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Back to School

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Someone once said, “A vacation is what you take when you no longer can take what you’ve been taking.” We reflected on this, returning post-Labor Day this week to a market where investors have been taking a lot so far in 2024. What will the next few months bring?

Our fondness for inflection points suggests there are many to consider. First, the economy. Despite many misgivings over the past eight months, US GDP growth has been remarkably solid. Second quarter numbers were revised upward from 2.8% to 3% in large part due to strong consumer spending. The third quarter is still hanging tough with estimates around 2%.

Yes, slowdown worries never seem far away. While a full-blown recession still appears unlikely, investors are anxious about any signs of softness. Weaker factory orders and a lower purchasing managers index checked that box this week.

Inflation, helpfully, is deflating. Latest CPI is 3%, with July figures due soon. Accordingly, the Fed has pretty much locked in the first rate cut at its September meeting. Markets have priced in more with an expected 3-ish percent by the end of 2025.

All this is constructive for dealmakers. One positive sign is credit risk. The awakening of bank lending this past January has compressed spreads providing easier access and more favorable terms for borrowers. And while most BSLs have been refinancings and repricings, a broader range of companies can extend and amend their existing facilities.

As our Chart of the Week highlights, the number of “weakest link” borrowers comprising the Morningstar LSTA Leveraged Loan Index has declined for three consecutive quarters. We have seen this positive trend echoed in the condition of our portfolios where the number of credit upgrades exceeded downgrades in a recent review.

Another sure sign of credit market health is CLO formation. Despite misgivings early in the year about how much appetite was available for equity risk, the arbitrage has proven out. Through August, volume for both BSL and middle market CLOs is above the levels set in 2021 when full-year numbers eventually hit a record.

Direct lenders anecdotally reported the summer was busier than expected. As one MD told us, “August was supposed to be quiet. I couldn’t get off the phone.”

Of course, increased volatility in the public markets this fall would not be a bad thing for private credit. Whether from US election jitters or economic worries, borrowers choosing the more stable buy-and-hold, non-syndicated option will continue the roll top private debt arrangers have been on for some time.