GUGGENHEIM

August 2021

## High-Yield and Bank Loan Outlook

# Looking at Yields in High-Yield Credit

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## Summary

As investors navigate record low yields in credit, a relative value assessment between corporate bonds and bank loans is warranted. Our credit spread dashboard shows that bank loans are cheap relative to both corporate bonds and their own history. Call risk, however, significantly limits near-term upside potential. Investors can look to the primary market where call protection is longest and find that loan yields look comparable to corporate bond yields in the BB-rated and B-rated groups.

U.S. economic growth is likely to slow for the remainder of the year and into 2022, leaving spreads vulnerable to widening if data disappoint. A healthy market correction is not unusual in the early stages of a credit cycle. Most vulnerable are CCC-rated corporate bonds, where our estimates show loss-adjusted yields are the lowest compared to other high-yield ratings. A focus on BB-rated and B-rated cohorts is prudent given record low yields and could help limit portfolio volatility if a correction materializes.

## Highlights from the Report

- Our credit spread dashboard shows that secondary loan discount margins are cheap relative to corporate bond spreads, which is explained by differences in benchmark rates as well as higher call risk in loans.
- We expect average annual credit loss rates of 110 basis points in high-yield corporates over the next three to five years, below a historical average of 261 basis points. In loans, we estimate an average annual credit loss rate of 86 basis points, which is lower than corporates due to a higher recovery rate.
- Our forward-looking credit loss rate estimates result in positive loss-adjusted credit yields for most credit segments, but reveal little cushion in CCC-rated corporates.

# Leveraged Credit Scorecard
As of 6.30.2021

## High-Yield Bonds

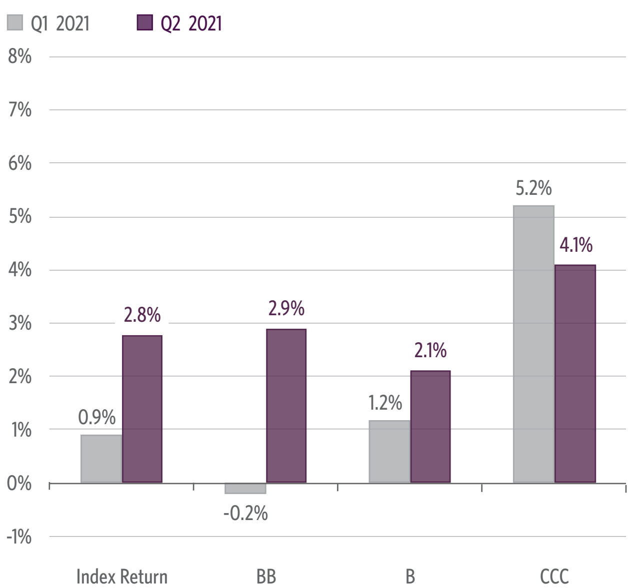
| | December 2020 | | April 2021 | | May 2021 | | June 2021 | |
|---|---|---|---|---|---|---|---|---|
| | Spread | Yield | Spread | Yield | Spread | Yield | Spread | Yield |
| **ICE BofA High-Yield Index** | 390 | 4.2% | 345 | 4.1% | 349 | 4.1% | 318 | 3.9% |
| **BB** | 281 | 3.2% | 249 | 3.3% | 253 | 3.3% | 231 | 3.1% |
| **B** | 422 | 4.5% | 386 | 4.4% | 397 | 4.5% | 367 | 4.2% |
| **CCC** | 804 | 8.3% | 667 | 7.1% | 651 | 6.9% | 593 | 6.4% |

## Bank Loans

| | December 2020 | | April 2021 | | May 2021 | | June 2021 | |
|---|---|---|---|---|---|---|---|---|
| | DMM* | Price | DMM* | Price | DMM* | Price | DMM* | Price |
| **Credit Suisse Leveraged Loan Index** | 486 | 95.73 | 449 | 97.59 | 443 | 97.82 | 443 | 97.96 |
| **BB** | 305 | 98.88 | 301 | 99.27 | 304 | 99.47 | 310 | 99.35 |
| **B** | 469 | 98.55 | 449 | 98.99 | 444 | 99.25 | 443 | 99.25 |
| **CCC/Split CCC** | 1,167 | 84.28 | 903 | 91.38 | 875 | 92.30 | 859 | 92.98 |

