

# Market Matters: 1<sup>st</sup> Quarter 2026

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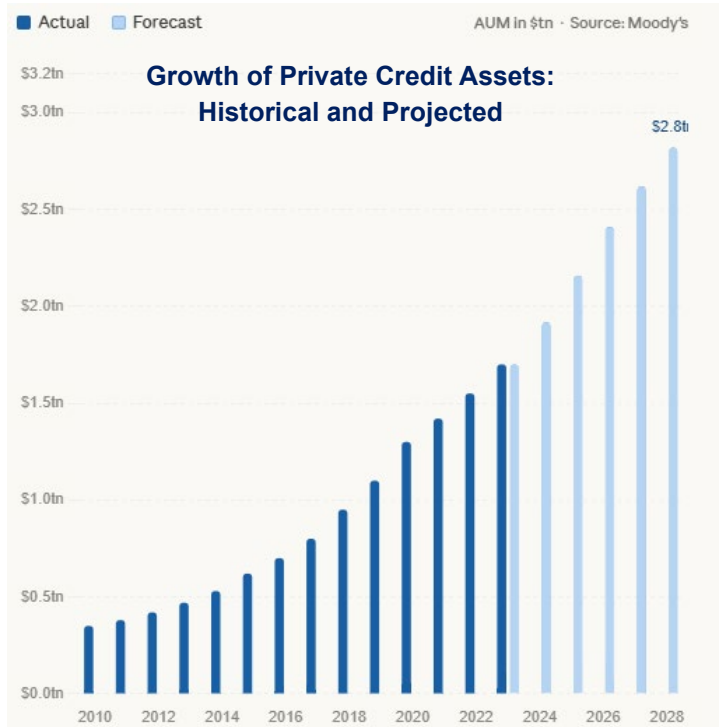
*“It’s only when the tide goes out that you learn who has been swimming naked.” – Warren Buffet*

- Private credit has grown into a roughly \$2 trillion global asset class driven by investor demand and banks retreating from middle-market lending.
- Direct lending investing via evergreen funds has stolen the spotlight and become a major access point for high-net-worth investors seeking income.
- Private credit encompasses highly diverse strategies including distressed credit, asset-backed finance and liquid credit in private funds.
- Structural risks are emerging in select vehicles — including liquidity mismatches, underwriting deterioration and sector concentration.

## Private Credit in Context

Private credit broadly refers to vehicles that hold credit instruments, including non-bank loans, asset-backed loans, broadly syndicated loans and bonds. Loans made by these funds are typically floating-rate and extended to companies backed by private equity sponsors, though funds also invest in traded bonds and loans. Each instrument has a place in a company’s capital structure and in an investor’s portfolio. Like a top-heavy building with a weak foundation, capital structures burdened by excessive debt face heightened risk of collapse under stress.

Private credit continues to offer a yield advantage over traditional fixed income. Higher interest rates may be a headwind for consumers, private equity, and small-cap stocks, but they continue to buffer credit investors from yield shocks. Against a backdrop of high oil prices, rising inflation, and global geopolitical conflict, several distinct private credit strategies play an important role in a diversified portfolio. Floating rate products capitalize on higher rates, opportunistic strategies take advantage of yield volatility, and asset-backed finance offers a diversified income opportunity.



