Private Markets

September 2024

Global Credit Outlook: 4Q2024

Focus on growth

BlackRock

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Key takeaways

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- In 3Q2024, the focus among many market participants in the U.S., Europe and the U.K. largely shifted from *upside risks to inflation* to *downside risks to growth*. Looking ahead to 4Q2024 (and beyond), our focus will be on the *depth* and *drivers* of the rate cutting cycles in these regions.
- The distinction between monetary policy "normalization" and "easing" is important for corporate credit investors to monitor, in liquid and private markets. Near-term policy *easing* in response to a sharp growth downturn or labor market deterioration would likely be accompanied by meaningful credit spread widening. By contrast, policy rate normalization in response to improved inflation is a more supportive backdrop for credit (and largely what is priced into spreads, currently).
- The trend of "dispersion but not widespread market disruption" – which we have been flagging over the past few quarters – should also remain firmly in place in 4Q2024. We see opportunities for performance and fundamental differentiation across asset classes, sectors, and issuers. We also see scope for some fundamental improvement, as rate relief flows through to borrowing costs. Sponsor M&A should also benefit.
- In general, our base case of supportive growth (especially in the U.S), reduced monetary policy restriction, and technical tailwinds (such as yield based demand) suggest spreads can likely remain in their narrow (and tight) ranges over the medium term. That said, we do expect some near-term volatility around the U.S. election, given the various potential paths that will impact corporate issuers: namely, tariffs/trade and taxes.

Normalizing vs. easing

In 3Q2024, the focus among many market participants in the U.S., Europe and the U.K. largely shifted from *upside risks to inflation* to *downside risks to growth*. This was underscored by central bank actions: the Federal Reserve (Fed), European Central Bank (ECB) and the Bank of England (BoE) each took steps to normalize policy rates from their respective cycle peaks (Exhibit 1).

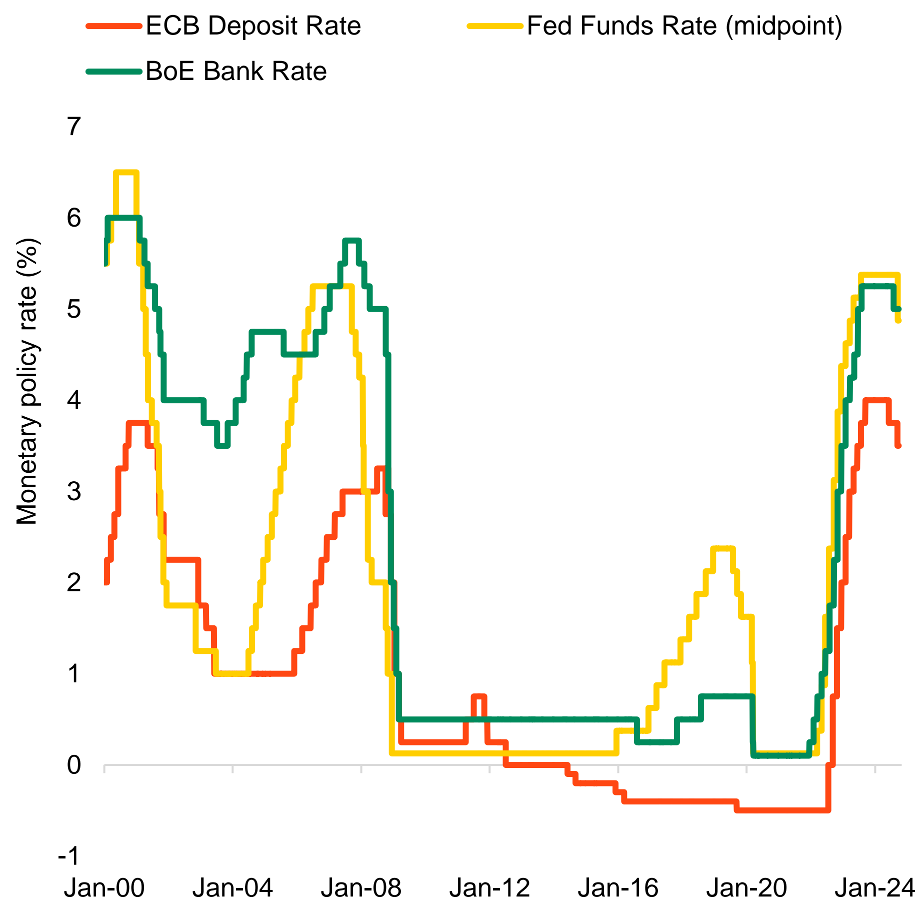
Among the most notable actions of 3Q2024 was the Fed's 50bps rate cut in September. Chair Powell repeatedly referenced a "recalibration" of monetary policy as recent weakening in the labor market brought both sides of the Fed's dual mandate (price stability and maximum employment) into balance.

Looking ahead to 4Q2024 (and beyond), our focus will be on the *depth* and *drivers* of these rate cutting cycles. The distinction between monetary policy "normalization" and "easing" is important for corporate credit investors. Near-term policy *easing* in response to a sharp growth downturn or labor market deterioration would likely be accompanied by meaningful credit spread widening. By contrast, policy rate *normalization* in response to improved inflation is a more supportive backdrop for credit (and largely what is priced into spreads, currently).

We also expect growth differentials to feature more prominently in 4Q2024 – across and *within* regions. For example, in late September policymakers in China announced a range of stimulus and policy measures to boost consumption and address property market declines. And within Europe, the weakness in the German manufacturing sector became more apparent in 3Q2024 – especially when contrasted to strength elsewhere (in the periphery, for example). Meanwhile, U.S. growth was tracking at an above trend pace of +3.1% as of late September.

Exhibit 1: The drivers and depth of future rate cuts will be important to monitor

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 September 27, 2024.

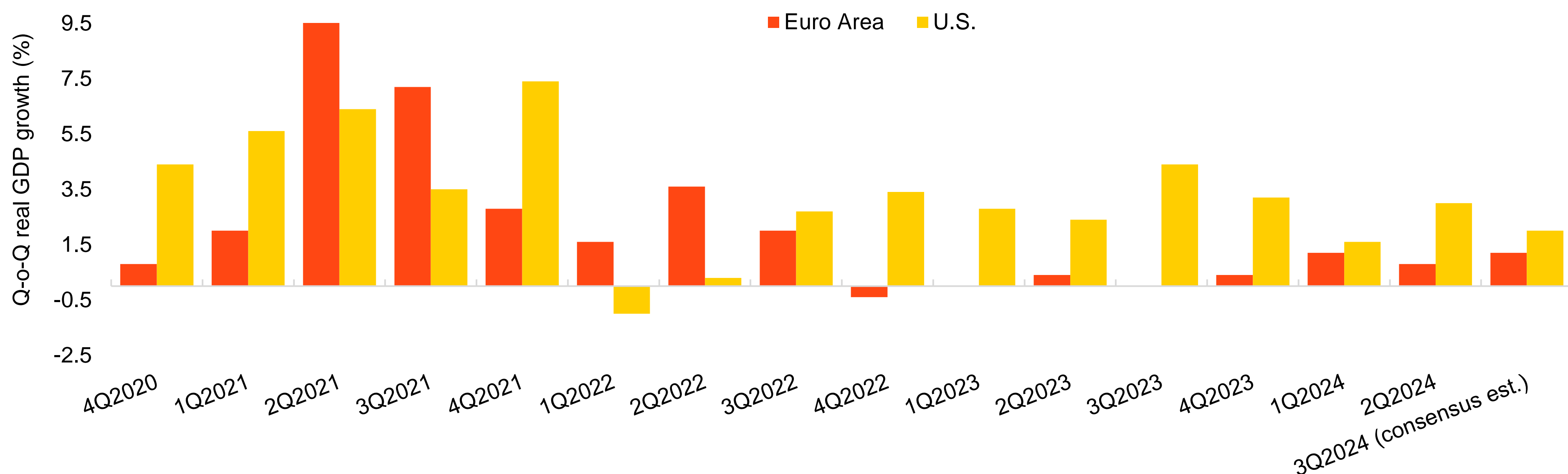
The growth backdrop is key

One of our key investing themes over the past few quarters has been "dispersion but not widespread disruption." This phrase reflects our view that, while the higher cost of capital environment of the past two years has been a headwind for subsets of the corporate credit universe, by and large, most corporations found ways to adapt. But the resilience of credit spreads despite higher interest rates can also be attributed to a supportive growth backdrop. For example, above trend GDP in the U.S. was a powerful mitigant to higher debt servicing costs. Looking ahead to 4Q2024, we expect the growth backdrop will continue to be important for investors' sentiment towards corporate credit risk – especially for the high yield (HY), leveraged loan, and private debt universes – which tend to be more economically sensitive relative to their investment grade (IG) peers.

We are most focused on (1) whether the momentum in U.S. economic activity can be sustained, and (2) whether the recent deterioration in parts of the Euro Area worsens and/or spreads. We are constructive on the U.S. outlook, which has been buoyed by a resilient consumer and should benefit from easing in the level of monetary policy restriction. While we have a slightly more cautious approach toward Europe, we believe the recent stimulus in China trims some of the "left tail" downside risks to European growth.

Exhibit 2: Supportive growth is key for continued credit spread resilience, in our view

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



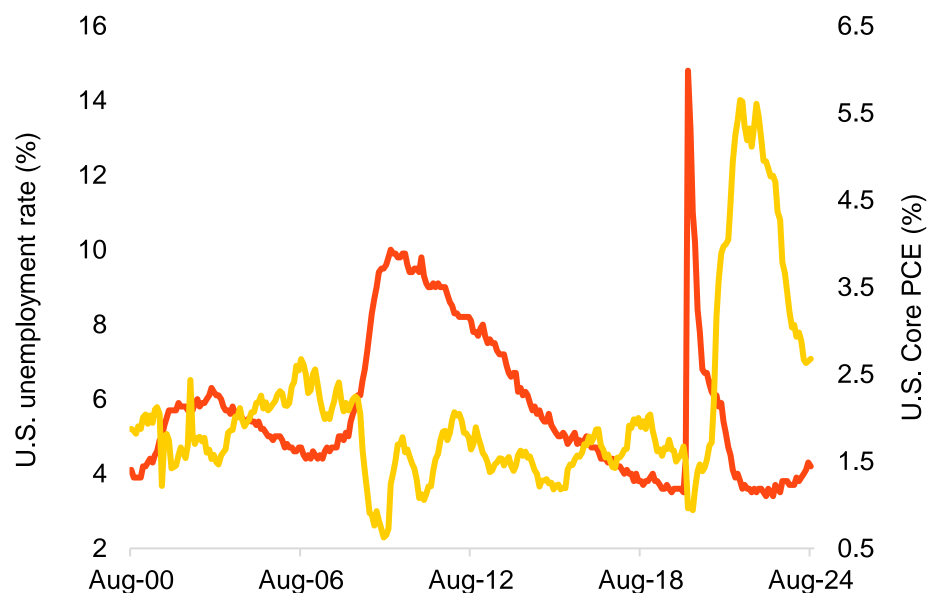
Source: BlackRock, Bureau of Economic Analysis, Eurostat. 3Q2024 forecasts use the Bloomberg Contributor Composite as of September 27, 2024. **There is no guarantee any forecasts may come to pass.**

Clarity on the neutral rate will be important

With the disinflationary process continuing and the unemployment rate rising in recent months, the Fed's dual mandate of price stability (inflation) and maximum employment has moved into better balance (Exhibit 3). For corporate credit investors, the *depth* and *drivers* of the forthcoming rate cutting cycle will be most important. For 4Q2024, we expect 50bps of additional cuts (25bps each in November and December). A sharp downturn in growth or additional increase in the unemployment rate (above 4.2%) would increase the probability of a 50bps cut. We see room for the policy rate to decline from its current restrictive level (4.75%-5.0%) well into 2025. But once the Fed Funds rate approaches 3.5%, conversations around the neutral rate of interest will become more important for fine-tuning the ultimate destination of the policy rate, in our view. The FOMC's September 2024 Summary of Economic Projections shows the median member expects a longer-run Fed Funds rate of 2.9% - a figure that has been gradually drifting higher over the past few quarters (Exhibit 4). That said, the range around this median forecast is very wide: from 2.4% to 3.8%.

Exhibit 3: The FOMC views the risks to its dual mandate as "roughly in balance"

U-3 U.S. unemployment rate (%) seasonally adjusted, and year-over-year U.S. Core PCE inflation (%) seasonally adjusted, RHS



Source: Bureau of Labor Statistics, Bureau of Economic Analysis. Captures data through August 31, 2024 (most recent as of September 27, 2024).

Exhibit 4: The "longer-run" Fed Funds rate projection has been drifting higher

The economic projections of the median FOMC member, as of the 4Q of each year shown

	2024	2025	2026	2027	Longer-run
Real GDP growth	**2.0**	**2.0**	**2.0**	**2.0**	**1.8**
June 2024 projection	*2.1*	*2.0*	*2.0*		*1.8*
March 2024 projection	*2.1*	*2.0*	*2.0*	*not given*	*1.8*
December 2023 projection	*1.4*	*1.8*	*1.9*		*1.8*
Unemployment rate	**4.4**	**4.4**	**4.3**	**4.2**	**4.2**
June 2024 projection	*4.0*	*4.2*	*4.1*		*4.2*
March 2024 projection	*4.0*	*4.1*	*4.0*	*not given*	*4.1*
December 2023 projection	*4.1*	*4.1*	*4.1*		*4.1*
Core PCE inflation	**2.6**	**2.2**	**2.0**	**2.0**	
June 2024 projection	*2.8*	*2.3*	*2.0*		*not given*
March 2024 projection	*2.6*	*2.2*	*2.0*	*not given*	
December 2023 projection	*2.4*	*2.2*	*2.0*		
Federal funds rate	**4.4**	**3.4**	**2.9**	**2.9**	**2.9**
June 2024 projection	*5.1*	*4.1*	*3.1*		*2.8*
March 2024 projection	*4.6*	*3.9*	*3.1*	*not given*	*2.6*
December 2023 projection	*4.6*	*3.6*	*2.9*		*2.5*

Source: BlackRock, Federal Reserve Summary of Economic Projections (as of September 2024). **There can be no guarantee any forecasts may come to pass.**

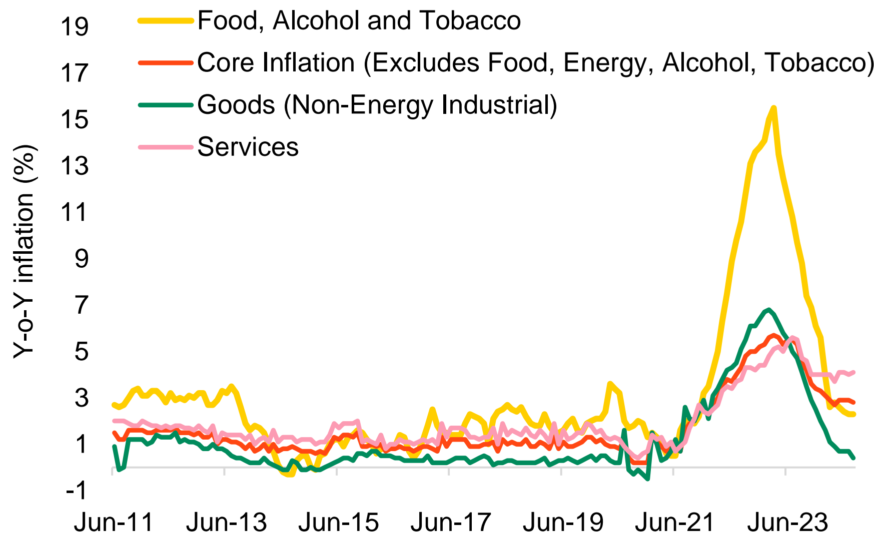
The ECB takes a more patient approach

The ECB had already begun its rate cutting cycle in 2Q2024 but took "another step in moderating the degree of monetary policy restriction" in September by lowering the deposit rate by 25bps (from 3.75% to 3.5%). This was notable as the ECB paused between the two meetings – opting to keep rates unchanged in July, owing to persistently elevated wages. The BoE took a similarly patient approach due to upward pressure in certain inflation categories. After delivering the first rate cut of the cycle in early August, it opted to leave rates unchanged at the September meeting – despite flagging downside risks to growth.

