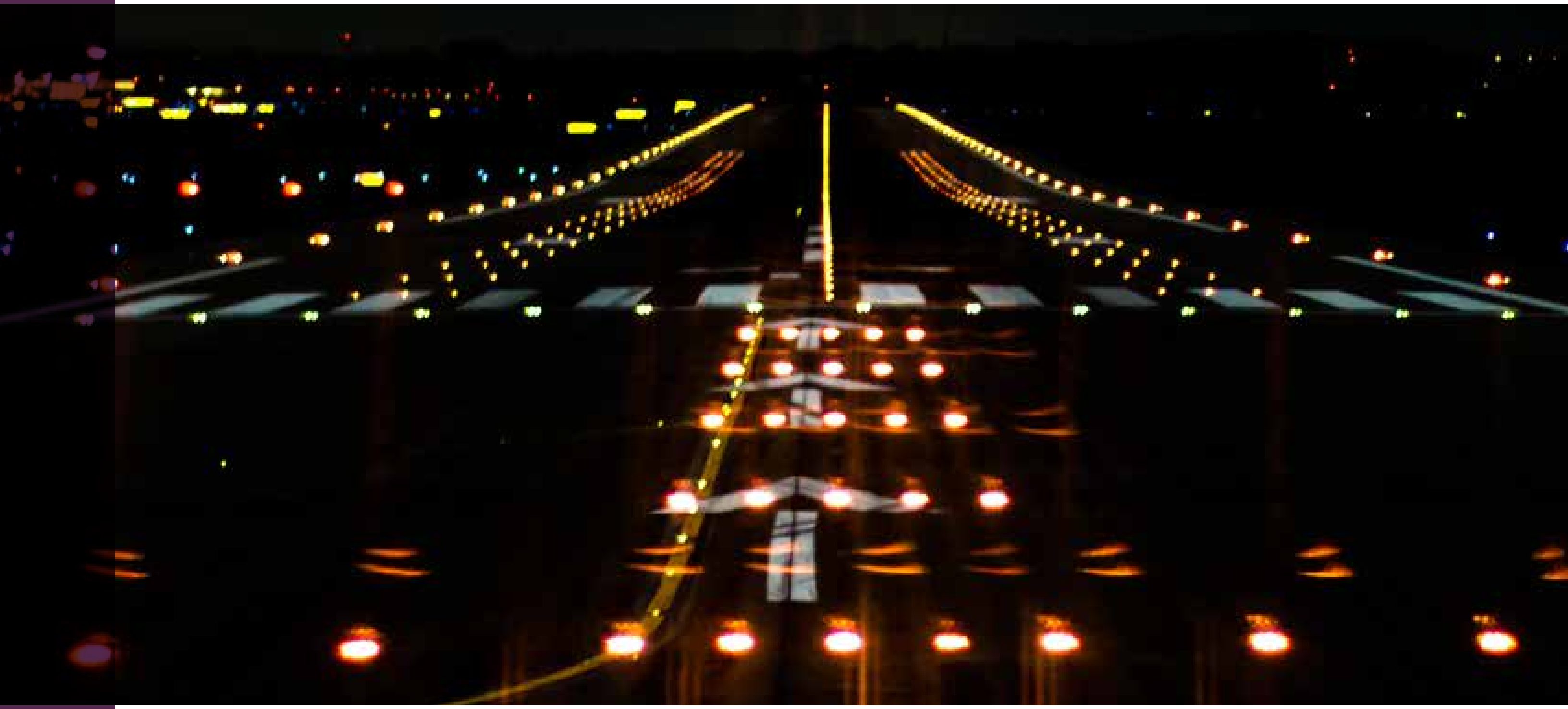
GUGGENHEIM

May 2020

High-Yield and Bank Loan Outlook

Reaching the End of the Runway



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Summary

High-yield bonds and bank loan markets are pricing in the damaging effects of the ongoing recession. Spreads widened to levels in March last seen in 2009, though both sectors could see more losses if spreads widen to 2008 peaks. While there is a lot of downside priced in, we expect the unemployment rate to rise above 20 percent, with output likely to contract by more in the first half of 2020 than was observed in the first two years of the Great Depression. Markets are assuming a quick recovery, but our interpretation of recent data is that we are in a deep contraction that will take years to recover from, and that conditions will be worse than what the market is pricing in.

