January 2026

Asset Allocation – Private Debt 2026

Context

Private debt has become a major global asset class over the past decade, supported by reduced bank lending activity and sustained investors demand. As we move into 2026, the market faces a mix of supportive macro tailwinds and emerging credit-specific headwinds. Overall **fundamentals** remain **reasonably solid,** though recent developments have increased investor focus on **risk discipline.**

Corporate and household balance sheets have largely stabilized, helping to **contain default pressures.** Within private credit, borrower fundamentals remain resilient, supported by easing monetary policy, which helps **lower interest burdens,** alongside moderating inflation and improving demand conditions that support **EBITDA growth.**

Fiscal policy is also expected to provide a supportive backdrop. In the U.S., ongoing fiscal expansion and elevated public spending, together with renewed fiscal support in parts of Europe, should help sustain **economic growth** into 2026.

At the same time, a few isolated, high-profile credit events (e.g., First Brands Group and Tricolor in 2025) have sharpened attention on **underwriting quality, sector exposure,** and **downside protection.** Importantly, these events reflect broader credit market risks rather than vulnerabilities specific to private debt and have remained **largely deal-specific** rather than systemic, reinforcing the importance of selectivity, diversification, strong covenants, and manager skill.

Overview 2026

Direct Lending	↑	Overweight
Mezzanine	↑	Overweight
Special Sits/ Opportunistic Credit	↑	Overweight
Distressed Debt	●	Neutral
Asset-Backed Lending	↑	Overweight

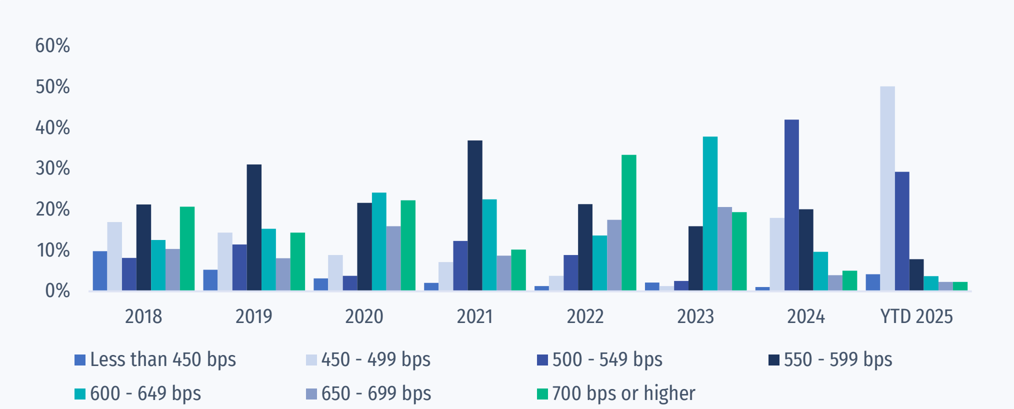
Tailwinds and Headwinds for Private Debt Allocation

Monetary Policy and Economic Growth

The interest-rate outlook for 2026 is **cautiously favorable** for borrowers following the sharp rate hikes of 2022–2023. Cambridge Associates expects the Fed to cut rates by about 75 bps through 2026, lowering interest costs on floating-rate debt and easing pressure on leveraged borrowers while modestly improving **coverage ratios** (see Exhibit 2).

At the same time, expectations of a soft landing or moderate growth in the U.S. and Europe support corporate earnings and credit performance. A stable macro backdrop and a less restrictive rate environment act as tailwinds, helping to reduce default risk. That said, this outlook remains sensitive to **inflation surprises,** policy shifts, or geopolitical shocks, and even in a benign scenario, default rates are likely to normalize from historically low levels.

