GUGGENHEIM

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High-Yield and Bank Loan Outlook
Up the Escalator, Down the Elevator

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A confluence of factors drove weakness in the fourth quarter of 2018, including a bear market in oil, risks of higher import tariffs, regulator warnings about the excesses in corporate credit, and concerns about tighter monetary policy. Adding to the pile was a government shutdown that showed no sign of resolution heading into 2019. As these events exposed the dying tailwinds to growth, the market awoke to the fact that there may be too much leverage in the system to handle an unfavorable economic environment. Highly leveraged companies were punished, with spreads moving sharply wider.

The Federal Reserve (Fed) initially failed to reassure markets that it would stem a collapse in asset prices, but the market seems to have forced the Fed's hand. Nevertheless, wider credit spreads and tighter financial conditions foreshadow higher defaults by the end of the year. We expect the uptick in defaults later this year will mark the beginning of a prolonged period of stress in the corporate bond market and heighten the importance of gradual portfolio de-risking that we have been recommending for several quarters.

Report Highlights

- Market volatility will force the Fed to pause rate hikes in early 2019, but we believe it will resume tightening monetary policy later in the year.
- While we believe that markets may rebound in coming months, we expect that 2019 will eventually turn unfriendly to borrowers, with bond and loan issuance slowing significantly from previous years.
- Spread widening in the fourth quarter implies an increase in the 12-month trailing issuer-weighted high-yield default rate to 3.2 percent this year, from 1.8 percent currently. A lack of credit availability compared to recent years presents upside risk to this projection.

Leveraged Credit Scorecard
As of 12.31.2018

High-Yield Bonds

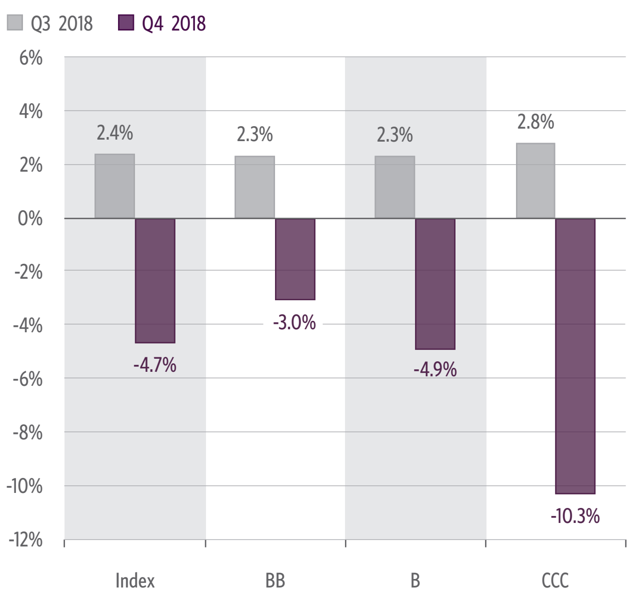
	December 2017		October 2018		November 2018		December 2018	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE Bank of America Merrill Lynch High-Yield Index	373	5.84%	390	6.89%	436	7.26%	539	7.95%
BB	228	4.43%	263	5.66%	290	5.82%	368	6.28%
B	381	5.89%	417	7.15%	469	7.57%	582	8.38%
CCC	850	10.54%	796	10.95%	919	12.08%	1,103	13.59%

Bank Loans

	December 2017		October 2018		November 2018		December 2018	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	416	97.63	398	98.04	443	96.83	552	94.09
BB	268	99.97	267	99.58	312	98.32	414	95.63
B	428	98.93	418	98.95	464	97.71	568	95.02
CCC/Split CCC	1,208	84.02	1,000	90.11	1,064	88.64	1,164	86.54

