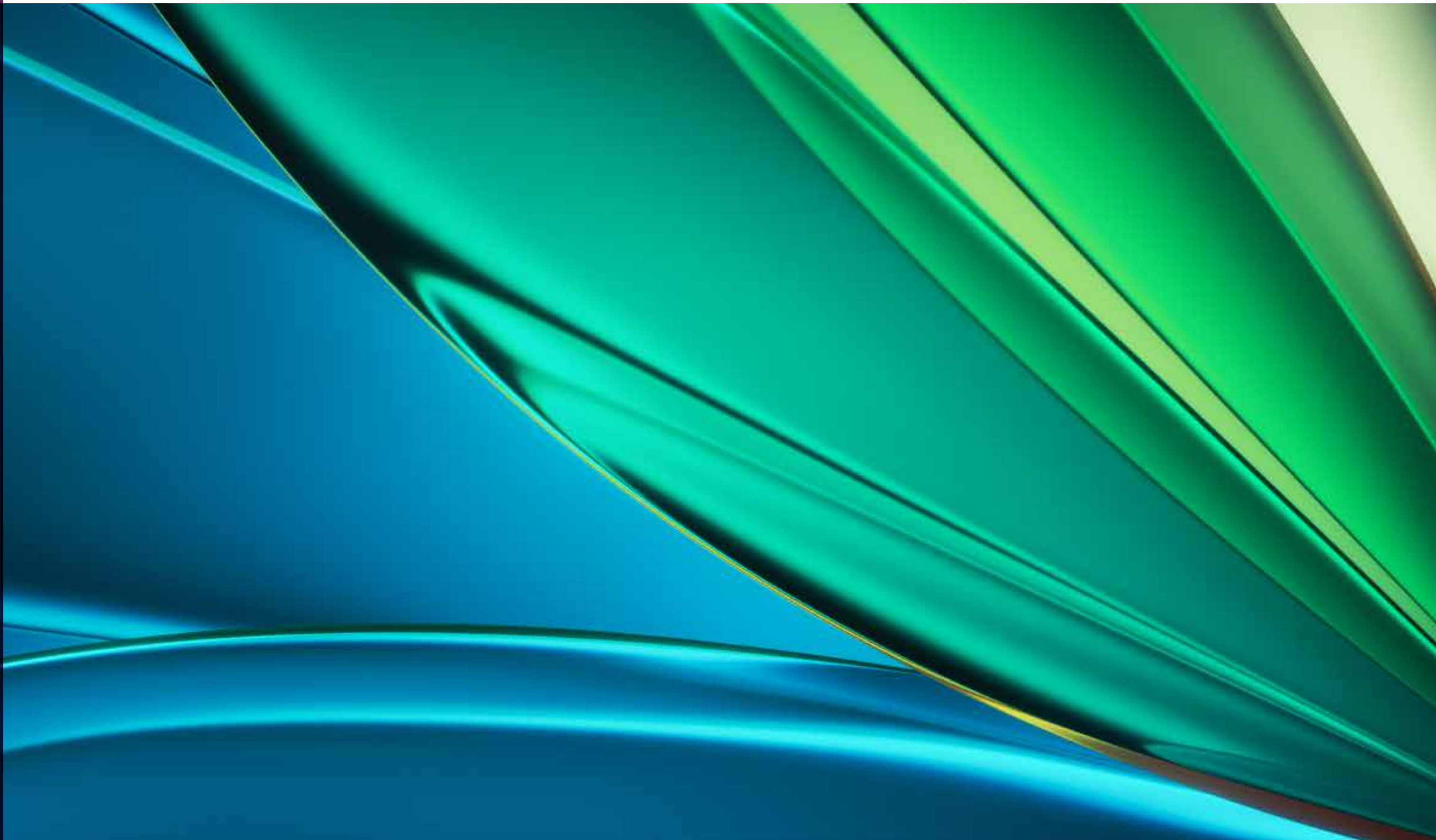
GUGGENHEIM

Second Quarter 2024

Fixed-Income Sector Views



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Portfolio Management Outlook

Balancing Attractive Yields and Tight Spreads

Even as they tighten, spreads in high grade sectors remain wide relative to fundamental risk.

Tighter monetary policy has weighed on the U.S. economy, but a broad recession has thus far been avoided primarily due to deficit fueled fiscal spending associated with the COVID-19 pandemic. This has created a resilient consumer, helped to fortify corporate balance sheets, and contained more widespread economic weakness, even as high interest rates created a "rolling recession" dynamic. Although expanding economic capacity allowed inflation to fall quickly in 2023 even with strong growth, progress stalled in the first quarter with three consecutive months of elevated prints. The Federal Reserve (Fed) responded by reinforcing a higher-for-longer policy stance that has incited some volatility in the markets. While volatility can be unnerving, we are mindful that the pause phase of the Fed's monetary policy cycle creates an environment that is constructive for fixed income and more specifically for active management in the credit markets.

A common theme across our sector team reports this quarter is that while spreads have been grinding tighter, yields remain high and attractive, particularly relative to post-Global Financial Crisis (GFC) norms. Even as they tighten, spreads in high grade sectors remain wide relative to fundamental risk. Credit fundamentals are healthy overall, but we are still seeing bifurcation between the larger issuers with better access to capital and an ability to pass along higher costs to customers, and smaller and lower quality issuers that are struggling with higher interest expense. We expect growth to moderate in 2024, with increasing dispersion under most scenarios.

Opportunities across fixed income remain broad based, even in categories that we have traditionally underweighted like Agency RMBS. Broadly we are prioritizing high carry and shorter duration instruments. Favored categories include non-Agency RMBS, senior CLOs, commercial ABS, current coupon RMBS, syndicated loans, high quality high yield and certain parts of the investment-grade corporate market. In thinking about spread valuations, the most attractive sectors remain primarily in securitized products, both Agency RMBS and non-Agency structured credit. Even as we take advantage of market conditions to invest at these levels, and the growing new issue pipeline, we are all also maintaining dry powder and taking a high-quality bias for future optionality.

The retracement in yields higher to start the year has cheapened certain parts of the yield curve. We find the front end and belly of the curve look most attractive as Fed easing expectations have been pushed back, which aligns with our longer-term expectation that the curve will bull-steepen as these expectations start to move toward rate cuts.