Exhibit 1: New-issue spread distribution of LBOs financed in direct lending



In this context, while some spread compression may occur, private credit continues to offer a meaningful yield premium of roughly **200–400 bps** above comparable public credits (bank loans, high-yield), supporting attractive returns for direct lending and mezzanine loans. In direct-lending LBOs, spreads have remained stable, with new deals typically pricing around **450–500 bps** over base rate, helping sustain compelling all-in yields even as base rates decline (see Exhibit 1).

Source: PitchBook | LCD • Geography: US • As of Nov. 30, 2025. Data reflects senior secured loans and unitranche facilities. Spread (bps) over base rate

Credit Quality

After several years of very **low default rates,** there are early signs that credit risk is beginning to normalize. Some borrowers have avoided default by recapitalizing or using PIK (payment-in-kind) interest to defer cash interest payments. According to Goldman Sachs, around **10% of private loans include PIK provisions**, with more than half added after origination—often indicating pressure on borrower fundamentals (see Exhibit 3).

Even so, default rates in private debt remain **moderate** (see Exhibit 4), and most expect **only a gradual increase** in 2026 from unusually low levels—likely concentrated first among more marginal credits if growth slows or financing conditions tighten.

Importantly, the aggregate credit profile entering 2026 still appears reasonably healthy, with no clear evidence yet of broad-based deterioration. Recent high-profile failures have been largely **idiosyncratic,** reflecting deal- and structure-specific issues (including alleged financing irregularities and, in some cases, fraud), reinforcing the value of rigorous due diligence and disciplined underwriting.

Overall, middle-market revenues and **EBITDA have held up**, and sponsor support continues to provide meaningful equity cushions for many borrowers, supporting **credit resilience** heading into 2026.

Refinancing and Liquidity Outlook

A meaningful refinancing wave (see Exhibit 5) is approaching across leveraged loans and private credit, reflecting a legacy of the issuance boom in 2017–2019 (many loans have roughly 5–7-year tenors).

As we approach 2026, the **looming maturity** wall can act as a tailwind for private debt by increasing demand for private capital. As loans mature, private lenders with available dry powder can step in to **provide extensions, refinancings, and structured capital solutions**—particularly for middle-market businesses with limited access to public bond markets.

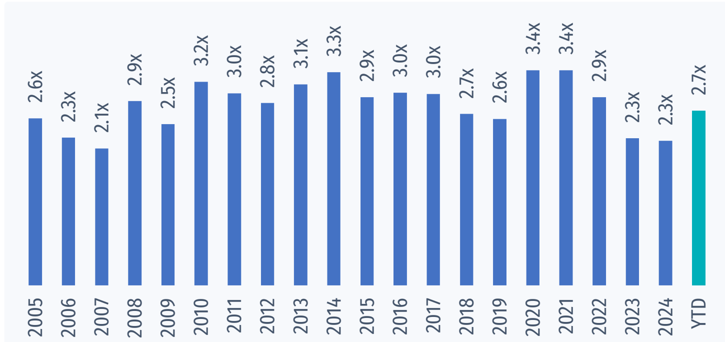
Even in a noisier market backdrop, this dynamic can **expand the opportunity set.** Well-positioned managers can be more selective, focus on higher-quality credits, and lend on more conservative terms than in the 2017–2019 vintages, while opportunistic credit strategies may benefit from dislocations and "good business / bad balance sheet" refinancing needs.

Selective Growth in a Competitive Lending Environment

As M&A and private equity activity gradually recovers into 2026, **demand for credit financing** should remain broadly supportive for private debt. A modest **pickup in LBO** activity would be favorable, enabling the deployment of dry powder and supporting fundraising efforts.

