Private Markets

July 2024

Global Credit Outlook: 3Q2024

Watching for a tipping point

BlackRock

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Key takeaways

Authors

Amanda Lynam, CPA
Head of Macro Credit Research

Dominique Bly
Macro Credit Research Strategist

James Keenan, CFA
Chief Investment Officer & Global Head of Private Debt

Jeff Cucunato
Head of Multi-Strategy Debt Solutions

- With progress on inflation becoming clearer, and the downside risks to growth more pronounced, central banks in the U.S., Europe and the U.K. have increasingly discussed (or started) rate cuts.
- Our base case calls for gradual and "shallow" rate cutting cycles, however. This means that consumer, corporate, and commercial real estate borrowers are unlikely to see material, near-term interest rate relief on their debt costs – at least not in 2H2024.
- For investors in corporate credit (liquid and private markets), the interaction between higher rates and economic activity will be paramount. Supportive growth would help mitigate the headwind from persistently elevated debt service costs, while preserving the fundamental resilience of the past few quarters. That said, we expect dispersion on a multitude of fronts (i.e., asset class, sector, issuer, manager, vintage).
- With rates elevated – at least by the standards of the post-financial crisis era – we expect to see incremental demand from yield-based buyers for subsets of corporate credit. This will likely keep IG and HY credit spreads range-bound in aggregate (and may even support tightening, as issuance slows through the summer).
- The inverted yield curve should continue to favor shorter- and intermediate-duration exposures, relative to the long-end. Capital allocated to corporate credit should be based on carry and income, in our view (as opposed to total return).

Monetary policy: Normalizing, not easing

After swift and compressed rate hiking cycles in the U.S., Europe, and U.K. from 2022-2023, market participants have turned their attention toward the start of rate *cuts*. For 2H2024, we see potential for the start of monetary policy *normalization* in these regions, but not widespread *easing*.

The European Central Bank (ECB) was first to move (in June) with a 25bp rate cut. That said, the Governing Council expressed a desire to preserve optionality regarding the pace of any additional actions beyond that point, due in part to a "bumpy" path for domestic services inflation (driven by elevated wages).

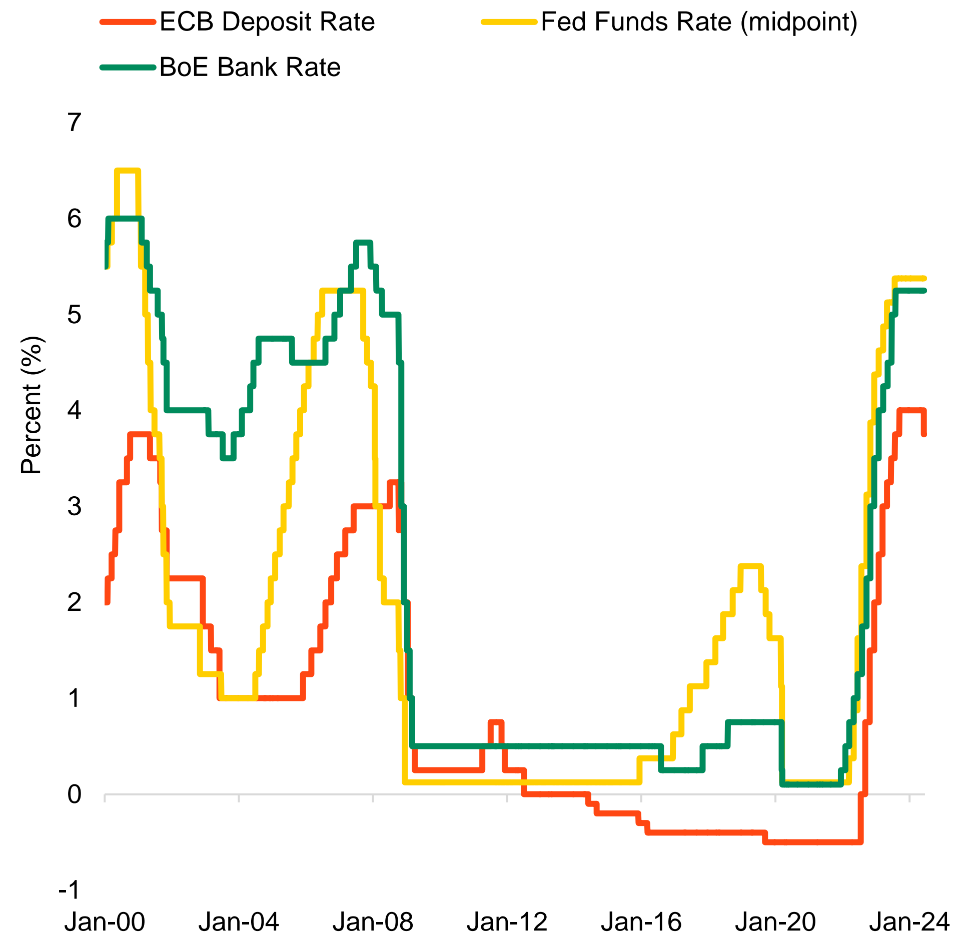
As ECB Executive Board Member Isabel Schnabel highlighted in a May 17th interview with Nikkei, the current policy cycle is unique "in the sense that rate cuts are not meant to counter a looming recession, but rather to gradually withdraw restriction without reigniting inflation." Uncertainty related to where the "natural rate" of interest is in "real time" further underscores the need for a cautious approach, according to Schnabel.

Adding to the call for a patient approach: ECB Chief Economist Philip Lane said that the "bumpy and gradual" improvement on domestic services inflation means that the ECB will "need to be restrictive all year long," such that "firms will think twice about trying to pass on cost increases" (referencing the potential for second-round inflationary effects from elevated wages).

While the Bank of England (BoE) kept rates unchanged at its June meeting, the decision to hold vs. cut was "finely balanced" for some members of the Monetary Policy Committee (per the minutes). The minutes pointed to the August meeting's forecasts to determine "how long Bank Rate should be maintained at its current level."

Exhibit 1: We expect shallow rate cutting cycles, barring a sharp growth downturn

Monetary policy rates for the European Central Bank, Federal Reserve, and Bank of England



Source: BlackRock, European Central Bank, Federal Reserve, Bank of England, Bloomberg. As of June 17, 2024.

We expect a shallow cutting cycle in the U.S.

Relative to Europe (and possibly the U.K.), the U.S. is farther behind in the start of a rate cutting cycle. As shown in Exhibit 2, the expectations for the first rate cut have shifted later as 2024 has progressed, driven by a combination of hotter-than-expected inflation in 1Q2024 and resilient economic data.

That said, after an in-line inflation reading for April, a better-than-expected print for May, and labor market rebalancing (Exhibit 6), we believe the groundwork is forming for at least one 25bp rate cut in 2024 (either in September, or in 4Q2024).

The onus will be on the next few months of inflation data to continue this recent (favorable) pattern, such that the FOMC receives the "greater confidence" it desires before starting to normalize monetary policy.

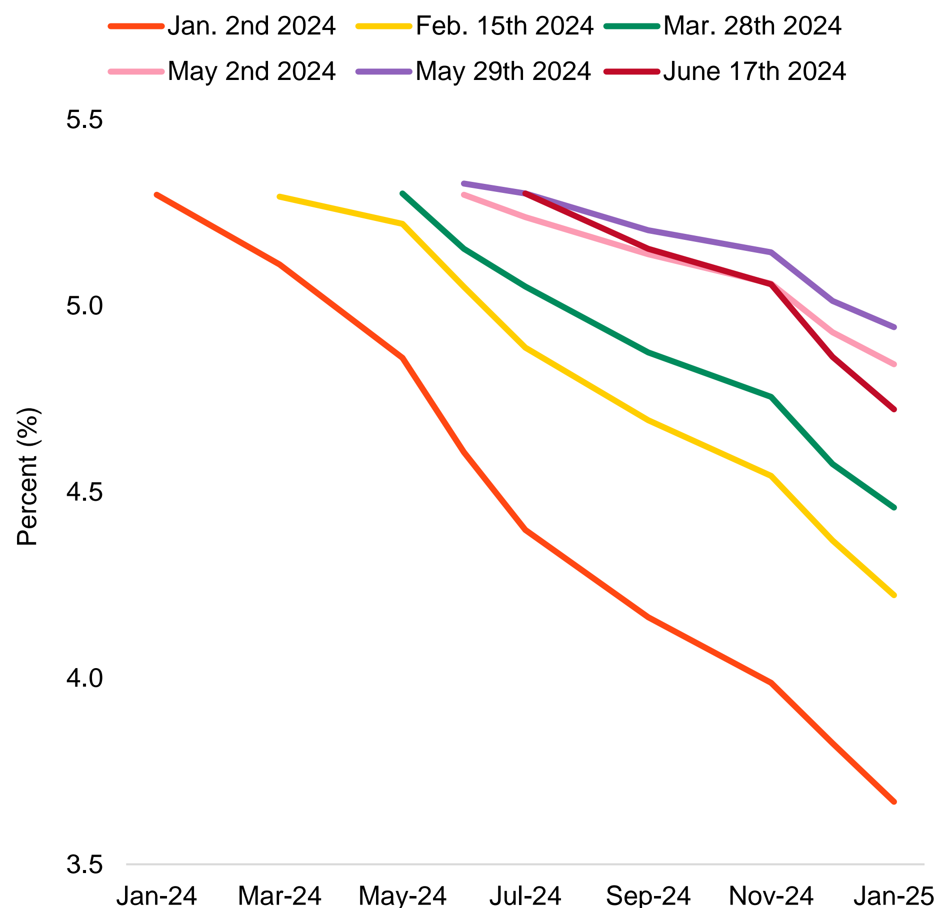
As we have highlighted previously, the *reason* for eventual rate cuts is more important than the *timing*. Rate cuts in response to improving inflation are much more supportive for risk sentiment compared to rate cuts in response to a sharp deterioration in economic activity (or the labor market).

So long as U.S. growth remains at or above trend (note: 2Q2024 real GDP is tracking well above trend, at 3.0% per the Atlanta Fed GDPNow as of June 20th), we continue to expect a "shallow" rate cutting cycle. This makes the prospect of significant, near-term interest rate relief (on consumer and corporate borrowers' debt service costs) unlikely.

But it will also leave "all-in" yields elevated for a range of investors seeking to deploy capital into the corporate credit markets. This will likely keep IG and HY credit spreads range-bound in aggregate (and may even support tightening, as issuance slows through the summer).

Exhibit 2: The U.S. rate market pricing has shifted to reflect "high for longer"

The U.S. policy rate implied by Fed Funds Futures, through early 2025



Source: BlackRock, Bloomberg. As of June 17, 2024. **There is no guarantee that any forecasts made will come to pass.**

Restrictive vs. *sufficiently* restrictive

Given the resilience of economic activity in the U.S., we expect policymakers (and market participants) to remain focused on the transmission of monetary policy, as well as the degree of restrictiveness embedded in the current stance (Exhibit 3).

The "longer run" Federal Funds rate is now 2.8% per the median "dot" in the June 2024 Summary of Economic Projections (SEP) – up from 2.6% as of March 2024, and 2.5% as of December 2023. While Chair Powell pushed back (in the June FOMC press conference) against the relevance of the long-term neutral rate for setting near-term monetary policy, he acknowledged that this drift higher reflects a "view that rates are less likely to go down to their pre-pandemic levels" which were low by historical standards.

Chair Powell also reiterated his prior messaging that while he views the current stance of monetary policy as "restrictive," the question of whether policy is "sufficiently restrictive" is one that will be known over time.

Other Federal Reserve officials, such as Minneapolis Fed President Neel Kashkari, have also questioned the degree of restrictiveness in the current stance of U.S. monetary policy. President Kashkari has pointed, for example, to the resilience of the U.S. housing market.

A large subset of corporate borrowers have also demonstrated resilience to the rate hiking cycles in the U.S. (and Europe). We attribute this to three factors: (1) the supportive growth backdrop, especially in the U.S.; (2) the proactive liquidity raising done in 2020-2021, when rates were very low; and (3) the emergence of the private debt funding channel as another viable option for corporates' borrowing needs, which we view as a positive for financial stability.

Exhibit 3: Financial conditions have eased from local tights in April 2024

Goldman Sachs U.S. Financial Conditions Index

Source: BlackRock, Bloomberg, Goldman Sachs Global Investment Research. As of June 17, 2024.

The interaction between rates and growth

As a result of this backdrop, the interaction between higher rates and economic activity will be paramount in 2H2024. Solid economic growth should allow most of the corporate credit market to continue to navigate the “high for even longer” interest rate environment with relative resilience – extending the trend of the past few quarters.

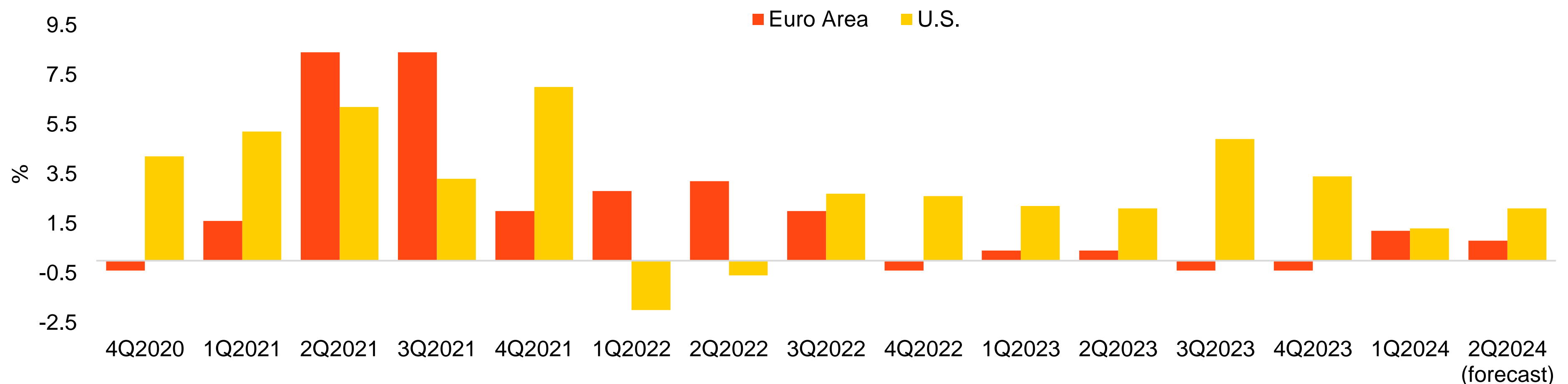
The exception, in our view, will be capital structures with unsustainably high leverage and an inability to grow in a *capital efficient* way, which have already driven modest increases in corporate default rates in the liquid market (discussed later). This underscores the importance of credit and sector selection, in our view, and supports the case for elevated dispersion across asset classes, sectors and issuers.

As Exhibit 4 illustrates, the differences in growth across regions have been notable. In the U.S., growth in 1H2024 has already slowed relative to the exceptionally strong pace of 2H2023. We expect this to continue, but for growth to nonetheless settle at or above trend for 2024.

In Europe, we are optimistic that growth may have turned a corner, owing to improved consumer real incomes and a fading drag from tight monetary policy. That said, economic activity varies sharply by region (Germany has been weak, while Spain has been stronger, for example). Governments’ ability to provide a policy framework for continued growth will be a focus in the wake of the EU and U.K. elections, as will any potential volatility around snap elections in France, especially if there are “spillovers” to the broader Euro Area.

Exhibit 4: The interaction between elevated interest rates and growth will be key, in our view

Quarter-on-quarter real GDP growth (%), seasonally adjusted at an annualized rate



Source: BlackRock, Bloomberg, Bureau of Economic Analysis, Eurostat. 2Q2024 forecasts use the Bloomberg Contributor Composite as of June 17, 2024, for the U.S. and Euro Area.

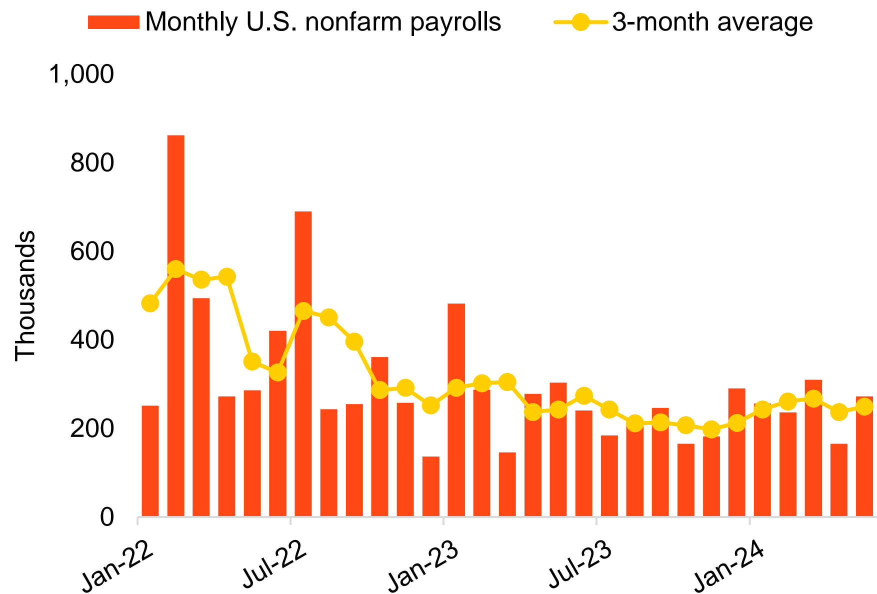
Watching for U.S. labor market softness

At the June FOMC, Chair Powell's prepared remarks acknowledged that "as labor market tightness has eased and inflation has declined over the past year, the risks to achieving our employment and inflation goals have moved toward better balance." As a result, the "reaction function" of the Federal Reserve is now somewhat asymmetric, as it currently guides to holding monetary policy at current levels or cutting rates (and *not* hiking).

The June FOMC statement specifically noted: "If the economy remains solid and inflation persists, we are prepared to maintain the current target range for the federal funds rate as long as appropriate. If the labor market were to weaken unexpectedly or inflation were to fall more quickly than anticipated, we are prepared to respond." During the Q&A, Chair Powell noted that it is an "unexpected deterioration in labor market conditions" that would be most likely to warrant a policy response. While the reference to "unexpected" is not new, the June SEP did reflect a slightly higher projection for unemployment in 2025 (4.2% vs. 4.1% as of the March 2024 SEP).

Exhibit 5: U.S. jobs growth has been solid

Monthly U.S. nonfarm payrolls and the three-month moving average pace of job creation



Source: BlackRock, Bloomberg, Bureau of Labor Statistics. Captures data through May 31, 2024.

Exhibit 6: A narrowing jobs-workers gap

The ratio of U.S. job vacancies to U.S. unemployed workers, both seasonally adjusted

Source: BlackRock, Bureau of Labor Statistics. Captures data through April 30, 2024 (most recent available).

A bifurcated U.S. consumer

Closely related to trends in the U.S. labor market is the health of the U.S. consumer. But just as the corporate credit and commercial real estate markets have experienced elevated dispersion, the U.S. consumer is no exception and remains notably bifurcated – extending the pattern we last revisited in early March.

For example, U.S. consumers in the top 20% of the income distribution generated 39% of U.S. spending and 87% of this group are homeowners (Exhibit 7), indicating many likely benefited from home price appreciation over the past few years (the S&P CoreLogic Case-Shiller U.S. National Home Price Index has increased 49% vs. December 2019).

Meanwhile, the bottom 20% of the income distribution is more likely to rent and generates a much smaller share of aggregate U.S. spending.

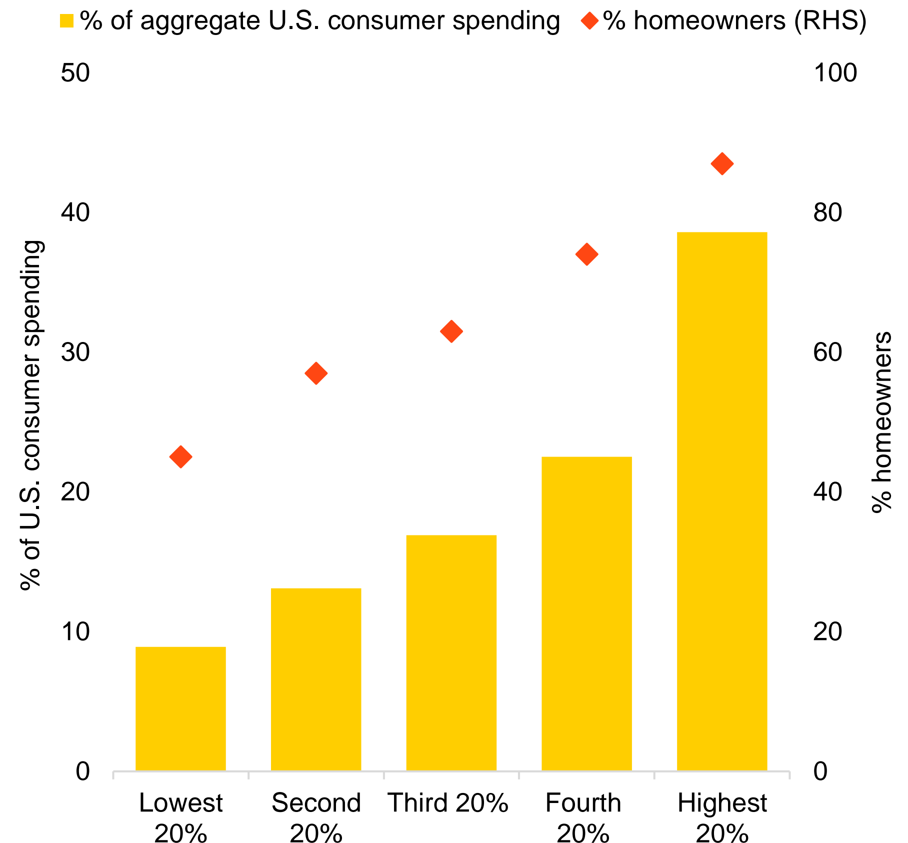
The May 2024 Quarterly Report on Household Debt and Credit from the Federal Reserve Bank of New York (NY Fed) shows a similar trend of bifurcation: the debt of younger borrowers is more heavily skewed towards student and auto loans (Exhibit 8).

