Downhill From Here

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One of the unalloyed joys of our job these days is around Fed meetings. We've known for four years this moment would arrive, but the timing and extent of the rate cut kept analysts guessing. And despite countless experts weighing in until the last minute, the Fed's "big move" caught many by surprise.

Not that the dovish option wasn't on the table. Indeed, until the last day or so, weak labor data pointed to the more dramatic move. But then lower-than-expected jobless claims shifted opinion back towards 25 bps. We supported that view, believing anything greater would signal panic. After such deliberate moves for so long, why rush?

Which is why these decisions are best left to the experts. Once it was announced, surprised or not, analysts and the markets applauded the move. Rather than anxiety about forestalling a recession, it telegraphed confidence that inflation was at last under control, and attention could now shift to keeping the economy momentum going and unemployment under control.

In his weekly podcast, KBRA's Van Hesser reported a subliminal message from the Fed: "We are not going to find ourselves behind the curve again." Historically, he recalled, this was a "break from convention" with loosening absent a looming downturn or "a crisis situation like the GFC or Covid."

Regardless of the steeper start to this phase of the rate cycle, the direction is clear. Over the next fifteen months rates will end in the 3.5% range, with some kind of pause then. Because we don't face any major crises, that scenario is appealing for the capital markets. Predictability, even within a range, is stimulative.

Does this lower-for-longer outlook mean the end of the Golden Era for private credit investors? All-in spreads have been at all-time high, but that high-tide lifted a number of boats. Bringing corporate and high-yield bond yields down will increase the relative attractiveness of middle market debt. Easing of financing costs will boost M&A and improve realizations for LPs.

Despite misgivings to the contrary, direct lending portfolios are in good shape. Experienced managers have navigated this environment with minimal defaults and losses. Continuous availability of private credit during the Fed liftoff allowed CFOs to right-size their balance sheets and comfortably extend financing maturities.

This also bodes well for the economy. Middle market companies provide big shares of growth and employment to US GDP. The challenge is that PE ownership of the middle market is only a fraction of the total number of companies. There need to be more incentives to invest more broadly in this critical sector.

In the meantime, corporate earnings and growth remain solid, and consumers are still spending. As we head into an uncertain election season, at least the technicals point to a good year for credit investors.