GUGGENHEIM

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High-Yield and Bank Loan Outlook
Cautiously Adding Credit Beta

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The volatility in credit markets over the past few months may not be over. Troubles in Greece, Syria, and, in particular, China, remain unresolved and may inject further volatility into U.S. markets. By delaying a rate hike, the U.S. Federal Reserve confirmed investor fears that global turmoil could have real adverse consequences for U.S. financial markets. We should be focusing, however, on the forest, not the trees—the U.S. economy remains solid and the chance of entering a recession in the near term is remote.

Now is the time to look for opportunities to deploy capital that has been sitting on the sidelines. Continued economic growth supports debt service capacity and keeps credit risk benign in many sectors. Though some investors are waiting for the all-clear signal, repositioning portfolios is not something that can be done overnight. We recommend that investors use the next six to eight weeks to add spread duration in order to position for an eventual rebound.

Report Highlights

- The Credit Suisse High-Yield Bond and Leveraged Loan Indices posted losses of 5.2 percent and 1.2 percent for Q3 2015, respectively, the worst performance since Q4 2008 for high-yield bonds and since Q3 2011 for bank loans.
- There may be some additional volatility ahead, but we are already seeing value that has resulted from spread widening over the past few months. The relative value of B-rated corporate bonds over higher quality credits looks especially attractive given our positive macroeconomic outlook.
- Leverage ratios, which have returned to historical highs, are indicative of a rapidly advancing credit cycle, but debt burdens are manageable given low borrowing costs. We believe leveraged credit markets have room to run in the current cycle.

Leveraged Credit Scorecard
As of September 30, 2015

High-Yield Bonds

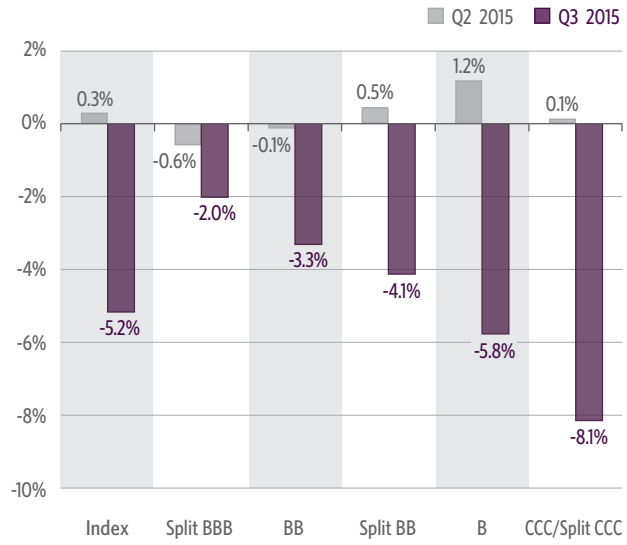
	December 2014		July 2015		August 2015		September 2015	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
Credit Suisse High-Yield Index	564	7.10%	565	7.04%	617	7.64%	704	8.39%
Split BBB	250	4.16%	296	4.60%	328	4.93%	321	4.68%
BB	364	5.22%	374	5.26%	407	5.65%	490	6.35%
Split BB	462	6.16%	445	5.76%	481	6.22%	562	6.89%
B	600	7.34%	591	7.25%	645	7.88%	731	8.63%
CCC / Split CCC	1,009	11.54%	1,026	11.55%	1,132	12.69%	1,265	13.94%

Bank Loans

	December 2014		July 2015		August 2015		September 2015	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	558	96.28	528	96.38	556	95.39	581	94.33
Split BBB	328	99.03	300	99.61	311	99.32	314	99.16
BB	403	98.15	374	99.15	393	98.54	404	98.18
Split BB	506	97.71	455	99.16	486	98.33	510	97.68
B	619	96.44	585	97.11	616	96.05	647	95.15
CCC / Split CCC	1,044	94.26	1,097	91.73	1,145	90.51	1,268	86.17

