

WHICH CREDIT SECTORS WILL MAKE THE CUT?



As we close out a year marked by rate market volatility and shifting market dynamics, 2025 looks set to continue the 'higher-for-longer' interest rate environment. While this backdrop presents opportunities for strong credit returns, not all sectors will benefit equally.

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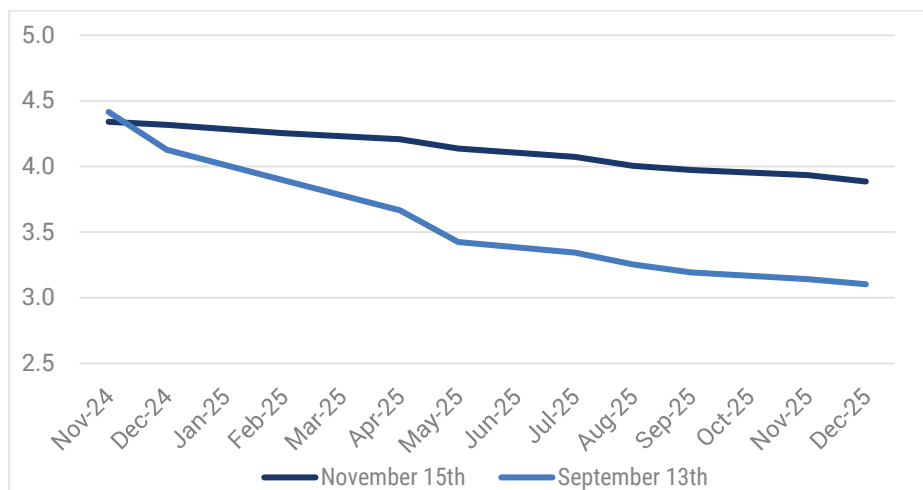
Navigating rate volatility and credit sector disparities

The global interest rate environment in 2024 was marked by considerable volatility, driven by revised growth and inflation expectations globally. Australia was no exception. Cash rate futures underwent significant repricing, with our expectations for Reserve Bank of Australia (RBA) rate cuts for 2025 reduced from ~125bps earlier in the year (refer Chart 1) to ~75bps today.



the **2025**
outlook
credit

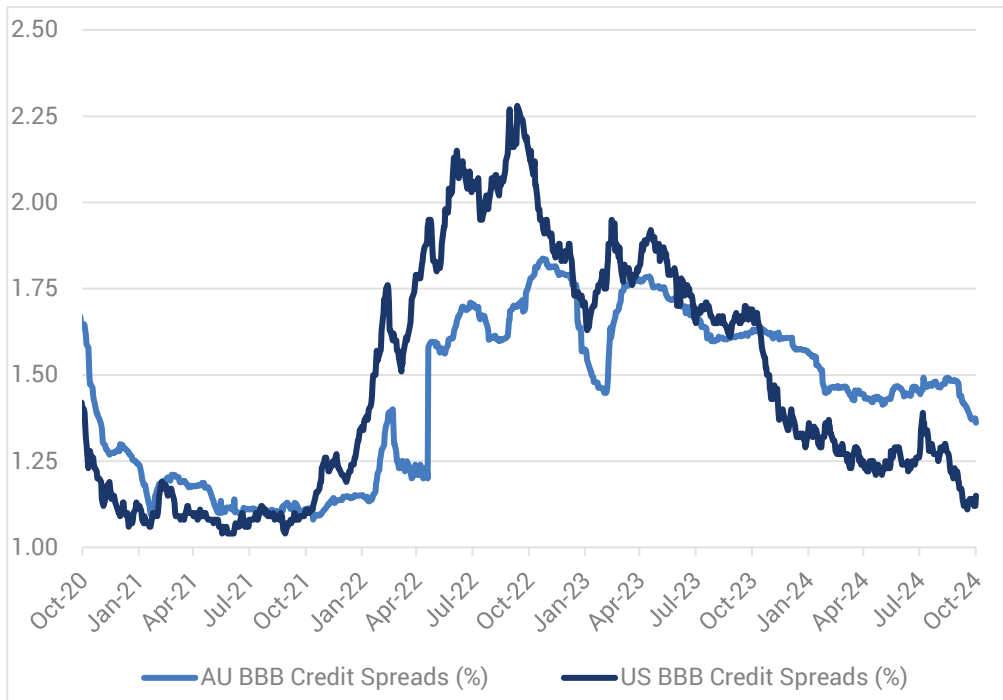
Chart 1: Cash Rate Futures (%)



Source: Yarra Capital Management/Bloomberg – November 2024

Despite this backdrop, investment grade (IG) credit spreads tightened throughout the year, (refer Chart 2), supported by higher outright yields. This trend is likely to continue into 2025, creating a favourable environment for IG credit returns.

