GUGGENHEIM

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High-Yield and Bank Loan Outlook

Higher-Quality Leveraged Credit Should Benefit from Fed Easing Cycle

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Summary

Following a year marked by increasing pressure placed on borrowers by the effects of tight monetary policy, the Federal Reserve's (Fed) December meeting may mark a pivotal moment for credit markets in 2024. Since holding rates steady from July, the Fed acknowledged that future rate cuts are now being discussed, and the Summary of Economic Projections (SEP) revealed expectations of more easing. This represents a notable departure from the Fed's earlier policy approach.

The leveraged credit markets—high-yield bonds and bank loans—delivered strong returns in 2023. This success, however, masked underlying challenges: rising defaults, weakening credit ratings, decelerating corporate earnings growth, and declining interest coverage ratios. The Fed's policy adjustment could positively alter the course for many companies, particularly those with moderate leverage ratios and robust cash flow cushions to cover interest expense, but the cumulative effect of higher interest rates and the disproportionate impact on smaller companies warrants close attention. Our analysis suggests that higher-quality bank loan and corporate bond markets are well positioned to navigate this transition.

Highlights from the Report

- The Fed's December meeting marked a significant policy shift, indicating potential rate cuts and a dovish stance in response to softening inflation. This led to a broad market rally, an easing in financial conditions, and a slight decline in recession probability over the next 12 months.
- Credit fundamentals worsened in 2023, with increased defaults and negative credit rating migrations, but the economic environment is shaping up to be more favorable for credit in 2024 given the expected start of an easing cycle ahead, although some borrowers are still adjusting to the higher rate environment.
- We are monitoring a growing bifurcation between large and small companies. However, with interest rates likely falling from here and larger firms better positioned to benefit from market conditions, we think 2024 should prove to be a good time to be a credit investor.

Leveraged Credit Scorecard

As of 12.31.2023

High-Yield Bonds

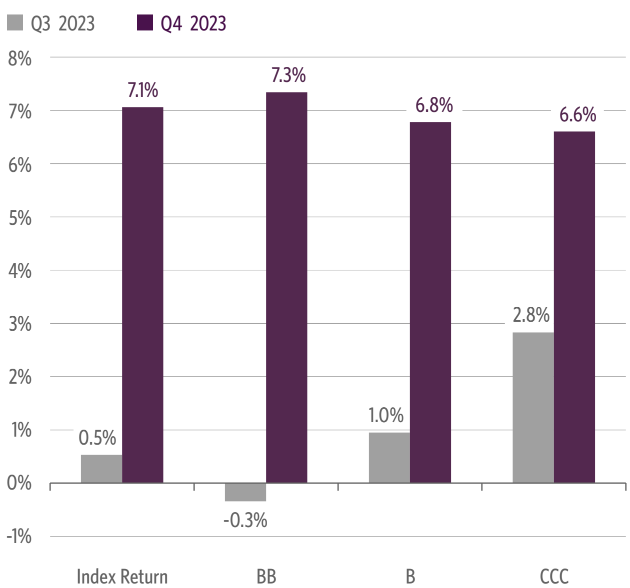
	December 2022		October 2023		November 2023		December 2023	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	491	9.0%	452	9.5%	402	8.5%	363	7.7%
BB	320	7.3%	301	8.0%	255	7.0%	235	6.4%
B	526	9.3%	478	9.7%	416	8.6%	367	7.8%
CCC	1,159	15.9%	1,055	15.5%	986	14.4%	889	13.0%

Bank Loans

	December 2022		October 2023		November 2023		December 2023	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	652	91.89	578	94.12	558	94.52	528	95.32
BB	363	97.64	351	98.70	332	99.13	315	99.62
B	691	92.25	561	96.16	534	96.84	496	97.90
CCC/Split CCC	1,605	74.35	1,435	78.33	1,445	78.06	1,378	79.36

