GUGGENHEIM

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High-Yield and Bank Loan Outlook

The Relative Value Case for Bank Loans Over High Yield

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Summary

In past reports we discussed moving up in credit quality, with a preference for higher-rated BB debt over lower-rated CCC debt. Indeed, BB bonds outperformed CCC bonds in 2019 by over 600 basis points. While we still prefer higher-rated over lower-rated debt, this report focuses on the opportunity to move up in quality within the corporate capital structure, preferring senior secured loans over senior unsecured bonds of comparable ratings. Loans offer better value than bonds based on both yields and loss-adjusted spreads.

The opportunity in senior secured bank loans is not without risk. Given weak earnings growth, rising uncertainty about the ultimate impact of the Wuhan coronavirus, and an accelerating pace of downgrades in corporate credit, we believe that active management is key to monetizing the opportunity while avoiding potential pitfalls. Easy credit availability may be keeping the weakest debtors on life support, but there are plenty of higher-quality borrowers that will survive the next downturn. While it remains prudent to stay defensive, some areas of the bank loan market offer such an opportunity.

Highlights from the Report

- Economic data suggest the Federal Reserve (Fed) has successfully pushed off a recession by cutting rates and injecting significant amounts of liquidity. After tightening notably at the end of 2019, we expect credit spreads to move sideways over the next quarter, with possible widening resulting from the coronavirus outbreak.
- The outperformance of high quality over low quality in 2019 highlights the realities within credit, namely that fundamentals are deteriorating rapidly at this late stage in the business cycle, and it is important to distinguish between haves and have-nots.
- For investors looking for ways to upgrade quality in leveraged credit, loans present a good opportunity to move up the capital structure while still earning better spreads and yields than unsecured corporates. Nevertheless, investors should be aware of refinancing risk in BB loans and downgrade risk in single B loans.
- We estimate that the high-yield corporate bond market offers a loss-adjusted spread of only 62 basis points compared to 274 basis points in bank loans.

Leveraged Credit Scorecard
As of 12.31.2019

High-Yield Bonds

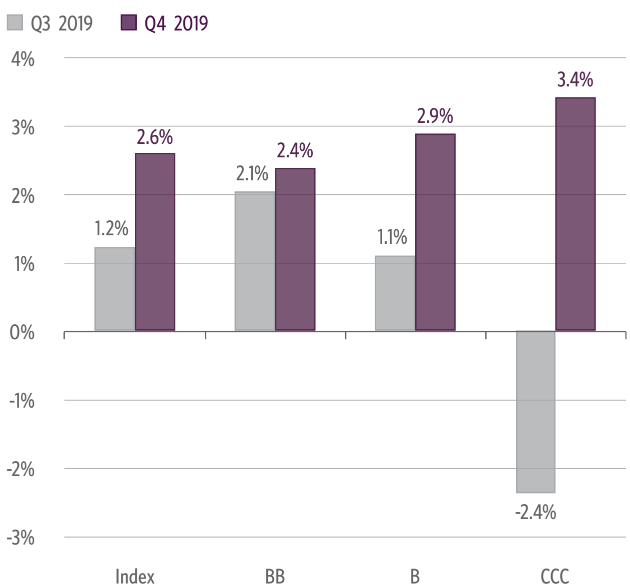
	December 2018		October 2019		November 2019		December 2019	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	539	8.0%	430	5.9%	416	5.8%	372	5.4%
BB	368	6.3%	255	4.2%	236	4.1%	214	3.9%
B	582	8.4%	458	6.2%	433	6.0%	374	5.4%
CCC	1,103	13.6%	1,060	12.2%	1,093	12.6%	964	11.3%

Bank Loans

	December 2018		October 2019		November 2019		December 2019	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	550	94.09	512	95.22	498	95.40	461	96.51
BB	414	95.63	283	99.23	278	99.37	262	99.81
B	568	95.02	540	95.69	525	96.13	470	97.67
CCC/Split CCC	1,164	86.54	1,415	78.58	1,455	78.03	1,365	80.14

