

First Quarter 2019

# Fixed-Income Outlook

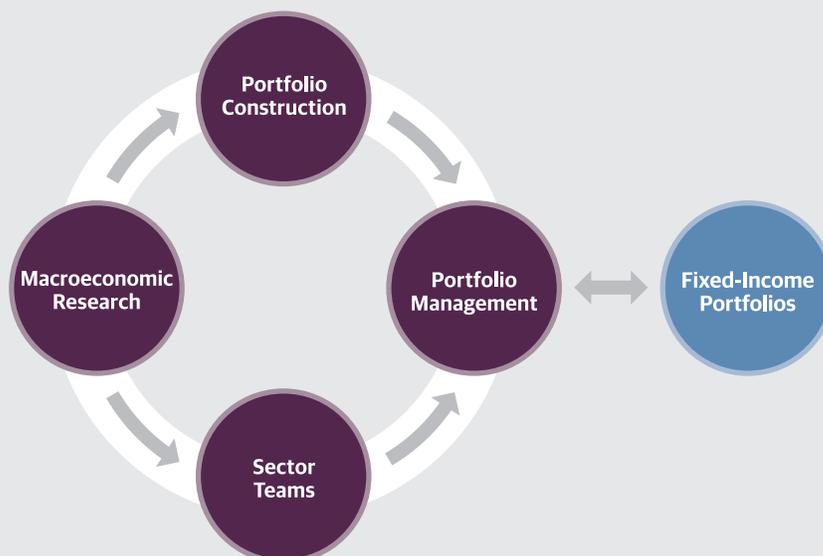
Late-Cycle Drama Is Unfolding

GUGGENHEIM

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## 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.

## From the Desk of the Global CIO

# Late-Cycle Drama Is Unfolding

Our last several installments have reiterated a central theme: The Federal Reserve (Fed), seeking to normalize policy and temper above-trend economic growth, was on course to cause a recession that we projected would begin in the first half of 2020. This timing is important because history has shown us that market conditions typically deteriorate in the 12 months leading up to a recession. This meant we had to manage around an overvalued market knowing that soon enough we would see dramatic spread widening and liquidity issues.

In the fourth quarter, this late-cycle drama began to unfold, and risk assets sold off. After setting peaks in October, equities and credit sectors began a wild ride down. The selloff intensified in December amid a severe lack of liquidity. Before the December Federal Open Market Committee (FOMC) press conference, the S&P 500 had set a new low of 2,546. It took another 7.7 percent dive following a series of policy blunders that included Fed Chair Jay Powell's "autopilot" comments about the Fed balance sheet runoff, President Donald Trump's attack on Fed independence, and Treasury Secretary Steven Mnuchin's call to major banks confirming that they had adequate liquidity. Financial markets had zero tolerance for policy mistakes in an already weak seasonal correction environment.

Learning from its mistake, the Fed will be sure to quell any uncertainty around its policies in 2019. The Fed has indicated it will move to the sidelines, and we expect it will deliver only one more hike later in 2019 and remove its balance sheet runoff from autopilot. This has calmed markets for now, but headwinds remain. Global economic data look increasingly poor, with Europe leading the way down. More policy action will be needed to ward off the recession we see on the horizon. We put the odds of a Fed rate cut at 50/50, and we believe the European Central Bank (ECB) will introduce another targeted program to encourage bank lending.

The experience we recount in this quarter's Fixed-Income Outlook should serve as a preview of what is to come when the cycle ultimately turns. For now, we expect risk assets to enjoy another rally while the Fed stays on hold, but the pause will only allow excesses we have highlighted before to become more pronounced. The defensive positioning we established in the third quarter of 2018 will remain intact, which will enable us to avoid the volatility that characterizes late cycle market behavior and give us the opportunity to pick up undervalued assets when others are being forced to sell.



A handwritten signature in black ink, appearing to read "Scott Minerd". The signature is stylized and fluid.

**Scott Minerd**  
Chairman of Investments and Global Chief Investment Officer

## Portfolio Management Outlook

# Liquid and Patient



**Anne B. Walsh, JD, CFA**  
Chief Investment Officer,  
Fixed Income



**Steve Brown, CFA**  
Portfolio Manager



**Adam Bloch**  
Portfolio Manager

Reduced spread duration of our investment portfolios helped dampen market volatility in the second half of 2018.

