

Credit Currents:

Insights across public and private credit

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Topics in this piece:

Private credit
Performance

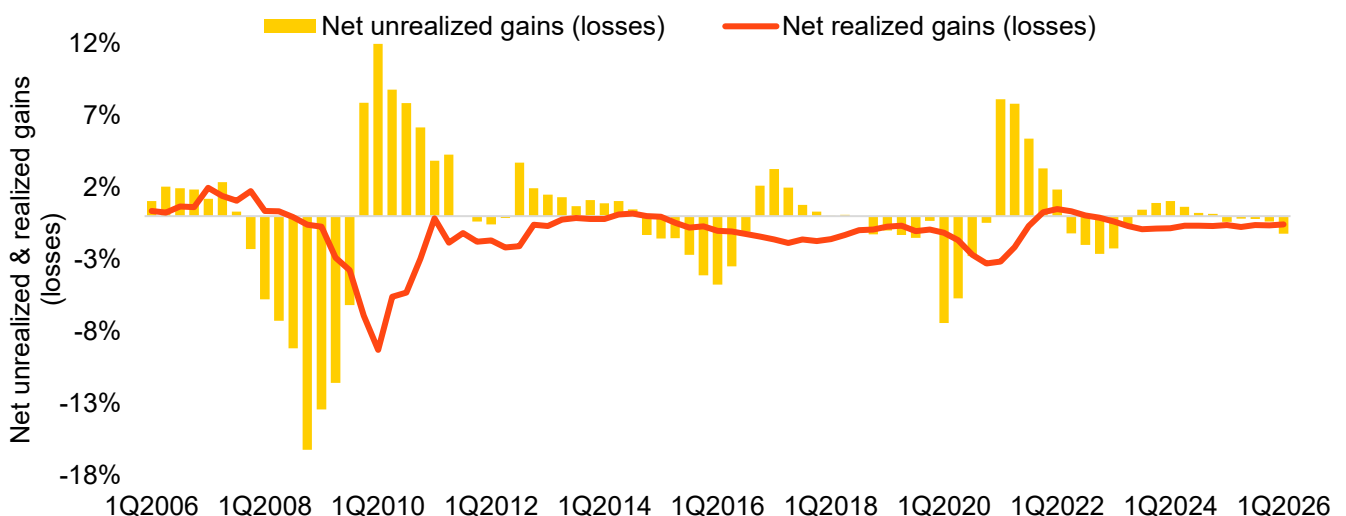
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Exploring the durability of private credit returns

- 1. Private credit market conditions remain competitive, but increasingly nuanced.** Spreads remain near the tighter end of their historical range, though some dispersion is emerging across borrower cohorts. Slower deal activity, especially among sponsor-backed borrowers, is likely also supporting spread stability.
- 2. Income remains the anchor of direct lending performance.** While interest income has moderated from 2023 highs, it remains attractive relative to realized losses.
- 3. Credit stress signals are rising, but outcomes are likely to become more differentiated.** Unrealized losses point to some normalization of realized loss levels, with stress concentrated in select borrower cohorts, including parts of the software sector where growth, margin durability, and AI-related disruption risks are under greater scrutiny.
- 4. That said, stress signals such as unrealized losses and defaults do not translate one-for-one into fund-level return impairment,** underscoring the importance of portfolio construction, asset selection, and manager workout capabilities.

Exhibit 1: Unrealized losses have historically been more volatile than realized losses

Trailing 4 quarter net unrealized and realized gains (losses)



Source: Cliffwater Direct Lending Index, BlackRock. As of 1Q2026. Performance data represents past performance, which does not guarantee future results.

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Exploring the durability of private credit returns

Private credit investors are increasingly focused on two related questions: what opportunities are available in today’s market and whether returns can remain sustainable as credit conditions normalize.

While the asset class has delivered strong performance in recent years, supported by elevated base rates, resilient borrower fundamentals, and relatively low realized losses, market conditions continue to evolve. As a result, investors are increasingly evaluating how higher credit stress may affect future returns.

In this *Credit Currents*, we use the latest available private credit data to assess both the current underwriting environment and the health of existing portfolios. We begin with an overview of underwriting conditions, including spread dynamics and deal activity. We then examine the relationship between interest income and credit losses, discuss the recent increase in unrealized losses and areas of concentrated stress, including software investments, and conclude with an assessment of how defaults ultimately affect fund-level returns.