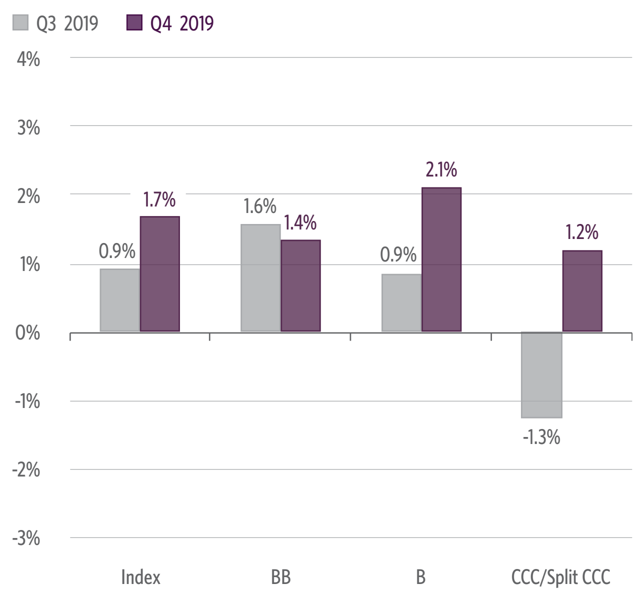
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE BofA High-Yield Index Returns



Source: ICE BofA. Data as of 12.31.2019. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 12.31.2019. Past performance does not guarantee future results.

> "There is always some uncertainty in risk, and given where credit spreads are, we know that we are not being compensated to take on too much risk. We continue to see erosion underneath the surface in credit, which calls for a cautious stance.
>
> – Scott Minerd,
> *Chairman of Investments and Global Chief Investment Officer*

Macroeconomic Overview

Easing Tension in the Outlook

Recent U.S. economic data demonstrate that the expansion is being helped by the Fed's policy easing. New home sales rose by 22.4 percent year over year in the fourth quarter of 2019, spurred by lower mortgage rates but also base effects. Nonfarm payroll gains were strong in January at 225,000, with year-over-year wage growth ticking up to 3.1 percent. The unemployment rate rose modestly to 3.6 percent amid further gains in labor force participation, as the lowest unemployment rate in 50 years draws more workers into the job market. Consistent with these trends, the Conference Board's consumer confidence index rose for the third consecutive month in January.

The latest evidence suggests that the Fed's easing efforts have given the U.S. economy the extra gas it needed to extend the cycle. Furthermore, the new year kicks off with some clarity on U.S.-China trade policy. The eleventh-hour Phase 1 U.S.-China trade agreement may give U.S. companies some comfort that they can expect tariffs on either side to remain where they are for now. This should help support the nascent U.S. manufacturing recovery, as seen in January's 3.1 point gain in the ISM Manufacturing PMI print to 50.9, the first expansionary level since July 2019.

Over the next several months, we expect the Fed will stay on hold as it watches incoming data to ensure that the current level of fed funds remains appropriate. Monetary policy acts on the economy with a lag, so the effects of the last rate cut in October 2019 might not be apparent until mid-2020. More economic data improvements may come as low rates flow through to consumers and to the credit markets.

The Wuhan coronavirus, however, has recently emerged as a key threat to China and the broader global economy. The number of confirmed cases and related deaths have increased dramatically in recent weeks, and while the Hubei province in China remains the epicenter of the outbreak, cases have now been confirmed in 28 countries. We expect that work stoppages, travel restrictions, and other efforts to contain the spread of the disease will result in a sharp contraction in real output in mainland China during the first quarter, which will have significant spillover effects given China's $4.5 trillion in annual trade flows with the rest of the world. How long economic activity in China and other affected countries will be depressed remains highly uncertain, but the coronavirus outbreak has the potential to be much more disruptive than other recent epidemics such as SARS, given that China's share of global GDP has nearly quadrupled to 16.3 percent since 2003. Thus, the Fed remains on hold, but given uncertainties, including the coronavirus, the risks favor a rate reduction rather than a rate increase.

Encouraged by positive data, market participants welcomed the new decade with cautious optimism. Credit spreads are near historical tights, but the CCC-BB spread in high-yield corporates and bank loans remains above their five-year averages. While off their 2019 lows, 10-year Treasury yields have failed several times to rise above 2 percent. This reminds us that while the Fed has successfully pushed off a recession, 2020 arrives with many risks worth watching, including the U.S. presidential election, U.S.-Europe trade negotiations, the potential for a military conflict between the U.S. and Iran, and rising corporate and local government defaults in China.