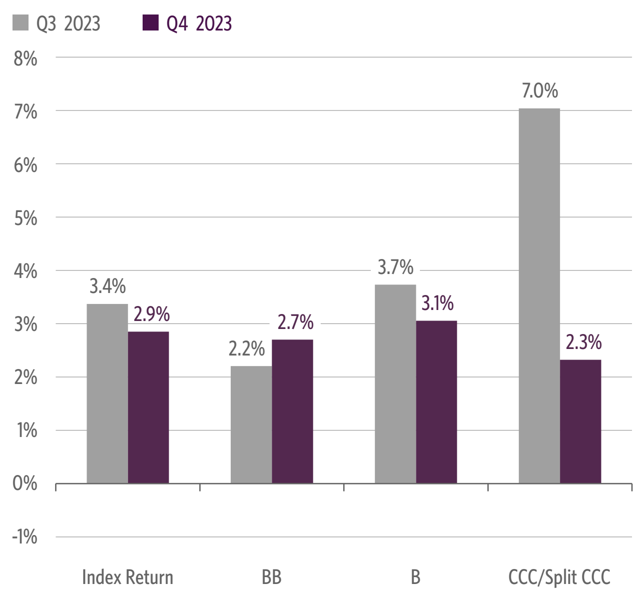
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE BofA High-Yield Index Returns



Source: ICE BofA. Data as of 12.31.2023. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



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Macroeconomic Overview

The Fed Starts Singing a Different Tune

The Fed underwent a noteworthy shift in its stance during the December Federal Open Market Committee (FOMC) meeting compared to what it had been signaling all year. At the post-meeting press conference, Fed Chair Jerome Powell, who had been reluctant to address the possibility of rate cuts all year, acknowledged that the committee had started to discuss this topic. The SEP also revealed an important change: The median FOMC participant now foresees a 75 basis point reduction in the fed funds target rate to 4.6 percent in 2024, and an additional 100 basis points in 2025, bringing the fed funds target rate to 3.6 percent in a couple of years. These projections assume no recession and only a slight uptick in the unemployment rate, reflecting the Fed’s optimism about achieving a soft landing.

The driving force behind the Fed’s pivot is the softening in inflation. The core personal consumption expenditures price index (PCE) has fallen to a 3.2 percent year-over-year rate as of November, but three- and six-month annualized rates are already at or below the Fed’s 2 percent target. With the fed funds target rate still fluctuating between 5.25 percent and 5.5 percent, current interest rates are becoming increasingly restrictive with inflation falling, something that the Fed must take into account. The real fed funds rate, calculated as the difference between fed funds and trailing core inflation, stands at over 2 percent, significantly higher than the 10-year average of -1 percent. So, despite the Fed’s median projections in the December SEP, it anticipates maintaining a restrictive stance in the coming year.

The market responded enthusiastically to the Fed’s dovish pivot, resulting in an “everything rally” in the fourth quarter. Short- and long-duration Treasury securities, small- and large-cap equities, investment-grade and high-yield bonds, commodities such as gold and copper, leveraged loans, and emerging markets, all saw meaningful gains. Interest rates declined across the board, with 10-year Treasury yields falling to 3.90 percent from a recent peak just below 5 percent in October.

While we believe it will be appropriate to deliver rate cuts next year to accommodate falling inflation, the Fed’s dovish messaging and its strong dependence on supply-side improvements raise concerns. The Fed’s indifference to the substantial easing in financial conditions that have unfolded since October implies that it believes these supply improvements are sufficient to offset any inflationary effects from a pickup in demand. Its own measure of financial conditions, which does not show the same easing by virtue of its longer lookback, may also be giving the Fed reason to look past recent market dynamics. But in our view, while the Fed’s change in tune reduces the risk of a recession, it also raises the likelihood of a potential resurgence in inflation.

Furthermore, while a soft landing would be a welcome development for markets, it remains prudent to keep an eye on headwinds, such as rising geopolitical tensions, a U.S. presidential election, the shrinking central bank balance sheet that is pulling liquidity from the market, the slow-moving deterioration in the commercial real estate market, rising loan and credit card delinquencies, and the accelerating pace of commercial and personal bankruptcies. The current market backdrop does not feel like a soft landing for many corners of the financial landscape.

