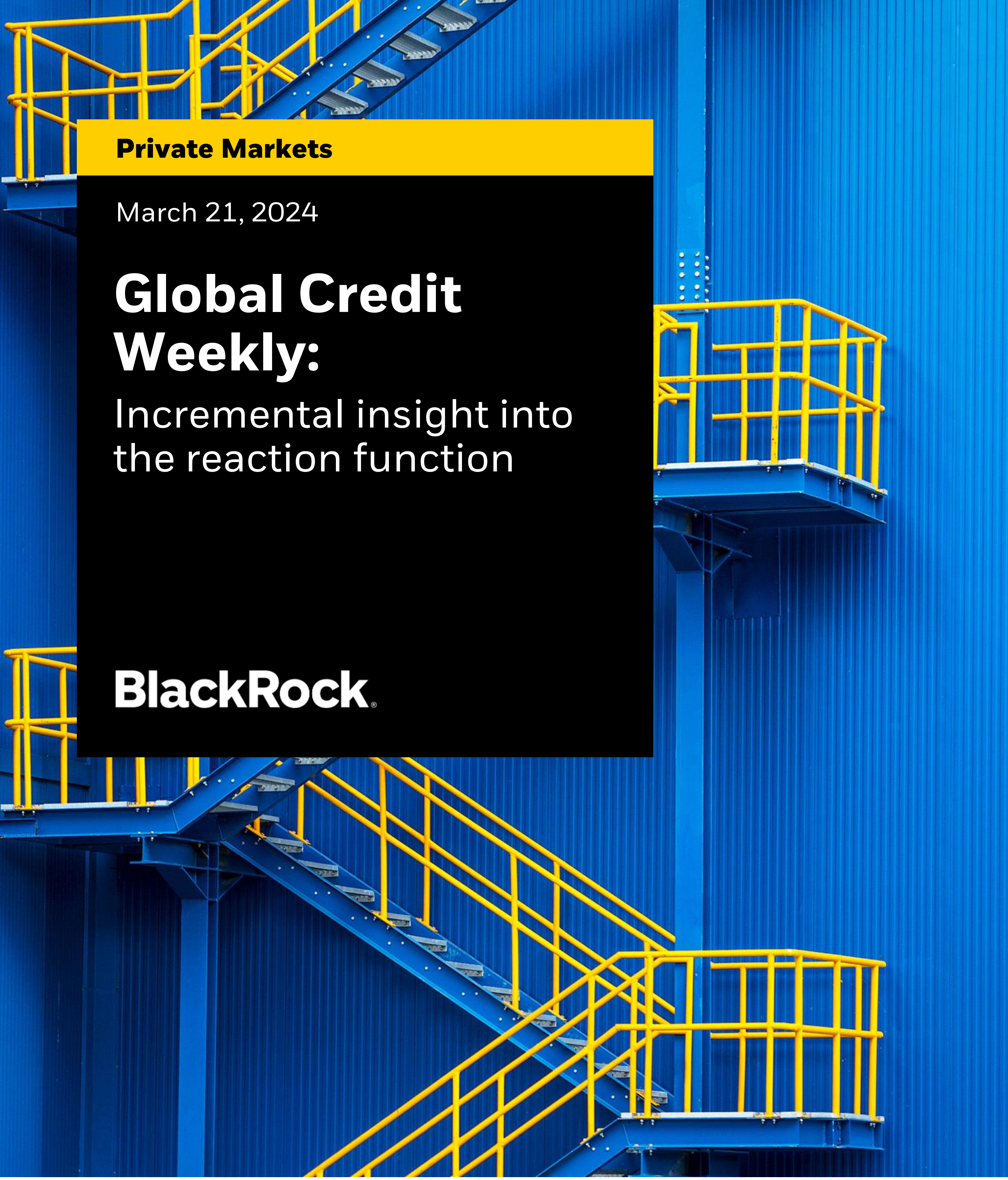

Private Markets

March 21, 2024

Global Credit Weekly:

Incremental insight into the reaction function

BlackRock

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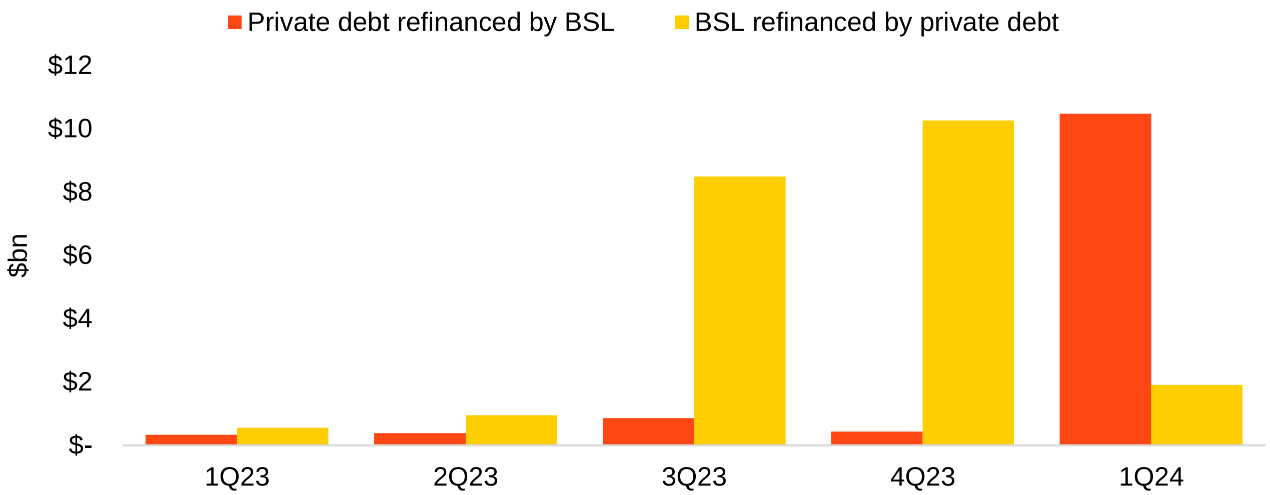
Key takeaways

- As was widely expected, the March FOMC meeting left the federal funds policy rate unchanged, at 5.25% - 5.5%. Despite a lack of movement on the policy rate, the refreshed quarterly Summary of Economic Projections provided incremental information related to the Federal Reserve's "reaction function". The March 2024 update reflected median forecasts for stronger GDP growth and higher core inflation in 2024 – but an unchanged projected policy rate for the same year.
- When asked whether the lack of a change in the median 2024 federal funds "dot" reflected an increased tolerance for higher inflation, Chair Powell stated that the Committee is "strongly committed to bringing inflation down to 2% over time…but we stress, over time." Chair Powell also warned against the risk of "dismissing data that you don't like," when highlighting a "bumpy" downward path for inflation. He added that "given the inflation data from January and February, it suggests we were right to wait until we were more confident" before starting a rate cutting cycle.
- A key support for risk assets was Chair Powell's reiteration in the prepared remarks that the "policy rate is likely at its peak for this tightening cycle" and that "it will likely be appropriate to begin dialing back policy restraint at some point this year." That said, he also noted that inflation risks warrant monitoring, and that the Committee is "prepared to maintain the current target range for the federal funds rate for longer, if appropriate." Our base case remains for the first Federal Reserve rate cut in 2H2024, with risks skewed earlier within that timeframe.
- Beyond investors' focus on monetary policy developments, market participants remain highly attuned to the ongoing structural evolution of the leveraged finance market – which in recent years has included private debt as a viable funding option for a range of borrowers, alongside the syndicated markets. In this *Global Credit Weekly*, we take stock of the mix-shift between the private and syndicated markets (Exhibit 1), which we expect will continue to ebb and flow over time, in response to market conditions, investor sentiment, and the macroeconomic backdrop.

