Powerful tailwinds to emerge for private credit as President-elect Trump returns to office

KEY TAKEAWAYS

- Private credit to benefit as U.S. economic growth remains strong amid stretched equity valuations and mounting inflationary pressures.
- Improving middle market CEO optimism to jumpstart M&A activity; direct lending spreads to widen.
- U.S. middle market remains largely insulated from global trade shocks.
- Beware the long and variable lag as manager performance dispersion to increase.

The bottom line: We believe President-elect Trump's return to the White House in 2025 has the potential to introduce powerful tailwinds for private credit. Expectations for lower taxes and market-friendly regulations will boost CEO optimism and kick M&A activity into high gear while tariffs and protectionist trade policies may put upward pressure on inflation, forcing the Fed to keep rates elevated. Floating rates, shorter duration, a steady yield premium and U.S. middle market focus will position private credit as a compelling relative value opportunity in this investment climate.

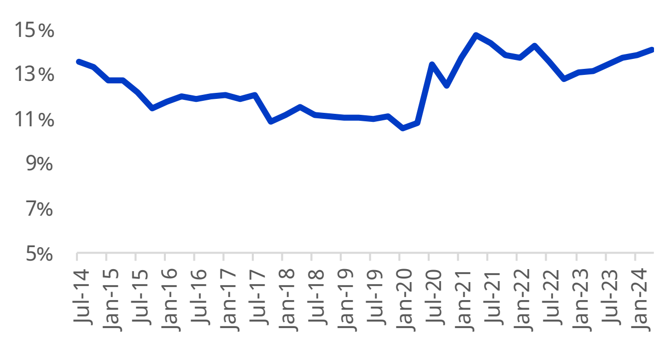
Private credit to benefit as U.S. economic growth remains strong amid stretched equity valuations and mounting inflationary pressures

The economy is currently on very strong footing compared to when President-elect Trump first took office in January 2017 and the global economy needed reflation. GDP growth remains strong, household balance sheets are in solid shape and the labor market, excluding the October NFP report, has shown few signs of weakness. Compared to November 2016, financial markets also are much more fully valued. High yield credit spreads are 200 bps tighter, the forward P/E for the S&P 500 sits at 22x vs.17x and corporate profits as a percentage of GDP are back near all-time highs ***(Figure 1)***, so scope for continued credit spread compression and equity valuation expansion may be limited.

FIGURE 1

Corporate Profits Back Near Record Levels[1]

Corporate profits before tax (without IVA and CCADdj) as % of GDP



1. Antares research and St. Louis Federal Reserve FRED Database and Bloomberg

The incoming Trump administration will be confronted with structurally higher fiscal deficits ***(Figure 2)*** and a prospective return of the 'bond vigilantes' to rein in profligate government spending, possibly curtailing some of their more ambitious policy goals. Nonetheless, a near-term boost to economic growth is expected which should continue to support credit fundamentals but could also spark a reacceleration in inflation. Inflation expectations have been steadily rising since the Fed cut rates in September, which in conjunction with higher growth could force the Fed to scale back the pace of interest rate cuts. ***(Figure 3)*** The forward SOFR curve has dramatically repriced higher to reflect this stronger growth outlook, now forecasting a terminal floor of 3.70% following the election vs. 2.87% after the September Fed meeting. ***(Figure 4)***

FIGURE 2

Bond Market May Force Fiscal Discipline[1]

Total Public Debt as % of GDP

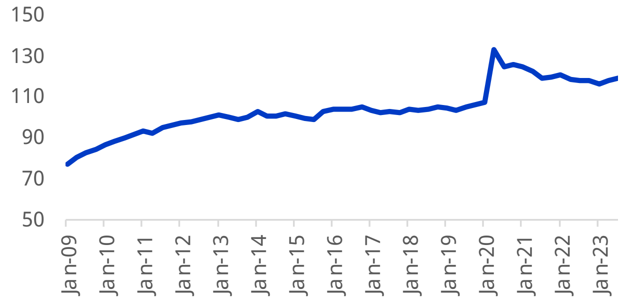


FIGURE 3

Inflation Expectations Drift Further From Fed's 2% Objective[1]

