October 2019

High-Yield and Bank Loan Outlook

Don’t Be Tempted by CCC-Rated Bonds and Loans

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Summary

The high-yield market was relatively unscathed by a series of negative events in the third quarter of 2019, delivering another quarter of positive performance. But the distribution of returns continues to highlight skittishness about credit risk in the lowest-quality segment. CCC-rated credit has trailed returns of BBs and single Bs as defaults have materialized, barely delivering positive excess return over Treasurys for the year. As a result, CCC spreads in both sectors are at their widest level in almost three years.

Overall, the leveraged credit market's exposure to CCC-rated credit is the lowest since 2000. Amid many concerning trends that we have highlighted in past reports, we consider this limited market exposure to CCC credit as a positive factor. Recent cheapening in this rating sector might tempt investors to seek value here, particularly given limited supply, but we believe now is not the right time. Our recession forecasting tools suggest there is a 50/50 probability of a recession arriving before mid-2020. Given this coin-flip probability, it would be unwise for the prudent investor to increase exposure to CCC-rated credit based on the asymmetry of return outcomes in a bull or bear market environment.

Report Highlights

- Over the past decade, the credit profile of the high-yield corporate bond market has improved, while that of the institutional loan market has deteriorated.
- Exposure to CCC-rated debt in total leveraged credit (aggregating high-yield bonds and institutional loans) is only 8 percent, the lowest since 2000.
- As of Sept. 30, 2019, high-yield CCC spreads are at 1,037 basis points, while CCC loans are at 1,329 basis points. Both are at their widest since November 2016.
- Although the market exposure to CCC is already smaller than in the past, investors should continue to limit exposure to this rating category despite recent cheapening because of the asymmetry of potential spread outcomes.
- In a bear market scenario, we think CCC corporate bond spreads could widen by another 1,300 basis points, while our analysis of a bull market scenario suggests they could tighten by 430 basis points.

Leveraged Credit Scorecard
As of 9.30.2019

High-Yield Bonds

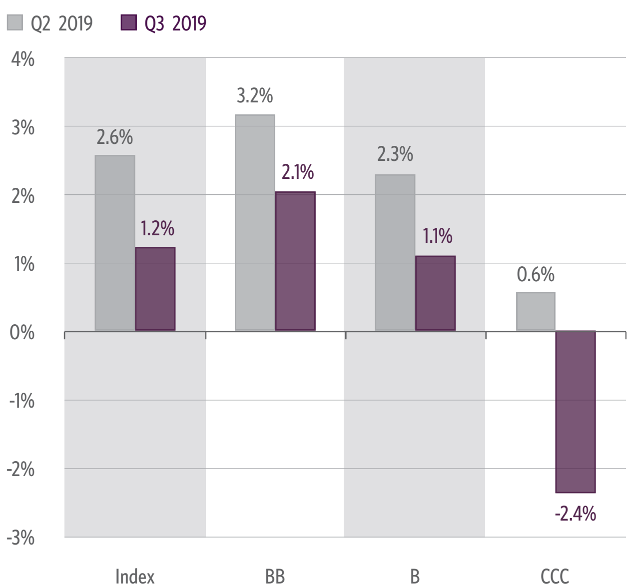
	December 2018		July 2019		August 2019		September 2019	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE Bank of America Merrill Lynch High-Yield Index	539	7.95%	407	6.02%	432	5.87%	420	5.87%
BB	368	6.28%	250	4.46%	260	4.18%	252	4.21%
B	582	8.38%	443	6.37%	473	6.29%	440	6.07%
CCC	1,103	13.59%	933	11.31%	1,028	11.81%	1,037	12.06%

Bank Loans

	December 2018		July 2019		August 2019		September 2019	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	550	94.09	449	97.02	473	96.29	478	96.18
BB	414	95.63	277	99.39	284	99.19	281	99.34
B	568	95.02	476	97.39	509	96.48	507	96.61
CCC/Split CCC	1,164	86.54	1,209	84.93	1,269	83.17	1,329	81.08

