Guggenheim’s Investment Process

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 results in asset allocations that differ significantly from broadly followed benchmarks.
Equities started the year in full melt-up mode, until the first correction in two years brought valuations back down to earth. Strong corporate earnings, synchronous global economic growth, and the discounted benefits of U.S. tax reform are justifying current levels, at least for the moment. With market sentiment now less exuberant, the stage is set for a continuation of the rally, albeit with more handwringing about when it will all stop.

I bring up the recent melt up in stocks in our bond publication only to point out that fixed-income markets have been walking this risk tightrope for several quarters. Bonds in most sectors are trading above par, yields are still historically low, and spreads are near or below pre-crisis levels. The best that a bond investor can reasonably hope for in this market is to earn the coupon, while principal is at risk from an active Federal Reserve (Fed), mark to market, geopolitical risk, and any credit deterioration. Our portfolio managers call it "an unfortunate asymmetry of risk."

This has been the story in fixed income for some time now, and it could continue a while longer. In the meantime, each of our sector teams is sounding similar themes. While no sector team has a negative outlook on its market, they favor "the up-in-quality trade" (investment-grade), "cash-flow stability" (Agency MBS), and "defensive, loss-remote investments" (CMBS).

When will it end? The answer is the same for both bond and stock investors. Bull markets do not die of old age, but as they grow older they become more vulnerable to shocks as companies and households get overextended. Monetary policy tightens to curtail overheating economic activity, and so ends the business cycle. This cycle should prove no exception, as the Fed will have to tighten to offset the late-cycle fiscal easing in the pipeline. Our Macroeconomic and Investment Research Group analyzed the late-cycle behavior of several key economic and market indicators, and concluded that the current expansion will end as soon as late 2019.

Current conditions could persist for some time—economic growth is accelerating, monetary policy is not yet overly restrictive, and optimism is high—but history has shown that with a recession approximately two years away, the time for caution is approaching. To borrow a concept from Ben Graham, our job is to find a margin of safety as we walk this risk tightrope.

Scott Minerd
Chairman of Investments and Global Chief Investment Officer
Mr. Market has high expectations for 2018, but we are concerned that the downside far outweighs upside returns in fixed income.

Our first quarter outlook last year described the faith-based rally. Markets were climbing higher despite Washington’s failure to deliver on the pro-business fiscal policies promised during the 2016 presidential election. Earnings were weak, but investors were hopeful that earnings would rebound in 2017. Since then, markets have rallied to new cycle highs: The S&P 500 ended the year at 2,809, the Dow Jones Industrial Average ended the year at 26,020, and investment-grade and high-yield corporate bond spreads hit their lowest levels since 2006. The administration passed the Tax Cuts and Jobs Act (although under a different name) in the 11th hour of 2017, and corporate earnings strengthened with the economic rebound. We suspect that the recent stock market correction will prove to be only a temporary setback, with the market likely to rally further on high expectations.

High expectations can be dangerous as they easily slip into false confidence, often with painful results. These are markets in which investors throw caution to the wind and are inclined to wager on high-risk opportunities. This environment presents many unique challenges in fixed-income markets because of an unfortunate asymmetry of risk: With bonds in almost every sector trading near or above par, most positive returns will be derived from coupon income alone. Floating-rate bonds continue to have more income upside with the rise in short-term rates driving coupons higher. But with spreads as tight as they are, the potential for mark-to-market losses outweighs potential price appreciation in many fixed-income sectors. Nevertheless, pockets of opportunity remain.

Changes to our portfolio allocation during the fourth quarter are consistent with our strategy over the past year of gradually reducing credit exposure. In our Core Plus strategy, we reduced our corporate bond allocation—including investment grade, high yield, and preferreds—to the lowest level since the financial crisis, given low absolute spreads across those sectors. Allocations to structured credit—primarily CLOs, ABS, and non-Agency RMBS—remain the largest in the strategy as spreads relative to corporates still look relatively attractive. Agency CMBS also remains a relatively attractive sector and fits with our theme of upgrading credit quality. We continue to position our Core Plus strategy for a bear flattening yield curve.
In a similarly defensive vein, we also reduced the corporate bond allocation in our Multi-Credit strategy to levels well below that of recent years. Within corporates, bank loans remain the most attractive sector, albeit one that continues to reprice at lower spreads. Holdings within structured credit—including CLOs, commercial ABS, and non-Agency RMBS—remain the primary allocation in the strategy. However, with an increasingly flat credit curve, particularly within subsectors like CLOs, our preference is to be more senior in the capital structure.

