Leveraged Credit 2025 Review and 2026 Outlook

Key Highlights

- **2025: Disruption Met with Resilience:** Despite a turbulent year marked by rising volatility, inflationary pressures, and a record-long U.S. government shutdown, leveraged credit markets proved resilient, with high yield bonds and leveraged loans posting positive returns for the third year in a row.
- **Strong Technicals; Higher Quality Outperforms:** Technicals remained strong as refinancing and repricing activity extended maturity profiles. Investors favored higher-rated credits, which outperformed lower-rated peers in both the U.S. and Europe amid volatile conditions.
- **Defaults Remain Low:** Default rates for high yield bonds and loans stayed subdued in the U.S., supported by solid balance sheets and abundant private capital. While Europe saw a modest uptick, overall distress levels remain limited, and the 2026 outlook is broadly stable.
- **Private Credit Faces New Challenges:** The private credit market continued to expand, particularly in AI-related deals. However, rising default rates and a more front-loaded maturity wall are emerging risks demanding close attention.
- **2026 Outlook Demands Agility:** Artificial intelligence is set to remain a powerful force, creating both opportunity and risk in leveraged credit. With tight spreads, political uncertainty, and economic headwinds ahead, the ability to manage portfolios with agility and selectivity will be critical for success in 2026.

We Bid Farewell to 2025

2025 was a year of disruptions. After a strong start supported by hopes that a new, market friendly Trump administration would cut red tape, lower taxes and reinvigorate deal making, "Liberation Day" in early April set markets "free" of stability, and risk-off sentiment permeated. Economic growth forecasts were lowered, inflation expectations were raised, the Fed paused its rate cutting cycle, and markets braced for the worst. Since then, while there have been periods of trade policy-induced volatility, the undercurrent of their impact has ebbed and flowed. Ultimately, the Fed resumed easing and cut rates twice more in 2025. As of the time of this commentary, the consensus appears to be that tariffs will be much lower and potentially less harmful than originally forecasted.

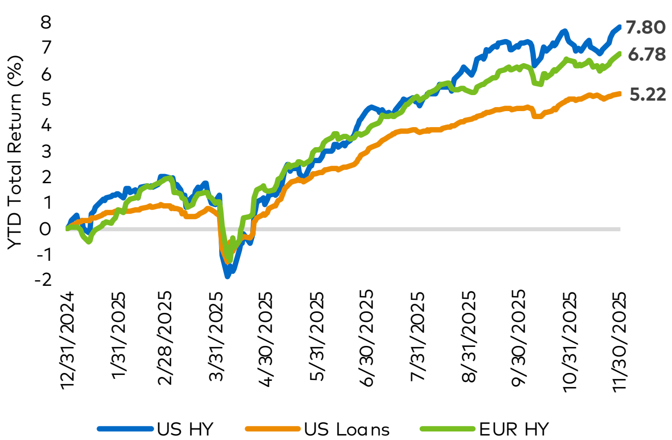
That last point reminds us of an adage that has been repeated, rephrased and applied in many contexts over the years: "**we tend to overestimate in the short run and underestimate in the long run.**" This expression seems fitting today. While artificial intelligence has been discussed and written about for many decades, AI's transition from science fiction to reality has hyper-accelerated. Its position as a disruptive technology entered the zeitgeist in earnest following ChatGPT's original release in late 2022. Since then, adoption rates have climbed, and 2025 saw the AI hyperscalers enter a great arms race in fear of being left behind. While this potential engine for enhanced productivity has primarily been funded through the cash flow of these often higher quality businesses, they have more recently turned to the credit markets to finance further growth. Although the AI trade lost some steam in November, it will undoubtedly be an important driver of markets in 2026 and beyond as businesses across the broader economy seek to leverage this transformative technology.

