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High-Yield and Bank Loan Outlook

Credit Yields Look Attractive Despite Rising Recession Risks

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Table of Contents

Summary

Despite attractive yields, it is no surprise that investors are skittish about the leveraged credit market. Coming off the worst first half on record, when returns were negative 14 percent, high-yield investors are understandably anxious. So too are holders of leveraged loans, which performed better, but still declined by 4.4 percent. Although July saw a solid recovery for risk assets, a looming concern is that aggressive Federal Reserve (Fed) policy will trigger an economic recession in the United States, a risk that rises with data showing stubbornly persistent inflation even as economic activity cools. We offer some signposts for what investors can expect as recession approaches, as well as some ways to prepare.

Highlights from the Report

- Whether facing rising unemployment or a decline in equity prices, the Fed is unlikely to back down in its efforts to break the back of inflation.
- In the lead up to recession, we expect to see corporate earnings outlooks fall, more credit downgrades than upgrades, and default activity rise from its current low.
- Strong balance sheets that boast a healthy liquidity profile and sticky cash flows to cushion a pullback in economic activity will be in demand.

Leveraged Credit Scorecard

As of 6.30.2022

High-Yield Bonds

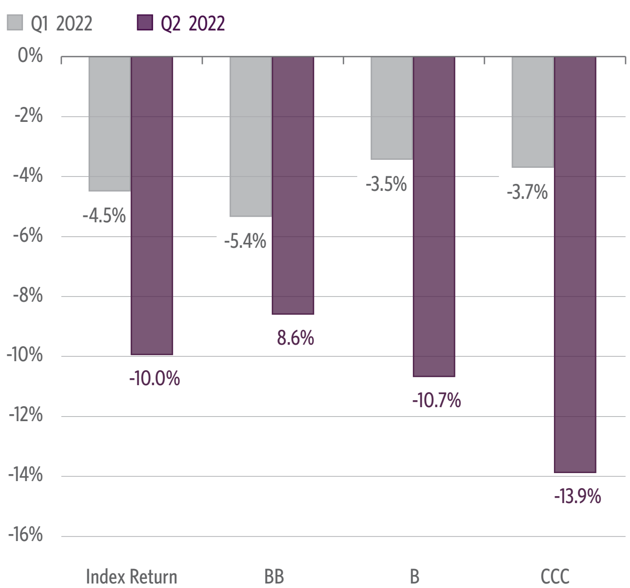
	December 2021		April 2022		May 2022		June 2022	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA U.S. High-Yield Index	330	4.3%	420	7.0%	436	7.1%	592	8.9%
BB	231	3.4%	301	5.9%	289	5.7%	422	7.2%
B	376	4.7%	455	7.4%	482	7.6%	657	9.6%
CCC	690	7.8%	873	11.6%	993	12.7%	1,198	15.0%

Bank Loans

	December 2021		April 2022		May 2022		June 2022	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	439	98.39	458	97.20	563	94.31	658	91.96
BB	307	99.42	319	98.71	393	96.67	472	94.65
B	444	99.15	464	97.78	582	94.67	681	92.26
CCC/Split CCC	945	90.61	1,052	86.36	1,240	81.28	1,244	82.13

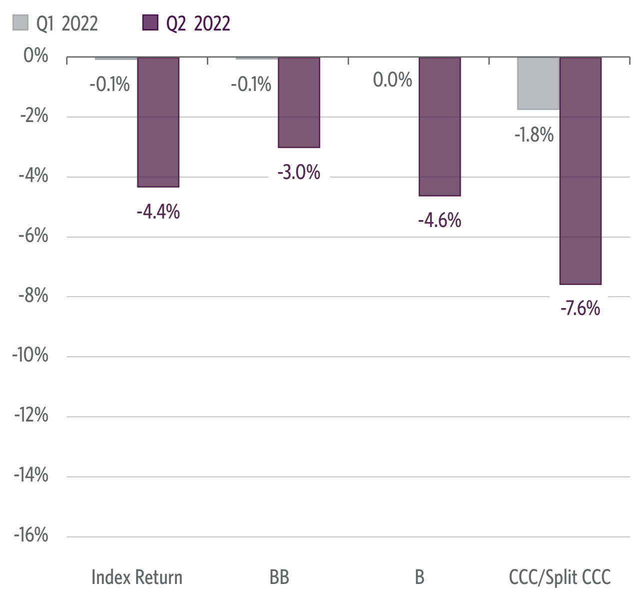
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE BofA U.S. High-Yield Index Returns