Exhibit 1: The mix-shift between the private and syndicated markets will continue to vary
New issue broadly syndicated loan (BSL) and private debt takeout activity, in billions



Source: BlackRock, Pitchbook LCD. BSL represents broadly syndicated loans. 1Q24 data as of March 13, 2024.

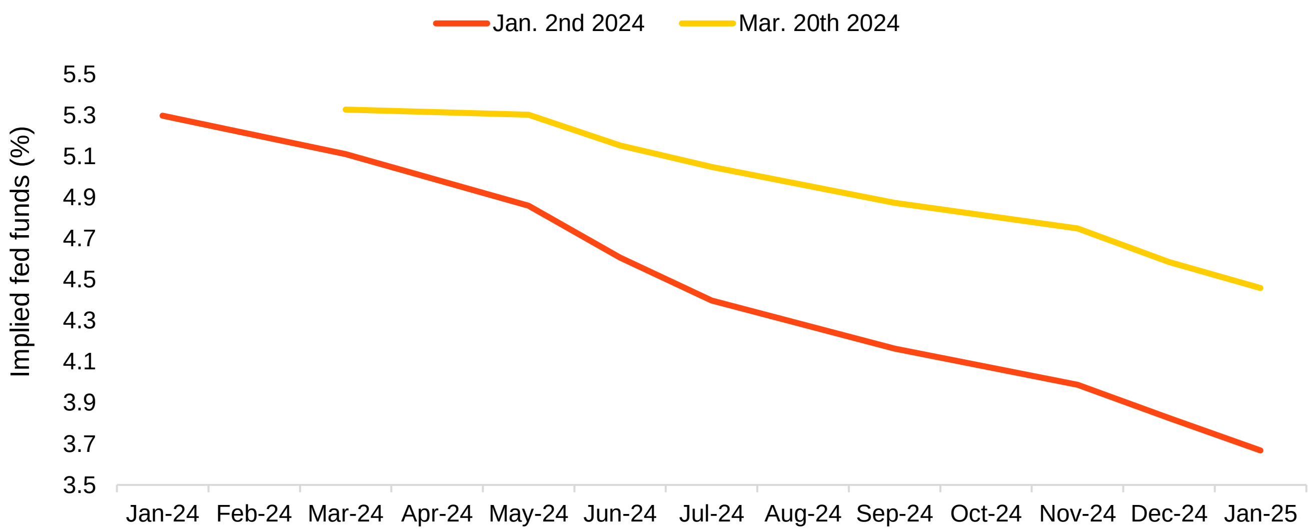
March FOMC recap: Shifts in projections, not policy rates

As was widely expected, the March FOMC meeting left the federal funds policy rate unchanged, at 5.25% - 5.5%. As illustrated in Exhibit 2, this outcome was highly anticipated and reflected in market pricing following Federal Reserve (Fed) Chair Jerome Powell's remarks at the last FOMC press conference on January 31st, when he noted that the Committee did not expect to cut the policy rate until it "has gained greater confidence that inflation is moving sustainably toward 2%," and reaching such a level of confidence in by the March meeting was unlikely. The prospect of near-term rate cuts was made even less likely by February's economic data, which included stronger than expected inflation prints (CPI and PPI).

But despite a lack of movement on the policy rate, the March 19th-20th FOMC still contained valuable information related to the Fed's "reaction function", partly in the form of a refreshed quarterly Summary of Economic Projections (SEP). Relative to the December 2023 SEP, the March 2024 update reflected median forecasts for stronger real GDP growth and higher core inflation in 2024 – but an unchanged projected policy rate for the same year (Exhibits 3 and 4).

Exhibit 2: Current market pricing reflects a later start to Fed rate cuts, vs. previously

The U.S. policy rate implied by federal funds futures, through early 2025



Source: BlackRock, Bloomberg.

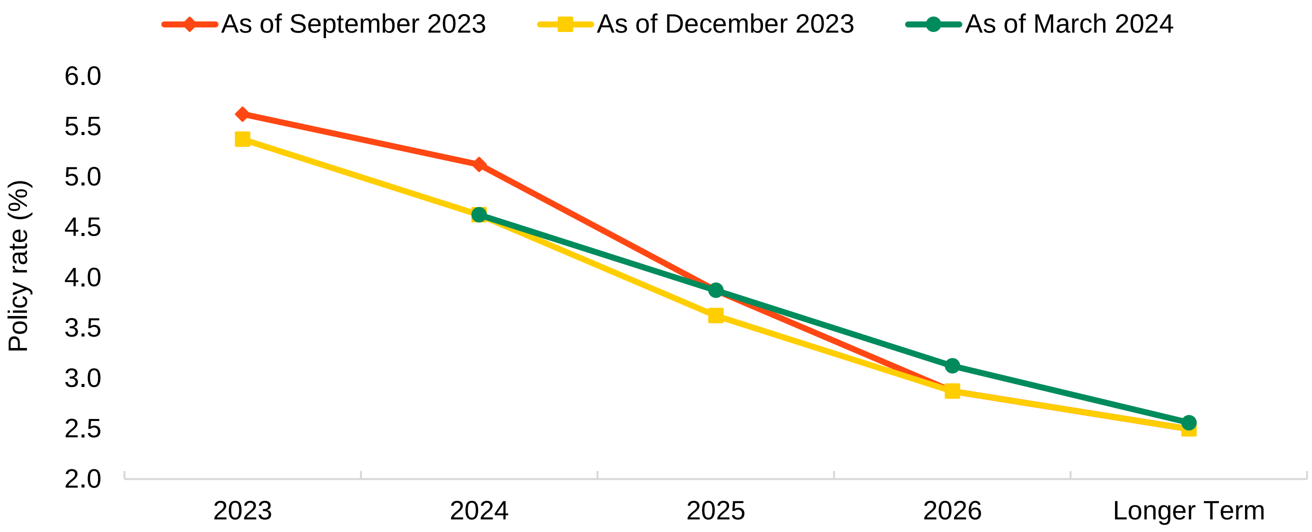
Exhibit 3: The March 2024 SEP reflected stronger growth and higher core inflation in 2024

Economic projections (median, %) of Federal Reserve Board members and Federal Reserve Bank presidents

	2024	2025	2026	Longer run
Real GDP growth	**2.1**	**2**	**2**	**1.8**
December 2023 projection	*1.4*	*1.8*	*1.9*	*1.8*
Unemployment rate	**4.0**	**4.1**	**4.0**	**4.1**
December 2023 projection	*4.1*	*4.1*	*4.1*	*4.1*
PCE inflation	**2.4**	**2.2**	**2.0**	**2.0**
December 2023 projection	*2.4*	*2.1*	*2.0*	*2.0*
Core PCE inflation	**2.6**	**2.2**	**2.0**	*not given*
December 2023 projection	*2.4*	*2.2*	*2.0*	
Federal funds rate	**4.6**	**3.9**	**3.1**	**2.6**
December 2023 projection	*4.6*	*3.6*	*2.9*	*2.5*

Source: BlackRock, Federal Reserve Summary of Economic Projections.

Exhibit 4: The 2024 median "dot" was unchanged in the March 2024 SEP, vs. December
FOMC median federal funds rate projections, as of the September 2023, December 2023 and March 2024 FOMC meetings



Source: BlackRock, Bloomberg, Federal Reserve Summary of Economic Projections.

Importantly, the SEP is not an official forecast (or expected plan of action) from the Committee. Rather, the SEP captures each participant's projections for real GDP, unemployment, and inflation for 2024 – 2026. It also includes their projections for the appropriate path for the federal funds rate. Tracking the path of the median participant is a market wide convention and can be informative, at least directionally.

As shown in Exhibit 3, the median 2024 real GDP growth forecast was raised to 2.1% in the March 2024 SEP – a meaningful upgrade from the 1.4% projected in the December 2023 SEP, driven by strength of the incoming data (including data on labor supply). This forecast compares to 3.1% *actual* real GDP growth in 2023. The median projection for 2024 core inflation was raised to 2.6%, from 2.4% as of the December SEP.

