GUGGENHEIM

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High-Yield and Bank Loan Outlook
Watching for Weakness in a Time of Strong Fundamentals

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High-yield bonds and leveraged loans delivered another quarter of positive returns amid tighter spreads and improving credit conditions. Mutual fund flows have been mixed, but healthy new issue activity and rising prices on the secondary market indicate that institutional demand for below investment-grade credit remains intact. Looking ahead, the strengthening economy and the unabated investor need for income should underpin positive performance in high yield and bank loans, but the chasm between strong and weak credits grows as borrowers take on increasing levels of debt.

Positive earnings growth has improved high-yield leverage and coverage metrics, but 2015 and 2016 demonstrated how quickly these ratios can turn. Average metrics can mask weakness beneath the surface. In this report, we take a deeper dive into leverage and coverage metrics for the current universe of publicly traded U.S.-based high-yield borrowers at the industry level, and show how dispersed their credit metrics are.

Report Highlights

- Leverage has declined for five consecutive quarters since the recent peak in 2016 and average interest coverage has increased. Improving fundamentals have driven spreads toward post-crisis tights.
- As high-yield spreads and yields approach historical lows, it is becoming increasingly important to avoid sectors and issuers that are unlikely to return full principal or satisfy interest payments for the life of the bond.
- Our research uncovered consistent differences between borrowers that defaulted from January 2016 to June 2017 and those that survived, as seen in metrics such as net debt/earnings, cash flow/interest expense, and balance sheet cash/interest expense. Moreover, early warning signs were evident as early as 2014. Using the same approach, we highlight the industries that are currently in the weakest credit positions, making them particularly vulnerable to an economic downturn.

Leveraged Credit Scorecard
As of 9.30.2017

High-Yield Bonds

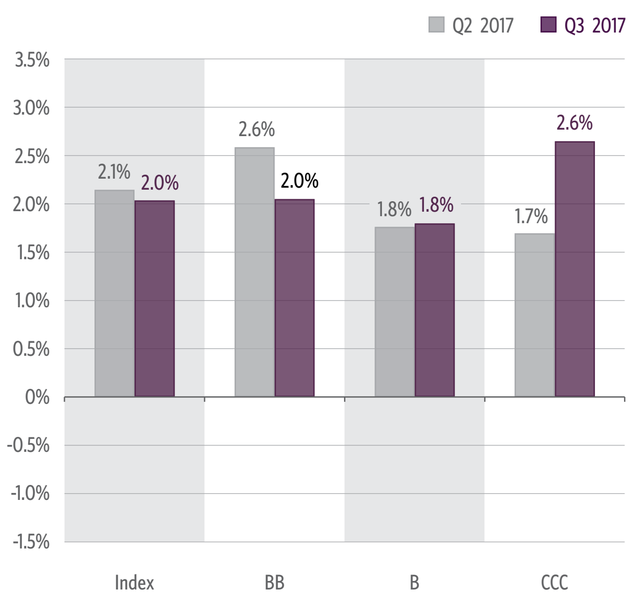
	December 2016		July 2017		August 2017		September 2017	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
Bank of America Merrill Lynch High-Yield Index	439	6.17%	374	5.46%	398	5.61%	367	5.47%
BB	286	4.71%	233	4.11%	248	4.17%	222	4.09%
B	432	6.06%	374	5.41%	399	5.57%	372	5.45%
CCC	977	11.43%	849	10.11%	901	10.57%	854	10.29%

Bank Loans

	December 2016		July 2017		August 2017		September 2017	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	461	97.18	423	97.60	436	97.16	432	97.34
BB	296	100.41	278	100.17	290	99.76	284	99.83
B	480	98.12	429	99.07	449	98.55	441	98.68
CCC/Split CCC	1,251	83.63	1,251	83.19	1,269	82.16	1,265	82.17