Source: ICE BofA. Data as of 6.30.2022. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 6.30.2022. Past performance does not guarantee future results.

Macroeconomic Overview

> “We’re starting to see the signs that the market has discounted all of the Fed tightening.
>
> – Scott Minerd, *Chairman of Guggenheim Investments and Guggenheim Partners Global Chief Investment Officer*

Several concerning pieces of inflation data released within a week of the June Federal Open Market Committee meeting prompted the Fed to scrap its forward guidance for a 50 basis point rate hike and instead raise the target range by 75 basis points, the largest single meeting increase since 1994. This move was followed by another hike of 75 basis points at the committee’s next meeting in July as inflation prints continued to signal elevated and broad-based price pressures. Fed Chair Jerome Powell’s remarks at both press conferences indicated that the central bank would continue to raise rates aggressively until the inflation data show clear and convincing signs of moderating—a commitment echoed by various other Federal Open Market Committee (FOMC) members since then. While there are tentative signs of inflation beginning to moderate, it may take some time before the Fed reaches its inflation target given that monetary policy acts with long and variable lags, and inflation itself lags economic activity.

On that point, inflation cooled in July, with the headline Consumer Price Index (CPI) rising 8.5 percent year over year compared to 9.1 percent in June. On a month-to-month basis, in July headline prices were flat after 25 consecutive months of rising prices, and core prices rose at a 0.3 percent pace, down sharply from June’s 0.7 percent gain. We will get another CPI print before the next FOMC meeting and we expect that inflation will likely continue to cool.

In recent press conferences, Powell notably acknowledged that the central bank must remain sensitive to headline inflation, a measure over which they admit to having less control than core inflation, as food and energy prices are driven by both global and domestic forces. The risk is that higher energy prices spill into consumers’ views on future inflation, causing inflation expectations to become unanchored. Since monetary policy has little influence on energy prices or the industry’s demand/supply dynamics, all the Fed’s monetary levers can do is attempt to cool demand in other sectors to offset the rise in energy prices, thus blunting the total impact on consumer wallets. Home prices, for example, have been on a tear, but this sector is very sensitive to a rise in mortgage borrowing costs, and is the area in which we have recently seen a significant decline in activity.

In addition to housing, economic data point to slowing activity that would be consistent with inflation eventually softening. Real gross domestic product (GDP) declined in both the first and second quarters, heightening recession fears. Many retailers, including Target Corp. and Walmart, warned that softening consumer demand is resulting in excess inventories that will require lowering product prices. The University of Michigan’s consumer sentiment measure remains near the lowest level since the series began in 1952. Survey respondents point to inflation as a major constraint on household finances, and as a result, consumers report a bleak outlook for spending in the months ahead. The retail sales data for July were mixed, with overall sales flat. As an early indication of third quarter consumption, after adjustment for inflation real retail sales were negative. If this pattern were to continue, third quarter GDP could contract again.