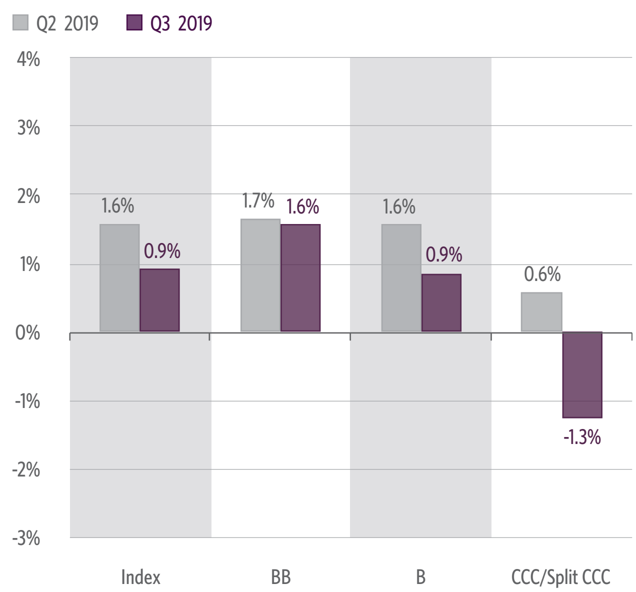
Source: ICE Bank of America Merrill Lynch, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE Bank of America Merrill Lynch High-Yield Index Returns



Source: ICE Bank of America Merrill Lynch. Data as of 9.30.2019. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 9.30.2019. Past performance does not guarantee future results.

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The data show that, at this point in the game, we have a 50 percent chance that we're going to get a recession within the next year. But there have been periods where aggressive action by the Federal Reserve has pushed the recession off. Can we avoid the recession? The answer is no. The recession is going to come; it's just a matter of whether it comes next year, or in two or three years.

– Scott Minerd,
Chairman of Investments and Global Chief Investment Officer

Macroeconomic Overview

Monetary Policy Is Now Focused on Sustaining the Expansion

The third quarter of 2019 ushered in the first U.S. rate cuts since 2008, with the Federal Reserve (Fed) explicitly stating that its focus is now on sustaining the economic expansion. This not-so-subtle shift implies that policymakers will do whatever it takes to ensure that the expansion continues. Although there has been considerable dissent among Fed policymakers about whether monetary easing is warranted at this stage, Chair Powell seems to have the full support of Vice Chair Clarida and New York Fed President Williams, adding credibility to Powell's focus on supporting growth.

The Federal Open Market Committee (FOMC) delivered two rate cuts of 25 basis points each in the third quarter. These cuts were positioned as an effort to guard against downside risks, and came even as unemployment sits at a 50-year low and inflation is moving back toward the Fed's 2 percent target. The market seems convinced that the Fed's commitment will not waver, with futures putting the fed funds rate another 65 basis points lower by December 2020. But the FOMC has been reluctant to commit to more easing, so it is still unclear whether the Fed will deliver the aggressive and preemptive policy action that may be needed to prolong the current expansion.

Recent economic data have been mixed, and with monetary and trade policy in flux, uncertainty about the economic outlook is higher than usual. On the positive side, we saw a pickup in the housing market as measured by housing starts and home sales. Additionally, the unemployment rate fell to a new cycle low of 3.5 percent in September, despite a continued moderation in payroll gains.

On the negative side, the ISM manufacturing index and most major subcomponents fell below 50 in August and plunged further in September to 47.8, the weakest reading since June 2009. The ISM non-manufacturing index also came in well below expectations at 52.6 last month, the lowest since August 2016. The non-manufacturing survey's employment component is now barely above 50 while the manufacturing employment sub-index stands at 46.3, well into contraction territory. Combined, the outlook for output and hiring has dimmed, potentially signaling trouble ahead for the labor market and consumers.

Much of the weakness in manufacturing data is owed to the ongoing trade dispute between the United States and China. A second-order effect of this trade dispute is its impact on consumer sentiment. Sentiment surveys show that fewer consumers believe now is a good time to buy homes, vehicles, and household durables, and headline consumer confidence measures have fallen over the past year. In addition to trade policy, we believe political concerns also weigh on sentiment, and both are set to ramp up further. Additional U.S. tariffs on China are due to take effect on Dec. 15, and the U.S. House of Representatives is pressing forward with its impeachment inquiry into President Trump. If both issues are resolved favorably, consumer spending is likely to power ahead with help from still-solid income growth, a year-to-date rally in the equity market, and lower borrowing costs. Alternatively, if these continue to weigh on sentiment, and the equity market fails to rally in the fourth quarter when seasonal trends are favorable, it will be a sign of more trouble brewing.

