Historical experience suggests bank loans should perform better than high-yield corporate bonds during a hiking cycle, but bank loan sector returns have lagged the bond market this year. Range-bound yields in intermediate U.S. Treasurys have helped stoke demand for fixed-rate high-yield corporate bonds. At the same time, the bank loan sector has seen loan refinancing and call activity reduce contractual spreads and limit price appreciation, and the sluggish increase in the London Interbank Offered Rate (Libor) has dampened gains from floating-rate loan coupons.

Going forward, the path of short-term rates will heavily impact the relative performance of bank loans and high-yield corporate bonds. The Federal Reserve’s (Fed) median projections for the fed funds target rate implies 180 basis points in cumulative rate increases between now and the end of 2019, but the Eurodollar futures market is pricing in only 84 basis points of Libor increases over the same period. We expect that short-term rates will follow a path closer to the Fed’s projections than what the market is anticipating. If short-term rates evolve as the Fed expects, we expect to see bank loan coupons converge with high-yield corporate bond coupons, increasing the attractiveness of loans over bonds.

Report Highlights

- In June the Fed delivered its fourth rate hike since the financial crisis, raising the fed funds target range to 1.00-1.25 percent.
- The increase in short-term interest rates will drive bank loan coupons higher over the next two years. We expect bank loan coupons will eventually approximate high-yield corporate bond coupons.
- As bank loan coupons drift closer to those of high-yield bonds, we believe loans will be viewed as increasingly attractive to investors.
**Leveraged Credit Scorecard**

**As of 6.30.2017**

### High-Yield Bonds

<table>
<thead>
<tr>
<th></th>
<th>December 2016</th>
<th>April 2017</th>
<th>May 2017</th>
<th>June 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Spread</td>
<td>Yield</td>
<td>Spread</td>
<td>Yield</td>
</tr>
<tr>
<td><strong>Credit Suisse High-Yield Index</strong></td>
<td>472</td>
<td>6.47%</td>
<td>431</td>
<td>5.96%</td>
</tr>
<tr>
<td><strong>Split BBB</strong></td>
<td>224</td>
<td>4.13%</td>
<td>200</td>
<td>3.72%</td>
</tr>
<tr>
<td><strong>BB</strong></td>
<td>278</td>
<td>4.51%</td>
<td>250</td>
<td>4.16%</td>
</tr>
<tr>
<td><strong>Split BB</strong></td>
<td>342</td>
<td>5.16%</td>
<td>318</td>
<td>4.88%</td>
</tr>
<tr>
<td><strong>B</strong></td>
<td>435</td>
<td>6.06%</td>
<td>418</td>
<td>5.78%</td>
</tr>
<tr>
<td><strong>CCC/Split CCC</strong></td>
<td>1,124</td>
<td>13.07%</td>
<td>954</td>
<td>11.09%</td>
</tr>
</tbody>
</table>

### Bank Loans

<table>
<thead>
<tr>
<th></th>
<th>December 2016</th>
<th>April 2017</th>
<th>May 2017</th>
<th>June 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><em><em>DMM</em> Price</em>*</td>
<td><em><em>DMM</em> Price</em>*</td>
<td><em><em>DMM</em> Price</em>*</td>
<td><em><em>DMM</em> Price</em>*</td>
</tr>
<tr>
<td><strong>Credit Suisse Leveraged Loan Index</strong></td>
<td>461</td>
<td>97.18</td>
<td>440</td>
<td>97.56</td>
</tr>
<tr>
<td><strong>Split BBB</strong></td>
<td>228</td>
<td>100.60</td>
<td>211</td>
<td>100.54</td>
</tr>
<tr>
<td><strong>BB</strong></td>
<td>296</td>
<td>100.41</td>
<td>293</td>
<td>100.02</td>
</tr>
<tr>
<td><strong>Split BB</strong></td>
<td>364</td>
<td>100.28</td>
<td>351</td>
<td>100.18</td>
</tr>
<tr>
<td><strong>B</strong></td>
<td>480</td>
<td>98.12</td>
<td>447</td>
<td>98.76</td>
</tr>
<tr>
<td><strong>CCC/Split CCC</strong></td>
<td>1,251</td>
<td>83.63</td>
<td>1,196</td>
<td>84.04</td>
</tr>
</tbody>
</table>

Source: Credit Suisse. Split ratings shown use a single “blended” Moody’s/S&P rating to compute averages sorted by rating. Excludes split B because the split B loan index is heavily represented by one single corporate issuer. *Discount Margin to Maturity assumes three-year average life.

