GUGGENHEIM

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High-Yield and Bank Loan Outlook

In the Recovery Phase of the Credit Cycle

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Summary

Credit cycles move through a series of phases: recession, repair, recovery, expansion, and a speculative phase. Each phase can take several months or even years to unfold, but the unprecedented and ongoing policy response to the COVID-19 shock has accelerated the progression from one phase to the next. Risk asset prices troughed in the recession and bounced back faster than ever before, while corporations repaired their balance sheets simultaneously with the earnings recession, rather than following one. Although these features make it more difficult to pinpoint our current position in the credit cycle, our research suggests that we are in the recovery phase, in which we expect to see strong earnings growth, low default volumes, upward rating migration, and tighter spreads.

Looking ahead, we believe that the length of the recovery phase and the expansion phase of this credit cycle will depend on the discipline of borrowers and investors, as well as other factors including interest rates, economic growth, government policy, and external shocks. The credit cycle framework suggests that we will progress to other phases before we experience another wave of default activity, which eases our concerns about historically tight credit spreads. At this stage, we look for opportunities to add yield and total return to the portfolios while default risk is low.

Highlights from the Report

- Fundamental conditions support positioning long in credit despite tight spreads. Simultaneously, the recent backup in rates, steepening of the yield curve, and an upcoming stronger seasonal period for the Treasury market argue for an overweight duration position to hedge long credit risk.
- High-yield credit spreads have only been tighter 8 percent of the time dating back over 20 years. It is unusual for spreads to be this tight during the recovery phase of the credit cycle, as they typically get to their tightest during later phases. This bodes for even tighter spreads as we get into later phases of this cycle. However, the level of credit spreads must be measured and assessed relative to forward-looking default expectations. Our view is that fundamental conditions support staying long credit despite historically tight credit spreads, just as they did in the early 1990s when spreads stayed near similar levels for years.
- Earnings before interest, taxes, depreciation, and amortization (EBITDA) for publicly traded high-yield issuers are expected to grow 24 percent year over year based on median analyst estimates. We calculate that earnings growth alone would lower median leverage ratios to 4.1x, levels last seen at the end of 2018.
- Based on the pace of rating upgrades in the first quarter of 2021, almost 28 percent of the current high-yield index could receive an upgrade of at least one notch by the end of the year. As default probability falls with credit rating upgrades, in our view it makes sense to look for value further down the credit rating spectrum.

Leveraged Credit Scorecard

As of 3.31.2021

High-Yield Bonds

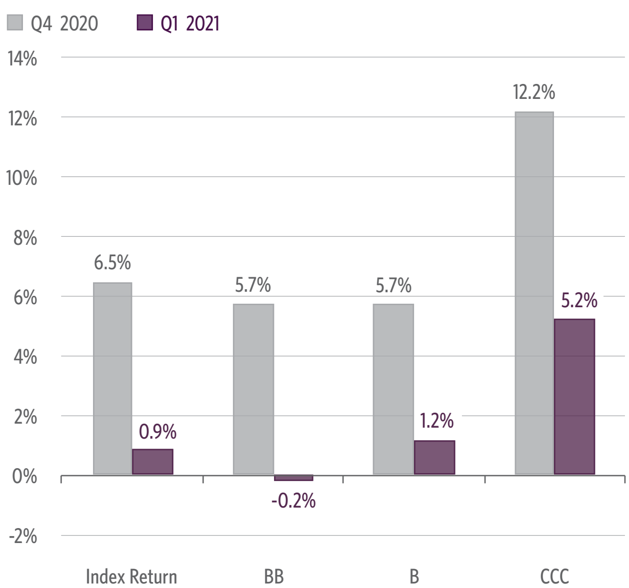
	December 2020		January 2021		February 2021		March 2021	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	390	4.2%	391	4.3%	374	4.4%	353	4.3%
BB	281	3.2%	285	3.4%	269	3.4%	258	3.5%
B	422	4.5%	435	4.6%	419	4.7%	393	4.5%
CCC	804	8.3%	746	7.7%	705	7.5%	666	7.2%