We believe we are taking prudent actions to protect our investors’ capital. In an environment of increasingly tight spreads, low yields, and near- or above-par bond prices, the incremental yield pickup from going lower in the capital structure or rating does not compensate for the added potential mark-to-market risk.

Investors’ compensation for taking on additional risk declines as the credit curve flattens. Our overarching strategy in such an environment is to go up in quality while reducing duration.

**State of the Market: Fixed-Income Sector Yield and Duration**

Source: Credit Suisse, Bloomberg, Citi, Guggenheim Investments. Data as of 2.13.2018. Representative Indexes: Bank loans: Credit Suisse Leveraged Loan index; High-Yield Corporate Bonds: Bloomberg Barclays High-Yield Corporate Bond index (excluding CCC subset); AA, A and BBB Corporate Bonds: Bloomberg Barclays Investment-Grade Corporate Bond index (AA, A, and BBB subsets); Agency MBS: Bloomberg Barclays U.S. Aggregate index; CLOs: JPM CLOIE index, CMBS 2.0 AA: Bloomberg Barclays CMBS 2.0 index (AA subset), Treasurys: Barclays U.S. Aggregate index (Treasurys subset), Non-Agency RMBS: Based on Guggenheim’s Non-Agency RMBS trading desk’s indicative levels.
Macroeconomic Outlook

Fiscal Policy Giveth, Monetary Policy Taketh Away

Investors should focus on credit quality amid further spread tightening as tax cuts take effect.

The performance of the global economy exceeded expectations in 2017, with growth accelerating and the expansion becoming more synchronized across countries. U.S. real gross domestic product (GDP) growth came in at 2.5 percent in 2017 (Q4/Q4). We forecast an even faster pace for 2018, girded by strong global momentum, supportive financial conditions, and an additional boost from tax cuts and federal spending increases. Corporate profit growth will also get a jolt from the tax cut, though some highly leveraged companies will be hurt by the new limits on interest expense deductibility.

While GDP growth has been tepid during this expansion, there is a growing risk of the economy running too hot, thanks in part to fiscal easing. The labor market is already in the early stages of overheating, with the unemployment rate at a cycle low of 4.1 percent in December. We see the unemployment rate ultimately falling to 3.5 percent, and expect that a tight labor market will nudge wage growth higher.

The fly in the ointment is core inflation, which remains below the Fed’s 2 percent goal on a year-over-year basis. Recent data have been firmer, however, with core consumer price index (CPI) inflation having accelerated to a 2.6 percent annual rate in the six months ending in January (see chart, top right).

Notwithstanding this uptick, some Fed officials remain concerned about the persistence of below-target inflation in recent years. Their caution can be seen in the Fed’s interest rate projections, which as of December showed a decline in the average number of rate hikes forecast for 2018 (see chart, bottom right) as some officials shifted their rate hike expectations into 2019. Curiously, this occurred despite a 0.8 percentage point cumulative increase in the median GDP growth forecast and a 0.2 percentage point drop in the median unemployment rate forecast. We still see four hikes in 2018 as opposed to the Fed’s baseline of three, reflecting our expectation for a steeper drop in unemployment this year, financial conditions that have eased in spite of Fed tightening, and a more hawkish Federal Open Market Committee composition.

The yield curve should continue to bear flatten as a result, driven by an outsized increase in shorter-term yields. With our work indicating that the next recession is about two years away, and with credit having richened further since the passage of tax cuts, we believe this is an opportune time to upgrade portfolio credit quality.
Core Inflation Has Recovered from the Abrupt Slowdown in Early 2017

Core inflation remains below the Fed’s 2 percent goal on a year-over-year basis. Recent data have been firmer, however, with core CPI inflation having accelerated to a 2.6 percent annualized rate in the six months ending in January.

