GUGGENHEIM

First Quarter 2023

Fixed-Income Sector Views

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Portfolio Management Outlook

Portfolio Positioning in an Opportune Market

Valuations have reset after a historically volatile year.

The emerging theme from our Sector Teams in this edition of Fixed Income Sector Views is that the market has come around to the view that the Fed's hiking cycle is nearing its end. This is an important and bullish transition in investor psychology and has led asset allocators to rethink their exposure to fixed income. After a year of aggressive rate hikes, a radical reshaping of the yield curve and volatile credit markets, the headwinds to fixed-income performance from 2022 are subsiding.

Contributing to this change in market perception is better news on inflation and the step-down in the size of rate increases at the last two Federal Open Market Committee (FOMC) meetings. As our Macroeconomic and Investment Research Group reports, falling core goods prices, slowing wage growth, improving supply chains, and a cooler rental market should keep inflation on a downward trend. While future Fed policy is uncertain and the risk of recession is rising, fixed income can again add both income and correlation benefits to a diversified portfolio.

As active fixed-income managers, our job is to anticipate market developments so that we can avoid problems and seize opportunities when possible. In the second and third quarters, credit risk across all sectors was attractively priced as quickly moving markets were offering historically wide spreads and attractive yields.

The subsequent recovery in credit has been disproportionate and has led to some dispersion among credit sectors. This presents a compelling opportunity for some opportunistic repositioning. Most attractive to us are the dislocations in higher quality structured credit, where spreads remain historically wide relative to corporate credit. In addition to wide spreads, the significantly discounted dollar prices offer attractive convexity and total return potential. Our strategies have broadly continued to add to this exposure while also using recent strength to lighten up in more cyclically sensitive categories of credit.

We remain positioned to benefit from tighter spreads and a normalizing of credit curve relationships, but are mindful of the risk of a reversal of the recent strength and a longer term weakening of credit fundamentals. Both risks call for active sector allocation, overweighting higher quality credit, disciplined security selection, and maintaining sufficient dry powder to allow for future flexibility.

By Anne Walsh, Steve Brown, Adam Bloch, and Evan Serdensky

Macroeconomic Update

Goldilocks Economy Now, But Recession Looms in 2023

We expect that a recession in 2023 will not be overly severe, particularly with improved global prospects.

Falling inflation has given a boost to consumers, whose rising real incomes have driven consumer sentiment off the lows seen last summer. As a result, fourth quarter economic activity held up better than many expected, with consumption growing at a 2.1 percent annualized pace over the quarter. Cooling inflation and resilient real gross domestic product (GDP) growth have driven a resurgence in market hopes for a "soft landing," which in this case means a return to 2 percent inflation without a recession.

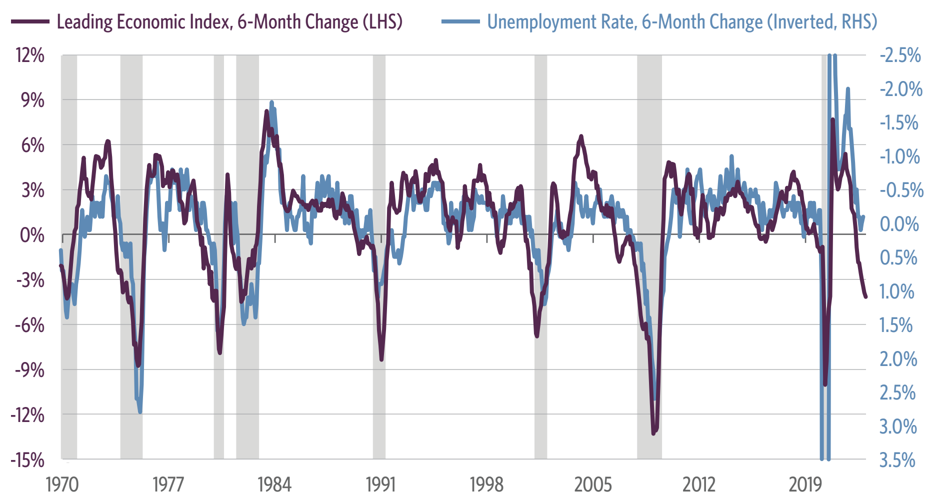
While a recession may be delayed, we are skeptical it can be averted. The boost to consumer sentiment from lower inflation should wane, as we are unlikely to see energy prices continue to fall at the same rate as they have over the last six months. Many of the tailwinds that helped bolster the economy in 2022 are now slowing, if not reversing, including service sector reopening, the spend-down of excess savings, and the wealth effect from gains in asset and home prices.

Even if the economy manages to power through these headwinds, the Fed has made it clear that it will push back against any growth acceleration in its quest for a weaker labor market. Recent inflation data, along with revisions to 2022 data, will reinforce Fed resolve to keep policy restrictive, as the inflation slowdown looks less convincing than it did just a few weeks ago. Trends for goods prices and shelter inflation continue to point to lower inflation, but the main concern now for the Fed is core services excluding shelter, a concern likely to be amplified by the strength of the latest jobs and wage numbers. A 2023 recession remains our base case, but we expect it will not be overly severe, particularly with improved global prospects from Europe's abating energy crisis and China's economic reopening.

By Brian Smedley, Maria Giraldo, and Matt Bush

Even if the economy manages to power through current headwinds, the Fed has made it clear that it will push back against any growth acceleration in its quest for a weaker labor market. A 2023 recession remains our base case.

Unemployment to Rise as Recession Unfolds Later This Year



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2022. Shaded areas represent recession periods.

Rates

A Positive Outlook for 2023

Looking to move into short duration assets and position for curve steepening.

