BC PARTNERS

2Q 2026 Credit Check

Middle-Market Credit: Best House on a Bad Block

BC Partners' Credit team, Ted Goldthorpe and Mike Terwilliger, highlight the geopolitical and economic challenges that have yet to slow markets, but remain an overhang.

The authors note that the U.S. Risk Curve—a cross-asset measure of yields—underscores the limited expected return available from equities, with earnings yields compressed further by the S&P 500's historic rebound in April and May.

The team articulates concerns that artificial intelligence may be fueling portfolio "looksmaxxing," or investors allocating capital with impunity in hopes of amassing wealth amid a potential AI storm.

Much as "software is eating the world" defined the previous market regime, the BC Partners team opines that the current backdrop is described as "AI is eating cash flow."

BC Partners again highlights the disconnect between public market and private credit default assumptions. While the media maelstrom quieted in the period, loss expectation for private assets remains meaningfully distorted.

Lastly, with an overload of dry powder and a dearth of LBO activity, many—if not most— private markets firms may struggle to deploy capital, hindering their ability to generate outsize returns.

In an unsettled economy and a bleak public market landscape, investors must expand allocation to middle-market private credit, which is among the last sources of potential alpha.

Macro Backdrop

We begin by noting economic and market challenges.

The Concerning

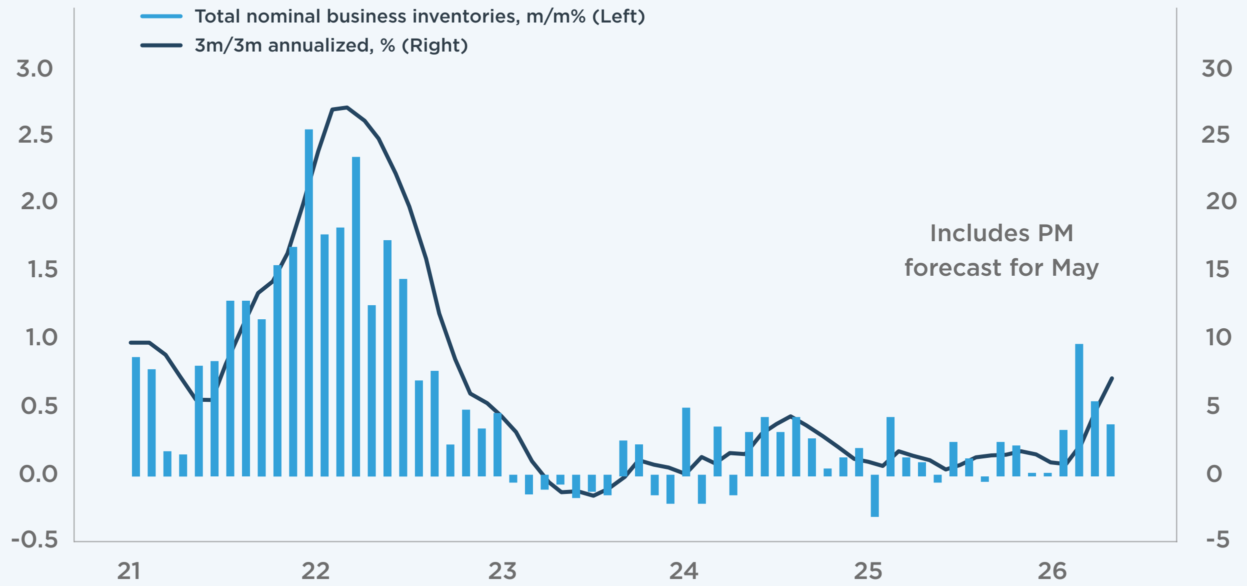
Potential headwinds in the second half of 2026

With higher-than-expected hiring activity, employment improved moderately in 2Q, but considering NFIB hiring intentions reaching pandemic-era lows in May and continued weak regional Federal Reserve survey data, we are skeptical that recent momentum will prove resilient.

As for the consumer, even with the benefit of higher tax refunds, U.S. personal savings rates dropped to 2.6% in April and 3.0% in May, well below the 6.0% post-GFC average.[1] This level of dissavings is inconsistent with consumer sentiment indicators, which deteriorated throughout 2026 on seemingly every measure; any boost to savings rates would provide a headwind to GDP.

Additionally, uncertainty from events in the Middle East may have prompted businesses to build inventory in recent weeks, as shown below:

U.S. Nominal Business Inventories



Source: Pantheon Macro, June Chartbook (06/30/2026)

[1] U.S. Federal Reserve Bank of St. Louis

Consumption of these stores may provide another obstacle to growth in 2H 2026.

