November 2020

High-Yield and Bank Loan Outlook

Opportunities in Credit Amid Challenging Conditions

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Summary

With the economy gradually improving and monetary policy anchoring Treasury rates to low levels, we remain constructive on below investment-grade opportunities in bonds and loans. Credit spreads have plenty of room to tighten given a general dearth of yield across fixed income and with spreads that still look attractive on a historical basis. There is, however, an overhang of a challenging credit environment as measured by market default rates, rating migration, and fundamentals which underscore the need for active security selection.

Central bank action has played a critical role in supporting credit availability, which has tempered forward looking default rate expectations as many issuers have accessed the capital markets to shore up liquidity. We expect some sectors however, namely energy and retail, will continue to experience defaults going forward. Avoiding those defaults is crucial, because on average investors recover only 40 and 70 percent of par in high-yield and bank loan default situations, respectively, with year-to-date recoveries significantly lower than those averages.

Post-recession recoveries are often punctuated with short periods of widening in credit spreads such as in 2002 and 2011. Both periods represented buying opportunities and proved to only be a temporary setback on the road to recovery. Any setback should be viewed as temporary and, as such, an opportunity to add to positions.

Industry analysis and credit selection in this environment is paramount. Within COVID-19 sensitive sectors we have prioritized investments that are structurally protected with strong collateral packages. Additionally, we have identified opportunities in less cyclical sectors and in fallen angels, the latter of which has seen $240 billion in volume already this year.

Report Highlights

- Credit spreads remain near the 60th percentile of historical observations dating back to 1998, giving them plenty of room to tighten.
- Aggregate 12-month trailing high-yield net leverage ratio of 4.5x has already exceeded the 2008–2009 default cycle peak of 3.9x, and is likely to get worse as 2019 data falls out of the calculation.
- We have selectively added high-yield exposure in longer maturity bonds this year, including in fallen angels.
- Our research shows fallen angel prices tend to rebound after they enter the high-yield index, supporting the existence of a structural anomaly that causes them to be oversold around the index transition period.

Leveraged Credit Scorecard
As of 9.30.2020

High-Yield Bonds

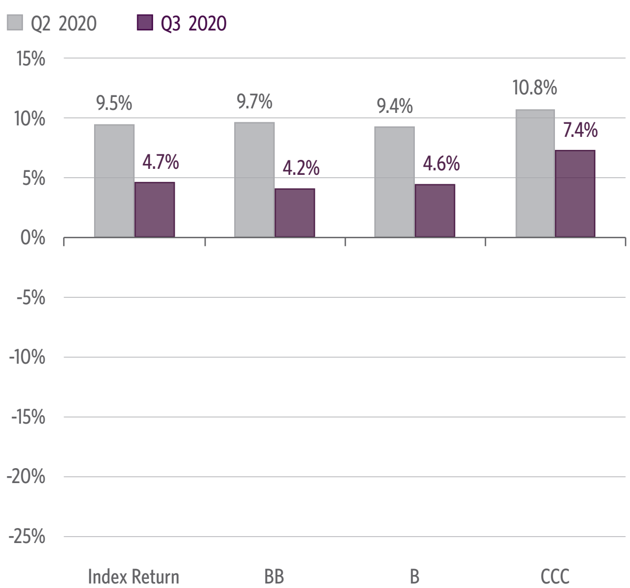
	December 2019		July 2020		August 2020		September 2020	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	372	5.4%	523	5.5%	508	5.4%	547	5.8%
BB	214	3.9%	362	3.9%	358	3.9%	403	4.4%
B	374	5.4%	553	5.7%	532	5.6%	579	6.0%
CCC	964	11.3%	1,257	12.8%	1,168	11.9%	1,153	11.8%

Bank Loans

	December 2019		July 2020		August 2020		September 2020	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	461	96.51	629	91.04	589	92.33	579	92.77
BB	262	99.81	389	96.32	363	96.88	369	96.81
B	470	97.67	590	94.93	555	95.94	547	96.32
CCC/Split CCC	1,365	80.14	1,649	73.36	1,474	77.53	1,371	80.16

