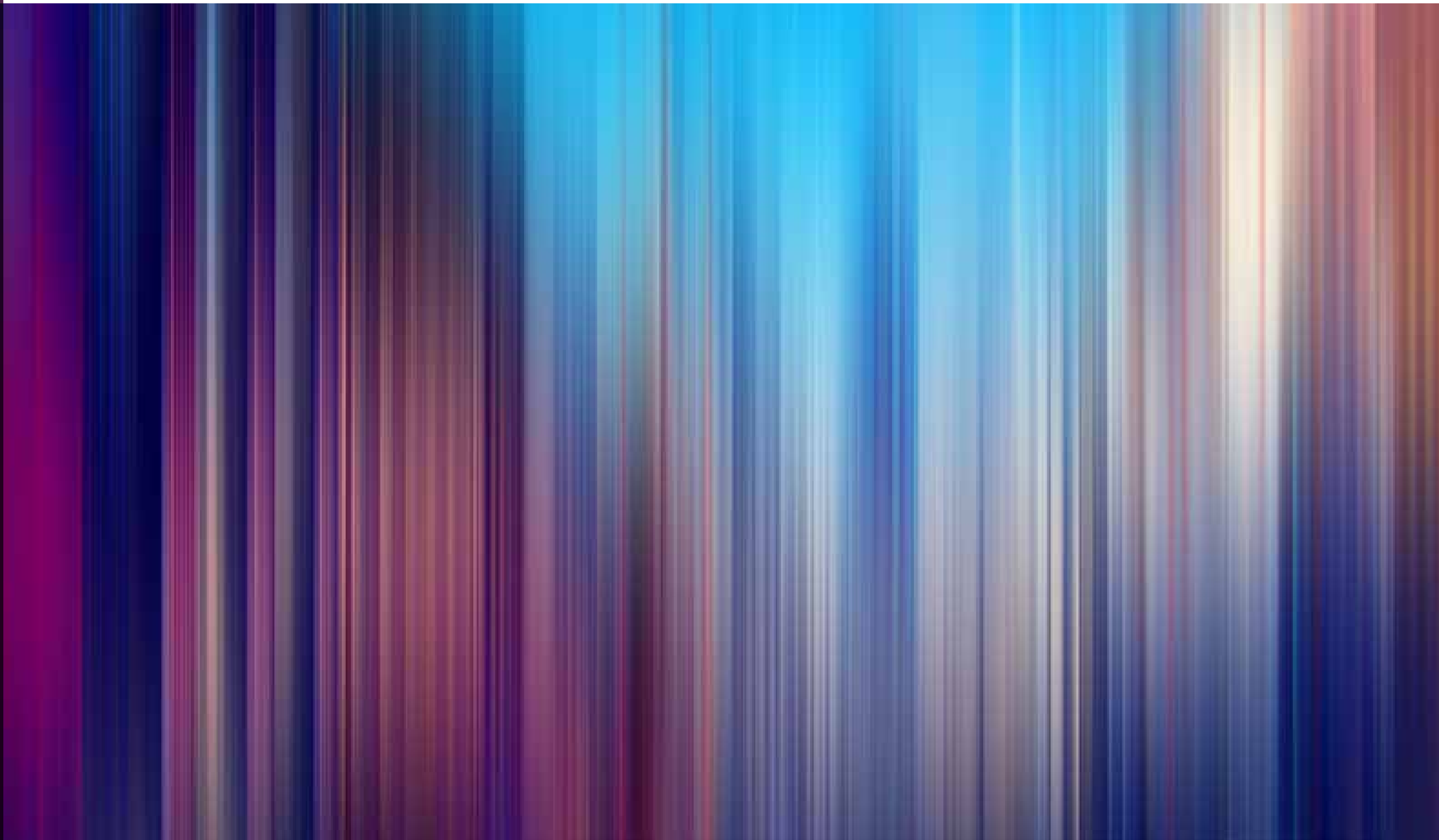
GUGGENHEIM

Fourth Quarter 2023

Fixed-Income Sector Views



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Portfolio Management Outlook

Consistent Strategy Through Volatile Times

Staying defensive and getting paid to do so.

As we near the end of 2023, it is safe to conclude that we have come through a period of unprecedented volatility that has left a wide range of possible outcomes going forward. We are coming off multiple years of poor returns across fixed income, particularly for longer duration, high-quality investments. But the past looks a lot worse than the future, and the worst drawdown for an asset class can prove to be a very attractive entry point for prudent investors as the end of the Federal Reserve's (Fed) aggressive rate hiking cycle will provide respite. The next major policy moves are likely to provide strong tailwinds for fixed income.

We continue to expect elevated volatility in the economy and markets, as well as a policy response to these conditions. This argues for the importance of diversification in asset allocation and within portfolios. The U.S. consumer has remained resilient, driving better-than-expected economic growth, but the risk of recession in coming quarters remains higher than normal. Tailwinds that have supported consumption and growth, such as the positive impact of sizeable fiscal spending and the benefits of rapid disinflation, will start to be overtaken by headwinds, such as the lagged impact of monetary policy, tighter financial conditions, reduced bank lending, and rising geopolitical risk. We will be watching for the credit impact of nominal and real interest rates at 15-year highs, trends in the shrinking Fed balance sheet, and the evidence that will drive the data-dependency of the Fed's monetary policy decision-making framework.

Our sector teams have identified positive technical trends that helped to support spreads, but we remain vigilant for signs of credit deterioration as the economy slows and the bite of higher rates starts to be felt by issuers. At a high level, this background leads us to prepare ourselves for a wide range of scenarios, including a soft landing or severe economic stress—and everything in between. Our portfolio strategy has remained consistent throughout the year. This means continuing to upgrade the credit profile of our portfolios and to seek strong income generation and the potential for capital appreciation. We have grown our exposure in high quality sectors, particularly in Agency RMBS and in structured credit investments such as non-Agency RMBS, senior tranches of CLOs, and commercial ABS. While spreads in these sectors have remained disproportionately wide, pricing in investment-grade corporate credit risk is closer to fair value and we have reduced our exposure.

Whether we are in for a soft landing or an outright recession, the yield curve will likely steepen. Given our outlook for a recession in the first half of 2024, our bias is towards a bull steepening. In terms of market opportunities, longer duration exposure is expressed via Agency RMBS due to credit quality, wider spreads, and better convexity profile.

