Second Quarter 2017

Fixed-Income Outlook
A Time for Caution in Complacent Markets
Guggenheim’s fixed-income portfolios are managed by a systematic, disciplined investment process designed to mitigate behavioral biases and lead to better decision-making. Our investment process is structured to allow our best research and ideas across specialized teams to be brought together and expressed in actively managed portfolios. We disaggregated fixed-income investment management into four primary and independent functions—Macroeconomic Research, Sector Teams, Portfolio Construction, and Portfolio Management—that work together to deliver a predictable, scalable, and repeatable process. Our pursuit of compelling risk-adjusted return opportunities typically result in asset allocations that differ significantly from broadly followed benchmarks.
From the Desk of the Global CIO

One of the things that troubles me about the asset management industry is that some portfolio managers change strategy way too often, reacting to the big headlines of the day or confusing tactics with strategy. This quick, reflexive behavior results in poor decision-making. We take a different approach to how we manage investments. We try to position our portfolios for longer horizons to take advantage of themes that we believe will be in place for several years.

For example, with the Federal Reserve (Fed) set to continue to raise interest rates—and at a faster pace than that which is priced in the market—the shape of the yield curve going forward will remain a major theme in our portfolios. In addition to two more hikes this year, I expect the Fed will raise rates four more times in 2018. The Fed is also plotting a strategy to reduce its balance sheet; this should pressure yields higher in the short end and belly of the curve, which is where most of the new Treasury issuance is likely to come. At the long end, rates are likely to stay low for some time. The last time the 10-year Treasury note traded below 3 percent, it lasted from June 1934 through March 1956, about 22 years. I am not saying that we will have 22 years of sub-3 percent rates, but history tends to rhyme.

My view on the global macroeconomic environment is positive, which should support strong credit fundamentals for several years. China has stabilized, Europe is recovering, corporate earnings in the United States are rising, and our Macroeconomic and Investment Research Group’s analysis indicates that a U.S. recession is unlikely before 2019.

At the same time, I am focused on the legislative complexities of passing President Trump’s pro-growth agenda. The ongoing struggle to draft a viable healthcare bill, the haste with which the administration’s tax priorities were released, and the absence of an infrastructure proposal shows me that work still needs to be done to put his agenda into effect in a timely manner—meaning markets may come to realize that the Trump rally is long on promise and short on delivery.

These themes lead me to conclude that the best strategic direction for our portfolios in the medium term is to position for a flattening curve, with a positive view on credit performance, but a conviction to wait for more attractive levels to take on more risk. My colleagues discuss shorter-term, sector-specific tactics for managing through current market conditions in the pages of this edition of the Fixed-Income Outlook. With spreads tight in investment-grade and high-yield corporate bonds, loans, structured credit, and Agency MBS, I expect an uptick in volatility this summer. While I see some near-term weakness ahead, our positioning for the themes I have identified should provide a sound long-term footing for our portfolios.

Scott Minerd
Chairman of Investments and Global Chief Investment Officer
The S&P 500 delivered a positive total return of 6.1 percent during the first quarter of 2017. Spreads on high-yield corporate bonds, bank loans, and investment-grade bonds were driven to near-2014 lows by strong inflows from mutual funds and institutional investors. Yet the conditions that sparked the rally in these markets—the promises of pro-growth fiscal policies—have yet to see much progress on the legislative front, causing us to continue to reduce our risk exposure as we hedge against the growing potential for disappointing news out of Washington.

According to our Global CIO and our Macroeconomic and Investment Research Group, we expect an uptick in market volatility over the summer. Investors have become increasingly reactive to political developments, which may continue to disappoint beyond President Trump’s first 100 days. This would occur in a period that already tends to be seasonally weak for risk assets. Every year we remember the old adage “Sell in May and go away,” which tells us that summer months tend to be the least rewarding for equity investors. Given the high correlation between equities and credit spreads, we believe that near-term risks to credit are skewed to the downside, hence our wait-and-see approach.

In our Multi-Credit strategy, we have continued to reduce below investment-grade credit exposure as we believe spreads are relatively unattractive. Our internal credit spread dashboard shows that high-yield corporate bond spreads have been tighter only 34 percent of the time, with BB-rated and B-rated bonds looking particularly tight, which means there is a greater probability of spreads widening from current levels. However, our high-yield team is not particularly concerned by the credit fundamentals in the sector. In fact, as the leaders of the team point out on page 10, default rates continue to decline as the worst of the energy distress dissipates. We would consider increasing our allocation to high yield at more attractive spread levels, but for now, our allocation to high-yield corporate bonds and bank loans is the lowest it has been in the last five years.

