

# A paradox revisited

Gaining new insights into private credit

---

## In brief

- Emerging signs of stress within private credit portfolios should not come as a surprise, given the predictable impact of high interest rates on lower-rated borrowers.
- Going forward, higher-quality borrowers may have to look to the full spectrum of lending options—across private and public markets—when refinancing their existing loans.
- Conversely, weaker borrowers may need to seek flexibility from their current lenders; some may require more significant recapitalization or restructuring.
- Investors' desire for liquidity will likely accelerate the pace of secondary market transactions, increasing both price transparency and volatility across the private credit sector.
- Private credit allocations should pivot toward funds focused on distressed credit, secondary opportunities and new direct lending—particularly those run by managers with fresh capital to deploy and proven underwriting skill.

## As some cracks appear, investors may need to revisit their assumptions about the private credit sector.

In July 2023, when we published [“The Paradox of Private Credit,”](#) asset managers and allocators alike were enjoying benign credit conditions and remarkably consistent investment performance. Despite the constructive environment, we suggested that private credit investors should anticipate a market shift and reserve space in their portfolios for secondary private credit funds and opportunistic/distressed credit funds. Should a downturn arrive, these strategies would be well positioned to take advantage of it, providing liquidity for an attractive premium and generating potentially high returns by addressing the complex needs of weaker borrowers.

This advice still holds.

Today, cracks have begun to appear in private credit, putting investors on edge. Over the past few months, a handful of high-profile borrower defaults, significantly discounted secondary sales and elevated requests for redemptions in semi-liquid strategies have rattled asset owners and the market. In response, we return to the three fundamental (and still somewhat perplexing) questions that investors ought to ask about what has been—until very recently—a rapidly growing market:

- 1) Why would borrowers pay significantly higher interest rates on loans from private non-bank lenders if they could potentially borrow more cheaply in the syndicated loan or high yield bond market?

## Authors



**Jared Gross**  
Head of Institutional  
Portfolio Strategy



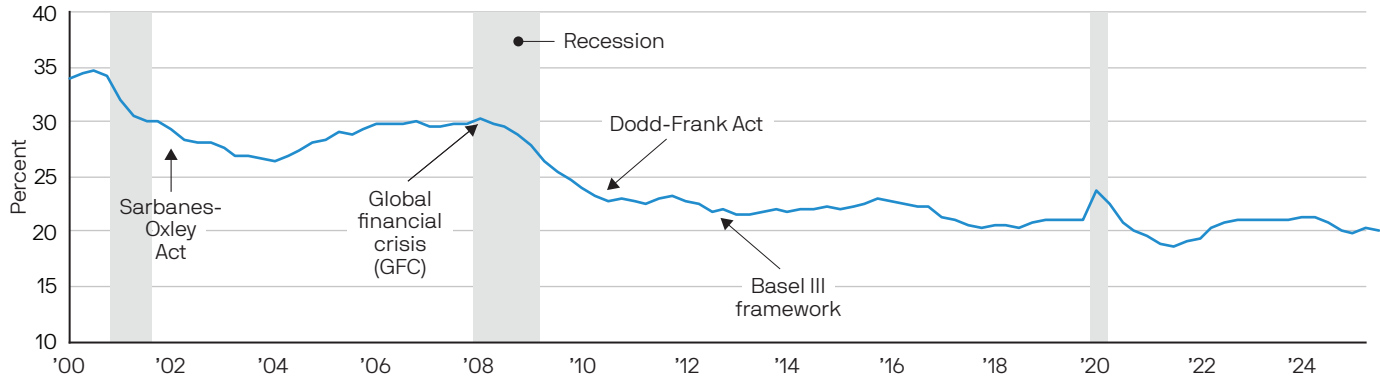
**Kathleen Clum**  
Associate,  
Institutional Portfolio  
Strategy



**Addison Muir**  
Associate,  
Institutional Portfolio  
Strategy

**Post-GFC, declining bank lending opened up space for private credit to grow**

Exhibit 1: Bank lending as percentage of nonfinancial debt



Source: Federal Reserve, J.P. Morgan Asset Management *Guide to Alternatives*; data are based on availability as of January 31, 2026.

- 2) With private credit funds raising a huge amount of capital, will the pressure to invest the money lower underwriting standards, lead to a compression of credit spreads—or maybe both?
- 3) Can an asset class built on charging high interest rates to lower-rated credits sustain its performance when some borrowers’ stress increases, and might the high interest rates themselves lead to elevated credit risk?