As referenced earlier, despite these upward revisions to growth and inflation, the median 2024 "dot" – which reflects the median participant's forecast for the 2024 federal funds rate – was left unchanged, at 4.6% (again, Exhibits 3 and 4). Over the longer term, the median 2025 and 2026 "dots" were each shifted 25bp higher, to reflect one less 25bp cut in 2025. The median longer-run value for the federal funds rate was also raised slightly (again, Exhibit 3).

Key takeaways from the March FOMC press conference:

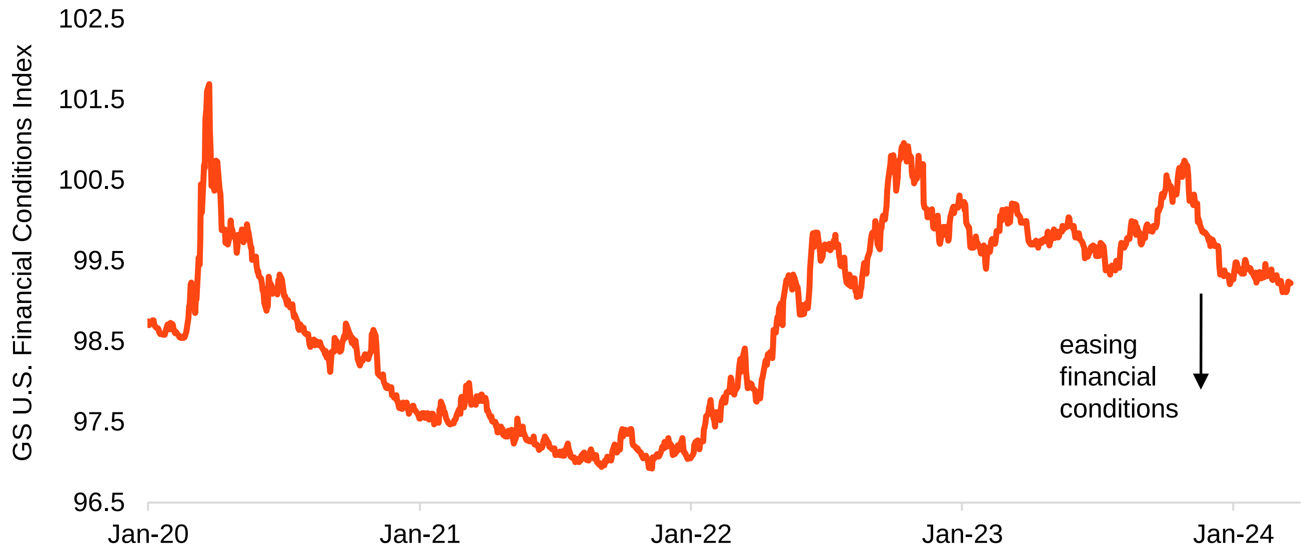
- **A likely peak for policy rates:** In his prepared statement, Chair Powell said that the "policy rate is likely at its peak for this tightening cycle and that, if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year." That said, he also noted that inflation risks warrant monitoring, and that the Committee is "prepared to maintain the current target range for the federal funds rate for longer, if appropriate."
- **Additional "confidence" is still required:** Chair Powell reiterated his message from the January FOMC, stating that "the Committee wants to see more data that gives us higher confidence that inflation is moving down sustainably to 2%." He also stated that "an unexpected weakening in the labor market could…warrant a policy response" to begin the process of reducing rates.
- **The 2% inflation target remains intact, but "over time" was stressed:** When asked whether the lack of change in the median 2024 "dot" – despite stronger growth and higher inflation forecasts - reflected an increased tolerance for higher inflation, Chair Powell stated that the Fed is "strongly committed to bringing inflation down to 2% over time…but we stress, over time."

March FOMC press conference takeaways (continued)

- **A "bumpy" path for inflation:** When asked about the recent strength in inflation data in January 2024 – and, to a lesser extent, February 2024 – Chair Powell warned against the risk of "dismissing data that you don't like," even if seasonal adjustments were largely behind the January strength. He said the Committee does not know "whether this is a bump in the road or something more," but that strength in the economy and labor market, alongside progress on inflation over a longer-term trend, "give us the ability to approach this question carefully." Chair Powell also mentioned that "given the inflation data from January and February, it suggests we were right to wait until we were more confident" before starting a rate cutting cycle. That said, he noted that the overall "story" that "inflation is coming down gradually on a sometimes-bumpy path" toward 2% remains intact.
- **The labor market "remains relatively tight":** Chair Powell noted that while the labor market "remains relatively tight," supply and demand conditions continue to come into better balance – a pattern the Committee expects to continue. While labor demand continues to exceed labor supply, nominal wage growth has been easing, and job vacancies have declined. Despite a solid three-month average pace of job creation (+265k per month) the unemployment rate recently increased to 3.9%, owing in part to a greater supply of workers (referencing both participation and immigration). Chair Powell said that strong job growth, in and of itself, is not a reason to be concerned about inflation or hold off on rate cuts.
- **A higher terminal rate:** During the press conference, Chair Powell referenced some longer-term forces which kept rates "very low" in the post-financial crisis era, and noted that he does not expect rates to retrace to those low levels in this cycle.
- **Balance sheet run-off:** Chair Powell said the Committee believes "it will be appropriate to slow the pace of runoff fairly soon," which would "help ensure a smooth transition, reducing the possibility that money markets experience stress and thereby facilitating the ongoing decline in our securities holdings consistent with reaching the appropriate level of ample reserves."
- **Financial conditions:** When asked whether the recent easing in financial conditions (Exhibit 5) posed an obstacle to the Fed's inflation fight, Chair Powell did not suggest there was a conflict. Rather, he noted that "financial conditions are weighing on economic activity," pointing to easing in certain demand-side labor market indicators (i.e., job openings, quits, surveys, hiring rate).

Exhibit 5: U.S. financial conditions have eased since late 2023

Goldman Sachs U.S. Financial Conditions Index



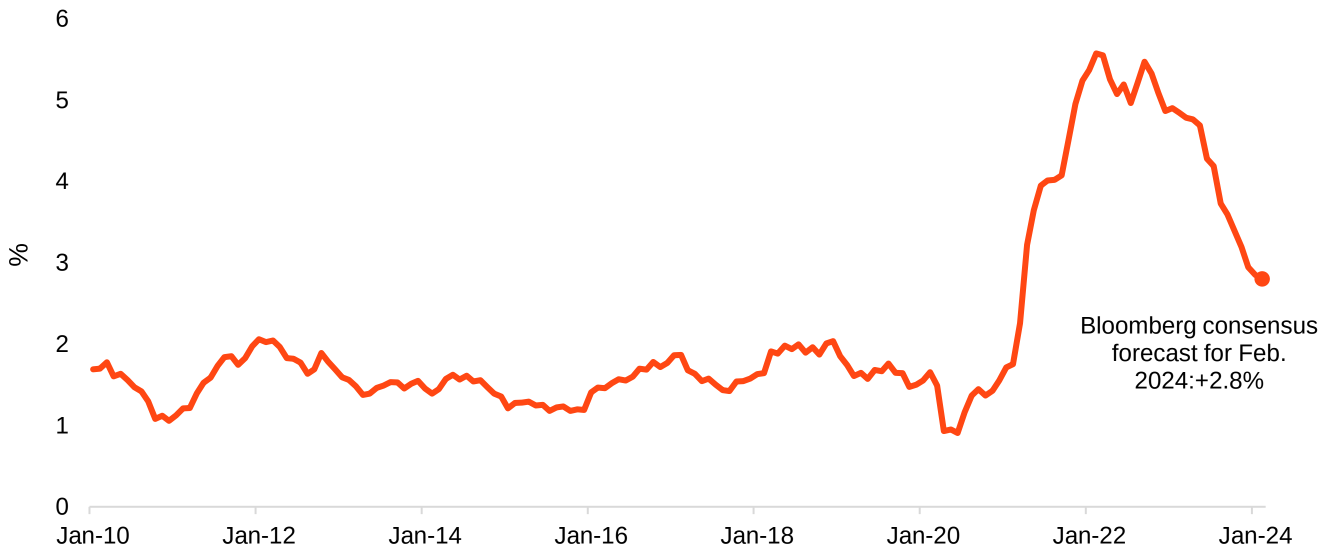
Source: BlackRock, Bloomberg, Goldman Sachs Global Investment Research. As of March 18, 2024.

