Private Markets

April 2024

Global Credit Outlook: 2Q2024

Seeking confirmation

BlackRock.

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Key takeaways

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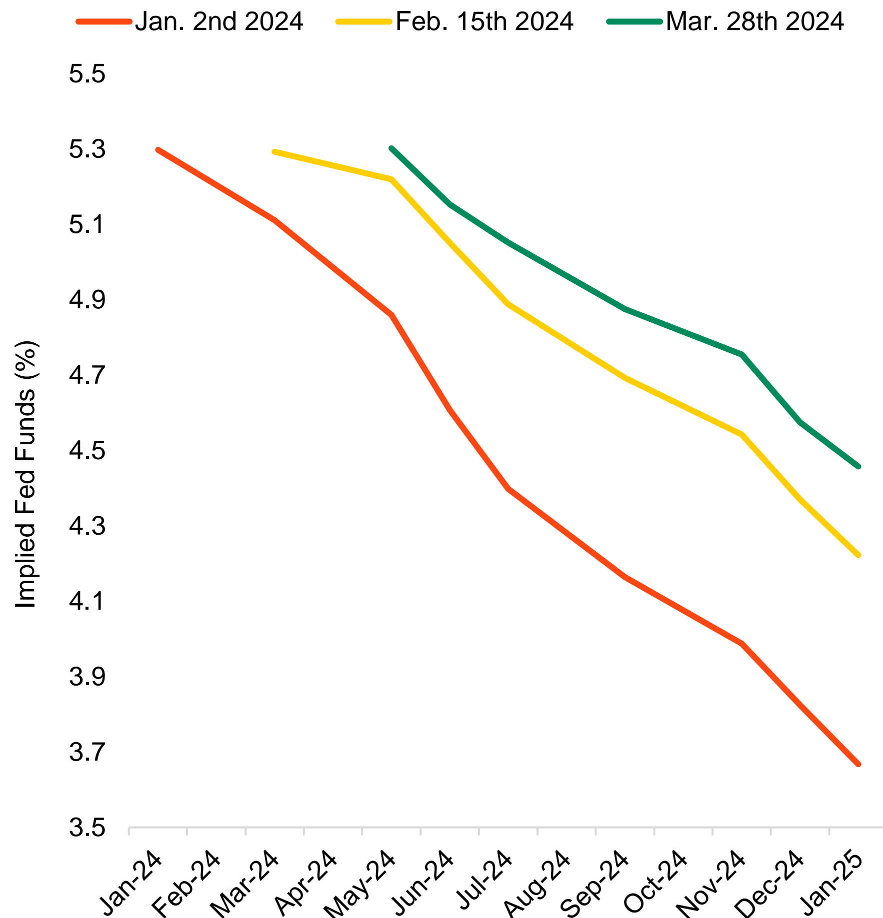
- 1Q2024 was characterized by a reassessment of the start "timing" *and* depth of the rate cutting cycle in the U.S., as ongoing economic resilience and sticky inflation underscored the Federal Reserve's (Fed) patient stance. A similar desire for more "confidence" on inflation fighting progress was echoed by the European Central Bank (ECB), despite a more challenging growth-inflation mix in that region.
- 2Q2024 will be critical as corporate credit investors seek confirmation on inflation progress and the start of monetary policy normalization.
- Despite the "delayed" prospect of rate relief, liquid and private corporate credit has been resilient – a trend we expect to continue in 2Q2024. That said, dispersion has been on the rise (in the USD and EUR markets) as borrowers continue to navigate this "high-for-longer" cost of capital landscape. The tactical case to own floating rate exposures in liquid and private credit should also persist into 2Q2024, given the rates backdrop.
- Our base case remains for the first Fed rate cut to begin in 2H2024, with the risks skewed earlier within that timeframe. That said, and as we have noted previously, the *timing* of the start of rate cuts is not the primary consideration for corporate credit investors.
- Rather, these factors are critical for investor risk appetite to remain supportive, in our view: (1) a high likelihood that the current Fed Funds rate represents the peak for this cycle (i.e., no more rate *hikes* are expected), (2) the expectation that rate *cuts will begin eventually* in 2024, and (3) the reason for the eventual rate cuts will be sustained improvement in inflation, as opposed to a sharp growth downturn.

Macro: Recalibrating rate cut expectations

Exhibit 1: Fed rate cut expectations were reset during 1Q2024

The U.S. policy rate implied by Fed Funds Futures, through early 2025, at various points during 1Q2024



Source: BlackRock, Bloomberg.

1Q2024 was characterized by a backdrop of resilience: solid economic growth, fading concerns related to a near-term recession (especially in the U.S.) and debt capital markets which became receptive to even the lowest rated borrowers after a lull in such activity in 2H2023.

This, coupled with upside surprises to inflation in January and February, caused the market to recalibrate its expectations for Fed rate cuts: both in terms of timing (later) and magnitude (shallower/fewer). Entering 2024, market pricing suggested meaningful odds for the first cut in March 2024, and implied more than six 25bp rate cuts for the year. By late-March, that had been reduced to just over three cuts beginning in July 2024 (Exhibit 1).

We have viewed the bar for monetary policy normalization as high, given economic resilience, persistently high price pressures in some inflation categories (such as services/wages) and the Fed's public commentary which signaled a reluctance to cut rates prematurely, only to have to "re-start" a rate hiking cycle. Our base case has remained for the first Fed rate cut to begin in 2H2024, with the risks skewed earlier within that timeframe. That said, and as we have noted previously, the *timing* of the start of rate cuts is not the primary consideration for corporate credit investors.

Rather, these factors are most critical for investor risk appetite to remain supportive in 2Q2024, in our view: (1) a high likelihood that the current Fed Funds rate represents the peak for this cycle (i.e., no more rate *hikes* are expected), (2) the expectation that *rate cuts will begin eventually* in 2024, and (3) the reason for the eventual rate cuts will be sustained improvement in inflation, as opposed to a sharp growth downturn.

Inflation reacceleration is a key risk

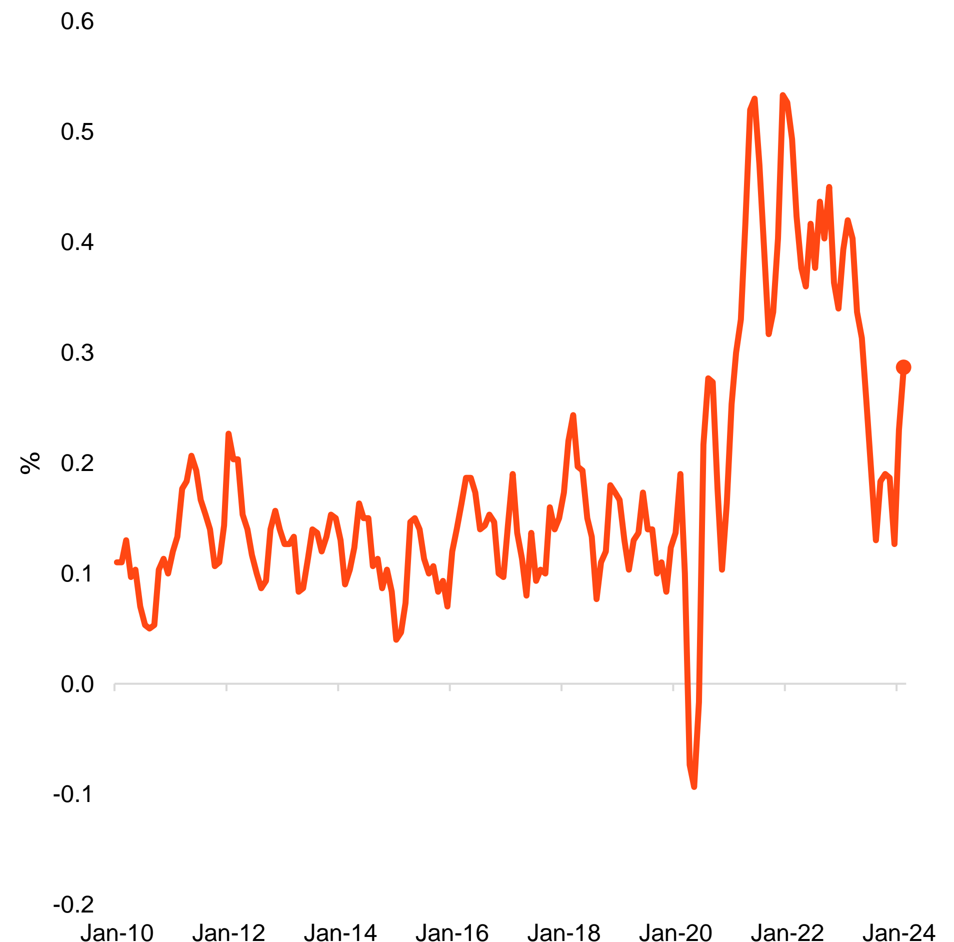
Inflation data in early 2024 has come in above consensus forecasts and has, on a higher frequency basis, halted the progress in place for much of 2H2023 (Exhibit 2). When asked (during the March FOMC press conference) about the strength of inflation data in January 2024 – and, to a lesser extent, February 2024 – Fed Chair Powell warned against the risk of "dismissing data that you don't like," even if seasonal adjustments were largely behind the January strength. He said the Committee does not know "whether this is a bump in the road or something more," but that strength in the economy and labor market, alongside progress on inflation over a longer-term trend, "give us the ability to approach this question carefully." Chair Powell also mentioned that "given the inflation data from January and February, it suggests we were right to wait until we were more confident" before starting a rate cutting cycle.

The Fed's March 2024 Summary of Economic Projections reflected median forecasts for stronger U.S. real GDP growth and higher core inflation in 2024 – but an unchanged projected policy rate for the same year. When asked whether the lack of a change in the median 2024 Federal Funds "dot" reflected an increased tolerance for higher inflation, Chair Powell stated that the Committee is "strongly committed to bringing inflation down to 2% over time...but we stress, over time." As a result, progress on the inflation fight will be key to watch in 2Q2024, in our view.

While not our base case, we view a *sustained* reacceleration in U.S. inflation data as a key downside risk for asset valuations. Such an outcome would likely introduce significant uncertainty related to the forward path for monetary policy and may have the potential to un-anchor longer-term inflation expectations.

Exhibit 2: A "bumpy" path for inflation

U.S. Core Personal Consumption Expenditure (PCE), 3-month moving average of the month-over-month change (%)



Source: BlackRock, Bureau of Economic Analysis, Blomberg. Captures 3-month moving averages using actual data through February 29, 2024 (most recent).

ECB: Also looking for more inflation progress

The ECB's March 7th press conference underscored a patient approach, even as "the risks to economic growth remain tilted to the downside." ECB President Lagarde noted that most measures of underlying inflation (as well as energy prices) have continued to ease as the impact of past supply shocks fades and tight monetary policy weighed on demand. That said, she highlighted that services inflation remained sticky, noting "domestic price pressures remain high, in part owing to strong growth in wages" (Exhibit 3).

ECB staff decreased their 2024 growth projection to 0.6% (from 0.8%). They expect near-term economic activity to remain subdued, but gradually recover over the course of 2024, and in 2025-2026.

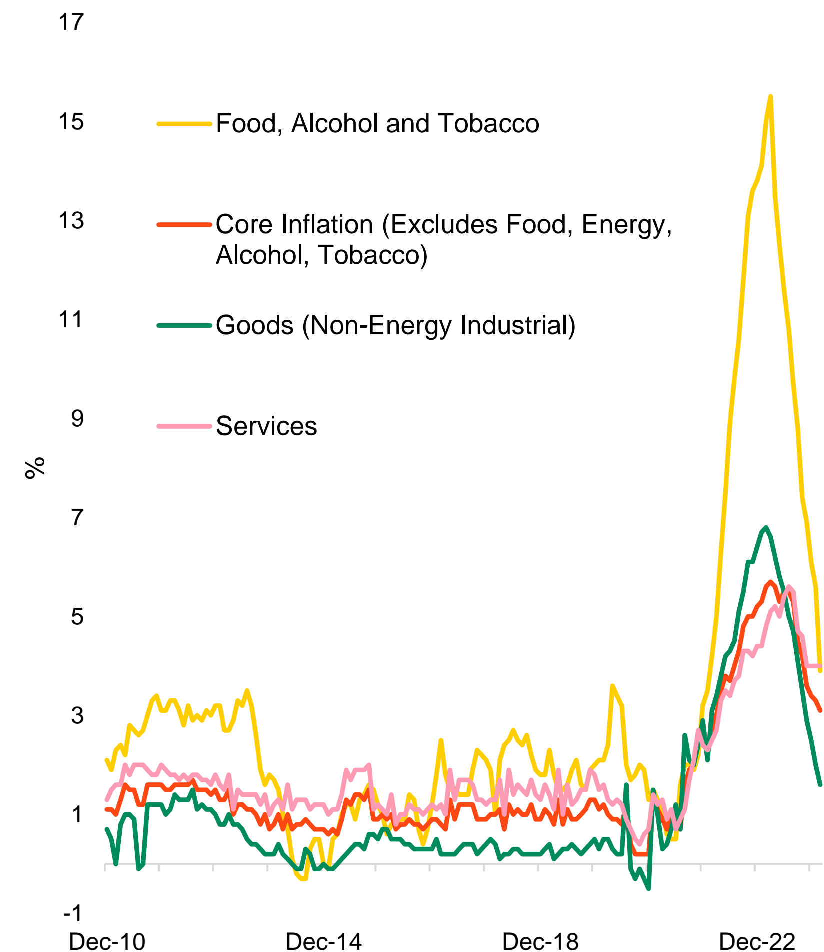
Similar to commentary from Fed officials, President Lagarde expressed a desire for more confidence that inflation is moving sustainably to the ECB's 2% target, and 2Q2024 appears to be a key period for data on the subject. President Lagarde noted "there is a definite decline which is under way, and we are making good progress towards our inflation target…But we are not sufficiently confident, and we clearly need more evidence, more data…We will know a little more in April, but we will know a lot more in June."

In highlighting the persistence of wage inflation, President Lagarde also stressed that it will be important to see profit margins *absorbing* those higher wages, to reduce the potential for so-called "second round effects" (i.e., a "wage-price spiral").

As for the timing of any rate cuts, President Lagarde emphasized: "the ECB is an independent central bank and will act independently…we will determine what action we need to take, and that will be done independently from what my colleague at the Fed decides to do."

Exhibit 3: Services inflation has remained sticky in the Euro Area, largely due to wages

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



Source: BlackRock, Eurostat. Captures data through February 29, 2024 (most recent).

The growth-inflation mix: U.S. vs. Europe

While both the Fed and ECB are similar in terms of their desire to see additional confirmation on the progress of inflation, the growth-inflation mix across regions remains quite different, as illustrated in Exhibit 4. That said, while U.S. growth continues to outpace its Euro Area peer, the pattern for 1Q2024 has shown some narrowing between the two regions.

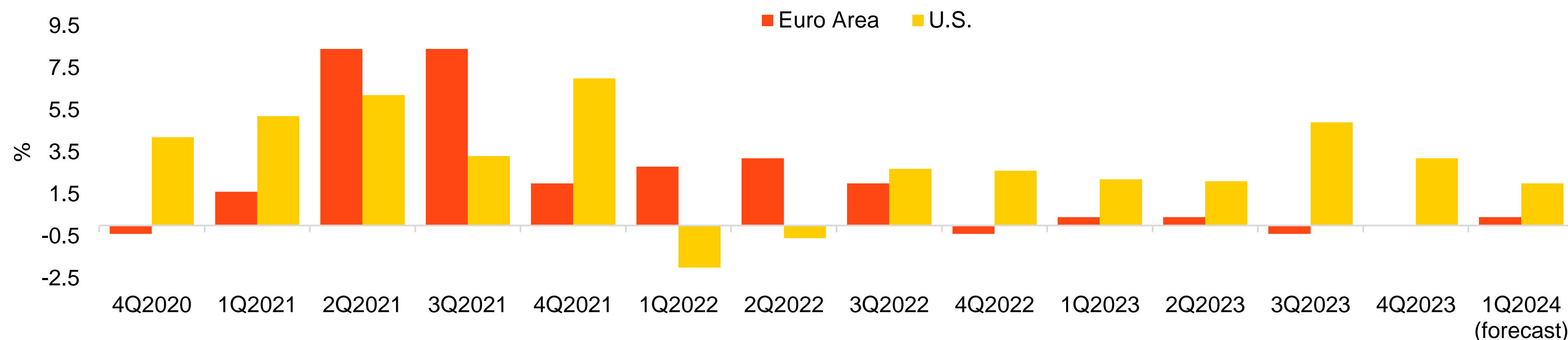
When discussing the Euro Area's weaker economic backdrop at the March 2024 ECB press conference, President Lagarde noted that "consumers continued to hold back on their spending, investment moderated and companies exported less, reflecting a slowdown in external demand and some losses in competitiveness." Weakness in the German industrial sector, in particular, has also been notable. As a result, activity in the south of the Euro Area (which has been relatively stronger as of late, vs. the North), as well as in the service sector, will be key to the eventual rebound that ECB officials expect (and for further confirmation of recent positive signaling from survey data).

Meanwhile, in the U.S., the consumer has been a supportive tailwind for the economy (barring some weakness among certain subprime cohorts). Elevated immigration has also driven growth in the labor force, as The Brookings Institution recently highlighted.

