GUGGENHEIM

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High-Yield and Bank Loan Outlook

A Strong Credit Market Shapes the Default Outlook

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Summary

The possibility of a U.S. recession raises the probability of rising defaults in credit markets. Several factors suggest the next default cycle could be more idiosyncratic and credit-specific and span multiple industries. The stress in this cycle is driven by unforgiving high interest rates as opposed to previous cycles triggered by a specific sector-related shock. Our biggest concern as we consider the outlook for credit is the possible lack of a typical monetary and fiscal policy response that occurs when the U.S. economy undergoes a recession, due to fears of reigniting above-target inflation. This tepid policy response would likely drag weak economic conditions into 2024 and stretch the default cycle.

Despite growing headwinds for the economy, we remain encouraged by the financial results we see across a large portion of the credit market. Debt issuers are heading into this slowdown in good financial shape, with strong balance sheets and historically high earnings. Given solid credit fundamentals, we view yields and discounted bond prices as offering the most attractive opportunity to portfolios in over a decade, but investors must be aware of downside risks that remain while the economy absorbs the full extent of policy tightening.

Highlights from the Report

- The default rate is likely to reach 3–3.5 percent by the end of 2023 in U.S. high yield and bank loan sectors but will continue rising after that as a likely longer-than-average recession ensues.
- After the recent rally, yields and spreads remain near the most attractive they have been in the past decade, and we think risk premiums in higher-quality high-yield compensate for default risk over the next 24 months.

Leveraged Credit Scorecard
As of 9.30.2022

High-Yield Bonds

	December 2021		July 2022		August 2022		September 2022	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	330	4.3%	497	7.7%	512	8.5%	550	9.6%
BB	231	3.4%	335	6.1%	355	6.9%	375	7.8%
B	376	4.7%	554	8.3%	538	8.7%	582	9.9%
CCC	690	7.8%	1,094	13.8%	1,170	15.1%	1,269	16.9%

Bank Loans

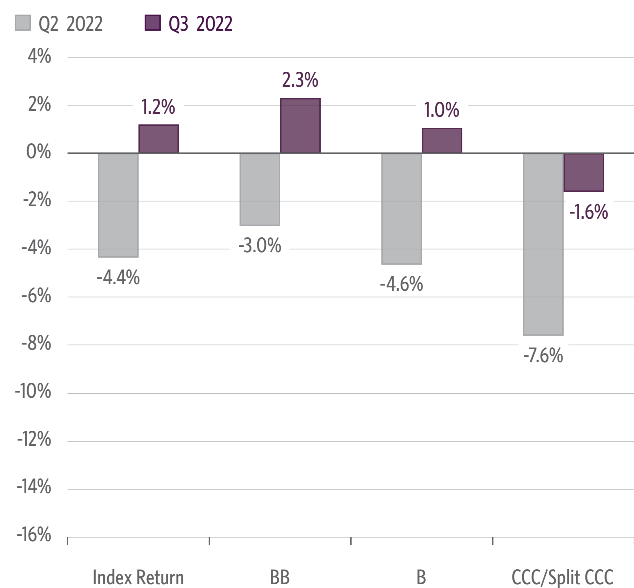
	December 2021		July 2022		August 2022		September 2022	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	439	98.39	602	93.30	564	94.19	668	91.60
BB	307	99.42	406	96.41	376	97.12	423	95.89
B	444	99.15	628	93.62	586	94.72	714	91.62
CCC/Split CCC	945	90.61	1,300	80.81	1,266	81.12	1,374	78.68

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 9.30.2022. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 9.30.2022. Past performance does not guarantee future results.

> “One of the most compelling points for credit right now is the starting health of corporate borrowers as the downturn begins.
>
> – Scott Minerd,
> *Chairman of Guggenheim Investments and Guggenheim Partners Global Chief Investment Officer*

Macroeconomic Overview

Central Banks Take Action to Protect their Credibility

The U.S. economy is sending mixed signals about the future direction of inflation even as the Federal Reserve (Fed) bears down on it with aggressive rate hikes. Data that signal inflation should have peaked include virtually zero real GDP growth over the past three quarters, slowing business investment, a tanking housing market, slowing retail sales, depressed consumer confidence, seven consecutive months without an increase in leading economic indicator readings, and weakness in manufacturing activity. By several measures, it could be argued that the United States is in a recession already.