Investors should bear in mind the cumulative impact of the change in interest rates since the Fed started tightening. Even if rates fall from here, we do not see them returning to the lows of the prior cycle. There are borrowers who relied on the low-rate environment that persisted after the Global Financial Crisis. The market's exuberant response must be balanced against downside risks posed by this reality on small businesses, lower-income households, and rate-sensitive sectors such as housing. Staying attuned to these shifts and their implications will be essential for informed decision making.

A Year of Strong Returns for Leveraged Credit

High-yield corporate bonds returned 13.5 percent and bank loans returned 13 percent, the strongest results since 2019 for bonds and since 2009 for loans. High-yield bond credit spreads narrowed to just 363 basis points by year-end, the tightest since April 2022, marking a significant reduction from 491 basis points at the beginning of the year. Leveraged loan discount margins tightened from 652 basis points to 528 basis points, but 44 percent of the loan index is trading at spreads below 400 basis points and the median loan ended the year at 464 basis points, highlighting both the impact of the tail skewing the index measure wider and the importance of a strategy that can narrow in on well-performing credits.

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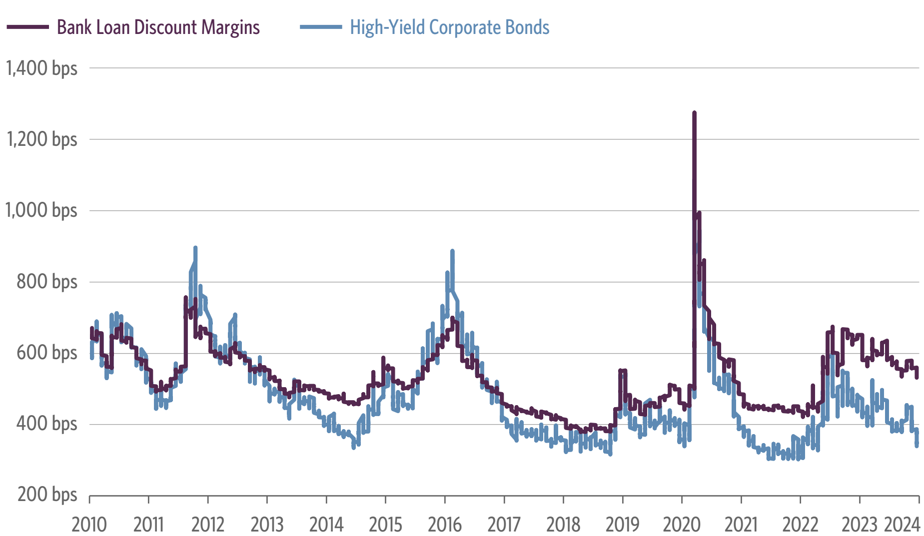
Credit Spreads Close 2023 Near Two-Year Tights



Source: Guggenheim Investments, ICE BofA, Credit Suisse. Data as of 12.31.2023.

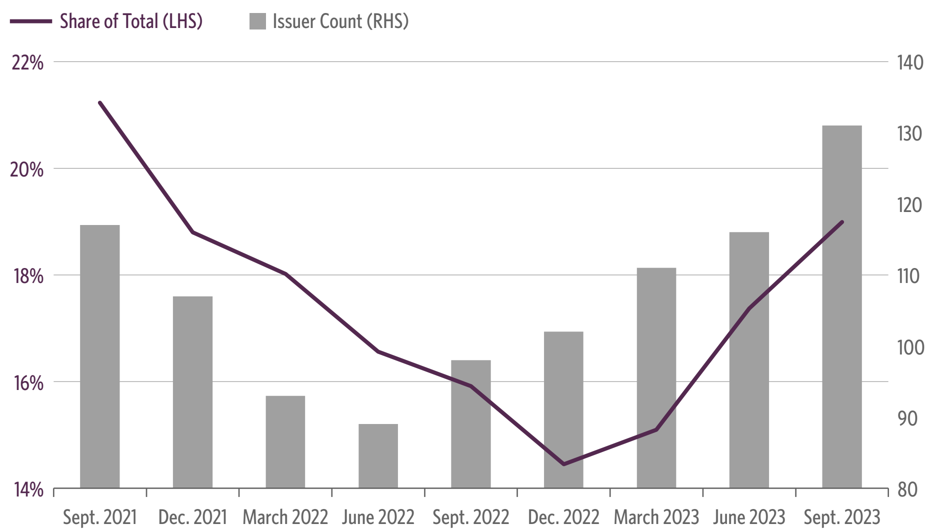
While market performance displayed strength, several of the less optimistic fundamental themes we outlined in our initial outlook materialized. Rating migration was negative, defaults increased, corporate earnings growth slowed materially, and certain credit ratios deteriorated.

