

JULY 2012

# High Yield and Bank Loan Outlook

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After a strong first quarter for high yield bonds and bank loans, the mixed performance of the second quarter has conjured up memories of 2011's volatility. While the lack of clarity in Europe and the looming U.S. fiscal cliff will continue to weigh on the economy, the current macro-induced price dislocations present attractive long-term opportunities for investors with patient capital.

The choppiness in the market, which is likely to persist in the near-term, has enabled us to opportunistically deploy capital as the market's need for liquidity grows. We continue to see value in fundamentally strong but seemingly out-of-favor, lower-rated securities. As global headwinds abate and fundamental factors once again reign over technical factors, we believe history will show that this was a good time to be buying.

## REPORT HIGHLIGHTS:

- A strong April for high yield bonds and banks loans was followed by a weak May, which registered the first negative monthly return since November 2011.
- June saw a return to positive territory, with the high yield bond and bank loan sectors registering 1.6 and 1.0 percent gains during the second quarter.
- The flight to safety trade and subsequent decline in interest rates drove outperformance in higher-rated high yield bonds, which have higher duration and lower perceived risk.
- Aside from minimizing the chances of a recession, the likelihood of intervention by the Fed creates a favorable backstop for investing in high yield bonds and bank loans.
- The Fed's apparent willingness to flood the system with additional liquidity, if necessary, should keep interest rates low and allow access to the capital markets for leveraged credit issuers.
- Floating-rate bank loans, which offer protection against rising rates and seniority in the capital structure, are attractive in the current low yield and volatile environment.

# Leveraged Credit Scorecard

AS OF MONTH END

## HIGH YIELD BONDS

	Dec-11		Apr-12		May-12		Jun-12	
	Spread	Yield	Spread	Yield	Spread	Yield	Spread	Yield
Credit Suisse High Yield Index	728	8.23%	629	7.12%	699	7.72%	660	7.39%
Split BBB	402	5.17%	381	5.01%	391	4.89%	365	4.70%
BB	511	6.04%	437	5.32%	509	5.87%	470	5.51%
Split BB	597	6.85%	536	6.12%	594	6.62%	561	6.29%
B	740	8.23%	649	7.23%	721	7.88%	673	7.44%
CCC / Split CCC	1,384	14.94%	1,122	11.94%	1,259	13.36%	1,193	13.06%

## BANK LOANS

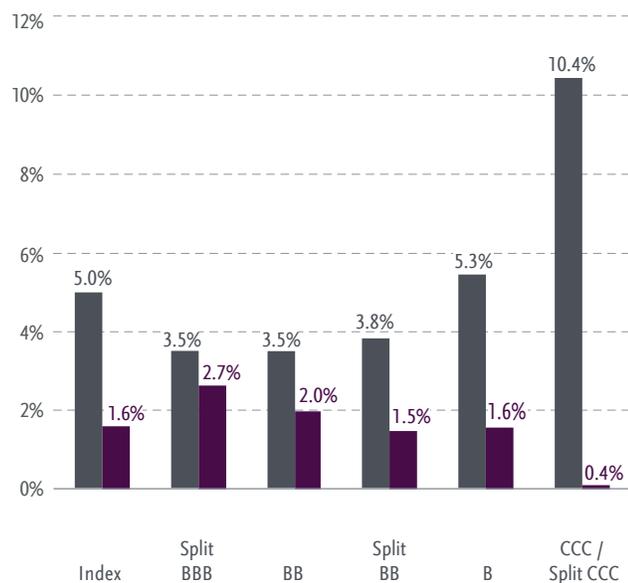
	Dec-11		Apr-12		May-12		Jun-12	
	DMM*	Price	DMM*	Price	DMM*	Price	DMM*	Price
Credit Suisse Leveraged Loan Index	656	92.19	576	94.76	612	93.77	602	94.29
Split BBB	325	99.30	297	99.74	312	99.21	309	99.36
BB	444	97.74	406	99.39	444	98.42	434	98.72
Split BB	542	96.91	476	99.40	527	98.22	524	98.41
B	726	92.89	591	97.13	639	95.97	629	96.34
CCC / Split CCC	1,615	71.23	1,214	81.12	1,243	80.56	1,197	81.25

SOURCE: CREDIT SUISSE. EXCLUDES SPLIT B HIGH YIELD BONDS AND BANK LOANS.

\*DISCOUNT MARGIN TO MATURITY ASSUMES THREE YEAR AVERAGE LIFE.