We expect that dispersion will remain a defining feature of the asset class in the quarters ahead. In this environment, manager selection is likely to become increasingly important, with portfolio construction, origination capabilities, and workout expertise playing a critical role in differentiating outcomes.

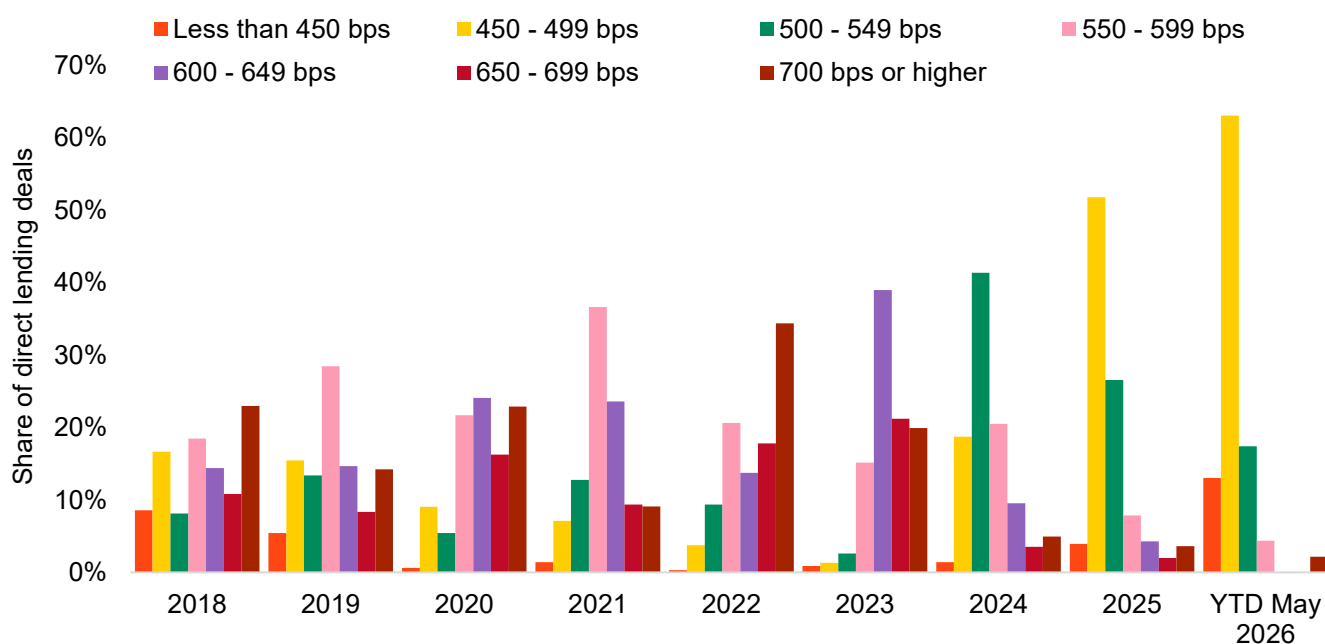
Private credit pricing remains stable, though dispersion is emerging

Consistent with the broader theme of elevated dispersion, underwriting conditions in private credit remain broadly stable, though trends vary across market segments. In aggregate, spreads remain near the tighter end of their historical range. This resilience has been supported by still-elevated base rates, strong dry powder levels, a slowdown in deal activity, and healthy risk appetite across both private and public credit markets.

Exhibit 2 shows new-issue spread distributions for leveraged buyout (LBO) financings in the U.S. direct lending market. While spreads have historically exhibited considerable variation, most transactions in 2025 and year-to-date 2026 have priced within a relatively narrow range of 450-499 basis points.

Exhibit 2: Deals priced from 450-499 basis points have represented over 60% of YTD activity

New-issue spread distribution of LBOs financed in the U.S. direct lending market



Source: Pitchbook LCD, BlackRock. YTD captures data as of May 31, 2026. Data reflects senior secured loans and unitranche facilities. From 2026 onward, direct lending spread data includes privately sourced values alongside those from LCD News, BDC filings, and other public sources.

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Private credit pricing remains stable, though dispersion is emerging (continued)

Beneath the surface, however, dispersion has begun to emerge. As shown in Exhibit 3, spreads for lower middle market and core middle market sponsor-backed borrowers have remained notably steady, even as some widening has emerged among larger borrowers¹.

