Integrated Capital Management

Q2 2026 Market Insights Letter

That Was Then. This is Now.

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"The constant lesson of history is the dominant role played by surprise. Just when we are most comfortable with an environment and come to believe we finally understand it, the ground shifts under our feet."

-Peter L. Bernstein

Background

As we entered 2026, markets across the globe echoed an optimistic tone. Non-U.S. and emerging markets stocks had a banner year, fueled by positive fundamental improvements and a significantly weaker dollar. Here at home, lofty valuations continued to be a concern, but massive spending plans by AI hyperscalers and a resilient consumer made those valuations palatable…at least in the near term. On the fixed income front, high quality bonds (U.S. treasuries in particular) presented investors with attractive yields and the potential for price gains as the Fed continued to ease interest rates.

That was then. This is now. Fast forward to March of 2026 and global equity and fixed income markets have been presented with two clear uncertainties. The first, rising concerns around the health of private credit markets, was somewhat expected, although its urgency accelerated a little more quickly than anticipated. ICM's CIO, Michael Paciotti, touched on this exact topic in last quarter's letter, entitled My AI is Smarter than Your AI. The other source of volatility would be best categorized as a black swan geopolitical event. Here, of course, I'm referring to the U.S. military strikes on Iran, deemed Operation "Epic Fury". The campaign began on February 28th and, as of this letter's publican date, has yet to find resolution. This has had far reaching effects across the globe, touching both equity and bond markets, as global oil prices have soared to their highest levels since the COVID-fueled inflation spike of 2022.

In this quarter's letter we'll address both of these volatility pressure points, but more importantly what implications they have for investors' portfolios.