This report discusses our default outlook for the below investment-grade sector, using history as a guide but also taking into account the current state of credit fundamentals. Tying together our economic and top-down credit views, we expect the U.S. speculative-grade default rate will reach 15 percent in this cycle; higher than the peaks in the 1990, 2002, and 2009 recessions. Given this view, our approach is to use the recent reprieve brought on by a flood of stimulus programs to sell weak credits and buy likely survivors. Even though there are still many risks that lie ahead, the current market offers the opportunity to look for quality investments at better entry points than we have seen in years, so we are taking advantage of that value.

Report Highlights

- Speculative-grade issuers are headed into a downturn with higher leverage multiples today than in 2008.
- The average high-yield corporate leverage ratio was 3.5x in the third and fourth quarters of 2008. As of the fourth quarter of 2019, it is 4.7x.
- The average bank loan leverage ratio was 5.0x in the fourth quarter of 2008. As of the fourth quarter of 2019, it is 5.4x.
- Earnings growth in recent quarters has been weak based on earnings before interest, tax, depreciation and amortization (EBITDA). Year-over-year EBITDA growth in 2019 averaged only 1.3 percent for high-yield corporates and 2.0 percent for bank loans.
- In the search for survivors, liquidity is king. We have found opportunities in technology, non-cyclical consumer goods, healthcare, food and beverage, and some restaurants. But we continue to approach both the high-yield bond and bank loan sectors with caution.

Leveraged Credit Scorecard
As of 3.31.2020

High-Yield Bonds

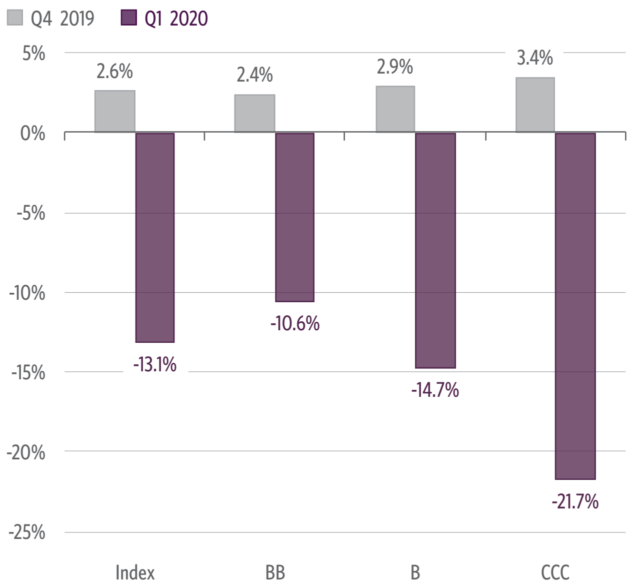
	December 2019		January 2020		February 2020		March 2020	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	372	5.4%	420	5.6%	524	6.3%	875	9.2%
BB	214	3.9%	259	4.0%	355	4.6%	657	7.0%
B	374	5.4%	427	5.7%	563	6.6%	980	10.3%
CCC	964	11.3%	991	11.3%	1,132	12.3%	1,673	17.4%

Bank Loans

	December 2019		January 2020		February 2020		March 2020	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	461	96.51	456	96.63	510	95.07	974	82.70
BB	262	99.81	266	99.71	322	98.02	661	88.88
B	470	97.67	466	97.82	526	96.15	1,047	82.74
CCC/Split CCC	1,365	80.14	1,307	81.21	1,330	80.16	2,220	62.93

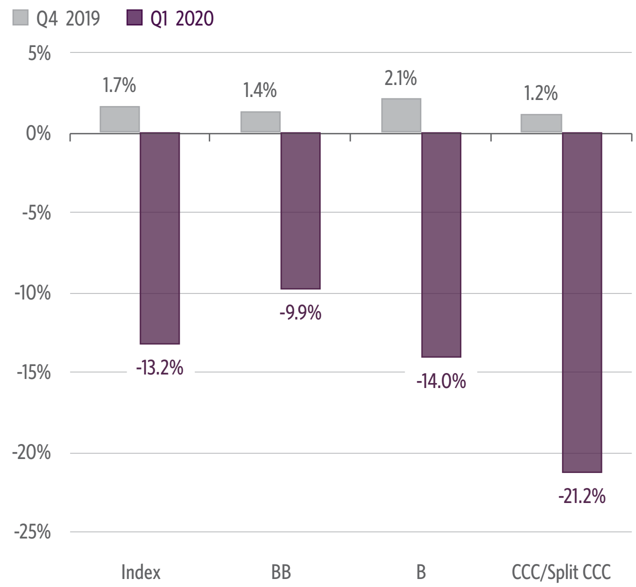
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE BofA High-Yield Index Returns



Source: ICE BofA. Data as of 3.31.2020. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 3.31.2020. Past performance does not guarantee future results.