This differential – to the extent it intensifies or persists – is likely to result in different catalysts for the beginning of rate cutting cycles, in our view. For the Euro Area, we see a higher likelihood for an earlier start of rate normalization catalyzed by economic weakness – presuming a decline in inflation consistent with the ECB's single-mandate focus on price stability. By contrast, in the U.S., we expect the Fed – which has a dual mandate of maximum employment and price stability – will continue to take a patient stance. This is enabled, in part, by the still tight labor market as demand for U.S. workers continues to outweigh supply (as measured by the so-called "jobs-workers" gap).

Exhibit 4: The growth backdrop in the U.S. is likely to remain more favorable vs. Europe

Quarter-on-quarter real GDP growth (%), seasonally adjusted at an annualized rate; for the U.S. and Euro Area



Source: BlackRock, Bloomberg, Bureau of Economic Analysis, Eurostat. 1Q2024 forecasts use the Bloomberg Contributor Composite as of March 31, 2024, for the U.S. and Euro Area.

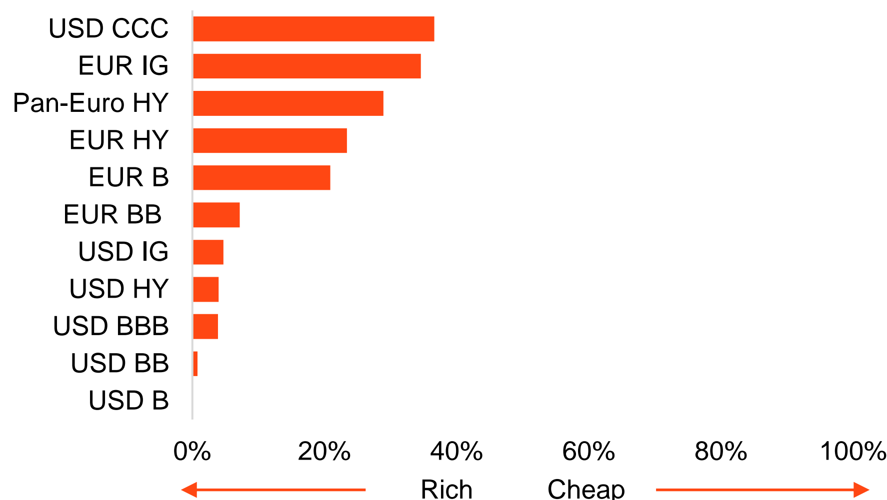
The spread vs. yield “tug-of-war”

Index-level spreads for the Bloomberg USD Investment Grade (IG) and High Yield (HY) Corporate indices moved meaningfully tighter during 1Q2024, closing the quarter at 90bps and 299bps, respectively. The tightening of index-level spreads was even more notable considering the heavy pace of new issue activity in markets (discussed later). While some market observers took note of the tight spread levels as a measure of a potentially distorted market, we continue to have a more nuanced view. As Exhibits 5 and 6 illustrate, a broader perspective of corporate credit relative value shows that all-in yields remain quite attractive on a historical basis, which has likely encouraged capital deployment in the corporate credit markets from yield-based buyers. Indeed, we see a case for spreads across many rating and regional cohorts to move slightly tighter in 2Q2024, as (in many cases) they remain wide to the mid-2021 local troughs.

To support such a scenario, the following factors are most critical, in our view: 1) a high likelihood that the current Fed Funds rate represents the peak for this cycle (i.e., no additional rate hikes are expected), 2) the expectation that rate cuts will begin eventually in 2024, and 3) the reason for the eventual rate cuts will be sustained improvement in inflation, as opposed to a sharp growth downturn.

Exhibit 5: Spreads are rich vs. history...

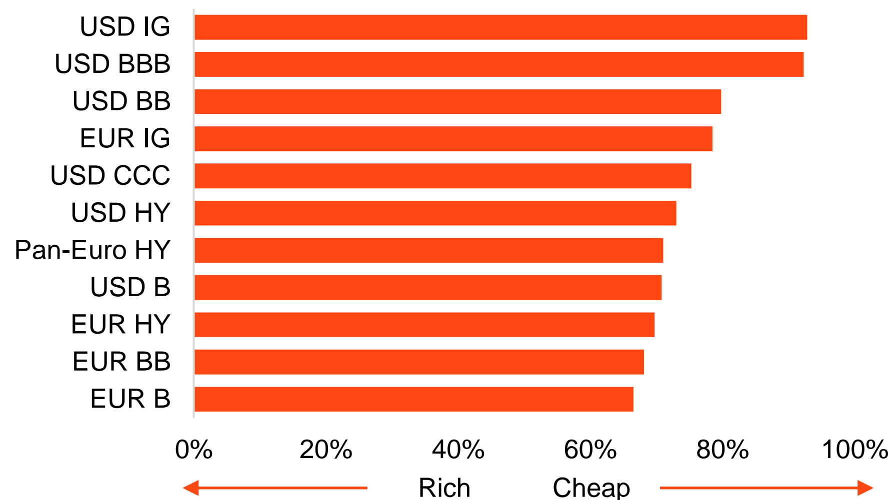
Percentile rank of daily index-level spreads since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. Captures option adjusted spread data through March 28, 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 6: ...but all-in yields are attractive

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



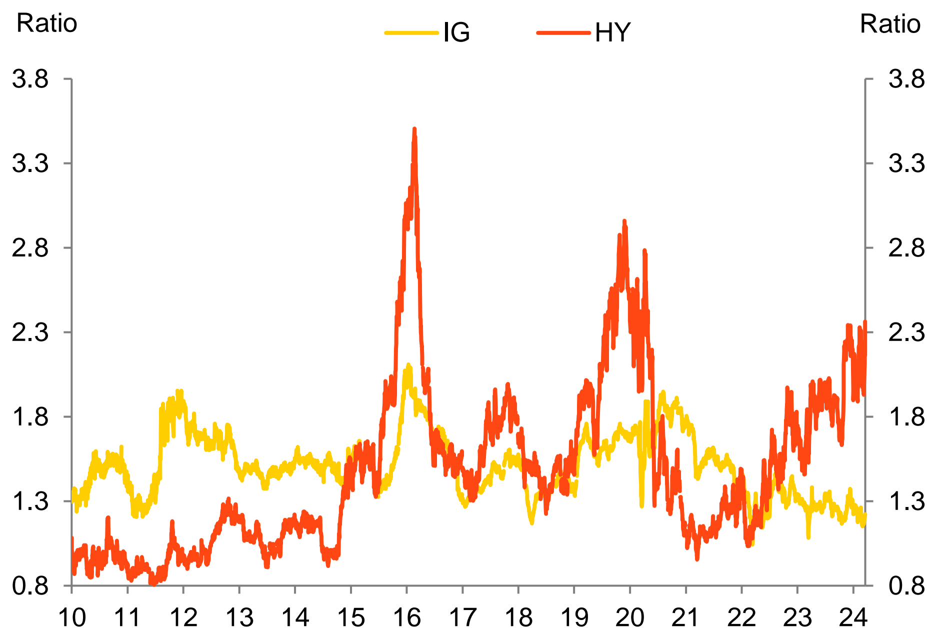
Source: BlackRock, Bloomberg, ICE-BAML. Captures yield-to-worst data through March 28, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Dispersion remains elevated

The index level metrics mentioned previously omit an important point, however: under the surface, dispersion *is* evident across corporate credit. Exhibits 7 and 8 illustrate this by showing a common measure of spread dispersion among the constituents of the iBoxx USD and EUR corporate credit indices. While dispersion among the IG-rated cohort has been range bound in the USD market and has been declining in the EUR market, dispersion among HY rated issuers remains very elevated. We can see this element of dispersion using another method, which looks at the distribution of bond level spreads in the Bloomberg USD HY Corporate Index. While the index level average spread of 299bps may seem optically tight by many measures, 50% of the index par value trades *inside* of 200bps.

Exhibit 7: USD HY spread dispersion is high

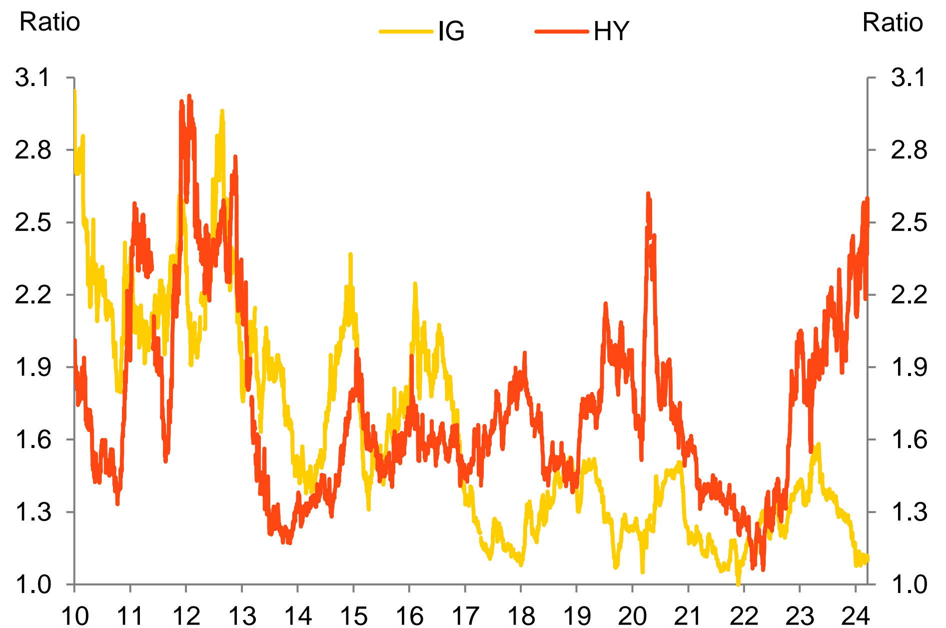
Spread dispersion shown is a normalized inter-decile range (i.e., difference between the 10% and 90% percentiles) of spreads across the iBoxx USD IG and HY index constituents



Source: BlackRock, Goldman Sachs Global Investment Research. As of March 25, 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 8: The same is true in EUR HY

Spread dispersion shown is a normalized inter-decile range (i.e., difference between the 10% and 90% percentiles) of spreads across the iBoxx EUR IG and HY index constituents



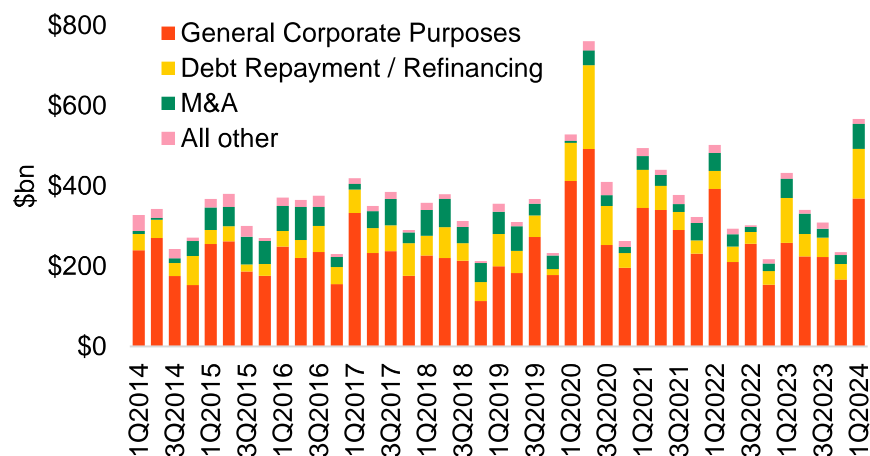
Source: BlackRock, Goldman Sachs Global Investment Research. As of March 25, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

USD primary markets: Elevated activity

More than $566 billion of USD IG gross supply was issued in 1Q2024, generating a new record for primary market activity in a 1Q period – even surpassing 1Q2020, when corporates rushed to secure liquidity following the immediate onset of the pandemic (Exhibit 9). Similarly, 1Q2024 USD HY gross supply of $89 billion was the most active quarter since 3Q2021 (Exhibit 10) – again, a period characterized by the post-pandemic rush to capital markets for financing. Moreover, this elevated level of supply has been well absorbed. According to deal-level data complied by Bloomberg, the average new issue concession (NIC) for USD IG deals in 1Q2024 (as of March 25th) was just 3.7bps. This compares to an average NIC of 8.5bps for all of 2023. Books for the USD IG deals so far this year have been, on average, 3.8x covered according to Bloomberg (vs. 3.5x covered, on average, in 2023). And in the USD HY market, the financing mix remains bondholder friendly, with debt repayment and refinancing representing 74% of the 1Q2024 proceeds (again, Exhibit 10). We expect this pattern of elevated debt issuance to persist in 2Q2024, as CFOs and Treasurers accept the current higher cost of capital environment and move forward with strategic initiatives (which may require funding) and/or take steps to make sure their capital structures remain resilient vis-à-vis upcoming maturities.

Exhibit 9: A record 1Q for USD IG supply

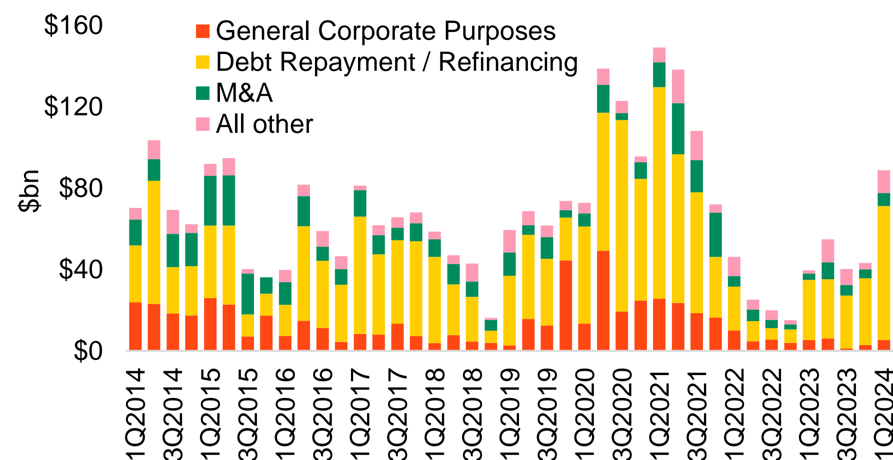
USD IG gross issuance by quarter and primary use of proceeds (as captured by Dealogic)



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 31, 2024. “All other” includes: Recapitalization, Restructuring, Project Financing, Spin-Off, Working Capital, Capital Expenditures, Aircraft, Investments, Dividend Recapitalization, Exit Financing, Securitisation, Expansion, Public Finance, Property, LBO/MBO, Shipping, Export Credit Agency (ECA) Financing, Private Placement, and Dividend Payment.

Exhibit 10: Robust USD HY supply in 1Q

USD HY gross issuance by quarter and primary use of proceeds (as captured by Dealogic)



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 31, 2024. “All other” includes: LBO/MBO, Dividend Recapitalization, Spin-Off, Restructuring, Capital Expenditures, Working Capital, Investments, Recapitalization, Exit Financing, Project Financing, Aircraft, DIP Financing, Property, Dividend Payment, Public Finance, Securitization, Equity Infusion, Expansion, and Shipping.

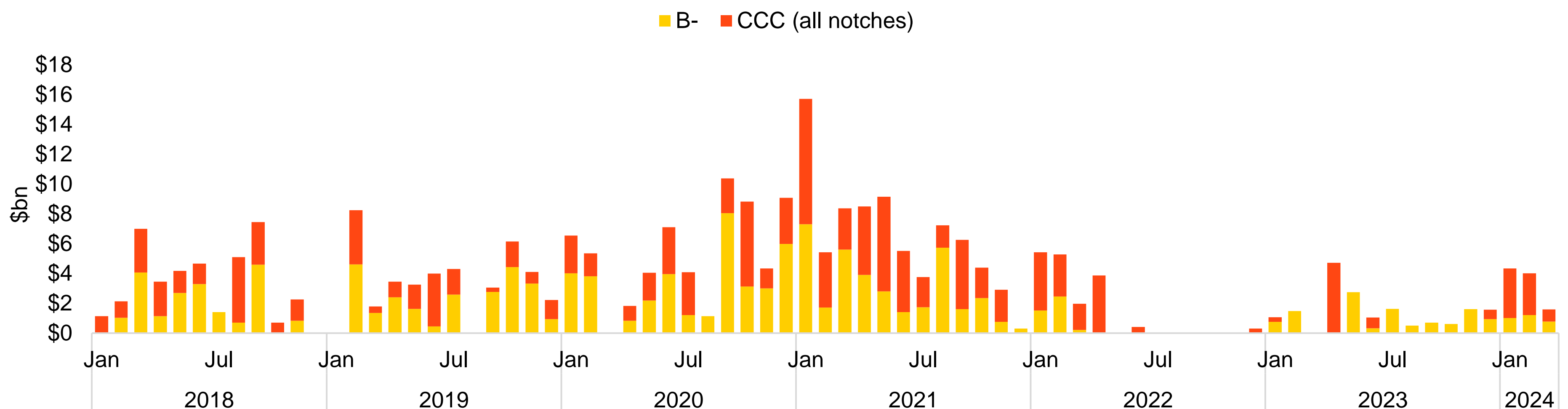
Refinancing: Open to the lowest-rated firms

More important than the *absolute volumes* of primary market activity, however, has been the *mix*. Specifically – the ability of the lowest rated firms to access the public debt markets for their refinancing activities. For most of 2H2023, market receptivity for CCC-rated refinancing (in particular) had been largely untested. Instead, USD HY issuance over that timeframe was skewed towards higher-rated groups (Exhibit 11). This was a key concern of ours in the fall of 2023, as an inability to access funding at a reasonably economic rate would have likely placed (1) downward pressure on valuations (as yields on existing debt would be brought higher, to match new funding) and (2) upward pressure on the default rate (as some overleveraged borrowers may not have been able to access financing, at any cost).