Lastly, regardless of 2H outlook, we highlight that even with the boost of tax refunds and inventory pull-forward, the U.S. economy posted underwhelming real GDP growth of 1.6% in 1Q 2026.[2]

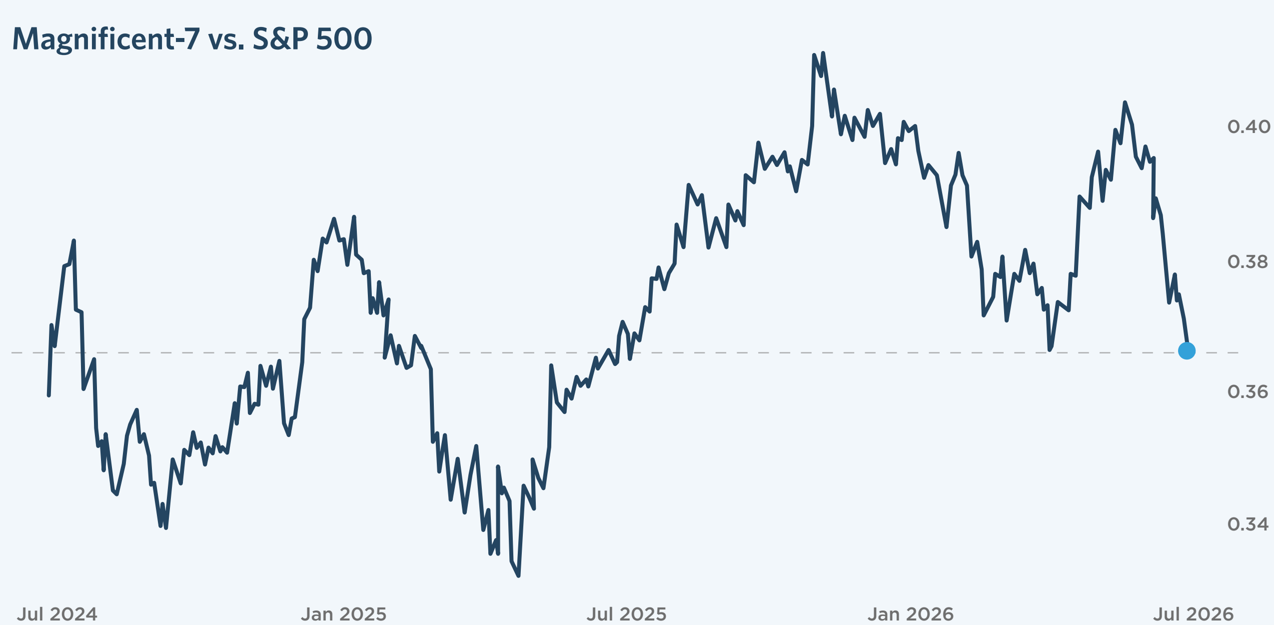
AI: The Known Unknown

Discussions about artificial intelligence have so saturated public discourse that we are reluctant to engage on the topic. However, with markets and the economy seemingly hinging on this emerging tech, we cannot not discuss AI.

If the expression "software is eating the world" defined the previous market, we believe "AI is eating cash flow" characterizes the current epoch.

We have long articulated a guarded view of AI—not due to doubts about its capabilities, which become seemingly more breathtaking with each iteration—but due to the astounding capital and infrastructure required to drive its realization.

The recent underperformance of the AI-heavy Mag-7 (depicted below), may reflect the markets' cooling to the AI cash bonfire, which is the crux of our concerns:



Source: The Daily Shot (06/25/2026)

Each of the Mag-7 stocks posted losses in June, with the best-performing down 8.0%, and the hyperscalers now trade at lower forward P/E multiple than the broader market—a remarkable valuation reversal.[3] This represents ominous signs for future AI spending.