Looking under the surface of aggregate inflation

While PCE is the Fed's "preferred" inflation gauge, the recent strength in CPI and PPI is notable given the "totality of data" the Fed often references. February PCE data is scheduled to be released on March 29th, although Chair Powell seemingly previewed it during the March FOMC press conference by saying February core PCE was "well below 30bp" which is "not terribly high."

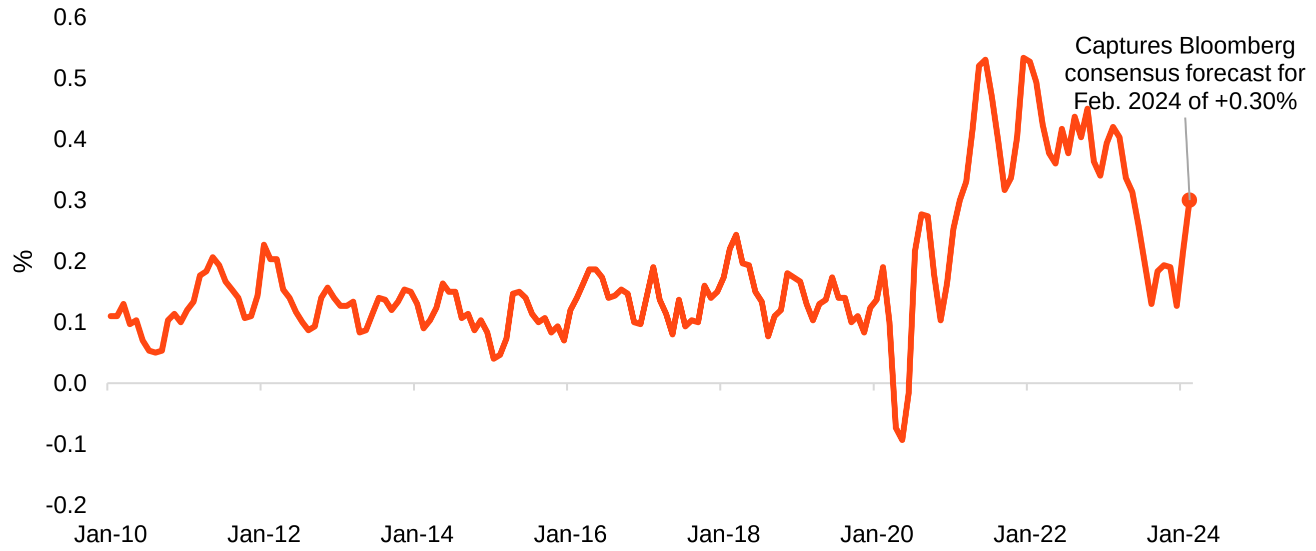
Exhibits 6 and 7 illustrate the trend of core PCE over two different time horizons. A sustained reacceleration in inflation data – to the extent the trend shown in Exhibit 7 persists – is the key downside risk for asset valuations, in our view.

Exhibit 6: The progress on the inflation fight is clearly visible on a year-over-year basis
U.S. Core Personal Consumption Expenditure (PCE), year-over-year change (%)



Source: BlackRock, Bureau of Economic Analysis, Bloomberg. Captures actual data through January 31, 2024 (most recent available), and Bloomberg consensus forecast (as of March 18th) for February 2024. Actual February 2024 data will be released on March 29, 2024.

Exhibit 7: Certain higher-frequency measures have shown some strength, however
U.S. Core Personal Consumption Expenditure (PCE), 3-month moving average of the month-over-month change (%)



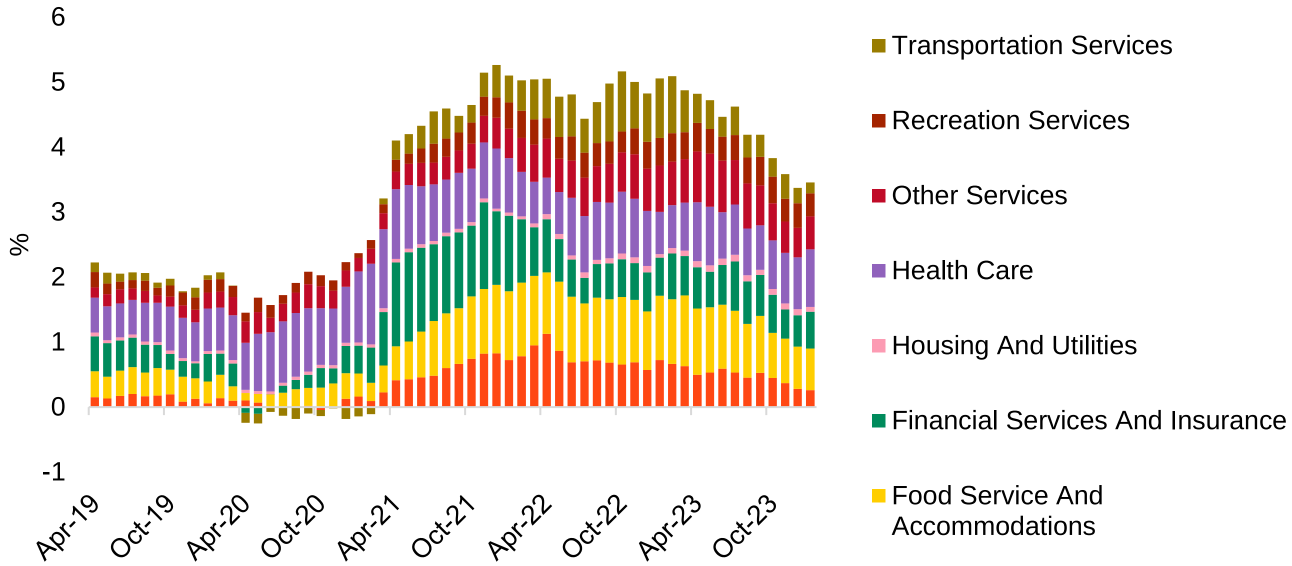
Source: BlackRock, Bureau of Economic Analysis, Blomberg. Captures 3-month moving averages using actual data through January 31, 2024 (most recent), and Bloomberg consensus forecast (as of March 18th) for February 2024. Actual February 2024 data will be released on March 29, 2024.

Additionally, as Exhibits 8 and 9 highlight, there are various components to aggregate inflation measures. At the March FOMC press conference, Chair Powell noted that "inflation has eased substantially while the labor market has remained strong," but that "inflation is still too high, ongoing progress in bringing it down is not assured, and the path forward is uncertain."

Chair Powell noted uncertainty about the timing of improvements in housing inflation, but cited confidence that lower current market rents will eventually flow through to overall housing services inflation. In order to get inflation back down to 2% sustainably, Chair Powell also said he would like to see a moderation in the pace of wage increases, given that wages are a key input into some types of services inflation.