Finding answers to these questions is more critical than ever for investors in private credit. Fortunately, the passage of time has given us additional insight into the activities of borrowers, lenders and investors.

**For borrowers, high borrowing costs but improved flexibility**

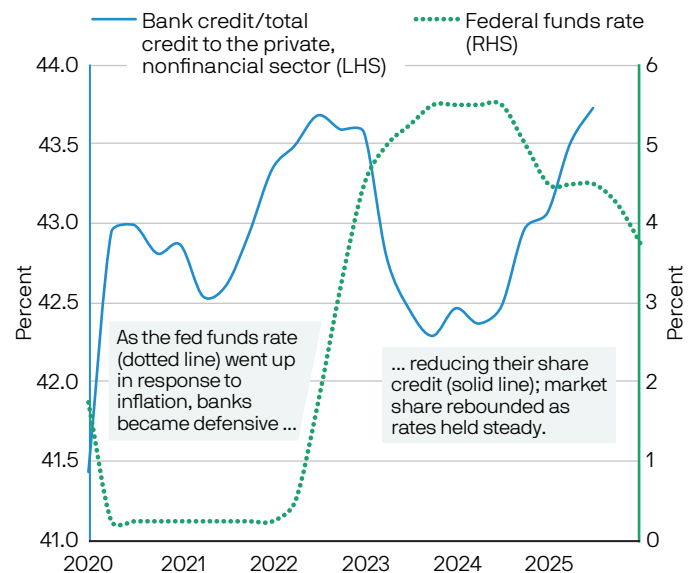
Borrowers’ pivot toward more costly private market financing likely reflects either stark necessity or compensatory benefits—and it appears to have been a bit of both.

A now-familiar explanation for private credit’s rise is that, in the wake of the Global Financial Crisis (GFC), private credit simply emerged to fill a void left by a decline in traditional bank lending and syndicated loans (Exhibit 1). At that time, a combination of risk aversion and tighter regulation caused many banks to reduce their exposure to both of these financing channels, and many borrowers were left with few other options.

Yet banks have continued to play a role in the market, and recently we have seen signs that bank lending is starting to recover some market share from private direct lenders (Exhibit 2). Although lending activity is lower than it was pre-GFC, many banks’ clients can still access bank financing via balance sheet loans and syndicated lending deals. Banks can also facilitate financing for clients with

**Bank lending appears to be stabilizing and possibly recovering market share**

Exhibit 2: Bank credit as a % of lending to the private, nonfinancial sector



Source: Federal Reserve, J.P. Morgan Asset Management; data as of December 31, 2025.

third-party private credit funds, rather than using their own balance sheets. Importantly, banks are also a primary source of leverage for private credit funds, lending against the fund’s portfolio rather than making loans directly.

A more nuanced view of private credit’s rise, however, would also acknowledge its structural advantages. Compared with banks or public debt markets, private credit lenders offer borrowers a streamlined underwriting process that can speed up deal execution and greater flexibility to customize loan terms and covenants. For financial sponsors in particular, the ability to work quickly and quietly with a private lender provides competitive advantages in executing leveraged buyouts. For small and mid-sized firms that may not borrow enough to justify a broadly syndicated loan (BSL), the availability of private capital opens up significant credit capacity.

While the relative cost of borrowing in the private credit market can be high, absolute cost is also a key consideration. Before the recent U.S. Federal Reserve (Fed) hiking cycle, very low short-term interest rates offset the wide credit spreads that private lenders demanded, keeping borrowers’ all-in yields affordable. Today, short-term interest rates are higher, and while credit spreads have begun to compress (**Exhibit 3**), the effects are not equal. Recent spread compression has not offset interest rates’ post-2022 rise, leaving private borrowers facing higher all-in yields on their existing debt.

Elevated debt service costs are clearly harmful to borrowers’ financial health. The longer they persist, the greater the risk that credit stress will expand, affecting more borrowers—and more severely impacting the weakest. With diminishing expectations of additional Fed rate cuts in the near term, the likelihood that elevated borrowing costs will continue has increased.

As current loans mature and come due, borrowers that need to refinance will seek to reduce their interest expenses to the fullest extent possible, potentially leading to some bifurcation in the market.