The Fed has been very clear in expressing its commitment to fight inflation, and even policy "doves" have been making hawkish statements. At the same time, Powell has also said that the Fed would be moving away from forward guidance and instead using a loose framework of data dependence for its policy decisions once rates get above neutral. In this framework, we would expect the Fed to scale down or even pause rate hikes if the cooling in inflation that began in July continues. But nevertheless, a 50 basis point hike is still expected for the September FOMC meeting. While the window is open for a pause at the early November FOMC meeting, a pause is unlikely if progress on inflation does not materialize. Stock market declines and widening credit spreads prompted the Fed to relent in the past, but this time it seems unlikely to do so. In fact, the selloff in risk assets is exactly what the Fed wants in order to tighten financial conditions and support the Fed's goal of slowing demand. Capital market activity has slowed to a crawl as corporate borrowers shelve plans for expansion and hiring. Even higher unemployment would not stop the Fed from raising interest rates if inflation continued at high levels, as the Fed has characterized the job market as too tight and spoken of the need to see slower wage growth. This tension in the Fed's communications will make the annual Jackson Hole conference and the September FOMC meeting particularly consequential for investors.

History shows that once unemployment starts rising, curbing joblessness before it causes a full-blown recession is difficult. Historically, too, we have not seen the headline consumer price year-over-year index slow by more than 2.5 percentage points without a recession. Thus, it was notable that in the FOMC's June Summary of Economic Projections, the median forecast for the unemployment rate sees an increase in 2023 and 2024 and a sharp slowing in headline inflation, which combined would historically be more consistent with a recession.

Market pricing points to the fed funds rate at around 3.5 percent by the end of 2022. This level would be enough to cause distress among some floating-rate borrowers. We also expect the tailwinds that are currently supporting consumer spending—the spending of excess savings from unspent fiscal stimulus and the reopening of the services sector—to fade. Headwinds are growing in the form of falling consumer sentiment and tightening financial conditions through higher rates, wider credit spreads, and lower equity prices. Forecasting recession timing is difficult, and even as models suggest that the probability of a recession in 2023 is rising meaningfully, there are some indications that the recession may have already arrived. For example, through July the Conference Board's Leading Economic Index (LEI) has now registered a decline in five straight months. There has never been a period when four straight monthly declines in the LEI was not accompanied by a recession.

Market Outlook
Key Signposts for the Second Half

Year-to-date total returns of -14 percent in high-yield corporate bonds marked the worst first half of any year on record.[1] This negative performance was driven by Treasury yields increasing and spreads widening, as excess returns relative to maturity-matched Treasurys returned -8.2 percent. Seeing both duration and spread factors detract from total return is unusual, but does reflect the backdrop of high inflation (driving benchmark rates higher) and a central bank willing to control it with a recession (driving spreads wider). The draining of market liquidity via quantitative tightening has also played a role in poor performance this year.

Leveraged loan returns were -4.4 percent over the same period, another indication of increased dislocation and recession fears.[2] By the end of the second quarter, the leveraged loan index traded at an average price of 92 cents on the dollar, with 9 percent of the index ($132 billion) trading below 90 cents on the dollar. Unlike high-yield corporate bonds, however, leveraged loans outperformed Treasurys at the belly of the curve as measured by the ICE BofA five-year Constant Maturity Treasury index, which was down 7.6 percent.

Following dismal market performance, which has also seen mutual fund outflows and dwindling new issue activity, many of our client questions have been centered around whether we are close to a bottom in prices and a peak in yields, especially given the strong bounce back in July. For reasons laid out in our macroeconomic section, we believe we are nearing the peak in Treasury yields. But with a U.S. recession the likely outcome to the Fed's pursuit of lower inflation, it would be prudent to consider how the credit backdrop might change even if returns fare better in the second half.

It is important to keep two things in mind: first, there are still many unknowns about what the next recession will look like in terms of its severity, duration, or the fiscal and monetary policy responses likely to be adopted. Second, valuations look attractive for long-term investors with deep credit expertise. Despite a lot of uncertainty about what is to come, we identify a few key signposts to help investors prepare accordingly.

Unless there is a dramatic upswing in economic activity and a substantial easing of financial conditions, the next six-12 months will almost certainly see more credit rating downgrades than upgrades. This would be a reversal from the last 12 months, which saw 200 bank loans and 641 high-yield corporate bonds upgraded, while only 131 bank loans and 208 corporate bonds were downgraded. Net positive rating migration has, until recently, offered some comfort to credit investors.