Exhibit 8: Several categories make up "Supercore" inflation

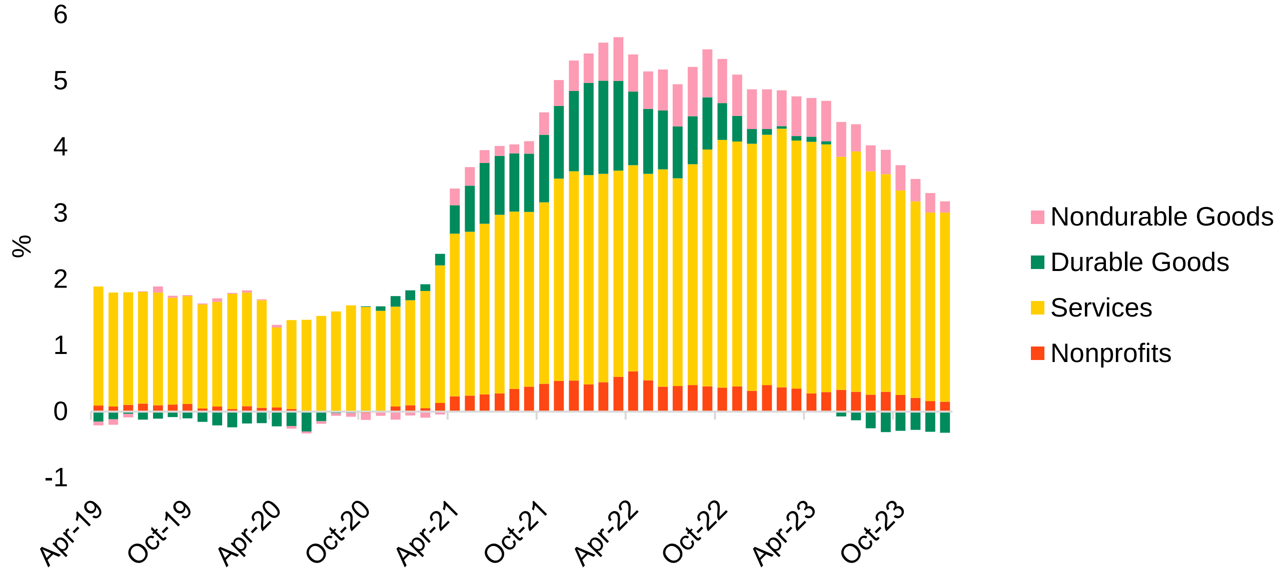
Contribution by category to year-over-year U.S. "Supercore" PCE (i.e., Core Services ex-Housing)



Source: BlackRock, Bloomberg, Bureau of Economic Analysis. Captures actual data through January 31, 2024 (most recent).

Exhibit 9: Progress on Services inflation will be key to lowering overall inflation, in our view

Contribution by category to year-over-year U.S. Core PCE (i.e., Headline PCE ex-Food and ex-Energy)



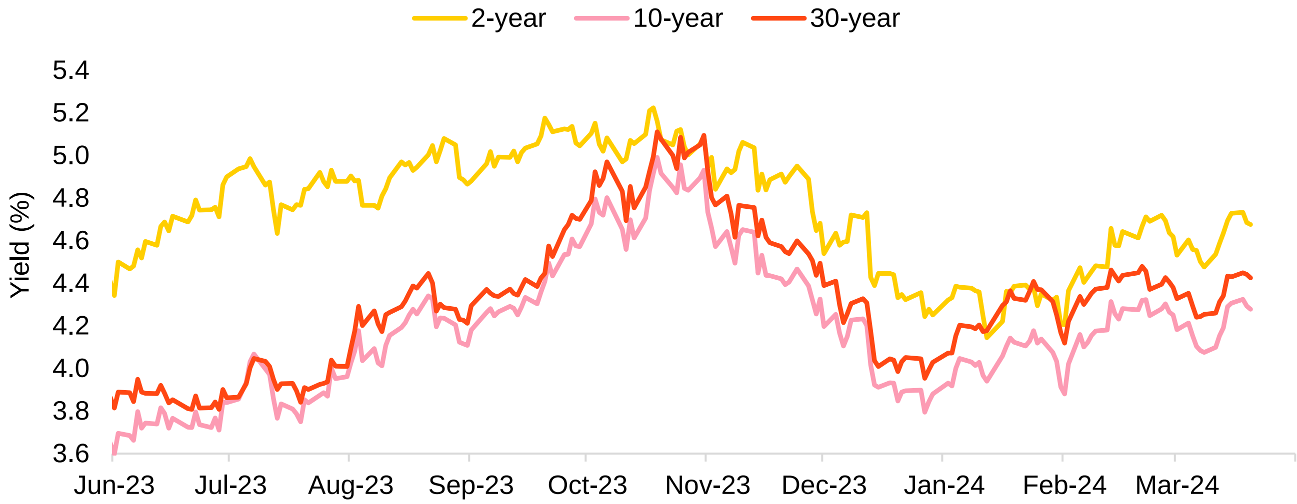
Source: BlackRock, Bloomberg, Bureau of Economic Analysis. Captures actual data through January 31, 2024 (most recent). .

The implication for asset allocation

With rate cuts "delayed", some asset allocators in corporate credit may consider tactical increases in exposures to floating rate assets – in both liquid and private debt markets. As we outlined last week, the carry differential between floating rate leveraged loans and fixed rate high yield (HY) bonds, for example, was hovering at the high end of the historical range. And as shown in Exhibit 10 below, both leveraged loans and HY bonds have outperformed their IG rated peer group, which has a longer duration (and greater sensitivity to interest rates).

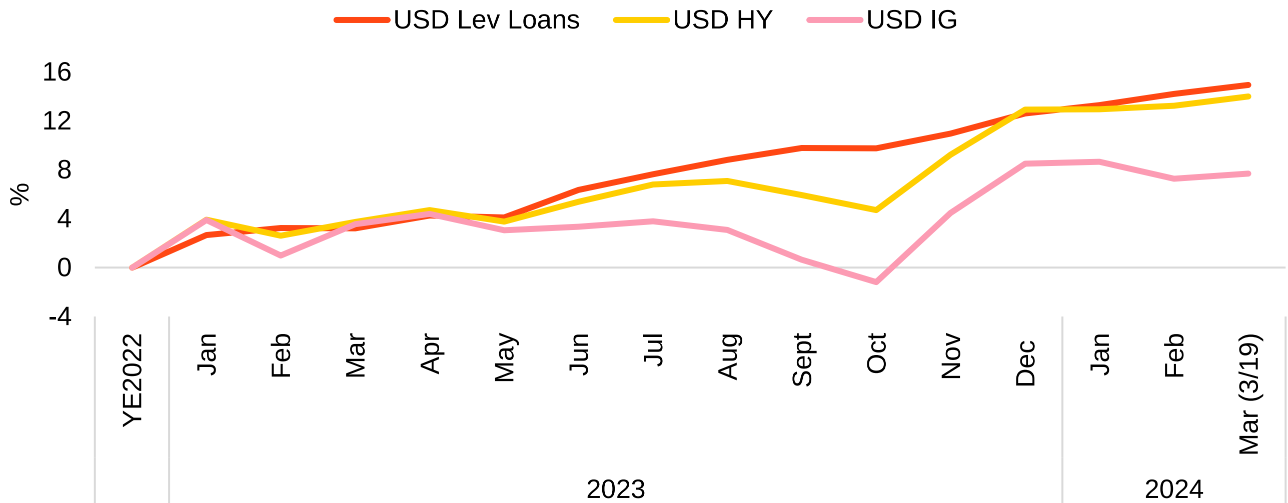
While a "high-for-longer" cost of capital environment poses fundamental pressure for some floating rate borrowers with limited financial flexibility (who may have been relying on prospects for near-term rate relief), this is somewhat mitigated, in our view, by the solid economic backdrop in the U.S. and receptive capital markets, as we have discussed on previous occasions.

Exhibit 10: U.S. rates are well off the local troughs of early 2024
Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)



Source: BlackRock, Bloomberg. As of March 20, 2024.

Exhibit 11: Longer-duration asset classes have lagged recently, on a total return basis
Cumulative monthly total returns (%) for the Morningstar/LSTA USD Leveraged Loan Index, the ICE-BAML USD HY Corporate Index, and the ICE-BAML USD IG Corporate Index



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD, ICE-BAML, Bloomberg. Captures data through March 19, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Private debt: a viable alternative within the leveraged finance landscape

Beyond investors' focus on recent monetary policy developments, another topic that remains top of mind for many market participants is the structural evolution of the leveraged finance market – which has shifted meaningfully in the last five years.