Our recession forecasting tools indicate that the economy remains in a vulnerable place. Our U.S. Recession Dashboard continues to point to a recession beginning sometime in the first half of 2020. Our Recession Probability Model indicates a 50 percent chance that a recession will come before mid-2020, and a 70 percent chance that it will arrive by mid-2021. Avoiding a recession now may take more policy action than has been delivered at this stage. It is difficult to say whether the Fed will succeed in its efforts to keeping the expansion going, but we judge that risk assets are not compensating investors for the possibility that it will not.

Credit Spreads Break from Macro Data

In recent years, a decline in U.S. manufacturing activity has coincided with widening credit spreads, but that has not been the case this year. High-yield spreads tightened 5 basis points over the quarter while bank loan three-year discount margins are 18 basis points wider, and both are tighter compared to the start of the year. The market appears to be resilient considering that our read of cyclical data suggests a high vulnerability to negative events. But we also note some worrying signs in the uneven distribution of returns across ratings.

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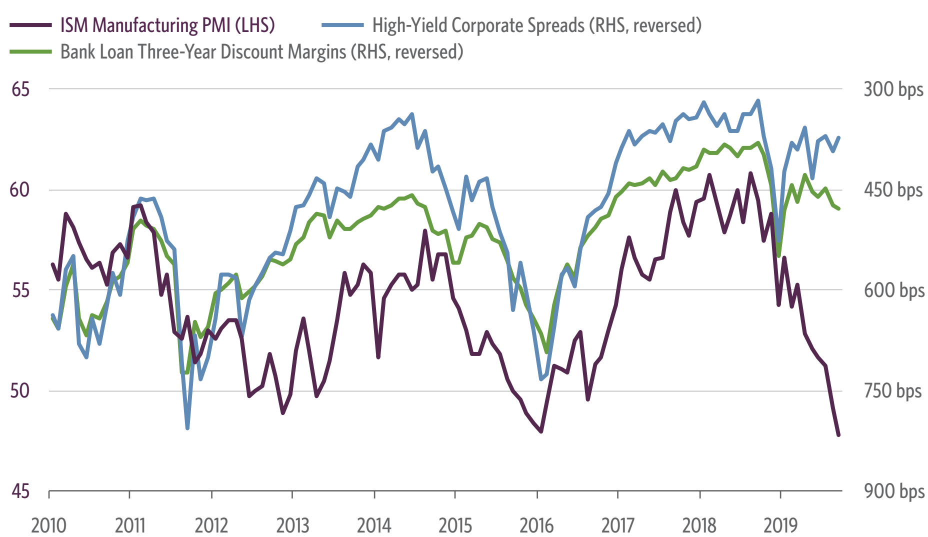
Spreads Resist the Slowdown in Manufacturing Activity



Source: Guggenheim Investments, Bloomberg, Bloomberg Barclays Indexes, Credit Suisse. Data as of 9.30.2019.

The high-yield corporate bond market delivered a return of 1.2 percent in the third quarter (11.5 percent year to date) while bank loans returned 0.9 percent (6.4 percent year to date). But the best performance has come from BBs, with a total return of 13.0 percent year to date, followed by single Bs with a return of 11.2 percent, and finally CCCs, trailing with a total return of 6.0 percent. In the bank loan market, year-to-date returns stand at 7.6 percent for BB loans, 6.1 percent for B loans, and 1.5 percent for CCC loans. Higher-quality assets generated stronger returns in the third quarter.

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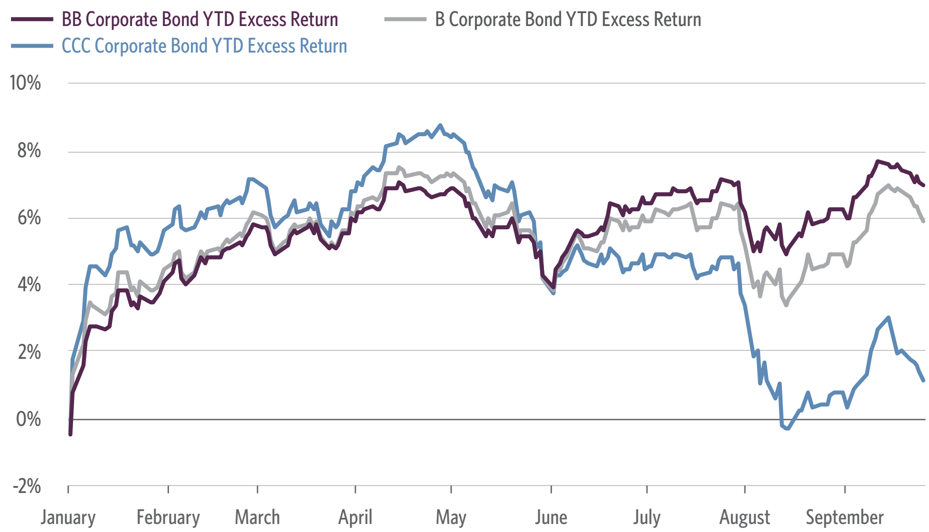
CCC Market Sputters



Source: Guggenheim Investments, ICE Index Services. Data as of 9.30.2019.

