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CCS – Q3 2025 Commentary

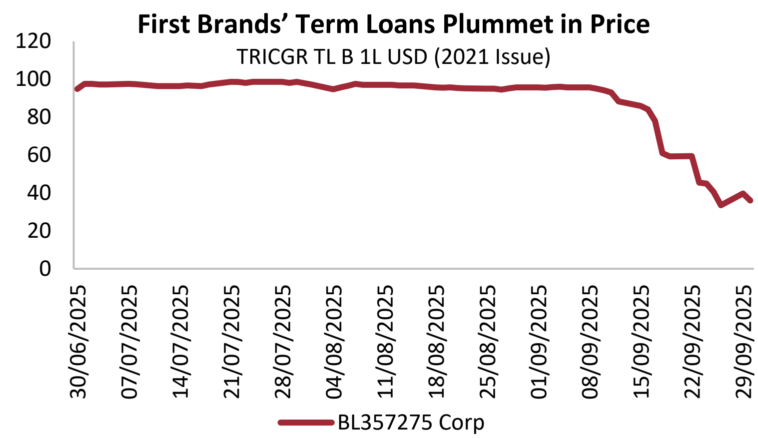
Macro & Sector Themes

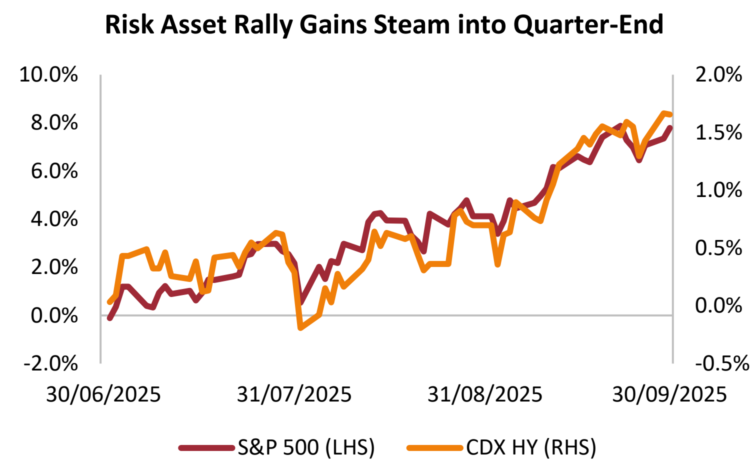
Last quarter we noted that though the U.S. economy and consumer had remained broadly fundamentally resilient, pockets of weakness were becoming more pronounced. We concluded that heightened dispersion and fragmentation across and within sectors was creating a credit picker's market that should reward those who pick their spots wisely. These comments now appear prescient after a quarter that exposed some of the deepest cracks in credit markets we have seen in quite some time. Tricolor, First Brands, and the flurry of headlines that followed have been explained away as idiosyncratic, one-off cases of fraudulent activity.

But we believe fraud typically appears where underlying credit problems lead. Moreover, while these bankruptcies appeared very sudden in the media, the underlying trends were anything but. We and others had flagged weakening subprime auto credit performance, with year-over-year delinquency comparisons printing markedly worse, in contrast to other consumer credit showing improved performance resulting from tighter underwriting standards. Spreads nevertheless remained near all-time tights. The deteriorating subprime auto credit performance backdrop coupled with overly accommodative ABS financing terms compounded corporate-specific red flags. Historical Tricolor loan performance showed inflated recoveries as they used their role as dealer to buy back defaulted cars potentially at elevated levels. First Brands' aggressive acquisition strategy raised questions around revenue growth versus debt accumulation—one had to question why a company of this size was financing itself at such high rates.

With many investor-level exposures in the hundreds of millions, there has been a clear sentiment shift as investors comb through portfolios for similar problems and renew focus on collateral verification and audit frameworks. These losses are sufficiently significant to create spillover effects across the asset-backed space, either from dampened demand or outright selling by affected holders. As dispersion and fragmentation have only become more amplified since we highlighted last quarter, we believe this dynamic has and will continue to create opportunistic dislocations. Unlike recent cycles, we may continue to see credit problems materialize without broader systemic financial stress.

