

# Credit Market Conditions

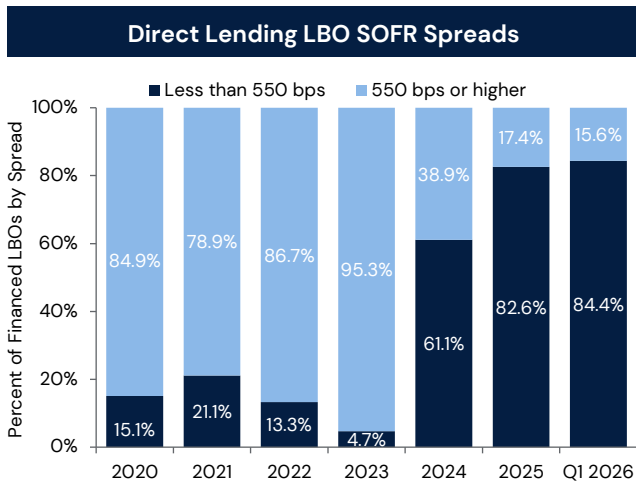
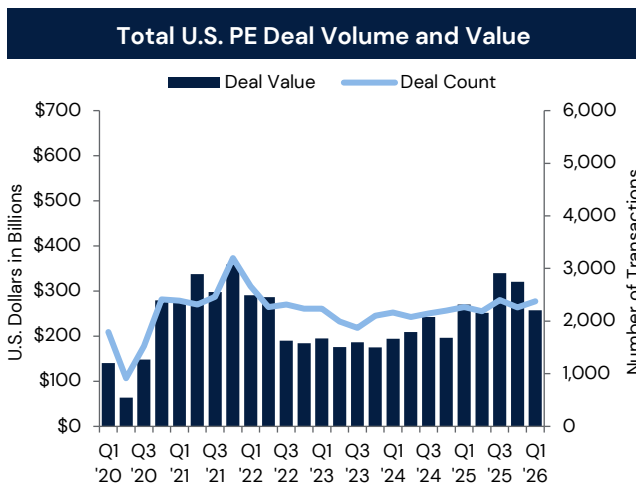
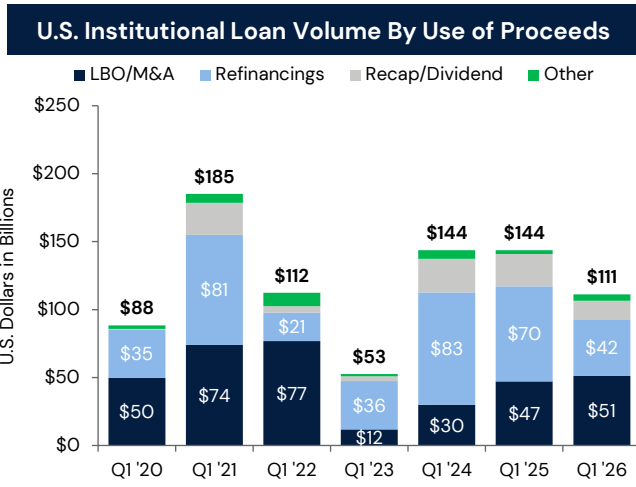
Positive Momentum in the Leveraged Loan Industry Stalls in Q1 2026 Due to Market Volatility and Uncertainty