Bank Loans

	December 2020		January 2021		February 2021		March 2021	
	3YDM*	Price	3YDM*	Price	3YDM*	Price	3YDM*	Price
Credit Suisse Leveraged Loan Index	486	95.73	461	96.80	446	97.79	449	97.46
BB	305	98.88	292	99.34	282	99.65	299	99.13
B	469	98.55	448	99.20	440	99.43	452	98.96
CCC/Split CCC	1,167	84.28	1,046	87.45	972	89.29	933	90.23

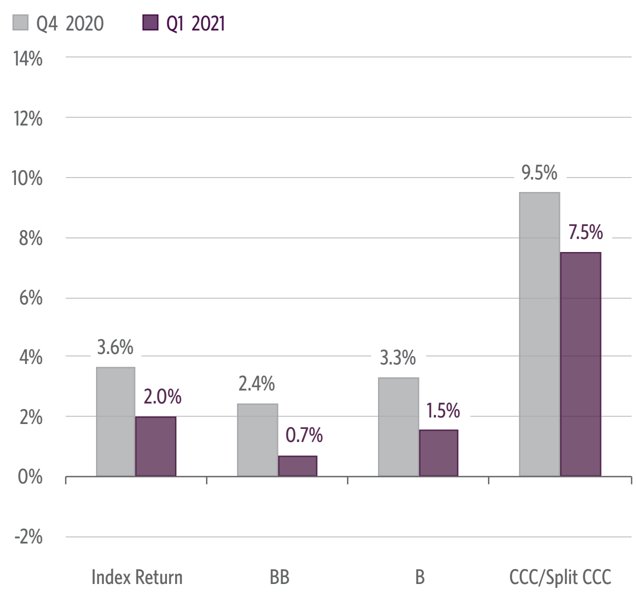
Source: ICE BofA, Credit Suisse. *The 3-Year Discount Margin assumes three-year average life. Past performance does not guarantee future results.

ICE BofA High-Yield Index Returns



Source: ICE BofA. Data as of 3.31.2021. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 3.31.2021. Past performance does not guarantee future results.

> “The paradigm around credit risk has changed with the socialization of credit, which has resulted from various government and Federal Reserve polices.
>
> – Scott Minerd,
> *Chairman of Investments and Global Chief Investment Officer*

Macroeconomic Overview

Strong Growth Expectations ≠ Earlier Rate Hikes

Our Macroeconomic and Investment Research Group upgraded our 2021 U.S. economic growth forecast during the first quarter from 5.5 percent to over 7 percent, factoring in more fiscal stimulus than previously anticipated. This forecast captures the effect of stimulus representing roughly 11 percent of 2020–2021 gross domestic product (GDP), versus the previous calculation of about 8 percent. As we highlighted last quarter, we see strength in the consumer sector and in housing activity. In addition, although U.S. vaccinations have most recently decelerated due to the Johnson & Johnson vaccine pause, new deaths and case fatality should continue to fall, which will enable further reopening. As of mid-May, more than 265 million doses have been administered in the United States, and 35 percent of the U.S. population has been fully vaccinated. The United States is seeing the best-case scenario unfold in its vaccine rollout, but other countries have not been as fortunate.

Europe’s vaccine rollout hit a major speedbump during the first quarter when questions surrounding the safety of the AstraZeneca vaccine led several major European countries to temporarily suspend distribution. Safety concerns, coupled with supply constraints, meant that less than 15 percent of the populations in Germany, France, and Italy had been vaccinated by the end of the first quarter, well under the pace needed to reach 70 percent inoculated by summer.

India is in the grip of a severe second wave of infections. The number of active cases, well over 3.7 million and rising, is nearly four times the peak of the first wave the last year. Despite more COVID-19 tests being conducted now than ever, test positivity stands at over 10 percent in India, suggesting that things could get worse before they get better. The latest outbreak in India appears to be related to the emergence of particularly infectious variants, a rise in unrestricted social interactions, and low vaccine coverage.

Unfortunately, a delay in ending the pandemic on a global scale has implications for other countries too, including the United States, where travel and hospitality workers represent a large share of the unemployed. Yet, despite vaccination delays in Europe and the severe wave in India, and their implications abroad, there has been meaningful improvement in the labor market as the U.S. moves forward with business re-openings. Seasonally adjusted initial jobless claims fell to 473,000 in the week ending May 8, the lowest level since the pandemic began. Although the April payroll report was very disappointing, with a gain of only 266,000 jobs coming in below all estimates, we believe standing in the way of additional labor market gains are remaining restrictions on certain sectors. Easing of these restrictions is expected by summer.

