BC Partners' Quarterly Credit Check

Why the unstoppable march of public equity inflows opens doors in mid-market lending

Ted Goldthorpe
Head of BC Partners Credit

Mike Terwilliger, CFA
Managing Director, Credit

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In this quarterly macro-commentary from the BC Partners' Credit team, Ted Goldthorpe and Mike Terwilliger, CFA, examine the current risks posed by ongoing asset price inflation and what the current trajectory of interest rate cuts throughout 2025 means for credit markets and investors - as well as why niche focuses within direct lending look set to outperform.

Macro Backdrop: The Concerning

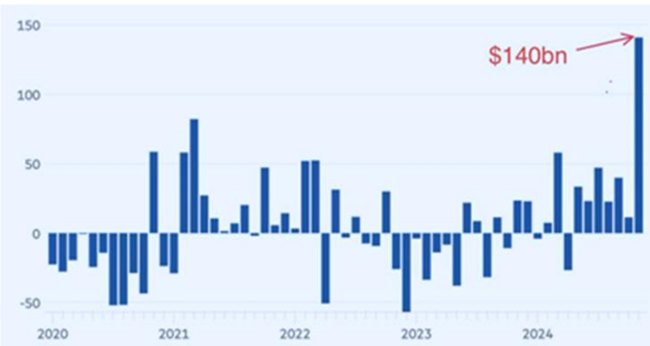
Inflation Risk Shifts from Consumer Prices to Asset Prices

Our headline view on economic and market conditions is best introduced with what we view as a simple fact: equity markets are expensive.

Interest rate cuts (first hoped for, and then realized) as well as high investment in artificial intelligence assets and the subsequent valuation boom have lifted the S&P 500 to its second consecutive year of +20% returns - something which has occurred only three times in the last 100 years.[1]

Even though "Buy Low Sell High" is a time-worn axiom, this momentum has caused investors to continue to plow into stocks, as reflected below:

Chart 1: Monthly Net Flows into U.S. Equity Funds ($ bn)



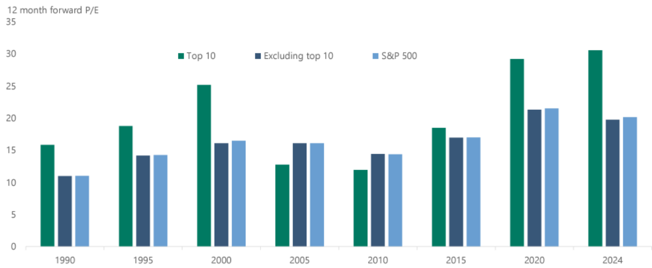
Source: EPFR, Sarna Capital

Putting this flow of dollars into context, $140bn represents 150% of current U.S. savings rate of 4% per month.[2] This latest stock stampede has significantly outpaced the peak SPAC and NFT post-COVID craze of early 2021. Readers need little reminder of the lack of residual value these investments presented once the hype cycle had faded.

That said, high valuations and investor enthusiasm do not necessarily represent a systemic problem. Bubbles, however, do.

In this context, and as reflected below, valuations amid the last AI-fueled market frenzy appear loftier than during the 1990s tech bubble, based on forward price/earnings ratios:

Chart 2: 12-Month Forward P/E



Source: Bloomberg, Apollo Chief Economist. Note: Median P/E, Date as of 30 September 2024. (11/01/2024)

In this context, misallocation of capital presents the overarching risk.

If the siren-song of AI attracts more dollars than can be put to productive use, we view a market crash as inevitable. Bubbles don't leak, they pop. There would, in time, also be a resulting drag on GDP from unproductive investments.

Relatedly, we highlight the recent *Wall Street Journal (WSJ)* article "*The Next Great Leap in AI is Behind Schedule and Crazy Expensive*[3]" as echoing concerns we raised last quarter about the extraordinary expense of AI. The *WSJ* reported that six-months of training for OpenAI's latest LLM model (GPT-5), cost OpenAI as much as half a billion dollars.

We make two vital caveats about the current backdrop. First, there is no "shot clock" on market exuberance. The dot.com era produced four consecutive years of 20% returns.[4] Time alone does not kill market fury. A catalyst is required.

Recessionary concerns and the Fed's hawkish tone killed the post-pandemic NFT boom-let. The latest AI mania can run for an indefinite amount of time until an unforeseen event emerges.

Second, and much more importantly, AI, could, in time, work. AI has the potential to launch an era of economic growth that elevates productivity—and therefore corporate profitability—that justifies (and perhaps eclipses) current valuations. This '*Land of Milk and Honey'* scenario appears to be the market's base-case, driving our view of an emerging bubble.

