

BC PARTNERS

Quarterly Credit Check: Nowhere to hide...



In this quarterly macro-commentary from the BC Partners' Credit team, Ted Goldthorpe and Mike Terwilliger discuss the decidedly mixed macro backdrop—with clear challenges and equally unambiguous economic positives.

The authors revisit their concerns about an AI bubble with a comparison to the dot-com era. Could AI be overdone and if so, create a correction in the S&P 500?

They also explore a key driver behind the growth of private markets—passive investing, which has muted fundamental investing and lead to capital distortions. Private credit remains among the last vestiges of active management and provides an attractive counterbalance for allocators.

The team highlights a recent transaction signaling the “top of the market” and note that PE's obstacles have translated into new lending opportunities.



Macro Backdrop

We tortured our Thesaurus writing our 3Q2025 Quarterly letter trying to find sufficient synonyms for “uncertainty,” which is a prevailing force shaping markets in 2025.

The Concerning - Job market dead stop:

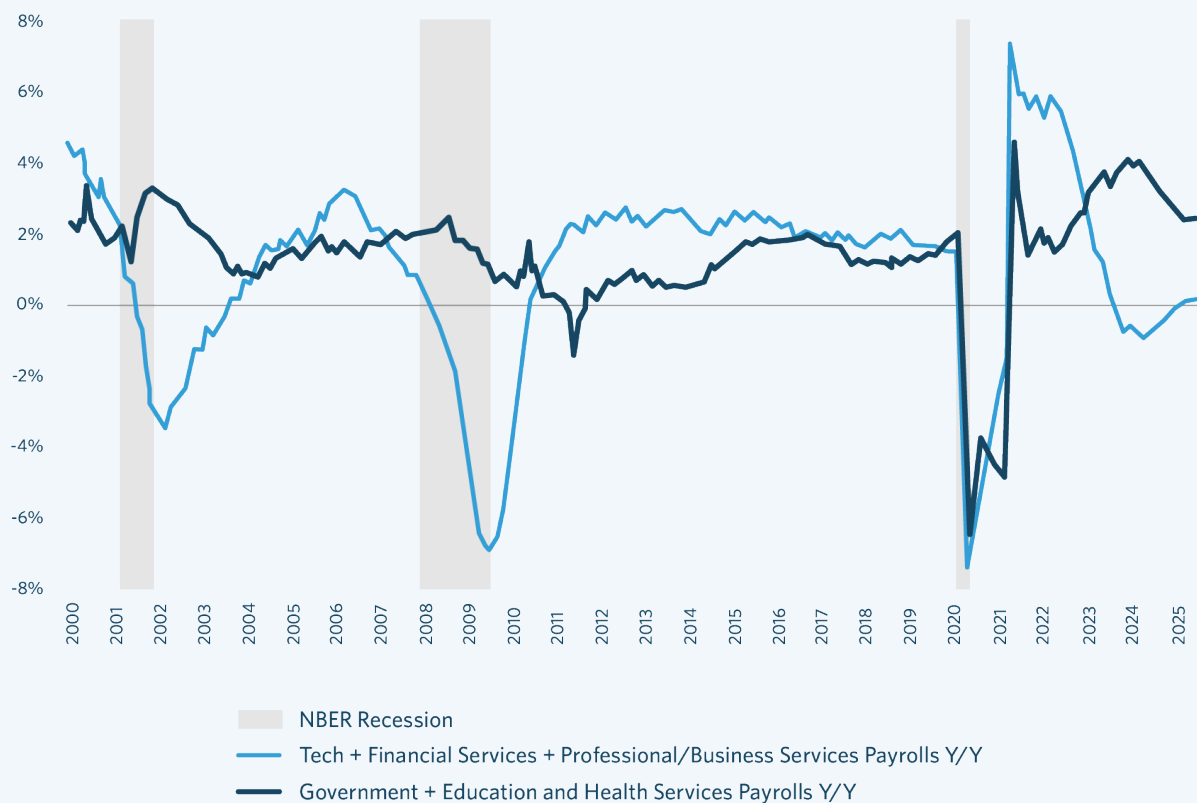
The weakening U.S. job market we’ve highlighted in recent quarters jumped from the subtext to the front page with the July jobs report.

The headline unemployment rate remained low at 4.2%, but this figure was likely boosted by the

shrinking labor force. Deportations have had a twin impact on the U.S. labor supply by literally removing workers and prompting others not to seek employment.

