

Strong Loan Returns with Tail Risk Considerations

Concerns remain over defaults and elevated interest burdens.

The Fed's 50 basis point rate cut in September marked the end of a two-and-a-half year rate hike cycle. The Credit Suisse Leveraged Loan Index returned a cumulative 21.8 percent over this period, benefitting from rising income associated with the floating rate coupons on loans. Through the end of 2025, additional rate cuts and continued repricing activity should help relieve some pressure on loan borrowers. Although some concerns over elevated interest burdens and defaults persist, the income opportunity in loans remains strong. With careful credit selection, loans offer attractive risk-adjusted returns and insulation from rate volatility.

Sector Commentary

- Loans delivered strong performance of 2.1 percent in the third quarter and 6.6 percent year to date. High all-in coupons and low duration should continue to support performance in the near term.
- The three-year discount margin on the Credit Suisse Leveraged Loan Index ended the third quarter at 498 basis points with the yield around 8.2 percent.
- A high share of loans continues to trade above par, ending September around 42 percent of the index. This suggests more contractual loan spreads may reprice lower, saving borrowers interest expense ahead of additional Fed rate cuts, but also moderating investor returns.
- Primary market activity picked up near the end of the third quarter. Almost \$50 billion, or 38 percent, was non-refinancing related in September, the highest monthly reading since 2022, driven by an uptick in both M&A and dividend recapitalization volume.

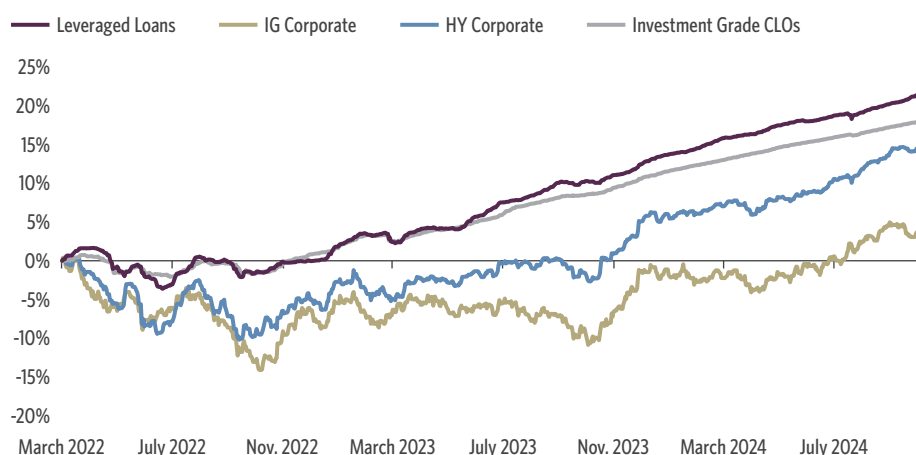
Investment Themes

- Loan demand remains strong, driven by CLO issuance, which is more than offsetting retail fund outflows over the past few months.
- While secondary loan prices have stabilized, the yield-to-maturity (YTM) remains above historical averages, offering investors an opportunity to capture attractive yields even as the Fed cuts rates.
- Rate cuts should help borrower fundamentals, but the impact will be gradual and tilted toward issuers already on solid footing.
- We remain concerned over the tail risk in the loan market given the impact of high rates on issuers' interest costs. We also expect loan recoveries to remain lower due to weaker documentation on loans issued in recent years and anticipate defaults will remain slightly elevated for an extended period.
- Distressed situations remain challenging to navigate, with liability management exercises (LMEs) the new norm.

By Christopher Keywork and Maria Giraldo

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Leveraged Loans Returned a Cumulative 21.8% since the Fed Started Hiking
Cumulative Sector Return Since Start of 2022 Fed Rate Hikes



Source: Guggenheim Investments, Bloomberg, JP Morgan. Data as of 10.21.2024. Leveraged Loans represented by the Credit Suisse Leveraged Loan Total Return; IG Corporate represented by the Bloomberg U.S. Corporate Bond Index; HY Corporate represented by the Bloomberg U.S. Corporate High Yield Total Return Index; and Investment-Grade CLOs represented by the JP Morgan CLOIE Investment-Grade Total Return.

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Investing involves risk, including the possible loss of principal. In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. During periods of declining rates, the interest rates on floating rate securities generally reset downward and their value is unlikely to rise to the same extent as comparable fixed rate securities. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations (“CLOs”), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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