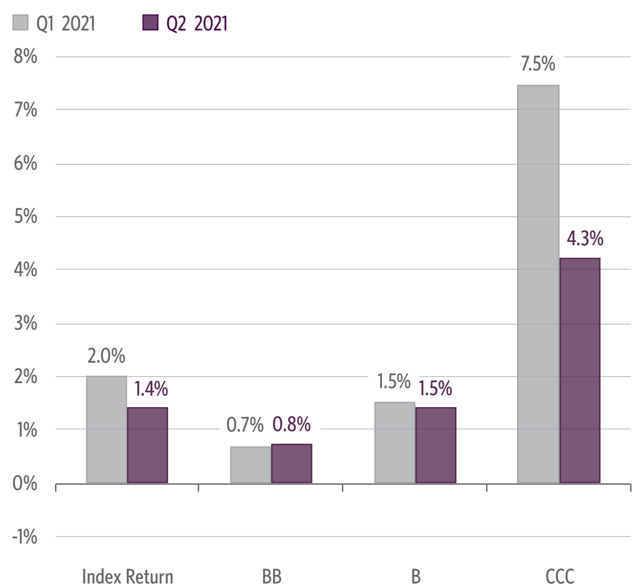
Source: ICE BofA, Credit Suisse. *Discount Margin to Maturity assumes three-year average life. Past performance does not guarantee future results.

### ICE BofA High-Yield Index Returns




Source: ICE BofA. Data as of 6.30.2021. Past performance does not guarantee future results.

### Credit Suisse Leveraged Loan Index Returns




Source: Credit Suisse. Data as of 6.30.2021. Past performance does not guarantee future results.

"Fundamental conditions support staying long credit risk despite the relative tightness of spreads, which can stay at or near these levels for several years during an economic recovery.

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

## Macroeconomic Overview
### Moving Through Peak Growth

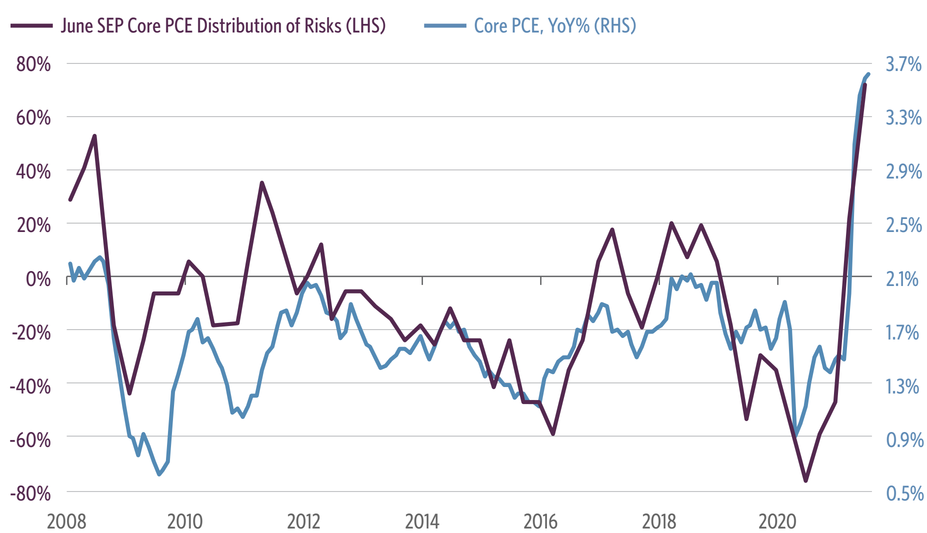
More states celebrated the end of COVID-19 related restrictions in the second quarter of 2021, marking a full reopening for almost all of the country. The United States has made solid progress on vaccinations, inoculating over 53 percent of the population, which has helped to spur a rapid recovery in the service sector and a continuation of robust manufacturing activity. The ISM Manufacturing PMI cooled a bit in June and July, but both the Manufacturing and Services PMIs remain near the peaks of recent cycles.

