KEY TAKEAWAYS

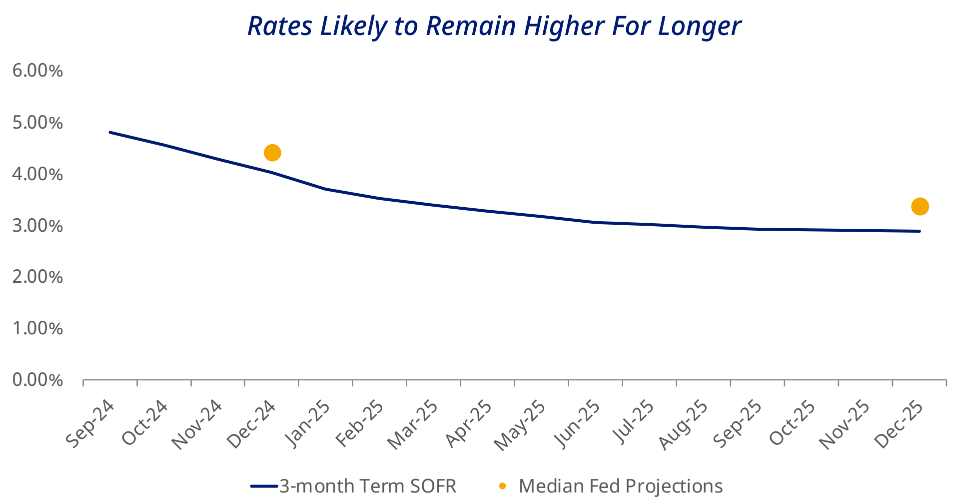
- The Fed signaled rates to gradually decline and remain higher for longer
- We agree with the Fed's base case of a soft landing for the U.S. economy. However, financial market volatility historically increases after the first rate cut which may prompt investors to consider investments like direct lending that can provide a volatility buffer
- A gradual decline in interest rates will provide relief to borrowers, facilitate a rebound in M&A activity and continue to support direct lending performance

Higher For Longer Still Intact

The Federal Reserve elected for an aggressive start to its first easing campaign in four years, reducing the benchmark rate by 50 bps at its September meeting. In our view, while the magnitude of the cut may have surprised certain market participants, the Fed's policy adjustment was already reflected in what market expectations for interest rates were in August. With the median dot plot for 2025 currently at 3.375% (vs. 4.125% in June), the Fed is now more aligned with the forward SOFR curve, which still shows a gradual path for easing toward a terminal floor of 2.75-3% in 2026.[1] ***(Figure 1)*** Also worth noting, the Fed did not change its 2025 GDP forecast and slightly revised unemployment projections higher by just a fraction, from 4.2% to 4.4%.

