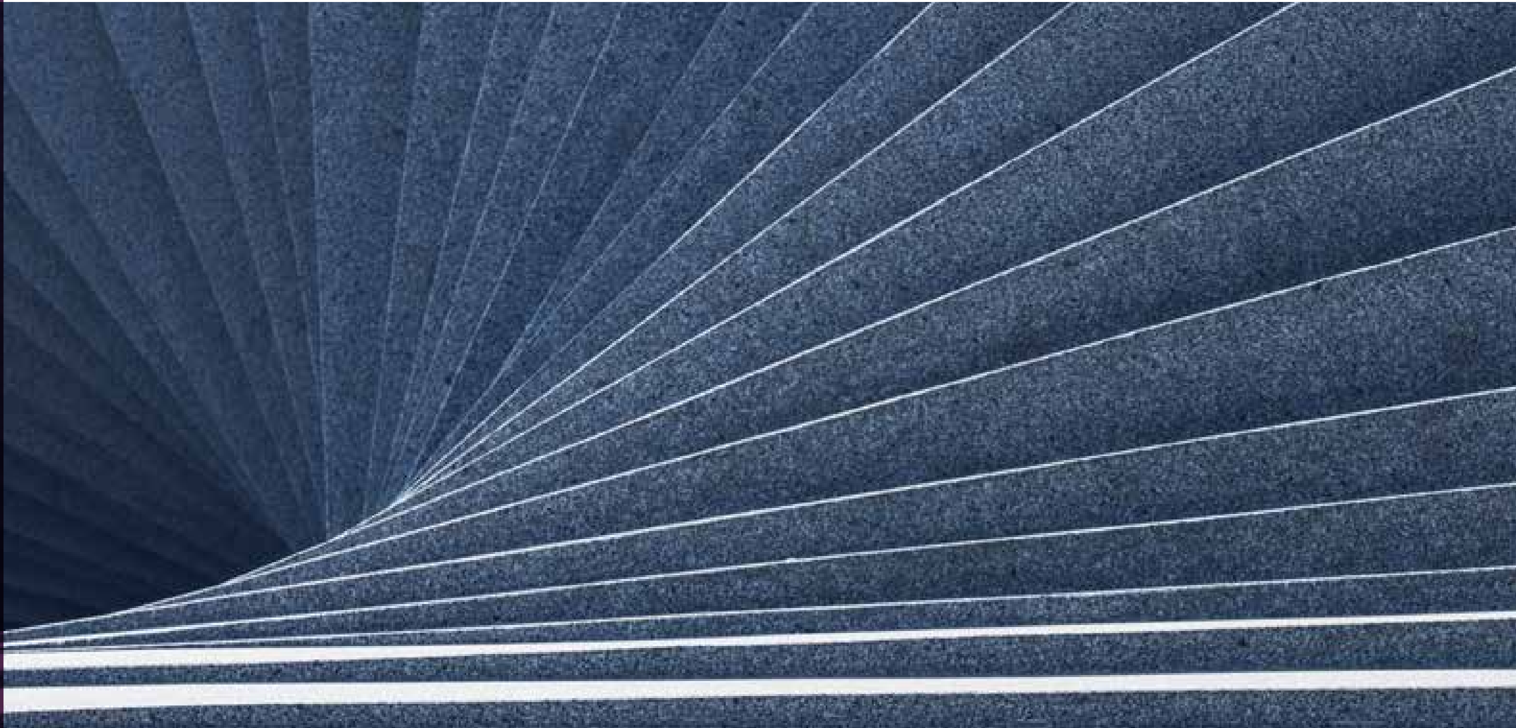
GUGGENHEIM

March 2022

High-Yield and Bank Loan Outlook

Credit Returns in the Upcoming Fed Hiking Cycle



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Summary

While we expect the Federal Reserve (Fed) will begin an interest rate hiking cycle in March 2022, there may be little reason for concern for leveraged credit markets: History shows that credit tends to deliver positive returns in these periods. Corporate debt defaults remain very low and are likely to continue that way, while many issuers have experienced a rating upgrade. Rates rising modestly from current levels are likely to be well tolerated, but investors should set leveraged credit return expectations accordingly following two years of strong performance. History can offer some guidance.

