

Macro Markets Podcast Episode 85: Corporate Credit Standing Strong After Volatile Q1

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Jay Diamond: Hi everybody, and welcome to Macro Markets with Guggenheim Investments, where we invite leaders from our investment team to offer their analysis of the investment landscape and the economic outlook. I'm Jay Diamond, Head of Thought Leadership for Guggenheim Investments, and I'll be hosting today.

The first quarter jolted markets as the conflict in Iran pushed geopolitical risk higher, oil crossed \$100 and corporate credit posted its first negative quarter since 2022. Now, the US economy has remained resilient, but with the path of energy prices and economic growth now hinging on developments in the Strait of Hormuz, investors are navigating a more fragile and perhaps uncertain backdrop for credit. What does this mean for corporate credit investors? Well, here to help us make sense of where we are and how to approach this market are two of our team leaders, Tom Hauser, Head of Corporate Credit, and Dan Montegari, Head of Research for Corporate Credit.

Welcome back, Tom and Dan, and thanks for taking the time to chat with us today.

Tom Hauser: Good to be back, Jay.

Dan Montegari: Thanks for having us back.

Jay Diamond: All right. Now, Tom, before we dive into a discussion of the current market and your outlook right now, can you give us an overview of the corporate credit landscape and the sectors that you manage?

Tom Hauser: Sure. Briefly, the corporate credit team, we consider it one integrated platform. And what that means is the same team is responsible for investment grade all the way down to private illiquid investments. And in the middle you have high yield bonds and syndicated bank loans. The team is about 85 investment professionals. But the core component of the team is our research capabilities.

At our core, we are a bottom-up credit research shop, are looking to evaluate individual credits in each of those categories that I mentioned and trying to eliminate the ones that we think are poor

relative value, poor risk reward, and build portfolios with our best ideas. And so the research team really is the engine that drives our results.

But it's a fully integrated team. They're working very closely with our portfolio managers, our traders and our originators to come up with the best ideas and build the best portfolios for our clients.

Jay Diamond: Now, how important is the economic backdrop in your credit analysis, Tom? I ask this because the Iran war has obviously introduced a lot of uncertainty into the economic outlook right now.

Tom Hauser: At our core, we are a bottom-up shop, but we certainly don't want to lose sight of that macro or that top-down view. And so we definitely take our cues from the macro research team here at Guggenheim. And we try and integrate those macro thoughts into our bottom-up analysis and figure out how it's going to impact the individual credits.

And we also like to look at our portfolios from a top-down perspective. After we pick the names that we're going to put into the portfolios, make sure we don't have any unintended bets or ideas in the portfolios or positioning in the portfolios that don't really make sense relative to those macro views. Today, if I think about the big macro themes that are impacting our markets, I think there are really three.

The first one would be AI and the ever-increasing advancement of that technology, and how that's going to impact industries, in particular the technology industry. But also, there's going to be first- and second-derivative impacts that we're trying to think through as well.

And then we have the conflict in the Middle East, which you just mentioned, Jay. Certainly, there's going to be an impact there. First and foremost might be inflationary pressure it puts on the economy and what that does to certain sectors in particular how that impacts the consumer.

And then lastly one that's a little bit more niche is the fall out in the private debt market and how that's going to impact individual companies as well as access to capital markets for borrowers.

Jay Diamond: We're going to get back to all of these things as we go through the conversation today. But Dan, let's start with the investment grade credit market first. How are you looking at credit quality right now, the story and supply and demand technicals. And what's your outlook for investment grade?

Dan Montegari: Sure. So we'll start with credit quality. When we look at leverage it's around the ten-year average, 2e have seen coverage ratios within investment grade come down as higher rates have made it through the balance sheets of these businesses, but overall still healthy at about ten times. And then when we look at the trend, the ratio of upgrades to downgrades within investment grade, it's been slightly above zero. So stable to slightly increasing.

Now when we look in the context of spreads, investment grade spreads at around 78 basis points puts it in the 15th percentile throughout the life of the market. And then looking at the bottom rung, the triple B, it's about 97 basis points with which puts it in the eighth percentile. So relatively tight spreads versus history.

With that said the absolute yield levels are attractive and it's keeping buyers interested. The main buyers in investment grade being insurance companies and pension accounts. You asked about the technicals. When we look at the technical market, we're going to need those buyers to remain engaged because the investment grade market is looking at a record issuance. I've seen estimates of about 2 trillion in gross issuance.

