Sycamore Tree
Capital Partners

January 2025

2025 Credit Markets Outlook

Market Outlook (see **page 2** for details)

- As we begin 2025, strong investor demand and abundant liquidity are fueling debt refinancing and new issuance. We remain cautiously optimistic about credit markets. With corporate bond spreads historically tight, the VIX subdued, and interest rates elevated, the current environment evokes comparisons to the credit market dynamics of the mid-1990s based on our experience. We expect continued interest rate volatility.
- There are potential key macro risks to be prepared for: resurgent inflation, reduced spending by low/middle-income consumers, and political/geopolitical risks.

Strategy Outlooks:

- **Floating Rate Bank Loans (page 3)** – With traditional fixed income spreads tight and ongoing rate uncertainty, loan yields are attractive on historical and relative bases. We expect loans to outperform High Yield and IG Corporate Bonds as they did in 2024.
- **CLO Equity (page 4)** – In contrast to Private Equity's J-curve and constrained distributions, CLO Equity has the potential to provide more immediate income and comparable total returns. With targeted mid-teen IRRs, CLO Equity can be an attractive complement to Direct Lending strategies.
- **Opportunistic Credit (page 5)** – Macro risk/volatility has created heightened dispersion across the $3 trillion credit universe, with liquid debt investment opportunities offering returns competitive with expectations for Public Equity and Private Credit through current yield and capital appreciation.
- **High Grade CLO Debt (page 6)** – High quality, floating rate liquid bonds can continue to enhance returns, diversify core fixed income portfolios and serve as "dry powder" while awaiting more attractive entry points in risk assets.

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2025 Credit Markets Outlook

U.S. credit markets closed the year on a strong note, bolstered by significant spread tightening and a robust corporate economy

Year-to-date through December 30, 2024, High Yield bonds and Bank Loans have delivered impressive returns of 8.5% and 9.3%, respectively, with spreads tightening by 57 basis points for high yield and 74 basis points for loans. **Strong investor demand and abundant liquidity—fueled by ample dry powder**—have fostered a highly receptive capital market for debt refinancing and issuance. These factors are expected to remain key tailwinds as we move into the coming year.

We remain **optimistic about credit markets** as we head into 2025. Corporate earnings growth, strengthening balance sheets, and improving cash coverage profiles suggest a 'mid-cycle' environment, especially when coupled with Federal Reserve easing, moderating inflation, and a pro-business, low-regulation federal government. Post-election 'animal spirits' appear to be fueling small business optimism, productivity-driven capital investments, a stable labor market, resilient consumer spending, and potentially increased M&A activity. With corporate bond spreads remaining tight, the VIX subdued, and benchmark interest rates elevated, the current environment evokes **comparisons to the credit market dynamics of the mid-1990s** based on our experience.

Mid-90s Cycle vs. Recent Environment[2]

	Feb. 95 to Aug. 98	Jul. 23 to Dec. 24
Peak Fed Funds Rate	6%	5.3%
Following Fed Actions	3 cuts and 1 hike	3 cuts and counting
HY Spread at Last Hike	437	405
HY Spread Low	304	TBD – Currently 316
Time to Reach HY Spread Low	25 months	TBD – 17 months so far
Time Between Low and HY Spreads Rising Above "Last Hike" Level	18 months	TBD

Through all this optimism, we see certain potential key macro risks to be prepared for:

- Resurgence of **inflation** driven by immigration policy (labor costs) and potential extreme tariff outcomes (import costs/reshoring inflation)
- High absolute price levels leading to **reduced spending** by low- and middle-income consumers
- Below expectation Fed rate cut path and **higher interest rate volatility**
- **Politics** around deficit spending, tax policy and the debt ceiling
- **Geopolitical risks** including current and potential conflicts

We are also observing **greater dispersion across sectors and individual names** in the credit markets. The prolonged higher-rate environment is exposing weaker business models that have struggled with constrained capital allocation for growth and innovation. Additionally, many 'pre-rate hike' vintage capital structures are proving unsustainable under current debt loads, necessitating restructurings in the years ahead. This 'winners and losers' dynamic has steepened the credit curve, presenting skilled active managers with significant opportunities to capture alpha—primarily by effectively avoiding losses.