---

[2] Bureau of Economic Analysis (06/25/2026)

[3] Bloomberg, (06/30/2026)

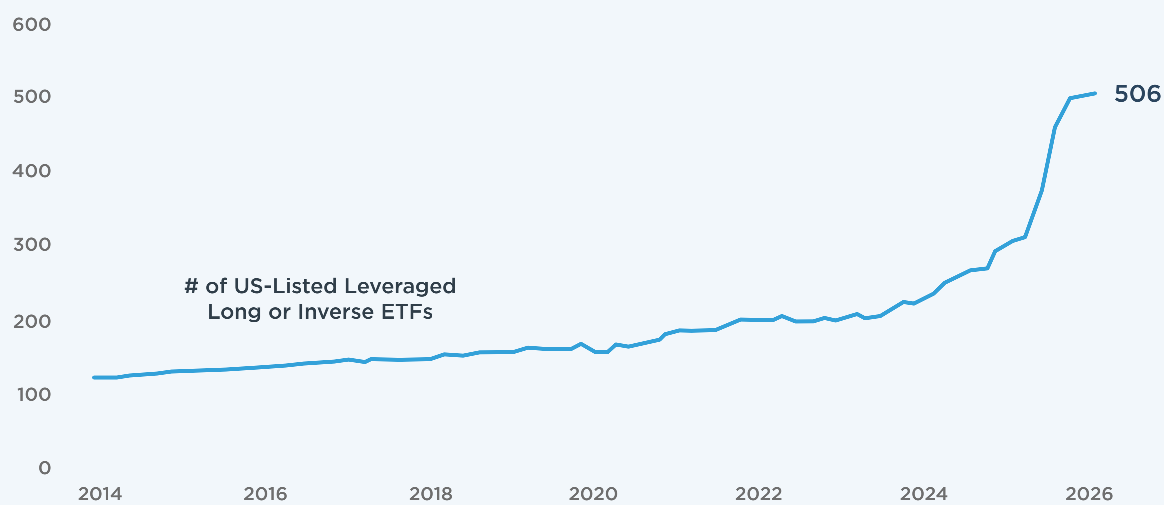
The largest reservoirs of global capital (hyperscalers, venture capital, sovereign wealth funds and public/private credit firms) have absorbed this spending, but in time, the full freight of AI's cost must be borne by business and household end users. Uber captured headlines for burning through its annual AI budget in March, highlighting the challenges of transferring this spend.[4]

AI's elusive path to profitability represents a known unknown risk to our economy and markets. With non-AI capex muted despite accelerated depreciation under the OBBB and AI-mania driving markets higher, thereby driving wealth effects, where would markets and the economy be without the hopes and dreams of AI?

Portfolio 'looksmaxxing'

There are myriad signs of incaution in the market beyond SpaceX's recent math-defying IPO including the spiraling growth of levered ETFs, illustrated below:

More than 500 Leveraged ETFs Now Trade in the U.S.



Source: Tracking Insight data via The ETF Shelf, U.S.-listed leveraged long or inverse ETFs, as of 02/10/2025.

Investors (many retail) are piling into the market in levered vehicles despite valuation metrics more than two standard deviations above their long-term mean.[5]

Options volumes in 2025 doubled relative to 2020 levels and notably, single-day option transactions (perhaps more akin to playing the Powerball than investing) have surged 3.7x since 2021.[6]

Fear, in our view, lies in the subtext of these bubble-like behaviors.

---

[4] "Corporate America Is Starting to Ration AI as Cost Skyrockets," Wall Street Journal (05/28/2026)

[5] The Daily Shot (06/25/2026)

[6] "America's bull market has entered the manic phase," The Economist (06/16/2026)

Knowledge-based work has become the cornerstone of the U.S. economy—a phenomenon amplified by the demise of domestic manufacturing post-NAFTA and China's 2001 entry into the WTO. With the cost of knowledge-based work potentially racing to zero, many of these jobs may be directly in AI's crosshairs.

Amid fears AI may render livelihoods obsolete, we posit that countless programmers, lawyers, accountants, etc. that enjoyed a bounty of affluence in recent decades are plowing money into markets in hopes of amassing wealth as a hoped-for shelter from AI. This portfolio 'looksmaxxing' represents an existential level of FOMO—a race to capture a slice of AI-related wealth before it potentially wipes out their worth.

Today's dizzying valuations may lead one to believe markets have structurally changed and that distortions wrought by COVID combined with the AI-capex cornucopia have permanently lifted asset values. That viewpoint aligns with the idea that "it's different this time," which has proven to be a dangerous lens.

Rates

Resurgent inflation due to conflict in the Middle East dramatically shifted rate expectations from near-certain cuts at the beginning of the year to ~75% probability of hikes today.[7] May's CPI reading of 4.2% year-over-year—the highest level in three years—likely dashed hopes for rate relief in 2026.[8]

Politically, the bar to deliver hikes is high, but the inflation-scarring of the pandemic presents policymakers with a treacherous backdrop.