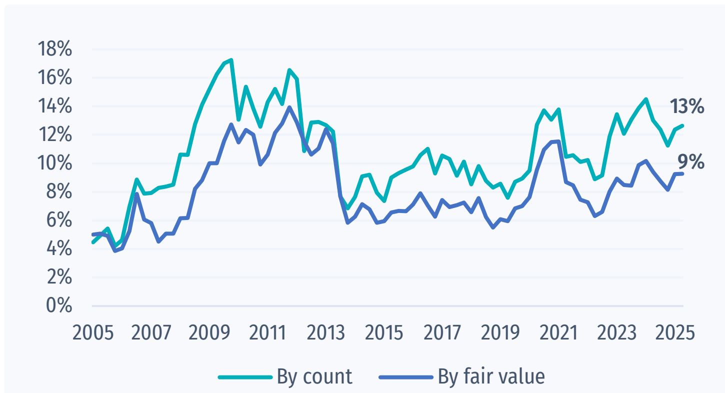
Data on interest coverage in private credit is limited. As a reference, interest coverage for LBOs financed in the syndicated loan market serves as a useful proxy, showing how higher rates compressed coverage in 2022–2023 and how easing rates may provide incremental relief for leveraged borrowers.

Exhibit 2: EBITDA/cash interest for LBOs financed in the syndicated loan market



Source: PitchBook | LCD• Geography: US • As of September 30, 2025

Exhibit 3: Share of outstanding BDC loans with PIK feature



Source: PitchBook | LCD• Geography: US • As of June 30, 2025

Exhibit 4: 20-Year Credit Loss Rates (2005 to 2024)

	Credit Loss		
Year	High Yield Bonds	Leveraged Loans	Direct Lending
2005	1.23	0.48	-0.89
2006	0.41	0.08	-0.63
2007	0.18	0.06	-1.74
2008	1.68	1.55	0.59
2009	7.99	6.62	6.91
2010	0.47	0.52	2.96
2011	0.87	0.13	1.78
2012	0.61	0.63	0.6
2013	0.33	0.53	0.19
2014	1.51	1.16	-0.01
2015	1.35	0.88	0.7
2016	2.48	0.56	1.41
2017	0.6	0.79	1.74
2018	1.08	0.64	0.94
2019	2.02	0.84	0.94
2020	4.84	2.08	3.3
2021	0.15	0.22	-0.27
2022	0.38	0.39	0.1
2023	1.41	1.3	0.86
2024	0.23	0.85	0.69
L 20Yrs	**1.49**	**1.02**	**1.01**
L 10Yrs	**1.45**	**0.85**	**1.04**

Source: JPMorgan Markets, Cliffwater, as of 2025 Q3. Direct Lending refers to Cliffwater Direct Lending Index. The credit loss rate equals the default rate multiplied by one minus the recovery rate.

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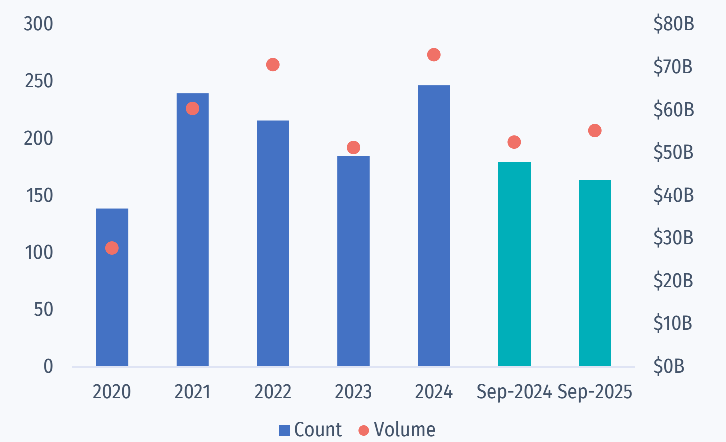
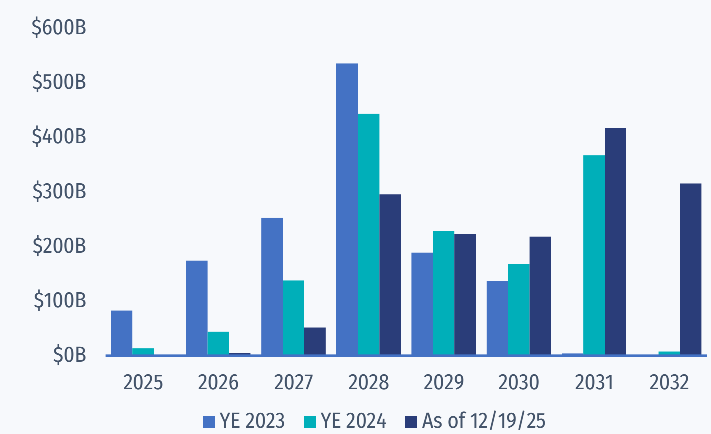
However, direct lending volumes for **new LBOs** have remained relatively **flat** (see Exhibit 5), creating the risk of **excess capital** competing for a limited number of deals, which would pressure spreads and returns if activity disappoints. This risk is partly offset by the large refinancing and **maturity wall** expected in 2026–2027 (see Exhibit 6), which should drive additional **demand for private credit** as sponsors turn to direct lenders to refinance or replace existing loans.