Aside from the impact that AI will have on the real economy as a disruptive technology, in October and November, it provided

Congress with some cover during the record 43-day government shutdown that proved to be a disruptive force in and of itself. Though markets seemed to accept that the shutdown would be eventually resolved, working Americans, together with the economy as a whole, certainly suffered in the face of unnerving Congressional dysfunction. In the end, it seems as if it was all for naught, as no grand plan was hatched and no great compromise was reached. Instead, Congress voted to pass another short-term fix, setting the public up for another episode of uncertainty in January when the continuing resolution approved in November expires.

That said, most markets, including leveraged credit markets, showed a great deal of resilience in the face of this year's volatility. For a third consecutive year, high yield bonds, both in the U.S. and Europe, produced positive performance largely driven by income. Although leveraged loans fell short of the promised yield from the start of the year, they too generated positive performance. For most of the year, new debt in leveraged credit markets was muted, as refinancing and repricing activity dominated. This dynamic resulted in a persistent supply-demand imbalance, with cash invested in existing deals, resulting in a strong technical bid for high yield bonds and leveraged loans. As a result, and as Figure 1 shows, even the downside created by policy uncertainty – namely, the market turbulence created in the wake of "Liberation Day" – was quickly erased once initial fears subsided.

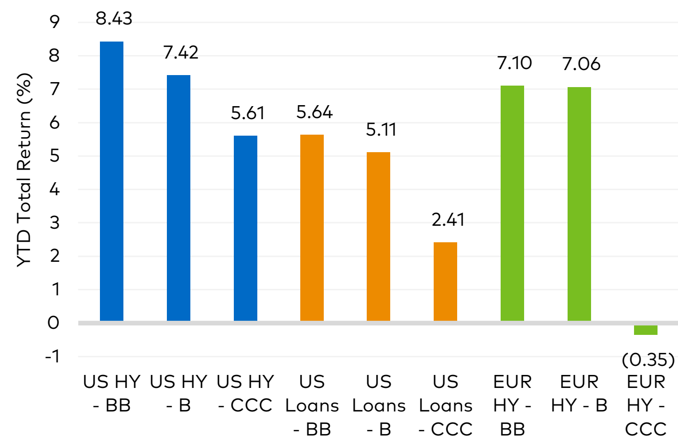
Figure 1: Leveraged Credit 2025 YTD Performance



As of 11/30/2025. **Source:** ICE and S&P/UBS. US HY, US Loans and EUR HY represented by the ICE BofA US High Yield Index, S&P/UBS Leveraged Loan Index and ICE BofA EUR High Yield Index (USD Hedged).

Parsing performance by ratings shows a decompression across leveraged credit markets (Figure 2). Using data from the ICE BofA U.S. High Yield Index, BB-rated U.S. high yield bonds generated a gain of 8.43%, benefiting from a 79 basis points ("bps") decline in 5-year U.S. Treasury yields since the beginning of the year. Single B-rated credits saw spreads widen by just 9 bps year-to-date, enhancing the benefit provided by the rate move, resulting in a gain of 7.42%, which was slightly above expected coupons. Lastly, CCC-rated credits among U.S. high yield bonds were the clear laggards, gaining just 5.61%. For CCCs, though spreads fell as low as 690 bps on Inauguration Day in the U.S., in light of the uncertainty regarding tariff policy and the economic growth trajectory, they widened to 894 bps by the end of November. This pattern of higher rated outperformance held in both the U.S. leveraged loan and European high yield markets. Notably, CCC-rated European bonds provided the weakest link, losing 0.35%, which was the result of dramatic price declines among issues in what is a relatively small segment of the market.