As a new trading year begins, investors in U.S. Treasury and Agency markets stand to benefit from the potential recovery of one the worst yearly return periods of the last 50 years. This opportunity for positive total return comes on the heels of a year shaped by the Fed's fight to tackle inflation that was more persistent than most market participants expected. As the FOMC increased the fed funds rate by a cumulative 425 basis points in less than nine months, Treasury yields pushed 200–370 basis points higher, reaching levels not seen for 15 years. Now, with inflation showing signs of abating, we believe that Fed tightening will reach its terminal rate by midyear.

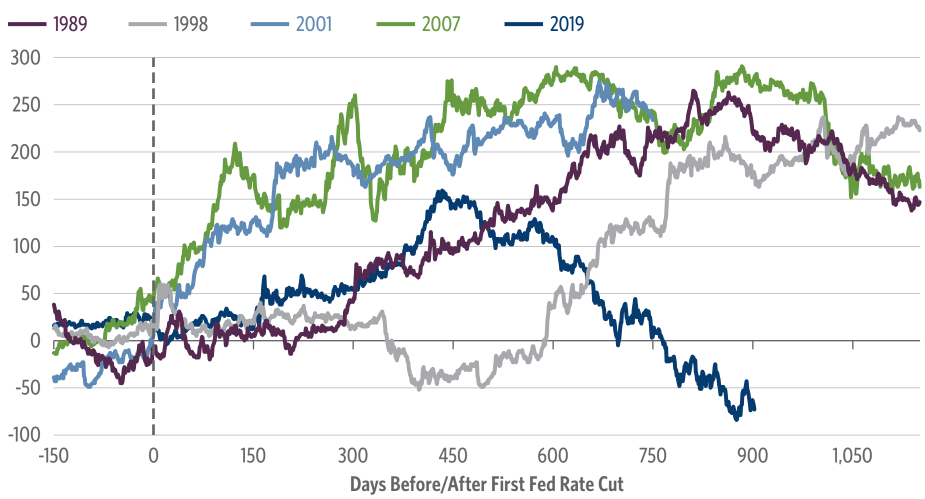
As market participants become more comfortable with the potential end to the Fed's tightening cycle, Treasury market liquidity should continue to improve and interest rate volatility should continue to decline. In this environment, callable Agency spreads will likely benefit and tighten from historically wide levels relative to Treasury securities of similar maturities. Additionally, we expect that attractive yields, historically wide spreads, and limited new supply for Agency bullet securities should help to drive positive performance for Agency debentures.

We believe that most of the flattening in the yield curve is behind us and that the Fed will keep rates on hold for longer than in past cycles. Accordingly, we have started to reduce some of our duration underweight positioning at the front end of the curve. Looking forward, as inflation continues to subside, the unemployment rate eventually rises from historically low levels, and the economy approaches a recession later this year, the Fed will likely wind down its hiking cycle, supporting the market's current pricing of the next easing cycle. In anticipation of this chain of events, we will seek opportunities to invest in assets in the front and intermediate part of the curve, and consider curve positions that will benefit from an eventual steepening of the yield curve.

By Kris Dorr and Tad Nygren

With inflation showing signs of abating, we believe that Fed tightening will reach its terminal rate in the first half of 2023. We also believe that most of the flattening in the yield curve is behind us and that the Fed will keep rates on hold for longer than in past cycles.

2/10-Year Treasury Curve Before and After Rate Cuts



Source: Guggenheim Investments, Haver Analytics. Data as of 1.13.2023.

Investment-Grade Corporate Bonds

Opportunistically Moving Up in Credit Quality

We expect technical tailwinds for investment-grade corporate spreads to continue in the first quarter of 2023.

Hawkish perception of Fed policy in the fourth quarter resulted in the Bloomberg U.S. Corporate Bond Index hitting a peak yield for the year of 6.13 percent. This led investment-grade corporate bond investors to broadly start deploying cash. Despite seeing the wides in spreads and highs in yield for the year in the fourth quarter, investment-grade spreads tightened over the fourth quarter, while all-in yields rallied 12 basis points to 5.42 percent over the quarter. Unfortunately, this fourth quarter rally was not enough to save the sector from its worst full-year total return performance in history of -14.8 percent.

We expect the fourth quarter 2022 technical tailwinds for investment-grade corporate spreads to continue in the first quarter of 2023. Traditional money managers and insurance company portfolios continue to carry heavy cash balances, while pension fund rotations into the sector should continue. At the same time, the primary market will likely see lower gross and net issuance as investor preference for low dollar-price bonds in the secondary market and all-in higher yields will continue to support further strength in investment-grade corporates. Absolute yields are attractive relative to both historical corporate bond index standards and equities.

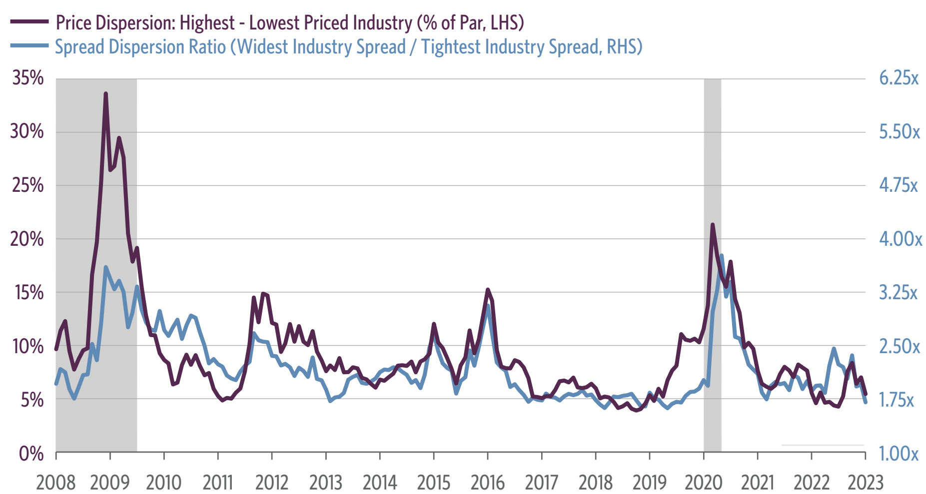
As we begin 2023, we are starting to see the market's focus shift to credit fundamentals through earnings releases and forecasts. Corporate credit fundamentals are likely to deteriorate as the economy shows signs of weakening, although balance sheets are starting from a much stronger position than in prior recessions. We also expect that the effects of quantitative tightening will be felt throughout 2023.