### Credit Suisse High-Yield Index Returns

<table>
<thead>
<tr>
<th></th>
<th>Q1 2017</th>
<th>Q2 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Index</strong></td>
<td>2.4%</td>
<td>2.6%</td>
</tr>
<tr>
<td><strong>Split BBB</strong></td>
<td>2.0%</td>
<td>1.6%</td>
</tr>
<tr>
<td><strong>BB</strong></td>
<td>2.5%</td>
<td>2.2%</td>
</tr>
<tr>
<td><strong>Split BB</strong></td>
<td>2.1%</td>
<td>1.9%</td>
</tr>
<tr>
<td><strong>B</strong></td>
<td>2.2%</td>
<td>1.3%</td>
</tr>
<tr>
<td><strong>CCC/Split CCC</strong></td>
<td>4.4%</td>
<td>-1%</td>
</tr>
</tbody>
</table>


### Credit Suisse Leveraged Loan Index Returns

<table>
<thead>
<tr>
<th></th>
<th>Q1 2017</th>
<th>Q2 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Index</strong></td>
<td>1.3%</td>
<td>1.1%</td>
</tr>
<tr>
<td><strong>Split BBB</strong></td>
<td>0.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td><strong>BB</strong></td>
<td>0.5%</td>
<td>0.9%</td>
</tr>
<tr>
<td><strong>Split BB</strong></td>
<td>0.5%</td>
<td>0.8%</td>
</tr>
<tr>
<td><strong>B</strong></td>
<td>1.2%</td>
<td>0.9%</td>
</tr>
<tr>
<td><strong>CCC/Split CCC</strong></td>
<td>5.0%</td>
<td>-0.4%</td>
</tr>
</tbody>
</table>

Macroeconomic Overview
The Fed Marches Forward

First-quarter real gross domestic product (GDP) growth came in weak relative to the third and fourth quarters of 2016, at only 1.4 percent quarter over quarter annualized, consistent with the historical pattern of soft first-quarter data. Tracking estimates point to a rebound in second-quarter growth, which we expect to be at least 2.5 percent. There have been concerns about consumer health amid weakness in retail and autos, but we maintain that these are experiencing sector-specific problems. Household balance sheets and consumer spending appear solid overall.

The unemployment rate continues to decline to levels not seen since 2001, despite muted economic growth. As of June 2017, the unemployment rate stood at 4.3 percent, below what the Fed forecasted as recently as March to be the cycle low, and we expect it will fall to 3.8 percent or lower next year. If we do see a 3.8 percent unemployment rate, this would be the lowest since 2000. While a tightening labor market has not done much to lift wage growth or inflation in the current cycle, Fed Chair Janet Yellen and many of her colleagues still believe in the Phillips Curve and see a tighter labor market as a reason to continue to remove accommodation.

In June the Fed delivered its fourth rate hike since the financial crisis, raising the fed funds rate target range to 1.00–1.25 percent. It proceeded with the rate hike despite three consecutive months of soft inflation readings. The tone of the statement, as well as the press conference that followed, was not affected by recent weakness in inflation. In fact, the statement noted that the Fed continues to expect inflation on a 12-month basis to stabilize around the 2 percent objective over the medium term. This suggests the Fed views recent weakness as transient. As long as the unemployment rate continues to decline, we believe the Fed will feel compelled to continue hiking to stay ahead of potential inflationary pressures, given the lags associated with monetary policy effects.

Median FOMC projections suggest one additional rate increase in 2017, three in 2018, and three more in 2019. As we highlighted last quarter, these are not conditioned on expectations for fiscal stimulus, though they do incorporate an expectation that the natural rate of interest will rise somewhat over time, but perhaps not as much as the Fed currently projects. We expect that the Fed will forego a rate hike in September in order to launch the tapering of portfolio reinvestments, but the Fed will pick it up again in December, contingent on steady economic data and supportive financial conditions. Weak oil prices over the second quarter of 2017 should once again boost headline inflation readings in 2018 due to base effects, which, when combined with steady economic growth and falling unemployment, will prompt the Fed to raise rates three or possibly four times in 2018, in our opinion. Judging by Eurodollar futures contracts, the market is not expecting this outcome: Investors are pricing in only 84 basis points of three-month Libor increases from now through the end of 2019. The risk is that the Fed’s current forecast of rate increases may be higher than what ultimately is experienced.

“When the Fed begins to shrink its balance sheet later this year and the other central banks start to consider tapering, I think we’re vulnerable for a correction given where asset prices are.”