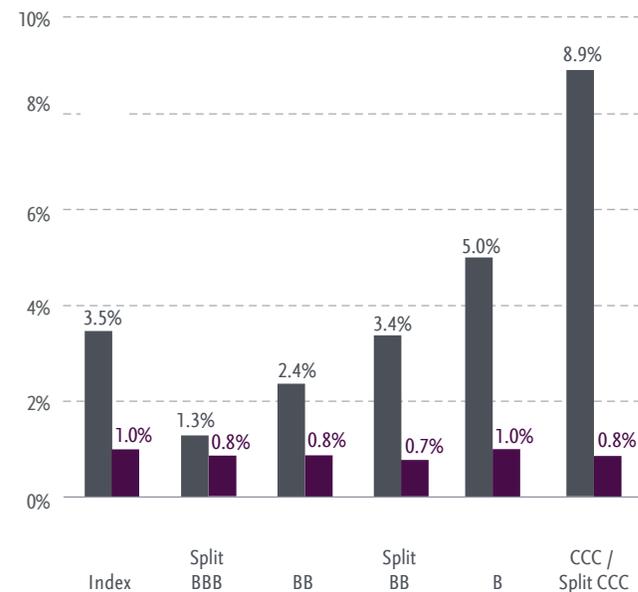
## HIGH YIELD BOND RETURNS

■ 1Q 2012 ■ 2Q 2012



## BANK LOAN RETURNS

■ 1Q 2012 ■ 2Q 2012



SOURCE: CREDIT SUISSE, DATA AS OF JUNE 29, 2012.

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*“I’ve said before that when central banks keep interest rates constrained while pursuing monetary easing policies, the net effect is overt financial repression. What’s interesting about periods like this, which are characterized by cheap access to capital, is that default rates tend to be low. Accordingly, credit tends to perform well. Looking specifically at bank loans and non-investment grade bonds, you can still buy securities that return 9 percent on a risk-adjusted basis. Compared to a lot of other options right now, I view that as an appealing opportunity to pick up yield.”*

– Scott Miner, *Chief Investment Officer*  
June 2012

## Macroeconomic Overview

### IN THE FED WE TRUST: RECENT ECONOMIC WEAKNESS LIKELY TO SPUR ADDITIONAL MONETARY ACTION

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Until recently, the lack of urgency displayed by policymakers suggested that Europe may need to experience its own “Lehman-moment,” before the region’s problems received any immediate and decisive action. However, the recent agreement to allow the European Stability Mechanism (ESM) to lend directly to banks is a significant step towards closer economic cohesion. The crisis appears to have the potential to force Europe to move in the right direction in the long-run, but the glacial pace of progress will likely continue to translate into heightened volatility in risk markets.

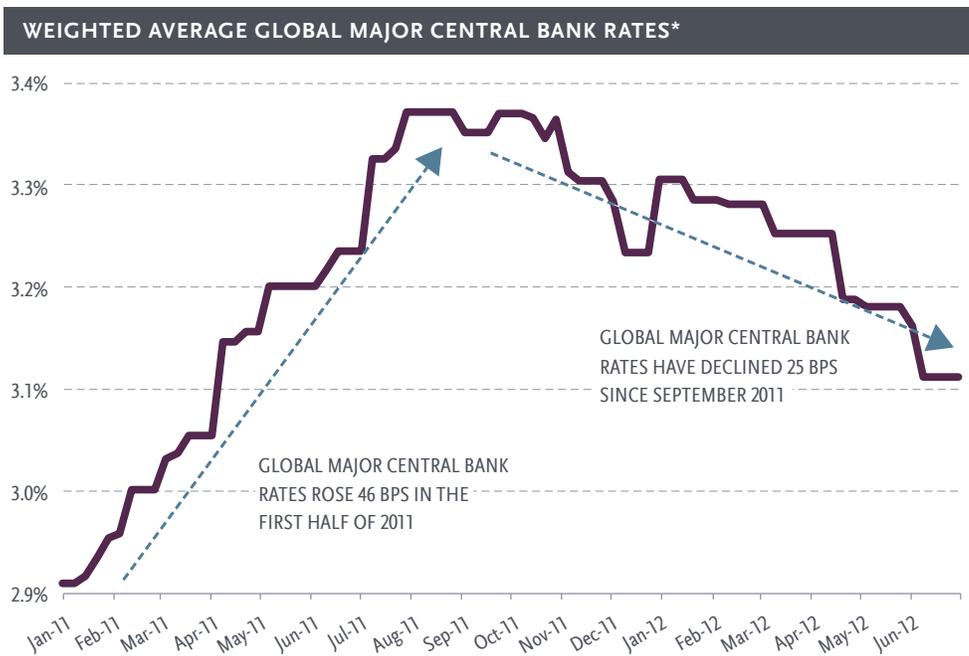
Structurally, the U.S. appeared to be relatively insulated from the problems in Europe. Total U.S. exports to Europe accounted for only 1.3 percent of 2011 U.S. GDP. It was assumed that the turmoil in Europe would not derail the U.S. expansion. Recent disappointing retail sales and employment data suggest that the U.S. economy is unlikely to emerge unscathed from the situation in the eurozone. However, the ability and willingness of the Fed to intervene in the markets to combat an economic slowdown helps support our constructive view of the U.S. economy.

