Private Credit – The Final Reckoning (Third of a Series)

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We spoke recently to a C-suite executive of a global specialty chemicals company about how tariffs are affecting his business. He outlined his strategy to expand production in the US, but also how these plans were being stymied by the cost of importing equipment.

"There are some things today, cranes for example, that are only manufactured in China and Germany," he told us. "You can't get them here. And now tariffs make this equipment prohibitively expensive. It's affecting our ability to grow here, production that would add hundreds of good jobs. I imagine this type of thing is happening across the country."

The impact of tariffs, despite post-Liberation Day softening of some policies, is real. National policies are typically designed to fix problems, not create them. We are a source of global instability, not stability, a top economist told a private markets audience last month.

On average, he reported, US tariffs will increase from 2% on average to 15%. Assuming every 1% tariff increase adds 10 bps to inflation, this means we could be going from a 2.5% CPI to 3.5%. For that same increase, he continued, GDP slips by 7-8 bps. This implies an economy slowing from 2% to 1%.

There's also concern about deficits worsened by Federal spending and tax policies. The primary deficit (excludes interest payments on the debt) as a percent of total GDP should be zero, not 3-4%. The actual deficit is 7%, above other nations. He estimates the effect of higher deficits could push Treasury yields higher, boosting the ten-year Treasury from 4.5 to 5.1%.

The threat of a recession has eased over the past two months. But as portfolio managers know, slow growth reduces flexibility for every borrower and increases the longer-term risk of recession. That doesn't include the effects of the Ukraine or Middle East conflict or potential escalation with Iran, which are hard to assess at this writing.

There's also the perennial question, what role could credit play in systemic risk? Markets are increasingly interconnected. The old hub-and-spoke model, with loans distributed to CLO buyers, being replaced by a financial web. A tremor in corporate credit could ripple across the banking system, affecting leverage and appetite in the system.

Public markets are ratings sensitive, particularly for borrowers that drift into triple-C territory. Nevertheless, Moody's head of leveraged finance research, Christina Padgett, expects loan defaults to slow from 4.1% to 3.1% by the end of 2026, versus the forty-year average of 4.2%.

In a nod to the resilience of the asset class, Padgett said, "Covid defaults could have been materially worse without private credit." What's the risk environment today? M&A has been slow, and exogenous risks remain, but the economy is still pretty good. And while rates are higher, they appear to be headed lower. "Private credit is fortified," she said.