Figure 2: Leveraged Credit 2025 YTD Performance by Ratings

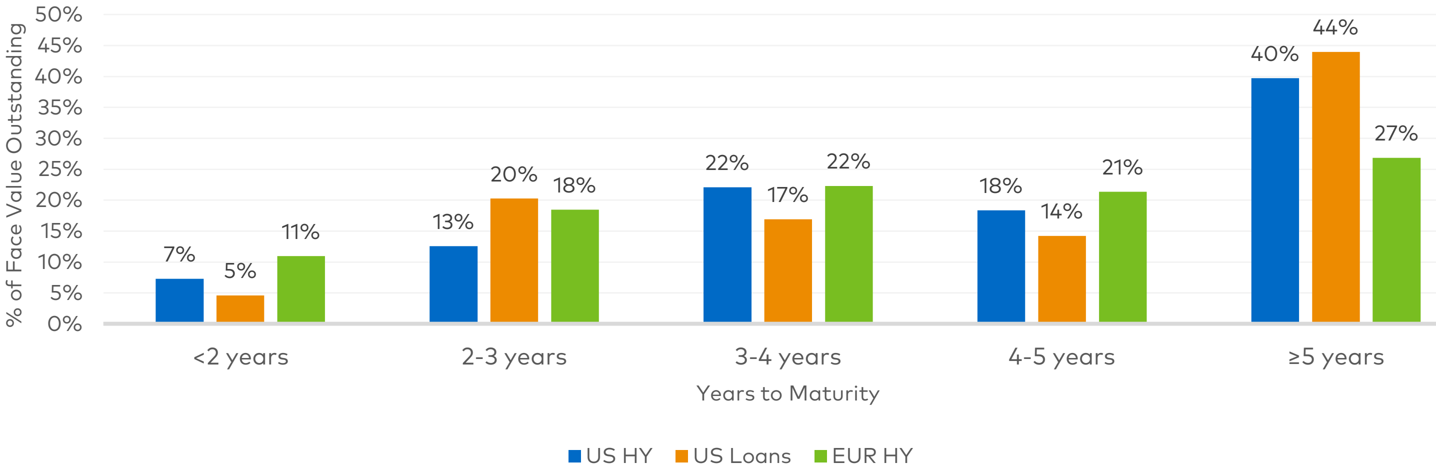


As of 11/30/2025. **Source:** ICE and S&P/UBS. US HY, US Loans and EUR HY represented by the ICE BofA US High Yield Index, S&P/UBS Leveraged Loan Index and ICE BofA EUR High Yield Index (USD Hedged).

Shifting our focus to primary market activity, while there were periods of stifled deal flow, overall, it was another strong year of gross new issuance. Through the end of November, U.S. high yield bond issuance of $310.1 billion has already surpassed last year's total. U.S. loan activity trails the record set in 2024, but a year of healthy CLO activity helped push loan issuance to $924.2 billion by the end of November. Meanwhile, European high yield bond new issuance has also exceeded 2024's full year total, and like their U.S. peers, issuance was dominated by refinancing. Robust repricing and refinancing activity in 2025 pushed out the maturity wall for public leveraged credit (Figure 3). That said, across leveraged credit, given the dearth of M&A activity, 2025 also saw an increase in dividend deals as private equity sponsors seek to take cash out of businesses.

Default activity remained contained, with some trends improving during the year. For example, leveraged loan default rates declined, liability management exercises ("LME") activity slowed year-over-year, and the gap between U.S. high yield bond and loan default rates narrowed from the record level set at the end of 2024. According to data from J.P. Morgan, as of this writing, the

Figure 3: Leveraged Credit Maturity Profile as of 11/30/2025



As of 11/30/2025. **Source:** ICE and S&P/UBS. US HY, US Loans and EUR HY represented by the ICE BofA US High Yield Index, S&P/UBS Leveraged Loan Index and ICE BofA EUR High Yield Index.

par-weighted high yield bond default rate sat at 0.79%, while for loans, the par-weighted default rate was 1.31%. Including distressed exchanges, those rates increase to 1.82% and 3.16%, respectively. Conversely, the European high yield default rate including and excluding distressed exchanges ended the period up from last year, and stood at 1.94% and 3.21%, respectively. Though we do not attempt to forecast default rates, indications from those that do suggest a similar year for defaults in 2026, which is in line with our expectations. Assuming an economic contraction does not materialize, there is limited distress in the market, no single sector is facing imminent issues, and there is ample dry powder in private markets looking for actionable areas to deploy capital.