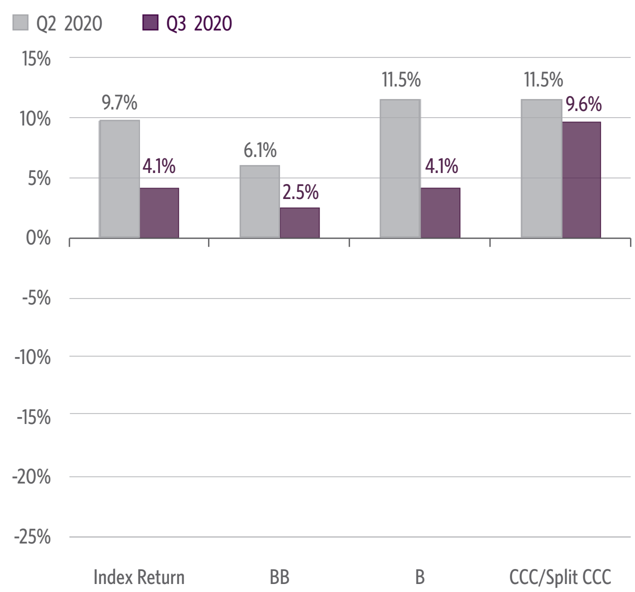
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE BofA High-Yield Index Returns



Source: ICE BofA. Data as of 9.30.2020. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 9.30.2020. Past performance does not guarantee future results.

Macroeconomic Overview

> “The most potent firepower at the Fed’s disposal is still the good old-fashioned printing press.
>
> – Scott Minerd,
> *Chairman of Investments and Global Chief Investment Officer*

Lower for Longer

While the outlook on fiscal policy is contingent on the 2020 presidential election outcome, the monetary policy outlook is far less dependent on it. Our views hold that the Federal Reserve (the Fed) will remain extremely accommodative over the next several years. This is in large part owing to the recent revisions to the Fed’s policy framework that resulted in a dovish shift in the policy reaction function.

Fed policymakers revised their Longer-Run Goals and Monetary Policy Strategy in August 2020. Labor market goals now focus on correcting shortfalls in achieving maximum employment, rather than managing deviations from it, which previously included tightening policy when the Fed thought the labor market was too tight. Instead, the Fed will now tolerate the unemployment rate falling below a level they consider to be maximum employment as long as it does not produce unwanted inflation. On inflation policy, the Fed will aim for core inflation to average 2 percent over an unspecified time period. This allows for inflation readings that are moderately above 2 percent over shorter horizons to make up for periods when inflation falls below its target.

The practical effect of the revised strategy would likely have meant no rate hikes from 2015–2018, as inflation was never above 2 percent for a sustained period and a low unemployment rate is now an insufficient justification for raising rates. But the revised statement, and Fed Chair Jerome Powell’s speech at Jackson Hole, which coincided with the release of the new framework, gave no explanation of how the Fed would actually achieve higher inflation, something it could not attain previously with years of short-term rates at zero and trillions of dollars in quantitative easing. A lack of concrete guidance on the overshoot (with no numerical target and no specified time frame) further weakens the policy and the associated response in inflation expectations, which remain lower than the Fed would favor.

We expect the Fed will have a very difficult time in reaching its inflation target in the coming years, let alone exceeding it, in part because core inflation lags real gross domestic product (GDP) growth by about 18 months. That means inflation should trend downward over the next several quarters after a brief spike as economic activity rebounds from recent lows. In addition, elevated unemployment and a high debt burden will weigh on the speed of the recovery. Given the rate of economic growth relative to potential output, the unemployment rate may not return to pre-COVID levels until 2024 or later. And as the last expansion demonstrated, even a strong economy with low unemployment does not necessarily produce inflation in excess of 2 percent, as many components of inflation are not responsive to interest rates or economic conditions.

Below-target inflation will help to anchor Treasury yields at low levels. In the near term, this will be reinforced by concerns over another COVID-19 wave complicated by the flu season, a slowing pace of improvement in the labor market, a lack of additional fiscal stimulus, and election uncertainty. These factors could push the 10-year Treasury yield down to 10 basis points. However, over the next year, as markets increasingly price in the view of the Fed stuck at zero indefinitely, and as comparatively higher yields in the United States attract capital from abroad, we expect to see the 10-year Treasury yield below zero.

