Where We Are (Last of a Series)

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In this series we've reviewed market conditions for issuers as we wrap up 2Q and head into the second half of the year. Let's conclude by looking at how investors view this environment and what questions and conclusions are arising.

As we've highlighted, there are headwinds and tailwinds in deal flow. Demand from managers who have raised significant dry powder is incessant. And for good reason: the uncertain rate and economic outlook is a major driver of investor appetite for private credit. With each month's inflation data alternating between good (slowing activity) and bad (heating up), no one has a clue on the timing of rate cuts or likelihood of a soft landing.

This lack of visibility on market direction has combined with private credit's performance and yield stability over time to convince many investors that alternatives generally – and private credit, specifically – is a strategic play, not a tactical one. Trying to time vintages ("betting" on illiquids, as some would characterize it), ignores how the risk/reward dynamic of the asset class has held up through cycles.

An excellent measure of this element is spread per unit of leverage. As our *Chart of the Week* highlights, this metric for first lien loans in direct lending portfolios consistently outperformed, both in stability and yield, that of broadly syndicated loans.

For investors who have made long-term commitments to use it as a core of their portfolio allocation, private credit is working as designed. That's why, according to Nuveen's recent EQuilibrium survey of 800 funds, over 75% of institutional investors expect to increase their private credit allocation over the next two years. PDI reported the vast majority of their survey responders believe private credit funds will perform at or better than the benchmark.

Investors should consider three questions as 2024 enters the second half. First, does credit risk increase in terms of higher default rates? Second, do asset prices become more volatile in a continued higher-for-longer world? Finally, do returns further compress as competition from BSLs sharpens direct lenders' pencils on new deal term sheets?

If present trends continue, we would answer these questions as 1) No, 2) No, and 3) Likely. Direct lending portfolios are performing as expected, though revenue growth is slowing from last year's pace. Hence loan valuations are stable. Defaults are subdued as experienced managers have worked with owners to plan for tight interest cushions. First-lien spreads may tighten 25-50 bps, but more deal supply should create a floor for yields.

For investors, then, conditions remain propitious for private credit. The delivery of yield premiums to liquids, lower risk, and predictable income should continue. With rates still high, leverage should remain in a range. And the more growth-oriented sectors will likely continue to offer the best opportunities for investing and financing.