September 19, 2024

Global Credit Weekly:

Recalibration

BlackRock

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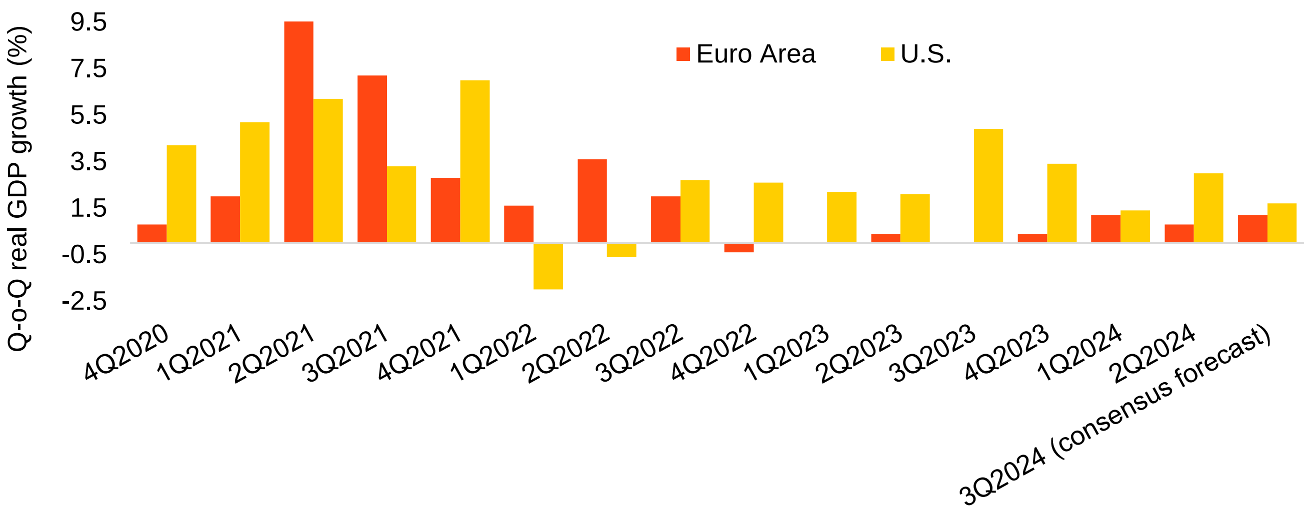
Key takeaways

- After days of debate by market participants between 25bp and 50bp, the Federal Reserve ultimately opted for the larger rate cut to begin this cycle – in what was repeatedly referred to as a “recalibration” of monetary policy. With the U.S. growth backdrop still relatively resilient – as highlighted by the consensus GDP estimates in Exhibit 1, as well as the Atlanta Fed’s 3Q2024 GDP “nowcast” of 2.9% (as of Sept. 18th) – we view the risks to market pricing for the Fed Funds terminal rate as skewed higher. While we see ample scope for the FOMC to normalize rates into early 2025, we believe additional clarity on the FOMC’s view of the neutral rate will be increasingly important to differentiate between “normalizing” and “easing” monetary policy.
- In the interim, we expect the growth backdrop to remain a key driver of corporate credit sentiment – especially for the economically sensitive high yield, leveraged loan, and private universes. A constructive fundamental macro backdrop, combined with supportive technical factors (i.e., persistent yield-based demand, reinvestment of higher coupon bonds, and limited net supply in certain markets), should keep most subsets of USD and EUR credit spreads within their recent narrow – and tight – ranges.
- While the Federal Reserve has now officially embarked on a rate-cutting cycle, the policy rate will nonetheless 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 signs of fundamental deterioration – especially from borrowers exposed to floating rate debt. In this *Global Credit Weekly*, we once again assess the default and recovery patterns of corporate borrowers – in the private and liquid credit markets. Many of the trends we have previously highlighted remain in place, including the differences between “sponsor” and “non-sponsored” ownership, the prevalence of “repeat defaulters,” the greater incidence of distressed exchanges (vs. “traditional” bankruptcies), and the persistent divergence between leveraged loan and HY bond default rates.

Exhibit 1: Supportive growth is key for continued credit spread resilience, in our view
Quarter-over-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 18, 2024. **There is no guarantee any forecasts may come to pass.**

September FOMC emphasizes a "recalibration" of monetary policy

After days of debate by market participants on the expected size of the widely anticipated first rate cut of this cycle, the Federal Reserve Open Market Committee (FOMC) ultimately opted for a larger, 50bp, rate cut at its September 18th rate decision. In his press conference, Federal Reserve (Fed) Chair Powell said the Committee opted for a 50bp rate cut (as opposed to the traditional 25bp) in response to a range of factors, including the recent 818k downward preliminary revision to non-farm payrolls, anecdotes of mixed activity in the August Beige Book, and the past two monthly readings on inflation (improving) and the labor market (cooling).

The choice for 50bp also appeared (at least in part) to be a "catch up," in our view. While Chair Powell stated that he did not believe the FOMC was behind the curve, he acknowledged in the Q&A that the Committee might have chosen to cut rates at the July 31st FOMC, if the July non-farm payrolls data (released August 2nd) had been available.

Chair Powell repeatedly referenced a "recalibration" of monetary policy in his opening remarks and during the Q&A. He characterized the 50bp cut as a reduction in the degree of policy restraint – an acknowledgement that, at 4.75% to 5%, the policy rate remains above the neutral rate, even after this move. Importantly, he characterized the 50bp rate cut as implemented to maintain the strength in the U.S. economy, as opposed to a response to pronounced economic weakness.

Other key takeaways (continued on next page):

- **A higher, but uncertain, neutral rate:** Chair Powell pointed to a high degree of uncertainty related to the neutral rate, once again emphasizing "we will know it by its works." The plan for the Committee, he said, would be to continue to reduce the degree of monetary policy restriction and see how the economy responds. That said, he acknowledged the neutral rate is likely "significantly higher" vs. the zero lower bound which prevailed for much of the post-financial crisis era (Exhibit 8). The September Summary of Economic Projections (SEP) reflected another increase in the median longer-run Fed Funds estimate, to 2.9% (vs. 2.8% as of the June 2024 SEP; Exhibit 2). That said, the range among FOMC members is wide: from 2.4% to 3.8% (consistent with the June SEP).

Exhibit 2: The September 2024 SEP signals another increase in the longer run rate

The median economic projections of the 19 FOMC members, for the 4th quarter of each year shown

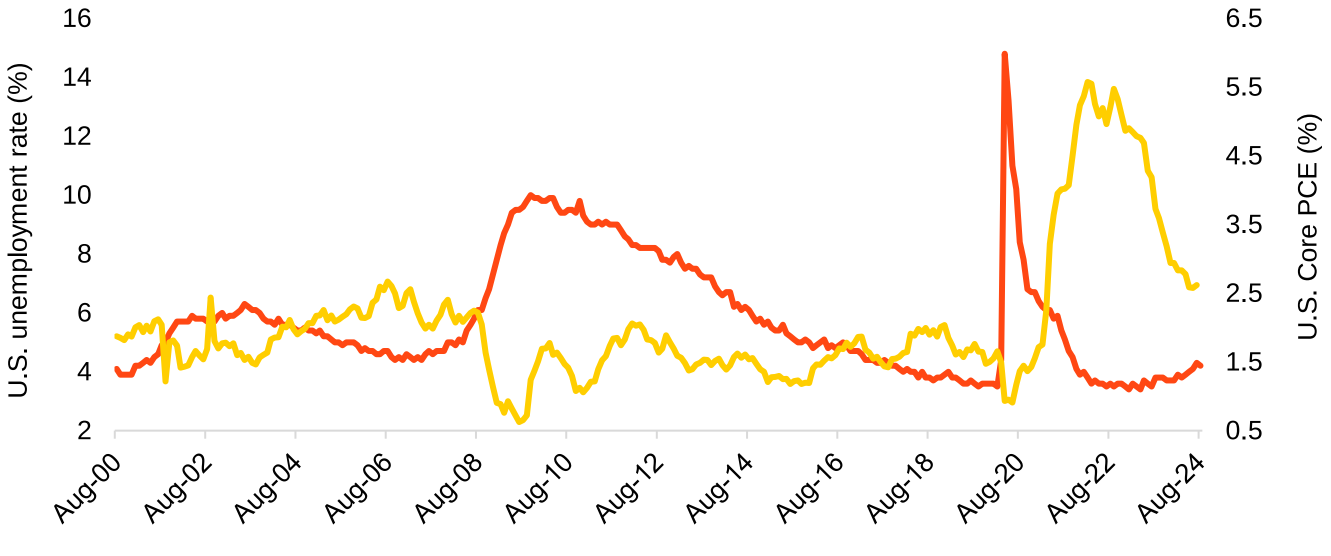
	2024	2025	2026	2027	Longer run
Real GDP growth	**2.0**	**2.0**	**2.0**	**2.0**	**1.8**
June 2024 projection	*2.1*	*2.0*	*2.0*		*1.8*
March 2024 projection	*2.1*	*2.0*	*2.0*	*not given*	*1.8*
December 2023 projection	*1.4*	*1.8*	*1.9*		*1.8*
Unemployment rate	**4.4**	**4.4**	**4.3**	**4.2**	**4.2**
June 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*
PCE inflation	**2.3**	**2.1**	**2.0**	**2.0**	**2.0**
June 2024 projection	*2.6*	*2.3*	*2.0*		*2.0*
March 2024 projection	*2.4*	*2.2*	*2.0*	*not given*	*2.0*
December 2023 projection	*2.4*	*2.1*	*2.0*		*2.0*
Core PCE inflation	**2.6**	**2.2**	**2.0**	**2.0**	
June 2024 projection	*2.8*	*2.3*	*2.0*		
March 2024 projection	*2.6*	*2.2*	*2.0*	*not given*	*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: Federal Reserve, BlackRock. As of the Federal Reserve's Summary of Economic Projections published on September 18, 2024. **There is no guarantee any forecasts may come to pass.**

