



Alternative Credit: 4Q23 Review

Most risk assets posted strong returns for 2023, but the headline numbers obscure what was a volatile year for many asset classes in the face of oscillating expectations for Federal Reserve policy.

While the prospect of “higher for longer” policy rates spurred a sharp selloff in Treasuries from April through October, dovish sentiment reemerged toward year-end to fuel a furious rally across a wide range of assets. Market dynamics heading into the new year suggested investors were confident that a soft landing was just over the horizon and the Fed would soon cut policy rates.

In conjunction with markedly improved inflation metrics, Fed rhetoric helped support the notion of a near-term pivot. Even the typically measured Fed Chair Powell has taken a softer stance of late; while falling short of declaring victory over inflation, he reiterated at the December Federal Open Market Committee (FOMC) press conference that 2% inflation wasn't a prerequisite for rate cuts and noted his caution not to “overshoot” the target with restrictive monetary policy that would unnecessarily weigh on economic activity. The latest dot plot of economic projections pointed to a federal funds rate of 4.6% by end-2024—implying 75 basis points worth of cuts from the current 5.25–5.50% range. Futures markets continued to be even more optimistic about easing, however, assigning a greater than 50% probability that rates would end 2024 no higher than 4%.¹

In our view, however, the continued strength of the domestic labor market remains a significant impediment to target-level inflation, as well as a drag on corporate margins and profits. Wage growth has been far less responsive to Fed tightening than broad inflation metrics; though off its cyclical peak, the Atlanta Fed Wage Growth Tracker (at 5.2% in its latest reading) continues to reflect a pace of wage increases not seen since 2001.² Previous episodes of wage growth at or near the current rate were reined in only when exceeded by two-year Treasury yields for a period of time; “higher for longer”—and the economic slowing and job losses likely to accompany it—may be a necessity if the labor markets don't begin to demonstrate some slack.

1. Source: Federal Reserve; data as of December 13, 2023.

2. Source: Bloomberg, Haver Analytics, Federal Reserve Bank of Atlanta; data as of January 10, 2024.

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.

Broadly Syndicated Loans: Strong Returns Driven by Technical Mismatch

Loan performance was bolstered in the fourth quarter—as it had been for much of 2023—by new-issue demand that outstripped limited supply, complemented by rising secondary-market prices and high base rates.

Though well off the lows seen in the back half of 2022, loan primary issuance in the fourth quarter continued to be sluggish and dominated by refinancings, which accounted for more than half of the quarter's total activity. Notably, refinancings for 2023 as a whole exceeded non-refinancing deals for the first time since 2011 and for only the second time in 20 years. With yields high and capital availability tight for certain borrowers, amend-and-extend deals—in which lenders agree to push out a loan's maturity through an amendment rather than a new credit facility—also were quite popular during the quarter and established a new annual record in 2023. In contrast, mergers and acquisitions (M&A) activity, a key driver of lender volumes, remained moribund amid the sharply higher cost of capital and macro and geopolitical uncertainty.³

Loan primary issuance in the fourth quarter continued to be sluggish.

While demand for loans—historically driven by a combination of collateralized loan obligation (CLO) formation and retail fund flows, with the former typically the much larger contributor—was down year-over-year in 2023, it outpaced supply handily to help support secondary market prices. An uptick in CLO activity in the second half of the year bolstered demand, and lower interest rates may support continued improvements in 2024. Loan retail funds, meanwhile, saw small outflows for the fourth quarter after a slightly positive third; regardless, the near-breakeven pace of the second half was a massive improvement over the significant outflows seen in the first two quarters of the year.⁴

In contrast with supportive market technicals, borrower fundamentals have continued to weaken, as the uncertain macro background and high cost of capital have translated into slower revenue and EBITDA growth and higher interest expenses, weighing on free cash flow. The par-weighted loan default rate including distressed exchanges—a backward-looking indicator—rose about 250 basis points over 2023 to finish the year at 3.2%; the loan default rate excluding distressed exchanges was 2.1%.⁵ Notably, default rates continued to be higher for non-sponsored borrowers than for their sponsored brethren, and the difference widened to more than 100 basis points by year-end.⁶ The distress ratio—a forward-looking indicator that reflects the percentage of institutional loans trading below \$80—eased slightly into year-end as loan prices rallied but remained quite elevated at 7.1%.⁷ We believe the deterioration in borrower fundamentals over the past two years or so has eaten into their cushion against adverse conditions, and default rates are likely to continue to increase even if a Fed pivot provides some relief.

