Alternative Credit Review: 4Q24

Rising Treasury yields toward year-end 2024 weighed on what to date had been decent performance for many fixed-rate assets, and longer-duration securities were particularly weak. Floating-rate issues saw greater success for both the quarter and the year, however, while lower-rated paper also outperformed.[1]

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

Performance dynamics throughout 2024 highlight the theme of low risk perception in US markets—supporting high equity market multiples, particularly for growthier stocks, and pushing credit spreads toward cyclical tights—as the country has benefitted from a Goldilocks economic scenario that unfolded against most expectations. Consumer and producer prices, though still slightly above target in recent readings, seemingly have been reined in, while resilient economic growth has helped bolster corporate fundamentals.

We remain wary, however; though the US has made significant progress against inflation, the battle has reached only a fragile peace, in our view, and the country remains vulnerable to renewed pricing pressures emanating from home (e.g. persistent wage inflation, tech capex and, more recently, tariffs) and abroad (e.g. moderating deflation in China).

Perhaps recognizing these challenges, the Federal Reserve's dovishness began to fade only a few months into its long-awaited rate-cut cycle. While 100 basis points worth of cuts from September to December brought the Fed's key policy rate down to 4.25–4.50% by year-end 2024, its latest dot plot release suggests cuts of only 50 basis points more in 2025, down from expectations of 100 basis points in September.[2] With economic growth strong and inflation stubbornly resisting a complete return to the Fed's target level, even this revised forecast may prove ambitious; "higher for longer" interest rates seem the likely outcome.[3]

1. Source: Bloomberg; data as of December 31, 2024.
2. Source: Federal Reserve; data as of December 18, 2024.
3. Source: Bureau of Labor Statistics; data as of December 11, 2024.

While certain markets have left little room for further spread compression or price convexity, elevated interest rates and modest credit spreads together translate into attractive gross yields, particularly when compared to what has been on offer since the global financial crisis. And while limited risk premia appears to remain in financial markets, historical precedence leaves us open to the idea that risk assets have the potential to exceed investor expectations.

On balance, we believe there will be periods of greater market volatility during 2025, though the timing of this volatility is itself highly uncertain. January macro data have already hinted at what may be to come, especially as it concerns interest rates. Macroeconomic "good" news—such as strong jobs data—often translates to "bad" news for risk assets given its potential impact on the levels of short-term monetary accommodation. In such an environment, dry powder will be key to taking advantage of market opportunities as they emerge.

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Broadly Syndicated Loans: Technicals and Fundamentals Remain Supportive

Syndicated loan prices were little changed during the fourth quarter, though the period was not without volatility. Demand for credit remained strong during the quarter. The $50.7 billion of institutional demand from collateralized loan obligations (CLOs) and $11.6 billion of retail demand from mutual funds and exchange-traded funds (ETFs) easily absorbed the $47 billion of net supply that came to market during the period.[4] We expect demand for credit to remain relatively strong going into 2025, as the return potential for credit—and loans in particular—remains attractive in our view given higher base rates. Supply, in contrast, remains somewhat constrained, as new mergers and acquisitions (M&A) transactions—and leveraged buyouts, in particular—have yet to pick up meaningfully.

Fundamentals generally remain supportive of loans, as continued US economic strength has been evident in recent corporate operating results, including persistent increases in loan issuer revenues and profits. Credit metrics remain benign, for now; though leverage has been stable, cash flow coverage may attract greater attention as older-vintage deals are replaced in a higher-rate environment.

Middle Market Direct Lending: Smaller Bias Remains Intact

While loan supply remains a bit sluggish, we expect ample supply from lower middle market borrowers—companies with annual EBITDA (earnings before interest, taxes, depreciation and amortization) of $5–$50 million. Given the strong US economy and borrowing costs that may move lower, if only slightly, private equity sponsors may become increasingly active in targeting smaller portfolio companies with attractive growth prospects. And while spreads have tightened across the fixed income complex, competition has been less impactful on loan terms in the lower middle market, as bigger credit managers seek larger-scale opportunities to deploy their massive capital stores.

Direct lending in the lower middle market can provide private lenders and their investors the potential for an attractive combination of yield, leverage and structure, while smaller deal sizes facilitate diversification across borrowers and industries. In addition, such loans tend to facilitate greater access to management teams, allowing for more comprehensive due diligence by lenders as well as closer collaboration that can help contain default exposure and maximize recoveries during challenging times.

