

GUGGENHEIM

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High-Yield and Bank Loan Outlook
**The Impact of the Fed's
Corporate Credit Facilities**



Investment Professionals

Scott Minerd

Chairman of Investments and
Global Chief Investment Officer

Kevin H. Gundersen, CFA

Senior Managing Director,
Portfolio Manager

Thomas J. Hauser

Senior Managing Director,
Portfolio Manager

Brian Smedley

Senior Managing Director,
Head of Macroeconomic and
Investment Research

Maria M. Giraldo, CFA

Managing Director,
Investment Research

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Summary

The leveraged credit sector has delivered stellar performance since the lows in March. High-yield corporates are up 26 percent from 2020 lows and bank loans are up 22 percent. Prices have recovered to over 90 percent of par, and spreads have tightened to historical average levels. We attribute much of the rapid price recovery to the introduction of the Federal Reserve's (Fed) Secondary Market Corporate Credit Facility (SMCCF).

The SMCCF was previously scheduled to cease new purchases on Sept. 30, 2020, but it has been extended to Dec. 31, 2020. The facility has proven highly effective despite having executed less than \$15 billion in total purchases out of a maximum program size of \$250 billion, making it a low-cost option for policymakers to support market functioning. This report shows that there is more progress to be made in reaching the program's objective, which supports our conclusion that an extension of Fed support will continue to serve as a tailwind for corporate credit.

Report Highlights

- With the Fed's SMCCF targeting a normalization of credit market functioning, we are monitoring metrics, including the level of credit spreads, credit curve shape, trading volume, and bid-ask spreads.
- There is still scope for improvement in the level of credit spreads. BBB-rated spreads remain 37 basis points wider than January levels. BB-rated corporate bond spreads are 124 basis points wider than January levels, and B-rated corporate bonds are 130 basis points wider.
- High-yield credit curves remain inverted. In the BB-rated sector, the difference between a nine- to 10-year maturity bond spread and a two- to three-year maturity bond spread is -36 basis points.
- Rating migration has been negative and default rates have risen, reminding us that the Fed's programs cannot repair solvency issues.
- Our work continues to focus on opportunistically capturing value as the Fed's programs support credit markets. As such, we are cautiously bullish.

Leveraged Credit Scorecard

As of 6.30.2020

High-Yield Bonds

	December 2019		April 2020		May 2020		June 2020	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
ICE BofA High-Yield Index	372	5.4%	761	8.1%	658	6.9%	649	6.9%
BB	214	3.9%	540	5.8%	470	5.1%	474	5.1%
B	374	5.4%	813	8.5%	673	7.0%	676	7.1%
CCC	964	11.3%	1,716	18.0%	1,501	15.4%	1,407	14.5%

Bank Loans

	December 2019		April 2020		May 2020		June 2020	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	461	96.51	847	85.69	734	88.56	700	89.47
BB	262	99.81	528	92.29	442	94.51	452	94.37
B	470	97.67	879	86.92	689	92.17	657	93.11
CCC/Split CCC	1,365	80.14	2,096	64.74	1,995	66.03	1,760	71.15

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 6.30.2020. Past performance does not guarantee future results.

Credit Suisse Leveraged Loan Index Returns



Source: Credit Suisse. Data as of 6.30.2020. Past performance does not guarantee future results.

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Due to the Fed's support, I think any weakness in bonds from here would be a buying opportunity.

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

Macroeconomic Overview

Uneven Progress

Medical research has led to a greater understanding of COVID-19. The fatality rate has fallen from original estimates and the demographics of the most at-risk populations are better understood. State governors weighed the risk of increased COVID-19 infections against the risks of a prolonged economic depression, prompting some to re-open local economies earlier than recommended by public health officials.

In the early stages of reopening, the economic benefits appeared to outweigh the health risks. The ISM Manufacturing PMI index and the ISM Services PMI index have both signaled expansionary activity during June and July. Nonfarm payrolls rebounded by a combined 9.3 million in May, June and July, bringing the unemployment rate down from 14.7 percent in April to 10.2 percent, but still above the peak unemployment rate during the financial crisis. From May to mid-June, the number of daily new coronavirus cases in the United States was also falling.

U.S. daily new cases surpassed the previous peak in late June, bringing into question the sustainability of gains from early re-openings. In July, the United States was logging over 60,000 new cases every day. By August, the pace moderated to around 54,000 daily new cases. Texas, Florida, and California partially reversed re-opening efforts by closing some or all bars to battle the surge in cases. New York and New Jersey, previous coronavirus hot spots, established quarantine measures for anyone traveling from emerging hotspot states. High frequency economic data began to slip as states restricted activity and consumers became more fearful.

