

Thirdpath

Middle-Market Direct Lending Outlook:

A Goldilocks Market Setup

Key Takeaways

1 Structural alpha erosion

We believe capital crowding, scale effects, and compressed illiquidity premia have materially reduced the opportunity for sustained alpha in middle-market direct lending.

2 Recessionary Reset Creates Opportunity

A recession-driven rate-cut cycle, while riskier, may reset spreads higher and improve forward-looking return prospects

3 Fundraising Pressure Elevates Credit Risk

Tighter fundraising conditions may reduce managers' flexibility to support stressed credits, increasing default risk across portfolios.

4 Discipline and Dry Powder Are Critical

We believe managers and allocators should actively manage reinvestment risk, stress-test yield compression scenarios, assess fundraising resilience and liquidity buffers, and preserve dry powder for potential dislocation vintages.

Executive Summary

Financial markets are currently characterized by public equities near all-time highs, corporate credit spreads at historically tight levels, and the potential for a transition toward a U.S. Treasury bull market should the Federal Reserve begin to cut rates. This report examines the potential implications of these conditions for middle-market direct lending, contrasting outcomes under a “Goldilocks” soft-landing scenario versus a recession-driven rate-cut environment. In this context, we also highlight key credit market indicators for investors to monitor as credit relative value and risk continue to shift.

Market Backdrop

Public markets continue to reflect a constructive risk environment.

- Equity markets are trading near record levels, indicating sustained investor confidence and a strong appetite for risk assets.
- In credit markets, spreads across both investment grade and high yield remain historically tight, resulting in limited risk premia.
- At the same time, interest rates have stabilized, with Treasury yields trending modestly lower amid increasing market expectations for potential Federal Reserve rate cuts.

Together we believe, these dynamics support a broadly favorable macro backdrop. However, this environment may present challenges for middle-market direct lending managers. Tighter spreads and lower base rates have contributed to compressed relative returns, increasing the importance of selectivity, structuring discipline, and sourcing advantages.

Cost of Capital & Relative Attractiveness

We anticipate that declining base rates, including SOFR and Prime, will directly reduce borrower coupons in floating-rate middle-market direct lending, placing downward pressure on portfolio yields. In a sustained Treasury bull market, gross yields in the asset class could compress meaningfully, with returns potentially trending toward the 7–8% range. As yields compress, relative value considerations become increasingly important. Public credit markets, including investment grade credit, structured credit, and mortgage-backed securities, may appear more attractive as their yields converge with those of middle-market direct lending, but without the same illiquidity trade-off. This dynamic underscores the growing relevance of relative value as credit markets adjust to a lower-rate environment.

Portfolio Dynamics

Lower rates can affect private credit portfolios through several second-order dynamics:

- **NAV Stability:** Falling rates can support valuations of fixed-rate components within private credit portfolios, including mezzanine positions, capital solutions, and certain structured credit tranches.
- **Reinvestment Risk:** Borrowers are more likely to refinance out of higher-cost legacy financings, accelerating repayment cycles and requiring redeployment into new assets at lower prevailing yields.
- **Convexity Gap:** Unlike public bonds, middle-market loans offer limited convexity, reducing upside participation in a Treasury bull market and constraining portfolio benefit from further rate declines.

Supply & Demand for Capital

Shifts in the relative attractiveness of public and private credit markets can materially affect both borrower behavior and deal flow in middle-market direct lending. As public high yield and investment grade markets reopen, some issuance that would otherwise be sourced through private credit may migrate back to public markets, particularly for larger or higher-quality borrowers.

At the same time, increased competition among private lenders can place pressure on deal terms, resulting in more borrower-friendly structures and pricing. On the demand side, capital flows may also become more selective, as institutional investors and retail capital accessed through vehicles such as BDCs reassess allocations to

middle-market direct lending when alternative yield opportunities are available elsewhere.

Fundraising & Valuation Implications

Lower base rates and tighter credit spreads have mixed implications across private credit vehicles. Business development companies may benefit in the near term from relatively stable net asset values as rates decline, but face increasing pressure on earnings and dividend generation as base rates fall. In this environment, valuation premiums to NAV may become more difficult to sustain.

For middle-market direct lending funds, fundraising momentum may moderate as the illiquidity premium narrows and relative value versus public credit becomes less compelling for certain investors. As capital becomes more selective, manager positioning takes on greater importance, with increased emphasis on sourcing differentiation, sector expertise, and the ability to deploy dry powder opportunistically as market conditions evolve.