Middle-Market Direct Lending: Finding Opportunities to Put Money to Work

Like broadly syndicated loans, direct lending in 2023 was impacted by an imbalance between supply and demand. Private equity dealmaking, by both count and value, has declined in six of the past seven quarters and is down sharply from its 2021 peak. “Platform” buyouts—in which a private equity firm acquires a relatively large business that it intends to expand over time through the purchase of multiple smaller businesses (aka, a “buy and build” strategy)—were particularly weak in the more conservative dealmaking environment. In contrast, “add-ons”—the smaller acquisitions that are assimilated into a sponsor's platform company—continued to provide private equity sponsors a way to deploy capital, albeit in smaller chunks, as they wait for markets to be more amenable to larger deals.

Despite these challenging conditions, the core middle market has been resilient, and the past decade has seen remarkable growth in the space. Rising private company valuations over the years prompted private equity

3. Source: PitchBook | LCD; data as of December 31, 2023.

4. Source: PitchBook | LCD; data as of December 31, 2023.

5. Source: JPMorgan; data as of January 2, 2024.

6. Source: PitchBook | LCD; data as of December 31, 2023.

7. Source: JPMorgan; data as of January 2, 2024.

sponsors to look toward the smaller end of the middle market for more cost-effective platform opportunities; in our view, the lower middle market currently has a more balanced supply/demand dynamic, which has provided managers the greater opportunities for diversification on behalf of clients. Further, while there were fewer opportunities overall to underwrite new cash flow loans in 2023, we believe a well-underwritten portfolio may still have the potential to generate strong long-term returns for investors even if volume is down, as we saw in the years immediately after the global financial crisis. It's also worth noting that asset-based lending (ABL) volumes were strong during 2023, particularly in the aftermath of the regional bank challenges; this was not surprising, as borrower interest in ABL facilities historically has increased countercyclically when other financing options grow scarce.

Though dealmaking has been challenged for much of the past 18 months, there are signs the leveraged-buyout space may be thawing. The potential release of pent-up M&A energy bodes well for new-money volumes ahead. Putting more than \$2.5 trillion of private equity dry powder to work on acquisitions at a conservative loan-to-value ratio of 50% would require \$1.25 trillion of private credit capital.⁸ Meanwhile, add-on volume seems likely to persist as lenders and sponsors continue to manage their existing portfolios, and refinancings may even come back into play if rates ease, as futures markets currently forecast.

Specialty Lending: US Housing Shortage Presents Opportunities

In light of our constructive view on US residential real estate—based on a shortage of housing, the disintermediation of banks from certain lending activities and still-resilient consumers— we believe the yields available in private market segments like residential transitional loans and land banking appear particularly compelling. In addition to offering complexity and illiquidity premia of 200–300 basis points over public leveraged credit, the short durations and robust cash flows typical of these assets enable frequent reinvestment of proceeds.⁹

The yields available in certain real estate specialty lending segments appear particularly compelling to us.

To many buyers, a refurbished home in an established neighborhood can be more desirable than a new home in a new area, allowing them to tap into proven infrastructure like schools, parks and retail, potentially at a better price. Demand for such homes combined with the aged US housing stock has fueled a surge in “fix and flip” activity among real estate developers, and the pullback in commercial banks' ability to finance these types of projects has opened the door to a fragmented group of specialty lenders. The majority of these lenders lack the capital to underwrite and hold these short-duration value-add renovation loans at meaningful scale, however; asset managers have stepped in to acquire loans individually, provide liquidity to the real estate market in exchange for compelling terms.

Another byproduct of post-financial crisis US housing market dynamics has been the shortage of permitted, build-ready lots for single-family construction. Ownership of such lots can substantially tie up capital on a homebuilder's balance sheet, and many have moved toward the flexibility of “land light” business models. Financing solutions like land banking have become a staple of such homebuilders' land inventory-management strategies, and they typically are willing to pay a significant spread over benchmark interest rates for the optionality and off-balance-sheet treatment a land-banking arrangement affords.