Global economic data weakened throughout the course of the fourth quarter. Macroeconomic and geopolitical events, including a trade war between the United States and China, falling oil prices, and concerns over slowing growth, triggered a broad selloff in risk assets. Spreads widened across all sectors, while interest rates fell over the quarter.

At its December meeting, the FOMC voted to raise the federal funds rate by 0.25 percent to a range of 2.25-2.5 percent. At the press conference, Fed Chair Powell failed to convey flexibility around the Fed's balance sheet policies. The Treasury yield curve bull steepened as future Fed interest rate hike expectations collapsed while risk assets sold off further. More recent Fed speak, particularly during the January post-FOMC meeting press conference, calmed markets by confirming data dependence and flexibility around interest rate and balance sheet policies.

Risk reduction in our portfolios continued in the fourth quarter and was concentrated in the first half of the quarter, prior to the most significant spread widening. All strategies pared back exposure to remaining credit sectors, including CLOs, non-Agency RMBS, and other ABS, with proceeds going toward government-guaranteed sectors, and cash and cash equivalents. As a result, portfolio credit quality further increased and spread duration was further reduced over the quarter.

In the Core Plus strategy, long-duration assets in our portfolio contributed to positive absolute performance as rates beyond one year fell between 20-45 basis points. Our investment strategy continues to employ a duration barbell by allocating key rate exposure on the very long end of the curve while remaining overweight floating-rate exposure on the short end, resulting in an underweight duration relative to its benchmark. While spreads widened in all credit sectors over the fourth quarter, the Core Plus strategy outperformed its benchmark on a spread basis as structured credit spreads held in better than corporate credit spreads.

In the Multi-Credit strategy, our prior risk reduction program and relatively low allocation to below investment-grade credit led to relative outperformance over the quarter. Similar to the Core Plus strategy, our senior structured credit exposure outperformed corporate credit, particularly AAA CLOs. Our short spread duration helped dampen performance volatility.

We believe that the Fed will pause rate increases in the first half of 2019, with the risk that this pause could last longer. Additionally, the possibility of a rate cut cannot be ruled out. Further weakness in global economic growth may spill into the U.S. economy, which could spur the Fed to react. Such events have occurred in the past. The Fed ultimately cut rates in 1995, in the aftermath of the Mexican peso crisis. Then, after a short hiking cycle, it cut rates again in 1998 due to the spillover effect from the Asian financial crisis.

The Fed pause is supportive of a rally across risk assets in the near term, but it will also allow excesses to continue to build in the system. Many of the concerning trends previously discussed by our sector teams, including the potential for high downgrade volume in the investment-grade market and defaults in certain credit sectors, remain at the forefront of our long-term thinking. In this environment where we believe credit spreads are not enough to compensate for these risks, it is prudent to stay up in quality and maintain adequate liquidity to pick up undervalued credits during more opportune times.

### Topsy Turvy: Sector Returns Flipped in the Fourth Quarter



Source: Guggenheim Investments, JP Morgan, Bloomberg Barclays, ICE BofA Merrill Lynch, Credit Suisse. Data as of 12.31.2018. Non-Agency RMBS: JP Morgan Research; Post-Crisis AAA CLOs: JP Morgan CLOIE Post-Crisis AAA Index; Bank loans: Credit Suisse Leveraged Loan Index; Non-Agency CMBS 2.0: Bloomberg Barclays CMBS 2.0 Index; Agency MBS Fixed-Rate: Bloomberg Barclays U.S. MBS Index; Treasuries: Bloomberg Barclays Treasuries Index; Taxable Munis: Bloomberg Barclays Taxable Municipal Index; High Yield Corporate Bonds: ICE BofA ML High-Yield Index; Investment-Grade Corporate Bonds: Bloomberg Barclays Investment-Grade Corporate Bond Index.

Fixed-income sector performance trends reversed course in the fourth quarter. Panicked selling exacerbated market volatility as some investors attempted to de-risk amid dwindling market liquidity.

## Macroeconomic Outlook

# It's All Downhill from Here



**Brian Smedley**  
Head of Macroeconomic  
and Investment Research



**Maria Giraldo, CFA**  
Managing Director



**Matt Bush, CFA, CBE**  
Director

Global growth has peaked, but a tight U.S. labor market will ultimately prompt the Fed to tighten again.