Default Risk Dynamics in a Slowing Fundraising Environment

A critical risk to monitor is how constrained fundraising conditions affect the ability of BDCs and middle-market direct lending funds to support portfolio companies during periods of stress:

- **Reduced Follow-On Capital:** If funds are unable to raise new equity or debt capital efficiently, their capacity to provide rescue financing or execute amend-and-extend solutions for struggling borrowers may be significantly diminished.
- **Increased Default Probability:** Companies facing liquidity pressure may be forced into restructuring or bankruptcy sooner if sponsors and lenders are unable to inject incremental capital.
- **Value Erosion:** Limited access to new capital can trigger fire-sale dynamics, impairing recoveries on existing loans.
- **Sponsor Dynamics:** Private equity sponsors may face challenges securing add-on capital to stabilize portfolio companies, weakening alignment between sponsors and lenders during periods of stress.
- **Contagion Risk:** In stressed sectors, the inability of multiple BDCs or direct lending platforms to raise capital simultaneously could amplify defaults across cohorts of borrowers and pressure broader market sentiment.

As a result, even in a lower-rate environment, default rates in middle-market direct lending could rise if a fundraising slowdown undermines lenders' ability to support borrowers through periods of stress.

Historical Context: Default Rates in the Middle Market

12-14%

Middle-market
default rate

Global Financial Crisis (2008-2009)

Middle-market default rates increased sharply into the 12-14% range, materially exceeding peak default rates in large-cap leveraged loans, which reached approximately 10%. Recovery rates were also significantly below historical averages, reflecting constrained liquidity and limited lender capacity to support stressed borrowers.

6-8%

Middle-market
default rate

COVID-19 Shock (2020)

Default rates in middle-market loans rose to approximately 6-8%, with outcomes varying by sector exposure. Unprecedented fiscal and monetary stimulus, combined with rapid fundraising by BDCs and private credit funds, helped contain losses. Many distressed borrowers benefited from amend-and-extend transactions and sponsor equity infusions.

3-4%

Middle-market
default rate

Long-Term Averages

Over a full cycle, middle-market loan defaults have historically averaged approximately 3-4% annually. However, outcomes are highly cyclical and closely linked to the availability of follow-on capital from lenders and sponsors.

This history highlights that liquidity and fundraising capacity are critical mitigants of default risk. When capital markets are disrupted or fundraising slows, middle-market borrowers tend to experience disproportionate stress relative to large-cap issuers with broader and more flexible financing options.

Scenario Analysis

To frame potential outcomes for middle-market direct lending, we consider two illustrative scenarios based on differing macroeconomic and credit conditions.

Scenario A: Soft Landing / “Goldilocks”

In a soft-landing scenario characterized by lower interest rates and stable economic growth, credit performance remains relatively strong. Default activity is limited, and overall credit quality remains resilient.

However, declining base rates contribute to yield compression and a shrinking illiquidity premium. As public credit markets reopen, heightened reinvestment risk emerges, with issuers increasingly drawn toward public high yield and investment grade markets, reducing private deal flow and pressuring forward returns.

Scenario B: Recessionary Rate-Cut

In a recessionary scenario, interest rates decline alongside slowing economic growth. Default rates increase, creating a larger pool of stressed and distressed opportunities. Credit spreads widen,

potentially producing attractive vintage years for new capital deployment as the liquidity premium re-expands. However, outcomes are highly dependent on access to capital. If fundraising stalls, BDCs and direct lending funds with limited balance sheet flexibility may be unable to stabilize borrowers, amplifying default risk and exacerbating credit losses despite more attractive entry points.

Key Takeaways & Implications

Sustained “Goldilocks” conditions may present meaningful headwinds for middle-market direct lending yields and challenge the asset class’s relative value as base rates decline and spreads remain tight. In contrast, a recessionary rate-cut environment, while riskier from a credit perspective, would likely reset spreads higher and create more compelling entry points for new capital deployment. Across both scenarios, fundraising capacity emerges as a critical determinant of outcomes. Constraints on fundraising can materially heighten default risk by reducing managers’ flexibility to support stressed credits, amplifying losses during periods of dislocation. As a result, both managers and allocators must remain focused on liquidity, capital availability, and the ability to respond dynamically as conditions evolve.

In this environment, key areas of focus include:

- Monitoring reinvestment risk as borrowers refinance and deal flow shifts

- Stress-testing portfolios under yield compression scenarios
- Assessing fundraising resilience and available liquidity buffers
- Preserving dry powder for potential dislocation-driven vintage opportunities

Conclusion

The current high-yield environment in middle-market direct lending is not structurally permanent. If Treasury yields decline and the Federal Reserve begins to cut rates, the asset class's forward return profile is likely to compress, reducing its relative attractiveness versus fixed-rate credit markets and other credit asset classes. In parallel, a slowdown in fundraising could impair lenders' ability to support stressed credits, increasing default risk even in an otherwise benign macro environment.

Historical experience during the Global Financial Crisis and the COVID-19 shock underscores the outsized role that liquidity and fundraising capacity play in shaping default outcomes in the middle market. Only in periods of market dislocation, when spreads widen and capital becomes scarce, does the asset class tend to regain its asymmetric return profile.

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Sources

1. S&P Index, NASDAQ.
2. Markit CDX Indices, Bloomberg/Barclays Indices.
3. SOFR, U.S. Treasury 2-Year, U.S. Treasury 10-Year.
4. S&P Global / Leveraged Commentary & Data (LCD).
5. Federal Reserve.

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