Economic developments drove a sharp increase in U.S. Treasury yields, which has been a topic du jour in 2021. The market pulled forward expectations of the next Federal Reserve (Fed) rate hike from December 2023 to December 2022, while repricing the long-run terminal fed funds rate estimate to as high as 2.36 percent from just 0.55 percent last August. We do not expect the Fed to raise interest rates as early as the market is anticipating, even though we expect strong GDP growth in coming years.

We expect year-over-year inflation measures rise over the next several months due to base effects, which may be compounded by supply chain disruptions in the goods sector and potential capacity constraints for certain services. However, we think these factors will prove to be short-lived, with base effects set to dampen inflation starting in the summer months. Moreover, the Fed is focused on generating sustainably higher inflation. Even if core inflation rises above the Fed's 2 percent target in 2021, the Fed's focus is on a long-term average of 2 percent. With years of shortfalls to make up, and the Fed now targeting labor market disparities as part of an expanded definition of full employment, we expect policymakers to remain resolutely patient. Any tapering of asset purchases will likely be deferred until later in 2022, with the first rate hike likely to come a few years after that.

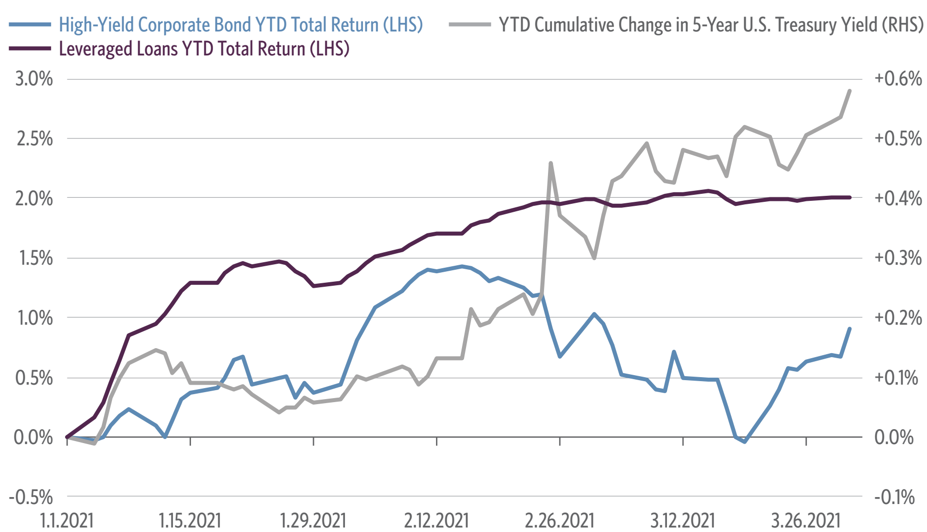
We expect easy financial conditions and low rates to support credit over the next few years. With market optimism pulling forward rate hike expectations and causing bond yields to rise, we view this as an opportunity to add incremental yield to portfolios.

First Quarter 2021 Performance Recap

The mid-quarter spike in Treasury rates in the belly of the curve erased a little over one-third of the gains that the high-yield market had year to date. Through Feb. 15, the ICE BofA High-Yield Index total return was 1.4 percent, but ended the quarter at 0.9 percent. In contrast, the Credit Suisse Leveraged Loan Index held on to performance as rates spiked, ending the quarter at a 2 percent total return. Nonetheless, high-yield corporate bond spreads tightened by 43 basis points over the quarter, which indicates that the sector absorbed some of the increase in Treasury rates as investors continued to clamor for income. Leveraged loan three-year discount margins tightened by 37 basis points.

The Credit Suisse Leveraged Loan Index held on to performance as rates spiked, ending the first quarter at a 2 percent total return. Nonetheless, high-yield corporate bond spreads tightened by 43 basis points over the quarter, which indicates that the sector absorbed some of the increase in Treasury rates as investors continued to clamor for income.

Loans Held Onto Return as Treasury Yields Spiked



Source: Guggenheim Investments, Bloomberg, Credit Suisse, ICE Index Services. Data as of 3.31.2021.

