Monroe Capital

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Tariffs and Turmoil: How to Navigate a Challenging Landscape

April 9, 2025

When Tariffs Loom, Look for Private Credit and Businesses Without Containers

The latest wave of tariffs—broad-based, sudden, and historically large—marks the most significant U.S. trade policy shift in over half a century with the latest calculations suggesting these new measures represent a 22-point[1] increase in the effective U.S. tariff rate, equivalent to a $700 billion[2] annual tax hike. The result? Recession odds are climbing, markets are reacting, and policy uncertainty is back in the spotlight.

Yet amid the volatility, one segment of the market appears relatively well-positioned: **U.S.-centric, asset-light, lower middle market private credit.** While no part of the credit universe is completely insulated from macro stress, this corner of the market has structural features that limit its direct exposure to trade policy—and, in many cases, position it to take advantage of market dislocations.

Stagflation Dampens M&A Outlook with Uncertain Impact on Rates

While many continue to expect that countries around the world will enter a period of negotiations with the aim of reducing the effective tariff rate over the coming months, the immediate macro impact is stagflationary. **Higher import costs and supply disruptions** are likely to erode growth while boosting inflation if current policies are left unchanged.

J.P. Morgan's models indicate that a sustained 20% tariff regime (with foreign retaliation) would shave roughly 2 percentage points off U.S. GDP and about 1 point off global GDP over the next year. Perhaps more importantly, business confidence is at risk. The abrupt policy shift increases uncertainty for corporate planning, which may delay investment and hiring decisions. **It is also likely to lead to a slowdown in new M&A.**

It's telling that J.P. Morgan has now raised its estimated **probability of a U.S. or global recession to 60%** – up markedly due to the tariff shock. We are essentially watching a large, non-linear risk factor materialize, one that could act as the catalyst for an economic downturn that was only a 10–25% probability scenario a few months ago.

Sources: 1. Fitch Ratings, Olu Sonola, Head of U.S. Economic Research, 2. Peter Navarro, Trump Administration Trade Adviser

This sudden deterioration in economic sentiment has also led market traders to increase their outlook to **anticipate up to five quarter-point rate cuts** by the Federal Reserve within this year, a notable increase from earlier projections. While this sudden change is driven by the assumption that tariffs will cause growth to stagnate and encourage the Fed to cut rates in response, we believe this ignores the fact that tariffs are also highly inflationary. The Federal Reserve under Jerome Powell has been steadfast in pursuit of taming inflation in recent years, a feat which has been increasingly challenging in the face of political pressure. While we don't invest on the basis of a particular economic outlook, we believe **it's just as likely that rates are increased to 5% again before they see 3%** given the inflationary impact of the tariffs as currently implemented.

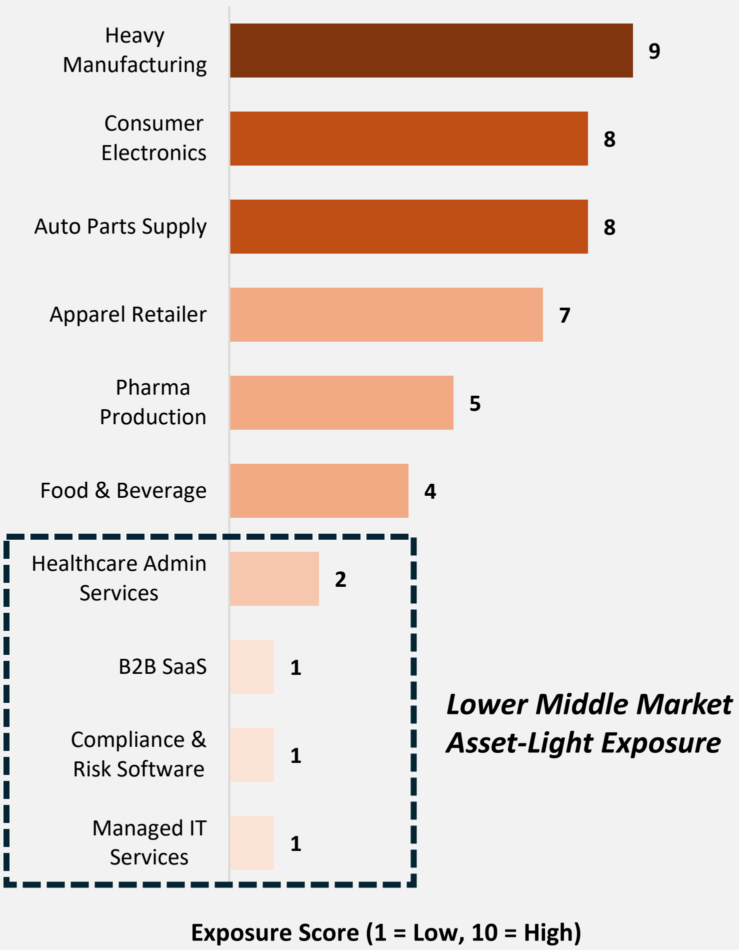
The Strength of the U.S. Lower Middle Market: Asset-Light by Design

