty Segment

While credit markets in general continue to bemoan the lack of spread compensation, this does not mean that more attractive spreads are not available. However, success in these specialty credit segments typically comes with a higher barrier to entry in terms of experience, expertise and technology.

> Structured credit offers investors a wide range of risk-return profiles, mostly at higher yields than traditional credit assets without significant additional credit risk.

We believe structured credit is one such market where investors can tap into assets offering a wide range of risk-return profiles, mostly at higher yields than traditional credit markets without significant additional credit risk. Structured credit, in short, refers to the process by which groups of similar, income-generating assets are pooled together into marketable fixed income securities collateralized by their cash flows. The assets comprising these pools may include traditional debt instruments (like residential mortgages and corporate loans), more esoteric cash streams (like airplane leases and music licensing revenues) or derivatives contracts (like swaps and options). Claims on these cash flows or derivative payments are divided into tranches that stratify credit risk based on seniority, providing investors the opportunity to target a range of risk/return profiles. Though only introduced a few decades ago, structured credit has evolved into one of the largest segments of the US fixed income market.[8]

For investors, structured credit offers the potential for higher returns, portfolio diversification and tailored credit-risk exposure. Thanks to relatively high base rates and what we believe are attractive spreads, yields on certain structured credit instruments appear enticing.[9] Total returns have been compelling as well. Since 2015, the cumulative return of structured credit (as represented by BB rated US CLOs) amounted to almost 140%, more than doubling the performance of both BB rated high yield bonds and BB leveraged loans—and highlighting that all ratings are not necessarily equal.[10]

Though the yield differential between structured and traditional credit currently is wider than typical, the existence of such a gap is far from novel; structured credit instruments historically have offered an attractive yield pickup relative to traditional fixed income investments.[11] While there are a number of valid reasons for the structured credit yield premium—including greater complexity, reduced liquidity and pronounced price volatility—greater credit risk is not one of them, in our view. In fact, certain structured products historically have realized significantly lower defaults than their like-rated traditional counterparts—including, in many cases, none at all.[12]

The flexibility to actively allocate among the disparate opportunities across credit—both public and private, and both single name and structured—may support efforts to generate meaningful incremental yield with manageable incremental risk while promoting potential diversification benefits in multi-asset portfolios.

8. Source: BofA Global Research; data as of June 30, 2024.
9. Source: JPMorgan; data as of June 10, 2024.
10. Source: JPMorgan, Pitchbook | LCD, Bloomberg; data as of May 31, 2024.
11. Source: JPMorgan, Bloomberg; data as of June 26, 2024.
12. Source: BofA Global Research, Moody's Investors Services; data as of June 30, 2024.

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Risk Disclosures

All investments involve the risk of loss of principal.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

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.

A **credit rating** as represented here is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments, or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality. For more information on the S&P Global Ratings' methodology, please visit spglobal.com and select "Understanding Credit Ratings" under About Ratings.

Exchange-traded funds (ETFs) are baskets of securities that trade on an exchange and generally track an underlying index.

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.

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