Older borrowers, on the other hand, have a larger weight toward housing-related debt (i.e., mortgages, home equity lines of credit).

This helps explain, in our view, some of the "conflicting" data points released about the financial health of the U.S. consumer in recent months (from high-frequency economic data, as well as anecdotal commentary from retailers and U.S. banks during earnings season).

Exhibit 7: The high-end of the U.S. consumer drives spending, more likely to own a home

U.S. annual aggregate expenditures by consumer income quintile, and the share of consumers in each cohort that are homeowners (RHS)



Source: BlackRock, U.S. Bureau of Labor Statistics Consumer Expenditure Survey (September 2023 – most recent available).

Delinquencies: Gradually increasing

While divergence across the income spectrum has always existed, we believe it matters more in the context of the current environment, which has been characterized by gains in assets (i.e., homes, investments) and higher debt burdens (i.e., rates on auto loans and credit cards, higher rent costs). Although some of these trends may be masked at the aggregate level, we believe they will drive elevated dispersion in the credit market in 2H2024 (as firms target different cohorts of consumers with various products and services).

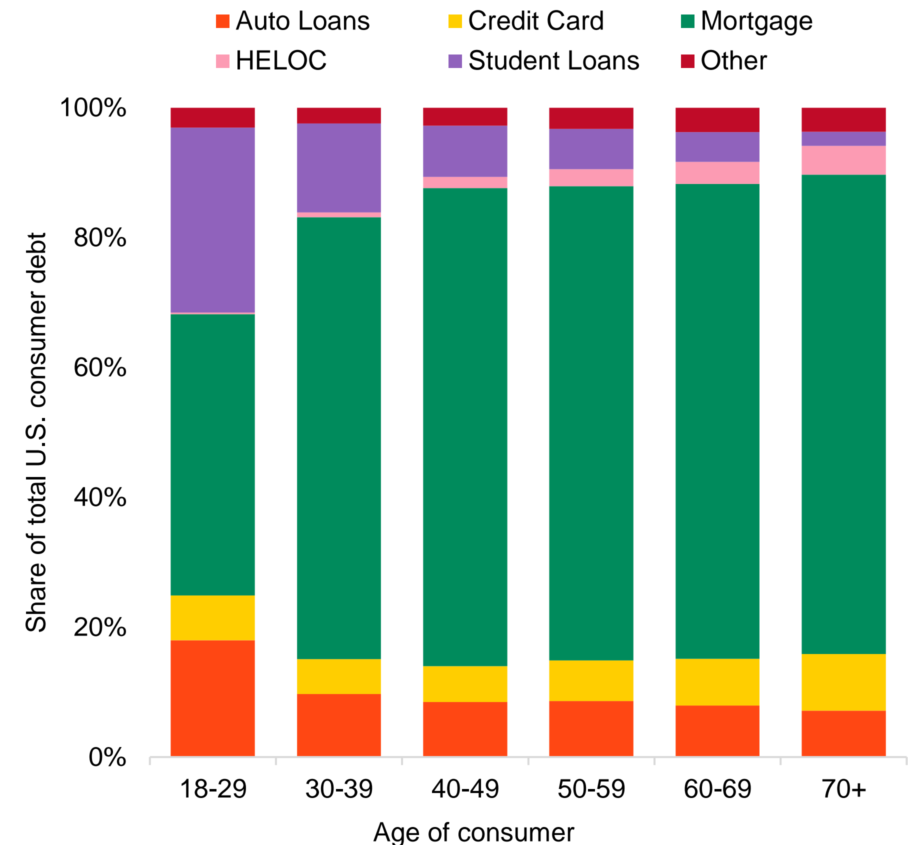
Overall U.S. consumer debt delinquencies have been gradually increasing over the past few quarters, per data from the NY Fed. As of 1Q2024, 1.83% of balances (across all loan types) were 90 days or more delinquent. This compares to the local low of 1.41% as of 4Q2022, and the pre-pandemic level of 3.15% (4Q2019).

The credit card, other (i.e., retail cards and consumer loans) and auto categories have been the main drivers of the recent uptick in overall delinquencies (as shown in Exhibit 9). But student loan delinquencies may revert closer to their long-term trend, once the grace period for late payments expires. (Note: the overall delinquency trend may be somewhat understated, as missed federal student loan payments will not be reported to credit bureaus until 4Q2024, per the NY Fed report).

Another notable takeaway from the NY Fed analysis[1] was the greater share of "maxed out" credit card balances transitioning into delinquency status (Exhibit 10). According to the NY Fed Center for Microeconomic Data, 18% of U.S. borrowers were utilizing at least 90% of their available credit as of 1Q2024 (labeled as "maxed-out borrowers" in the report).

Exhibit 8: Younger borrowers are more likely to have non-mortgage related debt

Percentage share of total U.S. consumer debt share by product type and age



Source: BlackRock, New York Fed Consumer Credit Panel/Equifax. As of 1Q2024. HELOC = home equity line of credit. The "Other" category includes retail cards and other consumer loans. (1) Andrew F. Haughwout, Donghoon Lee, Daniel Mangrum, Joelle Scally, Wilbert van der Klaauw, and Crystal Wang, "Delinquency Is Increasingly in the Cards for Maxed-Out Borrowers," Federal Reserve Bank of New York Liberty Street Economics, May 14, 2024.

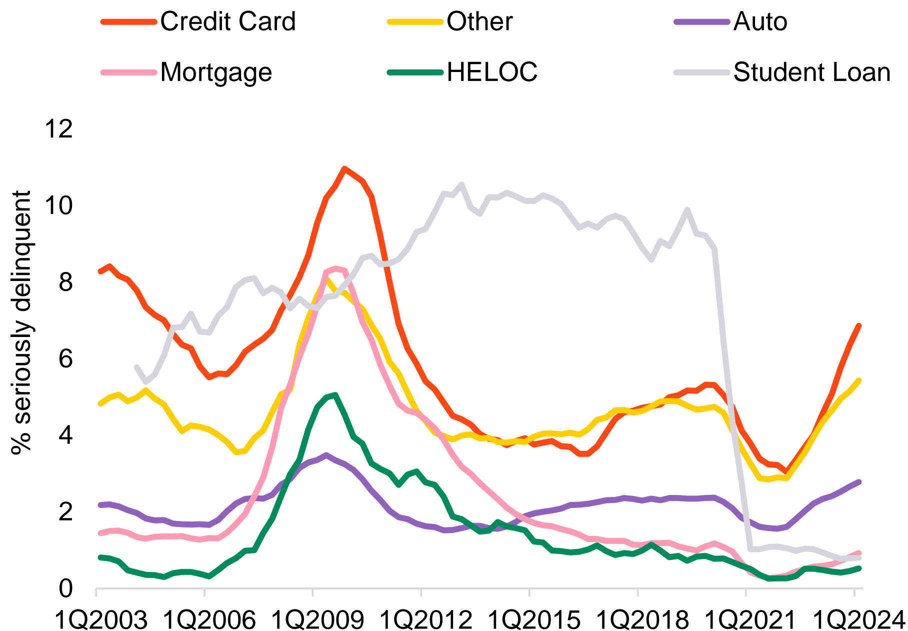
More “maxed out” borrowers

Here too, the theme of bifurcation is evident: that same analysis showed that 52% of consumers utilized less than 20% of their available credit. A large portion of “maxed-out” borrowers – but not all – are already delinquent. When isolating non-delinquent loans, the NY Fed found that “maxed-out borrowers” represented 9% of total borrowers and 16% of total balances. This compares to 2019 average levels of 10% and 16%, respectively.

With near term interest rate relief unlikely, we expect consumer debt delinquencies will continue to trend higher, driven by lower-income and younger borrowers. That said, so long as the labor market remains relatively firm, the increase in delinquencies is likely to be moderate, in our view.

Exhibit 9: Delinquency rates are not uniform

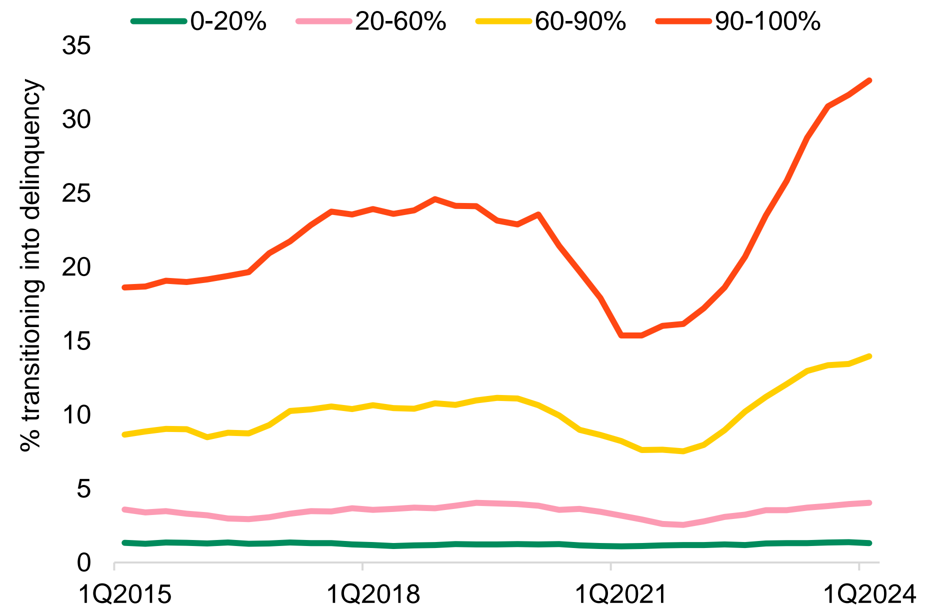
Percentage of seriously delinquent (i.e., 90 or more days delinquent) U.S. consumer debt balances, by type



Source: BlackRock, New York Fed Consumer Credit Panel/Equifax. As of 1Q2024. Note: HELOC = home equity line of credit. “Other” category includes retail cards and other consumer loans. Student loan data are not reported prior to 2004 due to uneven reporting.

Exhibit 10: “Maxed out” delinquency rates

Percent of balances transitioning into delinquency by borrower utilization rate



Source: BlackRock, New York Fed Consumer Credit Panel/Equifax. As of 1Q2024. Note: The chart shows balance-weighted transition to 30-day credit card delinquency among borrowers current on all accounts in the previous quarter. A borrower’s group is determined by their utilization in the previous quarter. Data are smoothed as four-quarter moving sums to account for seasonal trends.

U.S. elections: Considerations for credit

With the November 5th, 2024, U.S. Presidential election now less than five months away, market participants are increasingly focused on the potential impacts to the macroeconomic landscape and, by extension, the corporate credit market.

The Republican (former President Trump) and Democratic (President Biden) presumptive candidates are somewhat "known" to the markets in terms of their policy priorities in past and current administrations, respectively. That said, we see scope for such policy priorities to evolve in response to the unique backdrop, which includes: the large fiscal deficit in the U.S. (Exhibit 11), the timing of upcoming personal tax cut expirations (year-end 2025), and elevated geopolitical tensions.

As we highlighted earlier this year, we view these five areas as most important for corporate credit investors to monitor, as more clarity on the candidates' policy priorities emerges:

(1) potential changes to corporate tax policy, although the impact is likely to be nuanced, similar to the 2017 experience with the various provisions of the Tax Cuts and Jobs Act.

(2) the possibility of new tariffs on imports, and how any additional tariff revenue may be spent (i.e., deficit reduction and/or personal tax cuts).

(3) any changes in discretionary non-defense fiscal spending

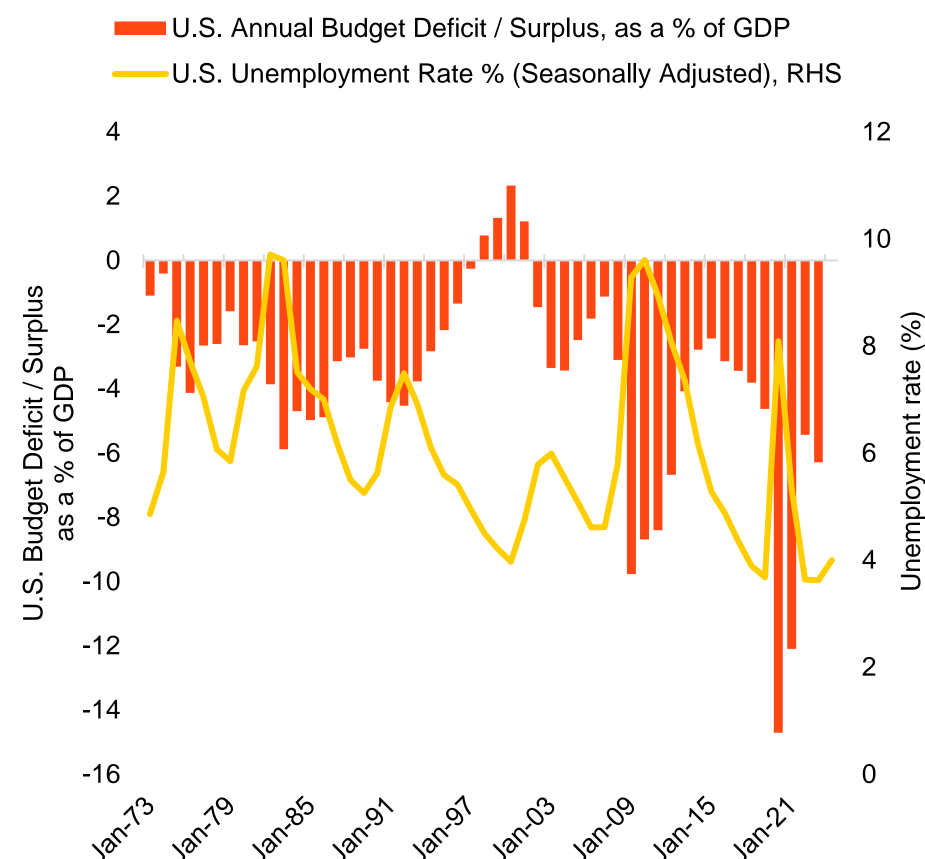
(4) any new developments related to regulation and anti-trust, and

(5) policies related to legal immigration, which may impact the supply of labor in the U.S.

Sector composition across the credit landscape is likely to garner increased importance over the next several months, in our view. The upcoming debates will be key for more insight.

Exhibit 11: The current U.S. budget deficit exists despite low unemployment

The U.S. annual budget deficit (or surplus, if positive) as a percent of U.S. annual gross domestic product (GDP), compared to the U.S. unemployment rate at each calendar year-end (RHS)



Source: BlackRock, Congressional Budget Office, Bureau of Labor Statistics. Historical data (including deficit as a percentage of GDP and unemployment rate) is as of each annual period. U.S. unemployment rate in 2024 is as of May 31, 2024 (most recent available).

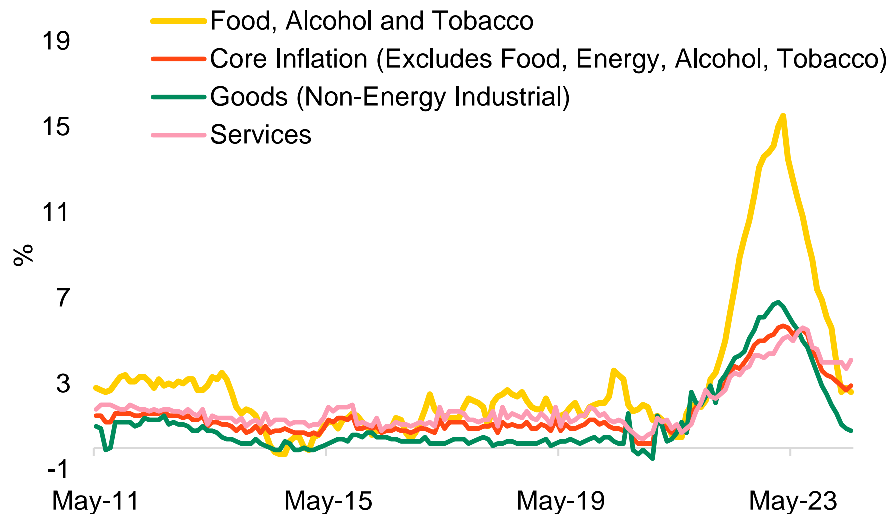
Wages in the Euro Area are still elevated

In the Euro Area, the metric we will be watching most closely in 2H2024 (beyond overall growth) is wages. Growth in compensation per employee has been elevated in the Euro Area since 2021 and reached 5.2% in 2023 – the highest annual rate since the start of the Euro. Wages can impact inflation through boosting demand (i.e., if consumers earn more, they may spend more) and input cost channels (i.e., firms may need to raise prices to "pass through" a higher cost of labor, otherwise margins could deteriorate).

According to the ECB, collective wage bargaining in the Euro Area covers approximately 80% of total employees. As a result, negotiated wages (Exhibit 13) are an important input into the overall compensation per employee calculation and are a key driver of wage growth trends in the Euro Area over the medium term. The trend for wage growth in the Euro Area will be important to monitor in coming quarters, but progress is likely to be gradual. Indeed, the ECB does not expect labor costs to normalize until 2026, consistent with a "multi-year adjustment process for wages."

Exhibit 12: Progress on inflation has stalled in some pockets of the Euro Area economy

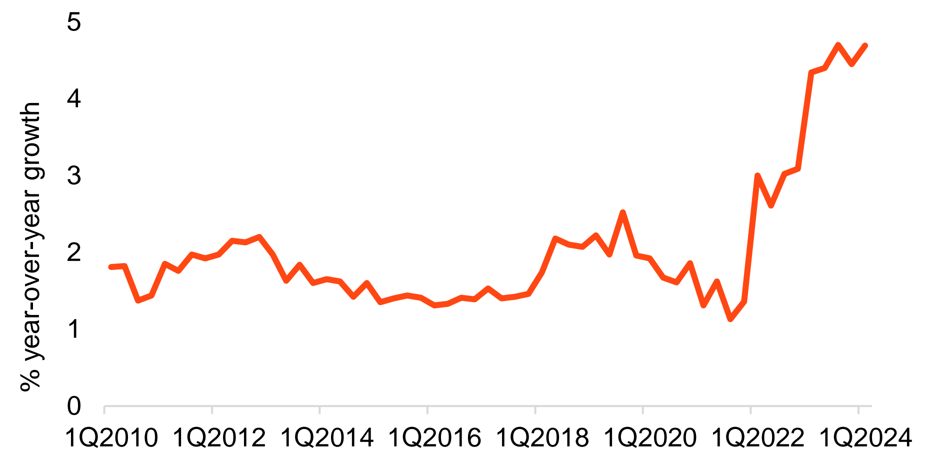
Year-over-year inflation (not seasonally adjusted) for Euro Area, by category



Source: BlackRock, Eurostat, Bloomberg, European Central Bank. Captures inflation data through May 2024 (latest available).

Exhibit 13: Negotiated wages are still elevated, which is keeping services inflation sticky

Year-over-year percentage change in Euro Area negotiated wages, per the ECB's wage tracker



Source: European Central Bank, BlackRock, Bloomberg. As of 1Q2024 (most recent). Note: Developments in negotiated wages can be monitored by the ECB's indicator of Euro Area negotiated wage growth, which has been compiled since 2001 and is based on data from nine countries: Belgium, Germany, Spain, France, Italy, Netherlands, Austria, Portugal and Finland. The indicator is published on a quarterly basis and includes structural wage increases as well as one-off payments.