That said, President Lagarde was clear: the Governing Council was "not pre-committing to a particular rate path" despite the "downside" risks to economic growth. She added that while the direction for monetary policy "is pretty obviously a declining path," it "is not predetermined neither in terms of sequence nor in terms of volume." That said, recent data from the (highly fragmented) region's largest economy – Germany – has been weak, especially in the manufacturing sector. As a result, we see scope for the ECB to adopt a more aggressive stance toward normalizing policy in late 2024 and into 2025.

Exhibit 5: Services inflation has remained sticky in the Euro Area, while goods has declined

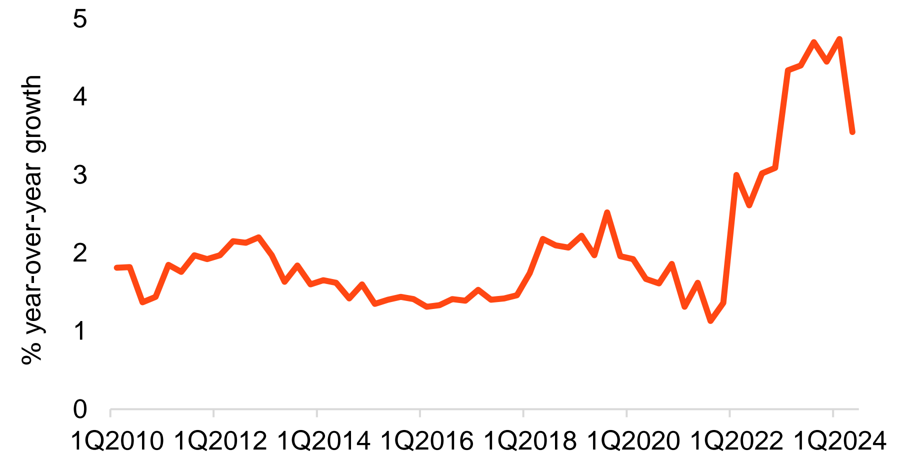
Year-over-year inflation (not seasonally adjusted) for Euro Area, by category



Source: BlackRock, Eurostat, Bloomberg, European Central Bank. Captures inflation data through August 31, 2024 (most recent available as of September 27, 2024).

Exhibit 6: Negotiated wages are normalizing, but are still elevated

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



Source: European Central Bank, BlackRock, Bloomberg. As of 2Q2024 (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.

U.S. election: Considerations for credit

Polls suggest a close race for the November 5th, 2024, U.S. election. For corporate credit investors, certain policies on taxes and trade/tariffs are among the most important to monitor, in our view, as they will likely have the most direct impact on borrowers' fundamentals, sector dynamics, and performance dispersion.

Starting with taxes, a second Trump administration is expected to prioritize the proposed extension of the expiring (by year-end 2025) provisions of the Tax Cuts and Jobs Act. This could result in further individual and/or corporate tax cuts. Trump has also proposed lowering the corporate tax rate to as low as 15%.

A Harris administration's tax extensions would be narrower, with tax increases on corporations (proposing a tax rate of 28%, from 21%, consistent with President Biden's previous budget plan) and high-income earners. A divided government (i.e., when party control of the presidency and Congress is split) would limit how much either presidential candidate could achieve on tax policy.

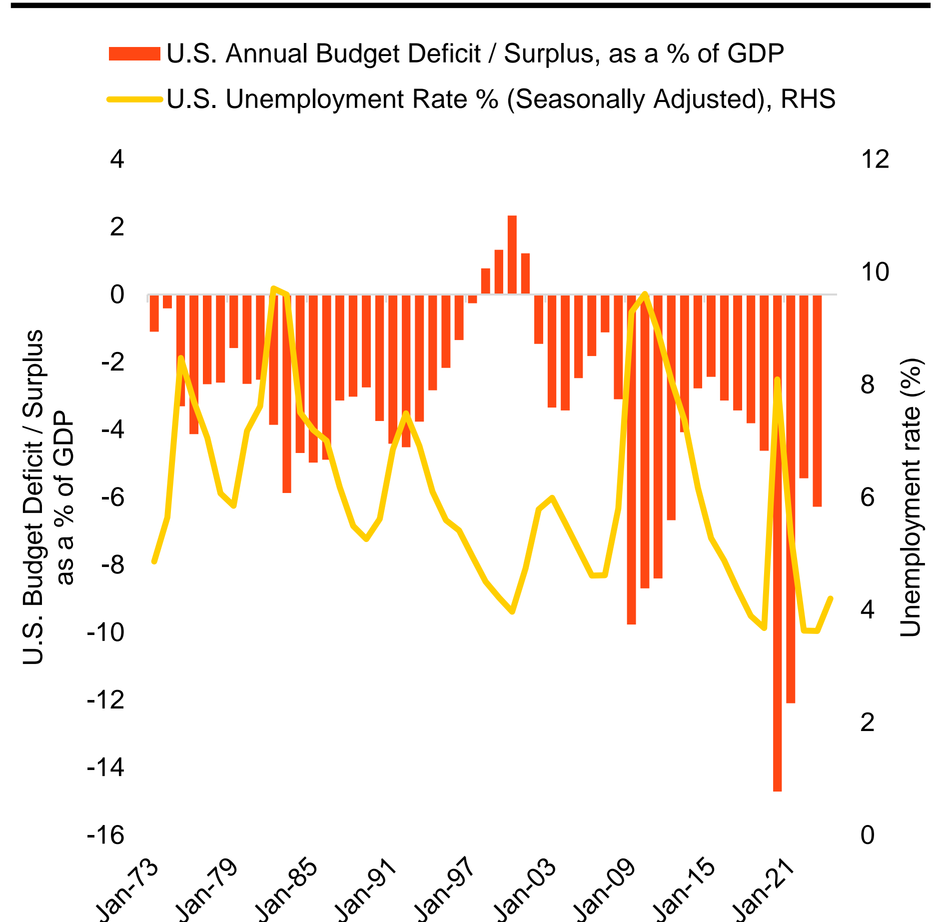
On tariffs, a president has considerable executive authority to impose tariffs on imports. Trump has proposed a 10%-20% universal tariff, a 60% or more tariff on all Chinese imports, reciprocal tariffs, as well as tariffs on countries that move away from the dollar. That said, the intensity and scope will depend on a number of factors, including the makeup of his cabinet.

A Harris administration would likely see a continuation of the Biden administration's trade and foreign policies – including certain protectionist measures such as tariff increases in specific sectors, export controls, and industrial policies. We expect continued intense competition with China under any scenario.

And regardless of the election outcome, we see scope for budget deficits to remain large by historical standards (Exhibit 7), with neither party indicating plans for sustained deficit reduction.

Exhibit 7: The current U.S. budget deficit is elevated, despite relatively 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 (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 August 31, 2024 (most recent available).

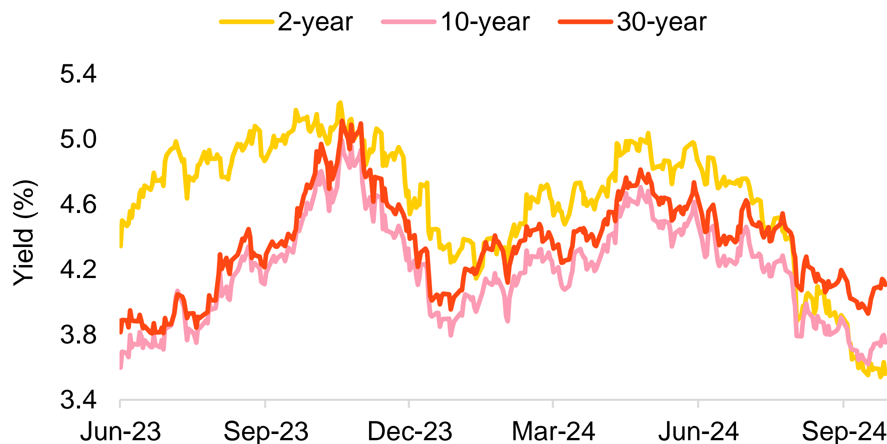
Steeper U.S. Treasury curves

U.S. Treasury yields rallied across the curve during 3Q2024, as shown in Exhibit 8. At times, the price action seemed incongruent: declines in U.S. Treasury yields appeared to reflect a risk-off tone (and, at times, heightened concerns about recession risk). But tight credit spreads were not signaling the same growth concerns. As the market "front-loaded" a path of Fed rate cuts, the U.S. Treasury curve also steepened, led by declines in the policy-sensitive 2-year yield (Exhibit 9).

We expect some modest curve steepening in 4Q2024 and are especially focused on long-end yields given the deficit overhang. In our view, this has the potential to increase the "term premium" – or the compensation investors demand for holding long-term U.S. Treasuries. Indeed, in a September 24th piece, Moody's highlighted the risk of deteriorating "debt affordability" and said, "in the absence of meaningful policy steps to reduce the fiscal deficit, rein in new borrowing to fund those deficits and slow the rise in interest expense..." U.S. "fiscal strength will materially weaken." The rating agency added that such debt dynamics would be increasingly unsustainable and inconsistent with a Aaa rating if no policy actions are taken to course correct. While Moody's currently rates the U.S. sovereign rating at Aaa/Negative Outlook, S&P and Fitch rate it one notch below, at AA+/Stable.

Exhibit 8: U.S. deficits may place upward pressure on long-end Treasury yields

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 September 27, 2024.

Exhibit 9: We expect additional U.S. Treasury curve steepening

2s10s U.S. Treasury yield curve (bps): 10-year yield minus 2-year yield

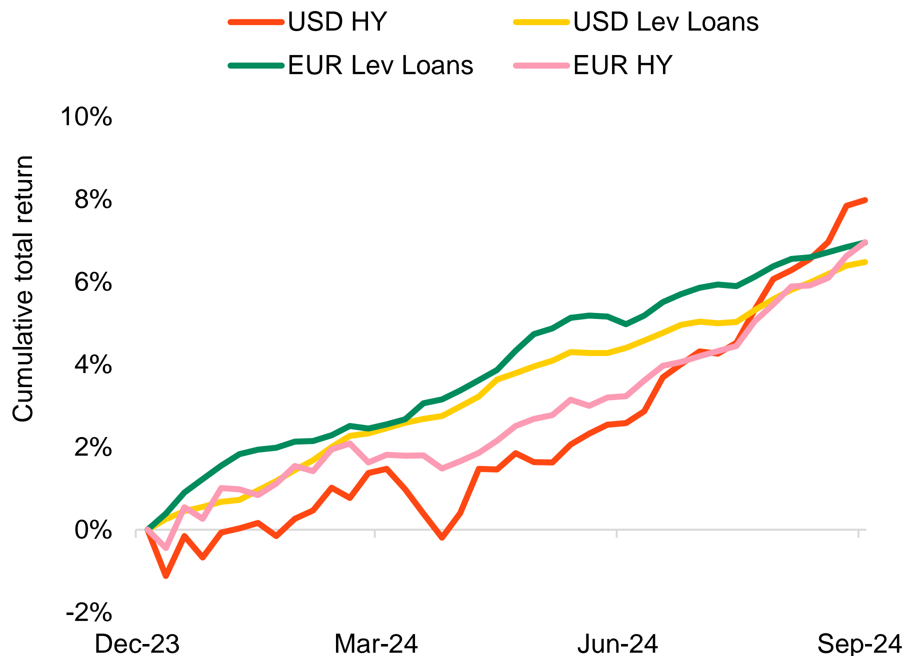
Source: BlackRock, Bloomberg. As of September 27, 2024.

The floating vs. fixed decision

Given this rate backdrop, the asset allocation between fixed-rate and floating-rate credit will be especially relevant in 4Q2024. While the recent rally in U.S. Treasury yields has provided a tailwind to fixed-rate total returns (Exhibit 10), we believe the bulk of the boost from duration has likely been realized – at least for the near term (and absent a negative growth shock). Meanwhile, the yield "pick-up" offered by leveraged loans has moved back to the high end of the historical range (Exhibit 11). While this will likely narrow as Fed rate cuts are realized, investors may look to tactically take advantage of yield differentials in 4Q2024.

Exhibit 10: The rate rally boosted USD HY returns

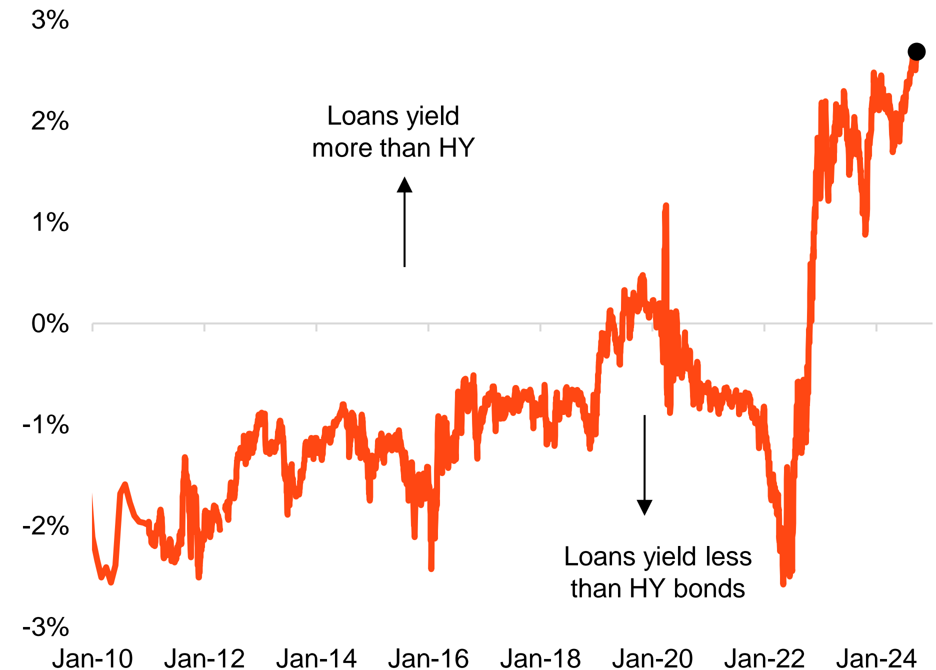
Cumulative year-to-date total returns for the Bloomberg USD and EUR HY Corporate indices and the Morningstar USD and EUR Leveraged Loan indices



Source: Bloomberg, Morningstar/LSTA, BlackRock. As of September 27, 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. Uses weekly return data.