Our initial outlook for 2023 was that an optimistic outcome for the year would be a 0 percent increase in annual earnings before interest, tax, depreciation, and amortization (EBITDA) for both high-yield bond and institutional loan issuers. Our base case assumed a 10 percent contraction predicated on a recession. A recession did not materialize so our forecast was too pessimistic, but EBITDA growth decelerated significantly from 21 percent on a trailing 12-month basis to a modest 7 percent by year-end through the third quarter of 2023 (with fourth quarter data pending publication at the time of this report). For loan borrowers, EBITDA growth slowed to just 2 percent.

Our primary concern regarding the corporate earnings outlook centered on its impact on credit fundamentals, with a focus on interest coverage ratios and leverage, topics we have explored in recent reports. We judge these metrics as healthy at an aggregate level, but rising interest rates and expenses due to inflation have taken their toll. Interest coverage declined to 3.8x from a high of 4.5x in the second quarter of 2022. Furthermore, the share of issuers with less than 2x interest coverage has increased to 19 percent of over 600 issuers as of the third quarter of 2023. This trend of growing stresses in the margins of the credit landscape will be an increasingly important theme as we seek to identify the best opportunities in credit over the coming easing cycle.

The share of issuers with less than 2x interest coverage stands at 19 percent of over 600 issuers as of the third quarter of 2023, having risen steadily each quarter in 2023.

Issuers with Less than 2x Interest Coverage



Source: Guggenheim Investments, S&P CapIQ. Data as of 9.30.2023. Interest coverage is defined as trailing 12-month earnings before interest, taxes, depreciation, and amortization (EBITDA) divided by 12-month interest expense.

The trend of negative rating migration affected the leveraged loan market most due to its sensitivity to interest rates and already elevated leverage ratios compared to the high-yield corporate bond market. In the high-yield corporate bond market there were 1.2x as many downgraded issuers as upgraded, an increase from 0.9x in 2022, according to ICE BofA. Downgrades in the loan market were more than double upgrades, according to Pitchbook, a deterioration from 2022 when the downgrade to upgrade ratio was 1.7x. While this ratio showed signs of improvement around the middle of the year, the three-month pace showed an acceleration in downgrades combined with a deceleration in upgrades, bringing the downgrade to upgrade ratio to 2.4x in the final quarter.

Finally, we argued that given our recession view, leveraged loan discount margins could widen to 900–950 basis points in an adverse environment and that high yield spreads could peak around 750 basis points. The only truly adverse period occurred in the first half of the year around the regional banking turmoil, but spreads peaked 200–300 basis points lower than those levels. Once again, while the market-related view did not materialize, the fundamental outcome was in line with our view. We forecasted a 3.5 percent leveraged credit default rate, which was close to most calculations. The table below illustrates the calculations by Moody's and S&P Ratings. Although default rates increased from very low levels in 2022, they remain below historical average. The recent easing in financial conditions, which will help drive capital market and lending activity, suggests that the pace could plateau from here for at least the next quarter or two.

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Actual LTM U.S. Default Rates

	Issuer	Par
All U.S. Speculative Grade		
Moody's*	4.9%	4.3%
S&P	4.0%	3.4%
Average	**4.4%**	**3.9%**

Source: Guggenheim Investments, Moody's, S&P Creditpro. Data as of 11.30.2023. LTM = last 12 months. * Includes distressed exchanges.

