

Possible Answers: Give Heed to the Warning Signs

The following points are offered as potential explanations for the current state of the art in the credit space. They should be regarded as working hypotheses rather than definitive conclusions and therefore warrant further investigation, integration, and critical evaluation.

1. Credit Risk, Interest Rates, and the Timing Mismatch

Broadly defined, credit risk encompasses not only defaults, downgrades, and spread widening, but also the impact of changes in the risk-free yield curve on asset valuations. Empirical evidence strongly supports this broader interpretation. The main challenge for investors is understanding and anticipating the transmission lag. The sharp rate hikes of 2022 triggered severe mark-to-market losses, making it one of the worst years for credit markets in decades. By contrast, the impact on corporate borrowers (credit migration, restructurings, debt haircuts) emerged much more gradually, becoming more visible only toward late 2024 and beyond. In many respects, today's credit challenges originate from corporates' decisions and market conditions established four years ago.

In 2026 with interest-rate volatility significantly lower than in 2022, credit portfolio managers appear relatively comfortable despite a structurally higher rate environment than participants expected only a few months earlier. Borrowers have generally been able to extend liabilities and gradually address the maturity wall, while investors have accommodated these extensions. As a result, mark-to-market pressures have remained contained and debt-servicing challenges have largely been deferred. The apparent disconnect between market pricing/credit market behavior and movement in interest rates should therefore be viewed as temporary rather than permanent. Higher funding costs continue to affect corporates debt-to-equity ratios, although the transmission mechanism differs across sectors. If I want to put it in another way: when sovereign bond markets price in elevated risk premiums that credit markets appear to overlook, the discrepancy tends to be temporary. The cost of that complacency often emerges later, and usually at a much higher price for high yield credit portfolios.

2. Private Credit: Growth, Transparency, and Market Structure

Private credit has established a significant presence across most developed markets, particularly where tighter banking regulation has shifted lending activity away from traditional banks and toward investment funds. A relatively small group of large managers controls a substantial share of the PC market, yet transparency regarding underlying portfolios often remains limited.

The big managers benefit from strong structural tailwinds. They provide financing to companies that increasingly fall outside banks' lending appetite and are well aware of their strategic importance within the financial ecosystem. While BDCs and other fund structures may eventually need to adapt to changing market conditions, the demand for private credit remains supported. This explains why large managers, in my view, still do not feel compelled to revise their narrative or provide greater transparency regarding the nature of the risks being assumed. They maintain the impression that all is well, yet the widespread use of 5% quarterly redemption caps suggests a more nuanced reality.

The growing role of private credit is consistent with a healthy and diversified financial system. The key unresolved question, however, is whether private credit managers genuinely possess superior capabilities in loan origination, underwriting, and monitoring. Greater transparency around leverage, liquidity transformation, portfolio concentration, and underwriting standards would help Limited Partners assess whether the sector's perceived diversification and attractive returns represent true alpha or simply concentrated exposure to risk factors that closely overlap with public credit markets.

3. Navigating an Exceptionally Complex Credit Environment

Credit markets are operating in one of the most challenging environments in decades. While the transition began during the COVID-19 period, when managers were forced to reconsider traditional asset-allocation frameworks, the complexity of current market conditions may be unprecedented in the modern era. Arguably, this is the most demanding credit environment of the past fifty years.

Performance dispersion across sectors, industries, and individual issuers has widened considerably, driven by increasingly idiosyncratic factors. Excessive leverage, shifting consumer preferences, technological disruption—particularly from artificial intelligence—and the growing difficulty of sustaining business competitive advantages against peers (mainly due to leverage), have accelerated the divergence between winners and losers. Long-standing investment assumptions in credit can become obsolete rapidly, requiring

continuous reassessment of credit fundamentals and more dynamic portfolio management.

At the same time, risk premiums remain compressed while valuations appear increasingly stretched relative to KPIs. This combination leaves little margin for error and increases vulnerability to volatility, spread widening, and abrupt market corrections.

4. CLO Equity: A Long-Term Cash-Flow Investment with Obligated Diversification

CLO equity should be viewed primarily as a long-term investment whose ability to generate compelling risk-adjusted returns is driven by cash-flow generation and the manager's flexibility to reposition the underlying asset pool as market conditions evolve. The refinancing and reset options embedded in CLO structures can significantly enhance returns for equity investors, particularly within vehicles that employ leverage of approximately 12x, provided the structure remains compliant with its tests.

Initial arbitrage conditions at issuance are rarely the primary determinant of long-term performance for subordinated notes. Instead, weighted average purchase price, capital structure design (ignored for years by the same managers), manager skill and vision, portfolio management decisions (not only in par creation), and the effective use of resets tend to be far more influential. Importantly, these value-enhancing levers are not always available (it depends where the PM has positioned the asset pool against tests), and manager performance can vary substantially. For this reason, diversification across vintages and managers remains one of the most effective approaches to mitigating risk and improving long-term outcomes in CLO equity investing. This is what I think after being invested and analysed this asset class for more than two decades.

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