Exhibit 11: The spot yield "pick-up" offered by leveraged loans is at the high end of the range

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



Source: Pitchbook LCD, BlackRock, Morningstar/LSTA, ICE-BAML. As of September 20, 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.

U.S. consumer is not "one size fits all"

The health of the U.S. consumer – which drives 68% of U.S. gross domestic product (GDP) – has been closely watched by market participants over the past several months, as mixed commentary from a range of retail and consumer companies has pointed to more cost-conscious behavior.

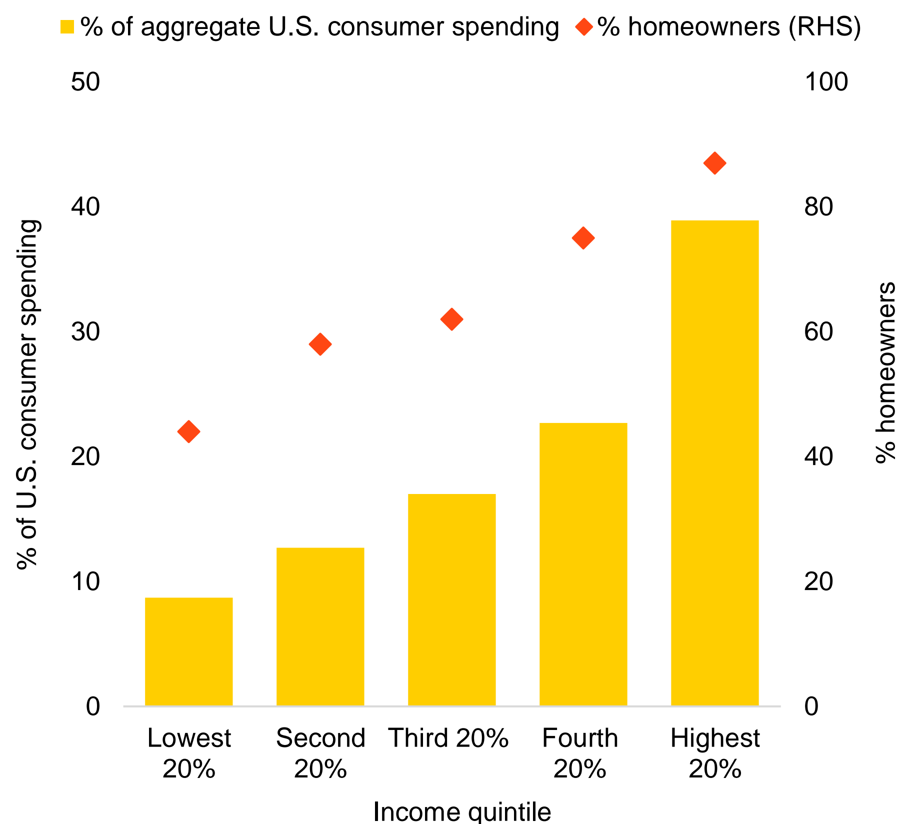
That focus further intensified in late September, following a downbeat consumer confidence survey, which highlighted respondents' more negative sentiment on the availability of "plentiful jobs." And of course, the potential for further weakening in the U.S. labor market had already been on investors' radars given the recent increase in the unemployment rate and the triggering of the "Sahm rule" recession indicator.

We believe developments related to the U.S. consumer's financial health are important for corporate credit investors to monitor for three reasons:

1) As mentioned above, US. consumer spending is a significant driver of overall economic activity. The current pace of above-trend growth in the U.S. has been a key tailwind behind the resilience of corporate credit spreads so far this year and will determine the sustainability of corporate credit's relatively tight spread valuations, going forward.
2) The USD IG and USD HY corporate credit markets have meaningful, direct sector exposure to consumer spending categories. And as we have previously noted, the consumer sector is represented in the private debt indices that we track.
3) The bifurcation which remains evident in the U.S. consumer is likely to drive persistent dispersion (performance, fundamentals) across sectors and issuers.

Exhibit 12: The high-end of the U.S. consumer drives spending and is 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 (released September 25, 2024).

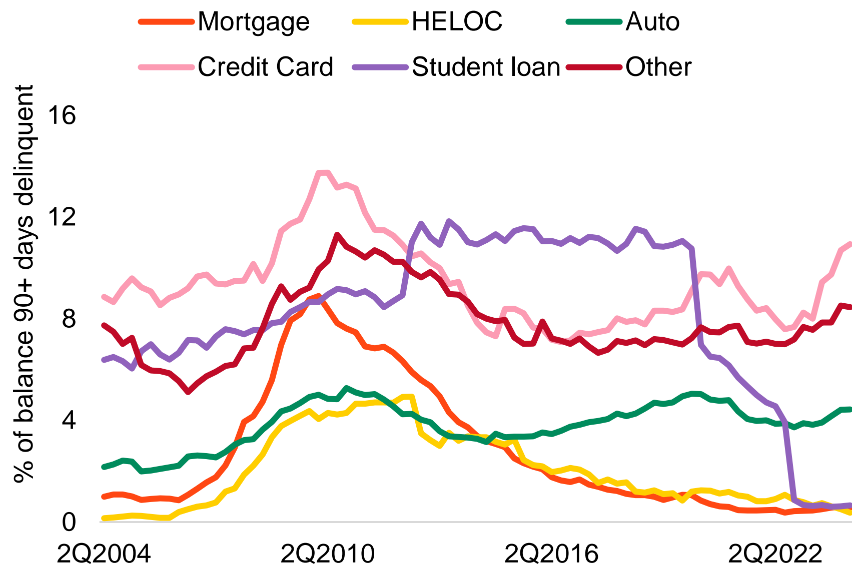
A bifurcated U.S. consumer

There is not a "one size fits all" U.S. consumer, in our view. As we have outlined previously, higher-income consumers have benefited from significant gains in assets they own (homes and investments). For example, the S&P CoreLogic Case-Shiller U.S. National Home Price Index has increased by 54% from year-end 2019 to July 31, 2024 (most recent). And the value of the S&P 500 has increased by 78% from year-end 2019 to September 25, 2024. Meanwhile, lower income consumers are facing headwinds from higher debt service costs and elevated price levels (in absolute terms) in recent years – even if the *year-over-year rate of inflation* is improving.

As shown in Exhibit 13, delinquency patterns are also bifurcated across consumer loan *types*. In 4Q2024, we expect the student loan delinquency rate will increase, as the grace period for reporting late payments expired in September 2024. We will also be watching for additional signs that the *severity* of delinquencies might be more pronounced in the current cycle. As this consumer bifurcation persists, more U.S. banks are focusing on underwriting higher-quality borrowers and are demonstrating more selectivity. According to the July 2024 Senior Loan Officer Opinion Survey (SLOOS), U.S. banks' lending standards for consumer loans were at "the tighter ends of their historical ranges [since 2005] for all consumer loan categories, especially for subprime credit card and subprime auto loans."

Exhibit 13: Housing-related delinquencies stay low, while others rise

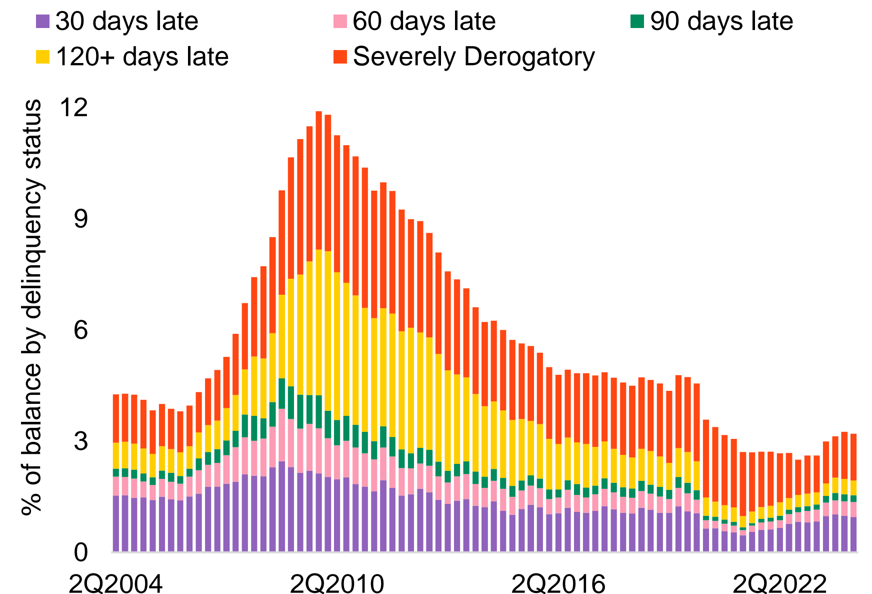
Share of balance 90+ days delinquent by loan type



Source: New York Fed Consumer Credit Panel/Equifax, BlackRock. As of 2Q2024.

Exhibit 14: Total delinquent debt balance is increasing, but is modest relative to history

Total debt balance by delinquency status



Source: New York Fed Consumer Credit Panel/Equifax, BlackRock. As of 2Q2024.

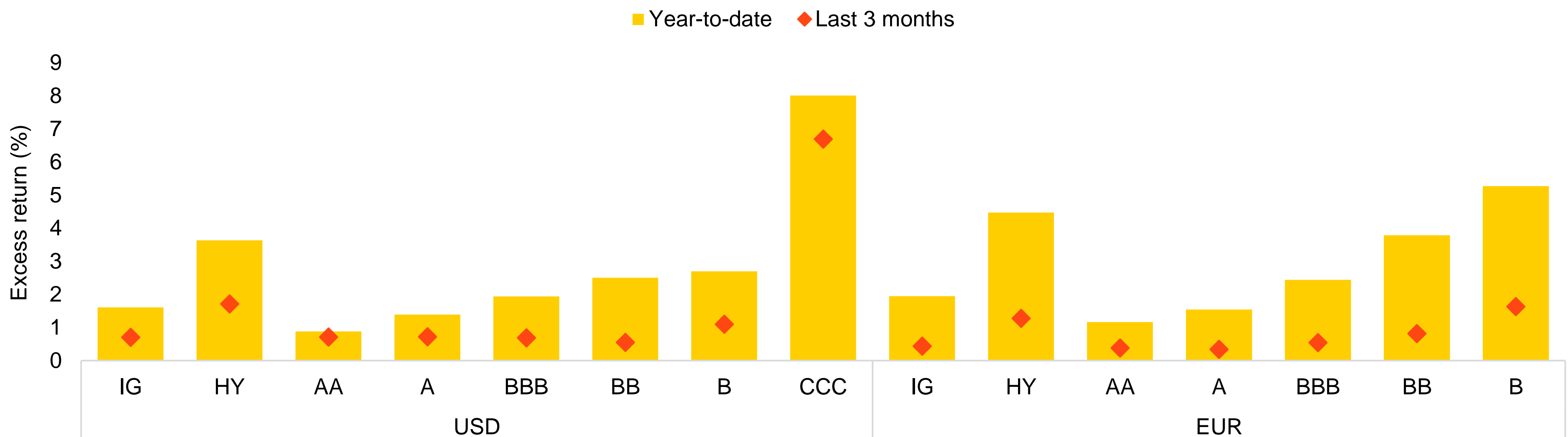
Lower-rated credit leads in performance

So far this year, the lower-rated subsets of the USD and EUR corporate credit market have outperformed their higher quality peers – a trend fueled by moderating, but still "supportive enough" growth, as mentioned earlier. Exhibit 15 illustrates this point using excess returns – which exclude the impact from interest rate moves and instead isolate the performance of credit spread risk. As shown below, HY has outperformed IG in both regions – on a year-to-date basis, as well as during the last three months. Similarly, within IG, BBB-rated credit has outperformed its A-rated peer, year-to-date. And the outperformance of USD CCCs – while a highly idiosyncratic group – has also been notable over the past few months.

In the scenario of a trend pace of growth (or ideally, above trend) and with central banks poised to continue to reduce the degree of monetary policy restriction, we see scope for this trend of outperformance in lower-rated credit to persist over the medium term. This leaves us comfortable moving down the quality spectrum, especially given speculative grade firms' proactive approach to refinancing upcoming maturities over the past several months (as discussed later). That said, issuer selectively in the highly-leveraged CCC cohort will remain key, in our view. And in the short-term, we do expect some credit spread volatility around the U.S. election, given the uncertainty – especially in sectors which may be subject to tariffs (depending on various policy outcomes).