Peeling Back the Layers of the Bifurcation Theme

As we look ahead, the most obvious shift in the macroeconomic landscape could be the start of the next easing cycle, which the market is currently pricing to start in March. This has led to some decline in longer-term interest rates already. These anticipatory market moves have resulted in a tug-of-war between two influential interest rate forces, one in which the level of interest rates is still punitive for credit as borrowers who relied on a 0 percent interest-rate policy continue to adjust to a higher-rate environment, and another in which the recent change in interest rates will provide relief for well-positioned borrowers. The key will be to identify which borrowers belong in each category.

Upcoming maturities over the next two years in the high-yield market offer a good example of the ongoing adjustment to the interest rate environment even after the recent rate rally. Comparing the current yields on high-yield bonds to their average coupons, issuers would pay about 2.2 percentage points more if they had to refinance 2024 and 2025 maturities today. It is possible that the start of a Fed easing cycle will lower yields further to bring them closer to current coupon rates, but our base case is that spreads will be somewhat wider by year-end given that the market is underappreciating still-elevated recession risks. This would mean that all-in yields could be unchanged or even higher by the time borrowers have to address these needs.

If we assume that over the year corporate bond yields will remain unchanged, the high-yield corporate bond market is generally in a good position to refinance upcoming maturities, primarily because BB-rated issuers represent 74 percent of 2024 maturities and 45 percent of 2025 maturities. This group is starting off with robust interest coverage ratios of over 5x, and we calculate that the negative impact from refinancing at current rates is less than 0.5x for BB-rated borrowers.

However, for lower-rated B and CCC-rated issuers with upcoming maturities, their starting points of interest coverage, which are closer to 2.5x and 1.7x, respectively, indicate that absorbing current market rates is very challenging. They represent only $5.7 billion of 2024 maturities, making the rollover need less imminent, but they will eventually have to address over $80 billion coming due in 2025. They require yields to decline even further to bring them closer to coupon rates, or we will likely continue to see an elevated pace of distressed exchanges.

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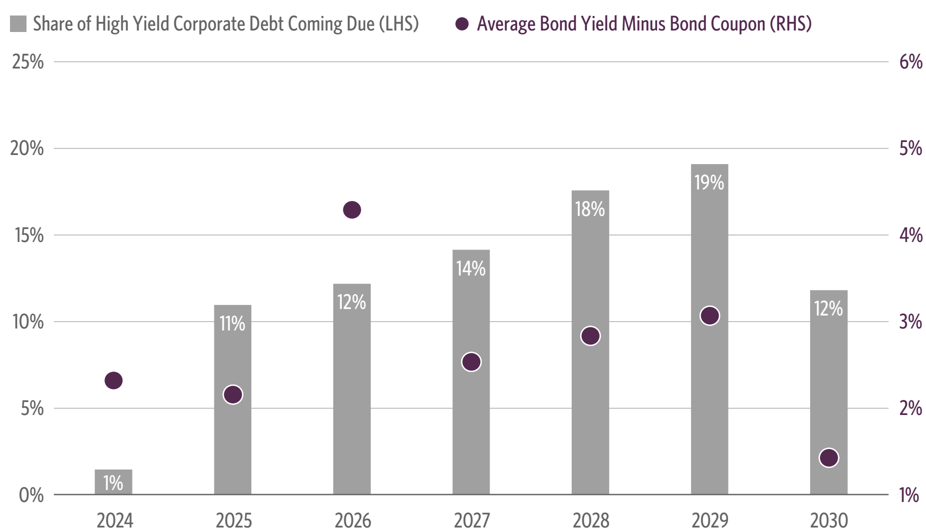
Upcoming High-Yield Maturity Schedule Appears Manageable



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2023.

To the extent that an easing cycle helps alleviate cash flow pressures in leveraged credit, the positive impact on loan borrowers is more direct than in the high-yield bond market. At a high level, assuming unchanged earnings growth, the median single B loan borrower could see their interest coverage ratio increase from 3.2x to 4.3x if the Fed lowers rates to 4.0 percent by the end of 2024, as is currently anticipated by the market. The wildcard is going to be the path of earnings growth, since recession risks remain. If EBITDA falls by 15 percent, interest coverage sees a smaller boost to 3.7x from the Fed cutting rates. We are careful of making too broad conclusions since less than 15 percent of the loan market is public, but we think it is indicative of the type of opportunity that a Fed easing cycle might create for both private and public borrowers, and by extension for credit investors.