In sum, we are building high quality, defensive portfolios positioned for attractive income and low likelihood of credit impairment. At the same time, we are reserving dry powder so that we can take on more credit beta if the environment or the pricing justifies it.

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

Macroeconomic Update

The Economy Is Not Immune to the Effect of Tight Monetary Policy

Recency bias hits the market's economic outlook.

Faced with a series of strong economic data releases, the market has increasingly come to the conclusion that the economy is structurally better able to withstand higher interest rates. This dynamic can be seen by decomposing the move in Treasury yields, with the selloff almost entirely due to real yields rather than inflation expectations, and most pronounced at the back end of the yield curve. Digging further, we can see that a large portion of this shift is due to a rising term premium, indicating greater uncertainty about the outlook. We agree with the view that the neutral rate for the economy has moved higher, but we think the magnitude of the move in the market is overdone. It is a mistake to think strong economic data will continue and that the impact from monetary tightening is behind us.

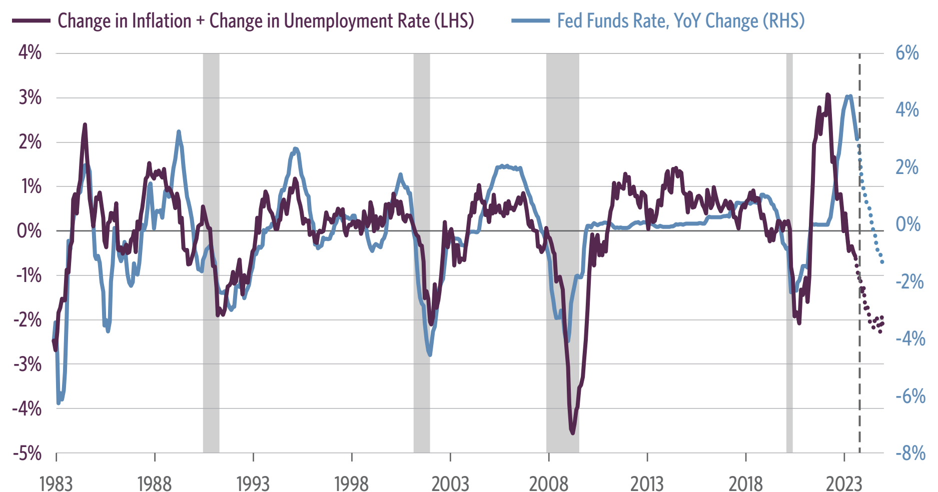
Many forecasters are extrapolating this year's economic strength without recognizing growth has benefited from a number of factors this year that are unlikely to be repeated, namely a huge expansion of the fiscal deficit, a major slowdown in inflation, and a rebound in labor supply. As these factors fade, the headwinds from tight monetary policy will be more apparent—headwinds that will only grow in strength. And the longer monetary conditions stay tight, the greater the risk of something breaking (regional banks and commercial office real estate remain key risks). All this means that the recent economic trajectory cannot be assumed to continue, especially given the substantial restraint that will be imposed by the recent rise in long-term borrowing costs.

Uncertainty is elevated, and rightfully so given the diverging signals in the data and many traditional economic models not "working" as they should. This uncertainty extends to the Fed, which looks set to hold off on further rate hikes while waiting to see if the data start to align better with the softening conditions reflected in their Beige Book reporting. We continue to think the gravitational pull of tight money and credit conditions will slow the economy and cool inflation over the next year, paving the way for more rate cuts than the market expects.

By Matt Bush and Maria Giraldo

The gravitational pull of tight money and credit conditions will slow the economy and cool inflation over the next year, paving the way for more rate cuts than the market expects.

Weaker 2024 Economy Should Pave the Way for Rate Cuts



Source: Guggenheim Investments, Haver Analytics. Actual data as of 9.30.2023. Change in inflation measured as six-month change in YoY% core PCE price index, change in unemployment rate measured as YoY change. Shaded areas represent recession.

Rates

More Volatility Ahead

Fed interest rate policy will likely cause the yield curve to steepen further.

The third quarter ushered in significant Treasury market repricing and volatility brought on by changes in projected Fed policy for the remainder of this year and into next. While the projected terminal rate remained unchanged at the Fed's last Summary of Economic Projections, the Fed is increasingly uncertain as to the need for any future rate hikes. The Fed will likely continue to rely on forward guidance to attempt the delicate dance of bringing inflation back to target, keeping long run inflation expectations anchored, while trying to engineer a soft landing. This balancing act will likely mean more talk and less action, depending on data and markets.

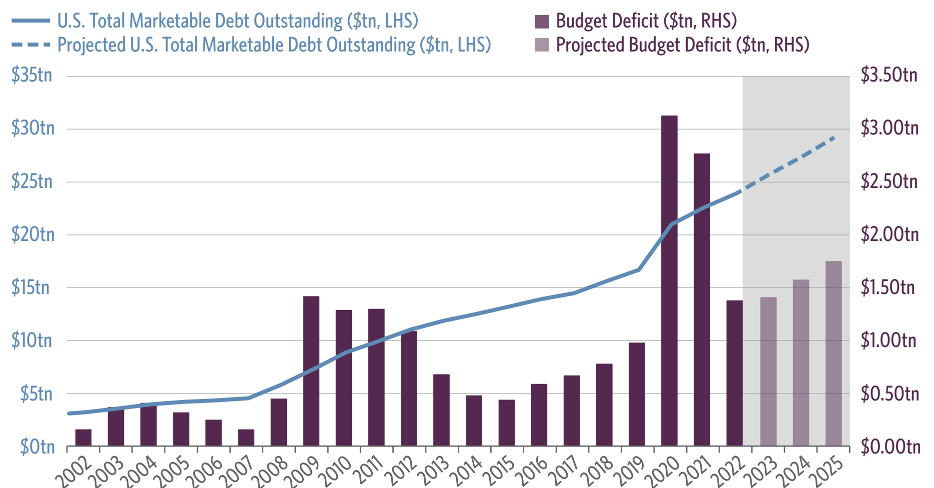
The magnitude of prior hikes and the Fed talk of a potentially prolonged timespan of higher rates have pushed up nominal and real yields to levels not seen since 2007 as the market required more term premium for purchasing Treasury securities. The selloff also brought into focus debt financing costs and the impact of quantitative tightening amid future increases of Treasury supply to finance fiscal spending. Excluding the extraordinary level of fiscal stimulus during the pandemic, budget deficits have been on an upward trajectory since 2016, pushing U.S. Treasury debt held by the public to $25.7 trillion, nearly 100 percent of nominal gross domestic product (GDP).