About 1 trillion in net issuance. A big driver of that net issuance, the billion dollars, is really related to one of the themes that Tom just talked about. The AI built out, I think AI infrastructure buildout is going to make up between 30 and 50 percent of that 1 trillion of net supply. The good news for the market: that supply is coming from high quality borrowers.

You think Amazon, Google, Microsoft, Meta, those borrowers are rated double-A or higher. And so the market should be able to absorb that supply given the quality of those borrowers. So maybe to just sum it up, you've got stable credit metrics. You've got a lot of supply coming in in a relatively tight spread environment relative to history. And so we do think that will probably create some indigestion for the market.

You'll probably see spreads widen out a little bit from here on a relative basis. So that's more of a technical. I think from a fundamental perspective, the long term driver of performance long-term the investment grade market is really going to be a function of the return on the investments that these hyperscalers are making. I think for right now, the market's giving them the benefit of the doubt, given their historical ability to allocate capital and generate very strong returns and the credit quality that they're coming to the market with.

Jay Diamond: Tom, how was the first quarter overall for leverage credit? Walk us through what you saw happening.

Tom Hauser: It was certainly a volatile quarter in terms of performance for both high yield bonds as well as syndicated loans. And it really was the first negative quarter for both in quite some time. I think the loan market had 14 consecutive quarters of positive return. High yield had 13 quarters of positive return. So over three years for both asset classes.

Now when we look at the first quarter performance for both, they basically finished right on top of each other with loans down about 47 basis points. High yield down about 50 basis points. And that's an environment where the coupon, as Dan just mentioned, is still pretty attractive for both. The themes that were playing out in the quarter, I think, were a little bit different.

For the loan market, the major theme that that dragged on the market was something we just mentioned earlier, the advancement of AI and the impact on the technology sector and why that impacted loans a little bit more than high yield is just because the tech sector within the loan market, it represents about 17 percent of the overall market. It's really grown over the last decade or 15 years.

If you look back to around 2010, it was only about 7 or 8 percent. But as that sector gained favor within the private equity landscape and many of the private equity sponsors out there were looking to take private some of these software credits, we saw that sector grow as an overall percentage of the loan market. And as I said, it represents about 17 percent today.

And within that 17 percent software is about 13 percent of the market. That is directly in the crosshairs of this AI investment. And what we saw was the market really start to re-underwrite those credits. And ultimately, we believe the terminal value of those businesses, what are they ultimately worth in this world where we see this AI advancement continue to encroach on their space?

And technology was down about 4 percent. So that was the biggest driver of the declines in the loan market. And then, as mentioned earlier, some of the tangential industries impacted by AI also start to see some softness. High yield certainly has its exposure to technology as well, but it's much smaller at around 8 percent of the overall market. And the quality of the buyers within the high yield market and, specifically within tech, tend to be larger businesses.

So better balance sheets and probably a little bit better or more insulated from the AI advancement. So the cause for the selloff in high yield was a little bit more widespread, and it really was just a bit more of a risk-off environment with some of the other factors we talked about, in particular the conflict in the Middle East.

And so what we ended up with was both markets saw spread widening. We saw the loan market move out about 60 basis points to about 515 basis points of all-in spread. And we saw the high yield market move out about 50 basis points to about 317 basis points.

Jay Diamond: Okay. Let's dig a little bit more into the loan market. What kind of trends are you seeing.

Dan Montegari: Yeah. So I think Tom hit the main trend that we really saw throughout the first four months of the year. It's really AI's impact on software businesses, which make up a big chunk of the loan market. And just to put some metrics around it, so S&P, they calculate leverage for software businesses at about eight times in cash interest coverage at about 1.4.

When you compare that to the market, that's about one-and-a-quarter turns more than the market from a leverage perspective. And about a half a turn less than the market from a coverage perspective. And so it kind of came into this AI disruption, if you will, from a relative starting place of weakness and you add on to that risk the existential threat of AI that could either displace your product or reduce your profitability and lower your growth rate, which obviously has a material impact on businesses that are highly levered.

The market reacted to this really in two phases so far. I would say going back to February, when you really started to see the market react. That was around the time when anthropic released the cloud coworking tools, and what we saw was an indiscriminate selloff in anything tech or tech adjacent. Really, in the back half of March and through April, we have started to see the market attempt to make some picks in terms of, and I won't say winners or losers, I probably say businesses that are more or less impacted from AI. And so we have seen some of the initial selloff from February, some of those borrowers regained ground. Not to the point that they were, but close to where they were. A couple points where they were pre-the February sell off. I think we expect this AI induced volatility to remain with us for the foreseeable future.