U.S. economic growth was solid at an estimated 2.6 percent in the fourth quarter of 2018, but we expect first quarter growth to slow to about 1.0 percent. This stems in part from tighter financial conditions, but reported growth is also likely to be weighed down by seasonal adjustment issues along with the temporary impact of the government shutdown.

The good news is that sequential growth is likely to rebound in the second quarter as statistical and shutdown distortions are reversed. Nevertheless, growth is now on a downward trajectory in year-over-year terms. The combination of tighter Fed policy and fading fiscal stimulus will ensure that growth in 2019 is weaker than it was in 2018. Leading indicators confirm that the peak in growth is behind us (see chart, top right), and our recession forecasting tools continue to point to a downturn starting by mid-2020. However, there is a chance that a Fed pause could delay a downturn until late 2020 or even early 2021.

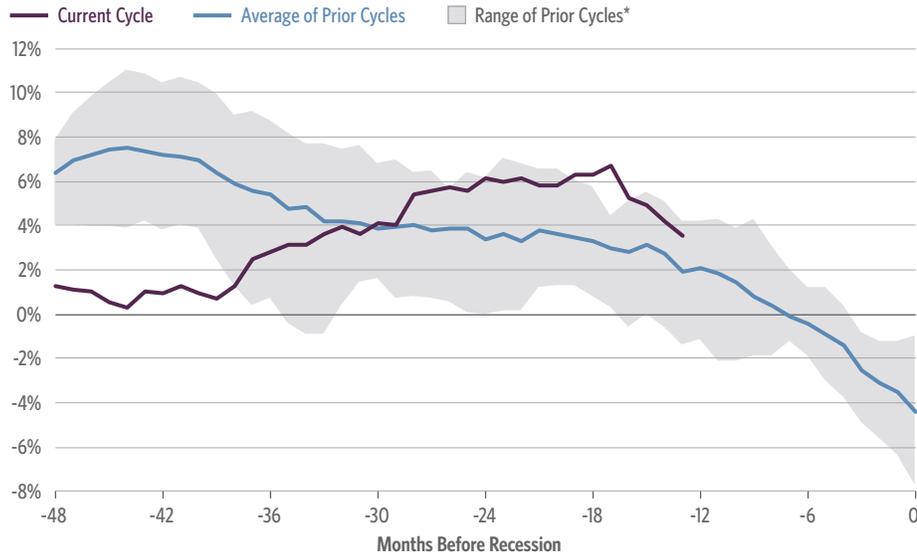
Meanwhile, the steady softening in global manufacturing purchasing managers' indexes illustrates how global growth momentum has faded (see chart, bottom right). Growth in Europe is sputtering, and the ongoing Brexit saga is still unresolved. The steady slide in Chinese growth has prompted authorities to announce a series of stimulus measures with more forthcoming, but policy lags will delay any positive impact.

Against this backdrop, the Fed has moved to the sidelines. A pause in the hiking cycle is likely for the first half of the year, but we do not believe the Fed is done tightening just yet. The labor market continues to strengthen, and we see further wage gains ahead. And while core inflation should remain soft in coming months, we expect it to rebound in the second half. Our baseline forecast now envisions one more hike later in the year. Further rate hikes may be required in 2020 should inflation expectations begin to rise meaningfully. Balance sheet runoff should conclude in the third quarter, with details likely to be announced at the March meeting. This will allay market concerns about balance sheet reduction being on "autopilot."

A more patient Fed and multi-pronged stimulus in China should foster a recovery in risk assets in the near term. Additionally, the ECB may add liquidity through long-term refinancing operations (LTRO) or targeted LTROs. This would support our call for an Indian Summer for risk assets, which is characterized by the warm spell that follows a cold snap. We see this as a window of opportunity to further de-risk portfolios in preparation for a 2020 recession.