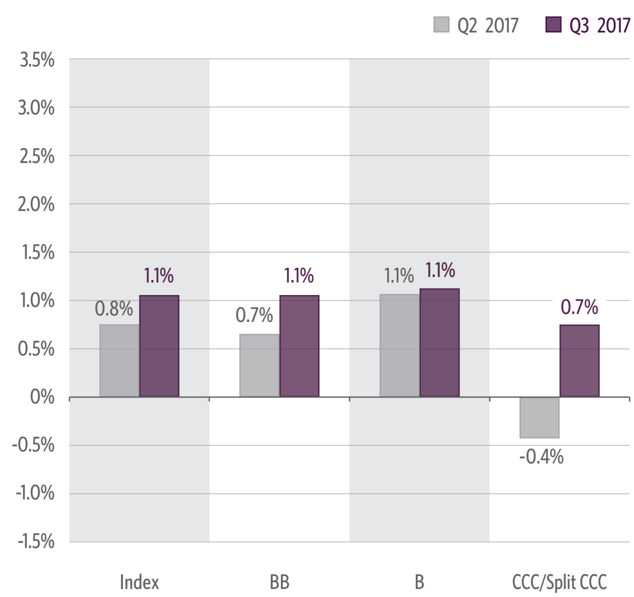
Source: Bank of America Merrill Lynch, Credit Suisse. *Discount Margin to Maturity assumes three-year average life.

Bank of America Merrill Lynch High-Yield Index Returns



Source: Bank of America Merrill Lynch. Data as of 9.30.2017. Past performance is not indicative of future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 9.30.2017. Past performance is not indicative of future results.

Macroeconomic Overview
Base Case and Tail Risks

"With many credit sectors getting so overvalued, I think one of the easiest decisions to make in fixed income is to go up in quality."

– Scott Minerd,
Chairman of Investments and Global Chief Investment Officer

The U.S economy has strengthened in 2017 as gains in consumer sentiment and small-business optimism fueled growth in consumer spending and business investment. On average, consumer spending and nonresidential fixed investment contributed 1.8 percentage points and 0.9 percentage point to annualized gross domestic product (GDP) growth in the first half, respectively. Housing activity also contributed modestly to growth. The ISM manufacturing index has remained above 50 for 13 consecutive months through September 2017, further indicating a strong, expanding manufacturing sector. All of this unfolded as the Federal Reserve (Fed) raised interest rates twice more, once in March and again in June. Assuming no major shocks, we expect the economy will grow by between 2.0–2.5 percent in real terms in 2017 and 2018, and potentially more if Washington delivers on promises to cut taxes.

The more likely downside risks to our baseline outlook would pose only temporary setbacks. The destruction caused by hurricanes Harvey, Irma, and Maria has resulted in localized disruptions to the housing, retail, and labor markets. We expect that the impact of these storms will subtract about 1.2 percentage points from GDP in the third quarter, but the recovery from those disasters should stimulate growth in the fourth quarter and the first quarter. Hurricane relief efforts actually hastened the passage of legislation that suspended the debt ceiling and funded the government until December. Should Congress fail to pass a timely budget at that point, a partial government shutdown would ensue. This would also have only a temporary impact, however, primarily hurting government employees and services, with a short-lived impact on bond and equity markets if investors sell risk. A shutdown could subtract about

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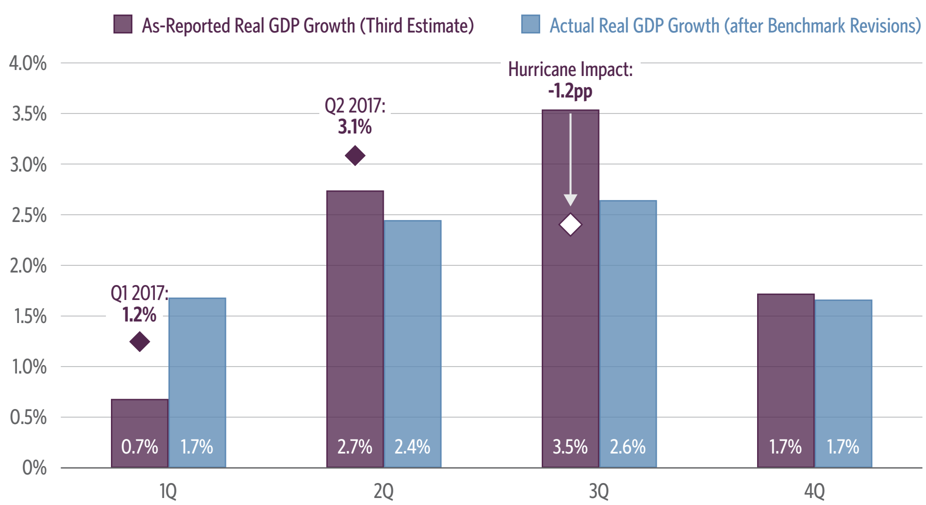
U.S. GDP Growth Is Following a Familiar Seasonal Pattern in 2017
Average U.S. Real GDP Growth Rates from 2012–2016, Q/Q SAAR



Source: Haver Analytics, Macroeconomic Advisers, Bloomberg, BEA, Guggenheim Investments. Data as of 6.30.2017. Tracking estimate as of 9.20.2017.