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[1]Source: JPMorgan, December 30, 2024

[2]Source: Monthly spread and Fed Funds rate data between Dec 1994 and Nov 2024 sourced from JPMorgan, St. Louis Federal Reserve Bank

2025 Outlook: Floating Rate Bank Loans

With traditional fixed income spreads tight and rate uncertainty lingering, seek attractive risk-adjusted returns and consistency through floating rate income

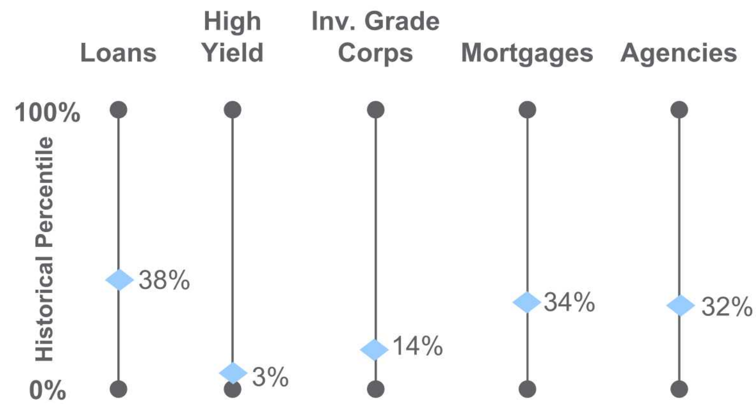
- Loan spreads currently rank in the 38th percentile historically vs. 3rd percentile for HY. Loan yields, at 8.7%, rank in the 84th percentile. Loans are yielding more than High Yield bonds with less sensitivity to interest rate volatility due to their floating rate nature.

- Loan market distress is in line with historical averages with ~5% of the market trading below 80. A positive outlook for the economy and earnings and declining benchmark interest rates should improve borrower coverage profiles, and we believe defaults will lessen in the year ahead. Though companies with weaker business models and capital structures still need to be avoided, especially with LMEs more common.

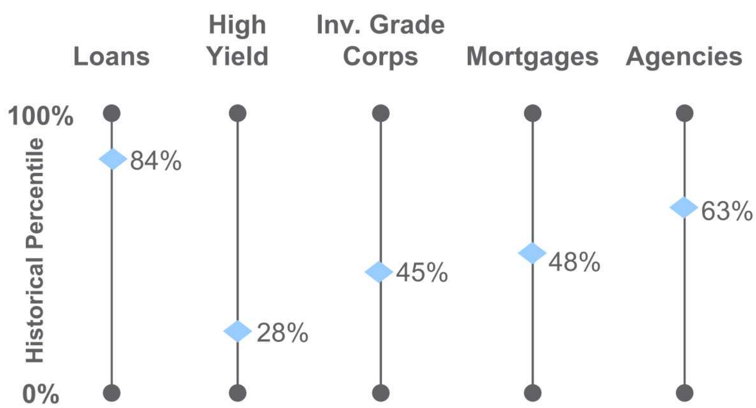
- Strong CLO issuance will continue to drive demand for loans in 2025. There will continue to be a supply demand imbalance though M&A loan issuance is expected to improve given the new administration's deregulatory stance.

- We expect floating rate bank loans to be able to achieve a ~7-8% return over the next year.

