Alternative Credit Review: 3Q24

While financial assets generally were strong in the third quarter, volatility trended higher as markets continued to be influenced by efforts to read the rate-cut tea leaves.

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.

The Federal Reserve's rate-cut cycle finally spung into life in mid-September with an oversized 50 basis point reduction. The federal funds rate cut—the first since the early-2020 onset of Covid-19—brought the central bank's key policy rate to a range of 4.75–5.00%. Fed Chair Powell characterized the move as a "recalibration" of policy that reflected the committee's growing confidence that labor market strength could be preserved amid healthy economic growth and further cooling in inflation. The latest summary of economic projections suggest an additional 50 basis points of cuts in 2024 and 100 basis points in 2025.[1]

Data released subsequent to the Fed meeting appeared to back up the central bank's confidence in the jobs market's resilience. Unflagging labor strength runs the risk of sparking inflationary pressures anew, however, a risk of particular concern given that wage growth, while well off its peak, remains above levels consistent with the Fed's 2% inflation target. A Fed shift back to a hawkish policy bias sooner than expected could bring a recalibration of investor risk appetites.

China's post-Covid weakness has been a counterpoint to US strength, as both structural and cyclical issues have weighed down the country's economy as well as global assets dependent on it, including a range of industrial commodities like copper and oil. Toward the end of the third quarter, another batch of uniformly downbeat data releases—from retail sales and consumer confidence to industrial production and fixed investment—spurred Chinese policymakers into action, and the government announced a series of stimulus measures to combat mounting deflationary pressures, stabilize housing and restore market optimism. The news was greeted enthusiastically by markets and prompted a positive inflection in expectations for real economic activity globally. The devil is the details, however, and it seems likely to us that China's deeper economic challenges likely will persist without measures targeting the oversupply of real estate in lower-tier cities and the bad debts related to it, as well as local governments' heavy reliance on the property market.

1. Source: Federal Reserve; data as of September 18, 2024.

Meanwhile, myriad risks beyond central bank policy continued to loom. Unrestrained government debt globally has raised the specter of currency debasement and other adverse financial outcomes, for example, while geopolitical risk—headlined by Ukraine/Russia and broadening military engagement in the Middle East—shows no sign of relenting. Nearing the end of what was a very active year in national politics, all eyes now have turned to the contentious race for president in the US, the results of which may have broad policy implications affecting both domestic and cross-border actors.

Broadly Syndicated Loans: Clipping Coupons in a Firm Market

Not immune from the late-July/early-August volatility across asset classes, syndicated loan prices moved lower in the third quarter. As has been the case for the year to date, however, lower prices were more than offset by income during the period, as base rates remain relatively high relative to the post-global financial crisis norm.[2] Economic conditions on balance appeared largely benign for corporate credit investors, as recent data on job growth, wages and unemployment suggested a relatively strong dynamic, while Fed accommodation further supported credit.

> The technical environment remained strong as net new issue volumes were more than offset by demand during the quarter.

The technical environment also remained strong, though perhaps more balanced than it had been earlier in the year. Increased net supply has been manageable amid persistent demand. Institutional demand for loans from the collateralized loan obligation (CLO) market totaled $41 billion in the third quarter compared to $51 billion in the second and $48 billion in the first. Net supply, meanwhile, rose $44 billion in the third quarter, up from $31 billion in the second. Just over $20 billion of that net new issuance was driven by leveraged-buyout (LBO) volume, the highest level of LBO activity since first quarter 2022 and the March start of the Fed's rate-hike cycle.[3] While demand decreased slightly and supply increased quarter over quarter, net new issue volumes were more than offset by demand during the period, leading to a fairly firm market.

Corporate fundamentals continued to trend in the right direction. Both revenue and earnings increased in the second quarter on a year-over-year and quarter-over quarter basis. Meanwhile margins remain at healthy levels, and leverage has been stable.[4] Interest coverage, which has remained a bit tight given higher rates, should improve given the decline in reference rates. While that may provide issuers with a reprieve on the margin, resilient economic and corporate data suggest the cost of leverage is likely to remain at levels meaningfully higher than it has been since the global financial crisis. This should continue to keep pressure on issuers with more-levered capital structures and is also likely to keep default and restructuring activity elevated.

Middle-Market Direct Lending: Signs of Life on the Lower End

After a relatively strong first half of 2024, direct lending slowed somewhat in the third quarter, though it remained well above the levels typical of 2022–23. Notably, refinancing deals have surged this year, with the number of transactions in the first nine months of 2024 already exceeding full-year 2023. With the broadly syndicated loan market having becoming more hospitable to lower-rated borrowers, some private credit lenders have made concessions—often in the form of tighter spreads—to keep or win back their clients. Meanwhile, the volume of leveraged buyouts financed by loans in the third quarter exceeded the volume financed through private credit for only the second time in the past 11 quarters.[5]

Mergers and acquisitions (M&A) historically have been a major feeder to the direct lending pipeline. While M&A activity as a whole is well off its pandemic-era bottom, the recovery has been somewhat sluggish in the upper middle market. Given still-elevated base rates and a challenging regulatory environment, US M&A deal count in