0.25 percentage point from fourth quarter 2017 GDP, judging by a White House Council of Economic Advisors estimate of the impact of the 2013 government shutdown. Other estimates have pointed to a larger impact, albeit generally less than 1 percentage point. Any such transient weakness is likely to be offset by increased spending associated with disaster recovery from hurricanes in the East and wildfires in the West.

More serious, if less likely, risks to our outlook include the possibility that escalating tensions between the U.S. and North Korea could increase market volatility, and with it corporate borrowing costs. In the unlikely event that the situation escalates to the point of a full-scale military conflict, it could be the catalyst for a major risk-off event, with lasting implications for markets and the economy. Separately, should President Trump appoint a hawkish Fed Chair—such as Stanford economist John Taylor or former Fed Governor Kevin Warsh—we could see a relatively rapid pace of monetary policy tightening over the next couple of years. With markets having come to expect a very gradual and reasonably predictable pace of Fed tightening, a hawkish shift in the Fed's policy reaction function and communications strategy could cause a significant tightening in financial conditions. This would bring forward our estimate for the timing of the next recession, which we currently believe will arrive around late 2019 or early 2020. We think the probability of either of these scenarios unfolding is low but not zero.

For the time being, economic and financial conditions are supportive enough for the Fed to raise interest rates and begin balance sheet normalization this year. The Fed announced in September 2017 that it would allow a maximum of $4 billion in Agency debt and mortgage-backed securities (MBS) and $6 billion in Treasurys to mature on a monthly basis starting in October 2017. This is a drop in the ocean compared to their $4.3 trillion portfolio. The monthly cap will rise gradually over the next few quarters, eventually reaching a maximum of $20 billion for MBS and $30 billion for Treasurys. Runoffs, however, will generally be lower than the fully phased-in caps: we estimate that combined runoffs will total $30 billion in 2017, slightly less than $400 billion in 2018, and slightly more than $400 billion in 2019.

What impact might the start of balance sheet normalization have on fixed-income markets? In her September Federal Open Market Committee (FOMC) press conference, Fed Chair Janet Yellen referenced a Fed working paper that found that the Fed's quantitative easing (QE) programs depressed the 10-year Treasury term premium by approximately 100 basis points. The term premium is the yield required by investors to compensate them for the risk that short-term rates will not evolve as expected over the life of a bond. Theoretically, unwinding QE should remove that source of downward pressure on term premiums, resulting in a commensurate rise in Treasury yields, all else being equal. A normalization of term premiums will have a modest impact if it occurs over several years. However, four years ago we saw the impact it could have on bond markets if investors price this in abruptly. During the Taper Tantrum of 2013, 10-year yields rose by 137 basis points between May and September as then-Fed Chair Ben Bernanke first spoke of the potential that the Fed would soon taper purchases of Treasurys and MBS. This caused corporate bond yields to rise as well, with yields on BB-rated corporate bonds increasing by 129 basis points over the same time period.

While we do not expect a sharp repricing in markets, it is important to consider the combined effect of slowly rising short-term rates and term premiums on corporate bond yields. An increase in term premiums in the Treasury market will likely raise borrowing costs for investment-grade corporate issuers, in turn raising costs for high-yield bonds as well. In September, Fed officials continued to project a third rate hike in 2017 (likely in December) and three more hikes in 2018. Rising short-term rates would have direct implications for bank loan issuers, whose coupons are tied to the London interbank offered rate (Libor), and eventually Libor's replacement.

The effects of rising borrowing costs will likely be obscured for now by strong earnings growth. Despite borrowers taking on increasing levels of debt, credit ratios such as debt/earnings and cash flow/interest expense have improved this year. If we learned anything from 2015-2016, however, it is that these metrics can quickly turn. Later in this report, we will show how looking through the average can help identify a deteriorating segment of borrowers well before we reach the next default wave. Ultimately, it is where these metrics turn that recession is likely to follow.