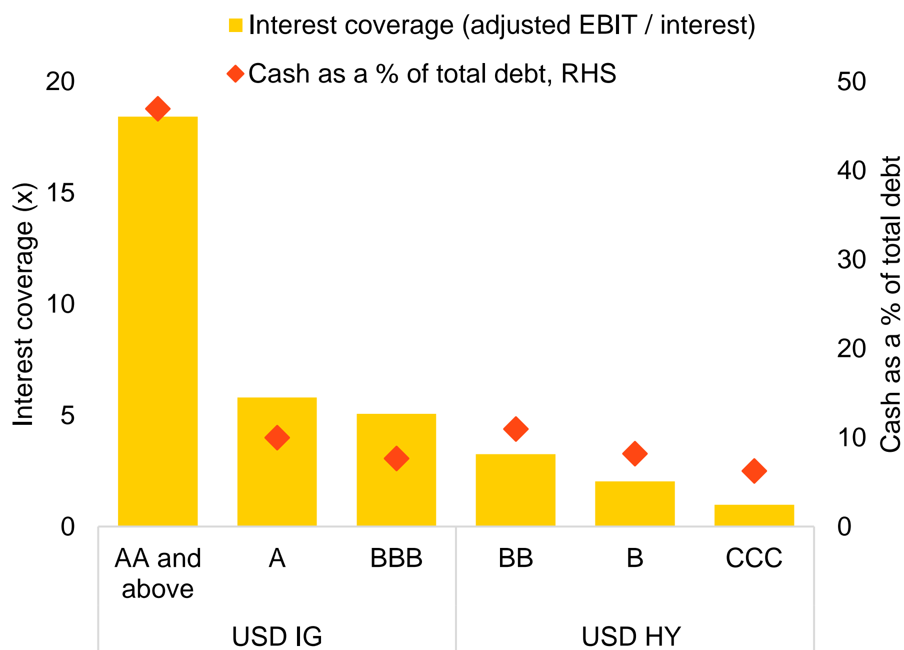
Dispersion in credit fundamentals

While corporate credit has navigated the "high for longer" backdrop with relative resilience, dispersion (in performance and fundamentals) has been evident under the surface. As Exhibits 14 and 15 illustrate, fundamental dispersion is clear across the various rating cohorts in the USD and EUR corporate credit markets. While ratings are an imperfect proxy for fundamental strength (as they can "react" to both positive and negative developments with a time lag), the comparison across the rating buckets is nonetheless informative.

For example, and as we discuss later, CCCs have lagged the overall spread tightening at the USD HY index level (Exhibit 18) – a pattern we expect to persist over the medium term, owing to this (highly idiosyncratic) group's limited financial flexibility (Exhibits 14 and 15).

Exhibit 14: USD credit fundamentals

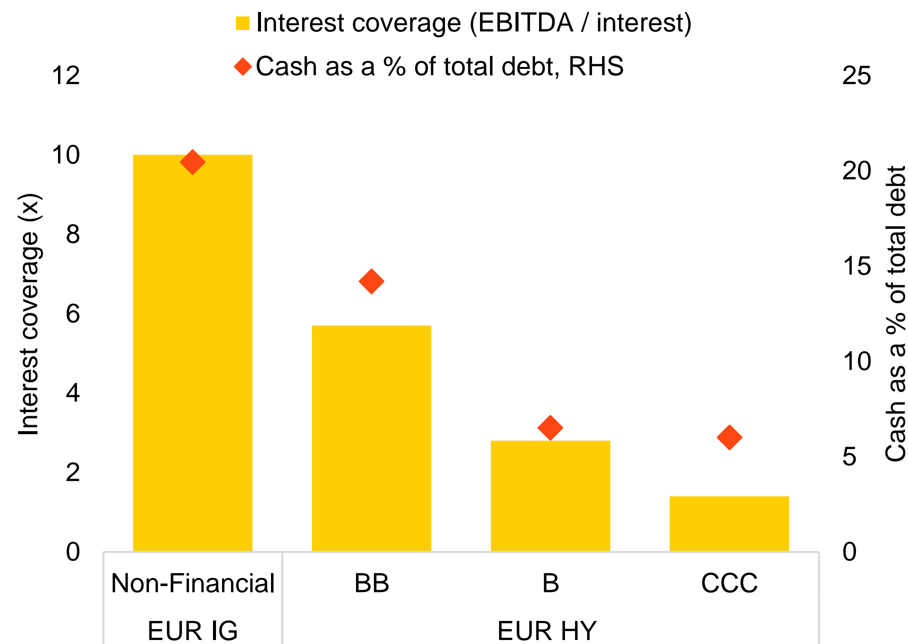
Median fundamental credit statistics (coverage and liquidity ratios), for the companies included in each rating-specific cohort of the Bloomberg USD IG and HY Corporate indices



Source: BlackRock, Bloomberg. Income statement metrics such as interest coverage ratios are shown for the trailing 12 months ended 1Q2024. Balance sheet metrics such as cash / total debt are shown as of 1Q2024.

Exhibit 15: EUR credit fundamentals

Trimmed mean (excludes bottom 10% and top 10%) credit statistics (coverage and liquidity ratios), for the companies included in each rating-specific cohort of the Bloomberg EUR IG and HY Corporate indices



Source: BlackRock, Bloomberg. Income statement metrics such as interest coverage ratios are shown for the trailing 12 months ended 1Q2024. Balance sheet metrics such as cash / total debt are shown as of 1Q2024.

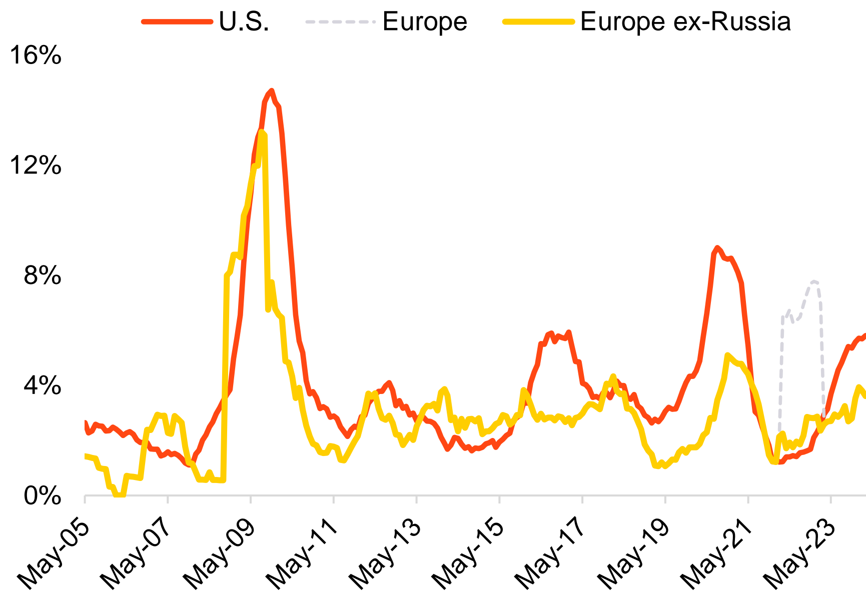
Defaults: Searching for a plateau

With the Federal Reserve on hold with its current monetary policy stance, many market participants have been bracing for a wave of financial stress among speculative grade corporate borrowers. Recent data has been encouraging, however, pointing to early signs of a plateau in default activity (Exhibits 16 and 17), as well as a modest improvement in recovery rates over the past few months. In 3Q2024, we will be watching for further confirmation that defaults have indeed peaked.

We continue to expect an investing landscape characterized by dispersion, but not widespread market disruption. That said, two factors underpin this view and will be important for corporate credit investors to monitor: (1) the global growth backdrop (especially in the U.S.), which will need to remain slightly above or at trend, to allow corporates to absorb elevated debt servicing costs, and (2) the USD HY and loan primary debt markets, which will need to remain amenable to refinancing from lower-rated issuers.

Exhibit 16: Signs of a peak in default activity

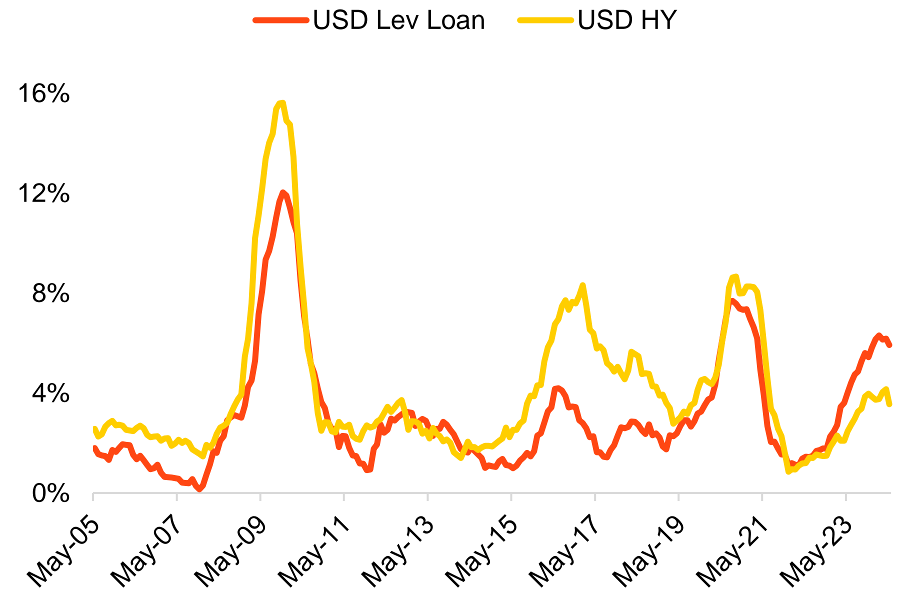
Speculative-grade, issuer-weighted, trailing 12-month default rates for HY and leveraged loan issuers (combined) in the U.S. and Europe



Source: Moody's, BlackRock. As of May 31, 2024. The increase in defaults in the EUR market in early 2022 reflects the defaults of Russian issuers following the onset of the Russia-Ukraine war.

Exhibit 17: Loan defaults still outpace HY

Trailing 12-month, issuer-weighted default rates (%) for the universe of USD HY bonds and leveraged loans tracked by Moody's



Source: BlackRock, Moody's. As of May 31, 2024 (most recent available).

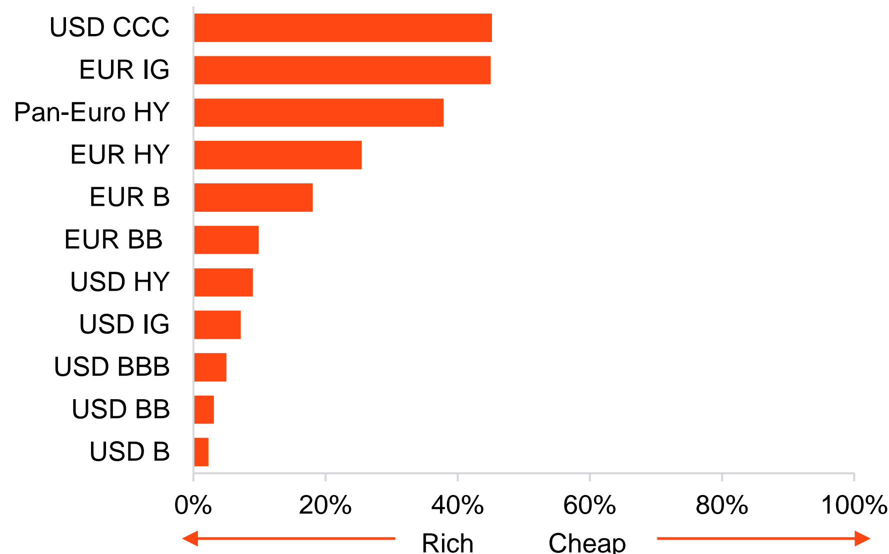
Yield vs. spread relative value “tug-of war”

When discussing relative value in corporate credit over the past several quarters (since the start of the rate hiking cycles in the U.S. and Europe), an emerging relative value “disconnect” has been top of mind for many market participants. Spreads across most rating cohorts appear tight by historical standards (Exhibit 18), especially in the USD market. The exception is in the USD CCC-rated universe, where spreads have lagged the overall tightening at the index level for USD HY (again, a function of this group’s more limited financial flexibility).

Meanwhile, all-in yields for most corporate credit subsets screen as attractive (Exhibit 19) due to the boost provided by the risk-free rates. This has resulted in diverging views related to relative value from the perspectives of spread-based buyers and yield-based buyers, which we believe is likely to persist into 2H2024. So long as any future increases in sovereign yields are relatively orderly and driven by stronger growth (as opposed to reaccelerating inflation), we believe it could catalyze additional yield-based demand for corporate credit.

Exhibit 18: Spreads are relatively tight…

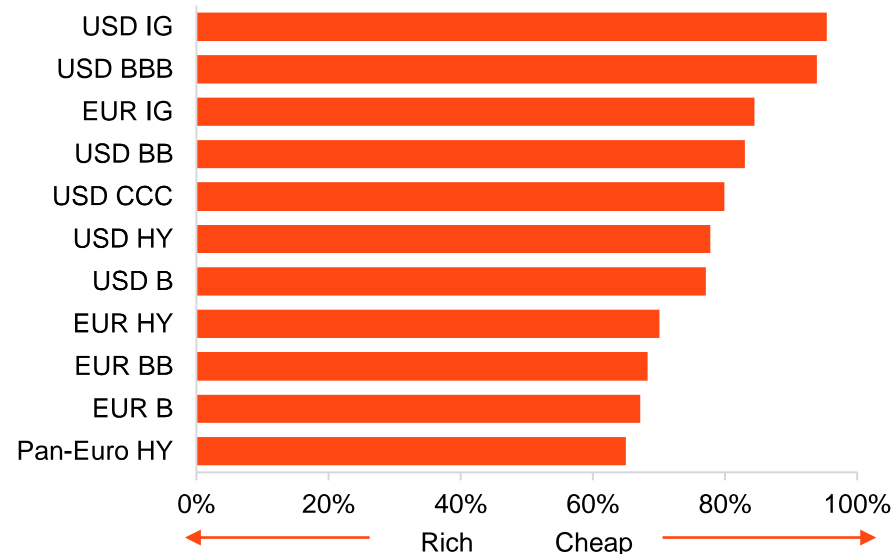
Percentile rank of daily index-level corporate bond spreads since January 1, 2010



Note: Captures option adjusted spread data through June 17, 2024.

Exhibit 19: …but yields are more attractive

Percentile rank of daily index-level corporate bond yields since January 1, 2010



Note: Captures yield-to-worst data through June 17, 2024.

For both charts: Source: BlackRock, Bloomberg, ICE-BAML. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

Income and yield are primary considerations

Given the backdrop of tight spreads and elevated all-in yields, we believe capital allocated to USD and EUR corporate credit in 2H2024 should primarily be based on income and yield (i.e., "carry") and not total return. Material, sustained, near-term declines in interest rates (at the policy-sensitive front-end, as well as at the long-end) are not our base case, due to the interaction of growth, inflation, monetary policy and fiscal considerations. This is especially relevant in the USD market where fiscal deficits are large (the Congressional Budget Office raised its 2024 deficit projection to $2 trillion in mid-June) and the rate cutting cycle is likely to be gradual.

Similarly, given the current valuations of spreads (Exhibit 21), we are not expecting significant, outright spread tightening from here. Both factors limit the scope for sizable absolute total returns. But there is still an attractive opportunity for yield-based investors to capture attractive all-in yields (Exhibit 20), relative to the historical pattern.

Exhibit 20: Yields are elevated vs. history

Yield-to-worst (%) for the Bloomberg USD IG and HY Corporate indices

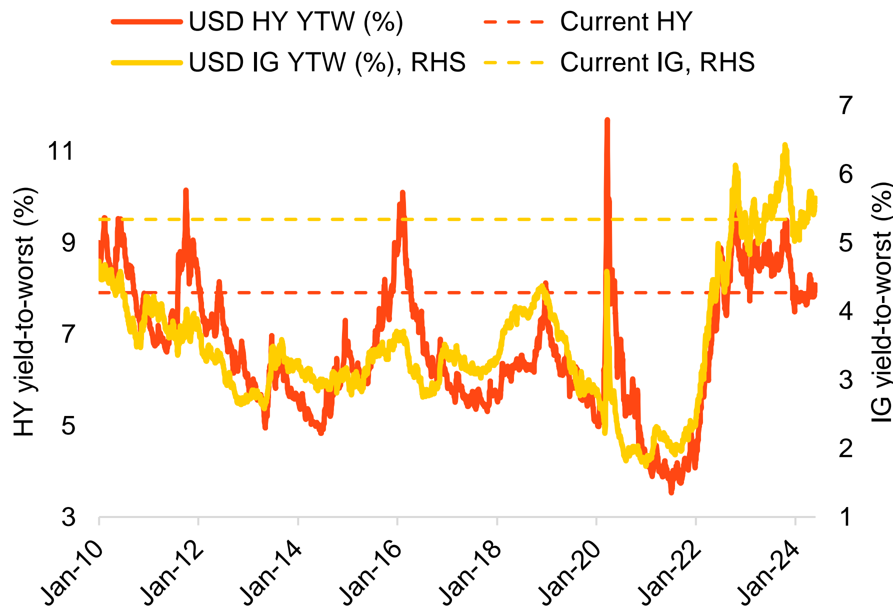
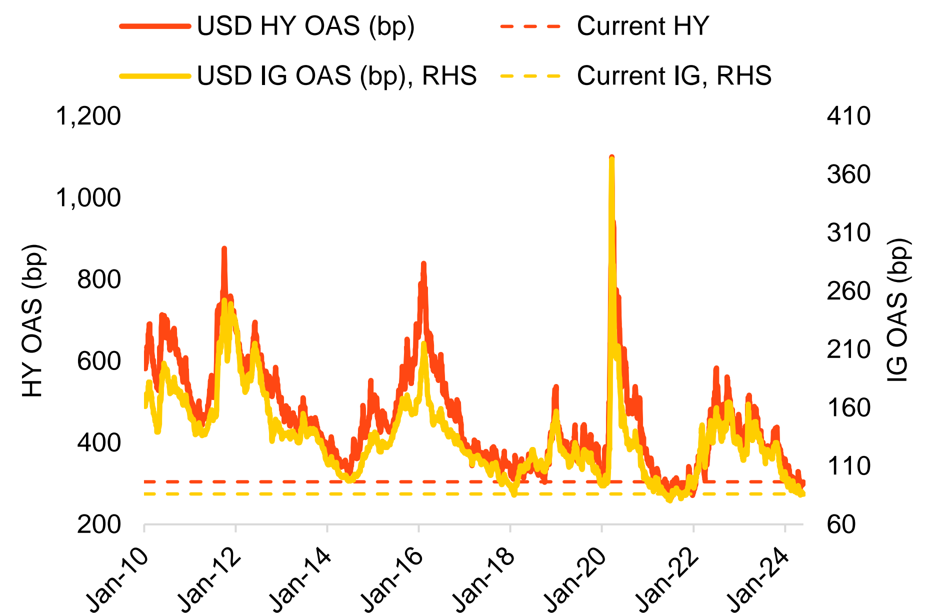


Exhibit 21: Spreads are tight vs. history

Option adjusted spreads (OAS, bp) for the Bloomberg USD IG and HY Corporate indices



For both charts: Source: BlackRock, Bloomberg. As of June 17, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

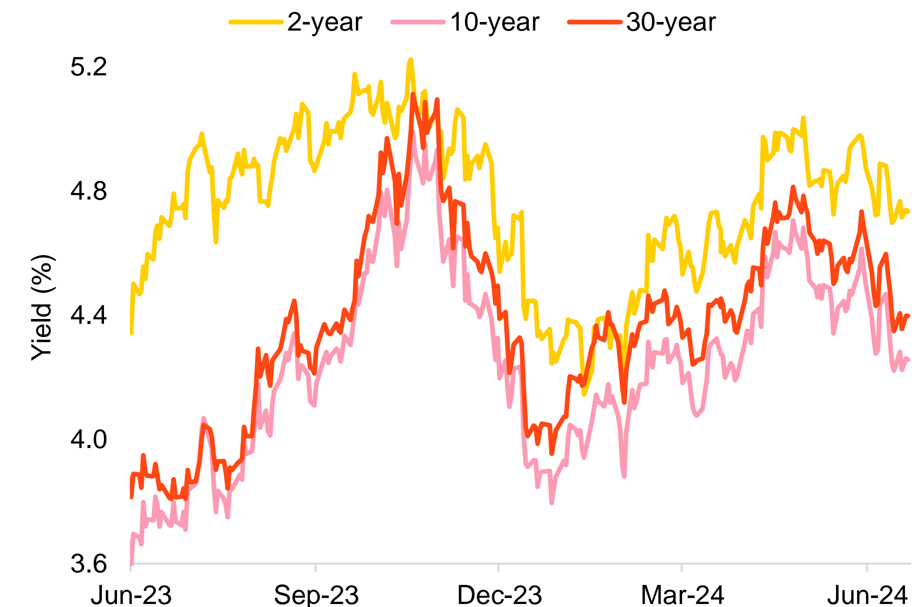
Duration in USD corporate credit

Away from coupons, volatility in rates (Exhibit 22) – as opposed to spread movements – has been a more pronounced driver of total returns in corporate credit over the past several months, and we expect this to remain the case in 2H2024. While higher U.S. Treasury yields have attracted yield-based demand for USD corporate credit, they have also mechanically weighed on total returns for longer-duration assets.

Exhibit 23 illustrates the role that duration has played in total return performance. The Bloomberg USD IG index (average duration of 6.9 years), outperformed in late 2023 as Treasury yields fell (again, Exhibit 22). But with a 0.17% total return so far this year, USD IG has lagged its shorter-duration HY peer (3.1 years), which generated a 2.54% total return (as of June 21st). Meanwhile, the Morningstar/LSTA USD Leveraged Loan Index (a floating rate asset class) outperformed both, generating a 4.2% total return so far this year.

