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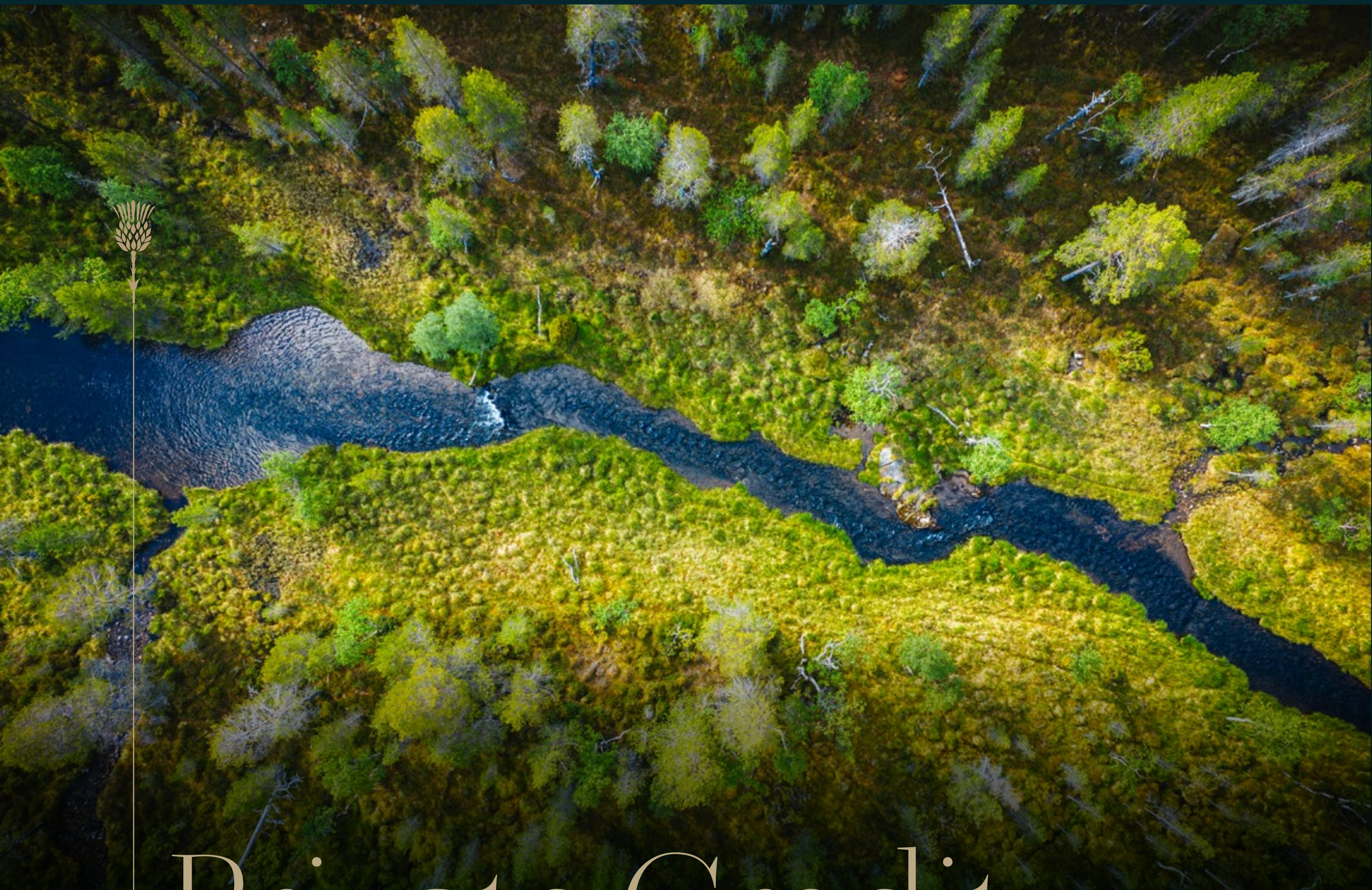
THE LONG AND SHORT OF IT

FEBRUARY 2024



Private Credit

Narrowing the Playing Field

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Private Credit: Narrowing the Playing Field

In our view, 2022 and 2023 were the Golden Age for private credit. Through this time and the concurrent macro shifts, we have favored various styles of private credit to generate attractive returns or provide a source of dependability.

As the Fed gradually moves towards more accommodative monetary policies, we expect private credit to deliver **more modest absolute and relative returns**, driven by a gradual decline in base rates as well as credit spreads on new loans. In addition, the opportunity set for opportunistic and distressed lending is likely to diminish on the back of moderating inflation and resilient growth.

Nevertheless, we believe that private credit will continue to play an important role in portfolios for 2024, albeit in a somewhat different capacity.

CASH DEPLOYMENT AND POCKETS OF POSITIVE CONVEXITY

After over a year of derisking and postponed implementation, cash and money market fund assets are near record levels and investors are looking to deploy that capital. In our view, the first logical step isn't necessarily the S&P 500, which is trading at historically high multiples and more concentrated than ever; or high yield bonds, the spreads of which are clearly trading in glaringly expensive territory. **In this context, private credit presents an elegant solution for cash deployment into investments with meaningfully higher return potential without dramatically greater risk exposure.**

In addition, despite some relaxation of the drastic one-sided power dynamic between lenders and borrowers, **we maintain our conviction in private credit's potential to deliver equity-like yields with a solid margin of safety. However, this positive convexity profile requires a more selective approach.**

DELVING INTO THE NOOKS & CRANNIES

The price actions in late 2022 and early 2023 reflected genuine market concerns that defaults would rise to recessionary levels after the sharp increase in borrowing costs. As we enter 2024, continued economic momentum coupled with easing financial conditions should offer a relatively favorable operating environment for companies in the coming quarters.

While borrower fundamentals should remain resilient, we expect the balance of power to shift away from lenders as credit market activity rebounds, dampening return expectations, especially on new loans.

A dominant trend in the past two years was the leakage of lending activities from the traditional banking system into private credit.

Recently, however, there have been signs that traditional lenders are looking to reclaim market share. Encouraged by a more benign macro backdrop, banks are offering attractive pricing to large cap borrowers in an attempt to lure back deals lost to direct lenders. We expect this intensifying competition to filter down from the broadly syndicated bank loans market into the direct lending market in the form of primarily tighter spreads and lighter covenants.

Given such, we place a strong preference on lenders that specialize in the mid- and small-cap space, where sponsors and borrowers have fewer options and unique financing needs that are better suited for private bilateral deals.

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