

# BC Partners' Quarterly Credit Check

*Why a 'soft-landing' is  
still not a certainty*

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*In this quarterly macro-commentary from the BC Partners' Credit team, Ted Goldthorpe and Mike Terwilliger, CFA, examine the currently unavoidable narrative of a 'soft-landing' in the U.S.; why a 'soft-landing' is anything but certain; how the Credit team views the path for U.S. interest rates, and what this all means for credit markets and investors.*

This market update comes against a decidedly murky macro backdrop. Public markets have been ebullient in recent months, boosted by the Fed's dovish tilt in December 2023, which has amplified the "soft landing" narrative. "Soft landing" has become such a market catchphrase that it requires further examination of what such an outcome would entail.

A soft-landing suggests that the market and the economy could escape the massive over-stimulus and inflationary spiral of COVID—and the resulting ~550bps of interest rate hikes—without experiencing economic pain or downturn. Such an optimistic outcome would seem to belie basic reason. More importantly, the soft-landing thesis ignores certain tremors at the foundation of our economy.

### Macro Backdrop: The Concerning

The Fed alluding to cuts this year reignited the market's animal spirits and loosened market conditions for many. However, not all corners of the economy have participated in the latest market celebration, as small- and medium-sized banks have continued to tighten lending activity.

A range of (not-insignificant) challenges has contributed to muted bank lending, including marked-to-market losses on long duration assets, commercial real estate ("CRE") concerns, regulatory overhang post-Silicon Valley Bank and depositor flight into Money Market Funds. In our view, none of these troubles appear likely to abate in the near-term.

Furthermore, banks play a vital role in our economy, beyond just business lending. Small banks provide nearly 70% of CRE loans, nearly 40% of residential real estate debt and more than 20% of consumer loans.

There are few segments of the U.S. economy not touched by the traditional banking channel. Banks have historically helped the gears of U.S. GDP to turn. Without lending, the U.S. economy will inevitably slow, as capital-deprived businesses may forgo expansion plans or (worst case) struggle to stock their shelves. In short, if banks remain sidelined, we believe a soft-landing will ultimately prove elusive.

### *Fears over the U.S. consumer*

The health of the U.S. consumer represents another potential threat to the market's current bull-run. As has been well documented, a lack of opportunities to spend during the pandemic as well as aggressive fiscal stimulus, enabled households to build "excess savings," which has helped propel the post-COVID economy. However, much of these savings have been exhausted—particularly among the most economically sensitive Americans.

Much of these remaining savings may remain trapped from an economic perspective. Given the lower marginal propensity to consume among wealthy households, these dollars may not be spent into the economy in the near-term, if at all.

Economically sensitive households—those who have borne the brunt of inflationary pain—have also not participated in recent market-driven wealth effects. Hence, while many consumers appear to be doing quite well, many are not. Underscoring this dynamic, an increasing number of Americans are paying minimum monthly debt payments and leaving significant balances outstanding.<sup>1</sup>

With segments of the U.S. population experiencing real pain from higher prices and higher cost of debt, consumer spending may shift from a tailwind to a headwind, which could upend the market's latest tear.

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<sup>1</sup> Source: Federal Reserve Bank of Philadelphia

## Small businesses not so optimistic

Business sentiment appears to reflect some of the underlying challenges in our economy. Notably, the NFIB Small Business Optimism Index for March registered the lowest reading since 2012:

Chart 1: NFIB Small Business Optimism



Source: NFIB and The Daily Dash

The chart above requires a pause for contemplation: despite a seemingly strong economy and an enthusiastic equity market, small business sentiment is worse than during the troughs of the pandemic.

## Interest rates: a market overhang

Interest rates represent a much-discussed market overhang as well. U.S. equity valuations are near historic levels with AI-mania centerstage of the stock market's recent furious gains. However, beyond AI, expectations for rate cuts have also catalyzed the latest market rally. These much-anticipated cuts have confronted the reality of an economy stronger than feared, a job market that continues to expand and inflation that has refused to surrender.

The S&P has yet to recalibrate for a more realistic appraisal of the path of rates in 2024.

For economic and political reasons, we anticipate one 25bps cut this year—most likely in July; we believe September would be considered too close to the election. The economic case for cuts, in part, stems from concerns about *real* interest rates. Even with inflation lodged in the +3.0% context, inflation-adjusted Fed Funds remain at the highest level since the GFC.

Chart 2: Real Fed Funds Rate



Source: Bloomberg

Additionally, much of the globe appears to be entering a synchronous cutting cycle, with Bank of England, European Central Bank and Bank of Canada all signalling cuts this summer. Other than Bank of Japan which may need to hike to defend its spiralling Yen, the trajectory of global rates is definitively downward. If the Fed does not cut, we risk an overheated dollar, which could weigh on GDP from lower export demand.

Finally, on the political front, the Fed will face increasing pressure from Washington to push rates lower in an election year—particularly with many consumers starting to feel the bite of higher rates. Hence, while perhaps not entirely economically justified, we expect one cut this summer.