Macroeconomic Overview
Brace for Impact

> The world is being confronted with the worst downturn since the 1930s. Given the high level of corporate leverage, any gaps in cash flow will make it impossible for many companies to service their debt. We are experiencing the end game of the great debt super cycle.
>
> – Scott Minerd,
> *Chairman of Investments and Global Chief Investment Officer*

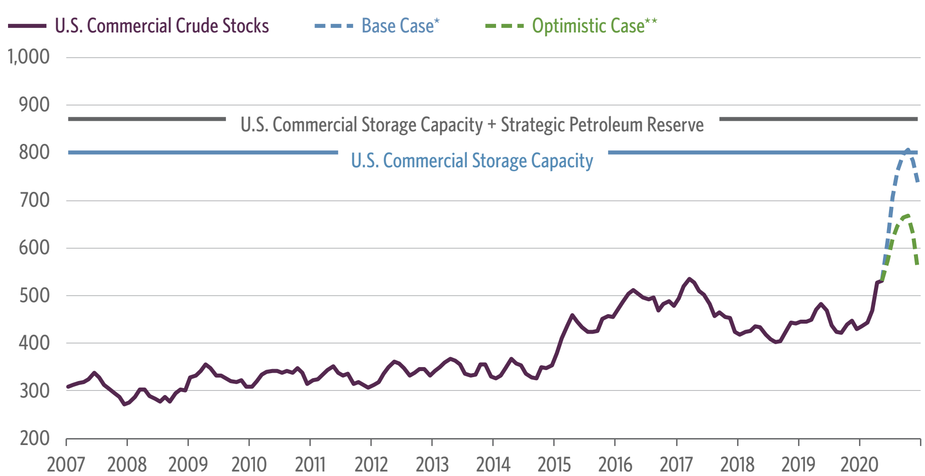
The global outbreak of the coronavirus, COVID-19, is at the center of everything this year. As of publication, COVID-19 has spread to 213 countries, resulted in over 4.8 million cases, and caused over 300,000 deaths. Thus far, the United States makes up nearly a third of global cases, and 29 percent of global deaths. States have required the labor force to work from home if possible, individuals to practice social distancing, and non-essential businesses to shut down. In the economic forecasting world, this chain of events set off a race to the bottom with U.S. growth projections downgraded almost daily.

Amid the global pandemic, the collapse in the OPEC+ alliance triggered further declines in oil prices. On March 5, OPEC members had agreed to a 1.5MMbbl/d cut, with two-thirds of the proposed cuts allocated to the member countries and the remainder to Russia and the other non-OPEC allies. However, the deal was conditional on the agreement of Russia, which rejected the proposal the following day. Worse yet, OPEC's existing production cuts expired on April 1 and were not renewed. A price war ensued, with Saudi Arabia slashing its official selling prices and ramping up production to retaliate against Russia. Aiming to regain market share from U.S. shale and other producers, Russia also increased output.

We are experiencing what several months ago would have been an unthinkable scenario for the oil market. The demand shock is so large that even with a new commitment from OPEC+ to cut production by at least 10MMbbl/d and significant production shut-ins elsewhere, the oil market will continue to be critically oversupplied until late third quarter or fourth quarter 2020. The sharp decline in oil prices, including a brief foray into negative territory, quickly repriced credit risk in the oil and gas sector.

We estimate oil inventories will continue to grow over 2020 and reach record levels. Spare storage capacity in the United States and globally is likely to be exhausted during the second quarter, which will provide downward pressure on oil prices and force production shut-ins.

U.S. Crude Inventories Will Reach Record Levels Despite Improving Supply, Demand Dynamics
Millions of Barrels



Source: Guggenheim Investments, Bloomberg, IHS, EIA. Data as of 5.13.2020. *Base Case: U-shaped demand recovery, strong OPEC+ compliance and moderate RoW production cuts. **Optimistic Case: V-shaped demand recovery, strong OPEC+ compliance and sharp RoW production cuts.

Markets took a severe hit as these events unfolded. March 2020 was the second worst month of returns on record for investment-grade corporates, high-yield corporates, and bank loans. Liquidity was very constrained. Below investment-grade issuance stalled. In a panic, many companies tapped the available credit on their undrawn revolvers and credit lines.