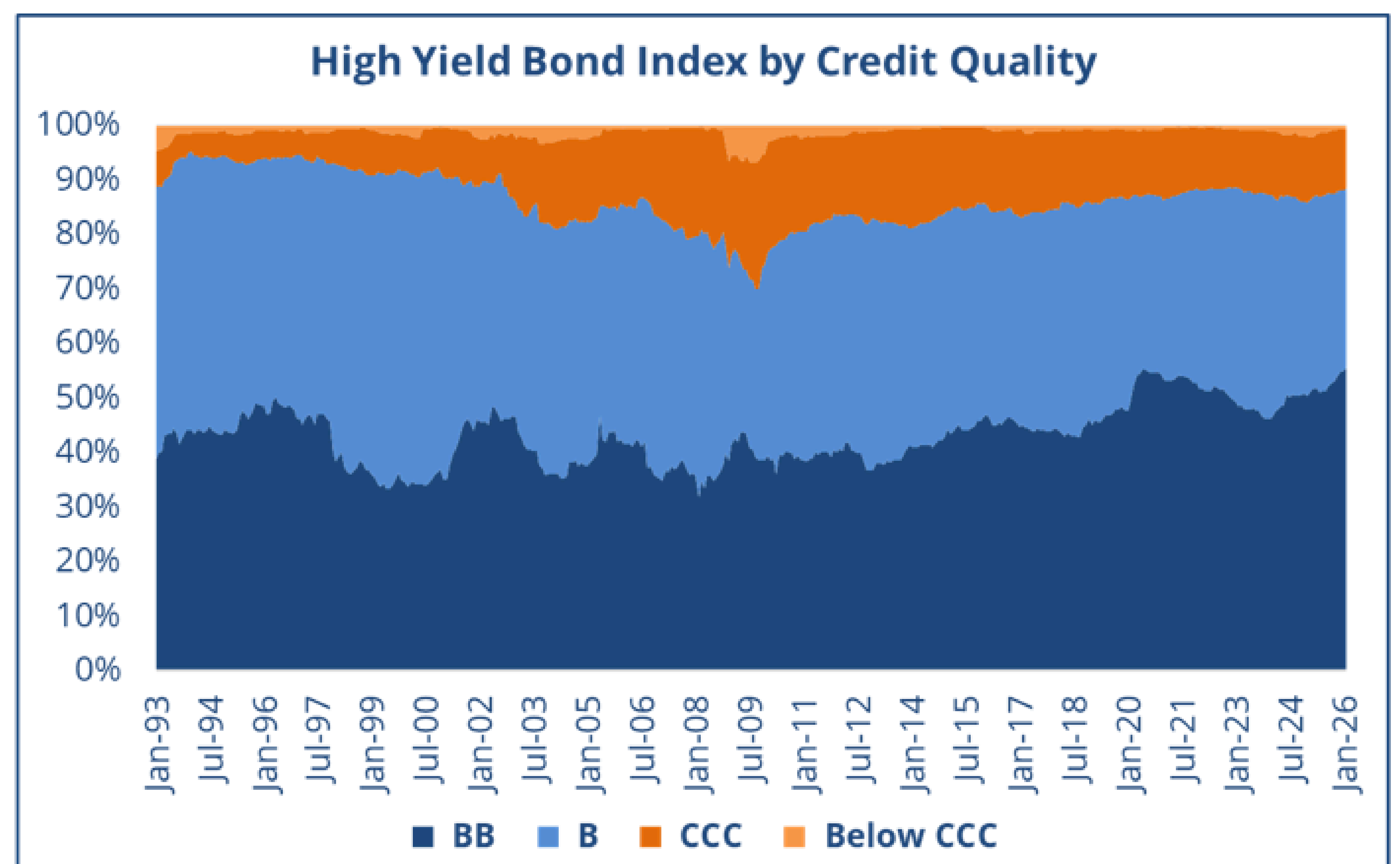
Pressure Point #1 - Private Credit

For those who have not had a chance to read last quarter's letter, we'll start this section with a high-level summary of private credit markets. Private credit simply refers to loans that are made outside of the traditional banking system and public markets. Traditional lenders include asset managers, private funds, and institutional investors. The lenders typically provide financing for highly levered or speculative borrowers that may not be established enough to access public markets. These loans are then packaged together and sold to investors via private investment vehicles or, in some cases, can be accessed through publicly-traded business development companies (BDCs). The goal…package a bunch of potentially high-risk investments together and entice investors with attractive yields. Sound familiar? It should. Major U.S. banks made a similar mistake during the Great Financial Crisis. At that time it was sub-prime mortgage loans being bundled. The bright spot currently is that those major systemic financial institutions appear to have learned their lesson and look to be generally free from contagion risk…although not entirely. We'll address this a bit later.

Interest in the space has been spurred by recent headline-grabbing fraud cases (e.g. Tricolor and First Brands Group), which inevitably prompted the frequently referenced "cockroaches" comment from J.P. Morgan CEO Jamie Dimon. While these stories are troubling, they're most likely idiosyncratic in nature, rather than widespread concerns. But that doesn't mean other key risks don't exist. The first is sector concentration of the underlying loan pools and the fear that AI disruption could call into question the viability of an entire group of borrowers. These concerns were recently brought to light, following the release of a new set of AI tools that could render many software companies obsolete. While it's difficult to measure the exact software exposure of private credit markets, we can use publicly-traded BDCs, which hold pools of private credit, as a proxy. According to recent data published by Goldman Sachs, 22% of BDC lending has been made to the software sector, compared to 13% for the public loan market, and just 3% for the public high yield bond market. Meaningful but not overwhelming exposure.

An additional risk relates to the overall credit quality of the space. As private credit has evolved over the last decade, it appears that lower quality borrowers, which had previously accessed public markets, may have sought financing via private lenders. This is evidenced by the evolving credit quality of the public high yield market. Today, BB-rated loans account for 56% of the public high yield market, compared to a long-term average of 43% and a low of 32% in 2008.

Chart 1



Data Source: Bloomberg.