An analysis from Cliffwater provides one possible explanation for this divergence, suggesting that some lenders active in larger-borrower financings may be managing liquidity and deployment more selectively, particularly where vehicles have greater exposure to wealth-channel flows.

That said, we expect a healthy, though selective, risk appetite in the broadly syndicated loan (BSL) market to help keep terms relatively stable for larger borrowers, which often have access to both private and public credit markets.

Reduced supply has likely supported spread stability, despite more selective lender risk appetite

Limited deal activity has likely also contributed to the relative stability in private credit spreads, in our view. Exhibits 4 and 5 (next page) show that direct lending activity has slowed in recent months from the elevated levels in late 2025.

The slowdown has been most visible in sponsor-backed activity, where issuance over the last three months (L3M) declined to its lowest level since the second quarter of 2023 (Exhibit 4). In contrast, non-sponsored activity has become a larger source of direct lending market volume, representing 36% of activity over the three months ended May 31, 2026, compared to an average of 23% since 2020.

Exhibit 5, which uses KBRA DLD data focused on sponsored borrowers, tells a similar story. Deal activity during the first five months of 2026 was 25% lower than during the same period in 2025. That said, the mix of activity has shifted, with LBOs and add-on M&A representing a larger share of total activity, while refinancing activity has declined. This mix shift likely reflects, in part, the reduced economic incentive to refinance as terms have become more lender-friendly in some segments of the market.

Exhibit 3: Spreads remain considerably tight, though with some dispersion

Average spread, in basis points, for private credit, sponsor-backed deals based on borrower EBITDA¹, 3-month rolling averages for first lien term loans



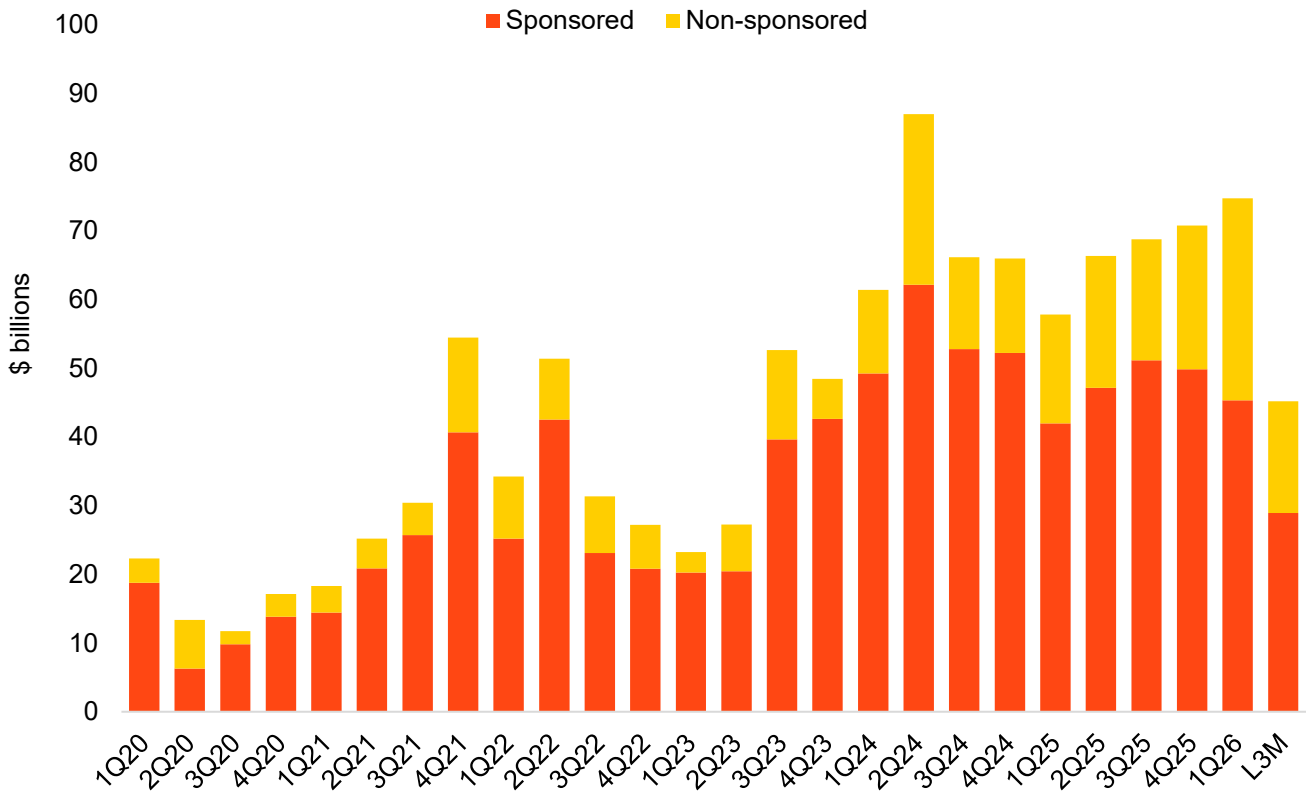
Source: KBRA DLD, BlackRock. As of May 31, 2026.