5-Year Breakeven Inflation Rate

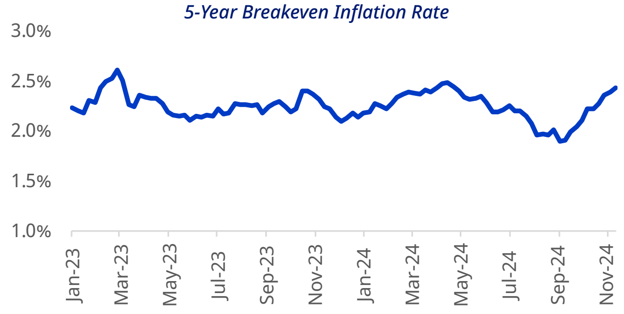
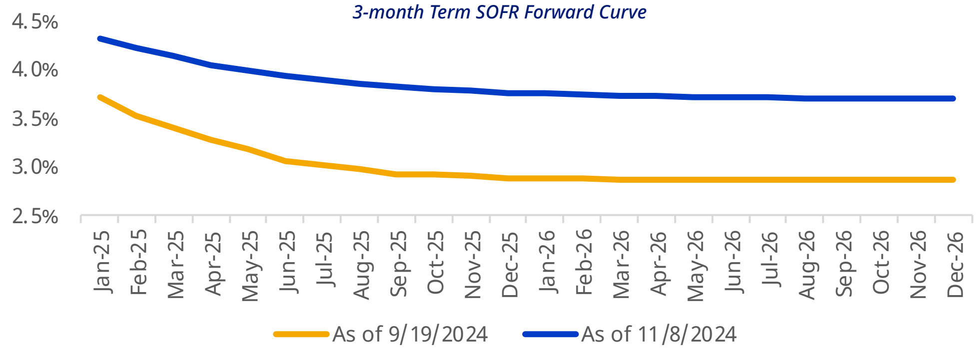


FIGURE 4

SOFR Curve Suggests Fewer Rate Cuts[2]

3-month Term SOFR Forward Curve



In our view, a protracted period of elevated base rates will continue to support high single to low double-digit all-in direct lending yields (depending on use of leverage), leading to 2025 being another year of attractive risk-adjusted performance for private credit. Furthermore, given the potential for increased macro uncertainty, we believe the current opportunity in private credit remains highly compelling as it offers investors a hedge to right tail growth risks (and accompanying higher rates from stronger growth) via floating rates and shorter duration, attractive relative value compared to investment grade fixed income or equities and a sustained yield premium over leveraged loans.

1. Antares research, St. Louis Federal Reserve FRED Database and Bloomberg
2. Chatham Financial as of November 9, 2024

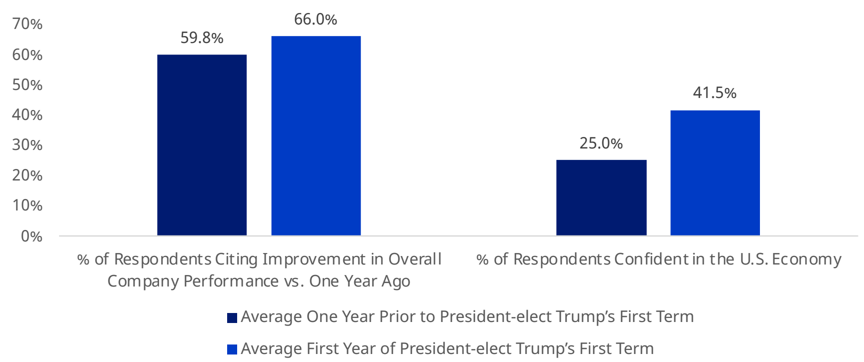
Improving CEO optimism to jumpstart M&A activity, direct lending spreads to widen. U.S. middle market remains largely insulated from global trade shocks