With Inflation Low, Some Fed Officials Want to Postpone 2018 Hikes

Some Fed officials remain concerned about the persistence of below-target inflation in recent years. Their caution can be seen in the Fed’s interest rate projections, which as of December showed a decline in the average number of rate hikes forecast for 2018.
Portfolio Strategies and Allocations

Guggenheim Fixed-Income Strategies

Bloomberg Barclays U.S. Aggregate Index

- **Governments & Agencies:**
  - Treasurys 37%, Agency Debt 2%, Agency RMBS 28%, Municipals 1%
- **Structured Credit:**
  - ABS 1%, CLOs 0%, CMBS 2%, Non-Agency RMBS 0%
- **Corporate Credit/Other:**
  - Investment-Grade Corp. 26%, Below-Investment Grade Corp. 0%, Bank Loans 0%, Commercial Mortgage Loans 0%, Other 4%

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 Income

- **Governments & Agencies:**
  - Treasurys 0%, Agency Debt 8%, Agency RMBS 5%, Municipals 11%
- **Structured Credit:**
  - ABS 15%, CLOs 7%, CMBS 14%, Non-Agency RMBS 1%
- **Corporate Credit/Other:**
  - Investment-Grade Corp. 20%, Below-Investment Grade Corp. 2%, Bank Loans 1%, Commercial Mortgage Loans 8%, 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 1.6% supranational and 1.0% sovereign debt. Please see disclosures at the end of the document. Totals may not sum to 100 percent due to rounding.

2. Guggenheim Core Fixed Income: Other primarily includes 2.9% private placements, 1.8% preferreds, 1.3% LPs, and 0.8% sovereign debt. Please see disclosures at the end of the document. 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.

3. Guggenheim Core Plus Fixed Income: Other primarily includes 5.9% cash, 1.5% preferred stock, and 0.1% sovereign debt. Please see disclosures at the end of the document. 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 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.

4. Guggenheim Multi-Credit Fixed Income: Other primarily includes 18.1% cash, 3.9% preferreds, and 1.7% private placements. Please see disclosures at the end of the document. 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

Tax Changes Enhance Technicals

Clarity on tax policy helps drive spreads to 10-year tights, but headwinds remain.

The passage of the new tax plan was a significant driver for investment-grade corporate credit spreads, which tightened to levels not seen in over a decade. We anticipate corporate credit spreads to remain at similar levels or tighten over the first quarter of 2018 despite multiple headwinds, such as quantitative tapering, geopolitical risks, and what many believe is the tail end of a virtuous credit cycle (see chart, top right). The firm tone will remain intact as the technical picture, driven by domestic and foreign demand, should persist in the near term. Net issuance for 2017 fell by 6 percent from 2016, and early estimates suggest net issuance will fall an additional 12 percent this year. If Treasury yields stay range-bound or back up in an orderly manner, we expect foreign and domestic demand to limit any spread widening in corporate credit (see chart, bottom right). The net effect of tax policy implementation on investment-grade credit at the industry level remains somewhat unclear, but is expected to be mostly positive and could lead to significant cash repatriation. All else equal, this could result in decreased supply from perennial issuers as it would create a steady wave of cash earmarked for reinvestment within the sector, further enhancing the technical picture.

The Bloomberg Barclays Investment-Grade Bond index returned 1.2 percent during the fourth quarter. Spreads tightened by 8 basis points quarter over quarter and 30 basis points since the beginning of the year, ending December at 93 basis points. Returns were mixed by rating, with AAA-rated bonds returning 8 percent in 2017, compared to returns of 4.6 percent for AA-rated bonds, 6 percent for A-rated bonds, and 7.1 percent for BBB-rated bonds. It is important to note that AAA-rated corporates represent only 2 percent of the index.

Tail risks in the market continue to creep higher, which should result in more cautious investor behavior later in the year. With that in mind, we still favor the up-in-quality trade as we move closer to the end of the credit cycle. We will look to add risk opportunistically if selling in long-dated high-quality corporates materializes, perhaps on the back of foreign selling. We remain constructive on bank preferred securities with higher floating-rate back ends, but we believe better entry levels will present themselves later in the year.
We anticipate corporate credit spreads to remain at similar levels or tighten over the first quarter of 2018 despite multiple headwinds, such as quantitative tapering, geopolitical risks, and what many believe is the tail end of a virtuous credit cycle.

Investment-grade corporate bond spreads have tightened since September despite a selloff in U.S. Treasurys that caused the yield on the 10-year Treasury note to rise 70 basis points. The passage of the new tax plan was a significant driver, helping spreads to tighten to levels not seen in over a decade.
Tax reform will be a key driver of performance for high-yield corporate bonds in 2018.