Exhibit 22: U.S. rate volatility

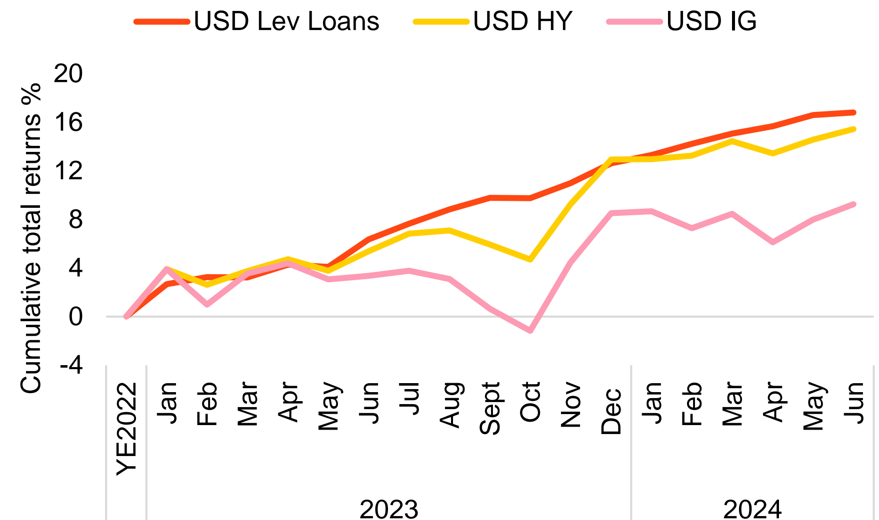
Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)



Source: BlackRock, Bloomberg. As of June 21, 2024.

Exhibit 23: Total return performance

Cumulative monthly total returns (%) for the Morningstar/LSTA USD Leveraged Loan Index, the ICE-BAML USD HY Corporate Index, and the ICE-BAML USD IG Corporate Index



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD, ICE-BAML, Bloomberg. Captures data through June 21, 2024 (most recent). **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

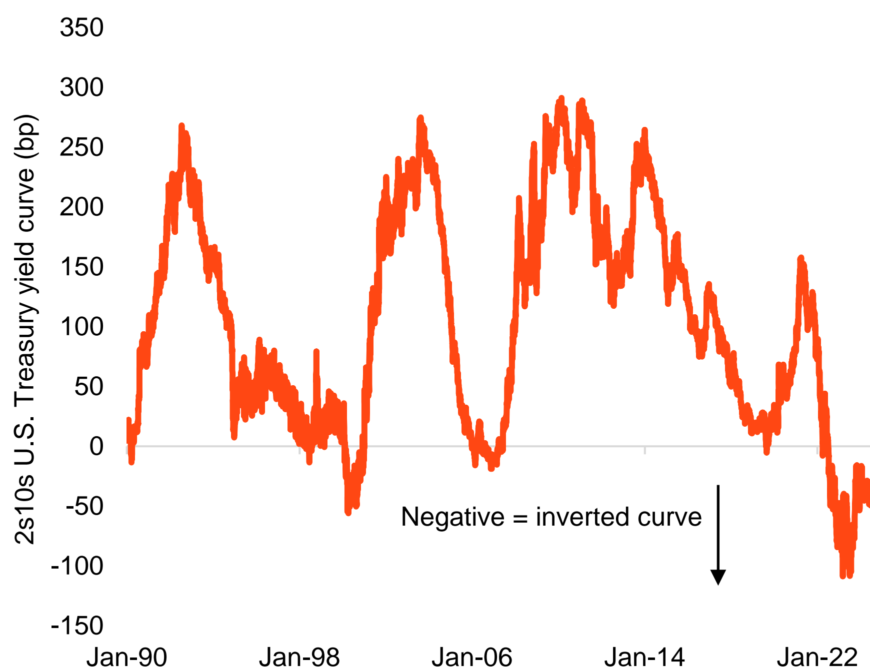
Curve positioning, and floating vs. fixed

In 2H2024, two decisions will likely be top of mind for asset allocators, as they have been for the past few quarters: (1) curve positioning, given the inverted U.S. Treasury yield curve (Exhibit 24) and (2) fixed vs. floating rate coupon exposure, given the "yield pick-up" available in USD leveraged loans vs. fixed-rate USD HY bonds (Exhibit 25).

Given our expectation for a shallow and gradual Federal Reserve rate cutting cycle, we expect the U.S. Treasury curve inversion will persist over the medium term, which still leaves us preferring short- and intermediate-term exposures, over their longer-duration peers. And while there are sector and rating compositional differences between leveraged loans and HY bonds to consider, the relative value relationship still skews in favor of loans – at least from a yield perspective. That said, the supportiveness of the U.S. growth backdrop will remain paramount, as not every floating rate issuer is equipped to navigate this "high for longer" backdrop from a fundamental standpoint.

Exhibit 24: An inverted yield curve

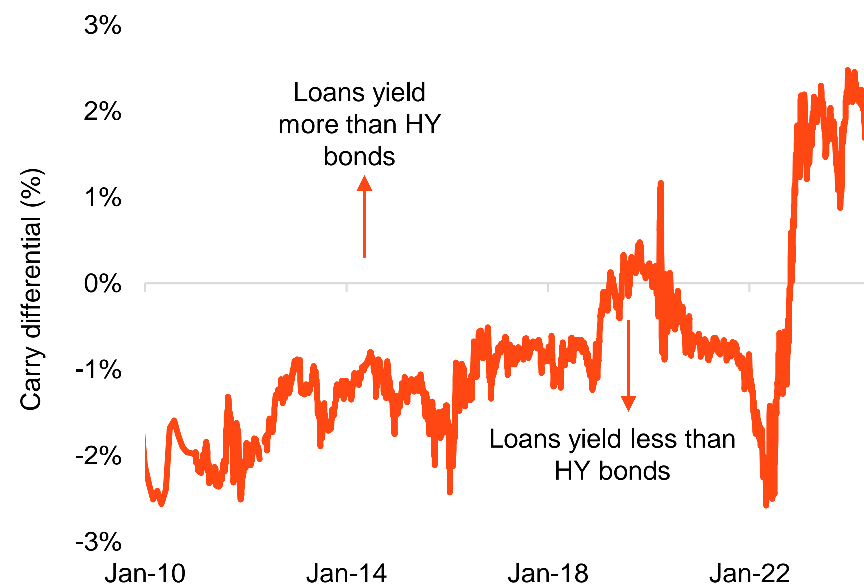
U.S. Treasury yield curve, in bp: 10-year maturity minus 2-year maturity



Source: BlackRock, Bloomberg. As of June 24, 2024.

Exhibit 25: Loans offer a yield "pick-up"

Yield differential (%): B-rated leveraged loans minus B-rated HY bonds



Source: BlackRock, Pitchbook LCD, Morningstar/LSTA, ICE-BAML. As of June 17, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

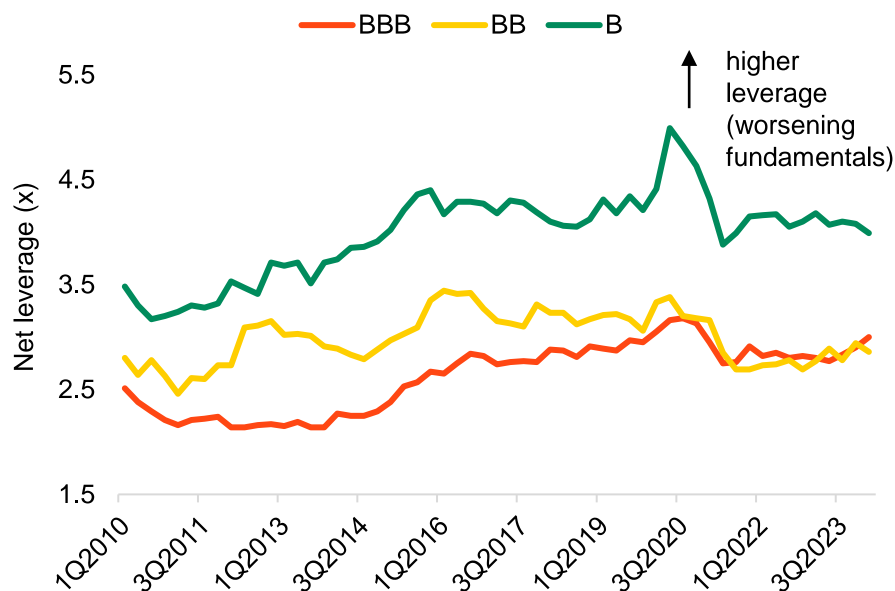
Stable leverage, pressured interest coverage

The fundamental trend across USD corporate credit over the past several quarters has largely been characterized by stable leverage but worsening interest coverage, as Exhibits 26 and 27 illustrate. The key driver of the deterioration in interest coverage metrics is, of course, the higher rate environment. As low-coupon debt issued between mid-2020 and early 2022 is refinanced into the current (higher) interest rate environment, fixed-rate borrowers are incurring higher debt service costs.

But in most cases, this has been a very manageable headwind. A combination of factors are underpinning this result, including the solid economic growth backdrop, the receptive market tone and corresponding investor appetite for new issues, and tight spreads (which factor into the cost of debt capital, alongside rates). Barring a sharp downturn in economic activity in 2H2024, this leaves us comfortable with our expectation for dispersion in the USD corporate credit market – not widespread market disruption.

Exhibit 26: Leverage has been stable

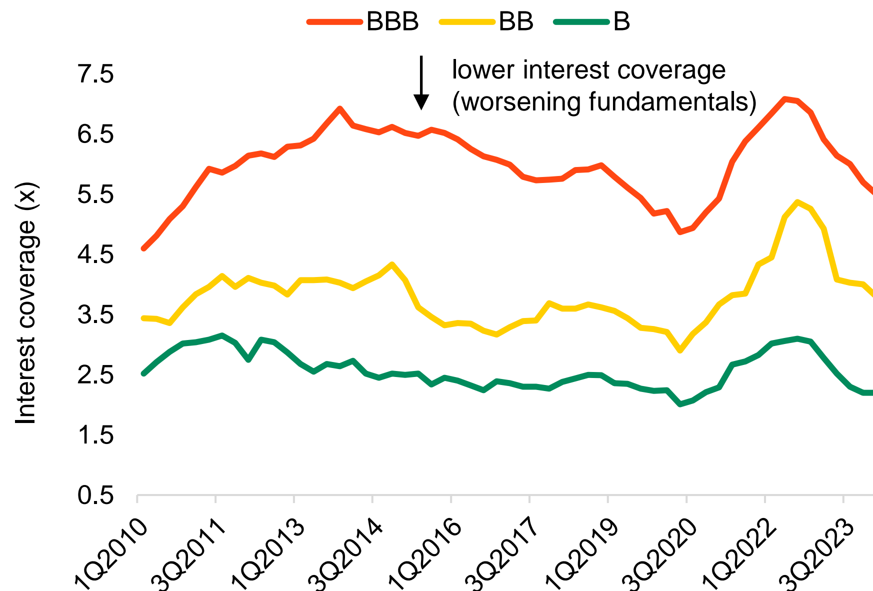
Trimmed mean (excludes the bottom 10% and top 10%) net leverage for BBB, BB and B rated issuers in the Bloomberg USD Corporate Indices



Source: BlackRock, Bloomberg. Net leverage is defined as: (Debt - Cash) / LTM EBITDA. Data as of 1Q2024 (most recent available). LTM = last twelve months.

Exhibit 27: Coverage has moved lower

Trimmed mean (excludes the bottom 10% and top 10%) interest coverage for BBB, BB and B rated issuers in the Bloomberg USD Corporate Indices



Source: BlackRock, Bloomberg. Interest coverage is defined as LTM EBIT / LTM Interest Expense. Data as of 1Q2024 (most recent available). LTM = last twelve months.

Early signs of improvement in loan metrics

In contrast to their fixed rate peers who are encountering higher borrowing costs only *if and when* they refinance low coupon debt, USD leveraged loan issuers have been managing a higher cost of debt since the Federal Reserve began its rate hiking cycle in March 2022, as their floating rate loans moved higher in tandem with the policy rate (presuming no rate hedges). This unsurprisingly weighed on interest coverage metrics over the past few quarters (Exhibit 29), despite stable leverage (Exhibit 28). But recent data suggests the trend might be stabilizing, as shown below.

So called "outer edge" credit metrics have also improved as of late, according to data compiled by Pitchbook LCD. For example, the share of USD leveraged loan issuers (with public financials) that had leverage (debt/EBITDA) greater than 7x declined to 16% in 1Q2024 (the lowest since 2019 and down from 20% in 3Q2023). Over the coming quarters, we will be looking for further confirmation of that trend, as borrowers continue to navigate this elevated cost of capital environment without near-term prospects for significant base rate relief.

Exhibit 28: Slight improvement in leverage...

Leverage (Total Debt / LTM EBITDA) for a sample of issuers in the Morningstar/LSTA USD Leveraged Loan Index that publicly file financial results; based on issuer count

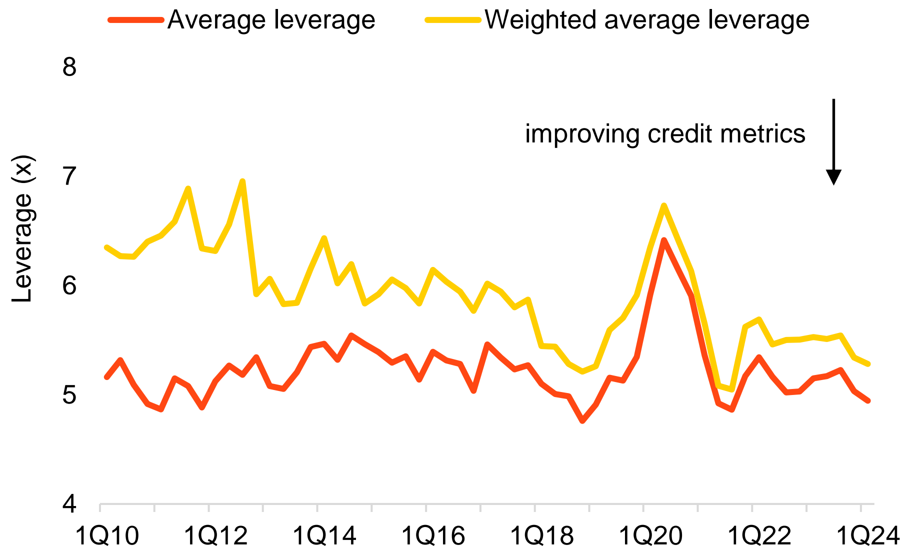
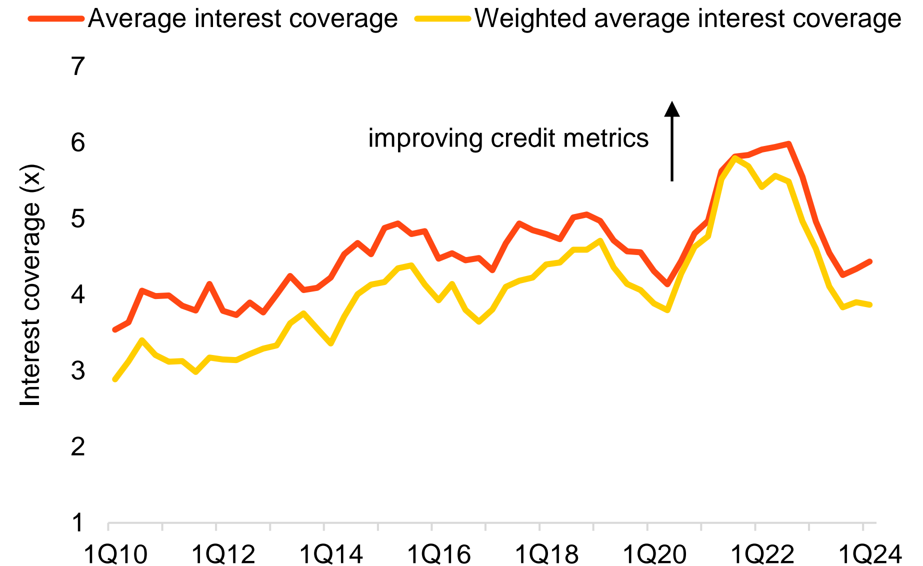


Exhibit 29: ...and for coverage

Interest coverage (LTM EBITDA / LTM interest) for a sample of issuers in the Morningstar/LSTA USD Leveraged Loan Index that publicly file financial results; based on issuer count



For both charts: Source: BlackRock, Pitchbook LCD, Morningstar/LSTA. As of 1Q2024 (most recent). LCD's sample for 1Q2024 included 158 issuers (with a total of $174 billion outstanding in the index). This sample accounted for 13% of the index by par value, which is a subset of all issuers with public financials. LTM = last twelve months.

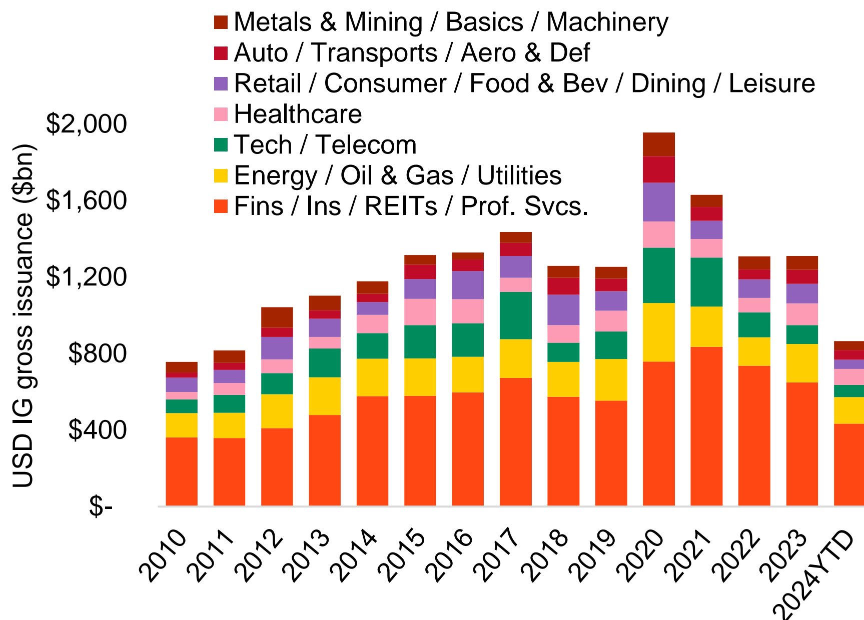
Receptivity for refinancing will be key

The USD IG and HY primary markets have been very active in 1H2024, on track to notably outpace 2023 volumes (Exhibits 30 and 31). Beyond these absolute issuance levels, two factors have been important for corporate credit risk sentiment. First, most of the year-to-date USD HY issuance has been earmarked for refinancing (Exhibit 31), resulting in modest amounts of "new money" to absorb. (The same has been true in the syndicated leveraged loan market, where we recently flagged a deficit of new supply relative to demand). Our review of deal level data from Dealogic and Bloomberg indicates some HY borrowers are addressing late 2025 and 2026 maturities.

Second, the syndicated HY market has been open to lower-rated issuers (i.e., B- and CCC) in 1H2024 – a sharp reversal from the more selective tone which prevailed for much of 2H2023. This will be important to monitor in 2H2024, as the receptive capital markets are a key factor underpinning our expectation for default activity to show continued signs of improvement (again, Exhibits 16 and 17).

Exhibit 30: The sector mix of USD IG supply

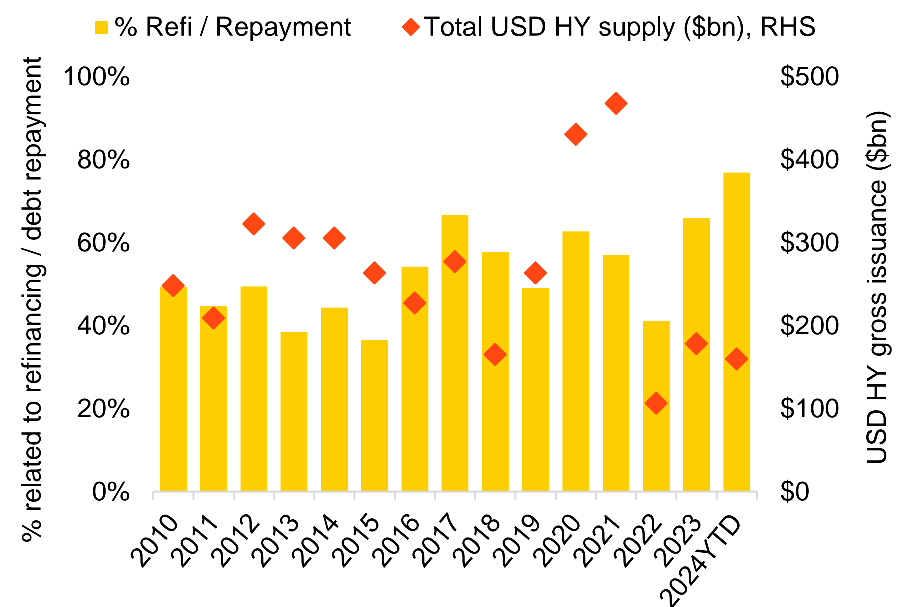
USD IG gross issuance by sector, as captured by the Dealogic "deal industry group"



Source: BlackRock, Dealogic (ION Analytics). Excludes Holding Companies, Closed End Funds, and Government. As of June 17, 2024.

Exhibit 31: 77% of YTD USD HY supply is for refi

USD HY gross issuance and the share earmarked for debt repayment/refinancing, per Dealogic "primary use of proceeds"



Source: BlackRock, Dealogic (ION Analytics). As of June 17, 2024.