The current investment environment should reward a balanced approach. Our preferred strategy is to preserve diligent underwriting standards, prioritize carry and maintain diversification across sectors and issuers.

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

Macroeconomic Update

Despite Q1 Setback, Lower Inflation and Fed Cuts Still Coming

The Fed's higher-for-longer approach should pay off, opening the door to cuts later this year.

Data on U.S. economic activity was surprisingly strong this year, continuing the trend of upside surprises seen in 2023. While first quarter real gross domestic product (GDP) growth was under 2 percent annualized, underlying domestic demand (consumption and fixed investment) rose at a 3.1 percent annualized pace, similar to the prior two quarters. Job growth also continued to beat expectations, rising at an average monthly pace of 246,000 this year, versus consensus expectations of sub-100,000 when the year started. With the peak impact of Fed tightening likely behind us, the economy should continue to expand but at a more moderate rate, gradually settling toward to a 1.5–2 percent pace in 2025.

One risk to continued economic growth is a new round of Fed hawkishness, should continued progress on inflation prove elusive. The core Personal Consumption Expenditures Price Index rose at a 3.7 percent annualized pace in the first quarter, a sharp acceleration following two quarters of inflation right on top of the 2 percent target. Despite this inflation setback, our read of the totality of the data continues to suggest inflation should soon settle back down. Indicators of labor market tightness show a better supply-demand balance, with wage growth cooling, labor churn falling, and immigration-led labor force growth helping to meet labor demand. Additionally, while market measures of inflation expectations have crept back up, most surveys of consumers and businesses show expectations are still trending down, matching pricing and wage setting plans in business surveys. Although bottom-up inflation analysis has been difficult in recent months, as some categories continue to "echo" pandemic price increases, we expect housing inflation and other categories that drove first quarter inflation to moderate in coming quarters, including a big gain in imputed financial services prices.

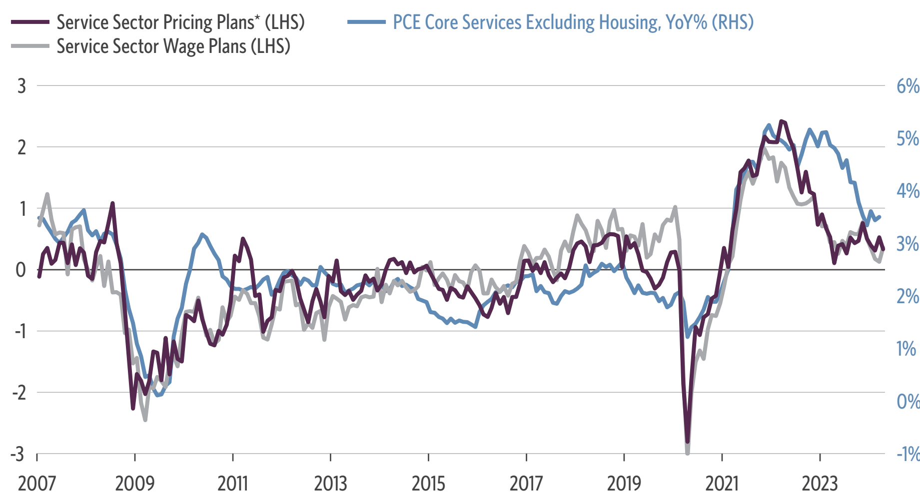
For now, the Fed has suggested that it will address any ongoing inflationary pressures by leaving policy at current rates for longer than initially projected, rather than by increasing policy rates further. The Fed has also embraced the view that the supply side of the economy is seeing strong growth, aided by immigration and productivity. This belief has led to a shift where robust economic activity is not seen as overly problematic.

With this backdrop, our base case is for Fed patience to pay off, with inflation slowing over the next several months to a sub-2.5 percent annualized monthly pace by the fourth quarter. That should open the door for the Fed to start cutting rates later this year, offsetting the growing strains from high rates and supporting the expansion.

By Matt Bush and Maria Giraldo

Despite higher than expected inflation in the first quarter, the data continues to suggest inflation should soon settle back down. Indicators of labor market tightness show a better supply-demand balance, with wage growth cooling, labor churn falling, and immigration-led labor force growth helping to meet labor demand.

Service Firms' Price and Wage Plans Point to Cooler Inflation



Source: Guggenheim Investments, Haver Analytics. Data as of 4.30.2024. *Pricing and wage plans represent average z-score since 2007 from the NFIB Small Business Survey and Dallas, Kansas City, New York, and Richmond Fed service sector surveys.

Opportunities as the Fed Stays Put

A resilient economy has led to significant market repricing in rates.

With continued strength in employment data and with inflation data surprising to the upside for three consecutive months, the market is reassessing the Fed's expected 2024 easing campaign. Even with the lower than anticipated increase in April employment, Federal Open Market Committee participants have indicated a longer timeline to rate cuts. In turn, Treasury yields have moved higher. This has not changed our call for the next cyclical move in the Treasury yield curve to be a bull steepening, nor where we continue to find value in the market.

Sector Commentary

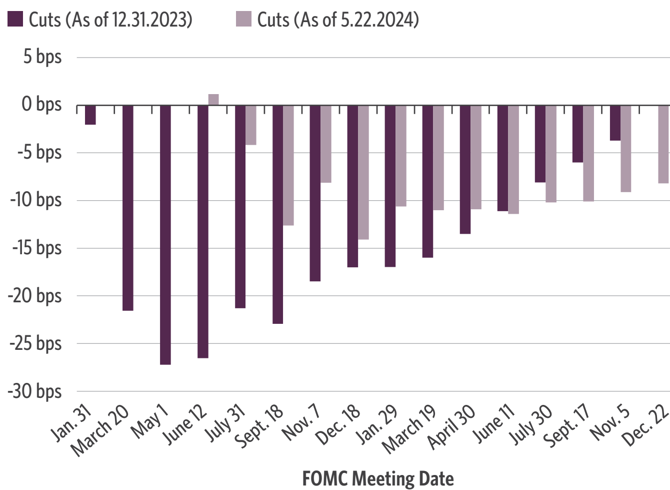
- Solid economic data and continued strength in realized inflation readings in the first quarter led the market to significantly reprice the number of Fed rate cuts expected this year, down from six 25 basis point cuts at the beginning of the year to just two cuts as of May.
- As the balance of economic data has proven more resilient than Fed officials expected, Fed messaging has shifted toward a higher-for-longer theme on rates.
- As the higher for longer rate messaging and market pricing has taken hold, real yields have increased on inflation-linked bonds.