- **The pace of cuts is not predetermined:** Chair Powell said the market should not interpret this 50bp cut as indicative of the pace of (expected) future cuts, going forward. The Committee is not on any pre-set course, nor is it in a rush, he said. Rather, decisions will be made "meeting by meeting." The 50bp rate cut is indicative of the FOMC's "commitment not to get behind," per Chair Powell.
- **One dissent and a range of views:** Governor Michelle Bowman, who preferred a 25bp cut, dissented. Bloomberg noted this was the first dissent by a Federal Reserve Board Governor since 2005, and the first dissent from *any* FOMC member (which also includes the regional Federal Reserve Bank Presidents) since 2022. Similar to the wide range of views on the longer-run interest rate, FOMC members also noted a difference of opinion in the near-term Fed Funds rate for year-end 2024 (ranging from 4.1% to 4.9%) and year-end 2025 (2.9% to 4.1%).
- **Dual mandate – attentive to risks on both sides:** The September statement included updated language, including that the FOMC "has gained greater confidence that inflation is moving sustainably toward 2%." This echoed Chair Powell's own remarks during his August 23rd speech at the Jackson Hole economic symposium, where he said: "my confidence has grown that inflation is on a sustainable path back to 2%". The September statement also noted the risks to the Fed's dual mandate of maximum employment and price stability (Exhibit 3) "are roughly in balance" (in the July statement this read: "continue to move into better balance").
- **Labor market is still "solid":** The September statement was updated to note that job gains have "slowed" (vs. "moderated" as of July). Chair Powell acknowledged the recent rate of change (i.e., deterioration) in certain labor market indicators. This was (unsurprisingly) a focus of the Q&A given market participants' recent attention on the so-called Sahm Rule, as well as Chair Powell's own comments at Jackson Hole which stated: "we do not seek or welcome further cooling in labor market conditions." But he also noted that the *absolute level* of the unemployment rate (4.2%) was still in a "solid" condition – and the goal of the FOMC is to keep it in that range (the September SEP points to an unemployment rate peak of 4.4%; Exhibit 2). Chair Powell also pointed to supply-side drivers (i.e., labor force participation, immigration) of the recent increase in the unemployment rate, as well as the reduction in job *vacancies* (which have a less severe economic consequence vs. layoffs).
- **Not declaring victory on inflation:** While Chair Powell noted his confidence that inflation is on a path to sustainably return to 2%, he also said that the FOMC has not declared victory, in response to a question during the press conference (as core PCE remains above target). Indeed, the median FOMC participant expects inflation to return to the 2.0% target in 2026 (Exhibit 2).

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, BlackRock. Captures data through July 31, 2024, for core PCE and August 31, 2024, for unemployment (both are the most recent available, as of September 18, 2024).

Market pricing: Focus shifts to the terminal rate

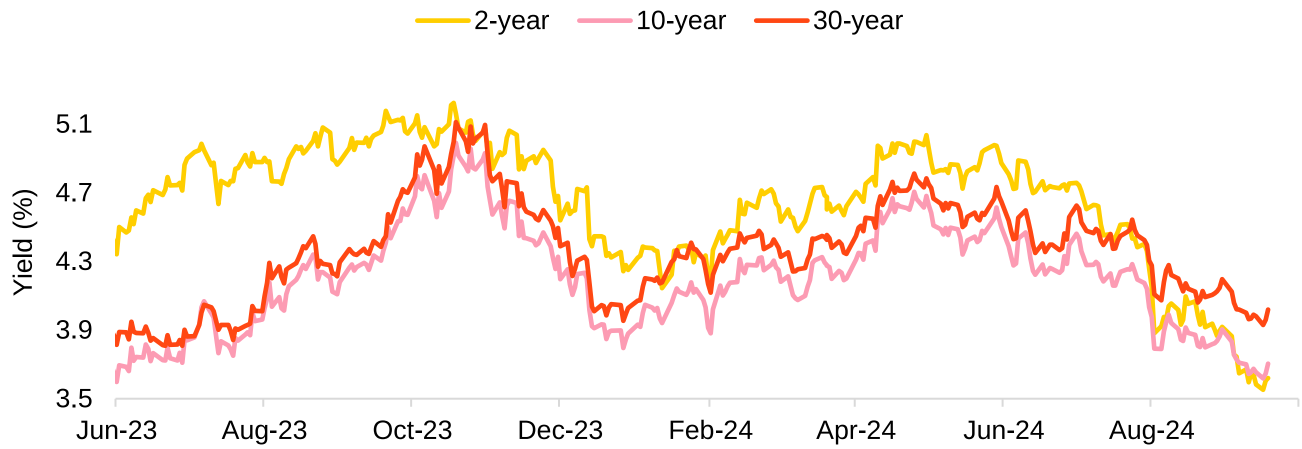
The median FOMC member projects (per the September SEP) 50bp of additional rate cuts in 4Q2024, 100bp of cuts in 2025, and 50bp in 2026 – all of which are reflected in the 2.9% median terminal rate forecast shown in Exhibit 2. This projection is slightly more hawkish than the terminal rate implied by market pricing, both before and after the FOMC rate decision on September 18th (Exhibit 5). As a result, U.S. Treasury yields moved *higher* following the rate decision (Exhibit 4).

A higher terminal rate is consistent, in our view, with the still-supportive growth backdrop in the U.S. While the consensus estimate of economists surveyed by Bloomberg tracks 3Q2024 U.S. real GDP growth of 1.7% (Exhibit 1), Atlanta Fed GDPNow has 3Q2024 activity at an above-trend pace of 2.9% as of September 18th.

As we have outlined previously, the *depth* and *drivers* of the rate cutting cycle are most important for corporate credit sentiment. With the growth backdrop still resilient, we see the risks to market pricing for the Fed Funds terminal rate as skewed higher. While we see ample scope for the Fed to normalize rates into early 2025, we believe additional clarity on the FOMC's view of the neutral rate will be increasingly important to differentiate between "normalizing" and "easing" monetary policy. In the interim, we expect the growth backdrop to remain a key driver of corporate credit sentiment – especially in the economically sensitive speculative grade universe (liquid and private credit).

Exhibit 4: Yields moved *higher* following the September FOMC rate decision

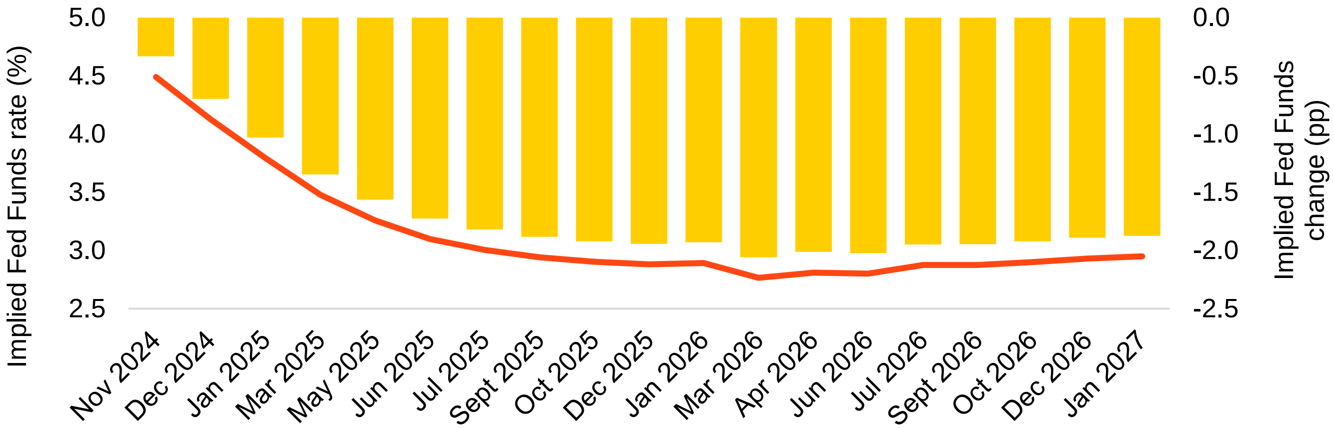
Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)



Source: Bloomberg, BlackRock. As of September 18, 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.