We remain concerned that credit excesses will balloon as a result of global central bank liquidity that is pushing on a string. Much of the global growth in this cycle has been driven by an accumulation of debt, which has a declining marginal return. Absent a down cycle to deflate some of the bubble, easy credit availability at this stage keeps the weakest companies on life support as low rates force investors to provide capital to borrowers teetering on the brink of downgrade or default. In this environment, even if the CCC-BB spread compresses back to historical tights, it is not a credit rally that we should chase. Given tight spreads and high prices, it remains prudent to invest where we assess creditworthiness to be solid and where spreads adequately compensate for risk.

Fundamental Realities

The leveraged credit market delivered an impressive performance in 2019, with total returns of 14.4 percent in high-yield bonds and 8.1 percent in bank loans. Returns confirmed our expectation at the start of 2019 that credit spreads would tighten, driven by a pause in monetary policy tightening. What was not clear on day one of the calendar year was that the Fed would later deliver 75 basis points in easing, pushing credit spreads even tighter than we expected and keeping them tighter for longer.

Index-level returns in 2019 disguise the true fundamental story in credit. CCC-rated corporate bonds and loans underperformed BBs by 6.0 percentage points in both sectors. In high-conviction credit rallies, CCC bonds should be the best performer. This market return profile instead conveys that 2019 was a year of weak earnings growth and deteriorating credit quality.

Through the third quarter (the latest data available), corporate earnings growth before taxes was -0.5 percent for high yield on a year-over-year basis and 3.0 percent for bank loans, both a slowdown from double digit growth over the same period in 2018. As a result of weak earnings, interest coverage fell and leverage ticked higher in a year when corporates went on a “debt diet,” which caused the high-yield corporate bond market to shrink. As of the third quarter, the ratio of high-yield debt to earnings stands at 5.0x, compared to 3.8x a year earlier. Interest coverage fell to 3.6x versus 4.2x over the same period. Importantly, rating agencies accelerated the pace of downgrades as companies failed to realize projected earnings growth or meet deleveraging targets.

S&P Ratings downgraded nearly 360 loans in the LSTA loan index in the 12 months through November 2019 compared to only 111 upgrades, for a downgrade-to-upgrade ratio of 3.2x. Similarly, but less severely, the downgrade-to-upgrade ratio was about 1.3x in the ICE BofA High-Yield Corporate index, reversing the trend from 2018 when there were 361 bond upgrades versus 276 bond downgrades, for a downgrade-to-upgrade ratio of 0.76x.

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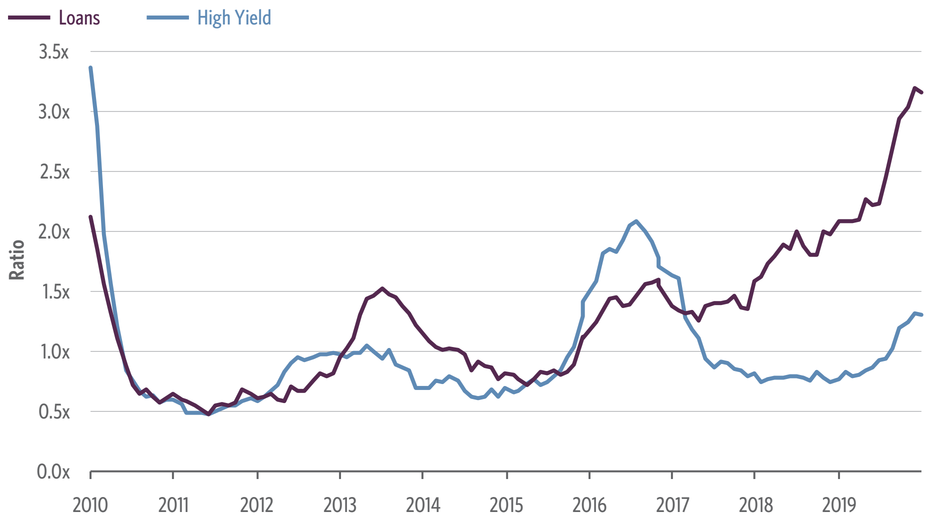
Loan Downgrade-to-Upgrade Ratio Jumps



Source: Guggenheim Investments, S&P LCD, ICE Data Services. Data as of 12.31.2019.