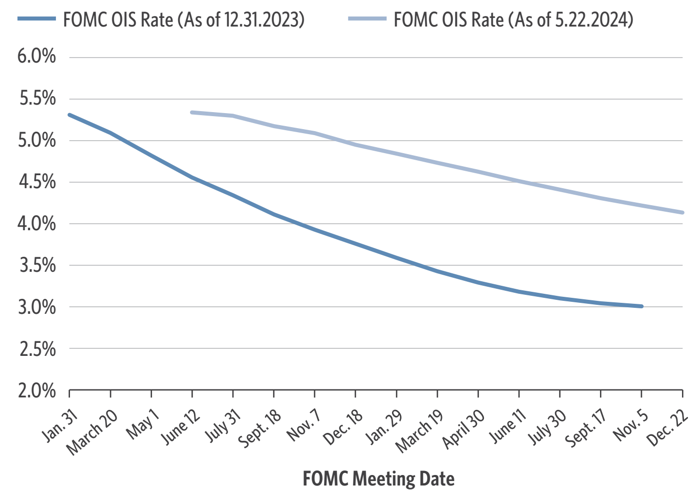
Investment Themes

- We expect yields to remain in a tighter range than 2023 and favor tactically adjusting duration based on where we are in the range.
- The front end of the Treasury curve looks attractive both on a real and nominal yield basis as Fed easing expectations have been scaled back.
- In an environment where inflation remains sticky and front-end nominal Treasury yields have risen close to 5 percent, we favor front-end Treasury Inflation-Protected Securities.
- With the increase in Treasury yields and nominal spreads remaining wide, longer-maturity callable Agency bonds look compelling for yield-oriented accounts.
- We continue to expect that the next large cyclical move in the Treasury market will be a bull steepening of the yield curve where front-end yields will decline more than longer-term yields.

By Kris Dorr and Tad Nygren

Dwindling Expectations of Rate Cuts Drove the Front End of the Yield Curve to Attractive Levels





Source: Guggenheim Investments, Bloomberg. Data as of 5.22.2024.

Investment-Grade Corporate Bonds

Take Advantage of Market Strength

Broad investor demand for investment-grade bonds presents an opportunity to trade up in quality.

The delicate balance between all-in yield buyers and spread sellers remains intact in the investment-grade corporate bond sector. We expect primary issuance to reduce materially over the remainder of the year, resulting in negative net issuance given an increase in bond maturities and coupon income likely redeployed into investment-grade credit. Overall, we see investment-grade corporate bond cash spreads rangebound for most of the second quarter, buoyed by strong technicals and attractive yields.

Sector Commentary

- Despite a record breaking first quarter for primary issuance of $566 billion, a 32 percent increase year over year, the Bloomberg U.S. Investment-Grade Corporate Bond Index tightened by 12 basis points in the first quarter.
- The sector experienced 25 consecutive weeks of investment-grade bond fund inflows, which helped support spreads.
- Index option-adjusted spreads (OAS) as percentage of yield sits at 16 percent vs. 20-year average of 37.5 percent. Only 2006 was lower, at 14 percent.
- Over the same timeframe, the index yield of 5.50 percent is in the 70th percentile, while long duration corporate yields are in the 90th percentile.

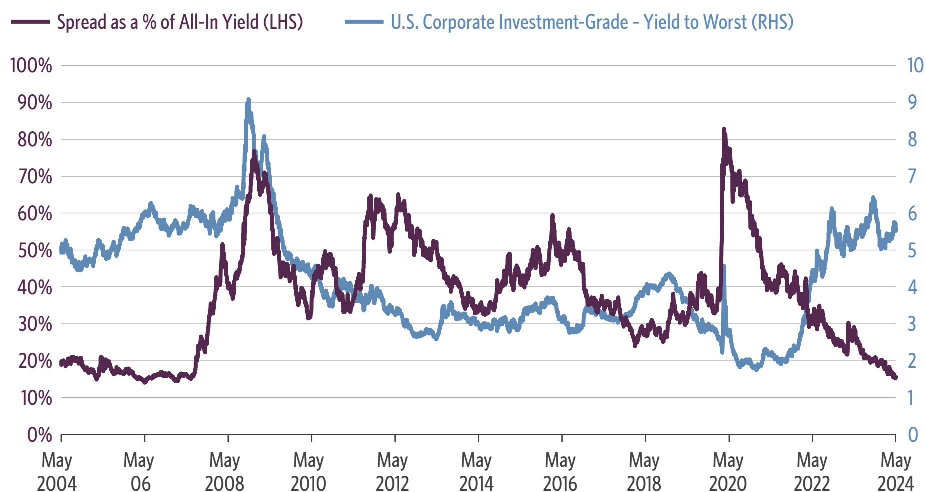
Investment Themes

- Looking forward, we favor banks over industrials. Banks, especially large money center banks, still look attractive despite a potentially higher for longer rate environment.
- Preferred securities still offer good relative value in short callable or higher current coupon vintages with a strong technical of negative net supply.
- The cheapness of BBB-rated bonds relative to A-rated bonds remains attractive and will likely compress further, albeit at a slower pace than the first quarter.
- We believe the second quarter presents an ideal time to move up in quality while reducing exposure to lower quality, cyclical bonds.

By Justin Takata

The Bloomberg U.S. Investment-Grade Corporate Bond Index tightened by 12 basis points in the first quarter.

Yields Are Attractive, but Spreads Are Tight



Source: Guggenheim Investments, Bloomberg. Data as of 4.30.2024. Past performance does not guarantee future results.

High Yield Corporate Bonds

Limited Net Supply Despite a Surge in Issuance

Now may be an ideal time to move up in quality while reducing exposure to lower quality, cyclical bonds.

The high yield market has seen a meaningful increase in gross supply, but net supply remains limited as the majority of issuance has been refinancing activity. Tight spreads have been supported by favorable technical dynamics and strong fundamentals, including low default rates and healthy issuer fundamentals. However, we expect more challenging dynamics in capital intensive sectors like communications, highlighting the need for selectivity. Our strategy emphasizes quality, while reducing some exposure to cyclical sectors.