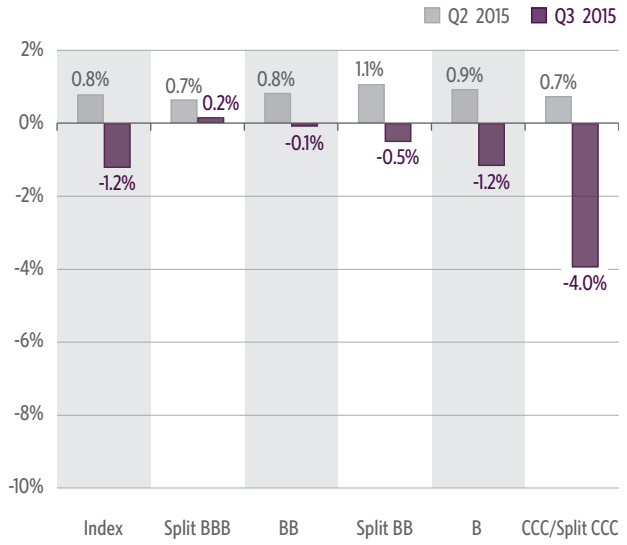
Source: Credit Suisse. Split ratings shown use a single "blended" Moody's/S&P rating to compute averages sorted by rating. Excludes split B because the split B loan index is heavily represented by one single corporate issuer. *Discount Margin to Maturity assumes three-year average life.

Credit Suisse High-Yield Index Returns



Source: Credit Suisse. Data as of Sept. 30, 2015.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of Sept. 30, 2015.

Macroeconomic Overview
Cautiously Wading into Credit Beta

"We are still in that season of extreme vulnerability and I don't think the storm has passed. We're going to get an opportunity to buy things cheaper than where we are now, but we shouldn't wait for the all-clear signal. We should take advantage of some of the value that has occurred in the widening of spreads, especially in lower quality assets. It is time to cautiously downgrade the quality of our credit portfolios to take advantage of a coming rebound."

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

The world kept a watchful eye on the U.S. Federal Reserve (Fed) this summer as headlines moved from Greece to China. Weak economic growth prompted several rate cuts by the People's Bank of China, and despite efforts by the Chinese authorities to support the market, the leverage-fueled boom in China's stock market unraveled, with the Shanghai Composite falling 32 percent in the 3.5 weeks following its June 12 peak. Left with few other meaningful alternatives, China devalued the yuan by 1.9 percent in August, the first devaluation of its currency in 20 years. Inevitably, markets drew parallels to the 1997 Asian financial crisis. As China's move sent shockwaves through global financial markets, the Fed opted to keep rates at the zero-bound at its September meeting, citing concerns about potential downside risks to the U.S. outlook posed by recent global market volatility.

An important lesson we might learn from the Asian financial crisis is that it can take several months or even years for the global contagion to spread. The initial devaluation of the Thai baht in 1997 eventually spread to the Philippine peso, the Singapore dollar, the Indonesian rupiah, and the South Korean won. It wasn't until 1998 that the crisis arrived at the U.S., when the hedge fund giant Long-Term Capital Management lost billions of dollars as a result of leveraged positions in Russia and Brazil. Given its ties to almost every major U.S. bank, the Fed organized a consortium of banks for a bailout. The loss of faith and liquidity that reverberated through the economy forced the Fed to abandon its tightening process, which prolonged the U.S. economic expansion until the recession began in March 2001—four years after the initial devaluation of the Thai baht. This gradual unfolding of global contagion is important to recognize in light of the Fed's decision to delay the beginnings of the policy normalization process in September. If global economic stress remains a key consideration for the Fed, the Asian financial crisis experience suggests that the Fed may not have the clarity it seeks to tighten U.S. monetary policy anytime soon. It is not surprising then that the Fed policymakers' median projections for the fed funds rate were revised lower in the September Summary of Economic Projections.

On a positive note, an accommodative Fed supports a benign credit environment, and the U.S. economy is well positioned for continued growth. In August, the ISM nonmanufacturing purchasing managers' index posted its second-best reading since 2005. Consumer spending has risen at a steady pace, according to U.S. Department of Commerce data, supported by steady labor market progress and low energy prices. The NFIB Small Business Optimism Index rose for a second consecutive month in August, up slightly from 95.4 to 95.9. Most importantly, job openings surged in July, increasing from 5.32 million to a record high of 5.75 million. We see the job openings data as a strong leading indicator of the labor market, and see prospects improving for the long-awaited acceleration in wage growth.