I think the challenging aspect of this period of time is Tom and I talked about this all the time, we actually expect a lot of these software businesses to produce in the near term very good results,

just given the contracted nature of their business. The hard part of the challenging part is kind of what happens to the terminal value of these businesses, as Tom hit on.

And I think ultimately we expect multiples for software to compress just because I think investors are going to be unwilling to pay for future cash flows, given the inability to predict what those future cash flows look like with a high confidence level. And so you're going to see multiples compress, LTVs increase, and you've got a lot of debt coming due. And it's something that the team is paying close attention to.

Jay Diamond: And how are the credit fundamentals looking in the loan market?

Dan Montegari: I would say the loan market specifically is skewing, all else equal, I think lower quality. If you look at the percentage of B3 and below assets in the loan market, it's the highest it's ever been. The good news, though, is while the skew is relatively negative, it's not accelerating to the downside. It's been relatively stable from a leverage perspective quarter over quarter.

And actually from an interest coverage perspective, we have seen coverage improve a little bit. So it is overall lower quality today relative to the historicals. We are seeing that show up in the default rate. The default rate if you include distressed exchanges is about 3.3 percent versus a longer-term average of 3 percent. So kind of in line with the longer-term average, I think the bigger challenge that we're seeing is the cost of being wrong in leverage credit today is higher than it's ever been because of recovery rates. Recovery rates are trending down. We expect that trend to remain because of the lack or the weakness of documentation as it's evolved over the last ten years. And so I would say you combine just a lower quality skew, lower recovery rates, and a large upcoming maturity wall.

I think you need managers who are credit pickers and are very fundamentally focused. And I think actually that sets up well for our platform.

Jay Diamond: Now, Tom, turning to high yield, how has that market been faring so far this year?

Tom Hauser: The first quarter was a bit volatile for the high oil market, and we saw its first down quarter in over three years where, as I mentioned, spreads widened out about 50 basis points to roughly 317 basis points at the end of the quarter. We've actually seen most of that reverse as we move into the first month of the second quarter, with spreads back to around 277 basis points, which in a historical context is fairly tight for a below investment grade product where you are going to experience defaults and credit losses.

Now at 277, the market is effectively, we believe, pricing in a roughly 1.5 percent default rate, which is right where we are on a trailing 12-month basis. And so when we take a step back and we look at why is the market trading tight, I think there are a couple factors. From a fundamental perspective, the market's in a fairly good place. And Dan just spoke a little bit about the bank loan market and how we've seen from a ratings perspective, the quality of the market deteriorate relative to historical as well as the expected recovery rate, or said differently loss, given default increase in the bank loan market. We've sort of seen an opposite story play out within high yield. As many of the credits that would have historically been high yield issuers have transitioned to the bank loan market, the quality of the high yield markets actually increased.

And so today we have a higher market where over 50 percent of it represents double-B quality credit. So, it's the highest credit quality we've seen in the market's history. And from an actual fundamentals perspective, leverage today is right around the long-term average below four turns. And interest coverage is about four turns.

So when you look at it from a top down, the market's in a pretty good spot from a fundamental perspective. And it sort of makes sense why spreads are trading where they are. And the expectation for default rates remains fairly low. The other side of it is also the technicals. We have seen very little net new issuance to the market.

What I mean by that is well, the headline issuance number for high yield has been fairly robust over the last couple of years. And in fact in the first quarter, we're up year over year versus last year. The vast majority of that issuance is just refining existing paper. And so it's not adding new issuance to the market. We're actually seeing the high yield market shrink in absolute size.

And while we did see some investor outflows, it's a market where you generate a monthly coupon that gets reinvested. And so net net the technicals were actually in high yield's favor. There was more demand than there was net new supply to the market. So we have strong fundamentals. We also have pretty good technical tailwinds. It makes sense that the higher market is trading where it does.

That's not to say there won't be defaults. And that credit picking doesn't become important when spreads are this tight. But where you have a coupon of around 7 percent, which is, in historical context, a fairly nice yield, if you can pick the right credits and avoid those defaults, we think High-Yield offers a fairly nice proposition for investors.

Jay Diamond: Dan, do you have anything to add, to what Tom was saying about the credit quality and the high yield?

Dan Montegari: Market fundamentals remain very attractive, and high yield, from our perspective, seems to be the sweet spot within the leverage market.

Jay Diamond: Tom, you mentioned that issuers can choose between the high yield market or the bank loan market for their funding. How do they make those choices right now?