The start of the year was a time to be long credit beta. BB-rated bonds delivered a total return of -0.2 percent in the first quarter of 2021, compared to 1.2 percent for B-rated bonds, and 5.2 percent for CCC-rated bonds. The best corporate index subset was front-end CCC-rated corporates, with a return of 7.2 percent for the quarter. The same is true of the loan market, where the strongest return of 7.6 percent was among the CCC-rated cohort. BB-rated loans and B-rated loans delivered returns of 0.7 percent and 1.5 percent, respectively.

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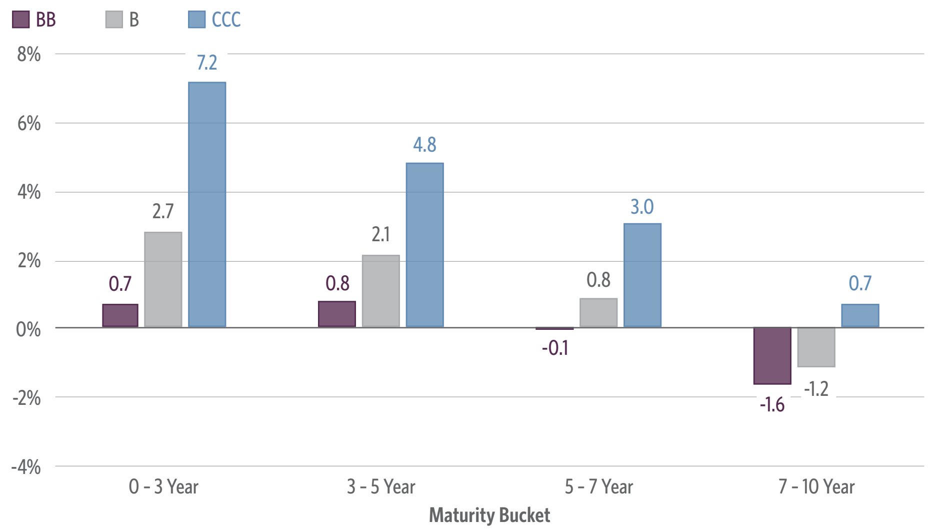
The Best Performing Sleeve in Q1 was Short-Maturity CCCs

Corporate Bond Total Return by Rating and Maturity Bucket



Source: Guggenheim Investments, ICE Index Services. Data as of 3.31.2021.

We expect the environment over the next two quarters to remain positive for credit, with the trajectory of business re-openings improving as vaccinations accelerate. In addition, we are now approaching the summer season, which tends to see rates decline, making this a good time to position overweight duration. At this time, investors can earn 1.8 incremental percentage points in annual yield by going out to 10-year maturities relative to three- to five-year BB-rated corporates, and a steeper curve means the roll-down return profile is attractive. The incremental yield pickup for doing the same in B-rated corporates is 1.2 percent.

High-yield credit spreads have only been tighter 8 percent of the time dating back over 20 years. It is unusual for spreads to be this tight during the recovery phase of the credit cycle, as they typically get to their tightest during later phases. This bodes for even tighter spreads as we get into later phases of this cycle. However, the level of credit spreads must be measured and assessed relative to forward-looking default expectations. Our view is that fundamental conditions support staying long credit despite historically tight credit spreads, just as they did in the early 1990s when spreads stayed near similar levels for years. This outlook is supported by our analysis of where we are in the credit cycle. The remainder of this report focuses on the view

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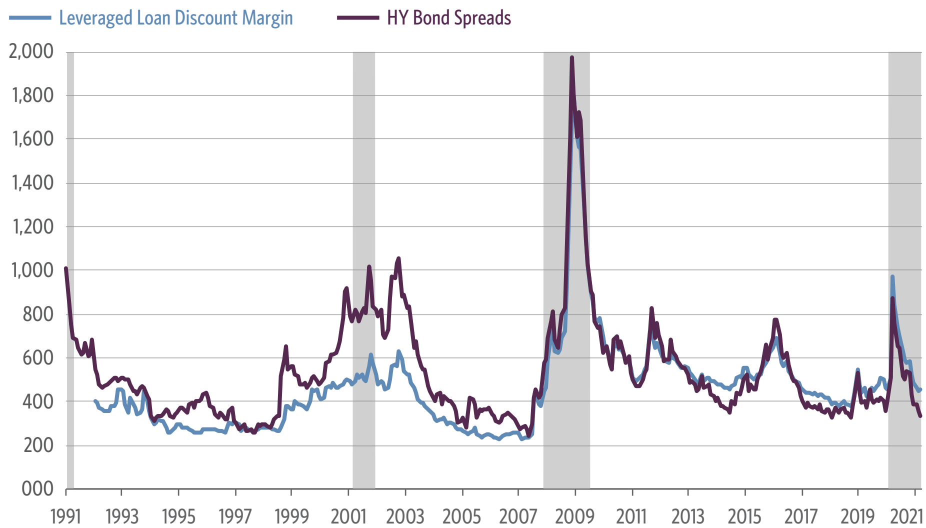
History Shows Extended Periods of Spreads Near Current Levels



