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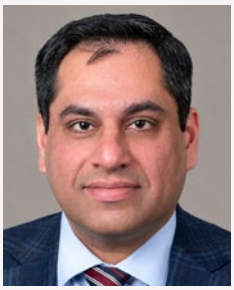
Higher rates widen the credit divide and reshape opportunities

A conversation with Oaktree's Raghav Khanna and Alison Mermey about credit markets in 3Q 2026



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Renewed inflation pressures and higher interest rates challenged borrowers in the third quarter of 2026. Alison Mermey (Head of BDC Investor Relations) sat down with Raghav Khanna (Co-CIO of Oaktree Strategic Credit) to discuss the evolving credit environment, emerging signs of stress and potential opportunities across public and private credit for disciplined lenders.

Alison Mermey (AM): The macroeconomic backdrop changed a lot during the third quarter. What mattered most for credit markets?

Raghav Khanna (RK): The biggest development was the shift in the interest-rate outlook. Markets entered the year expecting Federal Reserve rate cuts, but renewed inflation pressures, partly driven by rising energy prices, changed that trajectory. Instead, the Fed raised rates by 25 basis points in September[1] while the 10-year Treasury yield moved above 5% for the first time in nearly 19 years.[2]

That created a more challenging environment for credit, although the effects varied across markets. Leveraged loans benefited from their floating-rate coupons, returning approximately 2% during the quarter, while high-yield bonds declined nearly 2% as Treasury yields rose.[3] Importantly, corporate fundamentals have remained broadly resilient. But higher borrowing costs continue to weigh on more leveraged companies, particularly those with limited flexibility to manage interest expenses.

AM: Oaktree has emphasized the theme of dispersion throughout 2026. Did the third quarter reinforce that view?

RK: Absolutely. We've been talking about dispersion for some time, and we believe it's becoming one of the defining characteristics of this credit cycle. We're seeing it across borrowers, sectors, loan vintages and managers.

Broad market indices can appear relatively healthy, even as differences between borrowers become more pronounced. Higher-quality companies continue to access financing on competitive terms, while weaker borrowers face substantially higher funding costs and, in some cases, limited refinancing options.

But higher yields don't necessarily translate into better opportunities. Sometimes the spread—the difference between two yields—adequately compensates investors for the risk, but other times it reflects genuine financial distress and potentially significant losses. For performing credit investors, we believe success will increasingly depend on avoiding weaker credits and preserving contractual income. For opportunistic investors, the same dispersion may create opportunities to provide capital solutions where traditional financing is unavailable.

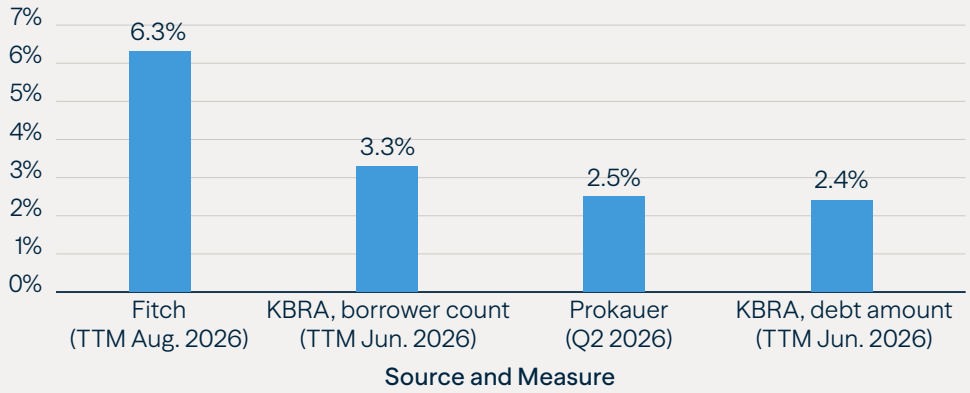
AM: Where is the greatest pressure today? Are these isolated problems or signs of broader credit deterioration?

RK: We continue to see pressure concentrated in particular borrowers and sectors rather than evidence of systemic deterioration across credit markets. In our view, the most vulnerable companies tend to have elevated leverage, limited free cash flow and capital structures established when financing was cheaper.

Headline private credit default rates have ranged from 2.4% to 6.3%, a wide range that depends on whether or not amendments count (**Figure 1**). However, default rates provide only a partial picture of credit quality. Material amend-and-extend transactions, cash-to-PIK (payment-in-kind) conversions and debt-for-equity exchanges can also signal credit stress.

Figure 1: Default Rates Depend on What Is Counted

U.S. Private Credit Default Rate



Latest available period for each series. TTM: Trailing 12 months. KBRA by count measures the share of borrowers experiencing or approaching default. KBRA by debt measures the share of outstanding debt associated with those borrowers. Source: Fitch Ratings, September 15, 2026; KBRA and Proskauer via Kadenwood Capital, August 2026.

We've been talking about dispersion for some time, and we believe it's becoming one of the defining characteristics of this credit cycle.

We're also watching recovery outcomes closely. Historically, senior secured lenders have expected meaningful recoveries following a default. But weaker documentation, limited equity cushions and complex liability-management transactions can result in lower and more uneven recoveries.