Tom Hauser: I think what you saw over the last decade were borrowers transitioned or moved into the bank loan market for a couple of reasons. One, prior to 2022, we were existing in an environment where the reference rate—bank loans are typically a floating rate asset—so we issued off a reference rate, was at zero. And so interest rates were extremely low. What historically was a very tight document or restrictive document from a borrowers perspective was morphing into a document that was much friendlier to the borrower. And so for those two factors, as the private equity sponsor and the LBO machine was turned on, in that environment, we saw more and more issuance move over to the bank loan market, and that came at the expense of the high yield market. And what historically would have been a single-B high yield issuer became a single-B bank loan issuer. And so we saw significant growth in syndicated bank loans. All the while, the high yield market was sort of shrinking in size and becoming higher quality as a result.

Dan Montegari: And I think the ability to refinance or to reprice your capital structure within leveraged loans without any call protection, or with very minimal call protection, was very attractive to the sponsor community as the markets evolved.

Jay Diamond: Tom, BDCs have been under some stress lately and in the headlines. How concerned should investors be about this packaged product and does it affect the broader leveraged credit market?

Tom Hauser: Yeah, I guess there's a couple of different ways to answer it. It's not a major component of either market, meaning BDCs aren't a major issue or within the high yield market or the syndicated bank loan market. The BDCs tend to be investment grade issuers. But it does touch upon one of those macro themes that we talked about at the beginning, which is the fallout in private credit or illiquid credit.

Taking a step back, BDCs tend to invest in private, illiquid bank loans. That is what the portfolio is made up of. And BDCs typically have from a high level two forms. One, they could be a publicly traded BDC so that the shares of the NAV is traded on a public exchange, or a non-traded BDCs where the NAV can't be traded on an exchange on a daily basis.

As investors start to have a bit of concern around the ultimate makeup of the portfolios, and in particular, a similar theme that played out in bank loans. Technology was a very large component of many of these portfolios, and if the portfolios hold up, meaning if the managers experience few losses and the loans continue to pay their coupons, and ultimately borrowers continue to repay that debt, we do think that the BDCs, both the publicly traded and non-traded BDCs, should be in a position to sort of survive this volatility. At the end of the day, it's going to matter what the portfolio looks like and whether they experience losses or not.

If they don't and the portfolios hold up, we think they'll be okay at the end of the day.

Jay Diamond: Now Dan sticking on this topic, but more broadly private credit, what is your take on that market? Is the fear too generalized or is it justified?

Dan Montegari: Well let's just dig into private credit because I think private credit BSL, high yield, its credit. Ultimately the goal of the underwriting process for private credit, BSL high yield, it's all the same. I would say the motivation for a borrower to choose private credit typically is a function of speed, certainty, and then generally they just don't want their information out in the public domain.

From an investor's perspective, within private credit, from a process perspective, you do get access, probably more access to the management team. You get more access to the sponsor and you get more detailed information. You need that because you're willing to accept typically illiquidity in private credit. And historically you're going a little bit deeper into the structure. And so, for that illiquidity, for that deeper attachment point, historically within private credit you earned a premium and you earned tighter documentation and all else equal with the premium, with tighter documentation, and with what would be quality underwriting, you should earn a better return than the BSL market.

What's really happened I would say over the past couple of years is we definitely think there's been a decline in the discipline in the underwriting process, and that's really just a function of there's

been such an inflow of capital into the private credit market, that capital needs to be deployed. That capital is competing with the BSL market to be deployed.

And so what you've really seen in private credit over the past few years is, I would say, the premium that you're getting for the illiquidity—that's shrunk relative to the more liquid syndicated market. The quality of documentation within the private credit market that's also eroded. As well, at the same time, you've seen the attachment point either stay the same or, even in some cases, increase.

And so that to us just means that future performance is probably going to underperform relative to where it's been historically. And really in par credit, which private credit is effectively part credit, oftentimes it's the investments that you don't make as opposed to the investments that you do make that define your performance. And so there's just been, I would say, an overall reduction in discipline in the underwriting process across private credit, a function of capital coming into the market. Tom also hit on the other, I would say, knock on private credit right now is just the exposure to software.

Software represents over 20 percent of the private credit market. So you had this combination of a reduction in the discipline of the underwriting process, combined with a sector that represents 20 percent of the overall asset class, that potentially has negative structural implications, and that likely means that all else equal, there will be an increase in defaults. I think the argument as to why, as Tom said before, the loss given default will be much better than the syndicated market as lot of these software businesses were written that 40 to 50 percent loan to values, which arguably gives you a lot of cushion to absorb that multiple compression. I think ultimately, at the end of the day, consistent with the BSL market or with the high yield market, it will come down to the fundamental underwriting process and credit selection.

