GUGGENHEIM

Bank Loans

Clipping the Highest Coupon in Two Decades

Yields are attractive even after accounting for credit losses in an above-average default environment.

For all the market's consternation over the bank loan sector's vulnerability to higher interest rates, one feature that may be getting overlooked is the historically attractive coupons that the sector is paying. The leveraged loan average discount margin to maturity is 573 basis points. When added to the three-month secured overnight finance rate (SOFR) of 5.4 percent, the current yield on the loan market based on the Credit Suisse Leveraged Loan Index was over 11 percent at the end of July. Coupons represent 9 percent of that yield, the highest coupon rate since 2001.

We believe this yield opportunity more than compensates for credit risk, especially for active managers. Our default rate forecast for bank loans is 3.5 percent in 2023 and a range of 5–7 percent in 2024, which means a cumulative default rate from today of 8.5 percent to 10.5 percent by the end of 2024. After applying the long-run trend of 60 percent for the recovery rate assumption, the loss-adjusted yield, assuming constant interest rates, would land between 5.6 and 7.6 percent in this scenario. This is far more attractive than the 4 percent yield on a seven-year Treasury and does not factor asset selection via active management, which should result in a potentially lower portfolio default rate. Floating rate loans also offer duration protection from the risk that the Fed is not quite done with the hiking cycle—a possibly underappreciated risk in an environment in which we have seen resilient economic activity.

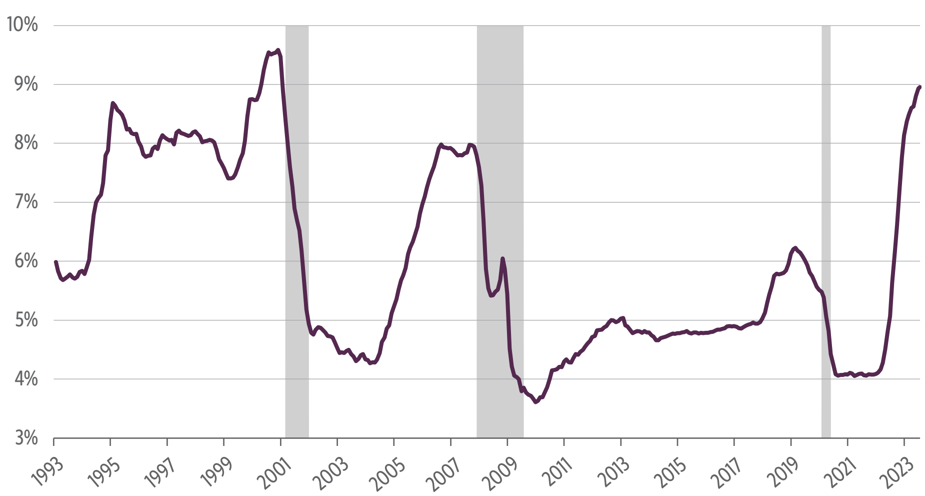
While the sector's yield looks attractive even on a loss-adjusted basis, we still think it is important to monitor the ongoing trend of credit defaults and negative rating migration. The 12-month trailing par-weighted default rate climbed to 1.7 percent as of June 2023, which remains below the historical average of 2.7 percent. The trend of more rating downgrades than upgrades also continued over the last three- and six-month periods, with a downgrade-to-upgrade ratio of 2.4x and 2.5x, respectively. In this environment, it is crucial to look for emerging single-security credit risk since they have been idiosyncratic in nature. Unsustainable leverage ratios, cost pressures, poor balance sheet liquidity, and upcoming maturities have all been among cited reasons for recent defaults across several industries. Some approaches that we take to mitigate this risk include monitoring borrowers' ability to cover fixed charges, focusing on issuers with pricing power and less margin vulnerability, and keeping a close watch on companies in more labor-intensive sectors such as healthcare, business services, and restaurants that may still be suffering labor shortages and wage inflation.

By Christopher Keywork and Maria Giraldo

Current annualized coupons for leveraged loans are at 9 percent, the highest coupon since 2001, which we believe more than compensates for credit risk.

Leveraged Loan Coupons Produce Highest Returns in Two Decades

Credit Suisse Leveraged Loan Index Annualized Coupon



Source: Guggenheim Investments, Credit Suisse. Data as of 7.21.2023.

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