Labor demand is also at record highs according to the National Federation of Independent Businesses (NFIB). The NFIB reported that nearly half of small-business owners could not fill job openings in July, making it the sixth consecutive month that the share of surveyed business owners citing jobs were hard to fill exceeded pre-COVID historical highs. To attract more workers, business owners are raising or planning to raise compensation, especially in low-wage sectors where enhanced jobless benefits have been competitive with wages. Corroborating this signal of strong labor demand are the consumer confidence data, which shows perceptions around job availability is above pre-COVID highs.

Looking ahead, we are assessing the potential consequences of a slowdown in U.S. economic activity. Second quarter U.S. real gross domestic product (GDP) registered 6.6 percent annualized growth. We expect sequential growth will slow from there heading into 2022: The impact of reopening businesses, which happens only once, will start to fade, and the impact of fiscal stimulus will cool, even with another spending package likely on the way. This natural slowdown in activity as we move through peak growth could present challenges if growth slows more than expected.

FOMC participants saw the most upside risk to inflation in over a decade, so forecasting hikes was prudent to keep inflation expectations from getting out of control. In the long run, keeping inflation expectations in check buys the central bank more time to keep policy accommodative.

**Fed View of Inflation Risk Highly Correlated with Trailing, Not Future, Inflation**




Source: Guggenheim Investments, Bloomberg. Data as of 6.30.2021. *SEP = Summary of Economic Projections.

One worrying trend that has exacerbated growth fears is the spread of Delta and other COVID variants, which appear to be much more contagious than previous forms of the virus. The spread of Delta among the unvaccinated and "breakthrough" cases of the vaccinated caught policymakers off guard, leading to a scramble to get ahead of the next COVID wave. Renewed mask mandates are the first step, with the possibility of more restrictions if cases continue to rise. Fortunately, vaccines appear to be effective in reducing the hospitalization rate, and vaccination rates are much higher for the most vulnerable groups than for the general population. This should limit the need for the kind of lockdowns that would cause the economic recovery to fully stall, but renewed fears of infections amid high case growth will exacerbate the economic slowdown.

Inflation is also likely to fall given that much of the recent increase is coming from categories suffering temporary supply chain disruptions. Earlier this year price pressures materialized in sectors directly affected by the pandemic, such as hotels, airfares, and car rentals, where demand bounced back faster than supply. With the initial reopening burst now behind us and the Delta wave leading to a pullback in activity in these sectors, similar price gains are highly unlikely to repeat. Another source of inflation has been shortages in areas such as semiconductors and building materials caused by factories and transportation abroad that have not returned to full capacity.

As these factors are resolved and supply comes back online, a decline in inflation prints and inflation expectations over the next several quarters will likely prompt a rethink of the Federal Reserve's (Fed's) forecasted hikes. Our interpretation of the Fed's surprise move in June to forecast two hikes in 2023 is that the Fed is willing to be patient in reaching its dual mandate, but not irresponsible. The quarterly Summary of Economic Projections showed Federal Open Market Committee participants saw the most upside risk to inflation in over a decade, so forecasting hikes was prudent to keep inflation expectations from getting out of control. In the long run, keeping inflation expectations in check buys the central bank more time to keep policy accommodative.

According to Fed Chair Powell, the Fed will likely commence tapering asset purchases in 2021, but as we have noted in the past there is risk of delay into 2022 if the Delta variant continues to spread. We continue to believe rate hikes will likely get pushed as far as 2025 as inflation cools and the Fed targets a historically tight labor market. This patience by the Fed would support credit conditions, which means low default volumes and positive risk-adjusted returns. Real U.S. interest rates are likely to remain deeply negative, further supporting the credit sector as income-seeking investors search for yield

## Year-to-Date Performance Recap

The ICE BofA High-Yield Index delivered a year-to-date total return of 4.4 percent through the end of August, while the Credit Suisse Leveraged Loan Index delivered a total return of 3.9 percent. Spreads have tightened 69 basis points since the beginning of the year in corporates and 37 basis points in loans. The pace of spread tightening has slowed as we approach historical tights and with yields still sitting near record lows. High-yield corporate bond yields ended August at just 3.9 percent, while average loan yields (to three-year takeout) are just 4.8 percent.

The coming slowdown in economic activity increases the possibility of a pullback in risk assets. Credit spreads historically tighten when manufacturing activity increases and widen when activity slows. Base effects should slow the rate of change in activity as we move through the second half of 2021 and into the first half of 2022. We believe this means investors should move up in quality within credit, but not avoid the sector as growth should remain positive.