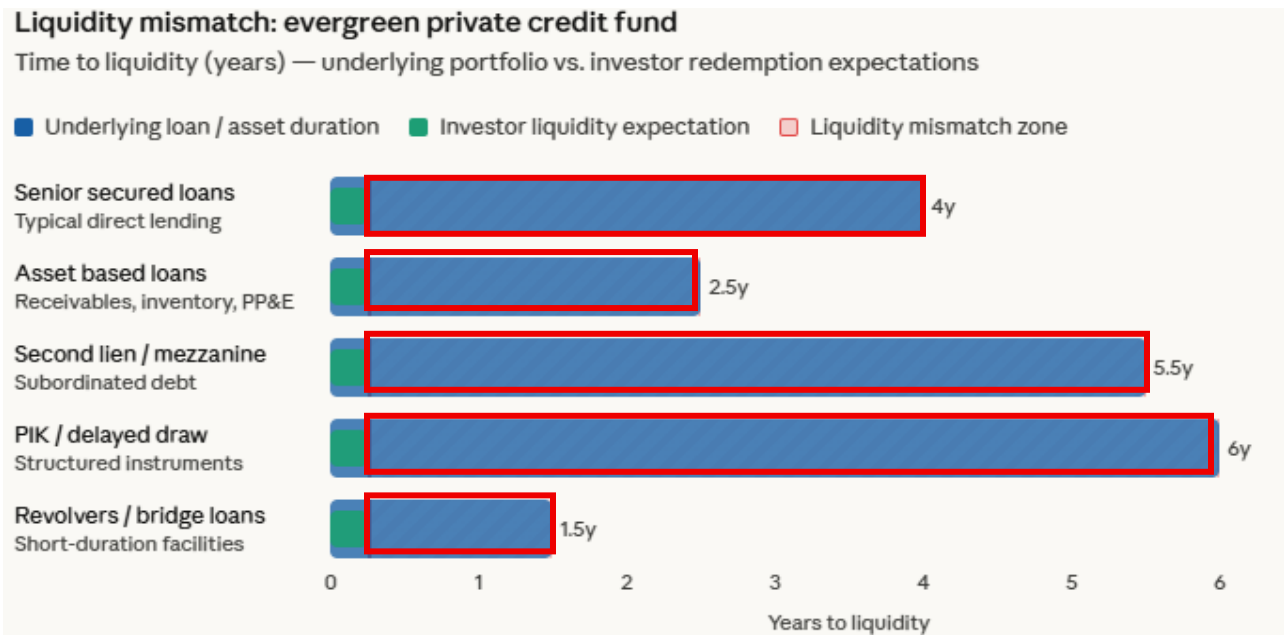
Private credit grew rapidly as interest rates rose in 2021, with yields rising in tandem and inflows accelerating. The faster the rise, the more critical it becomes to ask whether the foundation can bear the load.<sup>1</sup>

Recently, a selection of direct lending firms have been strained by capital flight and underlying risk in the software sector. Software risk has impacted small-cap stocks, private equity, and the large-cap universe, but the concentration of software company lending in some private credit funds has led to concern. Middle-market direct lenders focus on senior secured loans with moderate leverage levels, and are generally designed to prioritize capital preservation and stable income generation.<sup>2</sup> Asset-light software businesses with high recurrent revenue were prime assets for lending before the AI-induced sell-off early this year. Underwriting discipline is now more clearly differentiated - a clear illustration of how manager skill and selection matters.

## The Rise of Evergreen Private Credit Funds

A key structural innovation within the market has been the proliferation of evergreen fund structures. Unlike traditional closed-end private funds, evergreens allow investors to subscribe capital immediately and continuously, with low minimums, no capital calls or principle distributions, and no fund term. These features make the strategies more accessible, but also introduce their own structural tensions.

Most evergreen vehicles offer investors quarterly liquidity via an investor redemption option, but the underlying instruments carry a materially longer duration. Investors may request exit in 0.25 years (quarterly) and underlying loans cannot be sold at market value on that timeline.<sup>3</sup> The liquidity mismatch can be dramatic because underlying loans are rarely traded (or tradeable). The liquidity of the underlying assets consists only of loans close to maturity (or pre-payments) and income from the portfolio. In direct lending, the average maturity of a loan is typically ~5 years, though prepayments can reduce the overall



<sup>1</sup> Graphic from Moody's

<sup>2</sup> Prequin: Global Private Debt Annual Report.