As we noted last quarter, evidence of AI-driven gains remains scant (despite being the *de rigueur* buzzword on earnings calls), particularly in productive consumer

[1] *"Navigating Trump 2.025," Deutsche Bank,* November 25, 2024
[2] *Sarna Capital*, December 16, 2024
[3] https://www.wsj.com/tech/ai/openai-gpt5-orion-delays-639e7693
[4] *"Navigating Trump 2.025," Deutsche Bank,* November 25, 2024

applications. Ghosting writing emails does not harken the arrival of the next Cotton Gin.

Lastly, promises of future productivity pervaded the dot.com boom, but few businesses from that era remain—Amazon, eBay, Cisco and Google come to mind, but not many more. Even if AI hopes and dreams come to pass, there will be a trail of bad investments along the way.

The ascendance of crypto provides further potential signs of market forth, in our view.

Fiscal deficits have likely contributed to its resurgence among the fiat money skeptics. Nevertheless, over the years, crypto acolytes continue to develop ever-expanding use cases for the digital asset. However, in real-world conditions, it has proven to be not a medium of exchange, nor a store of value nor a hedge against inflation or markets.

Instead, we believe, digital assets have become a barometer of animal spirts—the "trading sardines" of the modern era (as recounted by Seth Klarman in *Margin of Safety*).[5] Klarman could have been foreshadowing the digital asset crowd when he trenchantly wrote in 1991, "*speculation offers the prospect of instant gratification; why get rich slowly if you can get rich quickly?*"[6]

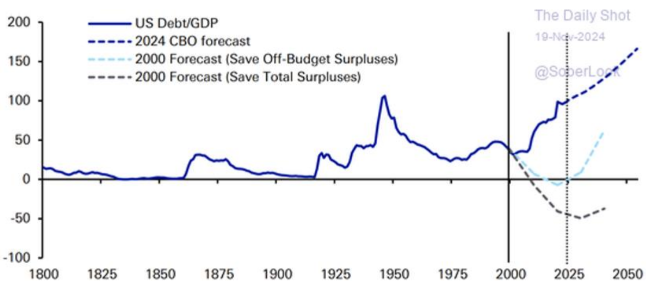
When Crypto is in-bloom, caution should abound.

Deficits Overhang

There is no free lunch.

The U.S. economy has grown, and markets have boomed, on the back of fiscal bounty unlocked during the pandemic. As reflected below, U.S. debt-to-GDP ratios are projected to reach once unfathomable heights:

Chart 3: U.S. Debt to GDP ratio and CBO forecasts



Source: Deutsche Bank Research (11/19/2024)

Interest rates remaining higher for longer will further balloon deficits as the Treasury's interest burden throws more debt onto the pile, with debt-to-GDP soon surpassing World War II levels. The ascendance of the dollar, baby-boom demographics, repurposed war-related PP&E, and reordering of global trade (among other factors) enabled the U.S. to outgrow this debt burden.

An AI productivity miracle provides a glimmer of hope. Otherwise, in time, deficits will weigh on growth as government debt crowds out productive private investment. A decade(s) of stagnation, as experienced by Japan over recent years, could be in the cards without a productivity breakthrough.

The final concern we highlight, reading the bond market, is that inflation concerns are not dead yet.

The yield on U.S. 10 Year Treasury has risen roughly 90bps since the Fed's first cut in September. As reflected below, 2-Year and 3-Year Inflation Expectations have risen steadily since then as well.

Wringing the last gasps of rising prices from the economy may prove challenging amid an ebullient market. The Fed seem to signal the centrality of this concern with a "hawkish cut" of 0.25bps in December.

As a consequence, term premia may continue to rise, and the risk-free rate remain elevated, should inflation concerns remain.

Macro Backdrop: The Uncertain

Policy Shift

Plenty of market watchers have speculated on the impact of the new Administration, so we will keep our commentary brief.

In short, we have no idea what policies the new Administration will pursue. Even President Trump's most ardent supporters would acknowledge the new President's mercurial nature. Some proposed policy initiatives could support growth (e.g. deregulation), while others (e.g. mass deportation), would not.

We note that tariffs may not, by definition, lead to broad-based inflation. Yes, certain asset prices may

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[5] "*There is an old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller said, "You don't understand. These are not eating sardines, they are trading sardines*." *Margin of Safety: Risk Adverse Value Investing Strategies*", *Seth Klarman.*

[6] "*Margin of Safety: Risk Adverse Value Investing Strategies*", *Seth Klarman.*

rise, but changes in consumption, substitute product sourcing and the stronger dollar would provide offsets.