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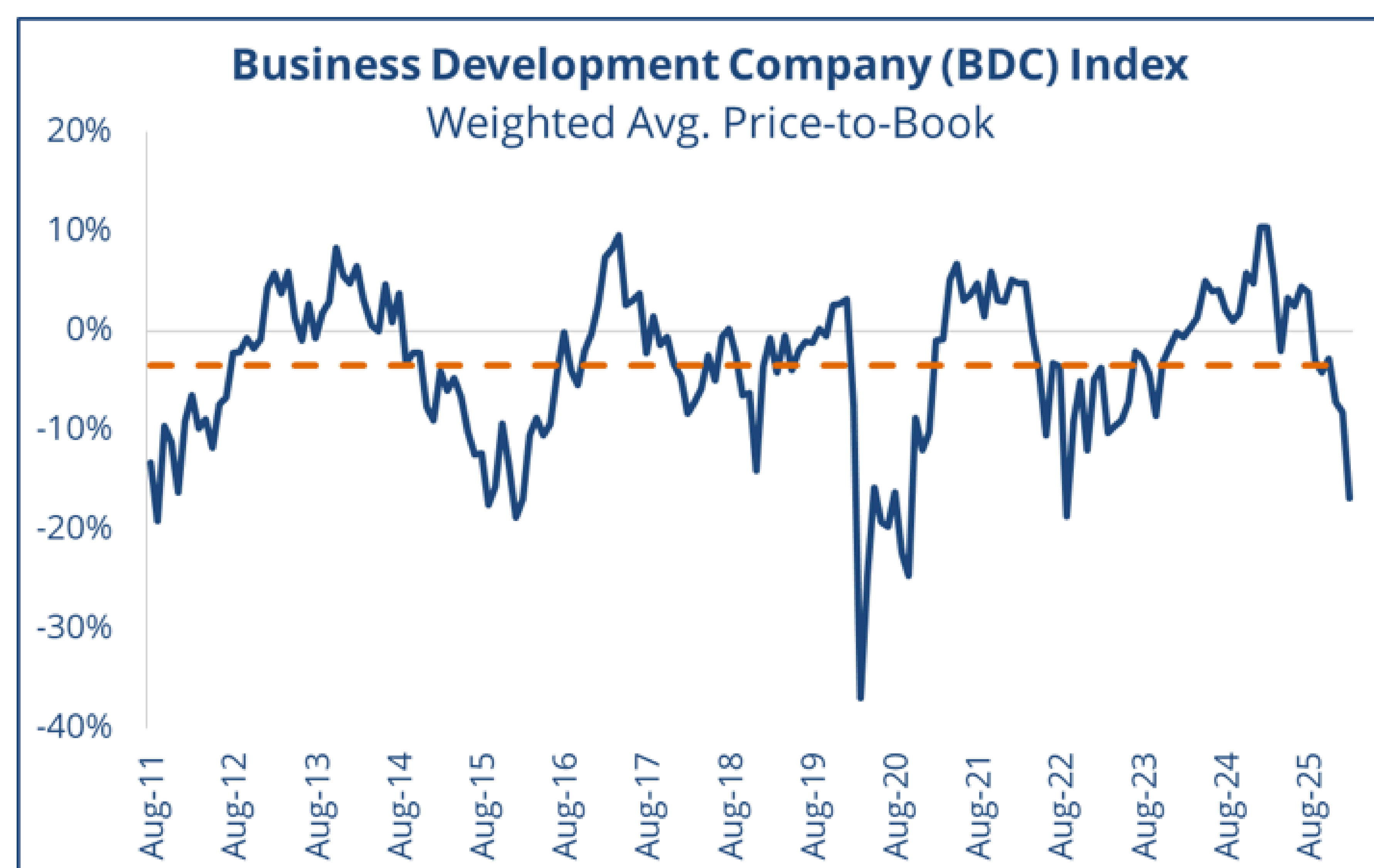
Conversely, CCC-rated issues account for just 11% of the market, compared to a high of 23% in 2009 (See Chart 1). This is a clear indication that credit quality has improved in public high yield space, likely the result of lower quality credits migrating into the murky waters of private markets. This is a clear indication that credit quality has improved in public high yield space, likely the result of lower quality credits migrating into the murky waters of private markets.