This overhang was, to a large extent, significantly reduced in 1Q2024 as multiple lower-rated issuers (i.e., B- and CCC) accessed the USD HY bond market (again, Exhibit 11). While there remains an element of selectivity and dispersion in the public markets (as discussed previously), this is unquestionably positive for *most borrowers'* ability to access needed funding and liquidity. The key, in our view, will be for lower-rated issuers and financially strained borrowers to show a path to a sustainable capital structure in a "high-for-longer" cost of capital environment, over the medium term. Because we do not expect rates to revert to the lower bound of the post-financial crisis period, we believe highly leveraged capital structures will need to prove their viability in the current cost of capital landscape in order to access most funding markets (liquid and private).

Exhibit 11: USD HY primary markets have been receptive to the lowest-rated issuers

Monthly USD HY gross issuance by Dealogic Effective Rating at Launch (only captures B- and CCC+/CCC/CCC- rated issuance)



Source: BlackRock, Dealogic (ION Analytics). As of March 31, 2024. Excludes private placements not reported to Dealogic.

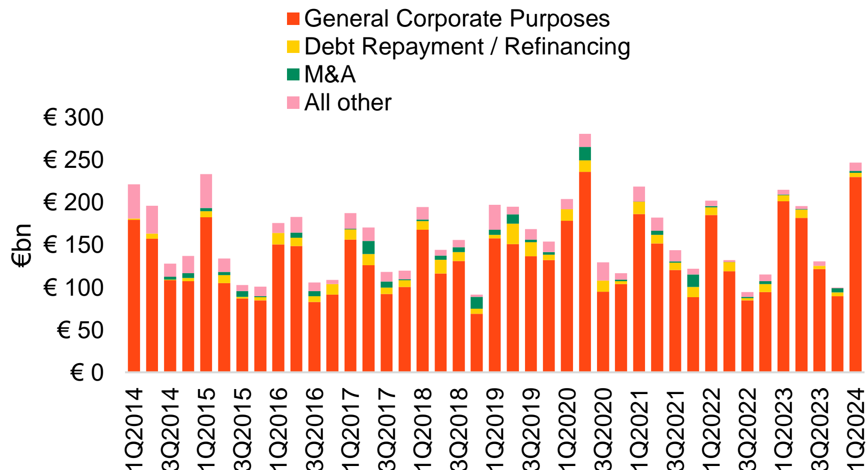
EUR primary markets: Also active

Similar to its USD peer group, the primary market backdrop in the EUR market has also been quite active. As illustrated in Exhibit 12, 1Q2024 gross issuance of $247 billion was the most active quarter since 2Q2020. Financials represented more than more than 53% of the year-to-date supply, consistent with the pattern of the past few years. Energy, Technology, Autos, Telecommunications and Transportation were also sizable contributors. The absorption of this elevated level of EUR IG corporate supply is even more notable considering that the ECB stopped purchases of EUR IG corporate bonds (via its various asset purchase programs) in 2022 and halted some reinvestments in 2023. The ECB had previously been a sizable and predictable source of demand for EUR IG corporate bonds. As evidence of that: it still held €319 billion in the Corporate Sector Purchase Program ("CSPP") as of February 2024.

As shown in Exhibit 13, activity in the EUR HY primary market also showed a notable rebound in 1Q2024 – again, consistent with the trend seen in the USD HY market. 46% of the 1Q2024 activity was related to debt repayment or refinancing, according to data captured by Dealogic. This stands above the 31% quarterly average from 2018 to 2023, and also above the 44% refinancing share seen in 1H2023 (when such activity was elevated). With risks to Euro Area growth skewed to the downside (as discussed earlier), we expect corporates will continue to focus on refinancing activity as 2024 progresses and the upcoming maturity walls move closer into view.

Exhibit 12: A busy 1Q for EUR IG supply…

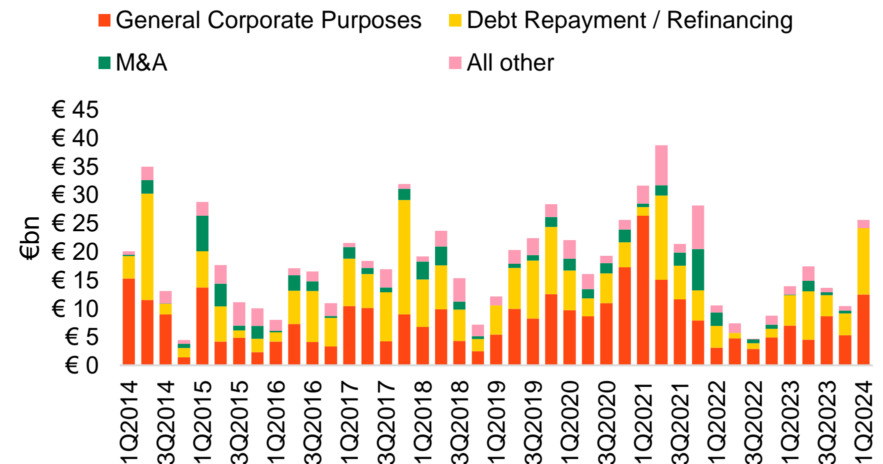
EUR IG gross issuance by quarter and primary use of proceeds (as captured by Dealogic)



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 31, 2024. "All other" includes: Recapitalization, Restructuring, Project Financing, Investments, Working Capital, Capital Expenditures, Spin-off, Public Finance, Securitisation, Aircraft.

Exhibit 13: …the same is true for EUR HY

EUR HY gross issuance by quarter and primary use of proceeds (as captured by Dealogic)



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 31, 2024. "All other" includes: LBO/MBO, (Dividend) Recapitalization, Restructuring, Spin-Off, Secondary Buyout, Working Capital, Exit Financing, Expansion, Property, Project Financing, and Shipping.

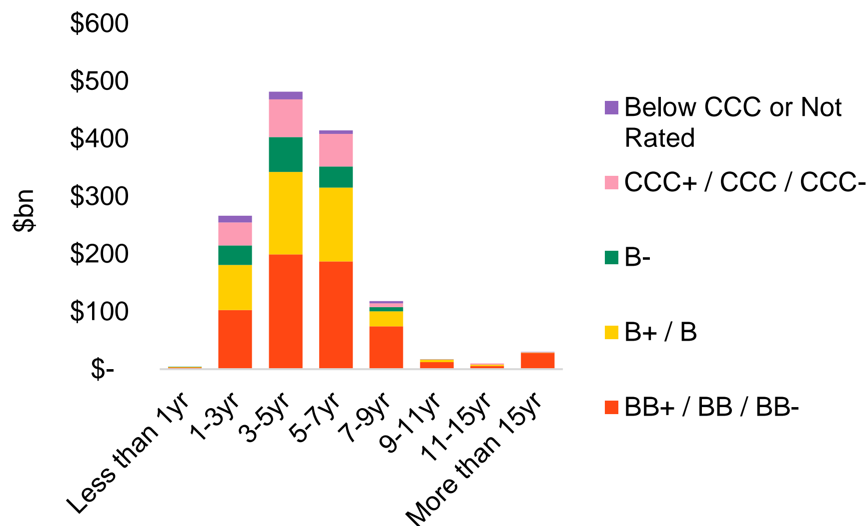
Maturity walls: Largely manageable

The robust primary markets activity among USD HY and EUR HY issuers – which, as discussed earlier, has been skewed towards refinancing – reflects corporates' proactive approach to addressing their upcoming maturity walls by taking advantage of the supportive market tone. Rather than waiting for interest rates to decline, the robust activity suggests that CFOs and Treasurers are instead moving forward with their capital management plans.

We view the size of the HY maturity walls as largely manageable – especially in the USD market. Using data compiled by Bloomberg, roughly 21% of the bonds in the $1.3 trillion Bloomberg USD HY Corporate Index are scheduled to mature in the next 1-3 years (Exhibit 14). The share of bonds in the €421 billion Bloomberg Pan-European HY Corporate Index maturing in the next 1-3 years is higher, at approximately one-third (Exhibit 15). As discussed previously, the ability of lower-rated borrowers to successfully access the capital markets for financing will remain important to monitor over the course of 2Q2024, given the ratings mix of the upcoming maturity schedules in the USD HY and EUR HY markets (again, Exhibits 14 and 15).

Exhibit 14: USD HY maturity walls

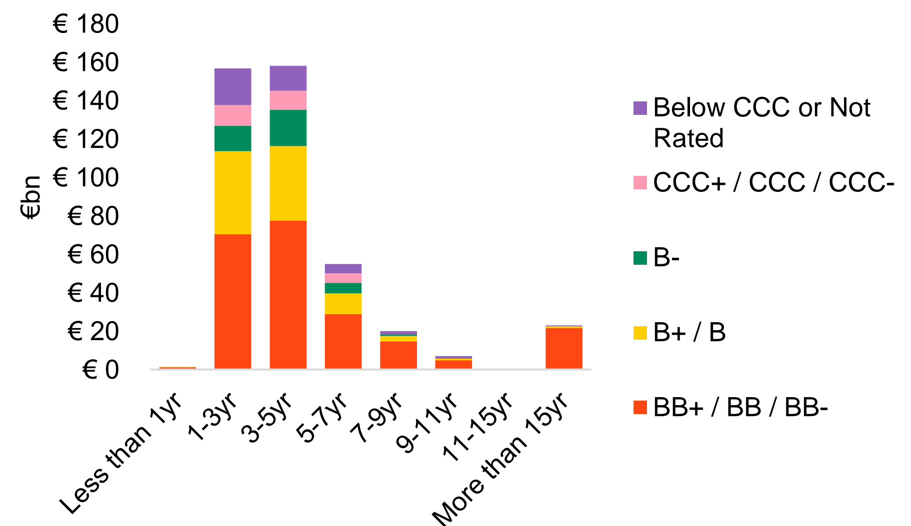
Maturity breakdown (by Bloomberg composite rating) of bonds in the Bloomberg USD HY Corporate Index



Source: BlackRock, Bloomberg. As of March 24, 2024. Excludes index ineligible bonds.

Exhibit 15: EUR HY maturity walls

Maturity breakdown (by Bloomberg composite rating) of bonds in the Bloomberg Pan Euro HY Corporate Index



Source: BlackRock, Bloomberg. As of March 24, 2024. Excludes index ineligible bonds.

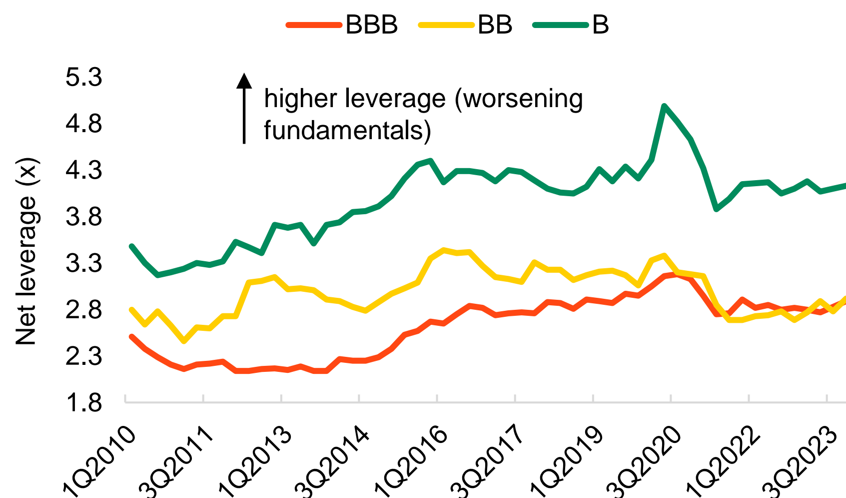
USD credit: Dispersion, not disruption

The fundamental trend across USD corporate credit over the past several quarters has largely been characterized by stable leverage but worsening interest coverage, as Exhibits 16 and 17 illustrate. The key driver of the deterioration in interest coverage metrics is, of course, the higher rate environment – especially intermediate and longer-term rates given the duration profile of the fixed-rate HY and IG corporate bond markets. As low coupon debt issued between mid-2020 and early 2022 is refinanced into the current (higher) interest rate environment, fixed rate borrowers are incurring higher debt service costs.

But in most cases, this has been a very manageable headwind. A combination of factors are underpinning this result, including the solid economic growth backdrop, the receptive market tone and investor appetite for new issues, and the recent tightening in spreads (which also factor into the cost of debt equation, alongside interest rates). In addition to the charts shown below, trimmed mean measures (compiled by Bloomberg) for North American BBB, BB and B firms show stable or improving margins over the past few quarters. Barring a sharp downturn in economic activity, this leaves us comfortable with our expectation for *dispersion* in the USD corporate credit market – *not widespread market disruption*.

Exhibit 16: Range-bound leverage

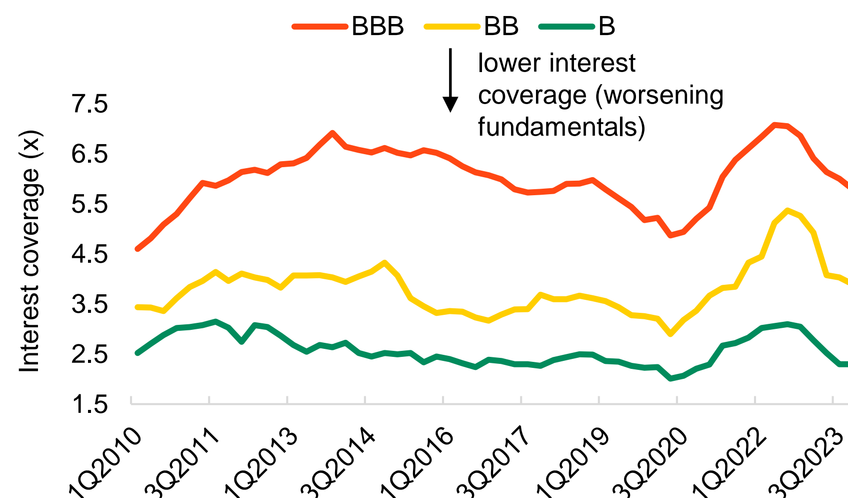
Trimmed mean (excludes the bottom 10% and top 10%) net leverage for BBB, BB and B rated issuers in the Bloomberg USD Corporate indices



Source: BlackRock, Bloomberg. Net leverage is defined as: (Debt - Cash) / LTM EBITDA. Captures most recent data available as of March 24, 2024. LTM = last twelve months.

Exhibit 17: Lower interest coverage

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



Source: BlackRock, Bloomberg. Interest coverage is defined as LTM EBIT / LTM Interest Expense. Captures most recent data available as of March 24, 2024.

EUR credit: Less encouraging fundamentals

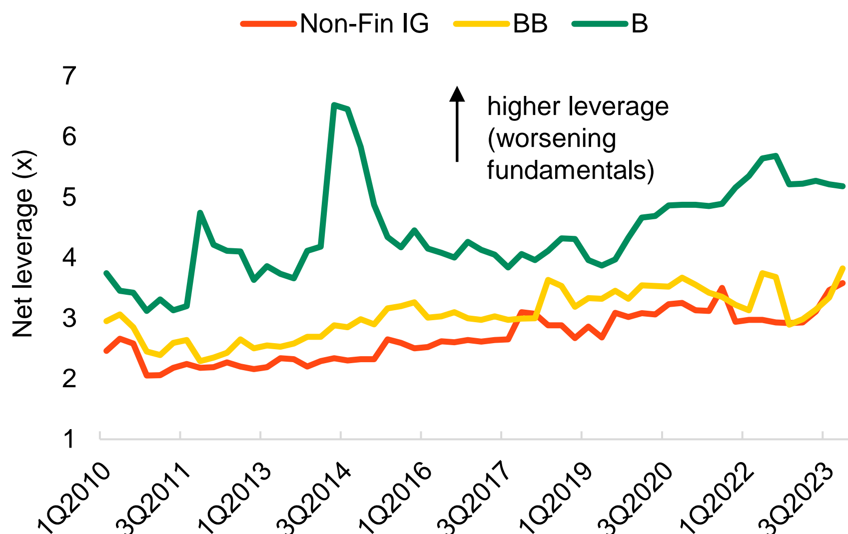
Relative to the USD market, the fundamental trends in EUR corporate credit have been somewhat less encouraging – likely a function of the more challenged growth backdrop, as discussed earlier. For example, Exhibit 18 shows that leverage for the universe of EUR Non-Financial IG issuers included in the Bloomberg EUR credit index has increased (i.e., worsened) over the past few quarters. A similar trend is visible for the high-end of the ratings spectrum in the EUR HY market (i.e., BB-rated issuers). For B-rated EUR HY borrowers, leverage has been range bound in recent quarters.

Similarly, EUR Non-Financial IG issuers have reported a sharp deterioration in interest coverage metrics since mid-2022 (Exhibit 19) – a period which coincided with the start of the ECB's rate hiking cycle in July 2022. Within EUR HY, interest coverage metrics for BB and B rated issuers have moved largely sideways over that same timeframe.

As shown previously, the relatively weaker fundamental positioning of the EUR credit market is already reflected in valuations, as spreads for various subsets of EUR corporate credit are trading cheaper vs. their own history, compared to that of their USD peers (again, Exhibit 5).