The Federal Reserve (Fed) stepped in quickly. The Federal Open Market Committee (FOMC) cut rates by 125 basis points in the first quarter and passed a series of stimulus programs. Among them were the Primary and Secondary Market Corporate Credit Facilities, which are lending programs primarily targeting investment-grade corporate bond issuers, implemented in concert with the U.S. Treasury. It was only after the announcement of this program that corporate credit found some relief from the selloff.

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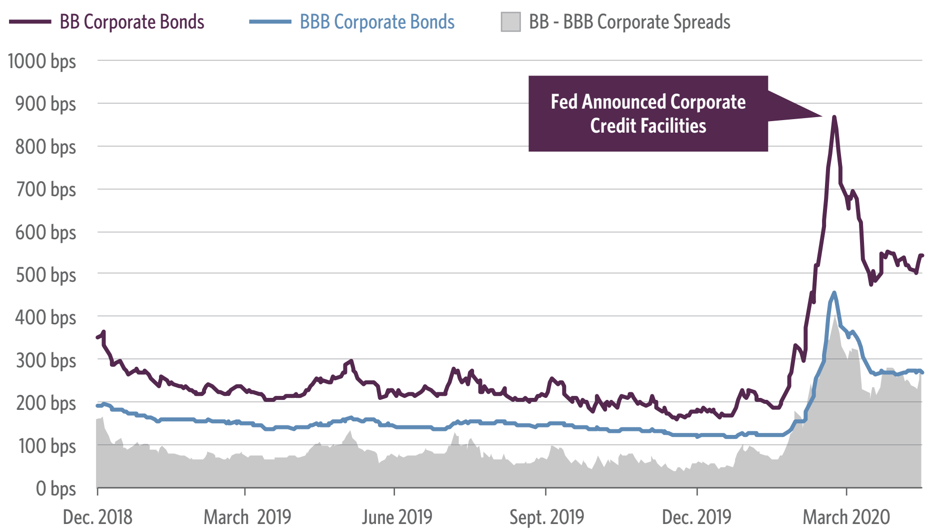
Fed Intervention Stalled the Selloff in High-Yield Bonds



Source: Guggenheim Investments, Bloomberg. Data as of 5.15.2020.

With an alphabet soup of monetary programs targeting relief from the coronavirus impact, fiscal policy has also stepped up to the plate, though delivering only a fraction of what will ultimately be needed. On March 26, a spending bill worth over $2 trillion was signed into law that aims to assist consumers, states, small businesses, and certain industries. There is no question that these programs will help ease the economic fallout from virus containment measures, but even $2 trillion is too small given the magnitude of the economic shock that we are facing. Additionally, it is far from clear that fiscal measures are an adequate solution to the issue at hand: the physical and psychological impediment to most of consumer spending. Fiscal and monetary policy can do their part, but ultimately it is public health policy that will be the greatest determinant of the economic outlook.

The U.S. economy is clearly already in the deepest recession since the 1930s. Early on, it appeared the economic hit would be limited to supply chain disruptions in industries such as electronics, autos, machinery, metals, and apparel when known coronavirus cases were only in Asia. Now the impact to these industries will be twofold given massive declines in both domestic and international demand. Closures, quarantines, and social distancing efforts have hit travel, hospitality, restaurants, and retail industries, with activity down 100 percent in some areas of the country. Further exacerbating the decline in output will be a sharp reduction in business investment, which was already stalling out due to falling profits, the trade war, and political uncertainty. The coronavirus shock and collapse in oil prices will further depress capital expenditures.

Markets are not priced for the worst. Consensus for S&P 500 earnings per share in 2020 is still in the range of $125–$130. Our research shows S&P 500 earnings per share could fall below $100. Similarly, economists have no way to calibrate how bad the economic data could be based on history. Expectations for the monthly change in nonfarm payrolls differ by millions, while unemployment rate forecasts have a range of several percentage points. We currently expect that second quarter U.S. real gross domestic product (GDP) quarter-over-quarter growth could fall by 40 percent annualized and the unemployment rate will likely rise above 20 percent. Beyond that, the severity of the crisis depends on containment and treatment of the virus and the effectiveness of the fiscal and monetary policy response, but expectations for a quick V-shaped recovery look wildly optimistic.

The permanent credit impairments that come from company bankruptcies, defaults, and restructurings lie ahead of us. We will have much more clarity on who is likely to survive the current situation during earnings season. For now, Guggenheim has been focused on running severe stress scenarios as we brace for the full impact yet to come.