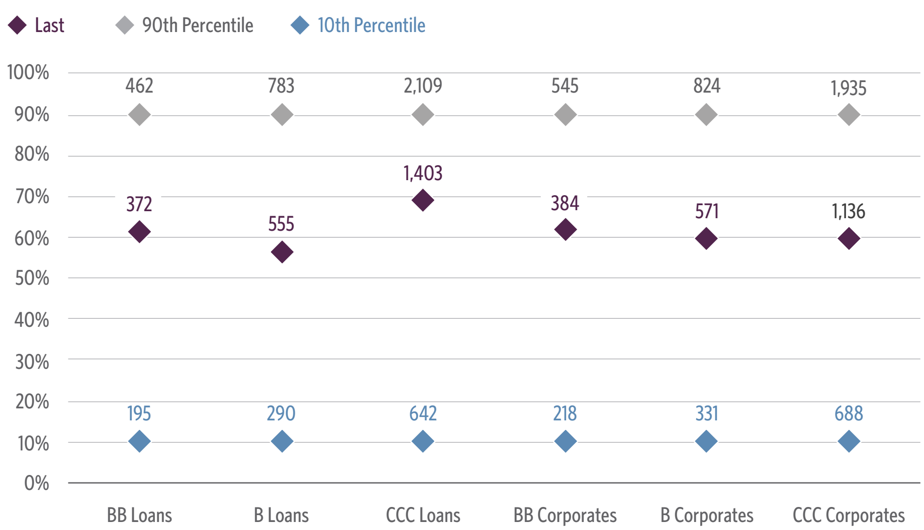
Market Outlook

Credit Conditions Remain Challenging

With the economy improving gradually and monetary policy anchoring Treasury rates at low levels, we remain optimistic about below investment-grade opportunities in bonds and loans. Credit spreads have plenty of room to tighten, and demand for yield is strong. As of Oct. 30, high-yield corporate bond spreads and leveraged loan discount margins are near the 60th percentile of monthly observations dating back to 1998, but there is an overhang of a challenging credit environment as measured by market default rates, rating migration, and corporate fundamentals.

As of Oct. 30, high-yield corporate bond spreads and leveraged loan discount margins are near the 60th percentile of monthly observations dating back to 1998, but there is an overhang of a very poor credit environment.

Credit Spreads Are Near the 60th Percentile of Historical Observations



Source: Guggenheim Investments, Credit Suisse, ICE Index Services. Data as of 10.30.2020. Percentile history based on monthly spreads from January 1998 to September 2020. Numerical values on the chart represent spread levels at the indicated percentile.

Aggregate 12-month trailing high-yield leverage of 4.5x has already exceeded the 2008–2009 default cycle peak of 3.9x, and is likely to get worse as 2019 data falls out of the calculation.

Negative rating migration remains alarming but has improved from earlier in the year. There have been five times more bonds downgraded than upgraded in the ICE BofA High-Yield index over the last 12 months, but on a three-month

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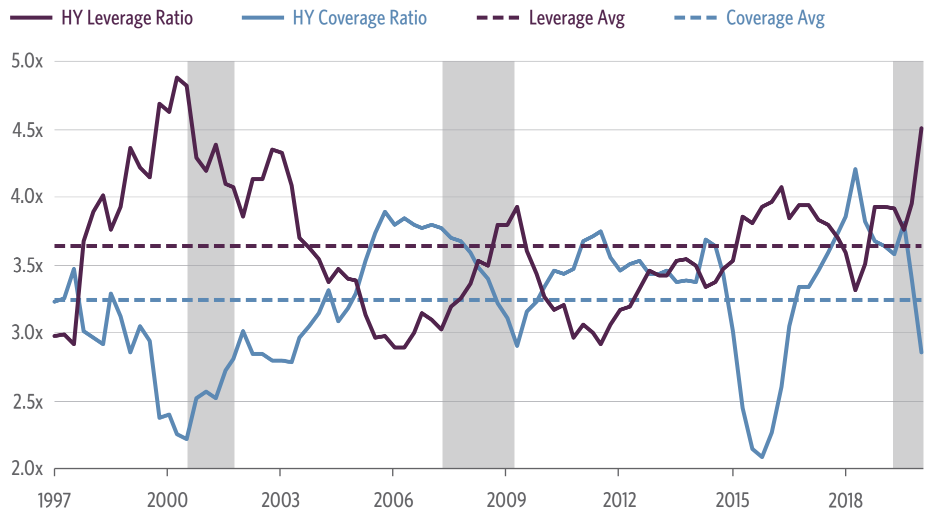
Fundamentals Are Highly Stressed in the Current Default Cycle