The tariff fallout isn't just headline risk. **A sustained slowdown is expected to compress margins, delay M&A activity, and constrain capital availability across the credit spectrum**. And while some borrowers—especially those tied to manufacturing or global supply chains—may face margin pressure or input cost shocks, others are less exposed.

In the lower middle market, portfolios are typically U.S.-centric without extensive global supply chains. Lenders focused on this segment tend to invest in business models that rely less on physical goods and more on people, software, and services. The lower middle market is more resilient to the current environment for the following reasons:

- **Minimal import dependence**: Borrowers often don't move goods across borders.
- **Domestic revenues**: These companies typically serve U.S. customers in U.S. dollars.
- **Intangible-heavy operations**: Enterprise software, compliance platforms, healthcare services, and B2B services companies don't rely on global inputs or shipping lanes.

Business Model Exposure to Trade Volatility



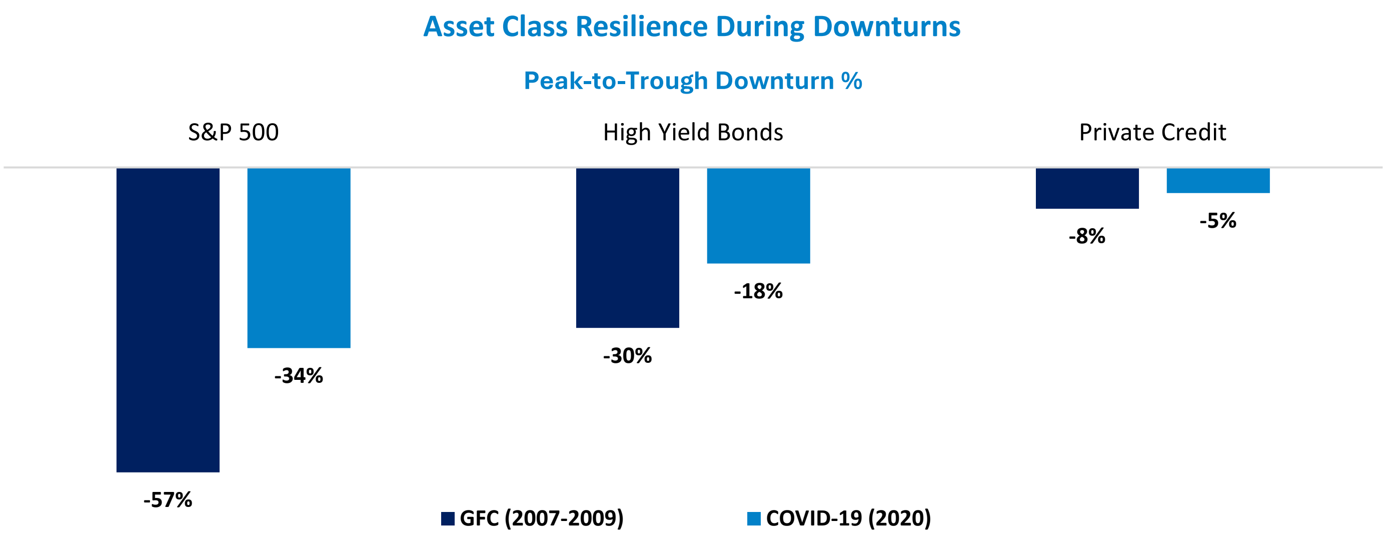
Source: J.P.Morgan April 2025

When tariffs are weaponized and global trade frays, the companies least dependent on containers are naturally better insulated.