Recently refinanced senior CLO tranches look attractive in light of our near-term call for spread widening given their short spread durations. We have added to non-Agency RMBS re-securitizations for similar reasons. In lieu of high-yield corporate bonds, we have increased our exposure to fixed-to-float bank preferreds. Our Multi-Credit strategy continues to maintain a significant weighting to floating-rate securities (roughly two thirds); however, we have also purchased protection that would pay off if long-term interest rates move lower to partially offset potential credit spread widening.
In our Core Plus strategy, we have continued to reduce our exposure to below investment-grade credit by lowering our target allocations to high-yield corporate bonds and bank loans. We have added to refinanced AAA-rated CLOs, which offer yields comparable to that of the Bloomberg Barclays U.S. Aggregate index (Agg), roughly 2.5–3.0 percent. We expect these sectors to perform well: Their floating coupons offer some upside as the Fed continues to raise interest rates, and their short spread durations can mitigate losses in a spread-widening environment. Similar to our more opportunistic strategies, we have also added to positions in non-Agency RMBS resecuritizations and bank preferreds to offset the reduced high-yield allocation.

We have maintained a barbell duration position in our Core Plus strategy, with floating-rate assets at the short end and some key rate duration exposure at the long end. In the first quarter of 2017, we expanded our barbell position by reducing the aggregate 0–10 year key rate duration target to less than 50 percent of the Agg’s exposure, and we added to the 30-year key rate position. We believe this rate strategy will continue to benefit not only from a greater jump in short-term rates as the Fed accelerates its pace of rate hikes, but also from the balance sheet normalization process that the Fed has signaled may commence by the end of 2017.

Our internal credit spread dashboard shows that high-yield corporate bond spreads have been tighter only 34 percent of the time, with BB-rated and B-rated bonds looking particularly tight, which means there is a greater probability of spreads widening from current levels.
Macroeconomic Outlook
Fed Likely to Stay the Course

A tightening labor market and near-target inflation will keep the Fed on track even as fiscal policy sputters.

Tracking estimates for first-quarter real gross domestic product (GDP) growth gradually fell throughout the quarter despite strong gains in consumer and business sentiment since the election. On April 28, the advance release of first quarter GDP came in at a tepid 0.7 percent. We attribute a large portion of the apparent weakness to seasonal factors that have depressed as-reported first-quarter GDP growth over the past several years. In keeping with this pattern, we would expect the final first-quarter GDP number to be revised higher once benchmark GDP revisions are released in July. More importantly, the prospects for quarterly U.S. GDP growth are better going forward, and we expect a strong bounce back in the second quarter.

Our medium-term growth outlook has dimmed marginally as a result of the minimal progress seen to date on the Trump administration’s fiscal policy initiatives. The ongoing struggle to create a healthcare bill has sapped early legislative momentum, and tax reform will be a politically fraught process. Nevertheless, financial conditions have eased since the election, despite Fed rate hikes in December and March, and we continue to expect the economy to expand faster than its potential growth rate. This should push the unemployment rate to under 4.1 percent by the end of 2018, well below its natural rate of 4.7 percent (see chart, top right), and support a continued gradual rise in underlying inflation, which is nearing the Fed’s 2 percent goal (see chart, bottom right).

In light of these trends, we believe that the market is underpricing the likely pace of rate hikes by the Fed in 2017 and 2018. Importantly, Fed Chair Janet Yellen noted in March that the FOMC’s baseline forecast of two additional rate increases in 2017 and three more in 2018 was not conditioned on expectations for fiscal stimulus. Rather, it reflected a need to gradually remove accommodation due to the fact that the Fed has essentially achieved its dual mandate objectives for employment and inflation. Fiscal easing, if it materializes, could result in a faster pace of tightening, she explained, as could a further overshooting of the Fed’s labor market objectives.

Markets are skeptical and are pricing in 1.5 more rate hikes in 2017 and fewer than 1.5 rate hikes in 2018, according to fed funds futures contracts. We expect that the Fed will deliver two more rate hikes in 2017 and another four in 2018. Fed policymakers also appear set to formally announce a change in their balance sheet policy later this year, likely in September. In the coming months we are likely to learn further details on how the Fed intends to begin to shrink its portfolio.
Underlying U.S. Inflation is Rising Toward the Fed’s 2 Percent Goal

The ongoing tightening of labor and product markets will support a continued gradual rise in underlying inflation measures, which are nearing the Fed’s 2 percent goal.

Financial conditions have eased since the election, despite Fed rate hikes in December and March, and we continue to expect the economy to expand faster than its potential growth rate. This should push the unemployment rate further below its natural rate.
Portfolio Strategies and Allocations

Guggenheim Fixed-Income Strategies

Bloomberg Barclays U.S. Aggregate Index¹

- Governments & Agencies:
  - Treasurys 37%
  - Agency Debt 2%
  - Agency MBS 28%
  - Municipals 1%

- Structured Credit:
  - ABS 0%
  - CLOs 0%
  - CMBS 2%
  - Non-Agency RMBS 0%

- Corporate Credit/Other:
  - Investment-Grade Corp. 25%
  - Below-Investment Grade Corp. 0%
  - Bank Loans 0%
  - Commercial Mortgage Loans 0%
  - Other 5%

The Bloomberg Barclays Agg is a broad-based flagship index typically used as a Core benchmark. It measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasurys, government-related and corporate securities, MBS (Agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (Agency and non-Agency). The bonds eligible for inclusion in the Barclays Agg are weighted according to market capitalization.