If we are reliving the late '90s, we should remember that the period between the initial devaluation of the Thai baht and the subsequent U.S. recession was characterized by a 1997 oil bear market, a Fed tightening cycle, and a major bailout, but it also coincided with 29 percent and 21 percent gains in the S&P 500 during the tech boom in 1998 and 1999, respectively. The U.S. economy grew briskly and the unemployment rate fell to 3.9 percent in December 2000, the lowest since 1970. While opportunity lies ahead, there will be more volatility. Investors must tread carefully and watch the fundamentals closely for signs of weakness that would make markets vulnerable to exogenous shocks.

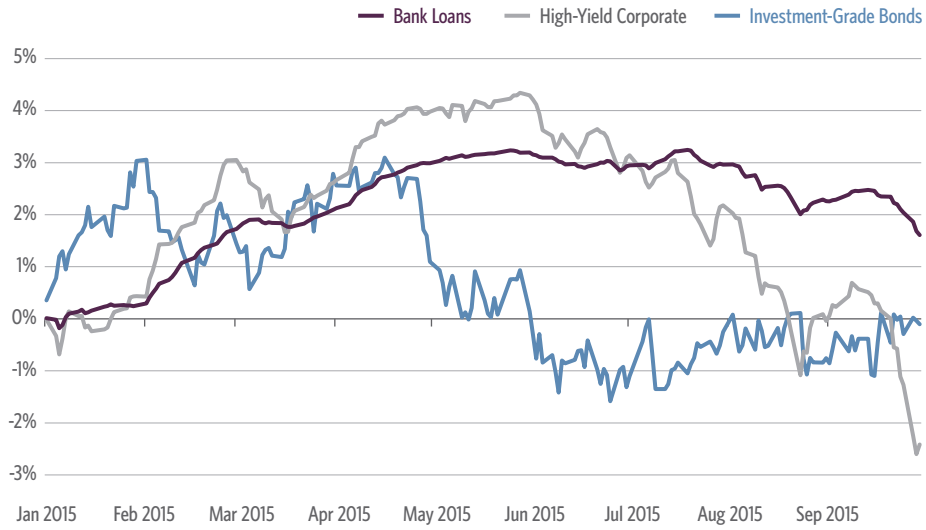
Q3 Performance Recap

Volatility Is Creating Opportunities

Following a relatively quiet July, the S&P 500 fell 6 percent in August, its largest one-month loss since September 2011, while the Credit Suisse High-Yield Index fell 2.05 percent, its largest one-month loss in almost a year. While investors capitulated in these markets, leveraged loans proved to be a source of relative stability, with the Credit Suisse Leveraged Loan Index posting only a 0.65 percent decline for the month. Ultimately, the bearish sentiment dragged into September, pulling markets even lower. High-yield bonds and bank loans lost 5.2 percent and 1.2 percent in Q3 2015, respectively, bringing year-to-date returns to -2.4 percent for high-yield bonds while bank loans have held on to a 1.6 percent total return for the year.

Bank loan mutual fund outflows, anemic new issue supply, and increased mergers and acquisitions (M&A) activity have masked one of the greatest benefits of bank loan investing—relative stability. Against highly volatile markets, the year-to-date performance of the bank loan market has been positive and stable. We continue to believe that bank loans will be one of the best performing fixed-income asset classes over the next couple of years.