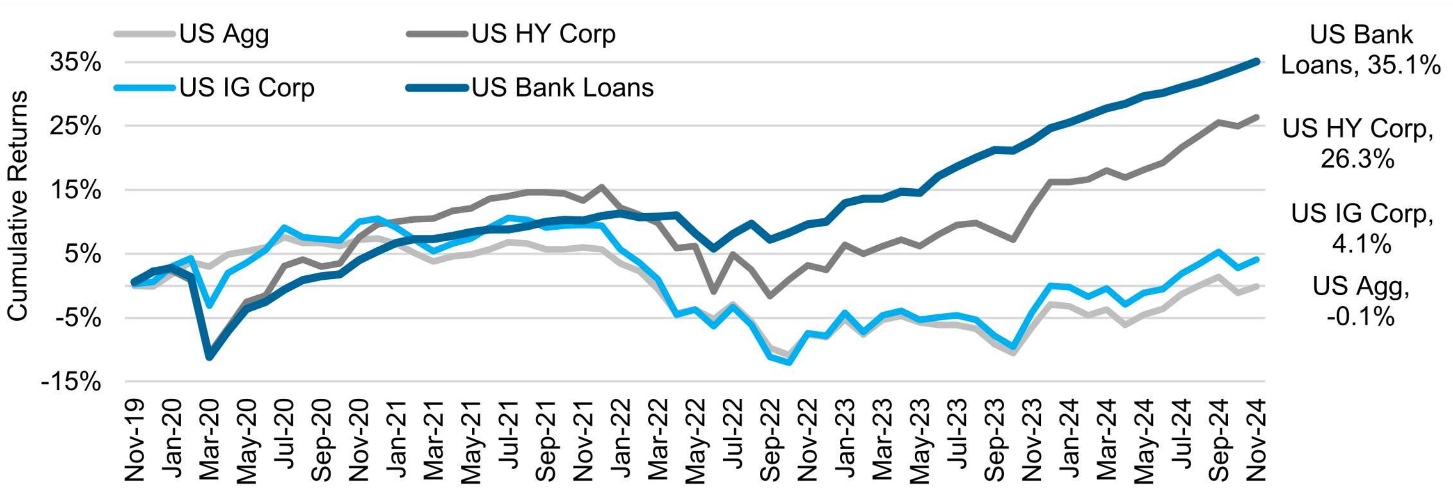
Loan Spreads Have More Room to Run Relative to Other Fixed Income[1]



Higher Base Rates Resulting in Historically Attractive Loan Yields[1]



Loans Have Demonstrated Steadier Returns than Bonds Over the Last Five Years[2]



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[1]Source: Morgan Stanley Research, Bloomberg, Pitchbook LCD December 2, 2024. US HY spreads since 1994, US IG & US MBS spreads since 1990, US Loan spreads since 1997, US Agency spreads since 1993. US HY, US IG & US MBS yields since 1990, US Loan yields since 2002, US Agency yields since 1993.[2] Source: eVestment though November 2024.

2025 Outlook: CLO Equity

In contrast with the Private Equity J-curve and with distributions now declining, CLO Equity has the potential to provide more immediate, high levels of income while targeting similar total returns

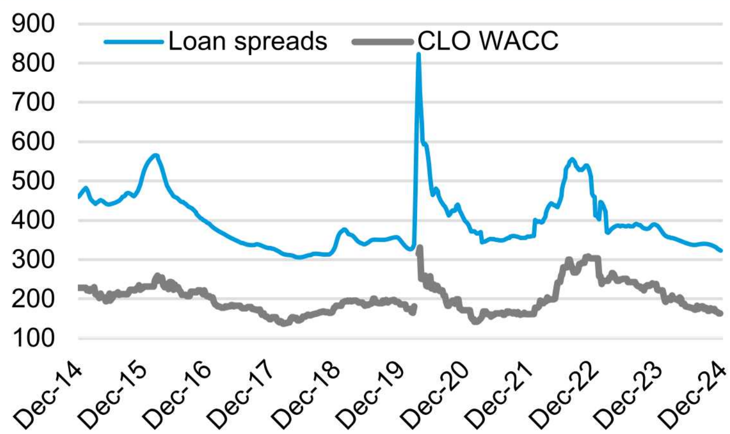
- We expect another record year of issuance (~$200bn) as spreads tighten across US loans and CLO liabilities and the CLO Equity asset class becomes more institutionalized.

- CLO arbitrage remains attractive for new issuance (current arbitrage is 227 bps/49th percentile) but more importantly, estimated CLO liability spreads are likely to see the tightest levels since the GFC – creating attractive CLO Equity return optionality should any of the macro risks create loan market price volatility. We expect actual defaults to continue to be modest, but the high relative level of CCCs and the accelerating LME activities in untenable capital structure are to be handled carefully.