A positive for the leveraged credit sector is that default rates remain below historical averages. The par-weighted high-yield default rate in the ICE BofA High Yield index rose to 3.5 percent in 2019 versus 2.0 percent in 2018, but ex-energy was only 1.6 percent. In loans, the par-weighted 12-month default rate of the LSTA Leveraged Loan index fell slightly to 1.4 percent versus 1.6 percent in 2018. Our high-yield default rate model indicates that the 2020 default rate will stay near 2019's rate, but we think there is risk that it will rise modestly given the recent decline in commodity prices.

Strong annual returns are typically followed by weaker returns in the subsequent year, so we do not expect double-digit returns in high-yield or leveraged loans in 2020. In fact, the likely range of total return outcomes continues to look asymmetrical, with risks skewed to the downside. In a bull market scenario for 2020, where spreads return to historical tights, we estimate high-yield corporate bonds would deliver excess returns over five-year Treasurys of 8–9 percent, while bank loans would deliver returns of 6–7 percent. However, it would take credit spread widening of only 210 basis points in high-yield and 190 basis points in bank loans to eliminate coupon return and produce a negative total return for the year.

In a more severe downturn where spreads widen to historical highs, our analysis suggests that the high-yield corporate bond market could lose 36 percent versus Treasurys. In bank loans, with a lower coupon, less favorable credit profile, and limited liquidity, the downside looks more like a 41 percent one-year loss.

Poor earnings growth, high leverage multiples, and margin pressure resulting from a tight labor market keep us looking for more defensive opportunities in credit at this late stage of the cycle. Although loans present a worse one-year total return downside potential, the rest of this report outlines why we find better value in higher quality BB and B+ loans relative to similarly rated corporates.

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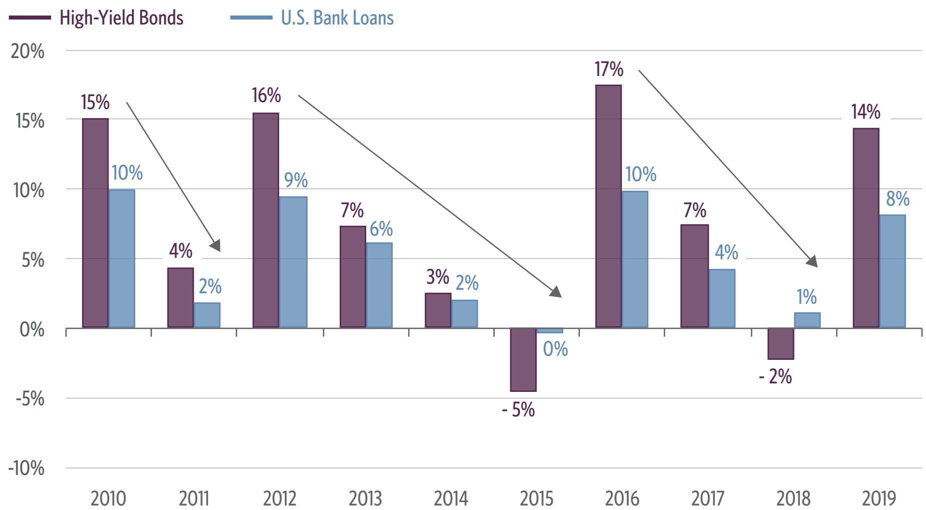
Weaker Returns Typically Follow a Strong Year



Source: Guggenheim Investments, ICE Data Services, Bloomberg, Credit Suisse. Data as of 12.31.2019.

Highlighting the Opportunity in Bank Loans

It is not very often that the markets offer an opportunity to earn a higher yield by moving up in quality. For credit investors with a footprint in both bank loans and high-yield corporates, 2020 kicks off with such an opportunity in BB and single B+ bank loans.