For context, global private debt assets under management (AUM) have doubled since 2019, reaching $1.7 trillion as of June 2023, according to Preqin (the most recent available). As detailed in our late 2023 Private Debt Primer, we see potential for private debt AUM to reach $3.5 trillion by YE2028.

At this size, private debt is now a sizable and scalable "stand alone" asset class. For example, third party data providers such as Preqin track private debt investment allocations (as a percentage of total assets), alongside allocations to private equity and real estate, among other asset classes. And as the asset class has grown, the "overlap" with the addressable market of borrowers served by the syndicated markets has also increased. As we highlighted recently (please see: Private debt: Exploring the nuances for more), private debt's addressable market opportunity now encompasses larger borrowers, loosely defined as those with an annual EBITDA of $75-$150 million (or, at times, greater).

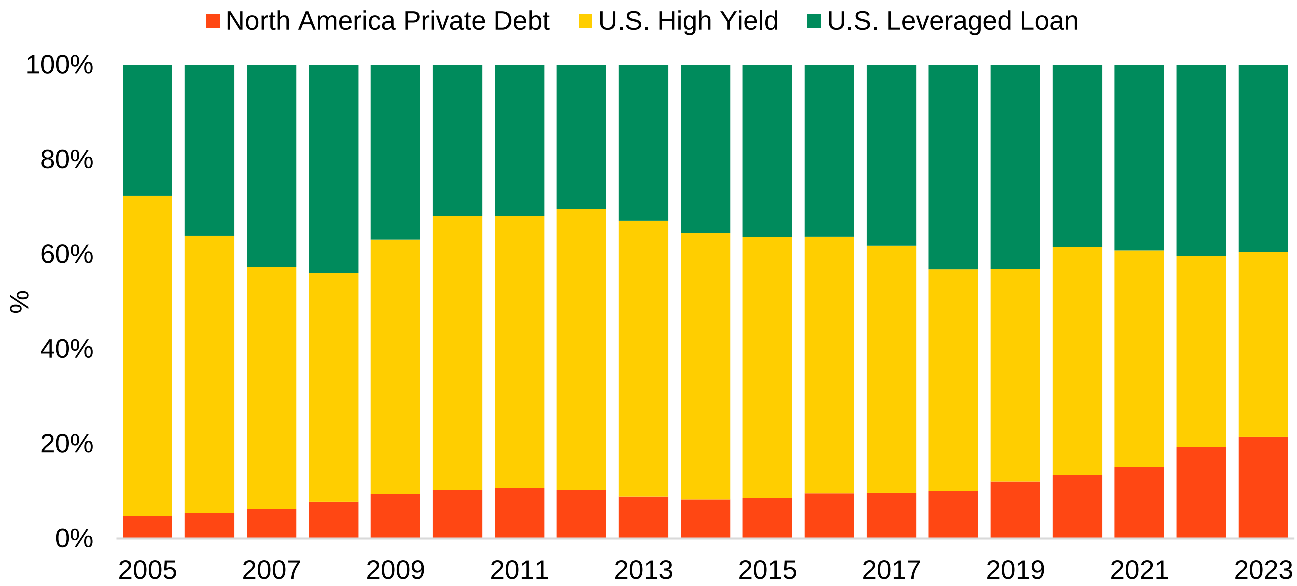
Private debt grows its share of the leveraged finance "funding pie"

As Exhibit 12 illustrates, private debt has grown its share of the leveraged finance "funding pie" – a trend we also illustrated in our late 2023 Private Debt Primer.

The outstanding par amount of the U.S. leveraged finance syndicated market – which includes leveraged loans and HY bonds – has held steady in recent years hovering between $2.7 and $2.9 trillion since 2021, according to data by Bloomberg and Pitchbook LCD. Barclays Research estimates that private debt has captured approximately $150 billion of supply from the U.S. syndicated market between 2019 and 2022[1].

It's worth noting, however, that *many* forces impact the outstanding par amounts of syndicated markets. For example, an increase in the quality of HY bonds has led to a migration up the rating spectrum, into the investment grade universe, thus helping to decrease the notional size of the HY market.

Exhibit 12: Private debt represents a growing share of borrowers' funding options
Share of U.S. leveraged finance market (public and private) by type, based on outstanding par amounts



Source: Blackrock, Preqin, Bloomberg, Pitchbook LCD. Private debt includes North America unrealized value and excludes dry powder. High Yield (captured by Bloomberg USD HY Corporate Index) and Leveraged Loan (captured by Morningstar/LSTA USD Leveraged Loan Index) include index outstanding par amounts. Includes only debt that is index eligible. As of year–end, except 2023 which is as of June 30, 2023.
1) Please see "Private Credit: Bridging the transatlantic divide, published on 29 February 2024."

The mix-shift between new issue activity will likely continue to vary

In recent years, the mix-shift between syndicated and private debt new issue activity has varied over time – a trend we expect to continue.

Exhibit 1 illustrates this clearly using data from Pitchbook LCD, highlighting a significant increase in the refinancing of syndicated loans into private debt in 2H2023. However, this trend reversed in 1Q2024, as borrowers chose to refinance private debt into syndicated loans (again, Exhibit 1). This refinancing activity is known as a “takeout” because the borrower will issue new debt to “take out” its existing debt.

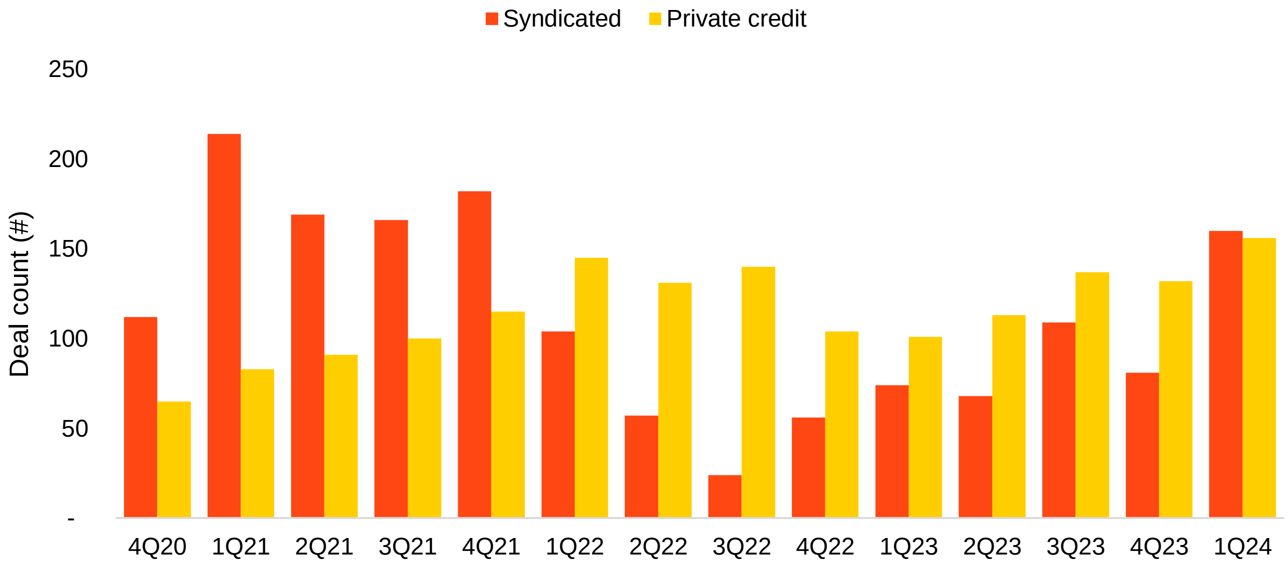
In our view, this reversal in takeout activity reflects, to some extent, the idea that the two markets (syndicated and private) can sometimes act as “substitutes” for one another. This is a departure from historical norms when the asset class of private debt was much smaller in size and scope and was generally reserved for more niche financing situations.