Sector Commentary

- We continue to see a high share of secured issuance in the market, representing 41 percent of volume this year, partially driven by issuers refinancing loans in the bond market.
- Credit spreads have averaged 318 basis points in 2024 and ended April at just 299 basis points. Spreads are in the 10th percentile of historical valuations dating back to 1994, but they are supported by favorable technical and fundamental dynamics.
- The par-weighted default rate in the high yield index is 2.4 percent, which is below the historical average of 4.0 percent. Fundamentals have been supportive of low default activity as many borrowers carry largely fixed-rate debt, which has allowed interest coverage to stay at healthier levels than in recent history.
- Yields continue to present attractive value, particularly in BB-rated and B-rated bonds.

Investment Themes

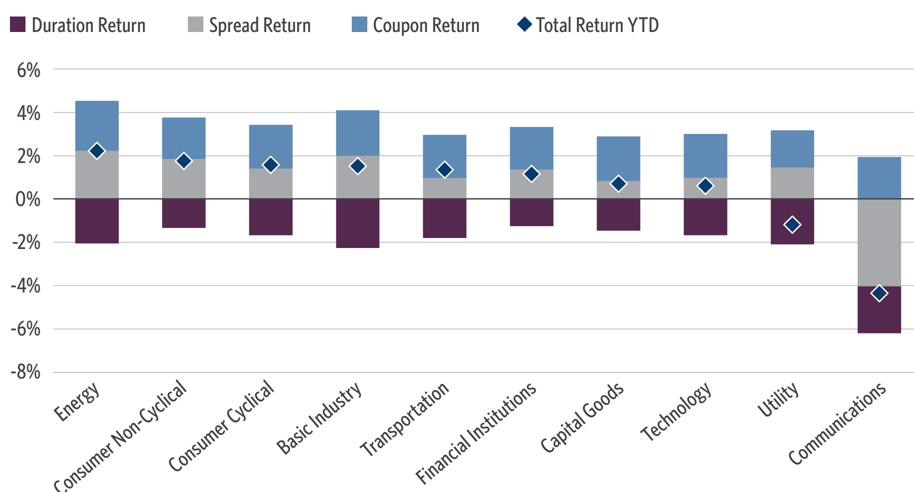
- High yield returns were positive through April 30, but interest rate volatility returned as Treasury yields backed up, detracting from performance. CCCs outperformed BB-rated and B-rated bonds due to their limited volatility, but we expect higher quality to outperform once the Fed's easing cycle is more clearly in sight.
- Returns were positive across most industries, but idiosyncratic risks weighed on some sectors. In communications, competition, high capital expenditure requirements, and weakness in some of the largest companies' capital structures, caused the sector to return -4.2 percent year to date. The top two performing industries were energy and consumer non-cyclical.
- Current yield to worst across sectors continues to look attractive, except for communications. We believe now presents an ideal opportunity to move up in quality while reducing exposure to lower quality, cyclical bonds.

By Thomas Hauser and Maria Giraldo

Credit spreads have averaged 318 basis points in 2024 and ended April at just 299 basis points. Spreads are in the 10th percentile of historical valuations dating back to 1994, but they are supported by favorable technical and fundamental dynamics.

Carry and Spread Tightening Supported Positive Returns

YTD Returns through April 30, by Industry



Source: Guggenheim, Bloomberg. Data as of 4.30.2024. Attribution returns are estimates and omit other sources of return including roll down and index constituent changes. Past performance does not guarantee future results.

Bank Loans

Coupons and Price Recovery Driving Strong Returns

Coupons remain attractive, but careful credit picking needed in higher-for-longer environment.

Institutional loan activity has significantly outpaced last year's volume, while secondary market returns were bolstered by high coupons and limited sensitivity to interest rate volatility. Meanwhile, repricing transactions have increased, allowing many borrowers to reduce interest costs by lowering the contractual spread by an average 50 basis points. Despite a minor increase in default rates, the loan market is supported by robust demand, stabilizing prices. We are mindful of the effect of high short-term interest rates, but continue to find favorable opportunities.

Sector Commentary

- Capital market activity accelerated in the first four months of 2024, bringing $185 billion of institutional loan gross supply ($81 billion excluding refinancing activity). Total volume is running 142 percent above last year's pace.
- Leveraged loans benefited from high coupons and insulation from interest rate volatility, with the Credit Suisse Leveraged Loan Index returning 2.8 percent year to date as of April 30. Loans continue to outpace high yield, driven by a high base rate and lack of duration as the market increasingly pushes out rate-cut expectations.
- Lower ratings categories continue to outperform given their higher coupons and lower prices, leaving more room for price appreciation. CCCs returned 5.9 percent year to date through April, followed by 2.8 percent for Bs and 2.2 percent for BBs.
- Loan default rates rose to 2.4 percent from 1.9 percent at the end of 2023, but still below the historical default rate of 2.8 percent.

Investment Themes

- The supply/demand technical backdrop continues to support loan secondary prices, as CLO issuance combined with retail flows outpaced new issuance for the fifth consecutive quarter.
- With 37 percent of loans trading above par, we expect more refinancing transactions and continued elevated repricing activity. This should support spreads as demand remains strong against limited net supply.
- Coupon rates are over 9 percent and are expected to remain elevated as long as the anticipated Fed easing cycle gets delayed.
- We remain cautious of where we are in the cycle, especially as defaults continue to pick up (albeit off of a low base), and issuer borrowing costs remain elevated.
- We view the new issue discount as compelling, and we continue to look to opportunistically exit or reduce positions that we believe have traded tight relative to their fair value.

By Christopher Keywork and Maria Giraldo

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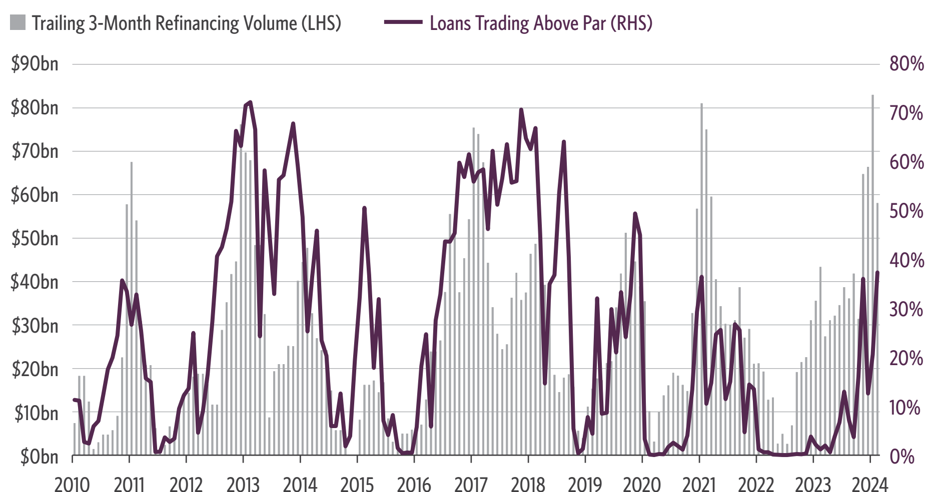
Refinancing Activity Will Continue as More Loans Trade Above Par



Source: Guggenheim Investments, Credit Suisse, S&P LCD. Data as of 4.30.2024.