It may surprise those who pulled $15 billion from high-yield bond mutual funds to pour $33 billion into bank loan mutual funds last year that, in fact, corporates outperformed similarly rated bank loans in the two most recent Fed tightening cycles. Realized spread compression is a key reason for this relative outperformance. The recent backup in credit spreads has now added some upside to corporate bond returns that evens the positive return potential between bank loans and high-yield corporates, but we continue to slightly favor bank loans given an expected step up in coupons and virtually no duration exposure if Treasury yields rise more than we expect.

Highlights from the Report

- Given broadening price pressures in the economy, there is growing urgency for the Fed to begin a rate hiking cycle in 2022 and shrink the size of their balance sheet. This report explores the performance of leverage credit in past tightening episodes and what we expect in this cycle.
- History shows that high-yield corporate bonds have outperformed loans in recent tightening cycles due primarily to spread compression. While it seemed unlikely that this would be the case in this tightening cycle with spreads near historical tights at the end of 2021, the recent spread widening in January 2022 added upside return potential for corporate bonds. This evens the return profile even with the corporate bond market's duration exposure.
- Rating upgrades present an interesting value proposition in both sectors corporates to capture spread tightening and improve the average quality of a credit portfolio. 2021 data show that the market does not always price in an expected upgrade.
- We slightly favor bank loans primarily due to their low duration profile and wider discount margins that leave more room for spread compression.

Leveraged Credit Scorecard
As of 12.31.2021

High-Yield Bonds

	December 2020		October 2021		November 2021		December 2021	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	390	4.2%	335	4.3%	386	4.8%	330	4.3%
BB	281	3.2%	235	3.4%	280	3.9%	231	3.4%
B	422	4.5%	389	4.7%	438	5.3%	376	4.7%
CCC	804	8.3%	666	7.5%	740	8.3%	690	7.8%

Bank Loans

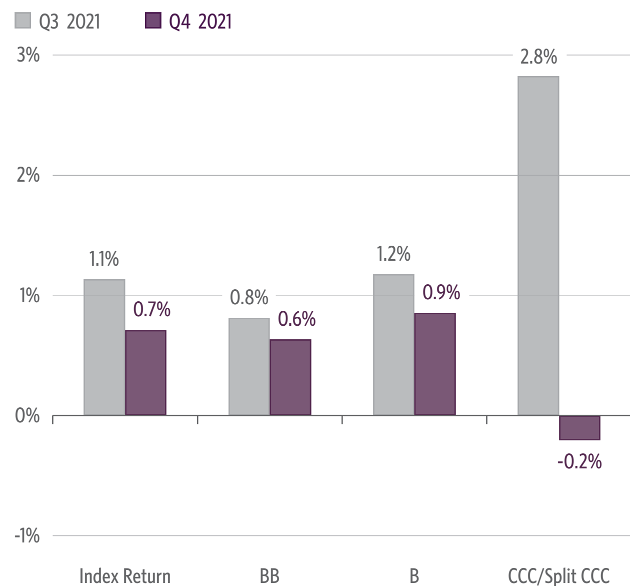
	December 2020		October 2021		November 2021		December 2021	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	486	95.73	440	98.53	451	98.06	439	98.39
BB	305	98.88	303	99.50	317	99.09	307	99.42
B	469	98.55	444	99.34	457	98.86	444	99.15
CCC/Split CCC	1,167	84.28	923	91.10	971	89.93	945	90.61

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 12.31.2021. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 12.31.2021. Past performance does not guarantee future results.

Macroeconomic Overview

Marching into the Inflation Battlezone

> “There is no reason to believe that inflation is embedded in the economy at this point, or we’re heading toward a bear market for bonds.
>
> – Scott Minerd, *Chairman of Investments and Global Chief Investment Officer*

Like wide lapels and avocado-green refrigerators, the word “inflation” is redolent of the 1970s. But while the tools likely to be used to combat surging prices are the same as those of nearly a half-century ago—namely, tighter monetary policy—today’s price pressures have different origins. A good deal of recent price pressures are likely to ultimately prove transitory, such as those caused by supply-chain issues, but this will now make little difference to the view that the next Fed hiking cycle will begin this year, 2022.