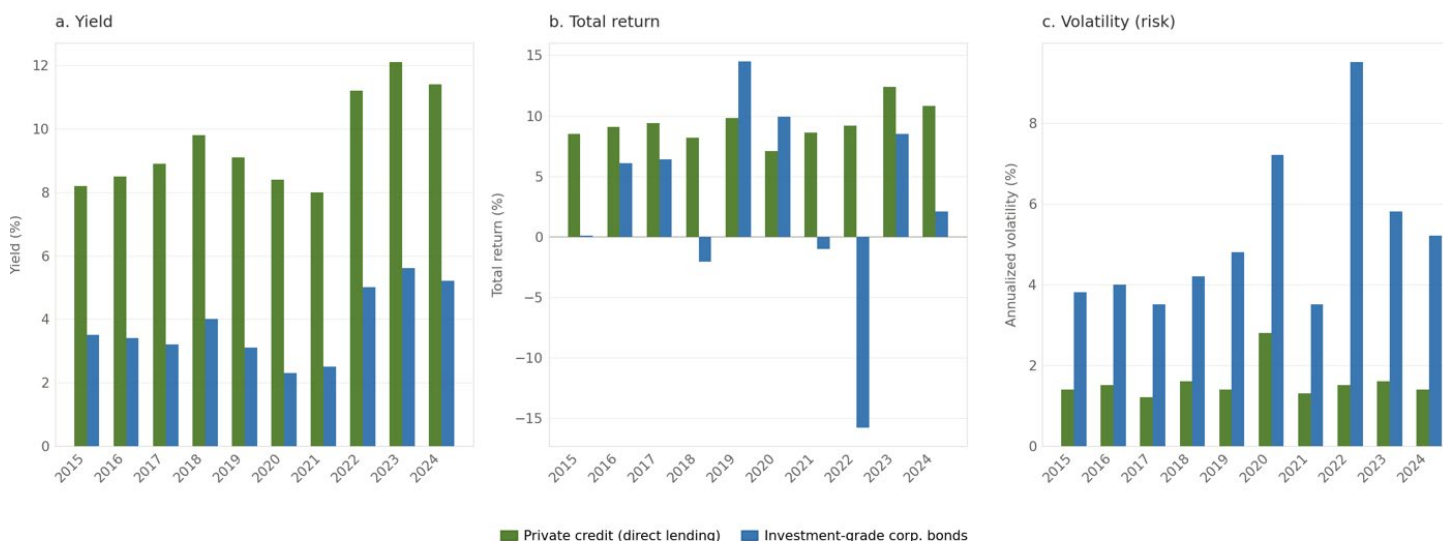
<sup>3</sup> Graphic from Claude.ai

length of the loan period.<sup>4</sup> In any given year, only 20-30% of an underlying direct lending portfolio might become liquid – a figure that may decline further in times of economic stress. Funds often keep a sleeve of liquid assets (often up to 10% of NAV), but in times where capital inflows are sparse this cushion is not enough to offset a stark mismatch between the 100% redemption option every quarter and roughly 5-6% average quarterly liquidity. If redemption demand rises suddenly, managers may need to enforce withdrawal limits or sell assets in unfavorable market conditions.<sup>5</sup> There is a similar, though less pronounced, mismatch for asset-based loans. A 5% per quarter fund-level gate is often implemented to slow redemptions and protect remaining investors. However, this is often discretionary and can be rescinded, leading to illiquidity precisely when many would want it most.

## Risk & Return Context

Private credit typically occupies a middle ground in the traditional risk and return spectrum. It offers higher income than bonds while maintaining lower volatility than equity investments. Compared to high yield bonds, the asset class has a higher return per unit of risk. Historically, middle-market direct lending has exhibited relatively modest default rates ranging between 1–2% over long time horizons, with recovery rates typically higher than those observed in broadly syndicated leveraged loans.<sup>6</sup> In core middle-market lending, lenders often maintain greater influence over loan terms and documentation. While defaults naturally rise during economic downturns, the combination of senior secured positioning, covenant protection, and lender influence in restructuring negotiations has historically supported relatively strong recovery outcomes in this segment of the market.<sup>7</sup>

Private credit vs. investment-grade corporate bonds: 10-year comparison



Indicative data, 2015–2024. Sources: Cliffwater CDLI, Bloomberg Barclays indices, J.P. Morgan Guide to Alternatives. Private credit volatility is appraisal-based.