Looking forward, we continue to believe that the next major move in the yield curve will be an additional steepening, and we continue to position our portfolios accordingly. As Treasury issuance needs increase in 2024, we believe much of the Treasury bill issuance seen since the resolution of the debt ceiling will be termed out along the coupon curve, adding to steepening pressure. Finally, with the significant increase in real yields, particularly at the front end of the curve, short maturity TIPS look relatively attractive.

By Kris Dorr and Tad Nygren

Budget deficits have been on an upward trajectory since 2016, pushing U.S. Treasury debt held by the public to $25.7 trillion, nearly 100 percent of nominal GDP.

U.S. Debt Will Near $30tn by 2025



Source: Guggenheim Investments, Bloomberg. Data as of 9.30.2023.

Investment-Grade Corporate Bonds

Taking Advantage of Technical Tailwinds

Credit conditions will be more challenging in 2024.

Investment-grade corporate credit spreads have continued to tighten on the back of strong market technicals. A dearth of long duration supply has been met by continued strong demand from traditional money managers, pension funds, and foreign demand from both Asia and Europe.

All-in yields have reached levels not seen since the Global Financial Crisis while issuer balance sheets are in a much healthier position. As the ratio of corporate index yields to the S&P 500 dividend yield reached a peak of 4.62x, the incentive for pension funds to rotate out of equities into fixed income remains attractive. Demand for duration has been met by a shrinking volume of longer dated corporate debt supply, with year-to-date 30-year corporate bond issuance down 17 percent versus last year. Corporate bond issuers, anticipating Fed rate cuts and lower coupons in 2024, remain hesitant to lock in higher rates for 20+ years. The lack of longer duration corporates has resulted in a historically flat 10/30-year credit curve, which will likely persist throughout the fourth quarter but then steepen as fundamentals worsen or if interest rates fall. As a result, we believe investors should consider taking profits from credit-curve flattening positions and start shifting towards curve steepening trades.

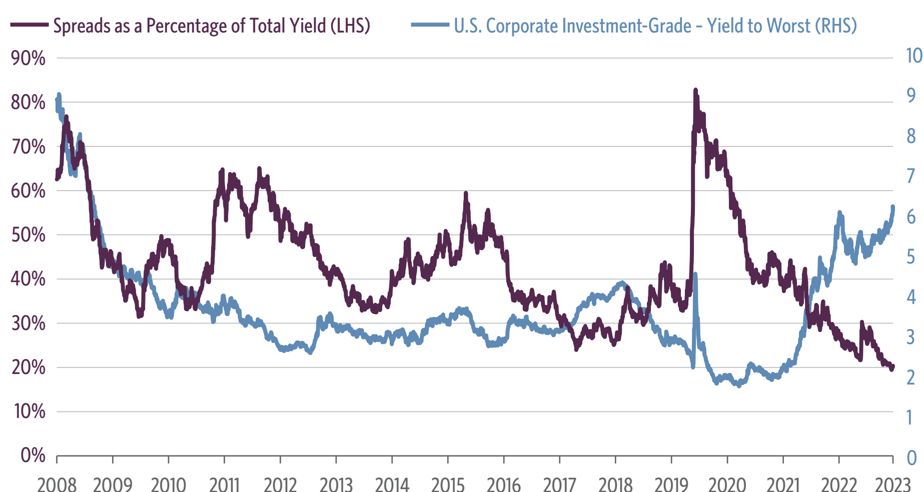
Although technicals and yields remains attractive, investment-grade corporate credit spreads as a percentage of all-in yield hit a 15-year low of 19.5 percent, a historically low measure of investor concerns around credit risk. As the economy slows, however, we believe credit fundamentals will continue to deteriorate. This will lead to increased dispersion of performance within investment-grade corporates, highlighting the need for careful sector selection. Utilities, a highly regulated industry, offers both historically attractive yields and duration profile in the form of 30-year first mortgage bonds. We continue to favor large, high-quality financials over industrials given historic spread relationships: Financials relative to industrials peaked in March at around 50 basis points, and ended the third quarter at 48 basis points. While this relationship is in part skewed by continued stress in regional banks, which we continue to avoid, this relationship should normalize and compress. Supply of bank-issued preferred stock ($1,000 par) will remain low but recent 7–8 percent new issue fixed coupons are at historically attractive levels for strong issuers.

Despite continued rate volatility and rising geopolitical concerns, we expect the attractiveness of investment-grade corporates from a yield and duration perspective will remain intact and provide support to credit spreads going into year end.

By Justin Takata

Although technicals and yields remains attractive, investment-grade corporate credit spreads as a percentage of all-in yield hit a 15-year low of 19.5 percent, a historically low measure of investor concerns around credit risk.

Investment-Grade Spreads as Percent of Yield Hit All-Time Low



Source: Guggenheim Investments, Bloomberg. Data as of 10.4.2023.

High-Yield Corporate Bonds

Evidence of Monetary Policy Lags in the High-Yield Market

More impact from tighter monetary policy ahead as debt rolls over.

Given its sensitivity to economic cycles, the high-yield market has faced heightened scrutiny throughout the year. Concerns over tightening financial conditions and the looming specter of a recession have stoked fears of higher defaults, which have indeed seen an increase. According to Bank of America research, the 12-month par-weighted high-yield default rate ended September at 2.5 percent, up from 1.5 percent at the end of 2022.

The positive economic backdrop has supported healthy high-yield credit fundamentals. Public filing data show that the sector's aggregate interest coverage ratio (EBITDA/interest expense) remains slightly above 5x as of the second quarter while gross leverage (debt/EBITDA) is a manageable 4.5x. Upside surprises in economic data have further contributed to narrowing credit spreads in the third quarter to 416 basis points, with market-implied forward default rates reflecting a soft-landing scenario. The fourth quarter is likely to see spreads remain rangebound given this momentum, although heightened geopolitical tensions in the Middle East present a very meaningful risk that credit spreads could widen.