8. Source: Preqin; data as of October 30, 2023.

9. Source: JP Morgan, Napier Park; data as of June 30, 2023.

The opportunity we see in US real estate debt is not limited to private deals. For example, publicly traded structured credit linked to real estate—such as agency mortgage-backed securities and credit risk transfer securitizations issued by government-sponsored enterprises Fannie Mae and Freddie Mac—may potentially provide attractive yields and serve as a complement to private deals. In fact, investors able to opportunistically manage their exposures to both public and private real estate debt markets may be well positioned to capture not only the benefits of each but also the relative-value discrepancies that periodically emerge between them.

Real Assets: Tailwinds Persist for the Ownership of Physical Assets

Higher benchmark interest rates and rising prices for real assets during 2023 were broadly supportive of investments in North American railcars, aviation and European renewables. We believe this segment continues to provide attractive opportunities for active managers of these real asset exposures.

Railcars. Railcars are relatively fungible items, and the environment of higher financing rates and rising labor and materials expenses drove railcar replacement costs higher and served as a constructive backdrop for lessors of existing railcars. The GATX Lease Price Index—which reflects the rate change of renewal leases on existing railcars—rose 33.5% in the fourth quarter, with an average renewal term of 65 months.¹⁰ Supply, meanwhile, remains constrained, and the number of railcars in storage continues to hover near a level about 40% below mid-2020 peaks.¹¹

Higher benchmark interest rates and rising prices for real assets were broadly supportive of investments in North American railcars, aviation and European renewables.

Aviation. By providing airlines with operational flexibility at a lower capital cost, aviation leases have gained significant traction in recent decades; it's estimated that leased aircraft comprises slightly more than half of the global commercial fleet.¹² Though the aviation industry was dislocated by the travel restrictions imposed with Covid-19, renewed demand for travel combined with constrained newbuild supply (exemplified by near-term highs in backlogs at market leaders Airbus and Boeing), manufacturing issues and high financing costs have pushed aircraft lease rates sharply higher in the latter half of 2023.¹³

Renewables. Demand for electricity is expected to rebound in Europe over the coming years, with supply expected to be driven by renewable generation.¹⁴ The European Union recently established new, aggressive goals for decarbonization, targeting at least 42.5% of the bloc's energy supply to be generated by renewables by 2030. The plan includes a range of subsidies and funding mechanisms, as well accelerated permitting for renewable energy projects—all of which we believe will help support investments in renewables, including solar photovoltaic power generation and storage.¹⁵

10. Source: Company reports; data as of January 23, 2024. The GATX Lease Price Index is a weighted-average lease-renewal rate for a group of railcars representative of the company's North American fleet. Data released by GATX—a large, publicly traded participant in railcar leasing—are often considered representative of trends in the industry.

11. Source: Railway Age, Wells Fargo Securities, AAR/Railinc; data as of December 5, 2023.

12. Source: Statista; data as of December 1, 2023.

13. Source: Napier Park Global Capital; data as of December 31, 2023.

14. Source: International Energy Agency; data as of January 2024.

15. Source: European Council; data as of October 3, 2023.

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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.

Atlanta Fed Wage Growth Tracker is a three-month moving average of median wage growth based on hourly data.

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.

Distress ratio measures the proportion of speculative-grade issues with option-adjusted composite spreads of more than 1,000 basis points relative to US Treasuries.

Dry powder refers to marketable securities that are highly liquid and considered cash-like. Dry powder can also refer to cash reserves kept on hand by a company, venture capital firm or individual to cover future obligations, purchase assets or make acquisitions.

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.

Government-sponsored enterprises (GSEs) were established and chartered by the US federal government for public policy purposes. They are private companies, and their securities are not backed by the full faith and credit of the federal government.

Mortgage-backed securities (MBS) are financial instruments collateralized by pools of mortgages.

Indexes are unmanaged and one cannot invest directly in an index.

GATX Lease Price Index is a weighted-average lease-renewal rate for a group of railcars representative of GATX Corporation's North American fleet. As GATX Corporation is a large, publicly traded participant in railcar leasing, its data are often considered representative of trends in the industry.

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