The tight range between the widest and tightest credit spreads in the index—also called the dispersion—implies that the market is not fully priced for a downturn that would affect some industries and issuers more than others. In fact, the ratio between the widest and tightest industry spread is just 1.7x currently, below the historical average of 2.7x and well below recession peaks. This lack of dispersion across investment-grade credit spreads presents an opportunity to reposition portfolios ahead of a likely recession. As we move into this next phase of the credit cycle, dispersion should increase materially to reflect varying degrees of credit deterioration, and we are opportunistically moving up in credit quality, as well as adding to shorter maturity bonds, specifically U.S. banks, through first quarter primary market issuance.

By Justin Takata

The current lack of dispersion across investment-grade credit spreads presents an opportunity to reposition portfolios ahead of a likely recession. The tight range between the widest and tightest credit spreads in the index implies that the market is not fully priced for a downturn that would affect some industries and issuers more than others.

Very Little Industry Dispersion in the Investment-Grade Index



Source: Guggenheim Investments, ICE Index Services. Data as of 1.31.2023. Shaded areas represent recession.

High-Yield Issuers Were Resilient Amid Fed Tightening

Robust high-yield earnings supported low default activity last year.

Despite the poor returns of the Bloomberg U.S. Corporate High-Yield Index in 2022, the low high-yield default rate—0.8 percent per S&P as of Dec. 31, 2022 (1.5 percent par-weighted per BofA Research)—continues to demonstrate strong corporate fundamental performance and resilience to the Fed's tightening efforts. A major tailwind has been corporate earnings, with trailing 12-month earnings before interest, tax, depreciation, and amortization (EBITDA) through the third quarter up 61 percent compared to the prior comparable period, and on track to finish up 33 percent year over year in the fourth quarter. Excluding commodities, cash flows were still strong, tracking up 29 percent year over year.

The fourth quarter of 2022 saw a resurgence in demand for credit risk and a turnaround in high-yield corporate bond prices as a possible end to the Fed hiking cycle came more into focus. This rally extended into the first four weeks of 2023. Credit spreads tightened from 552 basis points to end the year at 469 basis points, and have continued to tighten. Yields fell from a 2022 high of almost 10 percent to 8 percent currently. After dipping to as low as 84 percent of par, high-yield corporate bond prices are now closer to 89 percent of par, offering a little less cushion than at the end of last year.

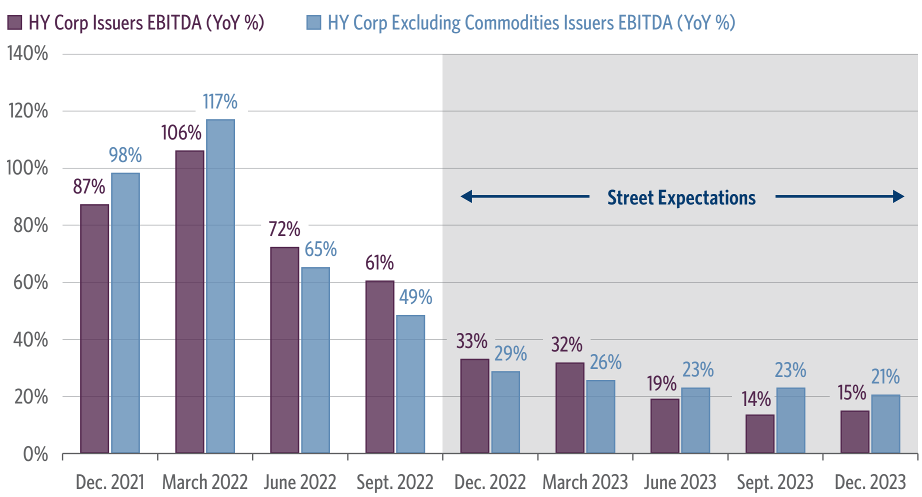
The elevated risk of recession in 2023 presents a meaningful challenge to leveraged borrowers. Wall Street consensus expects high-yield EBITDA to rise about 15 percent in 2023 for the group of over 350 high-yield companies that we track, including a 21 percent increase for non-commodity companies. These expectations may be too optimistic given the deteriorating economic backdrop, but we think the sector is still poised to weather a downturn better than in previous recessions. In addition to coming off of a strong earnings cycle, high-yield issuers' leverage is below 2019 levels, and interest coverage stands at over 5.0x.

While the sector's five-year duration was a drawback in 2022, we think it could be a benefit in 2023 if the emergence of a recession triggers a rally in U.S. Treasurys, thereby boosting returns. With yields still attractive in the current environment, we are positioning in sectors and issuers that we think are higher quality and likely to be more resilient in an economic downturn.

By Thomas Hauser and Maria Giraldo

We think the high-yield sector is poised to weather a downturn better than in previous recessions. In addition to coming off of a strong earnings cycle, high-yield issuers' leverage is below 2019 levels, and interest coverage stands at over 5.0x.

Strong High-Yield Corporate Earnings Supported Low Defaults in 2022



Source: Guggenheim Investments, S&P Capital IQ. Data as of 1.25.2023.

Bank Loans

Seeking Higher Quality Opportunities Amid Rating Downgrades

While the negative rating migration trend is likely to continue, we see opportunity in select sectors and issuers.