Exhibit 5: Direct lending deal count and estimated volume of deals financing LBOs ($B)



Source: PitchBook | LCD. Geography: US. As of September 30, 2025
The left axis represents the count, and the right axis represents the volume in USD billions

Exhibit 6: Maturity Breakdown of Performing Loans



Source: PitchBook | Morningstar LSTA US Leveraged Loan Index - Maturity Breakdown, as of 12/19/2025.
**Data excludes defaulted facilities and is based on par amount outstanding*

Performance

Across vintages, private debt performance shows remarkable consistency at the median level, with relatively **low dispersion** across vintages, reinforcing the asset class's **defensive and income-oriented profile** (see Exhibit 7 and 8). However, while vintage-to-vintage outcomes appear stable, meaningful dispersion emerges at the manager and strategy level (see Exhibit 9 and 10), where differences in underwriting discipline, portfolio construction, and downside protection drive outcomes.

In this context, robust **due diligence and disciplined manager selection** remain critical for capturing the intended risk-adjusted returns of private debt while avoiding underperformance.

Direct Lending

Direct lending will continue to be the **mainstay** of private debt portfolios in 2026. A **flight to quality** is one of the major trends here: LPs are giving preference to seasoned managers with solid underwriting and monitoring records, especially after seeing that many top managers avoided the risky deals that blew up.

Despite an uncertain macro-outlook and residual downside risks, the **senior-secured nature** of first-lien direct lending supports **stronger recovery** prospects. As a result, managers are prioritizing medium-sized, cash-flowing, sponsor-backed companies, particularly in defensive or non-cyclical sectors.

Exhibit 7: Private Debt Net IRR (Vintage 2010-2020)

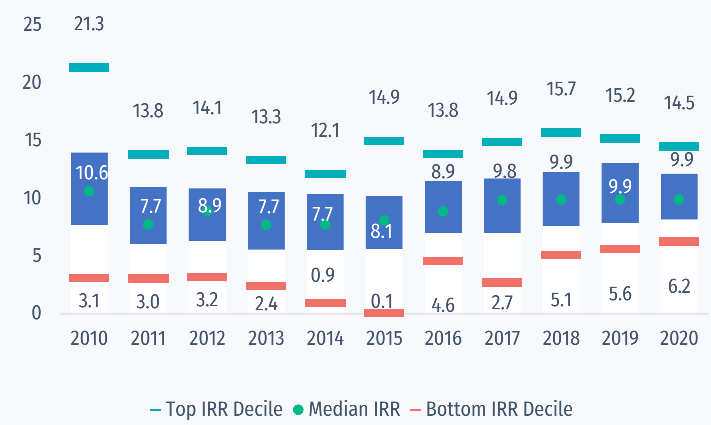
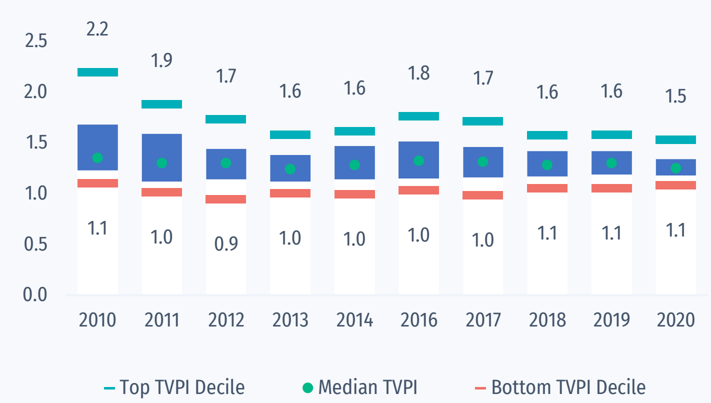