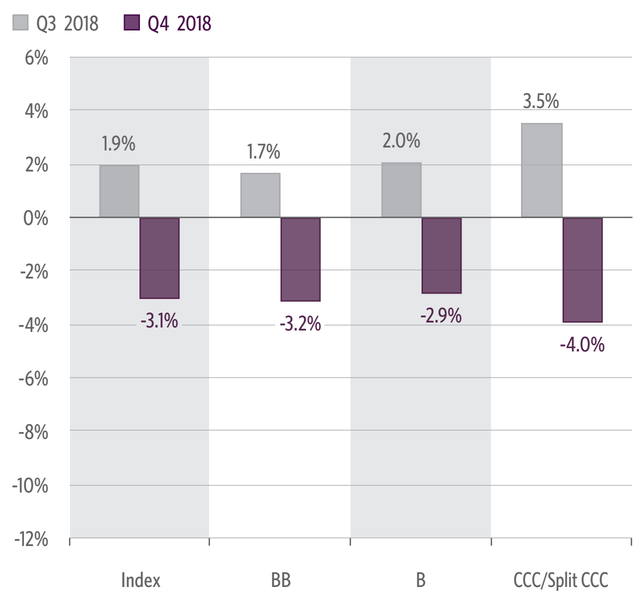
Source: ICE Bank of America Merrill Lynch, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

ICE Bank of America Merrill Lynch High-Yield Index Returns



Source: ICE Bank of America Merrill Lynch. Data as of 12.31.2018. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 12.31.2018. Past performance does not guarantee future results.

> “We are in this period of time where there is very little liquidity, and if this goes on long enough it’s going to lead to an inability for borrowers to refinance debt and we may start to see a material increase in defaults.
>
> – Scott Minerd,
> *Chairman of Investments and Global Chief Investment Officer*

Macroeconomic Overview
The Fed’s Conundrum

U.S. economic data has been broadly strong, but there is already evidence that certain sectors are losing steam. Consumers are becoming less positive on purchases of homes, autos, and appliances, citing rising rates as a major reason. Homebuilder sentiment has declined to the lowest reading since 2015, according to the National Association of Home Builders. Growth in nonresidential fixed investment is also slowing, reflecting a combination of higher borrowing costs and tariff uncertainty. With three major pillars of the economy showing signs of weakness, we see a broad-based slowdown in real U.S. gross domestic product (GDP) growth to below 2 percent year over year by the fourth quarter of 2019.

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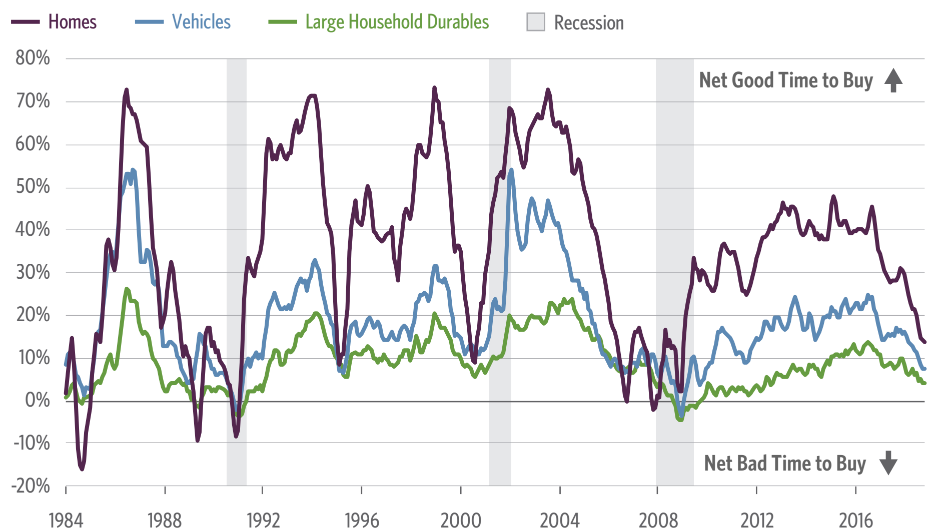
Rising Rates Will Slow Consumption in 2019



Source: Guggenheim Investments, Bloomberg, University of Michigan. Data as of 10.31.2018.