The high-yield sector's resilience to rising interest rates can be attributed in part to the fixed-rate nature of its debt and the lag with which issuers can adapt to market interest rates if they consider them unattractive. The average yield on newly issued BB-rated and B-rated bonds this year has been 7.7 percent and 10 percent, respectively, but the average coupon rate on high-yield bonds in the index is only 6.0 percent, ranging from as low as 5.3 percent for BB-rated bonds to 7.5 percent for CCC-rated bonds. It is yet unclear how well high-yield bond issuers will adapt to higher interest rates. Trends in the loan market, where transmission is more immediate, suggest that many issuers could pursue distressed exchanges or explore financing alternative in the private lending channel as borrowers seek better financing terms.

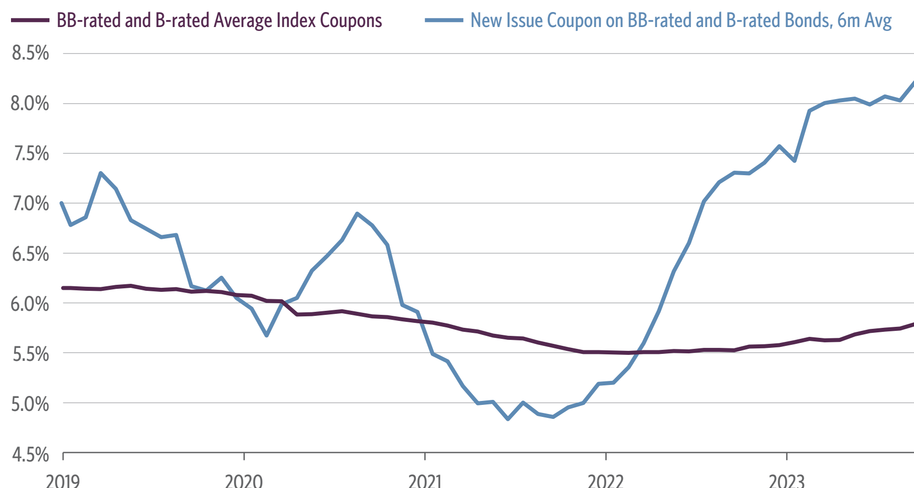
In any event, high-yield issuers face less than $50 billion in maturities in 2024, but this figure rises to about $260 billion when including scheduled 2025 maturities (including index-eligible and non index-eligible U.S. debt). This maturity wall dynamic is the reason that we believe there is still more impact from tighter monetary policy ahead as debt rolls over. Many issuers may find high interest costs unsustainable, and we continue to forecast a default rate of about 5 percent for high-yield corporate bond issuers in 2024.

By Thomas Hauser and Maria Giraldo

The average yield on newly issued BB-rated and B-rated bonds this year has been 7.7 percent and 10 percent, respectively, but the average coupon rate on high-yield bonds in the index is only 6.0 percent, ranging from as low as 5.3 percent for BB-rated bonds to 7.5 percent for CCC-rated bonds.

High-Yield Issuers Have Delayed Absorbing High Interest Rates

Average Index Coupons and New Issue Coupons



Source: Guggenheim Investments, S&P LCD, Ice Index Services. Data as of 9.30.2023.

Technical Dynamics Drive Best Performance Since 2009

Maintaining a defensive stance remains crucial despite gains.

With a 10 percent total return year to date, the best since 2009, leveraged loan performance has significantly outperformed other fixed income sectors. Performance can be attributed to several factors, including lack of duration risk, high coupons due to the Fed's rate hikes, limited net issuance that supported loan prices and risk premiums, and the positive technical and fundamental impact of private credit. We anticipate this strong performance will persist throughout the remainder of 2023, concluding a strong return year.

While issuance has been constrained this year, it has gradually gained momentum, primarily directed toward refinancing activity. Of the $195 billion in institutional issuance, refinancing activity amounts to $112 billion, comprising 57 percent and on track to set a record. Subtracting refinancing activity from total issuance, net supply equals only $83 billion, which is about the same volume as U.S. CLO issuance this year. This leaves little leftover for other sources of demand, such as institutional separately managed accounts, and does not account for paydowns and defaults that shrink the market size without replacement. Consequently, demand exceeds supply, keeping discount margins under 580 basis points since the regional banking crisis in the first quarter.

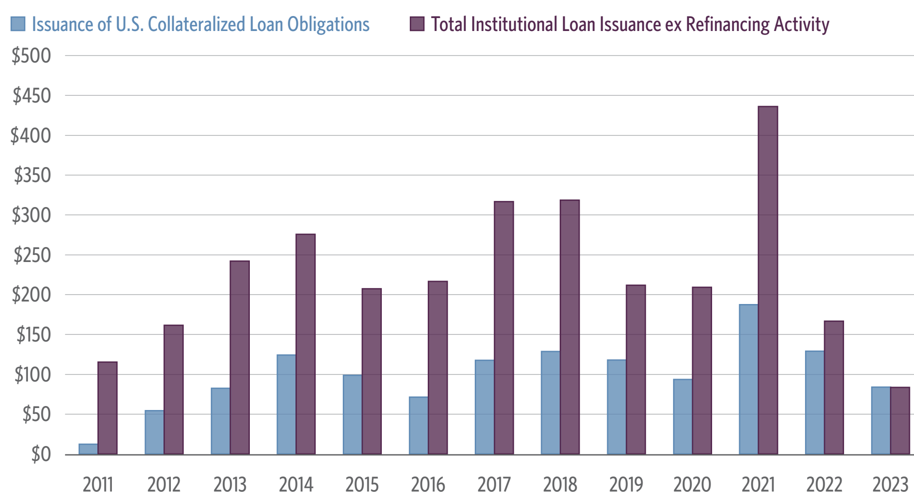
The prominence of private lenders this year is particularly noteworthy due to the scarcity of syndicated loans. Data from Pitchbook LCD reveals that private lending has completed twice as many leveraged buyout activity debt transactions in the past few quarters compared to the syndicated loan market. Borrowers sometimes explore both the syndicated loan market and private lending channels to secure the best terms, and private lenders have stepped in on several notable occasions to assist distressed issuers, averting potential defaults. This activity has also helped support risk premiums in syndicated loans, and it is something we will keep monitoring.

Looking ahead, if interest rates remain elevated as the Fed has recently cautioned, we anticipate elements of performance in the next year that could resemble the second half of 2023: We believe the loan market will continue to offer an attractive coupon exceeding 8 percent, providing a potential buffer for overall returns. However, we also anticipate an increase in defaults and downgrades as more borrowers grapple with high interest expense levels while earnings growth decelerates. Maintaining a defensive stance remains crucial, but investors who have retained exposure to loans have been generously rewarded.