What grabbed attention in the July data, echoed in the chart below, was evidence that the U.S. job creation engine has stalled.

Change in Rate of Payroll Growth



Source: Haver, Morgan Stanley Research (07/30/2025)

The August report, showing just 22,000, further underscored the dearth of job creation and ongoing weakness in NFIB Hiring Intentions portend continued subdued activity.

Identifying causality remains the central challenge for all market watchers, but the pall of uncertainty has been central to job market deterioration, in our view. Businesses will only expand within their immediate planning horizon. Until companies have greater clarity on trade and tariffs, we expect anemic employment trends to persist.

Fortunately, as previously noted, we believe the shadow of COVID may delay layoffs. After businesses battled to rebuild their workforce post-pandemic, many will be slow to fire this cycle. This has been evident in initial claims and WARN data, which reflects fraying, not dramatic decay. Post pandemic labor hoarding may forestall job losses, but it will not eliminate them should the economy downshift.



“Risk-on” rate cuts?

By signaling a rate cut in September, the Fed substantiated fading job trends.

We note the perverse logic of the market rally after the Fed’s dovish tilt. We believe a rate cut with inflation well above target combined with lofty asset values should presage caution, not “risk on.” The Fed will only cut if trends dramatically slow, which is not a reason to celebrate.

Underscoring another market inconsistency, CME FedWatch forecasts 100 bps of cuts through September 2026, a level of reduction that might be associated with recessionary concerns, of which credit spreads and equity values reveal no signs.¹ Only an uber-bullish scenario of inflation easing with no economic damage—despite incremental monetary accommodation—would justify this market signal.

Perhaps most importantly, rate cuts may fail to heal what ails our economy. Lowering front-end rates will steepen the yield curve if it stokes inflation and/or if the market perceives the Fed as having capitulated to political pressure (a risk amplified by recent intrusions on Fed independence).

Given that mortgages are benchmarked to the long end of the curve, rate cuts could, paradoxically, hurt the U.S.’s moribund housing market.

Additionally, rates remain a global phenomenon and Japanese, German, French and U.K. 30-year sovereign yields are hovering near multi-decade highs. U.S. front-end cuts will do little to counter the global interplay of long-term rates.

¹ CME FedWatch (09/03/2025)

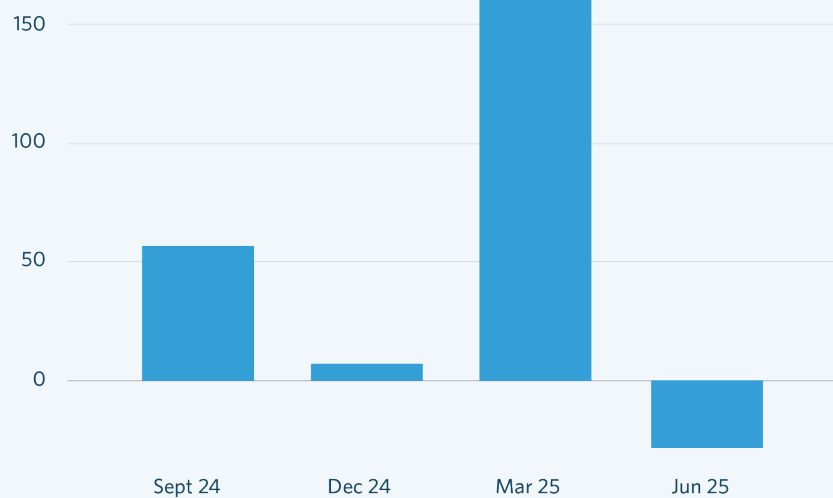
Lastly, and most importantly, the malaise of uncertainty cannot be solved through monetary policy. It is not cost of capital, but a general lack of certainty, that has restrained recent economic activity.

Final Sales — Reflect a Downshift

Tariff-related import/export activity has skewed recent GDP figures, making them a less reliable near-term gage. Final domestic sales (which exclude inventory changes) garnered greater attention in recent quarters and has begun to show signs of deceleration, slowing to +1.2% in 2Q 2025 vs. +1.9% in 1Q 2025 and +2.9% in 2Q 2024.²

Separately, 2Q GDP revealed that businesses may have depleted pre-tariff inventories.