Global growth has weakened drastically over the last 12 months. The eurozone manufacturing purchasing managers index (PMI) tumbled to 51.4, the lowest reading since February 2016. With it, eurozone consumer confidence plunged to a 20-month low in November. In Japan, third-quarter GDP contracted 0.3 percent on a quarter-over-quarter basis, inflationary pressure remained elusive, and Japanese manufacturers became less optimistic about business conditions. In China, official manufacturing and nonmanufacturing PMI data edged lower, retail sales growth fell to a 15-year low, and industrial production growth was the lowest since 2016. China’s economic growth slipped to 6.5 percent in the third quarter, the slowest growth rate in nearly 30 years outside of the global financial crisis.

Ongoing trade disputes between the United States and China, which have resulted in tariffs on a wide variety of imports, further threatens growth on both fronts. The International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) both lowered 2019 global growth forecasts. The souring picture for the global economy collided with rising production from U.S. oil producers to drive a 41 percent decline in oil prices in the fourth quarter. Subsequently, inflation expectations collapsed, and rate hikes priced for 2019 in the fed funds futures market evaporated.

A key bright spot in late 2018 was the U.S. labor market. The unemployment rate remained below 4.0 percent, near 50-year lows. Nonfarm payrolls increased nearly twice as fast as expected, while average hourly earnings printed at 3.2 percent year over year, the fastest growth in wages since 2009. With positive GDP growth likely to cause job gains to run above labor force growth, we expect unemployment to fall further in 2019, leading to an acceleration of wage growth.

With an eye on the labor market, but cognizant of softening inflation, the Fed proceeded to raise the fed funds target to 2.25–2.50 percent in December 2018. The Fed added to its December statement that it would monitor global economic and financial developments, but in the press conference Fed Chair Powell failed to convey flexibility on both interest rate and balance sheet policy should conditions deteriorate further. Markets sold off further in the days following the Fed decision.

Easing inflationary pressures against a very tight labor market present a conundrum to the Fed as policymakers walk a tightrope managing policy around the Fed's dual mandate of price stability and full employment. Ultimately, we believe the Fed will be forced to pause in early 2019 to monitor economic data in order to avoid inflicting further pain. But we continue to believe that with real GDP growth running above potential, unemployment below full employment and falling, and core inflation near the 2 percent target, the 2019 data should be solid enough for the Fed to hike two times later in the year.

A pause in monetary policy tightening may grant a short-lived reprieve to debtors at risk of caving under pressure from rising borrowing costs. Credit conditions would appear benign if the Fed seemingly saves the day by staying on hold. We believe any pause would only allow excesses to become more pronounced, and afford risk assets one more rally. This rally may be the last opportunity to sell into strength before the Fed resumes raising interest rates, pushing the U.S. into an economic recession in 2020.

From Tailwinds to Crosscurrents

Until the fourth quarter of 2018, the high-yield and bank loan sectors were poised to deliver positive total returns for the year. In the final weeks of the year, high-yield corporates and bank loans gave back some or all their year-to-date gains. High-yield corporate bonds lost 2.8 percent on a total return basis in 2018, while bank loans delivered a positive 1.1 percent total return. High-yield corporate bond spreads ended the year at 535 basis points with secondary market yields at 8.0 percent. Bank loan discount margins also widened sharply, ending the year at 552 basis points with secondary market yields around 8.2 percent. For both sectors, the severe tightening of financial conditions was comparable to 2015.

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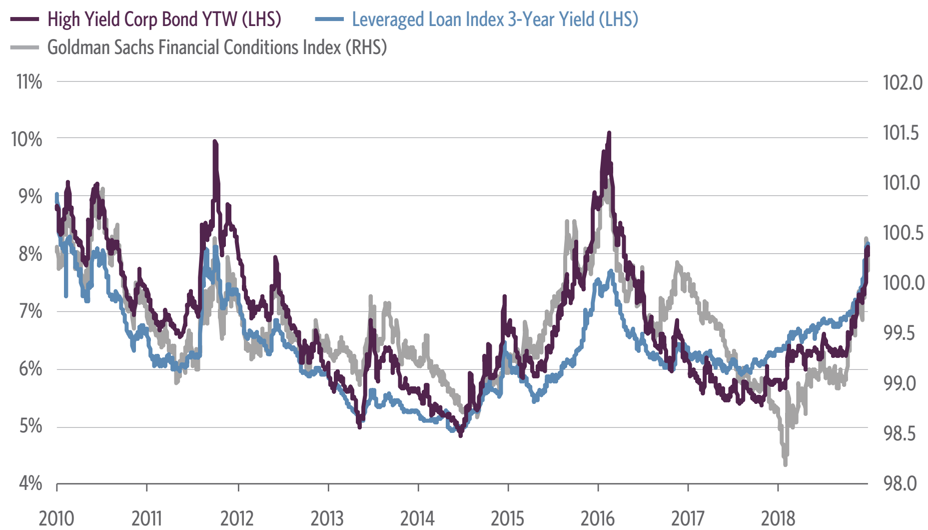
Financial Conditions Tightened Severely for Leveraged Finance in 2018