The impact of a strong dollar, improving supply chain channels, and the recent decline in commodity prices also point to inflation cooling off soon. Amid these disinflationary signals, however, we see that demand for labor remains extraordinarily strong, unemployment is low, and workers are seeing the strongest nominal wage gains since the 1980s, even if wages are not keeping pace with recent inflation numbers. There are still more job openings than unemployed people, as labor demand has been resilient even as economic growth cooled off. This strength in the labor market is a major cause of the persistence and breadth of inflation, which was illustrated by new sequential highs in monthly price increases across several services categories in September’s Consumer Price Index report. Some pressures showed signs of easing in the October report but core inflation remains well above the Fed’s comfort zone.

This is not the backdrop the Fed would like to see as it aims for 2 percent inflation. What’s more, the Fed faces challenges over which it has no control, such as the disruption in energy supplies in the wake of the Russia-Ukraine war. With Russia shutting off energy supply in retaliation for sanctions, natural gas prices have soared in Europe and are starting to affect key manufacturing industries, in turn impacting goods production—the very thing that needs to improve globally.

Central banks around the world, with the notable exceptions of the Bank of Japan and People’s Bank of China, have intensified their efforts to suffocate inflation out of fear that expectations of high inflation could become entrenched in consumers’ expectations for the future. This led the European Central Bank (ECB) to raise rates and signal that more rate hikes will be coming. The ECB’s policy rate is now 2.0 percent, the highest since 2009, and the market is pricing in a terminal rate of slightly above 3 percent. In the United States, the market is pricing in a terminal fed funds rate of about 5–5.25 percent, which would be the highest since 2007.

The market proved quick to punish the United Kingdom for its act against the global concerted effort to quell inflation. In September, new (now former) British prime minister Liz Truss announced £45 billion in tax cuts aimed to stimulate a quickly slowing economy. Almost immediately, this announcement sent the British pound crashing to near parity against the U.S. dollar, and gilt bond yields went soaring. In the days that followed, a number of voices, including the International Monetary Fund, denounced the British government’s fiscal stimulus

plan at a time when aggregate demand is already in excess of deficient supply. Finally, concerned about financial stability risks, the Bank of England was forced to announce a plan to buy long-dated gilts in unlimited amounts for a self-imposed limited period to prevent an "unwarranted tightening in financial conditions."

A few lessons can be learned from the United Kingdom's experience. First, in a fight against inflation, all major policymakers must be onboard. The market will not tolerate monetary policy tightening with fiscal stimulus, as it lacks assertiveness and calls into question overall policy credibility. This lesson will be a challenge later when global economies are in contraction, as governments may be hesitant to stimulate too soon.

The second lesson is that economies must be willing to take the pain to get inflation down. As Fed Chair Jerome Powell described during the September Federal Open Market Committee (FOMC) press conference, there is no painless way to achieve this part of the mandate. In September the median FOMC participant projected a 4.4 percent unemployment rate in 2023, which would be an increase of 0.9 percentage point from the recent cycle trough of 3.5 percent. An increase of this magnitude has never been seen outside of a recession. While inflation should cool soon with some supply side relief and the lagged effect of tightening financial conditions, a full return to target is not in sight until the labor market weakens substantially. This need for aggressive Fed policy virtually ensures a recession in the United States in 2023.

As we consider what risks rate hikes and recession pose to our credit investments, we are especially mindful of unforeseen consequences brewing from the impact of significant dollar strength and global interest rates considerably higher than expectations just a few months ago.

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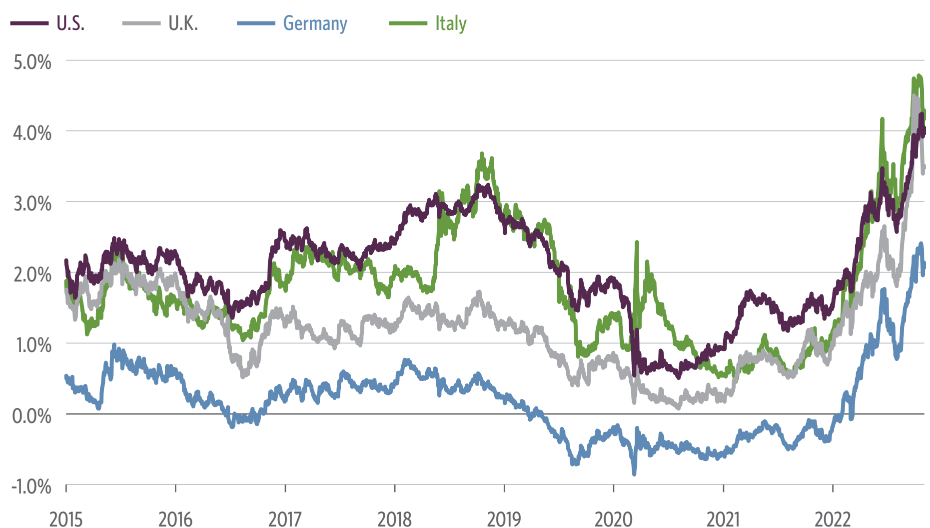
Substantial Increase in Global Interest Rates Pose Unknown Risks