## Macro Backdrop: The Positive

Tempering our decidedly guarded tone thus far, there are unquestionably many positive signals in the current backdrop. Namely, jobs are plentiful and household and corporate balance sheets are historically strong.

Additionally, circling back to artificial intelligence, AI enthusiasm could kick-off a wave of corporate investment and productivity reminiscent of the 1990s. We would note, however, that the 1990s productivity boom happened amid an era of budget surplus, unlike our current period of crushing fiscal deficits.

Another clear positive, should the economy weaken, is that the Fed has cuts at its disposal. Rate cuts provided diminishing efficacy during much of the post-GFC era. Because rates had been so low for so long, incremental cuts elicited little change in corporate or household behavior.



Now, having experienced the discomfort of higher rates, people will likely pounce when the cost of debt declines. People may race out to buy that car or dish washer, or other rate sensitive goods, for fear that rates may go up again, which could rekindle the economy.

### Macro Backdrop: The Opportunity

The discordant signals in the market provide a challenging backdrop for investors, but credit, in our view, remains a haven. Unlike exuberantly priced equities, middle market credit remains rich with opportunity. Muted bank lending is troubling for the economy, broadly, but has unambiguously translated into an opportunity. Small and medium-sized businesses are increasingly turning to non-traditional platforms for capital solutions.

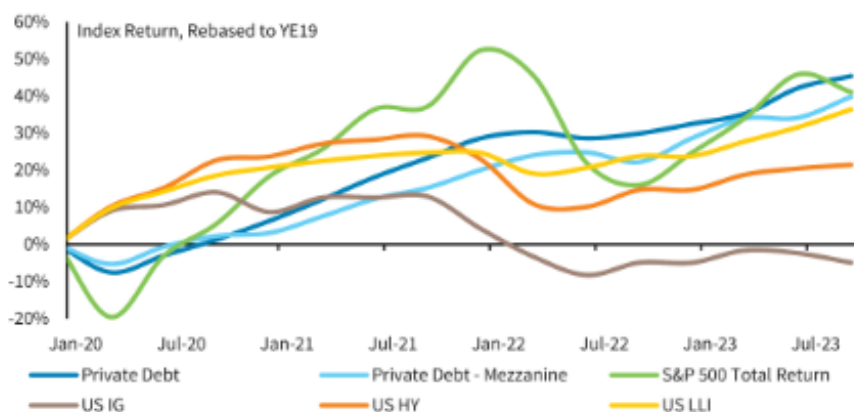
Blows to the U.S. banking system from COVID, rapid interest rate increases, bad CRE loans and the SVB collapse have accelerated the structural trend of increasing capital formation by non-bank institutions.

From an investor standpoint, we believe it is instructive to highlight the benefits of our private credit solutions as an asset class. As reflected in the chart below, private credit has handily outpaced all categories of fixed income and produced returns competitive with the S&P 500 (with markedly lower volatility), in recent years:

Not all private credit solutions, are the same, of course. BC Partners' focus on lending to companies with \$10mn to \$50mn of EBITDA uniquely positions us to capitalize on the pullback by small- and medium-sized banks. Many competing private credit funds—with billions of capital to deploy—must chase larger companies, which still have access to traditional lending channels. Hence, we believe we are uniquely positioned as a Fund and a firm to benefit from the structural decline of banks.

Ultimately, we believe the era of turbo-charged equity performance is likely over. Immediately prior to the reign of easy money, the S&P returned just 4.8% a year from 1996 to 2008. From 2009 to 2021—a time-period highlighted by negative *real* interest rates and QE by the Fed—the S&P gained 16.0% per annum. Put differently, the S&P generated a CAGR of 9.6% from 1928 to 2023<sup>6</sup>. Assuming that the last 13 years, prior to 2022, represent an outlier in performance, we believe that we will see fixed income returns rival the S&P going forward, offering a compelling investment case for private credit

### Index Returns, Rebased to 2019



Source: Data through 3Q 2023, Prequin, Barclays Research (04/11/2024)

## Important information

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<sup>3</sup>Barclays U.S. Aggregate Total Return Value Index – The Barclays U.S. Aggregate Total Return Value Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). Investors cannot invest directly in an index. Reflects cumulative return 10/28/2015 through 03/28/2024.

<sup>4</sup>S&P/LSTA Leveraged Loan Total Return Index – The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments. Investors cannot invest directly in an index. Reflects cumulative return 10/28/2015 through 03/28/2024.

<sup>5</sup>ICE BofA U.S. High Yield Index – The ICE BofA U.S. High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Investors cannot invest directly in an index. Reflects cumulative return 10/28/2015 through 03/28/2024.

<sup>6</sup>"Cost of Capital and Capital Allocation, Investment in the Era of 'Easy Money'" Morgan Stanelly (2/28/2024)

<sup>7</sup>Bloomberg, Total Return 10/27/2015 through 4/23/2024 RCIIC vs. PIMIX.

<sup>8</sup>Bloomberg, Total Return 10/27/2015 through 4/23/2024 RCIIC vs. HYG.