The trend was not to last: June was the first month since May 2020 that Standard & Poor's long-term rating changes saw more downgrades than upgrades. These changes happened across a broad range of industries including technology, consumer staples, consumer discretionary, and healthcare, many driven by out-of-

Note: 1. ICE BofA U.S. High-Yield Index. 2. Credit Suisse Leveraged Loan Index. Data as of 6.30.2022.

court restructurings that prompted the rating agencies to drop ratings to "default" or "selective default." We believe more negative rating migration lies ahead given that growth expectations continue to be downgraded.

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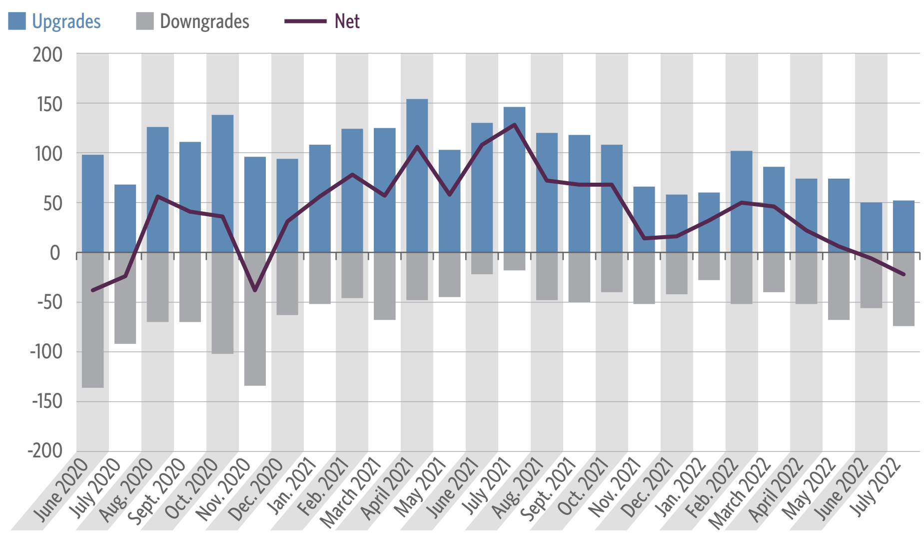
Reaching an Inflection Point in Rating Migration as Downgrades Accelerate

S&P Global Long-Term Rating Changes for U.S. High-Yield Companies



Source: Guggenheim Investments, Bloomberg. Data as of 7.31.2022.

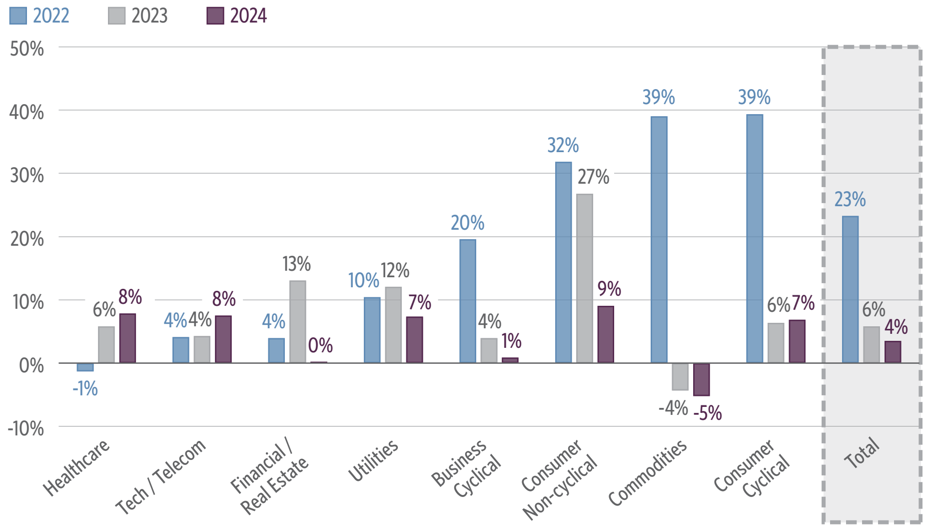
On a more positive note, equity analysts covering below investment-grade companies expect 2022 earnings before interest, tax, depreciation, and amortization (EBITDA) to be 23 percent higher than last year. These expectations soften to 6 percent year-over-year growth in 2023 and 3 percent in 2024. The plus side is that a big slowdown is already reflected in earnings growth. However, corporate earnings for high-yield issuers tend to decline by between 20–40 percent during recessions, and by between 10–20 percent for loan issuers. We think analysts are being too sanguine in expecting a soft landing considering how much the Fed needs to depress demand to get inflation back to their 2 percent target.