Market Review

The ICE BofA ML High-Yield index lost 14.4 percent and the Credit Suisse Leveraged Loan index lost 15.7 percent in the first quarter of 2020, their worst quarterly returns since the fourth quarter of 2008. At one point in late March, high-yield spreads had tripled from six-week lows, a spike never before seen in recorded history. Since the announcement of the Fed's Primary and Secondary Corporate Credit Facilities, credit markets have bounced back, but spreads remain much wider than 2019 levels.

In recent reports, we made several arguments for why the level of credit spreads was unsustainable in light of a weakening macro picture. Certain fundamental relationships, like the correlation between manufacturing data and credit risk premiums, had broken down. Internally, our fair value assessment indicated spreads should have been at least 315 basis points wider last year. We refrained from chasing the unsustainable rally and continued to move up in quality, but now we are wading in at more attractive valuations.

By spread measures, corporate bonds now appear cheap. High-yield corporate bond spreads have been wider only 10 percent of history dating back to at least the mid-1990s. This means that there is a greater probability for spreads to tighten

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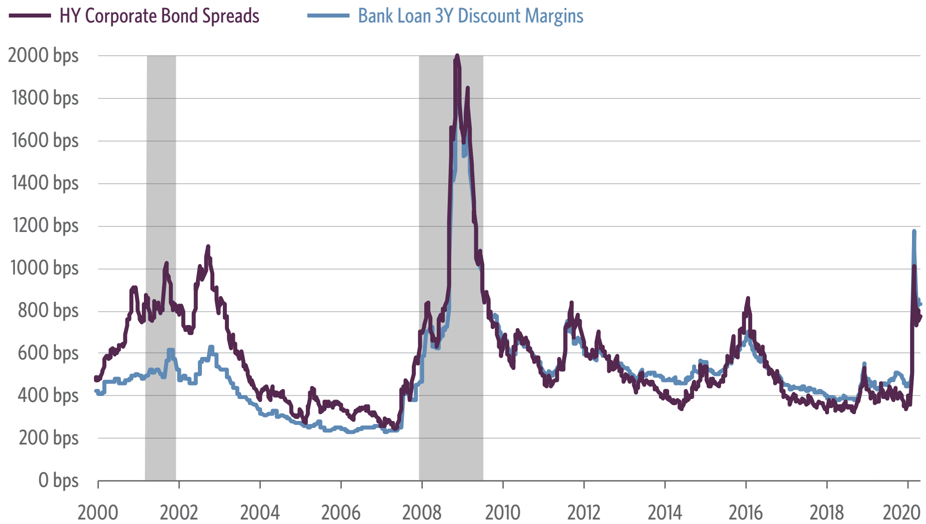
Spreads Widened Dramatically in the First Quarter of 2020



Source: Guggenheim Investments, ICE Index Services, Credit Suisse, Bloomberg. Data as of 5.15.2020. Shaded areas represent periods of recession.

from here based on history. But we also recognize that in the current environment, with limited visibility on the full earnings impact of the economic shutdown from COVID-19, there is a high risk of buying a bond that looks cheap at 80 cents on the dollar that could eventually default and fall to a lower recovery value. In the credit selection process, “deselecting” the unlikely survivors is crucial as we capture value in the current market dislocation.

We are confident that there will be another wave of defaults in energy given oil market dynamics and limited access to capital markets. Cyclical sectors like autos, gaming, leisure, media, and retail are also likely to see more defaults ahead. In our view, it is mostly a matter of when, not if.

A Page from History

Broadly speaking, history offers some guidance on how the next 12 months might evolve. In the recorded history of the high-yield corporate bond market, we identified May 1999 and December 2008 as the most comparable points in time to today (setting aside the uniqueness of the current pandemic). In these months, the U.S. high yield 12-month default rate was around 4 percent and rising.

By the time the high-yield corporate bond market had reached a 4 percent default rate in May 1999, the economy was beginning to experience a reacceleration in growth from 1998. Fed easing in 1998 and an emerging bubble in tech and telecom helped boost consumer net worth at a time when the U.S. economy was vulnerable to a recession. High-yield earnings growth also reaccelerated in 1999, and that helped delay some defaults for another year or two. Thus, between May 1999 and May 2000, the high-yield default rate was only 6 percent.