Exhibit 5: Post-meeting, market pricing points to a terminal rate of 2.75% by early 2026

Implied Federal Funds rate (%) and implied change (in percentage points, RHS), based on Fed Funds Futures, through January 2027



Source: Bloomberg, BlackRock. As of September 18, 2024. **There is no guarantee any forecasts may come to pass.**

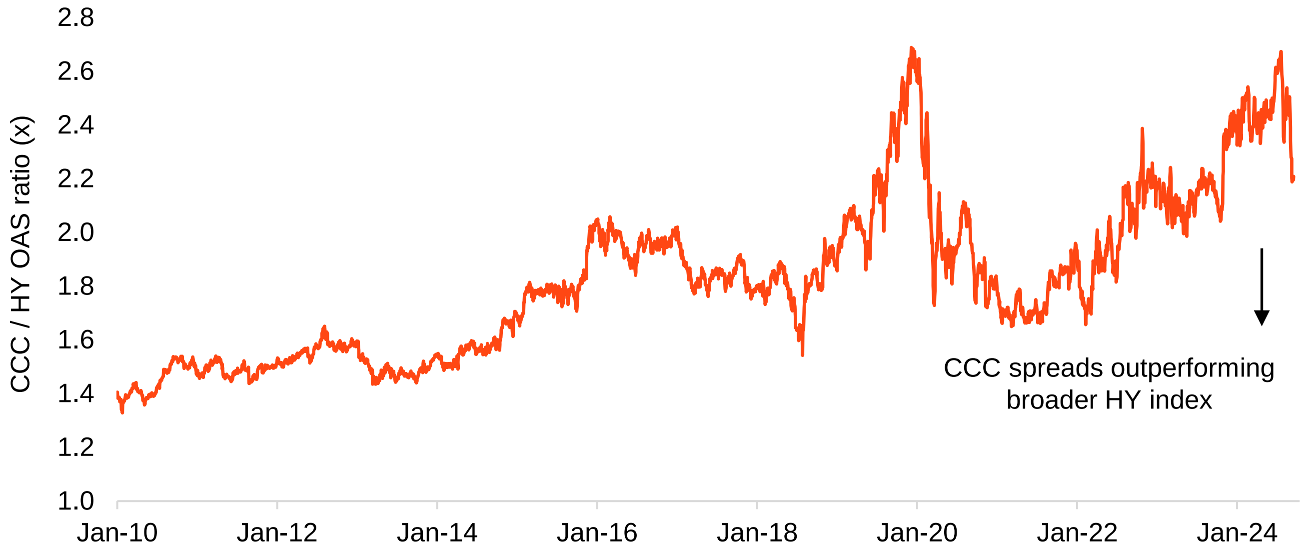
Recent outperformance in CCCs

One notable area of outperformance in the corporate credit market has been in the CCC-rated cohort of the USD HY index, as shown in Exhibit 6. The drivers, in our view, are multi-faceted, including some idiosyncratic developments, optimism around the ability to avert a sharp near-term economic downturn, and the interest rate relief accompanied by the anticipated start of the Fed's rate cutting cycle (as mentioned previously).

That said, fundamentals for this highly-idiosyncratic group of issuers remain pressured, at least in aggregate. As shown in Exhibit 7, trimmed mean interest coverage for the Bloomberg USD CCC Corporate Index dropped below 1.0x as of 2Q2024. While there is some scope for CCC spreads to continue tightening vs. the broader USD HY market (again, Exhibit 6), we would recommend a highly selective approach when assessing individual credits.

Exhibit 6: CCC spreads have closed a large portion of their "underperformance gap" vs. the broader USD HY market

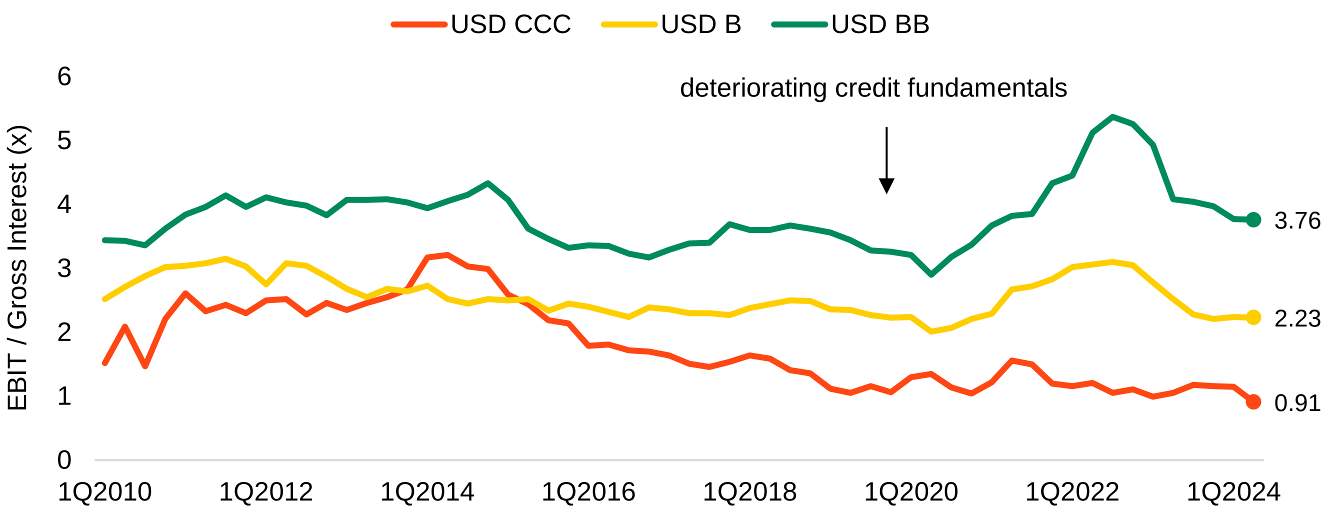
OAS ratio: Bloomberg USD CCC Corporate Index spread vs. Bloomberg USD HY Corporate Index spread



Source: BlackRock, Bloomberg. As of September 18, 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.

Exhibit 7: USD CCC interest coverage dropped below 1.0x in 2Q2024

Trailing 12-month interest coverage for the BB, B and CCC subsets of the Bloomberg USD HY Corporate Index



Source: Bloomberg, BlackRock. Captures data through 2Q2024 (most recent).

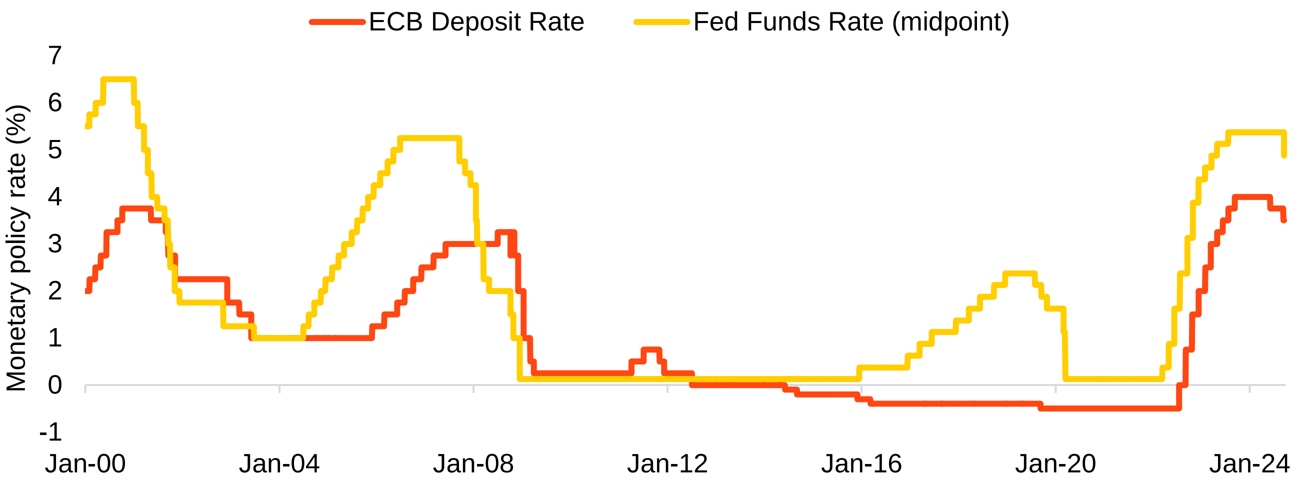
ECB: Taking a patient approach

The European Central Bank (ECB) "took another step in moderating the degree of monetary policy restriction" at its September 12th press conference, by lowering the deposit rate by 25bp (from 3.75% to 3.5%). But 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."

Key takeaways from the decision and press conference (continued on next page):

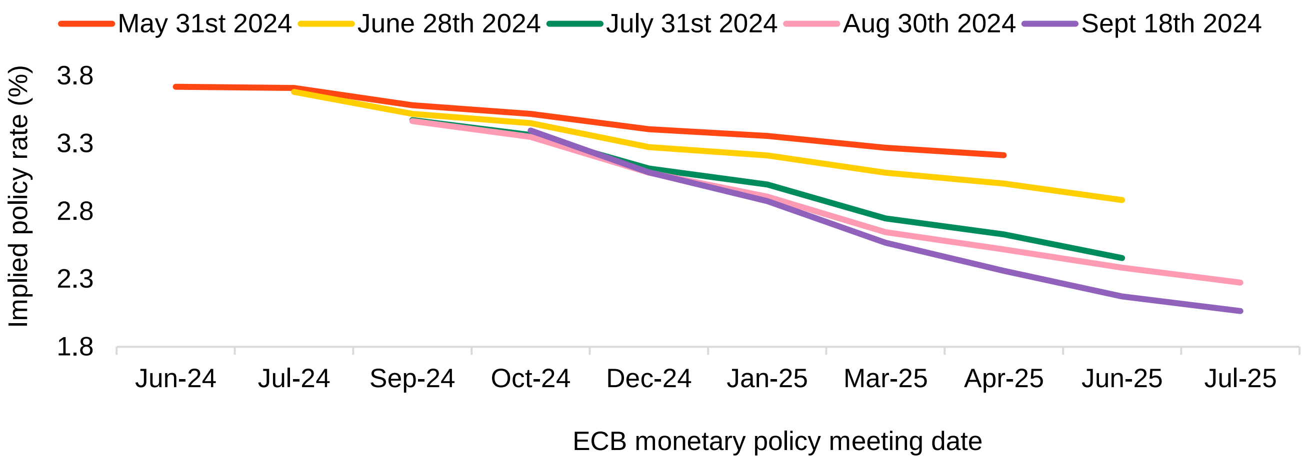
- **Growth is weaker, but not uniformly so:** ECB staff forecast 0.8% real GDP growth in 2024, 1.3% in 2025 and 1.5% in 2026. These forecasts are slightly lower than the estimates as of June, driven by a weaker contribution from domestic demand. Growth in 2Q2024 was just 0.2% (vs. 0.3% in 1Q2024), driven by net exports and government spending. Private domestic demand weakened as households consumed less, firms reduced investment, and housing investment declined. That said, the Eurosystem growth backdrop is not uniform. President Lagarde highlighted the recent weakness in Germany (led by the manufacturing sector), which stands in contrast to strong GDP figures from Spain and the Netherlands.