10-Year Government Bond / Note Yields



Source: Guggenheim Investments, Bloomberg. Data as of 10.31.2022.

It is possible the Fed never reaches the expected terminal rate as unpredictable shocks can cause severe damage to confidence and market functioning, create conditions of market illiquidity, and drive risk premiums toward historical levels previously thought unlikely to be seen again. These conditions would force the Fed's hand to modify or end its hiking cycle. We are keeping an eye on areas of the market where such risks could emerge, particularly focusing on corners of the market that have relied on cheap leverage to survive.

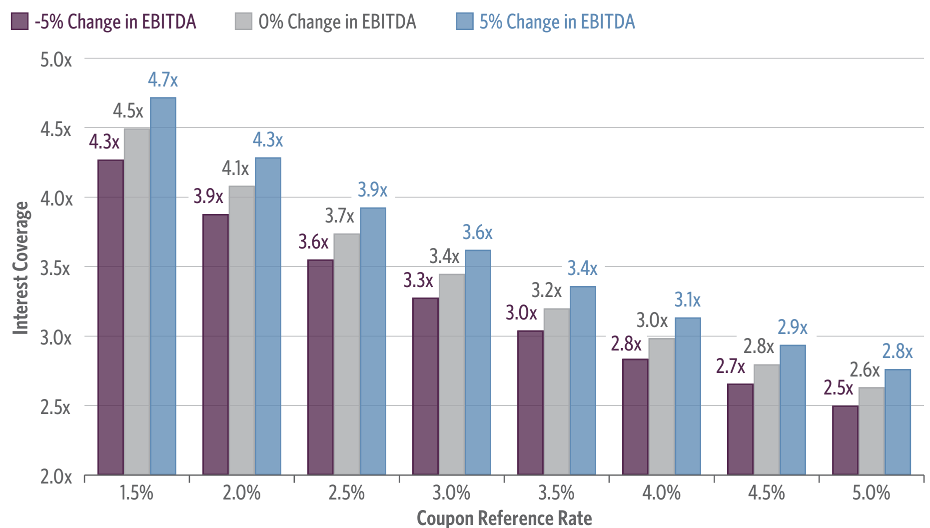
Third Quarter Leveraged Credit Performance Recap

Risk assets turned in mixed performance in the third quarter as markets rode a rollercoaster between the Fed's July and September FOMC meetings. In high yield, a strong bear market rally and falling interest rates in July returned 6 percent, the largest monthly gain in the Bloomberg U.S. High-Yield Corporate Bond Index since 2009. This was partially reversed in August with a loss of 2.4 percent as a chorus of Fed officials intentionally stifled dovish sentiment with warnings that rates may need to go further into restrictive territory. The high-yield selloff continued into September following the Fed's Jackson Hole meeting, with another loss of 3.6 percent as five-year U.S. Treasury yields spiked almost 100 basis points to 4.2 percent.

Bank loans, as represented by the Credit Suisse Leveraged Loan Index, delivered steadier returns of 1.9 percent in July, 1.5 percent in August, and -1.5 percent in September. While the sector's performance has benefited greatly from a low-duration profile, this seeming immunity to rising rates could eventually wane once the flowthrough of rate hikes to coupon resets is more pronounced. A combination

Our interest coverage sensitivity analysis suggests that many loan borrowers could see interest coverage halved as short-term interest rates approach 5 percent.

Bank Loan Market Interest Coverage for Given Coupon Reference Rate



Source: Guggenheim Investments, S&P LCD. Data based on an analysis of public loan issuer interest coverage ratios as of Q2 2022.

of lagged coupon resets, possible deployment of interest rate hedges, and strong corporate earnings have resulted in a healthy median interest coverage ratio of over 5x among public loan borrowers. However, our interest coverage sensitivity analysis suggests that many loan borrowers could see interest coverage halved as short-term interest rates approach 5 percent.