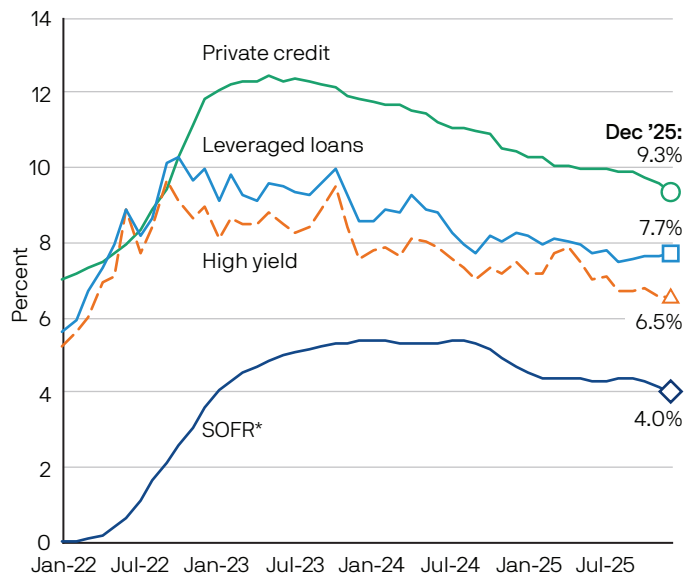
For borrowers, we expect to see differentiation around:

#### Higher quality credit

Borrowers with stronger financials will have more options in public and private markets. Those with

### After years of low rates that kept private credit borrowing costs manageable, short-term rates have risen sharply since 2022

Exhibit 3: Borrowing costs in public and private credit markets



Source: Bloomberg, FactSet, Federal Reserve Bank of New York, J.P. Morgan Asset Management; data as of December 31, 2025.

\*Secured overnight financing rate (SOFR)

access to comprehensive banking relationships will be able to manage their cost of financing more efficiently and may not have to accept the prevailing cost of private debt.

#### Weakened credit

Unfortunately, credits that are experiencing stress will pose a challenge to their existing private lenders. Some borrowers may require loan modifications; others may have to seek additional debt in lieu of making coupon payments (known as “payment-in-kind,” or PIK debt) as a temporary reprieve. Some of these borrowers will ultimately require a more costly refinancing or recapitalization by distressed-debt investors.

This differentiation may be mirrored across lenders as well.

#### Legacy funds

Managers of legacy private credit funds may be increasingly focused on credit risk, valuation and liquidity. New challenges could emerge in managing

risks in portfolio credits and aligning net asset values (NAVs) with secondary market prices. For those funds that offer liquidity, deciding whether to sell assets or fund redemptions through incoming contributions may add another layer of complexity.

### New funds

Private credit funds with fresh capital will likely have maximum flexibility. Whether these funds are offering compelling terms to the best credits, refinancing stressed borrowers or acquiring loans in the secondary market, the value of fresh capital and a clean balance sheet has risen. Private funds that are affiliated with banks can also offer clients the broadest spectrum of financing options: balance sheet, public debt, syndicated loans, private direct lending and “special situations” financing.

### For lenders, closed-end fund structures offer weakening protection from volatility

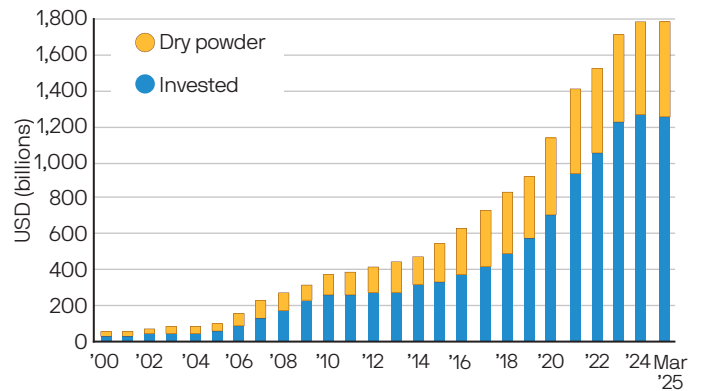
A common argument for private credit is that a closed-end fund with committed investor capital provides a more stable capital structure than a bank’s balance sheet, which is necessarily funded with short-term deposits. By eliminating the possibility of mass investor withdrawals—a classic “run on the bank”—private funds ensure that they are able to hold loans to maturity or sell them only when it is advantageous to do so.