While the COVID-19 numbers have since turned in the right direction, the delicate balancing act between containing the spread of COVID-19 and keeping the economy afloat complicates an already challenged second half of the year. The failure thus far to reach a deal on the next round of fiscal aid threatens the recovery in consumer spending. The upcoming presidential election will come into greater focus with the Democratic and Republican national conventions in August. Finally, as we enter the fall and winter months, elevated COVID-19 cases could strain hospital capacity during flu season.

In the face of so many unknowns, the certainty of central bank action has been potent. The Fed's effort to support proper market functioning via several emergency lending and asset purchase programs has been highly successful. The Fed "put" is still providing valuable support to credit markets, and helped to improve financial conditions well before many of the programs were enacted.

SMCCF in particular demonstrates the overwhelming role that the Fed's programs play in credit market performance. Despite the SMCCF's limited purchases of less than \$15 billion total in corporate bonds and exchange-traded funds (ETFs), market

functioning has significantly improved compared to March 2020. Returns have been stellar in investment-grade, high-yield, and bank loans, as spreads tightened to historical average levels.

The SMCCF was scheduled to end new purchases by Sept. 30, 2020, but on July 28, the Fed and the U.S Treasury extended this and several other programs to Dec. 31, 2020. This reflects the commitment from the Fed to continue to support credit availability until conditions return to normal. This report discusses various metrics we are monitoring to assess the likelihood that the program will be extended even beyond 2020.

Must All Good Things Come to an End?

After a 20 percent loss earlier this year, the ICE BofA High-Yield Index is down 0.3 percent year to date through the middle of August, having rebounded 26 percent from March lows. BB-rated corporates have returned 26 percent since the March lows, B-rated corporates have returned 25 percent, and CCC-rated corporates have also returned 25 percent. Index spreads tightened from about 1,100 basis points to 528 basis points.

After a 20 percent loss earlier this year, the ICE BofA High-Yield Index is down 0.3 percent year to date through the middle of August, having rebounded 26 percent from March lows. The bank loan sector is down only 2.0 percent through mid-August, after a 20 percent loss earlier this year.

High-Yield Corporate Bonds and Leveraged Loans Have Largely Recovered

Year-to-Date Total Return



Source: Guggenheim Investments, Bloomberg. Data as of 8.14.2020.

The bank loan sector is down only 2.0 percent through mid-August, after a 20 percent loss earlier this year. Three-year discount margins have tightened from 1,275 basis points at the peak in March to 600 basis points. The best-performing rating category in loans has been the B-rated sector, with a 23 percent gain since the March lows. BB-rated loans have returned 21 percent, and CCC-rated loans have returned 15 percent.

In addition to direct stimulus to businesses and individuals, we believe the Fed's SMCCF is largely responsible for strong credit market excess returns since March. To briefly recap, the SMCCF and the related Primary Market Corporate Credit Facility (PMCCF) are programs established by the Fed under Section 13(3) of the Federal Reserve Act, which requires approval of the Treasury Secretary. The PMCCF extends credit directly to eligible high-quality issuers, while the SMCCF buys securities in the secondary market. Those purchases include investment-grade bonds, high-yield corporate bonds that had an investment-grade rating as of March 22 (recent fallen angels), and ETFs. In both cases, the Fed lends to a special purpose vehicle (SPV) backed by Treasury capital appropriated by Congress under the CARES Act, which minimizes the credit risk the Fed incurs.

The mere existence of the facilities aided market functioning before they were active. The 2020 peak in credit spreads on March 23 coincided with the Fed's announcement of its corporate credit facilities and other 13(3) programs, although the SMCCF began purchasing ETFs several weeks later, and corporate bonds followed over a month after ETFs. The PMCCF has yet to see a single dollar in credit extension, as no issuers have chosen to opt in to that program.

The SMCCF has proven highly effective despite having executed a relatively small volume of purchases. Bond purchases include those of high-yield issuers like Delta Airlines, Apache, and Ford Motor Credit. ETF purchases include the SPDR Bloomberg Barclays High-Yield Bond ETF (JNK) and iShares iBoxx High-Yield Corporate Bond ETF (HYG).

Our Macroeconomic and Investment Research Group compiled a dashboard of market functioning measures to watch as the Fed assesses the need for more purchases while the program is active. We believe these measures will be taken into account when deciding whether to extend the program again later this year. The following section provides a gallery of the charts they have compiled. Our conclusion is that there is still some progress to be made, which would support a decision by policymakers to extend the facilities. Historical experience also supports this conclusion, as the Fed extended the 13(3) facilities introduced in 2008 until well after market conditions had normalized.

