

The lone cockroach

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Investors have observed several credit events that began in spring 2025 and intensified into the fall. The negative credit headlines started when retailer Saks restructured its bond after making only one interest payment. This was followed by instability at natural gas company New Fortress Energy. Attention then shifted to the leveraged finance sector with the sudden bankruptcy of subprime auto lender Tricolor Holdings and the rapid collapse of auto-parts supplier First Brands Group.

Although each credit setback had different causes, investors began to question whether the cumulative headlines indicate broader credit stress in the financial system. Jamie Dimon, CEO of JPMorgan Chase, contributed to these concerns during the bank's October earnings call, remarking, "When you see one cockroach, there are probably more." Dimon also suggested that many of these risks stemmed from private credit markets. In this case, we believe this was a lone cockroach.

What actually happened?

In the case of Tricolor's Chapter 7 bankruptcy, the company's subprime auto lending was structured as asset-backed securities, with approximately \$945 million in debt outstanding. Early court findings indicate that Tricolor engaged in questionable practices, including "double-pledging" loans to multiple lenders and duplicating vehicle identification numbers to secure more than one loan per vehicle. These actions are particularly concerning in asset-backed financing, where a lender's claim to collateral is essential for managing downside risk.

For First Brands, the collapse was driven by a lack of transparency. Starting in 2018, the company financed a series of acquisitions using broadly syndicated loan markets, which are typically transparent. Over time, however, First Brands relied more on off-balance-sheet working capital facilities to support its growth. This type of financing is relatively opaque and made it difficult for lenders to fully understand the company's liabilities. Once market participants became aware of the extent of off-balance-sheet borrowing, creditors declined to refinance the company's debt.

Recent credit market noise is idiosyncratic

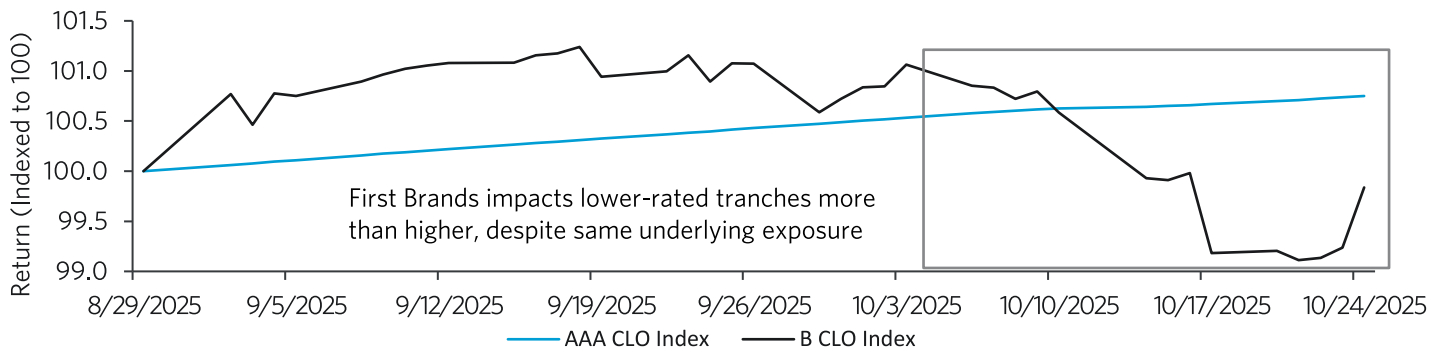
As outlined, the situations involving Tricolor and First Brands are largely idiosyncratic and are not seen as indicative of systemic risk across credit markets. Tricolor's outstanding debt remains at a manageable level and is concentrated within a sizable but relatively specialized segment of asset-backed finance.

In contrast, First Brands' bankruptcy is having a broader effect because its loans serve as inputs for numerous CLOs. Our analysis suggests First Brands' loans account for just 0.21% of the total exposures held throughout the CLO universe. Although any default is a concern, we believe the recent headlines may be creating more noise than substance.

When purchasing CLOs, there are several features that help insulate investors from events like the First Brands bankruptcy, which occurred on September 29, 2025. The first is diversification, provided by the large pool of loans that back CLO structures. This diversification spans both borrowers and sectors, which is why First Brands' exposure was limited to 0.21%.

The second is the structural protections built into CLOs, which vary depending on the tranche an investor holds. Since losses are first absorbed by lower-rated tranches, the AAA tranche benefits from a significant buffer. Recent performance differentials demonstrate this in real time, as the AAA CLO index has been largely unaffected by market noise. In comparison, lower-rated tranches have experienced noticeable negative returns.

Chart 1: AAA CLO Index primarily insulated from recent credit disturbances



Source: JPMorgan Indices

For the period September 1, 2025 through to October 24, 2025

For investors in high-quality tranches, structural protections provide an additional layer of defence against events like defaults. For example, AAA CLOs typically have about 32% par subordination, which means that 32% of the underlying loan principal acts as a buffer before AAA investors are affected. In practice, this requires approximately 32% of the underlying loans to default before losses reach the AAA tranche. By comparison, the peak leveraged loan default rate during the 2008/2009 Global Financial Crisis was around 11%, highlighting the significant cushion provided to AAA investors.

What risks deserve attention?

While Jamie Dimon's "cockroach" comment attracted significant media attention, we interpret the situation differently. The cases of First Brands and Tricolor are not indicative of systemic risk in credit markets, though they may signal the early stages of a shift in the credit cycle as we move further from the post-COVID "free money" era and adjust to persistently higher base rates.

In our view, the real concern is credit valuation. Across markets, credit spreads remain at decades-long lows, meaning investors are receiving less compensation for taking on credit risk. Yet, demand for credit is exceptionally strong, enabling public companies to issue additional debt and private credit managers to raise and deploy more capital. When demand exceeds supply, market distortions can occur.

We are less concerned about isolated credit events like Tricolor and First Brands, and more attentive to the potential for a gradual widening of spreads throughout the credit universe. Now is the time to monitor the credit cycle, not get distracted by idiosyncratic noise.

In this environment, investors should look past sensational headlines and approach credit with caution. We continue to prioritize higher-quality investments, focusing on AAA CLO tranches and shorter-duration credit within our mandates.

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