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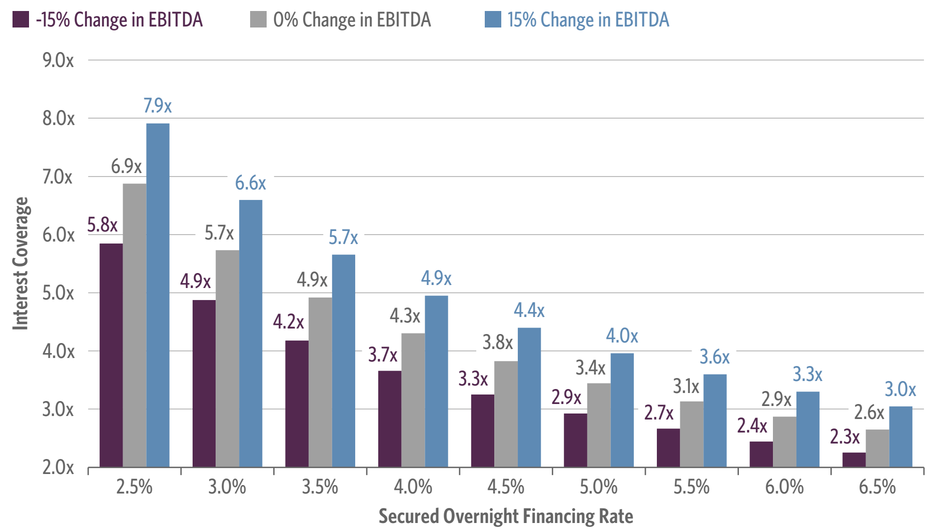
Single B Median Borrower Interest Coverage for Given Coupon Reference Rate

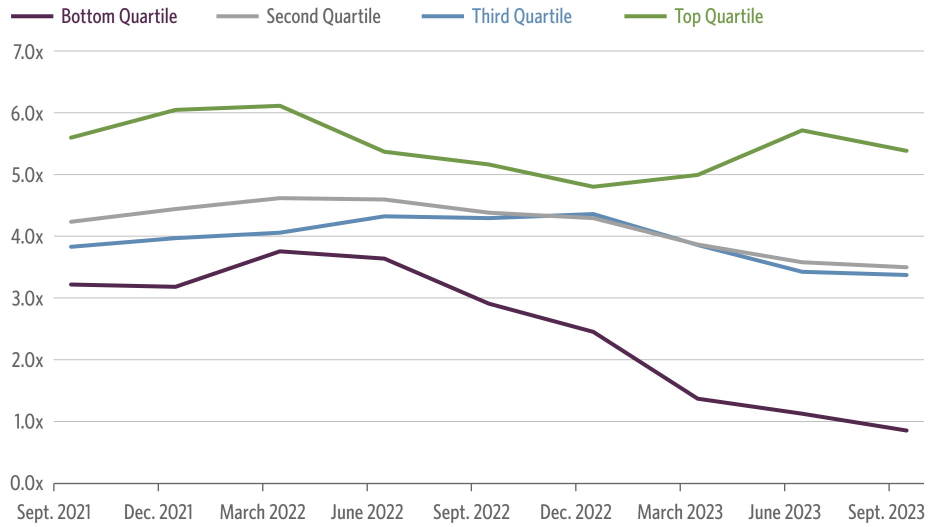


Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2023.

In addition to monitoring the ongoing borrower adjustment to the rate environment, another theme we expect to become more prominent this year is that of a growing bifurcation between large and small companies. An example is that the bottom quartile of leveraged credit issuers by annual EBITDA has seen a decline in aggregate interest coverage to less than 1x as of the third quarter of 2023. Narrowing it down even further to companies with less than $50 million in EBITDA, which represent 43 companies in our universe, interest coverage falls to zero given that more than half of companies in this group have negative EBITDA. This spans a mix of companies engaged in software, healthcare equipment, consumer services, pharmaceuticals, transportation, materials, capital goods, among other industries, and ratings spanning BB to CCC-.