Exhibit 18: Increases in leverage

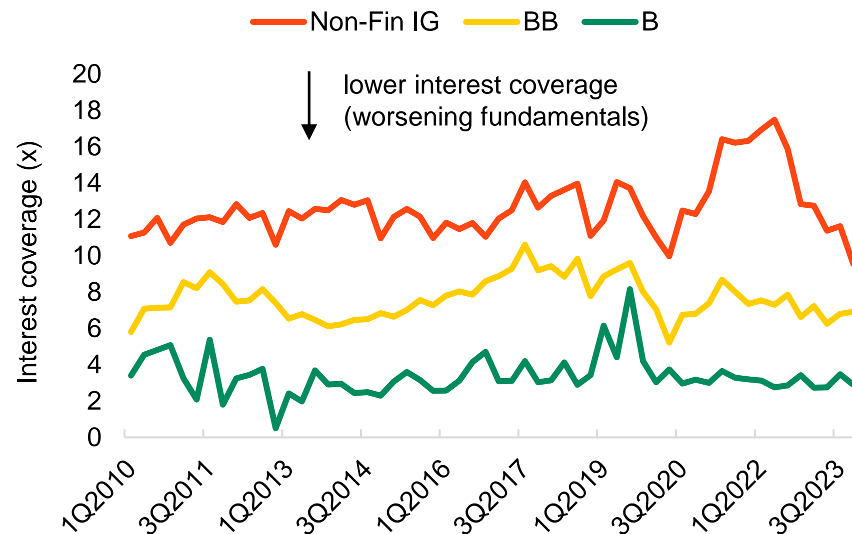
Weighted average net leverage for Non-Financial IG, BB and B rated issuers in the Bloomberg EUR Corporate Indices



Source: BlackRock, Bloomberg. Net leverage is defined as: (Debt - Cash) / LTM EBITDA. Captures most recent data available as of March 25, 2024. LTM = last twelve months.

Exhibit 19: EUR IG coverage has declined

Weighted average interest coverage for Non-Financial IG, BB and B rated issuers in the Bloomberg EUR Corporate Indices



Source: BlackRock, Bloomberg. Interest coverage is defined as LTM EBITDA / LTM Interest Expense. Captures most recent data available as of March 25, 2024.

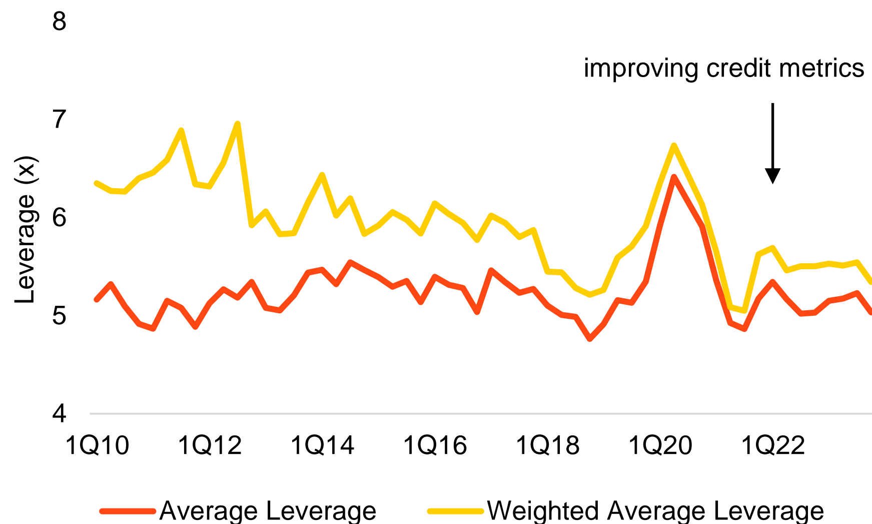
USD Leveraged Loans: Signs of stabilization

In contrast to their fixed rate peers who are encountering higher borrowing costs only *if and when* they refinance low coupon debt, USD leveraged loan issuers have been managing a higher cost of debt since the Fed 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). To put this in context, the all-in coupon for the Morningstar/LSTA USD Leveraged Loan Index (LLI) increased from roughly 4% as of 1Q2022 to approximately 9% as of 1Q2024.

This unsurprisingly weighed on interest coverage metrics over the past few quarters (Exhibit 21), despite stable leverage (Exhibit 20). But recent data from 4Q2023 suggests the trend might be stabilizing. So called “outer edge” credit metrics have also improved as of late. According to data compiled by Pitchbook LCD, the share of issuers (with public financials) in the LLI with leverage (debt/EBITDA) greater than 7x declined to 16.3% in 4Q2023 (the lowest since 3Q2021). And the share of issuers with cash flow coverage of less than 1.5x also declined vs 3Q2023, to 23.4% as of 4Q2023. Over the coming quarters, we will be looking for further confirmation of that trend, as borrowers continue to navigate this elevated cost of capital environment without near-term prospects for meaningful rate relief.

Exhibit 20: Leverage declined a bit in 4Q23…

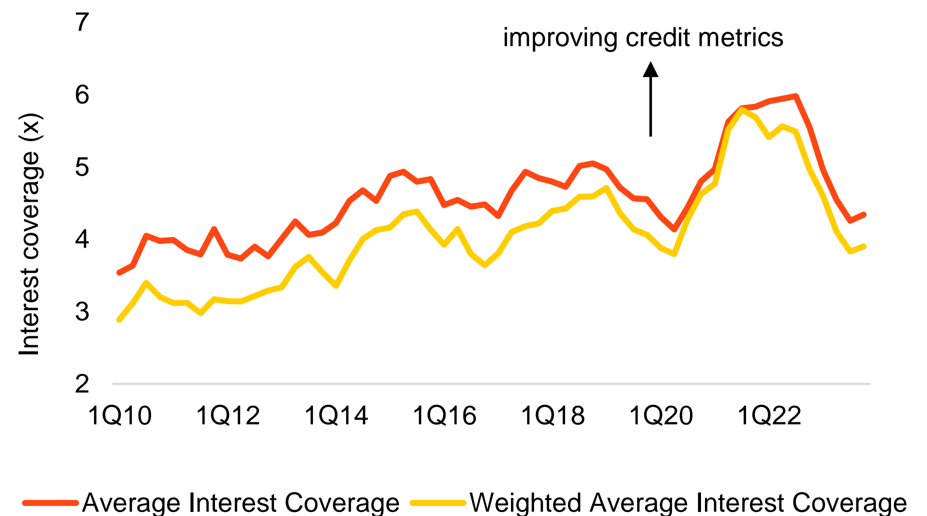
Leverage (Total Debt / LTM EBITDA) for issuers in the Morningstar/LSTA USD Leveraged Loan Index (LLI) that publicly file financial results; based on issuer count



Source: BlackRock, Pitchbook LCD, Morningstar/LSTA. As of 4Q2023 (most recent). LTM = last twelve months. LCD’s sample for 4Q2023 included 150 issuers with public financials, or 13% of index count, which is a subset of all issuers with public financials.

Exhibit 21: …and coverage increased slightly

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



Source: BlackRock, Pitchbook LCD, Morningstar/LSTA. As of 4Q2023 (most recent). LTM = last twelve months. LCD’s sample for 4Q2023 included 150 issuers with public financials, or 13% of index count, which is a subset of all issuers with public financials.

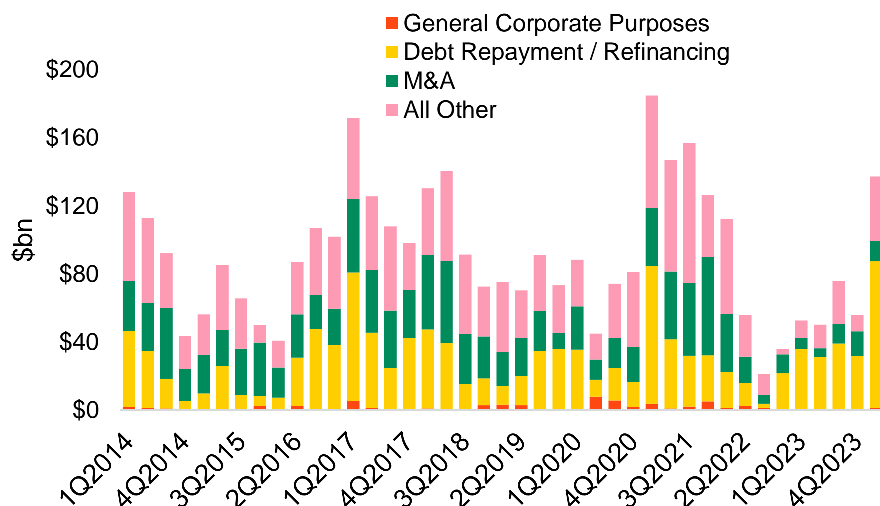
CLO creation supports loan supply

Similar to its fixed rate peer group, new issue activity in the USD syndicated leveraged loan market was off to a strong start in 1Q2024 (Exhibit 22). We expect this pattern to continue. A key factor underpinning this view has been the elevated volumes for collateralized loan obligation (CLOs) creations, which represent roughly 70% of primary market loan purchases (per Pitchbook LCD). Indeed, more than $48 billion of CLOs have priced so far in 2024 (as of March 29th), which represents a 51% increase vs. the same timeframe in 2023. The 1Q2024 pace represents the most active 1Q period in the post-financial crisis era, and the quarter's volume ranks at the high end of the historical range (behind only 3Q2021 and 4Q2021, per Pitchbook LCD).

The maturity walls in the USD leveraged loan market are less of a binding constraint, in our view, with absolute volumes of scheduled maturities in 2024-2026 totaling just 14% of the outstanding par amount of the Morningstar/LSTA USD Leveraged Loan Index. Furthermore, amend-and-extend activity has been extremely active. In fact, it set a new annual record in 2023 ($80 billion of outstanding institutional loans had their maturities extended) and another $33 billion was extended in 1Q2024 (as of March 26th), which was a quarterly record per Pitchbook LCD.

Exhibit 22: Loan issuance jumped in 1Q2024

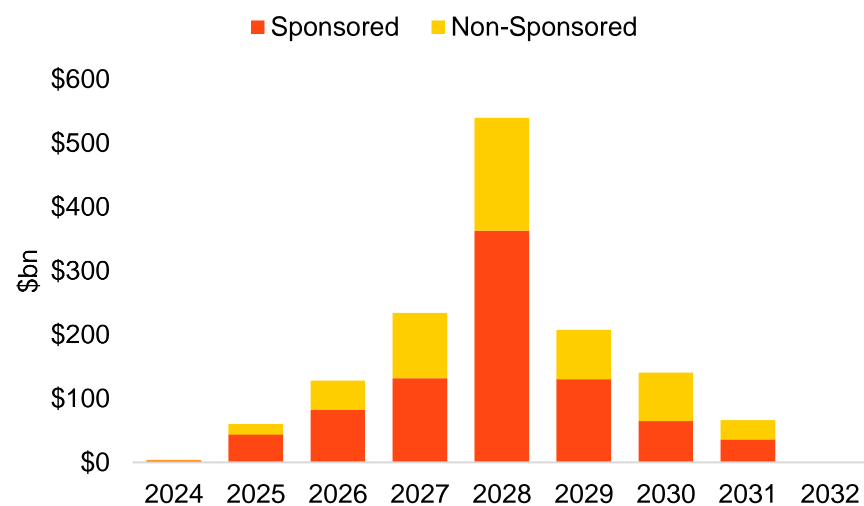
New institutional issuance in the syndicated USD leveraged loan market, by use of proceeds (as captured by Pitchbook LCD)



Source: BlackRock, Pitchbook LCD. As of March 25, 2024. "All other" includes: DIP, Exit Financing, Expansion/Capex, LBO/MBO, Project Financing, Dividend, Equity Infusion, General Recap, IPO, Stock Repurchase, Spin-off, and Working Capital/Trade Financing.

Exhibit 23: Modest near-term loan maturities

Maturity schedule for performing loans included in the Morningstar/LSTA USD Leveraged Loan Index



Source: BlackRock Pitchbook LCD, Morningstar/LSTA. Excludes defaulted loans, as well as loans that are not index eligible. As of March 15, 2024.

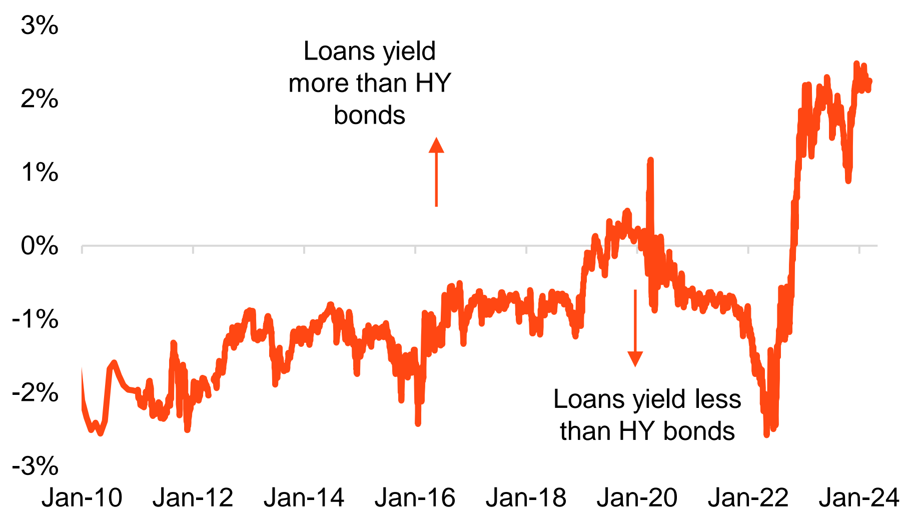
The HY vs. loan allocation decision

With rate cuts "delayed," some asset allocators in corporate credit may consider tactical increases in exposures to floating rate assets – in both liquid and private debt markets. Within the USD syndicated leveraged finance market, the allocation decision between leveraged loans and HY bonds is one that will likely continue to favor leveraged loans in 2Q2024. While there are meaningful sector and rating compositional differences between the two indices, the carry differential nonetheless remains at the high end of the historical range and suggests a 225bp yield "pick up" in loans (when controlling for rating; Exhibit 24).

While a "high-for-longer" cost of capital environment poses fundamental pressure for some floating rate borrowers with limited financial flexibility (who may have been relying on prospects for near-term rate relief), this is somewhat mitigated, in our view, by the (1) solid economic backdrop in the U.S. and (2) receptive capital markets. And as shown in Exhibit 25, both leveraged loans and HY bonds have outperformed their (higher rated) IG peer group on a total return basis, which has a longer duration (and greater sensitivity to interest rates).

Exhibit 24: The loan-HY carry differential remains at the high end of the historical range

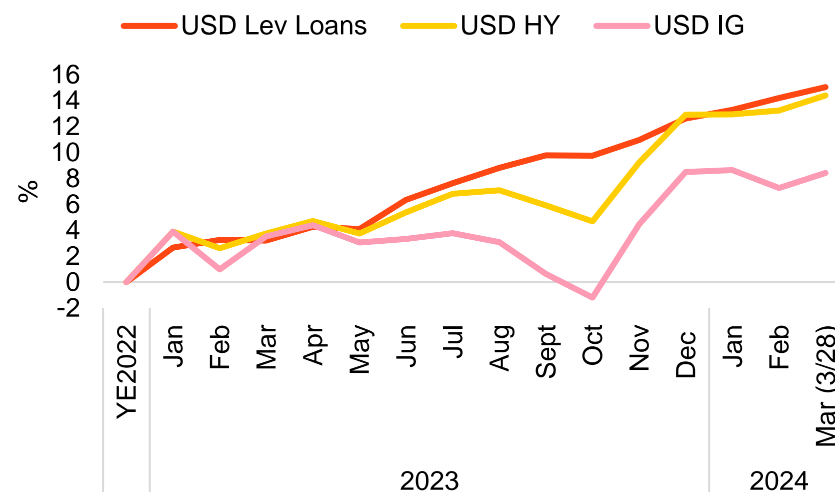
Carry differential (%): B rated leveraged loans minus B rated HY bonds, using the Morningstar/LSTA USD Leveraged Loan Index



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD. As of March 22, 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 25: Duration continued to lag in 1Q2024

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



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD, ICE-BAML, Bloomberg. As of March 28, 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.

Defaults: Expecting a peak

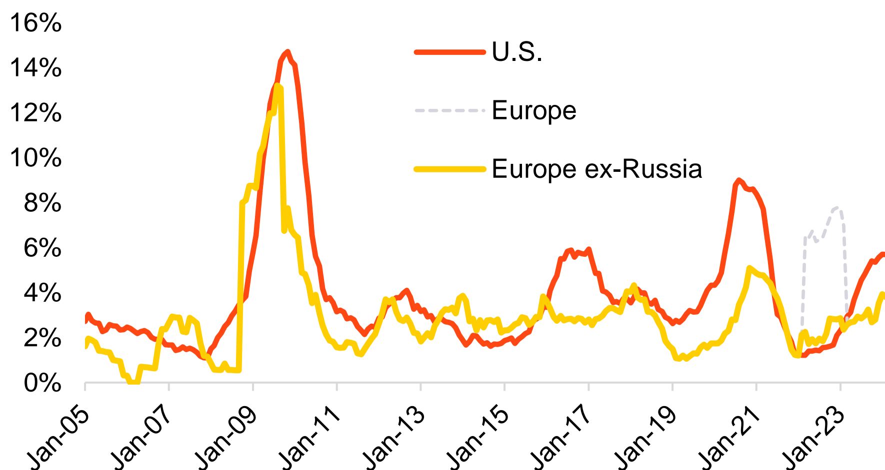
During 1Q2024, the USD HY bond issuer default rate showed signs of plateauing, while the USD leveraged loan default rate continued to increase (albeit at a slightly slower pace vs. 2H2023). We expect additional moderation in the pace of default activity as we approach mid-2024. A few factors underpin this view, including an expectation for capital markets activity to remain receptive to refinancing from lower rated issuers, eventual monetary policy normalization, and avoidance of a sharp downturn in economic activity. And while bank lending standards in the U.S. and Europe remain tight, the level of restriction has moderated vs. a few quarters ago. Mechanically, the trailing 12-month figures should also improve as previous defaults "drop out" of the calculation.