We expect debt markets will continue evolving as borrowers seek to optimize their capital structures to meet their needs. For example, a borrower may pair syndicated first-lien debt with a private debt mezzanine solution to capture the benefits of borrowing from both markets.

Exhibit 13 highlights the mix-shift between public and private markets yet another way, using deal counts sourced from Pitchbook LCD. As shown below, for most of 2021, the syndicated loan market outpaced its private loan peer in non-LBO (leveraged buyout) funding by deal count. But in 2022, the pattern shifted (shown by the yellow bars outpacing the red), as private financings outpaced their public counterparts. More recently, the "gap" between private and public financing activity has closed in 1Q2024 (to date).

The reasons behind these types of shifts are often nuanced and multi-faceted. For example, volatility in syndicated markets may act as a situational factor and incentivize borrowers to seek private funding, because of the clarity on price and certainty of execution that private lenders can provide. As another example, a borrower may choose the private market to keep proprietary information confidential, or to avoid lengthy investor roadshows or rating agency processes. Alternatively, some borrowers may feel that they are “ready” to become a public markets issuer and may see more favorable economics (depending on the market tone) in the public markets. We expect the mix-shift between these markets will continue to ebb and flow, over time, depending on the macroeconomic backdrop and market sentiment.

Exhibit 13: Non-LBO deal count is evening in 1Q2024, as syndicated activity ticks up
Count of non-LBOs financed in broadly syndicated loan versus private credit markets

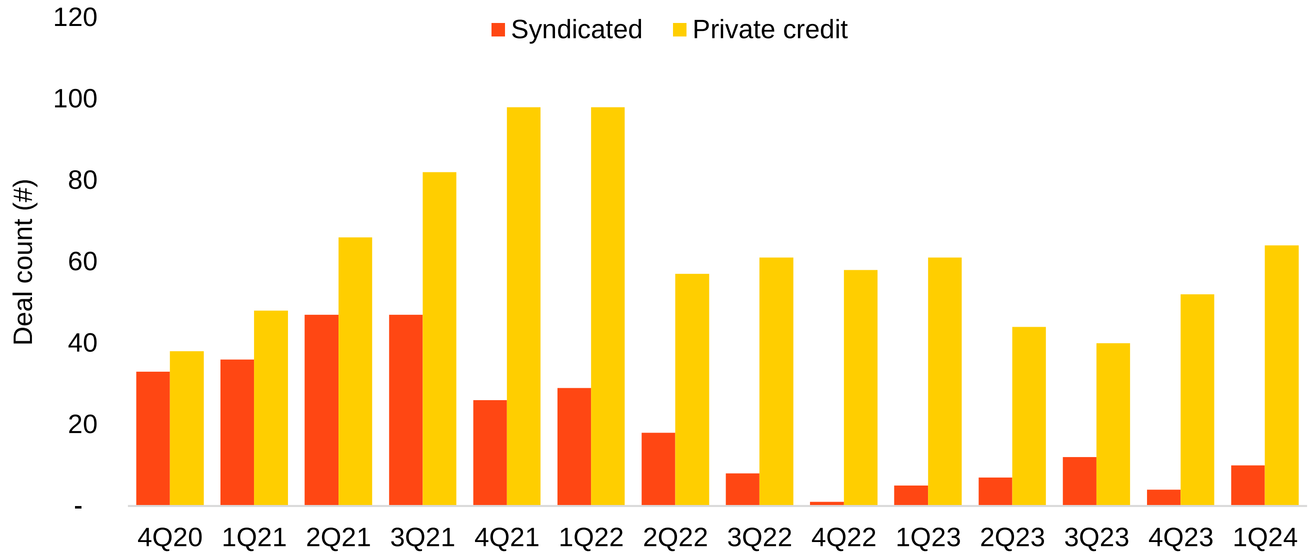


Source: BlackRock, Pitchbook LCD. Private credit count is based on transactions covered by LCD News. 1Q24 is as of March 18, 2024.

Exhibit 14 shows that private credit is still the dominant force for funding LBO activity. That said, overall sponsor-related transactions in the M&A market have been low in recent quarters, as shown by Exhibit 15, leaving this indicator as unlikely to capture the full dynamics of the financing environment, in our view.

Exhibit 14: Private credit continues to dominate LBO financing, by deal count

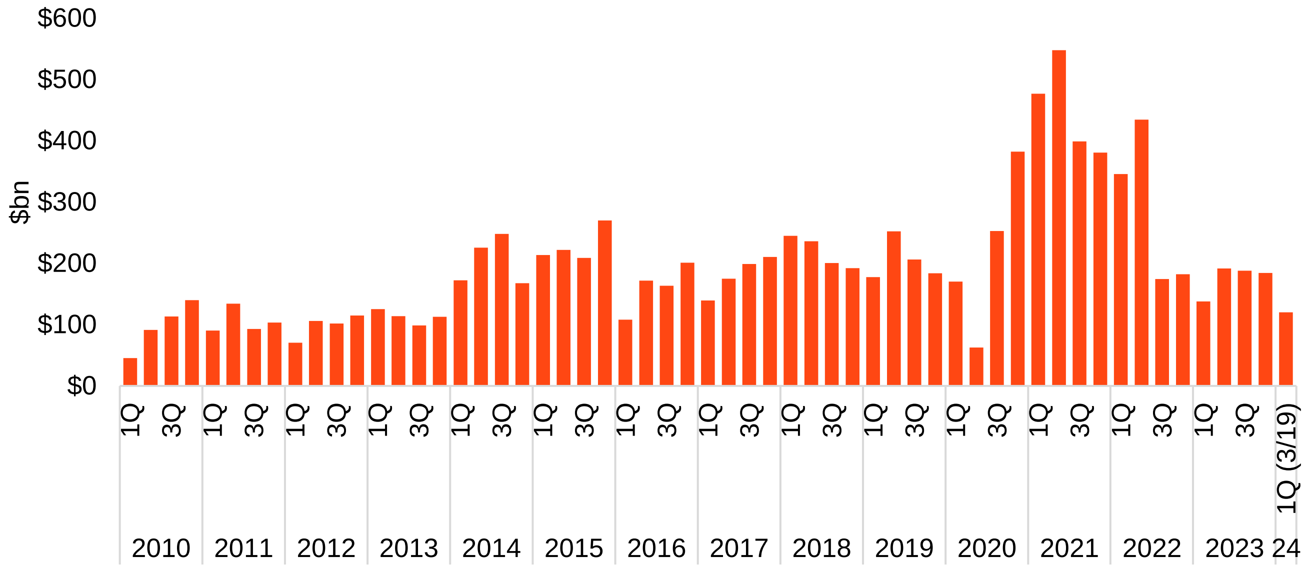
Count of LBOs financed in broadly syndicated loan versus private credit markets



Source: BlackRock, Pitchbook LCD. Private credit count is based on transactions covered by LCD News. 1Q24 is as of March 18, 2024.