Change in private inventories (\$bn)



Source: Bloomberg, Bureau of Economic Analysis (08/12/2025); Note: Chained 2018 dollars

Businesses pushing through higher costs as the economy begins to slow would represent textbook definition stagflation—a brutal backdrop for an economy to escape.

Kozmo.com 2.0?

“AI” is the only word used by more frequently than “uncertain” in 2025.

We want to revisit our AI bubble concerns with an analog from a bygone era: Kozmo.com

Launched during the peak dot-com boom in 1998, Kozmo promised one-hour delivery of groceries and other items, without cumbersome (yet revenue-generating) fees. We distinctly remember Kozmo delivering a pint of Ben & Jerry’s to my desk during a marathon conference call.

² U.S. Bureau of Economic Analysis

Did Kozmo.com increase productivity? Unquestionably. Did it make money? Absolutely not. The company shuttered in 2001 after slaughtering \$200mn of venture capital. The lesson: productivity tools are only sustainable if they can generate economic returns.

Does AI increase productivity? Speaking anecdotally, yes. However, does AI make money? While precise figures are elusive, evidence suggests overwhelmingly not.

Companies, predominantly Big Tech, will spend roughly \$400bn on AI-related infrastructure this year.³ By comparison, market leader OpenAI has guided to \$13bn of revenue in 2025—impressive growth relative to 2024 sales of \$5.5bn, but dwarfish relative to capital spend.

Sam Altman has predicted “trillions” of AI capex spend and McKinsey recently estimated the need for \$6.7tn of infrastructure investment by 2030 to keep pace with compute power.⁴

Hence, not unlike the VC dollars that subsidized the delivery of Chunky Monkey, each AI query is currently being financed largely by Big Tech. The staggering magnitude of capital required calls into question the viability of artificial intelligence, writ large.

AI kills the golden goose/geese?

Crucially, the current AI boom risks toppling the most sacrosanct names in the S&P 500, which creates significant systematic risk for U.S. investors. Given Big Tech’s monstrous Index weighting, the waning of the mania risks collapsing the S&P’s lofty valuation.⁵

The rents earned by U.S. mega caps have provided the riches to fund AI investment, but for how long will the market countenance these outlays?

The S&P 500 has been boosted by a handful of companies with near mythical business models that have enabled growth with *de minimis* marginal costs and therefore powering mammoth cash generation. These businesses have enjoyed a virtuous cycle whereby sky-high valuations have lowered their cost of capital, reinforcing growth, margin and cash flows. Amazon arguably enjoyed an effective zero-WACC before achieving scale and stumbling upon the AWS cash engine.

As demonstrated in the chart below, AI has already dimmed the magic of the S&P’s hegemony by consuming their vaunted cash flows.



³ “Who will pay for the trillion-dollar AI boom?” The Economist, July 31, 2025

⁴ “The cost of compute: A \$7 trillion race to scale data centers,” McKinsey Quarterly, April 28, 2025

⁵ “American Unexceptionalism,” GMO, (08/21/2025) Note: Big Tech comprises Apple, Microsoft, Alphabet, Amazon, Meta and Nvidia.

Capex, FCF margin and Revenue Growth: MSFT, AMZN, GOOG and META

		CapEx	→	Free Cash Flow Margin	vs.	Revenue
Microsoft	C2023	\$35B		30%		\$228B
	C2024	\$56B		27%		\$262B
	Y/Y Change	+58%		-10%		+15%
Amazon	C2023	\$53B		6%		\$575B
	C2024	\$83B		5%		\$638B
	Y/Y Change	+57%		-8%		+11%
Alphabet (Google)	C2023	\$32B		23%		\$307B
	C2024	\$52B		21%		\$350B
	Y/Y Change	+63%		-8%		+14%
Meta Platforms (Facebook)	C2023	\$27B		33%		\$135B
	C2024	\$37B		33%		\$165B
	Y/Y Change	+38%		<1%		+22%

Source: BOND Capital (06/02/2025)

Plus, massive capex today will create depreciation expenses (albeit non-cash) that will weigh on EPS for years to come.

Thus far, the market has rewarded Big Tech's spending, but at some point, chasing the chimera of AI riches with impunity may stop. Not unlike the market's refusal to reward growth in oil & gas post-shale (thereby strangling access to capital), sentiment towards spending can shift rapidly.

Ominously, in their *"The GenAI Divide: State of AI in Business 2025"* dispatch, MIT NANDA (Networked Agents and Decentralized AI) reported that 95% of businesses are reporting zero return on their AI investments.⁶ The shot clock on AI may be ticking...