A notable highlight in the third quarter was the second quarter financial results among publicly traded leveraged credit borrowers, which showed revenue growth of 22 percent versus the second quarter of 2021, and earnings before interest, tax, depreciation, and amortization (EBITDA) growth of 28 percent. These results provide evidence of issuers' ability to largely offset cost inflation with price increases. Excluding commodity sectors, growth rates fell to 17 percent for revenue and 9 percent for EBITDA versus the second quarter of 2021, which are strong, but highlight margin pressures for some corporations that absorbed the increase in material, labor, and energy costs. While the aggregate data show a very resilient credit market, some borrowers are getting squeezed by inflation. Pricing power has been an important theme in our credit selection in the last several months.

In upcoming quarters, we expect revenue and EBITDA growth to weaken and margins to compress further in non-commodity sectors. Some issuers will fail to achieve leverage and cash flow-to-debt targets which could affect their ratings. Companies with already negative EBITDA, which comprised 10 percent of publicly traded leveraged credit issuers that we track in the second quarter, could eventually burn through existing balance sheet liquidity to continue operating. In lieu of taking on more expensive debt amid wide credit spreads and dwindling primary market activity, some borrowers may proactively seek to haircut debt by offering lenders equity in exchange, or they may miss interest payments.

While the above scenario may sound dire, it is a common chain of events during recessions, just as it is normal to expect retail sales to slow, unemployment to rise, and the Treasury yield curve to invert around these periods as well. The question that markets grapple with is not whether a slowdown can be expected, but how severe will it be. In the next section, we describe our default outlook and the dynamics that support those views.

Guggenheim's Default Outlook

The next 12 months could see default rates approach the historical average, but we expect the subsequent 12 months to see default rates climb a bit further while remaining below prior crisis peaks. The full 24-month outlook is one which we have not seen market participants discuss in much detail yet, but it is influencing our portfolio positioning and increasingly defensive stance.

While the credit backdrop will become increasingly challenging, we believe we will see close to a 3.5 percent default rate next year, and 5–7 percent in 2024. We take several factors into account to set those default expectations, including:

- **Changes in financial conditions:** Over the past year, financial conditions indexes have shown severe tightening to a degree that is consistent with the beginning of previous recessions. Financial conditions gather indicators like credit spreads, currency exchange rates, interest rates and equity market valuations. Together, they are used to gauge whether funding is becoming harder or easier to obtain in financial markets. Changes in financial conditions act on the economy with a lag, so they can be used as a leading indicator of stress. Typically, we find the changes in financial conditions lead default activity by eight to nine months. The recent tightening in financial conditions is comparable to periods like 1998, 2000, 2007 and 2011—all periods that preceded an increase in high-yield default rates and two of which led into U.S. recessions. We use these periods to model what the next 12 months could look like with respect to default activity.

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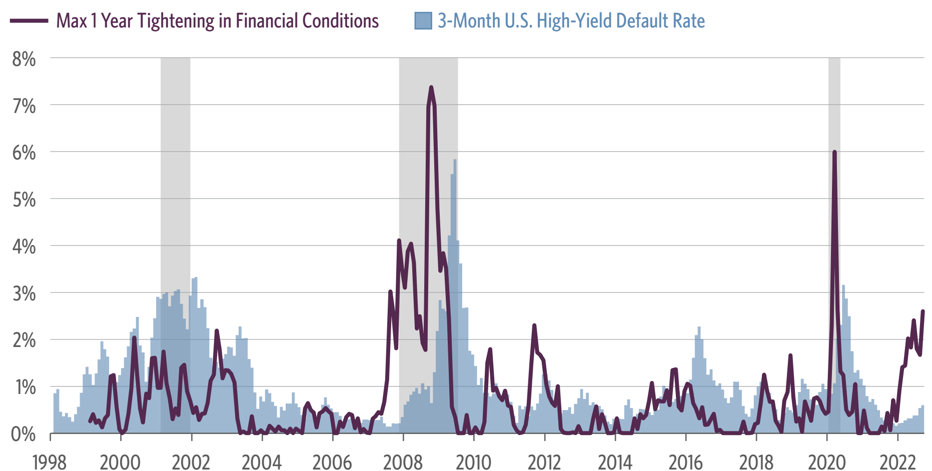
Default Activity Typically Trails Changes in Financial Conditions by 8-9 Months

U.S. High-Yield 3-Month Default Rate and Max Increase in Bloomberg Financial Conditions Index



Source: Guggenheim Investments, S&P CreditPro. Data as of 9.30.2022. Shaded areas represent periods of recession.