The current inflationary wave springs from the early days of the COVID pandemic when production lockdowns in Asia caused disruptions in the global supply chain. With orders drying up, makers of essential components such as semiconductor chips ceased production. Meanwhile, just as the flow of goods to Western markets was slowing, consumer demand for physical products increased as government-provided income-replacement programs went into effect, diverting spending from services such as travel and out-of-home dining that became unavailable due to the pandemic.

While pandemic shutdowns initially drove up unemployment, the easing of restrictions and reopening of the economy fueled labor demand faster than workers were willing to return, leaving employers scrambling. Nothing has been more emblematic of the consequences of the situation than the conga-line of cargo ships awaiting slots to unload at U.S. ports. Particularly on the West Coast, port facilities are inundated with containers because there aren’t enough truckers to move the goods nor workers at warehouses to store them. Now, Russia’s invasion of Ukraine threatens to prolong these supply chain issues.

Worker shortages have raised the cost of labor to the highest level since 2001, based on the year-over-year increase in the fourth quarter reading of the Bureau of Labor Statistics’ Employment Cost Index. Higher wages, as well as shortages of building supplies and low mortgage rates, have pushed up the price of new and existing housing and spilled over into rental prices, major components of the cost of living. These forces, as well as higher commodity prices, have contributed to higher prices for consumers. By the Fed’s preferred measure of inflation—the personal consumption expenditures price deflator—core prices rose 4.9 percent in December on a year-over-year basis, the fastest rate since 1983.

While we see signs that port congestion is easing and materials shortages are improving, the broadening of price pressures to the services sector has forced the Fed to pivot away from its position that recent inflation is entirely transitory. At its December meeting, the central bank accelerated its schedule for tapering asset purchases, and effectively opened the door for rate hikes to begin as soon

as March 2022. In doing so, the Fed is aiming to keep inflation expectations from becoming unanchored, especially in light of the Russia/Ukraine conflict that has pushed commodity prices much higher. The pivot toward tighter policy may already be paying dividends, as the New York Fed's January Survey of Consumer Expectations showed a 50 basis-point decline in three-year ahead inflation expectations, putting expected price growth at a level more consistent with the Fed's target of 2 percent.

While the situation in Ukraine remains a wildcard, we now expect the Fed will hike by at least four times this year, with the risk of larger or more frequent hikes if the inflation data continues to run hot. A big topic of debate is the central bank balance sheet, which we expect the Fed will begin shrinking by July of this year, if not sooner. The pace of runoff should be materially faster than in the last cycle given the relative size and the degree of economic overheating, which introduces an element of uncertainty around the expected impact of Fed tightening on growth and interest rates.

While the monetary policy backdrop will shift meaningfully in 2022, some strong tailwinds to growth remain. Consumption will benefit from the surge in household net worth and accumulated consumer savings over $2.4 trillion in excess of the pre-COVID pace of saving, helping to cushion the impact of fading fiscal support. Growth should get a further boost from rising business investment, as inventories are replenished from very low levels and capital expenditures increase amid a tight labor market. Although the compressed timeline of accommodative policy withdrawal presents uncertainties, the analysis in this report shows that the economic backdrop against which the Fed is tightening policy typically favors risk assets.

Leveraged Credit Returns During Tightening Cycles

With the Fed likely to hike rates in 2022 for the first time since 2018, a review of the performance of the leveraged credit market during previous tightening cycles, combined with an assessment of credit conditions today, are key elements of the sector outlook for the next 12 months. The available history of returns gives us the opportunity to examine performance over the last four hiking cycles. Each cycle has been different, but all inform our view on the factors that are going to influence returns while the Fed is tightening; namely the likely path for benchmark rate changes, spread changes, and default activity.