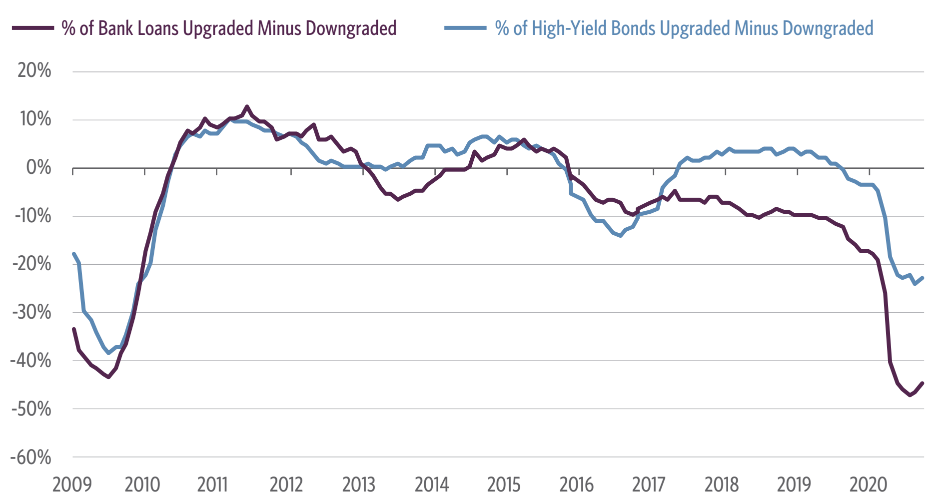


Source: Guggenheim Investments, BofA Merrill Lynch Research. Data as of 6.30.2020. Shaded areas represent recession periods.

trailing basis the ratio has fallen from 27x in the second quarter to 6x in third quarter. In percentage terms, the difference between the share of bonds upgraded minus those downgraded in the index over the last 12 months is -23 percent. In loans, there have been eight times more downgrades than upgrades in the S&P/LSTA Leveraged Loan index over the last 12 months, but the three-month ratio has improved from 43x in May to just 3x in September. The percentage of loans upgraded minus those downgraded in the index is -45 percent over the last 12 months.

The share of loans upgraded minus those downgraded in the S&P/LSTA Leveraged Loan Index is -45 percent, meaning that a far greater share of loans has been downgraded than upgraded. This is reminiscent of levels last seen during the 2008 recession. In high-yield bonds, the net share of loans upgraded minus downgraded is -23 percent, which is worse than the 2015–2016 default cycle, but better than during the 2008 recession.

12-Month Rating Migration Is Negative but Pressure Is Abating



Source: Guggenheim Investments, ICE Index Services, S&P LCD. Data as of 9.30.2020.

Central bank action has played an important role in credit availability, which impacts default probability and therefore rating downgrade activity. As of the third quarter 2020, we have seen $373 billion of gross new high-yield corporate bond supply, exceeding the largest annual volume on record of $341 billion in 2012, and the year is not yet over. Loans have not benefited as directly from credit availability. Institutional loan new-issue volume of $240 billion year to date represents a 14 percent decline from the same period last year. A key driver of this is limited issuance in the collateralized loan obligation market, the primary source of demand in the leveraged loan market, which is on track for the lowest annual issuance since 2016. Instead we have seen an increase in bond-for-loan takeout activity. Issuers have raised $73 billion of bond proceeds to repay existing loans this year, the highest total of such activity since 2013.

Twelve-month trailing default rates continue to climb, though the volume of quarterly defaults has slowed drastically. Defaults totaled $19.3 billion in the third quarter of 2020, much less than the $82 billion experienced in the second quarter, and even less than the $24 billion seen in the first quarter. There remains a high degree of uncertainty around the default outlook given that the CARES Act was a tailwind to consumer spending in the third quarter. We assign low odds of another fiscal package being passed in the next few months, but passing a fiscal stimulus bill will be the top priority for the next administration, whichever side emerges victorious.