– Scott Minerd,
Chairman of Investments and Global Chief Investment Officer
On its own, the start of Fed balance sheet normalization should not lead to a notable increase in market volatility. The Fed has signaled its intentions well in advance, giving markets time to prepare, and pay-downs will ramp up only gradually over the course of a year. That being said, volatility across a range of markets is abnormally low and asset valuations appear stretched. Markets shrugged off worrisome developments during the second quarter, including declining oil prices, a lack of progress on fiscal legislation in Washington, D.C., and rising geopolitical risks. We continue to believe a near-term pullback in risk assets may occur in the third or fourth quarters, with low volatility and tight spreads making credit markets particularly vulnerable during what is already a seasonally weak period for risk assets. Moves toward a less accommodative stance by the European Central Bank, the Bank of Japan, and/or the Bank of England may be a catalyst for instability.

**Q2 2017 Leveraged Credit Performance Recap**

High-yield corporate bond market performance continues to outpace the bank loan market. Second-quarter total returns were 2.0 percent for high-yield corporate bonds and 0.8 percent for bank loans. High-yield corporate bond spreads tightened by 22 basis points quarter over quarter, ending June at 428 basis points. Bank loan three-year discount margins were relative flat, declining only 2 basis points to end the quarter at 442 basis points.

Year-to-date performance has been strong. High-yield corporate bonds delivered 4.4 percent year-to-date returns through the end of the second quarter, while bank loans returned 2.0 percent. This is on track to meet the expectations that we laid out at the
beginning of the year. With prices already near par, we continue to expect that bond market returns will largely consist of coupons, with limited price upside in lower-rated tranches.

The bank loan market has lagged the bond market this year for a few reasons. Over the first half of 2017, loan market returns have been stymied by refinancing activity, reducing contractual spreads at the expense of the investor. Moreover, while three-month Libor increased from 1.0 percent to 1.3 percent over the course of the first half, it did not keep pace with increases in the effective fed funds rate. Historical performance suggests loans should perform better than bonds through the hiking cycle, but the question remains whether this will repeat in the current cycle.

A key driver of relative performance between high-yield corporate bonds and bank loans over the next couple of years will be the evolution of short-term interest rates, which will be determined primarily by the pace and magnitude of Fed rate hikes. The Fed and the market disagree over the number of rate hikes that the economy can withstand. In the next section, we analyze the differing implications from each view.

**Estimated Returns Through the End of the Fed Hiking Cycle**

Despite differences in credit seniority and coupon structure, high-yield corporate bond and bank loan prices are highly correlated during benign credit and rate environments. Since 2010, only two periods have seen the high-yield corporate bond price and loan price correlation break below 90 percent over a trailing one-year period: during the taper tantrum in 2013; and at the start of the decline in oil prices in 2014. Barring similar events over the next couple of years, we would expect to see loans and bonds maintain this high correlation. Therefore, the differences in performance may derive primarily from the coupon differential.

Over one- to two-year periods, coupon returns are fairly stable; the market’s coupon return at the end of the year will be close to the average coupon at the beginning of the year. In high-yield credit, coupons have been declining as a result of the low rate environment, averaging about 6.5 percent at the end of June 2017 versus 8.2 percent just five years ago. Today an average high-yield portfolio clips about 0.5 percent monthly return solely on coupon income.

Historically, loan coupons were determined by the sum of their contractual spread and quarterly Libor rates. With Libor rates near zero following the financial crisis, the bank loan market established Libor floors of about 1.0 percent, on average. This means that many loan coupons have been determined by the sum of contractual spreads and the higher of Libor or Libor floors (if they were specified in the terms of the agreement). Not accounting for the Libor floor benefit, contractual spreads have tightened very little, from about 400 basis points five years ago to 370 basis points as of the end of June 2017. Therefore, unlike the high-yield corporate bond market, which has seen coupons decline by about 1.7 percentage points, loan coupons have only declined by about 0.3 percentage point over the past five years.
Based on data as of the end of the second quarter, bank loans were paying coupons of about 5.0 percent, on average. With Libor now at 1.3 percent—above the average 1.0 percent Libor floor—actual Libor rates are once again factoring in to the coupon calculation. Absent spread compression, about six quarter-point Fed rate increases are needed for bank loan coupons to catch up to high-yield corporate bonds given that term Libor rates generally fix at levels slightly above the expected effective fed funds rate.

