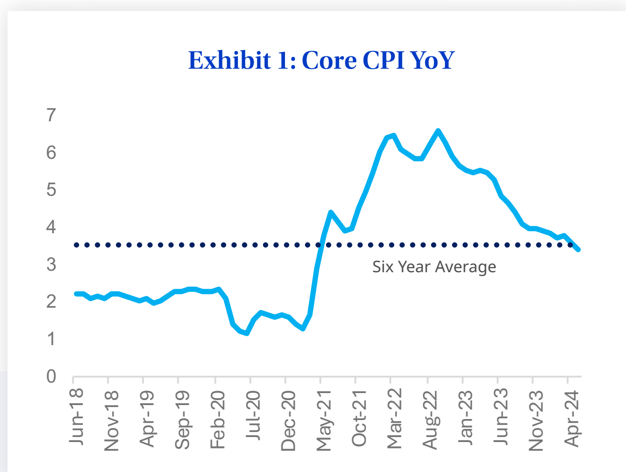
From "Golden Age" to "Goldilocks"?

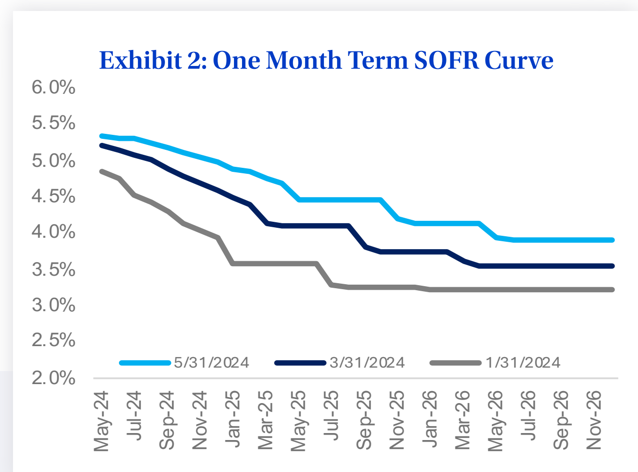
Base rate cuts ahead, but likely to be gradual with rates remaining "higher for longer"

Some market observers have recently suggested that the "Golden Age" for Private Credit may be coming to an end. From our perspective, double-digit first lien yields were never likely to be sustained long-term. Nevertheless, we believe the current environment with moderately lower yields could prove to be a tailwind for direct lending performance resulting in what we consider a "Goldilocks" scenario. In such a "Goldilocks" environment, yields are not too hot, where the higher cost of capital strains some borrowers' cash flows resulting in possibly higher defaults but also not too cold, still providing the potential for sustained yield premium and high absolute returns.

When we published our Asset Management Outlook at the start of 2024, we thought the market was overly aggressive in pricing in approximately five rate cuts in 2024 given still elevated inflation, strong growth and loose financial conditions. Surveying the current macro landscape, economic activity still appears to be relatively robust, with the Atlanta Fed's GDPNow model suggesting 3% GDP growth in 2Q24 (as of late June). However, there are some signs of consumer spending fatigue, especially among lower-end consumers, and recent inflation readings have surprised to the downside, with core inflation showing continued progress towards the Fed's 2% target. (Exhibit 1) As such, we now find ourselves in agreement with the SOFR curve and believe the Fed is now poised to gradually embark on easing policy, with the likelihood of at least one rate cut by year-end. (Exhibit 2) That said, we believe we remain in a 'higher for longer' environment where rates are likely to remain above their long-term average of 2.78% (since 1990) for an extended period.