Exhibit 15: We expect the trend of lower-rated credit outperformance to continue

Excess returns for the Bloomberg USD and EUR Corporate indices



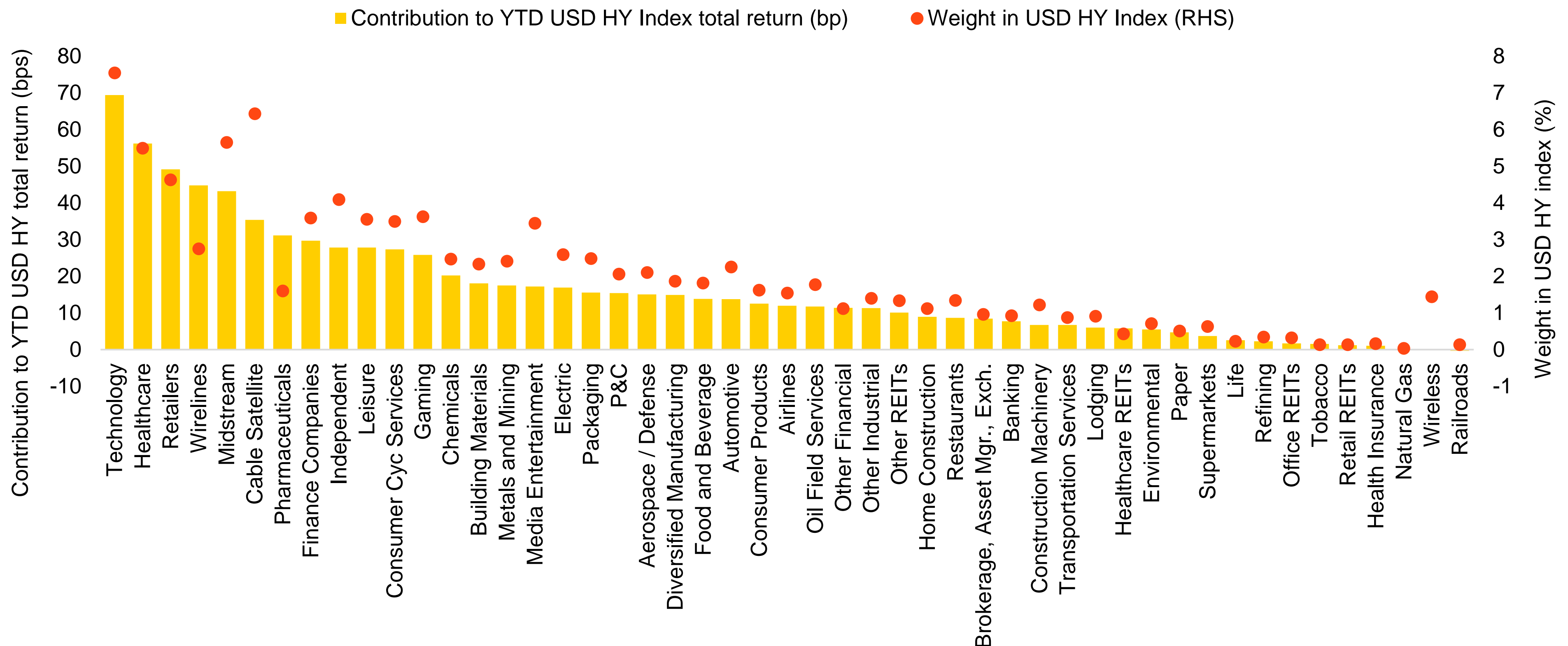
Source: Bloomberg, BlackRock. As of September 27, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index. We exclude USD AAA, EUR AAA, and EUR CCC due to their small size.

Sector dispersion should persist

The volatility around the U.S. election is also likely to result in additional sector dispersion – above and beyond what has already been evident so far this year. Exhibit 16 illustrates this differentiation using the sector contributions to the Bloomberg USD HY Corporate Index year-to-date total return of 7.98%. As shown below, some sectors such as Wirelines and Pharmaceuticals have contributed more than their index weight would suggest. Meanwhile, others have contributed much less (Cable Satellite, Midstream and Media Entertainment, among others). In our view, this underscores the importance of credit selection in the corporate credit markets – especially in the speculative grade universe. It also highlights that, despite the tight level of spreads at the index level (discussed later), performance differentiation is indeed visible.

Exhibit 16: Sector contributions to USD HY total return have not uniformly tracked their index weight

Sector contribution to year-to-date total return of the Bloomberg USD HY Corporate Index, and average index weight of each sector (RHS)



Source: Bloomberg, BlackRock. As of September 27, 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.

Spread vs. yield relative value "tug-of-war"

Many market participants have been surprised about the level of resilience in corporate credit spreads this year. For example, even during the period of elevated market volatility in early August, the widening in USD HY and IG credit spreads was relatively short-lived and was retraced quickly (Exhibit 17).

Sticking with the example of USD credit, average index-level spreads are unquestionably tight by historical standards: 299bps for USD HY and 89bps for USD IG. This compares to the post-financial crisis averages of 456bps and 134bps, respectively. That said – we see scope for spreads to move even tighter, owing to the level of all-in yields available, which are attractive by historical standards (Exhibit 18). Indeed, the local spread tights for both indices were set in mid-2021, when the yield backdrop was much lower. At that time, USD HY spreads dipped to 262bps, and USD IG spreads reached 80bps. A back-up in intermediate or long-end U.S. Treasury yields, to the extent it materializes, would likely generate additional demand for corporate credit from yield-based buyers.

Exhibit 17: Spreads are tight...

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

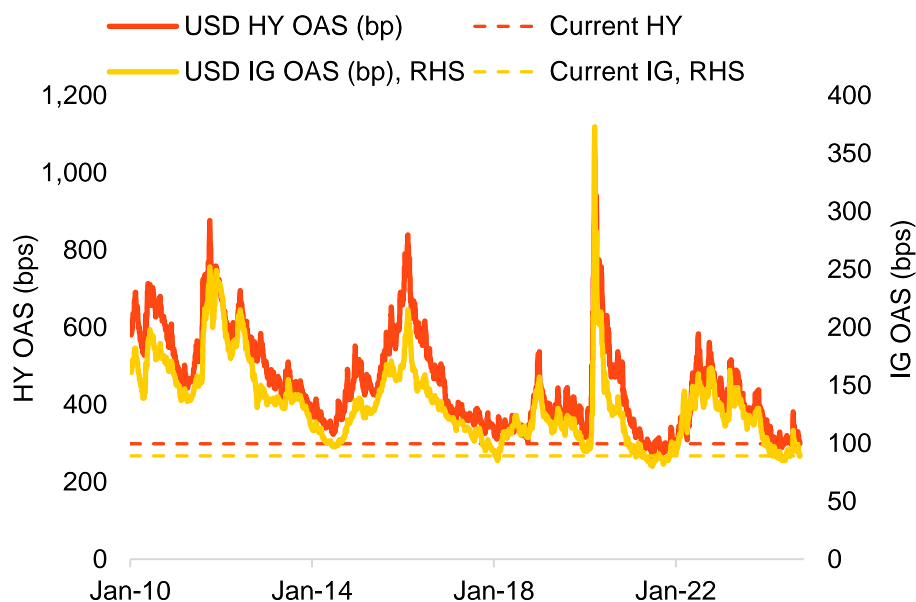
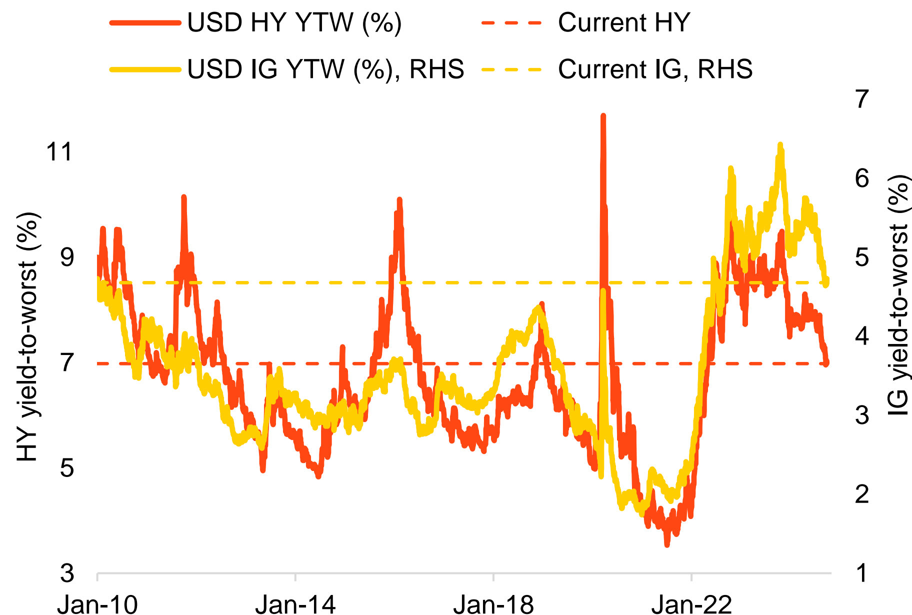


Exhibit 18: ...but yields are still elevated

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



For both charts: Source: BlackRock, Bloomberg. As of September 27, 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.

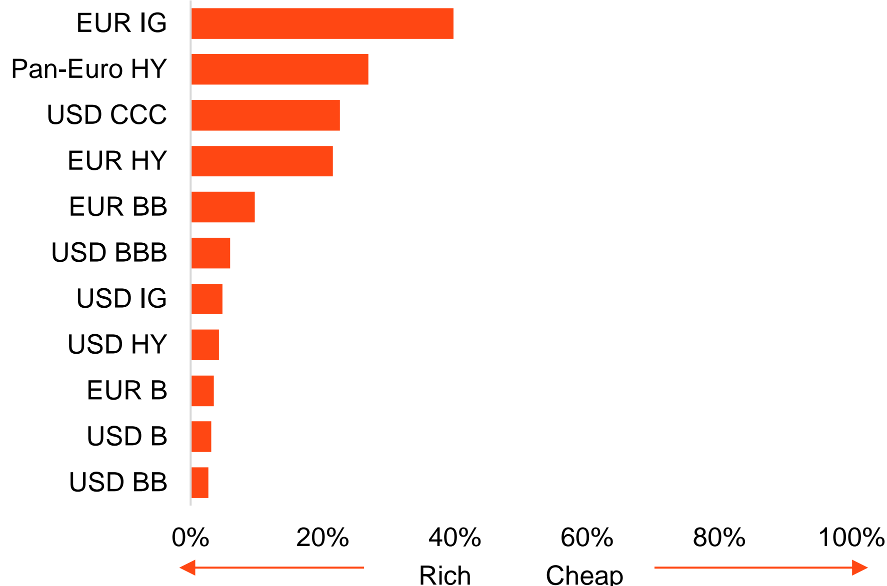
Placing valuations in context

Exhibits 19 and 20 shed further light on the current state of valuations in the corporate credit market, this time using percentile ranks of daily spreads and yields since January 2010. Importantly, while many subsets of the USD and EUR corporate credit market are currently trading at rich levels by historical standards, we believe this can persist owing to the strong technical support from yield-based investor demand. Additionally, in many markets there has been limited *net* supply, as much of the *gross* issuance has been for refinancing.

As shown in Exhibit 19, spread valuations in the EUR corporate credit market are somewhat more attractive (on a historical basis) – a reflection, in our view, of the more challenging growth backdrop in the region. And in the USD HY market, the CCC cohort has yet to fully close its underperformance gap vs. the broader USD HY index. Additional outperformance in the CCC universe is a key ingredient to meaningful index-level tightening (if the USD HY market is to revisit the mid-2021 local trough).

Exhibit 19: Spreads are relatively tight…

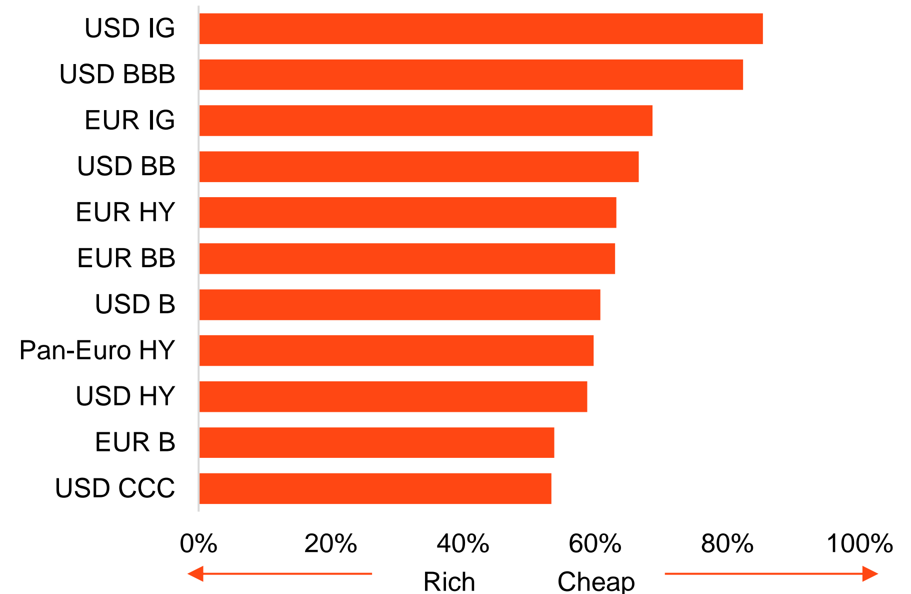
Percentile rank of daily index-level corporate bond spreads since January 1, 2010



Note: Captures option adjusted spread data through September 27, 2024.

Exhibit 20: …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 September 27, 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. We exclude USD AAA, EUR AAA, and EUR CCC due to their small size.

Multi-faceted growth drivers for private debt

Private debt continues to cement its status as a sizable and scalable asset class for a wide range of long-term investors. The asset class – which totaled more than $1.7 trillion globally as of December 2023 (most recent per Preqin) – represents roughly 13% of the $13.7 trillion alternative investment universe.

In our latest in-depth report on the asset class of private debt, we reiterated our forecast for global private debt assets under management (AUM) to reach $3.5 trillion by year-end 2028 (Exhibit 21). *Note: this forecast is specific to the various strategies of middle market corporate lending and excludes areas such as private asset-backed finance, which we have discussed separately*.

We see four multi-faceted growth drivers behind this global private debt AUM forecast:

(1) Borrower preferences for certainty of execution, flexibility and clarity on pricing – and an expanding "addressable market"

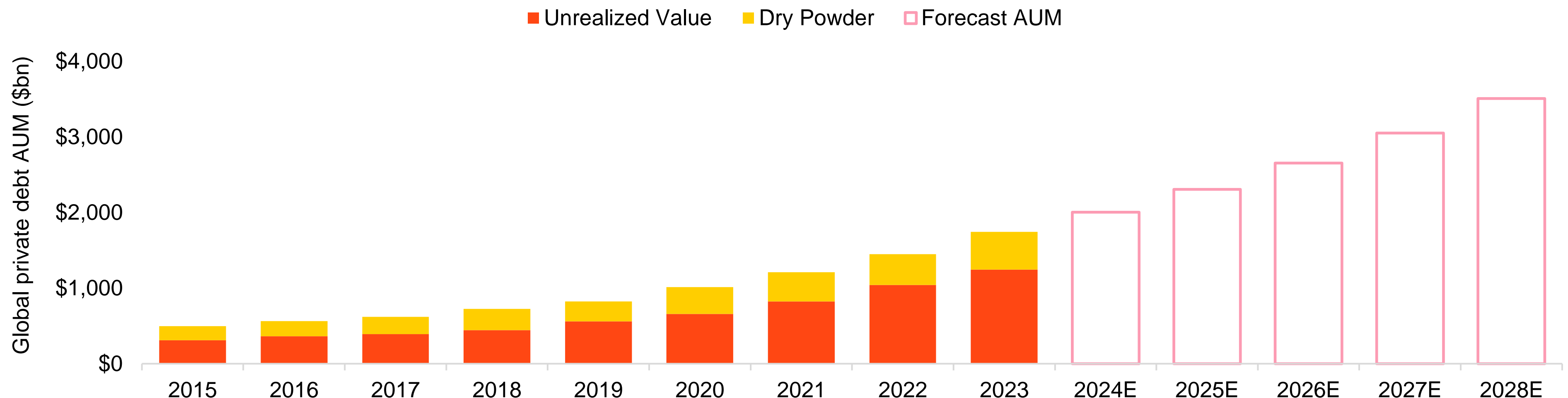
(2) Investor desires for portfolio diversification and increased comfort with private debt as an asset class

(3) Evolution in the public debt markets (which now serve larger borrowers) and equity markets (as firms stay private for longer), and

(4) Shifts in bank lending, as they focus on using their own balance sheet capacity in a capital efficient way.