Exhibit 8: The depth and drivers of the Fed and ECB rate cutting cycles are key, in our view
Monetary policy rates for the European Central Bank and Federal Reserve



Source: BlackRock, European Central Bank, Federal Reserve, Bloomberg. As of September 18, 2024.

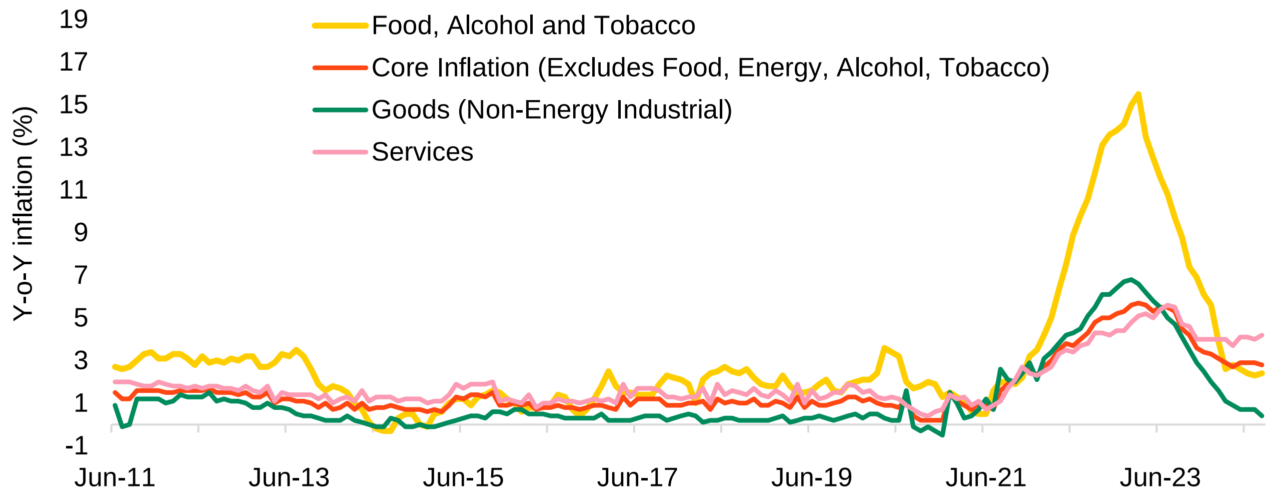
Exhibit 9: The market implied path for the ECB policy rate has moved lower, as growth has softened
The ECB policy rate path implied by Overnight Index Swaps, as of May 31st, June 28th, July 31st, August 30th, and September 18th



Source: BlackRock, Bloomberg. As of September 18, 2024. **There is no guarantee any forecasts may come to pass.**

- **Productivity continues to lag:** During her speech, President Lagarde highlighted the “urgent need for reform” to make the European economy more productive and competitive – pointing directly to analysis published by former European Central Bank President Mario Draghi earlier in September. She added that the report “poses a diagnosis which is severe, but which is just” in the view of the ECB. President Lagarde once again highlighted the benefits – in terms of financing innovation and boosting productivity – from a potential implementation of a Capital Markets Union. That said, she underscored that the ECB has one mandate, which is price stability, and that any potential structural reforms are “the responsibility of governments,” and “not the responsibility of a central bank.”
- **Inflation – Services remains a pain point:** President Lagarde pointed to ECB staff’s slightly higher projections for core inflation in 2024 and 2025, owing to higher-than-expected services inflation (+4.2% year-over-year, in August, vs. +4.0% in July). Wages continue to rise “at an elevated pace” but these increased costs are moderating and are, in part, being absorbed by corporate profits, per President Lagarde. Compensation per employee was +4.3% in 2Q2024 – the fourth consecutive quarterly decline. That said, negotiated wage growth is expected to remain “high and volatile” over the rest of 2024, due to one-off payments and staggered adjustments. Wage growth is expected to decline in 2H2025, per the ECB.

Exhibit 10: Services inflation has remained sticky in the Euro Area, while goods has declined
Year-over-Year inflation (not seasonally adjusted) for the Euro Area, by category.



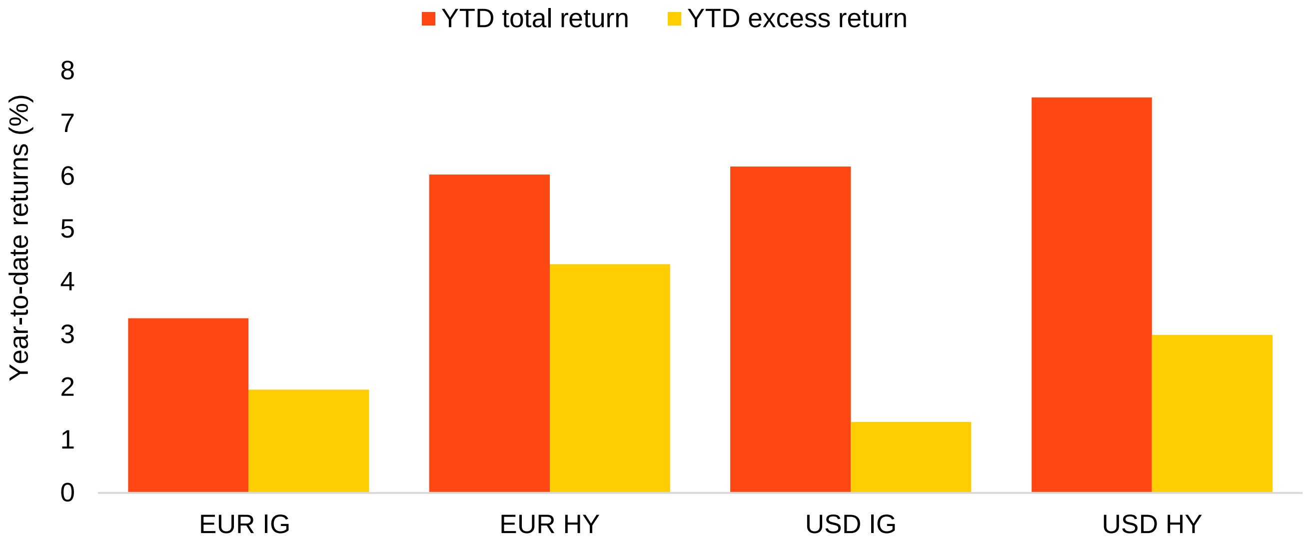
Source: BlackRock, Eurostat, Bloomberg, European Central Bank. Captures inflation data through August 2024 (latest available).

The read-through for EUR credit

The deterioration in the Euro Area growth outlook is reflected in the shift in market implied pricing for the ECB policy rate over the past few months, as shown in Exhibit 9. And while EUR HY and EUR IG indices have generated some excess return (i.e., returns excluding the impact of interest rate moves) quarter-to-date (Exhibit 12), there is differentiation happening under the surface in certain economically exposed sectors.

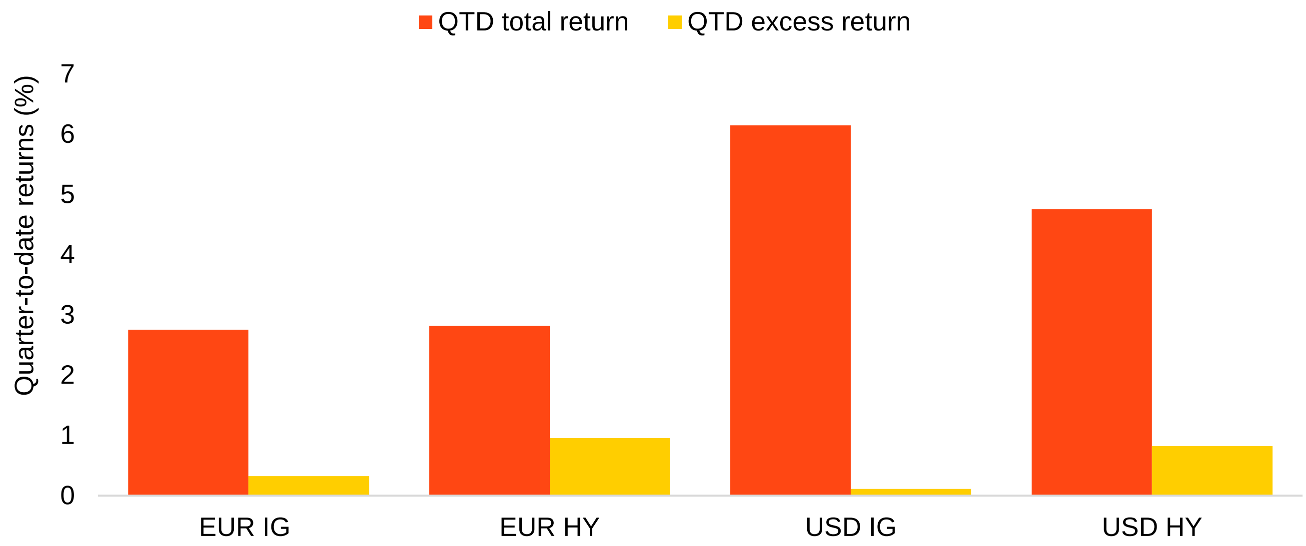
For example, the Autos sector (which is exposed to the weakness in German manufacturing) represents 6.0% of the Bloomberg Pan-European IG Index and 10.8% of the Bloomberg Pan-European HY Index as of September 2024. In both instances, Autos are among the worst-performing sectors quarter-to-date and month-to-date, based on our analysis of industry-level total returns.