By Christopher Keywork and Maria Giraldo

Net institutional loan issuance has been roughly equal to the amount of new issue volume in the collateralized loan obligation market. This leaves no spare supply for other sources of demand. The loan market has also experienced shrinking due to loan paydowns and defaults. These dynamics have been favorable to returns by keeping spreads tight.

Technical Dynamics Have Been Favorable to Loan Returns



Source: Guggenheim, S&P LCD. Data as of 10.15.2023.

Municipal Bonds

Some Relief from Technical Headwinds

Improving technicals and steady credit fundamentals should support munis in the near term.

As we forecasted in the third quarter outlook, technical headwinds since the end of the summer have led to negative total returns in tax exempt bonds. Treasury volatility and a steep drop off in principal and interest payments have reset yields higher. Institutional buyers have traded the market cautiously, keeping cash levels steady by matching new issue purchases with sales of existing positions. Conversely, individual investors—especially those with separately managed accounts—have become much more active as tax-exempt yields have shifted higher. When new issues run separate retail and institutional order periods, we have seen increased instances of retail taking down more than half of the deal, leaving a smaller than expected allotment for institutional buyers.

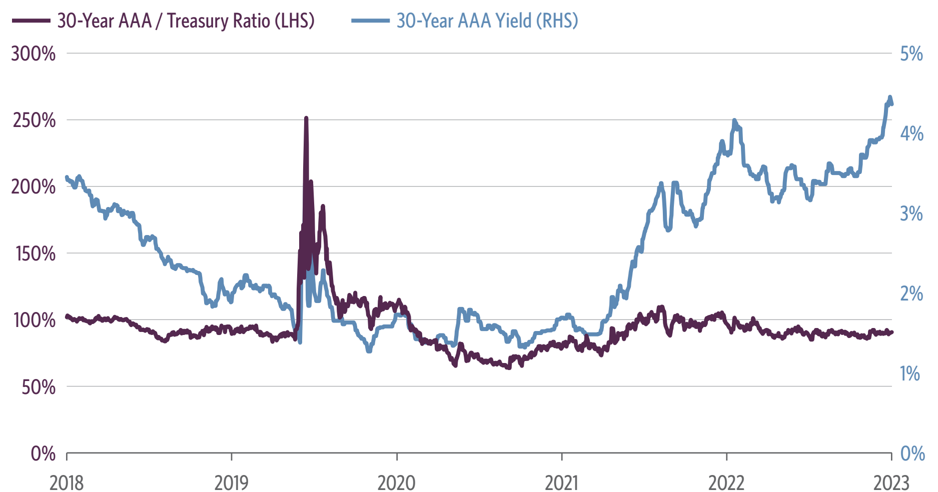
Traditional municipal sectors such as local government and essential utilities retain solid credit fundamentals. S&P has upgraded 641 credits and downgraded just 199 in 2023, a 3:1 ratio. Default rates rose from 0.03 percent in 2022 to 0.04 percent in 2023, with defaults concentrated in nursing homes and hospitals. Sales tax and corporate tax receipts have trended positive, while individual income tax receipts are down, with a caveat that a few states pushed filing deadlines from April to October. Given most domestic equity indexes are positive year to date, capital gains tax collections should trend higher than 2022, providing upside to revenues over the next one to two quarters.

Despite the reset in valuations, the ratios of tax-exempt yields to Treasury yields are still inside their one-year wides, with the 30-year AAA ratio sitting at 90 percent, in the middle of its one-year range of 85–102 percent. However, we would prefer to allocate now rather than waiting for valuations to reach extremes: the five-year high in this ratio was 251 percent in March 2020, when AAAs yielded 3.4 percent (they now yield 4.4 percent). Further, supply and demand should provide market support from December through early 2024, when principal and interest payments should exceed new issuance.

By Allen Li and Michael Park

Despite the reset in valuations, the ratios of tax-exempt yield to Treasury yield are still inside their one-year wides, with the 30-year AAA ratio sitting at 90 percent, in the middle of its one-year range of 85–102 percent.

Ratios of AAA Munis to Treasurys Are Within One-Year Wides



Source: Guggenheim Investments, Municipal Market Monitor. Data as of 10.18.2023.

Pockets of Opportunity in Structured Credit

Relative pricing versus corporates remains attractive.

Structured credit remains a meaningful allocation across our strategies, particularly as spreads remain wide relative to corporates. Our broader defensive tilt aligns well with the investment opportunity set, which currently exhibits discounted dollar prices, high levels of current income, and conservative credit profiles, providing the opportunity to maintain total return upside with often reduced volatility.

Looking forward, increased pressure on loan market fundamentals will disproportionally impact junior CLO tranches and underpins our preference for senior risk given attractive yields and the relatively low level of credit risk. The credit spread on senior CLO AAA tranches tightened from 200 basis points to 175 basis points in the third quarter, generating positive price performance and increasing deal sponsors' incentives to issue new deals—quarterly issuance rose to $36 billion from $22 billion in the prior quarter—and refinance 2022 vintage deals with historically high coupons. After roughly $50 billion in net downgrades of bank loan collateral year to date, 7 percent of CLO collateral is currently rated by S&P at CCC or below, compared to 5 percent at the start of the year. Another 6 percent of CLO collateral is rated B- and on negative outlook. With interest costs for bank loan issuers expected to remain at elevated levels, we expect borrowers' free cash flows to remain pressured and credit rating downgrade trends to continue in the near term.

We see economic and policy challenges in the consumer ABS market, particularly subprime. However, the approximately $250 billion commercial ABS market is currently among our higher conviction investment areas as positive supply/demand dynamics complement favorable valuations. Higher interest rates, low capital expenditures, and subdued mergers and acquisitions activity have decreased year-to-date commercial ABS issuance volume by 27 percent compared to last year. Primary markets are focused on data centers, fiber, and triple net lease properties, as issuers managed maturities and selectively continued originations. With commercial ABS maturities not slated to pick up until 2026, low supply expectations are supporting valuations. Commercial ABS credit spreads are historically attractive—ranking above the 70th percentile both on an absolute basis and relative to similarly rated corporate bonds. The ICE BofA AA-BBB ABS Index offers a 7.16 percent yield as of quarter end, while senior commercial ABS with defensive underlying collateral have recently traded between 6.5–7.0 percent yields. We remain focused on high-quality ABS backed by investment-grade rated corporate obligors or staple defensive assets, such as quick service restaurant royalties. Given recessionary and idiosyncratic risks, commercial ABS offers a unique opportunity to capture complexity premiums in subsectors that require scrutiny across sponsors and structures.