Source: Bloomberg, Credit Suisse, ICE BofA Merrill Lynch, Guggenheim Investments. Data as of 12.31.2018.

Spread widening was initially driven by trade and tariff concerns, impacting vulnerable sectors like technology, autos, and capital goods. It was then exacerbated by a bear market in oil. West Texas Intermediate oil prices fell from an October 2018 peak of $76 per barrel to end the year around $45 per barrel, a 41 percent decline in a single quarter. Like the 2014 experience, the decline in oil prices caused a sharp repricing of credit risk in high-yield energy, with spreads widening 237 basis points in the fourth quarter.

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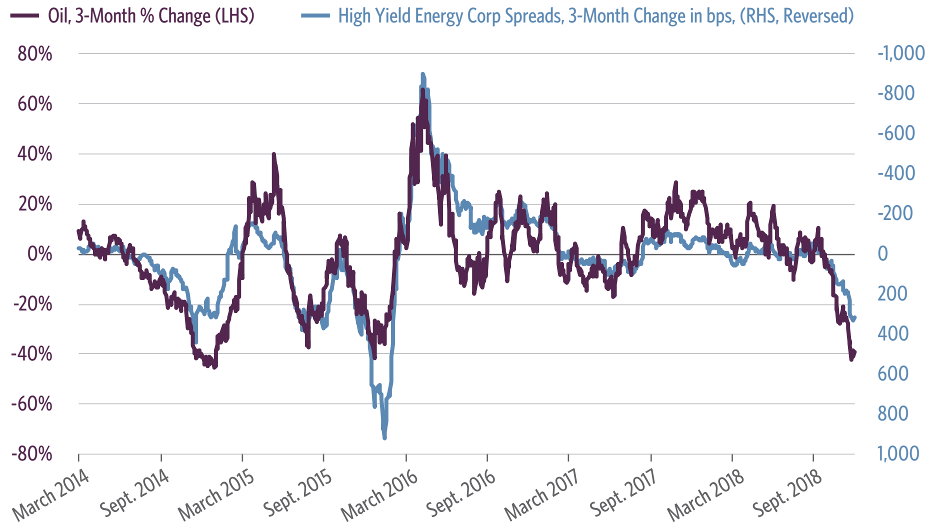
Déjà Vu: Oil Prices Weigh on the Energy Sector Again



Source: Bloomberg, ICE Bank of America Merrill Lynch, Guggenheim Investments. Data as of 12.31.2018.

Early in the fourth quarter, the bank loan market appeared immune to the credit selloff. Discount margins held inside a tight range of 380–389 basis points for three weeks after high-yield corporate bond spreads started widening. This immunity was broken when the decline in oil prices fed into falling inflation expectations, which then caused a drop in the market-implied rate hikes for 2019. Demand for floating-rate assets waned, driving massive outflows from bank loan funds totaling over $15 billion in the final quarter. With the market now expecting fewer rate hikes from the Fed, a lack of mutual fund demand for floating rate assets will weaken the technical backdrop that previously supported spread tightening.