1. EBITDA size is categorized as: Lower middle market (EBITDA < \$20m), core middle market (EBITDA = \$20m - <\$50m), upper middle market (EBITDA = \$50m - <\$100m), and large cap (EBITDA = \$100m+).

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Exhibit 4: Non-sponsored volume has become a larger component of direct lending activity

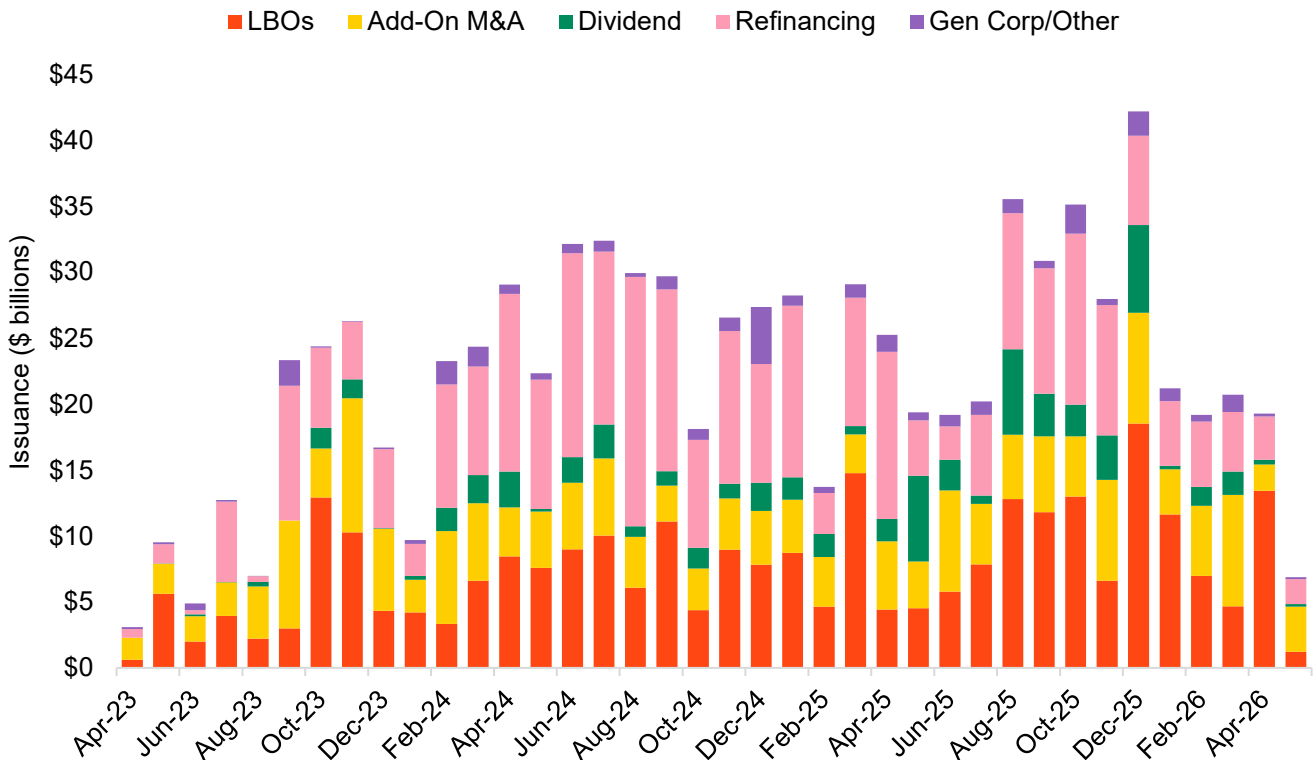
Estimated direct lending volume, in \$ billions, sponsored and non-sponsored



Source: Pitchbook LCD, BlackRock. L3M (last three months) as of May 31, 2026.

