

# Private Credit: An Antidote to Uncertainty

By Mick Solimene  
**MONROE CAPITAL**

**While equities test new highs**, advisors heading are confronting questions they haven't heard in some time. How can investors guard against inflation? How might rising rates affect performance? Where are the safe havens? And where can investors turn for steady yield should inflation fears fuel bond-market volatility?

It's against this backdrop, the surest answer for many RIAs is diversification. Anecdotally, many are exploring private credit to introduce alternatives into high-net-worth portfolios, while also preparing clients for whatever the market has in store. Beyond an uncorrelated source of returns and consistent income, we believe private credit – particularly lower-middle-market strategies—enjoy compelling tailwinds that will gain momentum.

## Inflation Risk is Real and Underestimated

Most economists neither live on Main Street nor invest in the small-cap companies that line these avenues. As a lender, with a real-time view across 500 companies, it is clear businesses are struggling in the face of higher input costs. Supply chain issues are amplifying these challenges, while higher wages further squeeze profit margins.

Normally, an inflationary environment would drive rates higher. However, the extent to which supply-chain constraints and labor shortages become a governor on growth means the Fed will seek a balance between addressing inflation while remaining dovish to avoid abrupt actions.

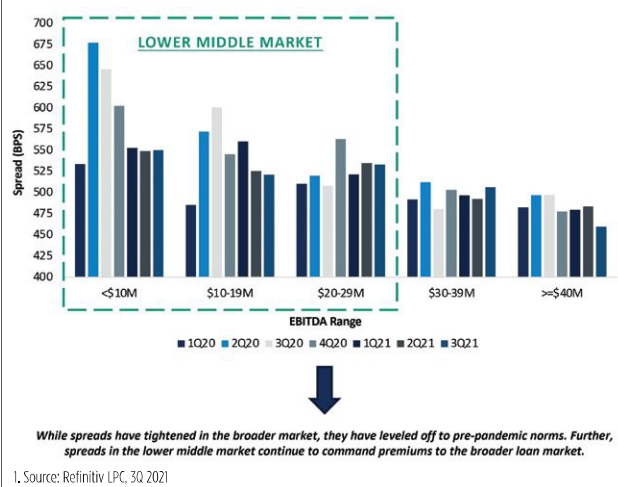
In either case, private debt represents an inflation hedge due to the floating-rate terms of most credits. While we anticipate rates will rise more slowly, should the Fed take aggressive action, investors would benefit from enhanced yields.

## Gap Between Winners and Losers Widens

To be sure, the recovery from the initial COVID lockdowns is well underway and pent-up consumer demand should fuel activity in the near term. Movement on an infrastructure bill and any additional stimulus would represent additional catalysts.

However, unlike the previous bull market in which a rising tide lifted all boats, economic expansion, post COVID, has been marked by distinct winners and losers. Generally, any area that can produce recurring and predictable cash flows are going to be in demand – think SaaS and software, business

## 1st Lien Spread by Ebitda Size (BPS)



services and healthcare companies. Alternatively, other segments will suffer. Apparel and entertainment come to mind.

From an investment standpoint, we believe this will favor active strategies, and within private credit, places more emphasis on underwriting to manage risk and take advantage of opportunities as they emerge.

## Generational-wealth Transfers Will Drive Middle-market M&A

Advisors, of course, need no introduction to the demographic shifts shaping their own business. What some may overlook amid the dramatic generational-wealth transfer already occurring is how the extent to which this drives M&A among small- and mid-sized companies. We believe private credit, as a facilitator, will benefit from a tidal wave of sales and recapitalizations over the next five to 10 years.

Moreover, as of Q3 there were 2,386 new private equity funds collectively targeting approximately \$764 billion, according to Preqin. This funding should help drive M&A and private credit opportunities for the foreseeable future.

Make no mistake, HNW investors are looking for a way into alternatives. Private credit offers an attractive path at a time when diversification and yield are increasingly tough to find. Within private credit, the lower-middle market stands out, first for its market inefficiencies, which translates directly into alpha, and second, for the breadth of the addressable market, contributing to the consistency of strategies targeting this segment. Private credit is an attractive diversifier in any market, but given the challenges today, it's almost ideally suited for investors seeking safety and yield in 2022. ■

Mick Solimene is Managing Director and Portfolio Manager, HNW Portfolios, at Monroe Capital LLC.

Learn more at [www.monroecap.com](http://www.monroecap.com).