Adding fuel to the fire, the second half of 2018 saw no shortage of warnings about excesses in the bank loan market. Between July and December 2018, concerns about loan growth, valuations, and their lack of covenants were voiced by the European Central Bank, the Bank of England, the International Monetary Fund, the Office of the Comptroller of the Currency, the Bank for International Settlements, former Fed Chair Janet Yellen, Senator Elizabeth Warren, and the Fed's head of Risk Surveillance and Data Todd Vermilyea—not to mention countless newspaper articles and sell-side research commentary reiterating those messages. The avalanche of warnings, which were intended to identify possible problem sectors that could threaten the stability of the financial system, may have itself been a catalyst for the instability.

Retracing financial conditions back to where they were in early 2018 seems difficult. Several crosscurrents lie ahead, not the least of which include slowing global growth, a fading boost from the U.S. tax cut, ongoing trade dispute between the U.S. and China, a resolution (or lack thereof) to Brexit, a divided Congress that kicked off 2019 with a government shutdown, and an acceleration in global quantitative tightening as the European Central Bank has ended its net purchases of assets. A Fed pause may support tighter credit spreads early in the year, but with investor confidence having been badly damaged, we believe 2019 will eventually turn unfriendly to borrowers once the Fed resumes hiking interest rates.

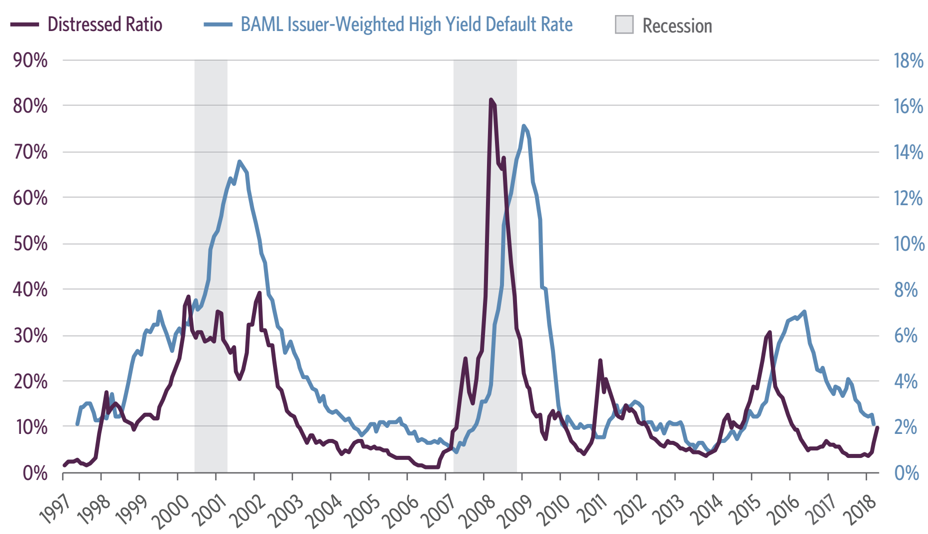
2019 Outlook and Investment Implications

We expect that spreads will tighten over the next three to six months. A Fed pause would signal to market participants that policymakers are responsive to financial markets and refuel some risk appetite. We think this will be a good opportunity to sell into strength as we continue our gradual shift up in credit quality.

Since 1986, a comparable year-over-year increase in high-yield corporate bond spreads has only happened six times (1989, 1998, 2000, 2007, 2011, and 2015). These periods have always been followed by an increase in defaults. Our default model projects the ICE Bank of America Merrill Lynch High Yield issuer-weighted high-yield default rate to increase from the current level of 1.8 percent to 3.2 percent. The distressed ratio (bonds trading at spreads wider than 1,000 basis points) also jumped from only 3.5 percent in September to 9.7 percent in December, supporting this projection.

The distressed ratio (bonds trading at spreads wider than 1,000 basis points) jumped from only 3.5 percent in September to 9.7 percent in December. An increase in the distressed ratio typically precedes an increase in defaults.

Distressed Ratio Leads an Uptick in High-Yield Defaults



Source: Bank of America Merrill Lynch Research, ICE Index Platform, Guggenheim Investments. Data as of 12.30.2018. The distressed ratio represents the share of bonds in the ICE Bank of America Merrill Lynch High-Yield Index trading at spreads over 1,000 basis points.

