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GLOBAL RESEARCH

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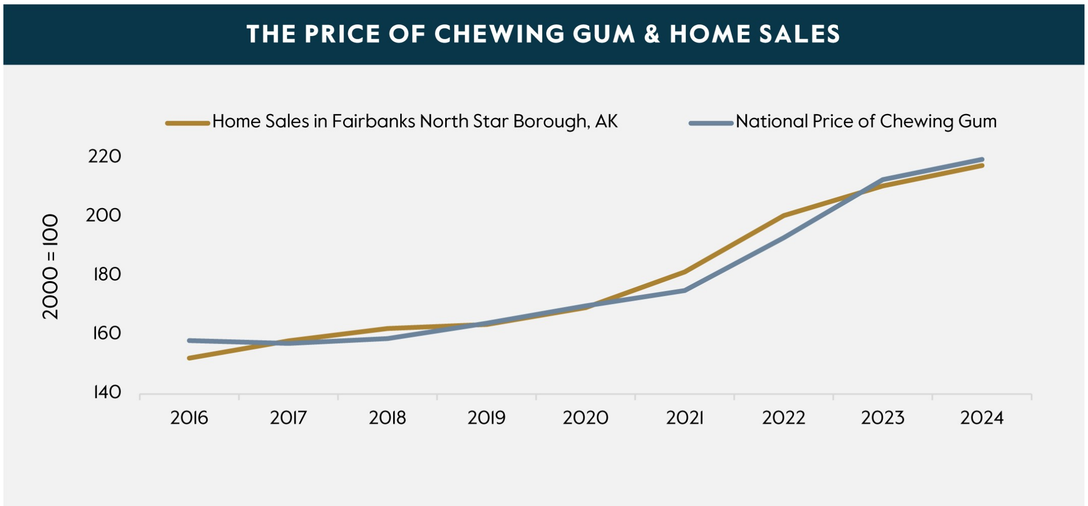
A Complacent Credit Market?

Exploratory data analysis may reveal that the average price of a pack of chewing gum sold in the U.S. is nearly perfectly correlated with residential property transactions in Fairbanks, Alaska. Indeed, over the past decade, that’s been the case (Figure 1). But who cares? Chaos theoreticians couldn’t hypothesize the mechanics behind this relationship.

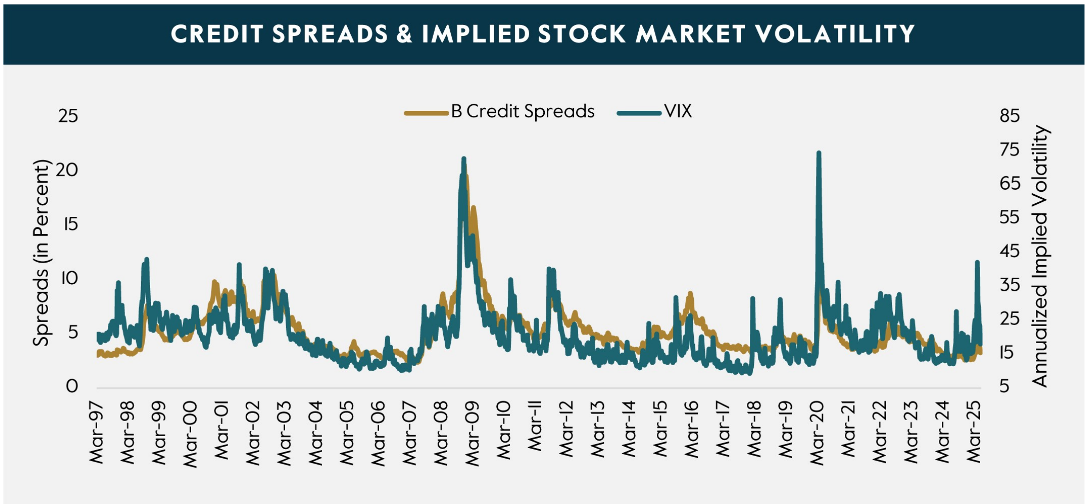
Figure 1: Don't Waste Your Time Explaining This One



Source: Carlyle Analysis; CBO, IMF WEO Database, Federal Reserve Data, May 2025. There is no guarantee any trends will continue.