At the same time, the rally in equities and macro credit gained steam into the end of the quarter largely fueled by AI optimism and arguably circular capital expenditures, with financing shifting to corporate and securitized debt markets, creating a dichotomy in the market. Even before the credit cracks emerged, many warned of complacency and a "priced to perfection" environment earlier in the quarter. The market is arguably now primed to react more harshly to any signs of further credit weakness, which should, at some point, flow through to macro risk assets more broadly.

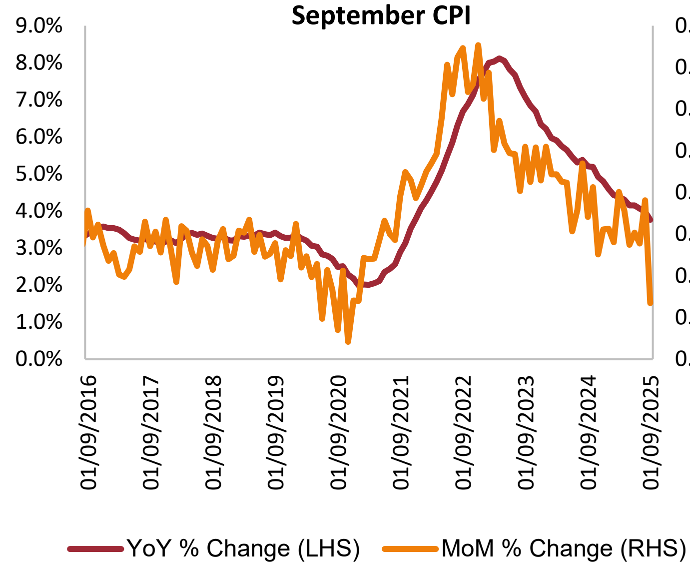




Source: Bloomberg

Another potential source of volatility comes from the question marks surrounding national data prints with the Administration's involvement in the BLS after a weak jobs report, soon followed by the lack of data due to the shutdown. With the market "flying blind" to an extent at a time when the dual mandate is in tension, any macroeconomic indicators can cause strong reactions and create opportunities for active trading. There is also creeping skepticism as discrepancies increasingly crop up in other data sources like housing starts and sales. More significantly, the September CPI print showed a dramatic collapse in owners' equivalent rent (OER), a highly significant component of inflation comprising a quarter of headline CPI and a third of core. After oscillating between 30-40bp month-over-month all year, in large part keeping inflation elevated, OER suddenly fell to 13bp, offsetting notable price gains in tariff-exposed sectors.

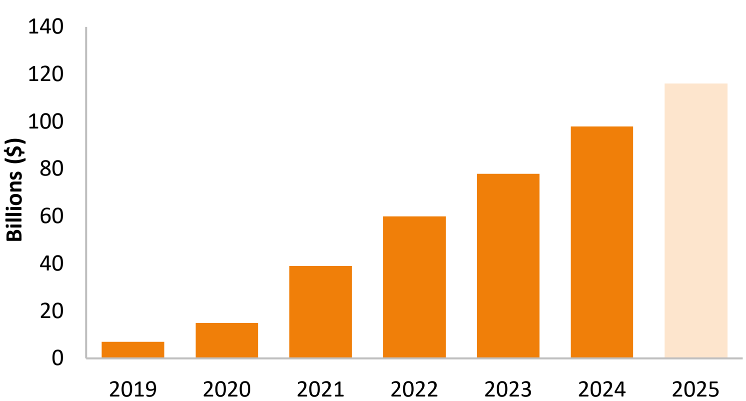
Owners' Equivalent Rent Plummets in September CPI