Exhibit 5: Sponsored direct lending activity has slowed, with YTD volume down 25% versus the same period last year

Monthly sponsored direct lending volume, in \$ billions, by use of proceeds



Source: KBRA DLD, BlackRock. As of May 31, 2026.

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Income remains the primary driver of direct lending returns

Though as underwriting conditions evolve, investors are increasingly focused on whether private credit returns will remain attractive, should dispersion across borrowers, sectors, and managers continue to rise.

We begin with return data from the Cliffwater Direct Lending Index (CDLI), which includes more than 22,000 U.S. loan segments and over \$560 billion of total assets. In 1Q2026, interest income remained the primary driver of total returns for the index (Exhibit 6).

Over the trailing 12-months (TTM), interest income for the CDLI totaled 10.12%, compared with realized losses of 58 basis points (Exhibit 7). Importantly, while income has moderated from the elevated levels in 2023 and 2024, reflecting 175 basis points of cumulative Federal Reserve policy rate cuts and a more competitive underwriting environment, it remains broadly in line with the 10-year average of 10.32%.

Looking ahead, absent a sharp deterioration in growth or the labor market, we expect the still-elevated policy rate backdrop to continue supporting income generation for floating-rate private credit loans, even should the peak income environment be behind us.

Exhibit 6: Interest income has been the dominant return component for the CDLI

Cliffwater Direct Lending Index (CDLI) cumulative returns by component

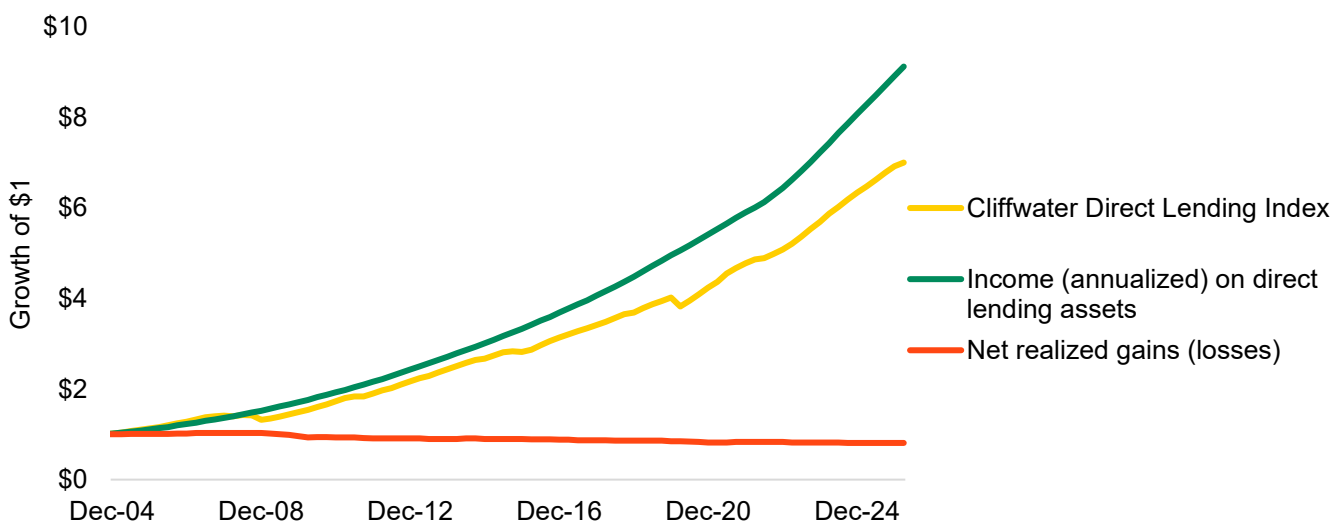
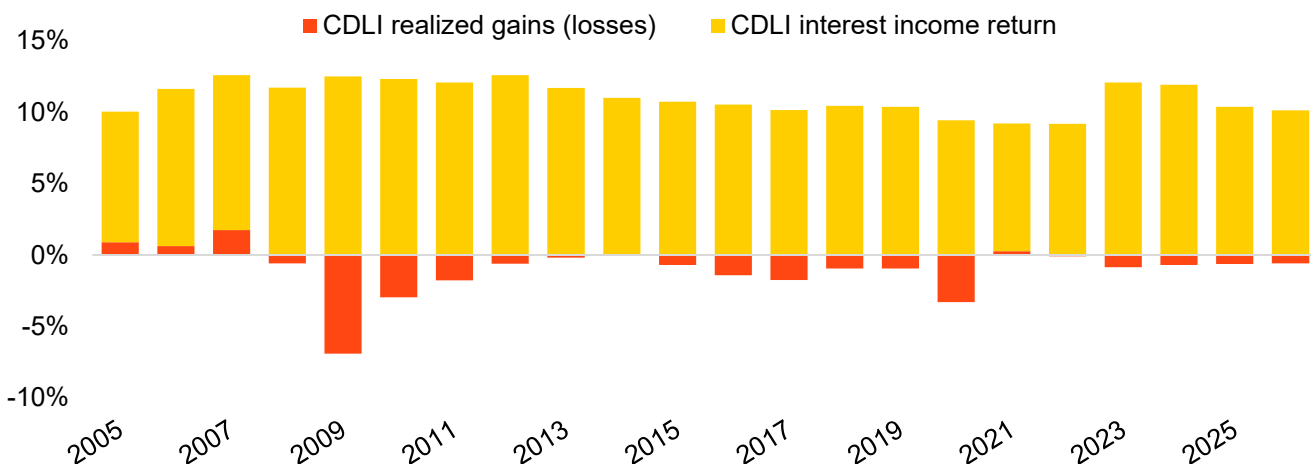