Balancing assets and liabilities is sensible, but the growth in liabilities—in the form of investor capital commitments—creates pressure on private credit funds to find attractive assets. Undrawn commitments generally do not generate fees for the fund managers or returns for their investors. As the flow of capital into the private credit sector has accelerated, a number of predictable effects have followed: Uninvested capital, or “dry powder,” has grown; credit spreads have narrowed; and underwriting standards have declined (**Exhibit 4**).

Traditionally, the primary pool of underlying assets has been whole private loans or large portions of privately syndicated lending deals. While these assets may be senior in the capital structure (and often come with some security in the form of pledged collateral), investors still

### As the private sector has grown, so has dry powder

Exhibit 4: Global private debt assets under management



Source: Prequin, J.P. Morgan Asset Management; data as of March 2025.

need to remain vigilant about credit risk. With asset level liquidity and secondary market price discovery extremely limited, effective risk management demands skill in underwriting and portfolio construction.

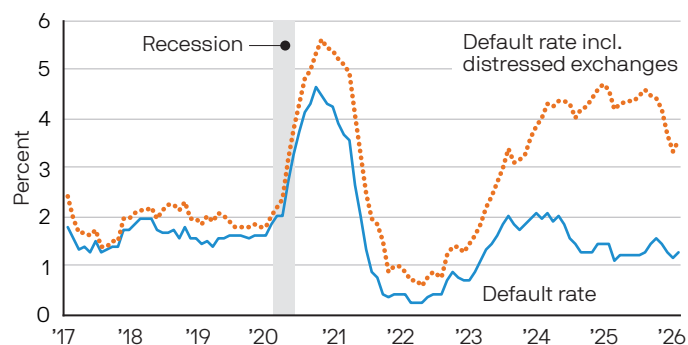
High yields do offer some protection against capital losses, but the asymmetry of the downside risk means that rising credit risk exposure will likely become a more significant driver of performance going forward. With post-default recovery values declining, even modest increases in default experience can lead to significant dispersion in performance. For funds with concentrated exposure to vulnerable sectors, such as software, the difference in default rates may be greater.

In recent years, the low default levels in private credit fund portfolios have been characterized as evidence of strong underwriting standards relative to other, more-speculative credit sectors, such as high yield and syndicated loans (**Exhibit 5A**). But the comparison may be somewhat misleading: Private lenders have far more flexibility to alter loan terms in a liability management exercise (LME) to improve the borrower’s position, or to accept additional debt in lieu of coupon payments (PIK debt) (**Exhibit 5B**).

There is a genuine debate as to whether these mechanisms serve to avoid, or simply forestall, a default. Time will tell.

### Default rates in private credit don't tell the whole story

Exhibit 5A: Default rate with and without distressed exchanges



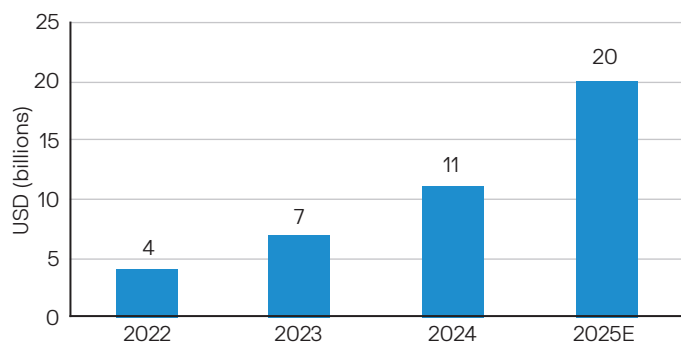
Source: Morningstar (PitchBook), J.P. Morgan Asset Management; data as of January 31, 2026. \*A distressed exchange is defined as an offer to a creditor of new or restructured debt by a company that amounts to a diminished financial obligation relative to the original obligation. The standard default rate is calculated using the last 12 months (LTM) number of defaults as a % of total issuers. The default rate including distressed exchanges is calculated using the LTM number of defaults plus distressed exchanges as a % of total issuers.

### Investors may want more liquidity than private funds can deliver

Limited liquidity is a feature of private credit markets. Closed-end private credit funds impose capital lockups and, in some cases, place restrictions on accessing liquidity in the secondary market. Even “semi-liquid” interval funds—those that offer investors limited, scheduled liquidity—cap periodic withdrawals at levels that may be insufficient to meet investors’ demands for liquidity.