Market expectations for the terminal fed funds rate for this cycle settled around 5 percent between October 2022 and January 2023 after a few encouraging Consumer Price Index reports, which caused the sector to rally. The Credit Suisse Leveraged Loan Index delivered a total return of 2.3 percent in the fourth quarter, bringing the annual return to -1.1 percent, and strong performance continued in January. Investors are cautiously optimistic about the end of the hiking cycle, with a Fed pause and rate cuts baked into futures market pricing starting in the second half of 2023.

Despite recent inflows into bank loan-focused strategies, investors remain concerned about the potential lagged impact of higher short-term rates and a deteriorating macroeconomic environment on loan issuers. Fueling these concerns is the accelerated pace of credit rating downgrades that occurred as economic projections moved lower. S&P LCD reports that 277 U.S. institutional loans were downgraded in 2022 versus 164 upgraded, the worst 12-month trailing ratio since April 2021. December saw 30 downgrades versus just seven upgrades.

Bank loans from nearly all sectors suffered rating changes in 2022, including industrials, consumer discretionary, healthcare, communication services, and technology, each with more than 20 downgrades. The two sectors somewhat spared were materials and energy, with only six and three downgrades each, respectively. Industry concentrations explain some of the trend, but a big factor is the unique macroeconomic tailwinds and headwinds that each industry faces. Revenue underperformance, margin pressure brought on by higher costs, and near-term risk of a liquidity squeeze were all frequently cited by S&P analysts. Rating outlooks provide a warning sign that more rating cuts may come. In the index, 164 loan issuers have a negative outlook by S&P while just 51 have a positive outlook. Sectors like retail and consumer goods appear most at risk, which corroborates the macro trend in consumer preferences for services spending over goods.

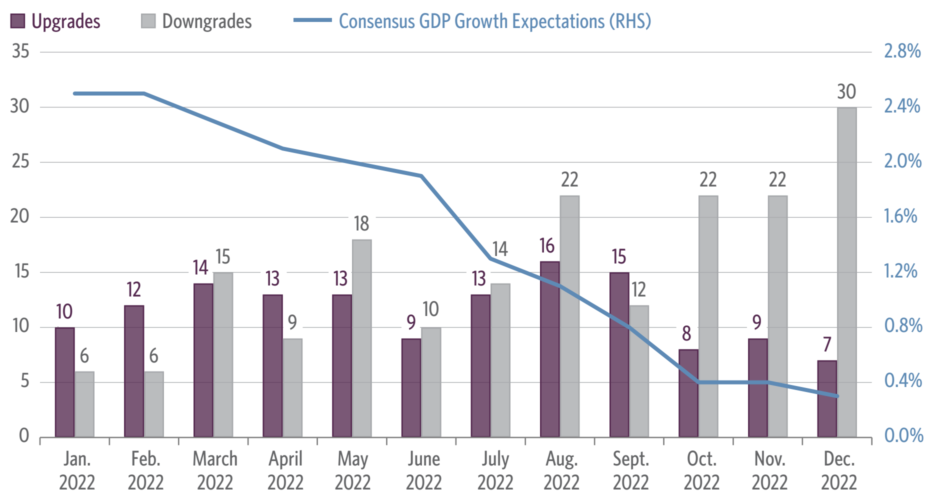
While the negative rating migration trend is likely to continue, we see opportunity in select sectors and issuers that offer some element of safety. We favor issuers with contracted revenue streams, senior secured first lien positions with modest leverage, players with strong market share, and issuers with adequate liquidity over the next 12 months. Investors will need to tread carefully, but opportunities exist given leveraged loans' cheapness relative to history, with discount margins in the 50th percentile of historical observations, and yields the most attractive in the past decade.

By Christopher Keywork and Maria Giraldo

Rating outlooks provide a warning sign that more rating cuts may come. In the index, 164 loan issuers have a negative outlook by S&P while just 51 have a positive outlook. Sectors like retail and consumer goods appear most at risk.

Credit Rating Downgrades Accelerated as 2023 Growth Expectations Declined

S&P Global Rating Leveraged Loan Issuer Upgrades and Downgrades



Source: Guggenheim Investments, S&P Capital IQ. Data as of 1.22.2023. Includes U.S. term loans and revolvers.

Municipal Bonds

The Case for Active Management in Munis

Non-index taxable munis look attractive relative to corporate bonds while providing an increase in credit quality.

Municipal bonds found firmer footing in the fourth quarter of 2022 compared to earlier in the year. During the fourth quarter, the Bloomberg Municipal Bond Index Total Return Index returned 4.1 percent, trimming full calendar year losses to -8.5 percent, while the Bloomberg Municipal Index Taxable Bonds Total Return Index returned 1.5 percent for the quarter, reducing calendar 2022 losses to -18.1 percent. Taxable municipals underperformed tax exempts in total return during 2022 due to taxables' longer duration.

Tax exempt mutual funds faced outflows for most of the quarter, but exchange-traded funds saw inflows as buyers took tax losses in mutual funds and reinvested into more liquid index products. Odd lot purchase activity also picked up as retail investors took advantage of all-in yields that were materially higher versus 12 months ago. While demand rose throughout the quarter, supply experienced a significant step down versus the prior year, with fourth quarter new issue volumes down 29 percent (including an astounding 50 percent drop in December—a month that traditionally experiences a year-end rush of underwritten deals). The imbalanced supply and demand relationship led to outperformance in tax exempt municipals despite higher Treasury rates during the quarter.

