



Alternative Credit Review: 2Q25

The “sell America” stock trade that emerged in mid-February reached a crescendo with Trump’s April 2 announcement of (not actually) “reciprocal” tariffs on trading partners the world over.

While public market assets of all types sold off sharply in response to the tariff news, easing tensions were enough to draw investors back and markets generally retraced losses and then some. The S&P 500 Index, for example, lost more than 15% in the days after the announcement, only to deliver a 10.9% second quarter return and establish a new record high.¹ Similarly, credit spreads generally finished the quarter tighter after an initial spike as the yield curve steepened.

The Bloomberg US Aggregate Bond Index returned 1.2%, the Bloomberg US Corporate High Yield Index delivered 3.5% and the S&P UBS Leveraged Loan Index gained 2.3% during the second quarter.²

Faced with what we perceive as still volatile economic conditions ahead, we are reminded of (seemingly) calm surfaces that can sometimes mask storms below.

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 First Eagle Alternative Credit and Napier Park teams.

1. Source: FactSet; data as of June 30, 2025
2. Source: Bloomberg; data as of June 30, 2025.

Long Interest Rates—Both Nominal and Real—Move Higher

With valuations and spreads back to levels that preceded tariff fears, risk perception in the equity and bond markets appears to reflect an economy in equilibrium—or what John Williams, president of the New York Fed, has described as “equipoise” to suggest a balanced labor market with target-level inflation.³ But even with evidence of equipoise in the current environment, investing by this barometer disregards the high levels of risk that we believe persist, especially risks stemming from renewed inflationary pressures.

Markets appear to reflect equilibrium but may disregard risk from renewed inflationary pressures.

The labor market is the epicenter of inflation risk, in our view. While the labor market may be in balance today, this equilibrium was achieved at levels tighter than typical of past cycles, with labor utilization near historical highs, wage growth above long-term averages, and the unemployment rate well below average.⁴ Accommodative financial conditions and ongoing deficit spending as outlined in Trump’s July 4 omnibus bill should support corporate profits and profit margins, the growth of which historically has led to an increase in job openings. And while labor demand seems likely to be biased higher, labor supply may be biased lower as the Trump administration’s aggressive approach to immigration cuts off what had helped offset the slowing natural growth of the US population.

Introducing more jobs into a stagnant labor pool is a potential spark for wage inflation.⁵ In recognition of this increased inflation risk and high levels of government borrowing, among other considerations, long interest rates have broken out to the upside, with the 30-year Treasury around 5%—a level not seen consistently since before the global financial crisis. With expectations of rate cuts weighing on shorter government paper, the Treasury yield curve steepened.⁶

Real interest rates have also been on the rise; the real yield on the 10-year US Treasury, for example, ended the second quarter around 2% and has spent most of the past 18 months trading at levels heretofore not seen in 15 years. As they represent the true cost of capital after adjustment for inflation, real rates may be the key transmission mechanism for market stress in a world of tight credit spreads. Real rates directly affect corporate decision making, from hiring to capital expenditures to financing. As real yields rise, so too does the hurdle rate for investments, compressing equity valuations and increasing debt stress, particularly for leveraged borrowers.⁷

Dispersion continues to widen across credit markets in general as idiosyncratic risk reasserts itself, and we see the mispricing of complexity and liquidity risk growing ever more acute. With selective stress more likely than systemic crisis, in our view, inefficiencies that may suggest potential asymmetric returns come into greater focus, particularly where capital is in retreat and/or complexity provides a natural barrier to entry.

3. Source: Federal Reserve Bank of New York; data as of February 11, 2025.

4. Source: Federal Reserve Bank of St. Louis; data as of June 30, 2025.

5. Source: Bloomberg; data as of June 30, 2025.

6. Source: Federal Reserve Bank of St. Louis; data as of June 30, 2025.

7. Source: Bloomberg; data as of July 3, 2025.

Broadly Syndicated Loans: Supply Overwhelmed Shifting Demand

Demand for credit was extremely scarce coming into the second quarter. During early April's most extreme volatility, the creation of collateralized loan obligations (CLOs) became constrained, as is typical in such environments, while syndicated loan mutual funds and exchange-traded funds (ETFs) saw their largest weekly outflows ever. As sentiment stabilized and turned bullish throughout the month of April, however, that dynamic began to reverse. CLO demand was particularly resilient, with \$50 billion of net creation during the quarter. Retail demand was more tepid, but flows into loan mutual funds and ETFs totaled \$1.9 billion in May and \$1.1 billion in June.⁸

Although defaults and restructurings are above historical averages, issuer fundamentals overall remain stable.

Capital markets activity has recovered, but supply remains constrained, with volumes skewed toward refinancing and, increasingly, repricing. The net supply of loans in April totaled just under \$2.3 billion, much of which came in one large transaction; net supply of \$18 billion and \$20 billion in May and June, respectively, brought the quarterly total to roughly \$40 billion. The rally in loan prices after the disruptions of April has helped support repricing activity; 44% of loans were trading above par as of quarter end and repricing activity was responsible for 36% of dealmaking activity during the period.⁹

Default and restructuring activity remains above its historical average of 3%; at 3.79% for the trailing 12 months through the end of June, increasing to 4.75% if restructurings are included. Technology issuers were most exposed. Fundamentals for loan issuers overall remain largely stable. Cash flow coverage improved during the quarter while leverage levels remain near the post-Covid low, thus girding against potential erosion in operating results in upcoming quarters.¹⁰