Exhibit 21: 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 AUM forecasts



Source: BlackRock, Preqin. Historical (actual) data from Preqin, as of each calendar year-end. 2024E to 2028E are BlackRock estimates. **There is no guarantee any forecasts may come to pass.** As of September 19, 2024.

The public vs. private "mix shift"

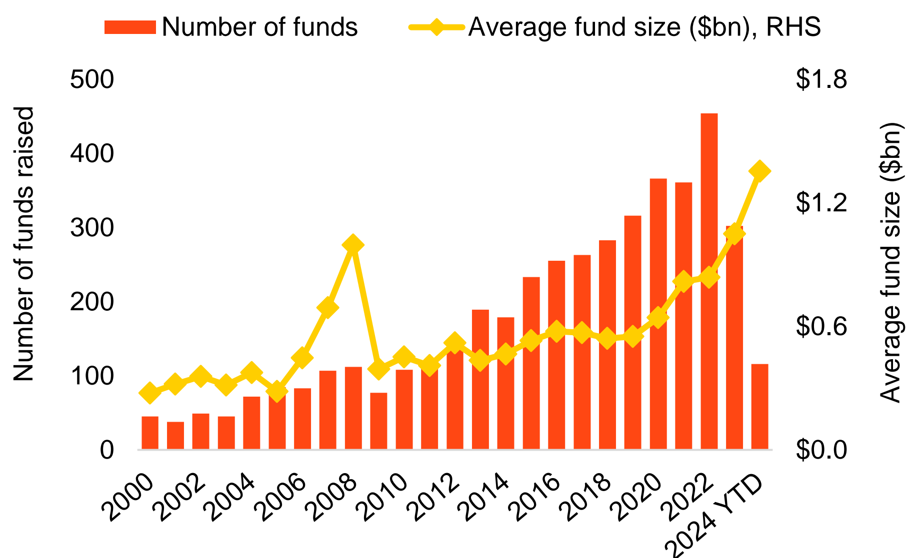
The "mix shift" between the syndicated and private debt markets will be an important pattern to watch in 4Q2024 and beyond, in our view. For context, the addressable market in private debt has expanded significantly over the past decade as the benefits to borrowers (i.e., certainty of execution, flexibility, etc.) have become more evident, and the size has become more practical for a wide range of deals.

In the earliest days of the asset class, private debt was used primarily for very small financing needs or for companies without meaningfully positive (or even negative) EBITDA. But this asset class is no longer reserved for niche pockets of the market. In recent years (as the size of the asset class has grown), private debt lenders have funded larger deals, leading to more competition with the traditional (syndicated) leveraged finance markets. This can be seen in the fundraising trends highlighted in Exhibit 22.

More recently, there have been several examples of firms refinancing debt (currently outstanding in the public debt markets) with private funding solutions (and vice versa; Exhibit 23). We view this as reflective of private debt's appeal to a wide range of borrowers (even those with demonstrated access to the public markets) and expect this "funding mix" to ebb and flow over time, depending on market conditions.

Exhibit 22: Larger private debt fund sizes

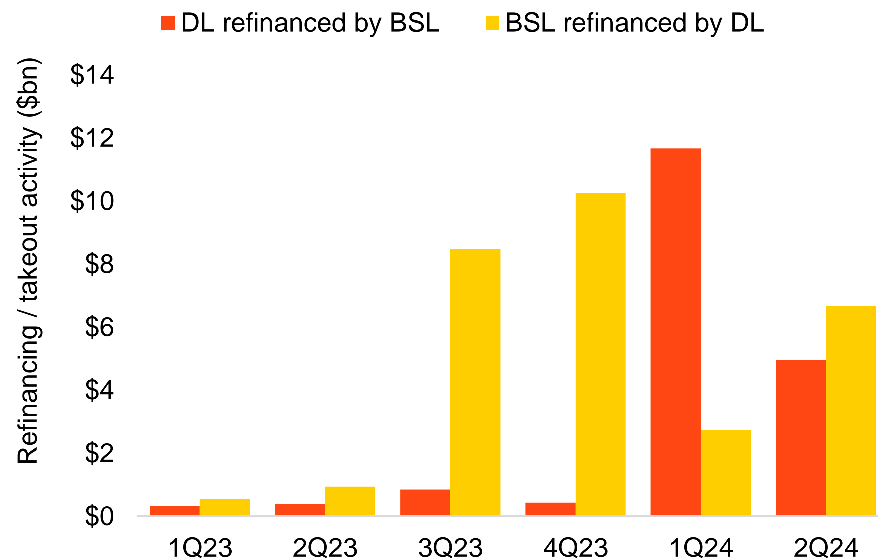
Global private debt fundraising (number of funds and dollar value raised on RHS). Captures the "final close date" for each fund.



Source: BlackRock, Preqin. As of September 23, 2024.

Exhibit 23: The mix-shift will ebb and flow

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



Source: Pitchbook LCD, BlackRock. Captures data through June 30, 2024 (most recent).

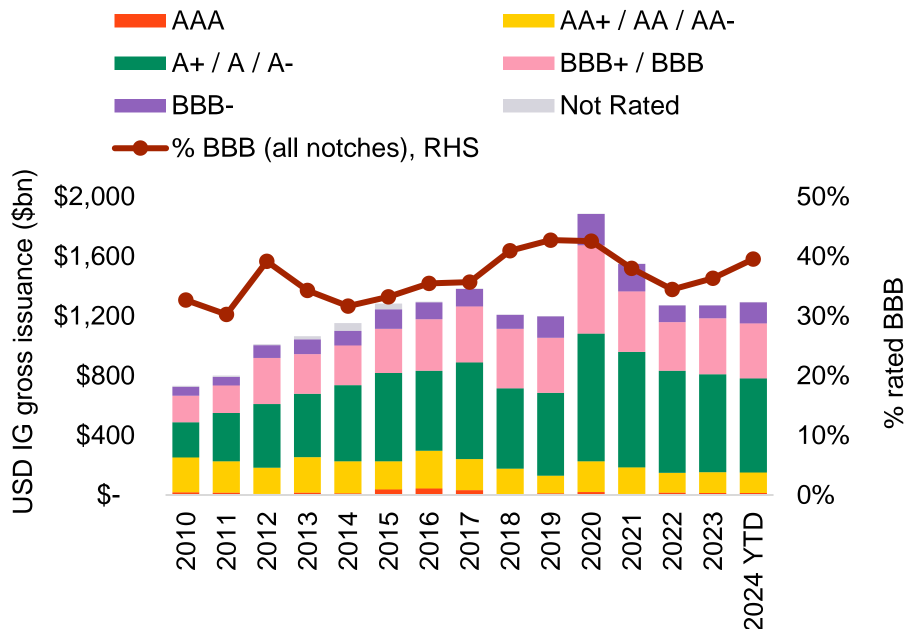
An expanding market of borrowers

Over the past several months, there have been anecdotes of IG-rated borrowers tapping the private debt markets for financing. Some market observers have questioned why a company with access to the public IG debt capital markets would choose this route for financing. While the USD IG primary debt markets are large, deep and open to a wide range of borrowers – including those at the cusp of HY ratings (i.e., BBB-), as shown in Exhibit 24 – we do see a rationale for an IG firm choosing a more bespoke, private financing solution.

For example, a firm with an already-sizable debt capital structure may have "saturated" the public debt markets, by approaching investors' issuer concentration limits. It may also have limited debt capacity at the holding company level, within the confines of an IG debt rating. Other examples could include (and are not limited to) a firm desiring certainty of execution amid volatility in public markets, or funding for a more complex transaction which may require rounds of additional investment.

Exhibit 24: The BBB share of USD IG issuance has increased in recent years

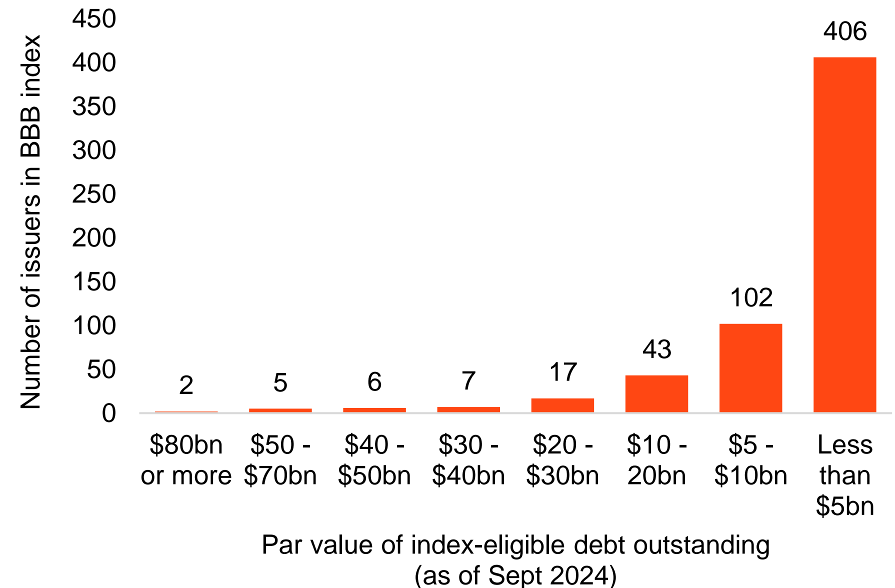
USD IG gross issuance by Dealogic Effective Rating at Launch



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

Exhibit 25: A portion of the BBB index has extremely large debt capital structures

Debt capital structure size distribution of issuers included in the Bloomberg USD BBB Corporate Index (ticker LCB1TRUU)



Source: BlackRock, Bloomberg. As of September 17, 2024. Excludes issuers that are not index-eligible.

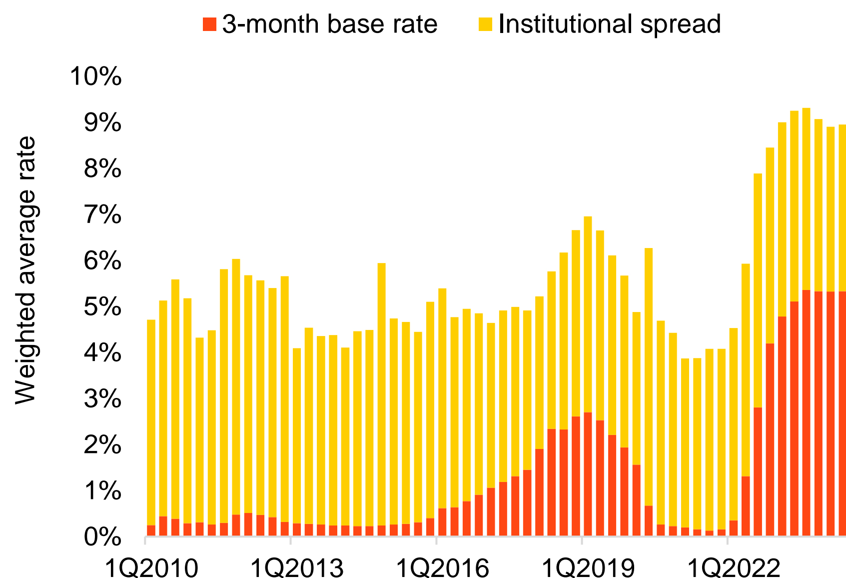
Some interest rate relief in sight

While we expect additional rate cuts from the Fed and ECB in 4Q2024 and into 2025, the policy rate will likely remain in restrictive territory for at least the next few months (and possibly longer, in our view). As such, market participants are still watchful for any additional signs of fundamental deterioration – especially among floating rate borrowers which have experienced sharply higher debt servicing costs for the past several quarters (Exhibit 26). This has unsurprisingly weighed on coverage metrics, as shown in Exhibit 27 (using a sample of issuers with public financials in the Morningstar/LSTA USD Leveraged Loan Index).

That said, there have been some signs of stabilization recently (again, Exhibit 27), as well as in the "outer edge" statistics tracked by Pitchbook LCD. For example, 22% of the issuers in the sample had cash-flow coverage of less than 1.5x as of 2Q2024. While this is still above the 19.7% average over the past eight quarters, it is improved compared to the 26.3% as of 3Q2023. For context, during the record low interest rates of 2021, the percentage was as low as 9%. We expect incremental improvement in fundamentals as additional rate cuts are realized – but again, the degree of support in the *growth* backdrop will remain paramount.

Exhibit 26: Sharply higher borrowing costs...

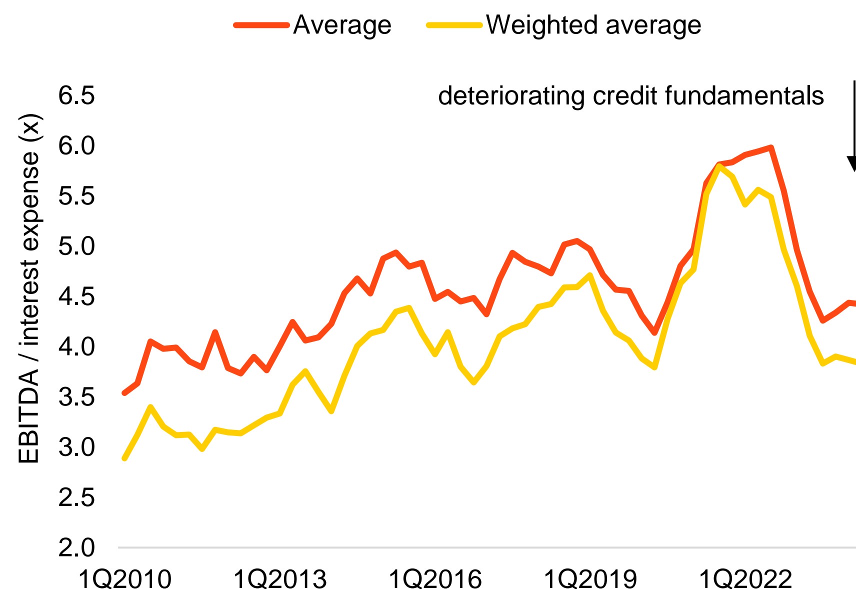
Weighted average absolute institutional rate for new USD leveraged loans priced in each period



Source: Pitchbook LCD, BlackRock. As of 2Q2024 (most recent). Base rate reflects the average during the quarter.