Positive fundamental factors underlying the corporate sector continue to underscore our constructive stance on high-yield corporate credit as we enter what our macroeconomic team believes to be the penultimate year before a recession. Average leverage ratios and interest coverage ratios improved in 2017 on the back of strong earnings growth. As fundamentals improved, the 12-month par-weighted trailing default rate in the Bank of America Merrill Lynch High-Yield index fell to just 1.65 percent by year end, compared to a historical average default rate of 4.15 percent (see chart, top right). We believe credit risk should remain benign in 2018.

High-yield corporate bonds lost steam in the fourth quarter, with the Bank of America Merrill Lynch High-Yield index delivering 0.4 percent total return with spreads wider by 5 basis points. High-yield spreads tightened by an average of 66 basis points in 2017. Total return for the year was consistent with our expectations of mostly earning coupon income plus some limited price upside. The high-yield corporate bond market returned 7.5 percent in 2017, with mixed returns by rating. BB-rated, B-rated, and CCC-rated bonds delivered 7.3 percent, 6.9 percent, and 9.3 percent total returns, respectively.

Tax reform will be a key driver of performance for high-yield corporate bonds this year. The reduction in the corporate tax rate from 35 percent to 21 percent is expected to help boost cash flow primarily for smaller, domestically focused companies given that they typically pay the highest effective tax rates. This description generally applies to high-yield borrowers, especially BB-rated and B-rated companies.

We believe this could be the catalyst for further spread compression between high-yield and investment-grade corporate bonds, where the premium remains at the 2005–2007 average level and above historical lows (see chart, bottom right).

We are concerned that the inability of borrowers to deduct interest expense above 30 percent of earnings before interest, taxes, depreciation, and amortization going forward will likely hurt many CCC-rated companies that already pay interest expense above this threshold. This change does not impact our strategy significantly, which has been focused on higher-quality borrowers for some time, but we believe it could spell trouble for 10–15 percent of the high-yield market. Investors should safeguard portfolios for a potential rise in CCC-issuer spread volatility by the end of the year.
Low Credit Default Rates Point to Benign Risk Environment in 2018

Average leverage ratios and interest coverage ratios improved in 2017 on the back of strong earnings growth. As fundamentals improved, the 12-month par-weighted trailing default rate in the Bank of America Merrill Lynch High-Yield index fell to just 1.65 percent by year end, compared to a historical average default rate of 4.15 percent.


Lower Corporate Tax Rates Could Spur Further Spread Compression

The reduction in the corporate tax rate from 35 percent to 21 percent could be the catalyst for further spread compression between high-yield and investment-grade corporate bonds, where the premium remains at the 2005–2007 average level and above historical lows.

Source: Bloomberg, Guggenheim Investments. Data as of 1.22.2018. Shaded areas represent periods of recession.
Bank Loans
A Borrower's Market

Credit performance has been strong, but the erosion of investor protections raises risks in the next downturn.

Low loan defaults and muted volatility in 2017 created a favorable credit environment for loan investors and borrowers alike. We saw another year of strong refinancing and repricing activity, which tightened contractual spreads by 6 basis points quarter over quarter and 34 basis points year over year. Refinancing activity also helped borrowers push the maturity wall out to 2024, when over 30 percent of loans are expected to mature (see chart, top right). Just three years ago, half of outstanding loans were expected to mature in 2020 or 2021. We expect much of the same for 2018. Refinancing and M&A activity should drive healthy supply, which we expect to be met with strong demand from investors looking for floating-rate assets in an environment in which the Fed is continuing to raise interest rates.

The Credit Suisse Leveraged Loan index posted a gain of 1.2 percent in the fourth quarter, bringing 2017 returns to 4.2 percent. CCC-rated loans were the best performers with an 8.0 percent total return, outperforming the high-yield corporate bond index, but not CCC-rated corporates. BB-rated and B-rated loans returned 3.5 percent and 4.5 percent, respectively, significantly underperforming CCs for the year.