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Duration Risk and Spread Compression Are Key Drivers as Rates Rise

	Approximate Return Attribution, Annualized				
	Income Factor	Duration Factor	Spread Factors	Credit Losses	Sum of Factors
1994 - 1995 Fed Tightening Cycle					
High Yield Corporates	10.17%	-5.88%	0.00%	-1.58%	2.71%
Bank Loans	6.70%	-	0.95%	-0.65%	7.01%
1999 - 2000 Fed Tightening Cycle					
High Yield Corporates	11.37%	-1.87%	-10.13%	-3.96%	-4.59%
Bank Loans	8.16%	-	-1.74%	-1.89%	4.53%
2004 - 2007 Fed Tightening Cycle					
High Yield Corporates	7.64%	-1.64%	1.15%	-1.14%	6.01%
Bank Loans	5.73%	-	0.41%	-0.45%	5.69%
2015 - 2019 Fed Hiking Cycle					
High Yield Corporates	6.44%	-0.77%	2.41%	-2.06%	6.02%
Bank Loans	5.03%	-	0.99%	-0.48%	5.53%
Next Hiking Cycle, modeled					
High Yield Corporates	5.27%	-1.01%	2.21%	-1.38%	5.10%
Bank Loans	4.84%	-	1.86%	-0.63%	6.07%

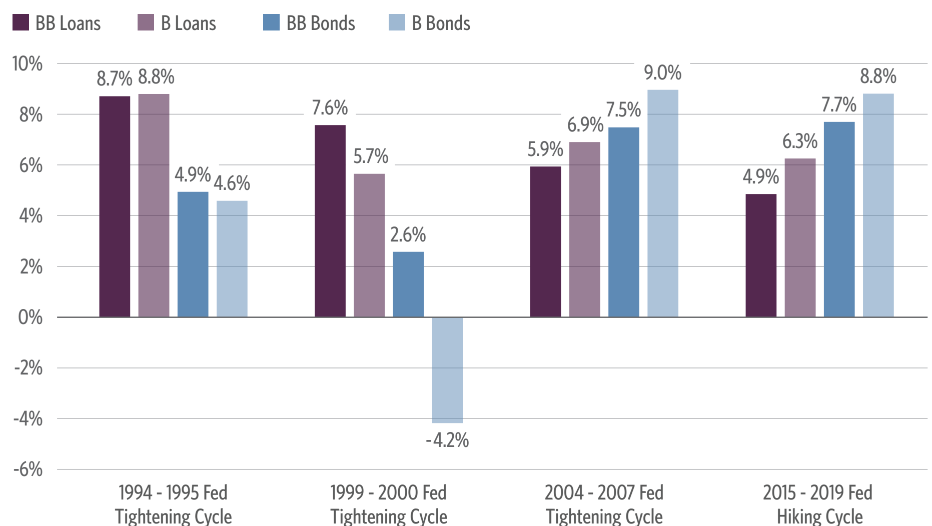
Source: Differences in each sector's rating profile are not controlled for in this analysis. Table is for illustrative purposes to show how key factors may have affected performance in previous tightening cycles. Duration factor for high-yield corporates is based on the product of the change in 5-year Treasury yields and the index modified duration. Spread factors are based on the product of the change in credit spreads and the index spread duration. Credit losses are based on the average default rate during the tightening cycle, net of a 45% recovery rate assumption for corporates and 70% recovery rate assumption for bank loans. Other factors not shown here include index turnover, refinancing activity, roll-down effect, and factors due to approximating index characteristics, which can also affect total returns.

Beginning with the hiking cycle that lasted from 1994 through mid-1995, bank loans outperformed high yield corporates as duration exposure drastically weighed on the returns of the latter. BB-rated loans and B-rated loans delivered annualized returns of 8.7 percent and 8.8 percent, compared to 4.9 percent and

High-yield corporate bonds have outperformed similarly rated bank loans in the two most recent Fed tightening cycles. Realized spread compression is a key reason for this relative outperformance.