Municipal Bonds

So Far, So Good, But Watch for Cracks

An imbalance in supply and demand helped munis rally.

Market conditions remain firm for both tax-exempt and taxable municipal bonds. Strong retail demand continues to support tight tax-exempt valuations, while taxables have rallied in line with other risk assets. There have been no major developments on the credit front, although we are monitoring potential revenue/expense mismatches that foreshadow structural deficits.

Sector Commentary

- Tax exempts have held up well so far in 2024, despite a 42 percent increase in new issuance and 50–60 basis point rise in long Treasurys. Tax exempt/Treasury yield ratios are essentially unchanged through April, with 5/10/30-year durations hovering around 61 percent, 60 percent, and 83 percent respectively.
- Typical seasonal volatility in March and April occurred as supply surged, while the ebb in principal and interest payments was subdued by persistent demand from separately managed accounts (SMA) and net inflows into mutual funds.
- Taxable spreads experienced some turbulence, with spreads on Build America Bonds (BAB) widening when a few large issuers exercised their Extraordinary Redemption Provision (ERP) calls.
- Taxables have mostly tightened on the year, as risk assets rallied and a 32 percent decline in issuance caused an imbalance in supply and demand.

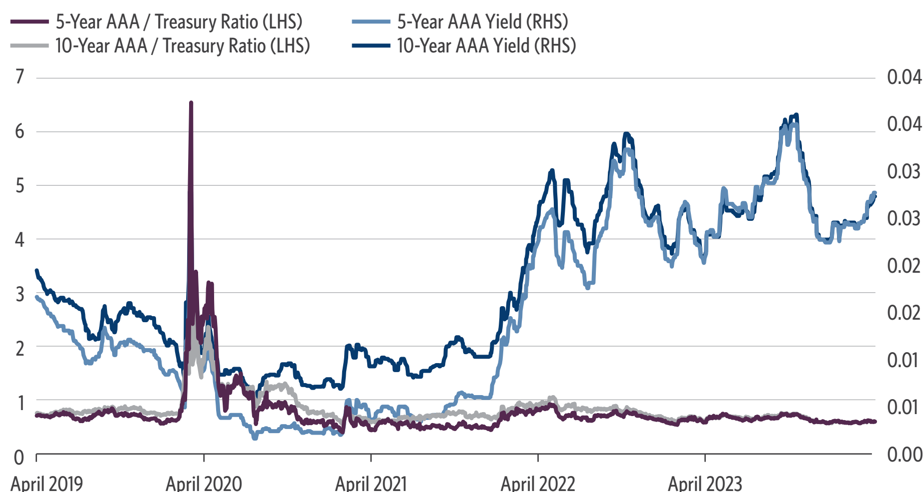
Investment Themes

- At current ratios and spreads, we prefer taxables over tax exempts. We believe market participants have looked past November and projected federal deficits—and consequently tax rates—to persist regardless of the electoral outcome, and have decided to lock in tax exempt yields. This implicit bet on the tax code likely keeps tax exempt ratios compressed in the near term.
- Improvements to credit fundamentals have slowed, with most states reporting stagnant tax receipts. We are monitoring situations with declining revenues and rising expenses, which foreshadow structural budgetary deficits.
- Labor tends to be the largest expense for municipal obligors, and four states have set minimum salaries for K-12 teachers, with five more in the planning stage. To maintain fiscal prudence, new spend minimums should be offset by sustainable new sources of revenue or reductions in other expenditures.

By Allen Li and Michael Park

Tax exempts have held up well so far in 2024, despite a 42 percent increase in new issuance and 50–60 basis point rise in long Treasurys.

Tax Exempt Munis Have Held Up Well So Far in 2024



Source: Guggenheim Investments, Municipal Market Monitor. Data as of 4.19.2024. Past performance does not guarantee future results.

Asset-Backed Securities and CLOs

Strong Issuance Meets Investor Demand

Opportunities in higher quality commercial ABS and CLOs.

Commercial ABS continues to offer an opportunity to capture excess yield relative to investment-grade corporate bonds. We expect issuance to outpace 2023 levels, driven by capital investment and growth in sectors led by digital infrastructure. We favor both private credit and broadly syndicated loan (BSL) CLOs for offering attractive yields and prefer to stay senior in the capital structure. Issuance has been strong, driven by both investor demand and technical factors such as captive manager equity funds.

Sector Commentary

- **ABS:** The ICE/BofA Commercial ABS Index yielded 6.4 percent as of quarter end, while senior commercial ABS with more defensive underlying collateral has recently traded between 5.6–6.1 percent. The credit spread difference between ratings-matched ABS and corporate bonds currently ranks above the 70th percentile, suggesting a historically attractive entry point for ABS. New issuance has been biased towards high growth sectors, such as data centers and fiber networks.
- **CLOs:** Near-record post-GFC issuance in the first quarter was met with strong demand, leading to spread tightening across the capital stack. Manager trading activity and strong underlying company performance have led to CCC balances in CLOs decreasing from 7.0 percent as of year-end 2023 to 6.8 percent by the end of April. We continue to see managers raising captive CLO equity funds to purchase the equity tranche in their deals, and we expect this dynamic to support issuance going forward.