Source: Guggenheim Investments, Credit Suisse, ICE Index Services. Data as of 3.31.2021. Shaded areas represent periods of recession.

that we are in a phase of the credit cycle that typically sees positive credit returns, strong earnings growth, upward rating migration, and low defaults. Although the best cycle gains may be behind us, there are opportunities for additional spread compression and income returns for active investors.

Understanding Credit Cycle Phases

Strategists often categorize the credit cycle into phases. Some describe it as early stage, middle stage, late stage, and recession. Others describe it as the repair phase, recovery phase, expansion phase, and recession, to which we have added a "speculative" phase somewhere between expansion and recession. No matter how it is described, identifying where we are in the credit cycle is an important analytical input in our estimate of near-term and medium-term default risk. Most credit strategists today would agree that the current credit cycle is somewhere between a repair and recovery phase that follow recessions, a time when default volume declines.

The lines distinguishing phases of the credit cycle are not clearly defined, and it can be more art than science identifying the prevailing stage. One feature of the repair phase is that companies shore up liquidity in reaction to an earnings recession. This phase is behind us now, having blended into the 2020 recession as the onset of the COVID-19 pandemic made an earnings recession unusually predictable. The repair phase was also compressed by the nature of the policy response which saw not only record volume of fiscal aid, but unprecedented Fed intervention in credit markets. The policy response caused asset prices to recover quickly, reflecting growth well into the future but also the technical impact of overwhelming market liquidity. From a fundamental perspective, however, we believe we are still in the recovery phase, which typically sees strong earnings growth, low defaults, and more credit rating upgrades.

The lines distinguishing phases of the credit cycle are not clearly defined, and it can be more art than science identifying the prevailing stage. This table offers a case study of the features of various credit cycle phases as we defined them between 2009 and 2016. In the recovery phase, we can clearly see stronger issuance volumes, a decline in the default rate, positive rating migration, and tighter credit spreads.

Credit Cycle Dynamics, July 2009–June 2016

Market Characteristic	Recession Phase Jan. 2008 - June 2009	New Cycle	Repair Phase July 2009 - June 2010	Recovery Phase July 2010 - Dec. 2012	Expansion Phase Jan. 2013 - June 2015	Recession 2 Phase July 2015 - June 2016
Cumulative Gross Issue Volume (% of Avg. Market Outstanding)	10%		13%	50%	53%	12%
Refinancing (% of Total)	44%		59%	52%	42%	35%
M&A / LBO (% of Total)	41%		21%	28%	37%	52%
Net Issuance (% of Avg. Market Outstanding)	5%		5%	24%	31%	8%
Default Rate (Avg., Lagged 12 Months) [1]	11.2%		3.7%	3.0%	2.6%	5.3%
ICE BofA High Yield Index Net Rating Migration (Avg. 3-Month Rate)	-11.9%		-1.1%	1.4%	0.7%	-6.6%
S&P / LSTA Lev Loan Index Net Rating Migration (Avg. 3-Month Rate)	-7.7%		-0.4%	1.7%	0.0%	-1.7%
Loan Market EBITDA Growth (Median YoY %)	-3.4%		12.3%	13.8%	7.1%	6.6%
High-Yield Market EBITDA Growth (Median YoY %)	-11.1%		29.6%	9.8%	2.9%	-24.4%
Lev. Loan 3-Year Discount Margins (bps, Avg.)	1193		666	600	453	671
High-Yield Bond Option-Adjusted Spread (OAS) (bps, Avg.)	1112		685	591	506	607

Source: Guggenheim Investments, Moody's, S&P LCD, ICE Index Services. 1. Based on Moody's speculative-grade default rate.