Compared to other major industrial powers, such as Europe and Japan, the Federal Reserve’s balance sheet is actually the smallest when measured as a percentage of GDP. Operation Twist, the policy which the Fed has been pursuing for over a year, has not increased the money supply. The importance of this is not lost on Dr. Bernanke, whose major criticism of U.S. policy in the 1930s was that the Fed did not take an active enough approach to stimulating growth. Should conditions warrant, we believe the Fed has the capability to engage in additional asset purchases.

Aside from the Fed, other global central banks have been easing monetary policy over the past year. The high probability of sustained monetary accommodation will likely place an upper limit on interest rates in the near-term.

This leads us to believe that despite the recent softness in data, the U.S. economy is not at risk of slipping into a recession. While global macroeconomic conditions have dampened since last quarter, the attendant implications of continued accommodative monetary policy and low long-term interest rates should result in low default rates. The net result of this is supportive for risk assets like high yield bonds and bank loans.

A weighted average of major central bank rates which includes the top 16 countries by GDP, has steadily declined over the past year and currently sits at 3.11%. The expectation of further declines in rates is supportive of global growth, and is one of the reasons why we do not expect a recession in the U.S.



SOURCE: IMF, BLOOMBERG, GUGGENHEIM INVESTMENTS. DATA AS OF 6/29/2012.

\*NOTE: COUNTRIES INCLUDE THE G-7 COUNTRIES, BRICS, AUSTRALIA, SOUTH KOREA, SOUTH AFRICA, MEXICO AND INDONESIA. THE GLOBAL MAJOR CENTRAL BANK RATES ARE WEIGHTED BY THEIR U.S. DOLLAR GDP AFTER ADJUSTING FOR PURCHASING POWER BY IMF.

## Leveraged Credit Second Quarter 2012 Recap

### FUND FLOW VOLATILITY LEADS TO INCONSISTENT PERFORMANCE

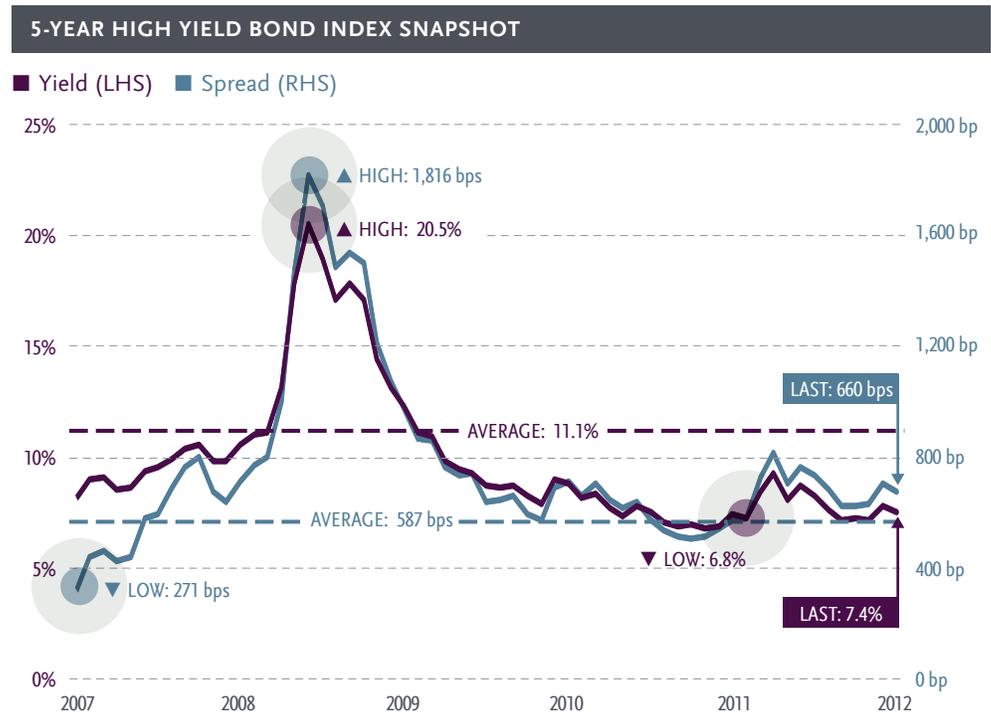
Unable to build upon the momentum of the first quarter, the leveraged credit markets registered uneven performance in the second quarter of 2012. Strong results in April were followed by a weak May, only to pick up again in June. For the second quarter, the Credit Suisse High Yield and Leveraged Loan Index returned 1.6 and 1.0 percent, respectively. Below are some of the key highlights from the period:

- Over a three week period beginning in late May, high yield mutual funds experienced nearly \$6 billion in outflows. May 2012 registered the first month of net outflows since November 2011. Retail demand picked up in June as the second quarter concluded with three consecutive weeks of positive inflows.
- The pace of high yield bond issuance fell significantly from the record-setting level of \$95 billion in the first quarter of 2012. Since 2009, the capital markets have enabled issuers to refinance nearly \$500 billion of high yield bonds and bank loans. Given the diminished need for capital, high yield bond issuance fell to \$51 billion during the second quarter.

- The resurgence of the collateralized loan obligation (CLO) market has helped mitigate volatility in bank loans, specifically in the secondary market. Following the \$3.7 billion in new CLO issuance in May 2012, June saw an additional \$4.2 billion of issuance. Year-to-date, 2012 CLO issuance totals \$17.9 billion compared to \$12.5 billion in all of 2011.

During the second quarter of 2012, high yield bond spreads widened by 39 basis points, while all-in yields increased by 16 basis points. The Credit Suisse High Yield Index ended June 2012 with a spread of 660 basis points to U.S. Treasuries and has returned 6.7 percent for the year. The Credit Suisse Leveraged Loan Index ended the second quarter with the average discount margin to maturity widening by 14 basis points. Over the same period, the flight to safety drove yields on 10-year Treasury notes down by 56 basis points.

*Yields in the high yield market are currently just 65 basis points off the historical lows, while spreads remain nearly 400 basis points wide of the historical tights.*



SOURCE: CREDIT SUISSE, DATA AS OF JUNE 29, 2012.

## Sector Forecast

### KEY THEMES TO FOLLOW IN 3Q 2012

In times of heightened uncertainty, investors tend to ignore risks in assets that they perceive to be safe, and neglect safety in assets that they perceive to be risky. Applying this investment principle to the U.S. fixed income market, we believe Treasury securities are riskier than assumed, and risk assets, such as high yield bonds and bank loans, are less risky than current spreads may suggest. Amid concerns that the U.S. economy may be approaching stall speed, we continue to believe compelling opportunities exist in high yield bonds and bank loans.

As we begin the third quarter of 2012, we are focused on two key themes that we believe could impact performance:

- 1. With continued uncertainty regarding the European sovereign debt crisis and the looming U.S. fiscal cliff, market volatility will remain elevated. This presents opportunities for long-term investors to capitalize on these dynamics by providing liquidity at attractive valuations.**
- 2. Favorable monetary conditions have led us to selectively increase exposures in high yield bonds and bank loans. A sustained period of low interest rates and access to capital markets should keep default rates significantly below historical averages. Leveraged credit securities continue to offer strong returns relative to other core fixed income alternatives such as agency securities and investment grade bonds.**

In the following sections, we will discuss each of these themes in more detail and conclude with our view of optimal portfolio positioning.