Guggenheim Core Fixed Income²

- Governments & Agencies:
  - Treasurys 0%
  - Agency Debt 9%
  - Agency MBS 4%
  - Municipals 11%

- Structured Credit:
  - ABS 0%
  - CLOs 9%
  - CMBS 9%
  - Non-Agency RMBS 2%

- Corporate Credit/Other:
  - Investment-Grade Corp. 21%
  - Below-Investment Grade Corp. 1%
  - Bank Loans 1%
  - Commercial Mortgage Loans 10%
  - Other 8%

Guggenheim’s Core Fixed-Income strategy invests primarily in investment-grade securities, and delivers portfolio characteristics that match broadly followed core benchmarks, such as the Bloomberg Barclays Agg. We believe investors’ income and return objectives are best met through a mix of asset classes, both those that are represented in the benchmark, and those that are not. Asset classes in our Core portfolios that are not in the benchmark include non-consumer ABS and commercial mortgage loans.

¹ Bloomberg Barclays U.S. Aggregate Index: Other primarily includes 1.7% supranational and 1.3% sovereign debt. Totals may not sum to 100 percent due to rounding.

² Guggenheim Core Fixed Income: Other primarily includes 3.5% private placements, 2.5% prefered, 3.5% LPs, and 1.2% sovereign debt. Totals may not sum to 100 percent due to rounding. Sector allocations are based on the representative account of each Guggenheim strategy. Compositions may vary between accounts and are subject to change.
Guggenheim's Core Plus Fixed-Income strategy employs a total-return approach and more closely reflects our views on relative value. Like the Core strategy, Core Plus looks beyond the benchmark for value. Core Plus portfolios have added flexibility, typically investing up to 30 percent in below-investment-grade securities and delivering exposure to asset classes with riskier profiles and higher return potential. CLOs and non-Agency RMBS are two sectors we consider appropriate for our Core Plus strategies, in addition to more traditional core investments such as investment-grade corporate bonds.

Guggenheim’s Multi-Credit Fixed-Income strategy is unconstrained, and heavily influenced by our macroeconomic outlook and views on relative value. As one of Guggenheim’s “best ideas” strategies, our Multi-Credit portfolio allocation currently reflects a heavy tilt toward fixed-income assets that we believe more than compensate investors for default risk. Our exposure to riskier, below-investment-grade sectors is diversified by investments in investment-grade CLOs and commercial ABS debt, which simultaneously allow us to limit our portfolio’s interest-rate risk.

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**Guggenheim Core Plus Fixed Income**
- **Governments and Agencies:** Treasurys 9%, Agency Debt 3%, Agency MBS 1%, Municipals 1%
- **Structured Credit:** ABS 10%, CLOs 31%, CMBS 9%, Non-Agency RMBS 21%
- **Corporate Credit/Other:** Investment-Grade Corp. 5%, Below-Investment Grade Corp. 2%, Bank Loans 3%, Commercial Mortgage Loans 0%, Other 3%

**Guggenheim Multi-Credit Fixed Income**
- **Governments and Agencies:** Treasurys 0%, Agency Debt 0%, Agency MBS 0%, Municipals 0%
- **Structured Credit:** ABS 13%, CLOs 36%, CMBS 4%, Non-Agency RMBS 11%
- **Corporate Credit/Other:** Investment-Grade Corp. 1%, Below-Investment Grade Corp. 4%, Bank Loans 16%, Commercial Mortgage Loans 0%, Other 14%

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1 Guggenheim Core Plus Fixed Income: Other primarily includes 2.7% preferred stock, 0.7% sovereign debt, and 0.1% private placements. Totals may not sum to 100 percent due to rounding. Sector allocations are based on the representative account of each Guggenheim strategy. Compositions may vary between accounts and are subject to change.

4 Guggenheim Multi-Credit Fixed Income: Other primarily includes 10.0% cash, 2.0% preferreds, 1.3% sovereign debt, and 0.3% private placements. Totals may not sum to 100 percent due to rounding. Sector allocations are based on the representative account of each Guggenheim strategy. Compositions may vary between accounts and are subject to change.
Investment-Grade Corporate Bonds
Technicals Should Remain Supportive

Foreign demand is likely to drive spreads tighter despite healthy supply.

First-quarter corporate bond supply of $372 billion was the largest quarterly gross issuance on record, beating the prior peak of $339 billion in the second quarter of 2015. This high watermark in gross issuance, however, was offset by some important technical items (see chart, top right). While gross issuance rose by 10 percent in the first quarter, year-over-year net issuance over the same period was virtually flat. Furthermore, M&A-related issuance ended the first quarter at only $29 billion, the lowest volume since 2014, and while a forward calendar of $170 billion appears promising, $50 billion of that is due to megadeal mergers between AT&T and Time Warner, and British American Tobacco and Reynolds American. Demand has not let up for mutual funds, which, according to Lipper, have seen 14 consecutive weeks of inflows, and buying programs from Asian investors continue to blanket the corporate bond curve from the front end to the long end. We have seen some intermittent selling with moves in currency hedging, but foreign net bias favors investment-grade corporates, which threatens to drive spreads tighter (see chart, bottom right). Therefore, the strong investment-grade corporate bond technical backdrop is likely to remain intact.