Exhibit 27: ...have weighed on coverage ratios

Average and weighted average interest coverage for a sample of public loans in the Morningstar / LSTA USD Leveraged Loan Index



Source: Pitchbook LCD, Morningstar LSTA, BlackRock. As of 2Q2024 (most recent). Pitchbook LCD's latest sample includes 157 issues, or 14% of the total index issuer count.

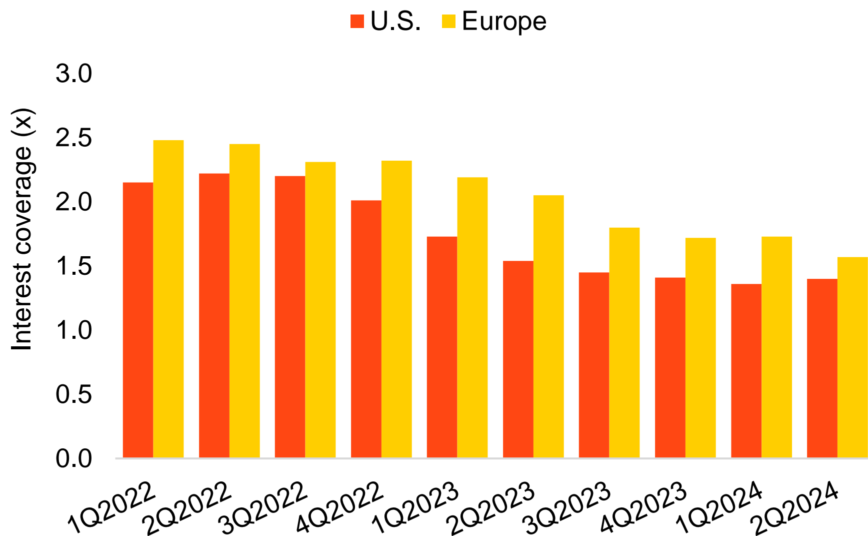
Fundamental resilience, in aggregate

In aggregate, private debt borrowers – which are also floating rate – have generated relatively resilient fundamentals despite the elevated cost of capital over the past several quarters. Using data from Lincoln International's Valuations and Opinions Group Proprietary Private Market Database, Exhibits 28 and 29 illustrate that interest coverage (IC) and fixed charge coverage (FCC) ratios for U.S. and European borrowers are holding in relatively well (i.e., not deteriorating sharply).

As we outlined previously, this has been driven by solid EBITDA growth, which has somewhat offset the headwind from higher borrowing costs. Looking ahead, an ongoing normalization of interest rates in the U.S. and Europe should provide some incremental relief in the debt service costs for borrowers in the private debt market. But here too, the growth backdrop is likely most important for these groups, as supportive economic activity is key for overall stability in business trends and margins.

Exhibit 28: Interest coverage ratios

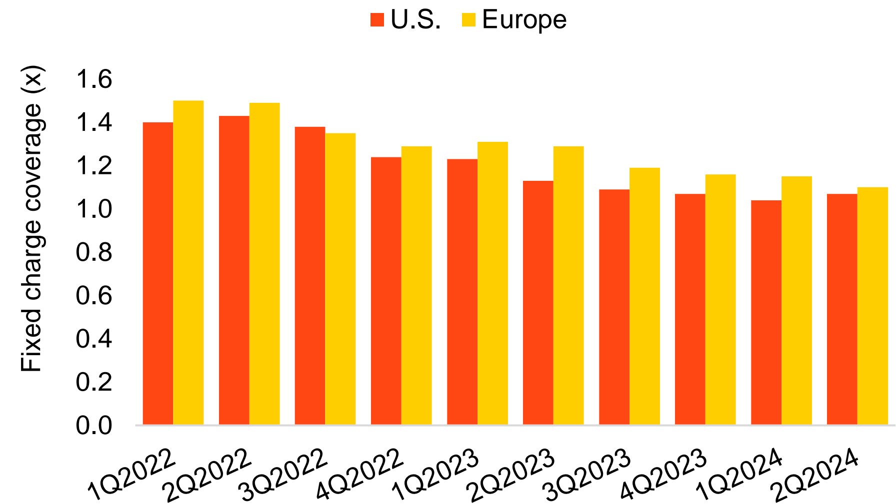
Size-weighted IC ratios for the universe of U.S. and European firms captured by Lincoln International



Source: BlackRock, Lincoln International Valuations & Opinions Group Private Market Proprietary Database. Captures data as of 2Q2024. Calculation: Interest coverage = last twelve months' EBITDA / Interest Expense. © 2023 Lincoln Partners Advisors LLC. All rights reserved. Used with permission. Third-party use is at user's own risk.

Exhibit 29: Fixed charge coverage ratios

Size-weighted fixed charge coverage ratios the universe of U.S. and European firms captured by Lincoln International



Source: BlackRock, Lincoln International Valuations & Opinions Group Private Market Proprietary Database. Captures data as of 2Q2024. Calculation: (EBITDA – Taxes – Capex) / (Interest Expense + 1% Debt Balance). © 2023 Lincoln Partners Advisors LLC. All rights reserved. Used with permission. Third-party use is at user's own risk.

Dispersion in defaults, under the surface

That said, there is differentiation under the surface of aggregate fundamental data, and we expect this pattern to remain in place in 4Q2024. For example, smaller borrowers have experienced higher covenant default rates than larger ones, partly due to more restrictive covenants in the lower middle market (Exhibits 30 and 31). It also reflects, in our view, the tendency of small firms to have less diversification (product, geography, customer, etc.), thinner financial cushions, and fewer economies of scale than their larger peers – all of which can make smaller businesses more vulnerable in certain macroeconomic environments. Sector exposures can also influence default and earnings experiences, as each industry is subject to different degrees of cyclicality, pricing power, operational agility, and financial flexibility. These trends are consistent with the dispersion we outlined in February 2024 across the various subsets of private debt strategies, vintages, and portfolio characteristics.

Exhibit 30: Nuances between size-weighted and instance-weighted default metrics

Aggregate covenant default rate (size-weighted and instance-weighted), for the U.S. portfolio companies included in the Lincoln International Proprietary Private Market Database

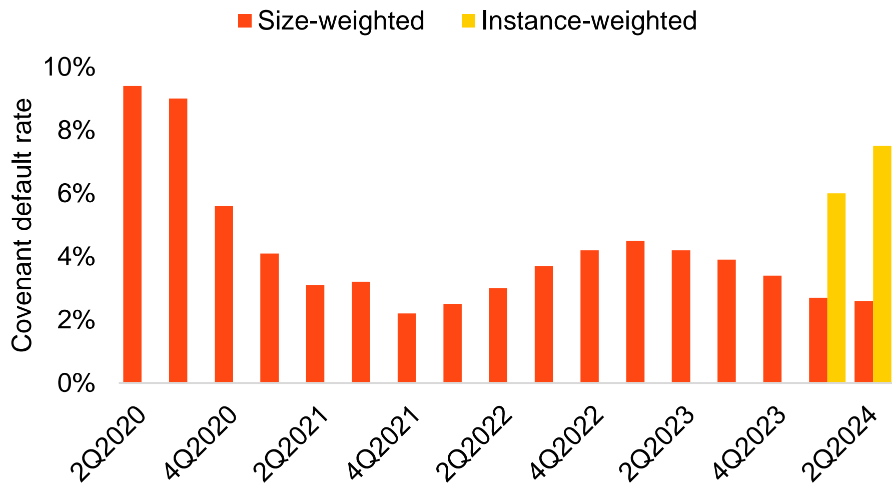
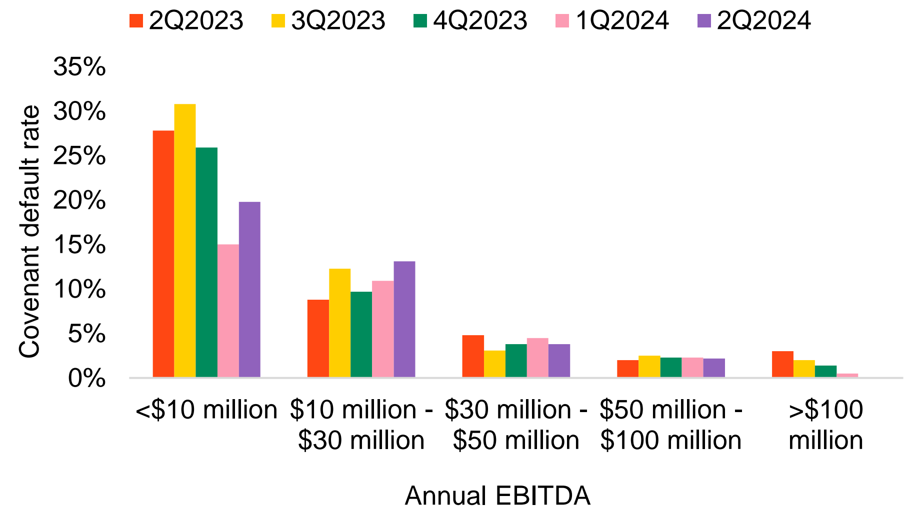


Exhibit 31: Covenant default rates vary by borrower size, with smaller firms leading

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



For both charts: Source: Lincoln International Valuations & Opinions Group Proprietary Private Market Database, BlackRock. As of 2Q2024. A default is defined by Lincoln as a covenant default (not necessarily a monetary default). The size-weighted calculation considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter. The instance-weighted calculation is only available for 1Q2024 and 2Q2024. © 2023 Lincoln Partners Advisors LLC. All rights reserved. Used with permission. Third party use is at user's own risk.

The impact of a rate cutting cycle

Beyond the impact of lower rates from the borrower's perspective, another common question we receive is: how will the Fed's rate cutting cycle impact the private debt asset class, from the investor's perspective?

As a floating rate asset class, a lower base rate will flow through to private debt yields. That said, and as we outlined earlier, we do not expect interest rates to revisit the ultra-low levels which prevailed for much of the past 15 years (between the global financial crisis and the onset of the pandemic).

Additionally, we expect the yield "pick up" relative to public markets to persist (although it will fluctuate, depending on market conditions). This is reflective of the illiquidity premium captured in the private debt markets.

Exhibit 32 illustrates this yield "pick up" using the Cliffwater Direct Lending Index (CDLI), which is an asset-weighted index of approximately 16,200 directly originated middle market loans (totaling $358 billion as of June 30, 2024).

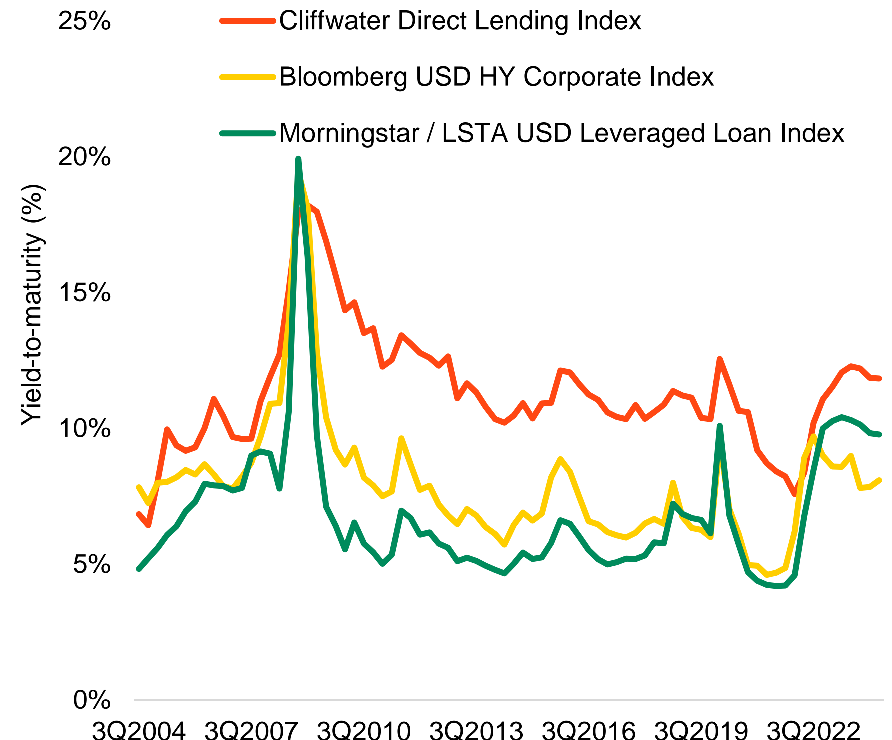
We use the CDLI for illustrative purposes as North American direct lending represents the largest subset (across regions and strategies) of the global private debt market, as we discussed recently.

The comparison to the USD Leveraged Loan Index is most relevant, given it is also a floating rate asset class.

As of 2Q2024, the yield differential between the CDLI and the Morningstar/LSTA USD Leveraged Loan Index stood at 206bps. That said, the average differential (using quarterly data) since 1Q2019 has been 320bps.

Exhibit 32: Direct lending has historically offered a yield "pick-up" vs. public markets

Average index yield-to-maturity levels



Source: Cliffwater LLC, Bloomberg, Morningstar/LSTA, Pitchbook LCD, BlackRock. As of 2Q2024 (most recent available for the CDLI, as of September 27, 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.

A historical view of income and losses

A range of factors will influence the differential between public and private debt markets, including broader macroeconomic conditions and risk appetite, volatility in the syndicated debt markets, and the competitive landscape in the private debt markets.

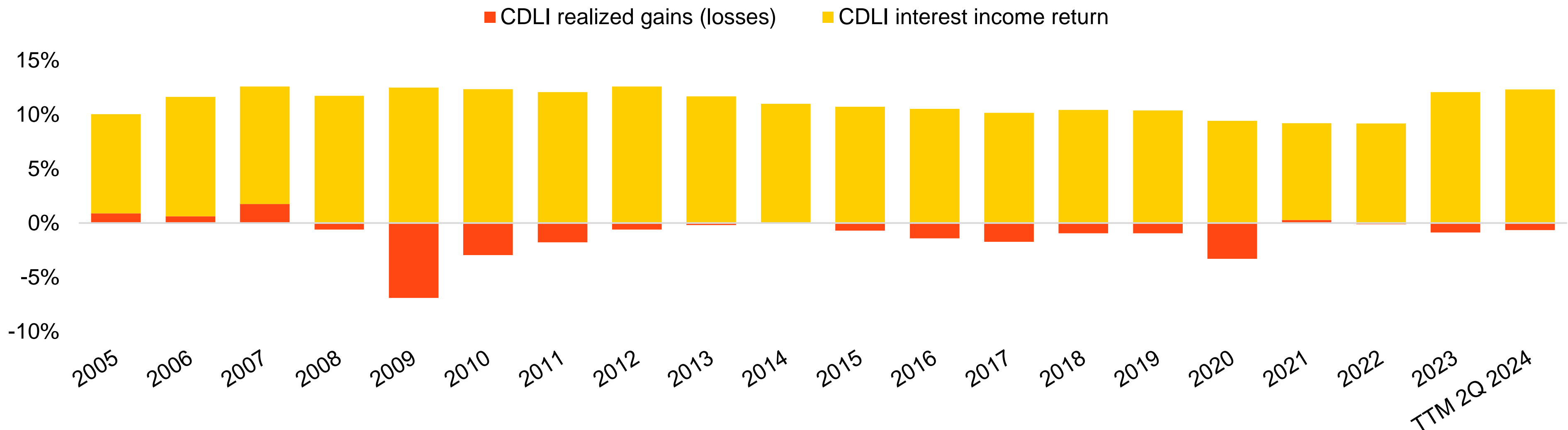
As Exhibit 33 illustrates, realized losses have typically been modest in the context of the interest income generated by the private debt asset class – again using the Cliffwater Direct Lending Index as a proxy for U.S. middle market lending. After an extremely low period of realized loss rates in 2021 and 2022, the CDLI loss trend has shown some normalization but remains contained.