If our assessment is correct, just how bad could the situation get? Well, it becomes quite concerning from a default perspective. As we stand today, the default rate for private credit loans sits at around 9%, according to recent estimates by Fitch Ratings. This number is a little murky though. First, this is a private market, so we don't have the same level of transparency as public debt markets. In addition, private borrowers are typically given more leeway on payment terms. This typically manifests itself in the form of pay-in-kind (PIK) arrangements, where borrowers are able to simply tack missed interest payments onto their remaining principal balance to avoid technical default. This type of activity has picked up dramatically and is about 11% of the total marketplace. 58% of these loans are considered "bad Payment In Kind Loans" or loans seeking to postpone a default. Add these loans to the equation and that 9% is likely understated by about 6%. This is called the shadow default rate.

Looking forward, our outlook is no less concerning, with some calling for future defaults as high as 15% under a worst-case scenario. However, like the current default environment, this may also understate the severity of the situation. Using the public credit markets as a proxy, let's assume that many of these private credit borrowers would receive a CCC or equivalent credit rating. Default rates for CCC-rated bonds have historically been 13%, but have exceeded 30% during periods of market stress. The technology bubble and Great Financial Crisis are two prime examples. If the AI disruption narrative plays out, or if credit markets simply become stressed, we would not be shocked to see default levels peak near those historical extremes.

These health concerns already have some investors heading for the exit. In just the last few months, firms such as Apollo, BlackRock, Cliffwater, and Morgan Stanley have all faced redemption requests well above their quarterly limits. And in one unique instance, Blackstone was forced to use firm and employee capital to help meet redemption requests for their BCRED fund. We've also seen investors fleeing their BDC investments, which unlike true private credit vehicles are traded on a daily basis. Using the MVIS®US Business Development Companies Index as a proxy, BDCs fell in value by roughly 10% in Q1 and based on their most recently reported book value trade a discount of 15% (See Chart 2). This is one of the steepest discount levels seen in the last decade, surpassed by only the COVID-19 selloff and the 2022 inflation scare. So BDCs are either offering investors a great value or are pricing in future defaults and potential write downs. We would argue the latter based on what we've discussed thus far.

Chart 2



Data Source: Invesco, MarketVector.

Now the question we have yet to answer….outside of BDCs, is there a potential this spills over into other public markets? Corporate credit is an obvious area of concern, but not from a default standpoint. As we discussed, the credit quality of public credit markets has improved greatly, with private credit likely stepping in to absorb some of the more speculative debt offerings. The likely risk to public credit (e.g. high yield bonds, investment grade corporates) will be seen in the form of spread widening, as private credit investors search for sources of easy capital to either cover losses or satisfy liquidity needs. This exact reaction occurred during the GFC, where spreads moved out and peaked for investment grade corporate and municipal bonds prior to speculative issues. We've already seen some signs of this in both investment grade and high yield corporate debt markets. That's not to say that spreads look anywhere near attractive at current levels…but high yield spreads have moved out by 73bps from their January lows, while investment grade spreads have widened by 18bps.

Regional banks are also a concern due to their heavy involvement in private credit lending. Recent data suggests that a handful of major regional lenders have more than 20% of their total loan portfolios in so-called Non-Depository Financial Institutions (NDFIs), while the industry as whole has approximately 4-5% of total assets allocated to direct private credit holdings. Now a single regional bank failure is likely not enough to cause a crisis. The Silicon Valley Bank (SVB) collapse that occurred just a few years ago was pretty well contained. However, the probability of a systemic shock increases greatly if we see a wave of bank failures due to private credit loan losses.

In terms of portfolio implications, the key takeaway here is to exercise caution within credit markets. We've already done so within our portfolios, which currently exhibit their lowest allocation to U.S. corporate bonds in the last twenty years, and have no dedicated allocation to below investment grade issues. Spreads remain well below their long-term average, despite the slight move upward recently and, with the potential for