Chart 2: Australian and US Credit Spreads (%)

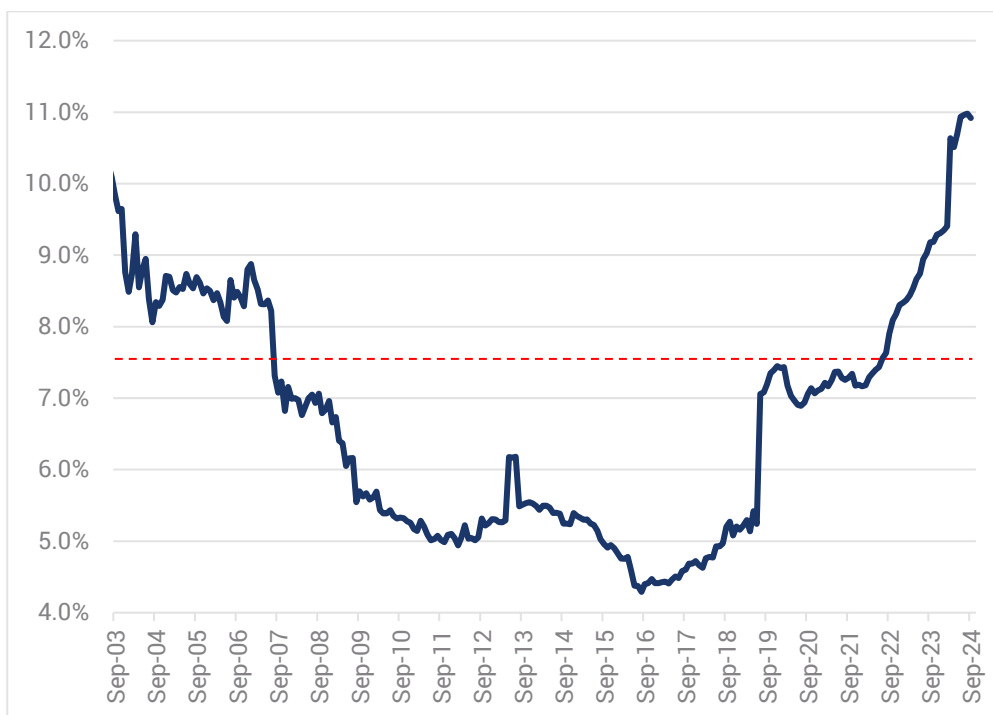


Source: Yarra Capital Management/NAB/Bloomberg – November 2024

Private credit to face sector-specific headwinds

Private debt in Australia has experienced explosive growth in recent years, with RBA data indicating that business lending outstandings by finance companies – often used as a proxy for private debt – reached ~\$130bn in 2024, representing ~11% of total business lending, up from just ~5% in 2018 (Chart 3).

Chart 3: Share of Business Lending Outstandings by Finance Companies (%)