Exhibit 8: Private Debt Net TVPI (Vintage 2010-2020)



Source: PitchBook • Geography: Global• As of most-up-to-date. Constructed by HMC using data accessed on December 22, 2025. Top decile refers to the top 10% of performers, top quartile to the top 25%, and the median represents the midpoint of the distribution.

Asset Allocation – Private Debt 2026

In terms of regional dynamics, the U.S. direct lending market is **more mature and competitive**, with tighter spreads and more borrower-friendly terms. By contrast, Europe's smaller but fast-growing market still shows a **financing gap**, with higher spreads and lower leverage, offering potentially better risk-adjusted returns—a dynamic that is increasingly attracting U.S. lenders to the region.

Under this positioning, the strategy is expected to deliver **high single-digit net returns**. Morgan Stanley projects cash yields on first-lien direct loans to trough around 8.0–8.5%; however, once fees, discounts to par, and portfolio-level effects are considered, total net returns are expected to remain in the upper single digits (approximately 8.85%, according to Cliffwater projections).

Mezzanine

Mezzanine is viewed as an **opportunistic niche** within private credit, where allocations can add value if sponsors resume more **leveraged transactions.**
According to Goldman Sachs, a **stronger M&A** environment should increase demand for mezzanine solutions, especially since PIK structures offer additional yield. Mezzanine can be appealing in this scenario because of its **larger yield cushion and upside optionality,** but it needs disciplined underwriting and seasoned managers.

This strategy typically targets **low double-digit** returns. Even as base rates ease, mezzanine lenders continue to command equity-like risk premia—often through PIK or warrant features—which help sustain attractive return potential.

Special Situations and Opportunistic Credit

Credit managers are expanding beyond plain-vanilla loans into complex opportunities. Opportunistic credit, similar in nature to special situations, targets complex, privately negotiated transactions with the potential for **superior risk-reward dynamics.**

Issuers with specific needs, like carve-outs, rescue financings, or covenant-lite refinancings, are anticipated to depend more on this kind of capital in 2026 as credit spreads approach multi-year tights and credit fundamentals become more uneven.

This backdrop creates **pockets of opportunity** for tailored capital solutions—such as super-senior, convertible, or second-lien structures—that can command attractive yields. These bespoke transactions often feature enhanced security packages or equity kickers, supporting low- to mid-double-digit net returns.

Distressed Debt

Distressed investing is most attractive when debt prices diverge meaningfully from asset values.

In the current environment, expected rate cuts and lender forbearance are likely to delay a broad default cycle, limiting near-term distressed opportunities despite elevated leverage. However, as the credit cycle matures, selective stress may emerge, particularly if growth slows or refinancing tightens, suggesting that more attractive distressed entry points could develop later in 2026 or into 2027.

As a result, many investors favor a neutral, watchful stance, prioritizing managers with restructuring expertise and flexibility. When dislocations do occur, successful distressed strategies can target mid-teens net returns, though outcomes remain highly manager-dependent.