FIGURE 1

3-month Term SOFR and Median Fed Projections

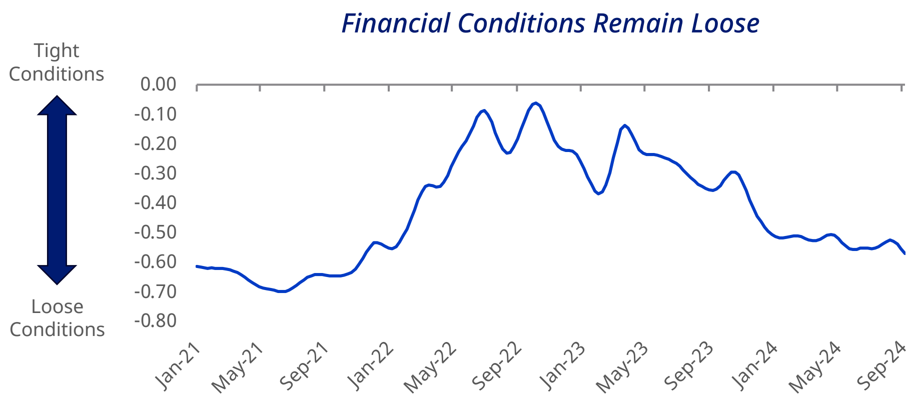


1. *Chatham Financial as of September 18, 2024*

While base SOFR rates are set to decline toward 3%, this 'normalized' level remains well above the average LIBOR rate of less than 1% from 2008 to early 2022, suggesting the 'higher for longer' narrative remains very much intact. Furthermore, we agree with the Fed's base case of a soft landing for the U.S. economy. While we acknowledge that history would indicate a less benign outcome, economic data suggests the economy is slowing, but not likely headed into a recession. Responses from our recent survey of borrowers in our June 2024 Credit Market Outlook Survey align with this view, with the majority (78%) expecting growth to slow, but only 10% expecting a recession in the next 12 months. Additionally, with financial conditions continuing to remain loose, implying ample liquidity in the financial system, the Fed has more latitude to maintain a restrictive policy stance and prevent a potential reacceleration in inflation.[2] *(Figure 2)*

FIGURE 2

Chicago Fed National Financial Conditions Index[2]

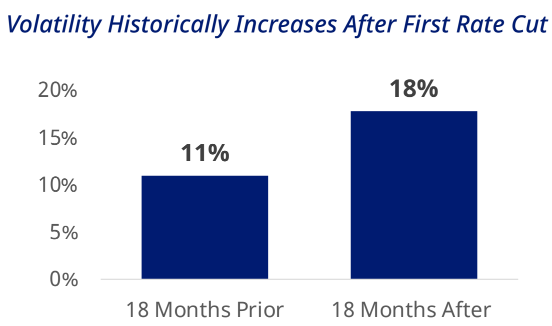


However, while we remain positive on the U.S. economic outlook, as investors pivot their focus from inflation to the downside growth tail, volatility across markets is likely to increase. Historically, in each of the prior easing cycles since 1989, there was a notable increase in equity market volatility in the period following the first interest rate cut.[3] *(Figure 3)* While equities may ultimately respond positively to easier monetary policy alongside reduced recession risk, the slowing growth dynamic is likely to lead to higher volatility across financial markets. Equity investors must contend with lofty valuations as the consensus S&P 500 bottoms-up P/E multiple is at 21x[4] , limiting the scope for multiple expansion.

So, for prices to move higher corporate earnings for large cap companies, which are sensitive to the economic cycle, will have to continue to meet expected growth targets. With the S&P 500 currently trading at ~5700 as of the time of writing (vs. median analyst consensus 2024 YE forecast of 5600[5]) price appreciation may be limited. Furthermore, with fixed income's correlation to equites hovering at its highest level in a decade, (.78 vs. average of .16 over the last 10 years) we think investors looking for fixed income to provide portfolio diversification may be disappointed.[6] This may prompt investors to consider tilting asset class exposure towards investments like direct lending that, in a diversified portfolio, can help provide a buffer against higher volatility.

FIGURE 3

Median S&P 500 Volatility Before and After First Interest Rate Cut in Prior Easing Cycles (1989 - 2019)[3]



2. *St. Louis Fed FRED database. Financial conditions track indicators across money markets, credit and equity markets, and the banking system*
3. *Antares Research, St. Louis Fed FRED database and Bloomberg*
4. *Yardeni Research as of September 17, 2024*
5. *Bloomberg*
6. *Fixed income represented by Bloomberg Aggregate Bond Index and equities by the S&P 500*

Direct lending tailwinds to strengthen

Over the first three quarters of 2024, credit trends have remained broadly stable. While certain subsectors face idiosyncratic headwinds, the positive economic backdrop continues to support portfolio performance and remains favorable for overall credit performance. As interest rates fall, borrowers will begin to experience less interest cost burden and revenue and EBITDA growth is expected to continue, albeit at a slower rate granted a soft-landing scenario.