- **The expected length and severity of the upcoming recession:** We expect a recession next year that will last four to five quarters. Given that household and corporate balance sheets are generally in good shape, the recession should not be especially severe, but it could drag on longer and transition to a weaker recovery due to Fed fears of reigniting inflation through monetary stimulus that is too vigorous. Some specific variables that are developed out of our recession severity views are expected changes in earnings growth, peak in leverage ratios, credit spread levels, and measures of lending activity.
- **The rating profile of credit sectors:** Currently, most of the high-yield corporate bond space is rated BB, which has an average one-year default rate of just 0.5 percent over the last 30 years, based on Moody's data. While we typically see more credit rating downgrades than upgrades when default rates are rising, the

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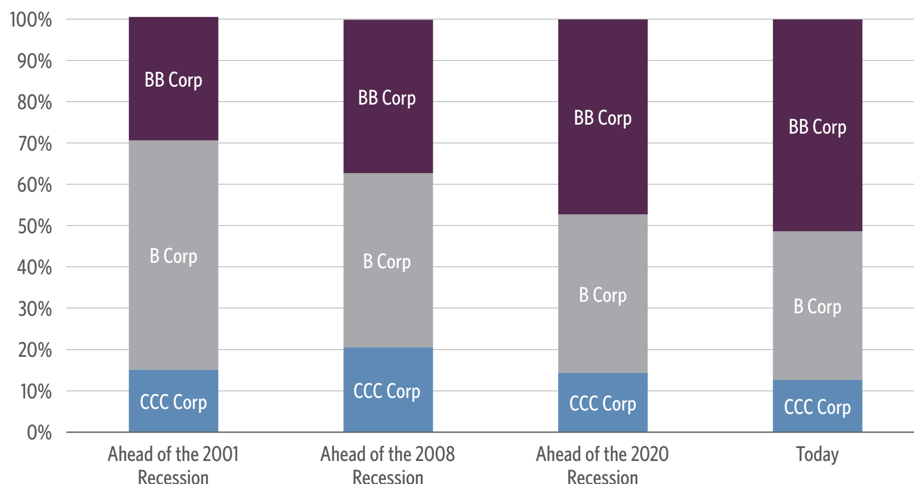
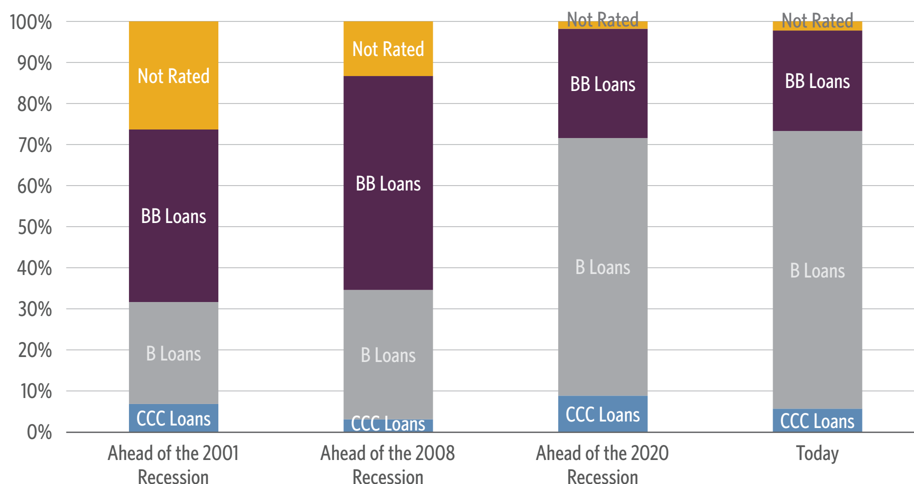
Credit Profile of the High-Yield Corporate Bond Market Has Improved...