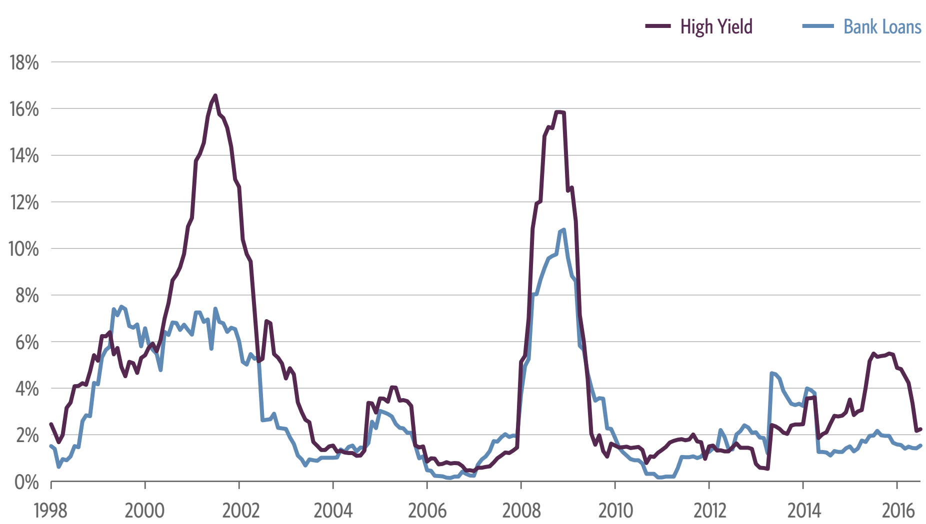
Third Quarter 2017 Leveraged Credit Performance Recap

High-yield bonds and leveraged loans posted their seventh consecutive quarter of positive returns, with the Bank of America Merrill Lynch High-Yield Index and the Credit Suisse Leveraged Loan Index posting gains of 2.0 percent and 1.1 percent, respectively. High-yield spreads tightened to 367 basis points, only 13 basis

The high-yield 12-month trailing par-weighted default rate has declined notably since its recent peak in November 2016.

High-Yield Default Rate Continues to Decline

Based on 12-month trailing par-weighted default rates.



Source: Bank of America Merrill Lynch Research, S&P LCD, Guggenheim Investments. Data as of 7.31.2017.

points above the post-crisis low reached in June 2014. Leveraged loan average contractual spreads and discount margins tightened by 12 basis points quarter over quarter. As of Sept. 30, leveraged loans were trading at an average three-year discount margin of 432 basis points, only 13 basis points above the post-crisis low.

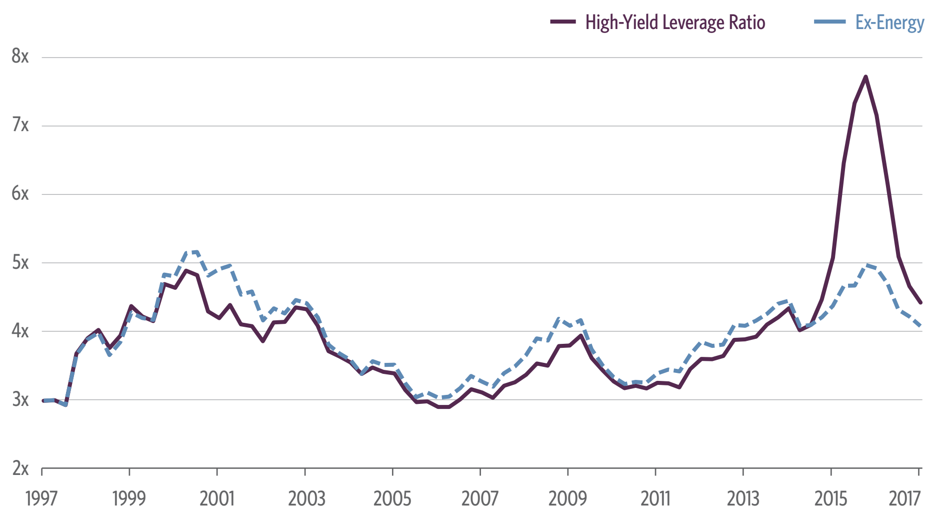
Average high-yield corporate bond yields of 5.47 percent are 0.58 percent above the post-crisis low of 4.85 percent. We think it is possible for spreads to tighten given our positive U.S. economic outlook for the next 12 months and the benign default environment. Indeed, the high-yield 12-month trailing par-weighted default rate has declined notably since its recent peak in November 2016.