Some might argue that easy lending standards contradict our default view. The latest Fed's Senior Loan Officer Survey indicated that banks were still easing lending standards on commercial and industrial loans, which historically would suggest low defaults over the next three quarters. However, the results of the survey are naturally backward-looking. The recent survey results were based on responses due Oct. 12, 2018, too early to reflect the market weakness that took hold of the fourth quarter. The recent 169-basis-point widening in bank loan discount margins would be consistent with the net percentage of banks tightening lending standards moving higher in the next survey due to be published in February 2019.

As the credit story unraveled, some market participants pointed to the maturity wall as a silver lining. The majority of leveraged credit is not due to mature until after 2020, which we agree alleviates some near-term risk of principal payment default. But we find limited comfort in this data point. Since 2007, the average life on a defaulted bond as of its default date was 4.9 years. We continue to believe that an inability to service ongoing interest payments will be a bigger driver of stress. As such, our analysis emphasizes cash flow stability.

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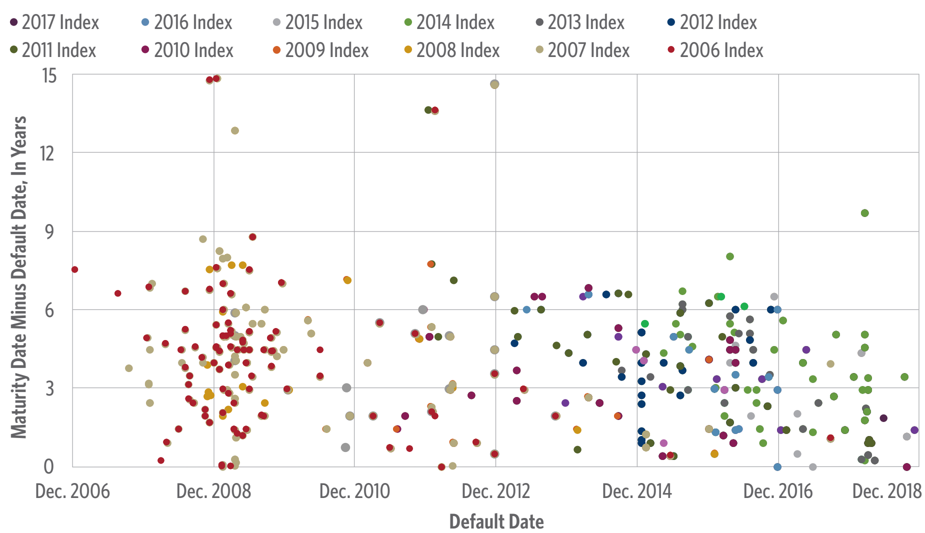
Maturity Date Is Not an Important Factor in Default Risk



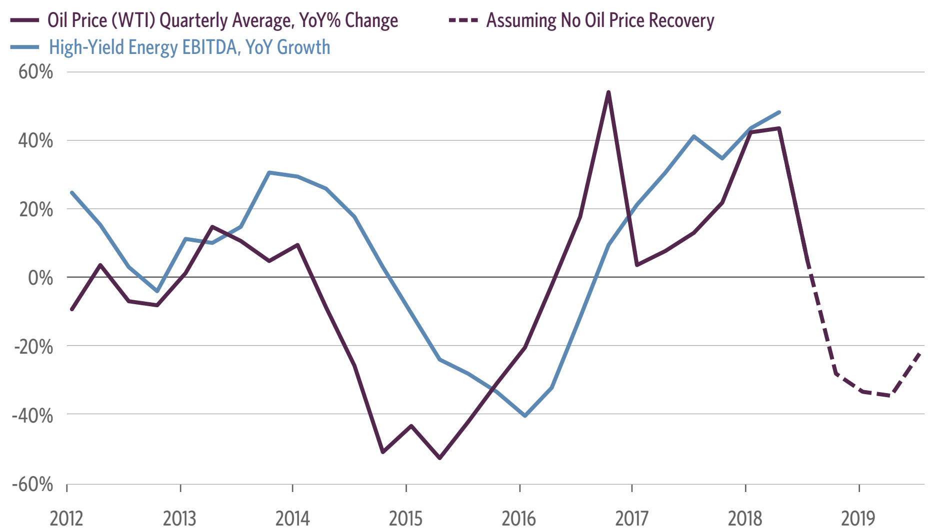
Source: ICE Bank of America Merrill Lynch, Bloomberg, Guggenheim Investments. Data as of 12.20.2018. Defaulted bonds are constituents of the ICE BofAML US High-Yield Index (H0A0). Note that a given defaulted bond can be present across multiple years of the index and thus overlap. The y-axis is capped at 15 years intentionally, resulting in several data points not being shown.

