

Weekly Market Commentary

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Private Credit Under Pressure: Liquidity Mismatches in an AI-Disrupted Cycle

Corporate credit markets have become unsettled about the potential for advanced agentic AI tools from firms such as Anthropic and OpenAI to automate functions across legal, analytical, marketing, and sales workflows, effectively targeting the software as a service (SaaS)/enterprise software space. Those concerns are highest within the private credit market, and that market is confronting its most meaningful stress test since becoming a dominant source of non-bank financing, with an emerging wave of redemption pressure providing the clearest early signal of underlying liquidity mismatches. The suspension of redemptions across several large non-traded vehicles has exposed how appraisal-based valuations, limited secondary-market liquidity, and concentrated exposures in enterprise software can interact in a higher-rate environment. These events are occurring against a macro backdrop defined by tighter financial conditions for some, weakening borrower fundamentals, and accelerating AI-related disruption, all of which are challenging the optimistic underwriting assumptions embedded in loans originated mostly during the 2020–2021 cycle. As redemption requests rise and managers respond through asset sales, return-of-capital programs, or permanent gating, we continue to advocate for investing in managers who apply disciplined, conservative valuation methodologies, with portfolios composed of senior secured debt securities.

What is Private Credit?

Private credit is a broad asset class that is roughly \$40 trillion in size and encompasses non-bank lending and debt investments that are not publicly traded. Unlike bonds issued in public markets, private credit transactions are negotiated directly between borrowers and investors, resulting in bespoke structures tailored to the specific needs of each deal. The asset class spans several strategies, including mezzanine financing, real estate debt, distressed debt, and asset-backed lending — and while most of the categories listed above are still in very solid positions, direct lending, which is a small piece of the private credit ecosystem, is the area that has been in the headlines recently.

At its core, direct lending involves non-bank lenders — typically alternative asset managers — providing senior secured loans directly to middle-market companies. These businesses are generally too large to rely solely on community banks yet too small to access broadly syndicated loan (BSL) markets efficiently. Direct lenders step into this gap, offering speed, certainty of execution, and flexible structures that traditional capital markets struggle to match.

The loans generated through direct lending are typically floating-rate instruments, tied to benchmarks such as SOFR (secured overnight financing rate), which generally become more attractive to investors as interest rates rise but more onerous to borrowers as interest expenses rise as well. They are also senior in the capital structure, meaning lenders hold the first claim on borrower assets in a default scenario. This combination of seniority, collateralization, and floating-rate income has made direct lending particularly attractive to institutional investors — pension funds, insurance companies, and endowments — seeking income with meaningful risk mitigation.

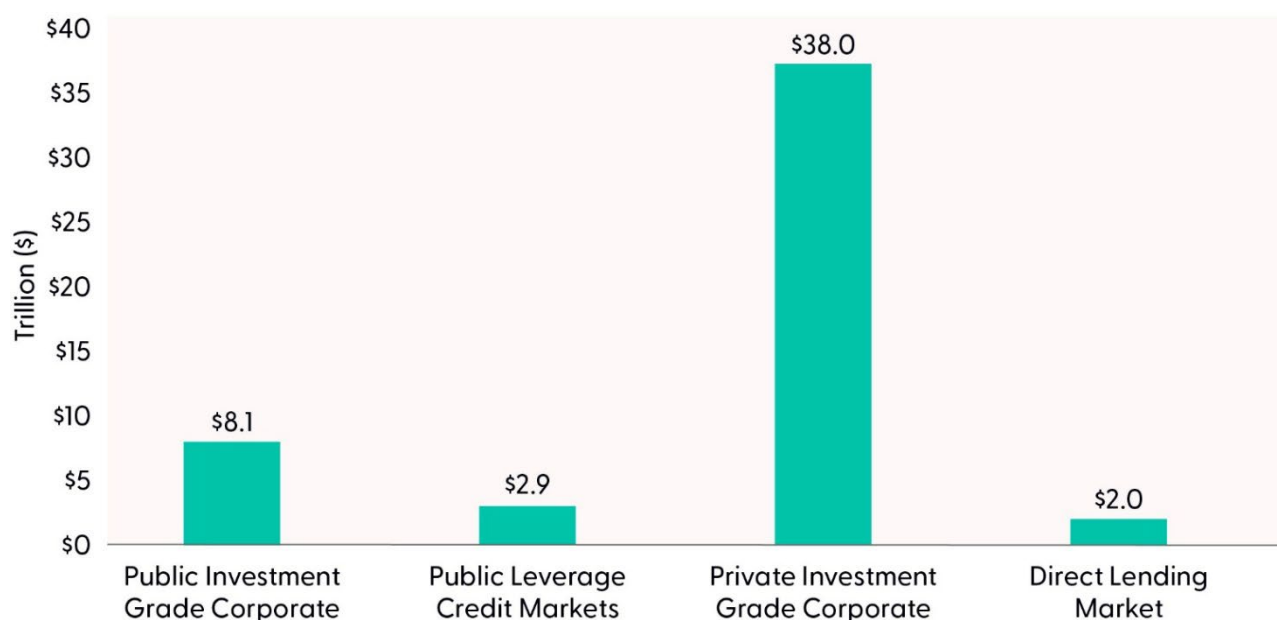
Unintended Consequences?