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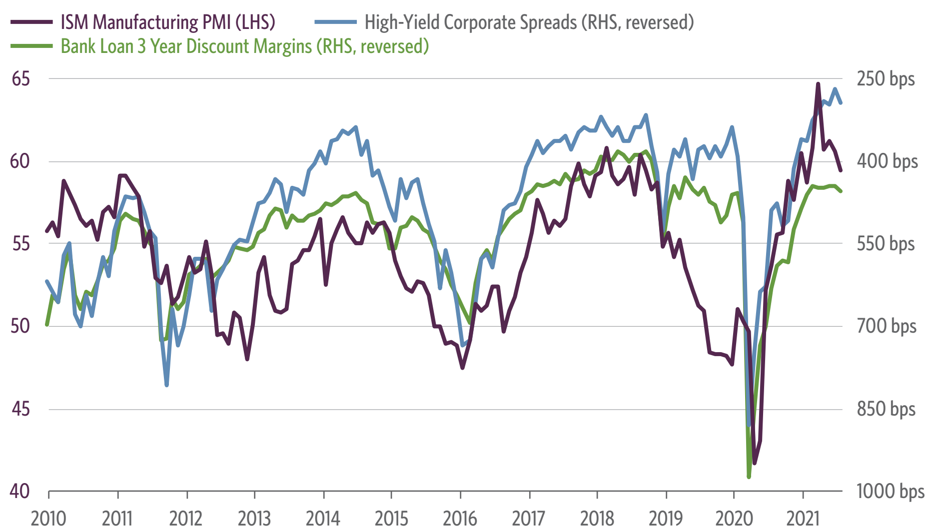
**Challenges Ahead for Spreads as Activity Peaks**




Source: Guggenheim Investments, Bloomberg, Bloomberg Barclays, Credit Suisse. Data as of 7.31.2021.

Improving fundamentals and easy lending continue to support expectations of low default activity. In aggregate, leveraged credit issuers reported revenue growth of 40 percent in the second quarter of 2021 over the second quarter of 2020. Expectations are for 20 percent year-over-year growth rate for the full calendar year.

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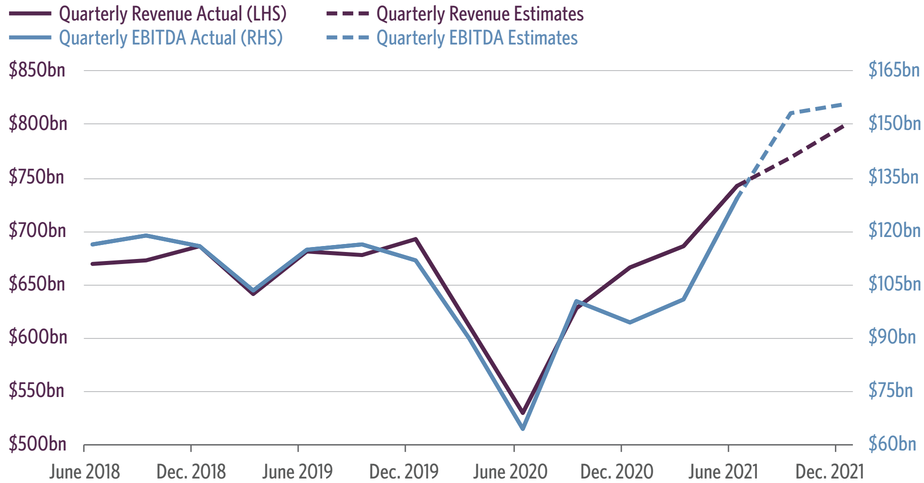
### Quarterly Revenues and Earnings Exceed Pre-Pandemic Levels




Source: Guggenheim Investments, S&P Capital IQ. Data as of 8.30.2021, based on Q2 2021 financials. Forward-looking estimates are based on median analyst expectations. Data are based on 467 companies that are rated high-yield by S&P where analyst estimates are available for each of the next two quarters, and where actual quarterly data is available since Q2 2018. This does not control for rating changes, so historical data may include companies that were not previously rated below investment grade.