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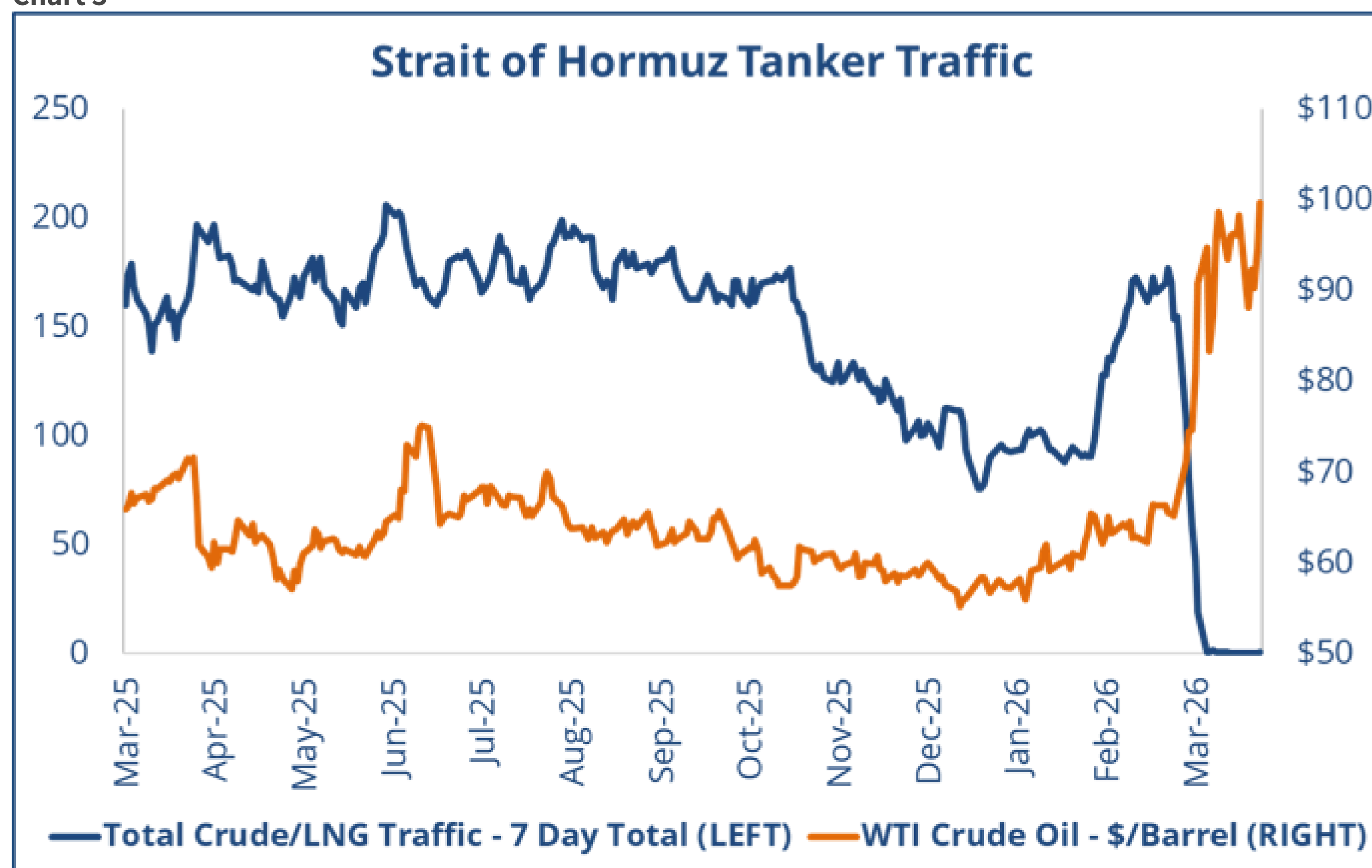
private credit concerns to grow, the likely path of spreads is wider rather than tighter. That said, a time to be opportunistic will likely arise in this space. As we mentioned earlier, public markets have seen an uptick in credit quality and have limited exposure to sectors susceptible to AI disruption. Both traits help to protect public credit from a meaningful permanent impairment of capital. However, they are likely to bear the brunt of increasing private credit fears, as the most liquid assets are typically the first to be sold. These are the exact types of situations we aim to take advantage of in our strategies and are prepared to act when the time is right. That time is just not today.