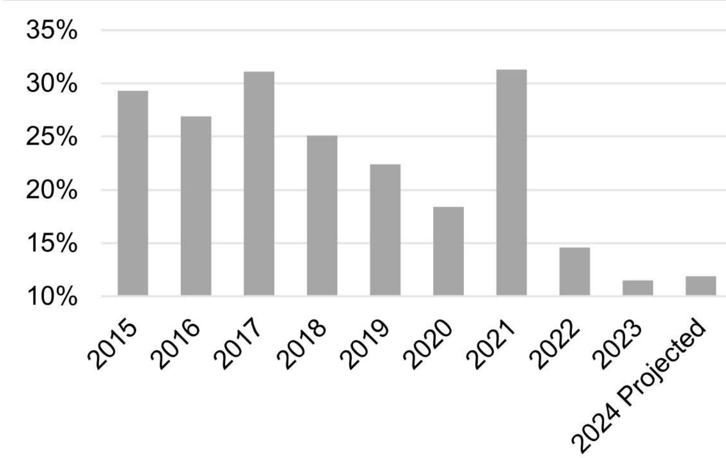
- Broader utilization of CLO Equity driven both by the front-loaded income portfolio of CLO Equity vs. PE's J-curve and slower than expected capital returns, as well as greater comfort in the resiliency and return ranges of the asset class.

- We believe CLO Equity yields will continue to produce mid-to-high teens distributions based on our outlook for spreads next year. Ongoing issuance and growth in the market size should lead to more new loan creation – both in terms of continuing to take back share from private credit, as well as an expected uptick in M&A deal activity later in the year.

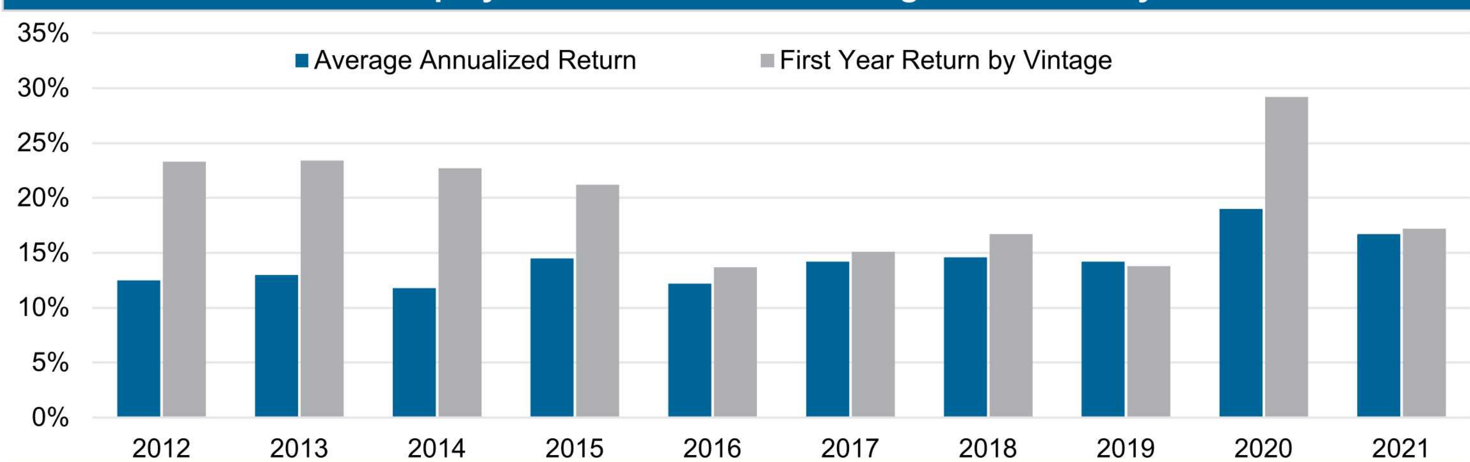
Locked-in, Long-term Funding Allows CLOs to Capitalize on Spread Widening[1]



Private Equity Distributions Declining in Recent Years[2]