With non-accruals at benign levels and interest coverage ratios stabilizing and positioned to improve, we believe the environment remains constructive for future direct lending performance. All-in yields, which are currently ~11%[7], should move lower as base rates decline, but a prospective increase in spreads could partially offset the decline. On balance, direct lending appears likely to continue to offer high single to low double-digit returns (depending on the use of leverage) as interest rates normalize, which we believe remains compelling on a risk-adjusted basis.

Historically, credit spreads tend to widen as base rates fall which should relieve some of the pricing pressure for first lien term loans.[8] *(Figure 4)* Certain market dynamics that drove spreads tighter have modestly abated in 3Q24. On the demand side, CLO issuance has slowed slightly (though still tracking for a very strong year) and in 2Q24 private credit has recaptured share from the syndicated market for refinancings, although the market remains highly competitive.[9] We think this trend will continue as syndicated market activity is subject to periods of dislocation and does not offer sponsors the same certainty of execution that private credit can provide. We witnessed this in August, when the short-lived volatility in equities led to the shelving of some BSL transactions.

FIGURE 4

Direct Lending New Issue First Lien Spreads

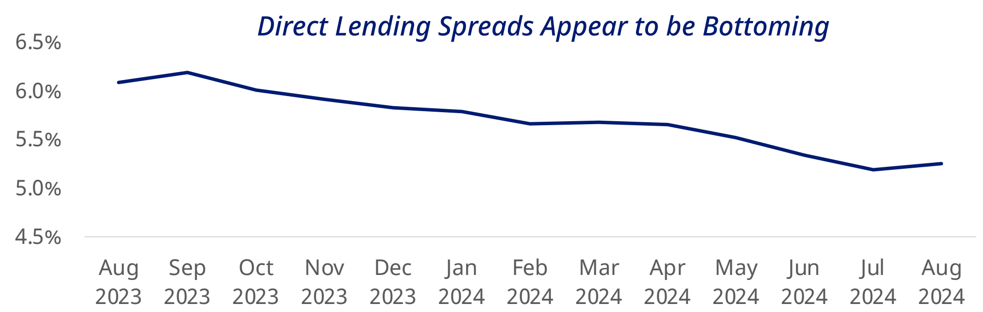
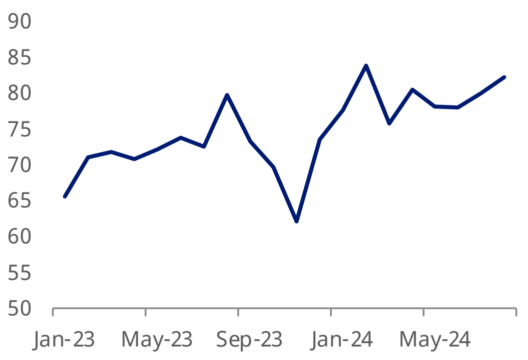


FIGURE 5

BCG M&A Sentiment Index



On the supply side, lower interest rates should facilitate the long-awaited rebound in M&A activity. Signs of a pickup emerged over the summer, with M&A activity showing improvement.

According to the Boston Consulting Group, in July there were 196 M&A deals valued at more than $100 million, the highest level of 2024 and their proprietary M&A sentiment index shows positive momentum.[9] *(Figure 5)* Anecdotally, many of our investment banking relationships have conveyed that during the remainder of the year, they plan to launch more deals from their extensive pipelines compared to 2023. With more than 30% of private equity portfolio companies being held for more than five years (vs. the typical 3-4 years), sponsors are likely to increase transaction activity to return capital to LPs.[10]

As markets contend with an uneven pace of rate cuts, slowdown in growth and the upcoming U.S. election, there will be no shortage of catalysts for increased volatility. In our opinion, the contractual income and enhanced downside protection that senior secured first lien loans offer represents a compelling opportunity for investors in the current investment climate.

7. *Cliffwater LLC as of August 13th, 2024*
8. *Cliffwater LLC as of August 13th,2024*
9. *Boston Consulting Group BCG's M&A Sentiment Index: Monthly Market Insights | BCG*
10. *Pitchbook LCD*

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