That said, and similar to the trend over the past several months, we expect distressed exchanges to represent a sizable share of default activity in 2024, as over-leveraged issuers may choose to evaluate the long-term sustainability of their capital structures. We also expect loans will continue to generate a higher default rate, consistent with the trend of 2023 (which stood in contrast to the longer-term pattern).

The key issue for credit investors is whether these defaults are adequately priced into valuations. As of the end of 1Q2024, 6% of the bonds in the Bloomberg USD HY Corporate Index traded with an OAS of 1,000bps or more – a rough proxy for distress. 8% of the par value of the ICE-BAML EUR HY Index trades at that same level. This suggests that, despite the optically tight index level spreads discussed earlier, the market is continuing to differentiate across capital structures in terms of financial strength and viability.

Exhibit 26: Signs of plateauing in defaults

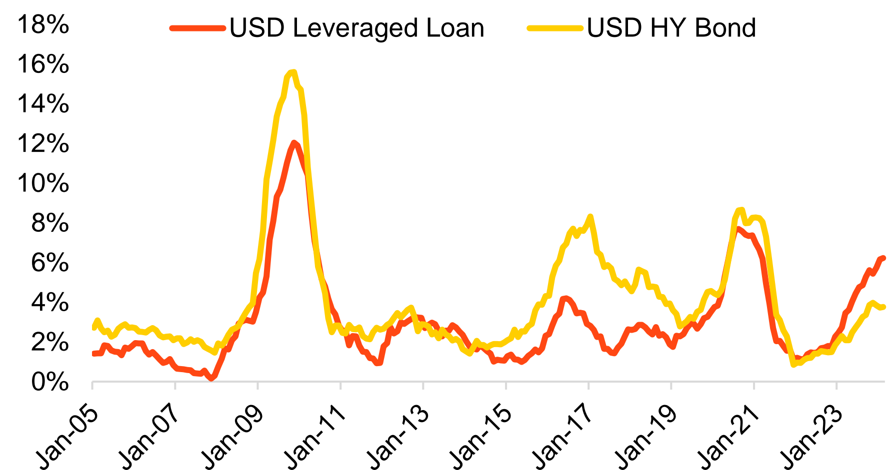
Speculative-grade, issuer-weighted, trailing 12-month default rates for HY and loan issuers (combined) in the U.S. and Europe



Source: BlackRock, Moody's. As of February 29, 2024 (most recent available). The increase in defaults in the EUR market in early 2022 reflects the onset of the Russia-Ukraine war.

Exhibit 27: Loans outpaced HY defaults

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



Source: BlackRock, Moody's. As of February 29, 2024 (most recent available).

Strategic M&A: Macro clarity is key

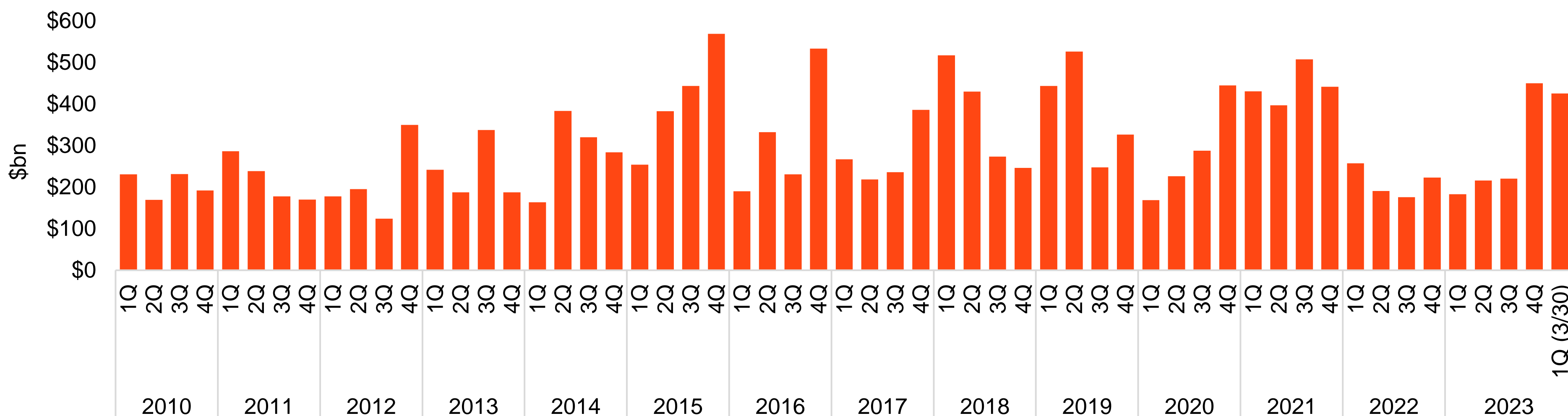
After a lull in strategic M&A activity for much of 2022 and the first nine months of 2023, 4Q2023 volumes highlighted a sharp rebound in deal announcements from North American and European firms (Exhibit 28). That momentum has continued into the early months of 2024, supported in large part, in our view, by increased optimism on the macroeconomic landscape. The rebound in M&A activity is also consistent with our view that *clarity* on the monetary policy and financing backdrop (not necessarily a *favorable* backdrop) is key for CFO and Treasurer confidence to move forward with large M&A. After all, while financial conditions have eased as of late, the cost of capital remains elevated.

CEO Confidence has likely played a meaningful role in the rebound, in our view. The Conference Board reported in its February 2024 update that CEO Confidence improved during 1Q2024 – crossing into optimistic territory (i.e., a reading above 50) for the first time since 1Q2022. In the 1Q2024 survey, 32% of the 138 CEO respondents said economic conditions were better vs. six months ago, compared to 18% who said the same in 4Q2023. And just 22% said conditions were worse, compared to 32% in 4Q2023.

We expect the environment for strategic deal making will remain active in 2Q2024. In fact, we view the recent reacceleration of M&A as a "re-start" of the pattern in place immediately following the onset of the pandemic, when corporates were laser focused on filling strategic gaps in their business models and when financing costs were ultra low.

Exhibit 28: After a lull in 2022 and 9M2023, strategic M&A volumes have rebounded

Announced strategic M&A by North American and European acquirers. Excludes cancelled and withdrawn deals. Captures deals valued at $1 billion or more, at announcement.



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 30, 2024.

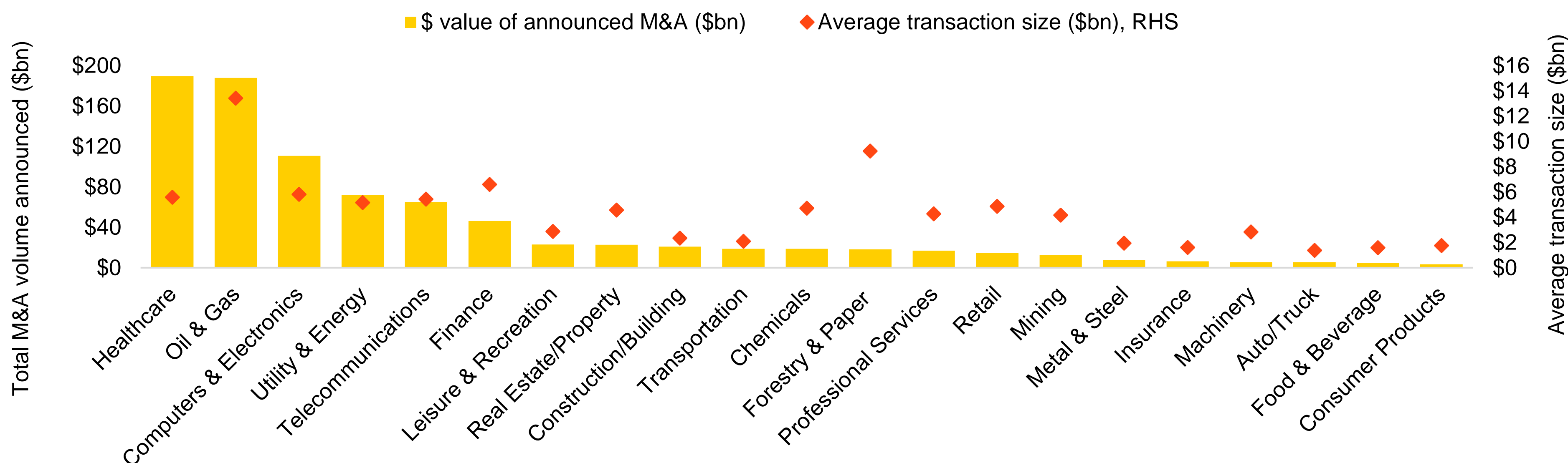
Strategic M&A: The sector drivers

Strategic gaps – such as a need for additional business diversification (i.e., product, customer, channel, or region) – were exposed for many firms (across a wide range of sectors) during the pandemic, owing to the "sudden stop" of the economy. More recently, other structural trends – such as the widespread adoption of artificial intelligence technology and ongoing drug discovery efforts in Pharmaceuticals – are also likely to encourage deal making, in our view. These strategic areas can often be more quickly addressed via inorganic growth initiatives (such as acquisitions), as opposed to organic changes over time.

Since the start of 4Q2023, there has been $875 billion of announced M&A by strategic (i.e., non-sponsor related) firms, driven by the Healthcare, Energy, Technology, Telecommunications and Financial sectors (Exhibit 29). As we have outlined previously, we believe balance sheet strength will remain a key determinant of future M&A activity. Corporates with strong funding options will have opportunities to grow and diversify their businesses, while higher financing costs might render those same opportunities as uneconomic for financially stretched firms. This is likely to be yet another driver of dispersion – albeit over a long-term trend – in the corporate credit market, in our view.

Exhibit 29: Multiple sectors have been behind the M&A rebound that began in 4Q2023

Announced strategic M&A by North American and European acquirers, by sector, since October 1, 2023. Excludes cancelled and withdrawn deals. Captures deals valued at $1 billion or more, at announcement.



Source: BlackRock, Dealogic (ION Analytics). Captures deals announced between October 1, 2023 and March 30, 2024

M&A: The cash/debt vs. stock funding mix

For corporate credit investors, the announcement of M&A generates multiple considerations. These include questions such as (1) what is the new business mix of the pro-forma combined enterprise, and (2) what is the credit/financial strength of the combined company (i.e., is the acquiror a highly rated IG firm purchasing a lower rated HY entity and guaranteeing its debt)?.

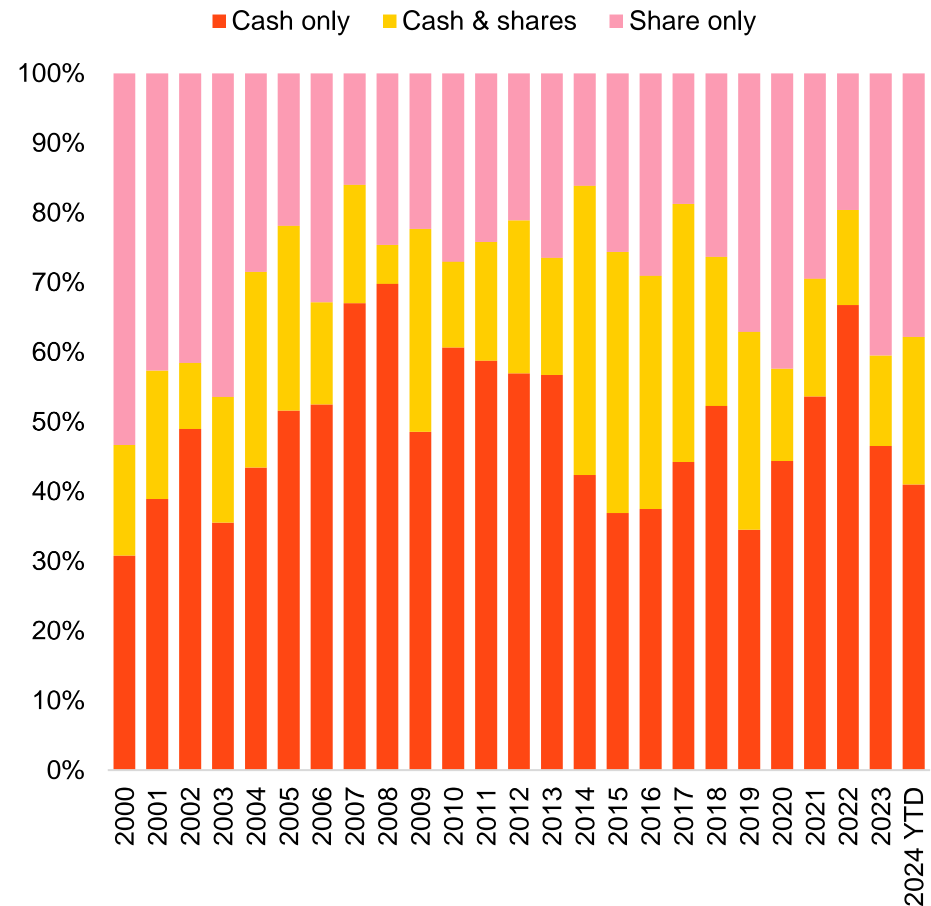
Perhaps the most important credit consideration as it relates to M&A activity, however, is the *funding mix* of the transaction. For example, a deal funded with cash (which could ultimately lead to a debt raise) could result in negative fundamental implications if liquidity cushions are depleted, or if too much leverage is added relative to the incremental earnings power of the combined firm. Transactions funded entirely with equity, on the other hand, can be credit positive due to the deleveraging impact they can often have on the combined balance sheet.

For the most part (so far) in 2024, the funding mix – in aggregate – has been rather friendly for bondholders, with a share of all-cash deals (41%) that is below the 49% average of the post-financial crisis era (Exhibit 30).

That said, there is a high degree of variation across sectors. For example, based on our review of recent deal level data from Dealogic, we find that deals in the Energy and Financial sectors have tended to be funded more with equity. By contrast, acquirers in the cash-rich Technology and Pharmaceutical sectors have generally used cash and/or incremental debt to fund their recent acquisitions, as they often have the balance sheet capacity to absorb incremental increases in net leverage while remaining comfortably within IG territory (in terms of their debt ratings).

Exhibit 30: A relatively benign funding mix for bondholders so far in 2024

Funding mix of announced M&A by North American and European strategic acquirers. Captures deals valued at $1 billion or more, at announcement. Excludes cancelled and withdrawn deals.



Source: BlackRock, Dealogic (ION Analytics), As of March 30, 2024.

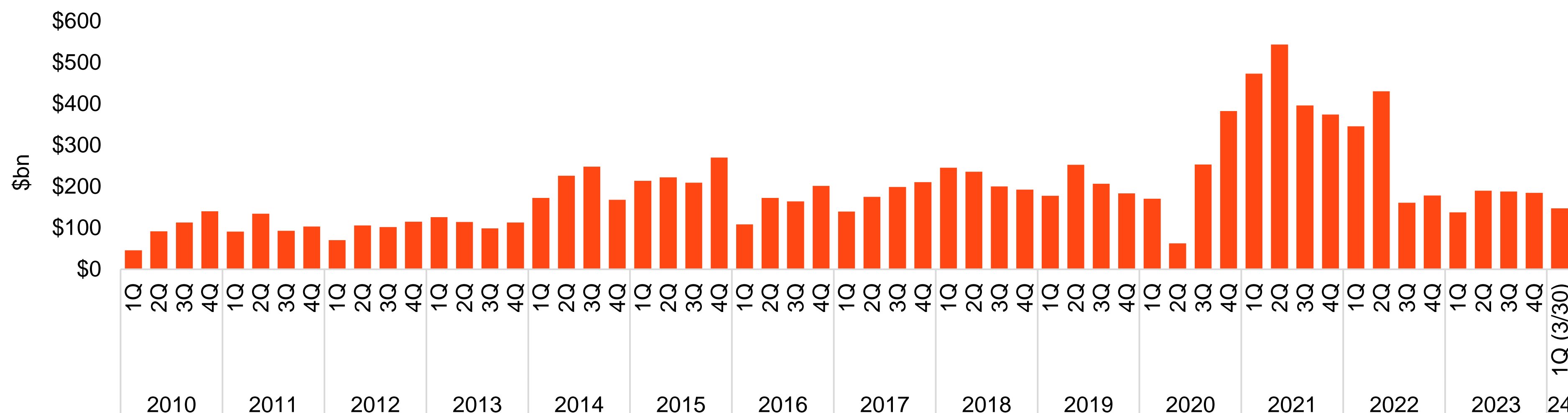
Sponsor M&A: Still muted

Unlike the rebound in strategic M&A, sponsor related transactions have remained subdued – continuing the trend in place since mid-2022 (Exhibit 31). The cost of capital environment has likely weighed more heavily on sponsor-related activity (relative to strategic deals), given the role that financial leverage can often play in generating returns. After all, financial sponsors often approach an acquisition as an investment (to be monetized at a later date) as opposed to a strategic buyer's approach to acquire a target in order to add a capability to its business (for the long term).