Jay Diamond: So the process you're describing reduced premium, more relaxed underwriting standards. This sounds like just a part of a credit cycle. So what's on the other side of this?

Dan Montegari: So I think what's on the other side of it is you'll likely see the flow of capital into private credit, particularly from the retail class, which was a new area of investment that the private credit market had to deploy. I think what you'll probably see is a reduction in the flow of capital from retail product into private credit.

Ultimately, that will just create more balance in the supply and demand within that market. And as there's just less capital to put to work, I think the opportunity for returns within that market will gravitate, and the discipline in that market from a documentation will gravitate more towards the historical perspective of private credit. And I think where Guggenheim sits today, we just raised \$8 billion in private credit, when we look at the portfolio, we're actually relatively underweight software to the market.

I think we set up really well to deploy opportunistically that capital in a market where others are pulling back.

Jay Diamond: Tom, with everything we've talked about today, as you look across the corporate credit landscape, where do you see the best relative value today?

Tom Hauser: Yeah, I'm going to be Switzerland here Jay. I'm going to say there's puts and takes to each of them. I'll start with the bank loan market. We touched upon some of the risks, Dan

mentioned it. Overall, the quality of the bank loan market certainly has deteriorated over the last ten, 15 years. When we look at the B3, B-minus component, which is the lowest rated single B component up the bank of the market, it's grown about four-fold from where it was a decade ago to about 20 percent of the market.

The maturity wall over the next three years. When you look at what comes due in 2027, 2028, and 2029, roughly 275, 280 billion of those loans maturing in the next three years are rated B-minus or lower. And given how accommodative capital markets have been over the last couple of years, there's a reason why those borrowers haven't yet refied or pushed out their maturities. It's because the market isn't available to them.

And so there are certainly tail risks within the loan market. But at the same time, it's a market that's currently trading just inside 500 basis points of discount margin. And when there's volatility in the market, you certainly get aspects of the baby thrown out with the bathwater. And so we're looking for opportunities in the secondary today where we think the market has oversold credit just in concert with some of the themes and the negative aspects of the bank loan market that are playing out today.

And so again, a credit picker's market. I'm certainly biased given the nature of how we go about our day to day in building portfolios. But we do think that volatility will bring ideas and opportunities to deploy capital at a good relative value in a historical context.

The high yield market we mentioned, it's a bit higher quality than we're used to historically. Spreads are certainly tighter, so that's represented by the spread level. But we do think because the fundamentals are fairly strong and the technicals remain fairly intact, there are opportunities to put capital to work in a yield context, which is still fairly attractive to investors at around 7 percent today.

Now, the problem with the market is you're only picking up about 275 basis points of spread. That's not a lot of cushion to absorb losses. So if you can pick the right credits and avoid those losses, you're building a book of names that are generating a decent coupon in a historical context we believe will reward investors over the long run, given you have decent call protection in that market relative to bank loans.

And then lastly, just echoing some of Dan's comments on private credit, we talked about the fallout that's occurring in private credit, investor concern, certainly an investor base or a newer investor base in the retail investor that maybe didn't really fully appreciate what they were getting into and now starting to look for liquidity.

All of that creates volatility, which should help to reprice the market, maybe put a little bit more discipline in terms of how capital is deployed. And that comes in the form of a better coupon. And it also should come in the form of a better document for investors, which we believe will protect them in the downside scenario.

Jay Diamond: Oh, thank you for that. And before I let you go, Tom, do you have any final takeaways for our listeners?

Tom Hauser: Always think it's a credit picker's market given the nature of how we go about it. But I do think in in all three markets we discussed at length today, there are opportunities. You just have

to be very cautious of where you put your capital to work. And if you do that, in the long run, it will result in good results.

Jay Diamond: Words to live by. Thanks again for your time, Tom and Dan. Please, I hope you'll visit again with us soon. And thanks to all of you who have joined us for our podcast. If you like what you're hearing, please rate us five stars. And if you have any questions for Tom or Dan or any of our other podcast guests, please send them to MacroMarkets@GuggenheimInvestments.com, and we will do our best to answer them on a future episode or offline.

I'm Jay Diamond. We look forward to gathering again for the next episode of Macro Markets with Guggenheim Investments. In the meantime, for more of our thought leadership, including our just published Fixed Income Sector Views, visit GuggenheimInvestments.com/perspectives show long.

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Definitions: BLS – broadly syndicated loans.

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