Negative rating migration and poor earnings growth are on track to reverse in 2021. Leverage ratios (total debt/EBITDA) for publicly traded leveraged credit issuers spiked in 2020 to 7.1x on an aggregate basis, and 5.3x on a median basis. Based on 2021 analyst earnings estimates, median EBITDA for publicly traded high-yield issuers is expected to grow 24 percent year over year. Keeping debt unchanged, and making some assumptions where estimates were unavailable, we calculate earnings growth alone could lower median leverage ratios to 4.1x, back to levels last seen at the end of 2018. Not all issuers will keep debt unchanged given the potential for net new issuance, and there will be some dispersion on leverage reduction by sector. But we expect this trend to trigger rating upgrades.

Credit rating upgrades have already taken place for several issuers, including some in the energy sector, retail, and services during the first quarter. Some 7.0 percent of high-yield bonds were upgraded in the first quarter of 2021, while 2.5 percent were downgraded, for a net upgrade rate of 4.6 percent. This is the highest three-month net positive migration rate since the second quarter of 2011, and at the current pace would result in upgrades for nearly 28 percent of the current high-yield index.

History suggests that net rating migration should remain positive in 2021 and 2022: After the 2008 recession ended in June 2009, the high-yield index experienced a positive net migration rate of 2.6 percent in the 12 months ending June 2010. One year later, the high-yield index experienced a net upgrade rate of 9.7 percent. In loans, the index saw a positive 12-month net migration rate of 2.3 percent by June 2010, exceeded the following year with a net rate of 12.5 percent.

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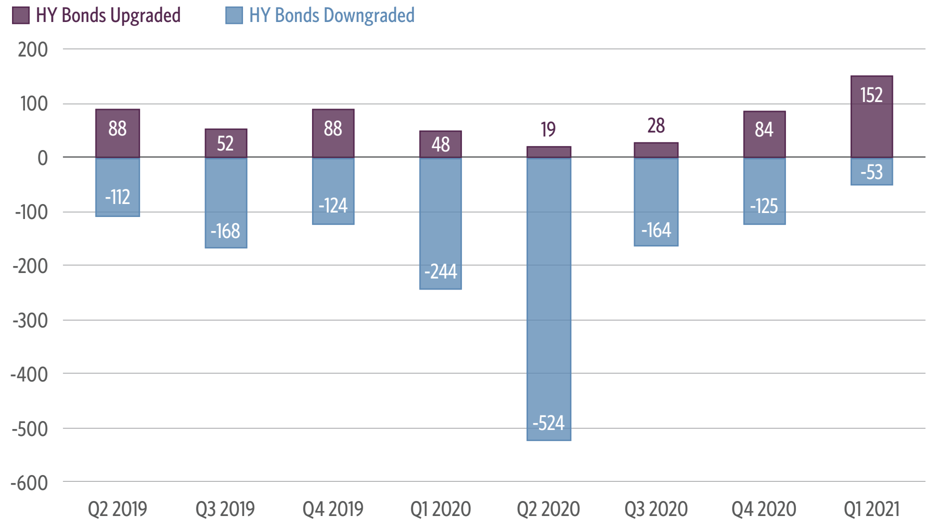
High-Yield Index Rating Migration Is Gradually Improving

3-Month Rating Changes



Source: Guggenheim Investments, ICE Index Services. Data as of 3.31.2021. Based on constituents of the ICE BofA High Yield Index only.

The market has priced in an outlook for positive rating migration into credit spread curves, which have flattened. But we still find opportunities for our portfolios while factoring in potential upgrades as well as downgrades. There are certainly plenty of opportunities in the new-issue market, which has seen record breaking volume.