The Market Functioning Gallery

The Fed established the SMCCF and other programs to support credit to employers by providing liquidity to the corporate bond market. Specifically, a stated objective of the SMCCF is to achieve sustained improvement in market functioning to levels at or near what prevailed prior to the COVID-19 dislocation. For simplicity, we assume that means a return to levels observed in January 2020.

These measures were outlined in the frequently asked questions section accompanying the Secondary Market Corporate Credit Facilities. Of those measures, for brevity's sake we only discuss the level of credit spreads, credit curve shape, trading volume, and bid-ask spreads. These are measures that we found the most telling.

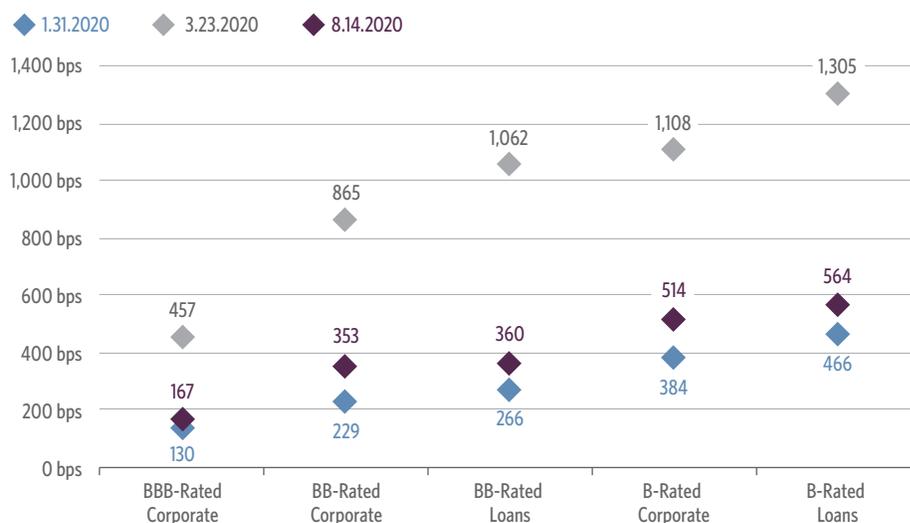
Credit spreads: Credit spreads have tightened significantly from March peak levels. BBB-rated corporate bond spreads remain 37 basis points over January levels. BB-rated corporate bond spreads are 124 basis points wider January levels, and B-rated corporate bonds are 130 basis points wider. If the objective is to return to levels that prevailed around January 2020, there is still scope for improvement in investment-grade credit and high-yield.

Differences in spreads between credit ratings remain somewhat distorted. BBB-rated spreads are trading 72 basis points above A-rated spreads, while in January this difference was only 52 basis points. In high yield, BB-rated are 186 basis points wider than BBB-rated spreads, well above January levels of 92 basis points. In other words, there is plenty of room for spread compression.

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Spreads Have Tightened Significantly Since March Peak

Spread Levels on Given Days, by Rating



Source: Guggenheim Investments, Bloomberg. Data as of 8.14.2020. Loan spreads shown are three-year discount margins.

Credit curve shape: The difference in spread between a long-dated corporate bond and a short-dated corporate bond of the same rating, and especially of the same issuer, is positive under normal circumstances. Lenders require a higher risk premium for the increased uncertainty associated with lending for a longer period. But this curve inverts during market stress, in part because rising default risk pushes down the dollar price of bonds across the curve, which translates into a greater increase in yields on shorter maturity bonds. In March 2020, the credit curve inverted for investment-grade and high-yield bond markets.

As of mid-August, investment-grade credit spread curves have normalized, but the curve for high yield remains highly inverted. For BB-rated bonds, the difference between a nine- to 10-year maturity spread and a two- to three-year maturity spread is -36 basis points. This has improved from a -161 basis point inversion in March, but remains abnormal. For single Bs, the shape for the same points on the

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Plenty of Room for Further Spread Compression