The Volcker Rule, part of the Dodd-Frank Act implemented after the 2008 financial crisis, prohibited large banks from engaging in proprietary trading and significantly restricted their ability to sponsor, invest in, or have certain relationships with private equity and hedge funds (as "covered funds"). This, combined with other post-crisis regulations like Basel III capital requirements, constrained banks' capacity and willingness to hold leveraged loans

on their balance sheets or provide high-leverage financing to riskier borrowers, particularly in the middle market and for private equity-sponsored deals.

As such, growth in direct lending accelerated sharply following the 2008 Global Financial Crisis, as tightened bank regulation curtailed pushed lending appetite elsewhere. Alternative managers filled the void, and today the direct lending market represents nearly \$2 trillion in deployed capital in the U.S. For middle-market borrowers, it offers a reliable funding partner. For investors, it delivers a yield premium over public credit — the so-called illiquidity premium — in exchange for capital lock-up (this is important).

Private Credit Markets are Larger than Public Credit Markets



Source: LPL Research, Apollo Global Management 03/15/26

Disclosures: Past performance is no guarantee of future results. Any companies or options referenced are being presented as a proxy, not as a recommendation.

Business Development Companies (BDCs) offer retail investors the most accessible entry point into private credit direct lending, providing high dividend yields due to their requirement to distribute 90% of taxable income. By investing mainly in the debt — and occasionally the equity — of middle-market companies, they give individuals exposure to private credit strategies typically reserved for institutional investors. However, BDC portfolios can be opaque, often employ leverage, and experience net asset value (NAV) volatility unrelated to loan performance. Major players such as Ares Capital (ARCC), Blue Owl Capital (OWL), and FS KKR (FSK) now anchor an industry exceeding \$500 billion in assets.

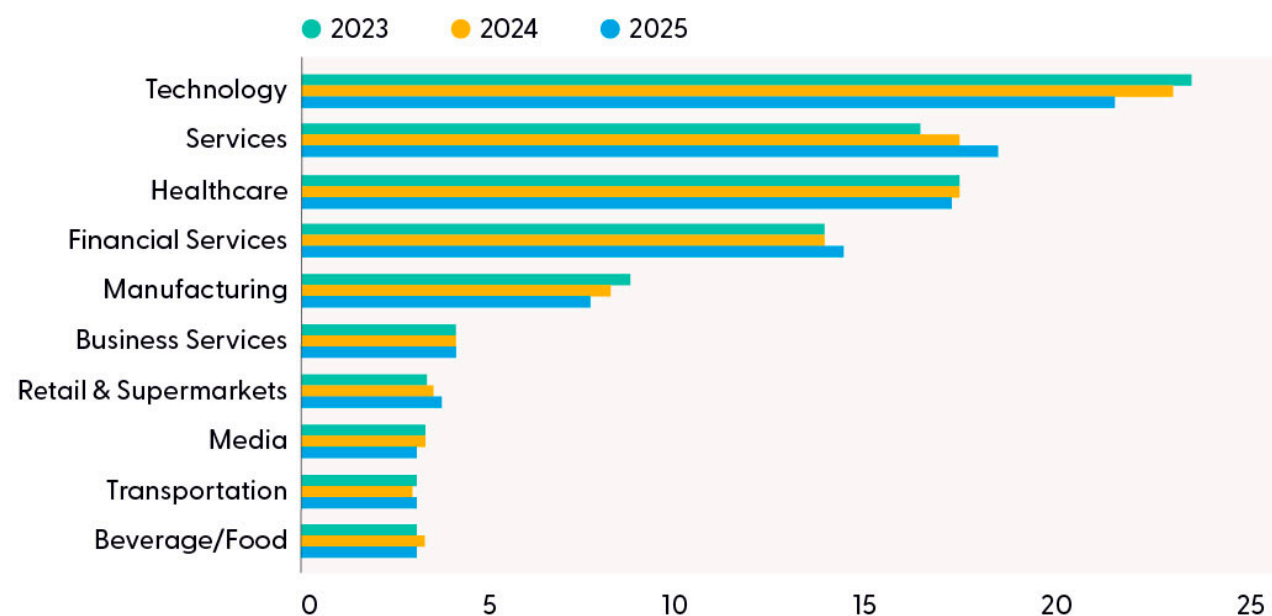
Meanwhile, private-credit ETFs are emerging rapidly, though they face structural challenges since illiquid private loans must be housed within vehicles offering daily liquidity. As a result, most ETFs combine true private loans with syndicated or investment-grade credit to manage redemptions and preserve liquidity. For investors, the appeal is higher yields with familiar ETF mechanics — but the exposure is only an approximation of private credit, and liquidity risks remain significant.