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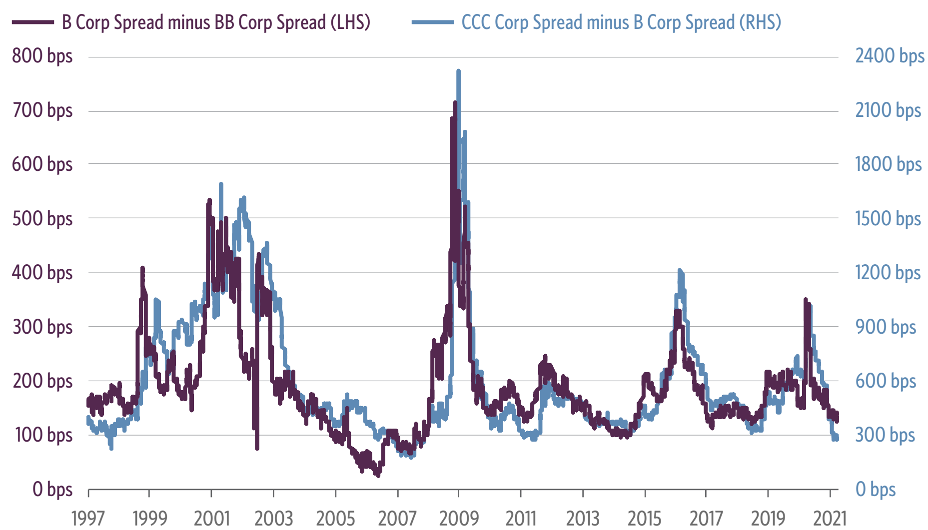
Credit Curves Have Flattened with Improving Expectations



Source: Guggenheim Investments, ICE Index Services. Data as of 3.31.2021.

Issuance Trends in the Recovery Phase

Though not steadfast rules, there are common new-issue trends that we expect to see at different stages of the credit cycle:

- The recession phase typically sees very little net new issue volume.
- The repair phase consists mostly of refinancing activity and very little net new issuance.
- The recovery phase may still see a high share of refinancing activity but also increasing volume of net new issuance.
- The expansion phase predominantly sees issuance for general corporate activity, such as capital expenditures, and for mergers and acquisitions (M&A) and leveraged buyout (LBO) activity.
- The speculative phase should experience the same type of transactions as in the expansion phase, accompanied by inflated valuations, high leverage ratios, additional losses in investor protections, and other signs of aggressive behavior.

The most prominent feature of primary market activity today is volume, with record low borrowing rates as a close runner up. In the first quarter of 2021, institutional loan issuance of $173 billion was the highest on record, while high-yield corporate issuance was the second highest on record at $132 billion. Total leveraged credit issuance of $305 billion exceeded the previous quarterly record of $254 billion, set in the first quarter of 2017.

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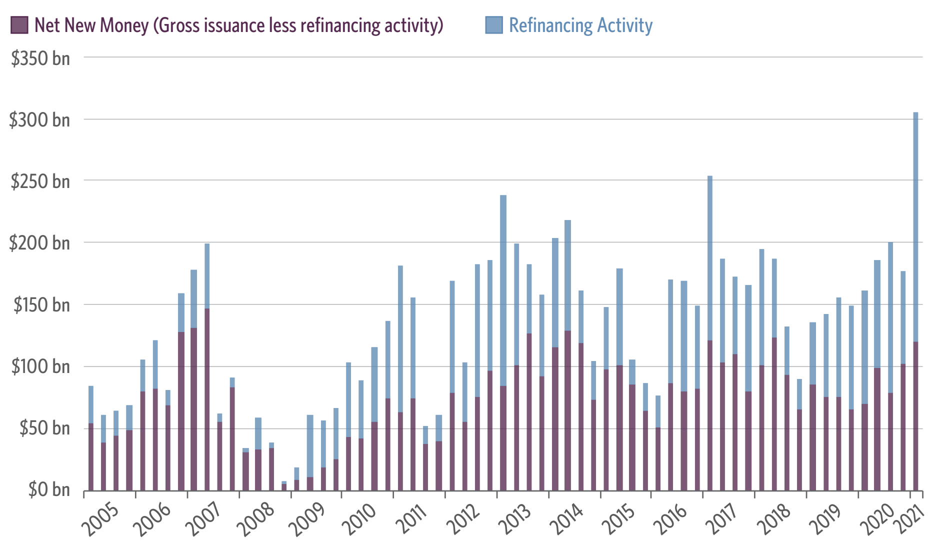
Quarterly Total Leveraged Credit Issuance Sets New Record



Source: Guggenheim Investments, S&P LCD. Data as of 3.31.2021.

Corporate borrowing costs were at record lows in the first quarter of 2021. Average new-issue yields were only 3.4 percent for BB-rated issuers, 5.4 percent for B-rated issuers, and 7.0 percent for CCC-rated issuers. CCC-rated issuers are now borrowing near rates extended to B-rated issuers just six months ago. Average loan new-issue yields were just 3.0 percent for BB-rated loans, 4.6 percent for B-rated loans, and 7.8 percent for CCC-rated loans.