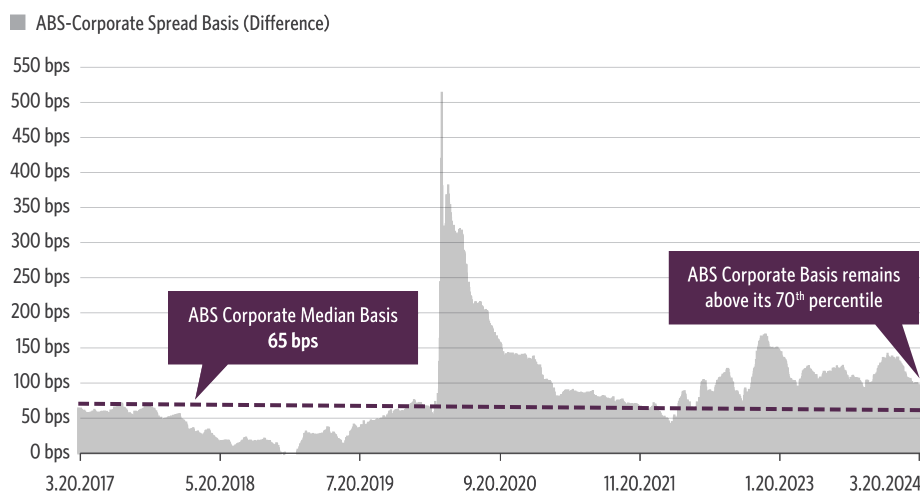
Investment Themes

- **ABS:** We favor senior exposures in higher quality commercial collateral such as franchise royalties, fiber networks, data centers, containers, and triple net lease real estate. Relative value opportunities have emerged in consumer ABS, which look favorable compared to similarly rated corporate credit.
- **CLOs:** We prefer to stay senior in the capital structure given attractive yields and relatively low levels of credit risk. There has been increasing interest in private credit CLOs, which accounted for approximately 20 percent of overall CLO issuance in the first quarter. We find value in both private credit as well as BSL CLOs. However, the spread pickup that private credit CLOs offer at the AAA level has compressed from more than 50 basis points to start the year to approximately 30 basis points currently, shifting relative value in favor of BSL CLOs.

By Michael Liu, Scott Kanouse, and Pooja Shendure

We favor senior exposures in higher quality commercial collateral such as franchise royalties, fiber networks, data centers, containers, and triple net lease real estate. Relative value opportunities have emerged in consumer ABS, which look favorable compared to similarly rated corporate credit.

The Difference in Commercial ABS Spreads vs. Similarly Rated Corporates Remains Attractive



Source: Guggenheim Investments, Bloomberg. Data as of 3.31.2024. Indexes referenced include ICE BofA AA-BBB ABS Index and Bloomberg Corporate Investment-Grade Index. Past performance does not guarantee future results.

Low Transaction Volume Should Benefit RMBS

Fundamental and technical tailwinds support mortgage credit performance.

We remain constructive on the non-Agency RMBS sector due to the combination of positive credit fundamentals and tailwinds from low transaction volume, which should benefit RMBS valuations. Accumulated home price appreciation, tight lending standards, and sound consumer credit profiles provide favorable conditions for mortgage credit performance. New issue volume is expected to be limited due to low home sales activity and the lock-in effect of outstanding low interest rate mortgages.

Sector Commentary

- The housing market is benefiting from low supply and healthy demand as the most recent Case-Shiller Index reading showed 6.0 percent year-over-year growth. Combined with a strong labor market, these conditions provide the foundation for stable mortgage credit performance.
- New issue volume is 50 percent higher year over year compared to the same period in 2023, and total annual volume for 2024 is forecast to be 20–25 percent higher than 2023 totals. Nevertheless, other than 2023, the estimated issuance volume for 2024 would be the lowest level since 2017.
- Despite positive net issuance due to the limited runoff of outstanding securities, strong demand is expected to limit any significant spread widening in the near term.
- Further spread changes are expected to follow the movement in the larger Agency market.

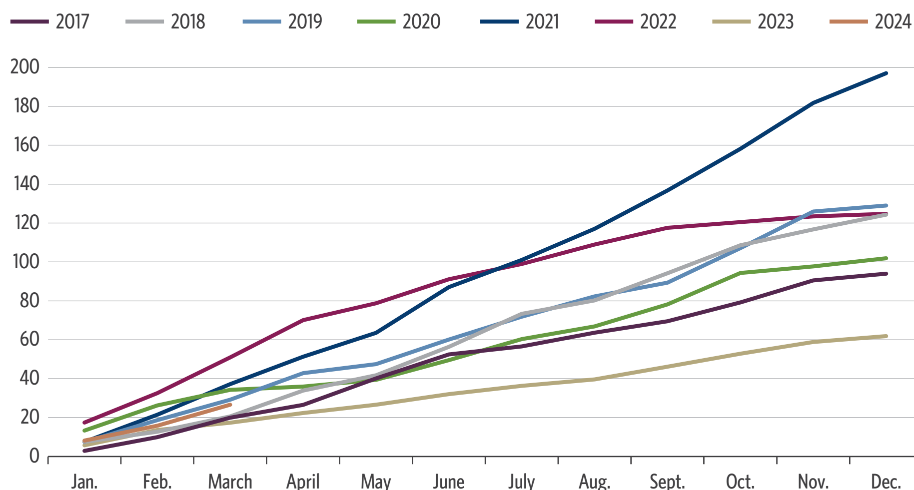
Investment Themes

- We continue to favor investment-grade securities from non-qualified mortgage (non-QM) transactions, as well as senior securities from pre-GFC RMBS 1.0 transactions, which are backed by seasoned loans with built up home equity.
- Non-QM AAA to single-A rated bonds offer attractive yields and have the structural protections to mitigate extension risk and withstand deteriorating credit performance similar to that experienced in severe recessions. Additionally, low spread duration can limit price declines in a spread widening scenario.
- RMBS 1.0 spreads remain wide relative to BBB corporate bonds. The loan pools that back these deals are expected to exhibit stable credit performance due to the loans' low loan to values and seasoning. Also, due to their low discount, dollar prices, there is upside potential should prepays pick up in a rate rally, resulting in earlier than expected principal distributions.

By Karthik Narayanan and Roy Park

New issue volume is 50 percent higher year over year compared to the same period in 2023, and total annual volume for 2024 is forecast to be 20–25 percent higher than 2023 totals. Nevertheless, other than 2023, the estimated issuance volume for 2024 would be the lowest level since 2017.

2024 Non-Agency RMBS Issuance Should Exceed 2023, the Lowest Since 2017



Source: Guggenheim Investments, Bank of America Global Research, Intex, Bloomberg. Data as of 3.31.2024.