2,5. Source: Pitchbook | LCD; data as of September 30, 2024.
3. Source: JPMorgan; data as of October 1, 2024.
4. Source: JPMorgan; data as of September 23, 2024.

the third quarter was down slightly from the second, though the aggregate transaction value of these deals was higher on a quarter-over-quarter basis. Meanwhile, deals are down about 17% by both number and value for the first nine months of 2024 relative to the same period in 2023.[6]

The lower middle market, in our view, appears to have a more balanced supply/demand dynamic overall. We've noted a high volume of refinancing activity at the lower end of the middle market and, more importantly, a resurgence in leveraged buyouts driven by the sale of businesses to first-time private equity ownership, a trend we think is likely to persist. Looking ahead to 2025, meanwhile, we are hopeful that a recovery in sponsor-to-sponsor activity will be supported by generally strong corporate profiles, the seemingly benign end to a long period of economic uncertainty and the easing cost of capital. Meanwhile, the combination of already-extended holding periods and the need to put historical levels of dry powder to work suggest private equity owners may be keen to opportunistically exit current positions and return capital to investors.

Structured Credit: Reaping the Rewards of High Barriers to Entry and Limited Competition

The ongoing disintermediation of the traditional banking system in the aftermath of the global financial crisis spawned one of the major investment trends over the past decade: the tremendous growth in credit strategies like middle market direct lending. These strategies in aggregate have grown by about 250% since 2016, attracting $1.6 trillion in new capital.[7]

Notably, alternatives like asset-backed securities and other forms of structured credit have attracted far less capital despite appearing similarly well positioned to benefit from the same post-crisis changes that have supported direct lending. In fact, credit hedge funds—which we believe are a good proxy for investor flows into asset-backed and structured credit strategies—have seen their assets under management contract since 2016 and now control capital equal to only about one-fifth of direct lending's stash.[8] As a result, these assets are among the few places where we believe there is less competition now than there was five or 10 years ago, which at least partly explains the higher returns available in the space compared to other forms of credit risk.

> We believe there is less competition in the structured credit space today, which may partly explain the potentially higher returns available compared to other forms of credit risk.

Admittedly, the barriers to entry in these complex markets are not insignificant. A structured credit product comprised of hundreds or even thousands of individual collateral assets and subject to a range of idiosyncratic deal terms and contractual obligations is far more difficult to appraise than the generic bond of a single corporate issuer. The required investment of time, resources and technology, not to mention the necessary real-world expertise needed to invest successfully, serves as a hurdle for many institutional investors and constrains the buyer base.

While the complexity of structured credit has helped earn it a reputation as a niche opportunity set, this characterization also has positioned experienced, research-driven managers to generate meaningful incremental yield without having to take on incremental risk in what is a very large and broad market. In our view, the risk-return profile of these assets may represent a particularly attractive diversifying complement to traditional sponsor-backed direct lending exposure, as appropriate.

6. Source: Paul, Weiss; data as of October 15, 2024.
7,8. Source: Preqin; data as of December 31, 2023.

The opinions expressed are not necessarily those of the firm. **These materials are provided for informational purposes only.** These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation to buy, hold or sell or the solicitation or an offer to buy or sell any fund or security.

Past performance is not indicative of future results.

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-backed securities (ABS) are debt securities whose payments of principal and interest are backed by the cash flow generated by pools of income-producing credit assets.

Broadly-syndicated loans (BSLs) typically refer to floating-rate commercial loans provided by a group of lenders—the syndicate—to a noninvestment grade borrower.

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

Direct lending refers to a loan agreement negotiated between a borrower and single or small group of nonbank lenders. Direct lending can also be referred to as "private credit" or "private lending."

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 **hedge fund** is a limited partnership of accredited investors whose money is pooled and managed by professional fund managers that employ a wide range of risk strategies.

A **leveraged buyout (LBO)** is the acquisition of one company by another using a significant amount of borrowed capital to meet the cost of acquisition.

Structured credit is a financial instrument that pools together groups of similar, income-generating assets.

FEF Distributors, LLC ("FEFD") (SIPC), a limited purpose broker-dealer, distributes certain First Eagle products. FEFD does not provide services to any investor, but rather provides services to its First Eagle affiliates. As such, when FEFD presents a fund, strategy or other product to a prospective investor, FEFD and its representatives do not determine whether an investment in the fund, strategy or other product is in the best interests of, or is otherwise beneficial or suitable for, the investor. No statement by FEFD should be construed as a recommendation. Investors should exercise their own judgment and/or consult with a financial professional to determine whether it is advisable for the investor to invest in any First Eagle fund, strategy or product.

First Eagle Investments is the brand name for First Eagle Investment Management, LLC and its subsidiary investment advisers. First Eagle Alternative Credit and Napier Park are brand names for the two subsidiary investment advisers engaged in the alternative credit business.

M-TL-ACT-ACR243-P-LT