4. Source: JPMorgan; data as of December 31, 2024.

Asset-Based Lending: Considered an All-Weather Financing Option

Although the need for asset-based lending (ABL) facilities is persistent, demand strength historically has been countercyclical to direct lending; borrower interest in ABL tends to increase when rates rise and cash flow-based loans become less affordable or accessible. While stricter requirements for cash flow loans are the norm during periods of economic uncertainty or tightening credit—as tougher credit standards challenge coverage ratios and other credit metrics—the backstop of collateral allows ABL providers to take advantage of attractive risk-adjusted opportunities, a dynamic that was particularly evident in the aftermath of 2023's regional bank failures.

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While the direct lending market as a whole awaits a resurgence in M&A activity to fuel a significant pickup in demand, ABL facilities may serve as what we believe is an all-weather alternative financing option for asset-rich but cash-constrained companies. ABL activity has picked up in recent years as higher rates have weighed on direct lending origination, and we believe the playing field for experienced, disciplined ABL providers is wide open. Regional and midsized banks—traditional providers of ABL facilities to middle market borrowers—remain highly selective and risk-averse following the regional bank failures of 2023, and in many cases are more focused on their liquidity profiles and capital reserves than on writing new business. Meanwhile, $2.2 trillion of commercial real estate loans, anticipated to come due by 2027, could create an additional source of demand for financing options.[5]

Residential Real Estate Debt: Private Opportunities Hold Greater Appeal

The secular themes supporting the US housing market—constrained supply and persistent demand—have remained intact amid high home prices and high mortgage rates. While this has supported the strong performance of publicly traded real estate-backed structured products like credit-risk transfer securities over the past 18 months or so, current entry points suggest limited upside for new investment.

At this time, we believe there are more attractive opportunities to be found on the private side of the real estate debt market, including residential transitional loans and land banking. Private markets tend to have a delayed and lagged response to changes in lending costs, and their structural complexity and illiquidity typically provide an additional boost to yields. Further, the short durations and robust cash flows typical of these assets enable the frequent reinvestment of proceeds, providing investors potential optionality to migrate into public credit opportunities should market conditions shift.

Residential transitional loans provide capital to developers seeking to purchase existing single- and multi-family properties to renovate and resell (or rent, in the case of multi-family) in a short period of time; loans are typically 12 to 18 months in tenor and secured by a first lien on the property. Typically, these loans are originated by small, regional private lenders; lacking the scale to hold the loans to maturity, originators often sell them to large, nonbank asset managers looking to build diversified portfolios in pursuit of compelling risk-adjusted long-term returns.

Land banking represents another opportunity for nonbank capital providers to secure potentially attractive income streams. Many homebuilders have moved to a "land-light" business model in their efforts to maintain robust development pipelines without compromising their liquidity or financial flexibility. As a result, we believe the off-balance-sheet solution of land banking has become a staple of homebuilders' land inventory-management strategies, one for which they typically have been willing to pay a significant premium to the prevailing interest rate on corporate debt, in our view.

5. Source: JPMorgan; data as of December 31, 2024.

Real Assets: Persistent Tailwinds Support Market

The prevailing higher-rate, higher-inflation environment proved to be a tailwind for real assets across 2024, as both structural features and the cost of capital have driven resilient demand for existing assets and constrained supply of new ones. Further, last year's buoyant financial markets provided ample opportunities to selectively monetize exposures through asset sales.

While a dependable, predictable stream of income is among the key reasons to consider real assets, such as railcars, aircraft and renewable energy assets, active management is essential to realizing their full value. Opportunistic dispositions of select assets over time may help support a portfolio's long-term performance—including its internal rate of return (IRR), multiple on invested capital (MOIC) and distributions to paid-in capital (DPI)—across market conditions.[6]

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6. Internal rate of return (IRR) measures an investment project's time-discounted rate of return. Multiple on invested capital (MOIC) measures the unrealized and realized investment return to relative to the total equity contribution. Distributions to paid-in capital (DPI) measures the cumulative distributions of income and return of capital to investors divided by the total equity contribution.

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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.

Dry powder refers to highly liquid marketable securities that can quickly be converted to cash. Dry powder can also refer to cash reserves kept on hand by a company or private equity fund in anticipation of attractive investment opportunities.

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.

A **Goldilocks** economic scenario refers to a level of growth that is neither strong enough to promote inflation pressures nor weak enough to suggest recession may be near.

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