We expect 2018 will see further loosening of credit standards. The covenant-lite issuance trend continues to strengthen, representing 74 percent of the par amount of loans outstanding (see chart, bottom right). In addition to the removal of financial maintenance covenants, we saw a weakening of negative covenants in credit documents as borrowers and sponsors continue to push the envelope to preserve their options in a downturn. We believe these actions will likely reduce lenders’ recoveries when defaults rise. Lastly, we have seen first-lien BB-loans issued with 0 percent London interbank offered rate (Libor) floors (or in a few cases, no Libor floor), reversing the post-crisis trend of 0.75–1.25 percent Libor floors. We categorize such activities as late-cycle behavior. The credit health of individual companies will likely remain strong for now, but loosening covenants and weakening credit documents remain a source of concern for our credit team as they will likely reduce recoveries when defaults rise. In response, we remain defensive in our credit selection, focusing on investments that we believe can survive the next downturn and allow us to comfortably hold them until maturity.
Another year of strong refinancing and repricing activity caused contractual spreads to tighten by 6 basis points quarter over quarter and 34 basis points year over year. Refinancing activity also helped borrowers push the maturity wall out to 2024, when over 30 percent of loans are expected to mature.

We expect 2018 will see further loosening of credit standards as we have seen over the past several years. The covenant-lite issuance trend continues to strengthen, representing 74 percent of the par amount of loans outstanding.
Asset-Backed Securities and CLOs

Focus on Prepayment and Extension Risk

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

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

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.

Non-Agency Residential Mortgage-Backed Securities  
**Watching for Credit Expansion**

With fundamentals improving, investors should weigh the benefits and risks of credit expansion.

We maintain our long-running constructive view on non-Agency RMBS as healthy housing fundamentals and improving borrower performance support the sector. Strong demand and muted new home construction have pushed inventories to historically low levels, in turn boosting home values (see chart, top right). Against this backdrop, ongoing credit curing of legacy MBS borrowers should result in improved prepayments and loss rates on bonds and has already emboldened greater risk-taking by lenders and investors.

Approximately $50 billion of new issuance is projected for 2018 across a variety of asset types, including non- and re-performing loans, credit risk transfer deals backed by “vanilla” government-sponsored enterprise loans, jumbo prime loans, and most recently, non-qualified mortgage (non-QM) loans. The QM rule was implemented in 2013 under the Dodd-Frank Act and stipulates a number of attributes necessary to provide legal safeguards for the lender. Loans that do not qualify for QM status tend to be investor properties, credit-blemished borrowers, first-time borrowers with higher debt-to-income (DTI) ratios, and self-employed borrowers who use bank statements to demonstrate their monthly cash income.

The non-QM market is small—$4 billion outstanding—with issuance concentrated in the last 12 months, but this market is likely to grow with heightened borrower awareness and increased lender comfort around credit performance and securitization execution. Traditional MBS credit metrics of credit score and debt-to-income ratio have remained stable for non-QM to date (see chart, bottom right), but the depth of originator diligence on bank statement-based loans could come under pressure if origination volumes grow significantly.

Non-Agency RMBS recorded strong performance in the fourth quarter, posting a 1.6 percent total return, outperforming the Bloomberg Barclays Aggregate index and bringing year-to-date returns to 10.5 percent. Trading volume tapered off in December while investor appetite and dealer inventory remained stable.

Non-Agency RMBS spreads have now tightened to post-crisis lows and the flat credit curve gives little compensation for bearing increased spread duration, subordination, or idiosyncratic event risks. We continue to favor senior tranches backed by credit-sensitive collateral types, which should benefit from monthly amortization and improving credit fundamentals.
Bank Statement Loans Gain Share of Non-Qualified Mortgage Market

Source: Guggenheim Investments. Data as of 1.10.2018.

The homeownership rate has risen after 10 years of declines, with gains coming from younger age groups, including first-time buyers. Strong demand and muted new home construction have pushed inventories to historically low levels, in turn boosting home values.

Originator diligence should come under pressure if volumes of non-QM loans grow significantly. Indeed, loans to borrowers who use bank statements to demonstrate their monthly cash income are growing as a percentage of non-QM issues outstanding. FICO scores have not deteriorated as a result of this trend.
Investors flocked to floating-rate investments in 2017 as rising Libor offsets post-crisis tights in spreads.

CMBS new issuance remained robust and pricing held steady throughout the fourth quarter. Conduit CMBS new-issuance volume was virtually unchanged from the same period in 2016, while large loan and single asset/single borrower (SASB) transaction volume soared to $14 billion, compared to $9 billion in the same period last year. The increased new issuance was almost exclusively in floating-rate transactions (see chart, top right). Despite credit spreads being at post-crisis tights, one-month Libor's rise from 0.77 percent on Jan. 3, 2017, to 1.57 percent at year end has caused yields to remain relatively high, and investor demand to appear insatiable. We are increasingly cautious of these floating-rate structures as investor compensation for riskier tranches is very low and deal terms tilt in borrowers' favor with increased loan term extension options.