Quarterly earnings before interest, tax, depreciation, and amortization (EBITDA) are now 15 percent above pre-pandemic levels. Second quarter aggregate EBITDA doubled from the same quarter last year and are expected to rise 65 percent year over year for the full calendar year. Median gross leverage ratios of 4.0x should decline further by the end of 2021.

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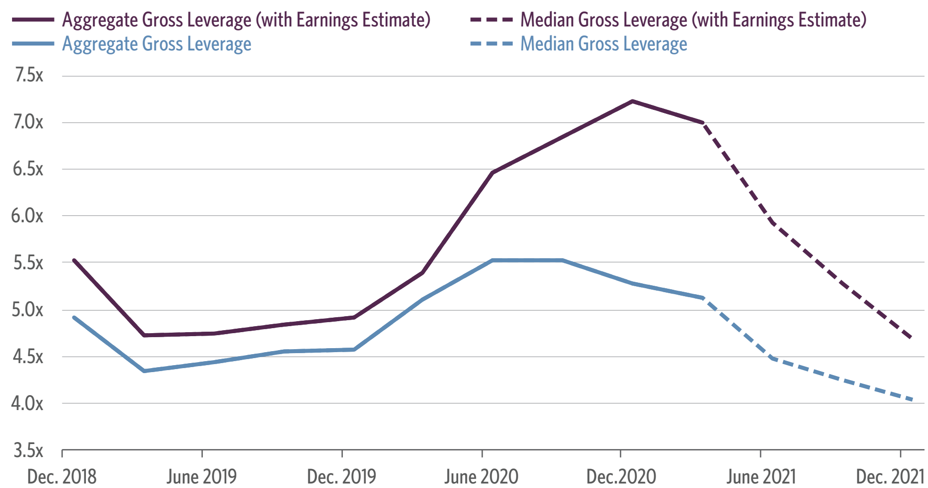
### Earnings Growth Could Aid the Market's Leverage Recovery




Source: Guggenheim Investments, S&P Capital IQ. Data as of 8.30.2021, based on Q2 2021 financials. Gross leverage measured as total debt / earnings before interest, taxes, depreciation, and amortization. Data are based on 467 companies that are rated high-yield by S&P where analyst estimates are available for each of the next two quarters, and where actual quarterly data is available since Q2 2018. This does not control for rating changes, so historical data may include companies that were not previously rated below investment grade.

We do not have reason to revise our rating migration and default expectations at this stage. Specifically, we expect an average annual credit loss rate of 110 basis points in high-yield corporates over a three to five-year horizon, below the historical average of 261 basis points. In loans, we estimate an average annual credit loss rate of 86 basis points, which is lower than corporates due their higher recovery rate.

## Why Loans Look "Cheap"

In our internal Credit Spread Dashboard, which monitors risk premiums across the credit landscape, bank loans appear cheap relative to corporate bonds. BB-rated loan discount margins are 311 basis points compared to BB-rated option-adjusted spreads of 231 basis points. B-rated and CCC-rated loan discount margins are 63 and 285 basis points higher than similarly rated corporate bond spreads, respectively. This is somewhat artificial since loan discount margins are quoted over the three-month London Interbank Offered Rate (Libor) while corporate spreads are relative to Treasurys. The steep yield curve makes discount margins looks comparably wider.

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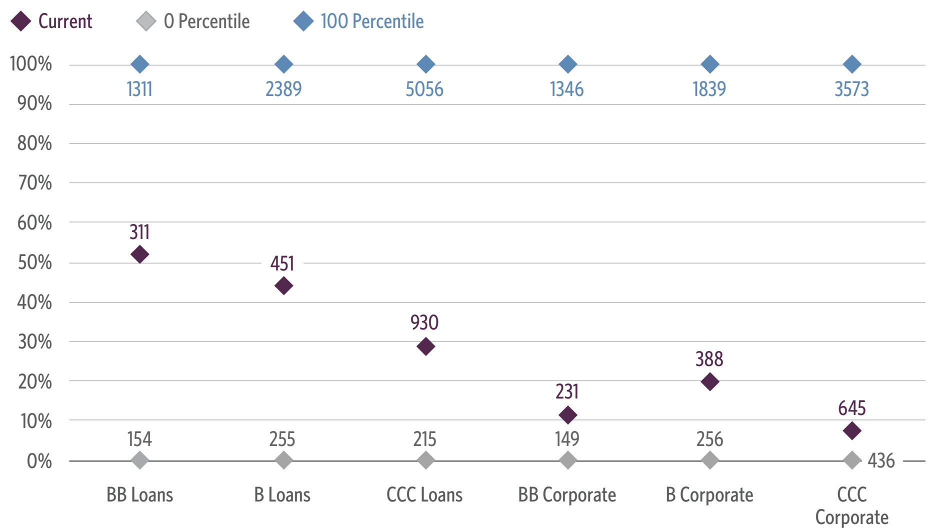
**Larger Risk Premiums in Loans than Corporates**




