

'QUIET DEFAULTS' ARE DRIVING A MORE COMPELLING BACKDROP FOR OPPORTUNISTIC CREDIT

Stock markets have been hitting all-time highs and credit spreads remain low, yet higher interest rates and mounting floating-rate debt are straining lower-rated borrowers. This tension is surfacing first in leveraged loans as “quiet defaults” become more common — opening up a dynamic set of opportunities for investors specialized in stressed and distressed assets.

A DECADE OF CHEAP DEBT COMES DUE

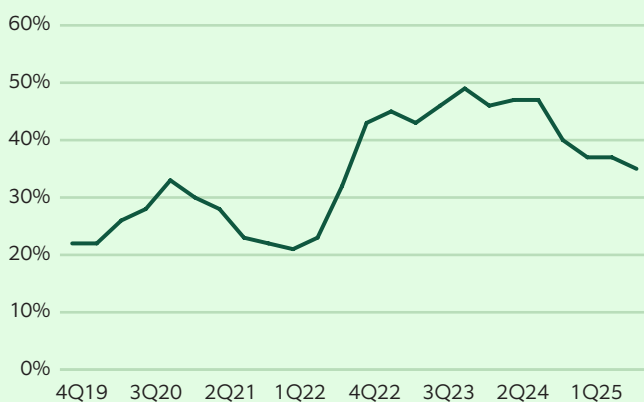
Years of exceptionally low interest rates prompted companies to borrow heavily, with lenders accepting weaker protections in loan agreements. Now, rising rates are colliding with high leverage, especially for companies whose loan costs rise directly with Federal Reserve policy.

Since 2019, the proportion of leveraged loan borrowers with interest coverage ratios below two has increased meaningfully (**Exhibit 1**). Lower ratios suggest less cushion for borrowers, making them vulnerable if economic conditions worsen.

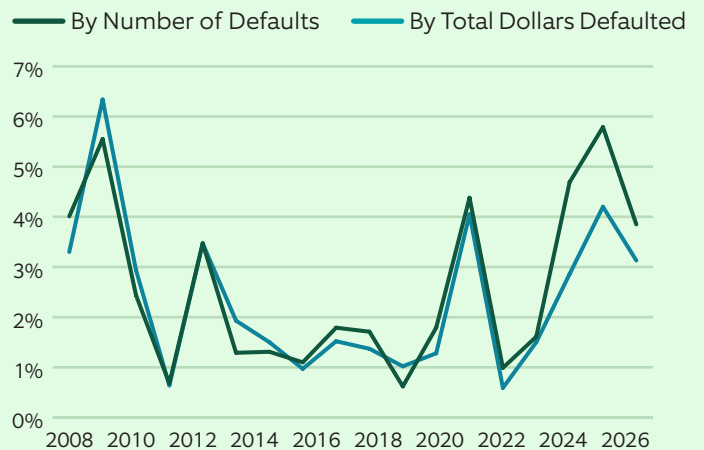
EXHIBIT 1 SIGNS OF DISTRESS IN U.S. LEVERAGED LOANS

An increasing number of U.S. companies are struggling to cover interest payments on leveraged loans, resulting in areas of financial distress.

U.S. Leveraged Loans with <2x Interest Coverage



U.S. Leveraged Loan Default Rates Including Distressed Debt



Source: JP Morgan. Interest coverage data is from the fourth quarter of 2019 to the third quarter of 2025. U.S. leveraged loan default data is from December 31, 2008 to December 31, 2025.

WHY LOANS, NOT BONDS, ARE BREAKING FIRST

Two main factors explain why stress has become more centralized in loans rather than high yield bonds:

Market mix: More lower-rated borrowers now rely on the loan market, leaving it exposed to rising rates, while the high-yield bond market holds stronger credits.

Floating-rate exposure: Borrowers with floating-rate loans feel rate hikes immediately, while those with fixed-rate bonds face increased costs at refinancing. In 2024, loan default rates outpaced high-yield bond defaults by the widest margin in decades.

Additionally, collateralized loan obligations (CLOs) — which own about two-thirds of U.S. loans — are forced to sell when holdings of downgraded (CCC-rated) debt exceed certain levels, often leading to “non-economic” selling and opportunities for these opportunistic credit buyers.