Pressure Point #2 - Iran

Our second pressure point comes in the form of the unexpected geopolitical conflict in the Middle East that began with the commencement of Operation "Epic Fury".Since the strikes began, we've seen volatility ripple through global markets and all for the same reason...commodity market disruptions. In just the last few months, investors have witnessed wild swings in crude oil prices, which fell below $56/barrel in early January only to climb to near $100/barrel at quarter end. The closure of the Strait of Hormuz has been the key source of this volatility. The strait is a critical shipping route for middle eastern oil that under normal conditions accounts for roughly 20% of global oil supply. Traffic within the strait came to a screeching halt shortly after the conflict began. At present there is essentially zero oil and LNG (liquified natural gas) tanker traffic, compared to a normal rate of ~150 vessels per week (See Chart 3). The fallout has been far reaching.

Chart 3



Data Source: Bloomberg.

For bond markets, investors would typically expect a "flight to safety" in a such an environment, resulting in lower yields and higher prices. Unfortunately, this does not occur when there is a risk of higher prices and subsequently higher inflation. This risk is currently priced into the U.S. TIPS (treasury inflation-protected securities) market. While inflation expectations over the next decade have only increased marginally (+20 bps), the 2-year breakeven rate has jumped by more than 100 bps since the start of the year, ending the quarter at an annualized rate of 3.4%. As a result, interest rates have increased across the yield curve and have greatly changed expectations for the future path of rates. At one point this year futures markets were pricing in roughly two and a half 25bps rate cuts by year end. As of quarter end, markets had ruled out cuts entirely and were pricing in essentially no change by the Fed's December meeting.

One important note, however, is that today's situation looks notably different than 2022. First, financial conditions were incredibly loose following the COVID-19 pandemic due to a combination of both accommodative fiscal and quantitative policies. Financial conditions today are relatively neutral; despite the rate cuts we've seen over the last couple of years. In other words, the risk of demand-driven inflation is relatively low. Today's interest rate environment is also noticeably different. The10-year treasury entered 2026 with a yield of 4.16%. At its low in 2021 the 10-year yield was barely above 1.00%. This provides investors with a healthy income buffer to absorb modest increases in rates, a stark difference from 2022. Absent a Volker-like moment, where the Fed has to choose between the economy and long-term commodities driven inflation, upside pressure on interest rates should be generally limited.

Moving to equity markets, stocks have declined across the globe with emerging markets taking the brunt of the pain. The S&P 500 has declined by 8% since the start of the conflict, while losses of 10% and 12% have occurred in non-U.S. developed and emerging markets, respectively. Within the U.S., the conflict does little to change our view that, at least in the short-term, the economy appears be on solid footing. Economic growth remains strong for a mature economy, the labor market has cooled but has yet to flash any signals of recession, and massive spending plans from mega cap technology names are unlikely to change.

The key risk, however, comes from an increase in the discount rate. This is important because stocks are traditionally valued based on their future earnings and dividends. To determine their present value you need to discount these cash flows at what is known as a discount rate. As the discount rate increases it diminishes the present value of a stock, as those future cash flows become less valuable today. In theory, this should have a disproportionately negative impact on high growth and high valuation names where investors are paying high prices for earnings that have yet to materialize. We've seen this play out in U.S. markets throughout the first quarter, where large value stocks have actually gained 2% while their growth counterparts have fallen by nearly 10%.

Outside of the U.S., emerging markets have experienced a disproportionately negative impact from the conflict in Iran, largely due to their high dependence on oil from the middle east. Unlike the U.S., who is a "net exporter" of petroleum products, many Asian economies rely on the Strait of Hormuz for the vast majority of their energy needs. China sources 40% of their oil needs from the middle east, India sources 45%, while South Korea relies on the middle east for over 70%. This not only presents the same price pressures we see at home but also introduces concerns

