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GLOBAL RESEARCH

# The Carlyle Compass

By **Jason Thomas**
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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team.*

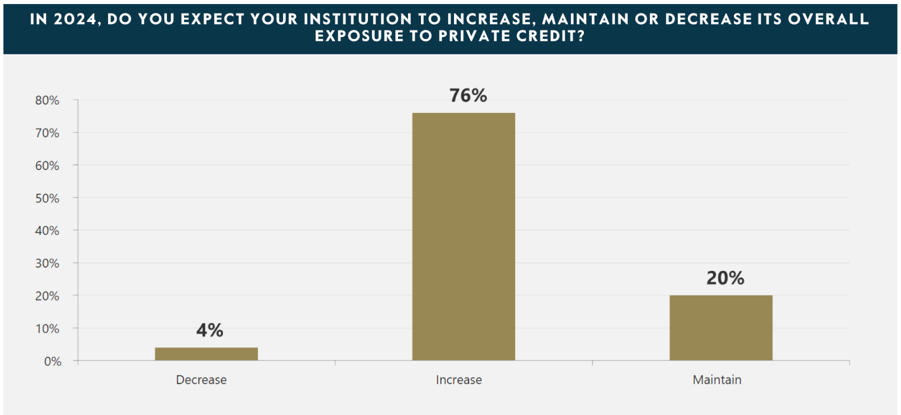
Like a tree falling in the woods when there's no one there to hear it, the Fed convenes this week for the second-to-last Federal Open Market Committee (FOMC) meeting of the year.

Don't worry if this week's other happening distracts your attention. The decision itself will be anticlimactic: a 25 basis points (bps) reduction that takes the fed funds rate to 4.625%. Of greater interest will be how Chair Powell—appearing on the portion of your television screen not consumed by the rolling chyron of the latest vote count in places like Schuylkill County, Pennsylvania—responds to questions about the firmness in wages and inflation since the Fed's September meeting.

After Thursday, the Fed almost certainly has one more rate cut in it, either in December or Q1 2025. But if core Personal Consumption Expenditures (PCE) inflation remains closer to 3%than 2% and the economy continues to grow at rates that are nearly 100bps above what we used to think of as its 'potential,' additional cuts may not be forthcoming.

High rates have increased the allure of credit allocations. A year ago, the typical Business Development Company (BDC) loan yielded more than 11%, roughly 200bps above the 9% return most investors target for their equity portfolios. But these loans sit atop the capital structure, which makes them less risky, all else equal, than the equity it subordinates in the cash flow waterfall. No wonder allocations to private credit have risen sharply since then (Figure 1).

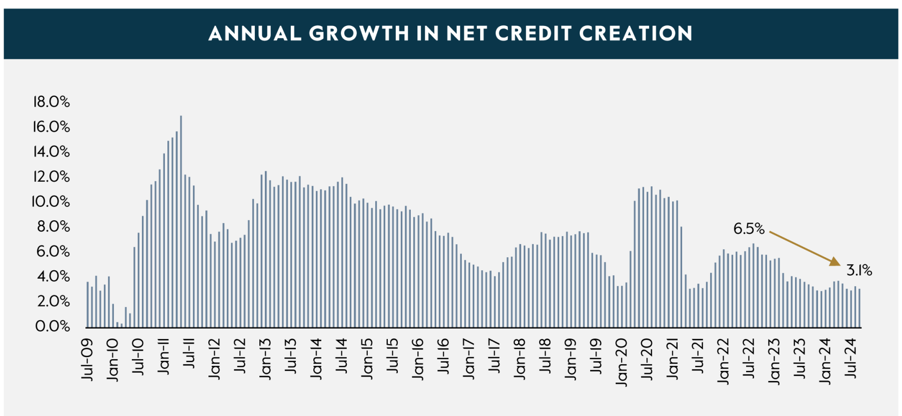
### Figure 1: Institutional Investors Scale Up Private Credit Allocations




Source: "Private Credit Allocation Outlook," CL Research. January 2024. There is no guarantee any trends will continue.

Increased demand for loans has been met with dwindling net new supply. Since the Fed started hiking rates, the annual growth in net credit outstanding across investment grade and high-yield bonds, broadly syndicated loans, and private credit has fallen by half (Figure 2). High rates deter new borrowing by design; it would be difficult for the Fed to have achieved the desired disinflation in its absence. But by simultaneously increasing the attractiveness of floating rate loans as an asset class, high rates have resulted in a supply-demand imbalance—i.e., more lenders than borrowers—that has led to a sharp tightening of credit spreads over the course of the year. Spreads on single-B corporate credit finished October at the tightest level in 17 years, just 50bps above their all-time lows.

### Figure 2: Slower Growth in Credit Demand Depresses Spreads




Source: Carlyle Analysis; Bank of America, November2024. There is no guarantee any trends will continue.

Lower rates should bring the market into healthier balance. Historically, credit spreads widen as short-term interest rates decline, often by a magnitude that leaves coupon income unchanged (Table 1). That's partly because interest rates and credit spreads are codetermined by the same macroeconomic factors. A weakening economy causes default risk perceptions to rise as base rates are cut. But there's more to it than that.

### Table 1: Spreads Widen as Base Rates Decline

| CREDIT SPREADS & BASE RATES | | | |
|---|---|---|---|
| **Variable** | **Impact of 100bps Reduction in Base Rates (2000-24)** | | |
| | **Low** | **Median** | **High** |
| Credit Spread | 59 | 83 | 106 |
| Spread Controlling for NTM Default Rate | 62 | 85 | 108 |
| Spread Per Unit of Leverage | 10 | 15 | 20 |
| Credit Risk Premium | 76 | 101 | 126 |

Source: Carlyle Analysis; Bank of America, Federal Reserve, November 2024. There is no guarantee any trends will continue.

Credit spreads tend to rise nonlinearly and completely out of proportion to the increase in defaults. Historically, the 'credit risk premium,' or portion of the spread not explained by default losses, rises sharply with macroeconomic uncertainty. Credit does not participate in 'upside' like equity; any increase in volatility manifests as greater compensation per unit of risk on new loans. In the past, the credit risk premium has risen 20% more than spreads as base rates declined (101bps vs 83bps, Table 1), with a meaningful increase in spread per unit of leverage on new loans (measured in terms of debt to operating cash flow or EBITDA).

In other words, while defaults are obviously bad for credit, *fear* of defaults increases returns on new lending more than the associated decline in base rates. And if the Fed keeps cutting rates in 2025, it's likely going to be because of precisely the sorts of worries about the growth outlook that have boosted credit returns in prior episodes.

But the real key for the market will be a continuation and broadening out of the growth in M&A volumes and net borrowing that we observed in Q3 2024 (Compass, October 15). Since Silicon Valley Bank's failure in March 2023, markets have repeatedly priced massive rate cuts that encouraged management teams to postpone acquisitions or debt issuance into the future when interest expense was thought to be lower. Now that rate cuts have finally arrived and the option value of waiting has declined, there could be significant pent-up demand for acquisitions and fixed investment that finally causes the number of borrowers to rise relative to lenders. That would result in a healthier market in 2025, where an increase in the price of credit risk keeps all-in yields near current levels.

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