Exhibit 7: Interest income has moderated as base rates and all-in yields have declined

Trailing 12-month income return and realized gains (losses) for the Cliffwater Direct Lending Index



For both charts: Source: Cliffwater Direct Lending Index, BlackRock. As of 1Q2026. Realized gains can be driven by equity stubs, warrants, and gains on exited investments. These were more common in 2005–2007, when second lien and mezzanine loans were a greater portion of the CDLI. 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. We exclude unrealized gains and losses in these charts. Long-term unrealized gains (losses) are approximately zero, as they either convert to net realized losses upon a credit default, or are reversed when principal is fully repaid.

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Unrealized losses point more to normalization than broad-based deterioration

While income remains the primary driver of direct lending returns, credit losses are becoming a more important part of the performance discussion. In 1Q2026, TTM realized losses declined modestly, from 64 basis points in 4Q2025 to 58 basis points. At the same time, TTM unrealized losses increased to 1.22%, reflecting a combination of individual borrower marks, software-related pressure, and public market spread movements, according to Cliffwater.

This matters because unrealized losses can be a signal of future realized losses. Over time, unrealized losses either become realized losses when a credit defaults or reverse when credit conditions stabilize and loan principal is repaid. Historically, however, unrealized losses have tended to overstate eventual realized losses.

A Cliffwater analysis of select prior stress periods, including the 2008 Global Financial Crisis, the 2015 energy downturn, the 2020 COVID period, and the 2022 policy rate hiking cycle, found that subsequent realized losses equaled roughly half of the preceding unrealized losses. Exhibit 1 shows the historical relationship between realized and unrealized gains/losses.