Commercial Mortgage-Backed Securities

Opportunities in Higher Quality Bonds

Select higher quality CRE CLOs and SASB bonds continue to offer attractive risk-adjusted returns.

CMBS moved in step with broader fixed-income markets. Institutional investors accounted for over 40 percent of CMBS buying in recent years, and renewed demand from this investor base has been substantial. Insurance demand also increased, and other players, including dealers and hedge funds, have supported primary and secondary markets. Behind this technical rally, however, fundamental challenges remain. We remain cautious in the CMBS sector, finding select opportunities but generally preferring risk-adjusted returns in other sectors.

Sector Commentary

- Commercial real estate (CRE) fundamental data broadly continue to deteriorate. A BofA study of 2023 conduit CMBS data found that only 65 percent of loans with balances over $100 million successfully refinanced on time.
- Commercial real estate transaction volumes remain depressed (down roughly 50 percent year over year), and many pressures persist, including the structural reduction in office demand.
- Some $19 billion in CMBS was issued in the first quarter, compared to $7 billion over the same period in 2023, driven by higher investor demand for the product.
- Given still-elevated interest rates and tightening lender credit standards, issuance has been mostly limited to higher quality single asset/single borrower (SASB) deals financing high quality industrial portfolios, and other performing retail and hotel properties. SASB represents 63 percent of issuance.

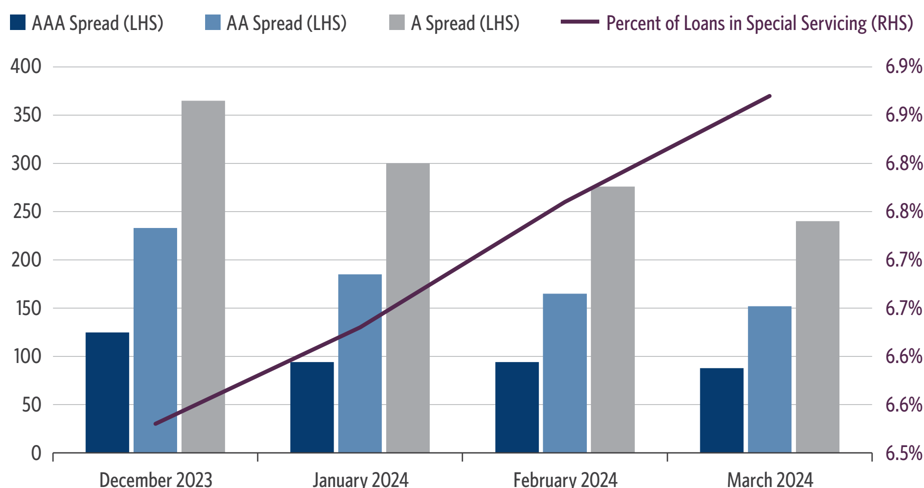
Investment Themes

- We favor select senior securities with higher credit enhancement, capable sponsorship, and limited office exposure. Select AAA, AA, and A-rated CRE CLOs and SASB bonds continue to offer attractive risk-adjusted returns.
- Conversely, we find that most mezzanine and junior bonds across CMBS subsectors fail to appropriately compensate investors at current levels.

By Tom Nash and Hongli Yang

The combination of structural protections and improving market refinancing conditions support investment in credit-enhanced, investment-grade CMBS bonds, but a Bank of America study of 2023 conduit CMBS data found that only 65 percent of loans with balances over $100 million successfully refinanced on time.

CMBS Credit Spreads Have Improved, but Select Credit Indicators Are Showing Increasing Rates of Stress



Source: Guggenheim Investments, Bloomberg. Data as of 3.31.2024. Past performance does not guarantee future results.

Agency Mortgage-Backed Securities

Keep Calm and Carry On

Agency MBS investors are playing the waiting game until the Fed starts cutting rates.

Agency MBS was the only sector of the Bloomberg U.S. Aggregate Index to post negative excess returns over the first quarter as strong economic data and three consecutive months of high inflation readings pushed out the timeline for Fed rate cuts and tighter Agency mortgage spreads. However, barring a Fed pivot away from eventual rate cuts, the medium to long-term bull case for Agency MBS remains and we have increased our exposure.

Sector Commentary

- Future performance of Agency MBS remains tied to the path of Fed rates. With the Fed doing its best to anchor the front end of the Treasury curve by projecting future rate cuts, the main tail risk remains the reacceleration of inflation, causing longer dated Treasurys to test local highs and the Fed to consider hiking rather than cutting rates.
- Despite poor performance in the first quarter, mortgage spreads have been rangebound. Yields remain at post-GFC highs due to reduced supply.
- The most negatively convex portions of the Agency MBS market have outperformed on a relative basis. We expect this outperformance to accelerate when rate cuts commence and the option cost embedded in mortgage bonds subsides.

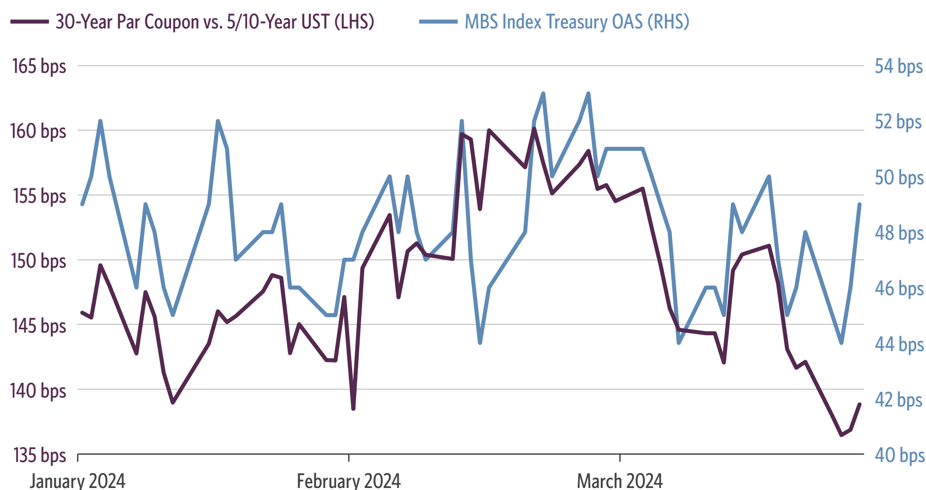
Investment Themes

- Extending the start of Fed rate cuts has favored carry trades as spreads remain rangebound. Notably, production coupons—high coupon bonds priced near par—have outperformed lower dollar price bonds that comprise the bulk of the Agency MBS Index.
- We expect Agency MBS Index performance to be subject to the whim of rates via passive investor flows, with further selloffs met by outflows and rallies met with inflows. We prefer to avoid this game of chance by positioning in 30-year production coupons that offer higher yields than the index and compensate investors while the Fed remains on hold.
- Agency CMBS spread performance has been notably strong due to reduced supply and an investor base that is more yield focused than its single-family cohort. As a result, we continue to prefer structured cashflows in the single-family space over multifamily for any longer duration needs.