<sup>4</sup> International Monetary Fund

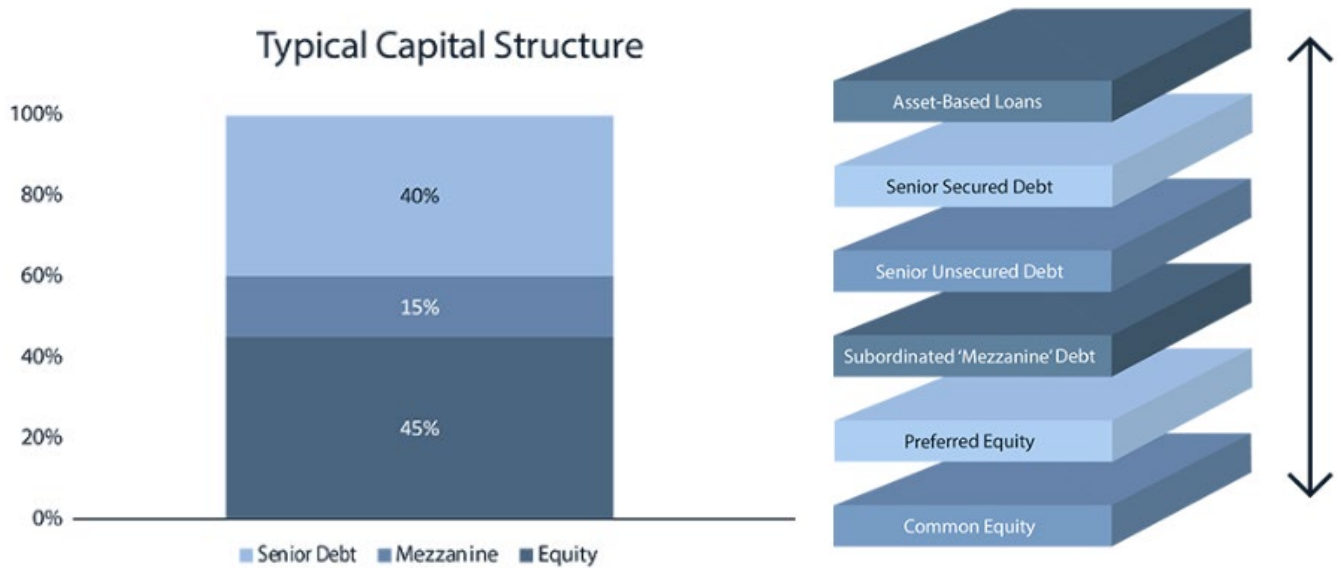
<sup>5</sup> Financial Stability Board

<sup>6</sup> Chart below from Claude.ai

<sup>7</sup> Cliffwater Direct Lending Index Report, 2024.

## Capital Structure: Only as Strong as its Foundation

Private credit investors typically occupy a defined position within the corporate capital structure. Understanding this hierarchy is key to portfolio construction.



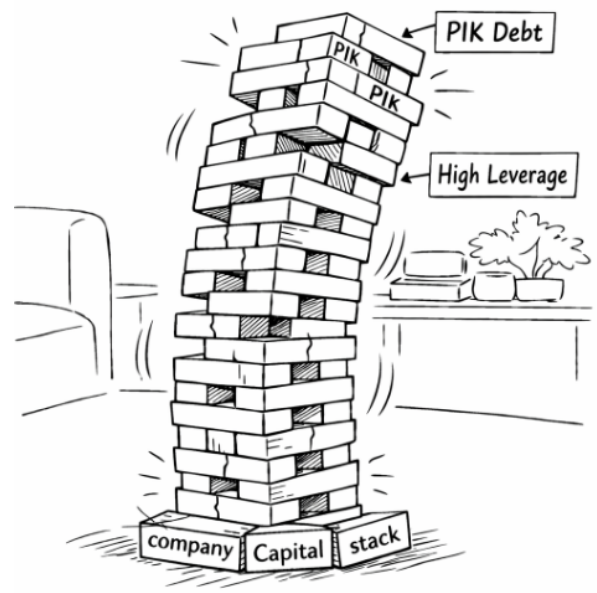
### Covenant Protection

Asset-based and senior secured loans generally sit near the top of the capital structure and have priority claims on company assets and cash flows. These positions function as the structural core and are last to give in if the structure falters.<sup>8</sup> Loan covenants and contractual provisions that require borrowers to maintain certain financial conditions, such as leverage and interest coverage ratios, further stabilize positions. During periods of rapid market growth, competition among lenders can lead to “covenant-lite” loans, where these protections are weakened. When covenants erode, the support for a position in the capital structure is quietly removed. The building may look the same from the outside, but it is less able to withstand stress.

<sup>8</sup> Graphics from Prudential Private Capital.

## Payment-in-Kind (PIK) Interest

Payment-in-kind (PIK) interest has drawn increasing attention in the private credit market. PIK allows a borrower to add their interest expense to the loan balance rather than paying it in cash, causing outstanding debt to increase and subsequent interest payments (typically also paid in-kind) to rise with the balance. PIK structures can serve legitimate purposes, but cash flow discipline is reduced, and lenders receive fewer early signals of financial stress.<sup>9</sup> By some estimates, public BDCs – one source of direct lending – are receiving ~12% of their income from PIK.<sup>10</sup> Private credit portfolio yields may appear artificially stable because PIK interest is recorded as income borrowers are not generating sufficient cash flow. Because of this, loans with significant PIK are often structurally riskier than traditional cash-pay senior secured loans. As payments are added to the principle of the loan, the debt in the capital structure expands. If company revenues do not grow quickly enough for the company to “grow into” its debt, the accumulating debt burden becomes top-heavy. A company carrying more debt requires proportionally stronger equity and cash flow beneath it to remain stable. When that balance breaks, the entire structure is at risk. This can increase losses if a borrower ultimately defaults.<sup>11</sup>