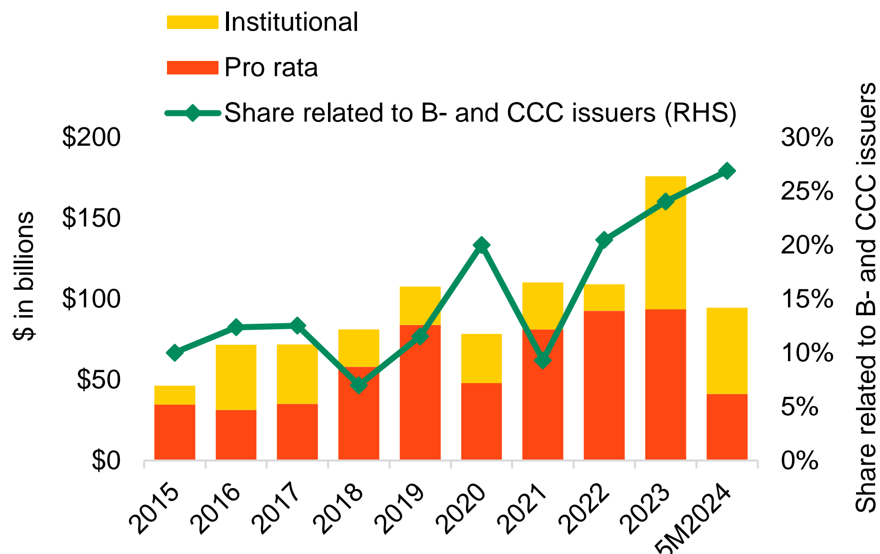
CLO demand meets heavy USD loan supply

In the syndicated market, institutional leveraged loan issuance of $288 billion (as of June 24th) is up 182% vs. the same time in 2023, per data from Pitchbook LCD. This record setting pace has been driven by refinancing activity (and to a lesser extent, M&A). Collateralized loan obligation (CLO) creation of $99 billion year-to-date – which has increased 88% vs. 2023 and is on track to surpass the prior record set in 2021 – has provided ample demand for this leveraged loan issuance (Exhibit 33).

Amend-and-extend activity – which allows borrowers to extend the maturity of an existing loan without repricing the entire facility – in the USD leveraged loan market reached $94.5 billion through the end of May 2024. As Exhibit 32 shows, this has already surpassed the full-year totals of 2014-2018 and 2020.

Exhibit 32: Lower-rated borrowers capture more share of amend-and-extend activity

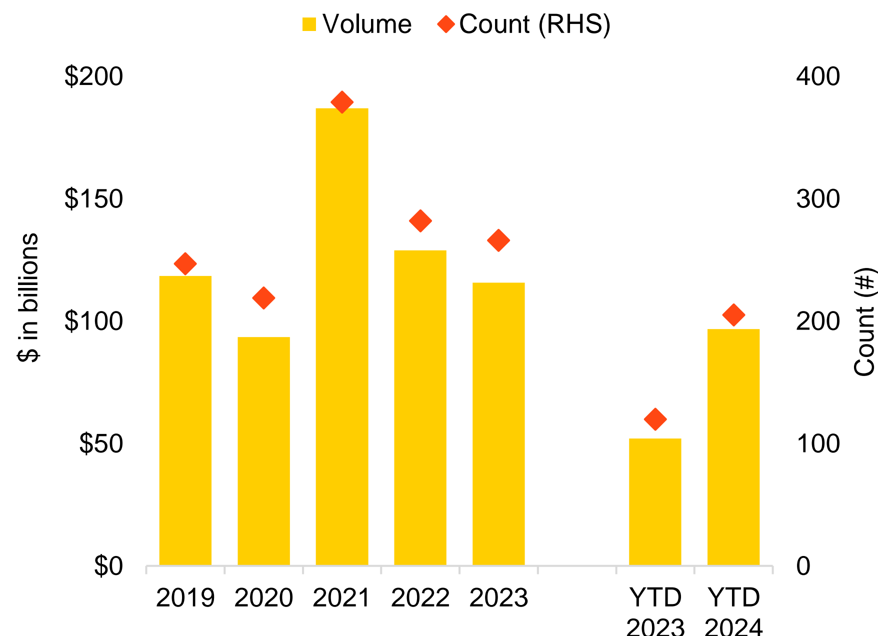
USD leveraged loan amend-and-extend (A&E) volume, and share of A&Es completed by issuers rated B- or CCC (all notches), RHS



Source: BlackRock, Pitchbook LCD. As of May 31, 2024. Pro rata debt typically entails amortizing TLAs and/or revolving credit facilities and is traditionally syndicated to finance companies and banks. Institutional debt consists of term loans structured specifically for institutional investors, including CLOs.

Exhibit 33: CLO creation has generated demand for leveraged loan supply

U.S. annual new issue collateralized loan obligation ("CLO") activity by USD volume and count, RHS



Source: BlackRock, Pitchbook LCD. As of June 17, 2024.

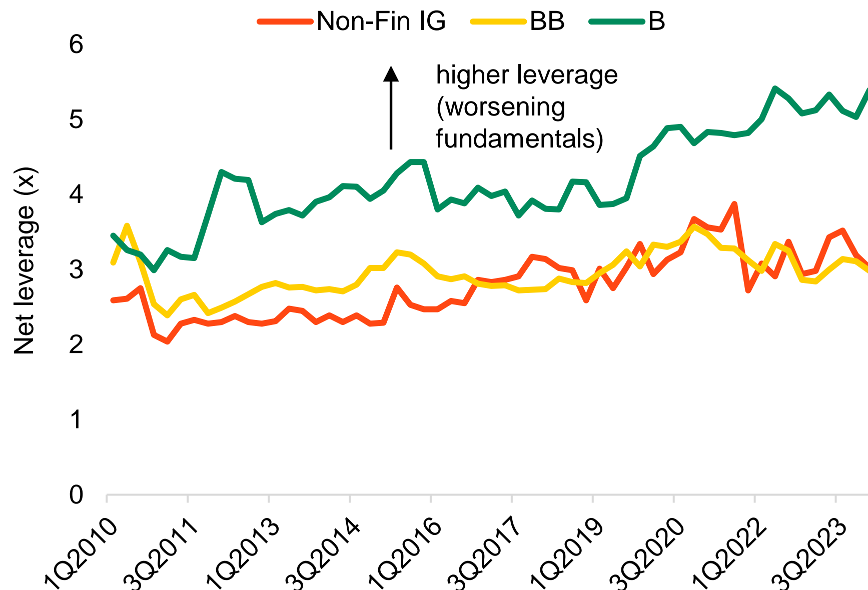
EUR fundamentals: Weaker, but priced in

The fundamental backdrop in the EUR corporate credit market has not followed a uniform trend across ratings (Exhibits 34 and 35). For example, B-rated issuers have experienced a sharp increase in leverage (Exhibit 34) – likely a function of the combination of a weaker growth backdrop (again, Exhibit 4) and a thin financial cushion. Similarly, EUR non-financial IG issuers have reported a sharp deterioration in interest coverage metrics since mid-2022 (Exhibit 35) – a period which coincided with the start of the ECB's rate hiking cycle in July 2022.

As shown previously in Exhibit 18, the relatively weaker fundamental positioning of the EUR credit market is already reflected in valuations, as spreads are trading wide vs. their own history, as well as compared to their USD peer groups. A convincing rebound in Euro Area growth, in our view, will be the key ingredient to close this valuation gap.

Exhibit 34: Dispersion in leverage metrics...

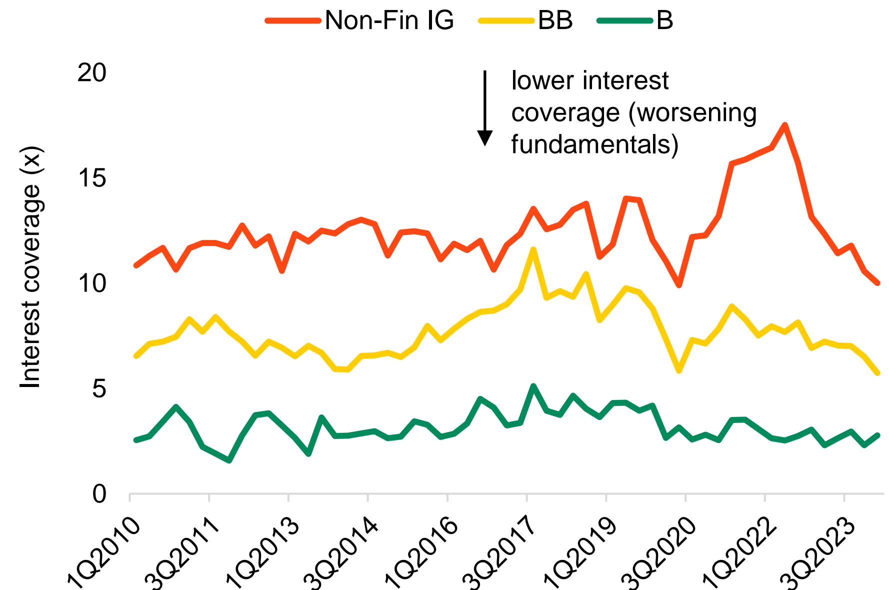
Trimmed mean (excludes the bottom 10% and top 10%) net leverage for non-financial IG, BB and B rated issuers in the Bloomberg EUR Corporate Indices



Source: BlackRock, Bloomberg. Net leverage is defined as: (Debt - Cash) / LTM EBITDA. Data as of 1Q2024 (most recent available as of June 17, 2024). LTM = last twelve months.

Exhibit 35: ...as well as in interest coverage

Trimmed mean (excludes the bottom 10% and top 10%) interest coverage for non-financial IG, BB and B rated issuers in the Bloomberg EUR Corporate Indices



Source: BlackRock, Bloomberg. Interest coverage is defined as LTM EBITDA / LTM Interest Expense. Data as of 1Q2024 (most recent available as of June 17, 2024).

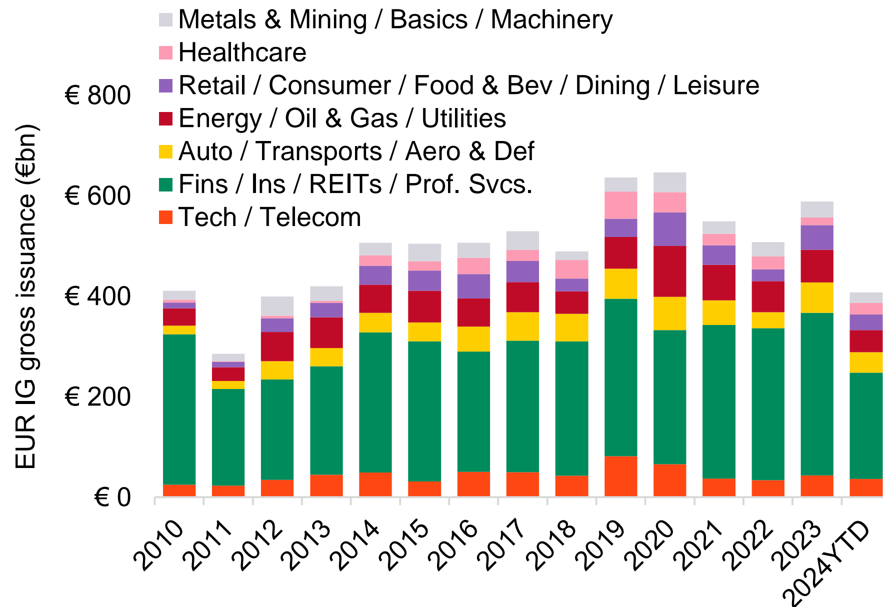
Elevated activity in EUR primary markets

Similar to its USD peer group, activity in the EUR market has also been elevated vs. the historical pattern. EUR IG gross issuance of €408 billion through June 19th is on pace to set a new annual record, to the extent this pace persists (Exhibit 36). The absorption of this elevated level of EUR IG corporate supply is even more notable considering that the ECB stopped purchases of EUR IG corporate bonds (via its various asset purchase programs) in 2022 and halted some reinvestments in 2023. The ECB had previously been a sizable and predictable source of demand for EUR IG corporate bonds. As evidence of that: it still held €307 billion in the Corporate Sector Purchase Program ("CSPP") as of June 2024.

Year-to-date EUR HY gross issuance of €54 billion is already close to surpassing the full-year 2023 level and has comfortably exceeded full-year 2022 (Exhibit 37). And importantly for bondholders, the mix has been creditor-friendly, with 51% of proceeds earmarked for refinancing, per Dealogic. This is the highest share since 2011's 52% (again, Exhibit 37).

Exhibit 36: A strong 1H2024 for EUR IG supply

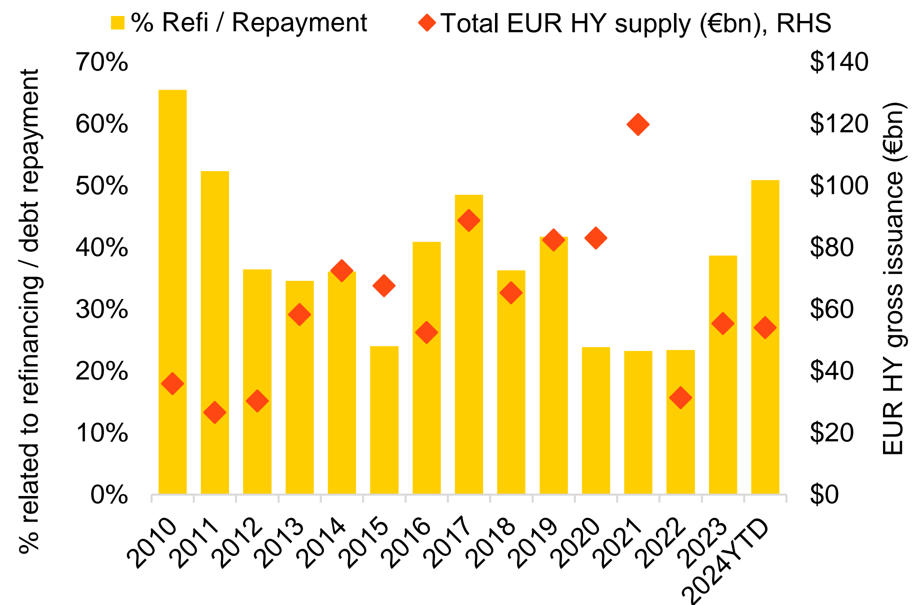
EUR IG gross issuance by sector, as captured by Dealogic "deal industry group"



Source: BlackRock, Dealogic (ION Analytics). Excludes Holding Companies and Government. As of June 17, 2024.

Exhibit 37: A heavy skew towards refinancing

EUR HY gross issuance and the share earmarked for debt repayment or refinancing, per Dealogic "primary use of proceeds"



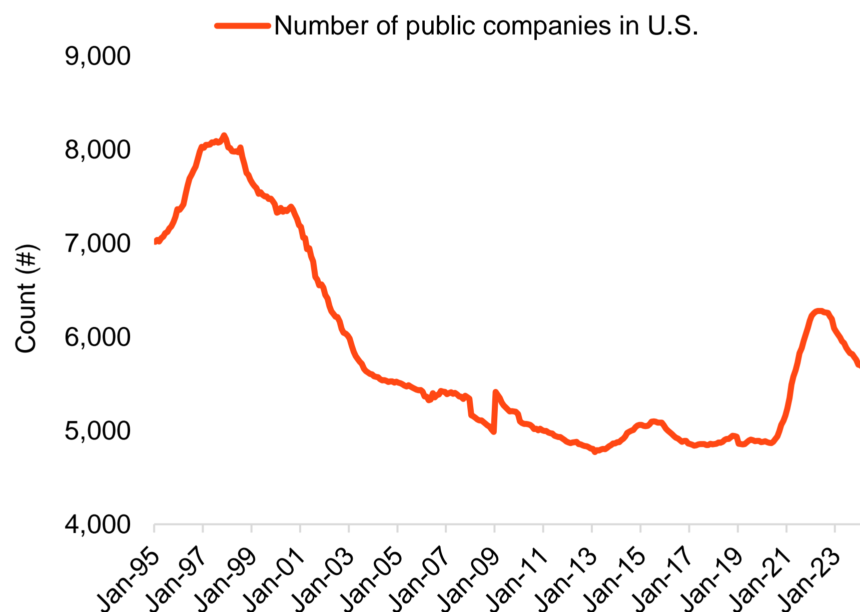
Source: BlackRock, Dealogic (ION Analytics). As of June 17, 2024.

Structural shifts behind private debt growth

We continue to expect that global private debt assets under management (AUM) will reach $3.5 trillion by year-end 2028, from $1.7 trillion as of September 2023 (the most recent figure available, per Preqin; Exhibit 39). There are four main structural drivers behind this forecast: (1) investors' desire for diversification and income; (2) borrowers' desire for certainty of execution and flexibility; (3) structural shifts in the public market, which are now serving larger borrowers as companies stay private for longer (Exhibit 38); and (4) ongoing selectivity in bank lending standards (in the U.S. and in Europe), which remain in "tight" territory (despite some moderation in recent quarters). While many of these forces are well-telegraphed, we believe the structural shifts in the public markets are somewhat less appreciated by many market participants.

Exhibit 38: Companies are staying private for longer

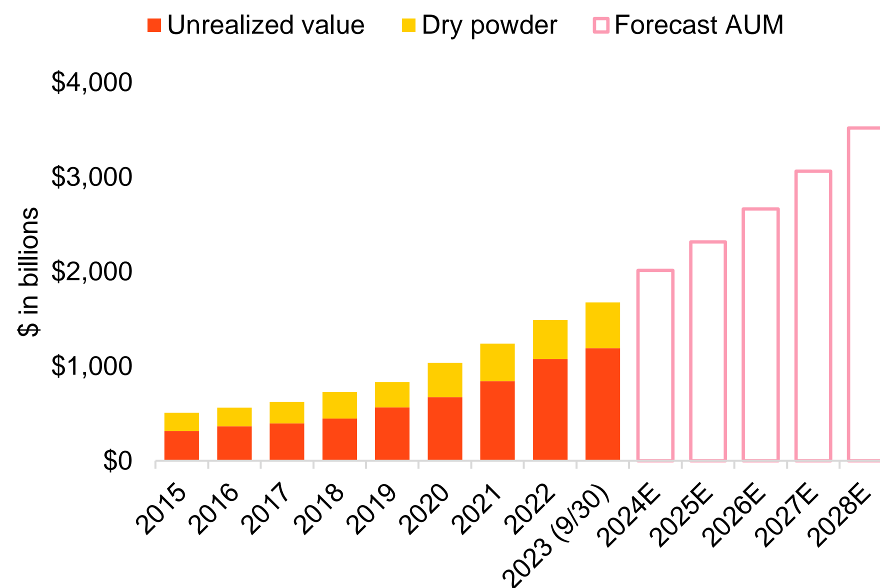
Number of public companies in the U.S., including those listed on New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ)



Source: BlackRock, World Federation of Exchanges, Haver Analytics. As of March 31, 2024 (most recent available).

Exhibit 39: We expect global private debt AUM to reach $3.5 trillion by year-end 2028

Private debt global assets under management (unrealized value and dry powder), and expectations for growth



Source: BlackRock, Preqin. Historical (actual) data from Preqin, as of each calendar year-end, through September 30, 2023 (most recent available). 2024E to 2028E are BlackRock estimates. **There is no guarantee that any forecasts made will come to pass.**

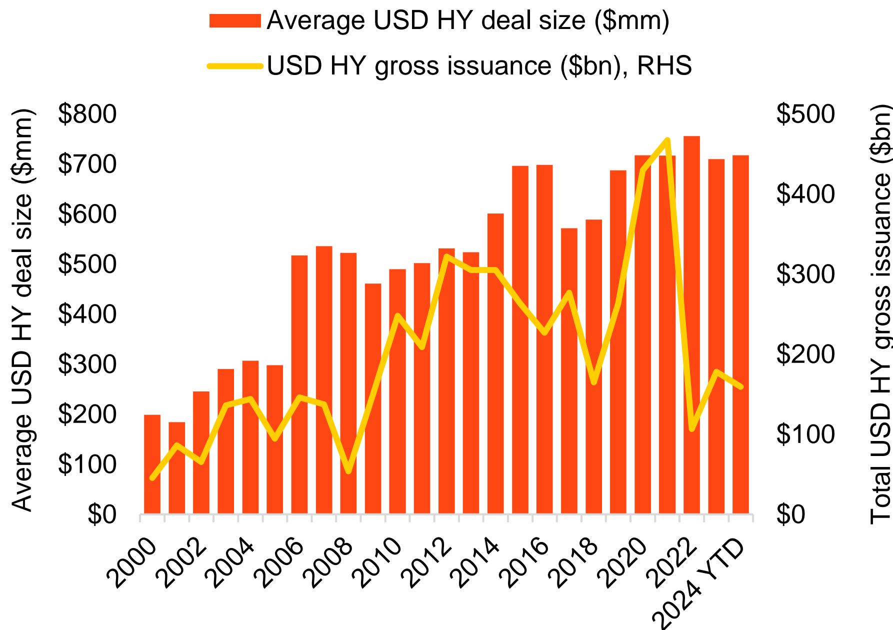
Public markets serve (very) large firms

As companies have stayed private for longer (Exhibit 38), the public debt markets have shifted to serve larger and larger borrowers. As shown in Exhibit 40, the average new deal size in the USD HY corporate bond market has been in excess of $700 million over the past five years and has been on an upward trajectory for much of the past decade. In the USD leveraged loan market, the average new deal size (for new institutional money) is lower, but still substantial, averaging $449 million since 2020 (Exhibit 41).