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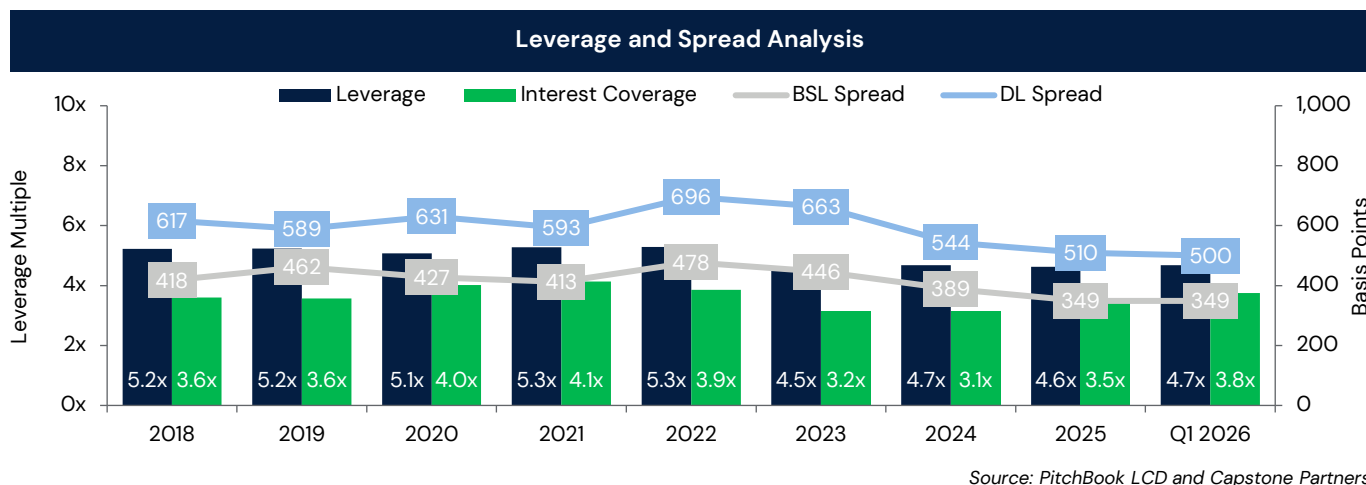
**First Quarter Review:** The U.S. Leveraged Loan market entered 2026 with widespread optimism: consensus forecasts from Bank of America (NYSE:BAC), Barclays (LSE:BARC), JPMorgan Chase (NYSE:JPM), and Morgan Stanley (NYSE:MS) projected a year of moderate expansion, driven by a long-awaited rotation from refinancing and repricing activity towards fresh merger and acquisition (M&A) and leveraged buyout (LBO) issuance, according to PitchBook’s 2026 U.S. Credit Markets Outlook report.<sup>1</sup> What began as a promising continuation of strong 2025 momentum gave way to concerns shaped by three converging and largely unforeseeable issues: 1) the outbreak of the U.S.–Iran military conflict in late February 2026 and its impact on the macroeconomy; 2) an accelerating artificial intelligence (AI)–driven reassessment of the Software industry’s credit quality; and 3) a wave of business development company (BDC) and private credit redemption requests that exposed structural vulnerability in the retail-oriented private credit model. The result of these issues was material deal volume headwinds for M&A activity and a stall of refinancings that caused a 22.5% year-over-year (YOY) decline in overall institutional leveraged loan value in Q1 2026, according to PitchBook’s U.S. Credit Markets Quarterly Wrap Q1 2026 report.<sup>2</sup>

**Private Equity Deal Activity and Loan Pipeline:** The private equity (PE)–sponsored deal environment, which drives the M&A loan pipeline, deteriorated on a deal value basis in Q1 2026. Total U.S. PE deal value reached \$257.4 billion across 2,374 transactions in Q1 2026, making it the lowest quarter for capital deployment since Q2 2025 (\$251.4 billion). This compares to Q3 2025’s \$339.3 billion and Q4 2025’s \$320.4 billion in total U.S. PE deal value. The slowdown reflects the combined impact of the U.S.–Iran military conflict, software credit reassessment, and redemption requests which introduced uncertainty that caused sponsors to delay new transactions and exits.



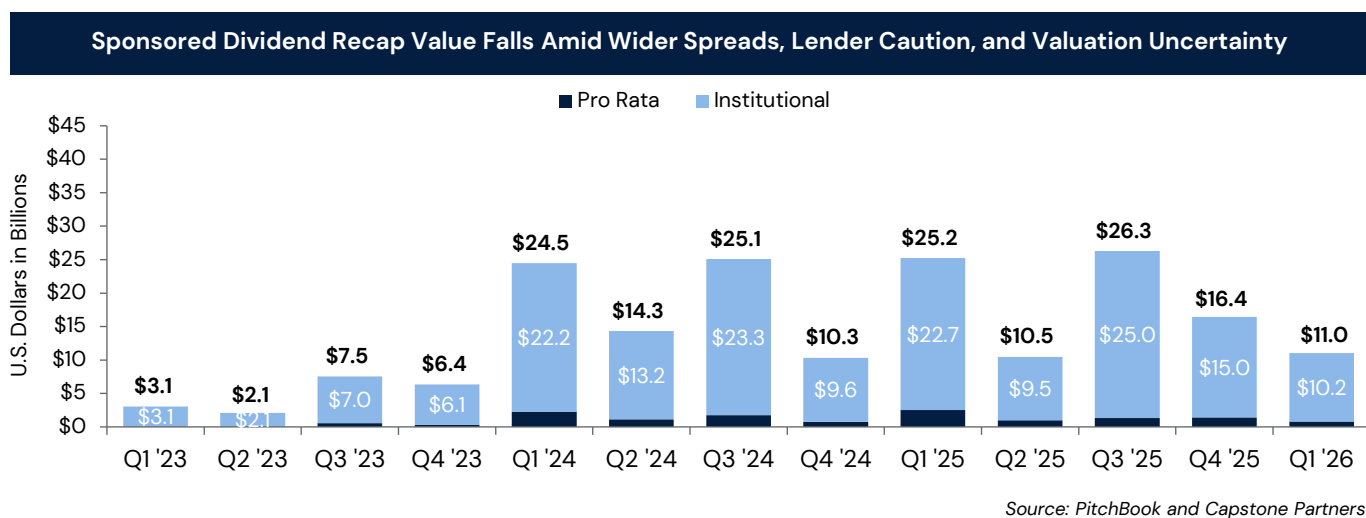
Source: PitchBook LCD and Capstone Partners