We characterize current new-issue activity as in the recovery stage, as 61 percent was driven by refinancing and repricing activity, which extends maturities and lowers borrowing costs, but does not increase market size or leverage ratios. Netting out refinancing activity, there was $120 billion in net issuance in the first quarter of 2021, the eighth largest quarter on record. Normalized for the size of the leveraged credit market, however, quarterly net issuance volume was just below 3 percent of the total, a level we consider healthy.

Elevated M&A or LBO-driven financing would offer a clear sign of the next credit cycle phase taking place, potentially later this year but more likely in early 2022. This activity was just under a quarter of total volume in the first quarter, significantly below the 2005–2020 average of 41 percent. It is not necessarily a negative trend, but it is a sign that issuers are capitalizing on improved cash flows, higher corporate valuations, and increased leverage capacity. That said, it can be a cause for concern when issuers or sectors struggle to achieve organic growth and can only do so through acquisitions.

One sign of more aggressive new-issue behavior is the increase in dividend recap activity, where private equity sponsors pay themselves a dividend from the proceeds of raising debt. At $20 billion of institutional loan issuance and $3 billion of high-yield corporate issuance, dividend recaps represented 8 percent of new-issue volume in the first quarter. It is an important trend to monitor, as this type of activity typically occurs later in the credit cycle. In the context of over 60 percent of total activity being credit-positive refinancing activity, the dividend recap trend seems a more strategic choice by sponsors looking to execute at cheaper rates before the opportunity passes.

Investment Implications

The evaluation of credit market trends through the lens of normal cycle dynamics helps investors to stay grounded and evaluate credit trends without bias. In our view, primary market trends look benign and should support steady returns and low defaults in the near term. Meanwhile, the strong pace of vaccinations, improving labor market, and significant levels of fiscal stimulus underlie a positive outlook for the U.S. economy which we expect will keep defaults low for the next couple of years.

From a technical perspective, record low yields are driving strong demand for sectors that offer spreads over riskless assets such as Treasurys. The willingness of lenders to extend credit to borrowers of any quality keeps financial conditions relatively easy, in turn lowering default risk and pushing out the next default cycle.

We view refinancing activity in an environment where rates are lower on a year-over-year basis as credit positive, given that borrowers reduce the interest on their debt. This also gives borrowers time to realize strong earnings growth, improve their balance sheets organically, and gain the benefits of improved credit ratings. These are all signs that we are still in the early stages of a new cycle.

Credit rating upgrades factor into portfolio decisions in important ways. Upward rating migration means that default probability declines for issuers that get upgraded, which affects expected credit-loss adjusted spreads. As yields set new record low levels, and stay near those levels, it becomes even more critical to look for signs that a default cycle is approaching to protect from losses that would lower the all-in credit yield. Immediately following a recession has historically been the furthest possible distance to the next default cycle due to the various phases that occur in between.

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/LSTA U.S. Leveraged Loan index** is designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads, and interest payments.

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.

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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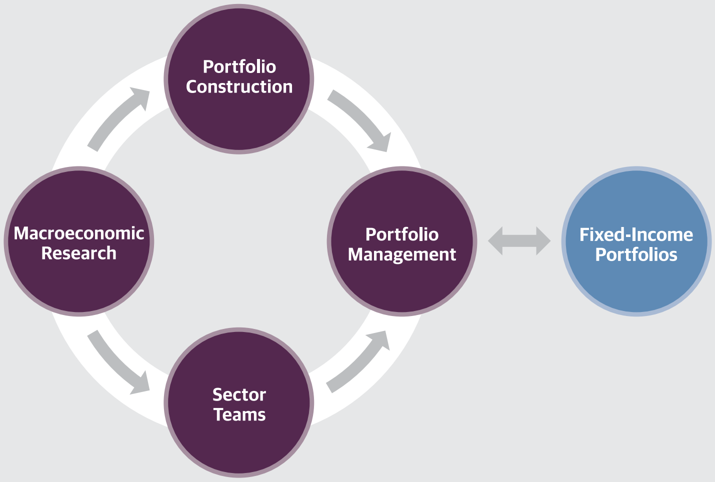

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