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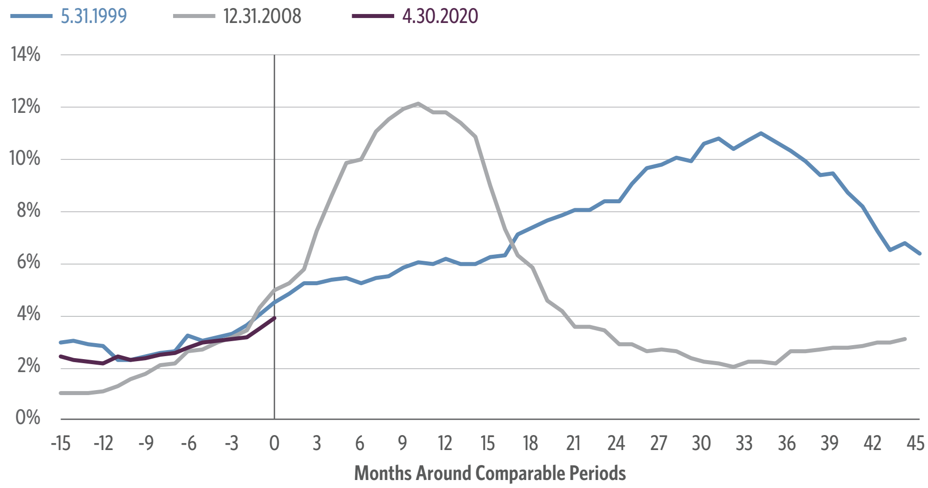
Late 1990s or Financial Crisis Default Cycle Ahead?

Trailing 12-Month High-Yield Default Rate



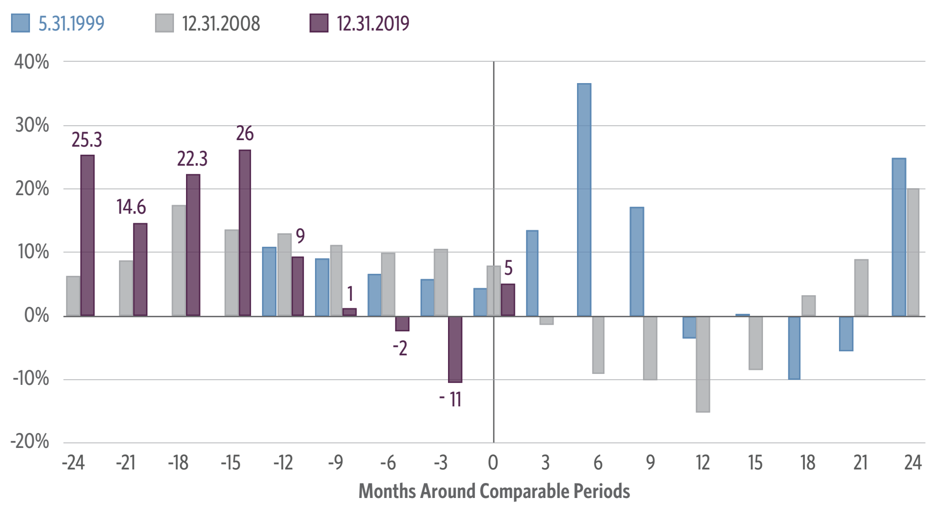
Source: Guggenheim Investments, S&P Global Ratings. Data as of 4.30.2020. Comparable periods of 5.31.1999 and 12.31.2008 were selected based on recent U.S. speculative-grade default rate and our outlook for defaults to increase in the next 12-24 months.

Government aid could once again add some runway to credit. The Fed and the Treasury's expanded support for corporate borrowers has removed some of the hazards that lead to default, such as being shut out of the market when in need of money. After high-yield issuance plummeted to only $4.2 billion in March, April activity rebounded to a healthier $39 billion of deals completed. More issuance has shifted to BB- or higher quality, however, which indicates that the neediest borrowers are unlikely to have an extended runway.

The pre- and post-COVID-19 fundamental picture in credit adds an important layer to our default outlook. In the lead up to 2020, high-yield and bank loan earnings growth was already very weak. Year-over-year EBITDA growth in 2019 averaged -1.7 percent for high-yield corporates and 2.0 percent for bank loans.

High-Yield Fundamentals Look Weaker Today Compared to Similar Periods

High-Yield EBITDA YoY Growth



Source: Guggenheim Investments, Bank of America Merrill Lynch Research. Data as of 12.31.2019. Comparable periods of 5.31.1999 and 12.31.2008 were selected based on recent U.S. speculative-grade default rate and our outlook for defaults to increase in the next 12-24 months.