Investor worries about low quality credit are justified given that U.S. corporate default activity is rising. There have been over $18 billion in U.S. high-yield defaults over the past 12 months (versus $12.6 billion the 12 months prior), bringing the 12-month trailing default rate to 1.6 percent. Most of those defaults ($10 billion) are in the energy sector, raising the energy par-weighted 12-month trailing default rate to 5.8 percent, up from 0.6 percent in 2018. Loans have also seen default volume totaling $9.7 billion over the last 12 months, with most defaults coming from the retail sector, followed by media/telecom and then energy. These recent trends have resulted in meaningful spread widening across CCCs. In both high-yield corporates and institutional loans, CCC spreads are at their widest level in three years.

The fact that the broader high-yield and leveraged loan indexes have delivered positive returns despite CCC spread widening and default activity suggests that the overall exposure to this segment is small. Amid many concerns we have about risk assets, the limited exposure to CCC credit is one positive factor. This means that supply is limited if investors seek value here.

Lowest Exposure to CCC in Over Two Decades

The combination of ratings downgrades from investment-grade to high-yield, upgrades from single Bs, and new issuance trends has made the high-yield corporate bond index more concentrated in BBs over the past decade. The largest share of the ICE BofA Merrill Lynch High-Yield Unconstrained index is BB-rated at 49 percent, versus 38 percent at the end of the last cycle. Single B corporates are the next biggest share of the high-yield index at 39 percent, while CCCs are at 11 percent, below the historical average of 15 percent and well below the peak in 2010 of 26 percent.

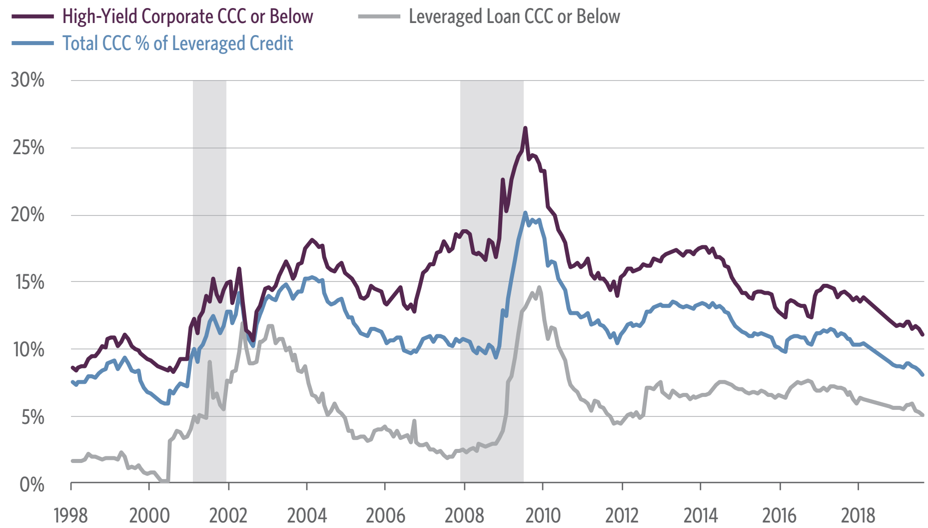
In the institutional loan market, the BB-rated category represents only 39 percent of the Credit Suisse Leveraged Loan index. The largest share is in single-B rated loans, at 54 percent, compared to its share of 25 percent a decade ago. The increase in single Bs is explained by motivations on both the demand and supply side. From the supply side, leverage ratios in newly issued loans are at record highs and loan covenants have weakened over the past decade. From the demand side, the increase in single B loans reflects the need for collateralized loan obligation (CLO) managers to maximize the spread they earn on assets (loans) over the spread they pay on liabilities. CLOs have restrictions on their exposure to CCC-rated loans.