Comovement attracts interest when consistent with theory-based restrictions, as observed when comparing the annualized implied volatility on the S&P 500 (as proxied by the VIX index) and average spreads on B-rated corporate credit. Over the past 28 years, the weekly variation in these time series has been 76% correlated, with that pairwise correlation rising to 80% when observed at quarterly intervals (Figure 2).

Figure 2: A Meaningful Relationship Consistent with Options Theory



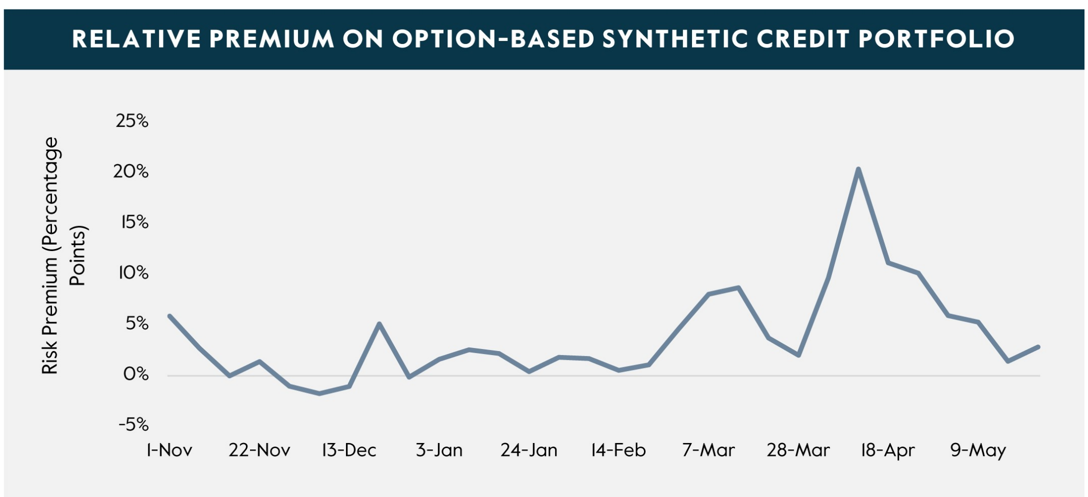
Source: Carlyle Analysis; Federal Reserve Financial Accounts of the United States, May 2025. There is no guarantee any trends will continue.

At first glance, one might expect this relationship to carry no more meaning than the correspondence between gum prices and Alaskan home sales. The samples differ greatly; S&P 500 constituents tend to be very large companies (a median market cap of over $30 billion) with pristine balance sheets. The companies in the pool of single-B borrowers tend to be about one-tenth the size, on average, and consist of leveraged public corporations and private companies that have recently been acquired in a buyout.

But these time series proxy for the same macro factor: the market price of risk. Implied volatility on the S&P 500 rises when investors fear that the enterprise value of U.S. businesses will fall. Such a decline would erode lenders' margin of safety, increasing the likelihood of default and leading to a corresponding rise in credit spreads. In fact, one could sell options on an equity index, like the S&P 500, to create a synthetic credit portfolio, with income from the option premium substituting for the cash interest on loans or bonds.

While implied volatility has been on a wild ride over the past few months, credit spreads have remained remarkably stable. In the aftermath of Liberation Day, the VIX rose 23 percentage points (2.9 standard deviations) while single-B spreads widened by 138 basis points (just 0.6 standard deviations). Implied spreads on synthetic credit portfolios spiked relative to those of loans and bonds and remain elevated (Figure 3), largely because credit spreads have since tightened nearly as much as they rose (128 basis points since April 11).

Figure 3: Insufficient Compensation for Risk in Credit Markets?