Bonds Outperformed in the Last Hiking Cycle

Annualized Total Return During Hiking Cycles



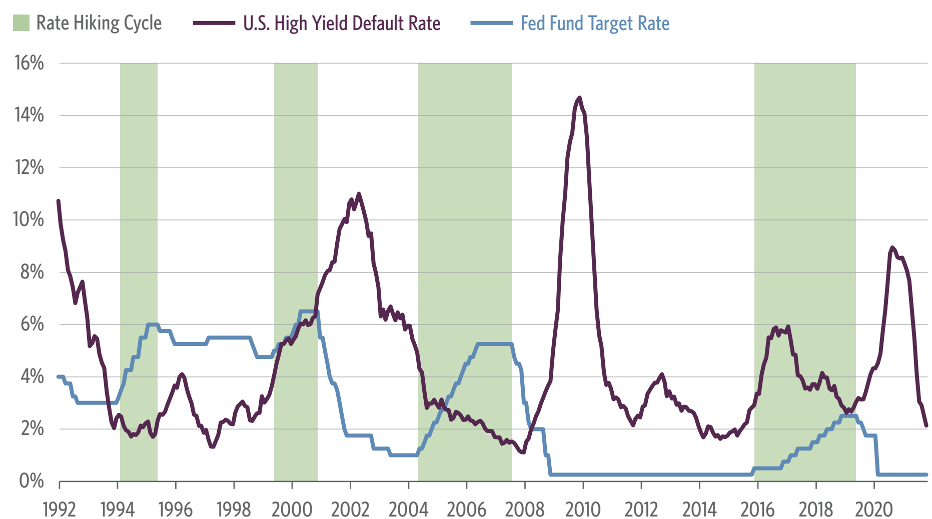
Source: Guggenheim Investments, Credit Suisse, Bloomberg. Data as of 12.23.2021

4.6 percent for BB-rated and B-rated corporates, respectively. The seven-year Treasury yield rose by 137 basis points in this cycle, measured from two months before the first rate hike until two months before the first rate cut. However, strong corporate profit growth resulted in low default rates, and spreads remained near 330 basis points. High-yield coupons of 11 percent offered some cushion for duration risk, leading to positive returns in corporates, but bank loans had the benefit of spread tightening, rising coupons and no duration exposure.

After several mid-cycle rate cuts that avoided a recession in the mid-1990s, the next hiking cycle began in 1999. This time the gap between loan and bond returns was wider, with annualized returns of 7.6 percent in BB-rated loans and 5.7 percent in B-rated loans, versus 2.6 percent for BB-rated bonds and a loss of 4.2 percent for B-rated bonds. The big detractor to performance was actually spread widening, as this is the only cycle in the last four where the default rate increased, causing spreads to widen by 132 basis points. The Fed's rate hikes brought about an 87 basis-point increase in seven-year Treasury yields which also weighed on corporate bond returns.

A move to higher rates is not necessarily a negative for risk assets and credit, based on history. Rate increases likely will tighten financial conditions, but they are tightening from extremely easy levels.

Fed Tightening Cycle Usually Occurs in Benign Credit Environments



Source: Guggenheim Investments, Moody's Investor Services, S&P Global Ratings, Bloomberg. Data as of 11.30.2021

The 1999–2000 hiking cycle took place during a vulnerable period just after the Asian Financial Crisis, a big collapse in oil prices, and already increasing corporate defaults. Of the few hiking cycles we examine in this report, this cycle may be the least comparable to today, with the key exception that Russia's potential default on sovereign debt could reveal unknown financial market exposures much like they did in 1998. Furthermore, China's strict policies on real estate could lead to a global growth slowdown. This could have similar consequences to the devaluation of the Thai baht that had ripple effects from 1997 through 1999.

This brings us to the hiking cycles in which high-yield corporate bonds have outperformed loans on a total return basis, those beginning in 2004 and 2015. Corporate bond spreads tightened more than similarly-rated bank loans in these periods, which we estimate added an average of 180 basis points annualized to corporate bond returns compared to an average of just 70 basis points annualized for bank loans. Bank loans price gains are effectively capped by greater refinancing risk than corporates.

Given the dichotomous view that history offers on the relative bond-vs-loan performance during hiking cycles, it is challenging to pin down a high-conviction conclusion as the Fed gears up to tighten policy again. On the one hand, refinancing risk looms over the loan market, limiting return upside, which would argue in favor of fixed-rate corporates over loans. Furthermore, the recent widening in credit spreads has added some cushion. High-yield corporate bond spreads of 367 basis points are still 113 basis points tighter than where they were at the start of previous rate hikes, but if spreads tighten by 100 basis points between now and the last rate hike, which history shows there is potential for, this could add 4 percentage points in cumulative returns on top of current yields of 5.3 percent.