...While the Bank Loan Sector's Is Increasingly Single B



Source: Guggenheim Investments, Credit Suisse, ICE Index Services. Data as of 9.27.2022.

prominence of BB ratings means there is room for that negative migration before reaching the high default probability that CCCs carry. In the bank loan market, single B-rated credits dominate and weigh on our default outlook for the sector, but a lot of those loans are sponsored by private equity groups and are secured by assets, which we feel both add incentive to avoid default situations or work them out privately with lenders for a mutually beneficial outcome, though nothing is guaranteed.

- **The market's industry composition:** In 2014, the high-yield corporate bond market's concentration in energy was a key driver in our view that default rates would rise as oil prices collapsed. We do not see concerning concentrations in any sector today. In fact, the U.S. high-yield sector's large exposure to energy may be a positive this time since those companies have improved operating margins and are benefitting from strong European demand. However, some sectors like

communications tend to be more negatively affected in recessions, which is reflected in market pricing. In both high yield and bank loan sectors, over 10 percent of debt in the communications space is trading at a distressed level.

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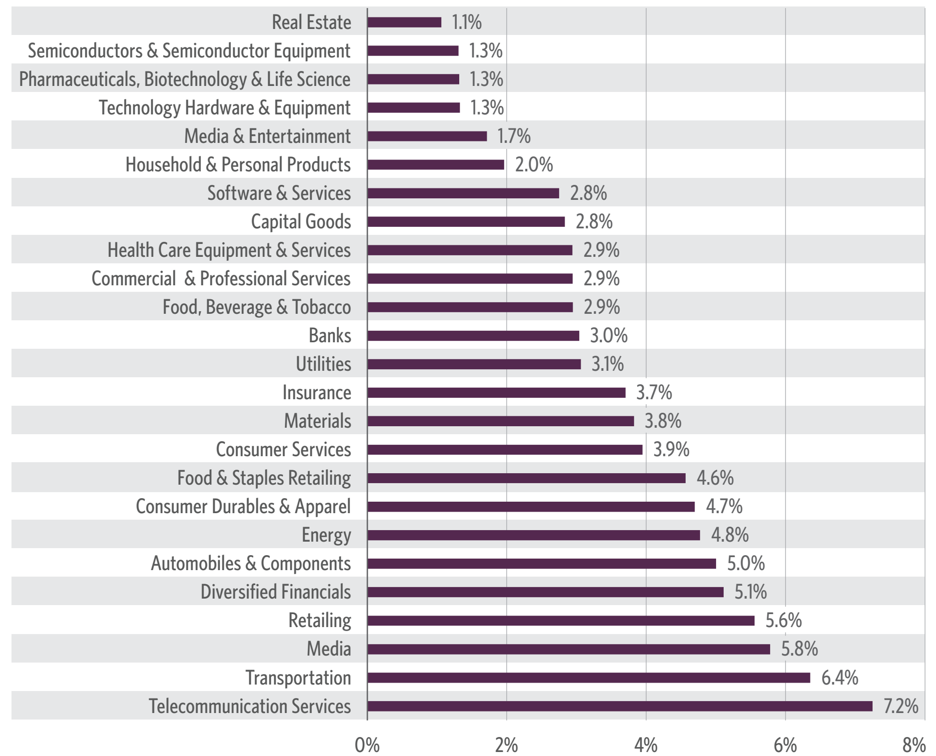
Real Estate, Semiconductor, and Pharma Sectors Tend to Be More Defensive

Historical Average Annual Default Rates, by Industry, 1990-2021



Source: Guggenheim Investments, S&P CreditPro. Data as of 12.31.2021.

Credit Trading at Distressed Levels by Sector

Sector	High-Yield Index		Leveraged Loan Index		Total Indexed Leveraged Credit	
	Market Value $mm	% of Sector Debt	Market Value $mm	% of Sector Debt	Total MV	% of Sector Debt, Bonds + Loans
Consumer, Non-cyclical	$26,898	13.1%	$48,344	14.5%	$75,242	14.0%
Communications	$23,895	9.7%	$26,774	13.4%	$50,669	11.3%
Technology	$4,278	7.3%	$28,302	12.0%	$32,580	11.1%
Basic Materials	$4,153	6.4%	$9,378	14.9%	$13,531	10.6%
Consumer, Cyclical	$26,172	8.3%	$25,531	10.3%	$51,702	9.2%
Industrial	$7,948	5.6%	$22,769	10.8%	$30,718	8.7%
Financial	$7,716	5.4%	$8,698	7.0%	$16,415	6.1%
Energy	$2,547	1.5%	$4,395	13.4%	$6,942	3.5%
Utilities	$0	0.0%	$1,246	5.4%	$1,246	2.1%
	$103,607	**7.5%**	**$175,438**	**12.0%**	**$279,045**	**9.8%**

Source: Guggenheim Investments, Bloomberg, Credit Suisse, ICE Index Services. Data as of 10.31.2022. Table sorted by highest to lowest share of total sector leveraged credit trading at distressed levels. Distressed levels are based on bonds trading above 1,100 OAS and loans trading above 1,100 three-year discount margin.