## Leading Indicators Confirm that the Peak in Growth Is Behind Us

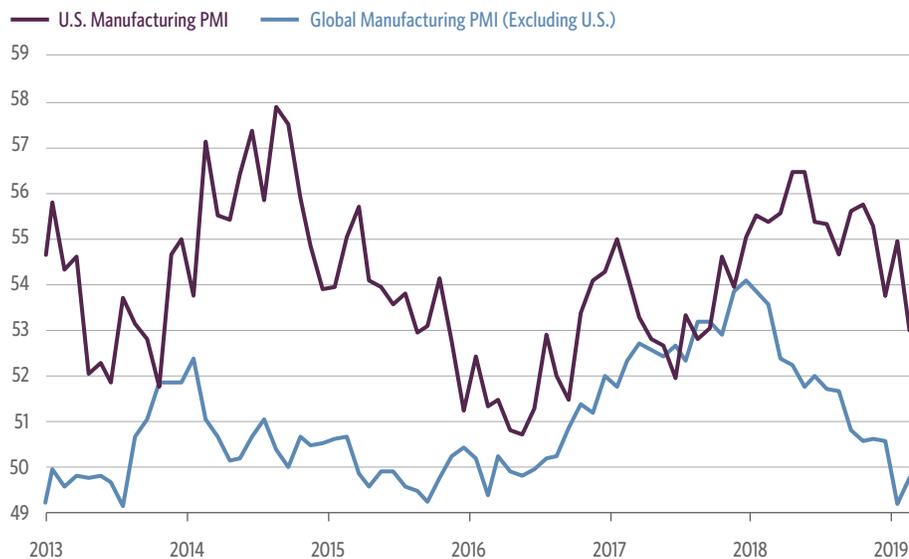
Leading Economic Index, YoY% Change



Source: Guggenheim Investments, Bloomberg. Data as of 1.31.2018. \*Note: includes cycles ending in 1970, 1980, 1990, 2001, and 2007. Shows the evolution of the LEI starting 48 months before the recession. Current cycle is assumed to end in February 2020.

Leading indicators confirm that the peak in growth is behind us, and our recession forecasting tools continue to point to a downturn beginning by mid-2020.

## U.S. Is Still Outperforming as Global Growth Downshifts



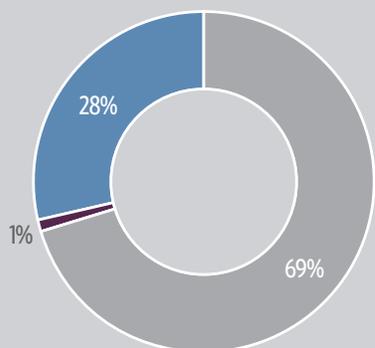
Source: Guggenheim Investments, Haver Analytics, Markit, JPMorgan. Actual data as of 2.28.2019. PMIs are GDP-weighted. Values above 50 denote expansion in manufacturing activity.

The steady softening in global manufacturing purchasing managers' indexes illustrates how global growth momentum has faded.

# Portfolio Strategies and Allocations

## Guggenheim Fixed-Income Strategies

### Bloomberg Barclays U.S. Aggregate Index<sup>1</sup>

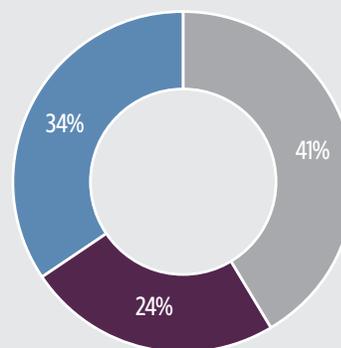


- Governments & Agencies:**  
 Treasuries 39%, Agency Debt 1%, Agency MBS 28%, Municipals 1%
- Structured Credit:**  
 ABS 1%, CLOs 0%, Non-Agency CMBS 0%, Non-Agency RMBS 0%
- Corporate Credit/Other:**  
 Investment-Grade Corp. 24%, Below-Investment Grade Corp. 0%, Bank Loans 0%, Commercial Mortgage 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 Treasuries, 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.

1. Bloomberg Barclays U.S. Aggregate Index: Other primarily includes 1.5% supranational and 0.9% sovereign debt. Please see disclosures at the end of the document. Totals may not sum to 100 percent due to rounding.

### Guggenheim Core Fixed Income<sup>2</sup>

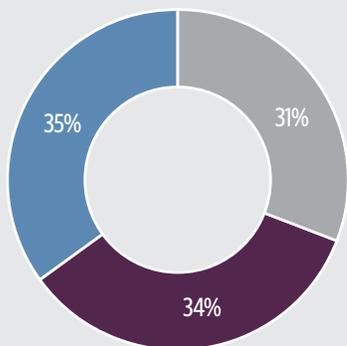


- Governments & Agencies:**  
 Treasuries 0%, Agency Debt 10%, Agency MBS 22%, Municipals 10%
- Structured Credit:**  
 ABS 14%, CLOs 8%, Non-Agency CMBS 2%, Non-Agency RMBS 1%
- Corporate Credit/Other:**  
 Investment-Grade Corp. 17%, Below-Investment Grade Corp. 1%, Bank Loans 1%, Commercial Mortgage 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.