Commercial real estate (CRE) market fundamentals enter 2018 somewhat mixed. Property performance growth has moderated from recent years, but is still positive. The decline in property performance growth negatively affected transaction volume in 2017, highlighting a valuation disagreement between buyers and sellers. In particular, we have noticed that buyers have slowed activity in primary markets and begun searching for opportunities in tertiary markets and value-add properties. That said, capitalization rate spreads, loan underwriting (see chart, bottom right), and general economic conditions all remain favorable (perhaps with the exception of retail), and we struggle to find a catalyst that would broadly disrupt the health of the CRE market in the coming year.

Post-crisis CMBS, as measured by the Barclays U.S. CMBS 2.0 index, gained 0.5 percent in the fourth quarter. The senior-most AAA-rated tranche and AA-rated tranche of the index returned 0.3 percent and 0.8 percent, respectively, while A-rated and BBB-rated CMBS 2.0 tranches had stronger total returns of 1.1 and 1.8 percent, respectively. For the year, CMBS 2.0 returned 3.9 percent.

We favor more defensive, loss-remote investments in conduit CMBS and CRE CLO transactions. We have also remained active in SASB where the underlying property quality is high and transaction terms are fairly balanced between lender and borrower.
Large Loan and SASB New Issuance Soared in the Fourth Quarter of 2017


Large loan and single asset/single borrower (SASB) transaction volume soared to $14 billion, compared to $9 billion in the prior comparable period. The increased new issuance was almost exclusively in floating-rate transactions.

Underwriting Statistics Support a Constructive View of Conduit Fundamentals

Source: Trepp, Guggenheim Investments. Data as of 1.19.2018. Note: There was no issuance in 2009, the year after the financial crisis.

Loan underwriting discipline has remained strong in CMBS. Percentage of loans with loan to value of greater than 74 percent are at post-crisis lows, while debt service coverage ratios remain high.
Commercial Real Estate Debt
A Bright Outlook for 2018

The commercial real estate market is poised for income growth with stable valuations.

The market is poised for additional income growth and stable values in 2018. While annual deal volume has decreased since the peak in 2015, valuations have continued to rise. (see chart, top right). The majority of this increase has been in the apartment and industrial sectors. The apartment market has been particularly resilient given the glut of new units over the past two years, the highest since the early 1980s (see chart, bottom right). New home formation continues to exceed supply (apartment and single family combined), and concern over future oversupply seems to be waning. Unlike previous cycles, this favorable supply/demand dynamic has been a major contributor to the stability in all sectors. This balance does not appear to be changing, as indicated by a pullback in construction lending by most national and regional banks in 2017. While interest rates and the changing retail landscape continue to be headwinds in further cap rate compression, the prospects for net operating income growth look favorable thanks to positive economic forecasts and tax law changes that should benefit long-term owners of real estate. There is also discussion in Washington regarding changes to the Dodd-Frank Act that could provide additional liquidity to the market. So while real estate may see an overall increase in cap rates in 2018, it should not offset the other positive impacts that occurred in 2017.

The Commercial Property Price index increased 7.0 percent in 2017, according to Real Capital Analytics data. Apartment and industrial sectors led the way, with 10.6 percent and 6.1 percent gains respectively. Retail and office properties had more modest 1.1 percent and 3.0 percent gains for the year.

With the recent increase in interest rates, especially in five- and seven-year yields, we are constructive on coupons on five-, seven-, and 10-year terms for loans at 65 percent loan to value and below. The bridge and construction loan space is still attractive, especially as Libor rates increased significantly in 2017 and will likely continue to rise in 2018. The pullback in construction lending by traditional sources is affording opportunities for nontraditional lenders. The spreads for these loans are particularly attractive as the loan to cost quoted by most lenders has decreased over the last 12-14 months.
Valuations Continue to Rise Despite Waning Deal Volume

Property valuations have continued to rise even as annual deal volume has decreased since the peak in 2015.

Volume vs. Pricing

Source: Real Capital Analytics (RCA), Guggenheim Investments. Data as of November 2017. RCA Commercial Property Price index (CPPI) is a national all-property composite index.

