Bank Loans

# Credit Selection Remains Paramount

## Elevated short-term rates should continue to support loan performance in the second half.

Managing through the current high interest rate environment remains the focal point for the sector. Some borrowers are only able to avoid bankruptcy through some form of debt restructuring or maturity extension. Others are reducing interest expense via repricing or refinancing. Eventually, rate cuts will become a debt service tailwind. Assessing credit quality remains dependent on a qualified judgement of idiosyncratic situations, but with loans still paying 9 percent yields, we believe the market offers attractive opportunities for investors focused on quality.

### Sector Commentary

- The three-year discount margin on the Credit Suisse Leveraged Index ended the second quarter at 495 basis points with the yield around 9.4 percent.
- Loans have delivered strong performance year to date, with a second quarter return of 1.9 percent and first half return of 4.4 percent. Leveraged loans continue to outpace fixed-rate corporates this year due to their high all-in coupons and lack of duration, and we see coupons continuing to support performance.
- Almost 60 percent of loans were trading above par during the second quarter, but by quarter end that number had declined to 40 percent due to elevated repricing activity. Loan valuations remain near their 40th percentile of historical levels since 1994.
- Issuers have repriced or extended $625 billion of loans, or 45 percent of the total loan market outstanding, allowing borrowers to reduce interest burdens and extend maturities.

### Investment Themes

- The weighted average nominal spread of the index is down 12 basis points to 386 basis points, amounting to nearly $2 billion of annual interest savings for issuers.
- Only $65 billion, or 5 percent of term loans outstanding, are maturing through 2025, limiting default risk.
- The pace of interest and payment defaults has plateaued, indicated by the gradual decrease in the Morningstar LSTA Leveraged Loan default rate from 2 percent at year-end 2023 to 1.6 percent currently. However, we continue to see liability management transactions to stave off actual defaults, so if we include distressed exchanges the default rate would be notably higher at 4.3 percent.
- We remain cautious over the tail risk in loans given the impact of high rates on interest costs and expect loan recoveries to remain lower due to weaker loan documentation.

*By Christopher Keywork and Maria Giraldo*

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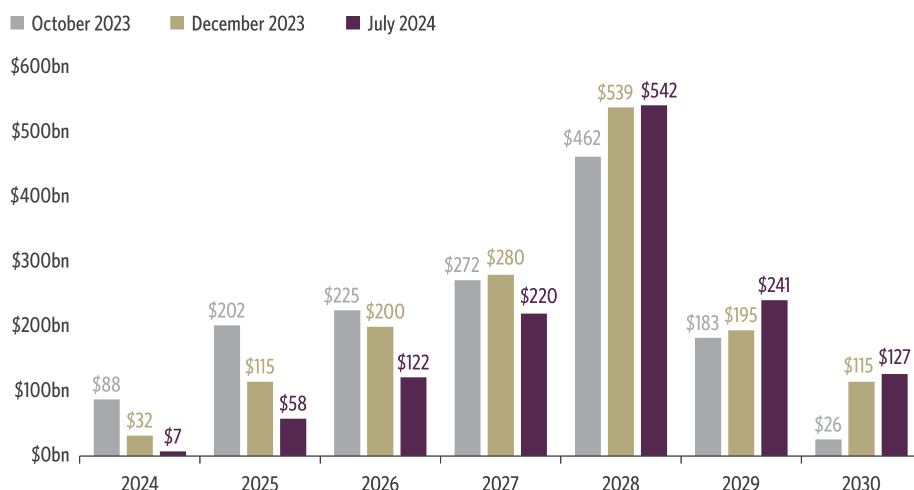
Only $65 billion of loans, or 5 percent of USD-denominated term loans outstanding, are maturing through year-end 2025, representing limited default risk driven by missed principal repayment.

**Less than 5% of the Loan Market Is Scheduled to Mature Before 2026**

USD Loans Maturity Schedule by Year, as of Varying Calendar Dates




Source: Guggenheim Investments, Bloomberg. Data as of 7.22.2024. Based on all USD term loans outstanding, and therefore includes loans that may not be index eligible.

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**Investing involves risk, including the possible loss of principal.** In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. During periods of declining rates, the interest rates on floating rate securities generally reset downward and their value is unlikely to rise to the same extent as comparable fixed rate securities. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations ("CLOs"), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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