For a middle market firm seeking funding from the public markets, these "average" sizes are prohibitively large. Issuing "too little" debt in the public debt markets can render a capital structure illiquid and poorly held among investors – an unfavorable outcome in the event the firm would like to refinance in the future, and likely a suboptimal outcome for investors.

Exhibit 40: The average USD HY deal size has been above $700mm for the past five years

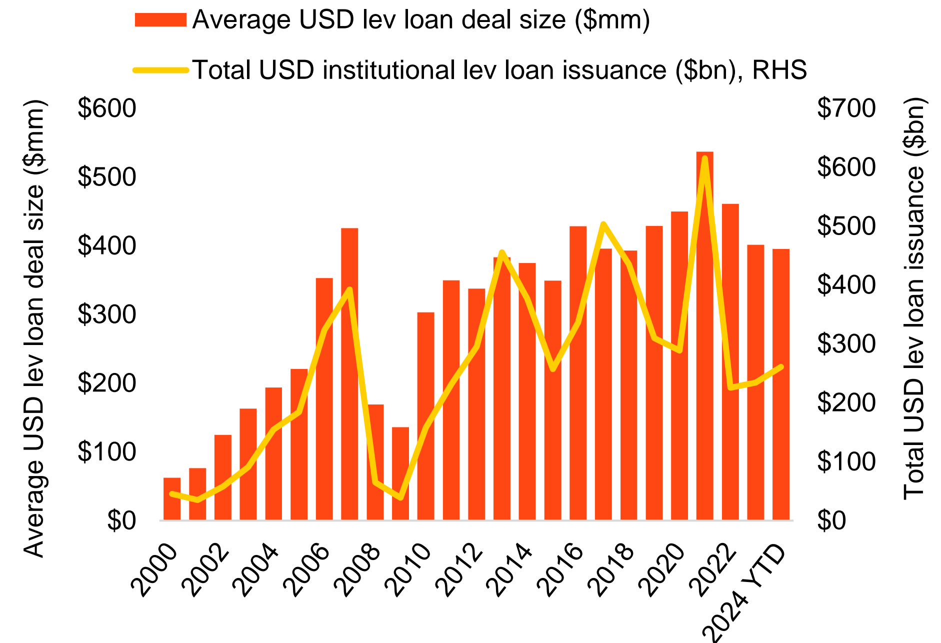
Average USD HY deal size ($mm) and total USD HY gross issuance ($bn)



Source: BlackRock, Dealogic (ION Analytics). As of June 17, 2024.

Exhibit 41: The average USD leveraged loan deal size is also substantial

Average USD leveraged loan deal size ($mm) and total USD institutional leveraged loan issuance ($bn)



Source: BlackRock, Pitchbook LCD. 2024 is as of June 17, 2024.

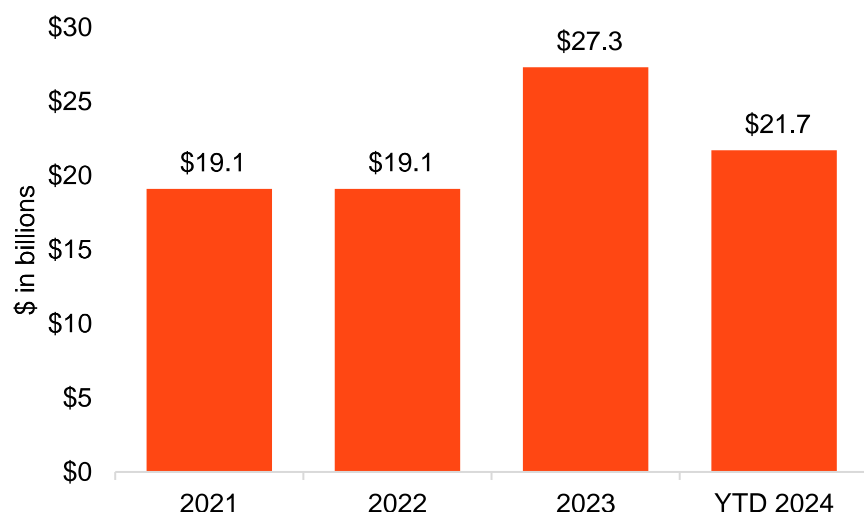
Overlap in the addressable markets

As private debt has grown into a sizeable *stand-alone* asset class, so too has its addressable market of borrowers. This is evident in the increased overlap between syndicated and private debt markets, as seen with "dual track" processes where borrowers simultaneously evaluate funding options in both markets. It can also be tracked via the "movement" of debt from one market, to the other. Exhibit 42 illustrates that, despite the well-telegraphed trend of "private-to-public" refinancing in 1H2024, activity of borrowers transitioning from "public-to-private" debt also remained strong. According to data by KBRA DLD and as of June 13th, 2024, $21.7 billion of syndicated loans were refinanced into the private market so far this year.

While there was an influx of activity into the private debt market in 2H2023 (as syndicated markets were choppy and recession fears were more elevated), the exact opposite pattern has been evident so far in 2024. We believe that the public market's readiness to refinance private debt may help to dispel a common concern: that private debt markets may be subject to an "adverse selection" of borrowers. In our view, the increased movement of borrowers between the public and private markets indicates that private debt can now act as another viable funding option for many firms, *alongside* syndicated debt markets. We expect that refinancing activity between private and syndicated debt markets will continue ebb and flow based on the macroeconomic backdrop and market sentiment (Exhibit 43).

Exhibit 42: Public-to-private volumes

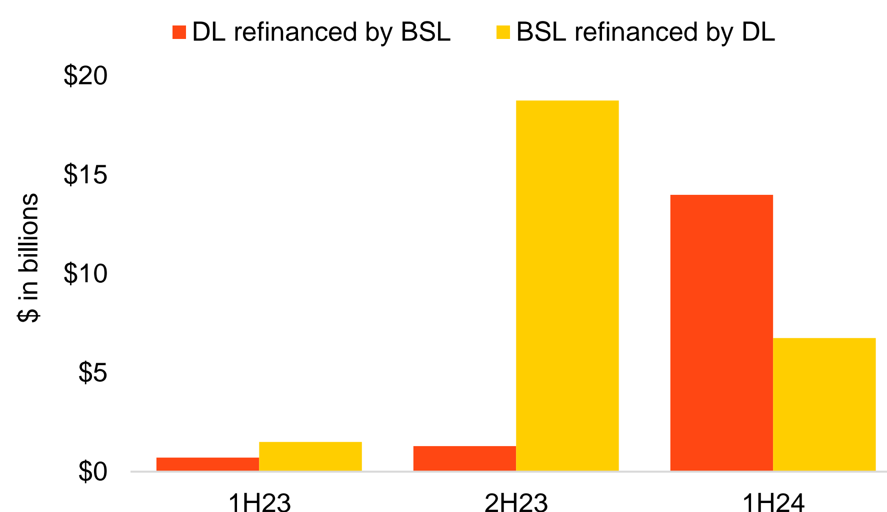
Volume of USD deals that have left the broadly syndicated loan market for direct lender execution ($bn)



Source: BlackRock, KBRA DLD. As of June 13, 2024.

Exhibit 43: The mix-shift will ebb and flow

New issue broadly syndicated loans (BSL) and direct lending (DL) takeouts ($bn)



Source: BlackRock, Pitchbook LCD. 1H2024 data as of May 21, 2024.

Asset-based finance: another growth path

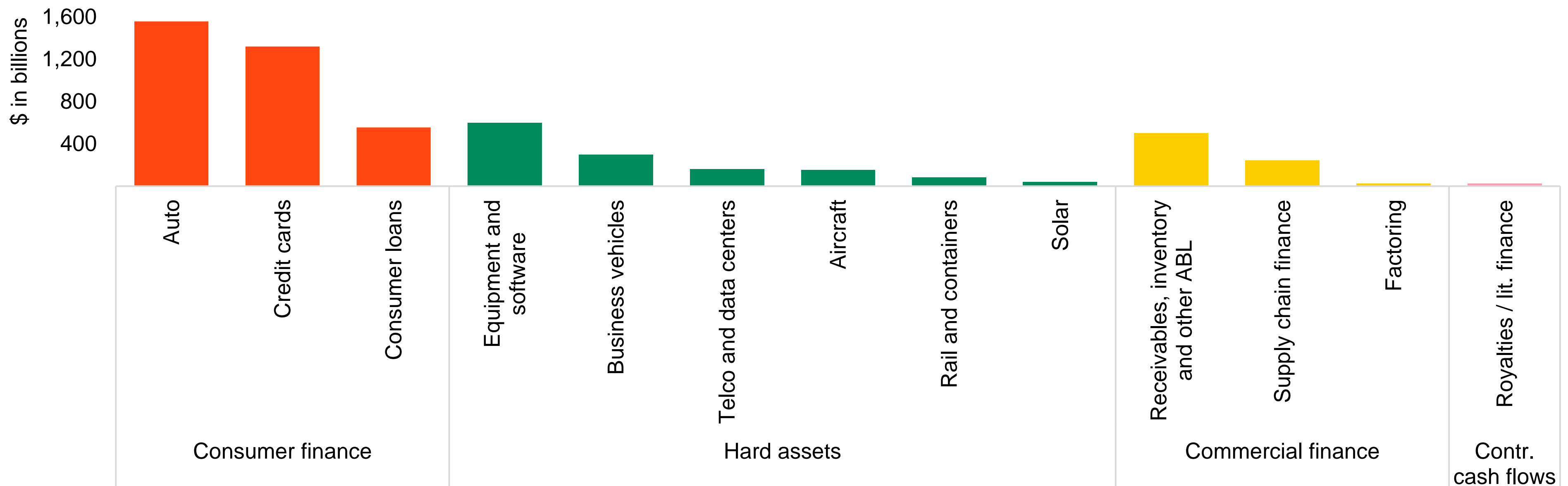
In our recent publication *Private debt: Exploring the Nuances*, we discussed how the term "private debt" encompasses a wide range of investing strategies – often with varying risk/return profiles. But as we noted at the time, much of that discussion – as well as the $3.5 trillion forecast we outlined earlier (Exhibit 39) – was focused on a specific subset of lending: middle-market loans to corporate borrowers.

Private debt, in the eyes of many market observers, can also be defined as any financing that is originated, structured, and held directly by the lender. This broad definition – which encompasses consumer debt, hard assets, commercial financing and intellectual property (Exhibit 44) – is estimated to be a $5.5 trillion market in the U.S., per an April 2024 Oliver Wyman analysis.

We refer to this activity as "private asset-based financing," or ABF. Per Oliver Wyman, roughly 54% of this activity is funded by bank balance sheets, 34% is financed by non-bank lending, and 12% is publicly securitized. Within the non-bank lending category, Oliver Wyman estimates that $200-$300 billion is funded by the private credit universe, which leaves its overall market share currently below 5% - implying ample room for additional growth.

Exhibit 44: The private asset-based finance market is poised for growth, in our view

U.S. specialty finance market sizing, per Oliver Wyman's April 2024 analysis



Source: Private Credit's Next Act, April 2024 by Huw van Steenis and colleagues, Oliver Wyman. Oliver Wyman analysis and estimates were aggregated from a range of sources including, but not limited to: Federal Reserve Board (Z1 tables, G19, G20 and H8); Federal Reserve Bank of New York; Federal Reserve Bank of Dallas; Bureau of Transportation Statistics (BTS); Dealogic; Conning, Inc., Conning Esoteric ABS Strategy Fact Sheet — used with permission; Finsight.com; Structured Finance Association; Boeing (Commercial Aircraft Finance Market Outlook); Secured Finance Network; Equipment Leasing and Finance Association; Morgan Stanley Research; CACIB Research; company reports and disclosures.

Resilient fundamentals, in aggregate

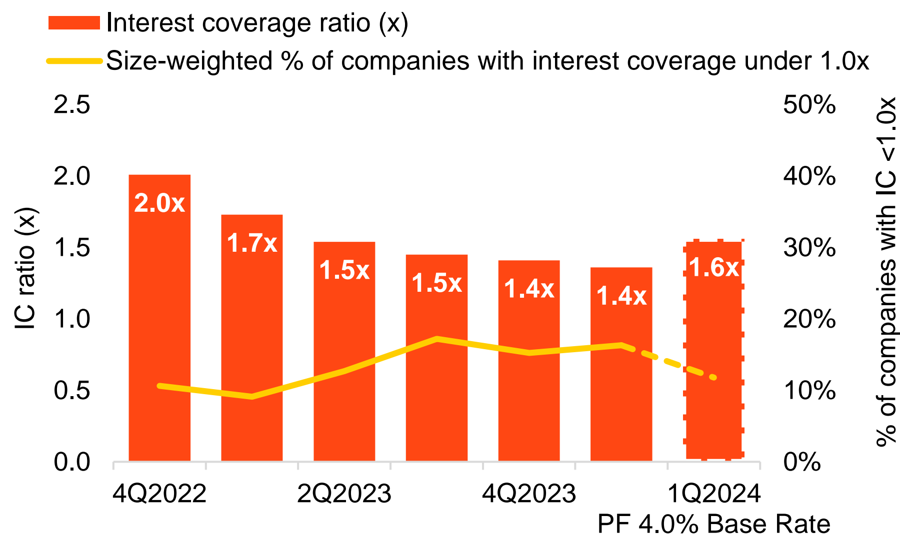
Floating-rate private debt borrowers, in aggregate, have generated relatively resilient fundamentals despite the elevated cost of capital environment. Using data from Lincoln International's Proprietary Private Market Database, Exhibits 45 and 46 illustrate that interest coverage (IC) and fixed charge coverage (FCC) ratios for borrowers are holding in relatively well (i.e., not deteriorating sharply).

For context, Lincoln is an independent valuation advisor specializing in illiquid alternative investments. As of 1Q2024, Lincoln's Valuations and Opinions Group (VOG) Proprietary Private Market Database included approximately 5,000 U.S. operating companies, representing over $185 billion of privately held principal and invested capital (primarily by private equity sponsors).

One key factor supporting this resilience is continued strong growth – similar to the tailwind behind public credit markets we highlighted earlier. U.S. companies tracked by Lincoln experienced an average year-over-year LTM EBITDA growth of 5.6% in 1Q2024. The ability to grow in a capital-efficient way is critical in a higher-rate environment, in our view. The pro forma (PF) 4.0% base rates in Exhibits 45 and 46 illustrate the improvement that rate cuts could provide. That said, as we outlined previously, this level of rate relief (i.e., five 25bp rate cuts) is unlikely to materialize in the near term, barring a sharp downturn in the macroeconomic environment.

Exhibit 45: Interest coverage ratios

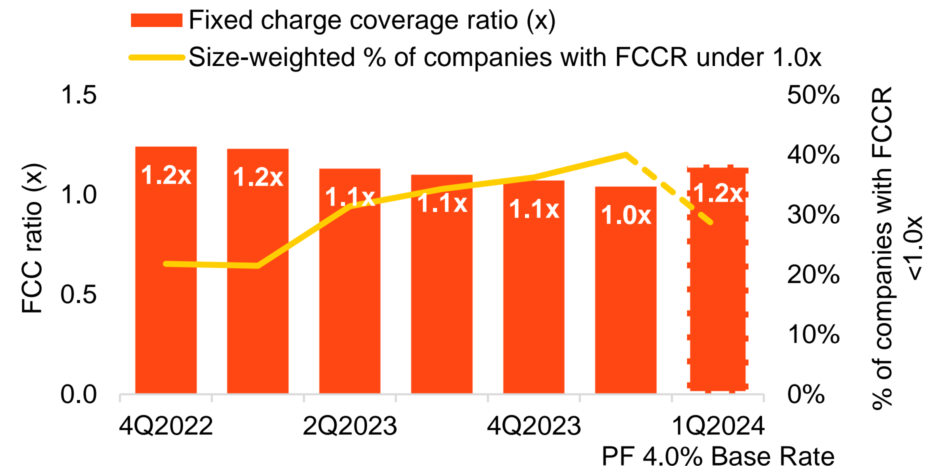
Size-weighted actual and pro forma IC ratios, and size-weighted percentage of companies with IC ratios under 1.0x (RHS)



Source: BlackRock, Lincoln International Private Market Proprietary Database. Captures data as of 1Q2024. Calculations: Interest coverage = LTM EBITDA / Interest.

Exhibit 46: Fixed charge coverage ratios

Size-weighted actual and pro forma FCC ratios, and size-weighted percentage of companies with FCC ratios under 1.0x (RHS)



Source: BlackRock, Lincoln International Private Market Proprietary Database. Captures data as of 1Q2024. Calculations: Fixed Charge Coverage Ratio = (LTM EBITDA – Taxes – Capex) / (LTM Interest Expense + (1% * Total Debt)). Capital expenditures ("capex") uses last twelve month ("LTM") capex. If LTM capex is not available, uses next fiscal year ("NFY"), and last fiscal year ("LFY") capex if both LTM capex and NFY capex are unavailable.

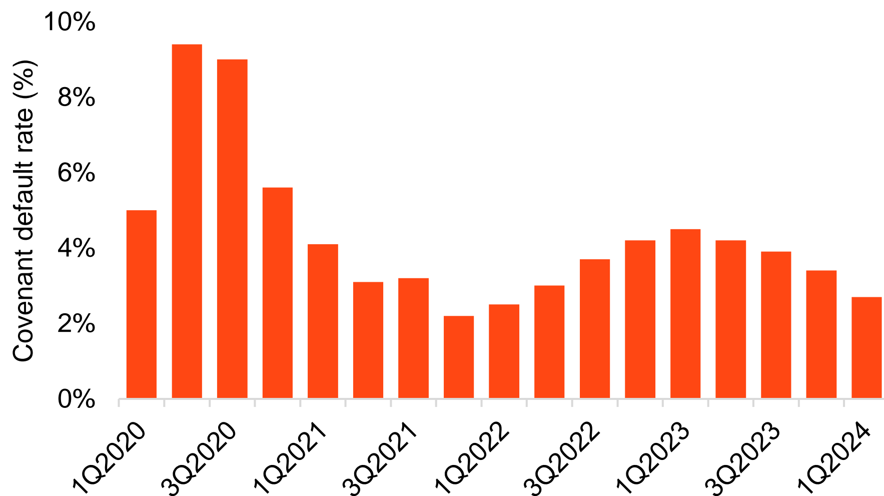
Lower defaults, modest realized losses

Recent data on covenant defaults and realized losses in the U.S. private debt market are similarly encouraging. Covenant default rates for the Lincoln International Proprietary Private Market Database have declined to 2.7% in 1Q2024 (Exhibit 47), marking the *fourth consecutive quarterly decline* in the aggregate covenant default rate. This decline is, in part, owing to the flexibility inherent in a long-term relationship between a borrower and lender (or a small group of lenders) in the private debt market, which typically allows for stresses to be addressed more efficiently (relative to working with dozens of lenders in the public market to obtain an amendment/waiver).

Data from a separate universe, the Cliffwater Direct Lending Index (CDLI) highlights contained loss rates. The CDLI, an index of 15,600 directly originated U.S. middle market loans (as of 1Q2024), experienced a trailing 12-month realized loss rate of 85bp in 1Q2024, below the approximate 1.0% long-term average (since 2005). Over the same 12-month period ending 1Q2024, the CDLI generated interest income of 12.3% (Exhibit 48), boosted by elevated base rates.

Exhibit 47: Covenant defaults declined for the fourth consecutive quarter

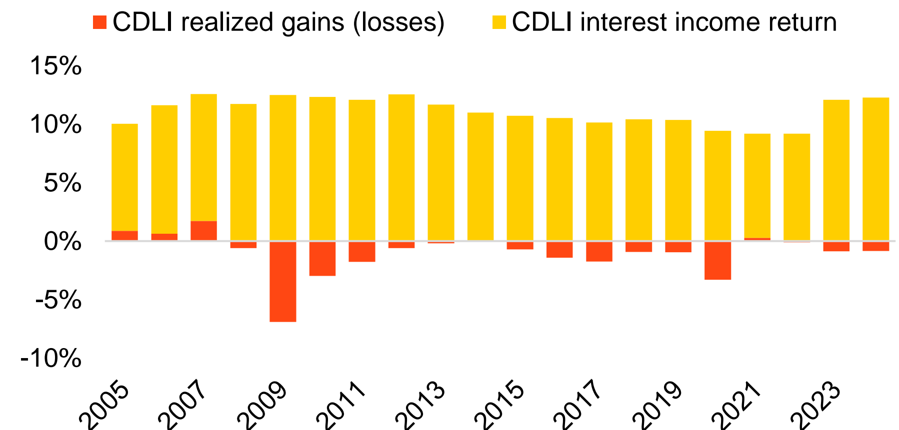
Aggregate covenant default rate for the U.S. portfolio companies included in the Lincoln VOG Proprietary Private Market Database



Source: BlackRock, Lincoln VOG Proprietary Private Market Database. As of 1Q2024. Note: A default is defined as a covenant default and not a monetary default. The analysis was performed based on a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

Exhibit 48: Realized losses stay below the long-term average of 1.0%

Cliffwater Direct Lending Index (CDLI) realized gains (losses) and interest income return, by annual period (2005 - 1Q2024)



Source: BlackRock, Cliffwater. As of 1Q2024. Excludes unrealized gains and losses. Realized gains can be driven by equity stubs, warrants, and gains on exited investments. These were more common in 2005-2007, when second lien and mezzanine loans were a greater portion of the CDLI. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Dispersion is evident under the surface

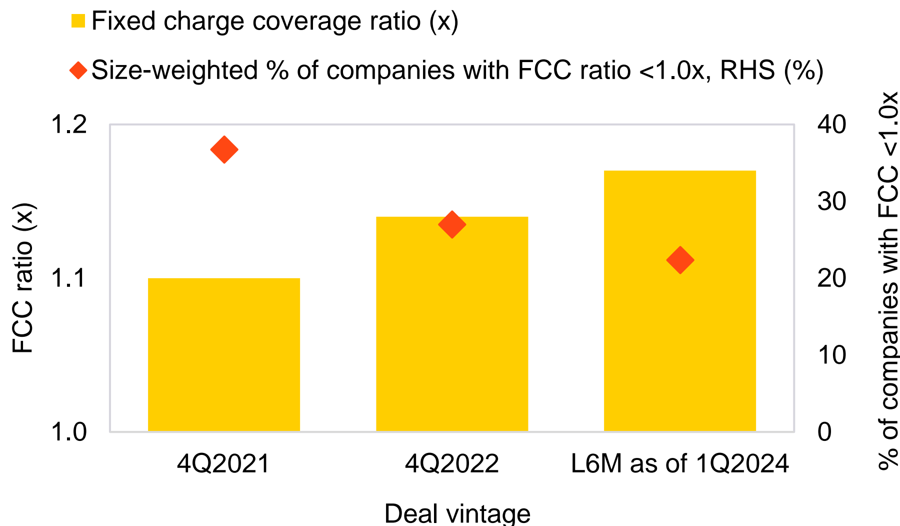
While private debt fundamentals, in aggregate, have demonstrated resilience, the higher cost of capital *has* contributed to increased dispersion. This underscores the importance of credit selection and diversification in 2H2024. As noted in *Private Debt: Exploring the Nuances*, we see three main elements of dispersion: vintage, portfolio (which includes sector and company sizes), and strategy (position in the capital structure, for example).