Historical Resilience: Private Credit Through the Cycle

Return seeking credit markets have faced two major tests in recent history: the Global Financial Crisis and the COVID-19 pandemic. In both cases, **private credit—particularly senior secured, middle market lending—demonstrated real resilience:**

- During the GFC, the S&P 500 declined ~57%; high-yield bonds fell 30%. Direct lending strategies saw drawdowns of just 5–8% on average, with **faster recoveries and materially lower volatility.**
- In 2020, equity markets plunged over 30% in weeks. Yet **private credit portfolios generally fell less than 5% and were fully recovered within months.**



Source: Alliance Bernstein, September 2023

Structured for Volatility and Downside Protection in the Lower Middle Market

This resilience stems from several enduring features: senior **secured positioning, contractual income streams, lower leverage levels,** and **illiquidity premiums** that are only earned if you're not forced to sell in a panic.

- **Senior secured focus:** Most loans sit at the top of the capital stack, with collateral and covenant protections.
- **More conservative leverage:** Leverage in the lower middle market often trends 3–4x, not the 6–7x seen in upper middle market and broadly syndicated deals.
- **Hands-on engagement:** Managers in this space maintain close, often direct, relationships with sponsors and borrowers. Monthly reporting, covenant testing, and routine dialogue are standard operating procedure.

These features help ensure that issues are surfaced early and can be addressed constructively. In contrast to larger club deals, **lenders in this part of the market have greater ability—and more tools—to actively manage outcomes when performance deteriorates.**

Discipline and Structure: The Differentiators That Matter Now

For many new entrants to the private credit market, this may be the first real cyclical test following a period of rapid AUM growth and increasingly borrower-friendly structures. **As the tide goes out, the differences between scale and discipline become much clearer.**

Managers who stayed disciplined on underwriting, insisted on structural protections, and invested in infrastructure to support portfolio oversight may find themselves in a stronger position, not just to protect capital, but to deploy it advantageously. In our view, we believe:

- **Spreads will likely widen**: Pricing is adjusted to reflect risk. New deals are coming with higher yields and more lender-friendly terms.
- **Structures are tightening**: Covenants, call protection, and equity cushions are being reintroduced in ways not seen since 2020.
- **Selectivity is rewarded**: Not all companies will weather a downturn equally. Lenders with the ability to originate their own deals, underwrite deeply, and say no often outperform when markets turn.

In short: volatility is increasing. But so is dispersion. And dispersion creates opportunity—if you're equipped to take advantage of it.

How does an Experienced Private Credit Manager Approach the Current Market?

Direct Portfolio Outreach – Benefitting from our position as the sole or lead lender for the vast majority of its portfolio, Monroe is in direct dialogue with the management teams and owners of its companies and aims to **identify potential challenges and work collaboratively on solutions**. While a lot can and will change in terms of the policy specifics, identifying exposure early can ensure that the right mitigation efforts are being pursued allowing Monroe to get in front of any potential underperformance, liquidity challenges, or covenant breaches.

Uncertainty Creates Opportunity – While the uncertain macro environment can have a dampening effect on new M&A, the breadth and depth of the U.S. lower middle market provides ample investment opportunities in any market cycle. In 2020, despite the volatility and uncertainty stemming from the COVID-19 pandemic, **U.S. private equity firms still acquired over 6,000 lower middle market companies**, investing over $300 billion. Managers with the dry powder and underwriting and structuring discipline can often benefit from higher spreads, lower leverage, and superior downside protections in periods when peers are forced to shift their investment professional resources towards portfolio monitoring and workouts.

Credit First, Zero Loss – As one of the few direct lenders with a 20-year track record, including experience investing in private credit through the Great Financial Crisis, Monroe knows firsthand that first lien lenders cannot and should not make investments predicated on a particular economic outlook. There are many high-quality companies that can generate steady cash flow and support modest leverage through an economic cycle. While these deals may not offer the largest spreads available in the market, **avoiding losses and getting paid back in full remains the key** driver of manager differentiation.

Conclusion: What to Watch Going Forward

Trade policy may be unpredictable. But the tools of disciplined credit investing remain the same: structure, selectivity, and proximity to the borrower. In a world where container ships and customs forms are back in the headlines, there's a certain comfort in lending to businesses that don't need to cross a border to operate.

Lower middle market, U.S.-centric, asset-light lending may not make headlines—but it's built to hold up when the headlines turn volatile. History suggests private credit performs well when structure matters most. And structure is starting to matter again.

Sources: J.P. Morgan Global Economic Research; J.P. Morgan Private Bank (Apr 2025); PitchBook Analyst Note (Q2 2025); FS Investments Insights (Apr 2025); Monroe Capital Portfolio Update (Apr 2025); Morgan Stanley Investment Mgmt (2024); AllianceBernstein (2023); StepStone Group (2023).

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