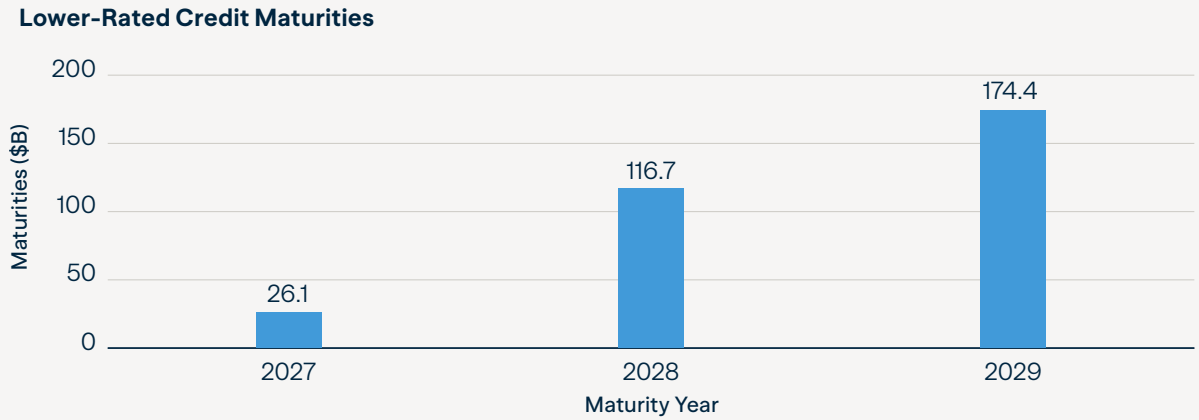
AM: Software has been a particular focus for credit investors. How much of the pressure reflects AI disruption vs. broader underwriting issues?

RK: We think it's important to separate the two, because they're related but distinct issues. Artificial intelligence (AI) is changing the competitive landscape for software companies. In some cases, it's lowering barriers to entry and challenging business models once considered highly defensible.

But many of the challenges software borrowers are facing existed before AI became such a prominent concern. A significant amount of software leveraged buyout (LBO) activity occurred in 2021 and 2022, when rates were low and sponsors financed acquisitions at elevated valuation multiples, often using aggressive leverage assumptions. Those structures are now facing refinancing pressure, including maturities in 2027–2029 (**Figure 2**). Although AI has added another layer of uncertainty and complexity, it did not create the underlying leverage and valuation challenges.

Additionally, we don't think all software companies face the same risks. Businesses with mission-critical products, entrenched customer relationships, high switching costs and strong cash generation may be better positioned than those with easily replicated offerings. We think investors should distinguish businesses experiencing fundamental deterioration from those whose valuations have declined largely because of negative sector sentiment.

Figure 2: Lower-Rated Sub-Investment-Grade Credit Is More Challenged by Near-Term Refinancing



Lower-rated sub-investment-grade credit refers to CCC and lower, B- and higher-grade software maturities, high yield and leveraged loans. Ratings are Morningstar facility ratings. Source: PitchBook, ICE BofA, Morningstar, August 31, 2026.

AM: Turning to direct lending, has the balance between corporate borrowers and lenders shifted?

RK: The way we see it, the conditions for lenders deploying new capital have improved from the more competitive environment we saw in 2024 and 2025.

During the third quarter, direct lending spreads remained relatively stable at around SOFR plus 500 basis points, approximately 50 basis points wider than at year-end 2025.[4] We've also seen more conservative underwriting and greater differentiation in pricing based on borrower quality and sector. Deal activity has started to recover as well. Third-quarter direct lending volume increased to nearly $50 billion, up from approximately $38 billion in the second quarter, although activity remains below last year's pace.[5]

One encouraging development is that private credit continues to offer a meaningful spread premium relative to broadly syndicated loans. For LBO financing, that differential widened to approximately 166 basis points during the quarter.[6]

At the same time, we don't think lenders can afford to become complacent. There is still substantial capital competing for attractive transactions, and stronger borrowers continue to negotiate favorable terms. The opportunity today is not just about trying to deploy more capital. It's to take advantage of potentially improved economics while maintaining discipline around leverage, documentation and downside protection.

AM: Beyond new-issue direct lending, where else could opportunities emerge?

RK: In performing credit, wider spreads and more lender-friendly structures may improve the economics of new investments.

We're also observing liquidity pressures among some private credit managers. As redemption requests and unfunded lending commitments compete for available cash, certain managers may be forced to sell higher-quality private assets because they're typically easier to sell. This dynamic can create opportunities for secondary purchases, rescue financings and other bespoke capital solutions.

We think it's important to evaluate opportunities across public and private credit. Liquid markets tend to reprice more quickly, which can create meaningful differences in relative value between comparable borrowers or securities. Of course, not every discounted asset represents an attractive investment. Some borrowers face fundamental challenges that additional capital cannot resolve.

AM: Looking toward 2027, what do you think credit investors should be watching most closely?

RK: From a macroeconomic perspective, we're keeping an eye on inflation, interest rates and economic growth. Higher rates support attractive current income for lenders, but they also increase the burden on borrowers. If inflation persists and growth slows, that could accelerate the pressure on weaker credits.

We're also watching transaction activity. Private equity sponsors have substantial undeployed capital and face growing pressure to generate realizations, which could support a recovery in deal flow.

Ultimately, we believe this environment reinforces the importance of disciplined underwriting and active credit management. Attractive starting yields are valuable, but they don't eliminate credit risk. As markets evolve, we think the ability to distinguish durable businesses from those facing structural challenges, and to identify genuine opportunities amid dislocation, will increasingly separate outcomes across credit markets through the rest of the year and into 2027.

Endnotes

1. Federal Reserve, September 16, 2026.
2. *The Wall Street Journal,* September 16, 2026.
3. J.P. Morgan, October 1, 2026. Leveraged loans represented by J.P. Morgan Leveraged Loan Index. High-yield bonds represented by J.P. Morgan High Yield Bond Index.
4. Valuation Research Corporation, "Private Market Trends: Q3 2026 Private Credit and Equity Update," October 8, 2026.
5. PitchBook LCD, "Private Credit Monitor," September 2026.
6. PitchBook LCD, September 2026.

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