Spread Differences by Rating

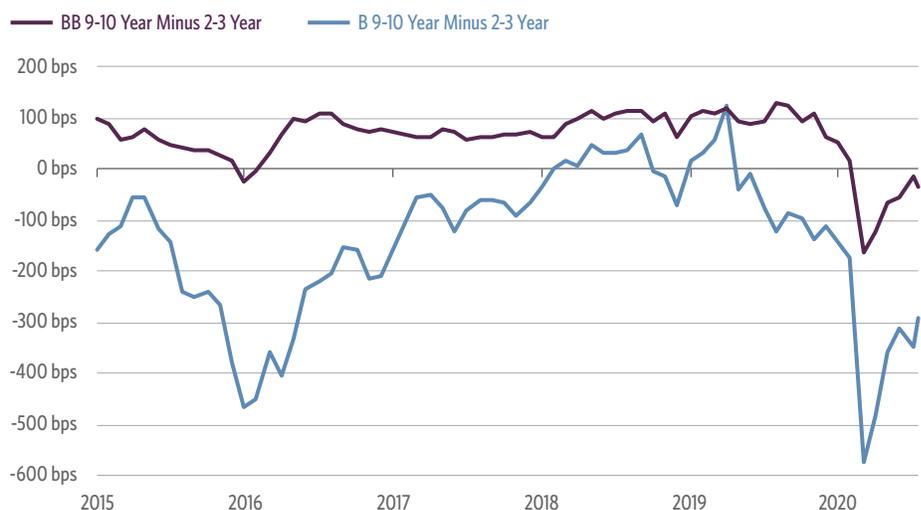


Source: Guggenheim Investments, Bloomberg. Data as of 8.14.2020.

curve is -293 basis points. This inversion represents lingering default concerns, which are more prevalent in high-yield corporate than in investment-grade. In normal circumstances, the high-yield credit curve should be upward sloping, but this measure of market functioning is reading “not normal.”

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High-Yield Credit Curves Remain Deeply Inverted



Source: Guggenheim Investments, ICE Index Services. Data as of 8.14.2020.

Trading volume: Corporate bond trading volume is best measured as a ratio of the value of the total market outstanding. This way we can see that there is a natural level of trading activity in corporate bond markets. In high yield, that natural level over a trailing 20 trading day period is between 8 percent and 15 percent of market

value. There are seasonal lulls around the beginning of the year and summer months when trading volume dips to no less than 5 percent of market value, which is natural. When volatility is high, trading volume spikes as investors look to de-risk quickly. This occurred in early April when on a trailing 20 trading day basis, high-yield trading volume spiked to 22 percent of the market outstanding, well above average levels of 11 percent in recent years.

Trading volumes have come down to slightly below normal levels seen in 2017, 2018, and 2019, when measured as a share of market size. The Fed may interpret this as a potential sign of declining liquidity, but we do not currently see this as a concern.

High-Yield Trading Volumes Have Returned to Normal Levels After Spiking

Trading Volume as a % of Market Value



Source: Guggenheim Investments, Bloomberg, FINRA TRACE. Data as of 8.14.2020.

Trading volumes have come down to slightly below normal levels seen in 2017, 2018, and 2019, when measured as a share of market size. The Fed may interpret this as a potential sign of declining liquidity, but we do not currently see this as a concern.

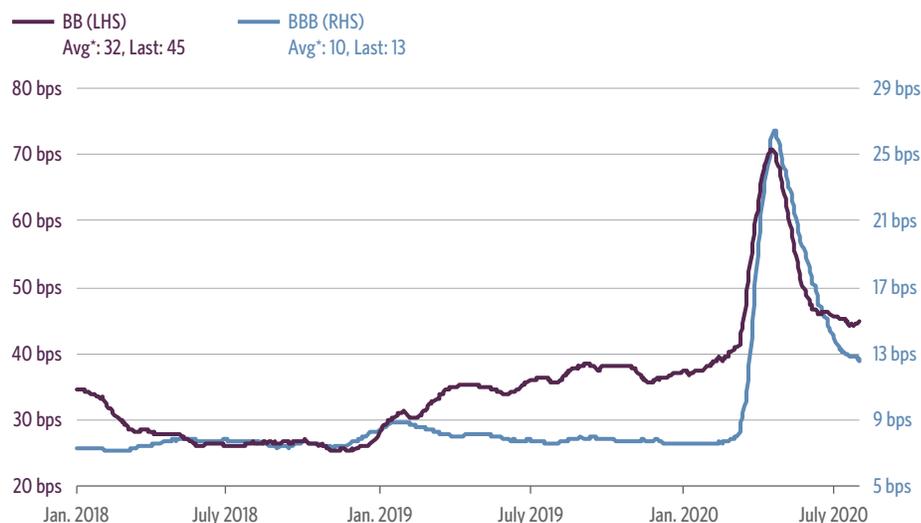
Bid-Ask Spreads: A broadly accepted measure of corporate bond market liquidity is the bid-ask spread. This measure is difficult to track because dealers quote different levels. We relied on data from BofA Global Research. The average bid-ask spread for BBB-rated corporates is about 10 basis points since 2011. In March, bid-ask spreads spiked to 27 basis points. The average BBB-rated corporate bond has a duration of about 8.5 years, so this translates to an average price difference of about 2.3 percent. This gap can make a substantial difference in an investor's ability to beat their benchmark.