The bottom quartile of leveraged credit issuers by annual EBITDA has seen a decline in aggregate interest coverage to less than 1x as of the third quarter of 2023.

Interest Coverage Falls Below 1x for the Bottom Quartile of Borrowers



Source: Guggenheim Investments, S&P CapIQ, Bloomberg. Data as of 9.20.2023.

On the other hand, companies in the top quartile, which represents more than $765 million in EBITDA, have maintained interest coverage near 5x, while the second and third quartile have also maintained robust coverage of over 3x. Like the bottom quartile, these groups span a broad range of borrowers operating in different industries, and ratings range from BB+ to CCC. But two notable differences between the top and bottom quartile are that the top quartile has more energy and far less tech/software exposure—the latter of which we have long exercised caution in given our view of frothy company valuations. EBITDA margins in the top quartile have also expanded over the last four quarters, while EBITDA margins compressed for the bottom quartile. We believe these observations both highlight how the upper quartiles are in good shape and that there are plenty of opportunities for credit pickers to avoid the riskiest borrowers.

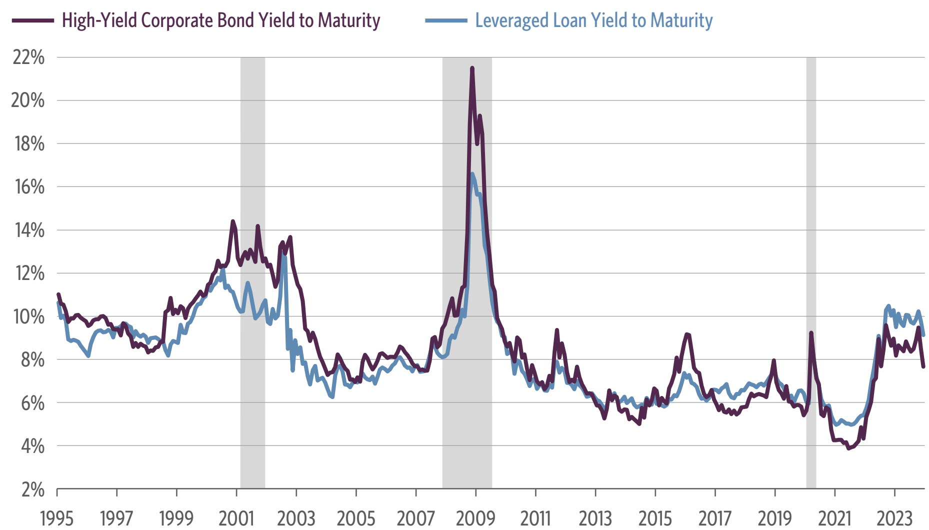
Outside of the leveraged credit universe, we must also consider the spillovers from corners of the economy that are under more substantial pressure due to the current level of interest rates. These include small businesses that do not generally raise financing via bonds, syndicated loans, and private credit. A recent report by the Bank for International Settlements showed that maturities for small companies are much larger than those for large companies when standardized as a ratio to annual revenues. This situation suggests that various sectors and borrowers must still adapt to higher interest rates. While this adjustment does not guarantee a recession, it does increase its likelihood.

Investment Implications: A Good Time to Be a Credit Investor

The primary factor supporting the credit opportunity narrative is the current allure of all-in credit yields. Over the last 15 years, corporate bond and bank loan yields have only reached these high levels during severely adverse market environments, which have also coincided with limited liquidity. In the present environment, investors have the capacity to construct a credit portfolio that captures these yields, potentially securing their advantages for the foreseeable future.

The primary factor supporting the credit opportunity narrative is the current allure of all-in credit yields. In the present environment, investors have the capacity to construct a credit portfolio that captures these yields, potentially securing their advantages for the foreseeable future.

Corporate Credit Yields Look Attractive



Source: Guggenheim Investments, ICE BofA, Credit Suisse. Data as of 12.31.2023. Shaded areas represent recession.