2. Guggenheim Core Fixed Income: Other primarily includes 3.5% private placements, 1.6% preferreds, 1.4% LPs, and 0.7% 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 Core Plus Fixed Income<sup>3</sup>



**■ Governments and Agencies:**

Treasuries 13%, Agency Debt 5%, Agency MBS 13%, Municipals 1%

**■ Structured Credit:**

ABS 7%, CLOs 13%, Non-Agency CMBS 2%, Non-Agency RMBS 12%

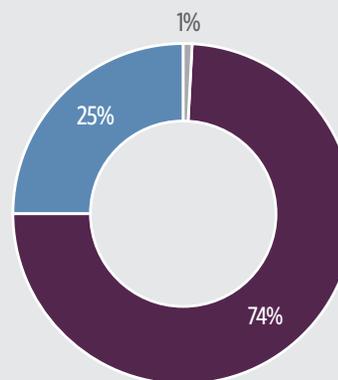
**■ Corporate Credit/Other:**

Investment-Grade Corp. 2%, Below-Investment Grade Corp. 0%, Bank Loans 1%, Commercial Mortgage Loans 0%, Other 31%

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 31.6% cash. 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 Multi-Credit Fixed Income<sup>4</sup>



**■ Governments and Agencies:**

Treasuries 0%, Agency Debt 0%, Agency MBS 1%, Municipals 0%

**■ Structured Credit:**

ABS 22%, CLOs 25%, Non-Agency CMBS 2%, Non-Agency RMBS 25%

**■ Corporate Credit/Other:**

Investment-Grade Corp. 1%, Below-Investment Grade Corp. 2%, Bank Loans 13%, Commercial Mortgage Loans 0%, Other 9%

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 5.7% cash and 3.1% 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

# Liquidity's Worth

### Portfolio allocation as of 12.31.2018



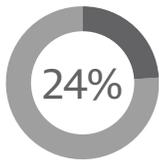
Guggenheim  
Core



Guggenheim  
Core Plus



Guggenheim  
Multi-Credit



Bloomberg Barclays  
U.S. Aggregate

Complacent markets learned a valuable lesson in December as panicked investors found buyers had vanished.

Investment-grade credit was drowning in complacency as third-quarter 2018 earnings announcements contained few surprises. Credit fundamentals were steady, and gloomy macro headlines surrounding geopolitics and trade wars were omnipresent, but largely ignored. After a meaningful move wider in the Bloomberg Barclays U.S. Corporate Index from the tightness of 2018 of 85 basis points to late August's 113 basis points, the fourth quarter appeared poised to follow the "Christmas rally" script of the prior two years. Instead, a spike in volatility driven by news on tech, FAANG, Huawei, and FOMC posturing exposed how poorly corporate credit can trade during a period of heightened illiquidity (see chart, top right). December illiquidity is not uncommon, but fund flows, supply technicals, and constrained dealer inventories amplified it to extraordinary levels.

The stage for December's liquidity event was set earlier in the quarter as the outflows from investment-grade funds accelerated. Fourth quarter outflows ultimately reached \$29.9 billion, erasing a third of prior year-to-date net inflows. Corporate bond trading volumes fell 8 percent from October to November and 23 percent from November to December, according to TRACE data (see chart, bottom right). The result was a rout of corporate bonds spreads of 46 basis points in the fourth quarter, or 43 percent spread widening. The weakness in the credit markets caused a dearth of new-issue supply in December, as the primary market produced a mere \$9 billion of investment-grade supply. This represents the lowest December issuance for 18 years, and far below the \$42 billion average. Low issuance levels are typically considered a positive technical for the market, but the lack of price verification in the primary market gave rise to an inability to price risk in the secondary market. Dealers cleaning up their balance sheets and reducing risk heading into year-end only exacerbated the move.

