UVA'S ECONOMIC INSIGHTS

Private Debt: Buying a First-Class Ticket on the Titanic

By Joshua Barone | Aug 12, 2025

Smooth Sailing—Until It Isn't

Private credit is often marketed as a high-yield, low-volatility solution for institutional portfolios, framed as non-correlated to public markets and a stabilizing force during periods of equity or bond market stress. But like passengers aboard the Titanic enjoying the first-class experience, investors are lulled by a false sense of structural resilience, unaware of the design flaws and hidden vulnerabilities embedded in the market.

In 2025, as the lagged effects of monetary tightening work through the economy, consumer, labor, and housing indicators are weakening. Credit card delinquencies are rising, payrolls have faced downward revisions, and the S&P CoreLogic Case-Shiller Home Price Index has flattened, signaling deceleration in housing.[1]

As economist David Rosenberg noted: "Housing is the quintessential leading indicator. And it's not just about volumes."[2]

Structural Vulnerabilities: The Icebergs Below

Private debt's core risk is the illusion of stability. Model-based NAVs show little volatility even as borrower fundamentals deteriorate. In practice, correlations with public credit spike during periods of market stress, eroding the non-correlation narrative.

Key Technical Risks:

- **Covenant-Lite Lending:** Lenders have minimal early-warning protections.[3]
- **Layered Leverage:** Many positions are second-lien or mezzanine exposures on top of already levered balance sheets, magnifying loss severity.
- **Liquidity Mirage & No Secondary Market:** Periodic redemption promises mask the fact that loans are illiquid with no reliable secondary market.[4]
- **Overlapping Exposure:** The same loan often resides in multiple funds, creating systemic contagion when a single borrower defaults.
- **Relative Pricing and Model Marks:** Ten-year performance tables reflect accounting conventions rather than market-clearing prices.

Market Stress: Defaults and Bankruptcy Trends

The U.S. is exiting the longest credit cycle in modern history,5 during which ultra-low interest rates suppressed defaults for over a decade. That cycle is now turning decisively.

- **Bankruptcy Volume:** 2024 saw 694 corporate bankruptcies, the highest since 2010, with a 14.7% YoY increase in business filings through March 2025.[6]
- **Private Credit Defaults:** Fitch reported a 4.6% trailing 12-month default rate for private credit in May 2025, with certain portfolios exceeding 8%.[7]
- **PE-Backed Borrowers:** Reliant on floating-rate private credit, these issuers are driving filings.

Jeffrey Gundlach, CEO of DoubleLine Capital, has been explicit. In his January 2025 webcast, he warned:

"Private credit is today's subprime—everybody's chasing yield in an opaque market with little price discovery. It looks safe until it isn't."[8]

Spreads, Risk Premia, and False Security

From a technical perspective, the risk/reward is skewed. Private loan spreads today are only modestly above public high-yield debt, while carrying materially higher illiquidity and structural risk. Credit spreads in public markets remain among the tightest in history, reflecting late-cycle complacency. As Barron's cautioned in a January 2025 review of leveraged finance trends, "Tight spreads and loose standards are the final chapter of every credit cycle." (Barron's, Jan 2025).

Private debt returns often rely on borrower-adjusted EBITDA, aggressive add-backs, and mark-to-model accounting. Without a functioning secondary market, the repricing mechanism is delayed but not avoided.

Valuation Committees: Rearranging Deck Chairs

Internal pricing committees—composed of PMs, CIOs, and compliance officers—often set valuations with limited observable inputs.

Cosmetic markdowns delay recognition of losses, but cannot prevent eventual repricing once defaults accelerate.

Lifeboats in Short Supply

Private credit today resembles the Titanic: overconfident design, insufficient safeguards, music still playing, and lifeboats in short supply. The apparent calm is created by delayed recognition through model-based pricing and the absence of a functioning secondary market, not necessarily by true resilience.

Key Takeaways for Investors:

- **Liquidity is an illusion:** In stress, redemption gates and suspensions will arrive before bids appear.
- **Correlation will spike:** Defaults and mark-to-market adjustments will move in tandem with public credit.
- **Structural leverage magnifies loss severity:** Second-lien and mezzanine tranches leave little margin for error.
- **Contagion risk is underappreciated:** Overlapping exposures mean one default can ripple across multiple portfolios.

Like the Titanic, this market was built for calm seas and marketed as nearly indestructible. When systemic stress forces repricing, there will not be enough lifeboats for every investor.

Actionable Guidance: Consider reducing exposure proactively, focusing on high-quality credits, limit fund overlap, and demand real illiquidity premia—before the water starts rising and exit doors are closed.

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Reference:

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