2Q2024 data for the CDLI (most recent available) highlighted realized loss rates (from payment defaults or restructurings) that, while higher vs. 2021-2022, remained moderate at just 66bps for the trailing twelve months ended 2Q2024.

Note: when comparing public and private credit fundamentals, we prefer to use realized loss rates (as opposed to defaults), as the definition of default can vary across the asset classes (see here for more detail, if interested).

Exhibit 33: Realized losses for the CDLI were modest during the Fed's recent hiking cycle

Trailing 12-month income return and realized gains (losses) for the Cliffwater Direct Lending Index



Source: Cliffwater Direct Lending Index, BlackRock. As of June 30, 2024 (most recent available as of September 19, 2024). 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. We exclude unrealized gains and losses in this chart. Long-term unrealized gains (losses) are approximately zero, as they either convert to net realized losses upon a credit default, or are reversed when principal is fully repaid.

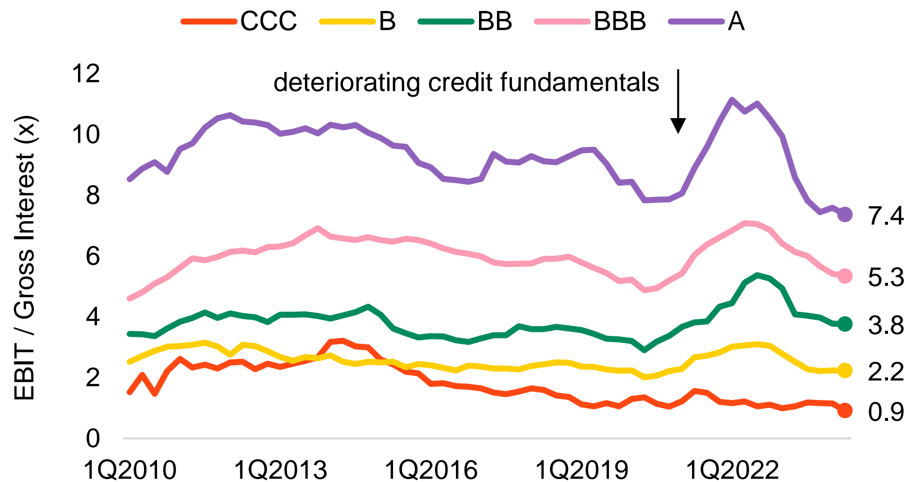
A more gradual response from fixed coupons

Unlike their floating rate peers, fixed-rate borrowers have encountered higher debt costs only *when and if* they choose to issue new debt, or refinance low coupon debt (from 2020 and 2021, for example), into today's higher interest rates. As a result, the increase in average coupon costs has been somewhat more gradual relative to what is displayed for leveraged loan borrowers (again, Exhibit 26). To put this in context: at the start of 2022, the average par-weighted coupons for the Bloomberg USD HY and EUR HY Corporate indices were 5.7% and 3.7%, respectively. As of September 23, 2024, these had risen to 6.3% and 4.8% - higher, but not to the same magnitude as the increase in the policy rate in each region. Similarly, over that same time frame, USD IG and EUR IG average coupons moved from 3.6% and 1.7%, respectively, to 4.3% and 2.7%.

That said, there has been fundamental deterioration – especially at the lowest-end of the ratings spectrum, as shown in Exhibits 34 and 35. For example, trimmed-mean USD CCC EBIT/interest coverage is less than 1.0x. Decreases in the policy rate will not have a direct impact on fixed rate coupons, which are more closely linked to rates in the intermediate and long-end of the U.S. Treasury curve. That said, declines in costs for floating rate debt should indirectly benefit borrowers with mixed capital structures (bonds and loans).

Exhibit 34: Highly rated firms are not immune

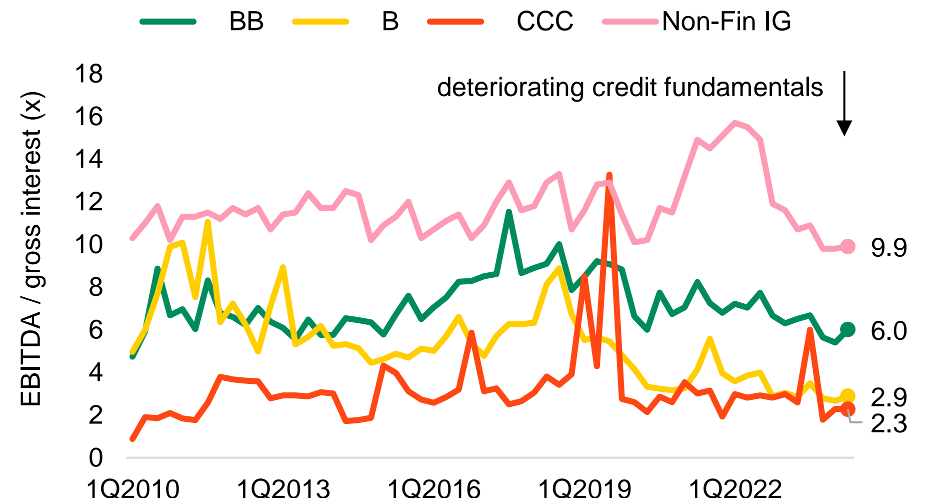
Trailing 12-month interest coverage ratios for each rating-specific cohort of the Bloomberg USD IG and HY Corporate indices



Source: Bloomberg, BlackRock. Captures data through 2Q2024 (most recent). Uses trimmed mean measurers, which exclude the top / bottom 10%. We exclude the USD AA grouping, which had an interest coverage ratio of 25.8x as of 2Q2024.

Exhibit 35: A similar picture in the EUR market

Trailing 12-month interest coverage ratios for each rating-specific cohort of the Bloomberg EUR IG and HY Corporate indices



Source: Bloomberg, BlackRock. Captures data through 2Q2024 (most recent). Uses trimmed mean measurers, which exclude the top / bottom 10%.

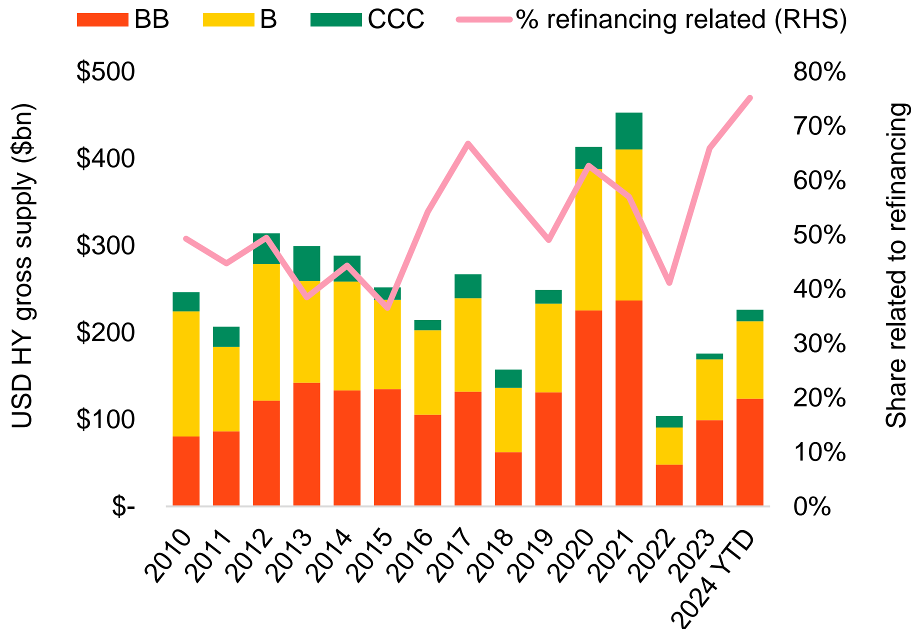
USD HY: A proactive focus on refinancing

During the first nine months of 2024, USD HY borrowers prioritized refinancing, choosing to capitalize on tight spreads and a strong tone. Indeed, as Exhibit 36 illustrates, 75% of the year-to-date gross new issue volumes in the USD HY market – which are elevated vs. the past two years – have been earmarked for debt repayment or refinancing, per data captured by Dealogic. This skew towards refinancing is higher than any annual period of the post-financial crisis era.

This has left near-term scheduled debt maturities in the USD HY market very low (Exhibit 37). Maturities through year-end 2026 represent less than 10% of the Bloomberg USD HY Corporate Index. This further mitigates the some of the downside risks to the corporate credit market over the medium term, in our view. While issuance may slow around the U.S. election, we expect corporates will stay focused on preserving balance sheet strength and will likely look to address 2026 and 2027 maturities over the next few quarters.

Exhibit 36: A record share of refinancing activity

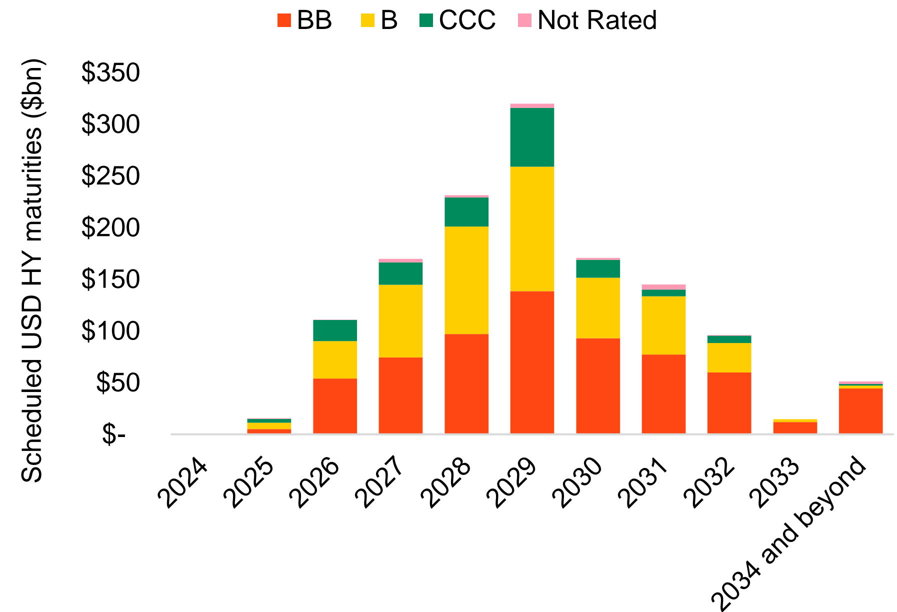
USD HY gross supply by rating, and the share earmarked for debt repayment or refinancing, RHS



Source: Dealogic (ION Analytics), BlackRock. As of September 23, 2024. The rating captured is the “Dealogic effective rating at launch.” Share of refinancing related debt is captured by Dealogic’s “primary use of proceeds”.

Exhibit 37: Near-term maturities are very low

Maturity schedule for the bonds included in the Bloomberg USD HY Corporate Index, by Bloomberg Composite rating



Source: Bloomberg, BlackRock. As of September 23, 2024. Excludes bonds which are not index eligible.

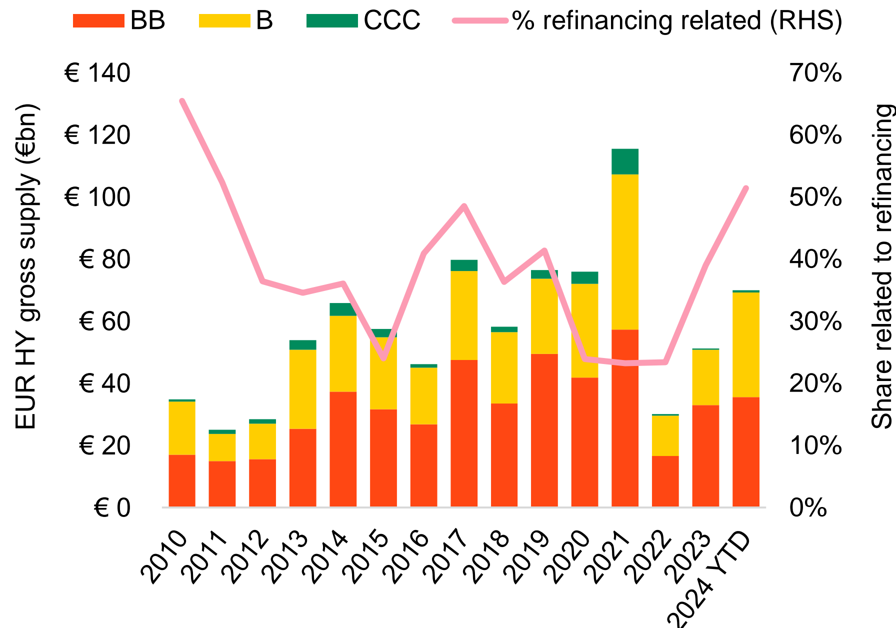
EUR HY: Issuance also skews toward refi

Borrowers in the EUR HY corporate credit market have demonstrated a similar focus on proactive refinancing. 51% of gross issuance has been earmarked for debt repayment or refinancing, per data complied by Dealogic. This is higher than all other annual periods except 2010 and 2011 (Exhibit 38).

The upcoming maturity walls in the EUR HY market are slightly steeper relative to its USD HY peer. Scheduled maturities through year-end 2026 represent 20% of the Bloomberg Pan-Euro HY Corporate Index (Exhibit 39). As a result, the pace of gross supply in the EUR HY market is expected to be elevated over the next few quarters. That said, so long as issuance continues to skew towards debt repayment and refinancing activity, the net supply figure should be relatively easily digested in the market – another technical tailwind for spreads.