Both high-yield and bank loan mutual funds and exchange-traded funds have had mixed flows for the year, but healthy institutional demand has allowed new issue activity to strongly outpace the comparable period in 2016, even as refinancing activity has taken a back seat to mergers, acquisitions, and leveraged buyout activity since June 2017. High-yield corporate issuers have raised $207 billion year to date through September, up 16 percent over the same period last year, while institutional loan issuers have raised $405 billion, up 74 percent over the same period last year. Primary yields have steadily declined, and the majority of the index continues to trade above par in both sectors.

Leverage has declined for five consecutive quarters. While broad fundamental improvements have supported spread tightening in 2017, we still see weak credits beneath the surface.

Leverage Ratios Have Declined for Five Consecutive Quarters

Measured as a ratio to 12-month trailing earnings.



Source: Bank of America Merrill Lynch Research, Guggenheim Investments. Data as of 6.30.2017.

The strong rebound in earnings is mitigating the effect on leverage ratios of borrowers raising more debt. When measured as a ratio to 12-month trailing earnings, which is the industry standard, leverage has declined for five consecutive quarters, according to Bank of America Merrill Lynch research. While broad fundamental improvements on the surface have supported spread tightening in 2017, we still see weak credits beneath the surface.

One measure that is generally inversely correlated with default rates is the average high-yield interest coverage ratio (earnings/interest expense). Positive earnings growth has improved interest coverage. At 3.5x interest expense as of June 2017, coverage is above the historical average of 3.2x interest expense. Interest coverage has been healthy for most of the cycle, with the exception of last year, where average ratios fell to as low as 2.1x interest expense. We have found based on historical analysis that interest coverage below 3x interest expense is generally consistent with periods of higher-than-average default volumes. However, this metric needs to be monitored at a more granular level. For example, defaults were already rising by the time average interest coverage fell below 3x in 2015.

In the next section, we show how, with the benefit of hindsight, the credit metrics of high-yield borrowers that ultimately defaulted clearly indicated weaker-than-average and deteriorating credit profiles well ahead of 2016. In our final section, we use the same approach to identify the share of U.S. based high-yield borrowers in the Bank of America Merrill Lynch High-Yield Index that are still in weak financial positions.

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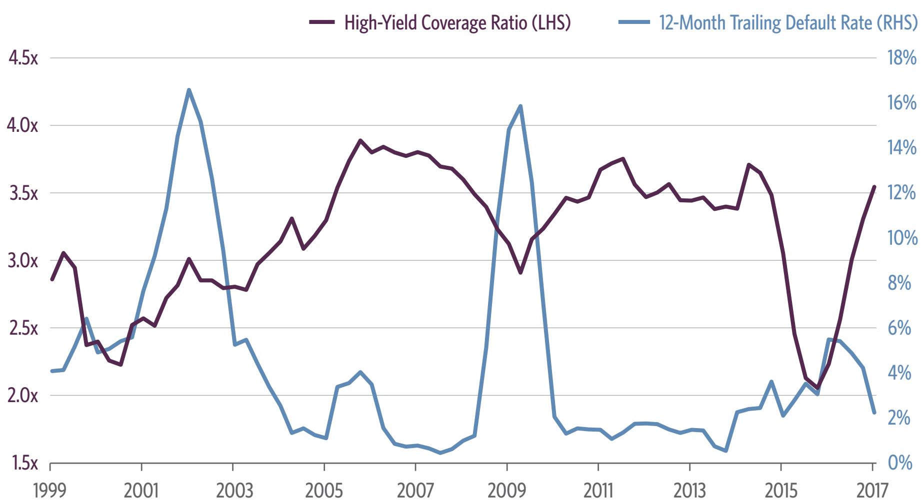
High-Yield Interest Coverage Fell Drastically in 2016 Before Rebounding

Average high-yield interest coverage ratio = earnings/interest expense.



Source: Bank of America Merrill Lynch, Guggenheim Investments. Data as of 6.30.2017.