## **1. Cautiously Pursuing Opportunities**

### **HEADLINE RISK LIKELY TO IMPACT PARTICULAR SEGMENTS OF THE MARKET**

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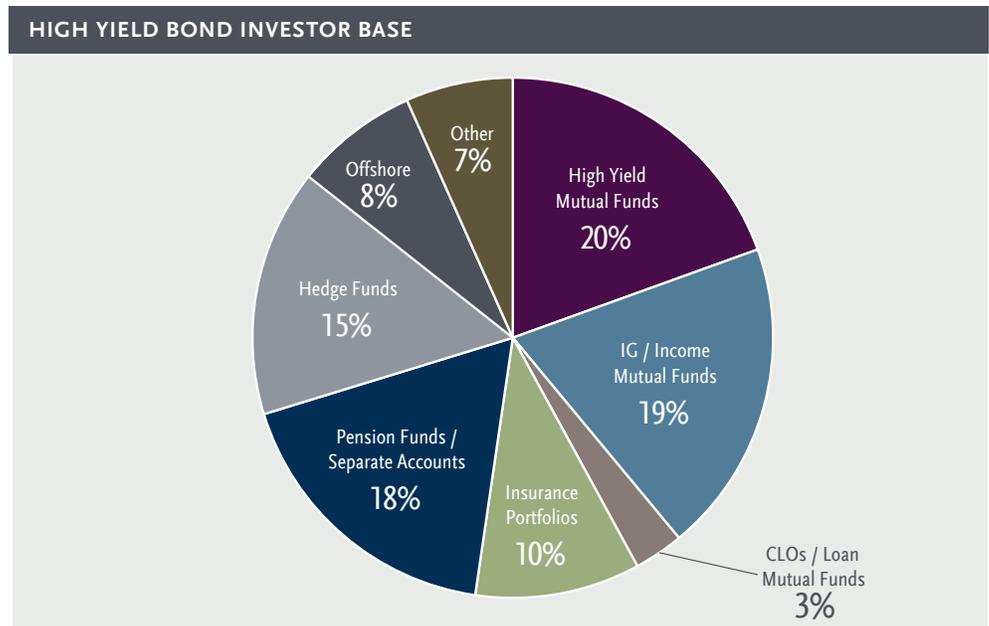
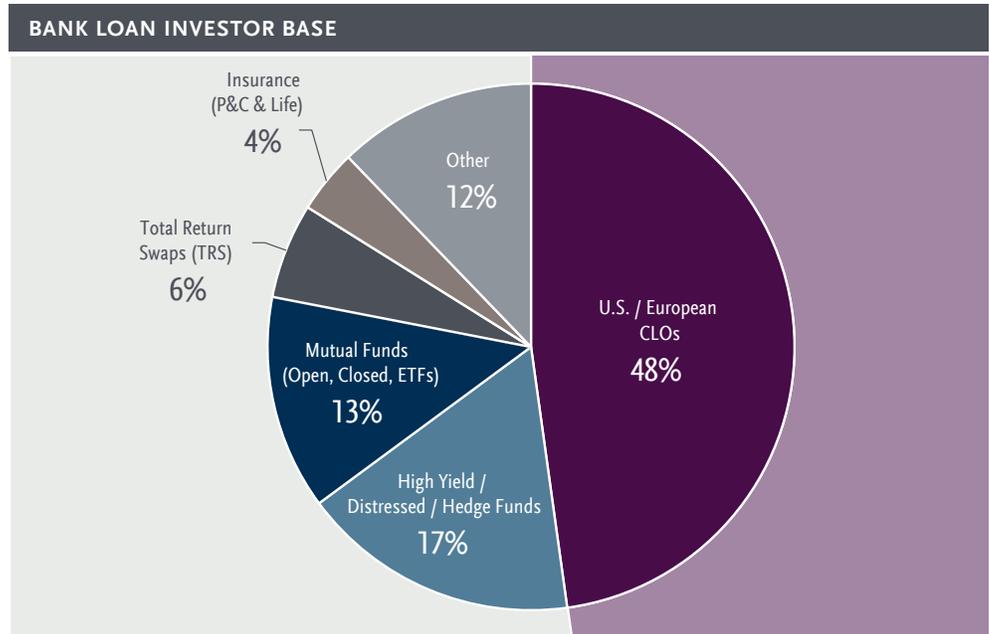
Since strong, macroeconomic forces can trump even the most solid fundamental analysis, it is important to identify susceptible sectors and securities. Currently, investing in specific European credits introduces an additional layer of geopolitical risk. Given the availability of opportunities in the U.S. market, we continue to remain underweight European credit due to the unresolved systemic risks imbedded in the financial system. Our holdings of European bonds represent 2.7 percent of total exposure relative to 9.5 percent for the Credit Suisse High Yield Index.

Specific sectors of the U.S. market, such as healthcare, defense, and education, could potentially be impacted by the fiscal cliff. As we approach the November 2012 Presidential elections, it is likely that some form of Congressional compromise will occur. That said, handicapping what programs will be extended and projecting the composition of the final deal is more of an art than a science. While continuing to allocate to high quality credits in these sectors, we remain extremely vigilant in monitoring these positions.

Aside from headline risk, the momentum swings in high yield retail fund flows is another risk institutional investors face. Over the last few years, mutual funds and exchange-traded funds (ETFs) have grown from 15 percent to an estimated 25 percent of the high yield market. This represents the highest level on record. High yield ETFs, a relatively new product, have grown from \$50 million to almost \$30 billion over the past five years. The recent upward trend in volatility, currently near post-2008 recession highs, can be partly attributed to the increased significance of high yield mutual funds and ETFs.

Volatility has been exacerbated in the more liquid, widely-held, indexed bonds. Our middle-market focus and long-term perspective enables us to hold higher yielding, less volatile bonds. Consequently, we tend to be significantly underweight many of the top names held by high yield ETFs. Out of the top 20 bonds held by the two largest high yield ETFs, iBoxx \$ High Yield Corporate Bond Fund (HYG) and SPDR Barclays Capital High Yield Bond ETF (JNK), we currently hold only seven. With less exposure to these higher beta, indexed credits, we have experienced lower correlation and volatility relative to the broader market.