The swift change in the interest rate regime over the past few years has likely impacted the valuations of a subset of sponsor-owned portfolio companies purchased in vintages defined by ultra-low interest rates (i.e., 2021). This has likely generated some disconnect between buyer and seller valuation expectations, keeping sponsor-related transaction volumes muted. To the extent that some portfolio companies struggle to adjust to an environment of higher funding costs: a November 2023 survey conducted by Preqin showed that 48% and 28% of limited partner respondents highlighted promising investment opportunities in special situations and turnaround strategies, respectively.

Exhibit 31: Unlike strategic M&A, sponsor transactions have remained subdued

Sponsor-related activity among North American and European firms. Captures transactions valued at $100mm or more, at announcement. A transaction is classified by Dealogic as a sponsor-related deal, if a sponsor is involved on either side of the transaction (i.e., as a buyer or a seller). Excludes cancelled and withdrawn deals.



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 30, 2024. Note: A transaction is classified by Dealogic as a sponsor-related deal, if a sponsor is involved on either side of the transaction (i.e., as a buyer or a seller). Excludes cancelled and withdrawn deals.

Private debt: We expect continued growth

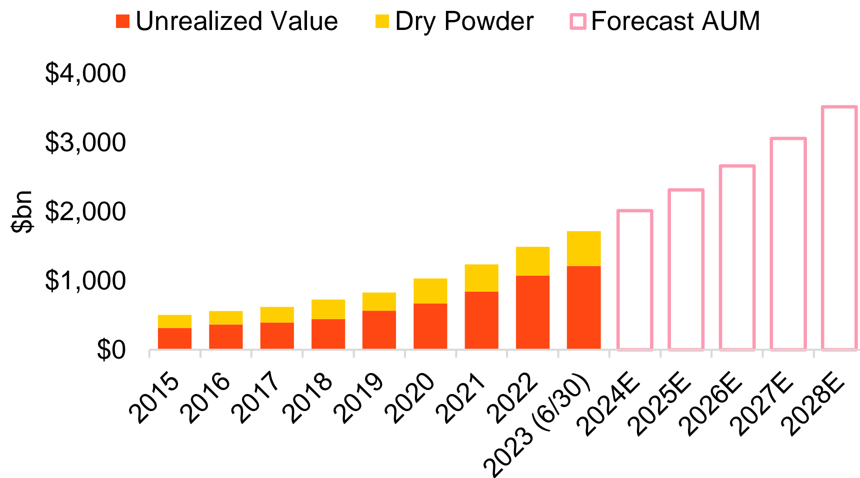
At $1.7 trillion in assets under management (AUM) globally (as of June 2023, most recent available per Preqin), private debt has cemented its status as a sizable and scalable "stand-alone" asset class for a wide range of long-term investors. That said, it still represents a modest 12% of the broader, $13.4 trillion alternative asset universe (per Preqin).

As we outlined in our late 2023 Private Debt Primer, we see scope for the global private debt market to reach $3.5 trillion in AUM by year-end 2028 (Exhibit 32). A range of factors underpin this forecast including (1) borrowers' desire for certainty and flexibility, (2) investors' desire for diversification, (3) structural shifts in the public markets to serve larger borrowers, and (4) potential decreases in banks' lending appetite. Investor participation in - as well as current allocations to - private debt also suggest room for continued growth relative to other alternative asset classes, as shown in Exhibit 33.

As the private debt asset class continues to grow, we anticipate additional overlap with the "addressable market" of borrowers in the syndicated markets – continuing the trend that has been visible over the past few quarters. And as we highlighted recently in Private Debt: Exploring the Nuances, we also expect ongoing dispersion across three main elements: strategy, portfolio and vintage.

Exhibit 32: We forecast continued growth

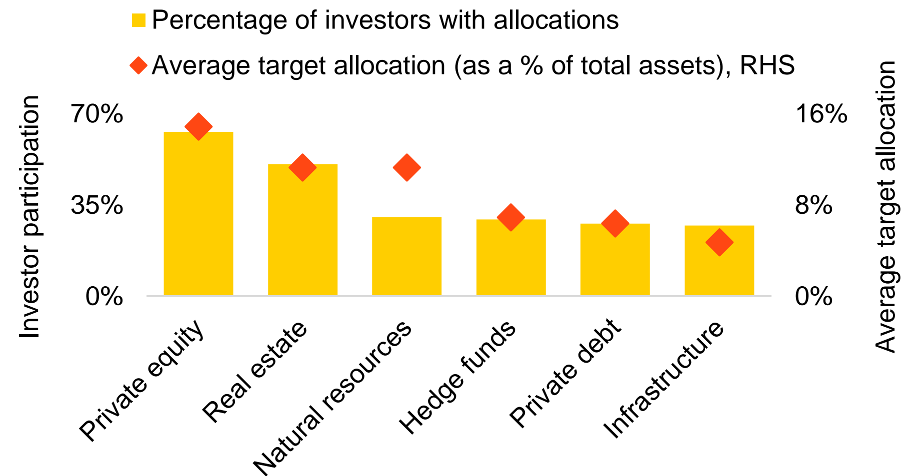
Private debt global assets under management – actual through June 2023 and BlackRock forecasts ($bn)



Source: BlackRock, Preqin. Historical (actual) data from Preqin, as of each calendar year-end, through June 30, 2023 (most recent). 2024E to 2028E are BlackRock estimates. Forecasts may not come to pass.

Exhibit 33: We see scope for allocations to increase

Percentage of Preqin investor survey respondents allocating to each alternative asset class and average target allocations (RHS)



Source: BlackRock, Preqin June 2023 Investor Survey. Venture capital is included in private equity.

Private debt: Declining covenant defaults

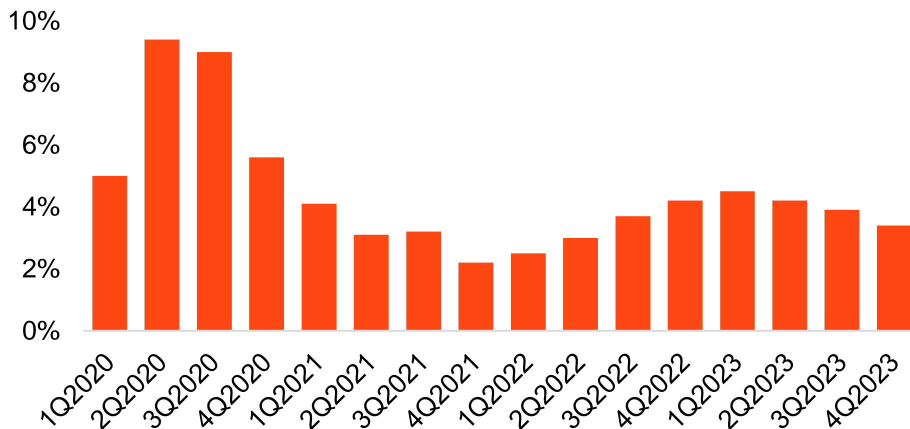
From a fundamental perspective, the recent signaling from the U.S. private debt market is encouraging. Despite the persistently high cost of capital environment, the covenant default rate for the companies included in the Lincoln International Proprietary Market Database, has *decreased* over the past three quarters (Exhibit 34).

This counterintuitive result is reflective, in our view, of the long-term relationship between a borrower and lender (or small group of lenders) in the private debt market. This dynamic can allow for financial stress to be addressed in a more proactive and efficient way relative to what may take place in the public universe (where many more lenders are typically involved).

For context, Lincoln International is an independent valuation advisor specializing in illiquid alternative investments. Lincoln's Valuations and Opinions Group Proprietary Private Market Database included approximately 5,000 U.S. operating companies as of 4Q2023, representing over $175 billion of privately held principal and invested capital (primarily by private equity sponsors).

Exhibit 34: Covenant default rates have declined

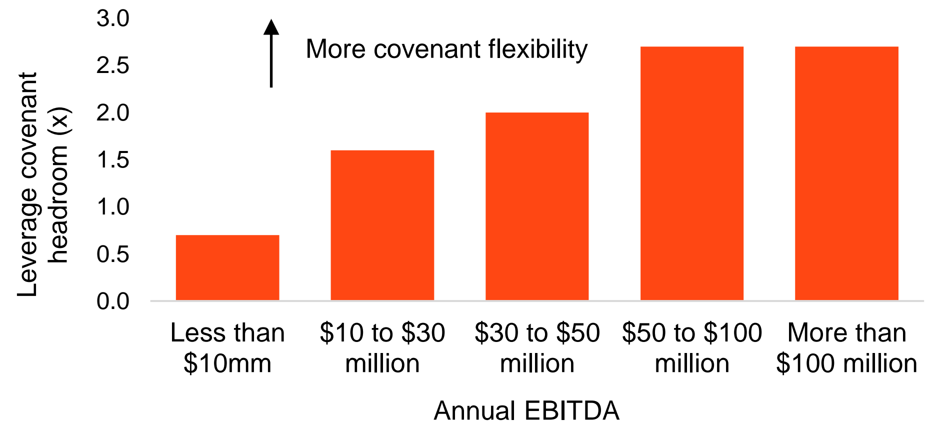
Aggregate covenant default rate for the U.S. portfolio companies included in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Market Database. As of 4Q2023 (most recent). 5,000 U.S. operating companies included as of 4Q2023. Note: A default is defined as a covenant default and not a monetary default. Analysis done using a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

Exhibit 35: Flexibility varies by company size

Leverage covenant headroom (size-weighted and as of 4Q2023), for the U.S. portfolio companies included in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Market Database. As of 4Q2023 (most recent). 5,000 U.S. operating companies included as of 4Q2023.

Private debt: Resilience amidst high rates

According to data complied by Lincoln International, more than 740 covenant amendments were completed in 2023 (involving 18% of the companies that Lincoln tracks). As Exhibit 35 illustrates, flexibility within existing leverage covenants varies considerably by size. The smallest company cohort tracked by Lincoln (i.e., those with annual EBITDA of less than $10 million) have much less "headroom" under their leverage covenants, relative to their larger peers. In our view, the patterns related to the amendments and covenant flexibility underscore the importance of credit selection and vintage diversification, especially in a "high-for-longer" cost of capital environment.

Beyond covenant default and amendment activity data, ongoing fundamentals are also holding in relatively well (i.e., not deteriorating) despite the persistently high cost of capital. For example, average (last twelve months) EBITDA growth for the companies in Lincoln's Database was 4.8% as of 4Q2023. This has helped keep interest coverage (Exhibit 36) and fixed charge coverage (Exhibit 37) ratios in a narrow range on a pro-forma basis, despite no relief (yet) in the form of interest rate cuts.

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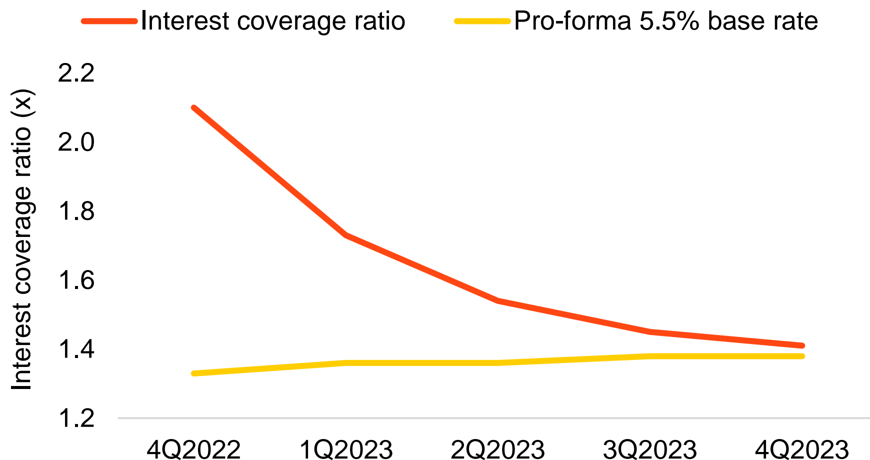
Exhibit 36: Interest coverage metrics have remained in a narrow range, on a pro-forma basis

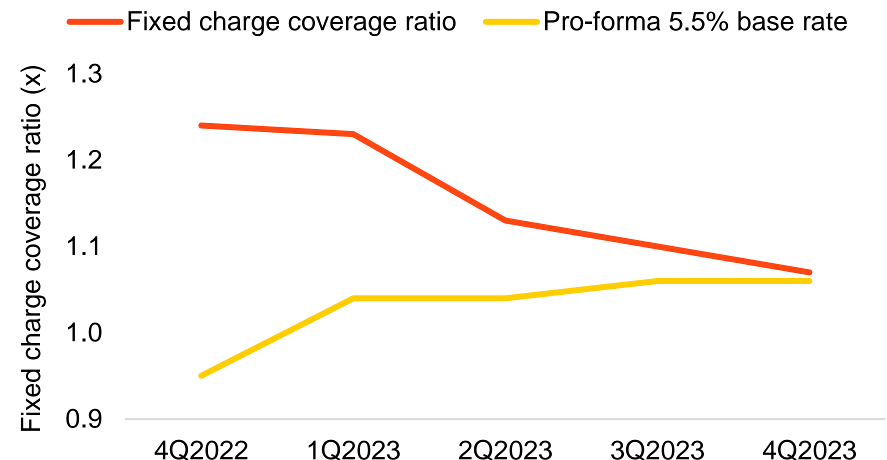
Size-weighted actual and pro-forma (using a 5.5% base rate) interest coverage ratio for the portfolio companies in the Lincoln International Proprietary Private Market Database



Source: BlackRock, Lincoln International Valuations and Opinions Group Proprietary Private Market Database. Captures data through 4Q2023. Interest Coverage Ratio = LTM EBITDA / Interest. LTM = last twelve months.

Exhibit 37: Pro-forma fixed charge coverage ratios have improved slightly vs. year-end 2022

Size-weighted actual and pro-forma (using a 5.5% base rate) fixed charge coverage ratio for the portfolio companies in the Lincoln International Proprietary Private Market Database



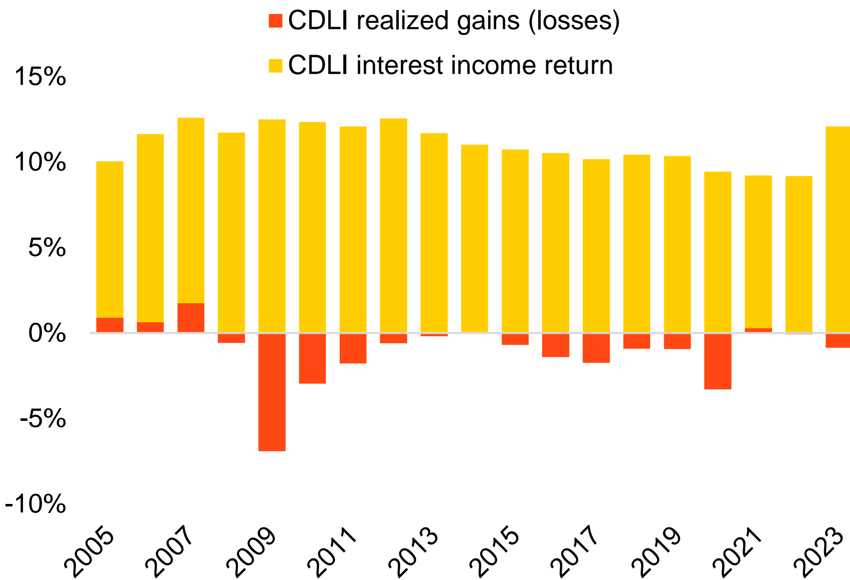
Source: BlackRock, Lincoln International Valuations and Opinions Group Proprietary Private Market Database. Captures data through 4Q2023. Fixed Charge Coverage Ratio = (LTM EBITDA - Taxes - CapEx) / (Interest Expense + (1% * Total Debt)).

Private debt: Losses compare favorably

We find that realized losses have also been tracking in a relatively benign way when using yet another private debt index - the Cliffwater Direct Lending Index (CDLI). The CDLI is an index of private U.S. middle market loans that was launched in 2015 and reconstructed back to 2004 using the SEC filings of business development companies. The CDLI tracks the U.S. direct lending market and captured roughly 14,800 directly originated middle market loans totaling $315 billion (as of December 31, 2023). As shown in Exhibit 38, the CDLI's realized losses for 2023 were 86bp, compared to 12.08% of interest income return. And relative to our estimates of losses-given-default for the universe of USD HY bonds and leveraged loans tracked by Moody's, this level of realized loss compares favorably to the syndicated markets (Exhibit 39).