Focusing on vintages, and again using data from Lincoln International, the average fixed charge coverage (FCC) ratio for deals done in 4Q2021 – a period when (lower) interest rate assumptions may have proved too benign – was 1.10x. And 36.8% of these deals had a FCC ratio below 1.0x. By contrast, the average FCC ratio for deals done in the last six months (L6M) as of 1Q2024 is 1.17x. And 22.4% of these deals have a FCC ratio below 1.0x (Exhibit 49).

EBITDA growth has also varied across sectors (Exhibit 50), as each industry is subject to a unique set of growth drivers and headwinds, creating different degrees of cyclicality, pricing power, operational agility, and financial flexibility.

Exhibit 49: Dispersion across rate regimes

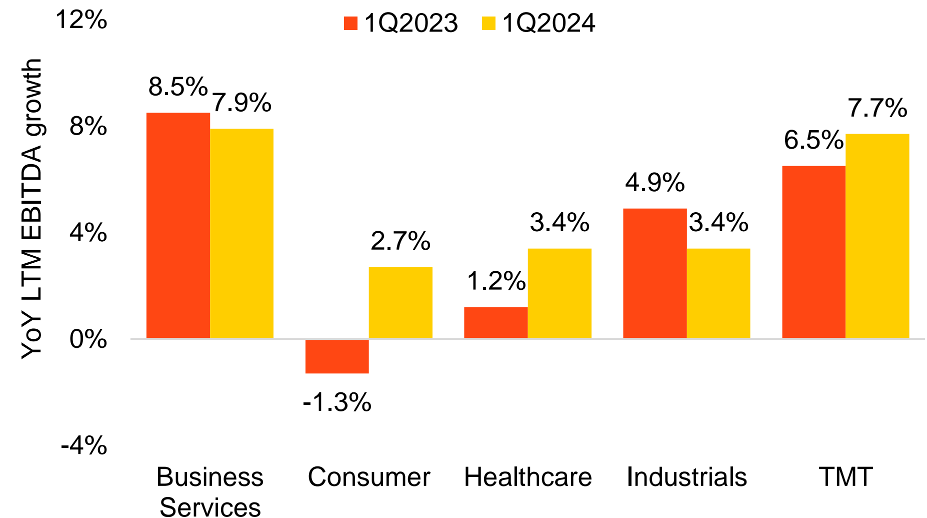
Fixed charge coverage ratios, by deal vintage, for companies in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International VOG Proprietary Private Market Database. Captures data as of 1Q2024. Calculations: Fixed Charge Coverage Ratio = (LTM EBITDA – Taxes - Capex) / (LTM Interest Expense + (1% * Total Debt)).

Exhibit 50: EBITDA growth has varied by sector

Year-over-year LTM EBITDA growth by industry, for companies in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International VOG Proprietary Private Market Database. As of 1Q2024. LTM = last twelve months.

Size may influence dispersion in covenant health

Data also suggests a relationship between borrower size and covenant health. For example, Exhibit 51 demonstrates an inverse relationship between borrower size and default rates in companies tracked by Lincoln International, with the smallest cohorts of borrowers (defined by Lincoln International as borrowers with annual EBITDA of less than $10 million, and between $10-30 million) experiencing default rates more than three times and two times larger, respectively, than borrowers of the larger cohorts.

Similarly, leverage covenant headroom, or flexibility for leverage to increase relative to a borrower's cash flow before the covenant is breached, suggests a positive correlation between size and headroom, as illustrated in Exhibit 52. Most notably, borrowers with less than $10 million of annual EBITDA have the least flexibility of any size cohort, with only 0.4x headroom, versus all larger categories, which exceed 1.5x of headroom as of 1Q2024.

Exhibit 51: Smaller borrowers experienced a higher covenant default rate in 1Q2024...

Covenant default rates (size-weighted) for companies in the Lincoln International Proprietary Private Market Database

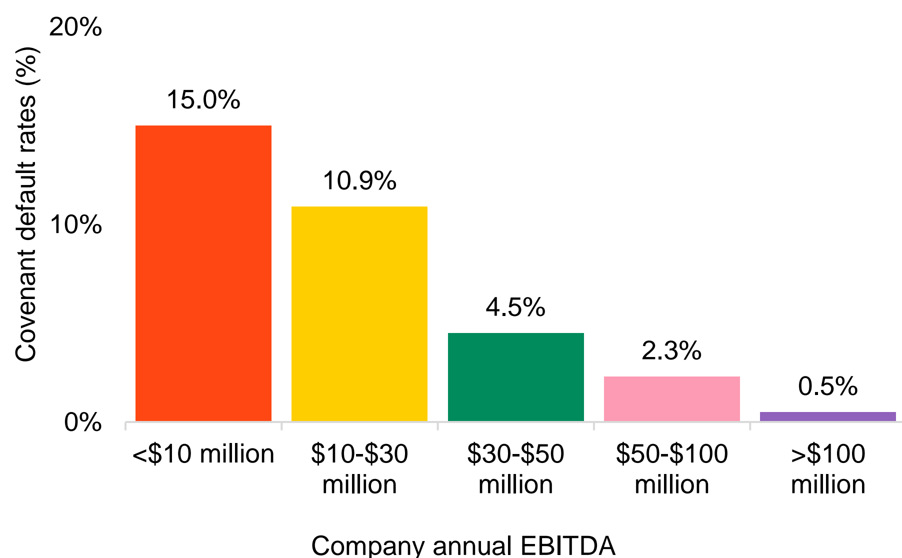
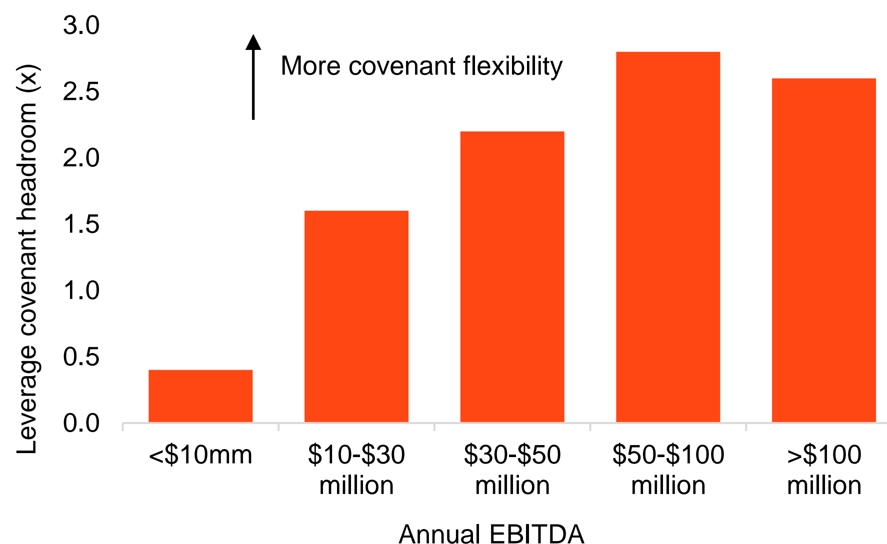


Exhibit 52: ...and had less covenant headroom

Leverage covenant headroom (size-weighted), for the U.S. portfolio companies included in the Lincoln International Proprietary Private Market Database



For both charts: Source: BlackRock, Lincoln International VOG Proprietary Private Market Database. As of 1Q2024 (most recent). Note: A default is defined as a covenant default and not a monetary default. The analysis was performed based on a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

Patterns in amendment activity

Covenants act as a tool to allow lenders a "seat at the table" in the event of borrower stress, and covenant amendments are one way a lender can help bridge a (credit worthy) borrower to a stronger financial position. Indeed, more than 730 amendments have been executed in the last twelve months ended 1Q2024, impacting 16% of the companies tracked by Lincoln International.

Exhibit 53 illustrates another instance of vintage dispersion, this time as it relates to amendment activity. In the last twelve months, approximately 50% of all amendment activity was attributed to 2021 and 2022 vintage deals (i.e., deals underwritten in the low-rate environment).

Notable too, 2023 vintage deals, or deals underwritten when there was more visibility into the higher rate regime, had the lowest amendment rate of all vintage categories in 1Q2024, according to Lincoln International.

Pricing amendments have been the most common amendment type over the last four quarters, though the nature of these amendments has evolved. In 2Q2023 and 3Q2023, cash amendments accounted for an average of 65% of total pricing-related amendments. In the two most recent quarters, however, repricings involving payment-in-kind (PIK) accounted for more of the activity (Exhibit 54).

Exhibit 53: Amendments skew more heavily to 2021 and 2022 vintage deals

Percentage of amendments per quarter, by deal vintage

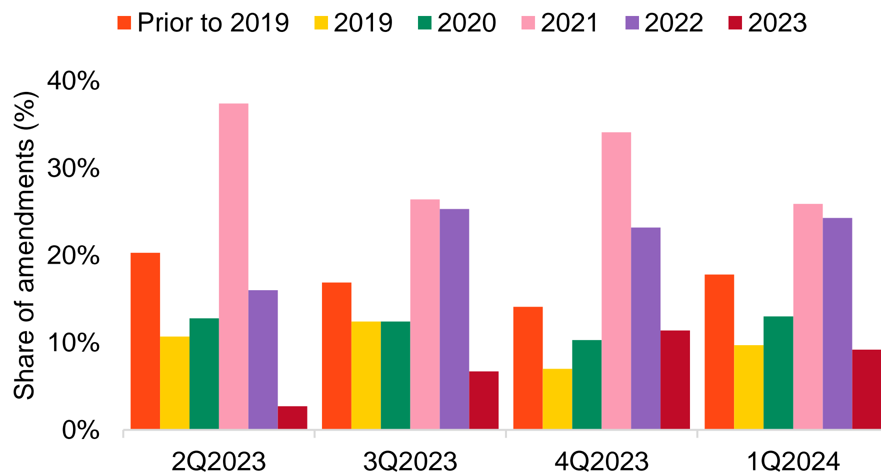
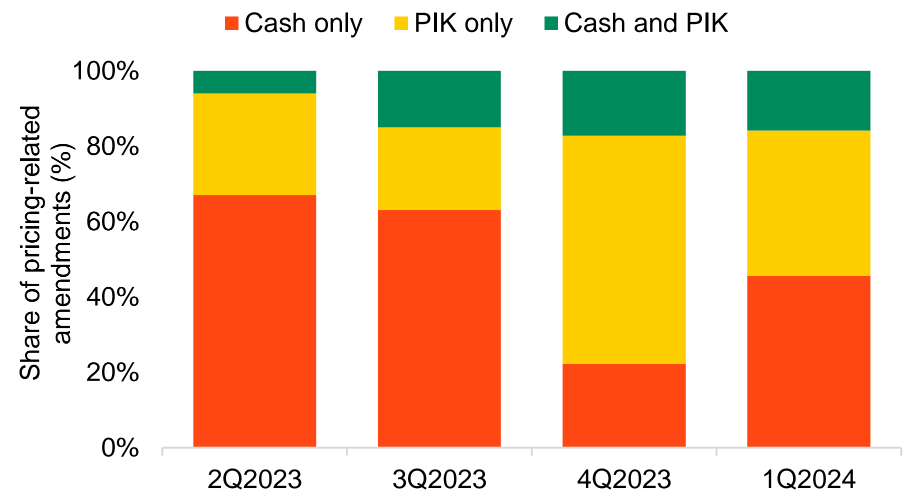


Exhibit 54: Recent amendments have included PIKs more frequently

Share of pricing-related amendments per quarter, by pricing type



For both charts: Source: BlackRock, Lincoln International VOG Proprietary Private Market Database. As of 1Q2024 (most recent).

Capital allocators prioritize experience

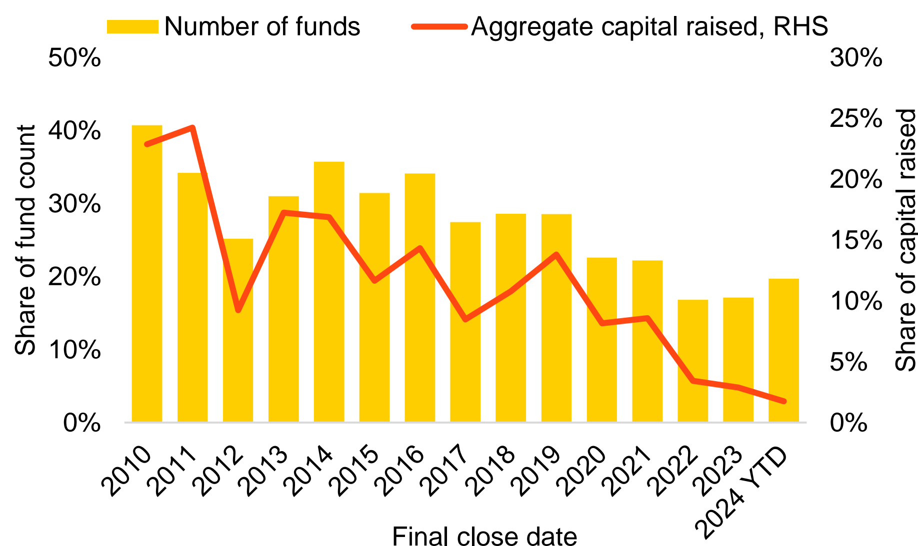
The growth of private debt AUM in recent years has raised concerns among some market observers that new entrants may be sacrificing underwriting discipline to capture market share. But fundraising data from Preqin shows a more discerning story: capital allocators have become more selective as we have entered a higher rate regime, instead favoring more experienced managers.

For example, Exhibit 55 shows that first-time private debt funds have captured, on average, 2.7% of total capital (per year) since 2022, well below the 2019-2021 run-rate of 10.2%. Similarly, as shown in Exhibit 56, established private debt managers (i.e., those raising their fourth fund, or later) have raised 84% of capital, on average, since 2022, compared to an average of 72% from 2019-2021.

In our view, a higher rate environment has encouraged investors to favor more experienced managers, who typically benefit from restructuring and workout expertise. Preqin notes that a higher concentration in private capital fundraising is common as an asset class matures and relationships with LPs become more entrenched.

Exhibit 55: First-time private debt funds have raised minimal amounts of capital

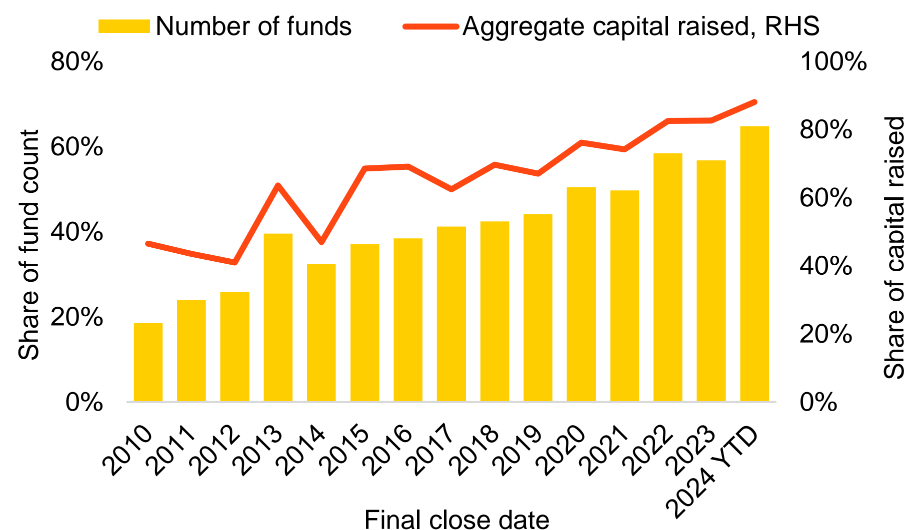
First-time private debt fundraising as a proportion of total funds and aggregate capital raised (RHS)



Source: BlackRock, Preqin. Captures data as of June 18, 2024. Captures closed-ended private debt funds.

Exhibit 56: Experienced managers have raised most of the capital since 2022

Fourth fund or later private debt fundraising as a proportion of total funds and aggregate capital raised (RHS)



Source: BlackRock, Preqin. Captures data as of June 18, 2024. Captures closed-ended private debt funds.

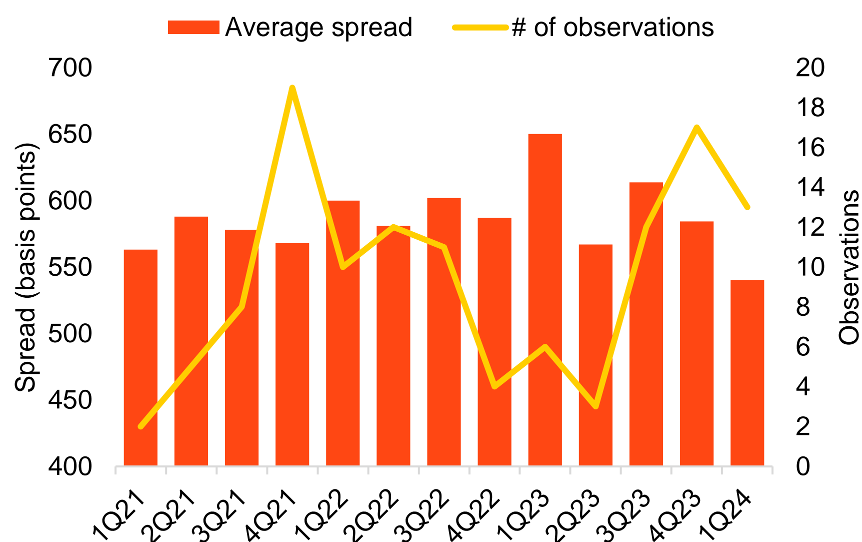
Competition has led to spread compression

The increased overlap in the addressable market of private and syndicated debt (referenced earlier) is most observable among large borrowers that are suitable to issue in both markets (generally categorized by third-party data provider KBRA DLD as "jumbo" loans of $1 billion or more). In practice, these jumbo loans often mean a deal would be large enough to be relatively liquid and index-eligible in the syndicated/public debt markets.

The receptive tone of syndicated markets (coupled with other market factors such as limited LBO activity) in 1H2024 has kept pricing competitive for borrowers that are eligible for both markets. For example, average jumbo spreads fell to S+540bp in 1Q2024 (from S+584bp in 4Q2023), marking the second consecutive quarter of tightening, according to KBRA DLD (Exhibit 57). And new issue prices also increased in 1Q2024 (reflective of smaller issue discounts and fees), as illustrated in Exhibit 58. While average spreads on new issue jumbo loans are tight relative to recent historical standards, elevated base rates, in our view, allow lenders to tighten spreads further without significantly compromising attractive all-in yields.