Notably, managers of private credit funds remain focused on both their traditional area of focus, middle-market direct lending, and more recently on larger loans that directly compete with the broadly syndicated markets. As we have mentioned in previous writings, during times of stress for the broadly syndicated market, private credit has stepped in and provided financing. Similarly, when capital market activity in syndicated markets has increased, so did competition for deals. This resulted in a compression in absolute spreads across credit as well as a decline in the illiquidity premium offered in direct lending.

Further, as competition between these markets accelerated earlier in the year, it became more common to hear of market participants forgoing certain traditional creditor protections, such as maintenance covenants, in order to win deals. In our view, these types of decisions are emblematic of late-cycle behavior. Private credit, in particular, seems to be suffering from a bit of an identity crisis. Long hailed as the perfect blend of high income and low risk, funds raised massive amounts of capital that were then deployed in a short period of time. Perhaps then it is not surprising to hear increasingly of troubled credits, elevated default rates, and a general rise in stress in that corner of the market. In 2025, private credit has moved into bespoke financing involving staggering sums of money, and has become a full participant in the AI boom, which for all of its promise will undoubtedly leave some carnage in its wake. For the first time in its history, private credit is busy defending itself as an asset class, a pattern of behavior that other below investment grade markets are very familiar with.

Like its broadly syndicated high yield bond and leveraged loan cousins, we believe that private credit certainly has a place in a portfolio of a diversified pool of assets. However, given the amount of capital raised compared with actual demand, opacity, lack of liquidity, and shrinking premium, investors should tread lightly during this pivotal time, especially as these markets continue to converge. The private credit default rate is on the rise as the period of prolonged elevated rates finally starts to bite. Further, the private capital maturity wall is more front loaded than that of high yield bonds and leveraged loans. As a result, their need to address maturities in the near-term is more pronounced, leaving this segment of the market more susceptible to a slowdown in economic activity than in previous periods.

2026: Into the Unknown

Turning our attention to the year ahead, we think it is best to zoom out and consider the broader backdrop for leveraged credit markets. First, the macro picture. While our focus is always on identifying investment opportunities by employing bottom-up fundamental analysis, at least as of this writing, the macroeconomic environment seems supportive of markets. Tariff uncertainty and the prolonged U.S. government shutdown harmed sentiment and economic activity, but growth nonetheless continues and will likely do so into next year. Both in the U.S. and in Europe, fiscal and monetary policy is accommodative.

Inflation has already migrated back to target levels in the European Union, enabling the European Central Bank to cut rates faster than in the U.S. Further, the German economy in particular is poised to benefit from increased spending on defense and infrastructure. In the U.S., the "One Big Beautiful Bill Act" passed earlier in 2025, coupled with the AI-capex boom and potentially pent-up demand from the recoupment of lost wages during the government shutdown, could provide a bump to economic growth.

Although inflation remains above the Fed's long-term target, it has stabilized. With the labor market showing signs of softening, and the recent data void created by the government shutdown, the Fed may take a "wait-and-see" approach for the remainder of 2025. However, their path forward remains anyone's guess and we will know for sure following their next meeting on December 10th. Regardless, the Fed seems more divided on policy decisions than at any other point that we can recall. Our expectation is similar to that currently priced in the market – namely, that the Fed errs on the side of cuts as it moves to a more neutral policy stance over subsequent meetings.

While inflation has moderated and we anticipate continued growth, the consumer will remain in focus. Several years of above-target inflation, recent softening in labor data, and concerns about an increasingly AI-driven economy have left consumers feeling on edge. Of course, the consequences from all these effects varies by income level and much has been said about the return of the "K-shaped" economy. Higher income cohorts continue to spend while lower income cohorts reduce or defer discretionary purchases, as elevated inflation continues to place financial stress on these consumers. A similar dynamic is also playing out among corporates as fewer businesses reap the benefits of the current AI-boom.