Cracks in the Core: Software Lending Is Stress Testing Private Credit Markets

Note: throughout the rest of this publication, we will refer to the direct lending segment as “Private Credit” as that has been the preference within the financial media.

Private credit remains the area where structural risks are most deeply embedded — and least visible. Over the past five years, enterprise software has become a core theme for private credit and private equity, with direct lenders funding 40% – 70% of leveraged buyouts between 2022 and 2023, up sharply from 15–25% pre-pandemic. Software and technology companies now represent over 20% of BDC investments, and market estimates are that between 25–35% of private-credit portfolios carry some degree of AI-related disruption risk.

Technology is the Largest Sector Within BDCs



Source: LPL Research, Pitchbook 03/15/26

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Compounding this, many loans were underwritten with optimistic income growth expectations that are proving unrealistic in today's higher-rate, slower-growth environment. Borrowers face margin pressure, deteriorating interest coverage, and increased use of payment-in-kind (PIK) features — where borrowers accrue, rather than pay interest — while valuations have compressed and venture funding has cooled. With roughly 15% of SaaS borrowers struggling to cover interest expenses, the sector holds hundreds of billions of dollars that may be more susceptible to default than comparable public-market credit.

That said, most loans are private equity-backed or sponsored. In this context, loan-to-value (LTV) ratios — which measure the loan amount relative to the enterprise value of the company — typically incorporate sizable equity cushions to protect lenders. Private credit loans often feature conservative LTVs in the range of 40–60% (frequently mid-40s to around 50–60%), meaning private equity sponsors contribute substantial equity (often 40–60% or more of the deal value). This creates a meaningful buffer that must be significantly eroded — through declines in company value, income drops, or other stresses — before the senior debt faces material impairment, enhancing risk mitigation compared to higher-leverage structures in some syndicated markets.

Redemptions Meet Reality: The Liquidity Limits of Private Credit

Growing unease about today's private credit market has seemingly reached a crescendo, with comparisons to the mortgage excesses that fueled the run up to the Global Financial Crisis almost overshadowing the escalating conflict in Iran. Market commentators continue to warn that private credit's surge, driven by nonbank firms stepping into roles once dominated by traditional lenders, echoes how subprime mortgage origination moved outside the banking system before 2008. In turn, this reduced market transparency and the overall health of financial markets. The recent bankruptcies of smaller private credit-backed portfolio companies and warnings from major market participants, most notably JPMorgan Chase CEO Jamie Dimon, have only fueled the already high levels of concern from investors.