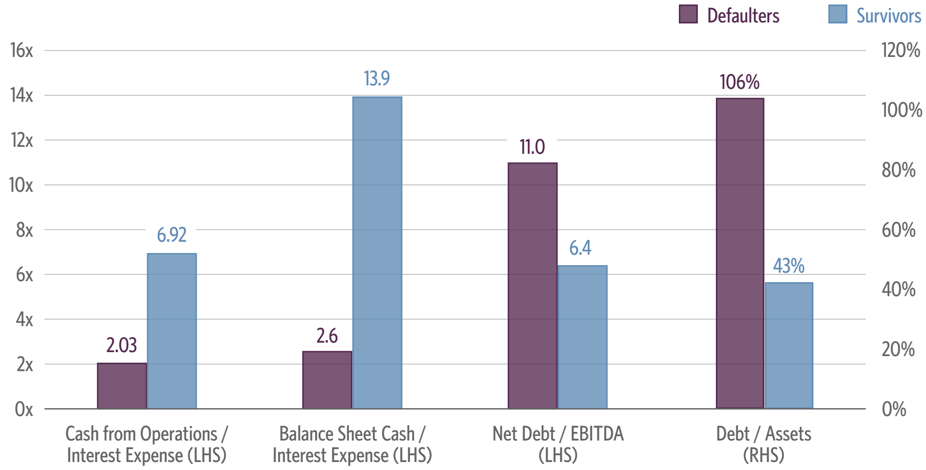
Lessons Learned from Recent Default Experience

Of 37 issuers that defaulted on high-yield debt in 2016 and the first half of 2017, we obtained and averaged various credit metrics for all of the publicly traded issuers, amounting to 30 companies. We looked at these metrics through December 2015 to compare the fundamental picture of the defaulting and non-defaulting cohorts just before earnings growth turned negative, and found notable differences. This exercise reaffirmed our view that sub-3x interest coverage is a red flag at the issuer level, even if the market average provides a late signal.

On average, the "survivor" cohort maintained cash from operations/interest expense at nearly 7x, balance sheet cash/interest expense at nearly 14x, net debt/earnings under 6.5x, and total debt/assets at 43 percent. An inability to service interest expense using operating cash flow was typically the first sign of near-term distress.

Credit Ratios Indicate a Borrower's Likelihood of Default

Average credit metrics in December 2015 highlighted major differences.



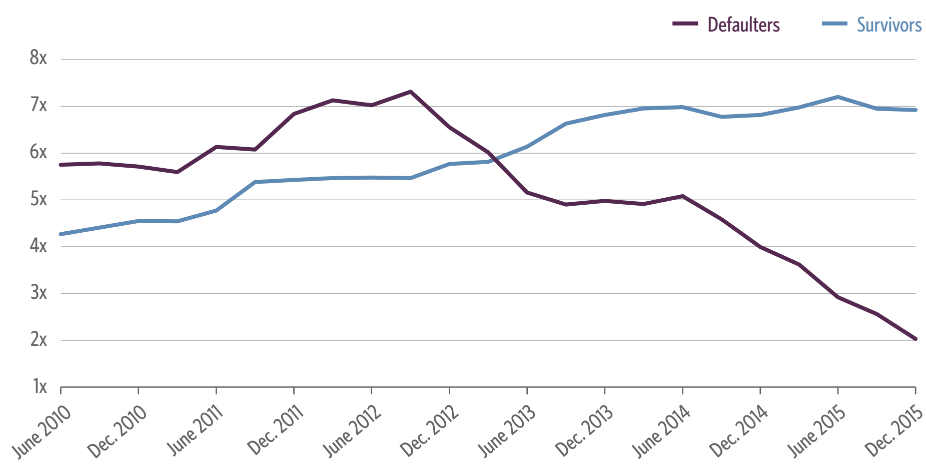
Source: Bloomberg, Guggenheim Investments. Data as of 12.31.2015. Based on a cohort of publicly-traded high-yield companies in the Bank of America Merrill Lynch High-Yield Index. EBITDA = 12-month trailing earnings before interest, tax, depreciation, and amortization. Defaulters include those companies that defaulted in 2016 and the first half of 2017.

On average, the "survivor" cohort maintained cash from operations/interest expense at nearly 7x, balance sheet cash/interest expense at nearly 14x, net debt/earnings under 6.5x, and total debt/assets at 43 percent. An inability to service interest expense using operating cash flow was typically the first sign of near-term distress, and an inability to service interest expense from existing cash on the balance sheet served as the final confirming signal. The combination of net debt/earnings above 10x, cash from operations/interest expense below 4x, and balance sheet cash to interest expense below 10x indicated that the borrower was very likely to default.

Operating cash flow/interest expense started to deteriorate as early as the first quarter of 2014 for the cohort of companies that would ultimately default in 2016 and early 2017, while the survivors maintained healthy interest coverage.