Exhibit 11: HY credit has outperformed IG on an excess return basis, year-to-date…
Year-to-date total and excess returns, for the ICE-BAML USD and EUR Corporate Indices (IG and HY)



Source: ICE-BAML, Bloomberg, BlackRock. As of September 18, 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.

Exhibit 12: …the same is true quarter-to-date
Quarter-to-date total and excess returns, for the ICE-BAML USD and EUR Corporate Indices (IG and HY)



Source: ICE-BAML, Bloomberg, BlackRock. As of September 18, 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 temperature check on default activity

While the Federal Reserve has now officially embarked on a rate-cutting cycle, the policy rate will nonetheless remain in restrictive territory for at least the next few months (and possibly longer, in our view). As such, market participants are watchful for signs of fundamental deterioration – especially from borrowers exposed to floating rate debt. In this *Global Credit Weekly*, we once again assess the default and recovery patterns of corporate borrowers – in the private and liquid credit markets.

Note: the nuances of default statistics (such as calculation methodologies and definitions) can influence default rates both within and across asset classes. We discussed this topic more in-depth, recently.

Private debt defaults: Generally contained in aggregate, but dispersed

We start with data from Lincoln International, an independent valuation advisor specializing in illiquid alternative investments. As of 2Q2024, the Lincoln International Valuation and Opinions Group Proprietary Private Market Database (Lincoln VOG database) included around 5,500 U.S. operating companies, with a median EBITDA of $40-45 million, primarily owned by private equity sponsors.

Lincoln International defines a 'default' as a covenant default, not necessarily a monetary one. This means a borrower default may not lead to lender losses but instead may give lenders time and a legal position to address issues before a payment default occurs.

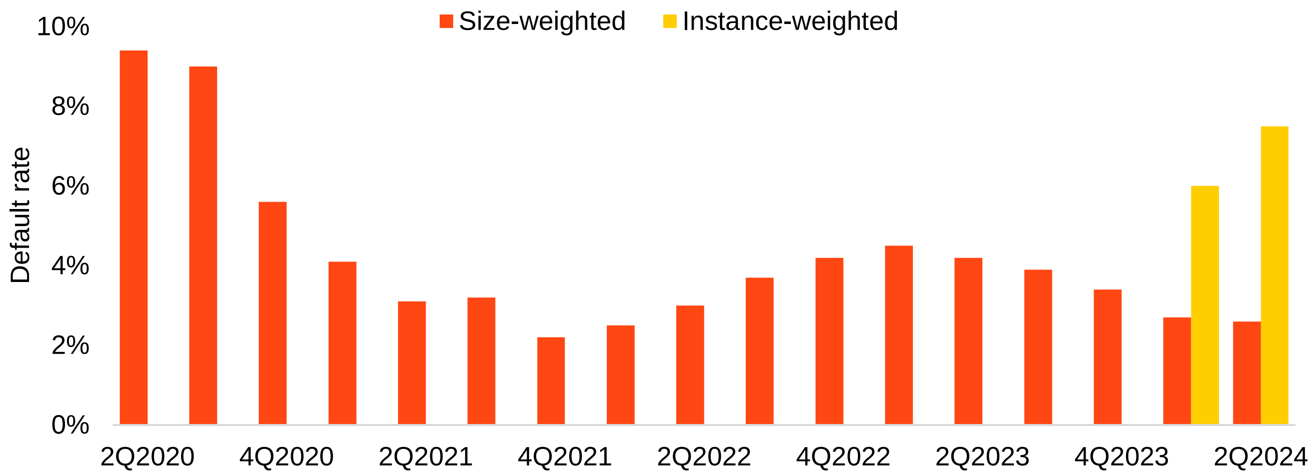
Lincoln's primary default rate calculation is size-weighted and indicates resilience in private debt. Indeed, Lincoln's covenant default rate fell to 2.6% in 2Q2024, marking the fifth consecutive quarterly decline. On the other hand, the instance-weighted default rate (which we view as akin to an issuer-weighted statistic) for the Lincoln VOG database increased from 6.0% in 1Q2024 to 7.5% in 2Q2024.

Exhibit 13 illustrates this difference in (1) the nominal level (i.e., 2.6% for size-weighted vs. 7.5% for instance-weighted) and (2) the quarter-over-quarter change (i.e., size-weighted declined, while instance-weighted increased) between the two metrics.

The difference, in our view, can largely be attributed to weighting methodology, with the instance-weighted default rate affected more by activity from smaller borrowers, which tend to have higher covenant default rates (as outlined later). Such differences in default methodology (i.e., par-weighted vs. issuer-weighted) are also frequently encountered in the public (liquid) corporate credit universe (which we will discuss later in this report).

Exhibit 13: Differences between size-weighted and instance-weighted default metrics indicate a nuanced topic

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



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.

Private debt is not a "one size fits all" asset class

As we outlined in February 2024, the risk-return profiles vary substantially across the different private debt strategies, portfolios, and vintages (see: *Private Debt: Exploring the Nuances* for more). This underscores the importance of manager selection, credit selection, and portfolio diversification within private debt, in our view.

Smaller borrowers have generally experienced higher covenant default rates than larger ones in the Lincoln database (Exhibit 14), partly due to more restrictive covenants in the lower middle market (as smaller EBITDA deals are typically underwritten with tighter covenants). 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.

In addition to company size, sector exposures can also influence default rates, as shown in Exhibit 15. This is because 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 14: Covenant default rates vary by borrower size

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

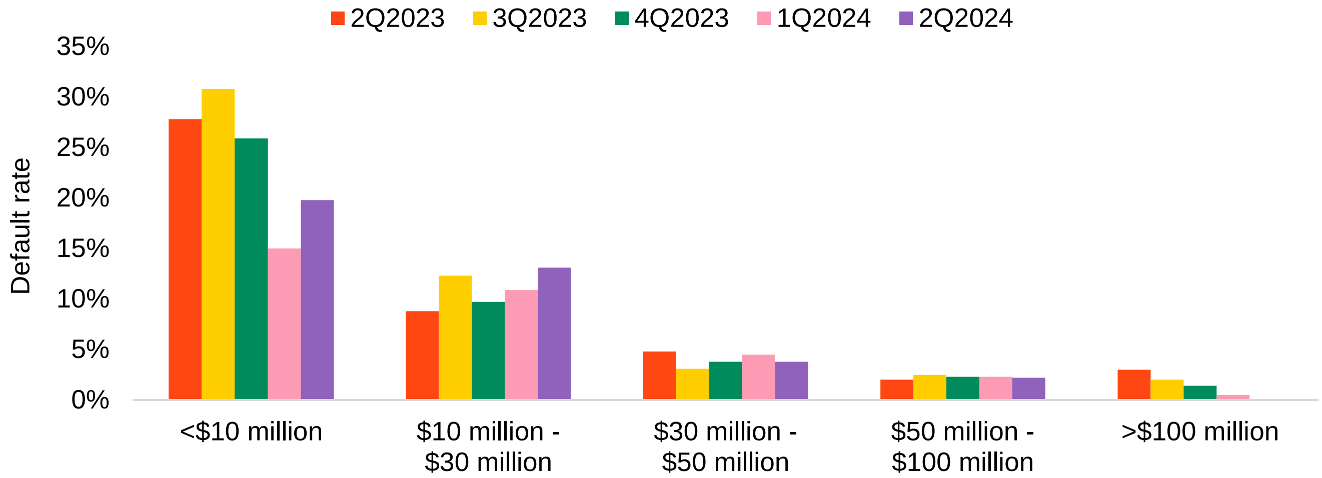
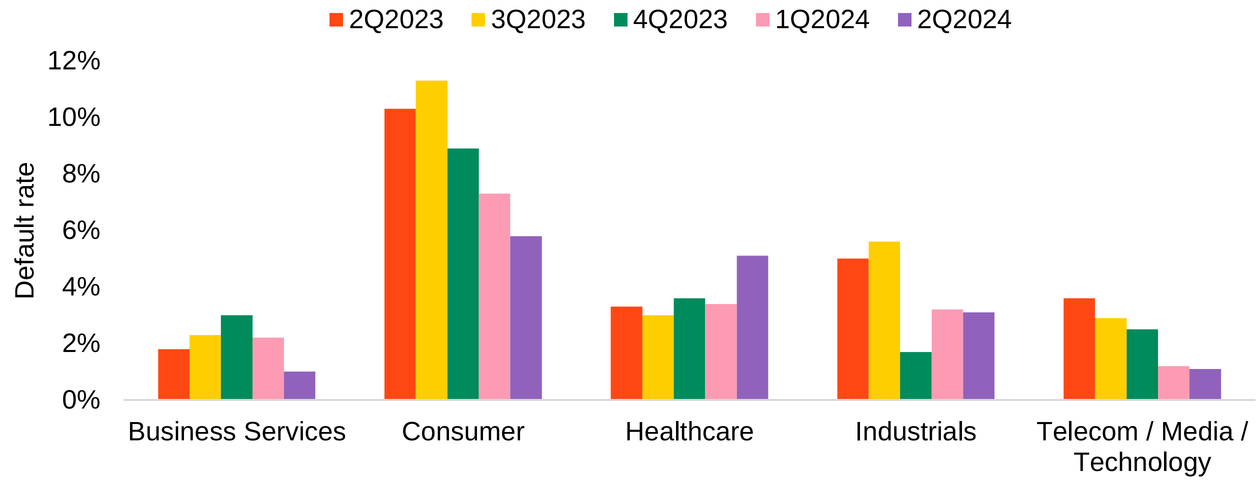


Exhibit 15: Covenant default rates vary by industry, with Consumer leading

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



For both charts: Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Market Database. As of 2Q2024. 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.