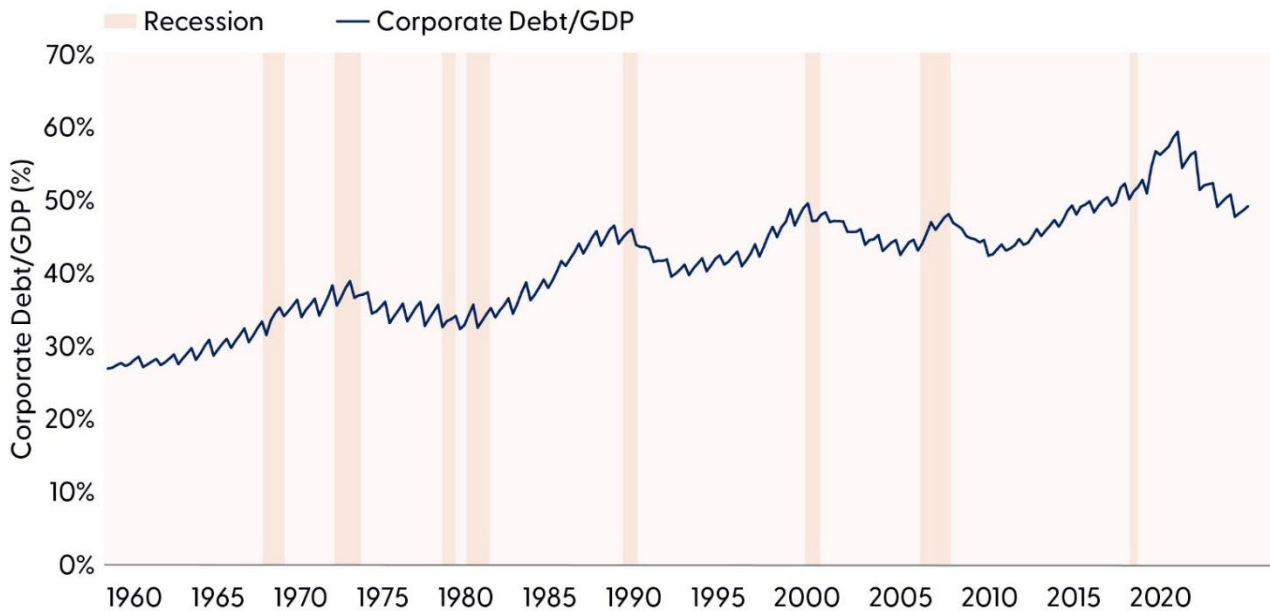
The recent episode was triggered by a combination of AI/software disruption fears, broader market unease, and the realization that inflows could no longer absorb outflows in a declining-rate environment where retail investors reassessed liquidity and risk. Industry-wide redemption requests spiked in late 2025 and early 2026, with several other large non-traded BDCs and interval funds capping or slowing withdrawals. Sales volumes in some of the largest retail private credit vehicles have slowed markedly. As well, similar to a modern-day bank run, news stories highlighting increased withdrawal requests caused additional withdrawal requests, which were only amplified by the opaque nature of these strategies.

This liquidity crunch highlights a core tension: private credit may offer higher yields but holds long-dated, hard-to-sell assets. When redemptions hit critical mass, managers must either sell loans (often at a discount in stressed markets), gate (restrict) withdrawals, or restructure the vehicle — each option risking further investor outflows and reputational damage. The gating has already moderated retail inflows, sparked legal scrutiny over disclosure practices, and prompted debate about whether illiquid strategies belong in retail-accessible products.

Should We Be Concerned About Systemic Risks?

While it is important to acknowledge the rise in credit risks, it is equally important to separate credit risk from systemic risk. For those of us that lived through the Global Financial Crisis, we see some similarities but distinct and important differences. What we're seeing today looks more like a healthy repricing and shift in sentiment — not the start of a broad credit unwind. Historically, systemic risk becomes a concern when corporate debt grows significantly faster than the overall economy. By that measure, we are not seeing red flags. Sub-investment-grade lending remains manageable relative to GDP, and even with the growth of private credit, the total share of non-investment-grade corporate lending is roughly where it was a decade ago. In fact, overall corporate debt-to-GDP levels have actually come down in recent years.

Corporate Debt to GDP Has Fallen Recently



Source: LPL Research, Bloomberg. 03/15/26

Disclosures: The National Bureau of Economic Research (NBER) defines a recession as a significant, widespread, and sustained decline in economic activity lasting more than a few months. Past performance is no guarantee of future results.