Whether we are looking in the U.S. or in Europe, company fundamentals remain on solid footing, and a healthy consumer will go a long way in maintaining that position. That does not mean that there have not been pockets of weakness as tariff uncertainties have caused disruptions across sectors. Although with tariffs, the bark has been worse than the bite, as pauses, exclusion lists and deals have taken some of the sting out of the worst-case scenarios originally imagined at the beginning of Q2 2025. Nevertheless, following the initial tariff-induced spike in spreads, leveraged credit markets recovered. As of this writing, spreads are on the tighter end of the historical range (Figure 4).

However, tight spreads do not tell the whole story. As we know, the ratings breakdown of the U.S. high yield market has improved while the opposite is true for leveraged loans. This change resulted in a lower average spread for the former, and a higher average spread for the latter, relative to each market's history. Further, higher yields continue to attract investors to fixed income and credit-focused strategies. While yields in public leveraged credit markets are at or below the 5-year average, relative to longer term averages, the potential return offered by these markets remains attractive (Figure 5). Further, although not depicted below, high yield bonds and leveraged loans continue to provide enhanced income opportunities relative to several other fixed income markets.

Figure 4: Today's Spreads in a Historical Context (in basis points)

	Nov 2025	2025 Max	2025 Min	5yr Ave	10yr Ave	15yr Ave
US HY	292	461	259	365	415	449
US Loans	465	567	444	510	506	518
EUR HY	287	429	261	383	390	429
11/30/2025 Spread % Above or Below Average						
US HY				-19.9%	-29.6%	-34.9%
US Loans				-8.9%	-8.1%	-10.2%
EUR HY				-25.1%	-26.5%	-33.1%

As of 11/30/2025. **Source:** ICE and S&P/UBS. US HY, US Loans and EUR HY represented by the ICE BofA US High Yield Index, S&P/UBS Leveraged Loan Index and ICE BofA EUR High Yield Index. For US HY and EUR HY spread provided is the Option Adjusted Spread ("OAS"), while for US Loans spread presented is Discount Margin to Three Year Take-out.

Figure 5: Today's Yields in a Historical Context (in %)

	Nov 2025	2025 Max	2025 Min	5yr Ave	10yr Ave	15yr Ave
US HY	6.71	8.66	6.56	6.97	6.71	6.65
US Loans	7.87	9.15	7.60	8.11	7.37	6.90
EUR HY	5.10	6.50	4.84	5.39	4.48	4.88
11/30/2025 Yield % Above or Below Average						
US HY				-3.7%	0.0%	0.9%
US Loans				-2.9%	6.7%	14.0%
EUR HY				-5.4%	13.8%	4.4%

As of 11/30/2025. **Source:** ICE and S&P/UBS. US HY, US Loans and EUR HY represented by the ICE BofA US High Yield Index, S&P/UBS Leveraged Loan Index and ICE BofA EUR High Yield Index. For US HY and EUR HY yield provided is the Yield to Worst while for US Loans yield presented is Yield to Three Year Take-out.

Regardless of the headline numbers, as active managers we are tasked with identifying compelling investments. In our view, 2026 should provide ample opportunity to do so. However, after three years of positive returns in the leveraged credit markets, expectations for next year are more muted. As we discussed earlier, spreads at the index level are tight. Moreover, variations around average spreads are limited. For example, approximately 48.7% of the ICE BofA U.S. High Yield Index trades at an OAS that is 100bps inside of the market, while just 16.2% trades 100bps wide. We find a similar situation in the ICE BofA EUR High Yield Index, where those same numbers are 47.8% and 14.4%, respectively. However, most of that "tightness" in both of those markets is concentrated in BB-rated credits. Said another way, BBs should provide some ballast to a diversified portfolio and act as a potential source of liquidity to fund purchases during dislocations, but adding incremental yield through this cohort is limited.

Therefore, moving down in quality increases the likelihood of identifying attractive credits that are trading wide of the market. Using those same indices as proxies for the U.S. and European high yield markets, we see that close to $117.6 billion and €18.3 billion face outstanding are trading wide of their respective markets. While one must conduct the necessary level of diligence when evaluating an investment in the lower tier in particular, these pockets of value provide opportunity to add incremental yield to high yield portfolios.