In practice, an individual company's earnings sensitivity is best analyzed and stress-tested by a dedicated credit analyst, but it helps to use historical cyclicality as guidance. For example, employment in sectors such as consumer discretionary and construction tend to suffer more in recessions because consumers curb spending in areas such as home improvement, purchases of vehicles, or discretionary activity like going on vacation, before they cut back on services related to healthcare, finances, and even some smaller forms of entertainment, such as streaming media. Given these dynamics, some likely prospects for negative earnings revisions lie in retail and durable goods manufacturing as consumers absorb rising prices by budgeting what they can back to services consumption.

A big slowdown is already reflected in expected earnings growth. However, corporate earnings for high-yield issuers tend to decline by between 20–40 percent during recessions, and by between 10–20 percent for loan issuers. We think analysts are being too sanguine in expecting a soft landing considering how much the Fed needs to depress demand to get inflation back to their 2 percent target.

Downward Adjustments to Corporate Earnings Growth Are Likely

Expected EBITDA Earnings YoY% Change by Sector



Source: Guggenheim Investments, S&P Capital IQ. Data as of 3.31.2022. Based on aggregate sector level corporate earnings before interest, taxes, depreciation, and amortization.

Another market dynamic that has been unfolding this year is limited new issue activity. Primary market volume for institutional leveraged loans is down 57 percent from the first seven months of 2021, and new issuance in high-yield bonds is down 78 percent. We expect low supply to continue, as the Fed is orchestrating an intentional slowdown in economic activity through higher interest rates. Borrowing costs have risen substantially, with average new issue yields in high-yield corporate bonds at 6.2 percent, versus 4.9 percent in June 2021. In loans, where the majority of new issue supply is in the single B cohort, average new issue yields are nearly 8 percent—up from 5.0 percent in June 2021. Generally, lower new issue activity precedes an increase in default volume.

Finally, realized default activity remains very low, totaling less than $15 billion across bonds and loans in the first half of the year, but this is very likely to rise in the second half of the year. According to Bloomberg data, the total volume of bonds trading at over 1,000 basis point spreads and loans trading below 80 cents on the dollar reached $200 billion combined, three times higher than at the start of the year. This also represents the highest amount since December 2020.

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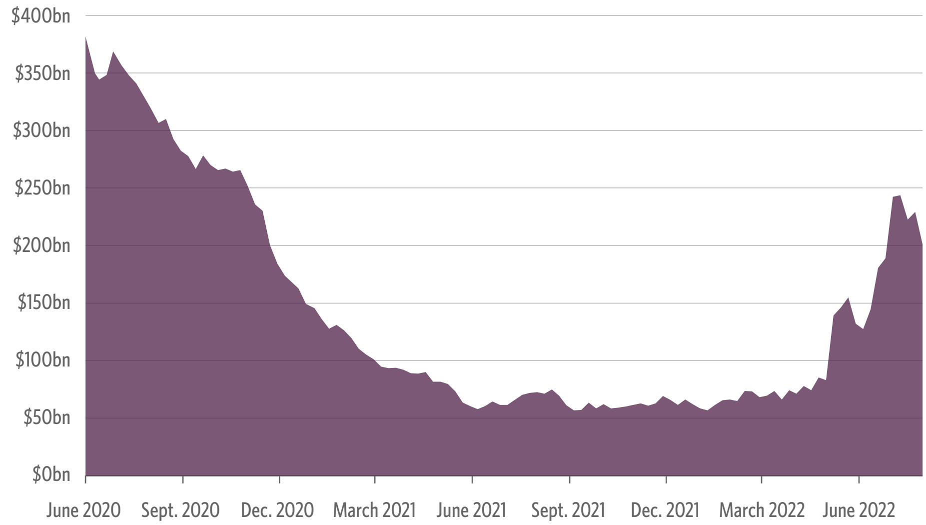
Defaults Are Low, but Signs of Distress Among Borrowers Is Rising