By Michael Liu, Scott Kanouse, Dominic Bea, and Pooja Shendure

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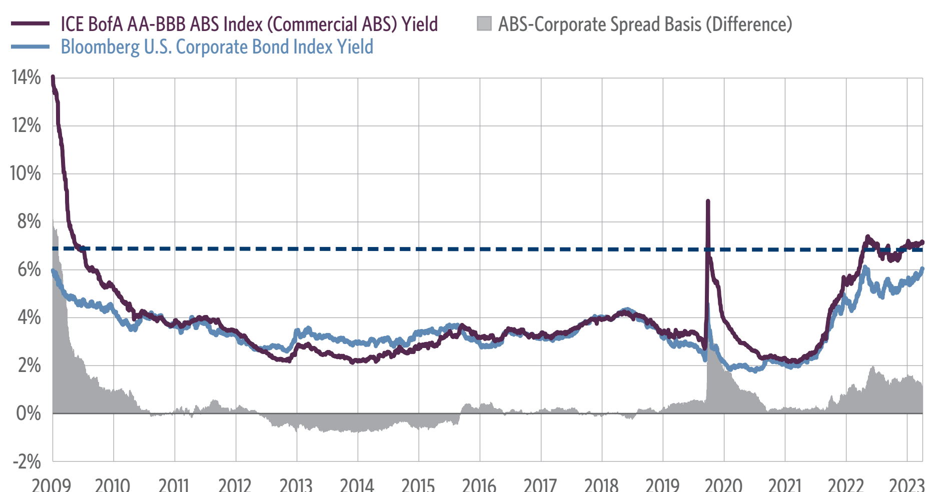
Commercial ABS credit spreads are historically attractive—ranking above the 70th percentile both on an absolute basis and relative to similarly rated corporate bonds. The ICE BofA AA-BBB ABS Index offers a 7.16 percent yield, while senior commercial ABS with defensive underlying collateral have recently traded between 6.5–7.0 percent yields.

Commercial ABS Yields Are at Multi-Year Highs



Source: Guggenheim Investments, Bloomberg. Data as of 9.30.2023.

Non-Agency Residential Mortgage-Backed Securities

Housing Strength Continues Despite Elevated Mortgage Rates

Strong technical factors support home prices and RMBS valuations.

Mortgage rates, which rose to almost 8 percent in October from a low of 3 percent in September 2021, are pressuring home purchase and refinancing activity, both of which have declined significantly. Given the constraint on supply, home prices have been resilient. Stable home prices, combined with low prepayment activity, attenuate credit risk, extension risk, and bond supply, and contribute to our overall positive view on non-Agency RMBS. This is another defensive asset class to which we have diversified exposure in our strategies.

As of August, national home prices increased 3.7 percent year over year and 5.2 percent year to date in 2023, outpacing home price appreciation through many recent historical periods despite mortgage rates reaching their highest levels since 2000. This resiliency is largely due to supply-related factors: the historically low 1.1 million units listed for sale as of August 2023, combined with an existing undersupply of housing and homeowners' reluctance to lose their low in-place mortgage rates. The positive price moves will add further to households' combined home equity of $32 trillion as of June 2023, and should provide a positive tailwind for credit performance for residential mortgages. Tepid transaction volumes have curtailed mortgage loan originations, which should keep RMBS new issuance low and provide a favorable technical environment for RMBS valuations. A less obvious benefit of high mortgage rates is that many RMBS deals are now pricing in low prepayments and are less likely to experience further price downside due to changing investor views on extension risk.

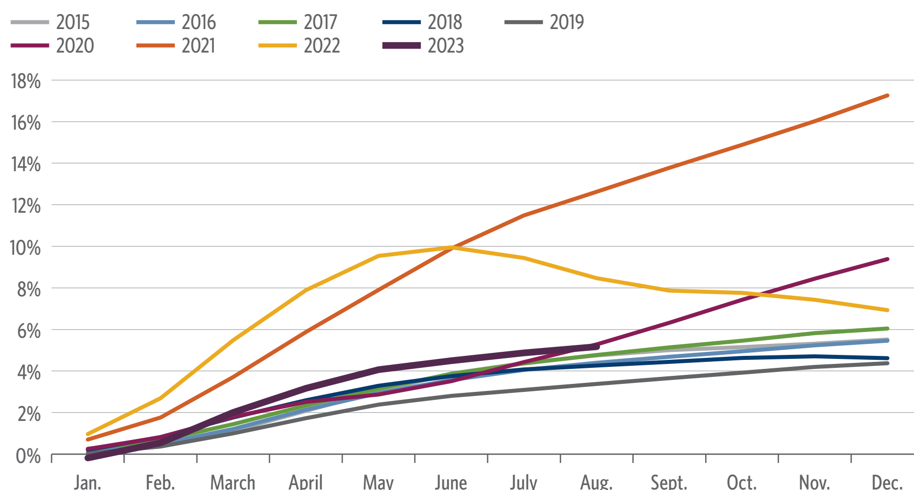
Among our favored trades are non-qualified mortgage (non-QM) RMBS 2.0 mezzanine and senior tranches with stable weighted average life profiles. Valuations for these securities reflect credit spreads that have retraced less than 60 percent of their credit spread widening since March 2023 versus the 85 percent retracement for the five-year Bloomberg U.S. Investment-Grade Corporate Bond Index. We also favor RMBS 1.0 and re-performing loan deals backed by loans with significant home equity. While carrying a lower likelihood of principal loss, current RMBS valuations reflect spreads wider than the long-run averages. These subsectors offered 6.5–7.0 percent yields in October and routinely trade at discounted dollar prices.

By Karthik Narayanan and Roy Park

As of August, national home prices increased 3.7 percent year over year and 5.2 percent year to date in 2023, outpacing home price appreciation through many recent historical periods despite mortgage rates reaching their highest levels since 2000.

Home Price Appreciation Exceeds Most Recent Years

National Home Price Appreciation by Month and Calendar Year



Source: Guggenheim Investments, Bank of America Global Research, CoreLogic. Data as of 8.31.2023.