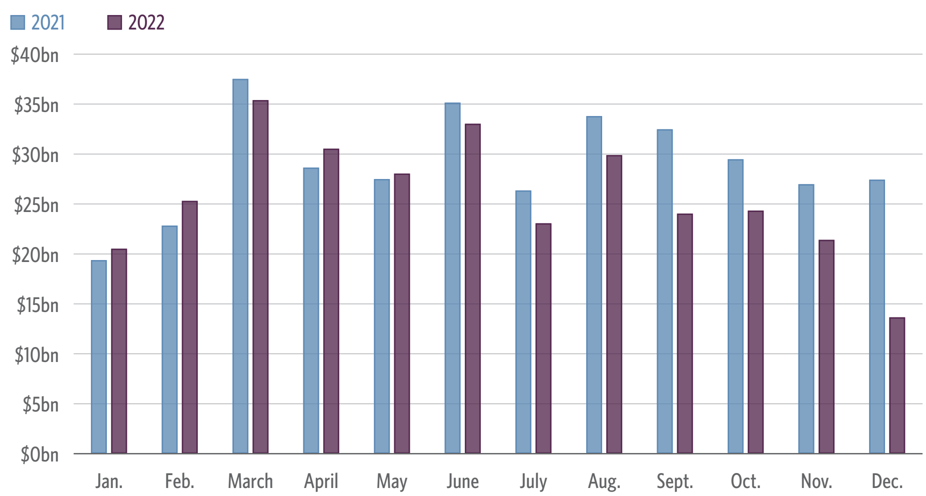
Municipal credit quality remains strong: 49 states had a budget surplus for the fiscal year ended June 30, 2022, while 33 states are on track for surpluses in fiscal 2023. However, municipalities with revenues more sensitive to markets and the economy, such as capital gains taxes—California, for example—have started missing top-line forecasts, portending a challenging 2023–24 budget season.

We believe tax exempt investors should focus on avoiding bonds with negative convexity, such as 5 percent coupon bonds with very short par call dates. Such structures give issuers the option to call their outstanding bonds if market rates fall, while sticking investors with rate volatility if rates rise—a poor bargain. On the taxable side, while index-eligible bonds are trading through corporates, non-index municipal bonds look attractive relative to corporate bonds while providing an increase in credit quality. Investors appear to be stepping down in liquidity when buying non-index bonds, but the liquidity difference between index- and non-index securities has narrowed in the current low issuance environment.

By Allen Li and Michael Park

While demand rose throughout the quarter, supply experienced a significant step down versus the prior year, with fourth quarter new issue volumes down 29 percent (including an astounding 50 percent drop in December—a month that traditionally experiences a year-end rush of underwritten deals).

Steep Dropoff in Tax Exempt Muni Supply During 2022



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2022.

Asset-Backed Securities and CLOs

Attractive Relative Value in High Quality Credits

Sizeable increases in utility ABS issuance helped offset declines in other ABS sectors.

CLOs continued their generally positive recent performance in the fourth quarter of 2022. Total returns for AAA and BBB-rated tranches were 2.5 percent and 4.8 percent, respectively, as credit spreads moved 30–40 basis points tighter for AAA–A tranches and 50 basis points tighter for BBB–BB tranches. CLO new issuance was a robust $130 billion in 2022, with issuance tapering to $8 billion per month in the fourth quarter. Issuance, which has been dominated by more established managers, was met with lower demand from core U.S. bank investors but saw rising demand from asset managers and insurance companies seeking opportunities to move up in quality without extending duration. Fundamental concerns over CLOs are rising, however, as B-rated loan exposures rose to 30 percent of CLO collateral pools in the fourth quarter, compared to 20 percent in 2019 and 10 percent in 2016. Downgrades and defaults of these loans in a recessionary environment could put pressure on CLO performance tests and junior tranche prices. We favor investing in higher quality AAA–A CLO tranches where valuations are favorable relative to the risk of principal loss or downgrade.

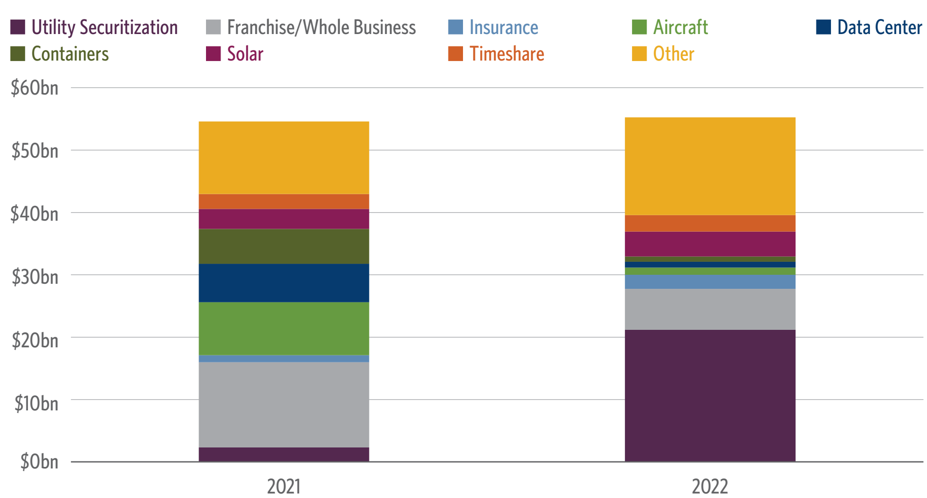
The ICE BAML AA–BBB U.S. Fixed Rate Asset Backed Index delivered a total return of 0.49 percent in the fourth quarter of 2022. In esoteric ABS, credit spreads widened by 50–85 basis points at the beginning of the quarter before narrowing and ending the quarter 30–40 basis points wider. As rates rose, issuance steadily declined during the quarter, with December's volume totaling just $5 billion versus a 2022 monthly average of $20 billion. This resulted in fourth quarter issuance ending 25.1 percent lower than in the comparable quarter in 2021. Total ABS (ex CLO) issuance for 2022 came in 8.8 percent lower than 2021 due to higher all-in financing costs for issuers. Utility issuers were a relative bright spot, as they tapped seldomly used ABS financing structures, including long duration AAA-rated tranches secured by ratepayer accounts, to pay for extraordinary costs related to natural disasters and grid updates. Other traditionally steady sources of esoteric ABS supply including container, whole business, and data center ABS, saw issuance decline, with some major whole business and net lease ABS issuers marketing but then pulling deals in hopes of a better financing environment. Next year should look different, as a build-up in container, net lease, and data center assets financed via warehouse facilities or construction loans should support securitized product issuance.