Total Volume of Distressed Bonds and Loans



Source: Bloomberg. Data as of 8.5.2022. Includes U.S.-based dollar-denominated bonds trading at spreads greater than 1,000 basis points and loans trading below 80 percent of par.

Investment Implications

Downgraded earnings forecasts, negative ratings migration, scarcity in new financing, and a rising number of distressed issuers may sound like a death sentence for credit markets given that year-to-date performance has already made investors skittish about their positions. There is always a balancing act between valuations, credit fundamentals, and market volatility, and it is difficult to overlook attractive value in credit currently: Credit spreads are at their widest levels since mid-2020.

Most sectors on our internal tracking dashboard remain relatively cheap, though prices have recovered from recent lows. Spreads across various sectors are in between the 50–80th percentile of historical valuations. The risk premiums on leveraged loans look especially attractive, ranging from the 65–75th percentile of historical levels.

Most Credit Sectors Are Cheap Relative to History

	Data Since	Spread / DM	Ex-Recession Average	Ex-Recession Maximum	Historical Maximum	Current Spread Percentile
Bloomberg High-Yield Index						
BB	Jan. 1994	275	305	683	1,278	47%
B	Jan. 1994	434	455	1,021	1,742	49%
CCC	Jan. 1994	905	823	2,026	2,606	62%
Credit Suisse Leveraged Loan Index						
BB	Jan. 1992	361	300	553	1,311	66%
B	Jan. 1992	573	465	956	2,389	71%
CCC	Jan. 1997	1,277	1,207	5,056	5,056	66%

Source: Guggenheim Investments, Bloomberg, Credit Suisse. Data as of 8.10.2022.

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Our percentile measures also tell us that there is potential for spreads to widen further, which is the downside view. For example, while BB-rated bank loan discount margins of 368 basis points are in the 69th percentile—much more attractive than when they were in the 8th percentile last year—it is possible that premiums may widen to 417 basis points, which would be the 85th percentile observation. We estimate an instantaneous shock in that direction would represent a 1.5–2.0 percent price loss.

As we navigate downside risks, our approach is to select the best credits within industry silos rather than avoiding cyclical industries altogether. For example, we have been finding value in select names within the consumer cyclical space which investors tend to avoid in recessions. We believe some companies in out-of-favor categories are positioned to survive a downturn due to their healthy liquidity profiles and sticky cash flows, which often come from long-term contracts in place or issuer bargaining power.

In both high-yield corporate bond and leveraged loans sectors, long-term value really stands out in their yields. High-yield corporate bond yields are nearly 8 percent, and leveraged loan yields are nearly 9 percent. Each has traded at average yields of 6.3–6.4 percent since 2010. There are only a few periods in the last decade where yields have been as high, but many regretfully missed out on the opportunity. We would advise credit investors in today's market to be prudent and not make the same mistake.