While it may be too early to get a sense of which of President-elect Trump's campaign proposals have the highest likelihood of being enacted, the overarching themes of deregulation, lower taxes and higher tariffs are broadly consistent with policies implemented during his first term, likely leading to further strengthening of middle market company fundamentals. Looking at National Center for the Middle Market data, there was an improvement in company performance and a notable increase in CEO confidence in the U.S. middle market during President-elect Trump's first year in office. ***(Figure 5)*** We anticipate a similar dynamic unfolding as we enter 2025, where middle market companies are likely to benefit from President-elect Trump's initial policies leading to continued revenue and EBITDA growth while increasing economic optimism sets the stage for an acceleration in M&A activity.

FIGURE 5

Middle Market Company Performance and CEO Confidence Increased After President-elect Trump's First Electoral Victory

National Center for Middle Market Indicator



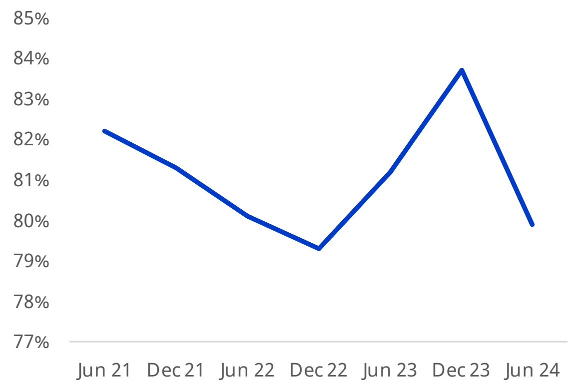
We therefore believe that private credit, by virtue of its exposure to the U.S. middle market, may be in a prime position to benefit from President-elect Trump's return to the White House.

- **U.S. dollar strength and tariffs less harmful to the middle market:** Middle market companies are generally more insulated from some of the adverse effects of President-elect Trump's economic and trade policies. Prolonged dollar strength that might result from U.S economic exceptionalism is less likely to impact middle market companies' earnings since around 80% of revenues are derived domestically vs. ~50% for S&P 500 companies. ***(Figure 6)*** According to a study by WisdomTree, in rising dollar regimes, S&P 500 earnings typically declined by ~2% in the following six months.[4] Additionally, the implementation of proposed tariffs could result in a material drag to growth for other countries with export dependent Europe most at risk to a significant cut to GDP growth forecasts for 2025. With only ~4% of revenues for U.S. middle market companies coming from Europe, it's likely they fare better than large cap companies, supporting the continued health of private credit portfolios.

FIGURE 6

Middle Market Companies Derive Most of Their Revenue from the U.S.[3]

% of Revenues from U.S. for Middle Market Companies



3. National Center for the Middle Market
4. WisdomTree Blog A Surprise Influence in S&P 500 Earnings? The Dollar

- **Normalization of M&A Activity in Sight:** We believe the long-awaited pickup in M&A activity should finally materialize in 2025. We are encouraged by the positive momentum in M&A activity, with indicators such as BCG's proprietary M&A Sentiment Index reaching the highest level since the Fed started raising rates. We are becoming more confident of a meaningful acceleration in activity in 2025, a topic we will explore in more detail in our upcoming 2025 Outlook. ***(Figure 7)*** A return to a more active M&A environment will allow direct lenders to prudently lend more capital against the current favorable deployment backdrop and further alleviate spread compression to offset the gradual decline in base rates. ***(Figure 8)***

FIGURE 7

M&A Activity Accelerating[5]