Further CCC-rated credits, which have displayed the widest range of outcomes in the past year, offer interesting idiosyncratic opportunities to harvest meaningful yield premiums, especially among short-dated, non-distressed issues in the U.S. high yield market. As of 11/30/2025, there was $34.4 billion face of non-distressed CCC-rated debt in the ICE BofA U.S. High Yield Index that traded at a spread 100-300bps wide of the market. Often underfollowed and misunderstood, these yield-enhancing opportunities can provide interesting investing opportunities for those with longer-time horizons, even in "tight" markets.

Although U.S. loans face headwinds from falling rates, pressure on fundamentals, and a weaker ratings mix, there remains opportunity for active managers to find relative value opportunities in this corner of the market as well. A similar analysis of the S&P/UBS Leveraged Loan Index shows that most opportunity is among B-rated credits. Heavy CLO demand has driven the market tighter as a refinancing and repricing wave in 2025 pushed spreads lower. That said, as of 11/30/2025, $65.8 billion of loan face outstanding trades 100-200bps wide of the market, while another $126.7 billion of face is trading 300-600bps wide of the market. It is true that many of these situations are stressed or in some cases distressed, but managers with the expertise to navigate such situations could be poised to reap considerable rewards.

Finally, although we do not undertake sector rotation in our bottom-up process, we are keenly aware of the dynamics playing out in each sector. For example, in Europe, given continued heightened geopolitical tensions, defense spending should be a tailwind for growth next year, to the benefit of issuers in several sectors. Further, the oversupply of commodity chemicals by China globally, and in Europe in particular, shows few signs of abating, which has stressed prices for these inputs. Conversely, we are identifying interesting high yielding opportunities in specialty chemicals, which is showing some early signs of bottoming.

Moreover, as we search for opportunities in the coming year, AI-themes will likely place pressure on the leveraged credit markets in several ways. For businesses in sectors poised for disruption, several existing issuers have already seen their capital structures priced for the worst outcome or at a minimum unduly punished. Since the ultimate effects from AI-disruption remain unknown, this downdraft in prices could be overdone.

To date, these AI-effects can be seen in the technology and software heavy businesses that comprise the largest sectors of the leveraged loan market, while high yield bonds remain more insulated. Even though private credit maintains large exposure to the sectors ripe for AI-disruption, we have yet to see the same type of volatility in the pricing of the debt in that corner of the market. Publicly traded BDCs, as the only tradeable outlet for many of these investors, could be bearing the brunt of this disruption, as their prices faced pressure in the second half of 2025. Further, an increase in AI-related new issue activity could cause some spread widening among existing leveraged credit debt as companies look to participate in the current boom.

Not to be outdone, tariffs too have inflicted wounds on sectors and businesses. However, some of these effects may ultimately prove to be overblown while in other cases, they may be underappreciated. Only time will tell, but in the interim active managers can take advantage of price dislocations to uncover attractive value. While the U.S. government shutdown has ended for at least the time being, issues remain and must be resolved. Further, by this time next year, we will know the results of the midterm elections in the U.S., which typically adds to market volatility and in more recent history has resulted in a loss of control by the incumbent party. It remains to be seen how the elections will play out but one would expect the current administration, and like-minded members of Congress, to exhaust all efforts to maintain control, or else the U.S. could have a lame duck president just two years into his term.

Regardless of how 2026 unfolds, our commitment remains to deliver compelling, risk-adjusted returns for our clients. We will continue to seek out high-quality businesses, offering attractive risk-reward that our research indicates are well positioned to navigate market corrections and meet their debt obligations. In times of volatility, discipline is the key. Although it can be uncomfortable at times, temporary mark-to-market fluctuations will not distract us from our long-term focus. History shows that periods of disruption often create exceptional buying opportunities as market inefficiencies emerge. While those disruptive periods have become increasingly shorter in duration, we remain poised to act when they do occur. By staying committed to our process and remaining agile to deploy capital to capture these opportunities, we believe that our clients' portfolios are well positioned to capitalize on these dislocations and add to performance over the long term.

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