Confirming our Global CIO and Macroeconomic and Investment Group's expectations, we experienced an Indian Summer in the investment-grade corporate bond market in the early weeks of 2019. Spreads rebounded, tightening from the recent peak. Looking forward, we will continue to move up in quality, as higher quality credits should better weather a cyclical downturn. Identifying strong and/or improving balance sheet stories will be key, as BBB financing costs have become elevated alongside wider corporate spreads. In addition to the up-in-quality trade, we will focus on reducing exposure to industries and credits we think will underperform in an illiquid and recessionary environment. The dramatic selloff in December reminds us to be mindful of the true cost of liquidity.



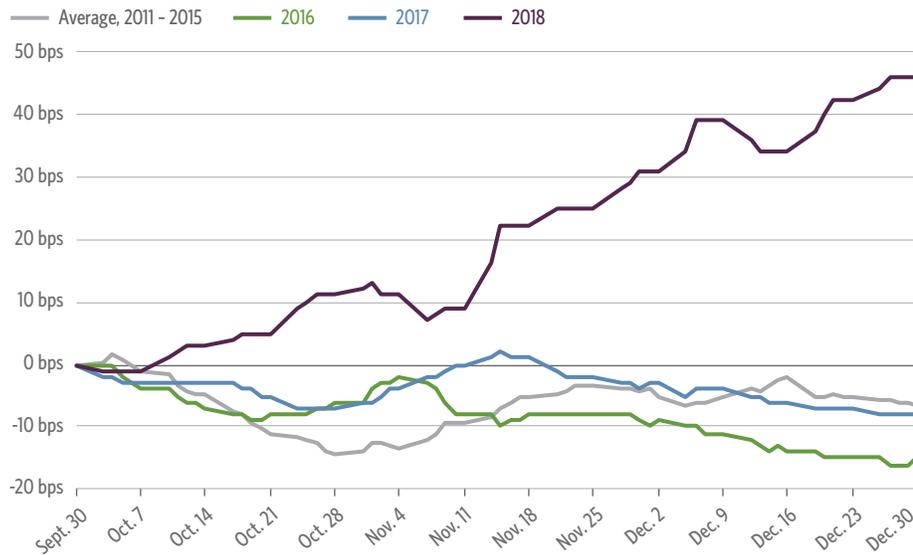
**Jeffrey Carefoot, CFA**  
Senior Managing Director



**Justin Takata**  
Managing Director

### The Typical Christmas Rally Failed to Materialize in 2018

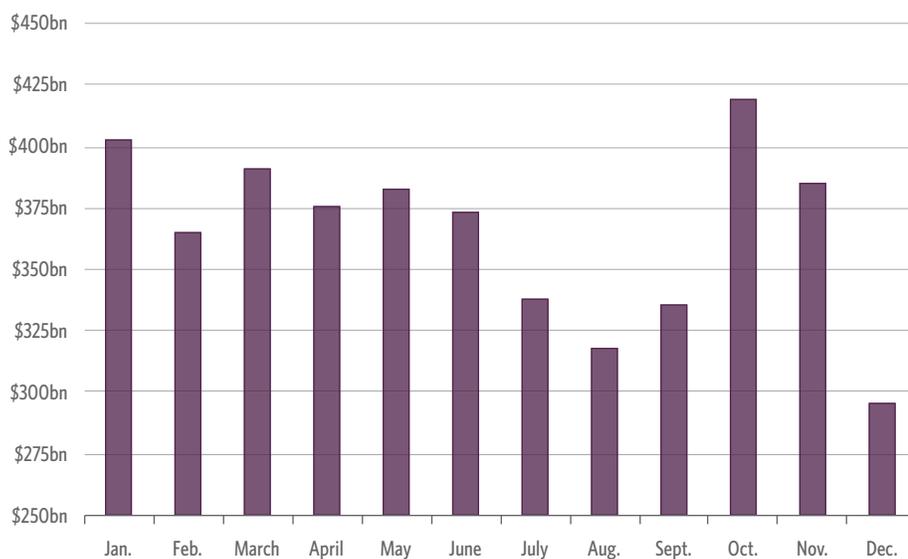
Cumulative Change in Inv. Grade Index Spreads from 9.30 of Each Year



Source: Guggenheim Investments, Bloomberg Barclays. Data as of 12.31.2018.