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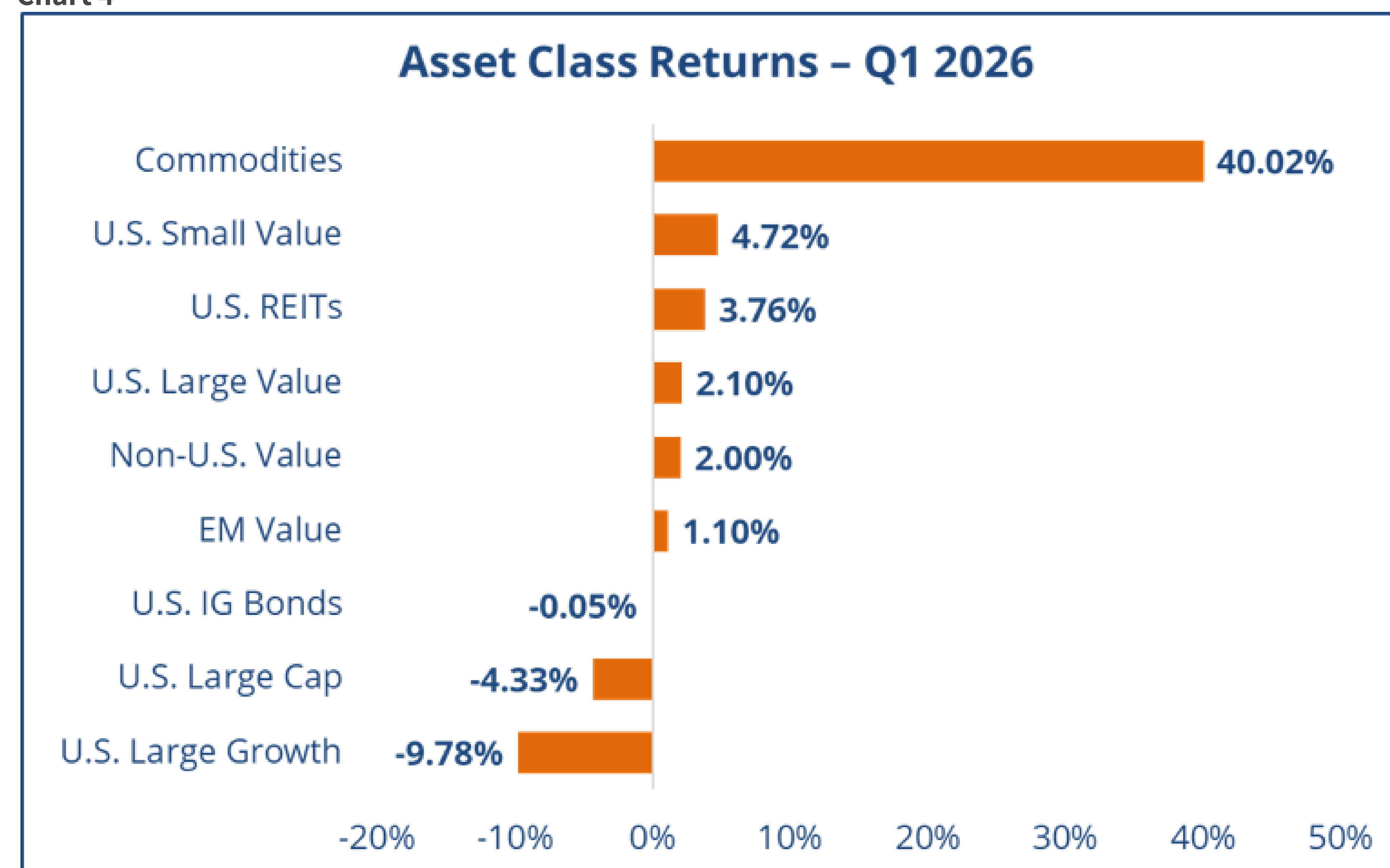
around supply disruptions. A second order effect of this is the currency impact. Given that oil is globally priced in dollars, a sharp increase in prices also increases the demand for USD. As non-U.S. economies exchange their currency for the greenback it should inevitably result in a weakening of their currency and corresponding strength in the USD.