The historical average bid-ask spread in BB-rated corporates is about 33 basis points. In March, the BB-rated bid-ask spread spiked to 71 basis points, or nearly 3 percent difference in price. Currently, bid-ask spreads for BBs remain elevated at 45 basis points, above the average since 2011 but well below March peak levels. We consider this substantially better with room for improvement.

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Bid-Ask Spreads Remain Elevated, but Are Well Below March Peak

Bid-Ask Spreads in Basis Points



Source: Guggenheim Investments, BofA Merrill Lynch Research. Data as of 7.31.2020.

Investment Implications

The corporate credit facilities have driven investment-grade corporate bond spreads tighter, leading to tighter spreads in high yield due to relative value and as investors reach for yield. This has spillover effects into tangential sectors as well.

Investors who buy both corporate bonds and bank loans, as we do at Guggenheim, make relative value decisions between those sectors. Our first quarter high-yield and bank loan report was dedicated entirely to our approach on relative value. It is no surprise to us that the monthly returns between the two sectors over the past decade have been 86 percent correlated. Therefore, while high-yield corporates directly benefit from some Fed's purchases, bank loans benefit from the lift in high-yield corporate bond valuations.

It is important to recognize that fundamentals remain challenged. Rating migration has been negative and default rates have risen in both sectors. We expect default rates to reach double digits, as discussed in our last quarterly report. Recovery values have plummeted to record lows according to J.P. Morgan research. In high-yield corporates, recovery rates are averaging 17 percent on a 12-month trailing basis, and recovery rates in first-lien loans are averaging 47 percent.

The Fed's programs will continue to play an important role in credit market performance. But as the fundamental credit backdrop has deteriorated in the past several months, we do not expect the programs to evenly support prices across ratings and industries, or repair solvency issues. We caution against a blind march into deeply distressed credit areas.

Our work continues to be focused on opportunistically capturing value as the Fed's programs support credit markets, while recognizing the limits of their impact. The programs will not prevent investors from pricing in defaults, as we have seen in certain sectors like energy, retail, and durable goods. As such, we navigate these markets with cautious bullishness.

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%.

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

The potential impacts of the COVID-19 outbreak are increasingly uncertain, difficult to assess and impossible to predict, and may result in significant losses. 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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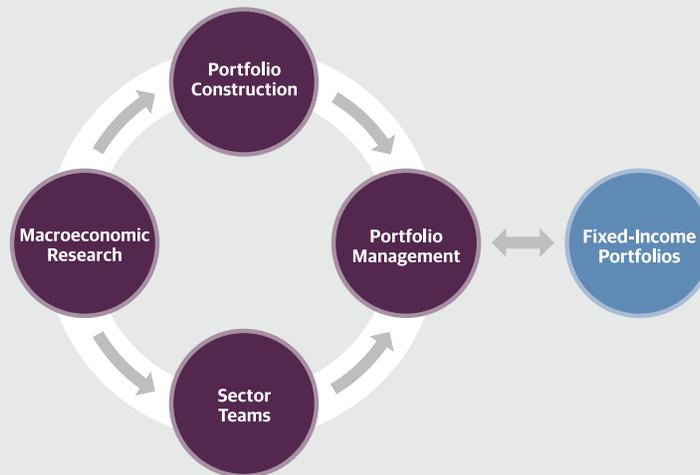
2. Guggenheim Partners assets under management are as of 6.30.2020 and include consulting services for clients whose assets are valued at approximately \$65bn.

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Guggenheim Investments

Guggenheim Investments is the global asset management and investment advisory division of Guggenheim Partners, with more than \$220 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 300+ 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

Guggenheim Partners is a global investment and advisory firm with more than \$280 billion² in assets under management. Across our three primary businesses of investment management, investment banking, and insurance services, we have a track record of delivering results through innovative solutions. With 2,400 professionals based in offices around the world, our commitment is to advance the strategic interests of our clients and to deliver long-term results with excellence and integrity. We invite you to learn more about our expertise and values by visiting GuggenheimPartners.com and following us on Twitter at twitter.com/guggenheimptnrs.

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