Bank Loans, High-Yield Bonds and Investment-Grade Bonds Year-to-Date Returns



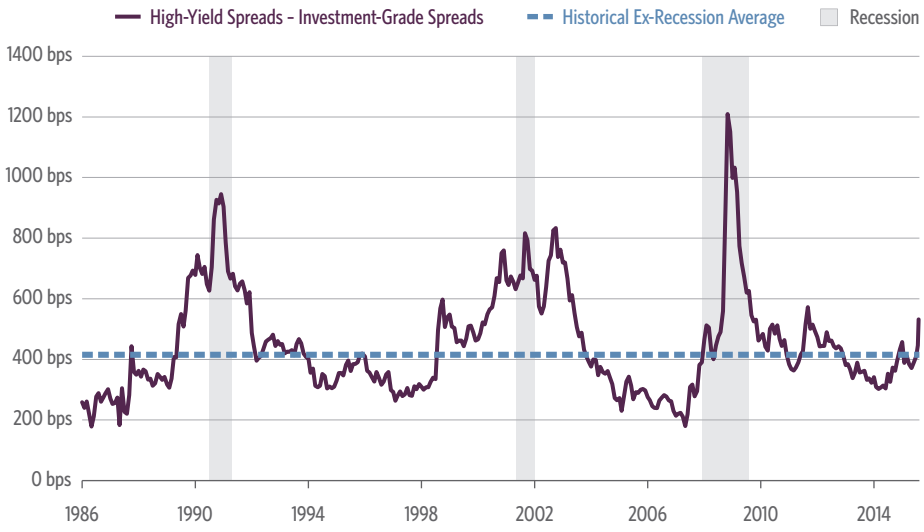
Source: Barclays, Credit Suisse, Guggenheim. Data as of Sept. 30, 2015.

The watchword across risk assets over the past few months has been caution. Partial evidence lies in mutual fund flows, where investors have pulled $5 billion from high-yield bond mutual funds and $8.9 billion from bank loan mutual funds year to date. The notable withdrawal of assets from bank loan mutual funds has not materially affected the loan market due to anemic supply (institutional loan issuance between January 2015 and September 2015 is down 38 percent from $333 billion in the first nine months of 2014) and a robust collateralized loan obligation (CLO) market, which has seen $80 billion of new CLO formations. We believe investors exiting the market for liquidity or credit concerns may have overlooked the relative stability of bank loans in the midst of heightened turbulence. Bank loans have outperformed both investment-grade corporate bonds and high-yield corporate bonds year to date.

While we remain constructive on credit, our position shifted toward a more defensive stance last year when we noted that CCC-rated corporate bonds were no longer offering adequate compensation for risk. This prudent strategy has served us well, but it is difficult not to view today's cheap valuations as a buying opportunity against a strong economic backdrop. Periods of economic expansion have coincided with tightening spreads and low defaults, and economic data highlighted earlier in this report support our view that the U.S. expansion remains on track. Yet, high-yield spreads have widened to 704 basis points, on average, above their ex-recession average of 535 basis points—levels not seen in over three years. Excluding commodity-sensitive sectors such as energy and metals and mining, high-yield bond spreads are trading at 634 basis points. Moreover, high-yield bonds are currently trading approximately 535 basis points wider than investment-grade bonds—levels not seen since late 2011, and well above the ex-recession average high-yield premium of 417 basis points over investment-grade corporate bonds.

The spread between high-yield corporate bonds and investment-grade corporate bonds has historically narrowed as the economy expands and business conditions remain strong enough to allay credit concerns. We believe investors should take advantage of the recent increase in high-yield risk premiums by reducing the credit quality of their portfolios on the margin.

Risk Premium Between High-Yield and Investment-Grade Corporate Bonds



Source: Credit Suisse, Barclays, Guggenheim. Data as of Sept. 30, 2015.