CLO Equity Cash Flow Returns Average 16% Annually[3]



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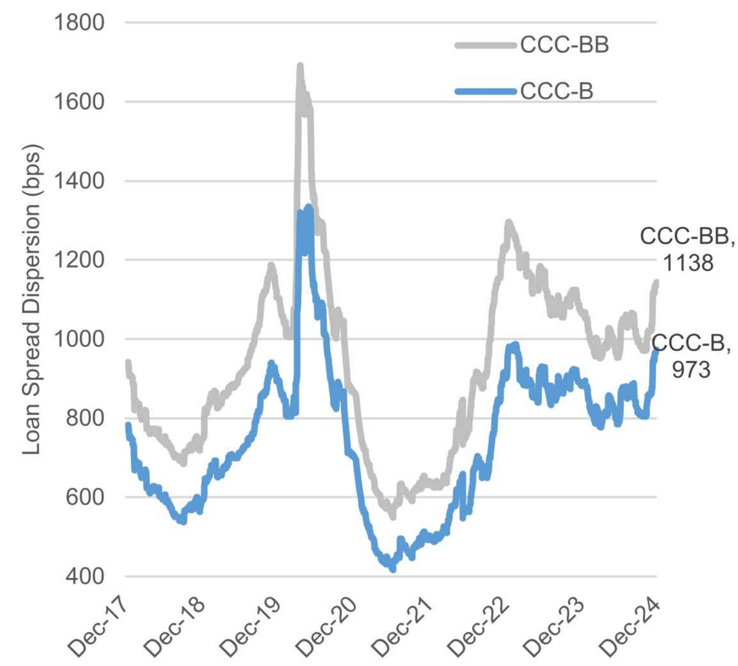
[1]BofA Global Research, Pitchbook LCD (December 16, 2024)
[2]Hamilton Lane, June 30, 2024
[3]JPMorgan, August 1, 2024

2025 Outlook: Opportunistic Credit

Generate high returns by income, picking the "winners" and avoiding the "losers" as macro risks create heightened dispersion across the $3 trillion+ credit universe

- As tactical investors with deep fundamental and contrarian mindset, we will look to navigate the "winners and losers" across sector and name exposures to capture alpha in transitional names. Wider spreads for weaker credits relative to history emphasizes the importance of avoiding the "losers" but also creates misunderstood opportunities.
- Versus Private Credit: similar yield with liquidity and opportunity for more significant upside and higher overall returns. Does not need to rely heavily on structural leverage
- Versus Public Equities: Yield potentially in excess of the consensus price-driven return outlook for public equity markets in 2025 with downside protection associated with debt investing
- We believe an actively managed opportunistic credit strategy has the potential to generate low to mid-teens returns in 2025.

Growing Dispersion Within Credit Sectors Presents Range of Opportunities[1]

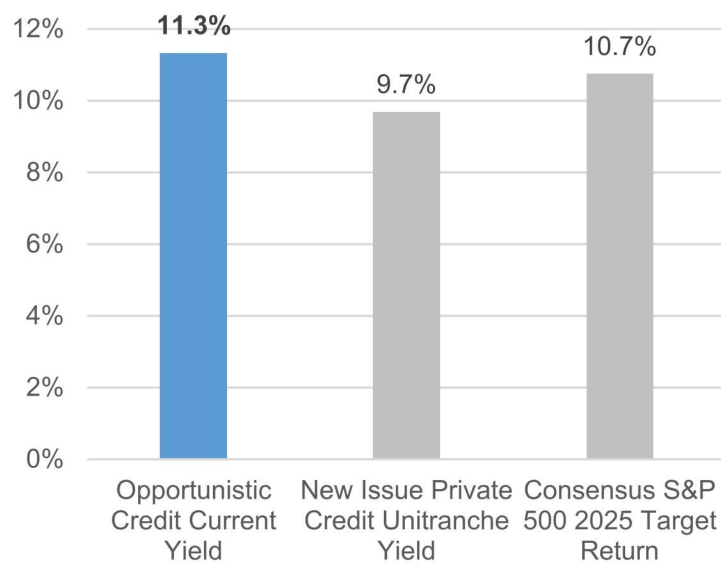


2024 Defaults Concentrated in Certain Sectors[2]

YTD HY and Loan Combined Industry Defaults (Including Distressed Exchanges)