The bank loan market is currently paying a higher yield than corporate bonds of comparable ratings. BB loans are yielding 0.4 percentage point more than BB

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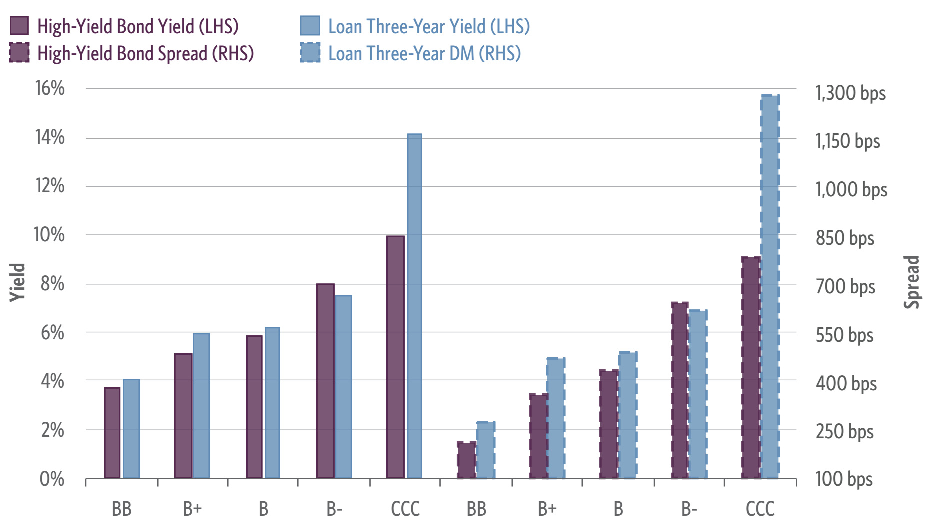
Loans Offer Better Value Than Bonds

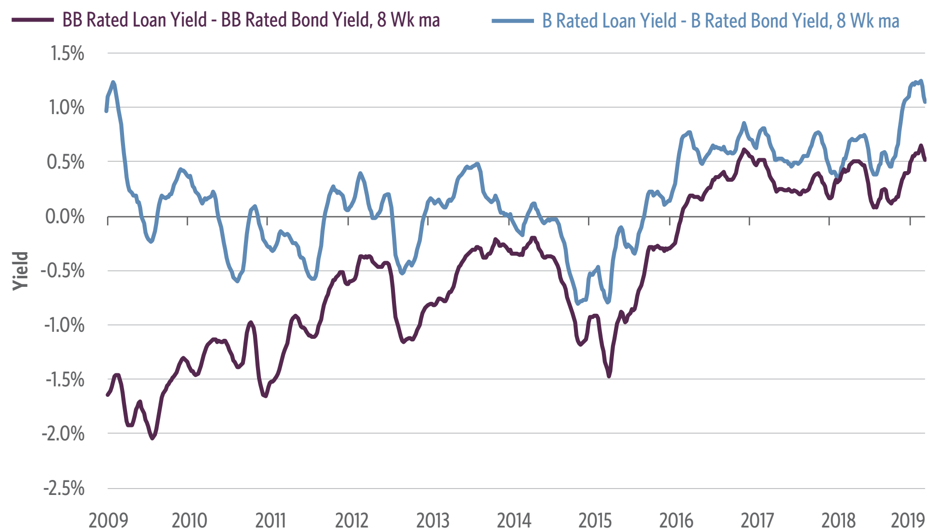


Source: Guggenheim Investments, ICE Data Services, Bloomberg, Credit Suisse. Data as of 1.31.2020.

corporates, above the five-year average of -0.1 percentage point. Single B loans yield 1.3 percentage points over single B corporates, compared to the five-year average of 0.3 percentage point. The same is true of spreads. BB bank loan discount margins are currently 83 basis points wider than BB corporate spreads and single B bank loan discount margins are 155 basis points wider than single B corporate spreads, both above five-year averages. In our view, this relative value is technically driven in BB loans, but fundamentally driven in single B loans.

BB loans are yielding 0.4 percentage point more than BB corporates, above the five-year average of -0.1 percentage point. Single B loans yield 1.3 percentage points over single B corporates, compared to the five-year average of 0.3 percentage point.

Loans Are Paying the Highest Yield Over Bonds in a Decade



Source: Guggenheim Investments, Bloomberg, Credit Suisse. Data as of 2.7.2020.