Source: Federal Reserve Bank of St. Louis

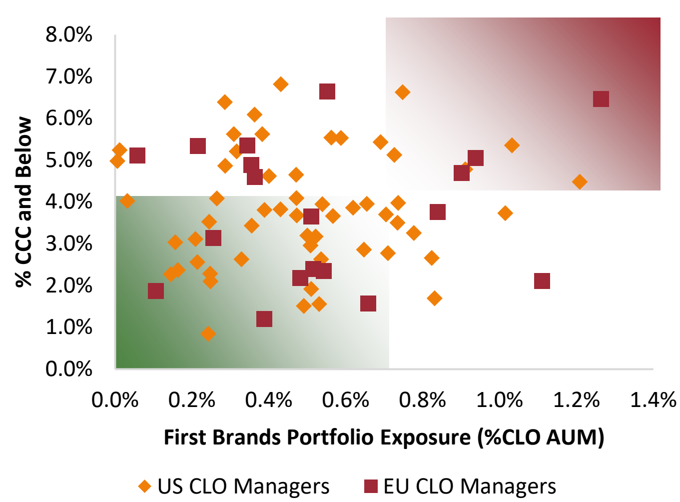
Such a dramatic decline is surprising. Rent and home price growth have been slowing for some time now, and methodological questions remained around growth rates staying persistently elevated relative to pre-pandemic levels. We and others, however, struggle to reconcile this step function down with private market measures, prompting speculation around noise potentially either from reduced BLS resources or more active management given the timing, significant impact, and heightened focus on shelter inflation by newly appointed Fed Governor Miran. In any event, indicators from alternative data sources such as loan-level credit performance have become even more meaningful. On that front, beginning with residential mortgage credit, non-QM delinquencies have shown some recent signs of stabilization as tighter underwriting standards prompted by weaker credit metrics worked their way through performance. National home prices have stabilized as well—after several months of sequential declines, price growth firmed and then turned positive, in part from the 50bp mortgage rate rally through the quarter. That said, weakness persists in high-supply geographies, and the direction of the market remains dependent on the back end of the curve.

Annual 'buy now, pay later' transaction volume



Note: 2025 is a projected value
Source: Emarketer

Managers with small buffers to their CCC thresholds & elevated exposure to First Brands could be at greater risk



Source: Intex, Morgan Stanley Research, 9/26/2025

Consumers broadly appeared more cautious but largely resilient throughout the quarter, with a willingness to continue spending. The broad theme we have discussed this year persists—consumer credit performance varies markedly by sector and cohort due to differences in underwriting. Interestingly, as the "Buy Now, Pay Later" market has grown to over $100bn from around $10bn in 2020, no longer entirely insignificant relative to the $1.2tn credit card debt outstanding,[1] negative headlines have increased particularly from the traditional banking sector. Banks have criticized the product, including calling up customers and warning them against it, while also simultaneously launching their own pay-later products. Traditional lenders appear more concerned about losing revenue and market share for their own loan products as BNPL becomes more popular. While continuously monitoring underwriting and performance is paramount, credit metrics for top BNPL originators have remained stable throughout the year.

Heightened fragmentation has certainly been underscored on the corporate side following the First Brands bankruptcy—there is more fundamental performance dispersion both for the underlying leveraged loans and the CLOs themselves. As one example, the First Brands portfolio exposure varied widely across deals and managers. More broadly, the share of loans trading above par has continued to ease, and the quality curve has decompressed across ratings. CLO BB downgrades have also picked up significantly this year, with more than 7% of BBs outstanding at the start of the year experiencing a downgrade, compared to only a 1% average annual downgrade rate from 2013-2024 excluding 2020. From a technical standpoint, the CLO market has gotten longer as post-reinvestment deals continue to reset. One consequences of this dynamic is that it decreases the supply of seasoned, de-levered post-reinvest paper, pushing spreads for this profile tighter, but extension in the market can also increase overall risk.

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1. New York Federal Reserve Consumer Credit Panel

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