For structural reasons (the maximum CCC exposure in CLOs), the exposure to CCCs in the loan market has always been lower than in corporate bonds going back to at least 1998. As of September 2019, CCCs comprised only 5 percent of the loan market. This structural cap on CCC-rated credit contributed to the loan market's comparatively lower average default rate versus the high-yield corporate bond market.

An accumulation of debt rated CCC or below would present a big problem to the credit market. The cumulative credit loss rate on a typical CCC-rated portfolio is 20 percent over an average five-year period according to Moody's. This is a large step-up from cumulative five-year loss rates of 4.8 percent for BBs and 12.7 percent rates for single Bs. But we find that this risk has fallen over time when aggregating CCC credit outstanding across both high-yield corporate and institutional loan markets. Cumulatively, the exposure to CCC-rated credit in leveraged credit is only 8 percent, the lowest since 2000 and well below the cyclical peak of 20 percent in 2009.

As of September 2019, CCCs comprised only 5 percent of the loan market. This structural cap on CCC-rated credit (the maximum CCC exposure in CLOs) contributed to the loan market's comparatively lower average default rate versus the high-yield corporate bond market.

Overall CCC Exposure Declined in this Cycle



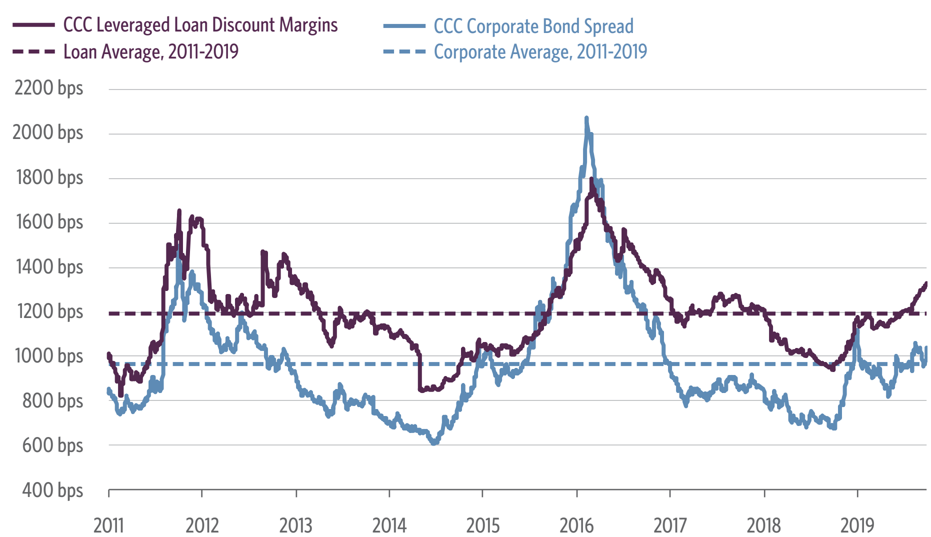
Source: Guggenheim Investments, Credit Suisse, ICE Index Services. Data as of 8.31.2019. Shaded areas represent recession.

Finding the Best Value Among Ratings

Despite the leveraged credit sector's limited exposure to CCCs, having any exposure to the rating category may not always be appropriate depending on spread levels and the economic outlook. At three-year wides, spreads might look appealing. However, as we highlight in the macroeconomic section of our report,

At three-year wides, spreads can look appealing to investors, but when we factor in the risk that default and downgrade volume could spike in a recessionary environment, current CCC corporate bond spreads of 1,037 basis points (828 ex-energy) are not enough compensation to justify the risk.