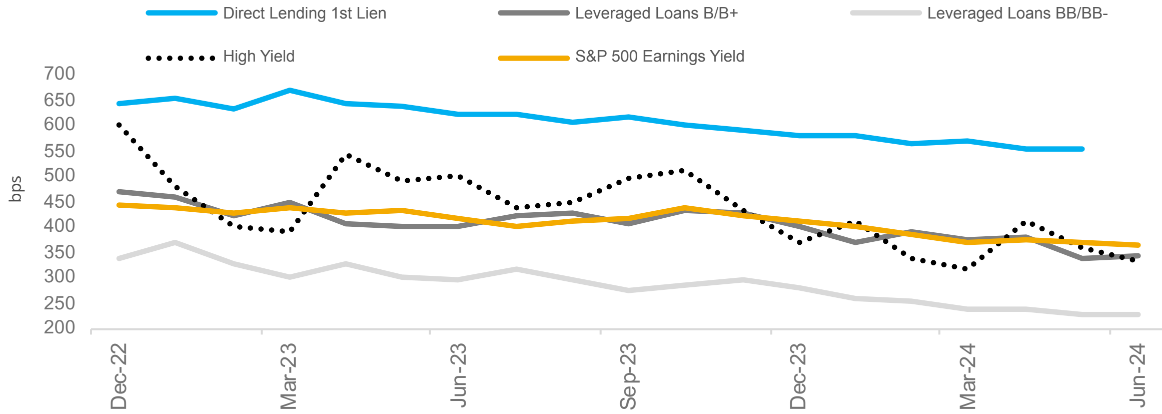


Source: St. Louis Fed FRED as of May 31, 2024



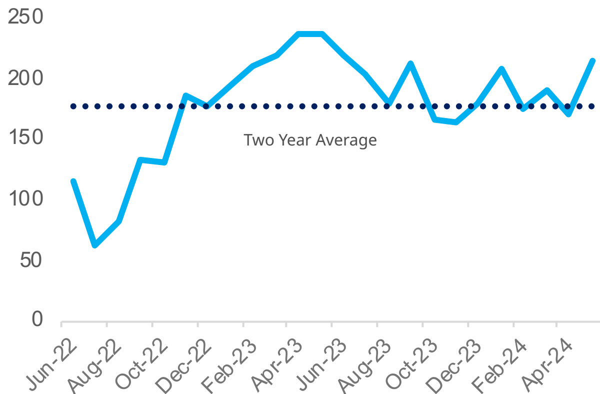
Source: Pensford Financial as of May 31, 2024

Exhibit 3: New Issue Spread Compression Everywhere



Source: Pitchbook LCD, KBRA DLD, Cliffwater LLC as of May 31, 2024

Exhibit 4: Direct Lending 1st Lien Yield Premium vs. Leveraged Loans (B/B+)



Source: Pitchbook LCD, KBRA DLD, Cliffwater LLC as of May 31, 2024.

It's all relative: Direct lending yields still appear attractive on a relative basis

While there has been concern regarding spread compression, it should be acknowledged that spread compression is not just specific to direct lending. (Exhibit 3) On a relative basis, direct lending's yield premium vs. the syndicated market remains near the high end of the historical range, suggesting borrowers continue to be willing to pay a premium for direct lending financing solutions.

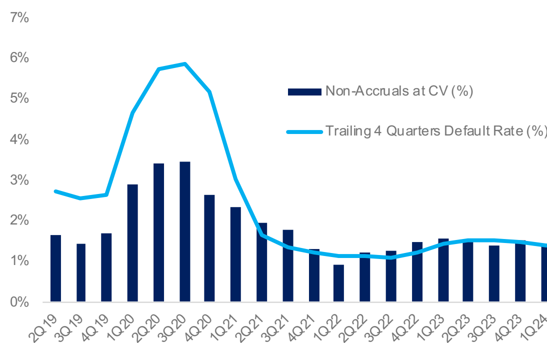
So what are the implications of lower base rates and spreads for direct lending?

Fundamentals have stabilized, likely to get a boost from lower rates. Non-accrual rates and defaults have held steady at relatively benign levels (Exhibit 5) and loan performance remains solid. (Exhibit 6) Also, according to Lincoln International, EBITDA growth for private companies in 1Q24 was the highest it has been in the last two years. If interest rates gradually decline and EBITDA grows as expected, interest coverage ratios should improve and default rates decline. As of June 2024, Fitch forecasts the default rate for leveraged loans to decline from 3.5-4% in 2024 to 2-3% in 2025.

A pickup in PE M&A activity which should improve the supply/demand balance for loans and alleviate spread compression. Top of mind for many direct lending investors is when will the M&A market normalize. While YTD sponsor-led M&A announcements are still tracking below pre-Covid average levels (2017-2019), activity in April and May has ticked up. Whether this marks a turning point or is just a temporary bump remains unclear. However, we do believe that sponsors will need to start transacting given the high levels of dry powder. Encouraging signs are beginning to emerge, with PitchBook LCD reporting that $44 billion of leveraged loans for M&A deals have been priced in the broadly syndicated market through May 16, which is running at double last year's rate.

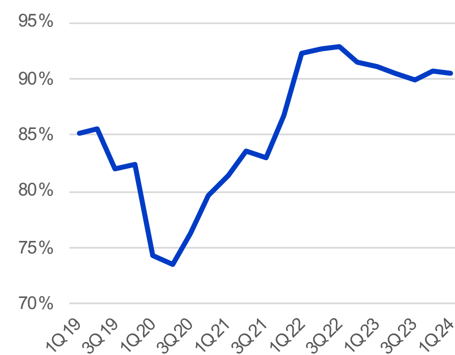
In our view, lower interest rates in the coming months should drive continued improvement in borrower fundamentals resulting in a favorable environment for direct lending.

Exhibit 5: CDLI Non-Accruals and Default Rate



Source: Cliffwater LLC as of March 31, 2024

Exhibit 6: CDLI Risk Ratings Meeting or Exceeding Expectations



Source: Cliffwater LLC as of March 31, 2024

[1]Lincoln International 'Lincoln Private Market Index Continued to Climb in the First Quarter on the Back of Steady Earnings Growth' May 2024

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