Source: Guggenheim Investments, Credit Suisse, Bloomberg. Data as of 8.27.2021. Y-axis shows spreads expressed as historical percentiles, with historical max shown as the 100th percentile and historical min shown as the 0th percentile. Historical data since January 1992.

To control for differences in benchmark rates, we can compare yields. The average loan yield (to three-year takeout) of 4.8 percent is 90 basis points above the average high-yield corporate bond yield. That is because the loan market average credit rating has fallen to single B, below the high-yield corporate index average quality, which is between B+ and BB-. A yield or spread comparison between the two sectors needs to be adjusted for rating profiles.

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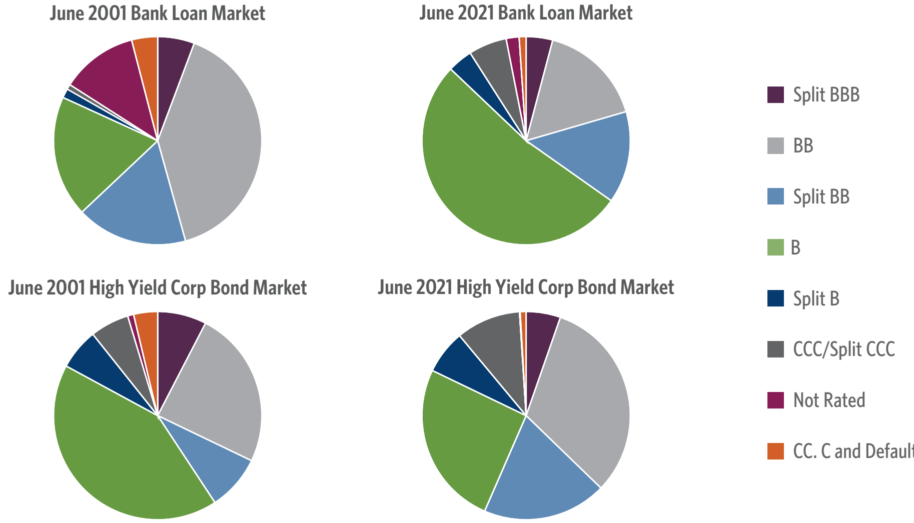
**Changes in Rating Composition Offer Some Explanation for Divergences in Value**

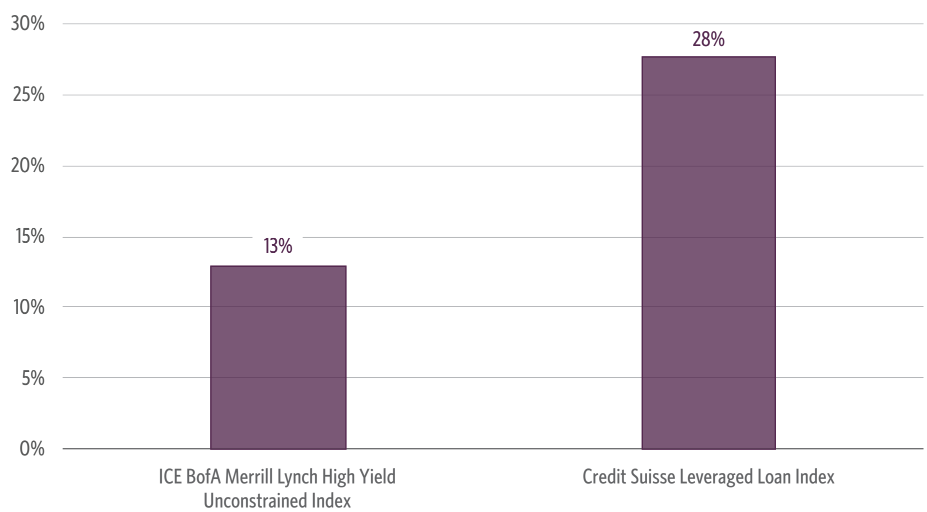



Source: Guggenheim Investments, Credit Suisse. Data as of 6.30.2021. Based on index-eligible debt only for the Credit Suisse Leveraged Loan Index and the Credit Suisse High Yield Index.