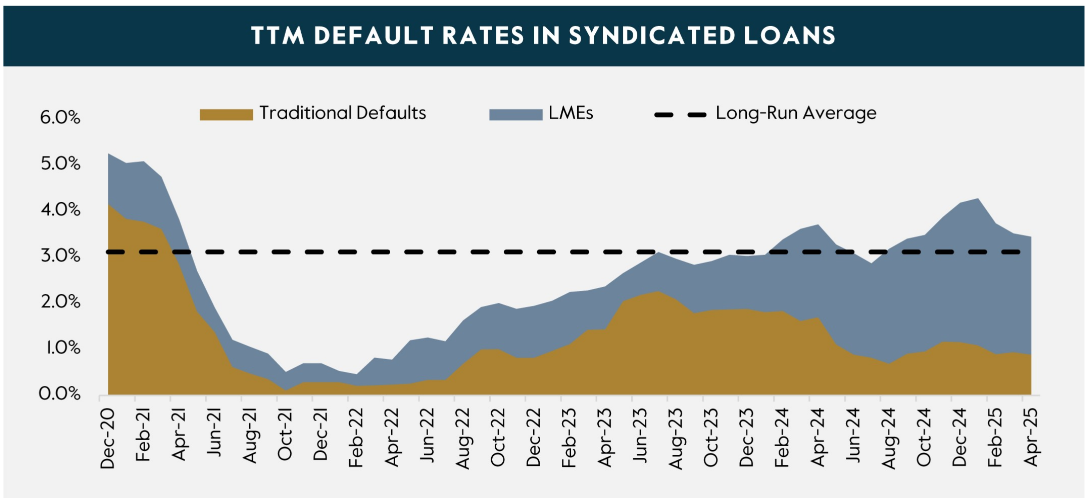
Source: Carlyle Analysis; Federal Reserve, May 2025. There is no guarantee any trends will continue.

A Bifurcated Market and New Default Cycle

What may appear as credit market complacency may instead reflect bifurcation. Tight spreads for single-B borrowers generally reflect solid performance. Businesses with strong earnings growth and relatively low leverage continue to access the market at favorable terms, with dividend payouts accounting for 12% of leveraged finance issuance this year, a record high. But only 7% of such deals have involved borrowers with debt-to-EBITDA ratios above 6x, down from 46% in 2021 when dividends were often a sign of aggressive lending.

Borrowers struggling with higher interest rates have had a different experience. Loans downgraded to CCC/D—and hence no longer in the single-B pool—typically trade below 80 per 100 of par. Though traditional defaults (missed coupon or principal payments) remain low, there has been a noticeable uptick in "liability management exercises" (LMEs), or opportunistic debt restructurings. When accounting for LMEs, the syndicated loan default rate has already risen above long-run averages, typically a sign of a turn in the credit cycle (Figure 4).

Figure 4: LMEs Take Default Rates Above Historic Averages



Source: Carlyle Analysis; BAML HY Credit Chartbook, May 2025. There is no guarantee any trends will continue.

LMEs can represent a "kicking the can" exercise where a participating class of creditors receives more favorable terms for providing liquidity to a company at higher risk of subsequent default, or agreeing to permanently reduce the amount of debt owed to lenders. Similar dynamics are evident in direct lending, where default rates remain low, in part, because creditors have converted struggling borrowers' cash-pay coupons into payment-in-kind (PIK) where foregone interest accrues to the principal balance. A recent survey found that loan-to-value ratios (LTVs) for these conversions have risen from 49% at the time of closing to 86% at the end of March 2025.

Creditors' willingness to work with troubled borrowers over the past few years seems to have been influenced by the threat of companies stripping assets from lenders' collateral pool, alongside rate cut expectations. At various times, the market has priced year-ahead base rates below 3%, levels that could materially improve the prospect that marginal credits could support their debt stack again. Such generosity is likely to fade as market participants come to terms with life in a new interest rate regime. As LMEs fall back into distress and equity evaporates in PIK conversions, expect default rates to move higher.

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