Commercial Mortgage-Backed Securities

Fundamental Deterioration Is Not Fully Priced

We remain defensive on the sector and await a better entry point.

CMBS has been the weakest performing sector in structured credit year to date as valuations have adjusted to expectations of longer and more numerous loan modifications as well as lower property values. Benchmark conduit CMBS AAA credit spreads tightened by 25 basis points quarter over quarter despite the ongoing negative trend in fundamental data. Year-to-date CMBS issuance of $32 billion is down 68 percent from the prior comparable period issuance of $101 billion, a drop that mirrors the roughly 70 percent yearly decline in overall commercial real estate (CRE) transaction volume. The limited volume of transactions reduces price transparency, adding to the many uncertainties that challenge new investment capital formation. We remain defensive on CMBS credit, still believing that many securities in the sector are overpriced relative to increasing fundamental risks. Our focus is on stable income opportunities with low sensitivity to extension or recovery risks.

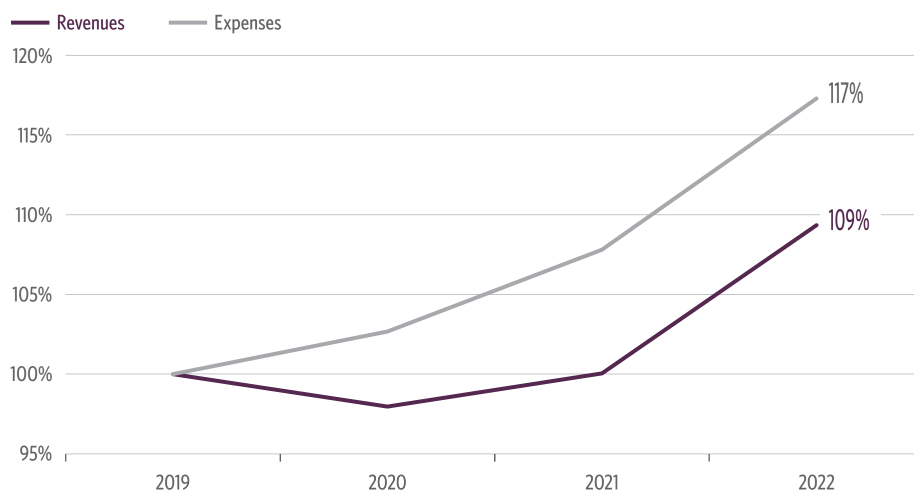
Credit fundamentals continue to deteriorate in the CRE market. Over 6 percent of conduit CMBS loans are currently in some state of special servicing. This number is likely to increase given the well-known problems in the office sector, and may meaningfully increase if recessionary conditions hit other property types as well. For example, multifamily property expenses are growing more quickly than rents, creating debt coverage and valuation pressure on the sector despite the underlying demographic support. With limited capital market activity, fewer CMBS loans are repaying on time as higher interest rates and lower CRE demand are making it harder for maturing CMBS loans to refinance. Only 62 percent of CMBS loans repaid on time in September, compared to 67 percent in June and 84 percent in March. Each failed refinancing adds to a substantial backlog of CRE loan issues created in this cycle.

The private and fragmented nature of the CRE market suggests a long timeline for the emergence of clarity around valuations, and we believe CMBS valuations have not yet priced in the full range of potential adverse outcomes. As such, we remain defensive on the sector and await a better entry point.

By Tom Nash and Hongli Yang

Multifamily property expenses are growing more quickly than rents, creating debt coverage and valuation pressure on the sector despite the underlying demographic support.

Multifamily Property Expenses Are Rising Faster than Revenues



Source: Guggenheim Investments, JP Morgan. Data as of 9.30.2023.

Agency Mortgage-Backed Securities

A Patient Approach to Agency MBS

The sector looks attractive given wide spreads and the nearing inflection point in the hiking cycle.

At the direction of our portfolio management teams, we have continued to generate trade ideas to grow our exposure to Agency RMBS as spreads test multi decade wides. Our preference is for close to current production coupons with discounted dollar prices and attractive convexity profiles. Historically attractive valuations have been driven by both the Fed and banks simultaneously running down their balance sheets and elevated interest rate volatility arising from Fed policy uncertainty. At one point MBS yields were near 6.50 percent, which represents a spread of 180 basis points over similar-tenor U.S. Treasurys, and the highest spreads seen since the Global Financial Crisis. While the Fed's terminal rate appears within reach, market expectations have shifted to focus on the timing of future easing with "higher for longer" extending the timeline for eventual MBS spread tightening.

In the meantime, the steepening of the yield curve has been a welcome development for MBS, even if it comes alongside higher rates. Curve steepening increases the appeal of the sector versus cash alternatives and decreases the prepayment option cost embedded in mortgage bonds. Over the medium to long term, we look for curve steepening to continue via lower overall rates as Fed tightening weighs on the economy.

We favor residential over commercial Agency MBS. The Agency commercial sector benefitted from both a drop off in supply and lack of Fed selling and has recently outperformed the residential sector. We believe that valuation and operating headwinds facing commercial real estate will test this technicals-driven outperformance. In residential MBS, we favor new-issue passthrough securities due to their wider valuations and higher current yields relative to the low coupons that dominate the Bloomberg MBS Index. With rates testing new highs, these bonds still require 1.00–1.50 percent lower mortgage rates for strong borrower incentive to refinance and also benefit from any prospective normalization in rate volatility as the future path of monetary policy becomes clear. This, layered on top of the superior convexity profile of select specified pools, allows for sector exposure while maintaining a strong degree of cash flow certainty.