Households have become acutely aware of higher prices, which can amplify price shocks. Gas represents a particularly salient category as consumers literally see (if not pay) higher pump prices. And while inflation expectations have remained anchored, secondary effects have yet to fully navigate supply chains.

We view cuts as out of the question (though nothing is totally out of the question in this norm-bending time), and believe the Fed will refrain from hikes without a dramatic inflation upswing, which we do not anticipate.

Still, newly elected Federal Reserve chair Kevin Warsh has been a vocal proponent of lower rates, arguing that AI-driven productivity could justify preemptive cuts.

We question that reasoning as higher productivity should increase return on capital, creating more demand for investment resulting in less savings and warranting higher rates.

Importantly, events in the Middle East triggered a meaningful repricing in global sovereign bond markets. With 10-year JGBs ~2.6% (the highest since the early 1990s), 10-year bunds ~2.9% (near the upper end of the post-Euro range), and U.K. gilts ~4.7% (approaching pre-GFC levels), it's a reminder that markets, not policymakers, ultimately dictate the path of rates.[9]

Yields edged lower following the conflict's latest supposed resolution, but equities effectively shrugged as rates moved sharply higher in May, perhaps the clearest sign of complacency in the current backdrop.

---

[7] CME FedWatch, (06/30/2026)

[8] Bureau of Labor Statistic

[9] Bloomberg, (06/24/2026)

The Good

Die hard

U.S. equity markets have not been dented despite a Gulf conflict that reshuffled global shipping routes and reset Middle Eastern security patterns; a European ground war that grinds on as drones strike Moscow and Kyiv, skyrocketing fuel prices; improving yet anemic domestic job creation; plummeting consumer sentiment; and an emerging technology that could fundamentally reshuffle society.

In fact, the S&P 500's 16% gain in April and May represents the strongest two-month return in the post-WWII era, excluding periods immediately preceded by recession or market shock, like the GFC.[10]

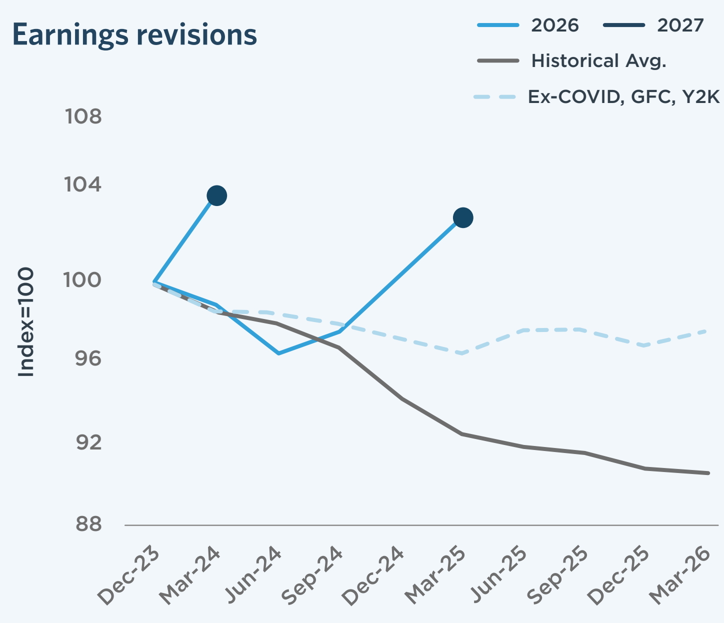
If the current environment has not wilted markets, what, pray tell, will?

Forgive the tortured logic, but recent capricious, if not ill-conceived, policy decisions may prove an unexpected blessing by restraining animal spirits—even if only modestly—preventing markets from becoming even more unkeeled.

[10] "What are the biggest market dislocations June," Deutsche Bank (06/02/2026)

Earnings bonanza

The low-hire/low-fire economy combined with higher productivity powered staggering earnings gains, which as demonstrated below, continue to outpace expectations:



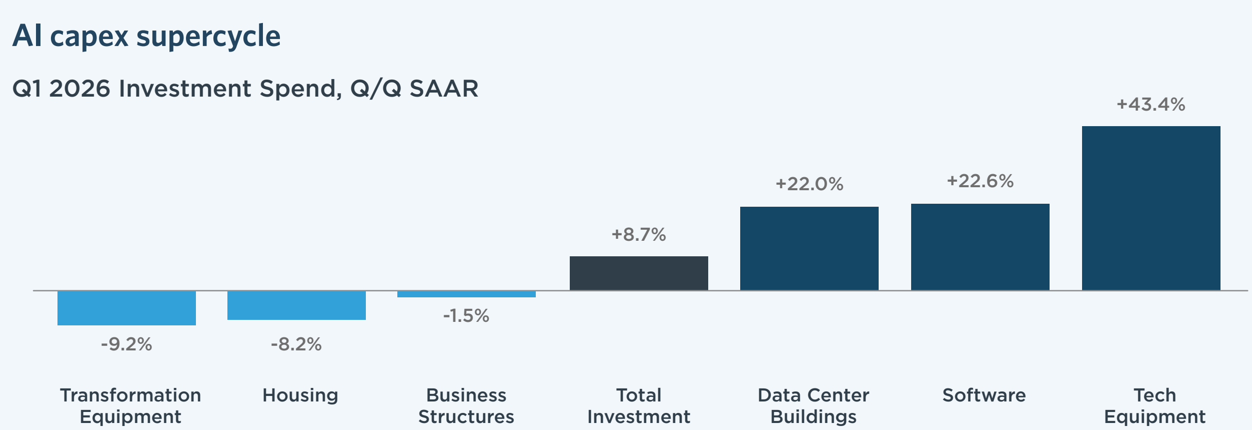
Source: Alpine Macro (03/02/2026)

For perspective, Q1 S&P 500 net profit margins of 14.8% were roughly twice the post-war average.[11]

Questions about the resilience of these gains abound. Micron, for instance, enjoyed a deluge of profits from an AI-induced spike in demand for memory chips, a commodity product that has exhibited extreme cyclicality. Historically, high memory chip prices invited new supply, resulting in price normalization, which would plateau — if not crater — Micron's earnings boon.

AI dance party

We've made our AI concerns clear, but as long as the music is playing, the U.S. economy will dance on:



Source: WSJ, BEA, Bloomberg as of 05/11/2026

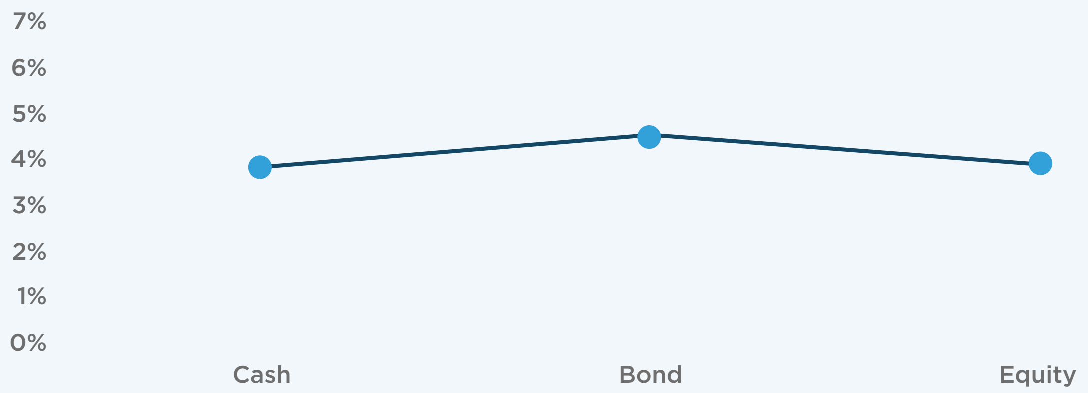
Unless or until investors recalibrate their view of such spending, the AI capex cycle will likely prove immune to market cycles and interest rates.

[11] "Earnings Forecasts Are on Steroids," Wall Street Journal (06/30/2026)

The Opportunity

The U.S. risk curve, which depicts cash rates, bond yields and equity earnings, provides a near-perfect visualization of the current market backdrop:

U.S. Risk Curve



Source: FRED, S&P 500 as of 07/07/2026.

Investors gain little incremental expected return from venturing out on the risk curve in the current environment. We believe sophisticated investors will recognize this indisputable math and allocate accordingly.

Further, the U.S. high yield spread remains in the 280bps range, despite increasingly hawkish global central banks and insurgent inflation—factors historically associated with spread widening. While we do not anticipate an uptick in defaults, we also do not view this as an attractive time to own public bonds.

As for private credit, we recognize the discordant signals about potential defaults. High yield spreads at 280bps suggest a benign default environment, perhaps as low as 1.3%, depending on one's excess spread assumption.[12]

Public BDCs have rallied since the First Brands and TriColor panic and the "software is going away" scare but remain at a hefty discount to book. Based on BC Partners' analysis, distilling portfolios into asset type, applying historical loss and recovery rates, and accounting for current capitalization, we calculate that markets are pricing public BDCs with an implied default rate of ~26% (~16% if book value-weighted).