CCC Spreads Are At Their Widest in Almost Three Years



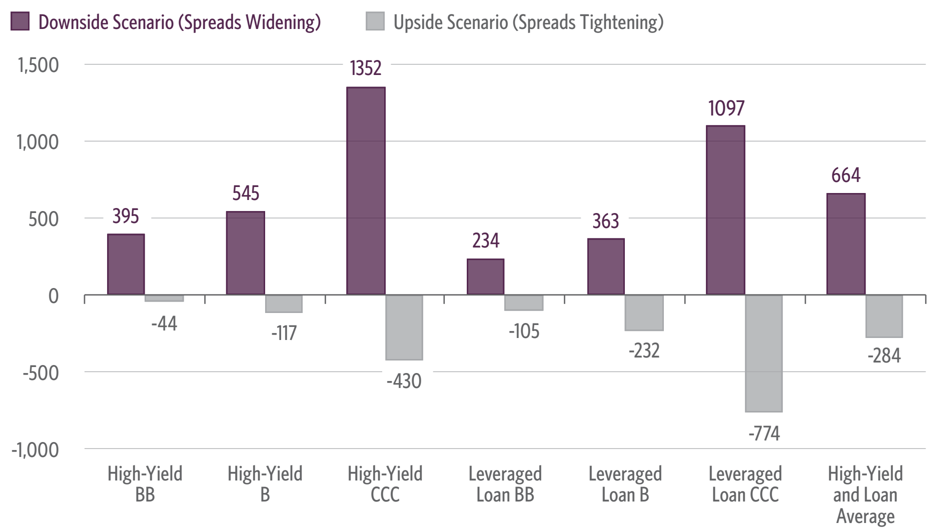
Source: Guggenheim Investments, ICE Index System, Credit Suisse, Bloomberg. Data as of 9.30.2019.

our recession forecasting tools suggest there is a 50/50 probability of a recession arriving before mid-2020. Given this coin-flip probability, we compare the return outcomes under a bear market environment that would accompany a recession and a bull market environment that would accompany an extended expansion.

According to index data since 1997, CCC-rated bonds have traded within a very wide range of 422 basis points at their tightest level in 2007, and 4,367 basis points at their widest level in 2008. These peak and trough levels may represent a few trading days in the entire history, so we also look at spreads in time-weighted percentiles. The 10th percentile for CCC bonds is a spread of about 607 basis points, and the 90th percentile is 2,389. A bull market scenario that gets CCC spreads to the 10th percentile would see about 430 basis points of CCC spread tightening, but a bear market would see CCC spreads widen by at least 1,350 basis points.

In BB corporates, the potential for spread tightening to get to their 10th percentile is only 44 basis points. On the other end of the ratings spectrum, in CCC-rated corporates the potential for spreads to hit the 10th percentile of spread levels since 1997 is 430 basis points of tightening, but the downside is that spreads would widen another 1,352 basis points to get to their 90th percentile level.

Potential Spread Widening Far Outweighs Potential Spread Tightening



Source: Guggenheim Investments, ICE Index System, Credit Suisse, Bloomberg. Data as of 9.30.2019. Downside scenario assumes that spreads widen to their 90th percentile level based on the history of spread data between 1997–2019. Upside scenario assumes that spreads tighten to their 10th percentile level over the same time frame.

Keeping rates unchanged and ignoring roll-down effects, the bull market total return potential for an average CCC portfolio is +18 percent before credit loss, which is very attractive, or about 15 percent loss-adjusted if we assume that defaults are low, consistent with spreads tightening. The downside is a total return of negative 22 percent, even after clipping an 8 percent coupon. Given that earnings growth looks weak and defaults are already rising, the asymmetry of return possibilities looks even more unattractive to us.

Using the same approach to establish our possible bull and bear market scenarios, single B corporates present a bull market return potential of about 8.9 percent after credit loss assuming low defaults, or a negative 7.6 percent total return in a bear market scenario. This is a much more attractive risk/return profile than in CCC bonds. BBs have a bull market upside total return of 7.2 percent, and downside of an 8.0 percent loss, which is more than in single Bs. This is because BB corporates are more overvalued relative to historical spreads than single Bs. But BBs carry lower default risk than single Bs and CCCs in any scenario, so we continue to find value in BB corporates as well. It is important to note again that these bull and bear market scenarios ignore the best and worst 10th percentile of market returns, so in reality, bull market returns could be higher and bear market returns could be lower.

With the economic outlook highly uncertain, we continue to believe that a tilt toward higher quality makes sense. Our scenario analysis helps quantify this perspective. This quality theme extends beyond rating categories to include lower beta industries that are less cyclical than others and generate more stable cash flows. Until CCC spreads reach a level that produce more evenly-balanced upside versus downside return scenarios, the category merits an underweight at this point in the cycle.

Important Notices and Disclosures

INDEX AND OTHER DEFINITIONS

The referenced indices are unmanaged and not available for direct investment. Index performance does not reflect transaction costs, fees or expenses.

The **Credit Suisse Leveraged Loan Index** tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/ BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

The **Intercontinental Exchange (ICE) Bank of America Merrill Lynch High-Yield Index** is a commonly used benchmark index for high-yield corporate bonds.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks, actively traded in the U.S., designed to measure the performance of the broad economy, representing all major industries.