*Despite the dearth of CLO issuance in recent years, CLOs still hold an estimated 48% of all bank loans. In the high yield space, the investor landscape is much more fragmented with no single group accounting for more than 20%.*



SOURCE: BARCLAYS CAPITAL, AS OF JUNE 29, 2012.

For investors looking to maintain exposure to the leveraged credit markets with reduced volatility, we would advise an increased allocation to bank loans. Aside from secured status, seniority in the capital structure and maintenance covenant protection, bank loans also serve as inflation hedges. Their floating-rate coupons make them less sensitive to changes in interest rates, which is especially valuable given the historically low yield environment. Additionally, relative to high yield bonds, bank loans have greater investor base concentration. While the high yield space is fragmented with no single investor type accounting for more than 20 percent, CLOs hold an estimated 48 percent of all bank loans. Due to the longer lock-up periods and tighter trading restrictions, CLOs represent more stable, longer-term pools of capital.

## 2. Favorable Monetary Backdrop for Leveraged Credit Markets

### MARKET AWASH WITH LIQUIDITY BOLSTERS CORPORATE BALANCE SHEETS

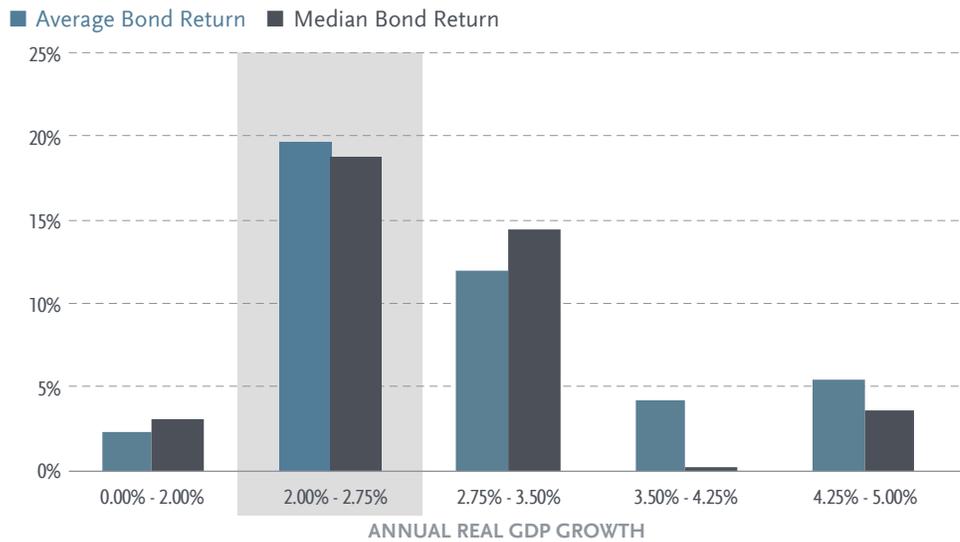
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The strength of the leveraged credit rally in the first quarter was aided by the resilience of the U.S. expansion to the effects of the eurozone debt crisis. With economic data releases during the second quarter of 2012 demonstrating that the strains of Europe and the U.S. fiscal uncertainty are beginning to weigh on the U.S. economy, we believe that the Fed stands ready and able to intervene should conditions worsen. Aside from minimizing the chances of a recession, the likelihood of intervention by the Fed creates a favorable backdrop for investing in high yield bonds and bank loans. As access to historically cheap funding through the capital markets remains readily available, we expect default rates to stay low as corporations continue to service their interest obligations and refinance debt maturities.

