Alternative Credit Review: 1Q26

Following a strong 2025 for credit markets broadly, mounting headwinds in early 2026 prompted a sharp increase in volatility and a repricing of risk.

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 Napier Park team.

Geopolitical turmoil during the quarter triggered supply disruptions and commodity price spikes that, if prolonged, could result in significant demand destruction, and even stagflation. Beyond disruptions in the physical world, the specter of dislocations on the digital plain also weighed—namely potential disruption to the tech landscape triggered by next-generation artificial intelligence (AI) tools.

The brunt of these fears initially was limited to stocks but soon spread to the credit markets. Performing software loans, which account for 13% of the Morningstar LSTA Leveraged Loan Index, fell about 700 basis points during the first quarter.[1] While private credit lacks a secondary market to capture short-term changes in sentiment, the sharp declines in the share prices of publicly traded private credit vehicles suggest the strain is also felt in middle market direct lending; a number of high-profile business development companies and listed alternative credit managers traded sharply off recent peaks.[2]

While the advancement of AI tools is likely to have an impact across software—and many other sectors—we believe there is more nuance to the AI story than the headlines would suggest. The degree of dislocation will likely vary among borrowers. In our view, enterprise software platforms with differentiated offerings, large installed bases and deep integration in customer ecosystems are likely to be most resilient in the face of AI—or potentially even add value to their client relationships by leveraging emerging functionality.

As the dust continues to settle—with still tight spreads, yield compression and heightened idiosyncratic risk—along with the apparent swift repricing of credit markets in the first quarter—we retain our view that caution is the new conviction.

1. Source: PitchBook | LCD; data as of March 31, 2026.
2. Source: Bloomberg; data as of March 31, 2026.

Structured Credit: Consumer Delinquencies Lower but Still Worrisome

Within structured credit, non-real-estate-related asset-backed security (ABS) issuance volumes amounted to $125 billion in first quarter 2026, about 1% lower than first quarter 2025. Issuance of auto ABS, which represents the largest share of the consumer ABS space, was off more than 14% in the quarter compared to last year.[3] Both prime and subprime auto loan and lease delinquency rates eased somewhat during the first quarter but remain troublingly high. Consumers have been resilient in the face of ongoing economic uncertainty and spiking energy prices, perhaps due in part to outsized income tax refunds. But supply disruption to world oil markets may weigh on economic growth and sentiment while adding to inflationary pressures facing consumers.

Middle Market Direct Lending: Smaller Loans Remain Sweet Spot for Risk-Adjusted Spread

Direct lending activity during the first quarter was reminiscent of second quarter 2025, with AI and the war replacing tariffs as the primary headwinds to issuance. After a record 2025, first quarter new issuance of $61 billion represented a 14% year-over-year decline. While dividend recapitalizations and refinancings were markedly lower during the quarter, financing to support M&A rose to its highest share of overall volume since fourth quarter 2023. Volume in the lower middle market fell to $2.0 billion in the quarter, however, down sharply from $6.1 billion in fourth quarter 2025. By deal count, the lower middle market's share of overall M&A deal activity fell to its lowest level since third quarter 2024.[4]

Many of 2025's borrower-friendly trends in direct lending showed signs of improvement in first quarter 2026. New-issue spreads widened across all deal sizes, with large cap spreads moving the most; though lower middle market spreads widened by only two basis points, sustained widening in the large cap market would likely trickle down into smaller markets over time. Spread per turn of leverage among lower middle market loans ended the quarter at its widest level since August 2024 and maintained an attractive premium to larger deals. Lower middle market yields continued to drift downward, ending the quarter at 9.1%. Default rates over the past 12 months, at 1.2% by dollar amount and 1.6% by deal count across the middle market, remain below 2024 levels but are forecast to tick higher in 2026 to 2% and 3.5%, respectively.[5]

Asset-Based Lending: Attractive Yields from Asset-Rich Borrowers

For many borrowers, asset-based lending (ABL) represents an attractive financing alternative to syndicated or direct loans during periods of ongoing macroeconomic uncertainty. With still tight spreads, the cost of capital remains high relative to post-global financial crisis norms, and large money-center banks remain selective about the companies and industries they will lend to. At the same time, middle market companies today face numerous challenges to their margins, including supply-chain disruptions, recession fears and soaring prices for input materials, wages and transport.

Times like these historically have created opportunities for nonbank lenders to work with borrowers and their sponsors to provide flexible access to capital, including asset-based loans. ABL facilities are governed by the value of specific assets of the borrower—such as inventory, accounts receivable, real estate, machinery and equipment, and intellectual property—and feature structural provisions and covenants designed to preserve the value of those collateral assets.