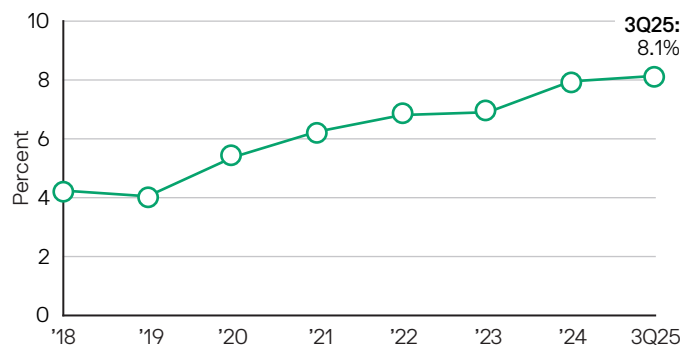
### A growing private credit secondary market offers a source of price transparency

Exhibit 6A: Private credit secondary trading volume



Source: Evercore Inc., J.P. Morgan Asset Management; data as of January 2026.

Exhibit 5B: Percentage of interest and dividend income paid-in-kind by business development companies (BDCs)

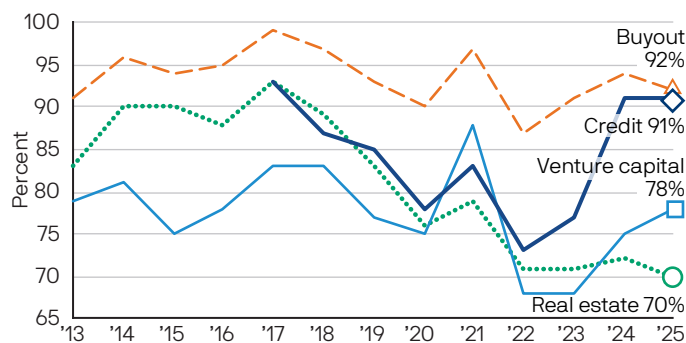


Source: Fitch Ratings, J.P. Morgan Asset Management; data as of 3Q 2025.

The net result is that more investors, needing liquidity, will have to make use of the secondary market—even though it may mean selling their stakes at a discount to the fund’s stated NAV. Some of this discount is simply a transactional penalty for demanding liquidity from an inherently illiquid product; it does not necessarily imply that valuations are too high. But some portion of this discount may also reflect buyers’ views about the value of the underlying assets.

As secondary market trading volume grows in volume and frequency, it is logical to think that transactions taking place at a discount to NAV represent a clearer form of price transparency with respect to the underlying loans themselves (Exhibits 6A and 6B).

Exhibit 6B: Private credit transaction prices in secondary market (% of NAV)



Source: Evercore Inc., Greenhill & Co., Jefferies Group, J.P. Morgan Asset Management; data as of December 31, 2025.

But the assumed stability of fund NAVs, which has been seen as a desirable characteristic of the asset class, may become less predictable as a result.

The outcome may be more dynamic valuations that closely track prevailing economic conditions and the specific risks of a particular portfolio. While more transparent pricing may not impact long-term returns—as long as the underlying loans are paid off in full at maturity—it could easily increase the volatility of the asset class. Investors may begin to experience a convergence between the low level of realized volatility presented by the fund’s general partner (GP) and the higher economic volatility used in most strategic allocation models.

### Long-term investors should trust, but verify

In the more speculative corners of the credit markets, investors must seek yields that are high enough to compensate for possible losses from defaults (net of recoveries). Private credit’s historical excess returns vs. leveraged loans are presumably long enough to provide “proof-of-concept” that the pricing is sound, but—taking a deeper look—the record may still be somewhat ambiguous (Exhibit 7). Private credit’s relative outperformance over leveraged loans has diminished recently, and it remains unclear how the fast-growing sector will fare during a severe or extended credit downturn.