Credit fundamentals remain sound across the majority of commercial ABS asset types, and the sector continues to offer discounted dollar prices and higher spreads versus similarly rated corporate credit alternatives. We remain vigilant for potential roll-over risk as higher interest rates could pressure future asset values and debt coverage parameters on certain deals.

By Michael Liu, Scott Kanouse, Dominic Bea, and Rafsun Faiz

Traditionally steady sources of esoteric ABS supply including container, whole business, and data center ABS, saw issuance decline. Utility securitizations offset this decline, including long duration AAA-rated tranches.

Esoteric ABS Issuance Declined in 2022



Source: Guggenheim Investments, JP Morgan. Data as of 1.6.2023.

Non-Agency Residential Mortgage-Backed Securities

Income and Appreciation Potential with Limited Downside Risk

Strong fundamentals keep us constructive on RMBS despite the cooling housing market.

Non-Agency RMBS credit spreads reached new post-COVID wides early in the fourth quarter in tandem with broader liquid credit markets before modestly recovering in December. RMBS 1.0 and RMBS 2.0 subsectors—RMBS issued pre- or post-Global Financial Crisis—posted -0.2 percent and -1.5 percent returns, respectively, in the fourth quarter. RMBS valuations lagged the late fourth quarter rally in broader risk markets due to a lack of trading volume and reduced risk appetite from end investors and dealers, thereby leaving spreads elevated relative to liquid credit benchmarks. For example, credit spreads on AAA-rated non-qualified mortgage tranches ended the year 85 basis points higher than they began 2022, while spreads for investment-grade corporate bonds widened by 30 basis points over the same period.

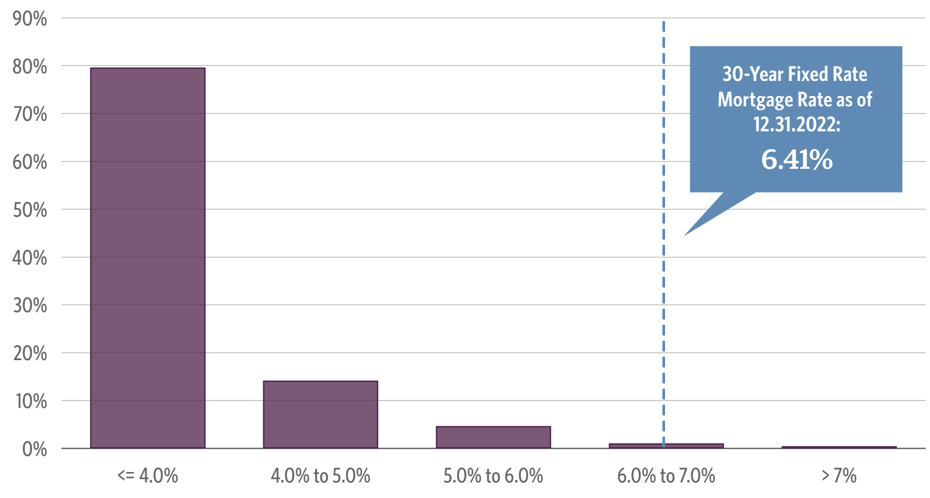
Fourth quarter RMBS issuance volume declined by 75 percent quarter over quarter, from $20.7 billion to $5.3 billion, and full year 2022 issuance of $110 billion marked a 33 percent decline from 2021. Primary issuance is expected to decline even further in 2023 due to higher mortgage rates and reduced home sales activity, which is now at levels last seen during the onset of the pandemic. Additionally, refinancing activity is expected to be minimal as nearly 98 percent of outstanding mortgages have rates below the current market rate. The expectation of slow prepayments, even under moderate interest rate declines, reduces the call risk in MBS and improve their yield profiles across interest rate scenarios.

Conservative mortgage underwriting, favorable consumer and labor market conditions, and an excess demand for shelter in the United States helped to alleviate the credit concerns posed by the cooling housing market. Prior to the recent softening in the housing market, price appreciation was robust. Consequently, home equity totaled $30 trillion versus $13 trillion in outstanding mortgage debt, providing ample cushion to endure any home-price declines. We continue to favor non-qualified mortgage RMBS 2.0 mezzanine and senior tranches with loss-remote, stable weighted average life profiles, reperforming loan deals, and RMBS 1.0 backed by loans with significant home equity. These subsectors have recently traded at discounted dollar prices with 6–7 percent yields while carrying a low likelihood of principal loss.

By Karthik Narayanan and Roy Park

Refinancing activity in 2023 is expected to be minimal as nearly 98 percent of outstanding mortgages have rates below the current market rate.

Rate Distribution of Outstanding Mortgages Will Pressure Refi Activity



Source: Guggenheim Investments, Bank of America Research, Recursion, Loan Performance. Data as of 12.31.2022.

Attractive Yield Opportunities in High-Quality CMBS

Favoring CMBS transactions backed by quality assets with strong sponsorship and structural protections.

CMBS spread performance was mixed in the fourth quarter as senior bond prices diverged from subordinated bond prices. Credit spreads on the benchmark 10-year conduit AAA-rated bond tightened from 147 basis points to 130 basis points in the fourth quarter of 2022, in step with the rally in broader markets. In contrast, credit spreads on more subordinated BBB-rated bonds increased from 535 basis points to 590 basis points over the quarter. This divergence reflects ongoing investor concerns about commercial real estate (CRE) fundamentals despite improved conditions in broader credit markets.