Once we control for quality, there is not much of a difference in secondary market yields. The difference between BB-rated corporate bond yields (which are 3 percent currently) and BB-rated loan yields (which are 3.5 percent) has averaged just 12 basis points so far in 2021. Historically, loan yields are lower than corporates due to their seniority and higher recovery rates. As we consider the probability of a reversion to the mean in this relationship, a key limiting factor is call risk.

The Credit Suisse Leveraged Loan index has seen about 28 percent of the index get called since the start of the year, compared to just 13 percent for the high-yield corporate bond index.

**Share of the Index That Has Been Called/Refinanced in 2021**




Source: Guggenheim Investments, Credit Suisse, ICE Index Services, Bloomberg. Data as of 8.30.2021.

The Credit Suisse Leveraged Loan index has seen about 28 percent of the index get called since the start of the year, compared to just 13 percent for the high-yield corporate bond index. This is because loans have less call protection than bonds. When measured on a yield-to-worst basis—the lowest yield possible when taking into account callable dates and scheduled maturity—the implied yields are negative for many loans that can get called at a lower price than where they are currently trading. Therefore, the capital appreciation potential of loan prices is more limited.

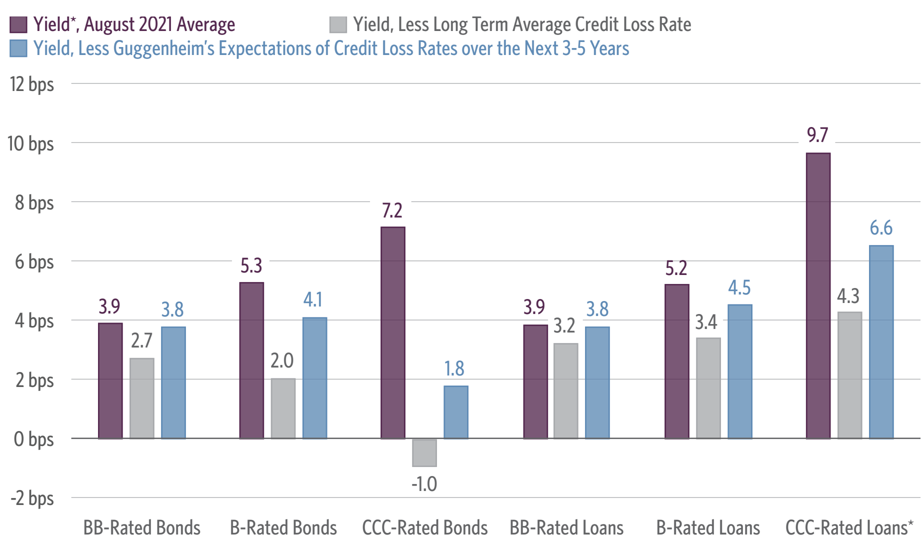
One way to manage for call risk is to source opportunities in the primary market where call protection is longer and new-issue loans are often issued at a discount to par to incentivize investor demand. New issue yields were 3.9 percent in August for both BB-rated loans and BB-rated unsecured corporate bonds, which we translate to loss-adjusted yields of 3.8 percent for each against our credit loss expectations. In this case, both rating categories fairly compensate for our expectations.

New-issue B-rated loan yields were 5.2 percent in August, compared to 5.3 percent for new issue B-rated corporate bonds. The loss-adjusted yields would be 4.5 percent and 4.1 percent, respectively. B-rated loans look slightly more attractive, but given that the loss-adjustments are based on our forward-looking default and recovery rate expectations, which may not be precise, our conclusion is that these yields look comparable.