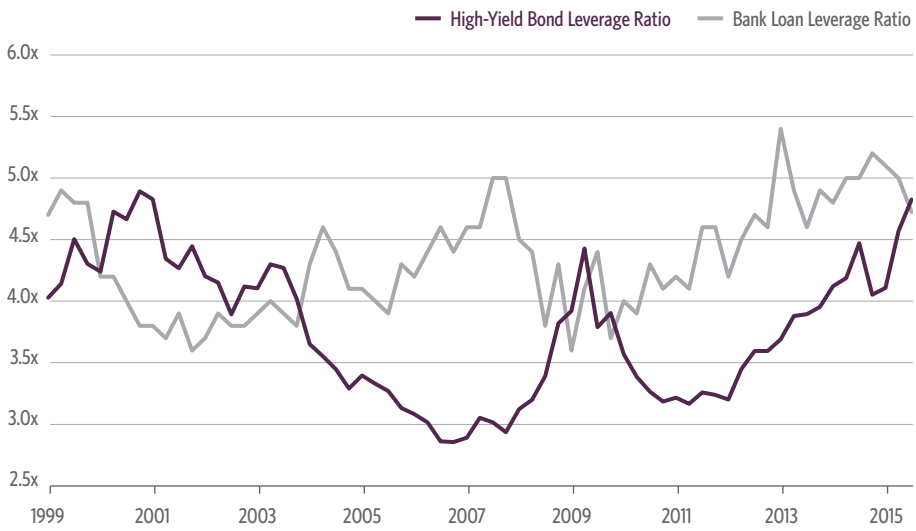
We predicted that 2012 would prove to be a good time to add risk given strong fundamentals and cheap valuations, and indeed it was. We believe that a similar opportunity exists today even though the Fed ended quantitative easing and has prepared the markets for the start of policy tightening. After all, the monetary policy remains highly accommodative, with a target range for the fed funds rate of 0–25 basis points. As a result, borrowing costs remain low, capital markets are still active, and lending standards continue to ease. However, the global factors that have driven volatility this year are not going to subside soon. Growth in emerging markets will likely remain weak, and commodity prices depressed, which portends more volatility ahead. Timing a bottom is not part of our long-term investment strategy given that changes in investment direction cannot be implemented in a single day, especially in a liquidity-challenged environment. We believe investors who heeded our advice last quarter and raised cash ahead of the turbulent summer should use the next couple of months to position for a rebound by adding spread duration to credit portfolios.

Can Leveraged Borrowers Withstand a Rising Rate Environment?

An impending Fed rate hike presses the question of where we are in the current credit cycle and whether credit markets can withstand higher rates. Metrics such as leverage multiples and new issue trends are often cited as key reasons why the credit market may be closer to the end of the cycle. These are important factors to consider, but they do not alone mark the end of the rally. Mitigating these risks is low interest coverage, or the ratio of earnings before interest, tax, depreciation and amortization (EBITDA) over interest expense, which remains at or above historical averages.

Elevated leverage ratios have raised concerns among investors, with some questioning whether leveraged borrowers will be able to withstand a higher interest-rate environment. We argue that while leverage trends warrant close attention, low interest burdens will mitigate credit risk as long as earnings continue to grow.

High-Yield and Bank Loan Leverage Ratios Near Historical Peaks



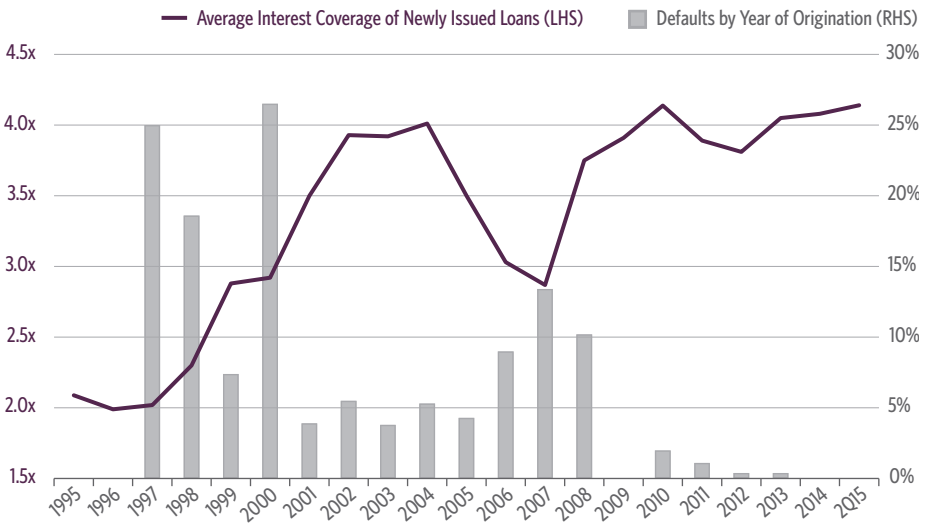
Source: Bank of America Merrill Lynch, S&P LCD. Data available through Q2 2015.