There are differing opinions over the pace and magnitude of upcoming Fed hikes. According to median FOMC projections, the Fed expects 180 basis points of cumulative fed funds rate increases between now and the end of 2019, while Eurodollar futures contracts are pricing in only 84 basis points of increases in Libor over the same period. These opposing views have meaningfully different implications for loan coupons over the next couple of years. Median FOMC projections would put bank loan coupons at roughly 6.4 percent by the end of 2019, while the market-implied path of short-term rates would put bank loan coupons at only 5.4 percent (just a 40 basis point increase from recent coupons because we factor in some expected spread tightening). If the market is right, and benign economic conditions persist, high-yield corporate bonds would outperform bank loans solely on the basis of their higher coupons. Our models suggest that the terminal fed funds rate is between 2.5–3.0 percent, which lines up more closely with the Fed’s median projections.

With these trends in mind, we set out to estimate average coupon rates over the next couple of years. We expect that refinancing activity and stable demand will continue to drive contractual loan spreads and high-yield coupons lower. For high-yield corporate bonds, we assume that coupons will decline at a steady rate based on the average month-over-month change over the past two years.

The net effect of rising Libor rates and spread tightening would cause loan coupon payments to approach that of high-yield corporate bonds, eventually converging at around 6 percent. History shows that the convergence in coupon rates has occurred in each of the past three tightening cycles.
In the loan market, we assumed that contractual spreads continue to decline at the same steady rate based on the average month-over-month change. Based on this path, as well as the Fed’s median path for the fed funds rate through 2019, the net effect of rising Libor rates and spread tightening would cause loan coupon payments to approach that of high-yield corporate bonds, eventually converging at around 6 percent. History shows that the convergence in coupon rates has occurred in each of the past three tightening cycles.

Average bond and loan prices—currently at 98 percent of par for high-yield corporate bonds and 97 percent of par for bank loans—limit the potential to generate additional return from price appreciation. As the business cycle matures, we will become increasingly attuned to downside price risks given the market’s discounting nature. As our chart shows, high-yield corporate bond prices have peaked in advance of the last three recessions, and bank loans have peaked in advance of the last two recessions (bank loan data are not available for the late 1980s). Therefore, the ability to clip coupons without experiencing overwhelming credit losses will be the key driver of positive returns in leveraged credit over the next few years. If bank loan coupons converge toward those of high-yield corporate bonds, we believe investors will find bank loans even more appealing given their lower spread duration, historically lower default rates, and historically higher recovery rates.

High-yield corporate bond prices have peaked in advance of the last three recessions, and bank loans have peaked in advance of the last two recessions.

**Markets Tend to Discount Recessions**

Historical High-Yield Corporate Bond and Bank Loan Prices

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Source: Guggenheim Investments, Credit Suisse. Data as of 6.30.2017. Note: Bank loan data are not available for the 1980s.
**Investment Implications**

In the near term, we continue to expect a pullback in risk assets, with low volatility and tight spreads making credit markets vulnerable to a bout of risk aversion. Seasonal trends suggest that the upcoming months could be weak for leveraged credit, particularly high-yield corporate bonds, which tend to see more price volatility over the summer. Signs of a seasonal slowdown were evident in June 2017, when CCC-rated corporate bonds underperformed BB-rated corporate bonds for the first time since April 2016.

Seasonal trends suggest that the upcoming months could be weak for leveraged credit, particularly high-yield corporate bonds, which tend to see more price volatility over the summer. While seasonal patterns are indicating some weakness ahead, we maintain a positive view on credit over the next couple of years.

While seasonal patterns are indicating some weakness ahead, we maintain a positive view on credit over the next couple of years. We expect the payout for hedging further rate increases will be positive in bank loans, compensated via higher coupons. Our expected rate path over the next couple of years, which approximates the Fed’s more than what the market is anticipating, supports our preference for bank loans over high-yield corporate bonds. We expect that loans will outperform bonds on a risk-adjusted basis in the longer-term.

Bonds appear more vulnerable to a potential rise in long-term interest rates as central banks scale back their extraordinary accommodation—a process that is already underway in the United States. A sharp rise in government yields or a major geopolitical risk event would cause a pullback in risk appetite, resulting in wider spreads and negative total returns, particularly for high-yield bonds.
High-Yield and Bank Loan Outlook

The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated “BB” or lower, meaning that the highest rated issues included in this index are Moody’s/S&P ratings of Baa1/BB+/ or Ba1/BB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

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 to which in the loan terms, ignoring trading prices and expected life of the loan expressed in discount margins.

The three-year discount margin to maturity (dmn), 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.

**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. Credit ratings 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’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 $237 billion1 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 275+ 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
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