Falling Cash from Operations/Interest Expense Signals Future Defaults

Based on a cohort of publicly traded high-yield companies in the BAML High-Yield Index.



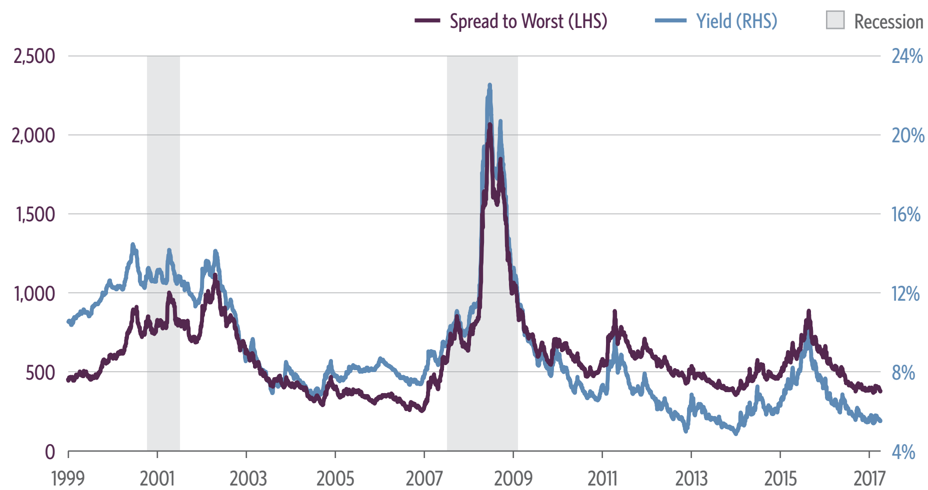
Source: Bloomberg, Guggenheim Investments. Data as of 12.31.2015. Based on a cohort of publicly-traded high-yield companies in the Bank of America Merrill Lynch High-Yield Index. Defaulters include those companies that defaulted in 2016 and the first half of 2017.

More importantly, interest coverage and leverage looked meaningfully different for each universe well ahead of the wave of defaults that hit in 2016 and early 2017. The nearby chart highlights that operating cash flow/interest expense started to deteriorate as early as the first quarter of 2014 for the cohort of companies that would ultimately default in 2016, while the survivors maintained healthy interest coverage. By the end of 2015, interest coverage had declined to only 2x for companies that would default in 2016 and early 2017, while interest coverage metrics averaging 7x for survivors suggest they continued to generate sufficient cash to service interest expense. Average market metrics failed to expose this vulnerability.

With spreads and yields near historical lows, investors should be careful to avoid sectors and borrowers that are unlikely to return full principal or satisfy interest payments for the full life of the bond.

High-Yield Spreads and Yields Approaching Historical Lows

Post-recession tights call for caution and a focus on credit quality.



Source: Bank of America Merrill Lynch, Guggenheim Investments. Data as of 9.30.2017.

Looking at a representative sample of borrowers for which we obtained financial data (approximately 40 percent of U.S.-based publicly traded high-yield issuers), 20 percent are carrying unsustainable debt loads of 8x net debt/earnings or more, and 13 percent have high debt loads and interest coverage below 3x interest expense. If market conditions worsen sharply next year, we could theoretically see the issuer-weighted default rate rise to at least 13 percent over the next 12 months. We do not expect market conditions to deteriorate so dramatically, but we believe this analysis provides more information about how much an average high-yield portfolio is exposed to credit risk.

Investment Implications

Exposure to weaker sectors is masked in the current environment by a borrower's ability to source additional financing and put a Band-Aid on financial weakness. A borrower's options for curing weak financial status will be extremely limited in a less supportive environment, where borrowing costs have risen as a result of tighter monetary policy, global growth is slowing and the economy is beginning to show signs of stalling. In that scenario, accepting today's yields of only 350 basis points over Treasurys for a high-yield bond with a five- to seven-year life will, in hindsight, seem like a poor investment decision.

As high-yield spreads and yields approach historical lows, investors should evaluate whether they are being sufficiently compensated for the risk they will carry over multiple years. It is becoming increasingly important to avoid sectors and borrowers that are unlikely to return full principal or satisfy interest payments for the full life of the bond.