Fed war a core threat

The recent infringement on Federal Reserve independence, in our view, represents the biggest threat to U.S. monetary policy since Andrew Jackson killed the Second Bank of the United States (a Fed predecessor), which left the country without a centralized authority for more than seventy years.

More recently, the most notable political interference in monetary policy occurred when Richard Nixon cajoled Fed chair Arthur Burns to lower rates ahead of the 1972 election. While many factors contributed to amplify its impact (e.g. oil shocks, hangover from LBJ's Guns and Butter programs), the Fed's imprudent cuts nevertheless catalyzed the debilitating inflation that manacled the economy throughout the decade. It required the courage of Paul Volker to wrangle inflation through punishing rate hikes, which smoothed aggregate demand.

⁶ "The GenAI Divide: State of AI in Business 2025," MIT NANDA (July 2025)

The U.S. economy paid a heavy price for the politicization of monetary policy. Nixon's meddling appears picayune relative to the current administration's attempts to fire a Fed governor to install a more dovish loyalist.

Turkey highlights the consequences of executive intrusion into monetary matters. President Erdogan has actively interfered with monetary policy, beginning with the appointment of his son-in-law as Turkey's finance minister shortly after his election. During Erdogan's tenure, which is ongoing, inflation averaged 26.7% (cumulative price change 967.8%) from 2014 through 2024.⁷

Paraphrasing renowned economist and former advisor to the New York Federal Reserve Kenneth Rogoff in his recent book *Our Dollar, Your Problem*, the global trust that the U.S. Federal Reserve will deliver stable prices is the "is the single most important bulwark that stands between global economic stability and the return of the macroeconomic stone ages—that is the say, the 1970s" Politicizing monetary policy undermines this fundamental trust.

The market has largely ignored the administration's efforts, reflecting the low likelihood of success on legal grounds. Further, we anticipate a galvanic negative bond market response would ultimately stomp out these incursions.

⁷ CPI Inflation Calculator

The Good

Market watchers always sound smarter emphasizing the negative; careers have been built on perma-bear narratives. Hence, we consciously attempt to provide balance to our commentary.



Hard to kill

The resilience of the U.S. economy amid a cavalcade of disorder has been astounding.

Global trade and security relationships have been reshuffled amid a protracted land war in Europe and the dramatic amplification of Middle East conflict, while U.S. rule of law, governance and monetary policy norms have been challenged by a rollback of both free-market orthodoxy and democratic institutions amid heightened cost of capital reflected by U.S. 10-year Treasury yields averaging 4.11% over the last three years compared to 1.54% in the previous three at the same time that American universities (the envy of the world) are under assault. (Editor's Note: intentional run-on sentence for dramatic effect)

Powering through this tumult is a testament to the U.S. economy's underlying soundness, likely a derivative of

COVID. Rock bottom interest rates and fiscal spending enabled household and corporate balance sheet repair and the ensuing market rally enabled astounding wealth creation.

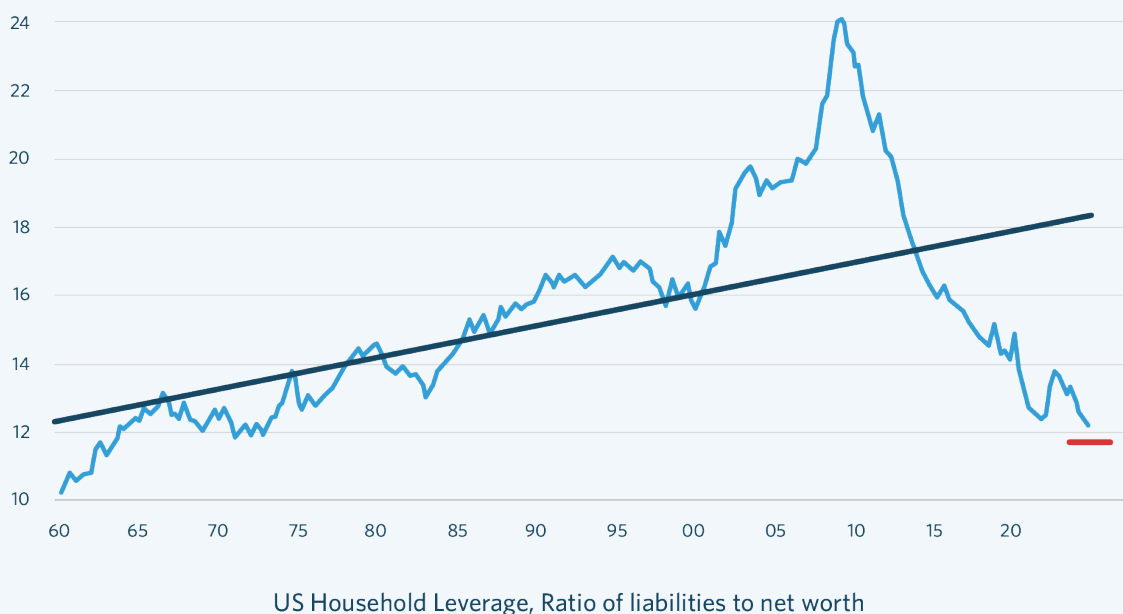
With confidence at the cornerstone of GDP growth, recent economic strength could become self-fulfilling if a perception of economic invulnerability takes hold. If this backdrop hasn't toppled U.S. GDP, what will?