Borrowing from our report published two years ago, high-yield leverage declined steadily between 2008 and 2011, but the opportunistic issuance of debt to lock in historically low borrowing costs has pushed up leverage to 4.8x among high-yield borrowers and 4.7x among bank loan borrowers (as of Q2 2015). Both have either returned to or surpassed their historic peaks, which has prompted many to question the ability of leveraged borrowers to continue to support such heavy debt loads under less favorable monetary conditions.

Lower borrowing costs continue to offset the risk from higher leverage ratios. High-yield bond interest coverage ratios stand at 3.0x, just under the historical average of 3.2x (reflecting an aging credit cycle and the negative impact of commodity-sensitive sectors), while bank loan interest coverage stands at 3.7x, above the historical average of 3.4x. These metrics suggest borrowers can support their debt service in the near term. High-yield borrowers also carry fixed debt costs, which are at all-time lows with average coupons of 6.8 percent. The majority of bonds and loans are not scheduled to mature until 2018 or after, allaying concerns about refinancing risks over the next three years. The greater concern would be in the loan market given their floating coupons.

Defaults in the loan market are highest among loans originated with coverage ratios of less than 3x. This relationship partially explains why we have had several years of below average default rates in the current cycle. Loans today continue to look healthy in their ability to service debt, with average cash flow coverage of 4.1x.

EBITDA / Cash Interest of Newly Issued Loans vs Default Rate by Origination Year



Source: S&P LCD. Data as of Q2 2015.

A couple of factors mitigate the immediate risk of rising borrowing costs in the loan market. First, London Interbank Offered Rates (LIBOR) floors delay rising coupon payments for approximately 90 percent of the loan market until LIBOR exceeds 1 percent (three-month LIBOR currently is 0.33 percent). Second, S&P LCD data shows that EBITDA growth in the loan market remains strong, coming in at 7 percent year over year in Q2 2015, which climbs to 10 percent year over year excluding borrowers in oil, gas and mining. Lastly, historical data shows that there is a direct relationship between defaults and coverage ratios at the time of origination. According to S&P LCD, 13 percent of loans originated in 2007 defaulted, a time when interest coverage of newly issued loans dropped below 3x. On the other hand, only 5 percent of loans originated in 2004 defaulted, a time when loans were still originated at an average interest coverage multiple of 4x. The average interest coverage multiple for newly issued loans this year is 4.1x.

We acknowledge that these metrics can change rapidly in the face of declining earnings. Interest coverage among high-yield energy borrowers stood at 4.7x before the beginning of the oil bear market in July 2014. Today, energy coverage ratios have deteriorated to only 0.7x on average due to declining earnings. In addition to interest coverage, we monitor sectors that have consistently had weak earnings in the current cycle and track how widespread the issue may be.

Our dashboard of credit cycle drivers highlights both healthy and deteriorating metrics in the current cycle. Among the weakest trends are leverage multiples and covenant lite loan deals, but there are plenty of still-healthy trends on the dashboard. Among those are interest coverage ratios, which demonstrate that borrowers are well positioned to continue servicing debt burdens.

Credit Cycle Drivers

Issuance

	2006	2007	2013	2014	2015 Q2
M&A/LBO as a % of Total Issuance	52%	53%	23%	42%	47%
Refinancings as a % of Total Issuance	24%	22%	51%	40%	26%
Dividend Deals as a % of Total Issuance	0%	6%	8%	7%	10%
Covenant Lite as a % of Total Loan Issuance	8%	29%	57%	63%	63%
PIK Toggle as a % of Total HY Bond Issuance	1%	3%	1%	1%	0%

Leveraged Buyout Activity (LBO)

	2006	2007	2013	2014	2015 Q2
Purchase Price Multiples	8.4x	9.7x	8.8x	9.8x	10.1x
Equity Contribution as a % of Financing	31%	31%	36%	37%	40%
LBO Leverage (Debt/EBITDA)	5.3x	6.2x	5.4x	5.8x	5.8x
LBO EBITDA / Cash Interest	2.3x	2.1x	3.2x	3.4x	3.2x

Fundamental Metrics

	2006	2007	2013	2014	2015 Q2
Bank Loan Leverage Multiple (Debt/EBITDA)	4.4x	4.9x	4.7x	4.9x	4.7x
Bank Loan Interest Coverage (EBITDA/Cash Interest)	3.0x	2.9x	4.1x	4.1x	3.7x
All High-Yield Leverage Multiple (Net Debt/EBITDA)	2.9x	3.1x	4.1x	4.1x	4.8x
All High-Yield Interest Coverage (EBITDA/Cash Interest)	3.8x	3.7x	3.4x	3.6x	3.0x

Source: S&P LCD, Bank of America Merrill Lynch, Guggenheim. Data as of Q2 2015.