Exhibit 38: Modest losses for the CDLI

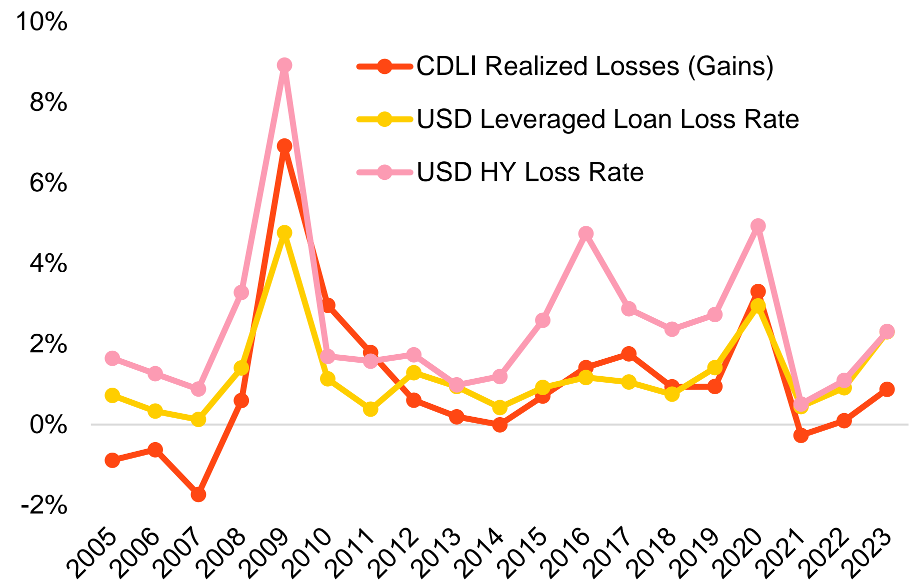
CDLI realized gains (losses) and interest income return, by annual period (2005 - 2023)



Source: BlackRock, Cliffwater. As of December 31, 2023 (most recent for CDLI). Excludes unrealized gains and losses.

Exhibit 39: CDLI losses vs. public markets

Historical loss rates (%) for the CDLI and the universe of USD high yield bonds and leveraged loans tracked by Moody's



Source: BlackRock, Moody's, Cliffwater. As of December 31, 2023 (most recent for CDLI). We assume a 40% recovery rate for HY and a 60% recovery rate for leveraged loans, to arrive at estimated loss rates given the Moody's issuer-weighted, trailing 12-month default data.

For both charts: 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 result.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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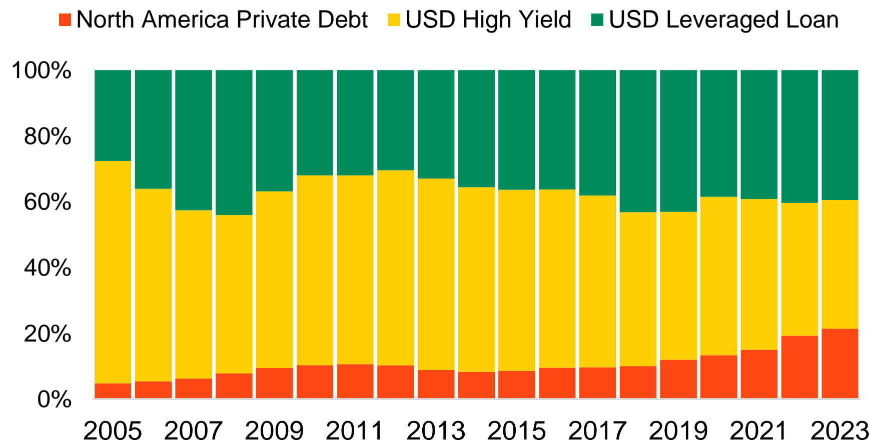
Private debt: Expanding addressable market

Beyond the growth of the private debt asset class, market participants remain highly attuned to the ongoing structural evolution of the broader leveraged finance market – which, in recent years, has included private debt as a viable funding option for a range of borrowers, alongside the syndicated markets. As Exhibit 40 illustrates, private debt has grown its share of the leveraged finance "funding pie" – a trend we also illustrated in our late 2023 Private Debt Primer.

In recent quarters, the mix-shift between syndicated and private debt new issue activity has varied – a trend we expect to continue. Exhibit 41 illustrates this using data from Pitchbook LCD, highlighting the amount of syndicated loans refinanced into private debt in 2H2023. This trend reversed in 1Q2024, as borrowers chose to refinance private debt into syndicated loans (again, Exhibit 41). In our view, this reversal in activity reflects the idea that the two markets can sometimes act as "substitutes" for one another. This is a departure from historical norms when the asset class of private debt was much smaller in size and scope and was generally reserved for more niche financing situations. We expect debt markets will continue evolving as borrowers seek to optimize their capital structures. For example, a borrower may pair syndicated first-lien debt with a private debt mezzanine solution to capture the benefits of borrowing from both markets.

Exhibit 40: The lending mix-shift...

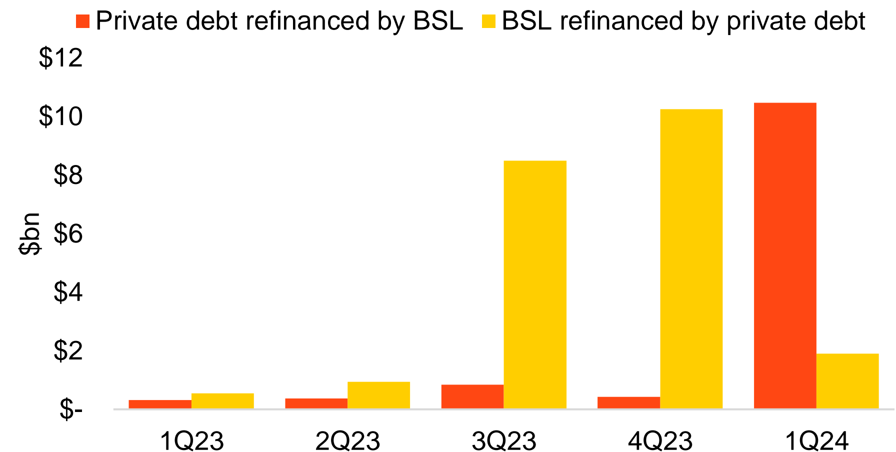
Share of USD leveraged finance market (public and private) by type, based on outstanding par amounts



Source: BlackRock, Preqin, Bloomberg, Pitchbook LCD. Private debt includes North America unrealized value and excludes dry powder. Uses index par amounts of Bloomberg USD HY Corporate Index and Morningstar/LSTA USD Leveraged Loan Index. As of year–end, except 2023 which is as of June 30, 2023.

Exhibit 41: ...should continue to ebb and flow

New issue broadly syndicated loan (BSL) and private debt takeout activity



Source: BlackRock, Pitchbook LCD. BSL represents broadly syndicated loans. 1Q2024 data as of March 13, 2024. This refinancing activity is known as a "takeout" because the borrower will issue new debt to "take out" its existing debt.

Private debt: An evolving "mix-shift"

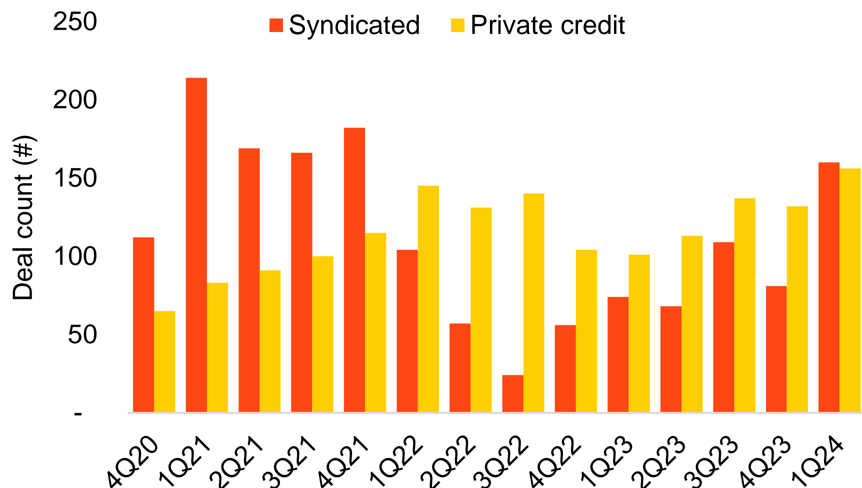
Exhibits 42 and 43 highlight the mix-shift between public and private markets yet another way, using deal counts sourced from Pitchbook LCD. As shown in Exhibit 42, for most of 2021, the broadly syndicated loan (BSL) market outpaced its private loan peer in non-LBO (leveraged buyout) funding by deal count. But in 2022, the pattern shifted (shown by the yellow bars outpacing the red), as private financings outpaced their public counterparts. More recently, the "gap" between private and public financing activity has closed in 1Q2024. Exhibit 43 shows that private credit is still the dominant force for funding LBO activity.

The reasons behind these types of shifts are often nuanced and multi-faceted. For example, volatility in syndicated markets may act as a situational factor and incentivize borrowers to seek private funding, because of the clarity on price and certainty of execution that private lenders can provide. As another example, a borrower may choose the private market to keep proprietary information confidential, or to avoid lengthy investor roadshows or rating agency processes.

Alternatively, some borrowers may feel that they are "ready" to become a public markets issuer and may see more favorable economics (depending on the market tone) in the public markets. We expect the mix-shift between these markets will continue to ebb and flow, over time, depending on the macroeconomic backdrop and market sentiment, among other factors.

Exhibit 42: Non-LBO deal count

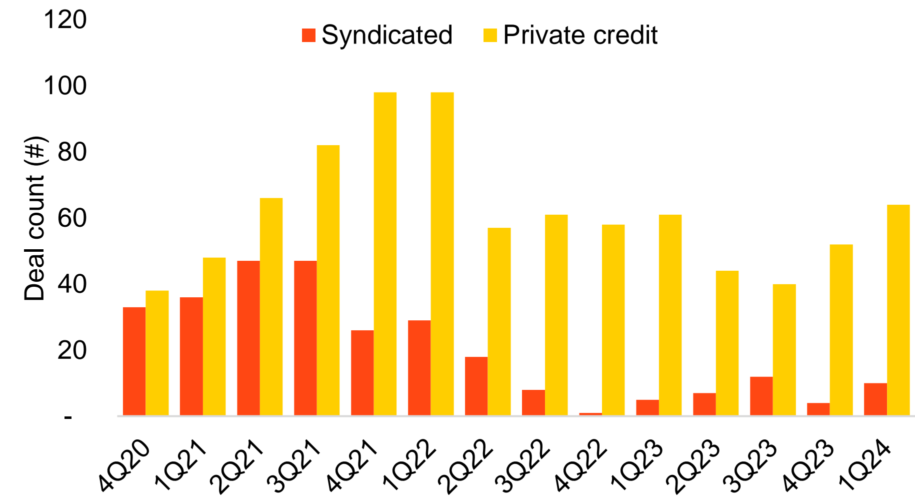
Count of non-LBOs financed in BSL vs. private credit



Source: BlackRock, Pitchbook LCD. Private credit count is based on transactions covered by LCD News. 1Q24 is as of March 18, 2024.

Exhibit 43: LBO deal count

Count of LBOs financed in BSL vs. private credit



Source: BlackRock., Pitchbook LCD. Private credit count is based on transactions covered by LCD News. 1Q24 is as of March 18, 2024.

“Private debt” is a wide-ranging term

In our recent publication Private debt: Exploring the nuances, we discussed how the term “private debt” is incredibly broad and encompasses a wide range of investing strategies – often with varying risk/return profiles (Exhibit 44). But much of that discussion related to private debt was focused on middle market lending to corporate borrowers. Indeed, the private financing landscape continues to evolve, due to macroeconomic factors, borrower needs, and lender capabilities. Most recently, private asset-based finance (“ABF”) has garnered the attention of market participants.

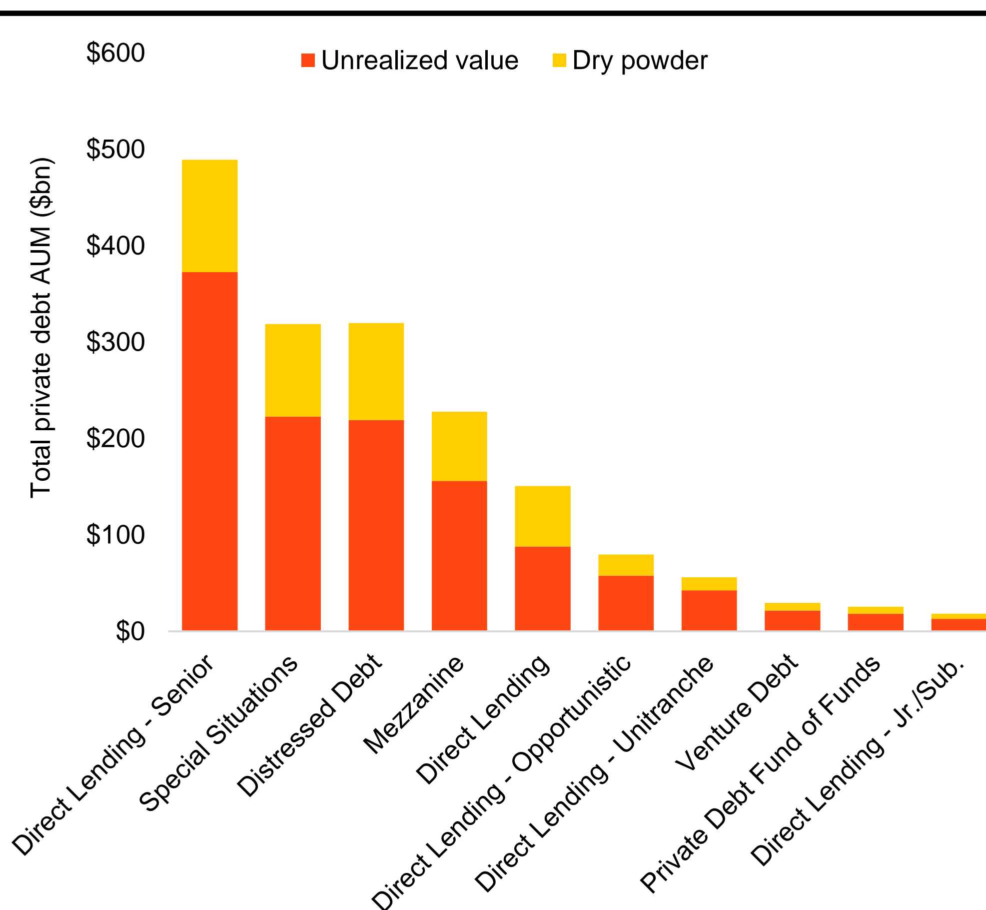
ABF is directly-originated lending that allows borrowers to take on debt by using their assets, such as accounts receivables or hard assets, as collateral. Most often, ABF structures are backed by contractual cash flows of the underlying asset(s). Many agreements include an additional layer of downside protection, by pledging the underlying asset to the lender.

Private ABF is distinct from private corporate credit, as ABF agreements are often backed by cash flows of an asset (or a pool of assets), which are separate from the credit worthiness of an individual corporate borrower. ABF is often categorized based on the underlying collateral. There are four major categories: consumer, commercial real estate, hard assets, and financial.

While we know the asset class is far-reaching, there is a wide degree of debate on just how large it is. Some market participants including Integer Advisors and KKR Research suggest the addressable market is around $5 trillion, while others estimate it is multiples larger.

Exhibit 44: The term “private debt” encompasses a wide range of investing strategies

Total private debt AUM, by strategy



Source: BlackRock, Preqin. 2023 is as of June 30, 2023 (most recent available). Excludes Real Estate and Infrastructure lending.

Growth beyond middle market lending

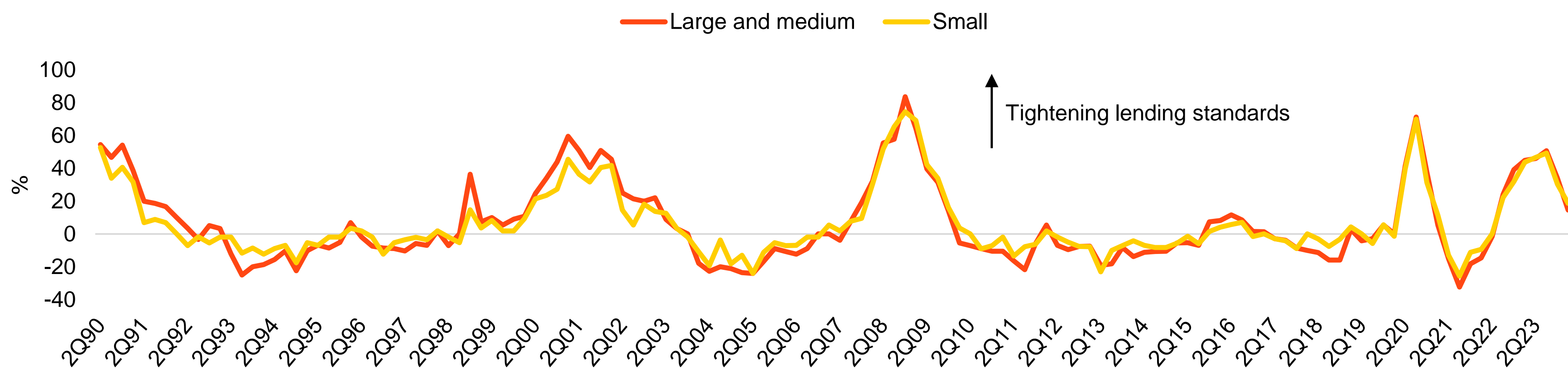
With $445 billion of dry powder (i.e., capital available for deployment) in global private debt funds as of March 2024, there is ample scope for private debt lenders to provide long-term financing to areas beyond middle market corporate lending. Other investors with a focus on long-term asset-liability matching are also well suited, in our view, to engage in such directly originated financing, such as insurers and pensions.

Notably, banks responding to the Fed's most recent Senior Loan Officer Opinion Survey (SLOOS) reported a moderation in the degree of lending tightening – but standards remain in "tightening" territory (above 0%, as shown in Exhibit 45). While standards are expected to remain "basically unchanged" for commercial and industrial (C&I) and residential real estate loans (per the survey), respondents highlighted an expectation for further tightening in commercial real estate, credit card and auto loans. Banks also reported an expectation for demand to strengthen across all loan categories, as well as an expectation for loan quality to deteriorate across most loan types during 2024.