While we are monitoring this theme of the emergence of bifurcation, it is important to note that we do find many opportunities in smaller companies with good fundamentals and healthy balance sheets. In our experience, this cohort often comprises names less covered by other research analysts and therefore offers some of the best relative value opportunities in the credit market. Their spread and yield pickup over larger borrowers typically compensates for credit and liquidity risks. But accounting for bifurcation and idiosyncratic vulnerabilities in the credit selection process will be key this year given that credit spreads are near historically tight levels. Identifying the smaller companies that will weather high interest rates requires many resources, including time and expertise. If investors can successfully avoid certain credit profiles, now is a great time to be buying high quality credit with a shift in monetary policy ahead that will bring yields lower.

Many contradictory macro signals keep us cautious. These include indicators that point to high recession probability (like the yield curve, leading economic indicators, survey data) versus activity measures that suggest strong momentum behind demand. As long-term asset managers, our high-level predictions hold significance in preparing for an expected range of likely outcomes. Positioning that emphasizes quality—whether in documentation and covenants, credit fundamentals, or subordination—is how we continue to tilt our portfolios. Recognizing that many defaults in 2023 were idiosyncratic, continuing to prioritize diversification remains prudent.

Another practical application of our outlook involves a thorough examination of our cyclical exposures, something we will continue to do in 2024. This process helps identify credits situated in cyclical industries but exhibiting non-cyclical behavior due to idiosyncratic factors such as strong market share or contractual arrangements. Additionally, we assess each loan issuer's sensitivity to various short-term interest rate environments as another approach to navigate the landscape shaped by the macroeconomic backdrop.

We expect 2024 will be another year in which downgrades exceed upgrades as interest rates are still elevated compared to 2021 and 2022 levels and, even with some rate cuts by the Fed, the market has to absorb higher rates to some extent. But given what we see in aggregate credit ratios, plus the easing in financial conditions in the back half of 2023 that has a lagged impact on broader activity, we expect the 2024 leveraged credit default rate to be only marginally higher than 2023 (between 4–5 percent). Of course, this could vary greatly across individual ratings.

The end to the Fed's rate hikes should alleviate some of the pressures that were felt by corporate borrowers in 2023. While 2024 will bring its own set of challenges, we think the leveraged credit market is poised to deliver another year of positive returns with the benefit of declining interest rates. However, we will continue to take a nuanced approach in positioning given that risk premiums are pricing in a lot of good news.

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 **ICE BofA U.S. High-Yield Index** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million. In addition, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden.

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 percent.

AAA is the highest possible rating for a bond. Bonds rated **BBB** or higher are considered investment grade. **BB, B, and CCC-rated bonds** are considered below investment grade and carry a higher risk of default, but offer higher return potential. A **split bond** rating occurs when rating agencies differ in their assessment of a bond.

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.

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

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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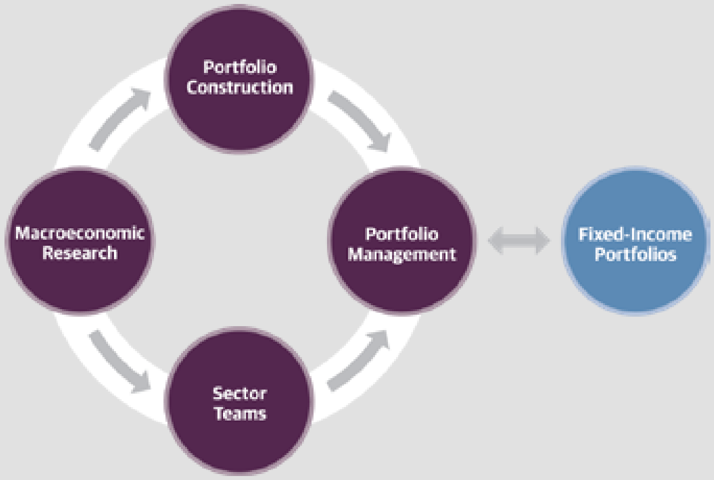
Guggenheim's fixed-income portfolios are managed by a systematic, disciplined investment process designed to mitigate behavioral biases and lead to better decision-making. Our investment process is structured to allow our best research and ideas across specialized teams to be brought together and expressed 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.



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