Investment-grade corporate bond spreads continued their march tighter over the first quarter, albeit at a slower rate. The Barclays Investment-Grade Bond index delivered a 1.22 percent total return during the first quarter. Spreads tightened by 5 basis points quarter over quarter to 118 basis points. The continued recovery in commodities was evident in metals and mining spreads, which tightened by 17 basis points to 148 basis points. Although crude oil prices traded well below the highs of the year, we continued to see industries such as refining and midstream (i.e., petroleum transportation, storage, and marketing) tighten by 21 basis points and 11 basis points, respectively.

Going forward, geopolitics and domestic policy will likely create some risk of widening in investment-grade corporate spreads. The positive technical landscape, however, should provide a backstop to any significant spread widening, and domestic banks at the preferred level and energy still look attractive on backups. We would avoid retailers, especially traditional retailers, which are in the midst of a secular decline and will likely continue to face headwinds.
Investment-Grade Corporate Bond Quarterly Gross Issuance Sets Record

First-quarter corporate bond supply of $372 billion was the largest quarterly gross issuance on record, beating the prior peak of $339 billion in the second quarter of 2015. Meanwhile, net issuance is essentially flat on a year-over-year basis.

Investment-Grade Corporate Bond Mutual Funds Continue to Gather Assets

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High-Yield Corporate Bonds
Tight Spreads Breed Concerns

We expect volatility to pick up, but fundamentals are strong.

High-yield corporate bond spreads tightened in the first quarter of 2017, but not without some intermittent volatility. The sharp decline in crude oil prices during the first half of March led to price declines in the high-yield energy sector, highlighting the ongoing unease over the future of oil and gas producers (see chart, top right). Non-energy sectors did not go unscathed. As the market-implied probability of a March Fed rate hike climbed from only 25 percent to over 80 percent over two weeks, spreads widened across the board, from gaming and media/telecom to retail and healthcare. Spreads have since recovered in the early part of the second quarter.

The Credit Suisse High-Yield Index gained 2.3 percent in the first quarter, making it the fifth consecutive quarter of positive returns, albeit the weakest. High-yield corporate bond spreads tightened by 22 basis points quarter over quarter, ending March at 450 basis points. All rating categories delivered positive returns, and CCC-rated bonds continued to outperform BB-rated bonds and B-rated bonds.

Tight spreads continue to reflect an optimistic outlook on corporate earnings and the promise of pro-growth fiscal policies. While earnings are improving as expected, fiscal policy uncertainty is rising. As we mentioned last quarter, we are keeping an eye on the Chicago Board Options Exchange Volatility Index (VIX index), which measures implied equity market volatility. The VIX index has persisted at what our Macroeconomic and Investment Research Group believes to be unsustainably low levels. Meanwhile, our Global CIO expects that we could see some spikes in volatility this summer. Implied volatility levels tend to be closely correlated with corporate bond spreads (see chart, bottom right). Should implied volatility rise this summer, we would also expect to see some spread widening as well. This temporary spike in volatility should not be mistaken for fundamental deterioration in the leveraged credit space, however, as we continue to expect that defaults will decline through the end of the year.
High-Yield Spreads Are Highly Correlated to Implied Equity Volatility


Energy Sector Is Not Yet Out of the Woods

The sharp decline in West Texas Intermediate oil prices during the first half of March led to bond prices declining in the energy sector, highlighting the ongoing unease over the future of oil and gas producers.

Should implied volatility rise this summer, we would expect to see some spread widening as well. However, this temporary spike in volatility should not be mistaken for a fundamental deterioration in the leveraged credit space. We continue to expect that defaults will decline through the end of the year.
Bank Loans
Refinancing Surge Continues

Spreads continued to tighten as refinancing surges, but they remain well above pre-crisis averages.

The driving theme in the loan market continued to be the surge in refinancing activity, a trend we expect will continue at least through the third quarter. Borrowers who completed a refinancing transaction in the first quarter reduced contractual spreads by almost 90 basis points. New issue volume has also been robust outside of refinancing activity, with institutional loan issuance totaling $96 billion in the first quarter of 2017, up from only $33 billion in the first quarter of 2016 (see chart, top right). This increase was accompanied by significant demand from CLOs and mutual funds. On a net basis, new supply has fallen short of visible inflows for 12 consecutive months.

The Credit Suisse Leveraged Loan Index gained 1.2 percent in the first quarter of 2017 as three-year discount margins tightened by 17 basis points quarter over quarter. This makes it the fifth consecutive quarter of positive returns in the loan market. Lower-quality loans outperformed higher-quality loans again in the first quarter, with CCC-rated loans returning 5.0 percent versus 0.6 percent for BB-rated loans and 1.1 percent for B-rated loans.