Exhibit 38: EUR HY issuance is skewed to refi

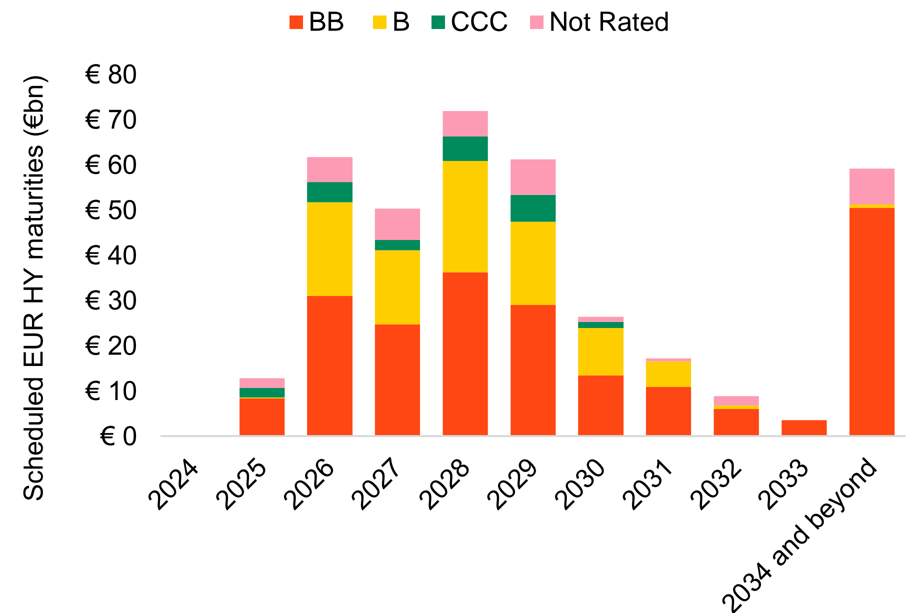
EUR HY gross supply by rating, and the share earmarked for debt repayment or refinancing, RHS



Source: Dealogic (ION Analytics), BlackRock. As of September 24, 2024. The rating captured is the “Dealogic effective rating at launch.” Share of refinancing related debt is captured by Dealogic’s “primary use of proceeds”.

Exhibit 39: Maturity walls are steeper vs. USD

Maturity schedule for the bonds included in the Bloomberg Pan-Euro HY Corporate Index, by Bloomberg Composite rating



Source: Bloomberg, BlackRock. As of September 2e, 2024. Excludes bonds which are not index eligible.

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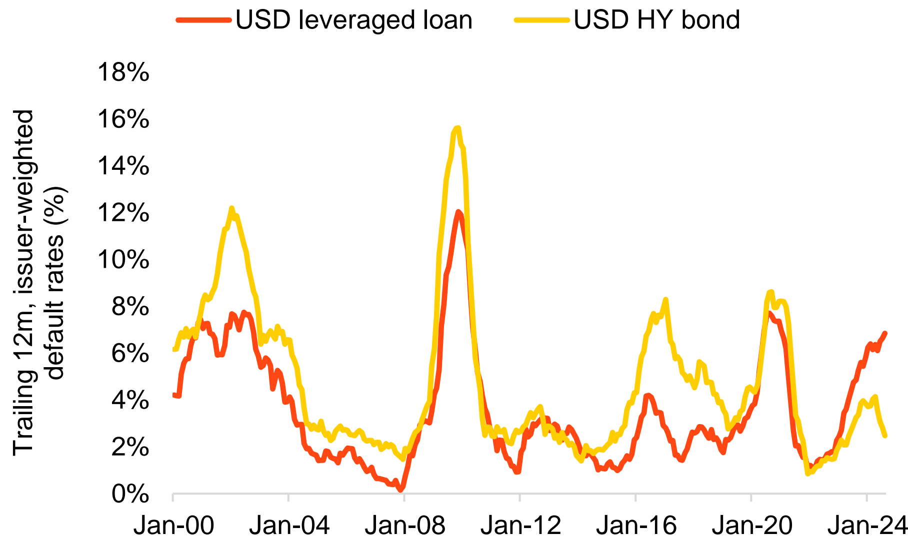
Default drivers in liquid credit

We believe aggregated default rates have peaked (or are nearing their peaks) in most subsets of the U.S. and European liquid credit markets. Under the surface, however, default rates have demonstrated a few notable patterns over the past few quarters, and we expect these trends will remain in place in 4Q2024. These include:

- The higher prevalence of "repeat defaulters," as not all firms have managed to grow in a capital efficient way amid a higher interest rate environment – underscoring the importance of credit selection
- The greater incidence of distressed exchanges (vs. "traditional" bankruptcies), which are more common among financial sponsor-backed borrowers; they can sometimes result in an "incomplete" solution for a stressed capital structure, as per the trend of "repeat defaulters"
- The persistent divergence between leveraged loan and HY bond default rates (Exhibit 40), which is a function of the swifter "transmission" of higher rates onto floating rate borrowers, as discussed earlier

Exhibit 40: The leveraged loan vs. HY bond default rate gap is wide

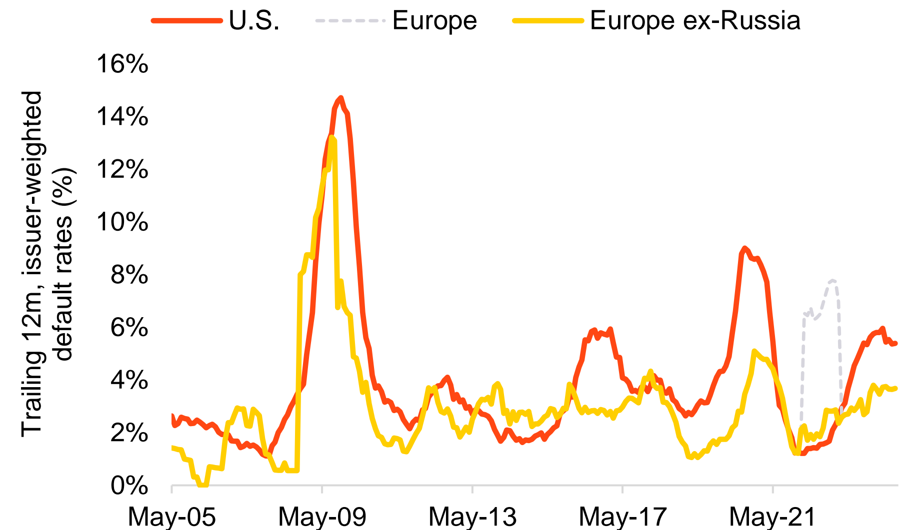
Trailing 12-month, issuer-weighted default rates for the universe of USD HY bonds and USD leveraged loans tracked by Moody's



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

Exhibit 41: Signs of a plateau in global defaults

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



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

M&A: The case for acceleration in 4Q

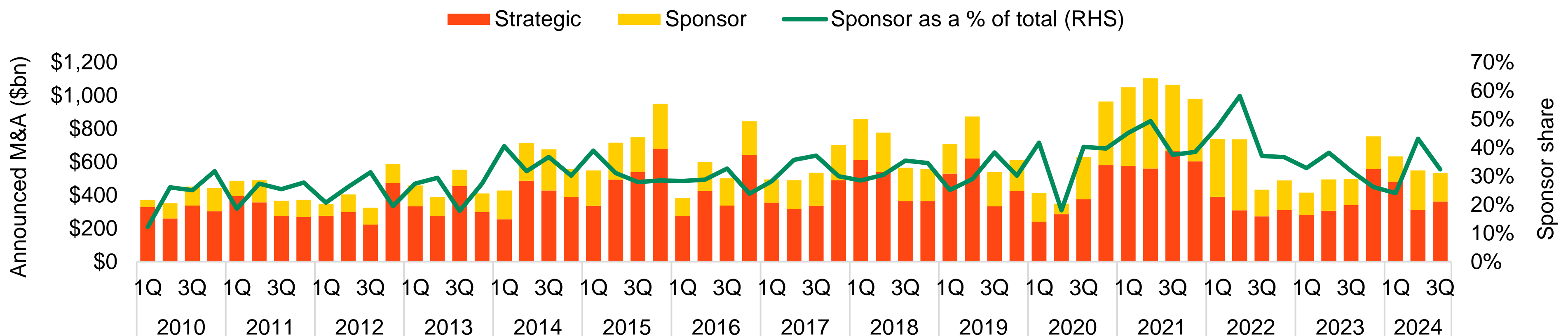
So far this year, M&A related activity has exhibited some differentiation between strategic deals (i.e., those between corporations, often done for diversification and growth) and sponsor deals (i.e., those involving a financial sponsor as a seller and/or buyer, for which financial leverage is a key portion of the investment calculus). Through September 25th, year-to-date strategic M&A volumes (by North American and European acquirers) of $1.16 trillion are well ahead of the average pace of the last two years ($937 billion) and only 2% below the 10-year average (2013-2023) of $1.18 trillion.

Sponsor related transactions have been slower to rebound, however. While up 19% vs. the same period in 2023, year-to-date volumes of $571 billion are still tracking 11.5% below the 10-year average. That said, with interest rates set to further normalize, we see scope for sponsor related volumes to "catch up" to their strategic peers.

For corporate credit investors, strategic (i.e., corporate-related) M&A activity can have implications for investment performance and bears close monitoring. Beyond potentially catalyzing meaningful changes to business diversification, they can also result in capital structure changes (for example, via debt assumption/issuance or debt reduction). For the strategic M&A announced so far this year, the funding mix has been slightly negative for bondholders, relative to the medium-term trend. For example, using data complied by Dealogic, 64% of this year's strategic deals have been funded entirely with cash (vs. the 57% average of 2019-2023). Similarly, 26% of this year's strategic M&A has been funded entirely with stock – a level slightly below the 2019-2023 average of 29%.

Exhibit 42: Sponsor related deal making has lagged the rebound seen on the strategic side

Announced sponsor and strategic M&A deals in North America and Europe. Captures deals valued at $100 million or more, at announcement. Excludes cancelled and withdrawn deals.



Source: Dealogic (ION Analytics), BlackRock. As of September 25, 2024. Sponsor related transactions are those that include a financial sponsor on either side (as buyer or seller).

Waiting for a rebound in CRE volumes

As with M&A activity, we expect interest rate clarity will support an acceleration in commercial real estate (CRE) transaction volumes (and price discovery). For much of the past few years, market participants have been waiting for signs of a sustained rebound in CRE volumes (Exhibit 43) – especially in the Office sector, which was impacted by the Fed's rate hiking cycle *and* structural shifts post-pandemic. We believe the 50bps rate cut received in September was an important step in helping to narrow the valuation gap between buyers and sellers. With more rate cuts anticipated per the FOMC's projections and with growth expected to remain relatively resilient, we expect a gradual acceleration in transaction volumes over the coming quarters – especially in the Apartment sector.

Away from transaction volumes, the trend of price dispersion remains firmly in place, as shown in Exhibit 44. The Industrial category continues to outperform other categories, as it benefits from structural tailwinds related to artificial intelligence (data centers) and supply chain resilience (on-shoring). We also see value in the Apartment sector, which tends to be rate-sensitive and is positioned to benefit from attractive fundamentals, such as the U.S. housing shortage (which Freddie Mac estimates to be 3.8 million units in the U.S.). Further, we believe the Retail category is positioned to benefit from price appreciation, contingent on the health of the U.S. consumer.

Exhibit 43: CRE volumes – gradually recovering

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

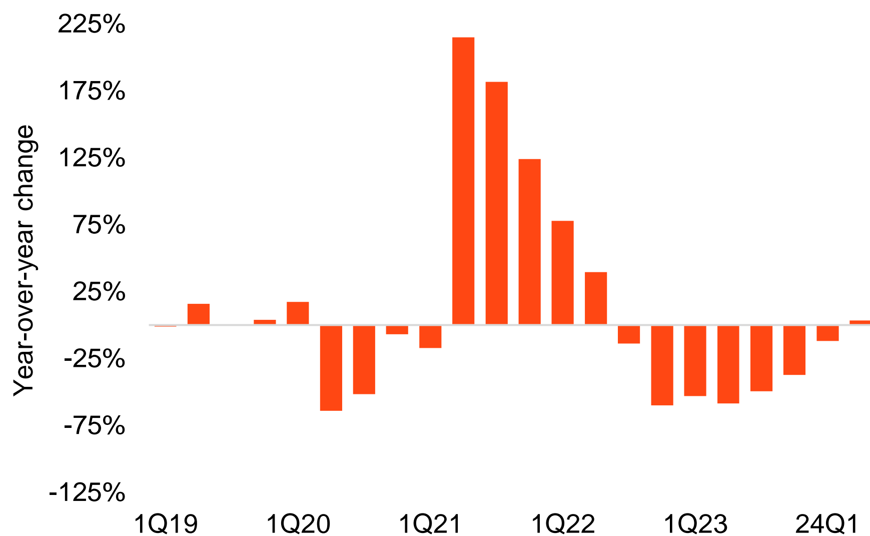
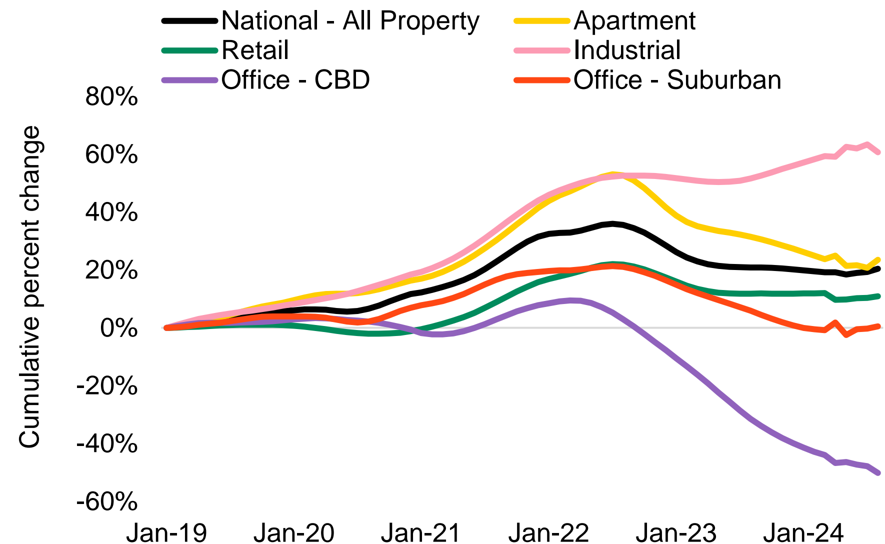


Exhibit 44: Dispersion across CRE sectors

Cumulative change in the level of the Real Capital Analytics Commercial Property Price Index, by sector, since January 2019



Source for both charts: BlackRock, Real Capital Analytics Commercial Property Price Indices (CPPI), National All-Property Index. Captures data through June 30, 2024 (Exhibit 43) and August 31, 2024 (Exhibit 44). **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. CBD = Central Business District.

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