Turning to our other comparable period in December 2008, the 12 months that followed witnessed unprecedented policy support for financial markets in the form of quantitative easing and programs like the Term Asset-backed Securities Loan Facility (TALF), much like today. By that point, a substantial amount of the economic, corporate and consumer damage had been done, so despite a rally in risk assets from a lower level than where we stood in March 2020, the year 2009 witnessed a 12 percent default rate in the high-yield market. In our view, this is the more likely outcome—that the Fed's programs will help lift risk assets to some extent but ultimately cannot undo the fundamental damage.

The pre- and post-COVID-19 fundamental picture in credit adds another important layer for determining the default outlook. In the lead up to 2020, high-yield and bank loan earnings growth was already very weak. Year-over-year EBITDA growth in 2019 averaged -1.7 percent for high-yield corporates and 2.0 percent for bank loans. In the next 12 months, our view is that revenue and earnings declines are likely to be more severe than in 2009. This will weaken the credit picture painted by leverage ratios even further, as they are already higher than in 2008:

- The average BB corporate bond leverage ratio averaged 2.3x in 2008. As of the fourth quarter of 2019, it is 3.9x, and has averaged 4.1x in the last four quarters.
- The average single B corporate bond leverage ratio averaged 4.4x in 2008. As of the fourth quarter of 2019, it is 5.2x and has averaged 5.3x in the last four quarters.
- The average bank loan leverage ratio averaged 4.7x in 2008. Today, it is 5.4x and has averaged 5.1x in the last four quarters.

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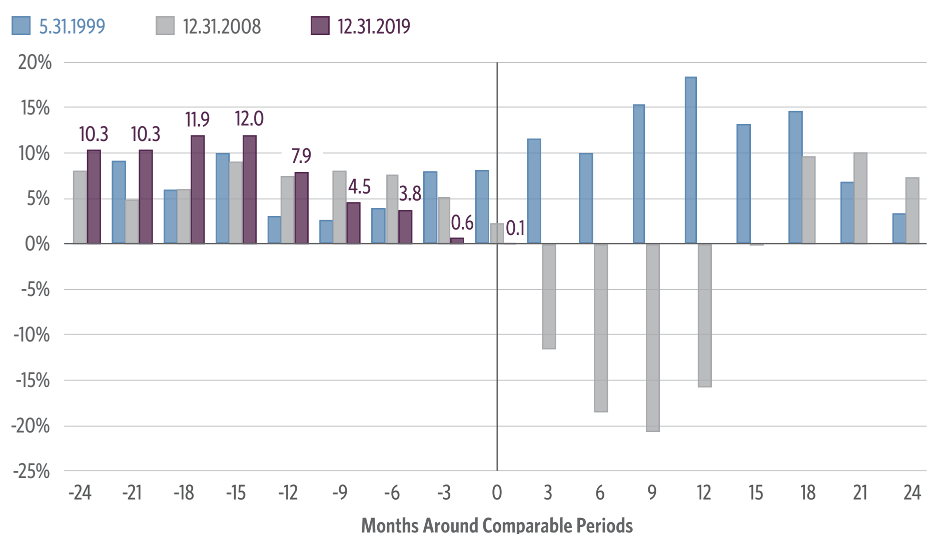
A Sharp Decline in Revenue Will Damage Previously Healthy Coverage Ratios

High-Yield Revenue YoY Growth Around Similar Periods



Source: Guggenheim Investments, Bank of America Merrill Lynch Research. Data as of 12.31.2019. Comparable periods of 5.31.1999 and 12.31.2008 were selected based on recent U.S. speculative-grade default rate and our outlook for defaults to increase in the next 12-24 months.

Until now, we would argue that borrowers could sustain higher leverage ratios given a healthy high-yield interest coverage ratio of 3.8x, compared to a 3.2x historical average, while in loans it is an even stronger 4.6x. But this argument will lose its grip when cash flow stalls due to business closures and a collapse in consumer mobility. The next two quarters of earnings data should confirm a quick and deeply negative impact on many borrowers' abilities to continue to make interest payments.

We would be remiss not to factor the colossal stimulus package passed by Congress into our outlook. The Coronavirus Aid, Relief, and Economic Security (CARES) Act provides for direct payments and jobless benefits for individuals, money for states, and loans for businesses. It includes $500 billion to back loans and assistance to businesses, states, and municipalities, including $50 billion to support the airline industry. The CARES Act established the Paycheck Protection Program, which extends loans to small businesses that can be forgiven if the proceeds are primarily used for payroll.