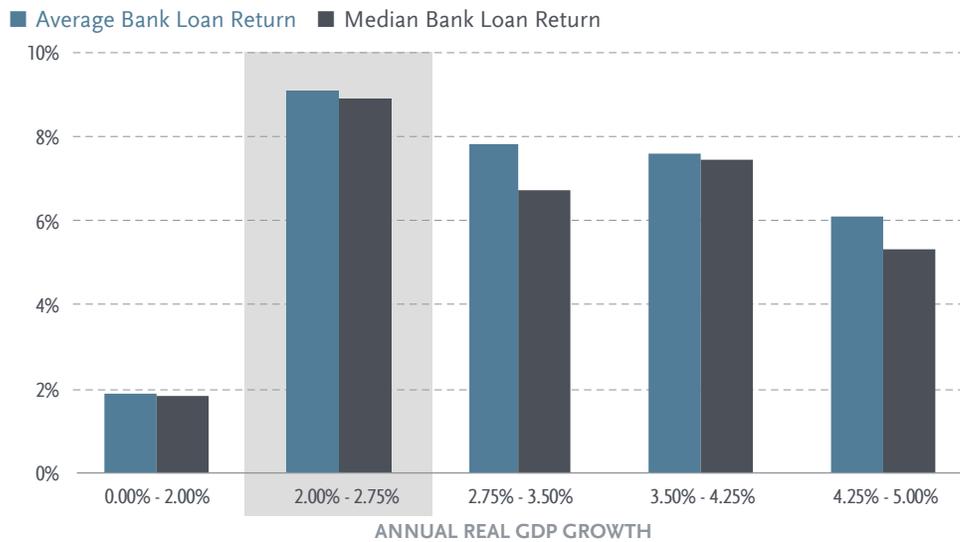
Leveraged credit markets have traditionally performed well during periods of modest growth. These periods are categorized by growth that is adequate to service interest obligations yet not sufficiently robust to justify higher levels of indebtedness or increased capital expenditures. Tempered economic prospects lead to corporate conservatism and a greater emphasis on balance sheet liquidity. Since 2009, strong capital markets have enabled issuers to refinance nearly \$500 billion of high yield bonds and bank loans. Corporate issuers have taken advantage of falling yields and strong demand for primary issuance to retire near-term, high-coupon debt and replace it with cheaper, longer-dated debt. This wave of refinancings has improved coverage ratios while extending debt maturity profiles. With U.S. corporations currently holding nearly \$2 trillion in cash on their balance sheets, they are well-positioned to weather potential downturns in the economy.

Unlike the equity markets which are more reliant on stronger economic growth, the leveraged credit markets traditionally perform well in periods of modest GDP growth. Given the liquidity of balance sheets and monetary conditions, high yield bonds and bank loans are likely to perform well under current economic conditions.

### HIGH YIELD BOND INDEX ANNUAL RETURNS UNDER VARIOUS GROWTH SCENARIOS



### LEVERAGED LOAN INDEX ANNUAL RETURNS UNDER VARIOUS GROWTH SCENARIOS

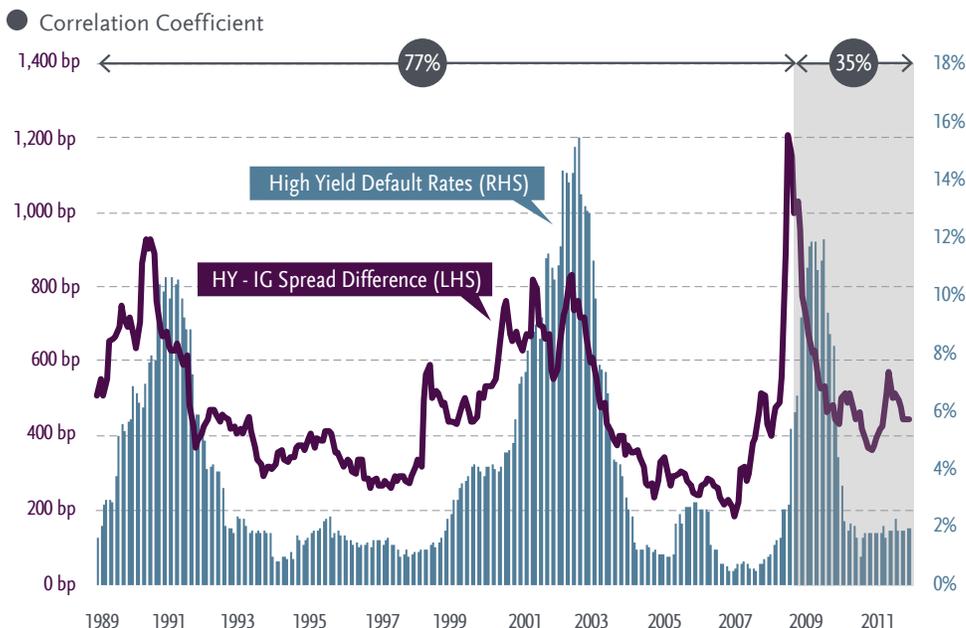


SOURCE: CREDIT SUISSE, DATA AS OF JUNE 29, 2012.

Despite low default rates in the leveraged credit markets, high yield bonds continue to offer a significant spread over investment grade bonds. Traditionally, during periods of low default rates, the spread differential narrows. From an asset allocation perspective, sustained periods of low nominal interest rates coupled with improving corporate fundamentals increase the attractiveness of higher yielding fixed income securities. Non-traditional investors with the flexibility to allocate to the leveraged credit markets may gravitate to high yield bonds and bank loans due to the low or negative real yields on core fixed income alternatives such as U.S. Treasuries, government agency securities and investment grade corporate bonds.