- **Fundamentals:** The state of corporate fundamentals looks healthy. However, the forward-looking view is that revenue and EBITDA growth will slow with the rest of the economy and could fall once the unemployment rate rises.
- **Upcoming maturity schedule:** While defaults typically are driven more by poor cashflow than debt maturity, we think bonds coming due can exacerbate an already stressed environment. Issuers took advantage of low interest rates in the last couple of years to reduce interest expense and extend maturities. As a result, only 8 percent of leveraged credit has a maturity date before January 2025 (11 percent of loans and 6 percent of corporate bonds). This lowers default risk on the margin.

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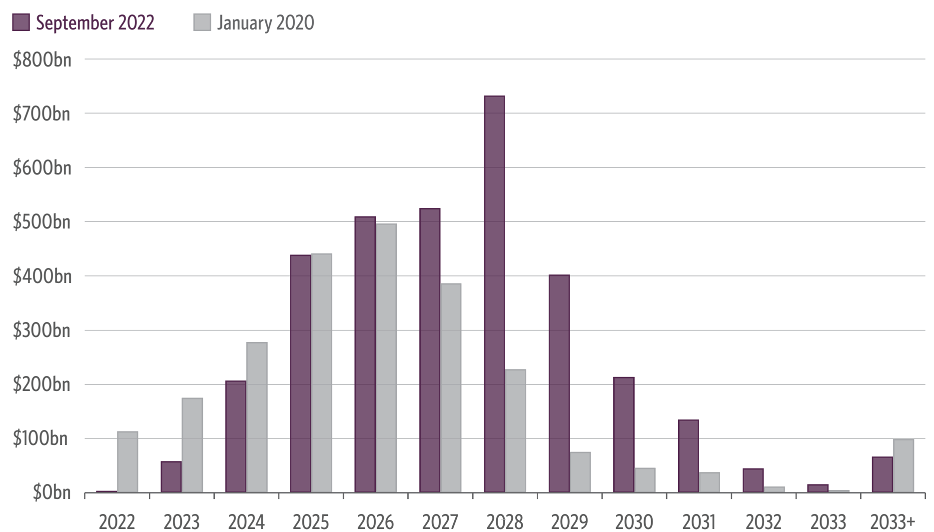
Leveraged Credit Maturity Wall Has Been Pushed



Source: Guggenheim Investments, Bloomberg. Data as of 9.27.2022.

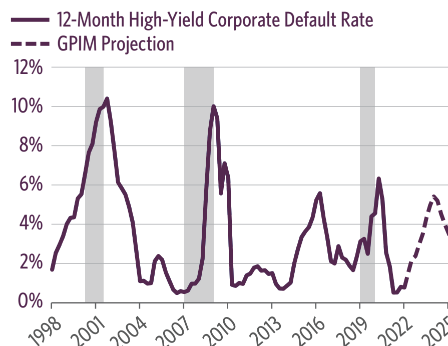
Considering all these factors, we currently project that measures such as the Fed's Senior Loan Officer survey will continue to show more banks tightening underwriting standards on commercial and industrial loans (which typically precedes an increase in default rates), but the decline in corporate earnings will be more mild than past recessions, and the peak in leverage ratios will be more short-lived than in the past.

Modeling after the steady ramp up in the default rate around previous default cycles that followed a similar tightening in financial conditions, we believe we reach a default rate of 3–3.5 percent by the end of 2023. But given our forecast of the recession lasting four or five quarters, we also see default rates continuing to rise in both sectors into 2024, ultimately peaking between 5 percent and 7 percent on a 12-month trailing basis sometime in 2024. We believe this view is not currently priced into market expectations, as it involves a lot of uncertainty. This means that once markets begin to price in a higher default rate, spreads could widen further.