## Structure Precedes Strategy: The Private Credit Ecosystem

The private credit market spans several interconnected strategies. Direct lending is one component of a broader ecosystem that includes asset-backed finance, distressed or opportunistic credit, and structured credit markets. These segments differ in their sources of return, liquidity characteristics, and risk exposures, and each plays a role in a well-constructed private credit portfolio. Diversifying across strategies can reduce concentration risk and exploit the liquidity gradient across the ecosystem.

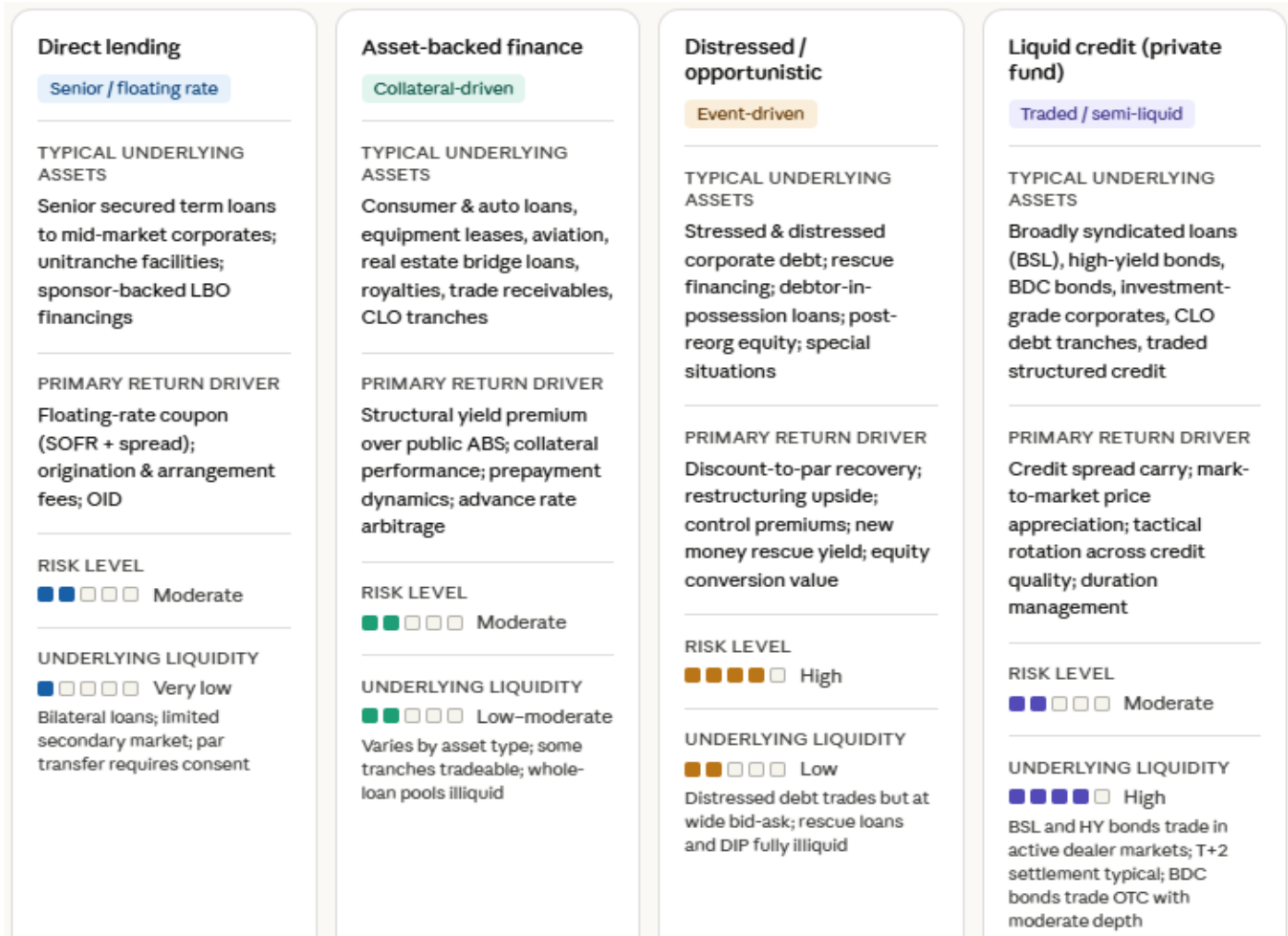
Asset-backed finance (ABF) strategies involve lending against pools of contractual cash-flow-generating assets rather than the enterprise value of a corporate borrower. These assets may include consumer loans, equipment leases, trade receivables, royalties, infrastructure revenue streams, or other forms of structured collateral. One key benefit of ABF is that loan performance is often driven by diversified underlying asset cash flows, which can provide attractive income with lower correlation to traditional corporate credit cycles. In addition, lenders typically benefit from structural protections such as over-collateralization and priority claims on specific assets, which can enhance downside protection. Risks include complexity and opacity in underwriting asset pools, potential sensitivity to consumer or sector-specific shocks, and reliance on servicing quality and data transparency.