As it relates to redemption requests turning into forced selling — especially after a few private credit managers activated redemption gates, including industry heavyweight BlackRock that enforced its 5% redemption gate on its HPS Corporate Lending Fund — gating isn't a signal that something is breaking; it's the structure doing exactly what it was designed to do. These vehicles exist to invest in illiquid loans, and the guardrails are built to prevent fire-sale conditions during periods of stress. When redemption requests rise, managers may use these gates to protect existing investors and avoid selling assets at poor prices. This mechanism helps contain stress and reduces the likelihood of broader market spillovers.

This protective design is common across the private credit ecosystem. Private-credit collateralized loan obligations (CLOs), for example, have structural features that automatically redirect cash flows during periods of strain, limiting the need to sell assets. Insurance companies, another key investor group, are also insulated from forced selling thanks to surrender penalties, liquidity facilities, and allocations to more liquid bonds that can be tapped first. Taken together, these structural safeguards help ensure that forced selling is unlikely to become a meaningful source of systemic risk, in our view.

The Bottom Line

As noted investor Warren Buffett famously said, when the tide goes out, you see who has been swimming naked. And over the past few years, liquidity has been abundant, but that liquidity is now ebbing. Private markets enjoyed a powerful tailwind during the period of ultra-low interest rates, and it is highly likely that many deals were underwritten with overly optimistic assumptions during that stretch. That suggests there is still likely additional adjustment and potential pain ahead. However, this does not imply that the broader private-market asset class is in jeopardy.

The era of ultra-low interest rates (post-GFC through much of the 2010s and early 2020s) played a key role in fueling current excesses in private credit by driving a relentless "search for yield." With traditional safe assets

offering near-zero returns, institutional investors piled into higher-yielding alternatives like private credit, enabling looser underwriting, higher leverage in some deals, and rapid AUM growth. This contributed to competitive dynamics where capital chased deals, sometimes compressing spreads and accepting lower-quality borrowers — a classic late-cycle behavior. Yet this is part of the natural credit cycle: low rates inflate asset prices and encourage risk-taking, while rising rates (as seen recently) discipline the market, force selectivity, and reset valuations. Overall, while excesses built during the low-rate regime warrant caution (particularly as 2020 and 2021 vintages need to refinance into a higher interest rate environment), the asset class's investor protections should limit spillovers into the broader economy.

Private credit is undeniably facing real, observable risks today. However, an immediate shock and contagion from the asset class failing is not in our forecasts. Rising defaults, an increase in PIK usage, and lower interest rate coverage ratios are immediate concerns to consider. Additionally, while less than 20% of private credit capital is invested in a vehicle offering some type of liquidity, much of that is within the retail industry and directly impacts our advisors. As such, we continue to advocate for investing in managers who apply disciplined, conservative valuation methodologies, with portfolios composed of senior secured debt securities.

Asset Allocation Insights

LPL's Strategic Tactical Asset Allocation Committee (STAAC) maintains its tactical neutral stance on equities. As the war in Iran continues and oil prices have moved sharply higher, investors may be well served by bracing for additional volatility. The stock market's resilient track record during geopolitical crises is reassuring, leaving STAAC to look for opportunities to potentially add equities at lower levels rather than remove equities due to what will likely be relatively short-term market disruption.

STAAC's regional preferences across the U.S., developed international, and emerging markets (EM) are aligned with benchmarks. Attractive valuations in non-U.S. equities are offset by upward pressure in the U.S. dollar, although the Committee continues to watch EM closely for opportunities due to improvements in fundamentals and the technical analysis picture pre-Iran conflict.

The Committee still maintains a slight preference for growth over value tilt and large caps over small caps. In terms of domestic sectors, communication services remains an overweight, while industrials were recently upgraded to overweight based on strong earnings momentum, technical trends, and tailwinds from fiscal spending and AI-driven investment. The Committee continues to debate other upgrade candidates, including healthcare and technology.

Within fixed income, the STAAC holds a neutral weight in core bonds, with a slight preference for mortgage-backed securities (MBS) over investment-grade corporates. The Committee believes the risk-reward for core bond sectors (U.S. Treasury, agency MBS, investment-grade corporates) is more attractive than plus sectors. The Committee does not believe adding duration (interest rate sensitivity) at current levels is attractive and remains neutral relative to benchmarks.

Important Disclosures

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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All investing involves risk, including possible loss of principal.

US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Private credit carries certain risks – illiquidity, opacity, borrower concentration, and bespoke structures – that distinguish it from corporate bonds and bank loans and complicate its evaluation and oversight.

All index data from FactSet or Bloomberg.

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