A **basis point (bps)** is a unit of measure used to describe the percentage change in the value or rate of an instrument. One basis point is equivalent to 0.01%.

The three-year **discount margin to maturity (dmm)**, also referred to as discount margin, is the yield-to-refunding of a loan facility less the current three-month Libor rate, assuming a three year average life for the loan.

The **London Interbank Offered Rate (Libor)** is a benchmark rate that a select group of banks charge each other for unsecured short-term funding.

Spread is the difference in yield to a Treasury bond of comparable maturity.

EBITDA, which stands for earnings before interest, taxes, depreciation and amortization, is a commonly used proxy for the earning potential of a business.

RISK CONSIDERATIONS

Fixed-income investments are subject to credit, liquidity, interest rate and, depending on the instrument, counter-party risk. These risks may be increased to the extent fixed-income investments are concentrated in any one issuer, industry, region or country. The market value of fixed-income investments generally will fluctuate with, among other things, the financial condition of the obligors on the underlying debt obligations or, with respect to synthetic securities, of the obligors on or issuers of the reference obligations, general economic conditions, the condition of certain financial markets, political events, developments or trends in any particular industry. Fixed-income investments are subject to the possibility that interest rates could rise, causing their values to decline.

Bank loans are generally below investment grade and may become nonperforming or impaired for a variety of reasons. Nonperforming or impaired loans may require substantial workout negotiations or restructuring that may entail, among other things, a substantial reduction in the interest rate and/or a substantial write down of the principal of the loan. In addition, certain bank loans are highly customized and, thus, may not be purchased or sold as easily as publicly-traded securities. Any secondary trading market also may be limited, and there can be no assurance that an adequate degree of liquidity will be maintained. The transferability of certain bank loans may be restricted. Risks associated with bank loans include the fact that prepayments may generally occur at any time without premium or penalty. High-yield debt securities have greater credit and liquidity risk than investment grade obligations.

High-yield debt securities are generally unsecured and may be subordinated to certain other obligations of the issuer thereof. The lower rating of high-yield debt securities and below investment grade loans reflects a greater possibility that adverse changes in the financial condition of an issuer or in general economic conditions, or both, may impair the ability of the issuer thereof to make payments of principal or interest. Securities rated below investment grade are commonly referred to as "junk bonds." Risks of high-yield debt securities may include (among others): (i) limited liquidity and secondary market support, (ii) substantial market place volatility resulting from changes in prevailing interest rates, (iii) the possibility that earnings of the high-yield debt security issuer may be insufficient to meet its debt service, and (iv) the declining creditworthiness and potential for insolvency of the issuer of such high-yield debt securities during periods of rising interest rates and/ or economic downturn. An economic downturn or an increase in interest rates could severely disrupt the market for high-yield debt securities and adversely affect the value of outstanding high-yield debt securities and the ability of the issuers thereof to repay principal and interest. Issuers of high-yield debt securities may be highly leveraged and may not have available to them more traditional methods of financing.

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2. Guggenheim Partners assets under management are as of 9.30.2019 and include consulting services for clients whose assets are valued at approximately $67bn.

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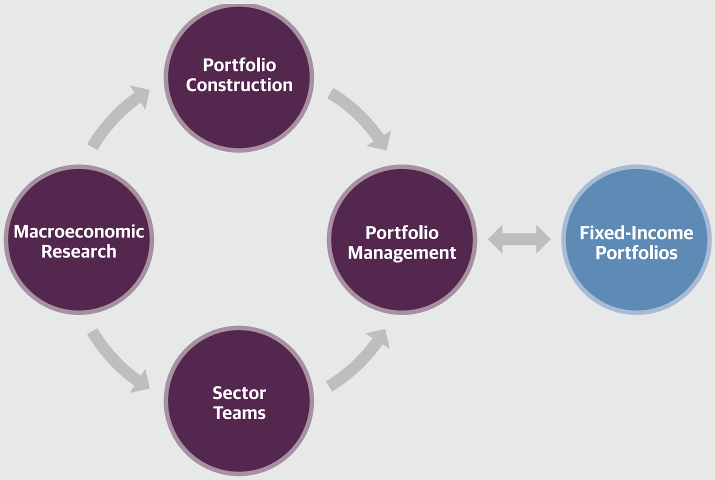

Guggenheim Investments

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Guggenheim Partners

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