After a meaningful move wider in the Bloomberg Barclays U.S. Corporate Index from 2018 tightens of 85 basis points to late August's 113 basis points, the fourth quarter appeared poised to follow the "Christmas rally" script of the prior two years. Instead, a spike in volatility driven by news on tech, FAANG, Huawei, and FOMC posturing exposed how poorly corporate credit can trade during a period of heightened illiquidity.

### Investment-Grade December Trading Volume Declined to Below Summer Lows



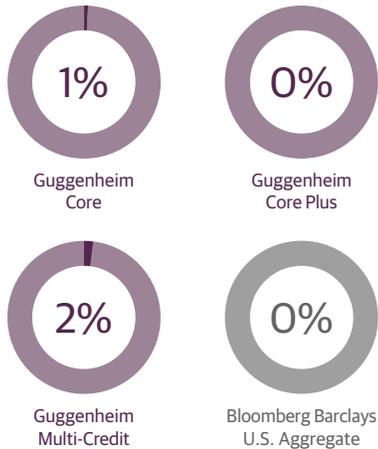
Source: Guggenheim Investments, Bloomberg, FINRA TRACE. Data as of 12.31.2018.

Corporate bond trading volumes fell 8 percent from October to November and 23 percent from November to December. The result was a rout of corporate bonds spreads of 46 percent in the fourth quarter.

## High-Yield Corporate Bonds

# Demand Shifts from Floating to Fixed

### Portfolio allocation as of 12.31.2018



**Thomas Hauser**  
Senior Managing Director



**Rich de Wet**  
Director

While high-yield bond spreads have recovered some of the ground they lost in the fourth quarter, we caution against adding too much spread duration at this point in the cycle.

In the early weeks of 2019, high-yield corporates have retraced almost half of the spread widening that occurred in the fourth quarter of 2018. Spreads widened by 200 basis points in the fourth quarter, but have tightened in 2019 (see chart, top right). At this pace, we may even revisit post-crisis tightness of 327 basis points. Our Macroeconomic and Investment Research Group believes the Fed will be forced to pause its rate hiking campaign through the first half of 2019 as it reacts to the recent tightening in financial conditions. We expect this pause to support high-yield corporate returns in the near term. The rally in oil also supports some upside for energy credits, which still comprise 15 percent of the high-yield market. Our Macroeconomic and Investment Research Group's oil model puts West Texas Intermediate prices closer to \$70 per barrel in the second half of 2019.

The ICE BofA Merrill Lynch Constrained High-Yield index lost 4.7 percent in the fourth quarter. In a stark reversal from previous quarters, lower quality significantly underperformed higher quality. BBs and Bs lost 3.0 percent and 4.9 percent in the quarter, while CCCs lost 10.3 percent on a total return basis. We had expected this reversal to occur at some point this year, given very stretched valuations in CCC corporates relative to Bs and BBs at the end of the third quarter of 2018. However, the recent selloff pushed relative value back in favor of CCCs, allowing the lower quality tranches to outperform higher quality in the rebound. High-yield corporates are up year to date, providing a healthy start to 2019 performance.

As the December freeze in activity thawed, we saw a healthy supply of high-yield corporates. After shutting down for five weeks in late 2018, year-to-date high-yield corporate bond issuance is now tracking above every year since 2015 (see chart, bottom right). Anecdotally, we find many deals to be oversubscribed as the Fed's pause has shifted demand from floating-rate to fixed-rate assets. Though high-yield fund flows were somewhat shaky to start the year, they are beginning to see strong inflows with two of the last four weeks ending Feb. 6 recorded as the largest weekly inflows since mid-2016. This demand dynamic may continue while the Fed is on pause. However, given fading tailwinds and slowing global growth, we remain cautious in our approach to credit investing, and would not look to add much spread duration at this point in the cycle.