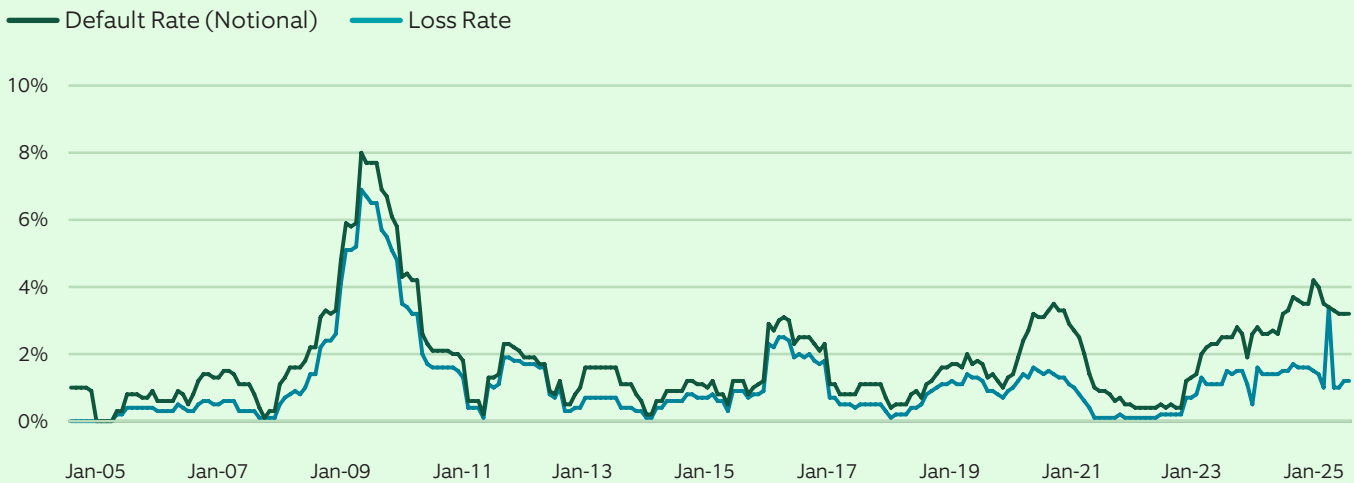
EUROPE AS A LEADING INDICATOR

The eurozone experienced this stressed and distressed opportunity before the U.S., with ongoing economic stagnation, persistent budget deficits and global uncertainty fueling distress. By mid-2025, several major restructurings spiked European default volumes, despite tight spreads. CCC-rated loans were hit hard, and capital became scarce for riskier issuers.

EXHIBIT 2 EUROPE'S DISTRESS

Continuing distress in the Eurozone, driven by slow growth, sustained deficits, and global unease, has led to default rates not seen since the 2008 Global Financial Crisis.

Eurozone Default and Loss Rates



Source: JP Morgan. Data from January 2005 to December 2025.

THE 'QUIET DEFAULT': HOW DEBT RESTRUCTURING IS CHANGING THE CYCLE

While formal defaults may appear low, many stressed borrowers are quietly restructuring debt through liability management exercises (LMEs). LMEs allow companies to renegotiate debt terms and improve liquidity without declaring bankruptcy. In 2025, the combined default rate — including both bankruptcies and distressed LMEs — ended the year at 3.5% by issuer count, with about 46% of defaults coming from LMEs rather than missed payments.

Weaker loan agreements have enabled the rise of LMEs, which can buy troubled companies time but often disadvantage creditors who do not participate. Frequently, LMEs signal deeper issues and may precede in-court restructurings if fundamentals fail to improve.

COMPELLING BACKDROP FOR OPPORTUNISTIC CREDIT INVESTING

This cycle of stressed and distressed investing is less about waiting for a massive bankruptcy wave and more about actively engaging across different opportunities. Expect a steady stream of LMEs, extend-and-amend deals, and creative capital solutions as companies address upcoming maturities in a higher-rate environment. Forced sales from CLOs and other technical pressures continue to create mispricing, particularly in performing but stressed senior secured debt.

Here are three main types of opportunities for opportunistic credit investors:

- **Liability Management Exercises (LMEs):** Also known as Capital Solutions, these allow troubled companies to adjust debt terms outside of court, with lenders often receiving tighter terms, higher yields, or equity stakes in exchange for support.
- **Stressed Situations:** Investors can purchase deeply discounted debt where borrowers are still meeting obligations, expecting eventual recovery to par value at maturity.
- **Distressed Restructurings:** Creditors can swap debt for equity, helping reduce company debt loads and interest expenses, while retaining potential upside from any recovery.

Specialized and nimble managers — like hedge funds — can exploit these situations across asset classes, jurisdictions, and legal systems, unlike mutual funds or ETFs.

BOTTOM LINE: DON'T WAIT FOR THE DEFAULT WAVE

Don't be misled by headline spreads or strong equity markets; underlying structural issues in the loan market and the surge in LMEs create a prolonged distressed credit opportunity set. Specialists capable of navigating complex legal scenarios, acting quickly during forced sales, and moving across the capital structure are best positioned for strong returns across varying economic environments.

For investors, we believe the best approach is to embrace this evolving landscape with a flexible approach—focusing on undervalued performing assets, bespoke capital solutions, and out-of-court and in-court restructurings—instead of waiting for an unlikely one-off wave of defaults.

GLOSSARY

Credit spread: The credit spread often is the difference between yields of a corporate bond and a government bond, such as a Treasury, of similar maturity. Investors demand additional yield as extra compensation for assuming the risk of default.

Leveraged loan: Leveraged loans are a type of loan for companies with below-investment-grade credit ratings, given by a group of lenders (syndicated).

Distressed credit: Distressed credit involves financial assets like bonds or loans that are significantly undervalued because the issuer is facing financial difficulties or the risk of default. This high-risk investment strategy aims to profit from potential recoveries in the issuer's financial status.

Interest coverage: Interest coverage is the ratio of earnings to interest expenses, an indicator of the ability of a company to make interest payments on debt.

Default rate: The default rate is the percentage of bond market assets represented by issuers who have stopped making debt payments and are declared in default by bondholders.

Senior debt: Senior debt has the first claims on a company's cash flows, with priority over subordinated debt.

Global Financial Crisis: The Global Financial Crisis of 2008 was caused by the collapse of the mortgage market to risky borrowers (subprime mortgages) after home prices peaked, resulting in a recession.

Hedge funds: Hedge funds are pooled investment strategies that attempt to outperform an average portfolio through a range of investing techniques, including investing with borrowed money and taking positions on market volatility. Investors must have a certain level of net worth to invest in the funds.

Yield: Yield is annualized interest (coupon) payments divided by the bond market price, expressed as a percentage.

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