New-issue supply of CCC-rated loans is generally low and was nonexistent in August, so here we look to the secondary market, where we estimate a CCC-rated loan loss-adjusted yield of 6.6 percent. However, we would caution that this is a

New-issue B-rated loan yields were 5.2 percent in August, compared to 5.3 percent for new issue B-rated corporate bonds. The loss-adjusted yields would be 4.5 percent and 4.1 percent, respectively. B-rated loans look slightly more attractive, but given that the loss-adjustments are based on our forward-looking default and recovery rate expectations, which may not be precise, our conclusion is that these yields look comparable.

**Positive Loss-Adjusted Credit Yields Based on Our Expected Credit Costs**




Source: Guggenheim Investments, ICE Index Services, Credit Suisse, Moody's Investors Service. Data as of 8.27.2021.*Based on August average primary market yields for BB-rated and B-rated categories, and August average secondary market yields for CCC-rated categories due to few observations in the primary market. Conventional yields are shown yield to worst for high-yield corporates and 3-year yield for bank loans.

small pickup in yield over B-rated loans relative to history, which limits additional price upside in CCC-rated loans compared to B-rated loans.

Our credit loss rate expectations suggest new-issue CCC-rated corporates offer little cushion to downside scenarios. We believe CCC-rated corporate bond loss rates will average 535 basis points over a three to five-year horizon (below 691 basis points average of the last 20 years). This leaves the average CCC-rated corporate loss-adjusted yield of just 1.8 percent.

Ultimately, total returns can be further affected by index rating migration and callability differences between loans and high-yield bonds. For example, in our first quarter 2021 High Yield and Bank Loan Outlook, we discussed how the high-yield index average rating quality has been improving. When an issuer's rating is upgraded, its spreads tighten. For corporate bonds with stronger call protections, there is greater potential for capital appreciation. But because loans have more limited protections, an issuer may consider refinancing the debt after an upgrade, which limits total return. Adjusted yields and total returns are both important when comparing bank loans and high-yield bonds in order to uncover opportunities in each market.

## Investment Implications

The previous section focused on spreads and loss-adjusted yields, but there are many other factors to consider when comparing value across bonds and bank loans. Differences in the industry profile, such as the corporate bond market's concentration in energy, can drive large divergences in value and volatility. Investors should also consider their liquidity preferences since high-yield corporates have standardized settlement of 2 days, with ability for sooner, while median loan settlements are between 10 to 14 days.

Analyzing loan credit fundamentals can also take more effort and resources, since 60 percent of loan issuers are private which reduces transparency. In comparison, just 35 percent of high-yield corporate bonds are issued by private companies.

Investors should also consider their own rate views. Loans are less exposed to interest rate volatility due to floating rate coupons, and generally benefit in a rate-hiking cycle. However, the duration component could benefit bonds should the market determine that rates should decline as monetary policy evolves. Regardless, we would expect that spreads of both asset classes could benefit from an extended period of easy monetary policy over the coming years.

In this environment, different segments of both high-yield corporate bonds and bank loans offer unique opportunities, and a properly diversified credit portfolio should have exposure to both asset classes given their comparable value.

# 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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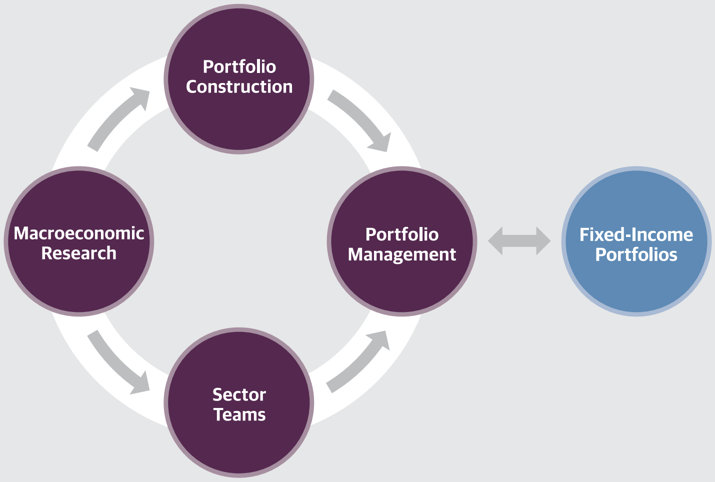
2. Guggenheim Partners under management are as of 6.30.2021 and include consulting services for clients whose assets are valued at approximately $78bn.

## 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 $255 billion[1] 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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