Regardless of the agenda pursued by the Administration, we are confident the market will provide guardrails.

Bond-vigilantes have been dormant since the 1990s, seemingly, lulled by nearly two decades of tranquil inflation and low nominal rates. However, given already elevated debt-to-GDP, should the Administration pursue an overly aggressive agenda—raising the specter of higher deficit or resurgent inflation—markets will respond swiftly.

Liz Truss's 49-day tenure as Prime Minster of the UK reminds us that markets are a natural foil to ill-conceived public policy.

Macro Backdrop: The Good

T.I.N.A.U.S.A.

A ballast to U.S. markets is a global T.I.N.A.U.S.A—There Is No Alternative (to the) U.S. of A.

Europe is currently riddled with political and economic uncertainty.

After a second consecutive year of flirting with recession, Germany's post-war economic model appears in question. Waning competitiveness, stemming from structurally higher energy and labor costs, have hindered Germany's export-led economy. By production volume, German industry has declined 15% since 2017.[7]

Adding to recent woes, China has flipped from coveting German cars to flooding Europe with cheap EVs. Further, *The Economist* recently highlighted that SAP (founded in 1972) represents the last successful German software start up.[8] While more figurative than literal, *The Economist's* point highlights the country's lack of business innovation despite its reputation for engineering and technical expertise. Lastly, German household spending has remained muted and constitutional debt breaks have thwarted a fiscal response.

The French government remains gridlocked—on its fourth Prime Minster in a year—after a failed attempt to pass a budget that (partially) addressed its fiscal deficit (projected ~6% of GDP). Additionally, the country's tepid GDP growth provides little hope for growing into its debt to GDP of ~110%.[9]

China remains trapped in economic malaise after its disastrous housing overbuild. To underline the magnitude of the problem, we highlight the following passage from MarcoStrategy Partnership:

> *"…there are 73mn presold but uncompleted dwellings in China. That is a problem of mindboggling proportions. To put that into context, that is just shy of 3x the number of exiting dwellings in the whole of the UK."*[10]

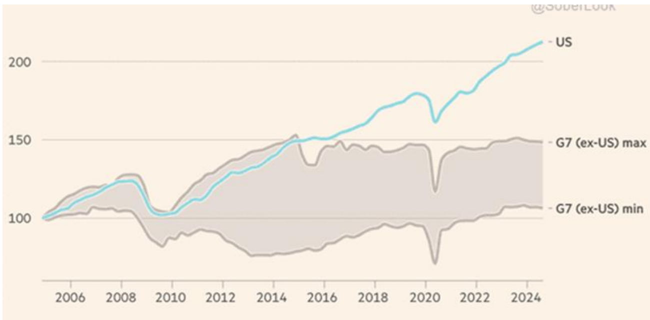
With significant household wealth trapped in (potentially failed) real estate and rising youth unemployment, Chinese consumers remain reticent to spend—a problem exacerbated by the country's lack of social safety net.

The risk of devaluing its currency—and thereby thwarting global ambitions for the Renminbi—as well as potentially triggering inflation, have limited China's ability address these issues through monetary policy.

Further, as it relates to emerging markets broadly, the strong dollar will present significant near-term headwind.

Lastly as it relates to T.I.N.A.U.S.A., recent capex trends, as reflected below, could continue to widen the gap between U.S. markets and the rest of the world:

Chart 4: Business investment growth, rebased (100 = 4Q 2004)



Source: Financial Times, LSEG and Oxford Economics (12/16/2024)

Some (if not much) of this has been priced in by markets, but looking at the chart above, where would you put your incremental investment dollar?

At risk of sounding like Lee Greenwood (of "Proud to be an American" fame), the global backdrop may

[7] *"Navigating Trump 2.025," Deutsche Bank,* November 25, 2024

[8] *"Once dominant, Germany is now desperate," The Economist,* November 20, 2024

[9] *"France steps into deep trouble," The Economist,* December 4, 2024

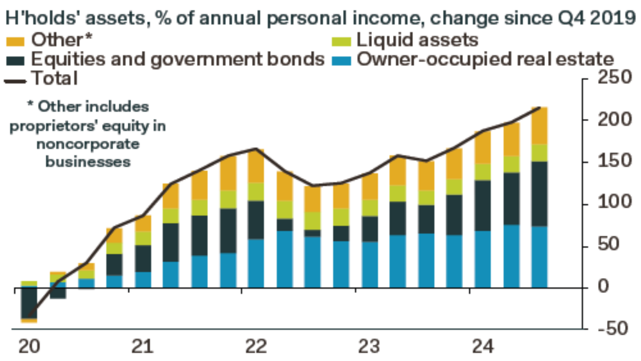
[10] "*China, Trump & the US $10,000 question" (MacroStrategy Partnership*, December 2, 2024

continue to promote the flow of capital into U.S. markets, keeping the good times rolling.