Apartments Lead the Pack on Property Price Growth

The apartment market has been particularly resilient despite the glut of new units over the past two years, the highest since the early 1980s.

Source: Real Capital Analytics (RCA), Guggenheim Investments. Data as of November 2017. Indexed to June 2012. RCA Commercial Property Price index (CPPI) is a national all-property composite index.
Municipal Bonds

Tax Reform Rocks the Muni Market

We focus on quality as the effects of unintended consequences from the tax overhaul loom large.

Since the first tax reform bill was proposed in November 2017, the municipal market has been fixated on provisions that would directly and indirectly impact tax-exempt municipal bonds. Not surprisingly, December 2017 generated $62.5 billion of new-issue supply, an all-time monthly record, as issuers reacted to proposals surrounding qualifications for tax-exempt issuances. This highlights once again the outsized influence of federal policies on municipal bonds. The elimination of advance refunding bonds immediately reduces upcoming years’ supply expectations (see chart, top right).

Behavioral changes in response to the tax plan may ripple through the market’s composition and credit quality. For example, increases in federal Medicaid funding, on which state and local governments have become increasingly dependent, may prove difficult to maintain given projected federal budget deficits. The $10,000 cap on state and local tax (SALT) deductions may enhance the relative value of tax exemption, but more migration from high-tax states to low-tax states would reduce the municipal market’s natural demand base. From a credit quality perspective, such migration will also impair the financial flexibility of high-tax municipalities (see chart, bottom right).

The Bloomberg Barclays Municipal Bond index posted a 0.8 percent gain during the fourth quarter of 2017, with longer-maturity bonds continuing to outperform the short end and lower-quality bonds outperforming higher quality. BBB-rated and A-rated municipal bonds returned 1.4 percent and 0.9 percent, respectively, versus 0.7 percent for AA-rated bonds and 0.5 percent for AAA-rated bonds. Municipal bonds were up 5.5 percent for the year.

In order to soften supply reductions, investment bankers may be prompted to deliver comparable financing solutions with non-standard features (e.g., shorter calls, non-5 percent coupons). Further, a lack of alternative financing options may encourage issuers to revisit strategies of using derivative contracts to manage interest rate risk. The municipal market’s changing dynamics are highlighted by the preservation of private activity bonds (PABs). Although PABs were eventually saved by a narrow margin, the legislative process underlined that unique features cherished by the municipal market are not sacrosanct. We continue to emphasize uncovering value through credit fundamentals.
SALT Deductibility Limits Will Reshape the Muni Market

State and local taxes as a percentage of total personal tax liability and income.

The $10,000 cap on state and local tax deductions will likely incentivize more migration from high-tax states, such as Connecticut and New Jersey, to low-tax states, such as Florida and Texas. Such migration would reduce the municipal market’s natural demand base and, from a credit quality perspective, will also impair the financial flexibility of high-tax municipalities.


Advance Refunding Dropped in 2017 from 2016 Peak

The elimination of advance refunding bonds will immediately reduce supply expectations. Further, a lack of alternative financing options may encourage issuers to revisit strategies of using derivative contracts to manage interest rate risk.

While short-term drivers for spread tightening are in place, we expect modest widening later in the year.

Agency MBS performance was positive in the fourth quarter, driven largely by carry as the quarter ended with higher rates and a flatter yield curve. Range-bound rates, low volatility, and reasonable valuations relative to credit sectors have resulted in stable Agency MBS spreads as investors continue to look for opportunities to add high-quality spread assets to their portfolios. Prepayment speeds were steady over the quarter. Agency MBS spreads have the potential to widen modestly from here as readings are tight compared to historical levels, and 2018 supply is expected to be higher than in recent years. However, we view this technical dynamic as disproportionately affecting Ginnie Mae (GNMA) MBS over Fannie Mae (FNMA). The GNMA share of outstanding Agency MBS has increased from approximately 10 percent to 30 percent over the last decade, as its share of net supply has been much higher (see chart, top right). Strong demand for GNMA MBS from domestic banks and Japanese investors has resulted in GNMA MBS trading at tighter spreads or at higher prices than FNMA. However, demand from these sources is likely to be more muted going forward, even as demand from the Fed declines.

The Bloomberg Barclays U.S. MBS index posted a 0.15 percent total return in the fourth quarter of 2017. Yields ended the quarter at 2.91 percent, higher than the previous quarter, while option-adjusted spreads were roughly 3 basis points wider over the quarter (see chart, bottom right). Conventional MBS outperformed GNMA, 30-year MBS outperformed 15-year MBS, and lower coupons outperformed higher coupons.