3. Source: SIFMA; data as of March 31, 2026.
4,5. Source: KBRA DLD Research; data as of April 10, 2026.

US Residential Real Estate Credit: Persistent Opportunity Within a Market of Homes

After falling steadily for most of the past 12 months, mortgage rates rebounded with the outbreak of the Iran war, sending the spring homebuying season off to a sluggish start. The rate on 30-year fixed-rate mortgages ended the quarter at 6.47%; up from 6.15% at the start of 2026, but still below levels that prevailed for much of the past three years.[6]

While rates weighed on housing market activity, secular tailwinds—pent-up demand for housing in the US and the ongoing need for capital to refurbish existing homes and to develop lots for new homes—remain intact.[7] With a housing shortfall in 2025 of more than 4 million units, significant supply is needed.[8] But with more than half of homeowners carrying mortgages at or below 4%—and 78% at or below 6%—the "lock-in effect" continues to dampen sales.[9]

After signs of improvement heading into year-end 2025, new-home sales softened in early 2026, though the three-month rolling average remained broadly in line with last year's pace. New-home inventory remained tight, and the median sales price fell.[10] Existing-home sales, which account for the vast majority of US housing market activity, also slowed after a second-half 2025 acceleration. Inventory continued to trend higher but remained a constraint and helped fuel a new record-high median sales price.[11]

Housing market dynamics combined with the retreat of traditional banks from construction lending, in our view, have created a supportive backdrop for nonbank providers of capital to the real estate industry. This includes capital to finance residential transitional loans (RTLs)—short-duration, value-add renovation loans—and builder financing transactions—off-balance-sheet financing provided to homebuilders for the acquisition and development of entitled and permitted land.

Broadly Syndicated Loans/Collateralized Loan Obligations: Issuance Eased Amid Still-Strong Institutional Demand

US broadly syndicated loan activity cooled in the first quarter; total primary market activity amounted to only $241 billion, 32% slower than 2025's pace. Overall activity remained focused on opportunistic loan repricings and refinancings, though volumes in both areas were well off year-ago levels. While new-money issuance related to mergers and acquisitions (M&A) picked up relative to last year, its concentration in a handful of very large transactions combined with flagging private equity dealmaking suggest headwinds to loan issuance may persist. In the secondary market, the weighted average bid of leveraged loans continued to decline, though ended the quarter above early-March lows; notably, the price change was far less severe when excluding the software sector.[12]

New issuance of collateralized loan obligations (CLOs), the primary driver of demand for broadly syndicated loans, eased in February and March after a robust start to the year. That said, CLO issuance during the quarter was modestly higher on a year-over-year basis and represented the second-strongest first quarter mark on record.[13] Given CLOs' track record of very low impairments relative to like-rated corporates bonds, institutional buyers—including banks, insurance companies, investment managers and Japanese investors—appear willing to continue investing in the vehicles despite spreads that remain tight relative to historical norms.[14] Retail demand for loans, in contrast, has continued to deteriorate, with loan fund outflows reaching $7.5 billion in the quarter after losing nearly $11 billion last year.[15]

6,7. Source: Freddie Mac; data as of March 31, 2026.
8. Source: Realtor.com; data as of March 3, 2026.
9. Source: Realtor.com; data as of April 30, 2026.
10. Source: National Association of Homebuilders; data as of March 19, 2026.
11. Source: National Association of Realtors; data as of April 13, 2026.
12. Source: PitchBook | LCD; data as of March 31, 2026.
13. Source: Barclays Research; data as of April 9, 2026.
14. Source: BofA Global Research; data as of April 17, 2026.
15. Source: PitchBook | LCD; data as of March 31, 2026.

A Note on Private Credit: Not All Loans Are Created Equal

The potentially disruptive impact of artificial intelligence has seeped into credit markets, raising questions about the quality and stability of private credit portfolios and their ability to meet investor redemptions. Recall that private credit encompasses a wide array of assets, with the individual characteristics of each—maturity, coupon rate and ability to return principal—impacting the manager's ability to manage liquidity and performance.

The most attractive direct loans in the lower middle market, for example, may be to private equity-sponsored companies with stable, cash-generative business models. Terms on these loans typically include floating rates, structural protections—including liquidity requirements—and strong sponsor relationships that trigger preemptive discussion and remediation—including cash infusions—to retain interest and principal repayment/ loan integrity.

RTLs are backed by hard assets whose values are transparent and subject to frequent validation through the sale of similar properties limiting the potential for an abrupt markdown. With typical maturities of about one year—far shorter than the usual five-year maturity of a traditional cash flow corporate loan—RTLs typically return principal quickly to create recurring organic liquidity that can support investor redemptions and preclude active liquidity management, including the forced sale of assets. Furthermore, the shorter lending period can provide visibility into current market conditions and factors that could potentially impair the performance of an illiquid asset, informing a potential decision to redeploy assets in times of stress.

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- 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;
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- 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.

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

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.

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."

Residential transitional loans (RTLs) are short-term loans to real estate developers for the purpose of renovating a residential property. The loans are secured by the property being renovated.

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

Morningstar LSTA US Leveraged Loan Index (Gross/Total) is a market value-weighted index that measures the performance of the US leveraged loan market. A total-return index tracks price changes and reinvestment of distribution income. (Gross/Total) is a market value-weighted index that measures the performance of the US leveraged loan market. A total-return index tracks price changes and reinvestment of distribution income.

Indexes are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

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