**Spreads:** With the Federal Reserve’s (Fed) April 2026 announcement and shift towards a rate pause and evaluation of conditions that could warrant rate hikes, the three-month average secured overnight financing rate (SOFR) spread has hovered around ~3.7% and is forecasted near that level over the next several quarters, according to the Fed Bank of St. Louis and Chatham Financial.<sup>3,4</sup> Market participants expect spreads to widen over the next six months given the volatility and potential risk factors in the market. While 84.4% of new-issue spreads of LBOs financed in the Direct Lending market priced below S+550, spread pricing will likely tick up 25-50 basis points (bps), particularly for deals that are lower in quality or in difficult to finance sectors, according to a PitchBook survey in its U.S. Credit Markets Quarterly Wrap Q1 2026 report.



**Refinancing Activity:** Refinancing and repricing activity, the dominant driver of leveraged loan value in 2024 and 2025, collapsed in Q1 2026. Refinancing issuance fell 40.6% YOY and repricing value dropped roughly 38.6%, according to PitchBook’s U.S. Credit Markets Quarterly Wrap Q1 2026 report. The pipeline of such opportunistic refinancings, which had produced \$191.8 billion in 2025 refinancings alone (the second highest total since 2013 behind 2024 which saw \$260.9 billion), has largely exhausted itself as borrowers who could refinance into tighter spreads had already done so. Credit quality bifurcation has complicated the refinancing outlook as those credits that are more challenged will likely face an environment with wider spreads, reduced investor appetite, and sector-specific headwinds (particularly in Software).

**Dividend Recapitalizations:** Q1 2026 brought a meaningful shift in the dividend recapitalization (recap) landscape. While typically not a preferred use of capital for lenders, dividend recaps were structured in 2024 and 2025 to return capital to PE funds ahead of the sale of a business. With wider spreads, heightened lender caution, and reduced certainty around valuation outcomes, it is expected that these transactions will be more difficult and/or expensive to execute moving into Q3 and Q4.



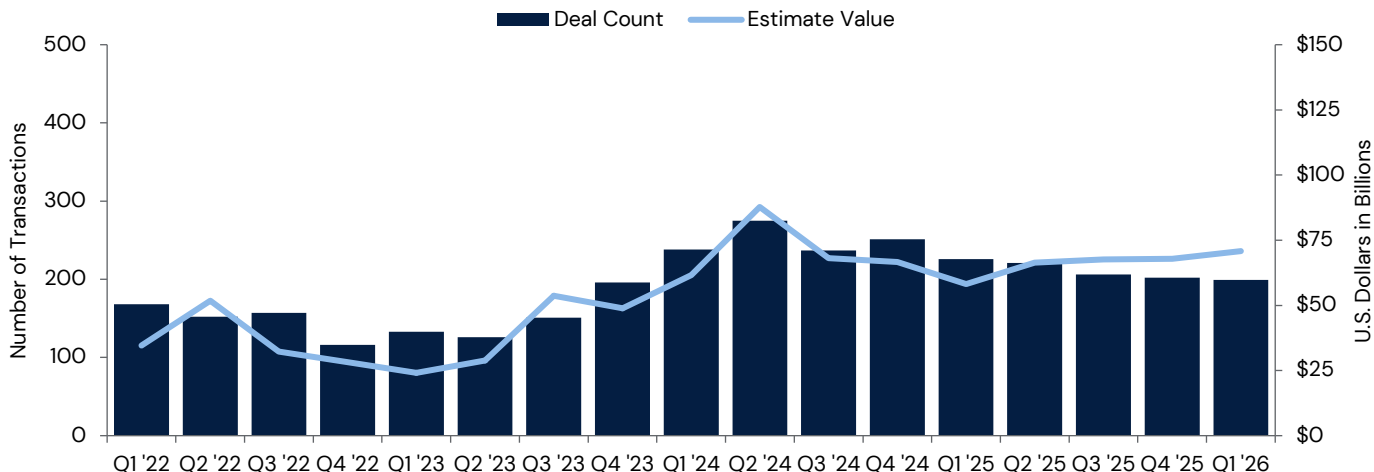
**The Iran War:** The coordinated military operation against Iran introduced decision-making paralysis across multiple sectors that meaningfully stalled activity in March 2026. The macroeconomic issues around potential energy cost increases for industrial and manufacturing businesses as well as the overall impact on consumers caused a pause pending clarity on the overall economic impact and outlook. Lenders responded by tightening underwriting standards for energy-intensive industries and businesses whose leverage was predicated on stable energy costs. The market will continue to watch oil prices and factor any movements into deals with heavy exposure over the next several quarters.