	Sector	% of Total Defaults by Amount	# of Defaults
Highest	Healthcare	23.1%	17
Highest	Technology	14.4%	9
Highest	Services	10.7%	8
Lowest	Utilities	0.2%	1
Lowest	Housing	0.2%	1
Lowest	Energy	0%	0

Opportunistic Credit's Income Profile is Comparable to Private Credit and Equity Returns[3]



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[1]Creditsights, December 13, 2024

[2]JPMorgan Default Monitor, December 2, 2024

[3]Source: Sycamore Tree Opportunistic Credit Strategy current yield as of December 4, 2024. New Issue Private Credit Unitranche Yield sourced from Morgan Stanley US Credit Strategy 2025 Outlook, December 10, 2024 (Rolling 90 days Unitranche Origination spread plus 4.4% 3-mth SOFR rate). S&P 500 2025 target return includes 2025 level forecasts from 14 sell side institutions relative to index value on December 2, 2024.

2025 Outlook: High Grade CLO Debt

High quality, liquid bonds to enhance income profiles, diversify core fixed income portfolios and serve as a ballast while awaiting more attractive entry points in risk assets

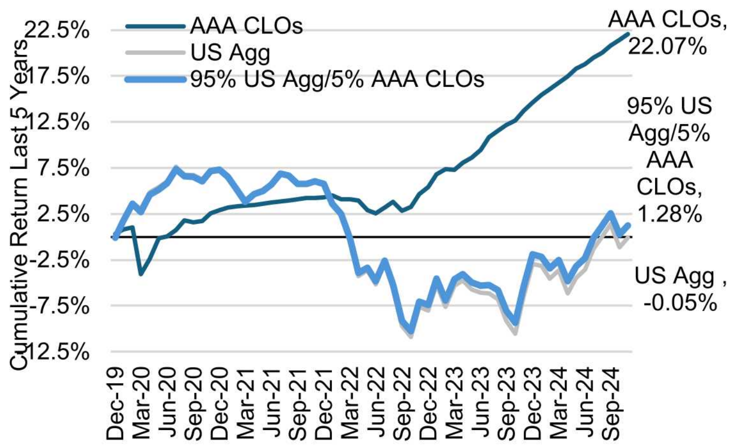
- Allocating 5% of a market-weight US Aggregate Bond portfolio to AAA CLO bonds would have resulted in +1.28% gain over the last five years instead of a (0.05%) loss.

- As defensively minded credit investors, we believe that having a ballast of low-volatility (both credit and duration), low correlation, income-oriented capital to both insulate against unexpected market drawdowns as well as provide dry powder for attractive mispriced opportunities is a prudent asset allocation approach – particularly with current spread valuation levels vs. the litany of unpredictable macro risks.

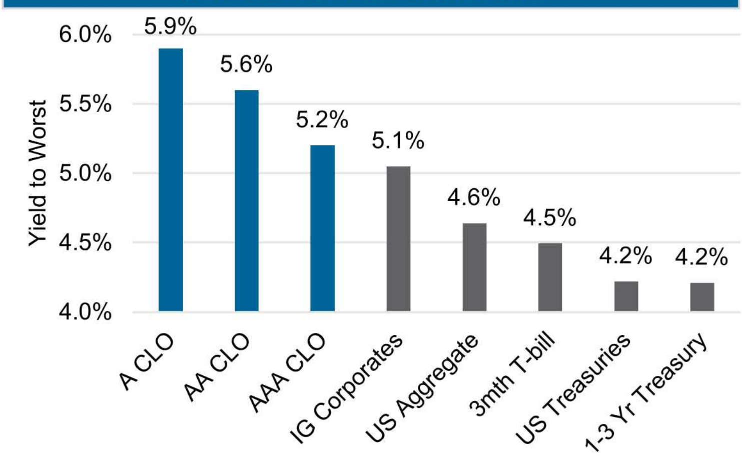
- The floating rate nature of the asset class should insulate the strategy against high levels of interest rate volatility, and the remote credit risk profile and muted historical price volatility (0.9 Sharpe ratio vs 0.1 for US Agg Bonds) make it a great alternative to play good defense and potentially achieve more tactical entry points[3].