On the surface, year-over-year high-yield earnings look uninspiring. According to JP Morgan, EBITDA year-over-year growth was 4.4 percent in the high-yield bond market during Q2 2015. Excluding languishing sectors tied to commodities, however, EBITDA growth was a healthy 10.9 percent. Furthermore, weak earnings are not widespread across industries, as we've seen ahead of severe default cycles. Less than half of the universe, seven out of 17 industry groups, had negative EBITDA growth in Q2 2015. By contrast, 14 out of 17 high-yield industries recorded negative EBITDA growth in Q2 2001, and 16 out of 18 industries had negative EBITDA growth in Q4 2008. There are strong credits within select industries that are fundamentally well positioned today, some of which we discuss in the next section.

Investment Implications

Ease into Credit Beta but Stay Conservative

Reiterating earlier views, the next six-12 month period is not likely to be a friendly environment for commodity-sensitive borrowers. Fifty-two percent of the high-yield energy market continues to trade at less than 80 percent of par—a level generally considered to be distressed—while 47 percent of metals and mining high-yield bonds trade below 80 percent of par. Outside of these, however, numerous sectors look fundamentally well positioned to survive additional volatility.

In the automotive space, suppliers are benefitting from cost reductions and lower input prices. Reflecting these tailwinds, Moody's upgraded the liquidity rating of numerous high-yield automotive suppliers in the midst of market turbulence in August. The housing and construction sector is benefitting from declining mortgage rates, which have followed Treasury yields lower. As of Sept. 30, 2015, the 30-year mortgage rate stood at 3.84 percent, well below the average over the past decade of 4.95 percent. As a result, U.S. homebuilder confidence is at the highest in a decade, with the September reading of the National Association of Home Builders sentiment index rising to 62, the highest level since October 2005. Other sectors that have consistently produced positive earnings results over the past four quarters are hotels, retail, and transportation—sectors that generally do well in an expanding economy.

Recent spread widening has also resulted in attractive relative value between ratings. B-rated bonds are currently trading 225 basis points wider than BB-rated bonds, 70 basis points above the historical average premium. We remain highly selective within the CCC-rated category. Yields of 13.9 percent in CCC look appealing, but only on a selective basis. Within this segment, we generally focus on credits we think may be mis-rated, and this prudent approach should help to safeguard our clients' assets over the long term.

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 **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.

The **Barclays Investment-Grade Corporate Bond Index** covers USD-denominated, investment grade, and fixed-rate, taxable securities sold by industrial, utility, and financial issuers.

The **Barclays U.S. Aggregate Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **BofA Merrill Lynch Core Fixed Rate Preferred Securities Index** tracks the performance of fixed rate US dollar denominated preferred securities issued in the US domestic market.

Spread is the difference in yield to a Treasury bond of comparable maturity.

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%.

Discount margin to maturity (dmm) is the return earned at maturity that is over and above a specific reference rate associated with some type of floating rate security. Discount margin to maturity assumes three year average life. Spreads and discount margin to maturity figures shown throughout this piece are expressed in basis points.

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 and changes in prevailing interest rates. Investing in bank loans involves particular risks.

Bank loans 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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[1]Guggenheim Investments total asset figure is as of 6.30.2015. The assets include leverage of $12.2bn for assets under management and $0.5bn for assets for which we provide administrative services. Guggenheim Investments represents the following affiliated investment management businesses: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Real Estate, LLC, Transparent Value Advisors, LLC, GS GAMMA Advisors, LLC, Guggenheim Partners Europe Limited and Guggenheim Partners India Management.

[2]Guggenheim Partners' assets under management are as of 6.30.2015 and include consulting services for clients whose assets are valued at approximately $49bn.

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