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2026 Outlook: Pick of the Litter

THE LEAD | December 16, 2025

With last Thursday’s Fed rate cut, the benchmark is down 200 bps from its peak in 2023. That’s the simple story behind so-called “spread compression” in private credit. While overall *yields* are down, middle market direct lending spreads are pretty stable.

What has shrunk are single-B spreads in the broadly syndicated loan (BSL) market. Those sit now at 275-325 bps, down from 400 not long ago. This means the premium illiquid loans are commanding today versus traded loans is higher than it was a year ago.

What will happen to private credit spreads next year? Unlike liquid loans, whose yields (and therefore prices, which like bond prices move inversely to yields) adjust as cash comes in and out of loan funds, middle market loan spreads change with supply/demand. When there are ample deals flowing in, managers can be fussy. If the perceived risk for the return isn’t attractive, the borrower needs to improve the yield and maybe other terms.

But is there too much money chasing too few deals? KBRA put out an excellent piece on this dynamic, with data points suggesting supply/demand is well-balanced. The leverage finance market (which includes BSLs, high-yield bonds, and direct middle market loans) has grown 6% since 2015. Non-leveraged corporate lending (bank commercial and industrial loans and investment grade bonds) grew 5% over the same period. Not much of a bubble.

Will private credit deal supply improve in 2026? Yes! Lower rates drive favorable financing conditions. This leads to more private equity firms putting existing portfolio companies up for sale. Realizations on those investments finally put money back in the hands of limited partners, who are then able to reallocate to new general partner funds. Even a slow growing economy will support these positive dynamics, particularly in non-cyclical businesses.

But if private equity and their credit partners focus on defensive sectors, doesn’t that increase competition for those deals and negatively impact origination and portfolio quality? Turns out that each manager has different sourcing and risk cultures. Even within narrow industry niches, there’s room to be both picky and productive. We only close 5% of incoming deals, all within business service sectors, and have no trouble allocating quality assets to our investors. The rejected 95% are still getting done. Whether those portfolios suffer remains to be seen.

How should investors think about manager selection for 2026? Only 5% of today’s managers existed before the GFC. Scale is also critical to speak for entire financings and provide solutions across the capital structure. Balance sheet solutions for GPs and LPs have also become essential in the current environment since some variety of volatility is always present.

Finally, having global partners supporting your business is a game-changer. That’s why credit managers pursue tie-ups with the largest insurance companies and asset managers. They have perpetual appetite for the risk-adjusted yield, income stream, and diversity private capital provides. And nothing gives investors comfort like a blue-chip name alongside them.

?? From the Editor: The Lead Left will be on break until the week of January 6th. To all of our readers, best wishes for a safe, healthy and restful holiday season.