- We expect high grade CLOs (largely AAAs) to be able to achieve a ~5-6% return over the next year, in excess of comparably rated treasuries and other corporate or structured income alternatives.

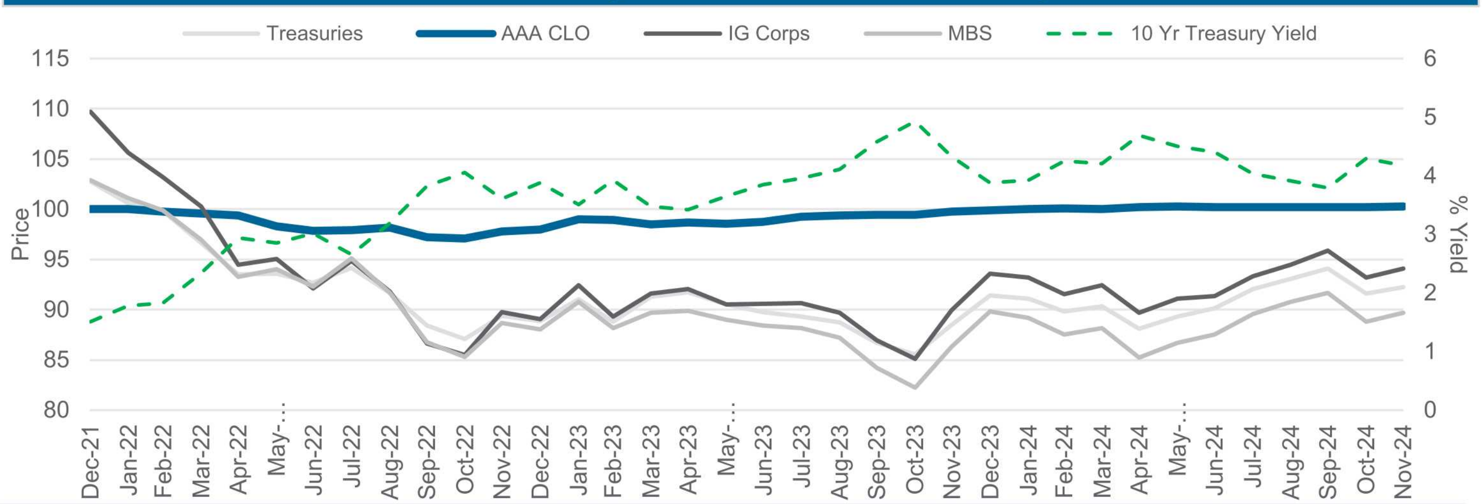
Allocation to AAA-rated CLOs Would Have Improved 5 Year Agg Bond Returns[1]



Yield Premium Relative to Conventional Inv. Grade Fixed Income[2]



Price Stability Amid Recent Rate Volatility[4]



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[1]Sources: Barclays, JPMorgan as of November 30,2024. [2]Source: Bloomberg, JP Morgan, as of November 29, 2024. Indices used to represent asset classes: AAA CLOs (JP Morgan AAA CLO Index), IG corporates (Bloomberg U.S. Corporate Investment Grade Index), US Aggregate (Bloomberg U.S. Aggregate Bond Index), 1-3 Year Treasury. (Bloomberg 1-3 Year Treasury Index), U.S. Treasuries (Bloomberg U.S. Treasuries Index), 3-Month Treasury Bill expressed as current yield). [3]Source: Sharpe based on monthly price data between Jan 2012 and July 2024 sourced from Bloomberg, JP Morgan. Calculated in eVestment. [4]Source: Monthly price data between Dec 2021 and Nov 2024 sourced from BofA, Barclays, Treasury Yield sourced from Wall Street Journal Markets.

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