A similar trend was visible in the most recent Euro Area Bank Lending Survey (conducted by the ECB). In 4Q2023, Euro Area banks said they expected "credit standards for housing loans to remain broadly unchanged, while a further net tightening is expected for consumer credit and other loans to households."

Exhibit 45: U.S. bank lending standards remain tight

Net percentage of domestic respondents (from large/medium and small banks) to the January 2024 SLOOS, which said they were tightening standards for C&I loans



Source: BlackRock, Board of Governors of the Federal Reserve System. January 2024 SLOOS update was released on February 5, 2024, and captures activity from 4Q2023.

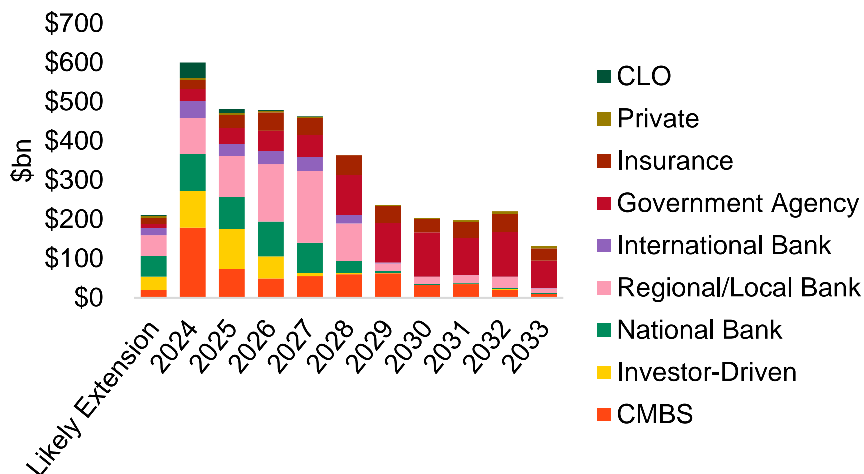
CRE: Maturity extensions in focus

While refinancing activity in the syndicated corporate credit markets has been robust, the backdrop in the commercial real estate (CRE) market has been more focused on maturity *extensions*. According to data compiled by Real Capital Analytics (RCA) and MSCI Real Assets, $214 billion of CRE loans that were scheduled for maturity during 2023 may have been extended into future years (as their analysis found no confirmation of refinancing or a sale of the associated collateral). This may leave the 2024 maturity walls as high as $820 billion according to RCA, when incorporating these "likely extensions" (Exhibits 46 and 47).

According to RCA, loans originated in 2021 – a period defined by ultra-low interest rates in the U.S. – represent the largest single vintage for the 2024 scheduled maturities, at 35%. While CMBS lenders represent the largest lender cohort for the scheduled 2024 maturities, banks represent 45% of the loans scheduled to mature between 2025 and 2027, per RCA. The incentives to extend are clear – property owners likely want to avoid foreclosing on office properties, for example, given the current market conditions with depressed (post-pandemic) office space utilization. And borrowers may not be inclined to refinance a CRE loan at a much higher interest rate, as doing so may result in a combination of higher borrowing costs and required equity contributions to offset a decline in the property value. Even with interest rate cuts from the Federal Reserve, rates are unlikely to retrace to the post-financial crisis era lows – suggesting the extension activity may only be a temporary solution.

Exhibit 46: CMBS and Banks represent 67% of 2024 maturities

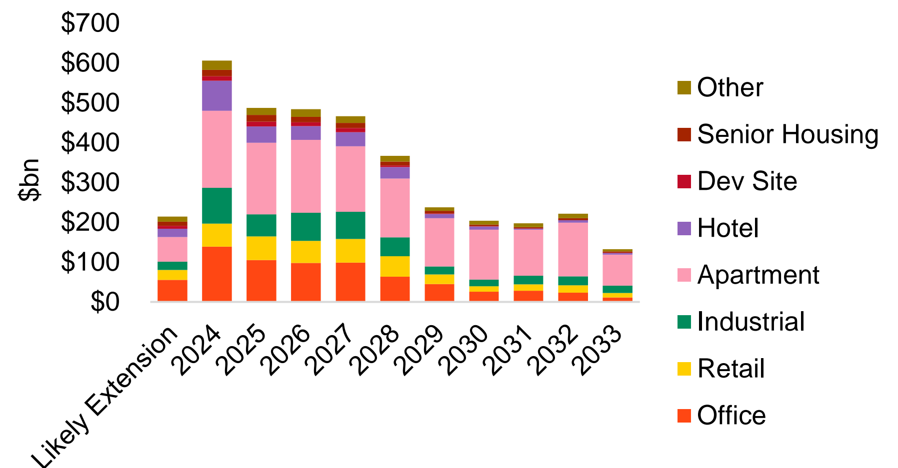
Volume of maturing commercial property loans, by lender type



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

Exhibit 47: Office loans represent roughly 20% of 2024 maturities

Volume of maturing commercial property loans, by property type



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

CRE: Looking for a trough in valuations

The extension vs. refinancing dynamic will warrant close monitoring over the next few quarters, especially in CRE categories facing headwinds. That said, and as we have highlighted previously, the asset class of CRE cannot be painted with a broad brush.

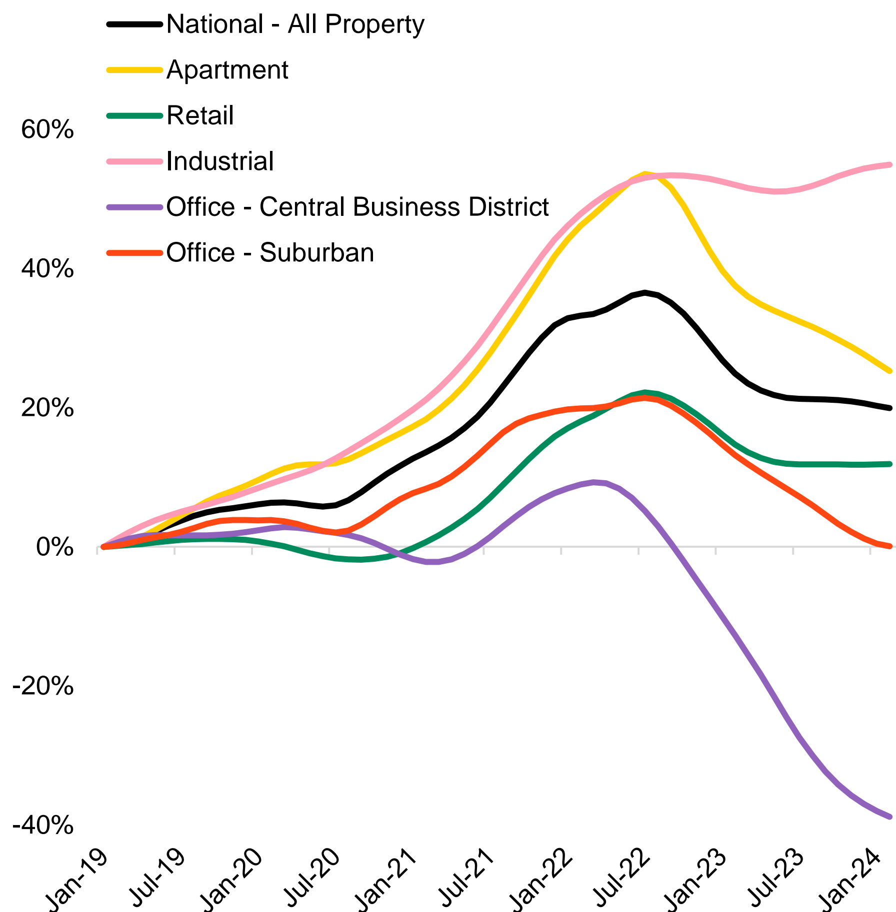
As Exhibit 48 shows, there remains a significant amount of dispersion across the various CRE categories, in terms of valuations. While Office remains under pressure due to well-telegraphed shifts in office space utilization, categories such as Industrial are recording price *increases*, due in part to tailwinds from efforts to build U.S. supply chain resilience (i.e., onshoring, near shoring).

And even *within* categories, there is significant differentiation. For example, Central Business District Office remains under more valuation pressure than Suburban Office (again, Exhibit 48). And performance across Apartment and Multi-Family remains somewhat dispersed on a regional basis, as some areas of the U.S. (such as the Sun Belt) have experienced more overbuilding and supply vs. others. Furthermore, some regions such as New York city have a large share of their available rental units rent stabilized (or, less frequently, rent controlled).

On an *aggregate* basis, some of the high-level valuation data has been encouraging. For example, in February 2024, the RCA Commercial Property Price Index reported a 4% decline year-over-year, which represented the most moderate decline since late 2022. That said, given the long-term nature of office space leases and the illiquidity of the CRE asset class, the price discovery and default/loss cycles are likely to be more protracted vs. what is typically observed in the corporate credit market.

Exhibit 48: CRE remains very nuanced

Cumulative percent change in the level of the Real Capital Analytics Commercial Property Price Indices, since January 2019



Source: BlackRock, Real Capital Analytics. As of February 29, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future result.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

CRE: Transactions are key for valuation reset

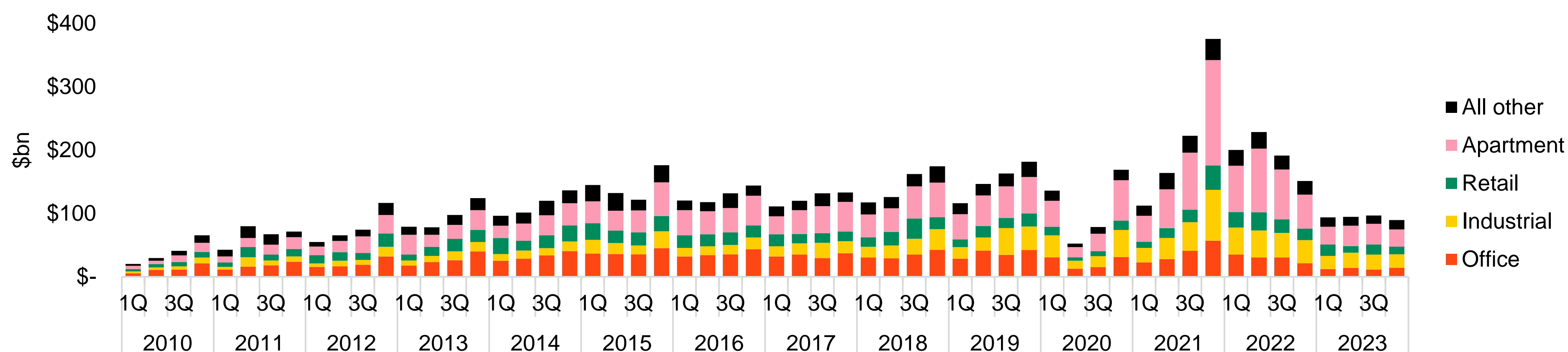
For example, in the period following the global financial crisis (GFC), it took 34 months (after September 2007) for the RCA Commercial Property Price Index to reach a bottom. With the important caveat that we view today's CRE market as distinctly different from the GFC era landscape, we nonetheless believe additional downward pricing pressure in CRE is likely to be a multi-year event, likely extending well into 2025. A recovery in CRE transaction volumes will be a key ingredient to this price discovery process.

In contrast to the rebound in strategic M&A volumes discussed earlier, U.S. CRE transaction volumes have yet to recover from the muted pace of the past few quarters (Exhibit 49). In fact, total U.S. CRE deal volume fell 51% in 2023, the sharpest year-over-year decline since 2009, according to data from Real Capital Analytics (RCA). On a global basis, volumes declined 48%. Beyond the well-telegraphed structural shifts facing some CRE categories (again, most notably Office), we believe its interest sensitivity has played a large role in keeping transaction volumes subdued. As an illiquid asset class highly dependent upon (re)financing, CRE is still adjusting to the swift tightening in monetary policy enacted by the Federal Reserve from March 2022 through July 2023. This adjustment has been particularly stark given the ultra low interest rates that prevailed in the period immediately following the onset of the pandemic (March 2020 through March 2022).

As a result, many CRE buyers and sellers have (still) not aligned on pricing, with buyers demanding lower asset valuations to offset higher interest costs. Indeed, the RCA MSCI Price Expectations Gap for Central Business District Offices stood at -19.7% for 4Q2023. This refers to the size of the asset valuation gap between buyers and sellers. The same measure was -9.5% for Suburban Offices in 4Q2023.

Exhibit 49: CRE transaction volumes remain muted

U.S. CRE quarterly transaction volumes, by property type



Source: BlackRock, Real Capital Analytics. "All other" includes: Hotels, Development Sites, and Seniors Housing & Care. Captures data through 4Q2023.

CRE: A slowdown in distressed activity

One area to watch, in our view, to gauge the momentum behind any meaningful recovery in CRE will be in the pipeline of distressed assets. Over the course of 2023, the balance of outstanding distress in the CRE market grew by $28.9 billion – bringing the total as of year-end 2023 to $85.8 billion. This represents the highest aggregate value of distressed CRE since 2013, although still well below the global financial crisis peak of just under $200 billion, per RCA data. That said, in 4Q2023 net new inflows into distressed totaled just $4.2 billion – less than half the amounts generated in both 3Q2023 and 2Q2023, according to RCA.

Office CRE represents 41% of the $85.8 billion of outstanding distressed CRE (Exhibit 50). And Exhibit 51 illustrates how the various CRE categories have contributed to the "potentially distressed" pipeline over the past few quarters.

A risk we are watching is whether a "high-for-longer" cost of capital environment triggers a renewed wave of stress, in light of the maturity extension activity that likely took place in 2023 (as discussed earlier and per RCA data). If the CRE refinancing environment is not sufficiently more amenable in 2024, we see a risk for renewed stress, which may reverse the trend of "growth moderation" in the distressed CRE pipeline.

Exhibit 50: Office represents the largest share of outstanding distressed

Balance of distressed CRE by property type

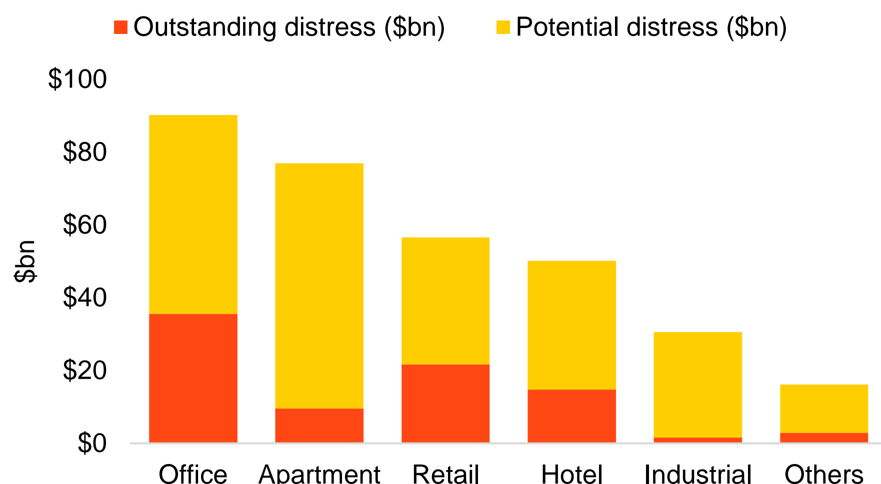
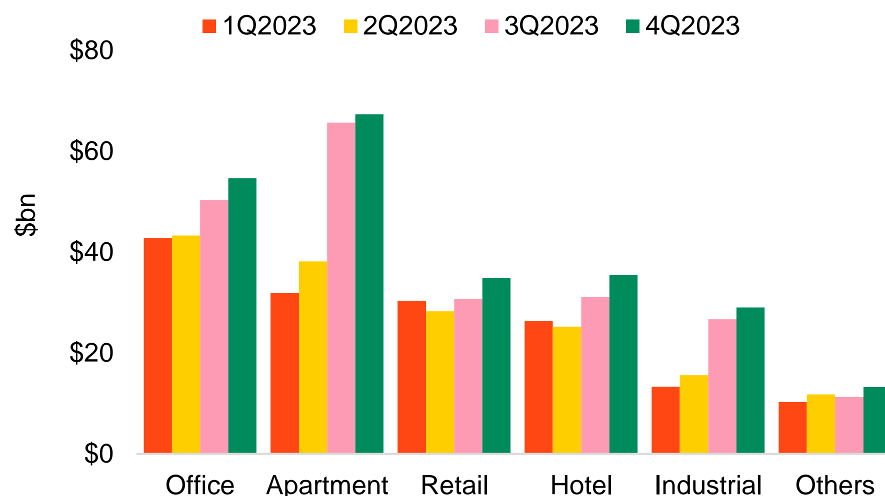


Exhibit 51: The mix-shift of potentially distressed CRE will be important to watch

Pipeline of potentially distressed CRE by category, at quarter end



For both charts: Source: BlackRock, Real Capital Analytics. "Others" includes categories such as self storage and manufactured housing. As of December 31, 2023. "Outstanding distress" indicates direct knowledge of property-level distress (via announcements of bankruptcy, default, foreclosure, and other publicly reported issues). "Potential distress" indicates possible future property-level financial trouble due to events such as delinquent loan payments, forbearance and slow lease up/sell out, among others. This also includes CMBS loans placed on master servicer watchlists.

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