Refinancing risk is the technical driver of the opportunity in BB loans. Newly issued BB loans are pricing around Libor + 200–225 basis points, which is lower than the average BB discount margin of 261 basis points for secondary loans. Without the refinancing risk, BB loans would trade closer to primary spreads, boosting the price to about 102.5 percent of par. But because there is refinancing risk, the average BB loan trades just under par today. In contrast, a smaller share of BB corporates is currently callable. BB corporates trade well above par, at around 104.8 percent, which tightens the spread more than in secondary BB loans.

More refinancing activity in loans will limit price return and lower coupon income. Without refinancing activity, BB loans could deliver a total return of around 6.0 percent with a 4.5 percent coupon and 60 basis points of spread tightening. Refinancing activity lowers that return estimate by 0.5 percentage point based on a lower coupon. During periods when loans are in high demand, repriced loans trade back above par even with the lower coupon, which helps offset some of the call risk in the early stage of a refinancing wave.

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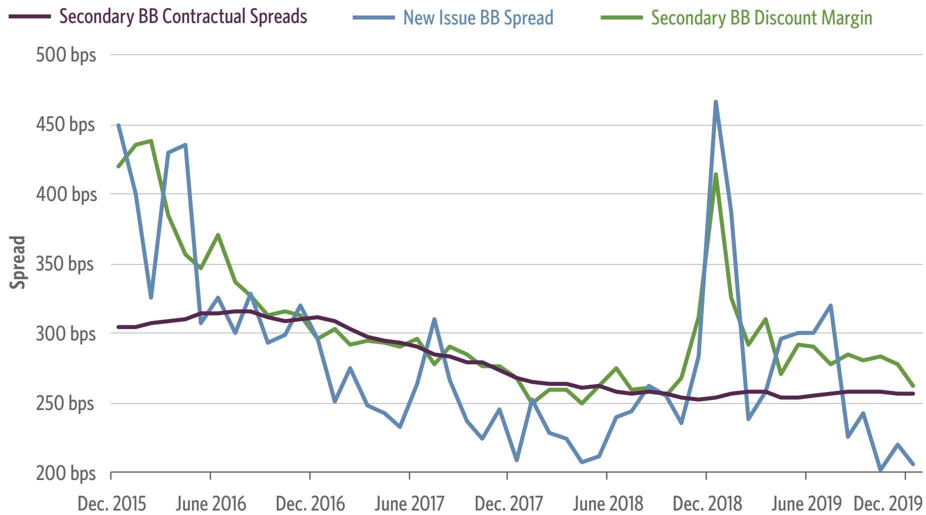
BB Loans Carry High Refi Risk as Primary Market Spreads Look Tight

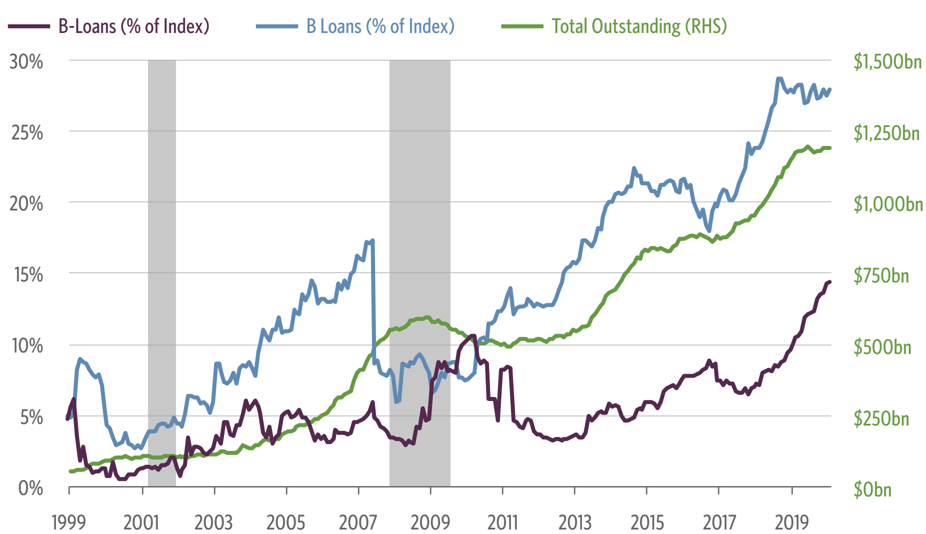


Source: Guggenheim Investments, S&P LCD, Bloomberg, Credit Suisse. Data as of 12.31.2019.