Exhibit 9: Aggregated Net IRR by Strategy (2010–2020 Vintages)

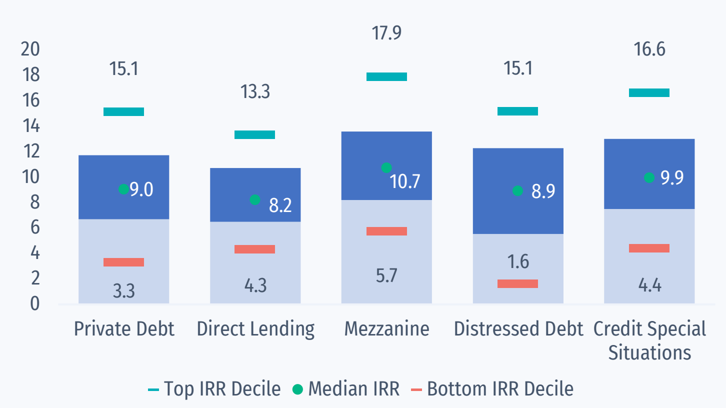
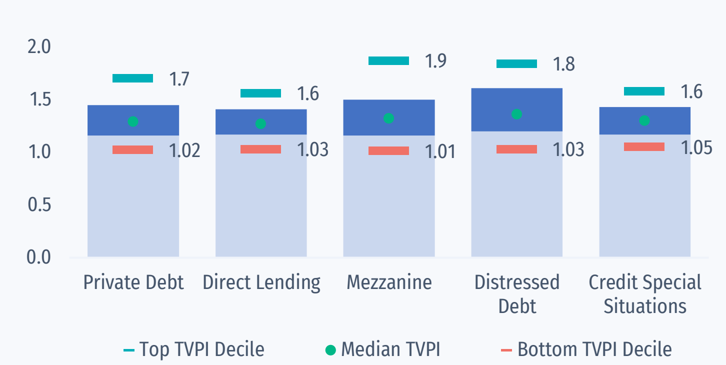


Exhibit 10: Aggregated Net TVPI by Strategy (2010–2020 Vintages)



Source: PitchBook • Geography: Global• As of most-up-to-date. Constructed by HMC using data accessed on December 22, 2025. Top decile refers to the top 10% of performers, top quartile to the top 25%, and the median represents the midpoint of the distribution.

Asset-based finance

Private ABS remains a small but growing segment of private credit. Goldman Sachs views it as a relatively nascent market, similar to the early growth of real estate credit, gaining traction as investors seek high collateral coverage and niche yield opportunities. Unlike traditional cash-flow lending, asset-based loans are backed by specific collateral pools or dedicated cash-flow streams, typically offering stronger lender protections and higher recovery prospects.

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Cambridge Associates favors allocations to asset-based finance funds in 2026, highlighting the **higher barriers** to entry and **more robust structural protections** often embedded in these strategies. That said, complexity is a double-edged sword: while it can create attractive opportunities, it also introduces execution risk. As a result, rigorous due diligence and ongoing monitoring are critical to ensure **collateral quality**, accurate valuation, and clean ownership.

From a return perspective, many ABF transactions are floating-rate and have delivered **low double-digit gross yields** recently. Looking ahead, net returns are expected to be broadly in line with direct lending, while offering portfolio diversification, as performance is driven more by collateral behavior and asset liquidation dynamics than by corporate earnings alone.

Real Estate Debt

Private debt has expanded into real estate lending as banks pull back, creating refinancing opportunities for private lenders.

Tailwinds into 2026 include continued demand for flexible financing, **potential stabilization in property values** as interest rates ease, and stronger fundamentals in segments such as multifamily, industrial/logistics, and specialized assets like data centers and life sciences, while Europe's **energy-efficiency** upgrades are creating financing needs for transition projects. Headwinds persist in weaker sectors, notably office and some retail, requiring conservative structures and significant equity cushions.