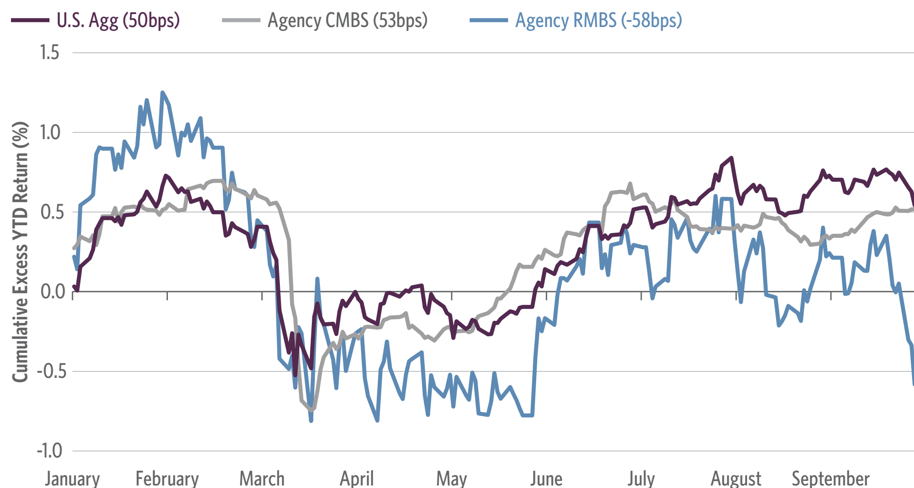
Against this backdrop of evolving market conditions, we remain constructive on Agency MBS. Given the strong liquidity and attractive pricing in the sector, investors can afford to be patient as Fed policy plays out and uncertainty around rates drops. Normalization of rate volatility and curve steepening are both positives for Agency MBS due to the embedded refinancing option.

By Louis Pacilio

The Agency commercial sector benefitted from both a drop off in supply and lack of Fed selling and has recently outperformed the residential sector. We believe that valuation and operating headwinds facing commercial real estate will test this outperformance.

Residential MBS Appears Attractive Relative to Commercial MBS

Cumulative Excess YTD Returns vs. U.S. Treasurys



Source: Guggenheim Investments, Bloomberg. Data as of 9.30.2023.

Commercial Real Estate

The Rocketing Cost of Property Insurance

Escalating costs are leading to diminished returns for real estate investors.

As we have discussed in recent issues of Fixed-Income Sector Views, the commercial real estate market is feeling the stress of limited transactions, challenging lending conditions, and hybrid work models. We are also seeing signs that long-term cost-related factors are affecting the fundamental backdrop in commercial real estate operations and valuations. Our CMBS sector team highlighted that expenses are rising faster than revenues in multifamily properties, which is pressuring debt coverage and valuations. Insurance has become a significant component of a property's operating expenses. Moody's recently reported that since 2017 property insurance costs have escalated at an average annual growth rate of 7.6 percent nationally, far exceeding the historical growth rate of 2–3 percent. Certain markets such as California, Texas, and the Sunbelt states have experienced an annual growth rate above 10 percent. There are several factors driving the increased cost of property insurance. The number of $1 billion+ natural disasters has steadily increased over the last two decades, resulting in higher losses. The rising cost of construction materials and labor, and the resulting higher replacement costs, have exacerbated the magnitude of claims. Property and casualty insurers and their reinsurers have exited some high-risk markets, and some smaller, non-diversified insurers in markets such as Florida went insolvent or were placed on regulatory watch.

Owners of all property types will feel the impact of rising insurance costs. Apartment and hotel owners cannot immediately pass on those costs to their tenants and guests, if at all, because rents or room rates are set based on what the market will bear. Office owners, already under stress from increasing vacancies, will struggle to absorb these costs in an environment where tenants are able to demand material concessions. In markets that have experienced disproportionate casualty losses, owners may also find that some coverages are simply not available at any cost, which poses significant problems when mortgage lenders require owners to provide full recourse for any uninsured losses.

While we have not drawn any red lines because of these circumstances, as we go through our due diligence process we are mindful of the rising cost of insurance, especially in regions that are more vulnerable to climate risks and other natural disasters. We do not expect the pressure points on costs to moderate soon, so we carefully consider the impact of the cost escalations on returns, adjust cap rates, and stress collateral appropriately.

By Jennifer A. Marler and Farris Hughes

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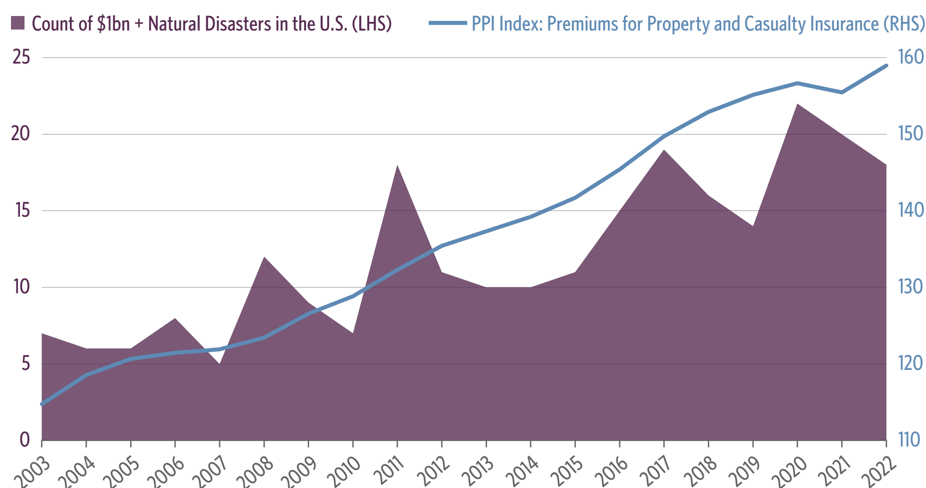
Multifamily Property Insurance Cost Has Doubled in the Last 20 Years

Property and Casualty Premiums Have Escalated as Natural Disasters Have Increased



Source: Guggenheim Investments, National Oceanic and Atmospheric Administration, U.S. Bureau of Labor Statistics, Federal Reserve Bank of St. Louis. Data as of 10.18 2023.

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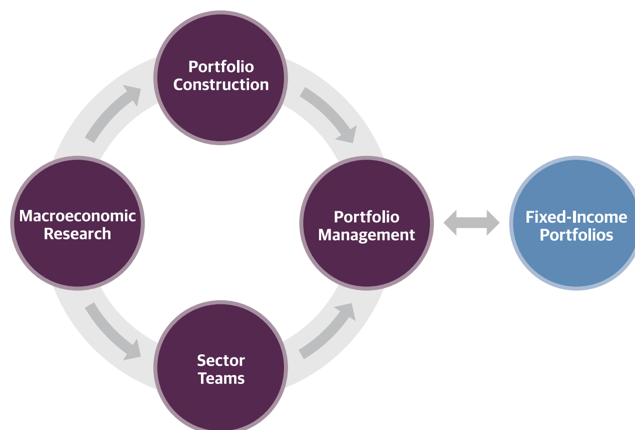

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