In single B loans, the wider spread compared to single B corporate bonds is driven by a recent acceleration in rating downgrades, which is more fundamental. Because of strong issuance and rating downgrades, single B- loans represent 14.0 percent of the loan index—the highest on record—up from 9.6 percent at the end of 2018. Single B- loans represent a key risk to loan investors due to their proximity to a CCC rating. Collateralized loan obligations (CLOs), which are the largest source of demand for loans, usually have a 5.0–7.5 percent limit on their exposure to CCC-rated loans. A rapid increase in the supply of CCC-rated loans would be met with limited demand, causing prices to drop. CCC loans do not have another large pool of natural buyers.

Because of strong issuance and rating downgrades, single B- loans represent 14.0 percent of the loan index—the highest on record—up from 9.6 percent at the end of 2018.

Record Share of B-Loans After Strong Issuance and Downgrades in 2019



Source: Guggenheim Investments, S&P LCD. Data as of 1.31.2020. Shaded areas represent recession.

We share the downgrade concerns in the loan market. Without downplaying the turmoil it will cause the sector one day, there may be occasions where fears are unfairly spilling over into higher-rated loans that may hold on to their existing ratings. Over the past five years, single B loans have traded at an average discount margin of 515 basis points, but 28 percent of single B+ loans and 34 percent of single B loans are trading at a wider spread than this average. Single B loans could offer total return upside of 8–9 percent if downgrades are avoided, which compares favorably to single B corporates that are higher beta, carry similar downgrade risk, and look more expensive relative to historical spread averages.

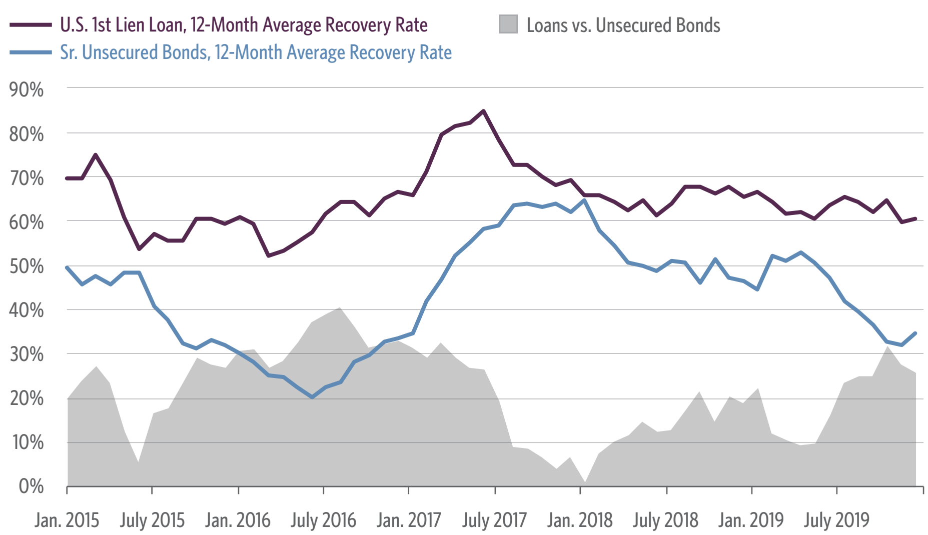
In both BB and single B loans, the opportunity is not without risk. Our work suggests that leveraged credit investors are being compensated more in loans than in bonds if they are willing to actively manage these risks. One way to manage, for example, is to look for opportunities where a loan trades cheaper than a bond by the same issuer. Only an active manager can identify and take advantage of such opportunities.

Thinking Strategically Through the Cycle

In the near term, loans could outperform high-yield corporate bonds on a total return basis if further improvements in economic data cause the rates market to price out the 30 basis points of Fed easing priced in over the coming year. With no rate duration, loans would avoid the negative impact from rising Treasury yields in a strong growth scenario. Loan spreads also have more room to tighten. To be sure, some of the spread tightening would be driven by refinancing activity, which limits the total return upside. While loans offer limited upside in a bull market scenario, we think the capped return is defensible given the downside protection in a high-default scenario.

