GUGGENHEIM

Portfolio Management Outlook

Technical Tailwinds and the Prospect of a Soft Landing

Managing through an increase in the range of possible economic and market outcomes.

Recent data and policy developments have fallen firmly in the soft-landing camp, and market performance has reflected this shift. Lower inflation and resilient economic growth caused an upside surprise to second quarter real gross domestic product, business investment is getting a boost from fiscal policy initiatives to onshore domestic production, and the housing market is showing signs of adjusting to higher mortgage rates. Fixed income, especially higher beta credits, delivered solid performance in the first half of the year as spreads tightened.

The Federal Reserve (Fed) has embraced the soft-landing narrative for the moment. This stance is supporting risk assets, but the acceleration in economic activity and the easing in financial conditions are a double-edged sword since a stronger economy would lead to resurgent inflationary pressures. We still expect the lagged impact of 525 basis points of rate hikes to precipitate a recession, but a soft landing would signal that the Fed's inflation fight is not over. The increase in the range of economic outcomes lends some uncertainty to market conditions, but at the very least this backdrop supports higher front-end rates for longer and continued elevated rate volatility. This dynamic is providing attractive, high quality investment opportunities across our strategies.

Our sector teams share a point of view that is remarkably similar across the market—yields are among the highest seen in the past decade or more, and spreads are generally held in check due to the first half decline in new issuance volume in many sectors. Bank loan coupons are 9 percent, the highest since 2001, contributing to a yield that our sector team believes compensates for rising credit risk. Our investment-grade corporate sector team reports that supply technicals and a natural buyer base for 30-year paper should support longer-duration securities. These technicals will also likely provide secondary market tailwinds for RMBS, CMBS, and other asset-backed securities.

The technical tailwinds are a positive dynamic for portfolio performance, but reinvesting high yields into markets with limited supply could also mute the market's ability to reprice credit risk appropriately. We are seeing early signs of the turning of the credit cycle. Downgrades are outpacing upgrades and defaults are rising for corporate and municipal credits. As we expected, our sector teams are seeing increased dispersion among credits. In this environment, it is crucial to look for trends in leverage and fixed-charge coverage ratios, upcoming maturity schedules, and exposure to labor pressures. For now, credit issues have been idiosyncratic in nature but over time these kinds of issues have the potential to become more pervasive among industries and/or sectors. We are only a few months removed from the mini banking crisis and challenges in that sector or others could appear at any time. In that vein, we are keenly focused on direct and indirect exposure to commercial real estate, a sector that faces severe headwinds and where our team notes that prices have dropped 11 percent year over year, geographic dispersion is significant, and capital availability is challenging, particularly for office properties.

During this period of elevated uncertainty, focusing on diversification, capital preservation, and maintaining portfolio optionality is key. Fortunately, relatively high yields are available on relatively low-risk assets, which gives us confidence that we can continue to find compelling values even as we take a defensive posture on behalf of our clients.

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