**AI Risk:** The most consequential new variable in leveraged credit markets in Q1 2026 was not macroeconomics, it was technology. An AI strategy and an evaluation of AI’s potential risk on a business have emerged as a critical analytical component both in underwriting a new transaction as well as evaluating private credit portfolios. The accelerating capability of large language models (LLMs) and their rapid enterprise adoption has compressed the disruption timeline for traditional Software-as-a-Service (SaaS) business models from multi-year horizon to merely quarters. Within private credit portfolios, this timeline matters as it narrows the refinance timeline and calls into question basic underwriting fundamentals—sticky recurring revenue, high margins, predictable cash flows, and high switching costs that made Software the largest single-sector exposure in both the Broadly Syndicated Loan (BSL) market and private credit portfolios over the prior decade, according to LPL Financial.<sup>5</sup> The question of whether AI poses a risk or is an opportunity is now a standard question with all processes and the market requires a more thorough analysis on a company’s overall information technology strategy. Many potential borrowers are seeking ways to enhance AI within their own environments to drive efficiencies and margins which may require new costs and investment.

**Private Credit/BDC Redemptions and Capstone Viewpoints:** The Private Credit market is navigating its most closely scrutinized period since the 2008 financial crisis. Rising retail investor redemption requests in non-traded BDCs and semi-liquid fund vehicles have generated significant negative press. The Securities and Exchange Commission (SEC) has opened several inquiries into large private credit managers with the Treasury Department also looking into their business models. While there are no fundamental alarm bells, there is certainly heightened attention around the industry.

The headlines that persisted in Q1 2026 were largely centered around retail redemption requests for BDCs. The current redemption request wave began in Q4 2025, driven by high-profile defaults in the Automotive sector, concerns over large exposure to software companies that could be affected by AI, increasing use of payment-in-kind (PIK) interest, and rising skepticism about portfolio valuations, according to Bloomberg.<sup>6</sup> While the traditional institutional investor base has a long term invest-and-hold strategy and is accustomed to periodic fluctuations, the Retail market investor wanted some of its money back. The quantum of investor redemptions is capped in a quarter (typically at 5% of NAV [Net Asset Value]) to protect the fund and its

Direct Lending Deal Count and Estimated Value



Source: PitchBook LCD and Capstone Partners

investors. The volume of redemption requests exceeded fund-level caps for many asset managers during Q4 2025 and Q1 2026, marking the first meaningful test of these semiliquid retail fund structures. Negative press articles surrounding the Private Credit market, AI-related risks, and valuation transparency issues accelerated through year-end 2025 and into Q1 2026, elevating retail investor anxiety. However, only exit demand surged, not actual redemptions. The industry’s response to this sentiment was orderly, and most firms have held to their 5% redemption caps.

Leading managers, independent analysts, and institutional voices have consistently drawn a distinction between the liquidity issues brought to light in the news headlines during Q1 and the underlying health of private credit as an asset class which continues to perform in line with or above historical expectations. “There’s been a lot of attention on private credit, but the headlines do not reflect what clients are telling us, what our portfolio data shows, or where we see the market going. Demand is structural. Private credit serves an important role in the financing ecosystems...Actually, institutional demand is accelerating,” said Larry Fink, Founder and CEO of BlackRock (NYSE:BLK), during the firm’s Q1 2026 earnings call.<sup>7</sup>

While there will be more scrutiny for the Private Credit market, Capstone believes that the industry will continue to thrive and provide a much-needed funding source for middle market companies that require financing that goes beyond the bank environment.

**Capstone Outlook:** Capstone continues to hear from lenders that sourcing good deals has been a challenge and there is concern that without a meaningful pickup in deal volume many firms will fall short of deployment budgets and goals for the year. The combination of issues that created the slowdown in Q1 have also created an environment where execution quality and credit selectivity will be critical to outcomes. Despite the challenges, the record level of dry powder for both PE and private credit funds continues and there is optimism in the marketplace that M&A activity is positioned to heat up once the geopolitical and AI uncertainties clarify.

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## Endnotes

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