Across all default activity over the past 12 months, the average first lien loan recovery rate was 60 percent versus 35 percent in unsecured high-yield bonds.

Loans Recover More Value Than Bonds in Defaults



Source: Guggenheim Investments, Moody's. Data as of 12.31.2019.

Recent default activity has shown that while loans are recovering less than their historical average, the average recovery rate is still higher than in high-yield corporate bond defaults. Across all default activity over the past 12 months, the average first lien loan recovery rate was 60 percent versus 35 percent in unsecured high-yield bonds. This difference in recovery value highlights why risk premiums should not be significantly higher in loans than bonds of comparable ratings, as they are currently.

As described earlier, due to the less favorable credit profile of the loan market (a greater concentration in single Bs), and because of limited liquidity, a return to historical wides in both sectors would produce a worse one-year total return outcome in loans. The loan market could lose 41 percent compared to a loss of 36 percent in high-yield corporate bonds. But over a full cycle horizon that includes a high default and recovery period, loans offer higher loss-adjusted spreads given their better recovery rates. Assuming a long-term default rate of 4.5 percent in both sectors, and a recovery rate of 35 percent in bonds and 60 percent in loans which matches recent experience, the high-yield corporate bond market offers a loss-adjusted spread of about 62 basis points compared to 274 basis points in bank loans.

The single B loan relative value opportunity should be approached with caution. We would heighten scrutiny on B- loans at this stage as the technical implications of a downgrade to CCC+ would outweigh the upside return potential. B+ loans are the better place in this rating cohort as we focus on up in quality via ratings and corporate capital structure.

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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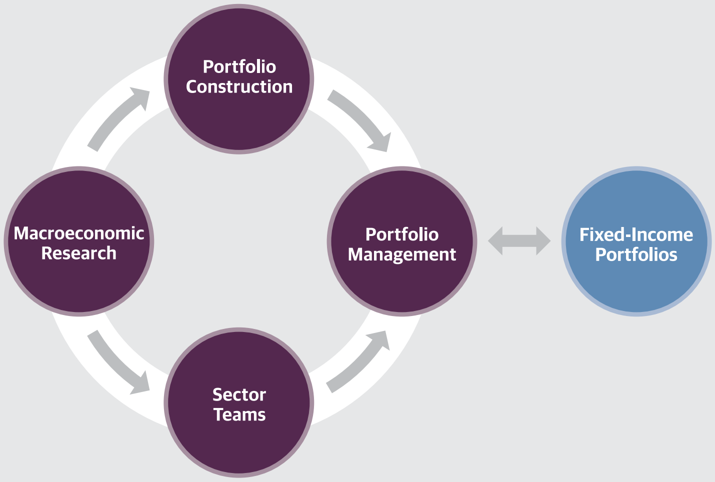
2. Guggenheim Partners assets under management are as of 12.31.2019 and include consulting services for clients whose assets are valued at approximately $67bn.

Guggenheim's Investment Process

Guggenheim's fixed-income portfolios are managed by a systematic, disciplined investment process designed to mitigate behavioral biases and lead to better decision-making. Our investment process is structured to allow our best research and ideas across specialized teams to be brought together and expressed in actively managed portfolios. We disaggregated fixed-income investment management into four primary and independent functions—Macroeconomic Research, Sector Teams, Portfolio Construction, and Portfolio Management—that work together to deliver a predictable, scalable, and repeatable process. Our pursuit of compelling risk-adjusted return opportunities typically results in asset allocations that differ significantly from broadly followed benchmarks.



Guggenheim Investments

Guggenheim Investments is the global asset management and investment advisory division of Guggenheim Partners, with more than $215 billion[1] in total assets across fixed income, equity, and alternative strategies. We focus on the return and risk needs of insurance companies, corporate and public pension funds, sovereign wealth funds, endowments and foundations, consultants, wealth managers, and high-net-worth investors. Our 290+ investment professionals perform rigorous research to understand market trends and identify undervalued opportunities in areas that are often complex and underfollowed. This approach to investment management has enabled us to deliver innovative strategies providing diversification opportunities and attractive long-term results.

Guggenheim Partners

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