Yields have fallen significantly due to the level of refinancing transactions taking place (see chart, bottom right). As of mid-April, contractual loan spreads averaged approximately 360 basis points in the secondary market, levels not seen since 2010 when the majority of outstanding loans were issued between 2005 and 2007 at the height of the previous cycle’s bull market. As we deploy capital at current levels, we are increasingly aware that many of these loans may have to survive another downturn. Therefore, despite seeing strong tailwinds that we expect will drive positive returns over the next two years, we maintain a more conservative outlook and continue to focus on more defensive credits with consistent cash flow and sustainable debt burdens. With this in mind, we continue to see opportunities in technology and selectively in energy, the latter supported by our Macroeconomic and Investment Research Group’s view that oil prices will gradually rise over the next two years.
Institutional Loan Issuance Rebounds Despite Refi Activity


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Institutional Loan Yields and Contractual Spreads Decline to Six-Year Lows

Asset-Backed Securities and CLOs
Spreads Churn Tighter

Finding value in off-the-run transactions.

In the CLO market, which has been dominated by refinancing and resets of 2014–2015 transactions, spreads have come in across all tranches to new three-year tights and approaching the post-crisis tights set in early 2013 (see chart, top right). However, CLO spreads have not kept up with tightening loan market spreads, constraining new issue volume (see chart, bottom right). We continue to see room for tightening as CLO spreads remain wider than securities of comparable rating and maturity. Rising Libor rates—up from 63 basis points to 115 points over the past 12 months—also make floating-rate assets more attractive than fixed rate, supporting further spread tightening. Meanwhile, outstanding ABS volume net of CLOs and collateralized debt obligations (CDOs) is down marginally year over year. Auto ABS issuance is down with overall auto sales and increasing concern over potential performance issues from a softening used car market and increasing subprime auto delinquencies. Spreads across the auto sector have tightened year to date. Esoteric ABS new issue has gained ground, as increasing investor confidence has allowed new issues in the container and structured settlement sectors, each of which had counterparty credit concerns stunt new issuance in 2016. Aircraft ABS and whole business ABS have each seen two new issue transactions, while fintech-generated ABS issuance is expected to be low in both the consumer unsecured and small business loan sectors amid performance issues.

According to J.P. Morgan’s benchmark CLO indexes, lower-quality CLOs again outperformed this quarter, with BB-rated post-crisis CLOs returning 8.0 percent versus returns of 3.9, 1.1, 0.9, and 0.7 percent for BBB-rated, A-rated, AA-rated, and AAA-rated CLOs, respectively. The broader index returned 1.4 percent. Discount margins tightened across all tranche ratings, with the discount margin of the broader index ending the quarter at 246 basis points, the tightest since mid-2015.

Looking ahead, tightening spreads increase the value of moving to off-the-run transactions to improve both credit and yield. Current senior AAA spreads on middle-market CLOs are wider than AA mezzanine tranches of broadly syndicated CLOs, offering the ability to improve yield and credit position. As the cycle matures and investors position for more difficult credit markets, trades like this increasingly make sense as a way to position more defensively while preserving portfolio yield.

In broadly syndicated CLO markets, we prefer refinancing to new issue, as the shorter maturities reduce spread duration and increase stress loss coverage.
CLO spreads have not kept up with tightening loan market spreads, constraining new issue volume. We continue to see room for tightening as CLO spreads remain wider than securities of comparable rating and maturity.


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Non-Agency Residential Mortgage-Backed Securities
Goldilocks Technicals Support Positive Outlook

Low supply, improving fundamentals, and investable scale form a constructive backdrop.

Spreads at post-crisis lows and limited price tiering between lower- and higher-risk tranches warrant more cautious positioning, but we maintain a positive outlook for non-Agency RMBS due to improving credit fundamentals and constructive technicals. The supply shortage in non-Agency RMBS is not a new dynamic: Prepayments, defaults, and loan amortization have reduced the outstanding non-Agency MBS market from a peak of $2.5 trillion in 2007 to $750 billion today, creating reinvestment demand and support for bond prices. This runoff also has a dark side—without adequate new issuance, markets could lose institutional sponsorship. Fortunately, the non-Agency RMBS market resides in a Goldilocks-like middle ground, with sufficient runoff to create positive technical support while maintaining an institutionally accessible $40 billion to $50 billion annual supply of new issues (see chart, top right), and outstanding balance comparable to the institutional leveraged loan market. New issuance has evolved to include performing (prime and non-prime) loans, distressed (non- and re-performing) loans, and the credit risk of “vanilla” government-sponsored enterprise loans through Credit Risk Transfer (CRT) deals. We view many of these segments as sustainable and poised for higher issuance in the future.