Relatedly, stimulus from OBBB—including provisions like the acceleration of depreciation expense—may provide fiscal fuel to reinvigorate the economy.

The leverage to leverage

The most traumatic economic episodes of the post-war era have given rise to today's historically healthy household balance sheets, as demonstrated below.

U.S. Household Leverage (%)



Source: Federal Reserve Board (07/10/2025)

The emotional wounds of the Great Financial Crisis and the subsequent decreased availability of subprime credit has driven significant consumer deleveraging, while elevated asset values have amplified net worth.

A jolt in confidence could prompt releveraging, driving further growth. The healthy aggregate consumer profile may also mute the next downturn by providing spending power for displaced workers. Recall, the pain of GFC was in part derived from households being forced to deleverage amid job loss, obliterating discretionary spending.

Dry powder

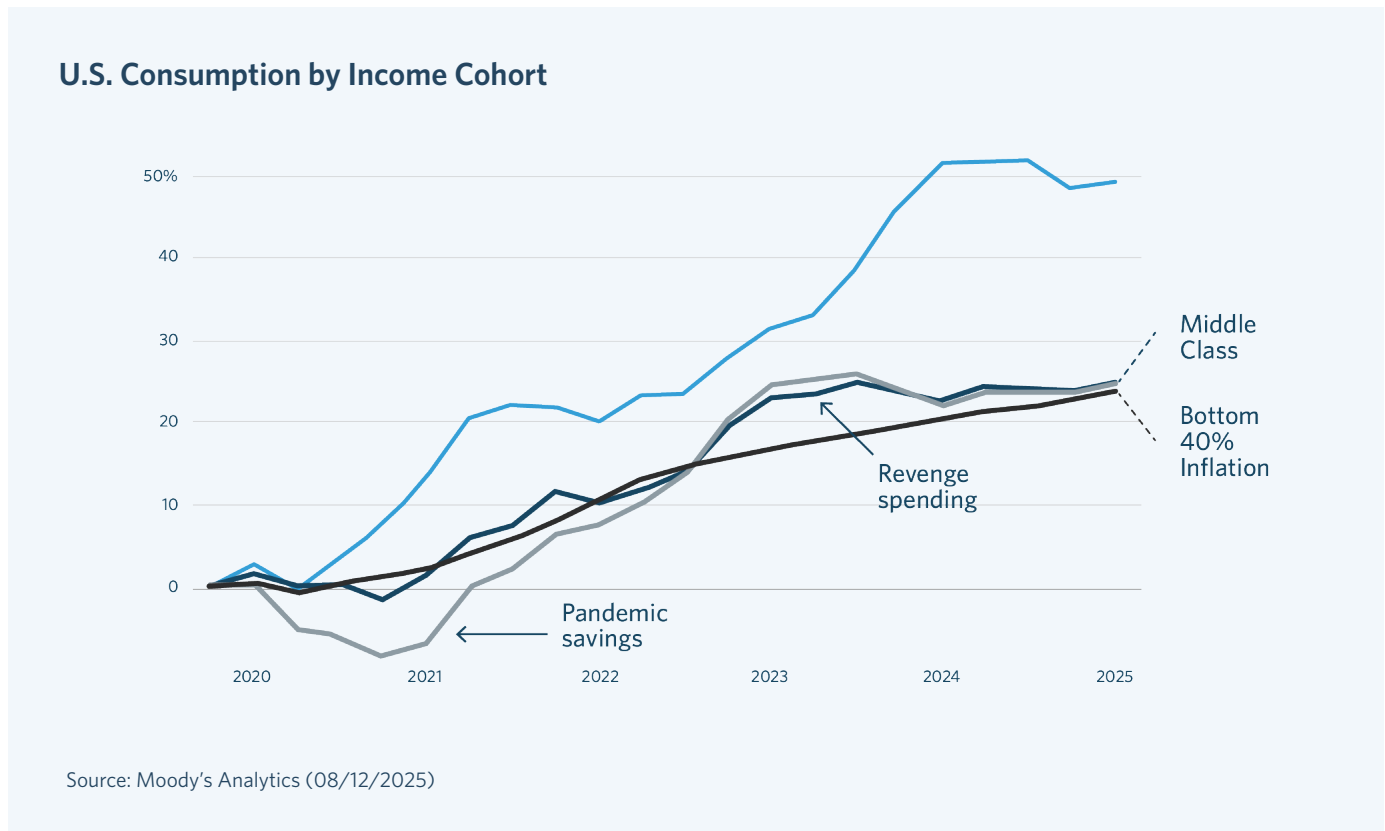
As well documented, roughly \$7tn of assets have flooded into money market funds (MMFs) since the Fed's first hike in March 2022.