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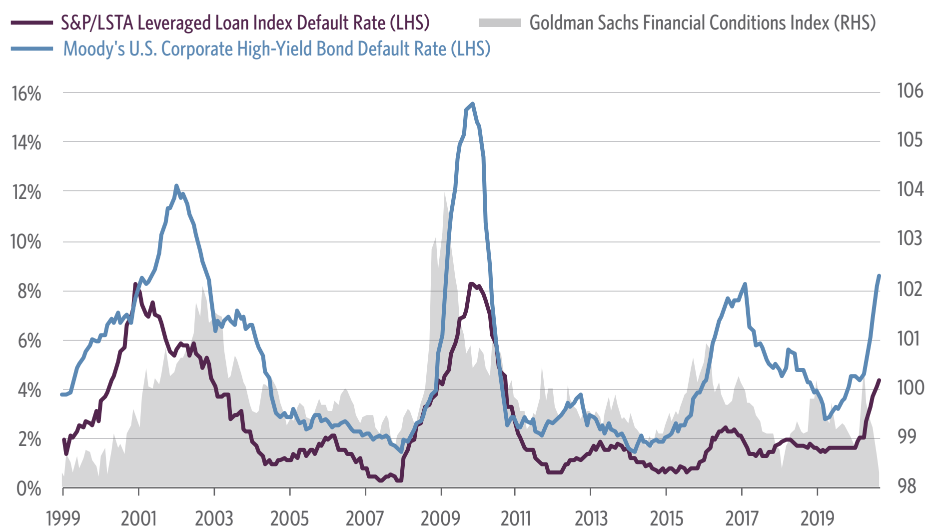
Default Rates Are Historically Correlated With Financial Conditions



Source: Guggenheim Investments, Goldman Sachs, S&P LCD, Moody's. Data as of 9.30.2020.

The Fed's efforts to ease financial conditions, which we covered extensively in last quarter's report, feature prominently in our default outlook. After all, an increasing in default volume historically follows a tightening in financial conditions, and in reverse, low default volumes historically coincide with easier financial conditions.

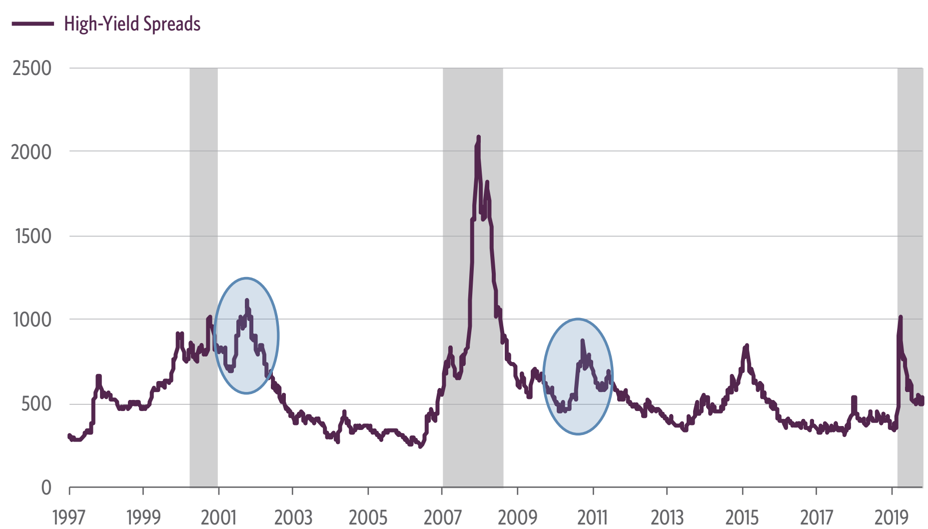
A detailed examination of the impact of the Fed's corporate credit facilities recently released by New York Fed economists also provides evidence that their efforts have reduced corporate credit risk through various channels. We agree with this position, but we believe that the improvement in financial conditions has its limitations in mitigating the effects of corporate balance sheet damage. Fiscal policy will have to carry a lot of the weight going forward.