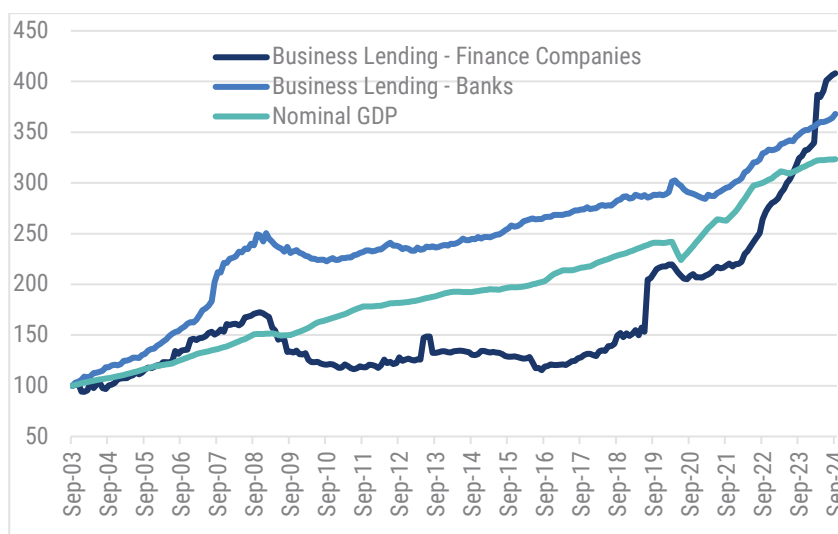
Source: Yarra Capital Management/RBA – November 2024

This growth is a result of tightened prudential regulation, which has restricted banks from lending to certain companies, aided by an inference from certain parts of the market that private debt offers ‘bank-like’ risk at attractive high-yield margins.

However, a closer look at the evidence suggests otherwise. While banks have reduced their exposure to select sectors, such as auto lending, the broader claim that banks no longer lend to a broad range of companies is an overused narrative that masks the increase in riskier lending by private debt managers.

A rule of thumb states that credit growth in an economy should roughly equate to nominal GDP through cycles. In Australia, bank business lending has consistently outpaced nominal GDP over the past two decades, indicating that there appears to be no significant shortage of credit (refer Chart 4).

Chart 4: Business Lending and Nominal GDP-Index Growth (Sept-03=100)



Source: Yarra Capital Management/RBA – November 2024

This suggests that private debt providers are not necessarily filling an unmet need for high-quality lending, but rather are either substituting equity in more aggressive capital structures or are lending to lower-quality borrowers.

This evolution raises concerns about the sector’s resilience. In a ‘higher-for-longer’ interest rate environment, coupled with below-trend economic growth, private debt impairments are likely to rise in the year ahead. Signs of stress is already emerging as we close out 2024.

Multi-sector portfolios offer a solution to sector-specific challenges

Given these dynamics, multi-sector credit portfolios offer a compelling solution. By allocating across a diverse range of credit opportunities – including IG corporate bonds, securitised assets, syndicated loans and private debt – investors can achieve diversification, mitigate sector-specific risks and enhance risk-adjusted returns.

For example, while public mezzanine RMBS/ABS deals have seen spreads compress to multi-year lows, private revolving warehouses backed by similar risk-rated collateral offer a premium of 250-300 basis points. These structures provide high-yield credit spreads of 450-600 basis points for portfolios with strong IG risk profiles. This excess return compensates for modest illiquidity, making private warehouses a superior alternative to public mezzanine credit in the current environment.

Importantly, private credit’s relative size in Australia remains small compared to global markets, which can lead to over-allocation in pursuit of yield. This can skew returns toward beta rather than alpha. By embedding private credit within diversified portfolios, investors can maintain a disciplined focus on through-the-cycle alpha generation while minimising concentration risks.

Looking ahead: Active management is paramount

As we close out 2025, the outlook for credit returns remain favourable. Elevated yields and a relatively benign economic environment should support continued performance. However, the days of broad beta-driven returns are likely behind us. Instead, active management focused on risk-adjusted returns, minimising impairments and hedging risk – such as through interest rate duration and/or credit default swaps – should provide the best opportunity for continued outperformance in 2025.

In our view, the Yarra Higher Income Fund's multi-sector IG quality portfolio is well-positioned to navigate 2025, leveraging continued higher yields while actively managing risks through selective exposure and dynamic hedging.

Conclusion

In a world where interest rates remain elevated and credit markets are becoming increasingly bifurcated, investors would be wise to adopt strategies that prioritise flexibility, diversification, and active oversight. Private credit, while an important component of the Australian market, faces headwinds in 2025 that make broad allocations less compelling. By contrast, multi-sector credit portfolios offer the agility and diversification necessary to deliver superior risk-adjusted returns, making them an essential tool for navigating the challenges and opportunities of the year ahead.



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