MMFs have historically exhibited near-perfect beta with the fed-funds rate, meaning their yields should fall in lockstep with potential cuts. As rates decrease, these dollars in time migrate into other assets, providing firepower for markets.

However, a lower rate environment isn't friction-free. A 100 bp decline in yields would wipe out \$70bn of (near risk-free) interest income from investors' portfolios. This could prompt investors to move out on the risk spectrum amid already lofty valuations, thus heightening asset bubble risk.

High-end consumer remains stalwart

Spending by high-end U.S. consumers shows little sign of slowing, as reflected in the graph below.



Lower income consumers show clear signs of stress as evidenced by higher delinquencies across lending categories; credit card delinquencies are near GFC highs.⁸ These consumers will face further stress from provisions in the One Big Beautiful Bill, including reductions of SNAP benefits and lost healthcare coverage.

Despite their economic strain, the lowest income cohort only represents around 9% of U.S. consumption compared to 39% and 23% for highest income quintile and fourth income quintile, respectively.⁹ Hence, strength at the high-end has so far subsumed low-end stress.

⁸ The Federal Reserve Bank of New York, Macrobook and Apollo Chief Economist (07/18/2025)

⁹ Haner Analytics and Apollo Chief Economist (07/18/2025)

The Opportunity

Evidence of lofty public market valuations are both unambiguous and well documented.

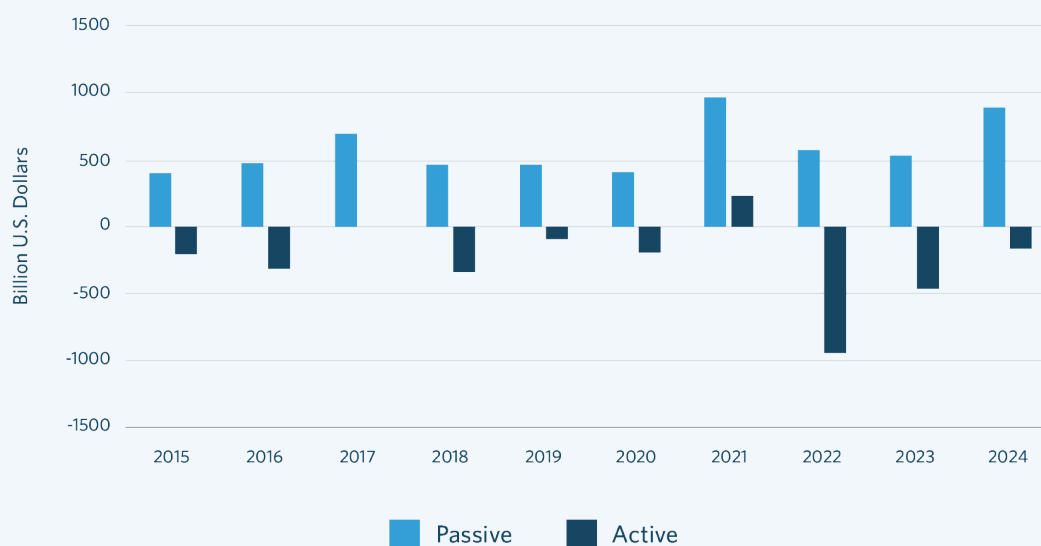
Anecdotally, BC Partners in recent weeks has walked away from deals priced at levels it would generously characterize as “aggressive.” In our specialty finance vertical, a company that filed for bankruptcy last year recently obtained financing at S+275 bps and a 92% advance rate. For perspective, that’s roughly the same

yield as 10-year Indian sovereign debt. Deals like this could herald the top of the market in public credit.