<sup>9</sup> Fitch Ratings, Private Debt Outlook, 2024.

<sup>10</sup> S&P Global.

<sup>11</sup> Ai generated graphic.

Opportunistic credit strategies invest in dislocated, stressed, or complex credit situations where pricing may be inefficient. These investments can include distressed corporate debt, rescue financings, structured equity-like debt, special situations lending, or secondary purchases of credit at meaningful discounts. A key benefit of opportunistic credit is the potential for equity-like returns driven by active restructuring, pricing dislocations, or negotiated terms. These strategies can provide flexibility to deploy capital across capital structures, allowing managers to adapt to changing credit cycles. However, risks are significant and include higher loss severity if restructurings do not proceed as expected or in the face of longer investment durations, as well as valuation uncertainty. Performance depends heavily on manager skill, legal expertise, and timing within the credit cycle.<sup>12</sup>



Private funds that trade liquid credit invest primarily in publicly traded instruments like high-yield corporate bonds, broadly syndicated leveraged loans (BSLs), CLOs, or securities issued by business development companies (BDCs), but do so within a private fund structure that allows for flexible positioning and, in most cases, the use of some amount of leverage. A key benefit of these strategies is greater liquidity and price transparency, which also enables managers to reposition portfolios more quickly as credit conditions change. They can also provide diversified exposure across industries, issuers, and credit tiers, reducing single-borrower risk and offering opportunities to capture spread widening or market dislocations. There

<sup>12</sup> Graphic from Claude.AI

tends to be less of a liquidity mismatch between underlying assets and redemption options, but more liquid funds are also more sensitive to market volatility and investor sentiment. Manager selection must be adjudicated carefully, as higher fees and lower liquidity than publicly traded liquid assets need to be justified by a combination of access to leverage, security selection expertise, dynamic portfolio allocation, nontraditional instruments like short positions or derivatives, and overall higher returns.

## Portfolio Construction in the Current Environment

Elevated oil prices stemming from the conflict with Iran could place renewed upward pressure on inflation, particularly if energy costs remain high for an extended period. Energy shocks tend to raise production and transportation costs across the economy, which can slow progress toward central bank inflation targets and delay expected rate cuts or lead to tighter financial conditions. Consumer spending faces pressure from both higher gasoline prices and broader price increases.<sup>13</sup> For private credit, higher inflation and interest rates can increase borrower debt-service burdens, especially for highly leveraged companies with floating-rate loans. At the same time, persistent inflation may weaken economic growth and corporate earnings, potentially leading to default risk and tighter underwriting standards. However, conservative senior secured lending strategies may remain comparatively resilient, as lenders retain greater ability to intervene early and preserve capital in a more challenging macro environment.

Private credit remains a compelling income-oriented asset class for long-term investors. As the market continues to mature, thoughtful manager selection and diversification across credit strategies are likely to become increasingly important. The higher a capital structure rises, the sturdier its foundation must be. The current cycle may therefore be one in which manager selection and underwriting discipline — grounded in senior secured positioning, cash-pay structures, and diversified risk profiles — become the primary drivers of performance, rather than the broad market tailwinds that characterized the earlier phase of private credit growth.

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<sup>13</sup> The Vanguard Group, Morgan Stanley.