While the share of bonds and loans priced for default has come down markedly, we believe we will continue to see defaults in the next 12 months. Avoiding those defaults is crucial given that on average investors are only recovering 30 percent and 55 percent of par in high-yield and bank loan default situations, respectively. Cyclical sectors like autos, gaming, leisure, media, and retail could also see further downside. The loan sector has cumulative exposure of only 17 percent to these sectors while the high-yield corporate bond market is more exposed with a 26 percent share. More bankruptcies in energy are likely, because despite oil's recent rebound, oil prices remain under pressure and still leave many shale players unprofitable. Given its aggregate indebtedness, the high-yield corporate bond market remains 15 percent exposed to energy alone.

We have identified opportunities in pharmaceuticals, food and beverage, technology, and even restaurants that have successfully navigated the impact of COVID-19. A healthy new-issue market has given us the benefit of remaining selective, and recently underwritten bonds are less likely to default, in our view. We also believe that longer-maturity bonds, most of which are issued by fallen angels, are uniquely positioned to benefit from further spread compression and a decline in Treasury yields.

Post-recession recoveries are often punctuated with short periods of widening in credit spreads such as in 2002 and 2011. Both periods represented buying opportunities and proved to only be a temporary setback on the road to recovery.

Short Periods of Credit Spread Widening After Recessions



Source: Guggenheim Investments, ICE Index Services. Data as of 11.4.2020. Shaded areas represent recession periods.

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Falling for Fallen Angels

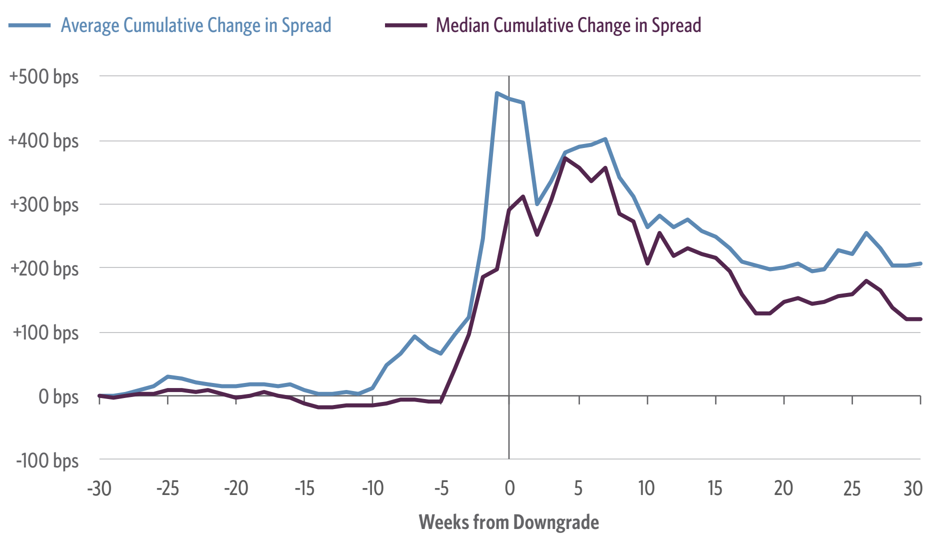
We have warned about the risk of a large wave of downgrades from investment grade to high-yield since 2018. Investment-grade corporate leverage has increased substantially from its nadir in 2011, with gross and net leverage climbing to record highs of 2.9x and 2.2x, respectively, in the second quarter 2020. Given this backdrop of several years of worsening corporate fundamentals and the catalyst of the COVID-19 recession, we have seen a record $240 billion of fallen angels in 2020 as of the third quarter, and we think another $200 billion to $300 billion is possible by the end of 2021.

The jury is still out on whether $240 billion in fallen angels this year had a negative technical impact on neighboring high-yield corporate bond prices. We had previously expected that there could be unexpected spillovers as high-yield investors made room for new entrants, but this is difficult to isolate and examine given broad-based volatility at the end of the first quarter. Our recent research suggests that fallen angel bonds tend to rally after entering the high-yield index, which we suspect is caused by a structural anomaly.

We analyzed the ICE BofA Fallen Angel Index to illustrate how bonds trade 30 weeks before and after being downgraded from investment grade to high yield. Using the index's constituents as of September 2020, we aggregated weekly

Our research suggests that fallen angels begin to sell off several weeks before they are downgraded. From the period beginning five weeks before their downgrade until one week after they became high yield, fallen angel prices fell about 13 percent, on average, with most of the decline occurring before the downgrade event.