As spreads are meant to compensate investors for risk of default, strong economic conditions with low high yield default rates have typically led to tightening between high yield and investment grade bond spreads. Since the 2008 recession, this relationship has broken down significantly as the spread differential has remained elevated despite default rates around 2 percent.

## LOW DEFAULT RATES SUGGEST SPREADS BETWEEN HY AND IG BONDS TO NARROW



SOURCE: CREDIT SUISSE, DATA AS OF JUNE 29, 2012.

## Prior Quarter Review

### REVISITING VIEWS EXPRESSED DURING PREVIOUS QUARTER

In last quarter's publication, four of the central themes we focused on included:

1. Robust investor demand in high yield mutual funds
2. A bullish thesis on CCC bonds based on our constructive view on the U.S. economy
3. Expectation of a moderation of new issue supply in high yield bonds
4. Relative attractiveness of bank loans over higher-rated bonds

Investor demand weakened from the first quarter and experienced significant volatility. We continue to believe capital will flow into the high yield markets, driven by the low nominal yields on core fixed income securities like Treasuries and investment grade bonds and the continued low level of high yield defaults.

CCC bonds, the most economically sensitive sector of the high yield market, underperformed during the quarter as U.S. economic growth decelerated. While tempering our bullish view on the economy, we believe the Fed's probable monetary stimulus this year should keep the U.S. from falling below stall speed. Our long-term bullish view remains intact and we continue to add to core positions within the CCC-rated bond universe.

The rapid pace of new issuance slowed in the second quarter, dropping 46 percent from the record-setting \$95 billion in the first quarter. A moderation in issuance combined with stronger investor demand should lead to spread tightening.

Bank loans trade at attractive valuations relative to higher-rated bonds. For example, leveraged credit investors can swap BB-rated bonds for single B bank loans and pick up 140 basis points in yield. Additionally, bank loans provide investors with less sensitivity to interest rates, secured status and decreased volatility. With interest rates currently at historically low levels and the threat of rising rates, we see greater value in floating-rate bank loans than long duration, fixed-rate high yield bonds.

## Investment Implications

### WHERE WE SEE VALUE

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*The current disconnect between market valuation and intrinsic value presents long-term opportunities for fundamentally-driven, absolute-return focused investors.*

The tepid returns of the second quarter of 2012 have slightly tempered the cautious optimism that existed in the markets at the end of the first quarter. The systemic risks, created by the lack of a resolution to the European sovereign debt crisis and the uncertainty surrounding the U.S. fiscal cliff, have led to elevated volatility. During the quarter, higher-rated high yield bonds, which typically track the performance of Treasuries, outperformed relative to securities lower in the credit spectrum. Market panics and subsequent flight to safety trades create attractive long-term value opportunities in high quality, lower-rated securities and off-the-run credits. Our long-term perspective affords us the ability to invest in fundamentally strong credits that are currently out of favor. As banks address increased regulatory constraints and seek to de-risk their balance sheets, we have been able to structure transactions with favorable terms. The experience of the second quarter reinforces three central ideas:

- 1. Cash is king: Declining dealer inventories has made the ability to provide liquidity a profitable investing strategy for absolute-return focused, long-term investors.**
- 2. Volatility is here to stay: The shift in the high yield bond investor base towards greater retail ownership has led to exacerbated market moves, particularly in the most liquid, indexed securities.**
- 3. Be a contrarian: Maintaining the flexibility to buy when the market is selling and sell when the market is buying requires a long-term perspective and patient capital.**

The increased market volatility is attributable to a confluence of macro factors: the euro area debt crisis, weaker domestic economic data and looming concerns regarding the U.S. fiscal cliff. This trend of risk markets trading on a “mark-to-headline” basis underscores the value of sound, fundamental analysis. In the short-term, statements from European finance ministers, proposals out of Washington on the fiscal cliff, or volatile retail fund flows may move the market. However, in the long-run, identifying value through security selection should trump momentum-based strategies that seek to profit from ephemeral trends. The current disconnect between market valuation and intrinsic value presents long-term opportunities for fundamentally-driven, absolute-return focused investors.

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\*The total asset figure is as of Q1 2012 and includes \$10.7B of leverage for Assets Under Management and \$0.8B of leverage for Serviced Assets. Total assets includes Security Investors doing business as Security Global Investors and Rydex Investments, Guggenheim Partners Asset Management, Guggenheim Investment Management, Guggenheim Funds and its affiliated entities, and some business units including Guggenheim Real Estate, Guggenheim Aviation, GS GAMMA Advisors, Guggenheim Partners Europe, Transparent Value Advisors, and Guggenheim Partners India Management. Values from some funds are based upon prior periods.

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