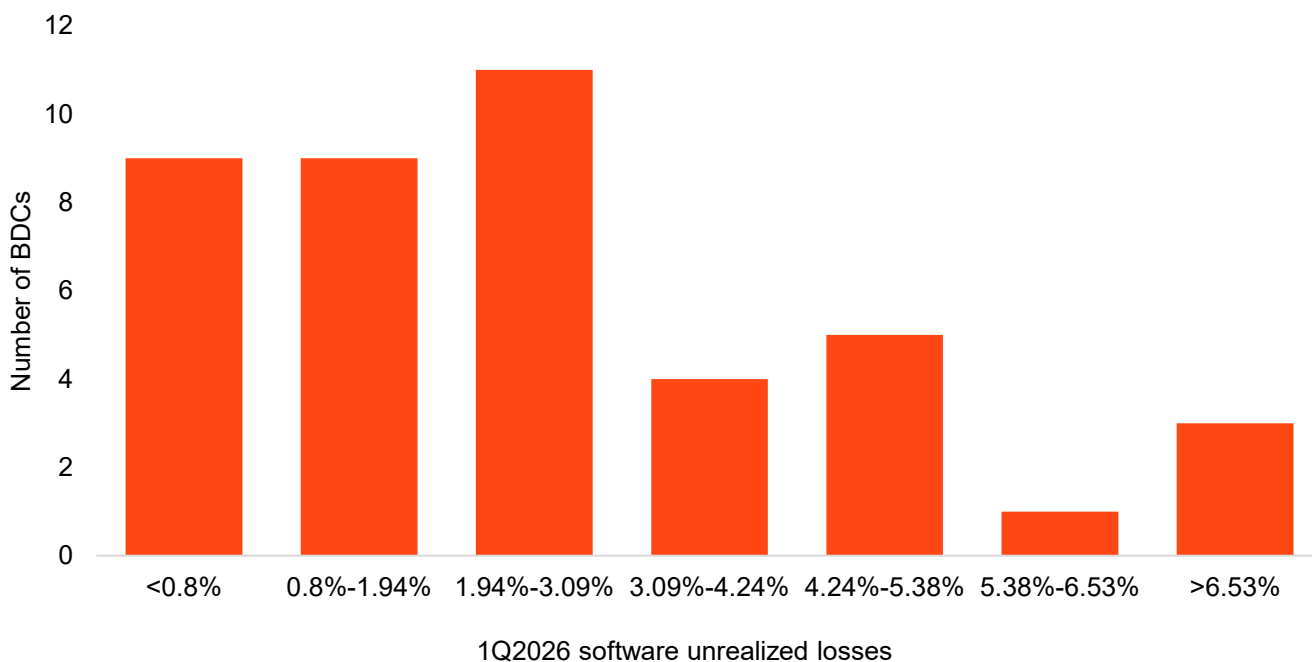
As such, the recent increase in unrealized losses suggests that realized losses may rise in the coming quarters. That said, an orderly increase in realized losses toward the long-term average of approximately 1% would, in our view, suggest a normalization rather than a broad-based deterioration.

Importantly, stress remains somewhat concentrated. Approximately 57% of unrealized losses added in 1Q2026 were associated with software borrowers, reflecting increased market concern about the software sector outlook, including the potential for AI-related disruption to widen borrower outcomes in the sector.

An [analysis](#) from Cliffwater that captured 43 BDCs with \$378 billion of total loan assets at cost, including \$72 billion of software loans, found that aggregate software holdings were marked at a 3% discount to cost value in 1Q2026. That said, the range of markdowns during the quarter varied meaningfully across BDCs, highlighting continued dispersion, even within sectors (Exhibit 8).

Exhibit 8: Most 1Q2026 software unrealized losses were between 0 and 5%

Distribution of BDCs by 1Q2026 software unrealized loss range, for select BDCs in Cliffwater Direct Lending Index



Source: Cliffwater Direct Lending Index, BlackRock. As of 1Q2026. Unrealized loss values represent negative changes in investment fair values. The markdown in software loan valuation is categorized as an 'unrealized loss' for accounting purposes, akin to 'reserve' accounting used by banks. The BDC sample is comprised of 43 BDCs that report software loans as a separate industry classification, representing \$378 billion in total assets at cost value, including \$72 billion in software loans. Cost value are adjusted for amortization of assorted accruals and payments.

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Connecting defaults with fund-level outcomes

As we've noted previously, defaults also represent an important stress signal in private credit, though their impact on fund-level outcomes is less direct.

In private credit, a default does not immediately translate to a monetary loss. Instead, a covenant default can serve as a tool to bring the borrower and lender to the table before stress becomes more severe. The ultimate impact on returns depends on several factors, including ultimate recovery values, the size of the exposure, portfolio diversification, and the manager's workout abilities.

To assess how defaults may flow through to returns, we review an illustrative analysis from Lincoln International that compares fund-level internal rate of return (IRR) outcomes under different default scenarios. Demonstrated in Exhibit 9, the analysis assumes: a five-year loan term, a 500 basis point unitranche spread, SOFR based on the forward curve as of May 6, 2026, a 65% recovery rate, a 10% cumulative default rate over three years with defaults beginning in year two and returns measured on an unlevered basis.

It is important to note that the 65% recovery assumption is above recent implied recovery levels from other private credit datasets. For context, implied recoveries for the CDLI were 53% as of 1Q2026, while KBRA DLD reported implied recoveries of 47.8% as of May 2026.