Before delving into areas of opportunity for BC Partners’ investors, we want to highlight a key driver behind the growth of private credit: the marked rise of passive investing.

As depicted below, passive vehicles have captured significant share from active over the last decade.

U.S. Flow of Funds



Source: Morningstar (year-end 2024)

Notably, in 2024, passive funds attracted \$886bn of new capital while active vehicles lost \$166bn of assets.¹⁰ Last year, passive surpassed active, comprising 53% market share compared to 47%.¹¹

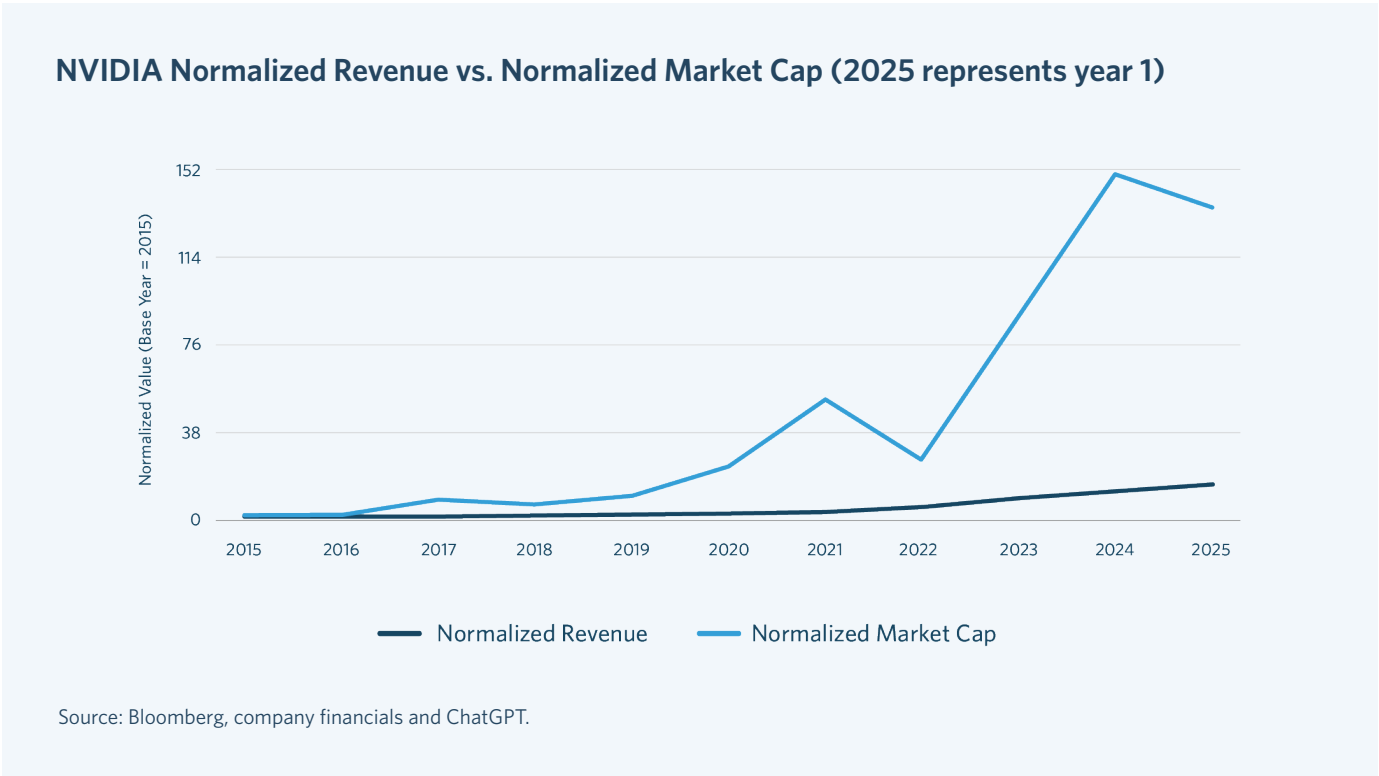
Asset selection has become a dying art as an increasing percentage of “buy” and “sell” decisions have become dictated solely by fund flows. Earnings and other signals have been muffled by cash inflows/outflows, stifling the market’s normal response mechanism.