Exhibit 57: Spreads are at their tightest level since the KBRA DLD series began in 1Q2021

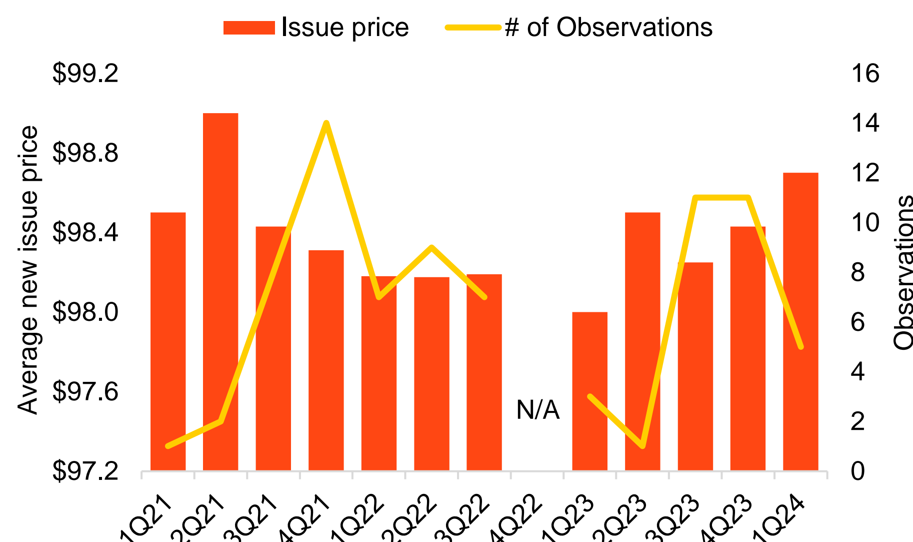
Average spread on jumbo loans (defined as loans $1 billion or larger) issued, in bp



Source: BlackRock, KBRA DLD. As of 1Q2024

Exhibit 58: New issue prices increase for the third consecutive quarter

Issue price on jumbo loans (defined as loans $1 billion or larger), out of par ($100)



Source: BlackRock, KBRA DLD. As of 1Q2024.

CRE: Looking for signs of a bottom in office

The various subsets of commercial real estate (CRE) have been characterized by a nuanced mix of headwinds (i.e., higher rates, tighter lending standards, structural shifts in office usage) and tailwinds (i.e., strong rent growth in some subsets, near-shoring, supply chain resilience). In 2H2024, we will be most focused on tentative signs of a bottom for price declines in the office sector (Exhibit 60). Although CRE transaction volumes are still very muted (Exhibit 59), the magnitude of the declines have been easing. Over the next few quarters, we expect the "price discovery" process will more fully reveal itself.

A wide degree of variation is evident across CRE sectors (again, Exhibit 60). For example, pricing for industrial properties continues to increase, driven by sector-specific tailwinds. Meanwhile, well-telegraphed structural headwinds related to office utilization have kept asset valuations under stress – especially for central business district (CBD) offices, per the Real Capital Analytics (RCA) National Commercial Property Price Indices (CPPI).

Exhibit 59: CRE deal volumes are still muted

Change in year-over-year transaction volumes (%) of the RCA CPPI National All-Property Index

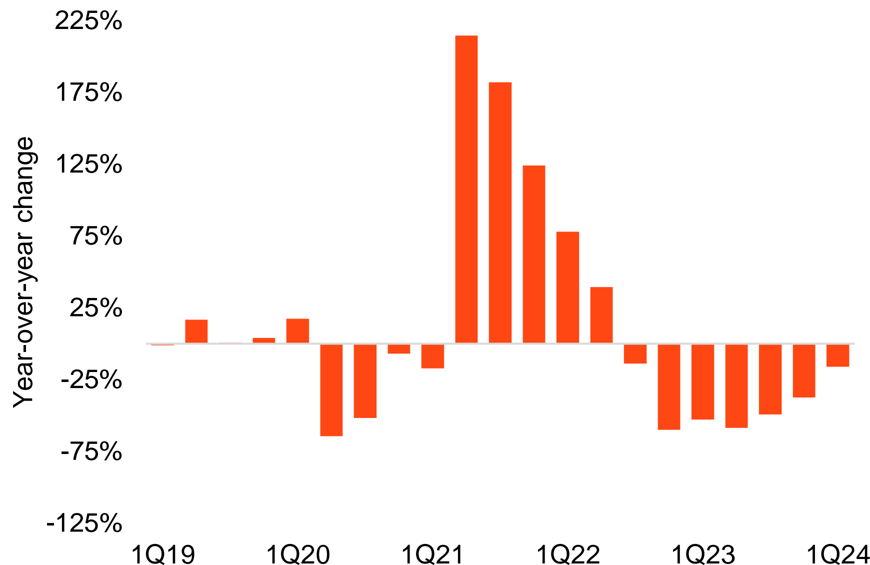
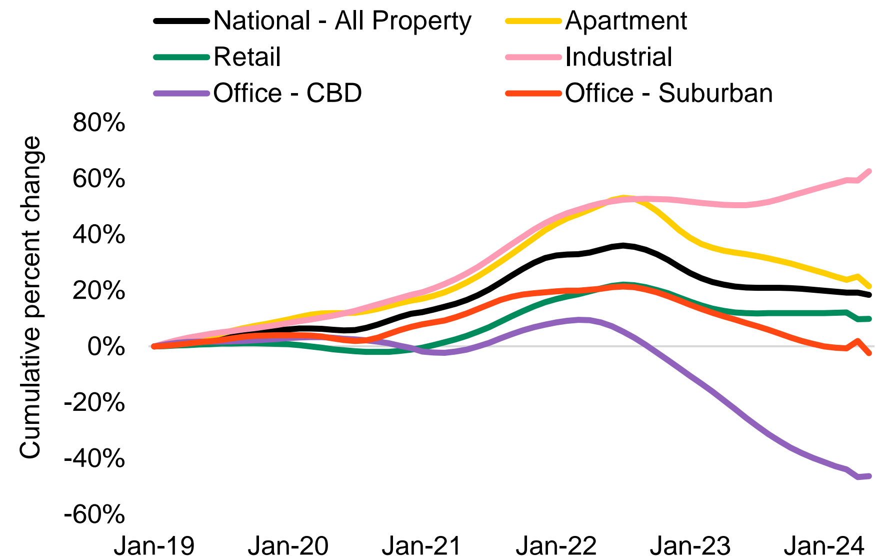


Exhibit 60: Dispersion across CRE sectors

Cumulative percent change in the level of the RCA CPPI sector-specific indices, since January 2019



Source for both charts: BlackRock, Real Capital Analytics Commercial Property Price Indices (CPPI), National All-Property Index. Captures data through May 31, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

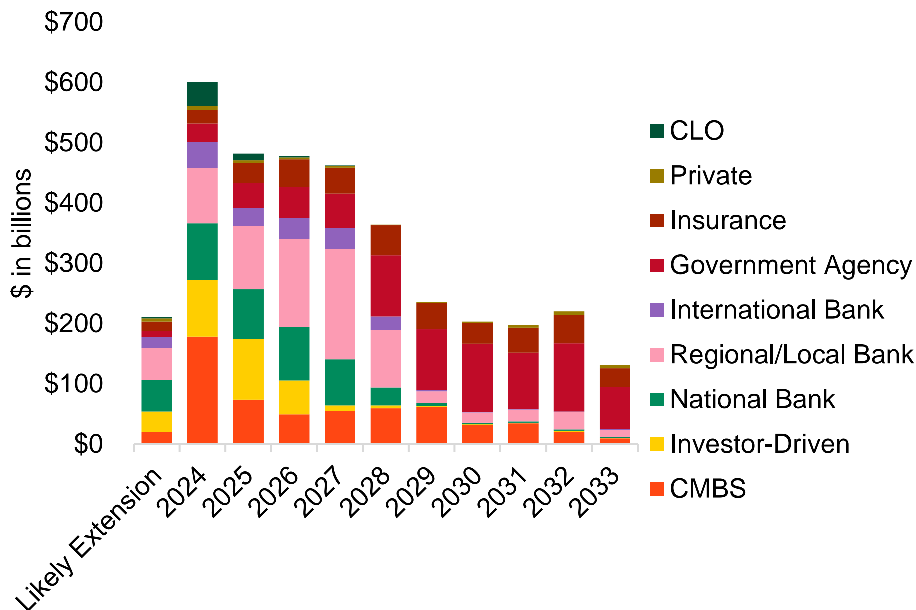
CRE loan extensions bear watching

While refinancing activity in the syndicated corporate credit markets has been robust so far in 2024 (as discussed earlier), the backdrop in the CRE market has been more focused on maturity *extensions*. According to data compiled by RCA and MSCI Real Assets, $214 billion of CRE loans that were scheduled for maturity during 2023 may have been extended into future years (as their analysis found no confirmation of refinancing or a sale of the associated collateral). This may leave the 2024 maturity walls as high as $820 billion according to RCA, when incorporating these "likely extensions" (Exhibits 61 and 62). According to RCA, loans originated in 2021 – a period defined by ultra-low interest rates in the U.S. – represent the largest single vintage for the 2024 scheduled maturities, at 35%.

We expect this pattern of extensions to persist, due to the combination of lingering uncertainty related to the interest rate environment, structural headwinds facing portions of the CRE market (such as office), and the valuation impact of the higher cost of capital, which may result in an "expectations mismatch" between buyers and sellers. That said, such extensions are likely to be only a temporary fix, in our view, as many of these headwinds are likely to remain in place over the medium-term (or longer).

Exhibit 61: Near-term maturities are steep…

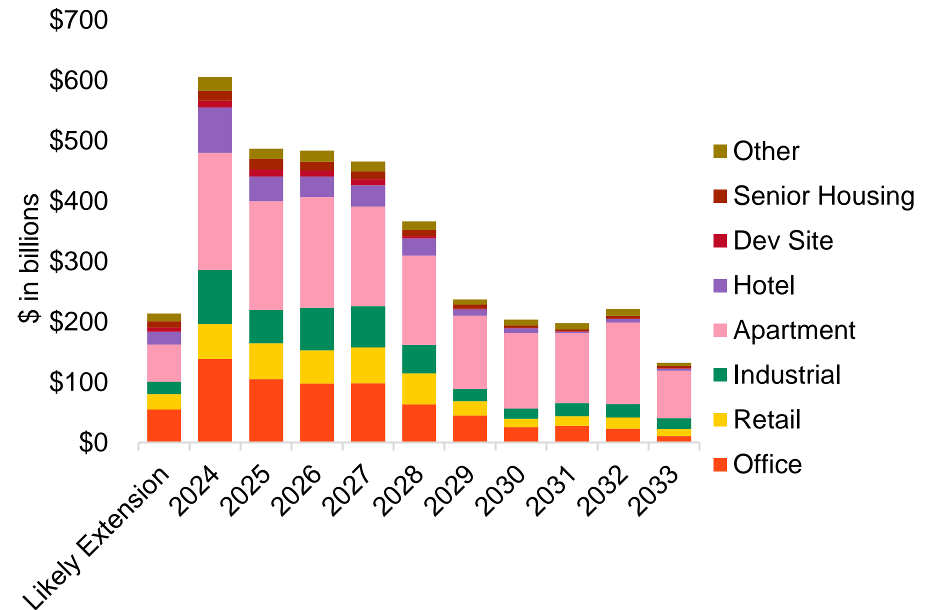
Volume of maturing commercial property loans, by lender type



Source: BlackRock, Real Capital Analytics. As of February 2024.

Exhibit 62: …especially including extensions

Volume of maturing commercial property loans, by property type



Source: BlackRock, Real Capital Analytics. As of February 2024.

CRE: U.S. banks' stress scenario exposure

U.S. banks represent approximately half of the ownership of the nearly $6 trillion U.S. CRE market, driven by regional and community banks (Exhibit 63).

This exposure remains closely watched by market participants, and in recent quarters U.S. banks have provided more granular data on the sizing of their CRE loans (relative to overall loan books and tangible common equity), loan-to-value ratios, as well as reserves for estimated losses.

Complicating matters, however, is the fact that many loan-to-value metrics (at the time of underwriting) are now likely stale given the declines in CRE valuations (across some categories) in recent years (again, Exhibit 60).

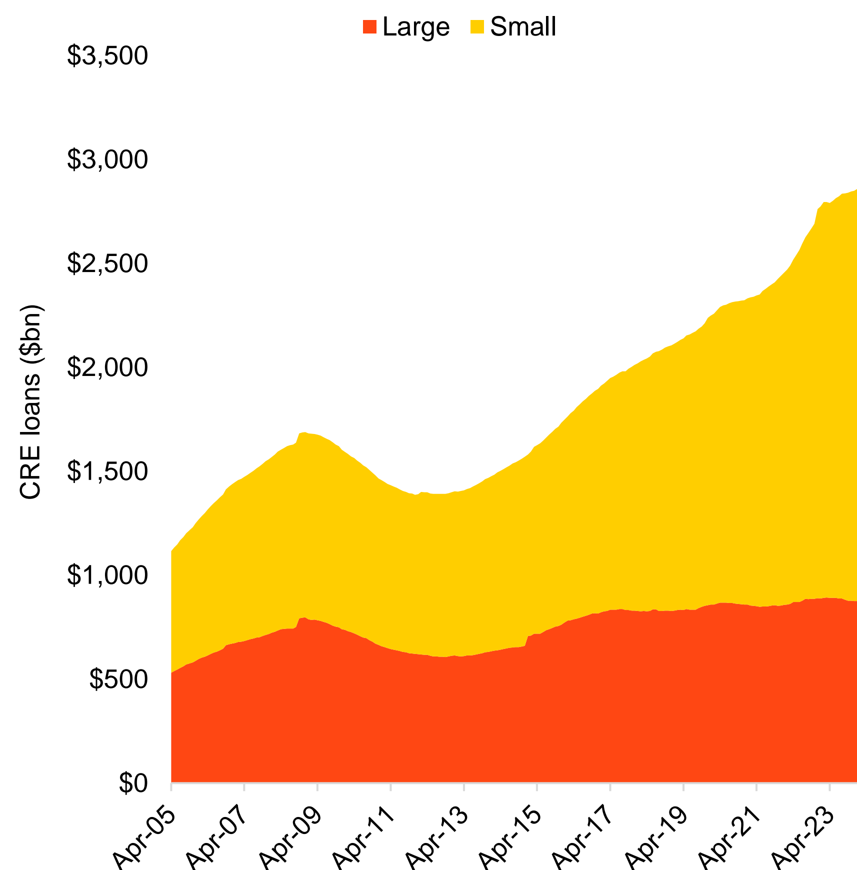
A June 2024 analysis by Moody's examined detailed loan information for the CRE portfolios of 41 U.S. banks and shed some light on a potential stress case for this subset of banks.

For "well-underwritten stable loans," Moody's estimated its "stress marks" were generally in the high single-digits, which it believes "most banks could likely absorb." That said, the overall average stress marks were 15% for Office and 19% for Multi-Family, according to the Moody's analysis – levels which the rating agency believes may be difficult for some U.S. banks to absorb, given capital levels and CRE market conditions in such a scenario.

Moody's noted that many regional banks are collaborating with borrowers to navigate upcoming CRE maturities – in an effort "to avoid challenges with repossession" – and are, in some instances, modifying loan terms (i.e., interest rate, maturity). This is consistent with the loan extension trend we noted previously, using the RCA data.

Exhibit 63: Smaller U.S. banks have been more active in CRE, relative to their larger peers

Commercial real estate loans held by U.S. banks (large and small)



Source: BlackRock, Federal Reserve Board, Haver Analytics. As of May 2024. Large U.S. banks represent the Top 25 domestically chartered commercial banks, ranked by domestic assets per the H.8 release.

U.S. banks are more selective in CRE lending

The Moody's analysis noted that some U.S. regional banks are taking "more novel approaches to reducing their CRE risk exposures, including selling a first-loss tranche of certain loan portfolios."

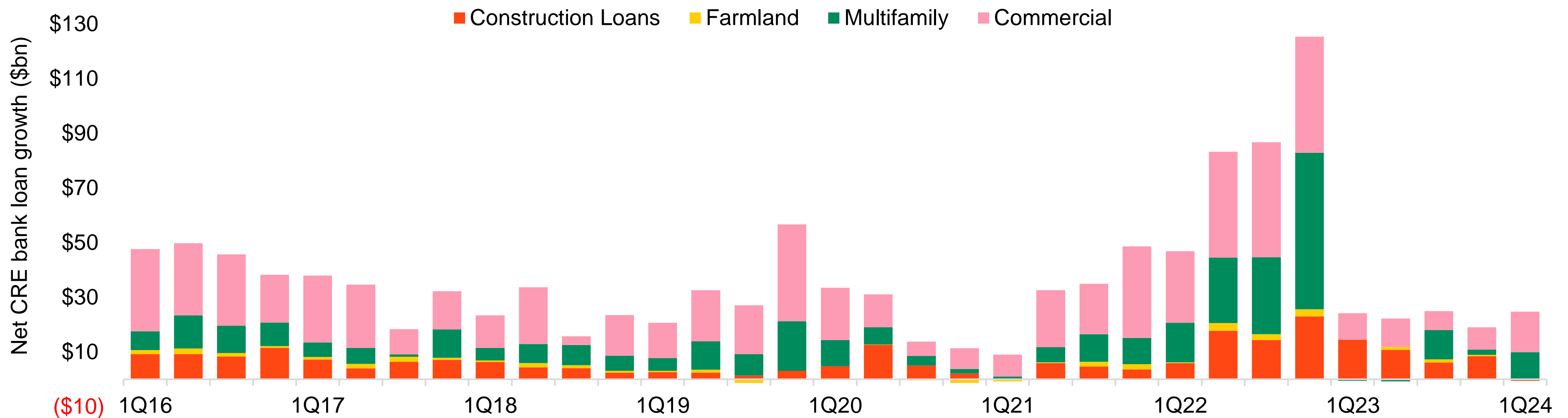
Data from Green Street confirms that U.S. banks have been paring back their exposure. As Exhibit 64 illustrates, U.S. bank CRE loan growth peaked in 4Q2022 and decelerated sharply in 2023, as turmoil in the regional banking sector coupled with weakening CRE fundamentals reduced banks' appetite to lend.

Responses to the April 2024 Federal Reserve Senior Loan Officer Opinion Survey (SLOOS) highlighted "tightening standards for all types of CRE loans," largely owing to less favorable (or more uncertain) outlooks for CRE market rents, vacancy rates, property prices and delinquency rates. Other drivers cited by banks included a lower risk tolerance, and concerns about regulatory changes. This CRE-specific tightening of lending standards has been evident in prior SLOOS responses, in recent quarters.

Just as the growth backdrop will be paramount for corporate credit borrowers' ability to navigate higher debt service costs, it will also matter for CRE. Solid economic growth would support tenant demand for CRE properties and income generation in the form of rent growth – both of which factor into asset valuations.

Exhibit 64: U.S. banks' CRE loan activity has declined sharply in recent quarters

Net CRE bank loan growth by property type



Source: BlackRock, Federal Reserve, Green Street. U.S. chartered banks only, excludes credit unions, foreign bank offices in the U.S., thrift institutions and banks in US territories (e.g., Puerto Rico). Data as of 1Q2024.

A slowing pace of new distress in CRE

In fact, we believe the solid U.S. economic growth over the past few quarters has helped to keep distressed CRE activity somewhat contained. As illustrated by Exhibit 66, the amount of outstanding potential distress *decreased* across all CRE property types except "others" in 1Q2024, in aggregate declining by 12% quarter-over-quarter.

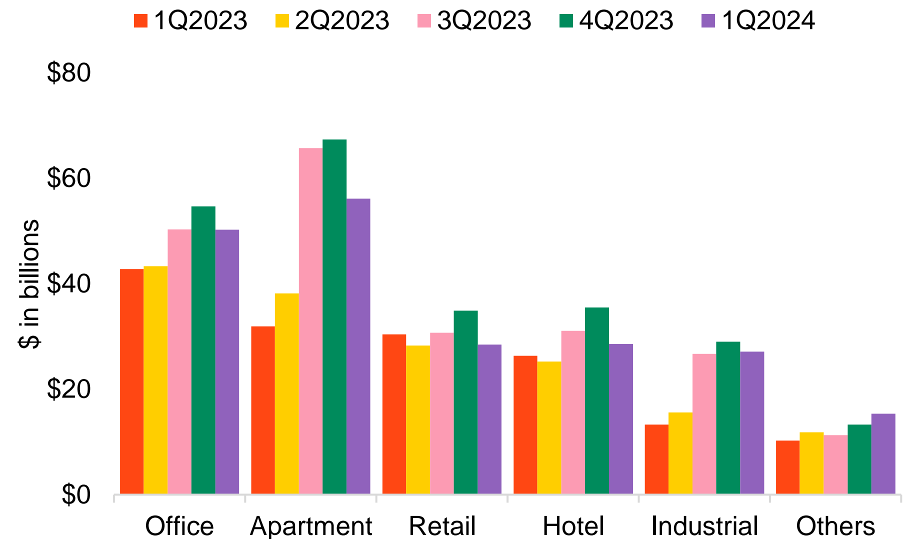
And while outstanding distressed volume grew on net by $2.7 billion in 1Q2024 (Exhibit 65), this net addition amount marked a third consecutive quarter of declining net additions and is 59% lower than the net additions of one year ago, according to RCA. Consistent with large declines in office asset values, the category represented 43% of total outstanding distressed value in 1Q2024. While we broadly expect CRE headwinds to be a longer-term trend, we believe a shrinking pipeline of potentially distressed CRE could signal a potential trough is on the horizon – at least in some corners of the market.

Exhibit 65: Office is the largest distressed category

Balance of distressed CRE by property type

Exhibit 66: Some declines in the distressed CRE pipeline

Pipeline of potentially distressed CRE by category, at quarter end



For both charts: Source: BlackRock, Real Capital Analytics. "Others" includes categories such as self storage and manufactured housing. As of 1Q2024. "Outstanding distress" indicates direct knowledge of property-level distress (via announcements of bankruptcy, default, foreclosure, and other publicly reported issues). "Potential distress" indicates possible future property-level financial trouble due to events such as delinquent loan payments, forbearance and slow lease up/sell out, among others. This also includes CMBS loans placed on master servicer watchlists.

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