The most recent Federal Reserve Senior Loan Officer Opinion Survey showed bank demand for CRE loans was at levels not experienced since the COVID pandemic in the third quarter of 2020, suggesting low debt supply and challenging financing conditions for weaker properties. CRE loan volumes through third quarter 2022 have fallen by 13 percent year over year as higher interest rates and secular headwinds (especially in the office sector) challenge property valuations and strategic refinancings.

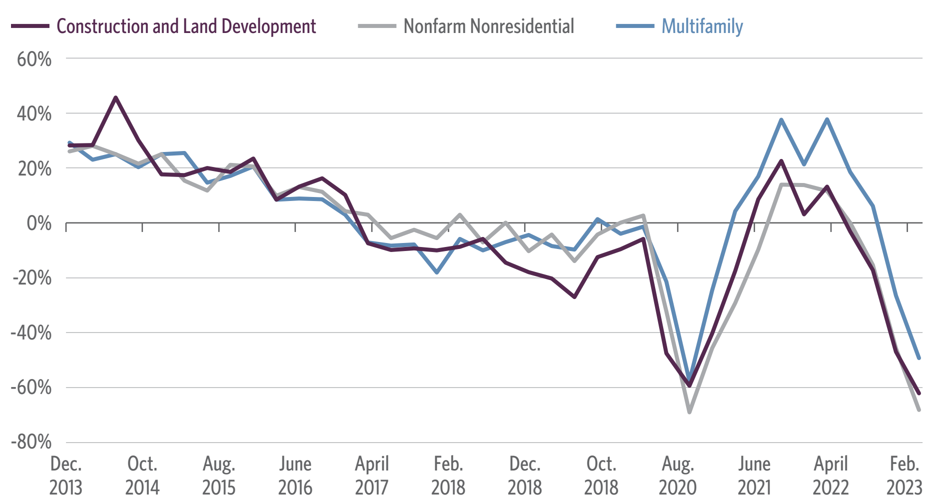
This lower CRE loan transaction volume has hindered new CMBS issuance. Only $8.4 billion of CMBS was issued in the fourth quarter, compared to $17.1 billion in the third quarter and $54.6 billion in the fourth quarter of 2021.

The challenges facing the CRE markets will take years to resolve. Investor outcomes differ not only by market or property type, but also within markets and property types given the location and property-specific idiosyncrasies inherent to CRE. CMBS investors with through-cycle discipline and security selection capability will continue to see opportunities to source historically high spreads and yields in well-enhanced credit. We continue to favor select CMBS transactions backed by quality assets with strong sponsorship and structural protections, with a focus on AA to BBB-rated single asset-single borrower (SASB) and CRE-CLO securities—the latter recently offered yields in the 7.0–8.5 percent range in secondary market trading.

By Tom Nash and Hongli Yang

The most recent Federal Reserve Senior Loan Officer Opinion Survey showed bank demand for CRE loans was at levels not experienced since the COVID pandemic in the third quarter of 2020, suggesting low debt supply and challenging financing conditions for weaker properties.

Bank Demand for CRE Loans Sits at 10-Year Low



Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices. Data as of 2.6.2023.

Agency Mortgage-Backed Securities

Agency MBS Spreads Normalize from Historical Wides

Fairly valued in the short-term but offering long-term value.

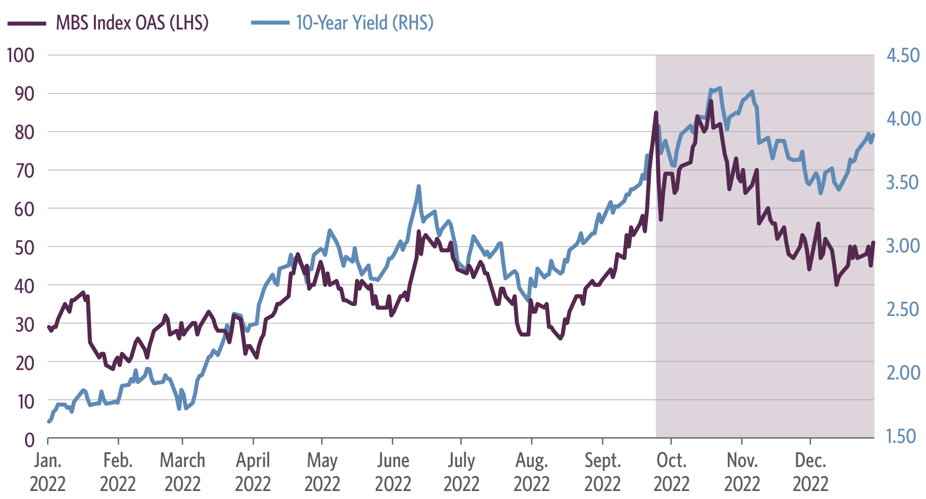
Agency MBS spreads narrowed relative to benchmark Treasurys in the fourth quarter of 2022 from historically wide levels in the third quarter as the market formed a consensus on the terminal fed funds rate for the hiking cycle, which lowered interest rate volatility and stabilized long-term Treasury yields. Option-adjusted spreads ended the quarter at 51 basis points, 19 basis points tighter quarter over quarter, helping the Bloomberg U.S. MBS Index post a total return of 2.14 percent. Demand for MBS improved, with inflows for both passive index-tracking funds and active fixed-income managers more than offsetting mortgage supply entering its typical winter lull. Agency CMBS posted fourth quarter total and excess returns of 1.29 percent and 0.14 percent, respectively. With full-year excess returns of -0.33 percent, the sector continued to benefit from reduced supply and a superior convexity profile compared to single-family mortgage MBS.

