Antares Capital

A Contrarian Macro Case for Private Credit

Exploring private credit's relative performance prospects if consensus is wrong about a "soft landing."

SUMMARY:

Financial markets have been rallying based on consensus expectation of a "soft landing" in 2025 with SOFR declining toward 3% by year end[1] and S&P500 earning growth accelerating to near 15%[2]. While a "soft landing" may be the most likely scenario, it is by no means assured given escalating geopolitical risks and other uncertainties. We argue investors can take comfort that private credit's risk adjusted return prospects look appealing, especially on a relative basis, even granted less rosy economic scenarios; however, performance dispersion could widen in downside scenarios which underscores the importance of being aligned with the right GP.

Reasons to be optimistic

We believe recent economic data has favored not just the "soft landing" scenario, but perhaps even a "no landing" scenario. For example, 2Q24 real GDP growth came in at a robust 3.0%[3] with the Atlanta Fed's GDPNow forecast for 3Q24 bouncing around a still health pace of 2.5-3.0% growth in recent weeks. On the labor front, non-farm payrolls rose by 254,000 jobs in September – well ahead of expectations – with the unemployment rate falling for the second month in a row to 4.1%[4]. Meanwhile, a continued cooling of inflation (with core PCE at 2.7% in August[3]) has allowed the Fed to kick off an easing cycle with a somewhat rare 50 basis point cut in the Fed Funds rate. These favorable trends have helped drive a remarkable 22% rally in the S&P500 YTD October 9th, 2024.

Granted a "soft landing" or a "no landing" scenario, we believe interest rates will likely remain "higher for longer" which would be supportive of private credit yields:

- **In a "soft landing" scenario,** SOFR is likely to decline toward 3% by early 2026 as currently depicted in the term SOFR curve[1], but this would still be "high" relative to a SOFR/LIBOR average of <1% in the 2010-2022 period. In this case, all-in direct lending yields would be expected to decline from current double-digit levels but to high single digits which would still be attractive on a relative basis. Moreover, defaults and losses would likely decline due to lower interest cost burden and M&A would likely rise which could support spread widening.

- **In a "no landing" scenario,** base rates and all in direct lending yields would likely stay even "higher for longer" which would help lift direct lending yields. On the credit side, presumably healthy economic growth would aid earnings growth which in turn would offset somewhat higher interest cost burden for borrowers vs. a soft-landing scenario. On balance, we would expect defaults and losses to trend lower and M&A to recover given favorable economic growth and still at least some modest interest cost relief.

Reasons to worry

While we believe soft or even no-landing scenarios collectively look most likely in 2025-26, they are by no means assured. "Soft landings" have been rare historically and there are plenty of risks looming large in our opinion, the most notable including:

- **Geopolitical risks.** Thus far, financial markets appear to have largely shrugged off the escalation of war in the Middle East and the continued carnage in the Ukraine, but that could change if escalation continues, oil prices surge and in particular if the U.S. gets dragged more directly into these conflicts. Meanwhile, tensions between China and Taiwan and in the South China Sea could flare up at any time. (*Note: U.S. election turmoil is another risk, though hopefully one that will be resolved shortly after this article is published.*)

- **Inflation risks.** Although inflation has cooled of late, a rekindling of inflation remains a risk, especially if the Fed cuts rates too aggressively. Other potential catalysts including possible new supply side shocks, excessive fiscal stimulus/deficit growth, tightened labor supply due to immigration curbs, and/or possibly a sharp increase in tariffs on imported goods.

- **Other ever-present risks** such as the potential for cyber-crime/warfare, pandemics, increase prevalence of natural disasters, etc.

Private credit performance prospects in a downturn; an historical performance perspective

We think one of the attractive features of direct loans are their "all weather," defensive attributes. These include seniority in the capital structure (typically 1st lien), covenants, and low loan-to-value ratios (currently typically in the 38-44% range) that provide a substantial cushion in the event of default. Moreover, most direct lenders also tend to focus on companies in less cyclical industry segments and with PE sponsor owners that are experienced at managing through challenging periods and most often willing to add capital if required during periods of stress. Private direct loans also typically aren't marked to market which reduces portfolio volatility and related risk of forced selling. Finally, direct lenders tend to be relationship oriented in stressed situations, working constructively with sponsors to maximize value preservation.

Reflecting these defensive attributes, direct lending as represented by the benchmark Cliffwater Direct Lending Index (CDLI) has had positive returns in every one of the last 19 years back to 2005 with the exception of 2008 which posted a -6.5% loss. Relatedly, Hamilton Lane notes in an exhibit in its Quarterly Market Brief titled "Worst Comes to Worst" that private credit's lowest 5-year trailing annualized performance from 1998-2003 of 4.3% has surpassed all other major asset classes (with most of them posting negative 5-year returns by this "worst comes to worst" measure)[5].

Here, it is important to note that these defensive attributes in direct lending's performance have NOT generally come at the expense of poor relative performance over the long run and in more normal conditions. In fact, since its inception in 2005, the CDLI has outperformed the Bloomberg HY and Aggregate Bond Indices and CS Leveraged Loan Index in all but 7 years of last 19 years through 2023, with the average annual return for the CDLI at 9.5% over this period (Note: this is not to say there aren't periods of opportunity or attractive relative value plays in public credit markets).

Of course, the same cannot be said of a comparison vs. the S&P500; however, even here, the S&P500 returns only outperformed the CDLI in 11 out of the 19 years from 2005-23 (i.e. 58% of the time), with the S&P500 average annual return of 9.76%[6] over this 19 year period very close to 9.45% for the CDLI. Moreover, looking forward, the S&P500 at the time of this writing is trading at an elevated PE of about 21 times its consensus 2025 EPS estimate[2] which presumes 15% growth in earnings vs. 2024. Such accelerated growth expectations (vs. ~10% growth in 2024) could prove optimistic, especially if economic growth slows. While lower than forecast S&P500 earnings growth could disappoint equity investors, even lower than expected earnings growth would likely prove to be constructive for credit markets since debt coverage ratios would still be likely to improve.

Important to pick the right GP(s)

While a strong case can be made for private credit's appeal as an asset class in a downside scenario relative to many other asset classes, as we have seen in past cycles, performance dispersion among GP tends to rise in a downcycle as defaults and losses mount. Not all private credit GP's would be expected to perform well in a downcycle. As such, it remains important to be aligned with GP's that have strong origination and incumbency advantages in credit selection, experience and credit discipline through multiple cycles, and strong workout capabilities to maximize recoveries when defaults occur.

Conclusion

Many if not most market observers expected a recession in 2023 which proved to be wrong. Today, most now expect a "soft landing." Might that prove wrong too? Only hindsight will tell for sure. While "past performance is not a guarantee of future returns," we believe historical market performance suggests exposure to private credit's all weather defensive attributes will likely have been well advised should a "hard landing"/recession materialize. However, alignment with the right GP(s) will likely prove to be all the more critical given the likelihood of increased performance dispersion in a downturn.

Commentary reflects Antares' beliefs unless otherwise cited with a source

Footnotes:

1. Chatham Financial as of 10/9/24
2. Factset Earnings Insight Oct, 4th 2024
3. Bureau of Economic Analysis
4. U.S. Bureau if Labor Statistics
5. Hamilton Lane Quarterly Market Brief May 2024
6. Officialdata.org