Outlook: Real estate debt can deliver **attractive yields,** often in the 8–12% range, backed by property collateral. Looking into 2026, potential stress in commercial real estate could also create opportunities through **discounted loan sales and restructuring activity.**

Infrastructure Debt

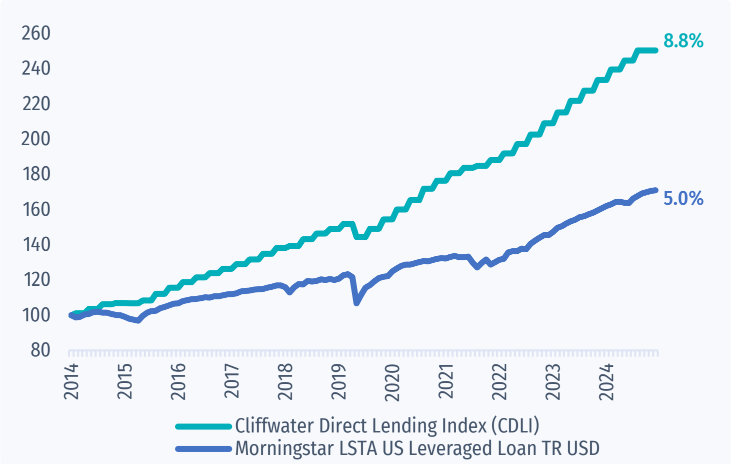
Parallel to real estate, infrastructure debt has grown as a private debt category, financing **essential assets** such as renewable energy, transport, and digital infrastructure, typically through long-dated, lower-risk loans that appeal to insurers and pension funds seeking stable cash flows.

Outlook: Demand should remain strong, supported by **energy transition priorities** and government efforts to crowd in private capital, with private lenders playing a key role where bank financing is limited. While yields are generally lower than corporate direct lending, they offer a premium over public infrastructure bonds and can include inflation protection, positioning infrastructure debt as a stable, income-oriented allocation rather than a high-yield strategy, with risks mainly tied **to duration and policy changes.**

Evergreens

- **Direct Lending remains the dominant evergreen private credit strategy:** According to PitchBook, AUM more than tripled from USD 63.6 billion in 2022 to over USD 209 billion in 2025, reflecting the continued appeal of private credit's income and yield profile.
- **Vehicle count and recent launches:** As of 2025, approximately 135 direct lending vehicles are active out of 505 total evergreen vehicles, with 8 new funds launched in 2025.
- **Alternative Credit has grown rapidly and gained share:** Alternative credit AUM more than doubled over the same period, increasing from USD 24.1 billion in 2022 to USD 52.3 billion in 2025. These vehicles typically invest across public and private credit, including structured credit, specialty finance, and opportunistic lending, offering diversification relative to traditional direct lending.
- **Vehicle count and momentum in 2025:** There are currently 114 alternative credit vehicles, of which 38 were launched in 2025, highlighting strong recent momentum in product development.
- Overall, the data shows that private direct lending has generated **higher and more stable cumulative returns** than public leveraged loans over time. While both strategies benefit from floating-rate exposure, direct lending has delivered a **smoother return profile with less pronounced drawdowns,** particularly during periods of market stress. This reflects structural features such as negotiated lending terms, seniority, and reduced mark-to-market volatility.

Exhibit 11: Evergreen Return Comparison (2014-Oct 2025)



	Annualized Return	Volatility	Sharpe Ratio	Worst Drawdown
Cliffwater Direct Lending Index	8.8%	4.47%	1.49	-11.8%
LSTA Leveraged Loan Index	5.0%	5.24%	0.56	-25.6%

Source: Constructed by HMC using data from Chiffwater and Bloomberg. The Sharpe ratio measures risk-adjusted returns by comparing excess return to the volatility of those returns. Worst drawdown represents the largest peak-to-trough decline in value over a given period, capturing the depth of losses during market stress. Data since inception (November 2014).

The Cliffwater Direct Lending Index (CDLI), launched in 2015 and reconstructed back to 2004, measures the performance of private middle-market direct loans. It was the first published index dedicated to direct lending and today tracks ~20,000 loans totaling USD 514 billion.