¹⁰ “The Passive vs. Active Fund Monitor,” PWL Capital (year-end 2024, published winter 2025)

¹¹ Morningstar report published in “The Passive vs. Active Fund Monitor,” PWL Capital (year-end 2024, published winter 2025)

As passive has crowded out fundamentals, daring hedge funds taking directional bets (shot and long) have been replaced by factor-driven pod shops with nano-second holding periods, amplifying the breakdown of market efficiency.

The silent coup d'état of passive has created market distortion like the once unthinkable prices of Big Tech. As highlighted below, NVIDIA's valuation has steadily outpaced its revenue growth due in part to passive investing.



If a passive vehicle receives inflows, those dollars will buy a proportionate share of a stock in the reference index; from 1x sales or 1000x sales, valuation is irrelevant in that equation. This dynamic skews our economy by potentially rewarding large index constituents with a lower cost of capital that can stifle competitors.

Private credit has no equivalent. An investor cannot, for instance, passively buy, overhaul, and sell a jet engine. Structured equity entails hammering out a capital solution specific to each individual company; there is no formulaic approach. Asset based lending involves a double-underwrite—both an assessment of the actual assets as well as the financial health of the borrower.

A passive approach to such lending would be a manifest disaster for investors. Formulaic flows would perhaps sustain some struggling private borrowers, but

more often would incinerate capital by providing more debt to businesses unable to service their borrowings.

In short, private credit is among the last remaining corners of active management. As allocators—both institutional and individuals—push an increasing share of their equities into passive, private credit provides compelling offset.

Of course, there are gradations of active management within private credit. Larger vehicles often serve as price-takers given the need to deploy hoards of capital, thereby forcing investors to sacrifice returns in exchange for the theopoetical safety of big shops.

In contrast, as among the most prominent players in the middle market, BC Partners believes in engaging in fundamental analysis and capital structure assessment and/or formation for every name in our portfolio.



BC Partners benefits from our ability to write “small checks” by virtue of our size and leveraging our institutional platform to capture larger transactions as well.

How we are making money

BC Partners benefits from its ability to write “small checks” by virtue of its size and leveraging its institutional platform to capture larger transactions as well.

The firm recently purchased a \$1.2bn aviation portfolio. In isolation, this deal would comprise a sizable percentage of our AUM and potentially represent an imprudent check size, regardless of its return potential.

However, BC Partners populated the deal among its internal vehicles and syndicated the remainder to our LPs as a co-invest. The flexibility to scale a deal,

when appropriate, unlocks opportunities and rewards our largest partners with a direct investment. We followed a similar path with a recent first-lien deal in the healthcare technology space.

To clarify, BC Partners does not need to write big tickets, but we can when the opportunity presents itself, which is an ideal setup, in our view.

As previously noted, the dearth of private equity exits has boosted demand for BC Partners’ NAV lending and structured equity solutions. The difficult PE backdrop has also uncovered bridge equity opportunities. BC Partners has been lending sponsors short-term capital on a first lien basis, which gets repaid at transaction closing.

Wrap-up

We are not macroeconomists—and our investment process is ultimately driven by fundamental credit selectin—but a consideration of the economic backdrop underpins all of our investment decisions. We contrast our approach with those of passive peers.

Uncertainty looms, with stagflation potentially emerging, which could be worsened by a pullback in AI spending that could puncture the S&P 500. While rate cuts may reinvigorate GDP and jolt animal spirits, it may lead to further inflation and elevate asset bubble risk.

Regardless of the route, stretched public market asset prices provide a narrow path for investors, in our view. Deploying capital at higher valuations has historically resulted in underwhelming returns. Plus, should the market rollover, the downside decent could be steep.

As noted earlier, BC Partners has concerns that we may be at the top of the market which may pose a risk to investors who over allocate to passive funds. In our view, actively managed private credit funds should be more attractive.

Actively managed private credit provides a safe haven.

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