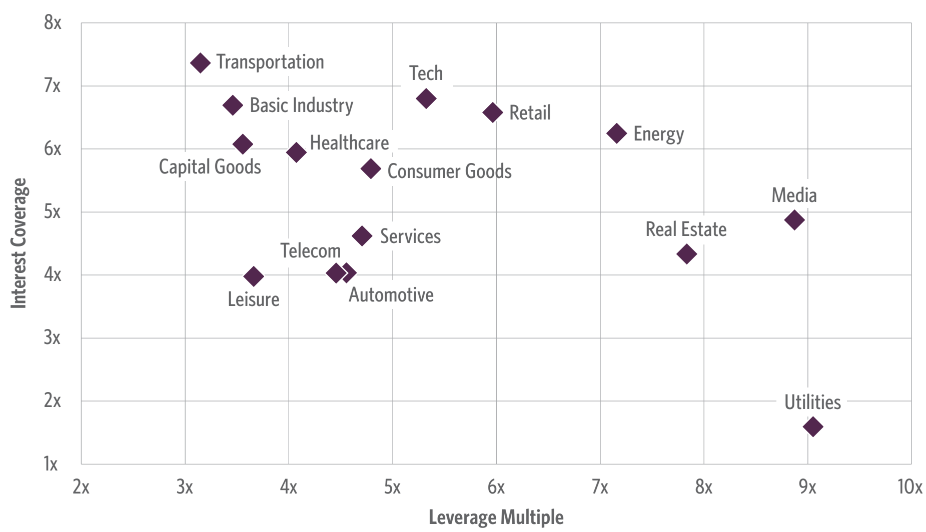
From the current universe we reviewed, the borrowers with the worst metrics today were primarily in energy and utilities, but could also be found in autos, healthcare, and technology, demonstrating how dispersed weaker names can be. As we expected, sectors that are consistently in relatively poor financial condition include retail and utilities. But media companies also carry high leverage ratios, and their earnings tend to be more cyclical, making them very sensitive to the health of the broader economy.

Positive cash flow generation will keep borrowers afloat, which means that positive earnings growth has extended the runway for another year. As the cycle ages, however, we will grow increasingly cautious of those industries that are most vulnerable to a cyclical decline in earnings and are also sensitive to rising rates, namely retail, utilities, and media.

Sectors that are consistently in relatively poor financial condition include retail and utilities. But media companies also carry high leverage ratios, and their earnings tend to be more cyclical, making them very sensitive to the health of the broader economy.

Retail, Utilities, and Media Companies Are Most at Risk

Leverage multiple and interest coverage by industry.



Source: Guggenheim Investments, Bloomberg, Bank of America Merrill Lynch. Data as of 6.30.2017. Leverage multiple = net debt / 12-month trailing EBITDA. Interest coverage = 12-month trailing EBITDA / 12-month trailing interest expense.

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 **Bank of America Merrill Lynch High-Yield Index** is a commonly used benchmark index for high-yield corporate bonds.

The **Credit Suisse High-Yield Index** is designed to mirror the investable universe of the $US-denominated high yield debt market.

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%.

Contractual spread is the fixed spread over Libor agreed to in the loan terms, ignoring trading prices and expected life of the loan expressed in discount margins.

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 **ISM Manufacturing Index** is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management.

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.

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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[2] Guggenheim Partners' assets under management are as of 8.31.2017 and include consulting services for clients whose assets are valued at approximately $62bn.

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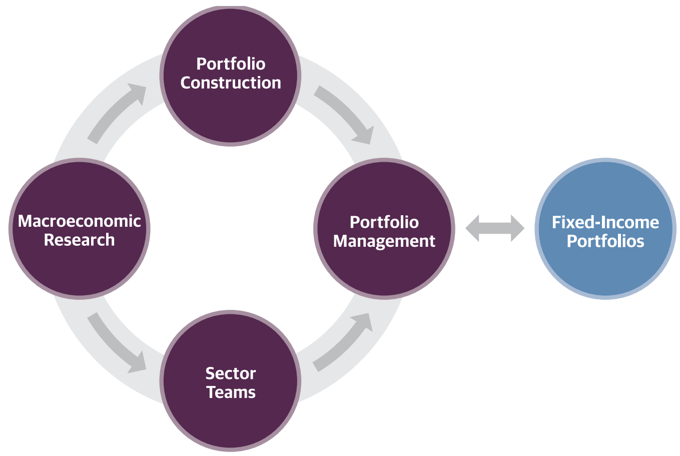

Guggenheim Investments

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Guggenheim Partners

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