All of this has played out as expected. The MSCI Emerging Markets index has fallen by 12% since the conflict began, with South Korea serving as the largest detractor (-22%). At the same time, the basket of EM currencies has weakened by nearly 3% versus the U.S. dollar. Despite this setback, emerging markets have yet to relinquish their performance advantage built up from earlier in the year, leading U.S. large caps by more than 4% on a YTD basis (-0.17% vs. -4.33%) and outperforming U.S. growth stocks by more than 9.50% (-0.17% vs. -9.78%). Emerging value stocks displayed an even stronger advantage, ending the quarter in positive territory (See Chart 4).

Chart 4



Data Source: MSCI, Russell, FTSE, S&P.

How will the conflict continue to play out and what will be the potential impact on markets? That is the million dollar question. A speedy resolution is obviously the ideal scenario. The longer the Strait of Hormuz remains closed the more the pressure on commodities prices builds…and this doesn't mean just crude oil. The strait is also a key transport route for liquified natural gas and nitrogen, a key input in fertilizer production. However, investors also need to view this using a long-term lens. Iran is the key destabilizing force in the middle east and their ability to develop nuclear capabilities is a true global threat. So, while the short-term pain may be uncomfortable, if current war efforts are successful, we are likely to see long-term benefits.

From a portfolio perspective, if the recent volatility has taught us anything it is that diversification has its benefits. Investors that have suffered the greatest losses are those with concentrated holdings in high valuation U.S. large growth stocks. Those who are broadly diversified or, ideally, positioned in attractively -valued assets have weathered the storm quite well. While large growth names and the Magnificent 7 ended the quarter squarely in correction territory, a handful of assets such as U.S. large and small value stocks, REITs, and even developed and emerging markets equities were either generally flat or positive in Q1. Then there's commodities, which have proven to be a safe haven. They've risen by as much as 40%, depending on the index you follow. So, the clear takeaway here is that although the headlines have been negative and volatility is clearly elevated, truly diversified investors may be pleasantly surprised to actually see positive returns when they open their quarterly statements in a few weeks.

Conclusion

In this quarter's letter we explored two sources of market volatility that have greatly changed the way investors view markets in 2026, hence the title, **"That was then. This is now"**. The first, private credit, has been slowly bubbling to the surface over the last year or so. Recent headlines around fraud and funds limiting access to capital have now brought the asset class to the forefront of investors' minds. Thus far, the impact on public markets has been limited to a selloff in BDCs and a slight uptick in credit spreads. However, should the default environment worsen, which we expect it will, it does have the potential to spill over into public credit markets and may pressure the balance sheets of regional banks. In such an environment the best course of action is caution. We've recently reduced our position in corporate credit but are ready to respond should an opportunity present itself. As we mentioned earlier, public credit markets appear relatively insulated from the key risks impacting private credit and any spread widening will likely be the result of forced selling rather than a deterioration of fundamentals.

The Iran conflict is the second event that has changed the investing landscape in 2026. Concerns around commodity disruptions have stoked inflation fears, which have rippled through both equity and bond markets. As we think about positioning portfolios with this as a backdrop, it does little to change our current convictions. High quality fixed income, and treasuries in particular, have gotten even more attractive. YTD losses have thus far been minimal (-0.05%) and higher starting yields simply increase future return expectations. Market dynamics today differ greatly from 2022, making a repeat of that environment unlikely. In terms of equity markets, the fundamental story remains unchanged at this point. U.S. value and non-U.S. stocks continue to offer the most attractive relative value opportunities across the globe. Any near-term resolution to the current conflict would simply serve to reinforce this. The greatest risk remains within highly valued growth sectors, whose multiples are the most susceptible to rising discount rates. This is precisely what has played out thus far in 2026.

To conclude, to those investors concerned about recent headlines and the impact on their portfolios, we would recommend staying disciplined and diversified. We remain focused on the long-term and continue to position our portfolios in undervalued areas of the market. This strategy has served our investors well thus far in 2026, just as it has in prior periods of market volatility. As always, thank you for your trust and confidence.

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All data as of 3/31/2026 unless otherwise noted.

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