Non-Agency RMBS tracked the broader rally in credit risk markets in the first quarter of 2017, posting a 2.2 percent total return. Trading volumes increased, as did dealer risk appetite, relative to the doldrums of the fourth quarter 2016. Housing data were generally positive and investors looked to potential pro-growth fiscal policies to extend the current economic expansion.

With the housing recovery maturing, we look for performance gains to come more from improved prepayments than from lower collateral defaults. Over time, loan pools have experienced positive selection: Weak borrowers defaulted, while remaining borrowers rebuilt their credit history, paid down their mortgages, and benefited from increased home prices. Even as default rates stabilize, prepayments continue to rise (see chart, bottom right), an accretive trend for non-Agency RMBS priced at discounts to par. We currently favor a two-pronged investment approach of focusing on shorter maturity senior tranches backed by pre-crisis subprime, non- and re-performing loans, and selected discount-priced floaters that stand to benefit from improvements in credit performance and prepayments. We continue to avoid deeply subordinated or long maturity tranches with limited yield pickup and potential for heightened price volatility.
Non-Agency Issuance Offers Diverse Investment Opportunities

The non-Agency RMBS market resides in a Goldilocks-like middle ground, with sufficient runoff to create positive technical support while maintaining an institutionally accessible $40 billion to $50 billion annual supply of new issues, including prime, non-prime, non-performing and re-performing loans (NPL/RPL), and CRT deals.

Even as Default Rates Stabilize, Prepayments Continue to Rise

For both performing and re-performing loans, default rates have stabilized while prepayments have been improving, an accretive trend for non-Agency RMBS priced at discounts to par.


Source: Amherst Securities, Guggenheim Investments. Data as of 2.28.2017. CRR= Conditional repayment rate, which is an annualized rate of voluntary prepayments relative to the outstanding balance of loans. CDR= Conditional default rate, which is an annualized rate of defaults relative to the outstanding balance of loans.
Commercial Mortgage-Backed Securities
Same Risk, Less Reward

Negative net supply, insatiable demand, and risk retention requirements compress AAA/BBB spreads.

CMBS rallied sharply during the first quarter, particularly in more subordinated tranches, owing to strong demand, negative net issuance of -$18.4 billion, and new risk retention structures. The clamor for risk assets and yield pushed historically conservative real money asset managers and insurance companies into more subordinated and riskier CMBS investments. The heightened demand from these traditionally more conservative investors compressed the spread differential between AAA and BBB tranches to post-crisis tights (see chart, top right).

The heightened demand for subordinated CMBS securities, as well as for other parts of the capital stack, may be partially explained by the new risk retention requirements (see chart, bottom right). The market believes that the “skin in the game” required by the new regulations results in a generally superior risk profile for the risk retention structures. Our analysis of these securities, however, has found that their credit quality is generally similar to 2015 and 2016 pre-risk retention transactions. In our view, “risk retention” is more of a marketing hook driving investor preference, as opposed to a fundamental credit improvement.

We have also observed heightened risk tolerance in short-tenor, floating-rate large loan and commercial real estate (CRE) CLO investment alternatives. In many cases these securities are trading at premium prices in the secondary market, despite being freely callable. The risk of these securities being called and refinanced remains high in our estimation, and as a result we have generally withdrawn from those secondary markets.

Post-crisis CMBS, as measured by the Barclays U.S. CMBS 2.0 Index, had a positive total return of 1.0 percent in the first quarter. Lower-quality tranches outperformed, with BBB-rated CMBS returning 3.0 percent versus 2.2, 1.1, and 0.8 percent for the A-rated, AA-rated, and AAA-rated tranches, respectively.

In such a strong market, we are locating relative-value opportunities in pre-risk retention transactions. There are many with similar or stronger credit metrics than their risk retention-compliant counterparts, and those pre-risk retention transactions trade at comparatively wider spreads and cheaper prices. We also remain active in floating-rate large loan and CRE CLO transactions, but have limited our activity to primary markets where the purchase price is not at a premium and our investors are not exposed to negative yields in a call scenario.
Risk Retention Requirements Drive Wider Subordinated Pricing Discrepancy

The heightened demand from traditionally more conservative investors compressed the spread differential between AAA and BBB tranches to post-crisis tights.

The heightened demand for subordinated CMBS securities, as well as for other parts of the capital stack, may be partially explained by the new risk retention requirements. Our research shows the credit quality of pre-risk retention securities is generally similar to risk retention structures.
Commercial Real Estate Debt
Industrial Beats Residential in Q1

Increasing apartment supply and the strength of the industrial sector reshape market dynamics in 2017.

Only the industrial sector saw positive year-over-year property sales growth in the first quarter of 2017, up by 3 percent. This growth is being driven by an expanding economy, e-commerce company demand for large distribution properties, and a muted new construction pipeline. Meanwhile, sales of apartments were down 35 percent year over year in the first quarter—the worst since the first quarter of 2014 (see chart, top right), and standing in stark contrast to the 2014–2016 trend where year-over-year sales were up 20 percent, on average. Occupancy and rental growth in Class A apartments is turning negative in some of the more heavily supplied markets like New York, San Francisco, Miami, Denver, and Houston. We do not expect apartment sales growth to return to the torrid pace of the last two years, particularly given that 375,000 units are already scheduled for delivery in 2017.