The value of a sponsor

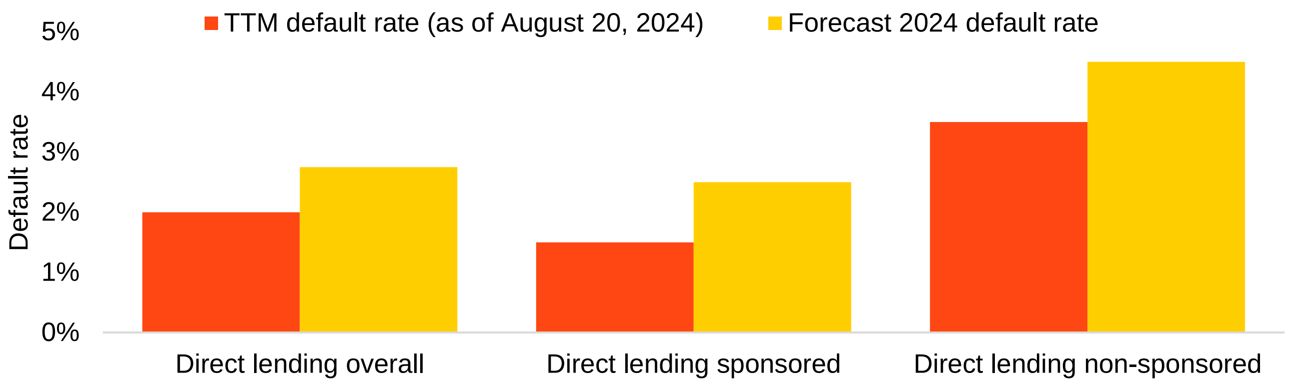
Beyond company size, ownership can also impact a borrower's propensity to default. For example, ownership by a private equity sponsor (i.e., "sponsor ownership"), which is prominent among borrowers in the private debt and leveraged loan markets, can benefit both borrowers and lenders. This is because sponsors often have a financial incentive to keep borrowers current (i.e., the capital they've already invested) and can provide liquidity support, as they tend to be large, investment grade rated firms.

Data from KBRA DLD – another third-party data provider that tracks direct lending defaults – highlights the "sponsor vs. non-sponsor" differential. The KBRA DLD Direct Lending Index includes about 2,400 borrowers. KBRA DLD default metrics are instance-weighted (not size-weighted), and a "default" is defined as a bankruptcy, payment default, or distressed exchange. As of August 2024, KBRA DLD's direct lending universe experienced a 2.0% trailing twelve-month (TTM) default rate, comprised of a 1.5% default rate for sponsored issuers and a 3.5% default rate for non-sponsored issuers (Exhibit 16). Further, KBRA DLD's non-accrual rate provides additional color on the health of corporate borrowers because some non-accruals do not trigger a default (as defined by KBRA DLD). As such, the *combined* TTM default and non-accrual rate for the KBRA DLD Direct Lending Index is near 5%.

Research from Pitchbook LCD also shows the benefits of sponsor ownership using the Morningstar LSTA USD Leveraged Loan Index. Pitchbook LCD's weighting methodology (instance-weighted) aligns with KBRA DLD's, *but* their definition of a default differs, with Pitchbook LCD defining a default as a missed payment or bankruptcy filing (i.e., excluding distressed exchanges, which KBRA DLD includes).

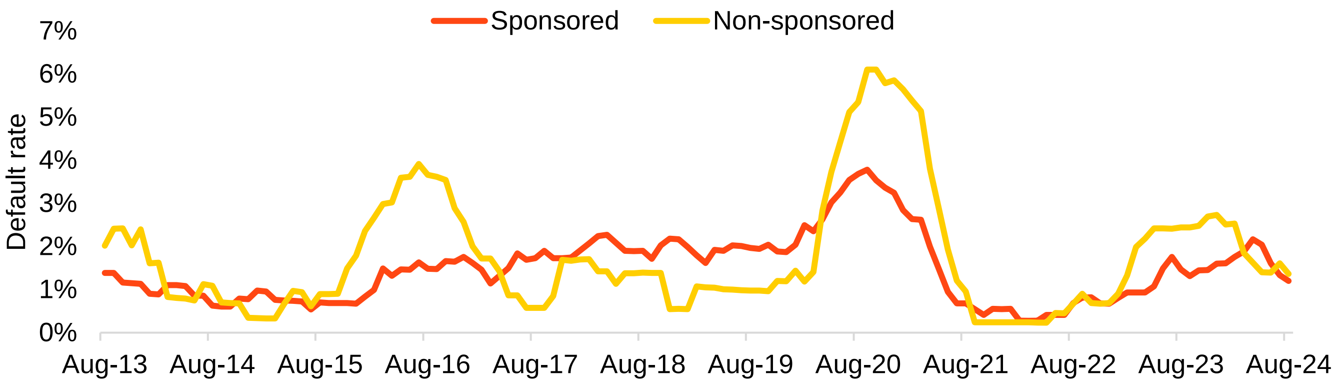
Exhibit 17 illustrates how sponsored default rates remain *contained* during large spikes in non-sponsored default rates (i.e., 2016 and 2020). This, in our view, highlights the benefits of sponsor ownership during times of market stress.

Exhibit 16: The sponsored direct lending default rate remains below the non-sponsored
Trailing 12-month (TTM) default rate and KBRA's 2024 forecast default rate, by issuer count



Source: KBRA DLD, BlackRock. As of August 20, 2024. Defaults include bankruptcies, missed payments, distressed debt exchanges, and/or restructurings. Forecasts are KBRA's. **There is no guarantee any forecasts may come to pass.**

Exhibit 17: Sponsored defaults have remained contained during times of stress
USD leveraged loan default* rate, by issuer count



Source: PitchBook LCD; Morningstar LSTA US Leveraged Loan Index, BlackRock. Data as of August 31, 2024. *Default is defined as interest payment misses or bankruptcy filings.

Syndicated market default trends

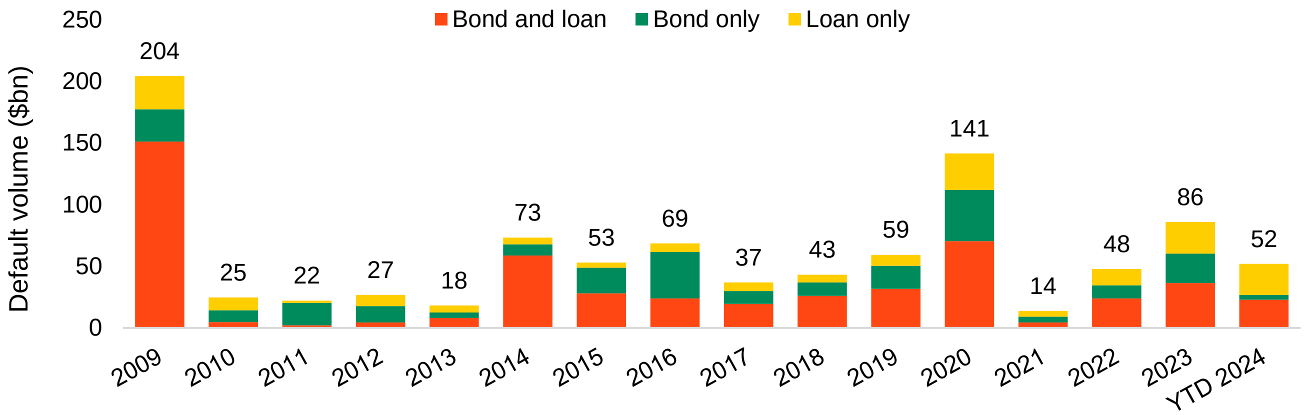
In the syndicated market, many of the trends we last highlighted in June remain intact. For example, leveraged loan issuers continue to pursue default/distressed activity at a higher rate than their HY bond issuer peers – driven in part by the floating rate nature of loans. Indeed, leveraged loan issuers 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). In contrast, their fixed-rate HY bond peers encountered higher borrowing costs only *if and when* they refinanced the lower coupon debt issued in 2020 and 2021.

According to JP Morgan Research, loans account for 81% of the $52 billion year-to-date default/distressed dollar volume as of August 2024, versus an average of 42% of default/distressed activity since 2008. Further, borrowers with bond-only capital structures accounted for only 8% of year-to-date ("YTD") default volume, the smallest share on record (Exhibit 18).

