

Rates

Steady Summer



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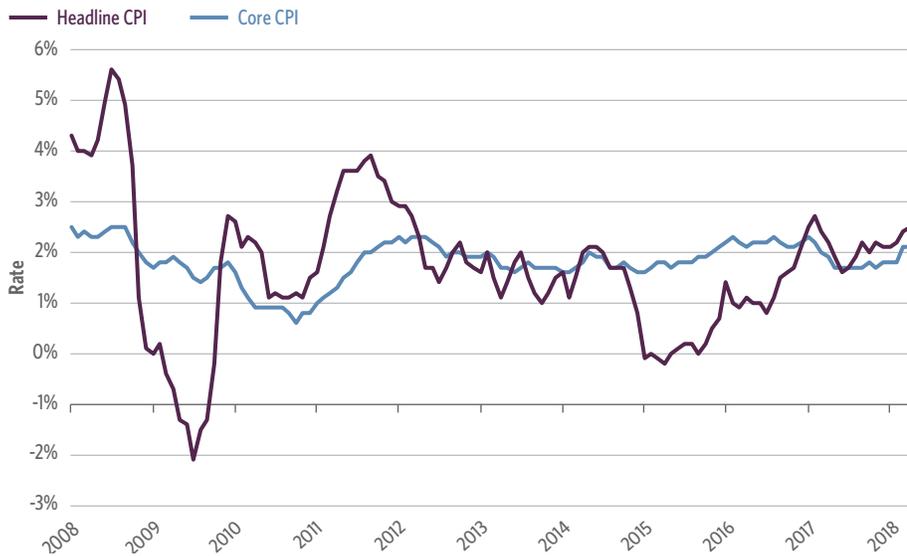
Spread widening in the Agency market could present an attractive opportunity to allocate assets.

U.S. economic momentum remained robust in the second quarter of 2018, supported by strong employment growth and supportive fiscal policies. Headline and core consumer price index (CPI) inflation exceed 2 percent (see chart, top right), and GDP growth appears solidly above trend, prompting the Fed to remain on the path of normalizing monetary policy. As expected, the FOMC increased the federal funds rate by 25 basis points at its June meeting, raising the target range to 175-200 basis points. The yield curve continued its bear-flattening trend, which benefitted our underweight duration and curve-flattening positioning. Two-year notes increased 26 basis points in yield, while the increase in yield in the intermediate and long end of the curve was less pronounced. Five-year notes increased by 18 basis points, 10-year notes increased by 12 basis points, and 30-year bonds increased by just 2 basis points. The long end of the Treasury curve continues to be supported by strong demand for long-duration Treasury strips, with long-dated swap spreads continuing to widen as we have expected. These rate moves are consistent with past tightening cycles (see chart, bottom right).

The Bloomberg Barclays U.S. Treasury index produced a small positive total return of 0.1 percent in the second quarter, resulting in a year-to-date total return of -1.08 percent. The Bloomberg Barclays U.S. Treasury 20+ year index returned 0.35 percent, bringing its year-to-date total return to -3.02 percent. The Bloomberg Barclays U.S. Agency index was flat, resulting in a year-to-date total return of -0.53 percent.

Looking ahead, our Macroeconomic and Investment Research Group expects economic growth to remain healthy and inflation to exceed the Fed's target of 2 percent, which will lead the FOMC to increase the federal funds rate by 25 basis points at both its September and December meetings. While we remain cautious on recent trade and tariff rhetoric and its potential to lead to a much larger global trade war—and ultimately a significant slowdown in growth—we believe underlying growth in the United States remains strong. Moreover, tariffs will put upward pressure on inflation, which is already at the Fed's target. Talk of potential government sponsored entity (GSE) legislative reform widened spreads on Agency bonds, but we do not believe GSE reform is imminent. Any additional widening of spreads will present us with attractive investment opportunities in the sector.

Headline and Core CPI Inflation Have Risen



Source: Bloomberg, Guggenheim Investments. Data as of 5.31.2018.

Headline and core CPI inflation exceed 2 percent, and GDP growth is solidly above trend, prompting the Fed to remain on the path of normalizing monetary policy.

We See Further Bear Flattening as the Fed Continues to Tighten



Source: Bloomberg, Guggenheim Investments. Data as of 7.27.2018. Based on the average change in Treasury yields from six months before the beginning of Fed tightening until the last Fed rate hike.

During the past three Fed tightening cycles, the two-year Treasury note yield has risen by an average of 263 basis points, while the 30-year Treasury yield has risen by an average of only 67 basis points. This pattern is playing out in the current cycle, where the two-year note yield has risen by 171 basis points since the beginning of Fed tightening, and the 30-year Treasury yield has risen by only 10 basis points over the same period. We are positioned for further bear flattening.

Investing involves risk. In general, the value of fixed-income securities fall when interest rates rise. High-yield securities present more liquidity and credit risk than investment grade bonds and may be subject to greater volatility. Asset-backed securities, including mortgage-backed securities, may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity risk. Investments in floating rate senior secured syndicated bank loans and other floating rate securities involve special types of risks, including credit risk, interest rate risk, liquidity risk and prepayment risk. Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Real Estate, LLC, GS GAMMA Advisors, LLC, Guggenheim Partners Europe Limited and Guggenheim Partners India Management. ©2018, Guggenheim Partners, LLC. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Guggenheim Partners, LLC.