We currently favor securities with less interest rate sensitivity—less negatively convex—where either the collateral or structure offers some cash flow stability. Accordingly, we find select subsectors attractively priced in the current environment, including longer-maturity Agency multifamily bonds, new collateral types recently introduced by the government-sponsored enterprises, and some collateralized mortgage obligation structures. We continue to avoid assets, such as GNMA MBS, where valuations are relatively stretched and which may be more negatively affected by the Fed’s balance sheet runoff or a potential easing of the Basel Liquidity Coverage Ratio, which has motivated a portion of bank demand in recent years.
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GNMA's Share of the Agency MBS Market Has Tripled in the Past Decade
Share of Outstanding Agency MBS by Issuer

The GNMA share of outstanding Agency MBS has increased from approximately 10 percent to 30 percent over the last decade, as its share of net supply has been much higher. Strong demand for GNMA MBS from domestic banks and Japanese investors has resulted in GNMA MBS trading at tighter spreads or higher prices than FNMA.

Agency MBS Spreads Widened Slightly in the Fourth Quarter
Bloomberg Barclays U.S. MBS Index Option-Adjusted Spread

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Rates

Anticipate Further Yield Curve Flattening

Economic conditions, goosed by tax reform, call for a faster pace of Fed rate hikes.

The Treasury yield curve continued to flatten in the fourth quarter, a trend that was in place for the majority of the year. The front end of the Treasury curve underperformed, with two-year notes increasing 40 basis points in yield as the Fed delivered another 25 basis-point increase in the federal funds rate at its December FOMC meeting. At the same time, inflation remained moderate (see chart, top right), and robust demand for long-duration assets caused the long end of the Treasury curve to outperform, with the 30-year Treasury bond yield falling 12 basis points. The 2s/30s yield curve flattened by over 100 basis points over the year, with the two-year note yield increasing from 1.19 percent to 1.89 percent, and the 30-year bond yield decreasing from 3.07 percent to 2.74 percent.

The flattening of the Treasury curve during the quarter delivered mixed returns for the overall Treasury market. The Bloomberg Barclays U.S. Treasury index returned 0.05 percent for the quarter, bringing the total return for the year to 2.30 percent. The Bloomberg Barclays U.S. Treasury 20+ year index returned 2.55 percent for the quarter, delivering a total return of 9.00 percent for the year. The Barclays U.S. Agency index returned 0.06 percent for the quarter and 3.0 percent for the year. Globally, the Bloomberg Barclays Global Treasury index returned 1.10 percent for the quarter and 7.30 percent for the year.

Looking ahead, we expect the Fed to increase the fed funds rate by another 25 basis points at its March meeting. With the new tax law now taking effect, economic growth is likely to remain strong this year and cause the labor market to overheat, which should prompt the Fed to tighten at a faster pace. We expect the Fed to deliver four interest-rate hikes in 2018. Providing additional pressure on the Treasury market is the looming increase in supply. The recently released Treasury refunding schedule indicates that the marginal increase in Treasury issuance needed to fund a larger budget deficit and the runoff of the Fed’s portfolio will be tilted toward shorter coupon maturities as well as bills (see chart, bottom right). Four rate hikes in 2018, combined with the expected tenor mix and amount of Treasury issuance, should disproportionately pressure front-end yields that should support further bear flattening of the yield curve. A more hawkish Fed could cause realized and implied interest rate volatility to rise from current low levels, which could result in attractive investment opportunities if it leads to a widening of high-quality Agency spreads.

Note: “Rates” products refer to Treasury securities and Agency debt securities.
The U.S. Treasury Department’s recent refunding announcement reflects an increase in the government’s borrowing needs. The outcome will be increased issuance for every maturity, with extra emphasis on the two- and three-year tenors, as well as bills. The looming Treasury supply and tenor mix, combined with our expectation for four Fed rate hikes in 2018, will likely result in disproportionate pressure on front-end yields that should support further bear flattening of the yield curve.

The fiscal easing in the pipeline will boost real GDP growth, which leads core inflation by six quarters. In turn, the Fed will look to get ahead of a possible overheating of the economy by raising rates four times in 2018, rather than the three hikes they projected as of December.
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