By Louis Pacilio

Despite poor performance in the first quarter, mortgage spreads have been rangebound. Yields remain at post-GFC highs due to reduced supply.

Despite Poor Q1 Performance, Agency MBS Spreads Remain Rangebound



Source: Guggenheim Investments, Bloomberg. Data as of 3.31.2024. Past performance does not guarantee future results.

Commercial Real Estate

Construction Costs Weigh on New Development

The lack of new supply in the face of demand for modern assets is supporting values.

Commercial real estate learned an important lesson from the GFC: be wary of overbuilding. Now, with vacancies for asset classes other than office real estate near historical lows, the industry faces a different problem: how to deliver in-demand assets at a cost investors will pay for them.

Sector Commentary

- Although the supply chain issues have moderated, construction costs have continued to escalate, led by labor costs fueled by a shortage of trained construction workers. Demand for electrical and other products that support tech-heavy buildouts continues to outpace supply, challenging delivery schedules.
- Declining private sector construction comes at a time when some sectors are facing tight historical fundamentals. Demand remains high, with limited availability of well-located, modern buildings.
- The retail sector has an average vacancy rate of just 4.1 percent, and continues to see steady rent growth. New supply has been limited for more than a decade, with new deliveries in the past year more than 40 percent below the prior 10-year average.
- Despite average property prices falling almost 5 percent year over year, the industrial/logistics sector continued to see positive rent growth.

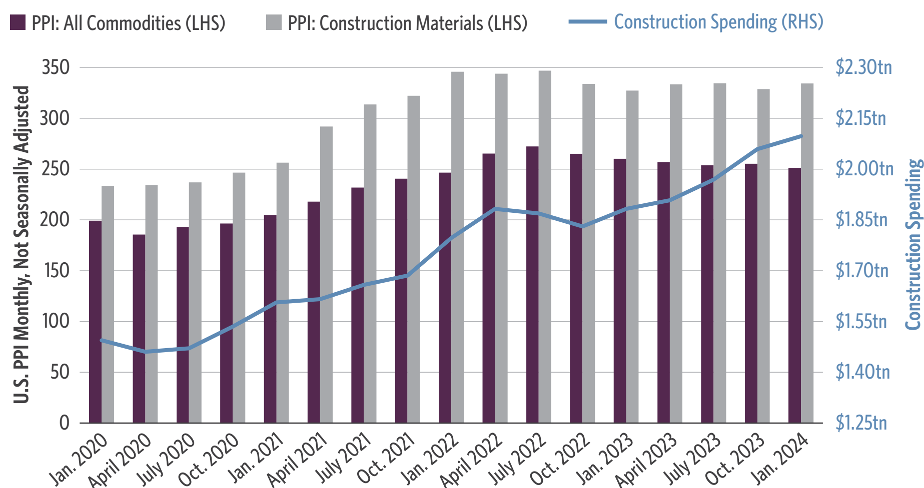
Investment Themes

- The replacement cost to build new properties will serve as a tailwind to the values of existing assets, especially the most modern property types in strong locations that have been constructed in the last five years. With the cost to construct the same product as much as 25 percent higher today, we expect investors will seek opportunities to acquire existing hard assets.
- Companies pursuing on-shoring and re-shoring strategies to alleviate geopolitical risks and supply chain disruptions are also expected to bolster demand for hard assets as they evaluate the cost of constructing new facilities and the potential time delays to source required materials.
- An eventual moderation of interest rates will not be enough by itself to incentivize developers to materially ramp up new construction in the face of such persistent escalation of costs, increasing demand for existing modern commercial real estate.

By Jennifer A. Marler and Farris Hughes

With the cost to construct the same product as much as 25 percent higher today, we expect investors will seek opportunities to acquire existing hard assets.

Construction Costs Continue to Climb Across the Board



Source: Guggenheim Investments, U.S. Census Bureau, U.S. Bureau of Labor Statistics. Data as of 4.30.2024.

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One **basis point** is equal to 0.01 percent. Likewise, 100 basis points equals 1 percent. **Beta** is a statistical measure of volatility relative to the overall market. A positive beta indicates movement in the same direction as the market, while a negative beta indicates movement inverse to the market. Beta for the market is generally considered to be 1. A beta above 1 and below -1 indicates more volatility than the market. A beta between 1 to -1 indicates less volatility than the market. **Carry** is the difference between the cost of financing an asset and the interest received on that asset. **Dry powder** refers to highly liquid assets, such as cash or money market instruments, that can be invested when more attractive investment opportunities arise.

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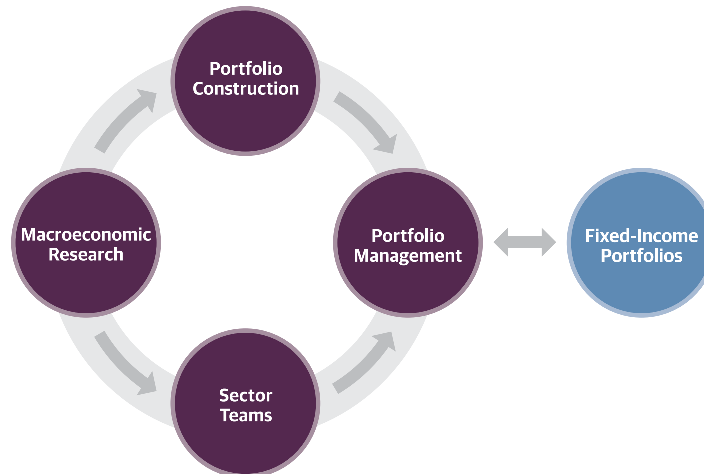

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