BCG M&A Sentiment Index

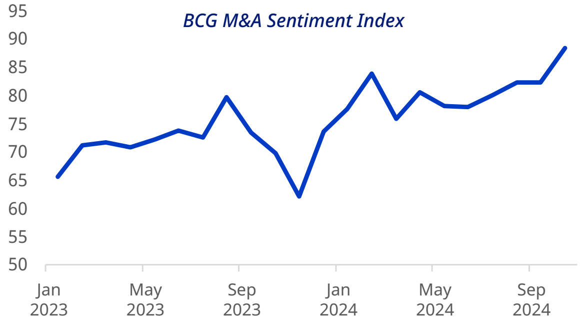
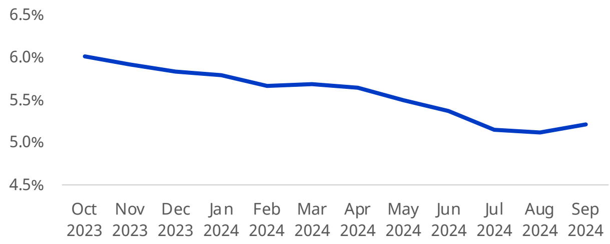


FIGURE 8

Accelerating M&A Activity to Drive Wider Spreads[6]

Direct Lending New Issue First Lien Spreads



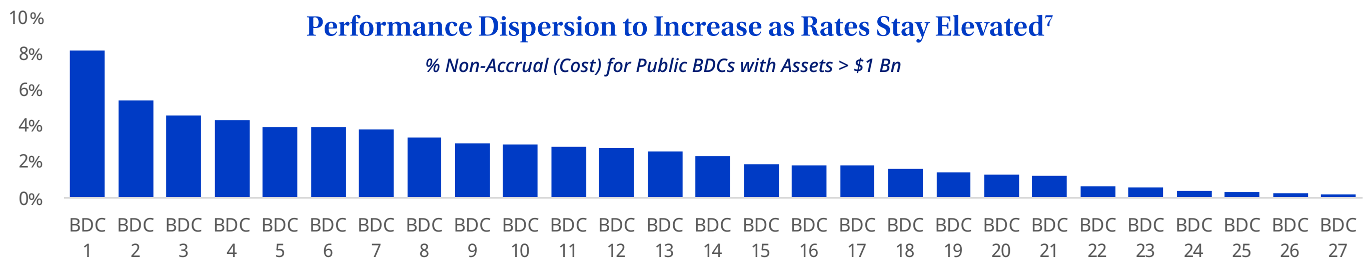
- **New Opportunities for Private Credit to Emerge:** President-elect Trump's policies seem to be targeting investment in infrastructure and manufacturing, sectors reliant on private credit financing as many of the companies in these sectors may not have easy access to traditional bank loans. Manufacturing has stagnated under President Biden over the last two years and a revival under President-elect Trump, we believe, should broaden the opportunity set for private credit.

- **Beware of the long and variable lag:** A more protracted period of higher rates could lead to increased credit stress and performance dispersion for direct lenders. As we discussed in our Creating Alpha Series, alpha in private credit is avoiding losses and maximizing recoveries. Looking at non-accrual data for large publicly traded BDCs, there is a wide dispersion amongst managers which reinforces the need for careful manager selection. ***(Figure 9)*** We believe that performance dispersion will likely increase over the coming months as some managers' portfolios are more sensitive to pressure from a prolonged period of higher rates.

FIGURE 9

Performance Dispersion to Increase as Rates Stay Elevated[7]

% Non-Accrual (Cost) for Public BDCs with Assets > $1 Bn



With traditional markets richly valued and the return of President-elect Trump introducing right tail risk to growth and inflation, we believe private credit may be one of the few asset classes that offers relative value and the prospect for compelling risk adjusted returns. However, investors must take note of the potential for rising credit stress as rates remain elevated, leading to increased performance dispersion. Managers with scaled, diversified portfolios and experience through credit cycles may be best positioned to navigate Donald Trump's return to office.

5. Boston Consulting Group, BCG M&A Sentiment Index as of November 9, 2024
6. Cliffwater LLC as of September 30, 2024
7. Antares research and LSEG LPC BDC Collateral

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