Fallen Angel Credit Spreads Tend to Widen Before They Are Downgraded



Source: Guggenheim Investments, Bloomberg, ICE Index Services. Data as of 9.30.2020. Based on a study of over 300 bonds in the ICE BofA Fallen Angel High Yield Index and their S&P rating history since January 2017. The median and average calculations are only of bonds downgraded from investment-grade to high-yield status by S&P Ratings between January 2017 and October 2020 (between 150-200 bonds depending on weekly pricing data availability).

performance of bonds that became fallen angels between January 2017 and September 2020. Our sample size fluctuates moderately over the period as not every fallen angel analyzed has traded for 30 weeks before or after it was downgraded within our study's time horizon.

Our research suggests that fallen angels begin to sell off several weeks before they are downgraded. From the period beginning five weeks before their downgrade until one week after they became high yield, fallen angel prices fell about 13 percent, on average, with most of the decline occurring before the downgrade event. Spreads widened by an average of 392 basis points over the same period. In the subsequent weeks, however, prices rally and spreads tighten, although they do not fully recover to pre-fallen angel levels within our studied time frame of 30 weeks.

The price action before the rating change suggests that early warning signs exist. These may include slow-moving balance sheet deterioration, downgrades of the issuer by other rating agencies, downgrades of industry peers, other communication by the rating agency (for example, a credit being put on negative watch), and publicly known corporate developments, all of which we have developed tools to track.

If markets are generally efficient, and given that issuer fundamentals do not change substantially within several weeks, why do bonds rally so much after the downgrade event? We believe the reason is largely structural: both passive and active investment managers with portfolios constrained to the investment-grade universe must sell fallen angels, leaving spreads wider than is justified by fundamentals.

Investment Implications

As active high-yield managers, we have taken advantage of some, though not all, individual fallen angel events. Since prices tend to rally within several weeks, investors must anticipate rating actions and react quickly when they occur. But our credit research has identified that not all fallen angels may be creditworthy in this highly uncertain environment. Our credit research team is structured in such a way that analysts cover both investment-grade and high-yield issuers within the same industry, giving Guggenheim an advantage of continuity in credit coverage when an investment-grade company becomes high-yield rated. Our Macroeconomic and Investment Research Group is also highly involved in forecasting and monitoring potential fallen angel candidates.

We expect that there will be more opportunities to capture value in these downgrades as COVID-19 continues to leave its mark on the credit landscape, and we believe our disciplined investment process is well-suited to stay focused on long-term fundamentals and take advantage of such situations as they arise.

All indications point to continued improvement in below-investment-grade bonds. Any setback should be viewed as temporary and, as such, an opportunity to add to positions.

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

The potential impacts of the COVID-19 outbreak are increasingly uncertain, difficult to assess and impossible to predict, and may result in significant losses. 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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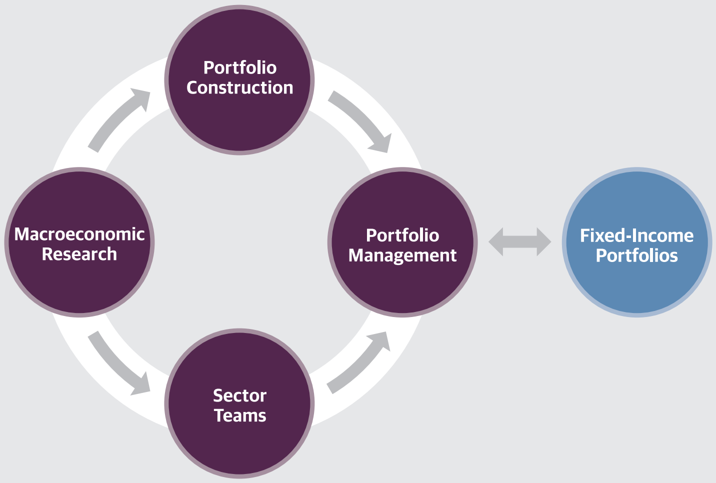
2. Guggenheim Partners assets under management are as of 9.30.2020 and include consulting services for clients whose assets are valued at approximately $69bn.

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 $233 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 $295 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.

For more information, visit GuggenheimInvestments.com.

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