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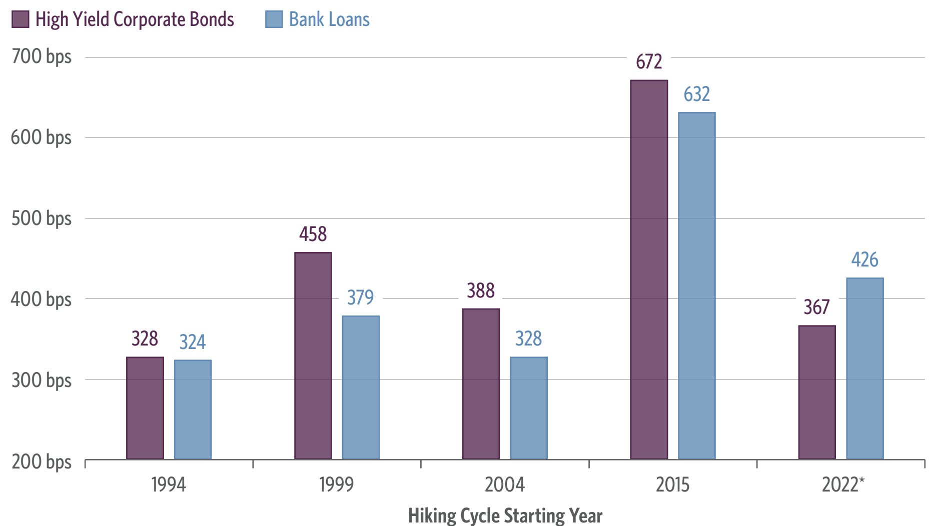
Bonds Spreads Are Tighter in This Hiking Cycle

Spreads at the Start of Past Hiking Cycles



Source: Guggenheim Investments, Bloomberg, Credit Suisse. *Based on spreads as of 2.17.2022.

If defaults stay low and spreads remain tight, as we expect they will, the wildcard for fixed-rate corporates will be duration risk, similar to the 1990s hiking cycles when it weighed on performance. How much interest rates are likely to rise from here depends on a variety of factors, but our estimate is that rates will peak around 2–2.25 percent. This implies about 30–55 basis point cumulative upside

for the belly of the curve (five- and seven-year Treasury yields), resulting in 1.5–2.5 percent cumulative negative contribution to total return. It would partially offset the return boost from our assumed spread tightening path.

Duration is a risk that the bank loan market does not face directly. The floating-rate coupon on bank loans should rise in tandem with the general movement of short-term interest rates and cushion their performance. That should result in less volatility in bank loans. And there is room for price upside with the average bank loan currently trading at a price of 98 percent of par. With bank loan coupons starting off at 4.5 percent, rate hikes ahead, and a positive credit outlook, the return prospects for loans look slightly more attractive.

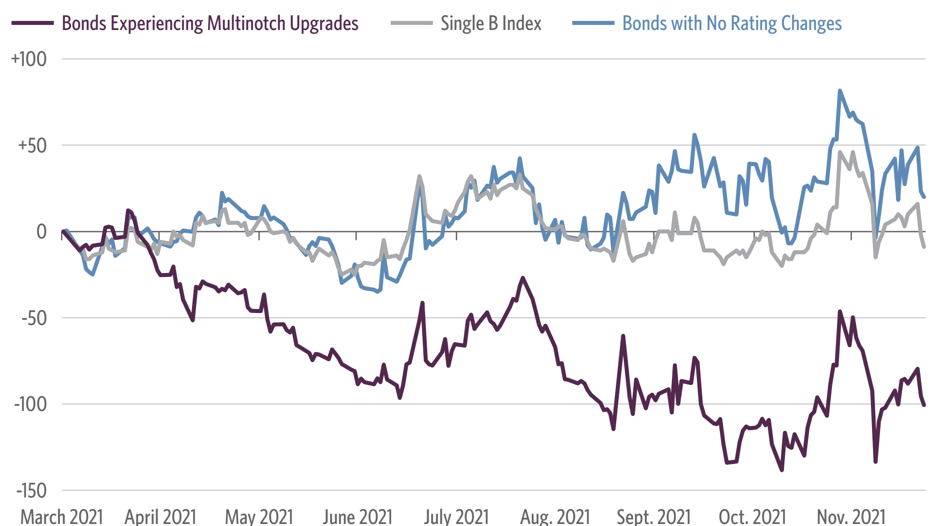
In both sectors, the environment provides opportunities for the credit savvy. One of those is riding the escalator of credit upgrades, which still presents spread tightening opportunity. Over the last six months, 14 percent of the ICE BofA High Yield Index has seen at least one notch upgrade, versus only 5 percent that have experienced a credit rating downgrade. In loans, 7 percent of the S&P / LSTA Leveraged Loan index has seen at least one notch upgrade versus only 4 percent experiencing downgrades.