Exhibit 15: Sponsor transaction activity remains low

Sponsor-related transaction activity (captures deal values of $100 million or more, at announcement) among North American and European firms



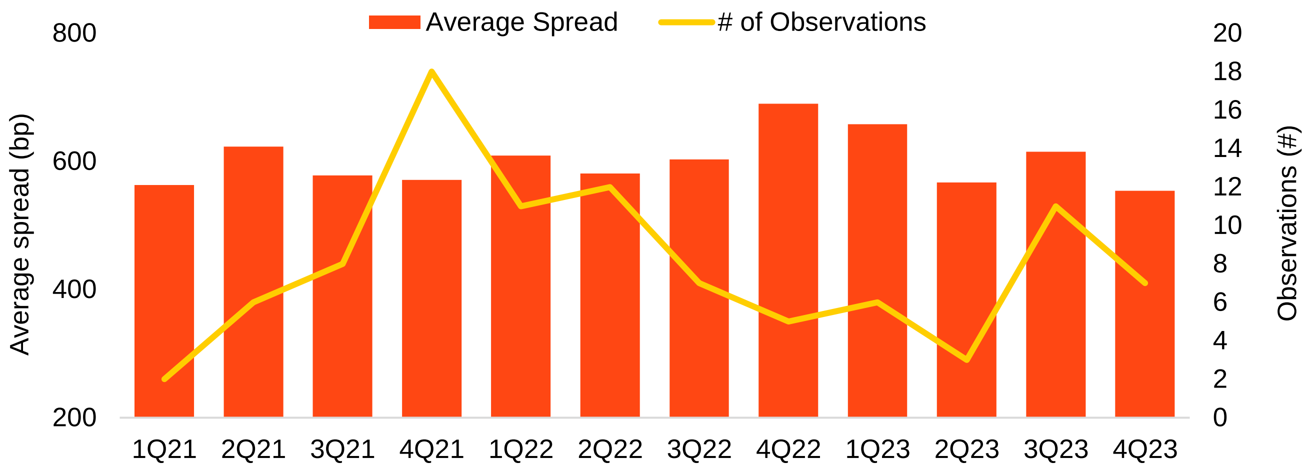
Source: BlackRock, Dealogic. 1Q2024 is as of March 19, 2024. Note: A transaction is classified by Dealogic as a sponsor-related deal, if a sponsor is involved on either side of the transaction (i.e., as a buyer or a seller). Excludes canceled and withdrawn deals.

Competition encourages tighter pricing – especially for larger loans

Competition between syndicated and private markets, coupled with ample private debt dry powder, has encouraged tighter pricing, especially for larger borrowers who have access to both markets (again, loosely defined as those with an annual EBITDA of $75 to $150 million). Jumbo private loans (i.e., at least $1 billion in size), are an example of those generally eligible for both private and public markets (where size and liquidity for index inclusion is often a consideration). Average spreads on new issue jumbo loans fell to S+554bp in 4Q2023, according to KBRA DLD (Exhibit 16). Notably, elevated base rates allow lenders some flexibility to compete on pricing without compromising too much on overall yield. Exhibit 17 illustrates how new issue yields have tightened across all markets following the re-opening of syndicated markets in late 2023, according to data by KBRA DLD and Pitchbook LCD.

Exhibit 16: Quarterly average new issue spreads for jumbo loans declined 61 bp in 4Q2023

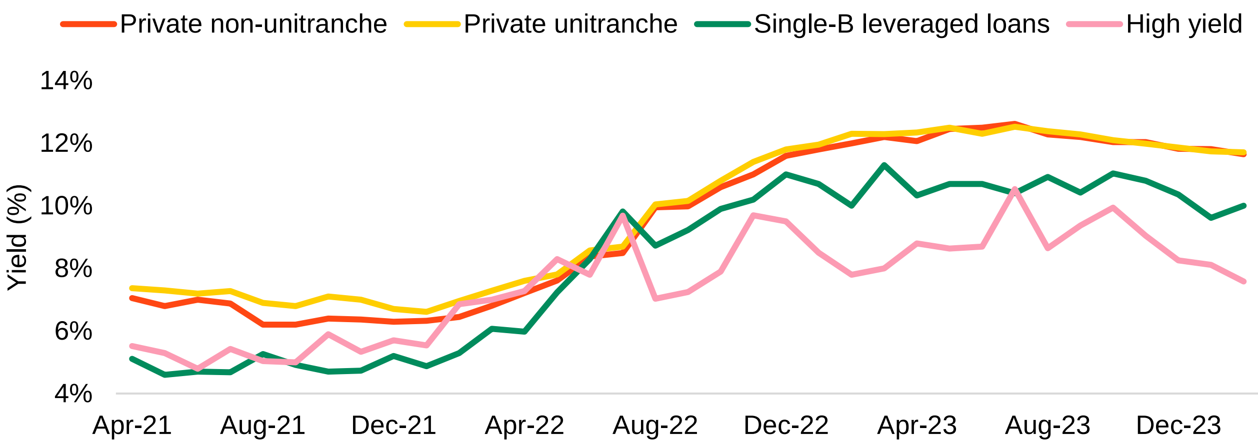
Quarterly average new issue spreads for private jumbo loans, in bp



Source: BlackRock, KBRA DLD, public filings. As of December 31, 2023. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 17: New issue yields have moved tighter

3-year yield-to-call for private and yield-to-maturity for syndicated, in percent

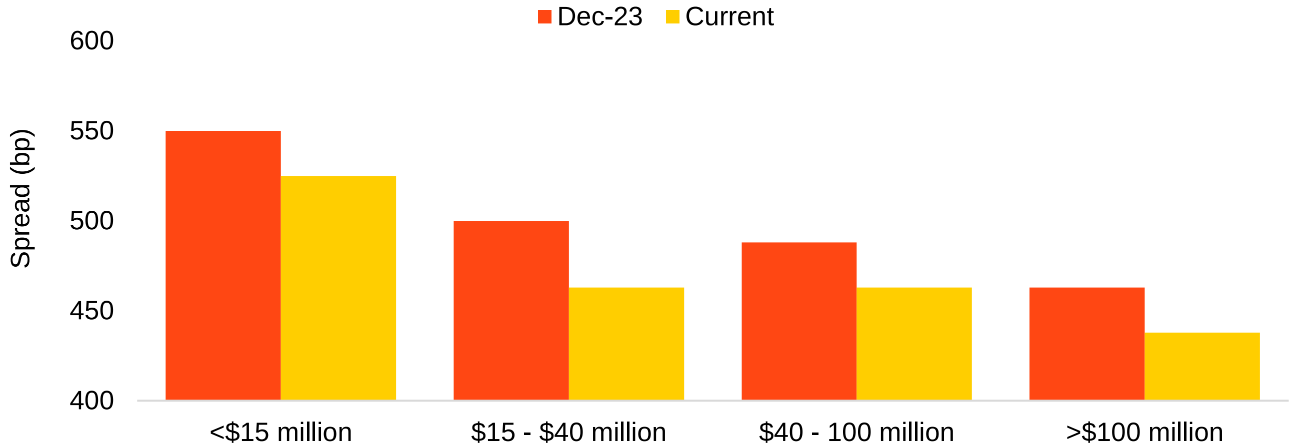


Source: BlackRock, KBRA DLD Private Data, Pitchbook LCD. Private non-unitranche spreads are 1L only and reflect buyout financing only, other proceed types are excluded; Unitranche averages include all proceeds. KBRA DLD defines unitranche as loans with >=4.5x senior leverage. Reference rate for DLD yields is CME Group's 3M Term SOFR, beginning in January 2022. Single-B leveraged loans and high yield includes 90-day rolling averages for 3-year yield to maturity, using a blended LIBOR/SOFR rate provided by IHS Markit. As of February 29, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Lincoln International, whose Proprietary Private Markets Database includes approximately 5,000 U.S. operating companies and represents over $175 billion of privately held principal and invested capital (primarily by private equity sponsors), notes that while competition with syndicated markets is generally contained to larger financings, competitive pricing terms have flowed through to smaller borrowers, too (Exhibit 18). Lincoln cites low LBO activity and ample private debt dry powder as key factors driving pricing tighter.

Beyond pricing, competition has also fueled an uptick in leverage, according to data captured by Lincoln. Even so, leverage metrics remain below 2021 levels, with lenders focused on underwriting to a "higher-for-longer" rate environment.

Exhibit 18: New issue spreads have tightened across all size categories
Spreads for new issue cash flow senior loans by EBITDA size, in bp



Source: Blackrock, Lincoln international Valuations & Opinions Group Proprietary Private Markets Database. Current is as of March 18, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Unless otherwise stated, all reference to $ are in USD.

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