A wider dispersion between weak and strong credits in 2019 will be a key factor to monitor, especially given good fundamentals at the index level. Our report last quarter highlighted those positive fundamental data in leveraged credit, including strong earnings growth and healthy interest coverage. We also pointed to rising cost of debt. Cost of debt has risen further since we published our last report. An anticipated slowdown in earnings growth, coupled with rising borrowing costs, will put pressure on margins and expose those borrowers with limited capacity to continue servicing debt.

More specifically, the energy sector may feel some pain from the drastic decline in oil prices as many oil producers had not hedged production for 2019. In the high-yield corporate bond universe, at least five issuers in the energy sector (including midstream and oilfield services) had negative cash flow from operations in the third quarter of 2018, making them particularly vulnerable. Though we do not expect the same default scenario as we experienced in 2015 and 2016 in the energy market, it is likely that lower oil will once again claim a few corporate victims.

As the chart shows, at current oil prices, the year-over-year impact would weigh on high-yield energy earnings growth. Our internal oil model forecasts a modest recovery in oil, with WTI averaging about $72 per barrel in the third quarter before declining again in the fourth. This decline may negatively impact some high-yield energy names, but we do not expect a repeat of the 2015/2016 default scenario.

Without a Recovery, Oil Decline Presents a Major Headwind to Earnings



Source: Bloomberg, Factset, Guggenheim Investments. Oil price data as of 12.31.2018. Earnings data as of 9.30.2018.

Issuers with cash flow problems will not be able to look to primary markets for help. December issuance was clear evidence of this, when for the first time on record, the high-yield corporate bond market failed to raise a single new dollar. For some, this will mean postponing a planned merger or acquisition, revising expectations of cost reduction through refinancings, or forgoing new projects intended to generate growth.

Lower bond and loan supply for 2019 would be a positive technical dynamic that supports valuation in the secondary market than we have seen in several years, but we remain cautious in how we evaluate creditworthiness in an environment of slowing economic growth. Recent market volatility reminds us that risky asset returns typically follow an "up the escalator, down the elevator" motion—performance is slow and steady on the way up, but swift and steep on the way down, which supports a gradual de-risking as we have been recommending for several quarters.

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%.

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.

The **London Interbank Offered Rate (Libor)** is a benchmark rate that a select group of banks charge each other for unsecured short-term funding.

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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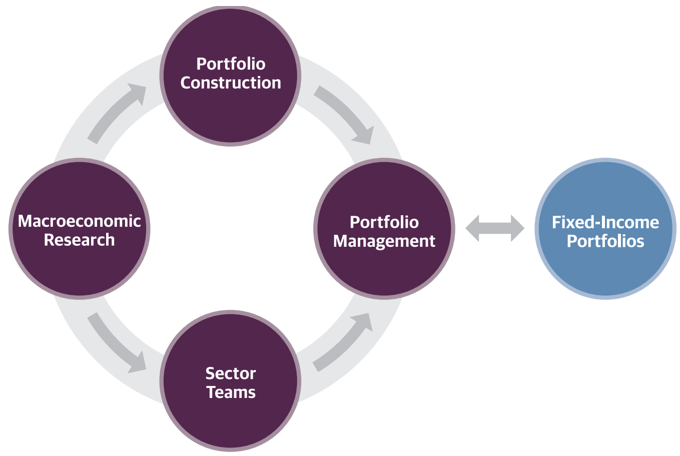

Guggenheim Investments

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Guggenheim Partners

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