Household Wealth Effects

In a similar vein, the post-COVID era has witnessed extraordinary wealth creation for many U.S. households:

Chart 5: Household Assets as % of Annual Personal Income, since 4Q 2019



Pantheon Macro (12/13/2024)

Wealth-effects, of course, can have a self-reenforcing dynamic: higher asset prices push consumer spending, which further supports asset prices, etc.

To follow a negative tangent amid “The Good” section of the letter, as we have noted before, rising asset prices only benefit a segment of the U.S. population (and those with the lowest marginal propensity to consume).

Contributing to difficulties faced by lower income cohorts, as reflected below, the aggregate impact of inflation has increased household prices by roughly 22% since the pandemic:

Chart 6: U.S. CPI (y/y) vs. U.S. CPI Index

Source: Bureau of Labor Statics, Blomberg and Apollo Chief Economist (11/30/2024)

Higher prices represent a permanent drag on consumption. Paying more for “needs” (like the roughly 50% increase in car insurance and 30% more for cereal) will, in time, force households to spend less for “wants” (like new cars, vacations, etc.)—a risk for our consumer-led economy.

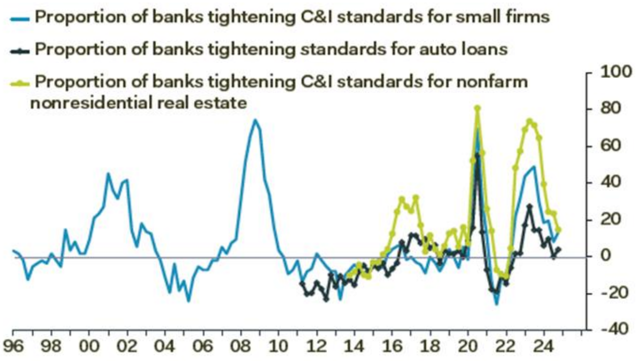
<u>The Opportunity: Expansion of private markets</u>

Public market credit valuations *writ large* are stretched. U.S. Investment Grade credit spreads are hovering at the lowest level since May 1998 and U.S. High Yield spreads have reached the tightest since May 2007.[11]

As credit-pickers, we always find opportunities, even in an overbought market, but the greater opportunity unambiguously resides in privates.

Despite optimism seeming to reign supreme—and election uncertainty behind us—U.S. banks remain overly cautious. As shown below, across all major categories, banks continue to tighten lending:

Chart 7: Portion of Banks Tightening C&I, Auto and Non-residential real estate



Source: Pantheon Macro (12/13/2024)

Banks’ structural decline has expanded private credit into new segments.

Although a “hot” corner of the market—private credit is not monolithic. Much as there are “large cap” and “mid cap stocks,” there many different types of private credit.

Large sponsor-lead direct lending will struggle in a backdrop with tight credit spreads. These managers will be forced to lower yields and sacrifice covenants to win deals from public investors—undermining the point of allocating to private credit. These funds will essentially become less liquid, higher-fee equivalents of a High Yield or Levered Loan fund.

While large-cap competitors may struggle, BC Partners views this as an ideal backdrop for our true middle-market specialty vehicles.

Many private credit solutions have centered on direct lending to sponsor-led businesses. In our direct lending, BC Partners deemphasizes the market by

[11] *“Navigating Trump 2.025,” Deutsche Bank,* November 25, 2024

focusing on owner-lead transactions—a much less competitive and higher-returning vertical.

Alongside this focus, BC Partners also offers investors access to other attractive sub-segments of private credit. A well performing example of this is Specialty Lending—including asset-backed borrowing, NAV-lending and aircraft leasing—which offers equity-like returns from secured, collateralized loans.

Emphasizing non-sponsored direct deals as well as exposure to attractive segments like Specialty Finance and now-venture lending, BC Partners offers investors differentiated exposure to private credit.

A world beset by macro uncertainty and lofty public valuations demands that investors look to expand their allocation towards private markets—leaning into differentiated solutions provided by BC Partners.

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