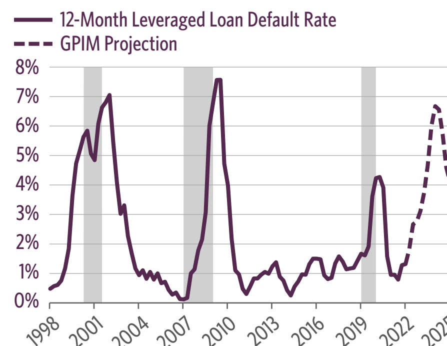
Given our projection of the recession lasting four or five quarters, we also see default rates continuing to rise in both sectors into 2024, ultimately peaking between 5 percent and 7 percent on a 12-month trailing basis sometime in 2024.

Recession Will Likely Push Default Rates Higher in Both Sectors

High-Yield Corporate Default Rate and GPIM Projection							
Actual	Forecast						
Jun-22	Dec-22	Jun-23	Dec-23	Jun-24	Dec-24	Jun-25	Dec-25
0.8%	1.5%	2.4%	3.5%	5.0%	5.2%	4.0%	3.1%



U.S. Leveraged Loan Default Rate and GPIM Projection							
Actual	Forecast						
Jun-22	Dec-22	Jun-23	Dec-23	Jun-24	Dec-24	Jun-25	Dec-25
1.3%	1.8%	2.8%	3.7%	6.0%	6.6%	4.6%	3.6%



Source: Guggenheim Investments, S&P CreditPro. Data as of 10.31.2022.

Investment Implications

Despite our view that default rates are heading higher, we think credit constitutes a good place to invest. Issuer fundamentals are strong, and yields are near the most attractive levels they have been in the last decade. High-yield corporate bond yields were near 9 percent at the end of October, having already declined from the recent high of almost 10 percent, and they remain near levels only seen a few times since the 2008 global financial crisis: amid the COVID-related selloff, at the peak of the energy-market distress in 2016, and following S&P's downgrade of the U.S. credit rating in 2011.

Credit spreads are between the 50th and 60th percentile of historical valuations, which—for a large portion of the market—translates into returns that more than compensate for likely default risk. Mindful of those risks, we are currently underweight the lowest-rated credits, but we think spreads of 290 basis points on BB-rated bonds and 480 basis points on B-rated bonds fairly compensate for 20-year average annual credit losses of just 35 and 134 basis points each, respectively. The same applies to discount margins of 378 basis points on BB-rated loans and 705 basis points on B-rated loans. In all cases we are mindful of negative rating migration.

Defaults over the last 18 months have not been associated with a macro theme, such as stress concentration in the energy sector from 2015–2016 (and twice more after that). Instead, defaults have been idiosyncratic and credit-specific, and several had known fundamental problems for over a year prior to default and were priced accordingly. Given that the current driver of an economic slowdown is expected to be rising interest rates, which are going to affect all industries, the idiosyncratic nature of the default cycle is likely to continue.

Depending on the severity and length of the recession we see coming next year, a slowdown in business and employment also is likely to slow demand and persuade markets that inflation is contained. Once that occurs, lower rates will follow, which will serve as ballast for future fixed-income performance.

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.

Gilt bonds are government bonds in the United Kingdom, equivalent to U.S. Treasurys in the United States.

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.

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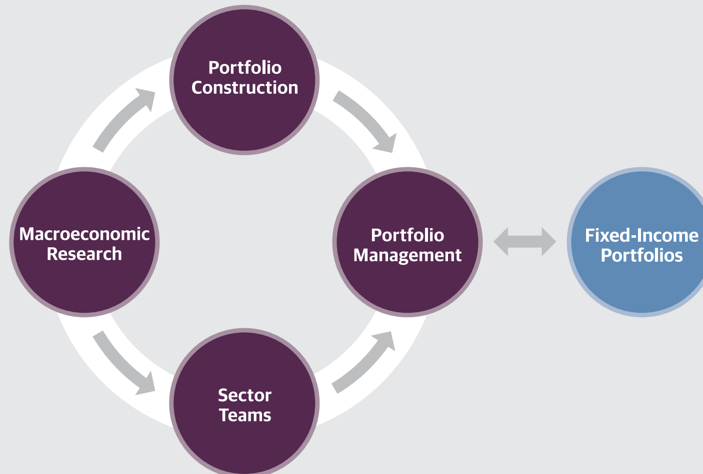

Guggenheim Investments

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