The first and second quarters usually see commercial real estate loan spreads tighten as lenders, flush with new allocations, are anxious to get new business on the books. The first quarter of 2017 was no exception, with life insurance companies tightening spreads by 10–15 basis points on seven- and 10-year term loans. They are currently pricing 160–170 basis points over 10-year Treasurys for 60–65 percent loan to value (LTV) for the four major property types.

Cap rates did not increase with the decline of sales in apartments, but we are cautious here, particularly amongst Class A properties. The industrial sector, where cap rates remain higher than apartments, looks attractive given that we believe the tailwinds are sustainable. Investors have also not been as aggressive in the purchase of industrial properties as in apartments (see chart, bottom right). Elsewhere, we have kept an eye on the retail sector for a while and it seems negative headlines are gaining momentum in this space. Mall is a four-letter word, and lenders are wary of big-box retail power centers but still constructive on grocery-anchored centers in good demographic locations. We typically do not see much value in retail relative to the risks. In terms of loan structure, we like floating-rate lending with spreads between 350–500 basis points over Libor, which tend to be in construction lending and bridge product. In particular, our focus is on shorter term five- and seven-year loans on the permanent product. We are also looking at loans with over 65 percent LTV given that the premiums for these loans are rising as CMBS lenders decrease leverage due to risk retention rules.
Sales of apartments were down 35 percent year over year in the first quarter, indicating a shift by investors from this property type in 2017.

The industrial sector, where cap rates have ticked up since mid-2016, looks attractive, while we are cautious on apartments. Elsewhere, we have kept an eye on the retail sector for a while and it seems negative headlines are gaining momentum in this space, and we do not see value relative to the risks.
Portfolio allocation as of 3.31.2017

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<tr>
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<td>Guggenheim Multi-Credit</td>
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<td>1%</td>
<td>Bloomberg Barclays U.S. Aggregate</td>
</tr>
</tbody>
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Municipals
Focus on Revenue Bonds

Monitoring credit implications of macro and micro factors.

Since the presidential election, the municipal bond market’s attention has been split between high-profile troubled issuers and the policy focus du jour of the Trump administration and Congress. Away from the ongoing headlines involving developments in Puerto Rico, Illinois, Chicago, tax reform, and healthcare reform, we are focusing in on macro and micro factors that may have long-term municipal credit implications. For example, the ongoing rise in home prices, which have surpassed the previous high from 2006, bolsters local governments’ credit quality given that property taxes account for almost half of their revenues, or more than one-third when combined with state (see chart, top right). On the other hand, we are still concerned about the fundamentals in state and local governments, where the gap between assets and liabilities continues to grow. State and local government defined-benefit pension plans have been underfunded consistently since 2002 (see chart, bottom right).

Tax-exempt ratios and taxable credit spreads were largely unchanged over the first quarter despite elevated uncertainty. Municipal bonds posted a 1.6 percent gain in the quarter, with lower quality bonds outperforming. BBB-rated municipal bonds returned 2.2 percent, versus returns of 1.7, 1.5, and 1.4 percent for A-rated, AA-rated, and AAA-rated bonds, respectively.

Our strategic focus continues to be on dedicated revenue bonds characterized by high essentiality, as well as general obligation issuers with less vulnerability to structural pension issues and federal government policies. We believe value, or lack thereof, in our space resides in the minutiae and overlooked details that can uncover true credit risk. The March bankruptcy of Westinghouse Electric Co., which affects approximately $10 billion of municipal debt of Georgia and South Carolina issuers, emphasizes the scrutiny necessary for all underlying contractual and legal nuances. The bankruptcy also highlighted added layers of risk for greenfield project financings that will be increasingly relevant for infrastructure investments funded by the municipal market.
Property Taxes Drive State and Local Tax Revenues


State and Local Defined-Benefit Pension Plans Are Increasingly Underfunded


Trends in home prices, which have surpassed the previous high from 2006, bolster local governments’ credit quality given that property taxes account for almost half of their revenues, or more than one-third when combined with state.

The gap between assets and liabilities of state and local defined-benefit pension plans continues to grow. Plans have been underfunded consistently since 2002.
The Fed’s balance sheet normalization plans raise concerns, but declining prepayment risk should diminish the net impact.

The first glimpse into the Fed’s plan for balance sheet normalization came in the March 2017 FOMC minutes. Nothing official has been released, but we believe the Fed is attempting to set expectations that an announcement regarding the tapering of reinvestments will be delivered later this year. In fact, our Macroeconomic and Investment Research team believes this announcement could come with the September meeting. Investors are concerned about the impact this might have on Agency MBS spreads, but our view is that a full unwind of the Fed’s MBS portfolio would push Agency MBS spreads higher by 20–25 basis points from current levels over a prolonged period of time. This upward pressure is likely to be lessened by the declining incentive for borrowers to prepay their mortgages via refinancing activity (referred to as optionality). With only 10 percent of Agency MBS paying a weighted average coupon of more than 5 percent (see chart, top right), a large share of mortgages in the Agency MBS market are not in the money to refinance. As this prepayment risk declines with rates going higher, the declining optionality should diminish the net impact from Fed balance sheet normalization.