Middle Market Direct Lending: Tariff Sensitivity Varies in Diverse Market

While it's difficult to obtain precise statistics on the more fragmented and less transparent direct lending market, past experience suggests that the challenges that emerged in the public credit markets will take time to trickle into the direct lending space, as the lack of a secondary market has tended to insulate valuations from short-term fluctuations. And while investment grade credit spreads quickly returned to pre-Liberation Day tight, spreads in direct lending remain above cyclical lows, suggesting better compensation for risk.¹¹

That said, a slowing economy would pose risks for all leveraged borrowers in the US. The direct financial impact of tariffs could be muted among lower middle market companies, however, as many tend to be smaller in scope and have limited direct exposure to global trade dynamics. High-quality businesses with low capital expenditures, strong revenues and limited cyclicality—often found in areas like healthcare services, professional services and software—may be particularly well positioned to withstand the macroeconomic impacts of tariffs and be attractive targets for deal activity.

8,9,10. Source: JPMorgan; data as of June 30, 2025.

11. Source: Lincoln International; data as of May 5, 2025.

Structured Credit: Dispersion Highlights Importance of Selectivity

In contrast to the post-global financial crisis era of synchronized beta, dispersion—across ratings, sectors, geographies and structures—again dominates structured credit markets, highlighting the importance of underwriting skill.

Within consumer credit, the bottom third of income distribution looks especially fragile, with subprime auto loans, student loans and credit card delinquencies all on the rise. And while corporate credit spreads appear stable at the index level, single-name risk has exploded; defaults among large cap and middle market

borrowers are at multi-year highs. Geographically, European credit markets have meaningfully outperformed the US year to date, reflecting lower default rates, fewer idiosyncratic risks and easing monetary policy coupled with unprecedented fiscal stimulus.¹²

Structured credit, in general, typically becomes more sensitive to underlying collateral performance when real rates are rising, especially in environments with rising defaults. A focus on floating-rate, short-duration assets—with minimal exposure to long-duration interest rate risk—may be advised.

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Real Estate Debt: Supply Imbalance Persists While Affordability Pressures Demand

The long-term secular drivers fueling US residential real estate—particularly the supply/demand imbalance and the need for renovation capital—remained intact during the second quarter and continue to provide a constructive backdrop for capital deployment in residential transitional loans (RTLs) and land banking.

Nationally, we see a supply shortage of housing in the US, driven initially by the lack of building following the global financial crisis. In the 15 years since, chronic underbuilding widened this housing gap to create a shortage of an estimated 3.8 million housing units nationwide, when accounting for pent-up demand from the 1.6 million younger adults who would form households if they could afford to do so.¹³

Meanwhile, dynamics in the existing-home market—which accounts for the vast majority of US housing market activity—have further exacerbated the overall supply/demand imbalance. While up from pandemic-era lows, the inventory of existing homes for sale continues to run below long-term averages and the six months of supply widely considered to be the equilibrium level. This is largely due to the “lock-in effect” in which a homeowner’s existing mortgage rate is significantly lower than the rate currently available and serves as a disincentive to sell. With the median age of owner-occupied homes nationally at 41 years, the existing housing stock supports ongoing demand for RTLs by experienced developers that can renovate homes within existing communities, which are frequently selling at attractive price points relative to new homes.¹⁴

While affordability continues to be an impediment to increased home sales, recent economic data shows that existing-home sales stayed flat over the past several months.¹⁵ Additionally we expect that home-price appreciation will continue to moderate from the extremes of the Covid-19 era due to the recent increases in inventory; that said, inventory remains below pre-pandemic levels while the population has grown 2.6%.¹⁶ We anticipate that a rate rally may alleviate some affordability pressure, with broad consensus that mortgage rates retracing to 5.5% will unleash significant housing demand.

12. Source: Bloomberg; data as of June 30, 2025.

13. Source: Realtor.com; data as of March 10, 2025.

14. Source: National Association of Homebuilders; data as of May 1, 2025.

15. Source: National Association of Realtors; data as of July 23, 2025.

16. Source: US Census Bureau; data as of December 31, 2024.

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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 or 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-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.

Credit default swaps (CDS), most commonly, are derivative contracts that transfer the default risk of a particular fixed income security from the swap buyer to the seller in exchange for a fee.

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."

Purchasing managers' index (PMI) measures the growth or expansion of certain segments of the economy.

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

Bloomberg US Aggregate Bond Index (Gross/Total) measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market in the US, including Treasuries, government-related and corporate securities, fixed-rate agency MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS. A total-return index tracks price changes and reinvestment of distribution income.

Bloomberg US Corporate High Yield Bond Index (Gross/Total) measures the US-dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below and is composed of fixed-rate, publicly issued, non-investment grade debt, is unmanaged, with dividends reinvested, and is not available for purchase. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility and Finance, which includes both US and non-US corporations. A total-return index tracks price changes and reinvestment of distribution income.

S&P 500 Index (Gross/Total) measures the performance of 500 of the top companies in the leading industries of the US economy and is widely recognized as a proxy for the US market as a whole. A total-return index tracks price changes and reinvestment of distribution income.

S&P UBS Leveraged Loan index (Gross/Total) formerly named the Credit Suisse Leveraged Loan Index, measures the performance of the investable universe of the US dollar institutional leveraged loans. A total-return index tracks price changes and reinvestment of distribution income.

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

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