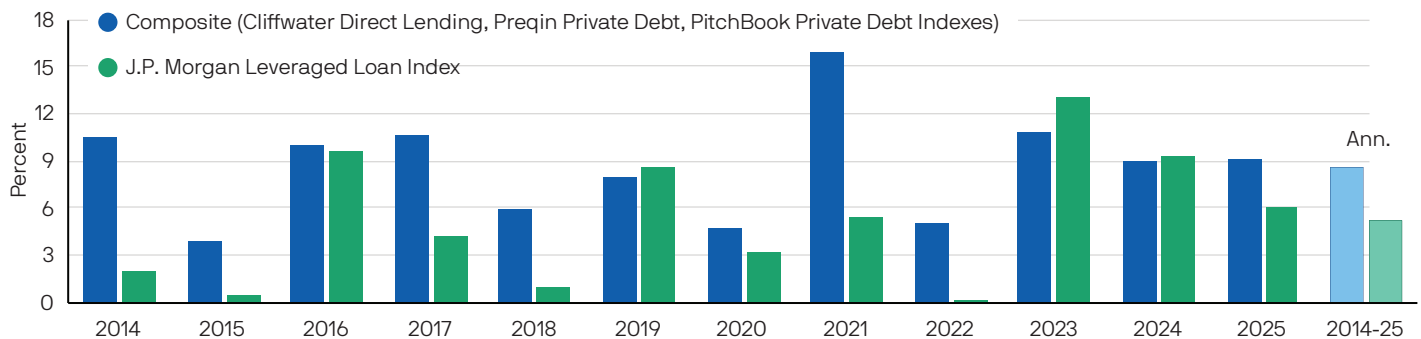
In light of recent economic uncertainty, it may be worthwhile reviewing the assumptions that underpin our long-term expectations for the asset class. J.P. Morgan Asset Management’s *2026 Long-Term Capital Market Assumptions* (LTCMAs) provide a useful framework for thinking about the different components that make up private credit returns (Exhibit 8).

Given our outlook for the primary underlying drivers of return and risk, we expect to see a more challenging environment for private credit going forward. Although the asset class has delivered exceptionally strong performance historically, a modest decline in future return expectations may be unavoidable. Salient factors that should be monitored include:

- With the Fed currently on hold and the “tail risks” of inflation, recession or even stagflation still present, base yields’ path is uncertain. Further Fed cuts would likely indicate economic softness (itself a key risk for borrowers), while flat to higher rates could prolong or increase a period of stress.
- Signs of credit stress are increasing among private market borrowers. Even if outright default levels remain low, the growing use of LMEs and PIK debt arrangements suggests a slower return of capital to lenders and potentially diminished investor returns. If a broader credit downturn materializes, the impact could be more significant.
- The credibility of fund NAVs and individual asset marks is likely to be tested by a rise in secondary

### Private credit has historically outperformed leveraged loans

Exhibit 7: Total returns of private credit benchmarks vs. J.P. Morgan Leveraged Loan Index



Source: Bloomberg, Cliffwater, Preqin, PitchBook, J.P. Morgan Asset Management; data as of 2025. Past performance is not indicative of current or future results. Indexes do not include fees or operating expenses and are not available for actual investment.

**In light of recent market uncertainty, it's useful to consider the underlying assumptions driving private credit performance**

**Exhibit 8: Components of private credit returns**

Yield components	Commentary on current conditions
Cash rate	Private credit returns have benefited from the significant rise in short-term yields since 2022. The path of short-term interest rates remains uncertain, but rate cuts in the face of an economic downturn could be damaging.
Weighted average spread	Wide spreads in private credit, reflecting borrowers' higher debt/EBITDA, have been compressing over the past few years. Some compression may be due to fundamentals, but much is being driven by excess capital.
Credit costs	True defaults are rising slowly, but have been limited thus far. The use of liability management exercises, PIK debt and term extensions may avert the worst outcomes but could also reduce returns.
Financial components	Commentary on current conditions
Leverage	Many private credit strategies employ fund-level leverage to enhance returns, usually between 1x and 2x relative to the capital invested. If rolling short-term funding is used, it can reintroduce some asset/liability mismatch.
Cost of financing	Leverage, often in the form of NAV financing (backed by fund assets) or subscription lines (backed by investor commitments), is priced well below the spreads on underlying loans (~SOFR plus 200 basis points in normal times).
Fees	Fees are a combination of operating expenses, management fees and performance fees. Typical base fees range between 1% and 2%; fees are often 10% to 20% above a hurdle rate of 5% to 7%.

Source: J.P. Morgan Asset Management's 2026 Long-Term Capital Market Assumptions.

market sales and investor redemptions from semi-liquid private credit funds. It is likely that the assets sold by funds offering periodic liquidity could be higher in quality, limiting the impact of any discount to NAV but simultaneously diminishing the average quality of the residual portfolio.