This is admittedly an oversimplification because it ascribes discounts to expected credit losses but remains consistent with the market's default signals. For context, peak BDC defaults hit 6% to 7% range in 2009 and 2010.[13]

This suggests the demise of private credit remains greatly exaggerated.

---

[12] Implied default = (HY OAS – excess spread) / (1 – recovery) or 280bps – 200bps / (1 – .40) = 1.3% Historically, many market participants utilized ~300bps as an excess spread benchmark (or the returns earned by holders for ill-liquidity, tax, etc.), but this is an unobservable input. Post-TRACE and with growth of ETFs and systematic trading platforms, liquidity premium has continued to shrink.

[13] "Moody's Credit Convergence Monitor," Moody's Investor Services (16/08/2018)

We reiterate that there has been a gross misallocation to private credit, with too many dollars chasing large cap, sponsor-led deals. That segment is essentially a passive participant, because such deployment relies on large LBOs. How can one proactively engage in asset selection with such a paucity of opportunities?

Notably, with full public valuations, heightened geopolitical uncertainty and a shifting rate environment, the market has not priced a buyout financing exceeding $2bn since early March and year-to-date direct lending LBO volumes are down 21% year-over-year at $30.2bn in total.[14] What do monster funds do without deal flow, buy Treasuries? Better that than chasing deals...

Seeking alpha amidst turbulence

Amid a sea of undesirable options, BC Partners' private credit solutions have become vital for allocators seeking alpha.

Non-sponsor transactions remain our core. During the quarter, BC Partners financed a management buyout in the payments space for a provider that boasts strong retention metrics and significant growth in new merchant cohorts.

Our structure included a first lien term loan with a cash coupon of S+650bps, 3 points of discount, sliding amortization (2.5% to 10% based on leverage) as well as penny warrants for 3.0% of equity. Importantly, our deal contemplated net closing leverage of just 4.3x. We believe a competitive sponsor-led process would not have survived either our attractive economics nor conservative leverage.

Flexibility also remains BC Partners' hallmark, and financing tariffs claims is our latest foray into a unique new category.

In February 2025, the U.S. Supreme Court ruled in *Learning Resources vs. Trump* that the president did not have tariff authority under the International Emergency Economic Powers Act (IEEPA), requiring refunding the collected dues.

BC Partners has been buying these claims at an ~85% effective purchase price that includes an OID and holdback. So far, the realized portfolio has an average ~1.0-to-1.5-month duration at exit.

A feature of these deals is that they are small, idiosyncratic and bespoke — not built to scale for those required to deploy billions, but well suited to BC Partners' alpha-generation model.

[14] "Large deal drought drags private credit LBO financings down 21% YoY," Pitchbook (06/25/2026)

Conclusion

Private credit as a category remains healthy and growing, despite scrutiny through the recent media maelstrom. The market recognizes that an overallocation of capital to certain strategies offers similar outcomes due to a dearth in differentiation.

Such crowding has been harmful for investors as evidenced by the degradation of covenants in large-cap private credit. As we've noted before: without covenants, you do not have private credit.

Nevertheless, herding of capital into mega-funds has, paradoxically, been beneficial to BC Partners and our LPs. As firms have raced upmarket or been absorbed into other platforms, the true middle market has become less crowded.

Alpha-orientated funds should be front of mind as investors consider alternatives to the larger vehicles and their beta-like strategies.

Important Information:

All information contained herein has been sourced from BC Partners Advisors L.P. (the "Advisor"), unless otherwise noted. Certain information contained in this Presentation may have been obtained from published sources prepared by other parties. Such information is believed to be reliable, but has not been independently verified or audited. The information presented herein is for illustrative purposes only and should not be considered reflective of any particular security, strategy, or investment product. It represents a general assessment of the markets at a specific time and is not a guarantee of future performance results or market movement. The information contained herein does not constitute financial, legal, tax or other advice, and is intended solely for the person(s) to which it has been delivered. It may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior consent of the Advisor. Nothing herein is or should be construed as an offer to enter into any contract, investment advice, a recommendation of any kind, a solicitation of clients, or an offer to sell or an offer to invest in any particular fund, product, investment vehicle or derivative. The information contained herein is not complete, may not be current, and is subject to change. The Adviser is under no obligation to update such information. This material is not directed at, nor is it available for distribution to, U.S. investors or any persons in any jurisdictions in which the Adviser or its affiliates are prohibited by law from making this information available.