Issuer-weighted default data from Moody's echoes this too, with the loan default rate exceeding the HY bond default rate in August 2024 by the highest amount since the data began in 1996 (Exhibit 19). That said, if the U.S. growth backdrop remains resilient and additional Fed rate cuts are realized, we believe the peak in the USD leveraged loan default rate may be near.

Exhibit 18: Capital structures that include loans have accounted for 92% of defaults or distressed transactions in 2024, thus far

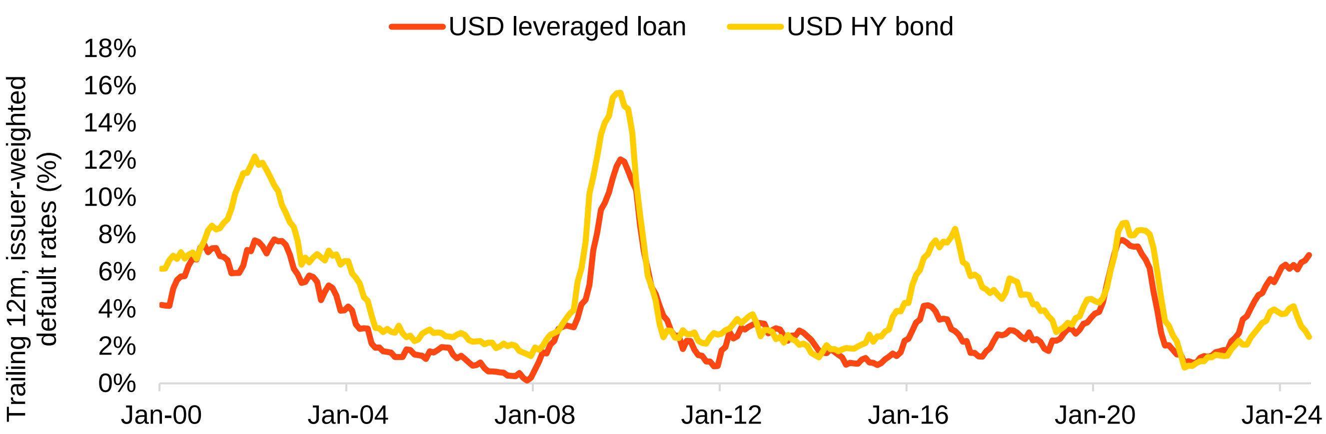
Default action* volume in billions, by issuer type (bond and loan, bond only, and loan only)



Source: J.P. Morgan, PitchBook, Bloomberg, S&P/IHSMarkit, BlackRock. As of August 2024. *Default action includes defaults and distressed transactions.

Exhibit 19: Loan defaults should continue to outpace their HY bond peers

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 available as of September 18, 2024).

Distressed exchange volume is on the rise

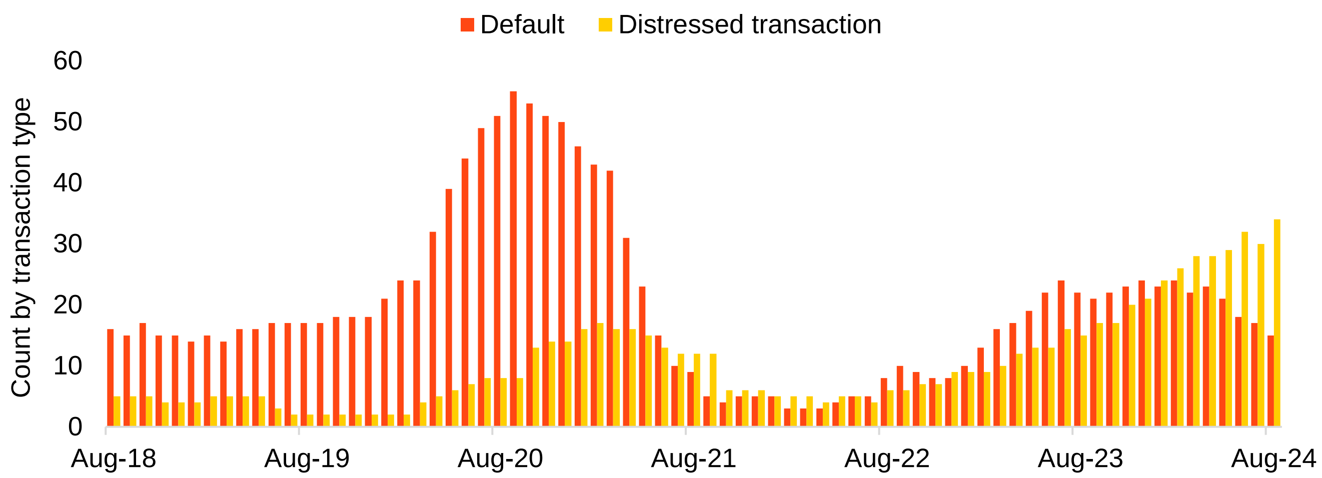
Another consistent trend (from our June report) is the prevalence of distressed exchanges. Borrowers in the syndicated market are choosing to execute distressed transactions over defaults at a higher pace than in past years. As of August 2024, 67% of YTD distressed/default dollar volume is attributed to distressed transactions compared to a 16-year average of 17%, according to JP Morgan Research.

Data from Pitchbook LCD demonstrates the same trend, with the number of distressed transactions in the leveraged loan market outnumbering the number of payment defaults since the year began (Exhibit 20). This marks a notable shift, as payment defaults have historically represented a larger share of activity in the leveraged loan market.

Private equity sponsors (who are active in the leveraged loan market) may favor distressed transactions to avoid the costs associated with a traditional bankruptcy, as they aim to maintain the borrower's equity value. Indeed, according to Pitchbook LCD, private equity-owned borrowers have conducted 82% of the YTD distressed transactions in the leveraged loan market (by count; Exhibit 21).

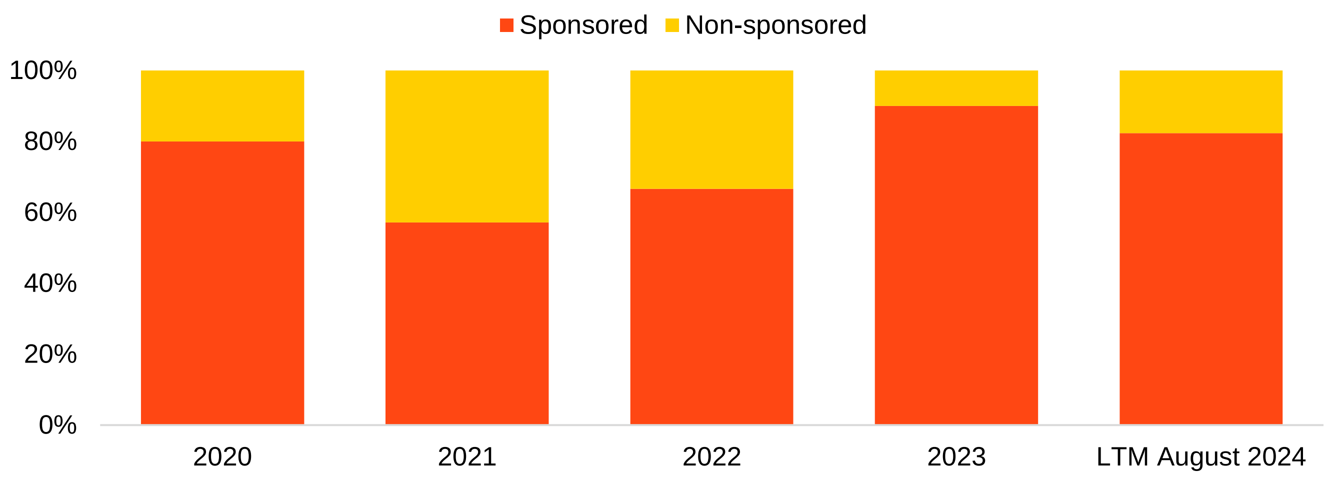
That said, distressed exchanges can sometimes fall short of a permanent solution for a stressed capital structure. Indeed, data show that some firms return to a default/distress transaction in the years following the exchange.

Exhibit 20: The profile of distressed activity has evolved in the USD leveraged loan market
Trailing 12-month count of defaults* and distressed transactions in the Morningstar LSTA US Leveraged Loan Index



Source: PitchBook LCD; Morningstar LSTA USD Leveraged Loan Index, BlackRock. Data as of August 31, 2024. *Default is defined as interest payment misses or bankruptcy filings.

Exhibit 21: Sponsor-owned borrowers executed most distressed transactions in the leveraged loan market
Share of distressed transactions in the Morningstar LSTA USD Leveraged Loan Index, by ownership type



Source: PitchBook LCD; Morningstar LSTA US Leveraged Loan Index, BlackRock. Data as of August 31, 2024.