Agency MBS, which appear fairly valued in the short term given their recent spread tightening, continue to offer long-term value. Spread levels are generally in line with the 2018–19 period of Fed quantitative tightening but remain higher than the averages since the Global Financial Crisis. In addition, with virtually the entire MBS universe well out of the money for refinancing, the sector exhibits low callability and prepayment risk and a higher certainty of cashflows than is typical. We expect cashflow stability to continue and the sector to outperform as the real economy cools and rates move lower. The long-term value proposition in the sector arises from both spread tightening and a reduction in option costs, which remain at elevated levels. We expect this to be achieved by either a steepening of the yield curve, a drop in interest rate volatility, or both. Agency RMBS passthroughs and low pay up-specified pools appear attractively priced in such an environment. In contrast, valuations in the supply-constrained Agency CMBS sector appear rich. Instead, we see better value in the long-duration space from collateralized mortgage obligation (CMO) structures with lockout periods for principal payments, which offer both wider spreads and higher all-in yields.

By Aditya Agrawal and Louis Pacilio

Agency MBS spreads narrowed relative to benchmark Treasurys in the fourth quarter of 2022 from historically wide levels in the third quarter as the market formed a consensus on the terminal fed funds rate for the hiking cycle, which lowered interest rate volatility and stabilized long-term Treasury yields.

Mortgage Spreads Tightened in the Fourth Quarter of 2022



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2022.

Where to Shop for U.S. Retail Property Investments

We see value in neighborhood retail properties, particularly in markets that have seen inbound population migration.

Nearly three years after the massive wave of COVID-related retail store closures, demand for retail space has recovered to pre-pandemic levels, evidenced by rising net absorption and declining vacancies. The sector is seeing a divergence of performance, however, with small and medium-sized centers and free-standing properties seeing strong demand, while malls continue to struggle to attract tenants.

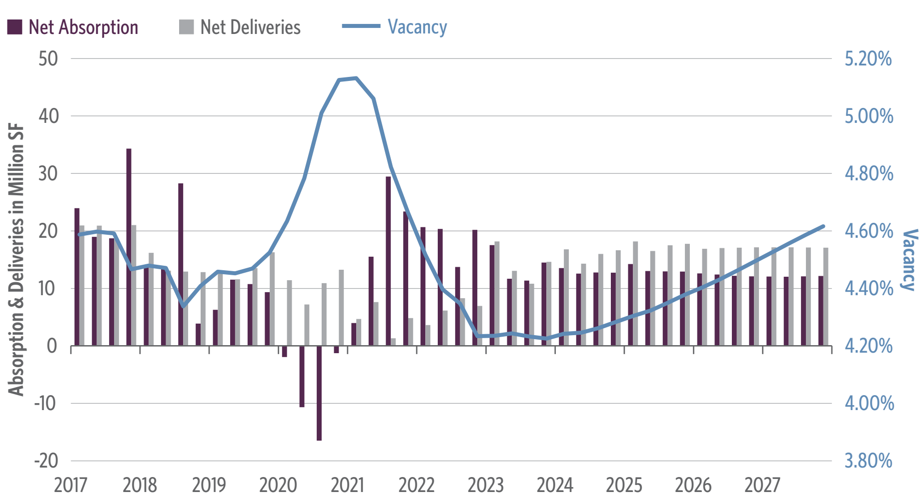
Retail vacancy rates fell to 4.2 percent at the end of 2022, according to Cushman & Wakefield, the lowest level on record. Strong fundamentals supported the sector: Development of new retail properties slowed during the pandemic and has remained depressed, retailers opened more stores in 2022 than they closed, and owners have demolished over 130 million square feet of dated retail properties over the past five years. We expect that challenging debt markets and increased construction costs will continue to deter new development. Over 85 percent of the new space that opened in late 2022 was pre-leased, indicating that developers and their lenders have avoided new speculative development that could lead to an oversupply of available space, a lesson learned from the Global Financial Crisis. As a result, demand for space remains strong and retail rents have increased. Although transaction volume moderated in the latter half of 2022, the retail sector saw a lot of properties trade as buyers had access to capital.

We expect the retail real estate sector to face some headwinds with continued inflation, increased debt costs, and potential for a broader market recession. However, we continue to see value in neighborhood retail properties, particularly in markets that have seen inbound population migration, such as the Sun Belt. These properties are benefiting from increased demand beyond traditional retail tenants, including consumer and experiential services, such as medical, entertainment, fitness, and dining. In 2022, experiential tenants nearly doubled their share of historical new leasing activity. With new construction starts expected to remain below historical levels in the near term, we anticipate vacancy rates will remain low and support continued growth in rents and property prices.

By Jennifer A. Marler and Farris Hughes

Retail vacancy rates fell to 4.2 percent at the end of 2022, according to Cushman & Wakefield, the lowest level on record, as strong fundamentals supported the sector.

U.S. Retail: Net Absorption, Net Deliveries, and Vacancy Rates Improved



Source: Guggenheim Investments, Cushman & Wakefield. Data as of 1.16.2023.

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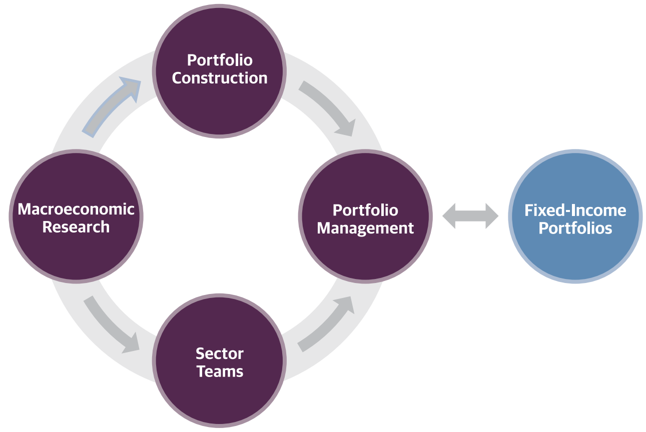

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