Many bonds experienced multi-notch rating changes in 2021 alone, and our review of those bonds showed that their potential for a rating upgrade was not always priced in. Based on a pool of B-rated bonds that were upgraded multiple times in 2021, spreads tightened by 100 basis points more compared to bonds that saw no rating change over the same period.

Many bonds experienced multi-notch rating changes in 2021 alone, and our review of those bonds showed that their potential for a rating upgrade was not always priced in.

Potential for Credit Rating Upgrades Give Room for Spread Compression

Cumulative Spread Change for B-rated Bonds With vs. Without Rating Changes



Source: Guggenheim Investments, ICE Index Services, Bloomberg. Data as of 12.23.2021. Based on a sample of 12 index-eligible B-rated bonds that experienced muti-notch credit rating upgrades versus 12 index-eligible B-rated bonds that saw no rating change between Q1 2021 and Q4 2021.

Investment Implications

Credit investors need not fear a Fed tightening cycle, since rate hikes typically occur when growth is strong and defaults are low. The one exception was the late 1990s, but based on the Treasury yield curve signal, that cycle was far more advanced and vulnerable than the current environment. Even then, bank loans performed well despite some spread widening.

We believe leveraged credit continues to offer an attractive opportunity for fixed-income portfolios as the Fed is only about to begin withdrawing monetary policy accommodation. Both sectors carry features that can support returns as the Fed is raising interest rates, namely spread compression in high-yield corporates and floating coupons in bank loans.

As we think about key features of the current environment to factor into our forward-looking views, COVID variants and supply-chain problems still cloud the macro outlook. But double-digit earnings growth in both high-yield corporates and bank loans, coupled with low borrowing costs, currently mitigate the consequences of short-term growth setbacks on credit worthiness. More prolonged setbacks would likely keep the Fed from raising interest rates and tightening financial conditions too quickly.

The tightening periods studied in our report include only those months in which rate hikes took place and the period in which the Fed was on hold just before cutting rates. Therefore, capturing the performance that typically occurs in periods we have defined as “rate hiking cycles” will necessitate accurately forecasting when the tightening cycle is coming to an end. Proprietary indicators developed by our Macroeconomic and Investment Research Group suggest we are likely a couple of years away from a downturn that would prompt the Fed to begin a rate cutting 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 High-Yield Index** is a commonly used benchmark index for high-yield corporate bonds.

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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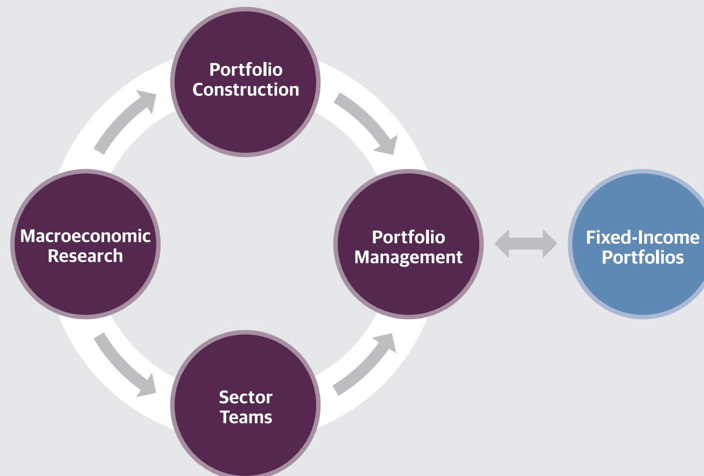

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