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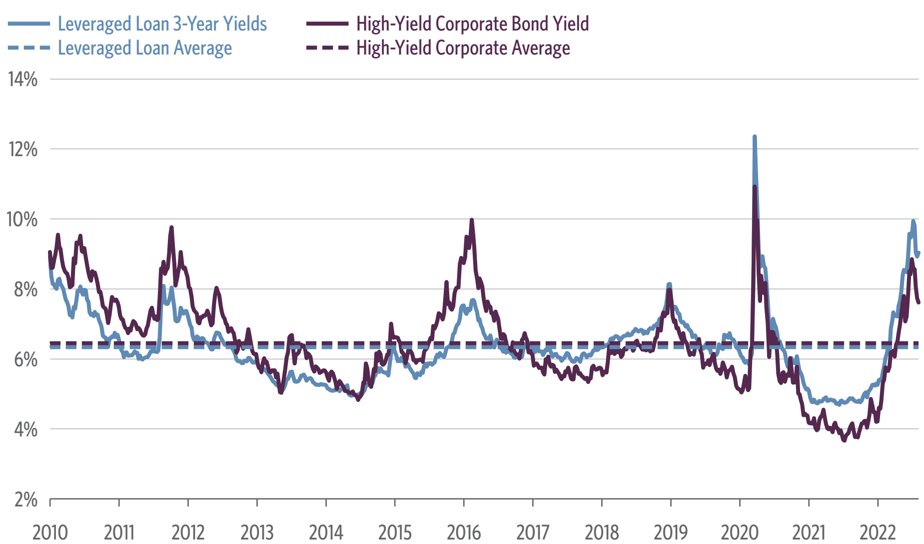
Leveraged Credit Yields Look Relatively Attractive



Source: Guggenheim Investments, Bloomberg. Data as of 8.5.2022. Leveraged loans are represented by the Credit Suisse Leveraged Loan Index; high-yield corporate bonds are represented by the ICE BofA U.S. High-Yield Index. Past performance does not guarantee future returns.

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%.

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.

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.

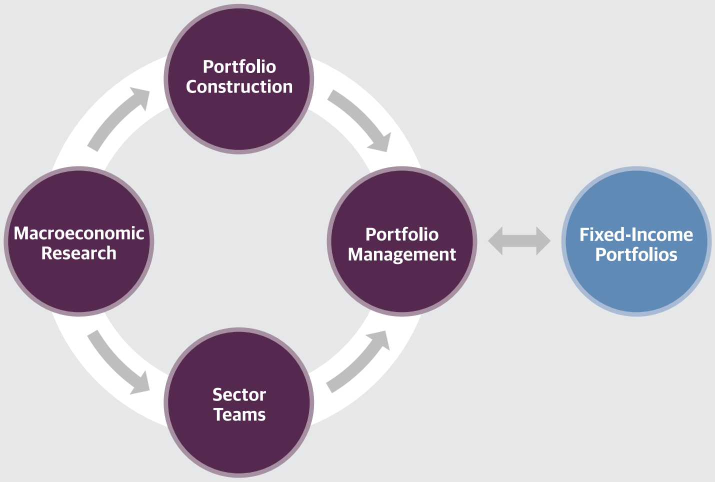
Bank loans are generally below investment grade and may become nonperforming or impaired for a variety of reasons. Nonperforming or impaired loans may require substantial workout negotiations or restructuring that may entail, among other things, a substantial reduction in the interest rate and/or a substantial 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.

1. Guggenheim Investments assets under management are as of 6.30.2022 and include leverage of $18.3bn. Guggenheim Investments represents the following affiliated investment management businesses: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Partners Advisors, LLC, Guggenheim Corporate Funding, LLC, Guggenheim Partners Europe Limited, Guggenheim Partners Japan Limited, GS GAMMA Advisors, LLC, and Guggenheim Partners India Management.

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 $228 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 250+ 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 diversified financial services firm that delivers value to its clients through two primary businesses: Guggenheim Investments, a premier global asset manager and investment advisor, and Guggenheim Securities, a leading investment banking and capital markets business. Guggenheim's professionals are based in offices around the world, and our commitment is to deliver long-term results with excellence and integrity while advancing the strategic interests of our clients. Learn more at GuggenheimPartners.com, and follow us on LinkedIn and Twitter @GuggenheimPtnrs.

For more information, visit GuggenheimInvestments.com.

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