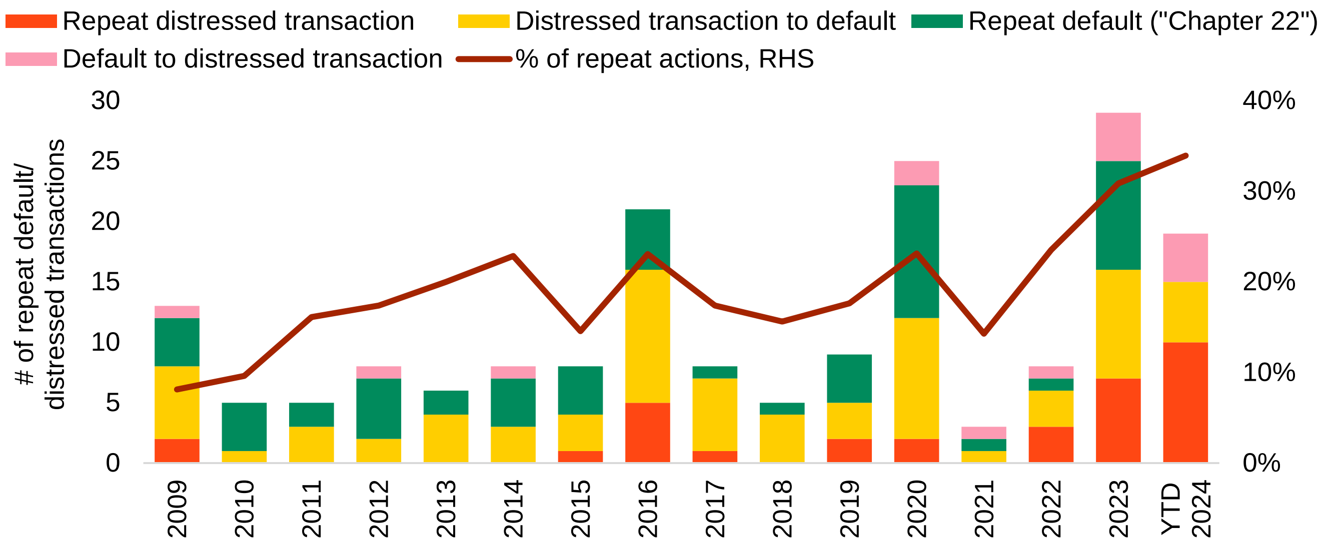
The share of repeat default actions hit a historic high

Another signal informing the health of credit markets is the share of repeat defaulters (i.e., those that defaulted or executed a distressed transaction following a previous such action) relative to total defaults in the respective year.

The share of repeat offenders in syndicated debt markets hit an all-time high in August 2024, with 34% of YTD defaults/distressed exchange transactions executed by repeat defaulters, surpassing 31% in 2023 and the 16-year average of 18%, according to JP Morgan (Exhibit 22). Pitchbook LCD suggests a similar trend, with 33% of leveraged loan issuers that conducted a distressed exchange in 2022 (less than two years ago) returning to market again with a payment default or bankruptcy (Exhibit 23).

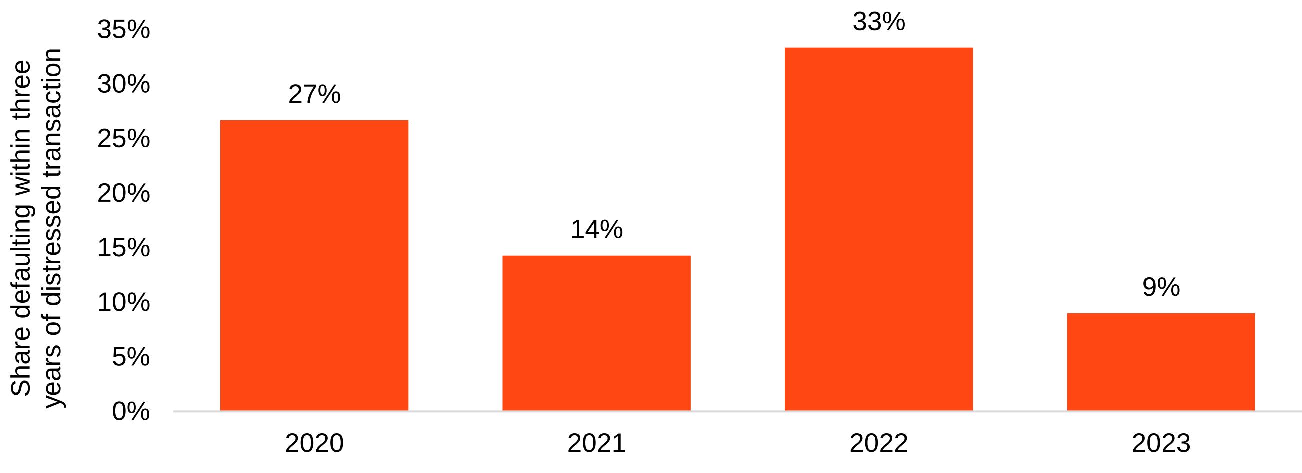
In our view, the prominence of repeat offenders underscores the importance of accurately assessing a borrower's financial health, including the sustainability of their capital structure and their ability to grow in a capital efficient way in a higher-rate environment. Further, we believe it also highlights the importance of manager selection and underwriting and/or restructuring experience in capital allocation.

Exhibit 22: The share of repeat default actions reached a historic high of 34%
Count of default actions* from repeat offenders (by transaction type) and share of total default actions* that were repeat offenders (RHS)



Source: J.P. Morgan, PitchBook, Bloomberg, S&P/IHSMarkit, BlackRock. As of August 2024. "Chapter 22" refers to a company filing Chapter 11 bankruptcy a second time. *Default action includes defaults and distressed transactions.

Exhibit 23: 33% of loans that conducted a distressed exchange in 2022 have already defaulted (via a missed payment or bankruptcy filing)
Count of issuers that conducted a distressed exchange transaction in each year that returned with a payment or bankruptcy default in the subsequent three years



Source: Pitchbook LCD. Data through August 31, 2024.

Recoveries vary by transaction type

Beyond the *frequency* of defaults, the outcome and *severity* of default/distressed activity also have important implications for investors and lenders. To understand this, we turn to recovery rates, which offer insight into the amount of money returned to the lender following such action.

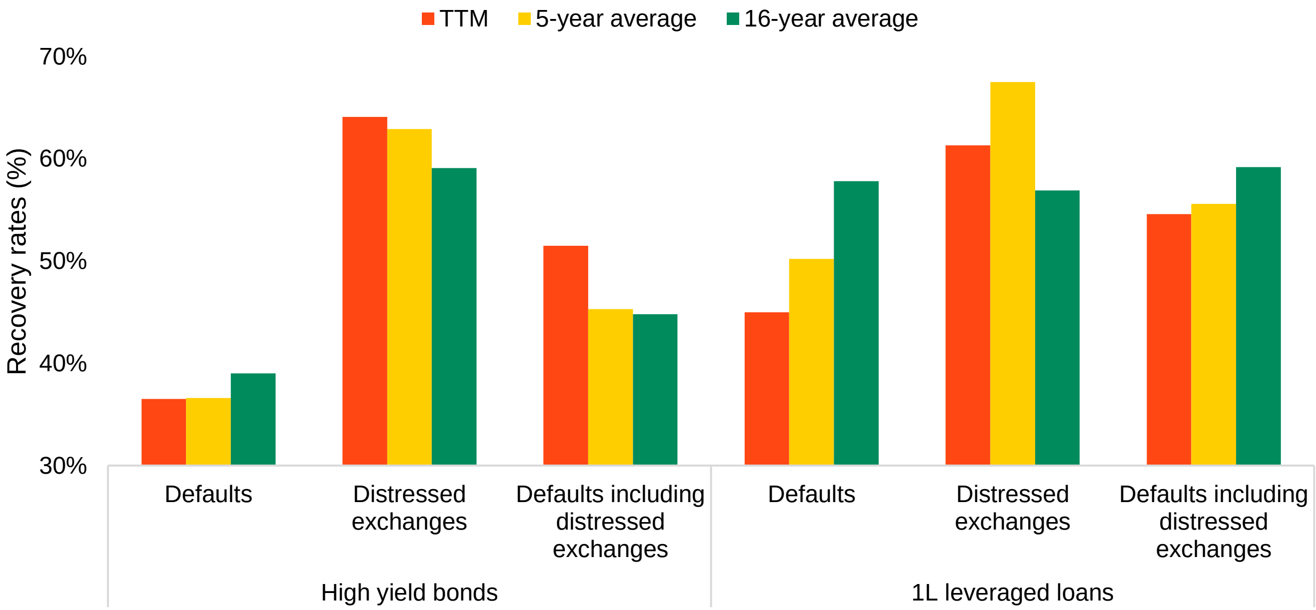
In recent history, distressed exchanges have resulted in higher recovery rates than defaults for both HY bonds and 1st lien (1L) leveraged loans, according to data by JP Morgan (Exhibit 24).

As distressed exchanges have become more prominent in the leveraged loan market in recent years, they have supported the aggregate recovery rates for leveraged loans (i.e., recovery rates on 1L leveraged loan 'defaults including distressed exchanges'; again, Exhibit 24). As such, while average default recovery rates for leveraged loans have fallen (from a 16-year average of 57.8% to a 5-year average of 50.2%), the decline was less severe for 'defaults including distressed exchanges' (which fell from a 16-year average of 59.2% to a 5-year average of 55.6%).

As noted in Exhibit 21, sponsor-owned borrowers tend to execute distressed exchanges at a higher rate than non-sponsor-owned peers in the USD leveraged loan market. We believe this may influence aggregate outcomes of distressed exchanges because private equity sponsors tend to be focused on value preservation. Further, we expect that recovery rates across all transaction types will continue to fluctuate based on factors such as the macroeconomic environment, type of default action, position in the capital structure, and borrower characteristics (including sector, amount of tangible assets, etc.).

Exhibit 24: Distressed exchanges have, on average, had higher recovery rates than defaults in recent history

Trailing 12-month (TTM), 5-year average, and 16-year average high yield bond and 1L leveraged loan recovery rates for defaults, distressed exchanges, and defaults including distressed exchanges



Source: J.P. Morgan, PitchBook, Bloomberg, S&P/IHSMarkit, Moody's, BlackRock. As of August 2024.

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