The Agency MBS-U.S. Treasury basis has remained fairly stable as the market wrestles with shifting rate expectations. Agency MBS bonds posted a positive return of 0.5 percent in the first quarter of 2017. Yields ended the quarter at 2.9 percent, roughly unchanged from the end of 2016.

Our long-term view on the sector is that history has shown Agency MBS can deliver good risk-adjusted returns from a Sharpe and information ratio perspective (see chart, bottom right). For those looking to Agency MBS for duration management, we prefer a combination of seasoned and cash flow story pass-through pools. In the near term, we believe there may be opportunities to pick up bonds at substantially wider spreads as the market adjusts to altering technical dynamics driven by Fed balance sheet expectations. In the event of continued rate increases, short-duration collateralized mortgage obligations (CMOs) will increasingly fill demand due to decreased production of traditional refinancing products such as 10- and 15-year pass-through pools. This will leave opportunities to pick up relative value in the remaining longer-end CMO structures.
Just 10% of Agency MBS Coupons Top 5%, Lowering Refinancing Risk

Volatile refinancing-directed prepayments are very low, and as rates rise, the spread compensation for this risk will decrease even further. In this low refinancing environment, prepayment activity will primarily be guided by more stable home price appreciation.

Agency MBS Was a Top Risk-Adjusted Performer in Past Rate Hike Cycles

Over the past 20 years, there have been two complete cycles where the Fed raised rates. During both of these environments, the Agency MBS sector was a top performer from both a Sharpe and information ratio perspective.

Source: Barclays, Guggenheim Investments. Data as of 4.4.2017. The Sharpe ratio and the information ratio are standard calculations used in performance assessments: The Sharpe Ratio measures excess return per unit of standard deviation of returns, while the information ratio measures excess return versus a relevant benchmark index.
Rates
Keeping an Eye on Fed Tapering

Watch for a possible trade up in quality as credit spreads stay tight.

The market began the year anticipating that reduced regulation and fiscal stimulus would lead to stronger economic growth both in the United States and globally. At the same time, the market was pricing in less than a 25 percent probability that the Fed would increase interest rates at its March 15 FOMC meeting. Given this backdrop, risk assets continued to perform well and Treasury yields remained at the higher end of their recent range. As the quarter progressed, economic data remained supportive, and statements made by members of the FOMC made it clear that a March rate hike was very much on the table. The market repriced accordingly, and the Fed met revised expectations by raising the target range for the federal funds rate to 0.75-1.0 percent.

The yield curve flattened during the first quarter, with the two-year Treasury yield rising from 1.19 percent to 1.26 percent, and the 10-year Treasury yield falling from 2.45 percent to 2.39 percent, after spending the quarter trading in the 2.31-2.63 percent range. The Bloomberg Barclays U.S. Treasury index returned 0.67 percent for the quarter, and the Bloomberg Barclays U.S. Agency index returned 1.29 percent for the quarter. The Bloomberg Barclays Global Treasury index returned 2.09 percent for the quarter.

Looking forward, we continue to believe that the yield curve will flatten and that a barbell position is appropriate. We believe that the Fed will raise rates in June, and expect to hear more discussion from the Fed over the coming months about reducing the size of its balance sheet. This will likely be accomplished through the tapering of reinvestments as opposed to outright selling, and our Macroeconomic and Investment Research team believes an announcement could come in September. The start of this process, in addition to the evolving fiscal stimulus and Treasury debt management policy discussions, could lead to increased Treasury market volatility throughout the year. Given the strong run in risk assets and tight credit spreads, investors may look to move up in quality, and this could benefit high-quality debt. We believe this would be a positive technical for Agency spreads, and we will continue to look for attractive investment opportunities in this sector.

Note: “Rates” products refer to Treasury securities and Agency debt securities.
On March 15, the Federal Open Market Committee (FOMC) raised the fed funds target rate by 25 basis points to a range of 0.75–1.0 percent. The hike itself had little impact on markets because several FOMC members, including Chair Janet Yellen and New York Fed President William Dudley, had indicated in the weeks leading up to the meeting that a hike was likely, allowing the rates market to price in the increase.

The minutes of the FOMC’s March 2017 meeting revealed that most officials supported a change to the reinvestment program policy later this year. We expect that the Fed will gradually roll off reinvestments, limiting the market impact at the early stages of the balance sheet normalization process. As the chart shows, however, the end of the reinvestment program may have a bigger effect later in 2018 and 2019 when a significant volume of securities are expected to mature.
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1 Guggenheim Partners’ assets under management are as of 3.31.2017 and include consulting services for clients whose assets are valued at approximately $59bn.

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