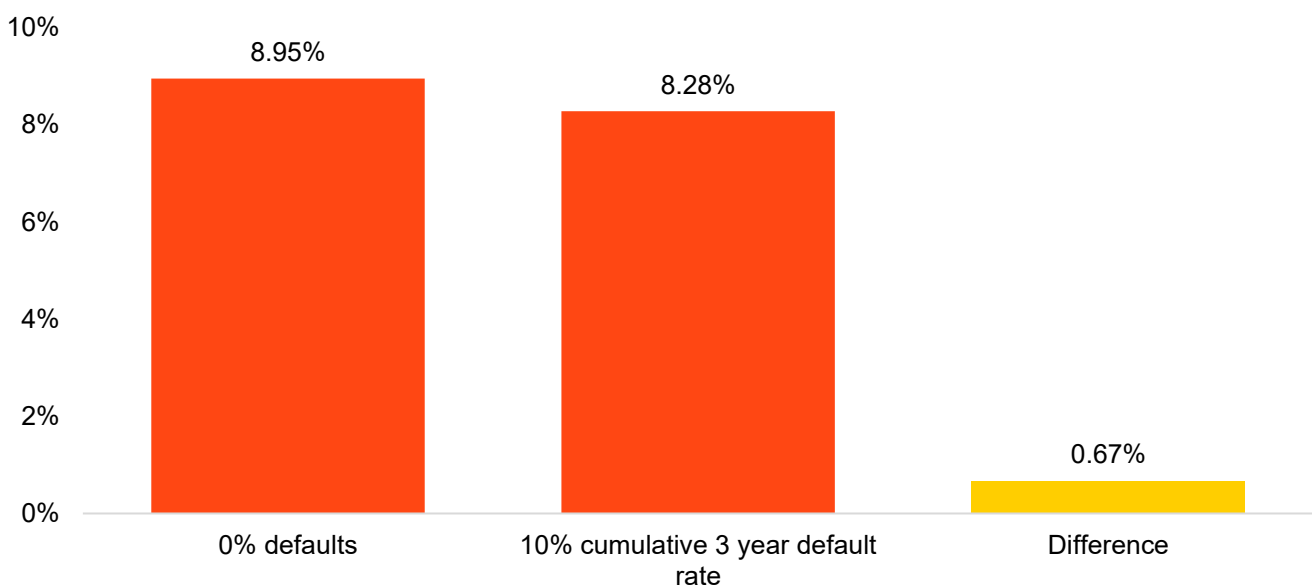
With this caveat, the key takeaway is that defaults do not translate one-for-one into portfolio-level return impairment. The impact may be more modest than headline default rates suggest when portfolios are diversified, recoveries are meaningful, and interest income continues to provide a return buffer.

This underscores two important points. First, portfolio construction, asset selection, and manager selection remain critical, particularly as dispersion increases across sectors, borrower sizes, and credit outcomes. Second, interest income remains an important buffer, helping to absorb credit losses and support aggregate fund-level returns.

Taken together, the analysis reinforces our broader view that private credit returns can remain resilient, even amid normalizing credit losses, but outcomes are likely to become more differentiated. In this environment, disciplined underwriting, thoughtful portfolio construction, strong origination capabilities, and effective workout expertise are likely to play a larger role in determining performance.

Exhibit 9: The impact of defaults on broader fund-level performance is dependent on a variety of factors

Illustrative impact of defaults on credit fund internal rates of return (IRRs), based on an analysis from Lincoln International



Source: Lincoln Lens - Private Market Intelligence, BlackRock. Analysis assumes a five-year loan term, a 5.0% unitranche spread over the SOFR forward curve (as of May 6, 2026), a 65% recovery rate, and a 10% cumulative default rate over three years (equivalent to approximately 3.3% annually), with defaults beginning in year two. Returns are shown on an unlevered basis.

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Cliffwater Direct Lending Index (CDLI) is an index that assists investors to better understand private credit as an asset class. The CDLI seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain eligibility criteria. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs. Eligibility is set as all assets held by BDCs that (1) are regulated by the SEC as a BDC under the Investment Company Act of 1940; (2) have a substantial majority (approximately 75%) of reported total assets represented by direct loans made to corporate borrowers, as categorized by each BDC and subject to Cliffwater's discretion, and (3) file SEC form 10-Q (or 10-K, as applicable) within 75 (or 90) calendar days following the current Valuation Date. If a BDC meets the eligibility criteria, but has not filed its report on Form 10-K or 10-Q with the SEC at the time the index is reconstituted, asset information from its report will be included in the index at the time of the next reconstitution. This information is derived from sources that are considered reliable, but BlackRock does not guarantee the veracity, currency, completeness or accuracy of this information.

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