Asset-Backed Securities and CLOs

Focus on Prepayment and Extension Risk

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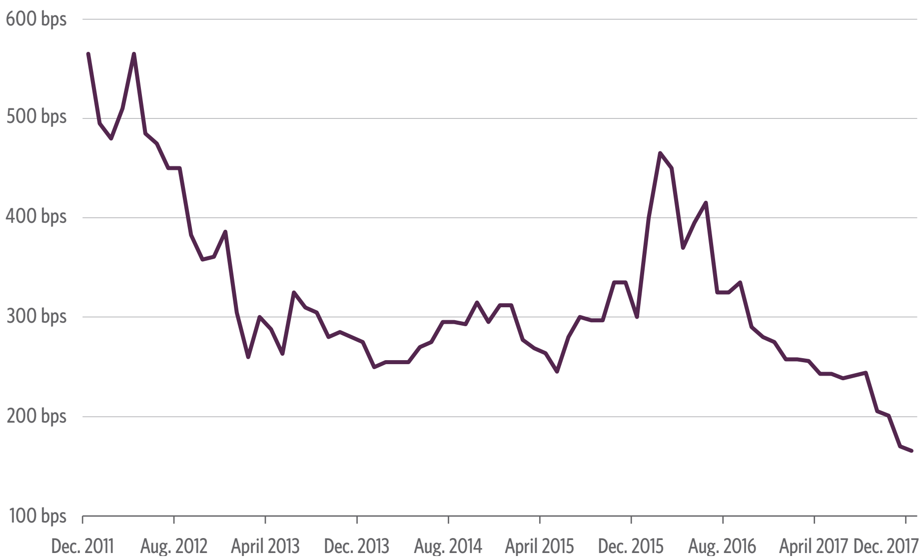
Tight spreads and weak call protection fuel our preference for shorter CLO and senior ABS tranches.

CLO spreads are at post-crisis tights, having fully recovered from the sharp widening in the first half of 2016. We expect spreads to continue to collapse near pre-crisis levels, with AAA coupons down to Libor plus 50 basis points or potentially tighter. Credit curves have flattened, reducing compensation for structured products relative to corporate debt, and for subordinate versus senior tranches (see charts). New primary issuance in 2017 of $118 billion, which ranks as second-highest, was supplemented by $102 billion of refi and $64 billion of reset issuance. Middle-market CLO issuance reached a new peak of $14 billion, and a new peak of 99 managers issued CLOs in 2017. Credit metrics underlying the CLO market remain strong, and increasing diversity in broadly syndicated loan CLOs reduces idiosyncratic credit risk. New-issue CLOs generally price wider than secondary CLOs, but we remain cautious of the asymmetry of return on new-issue CLOs with long reinvestment periods given weak call protection, the ability of managers to extend or shorten portfolio maturity, and our expectation of a credit cycle turn. We are focused on refi and reset transactions with short reinvestment periods (typically two years).

Per the JPM CLOIE indexes, lower-quality CLOs outperformed higher-quality CLOs over the fourth quarter, with BB-rated post-crisis CLOs returning 3.5 percent versus returns of 1.4, 1.0, 0.9, and 0.7 percent for BBB-rated, A-rated, AA-rated, and AAA-rated CLOs, respectively. The broader post-crisis CLO index returned 1.0 percent.

We favor nontraditional ABS sectors given low levels of spreads in traditional auto, credit card, and student loan classes. Whole-business securitization issuance set a new peak of $7.4 billion in 2017, and spreads tightened by approximately 50 basis points in the sector. We continue to focus on top-tier restaurant names and avoid weaker restaurant concepts and non-restaurant issuers. Aircraft ABS also reached a new high of $6 billion new-issue volume, with 10 transactions, six from first-time servicers. We remain focused on very tight structures, strong servicers, and capable and well-resourced equity sponsors. Container ABS issuance and performance strengthened relative to 2016, while railcar ABS remains marred by overcapacity. Triple net-lease ABS has been affected by portfolio and sponsor issues. We continue to be wary of cyclical businesses and securities with extension risk in nontraditional ABS, primarily those related to soft-bullet maturities.

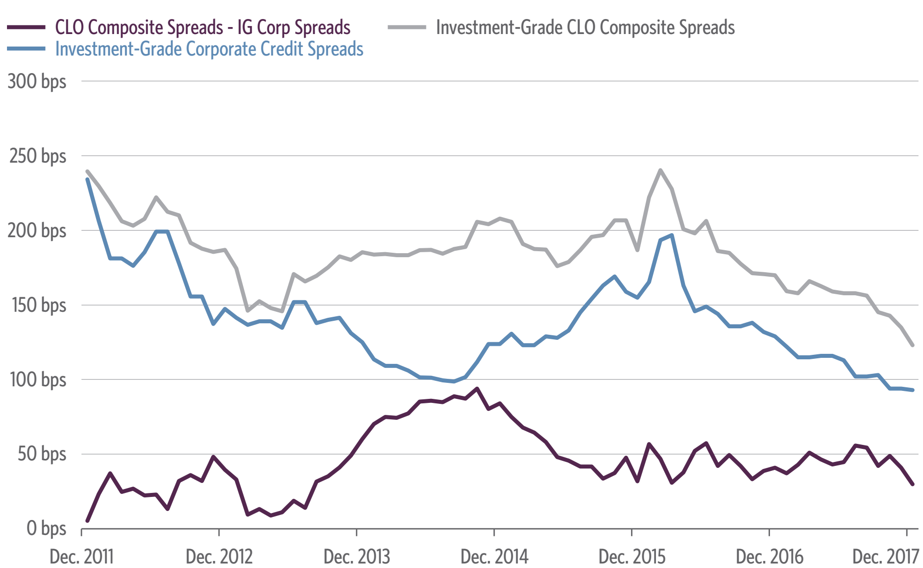
AAA-BBB Credit Curve Continues to Flatten



Source: J.P. Morgan, Guggenheim Investments. Data as of 12.31.2017.

The credit curve for investment grade-rated tranches (spreads for AAA-rated bonds minus spreads for BBB-rated spreads) flattened by 40 basis points during the fourth quarter.

Investment-Grade CLO and Corporate Bond Spreads Are Converging



Source: J.P. Morgan, Barclays, Guggenheim Investments. Data as of 12.31.2017. Guggenheim estimates an investment-grade CLO Composite on a weighted-average basis based on the average share of AAA, AA, A, and BBB-rated tranches in a typical CLO capital structure.

CLO spreads are at post-crisis tights, having fully recovered from the sharp widening in the first half of 2016. Spreads have tightened faster than in the investment-grade corporate bond market, reducing compensation for structured products relative to corporate debt.