Asset Allocation – Private Debt 2026

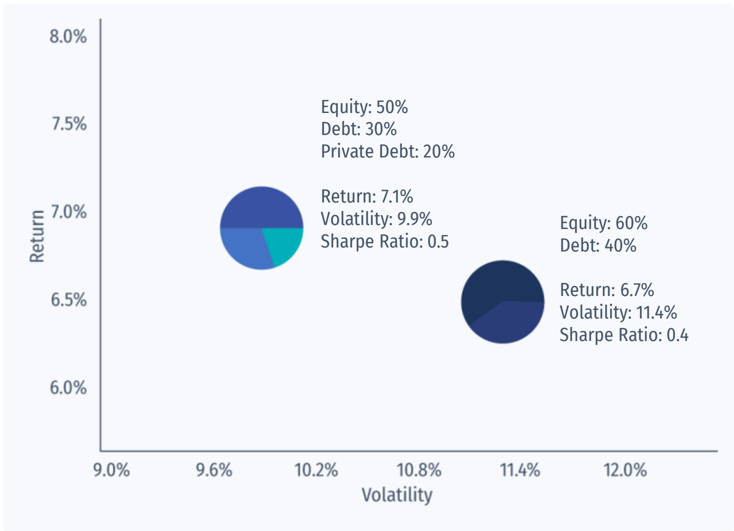
Key Themes Shaping Asset Allocation

- ✓ **Diversify Across Strategies:** Given the evolving credit landscape, investors should blend core and opportunistic credit. Continue meaningful allocations to high-quality direct lending for steady income but complement with special-situation and opportunistic funds to boost returns.
- ✓ The industry's mantra is **diversification** and **specialization,** diversifying across different types of credit and specializing in areas where a manager can have an edge. This is partly driven by high **competition in plain vanilla lending,** which compresses yields and forces managers to seek alpha in less trafficked areas.
- ✓ **Private debt in 2026 remains a global opportunity:** The U.S. is the largest and most competitive market, dominated by large direct-lending funds alongside many niche strategies, with some U.S. managers increasingly expanding abroad in search of less crowded opportunities. Europe, while smaller, continues to grow as banks retreat, offering a less competitive lower mid-market, more **conservative leverage, stronger covenants,** and often higher all-in yields. These features support increasing exposure to European private credit.
- ✓ **Emphasize selectivity and manager quality:** As private credit becomes more capital-intensive and performance dispersion widens, disciplined manager and asset selection is critical. Investors should prioritize managers with proven **underwriting discipline, deep sector expertise, and strong downside protection.**

Incorporating private debt into the portfolio meaningfully improves the risk–return profile. Compared with the traditional 60/40 allocation, the portfolio that includes 20% private debt delivers a higher expected return, lower volatility, and a stronger Sharpe ratio.

This highlights the role of private debt as an effective diversifier, enhancing risk-adjusted returns by smoothing volatility while preserving income and return potential within a balanced portfolio.

Exhibit 12 Risk/Return Profile



Source: HMC construction. The equity component is based on MSCI ACWI (Total Return), the fixed-income component on the Bloomberg Global Aggregate Index, and the private debt allocation on the Private Debt PitchBook Index. Data covers June 2015 to June 2025. We intentionally use the smoothed Private Debt series to reflect the return pattern an investor would actually experience. Using an unsmoothed series would increase portfolio volatility only slightly (from 9.9% to 10.4%) a negligible difference.

About HMC Capital

HMC Capital is a Global Alternative Investment firm with over 16 years of experience

and more than US$22.5 billion in assets under management and advisory. With a team of 100+ professionals across Latin America, the United States, and the United Kingdom, we deliver tailored solutions across multiple asset classes, backed by a solid track record in long-term investments.
Combining global reach with local execution, we serve institutional investors, wealth managers, and high-net-worth clients, fostering sustainable growth and value creation through strategic partnerships worldwide.

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