- Leverage providers may become more risk averse, potentially restricting the amount of financing, reducing its duration and/or increasing its cost. The economics of the funds may diminish while their balance sheets become less stable.

A likely outcome of one or more of these factors is that the private credit asset class will deliver moderately lower returns with modestly higher volatility than it has historically. While perhaps not ideal, this outlook is consistent with a maturing, increasingly competitive investment sector that has achieved widespread adoption and global scale. Future iterations of the LTCMAs will capture these developments more fully and should inform strategic allocation weights going forward.

Within private credit allocations, fund-level performance dispersion would likely rise as macro headwinds diminish the yield cushion, and rising credit stress exposes individual managers' skill in underwriting and portfolio construction. Re-underwriting current private credit managers chosen in an earlier phase of the sector's development could be prudent; newer managers with demonstrated skill and preferential access to loan origination could also be well positioned.

Finally, history suggests that, should a more severe credit downturn occur, the relative illiquidity of private credit could ripple through other components of the asset allocation. For investors concerned about total exposure to the credit risk factor, the barriers to reducing private credit allocations may lead them to trim exposure in other, more liquid credit sectors, such as high yield or investment grade bonds. Significant widening of spreads in these sectors could represent an attractive entry point for investors, but only for those with sufficient liquidity.

---

## Conclusion: Focus on new opportunities to offset legacy risks

Private credit remains a core component of the capital markets, but it is undergoing a period of transition that may lead investors to question some of their assumptions about its risks. For allocators of capital that has already been committed and invested, there may be little alternative to riding out a period of market turbulence with existing managers.

Fortunately, for most private credit managers, legacy assets' high yields should provide a healthy cushion against the impact of credit stress. Should the market downturn become more severe, however, even modest differences in managers' default experiences could lead to sizable performance dispersion. Such a shakeout would reveal those with genuine skill in underwriting and portfolio construction.

### J.P. Morgan Asset Management

270 Park Avenue | NY 10017

---

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision, and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for informational purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted.

J.P. Morgan Asset Management is the brand name for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our privacy policies at <https://am.jpmorgan.com/global/privacy>.

This communication is issued by the following entities: In the United States, by J.P. Morgan Investment Management Inc. or J.P. Morgan Alternative Asset Management, Inc., both regulated by the Securities and Exchange Commission; in Latin America, for intended recipients' use only, by local J.P. Morgan entities, as the case may be.; in Canada, for institutional clients'

Investors need not remain passive in the face of potential disruption. With just a modest pivot in strategy, they can turn current challenges into potential advantages. As we suggested almost three years ago, two strategies—secondary private credit funds and opportunistic/distressed credit funds—would be well positioned to generate potentially strong returns in a weakening credit market.

To this pair of strategies we would now add a third: New funds, with highly proficient managers and fresh capital to deploy, will be well positioned to attract high-quality borrowers. In particular, we think investors would do well to identify funds that can operate in close partnership with banks; these funds have many competitive advantages in sourcing opportunities among selective borrowers looking to manage costs in uncertain times.

use only, JPMorgan Asset Management (Canada) Inc. is a registered Portfolio Manager and Exempt Market Dealer in all Canadian provinces and territories except the Yukon, and an Investment Fund Manager in British Columbia, Ontario, Quebec, and Newfoundland and Labrador. It is also a Derivatives Adviser in Manitoba, a Commodity Trading Manager in Ontario, and a Derivatives Portfolio Manager in Quebec. In the United Kingdom, by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in European jurisdictions, by JPMorgan Asset Management (Europe) S.à r.l. In Asia Pacific ("APAC"), by the following issuing entities and in the respective jurisdictions in which they are primarily regulated: JPMorgan Asset Management (Asia Pacific) Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited, each of which is regulated by the Securities and Futures Commission of Hong Kong; JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), which this advertisement or publication has not been reviewed by the Monetary Authority of Singapore; JPMorgan Asset Management (Taiwan) Limited; JPMorgan Asset Management (Japan) Limited, which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia, to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Commonwealth), by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919). For all other markets in APAC, to intended recipients only.

For U.S. only: If you are a person with a disability and need additional support in viewing the material, please call us at 1-800-343-1113 for assistance.

Copyright 2026 JPMorgan Chase & Co. All rights reserved.

PROD-0326-6011109-AM-ALLOCSPOTLIGHT  
dece2b4e-37ce-11f1-8b88-013669729950

---