The CARES Act seeks to plug liquidity gaps where businesses might require two to three months of overhead costs to stay afloat. This was crucial when access to credit was challenging. This aid may be the deciding factor between a business surviving or disappearing in the next few months, but it cannot make up the lost revenue, current or future. More stimulus programs will be needed.

Our outlook on growth, the labor market, and corporate revenue growth, tied with our comparison of corporate fundamentals today versus 2008, leads us to expect that the default outlook could be most comparable to the 2008 – 2009 experience. This makes a 12 percent default rate the floor scenario for the next 12 months. Internally, we have also run a more granular, industry-level stress picture, and concluded that the U.S. speculative-grade default rate is likely to reach 15 percent in this cycle. This would be higher than the peak in 1990, 2002, and 2009.

Taking Advantage of Value

In search of companies likely to survive a prolonged economic downturn, we ask the following questions when we do our internal stress tests: Does the borrower have enough cash flow or balance sheet cash to continue operations? Does the borrower have undrawn revolving debt it can access? Can the borrower survive a severe shock to earnings? Does the borrower have heavy capital expenditure requirements? In the end, our stress results keep coming back to the same conclusion: liquidity is king.

To avoid defaulters, we are looking for healthy cash cushions, strong free cash flow in recent quarters, strong industry position to sustain cash generation, limited cyclicality, and manageable debt. A few industries where we have recently identified opportunities include technology, non-cyclical consumer products, healthcare, food & beverage, and restaurant businesses that have established delivery capabilities and a market presence to sustain demand while consumers are forced to stay home.

In addition to defaults, we expect a slew of downgrades to come in both high-yield corporates and bank loans. While downgrades are occurring within high-yield, an avalanche of fallen angels (investment-grade issuers downgraded to high-yield) adds to market liquidity concerns. In the first quarter of 2020, the downgrade of three particularly large issuers—Kraft Heinz, Occidental Petroleum, and Ford—added over $75 billion of debt to the high-yield index combined. Their downgrades may have exacerbated the selloff in high-yield as investors made room for the new entrants, but in some cases, they did also present interesting buying opportunities.

A lot of downside is reflected in current price and spread levels, but more pain may come as economic data and corporate earnings reveal the extent of the damage COVID-19 has inflicted on the economy. Credit investors should be prepared for the worst-case scenario and use the recent reprieve brought on by a flood of stimulus programs to sell weak credits and buy likely survivors. The current market offers the opportunity to look for quality investments at better entry points than we have seen in years. Even though there are still many risks that lie ahead, we have begun to take advantage of value.

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%.

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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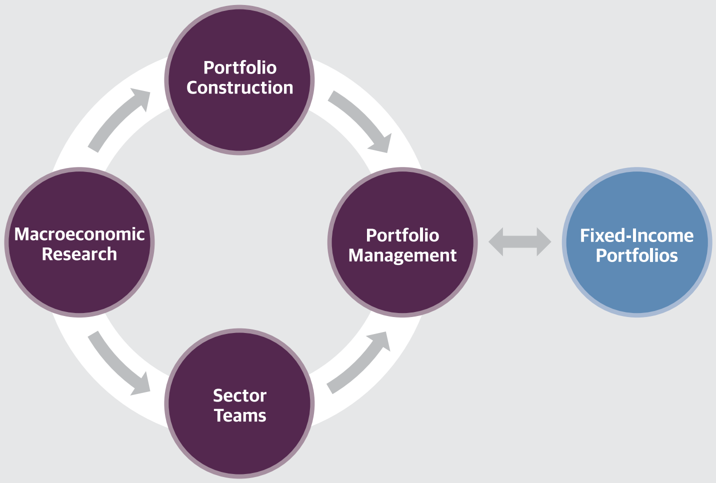
2. Guggenheim Partners assets under management are as of 3.31.2020 and include consulting services for clients whose assets are valued at approximately $69bn.

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 $205 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 300+ 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

Guggenheim Partners is a global investment and advisory firm with more than $270 billion[2] in assets under management. Across our three primary businesses of investment management, investment banking, and insurance services, we have a track record of delivering results through innovative solutions. With 2,400 professionals based in offices around the world, our commitment is to advance the strategic interests of our clients and to deliver long-term results with excellence and integrity. We invite you to learn more about our expertise and values by visiting GuggenheimPartners.com and following us on Twitter at twitter.com/guggenheimptnrs.

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