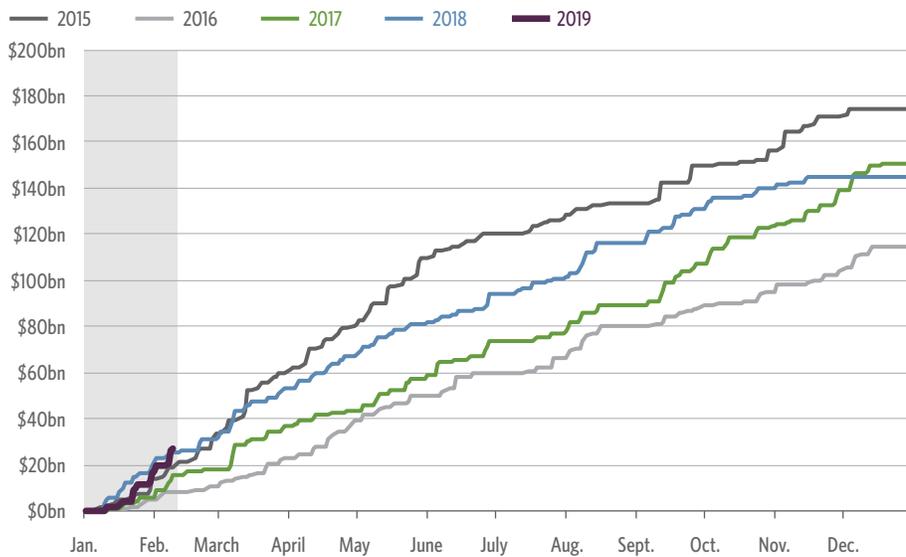
### High-Yield Bonds Have Retracted Almost Half of the Widening from Last Quarter



Source: Guggenheim Investments, ICE Bank of America Merrill Lynch. Data as of 1.24.2019.

High-yield corporates have retraced almost half of the spread widening that occurred in the fourth quarter. Spreads widened by 200 basis points in the fourth quarter of 2018 but have tightened in 2019.

### High-Yield Issuance Has Rebounded and Is in Line with Recent Years



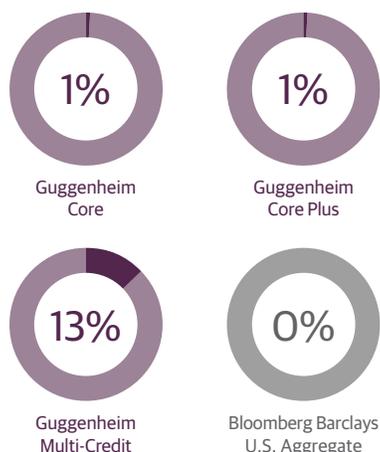
Source: Guggenheim Investments, S&P LCD. Data as of 2.8.2019.

After the December freeze in activity thawed, high-yield corporate issuance is now tracking the pace of the last few years.

## Bank Loans

# December Lessons

### Portfolio allocation as of 12.31.2018



Loan investors learned about illiquidity during December's volatility, but careful positioning can still add value.

Demand for floating-rate assets waned when market expectations for Fed rate hikes in 2019 fell from two to zero, resulting in record fund outflows. This repositioning caused mutual fund managers and exchange-traded funds (ETFs) to shed their more liquid holdings to cover redemptions, which led to larger loans underperforming smaller, less liquid loans on a price and total return basis (see chart, top right). The bank loan market's limited liquidity, combined with heavy outflows, exacerbated the negative pressure on loan prices, and resulted in performance that appeared to be more driven by liquidity concerns than credit. For example, as the selloff intensified in December, the gap between first- and second-lien discount margins (based on a three-year life) tightened by 34 basis points for the quarter. The painful lesson learned: liquidity is not a given, and the exits tend to shrink on the way out.

While the Credit Suisse Leveraged Loan index lost 3.1 percent in the fourth quarter of 2018, reducing full year returns to 1.1 percent, loans outperformed high-yield corporates for the first time since 2015. Performance across all rating categories was negative, with BBs losing 3.2 percent, Bs losing 2.9 percent, and CCCs losing 4 percent. Despite their underperformance in the fourth quarter, CCCs were the best-performing category in 2018.

In contrast to market expectations, our Macroeconomic and Investment Research Group expects the Fed will raise rates once in 2019, with the hike occurring in the second half of the year. Even without rate hikes, we think bank loans offer comparable value to high-yield corporates. The average BB loan trades at a yield below comparable corporates (see chart, bottom right). This typically occurs toward the end of a hiking cycle. Ultimately, loans should once again outperform other sectors when the Fed recommences its hiking campaign. Given late-cycle dynamics, we continue to defensively position credit portfolios through higher quality, which entails a preference for first lien over second lien loans, with a continued focus on less-cyclical business models with stable cash flows and strong liquidity positions.

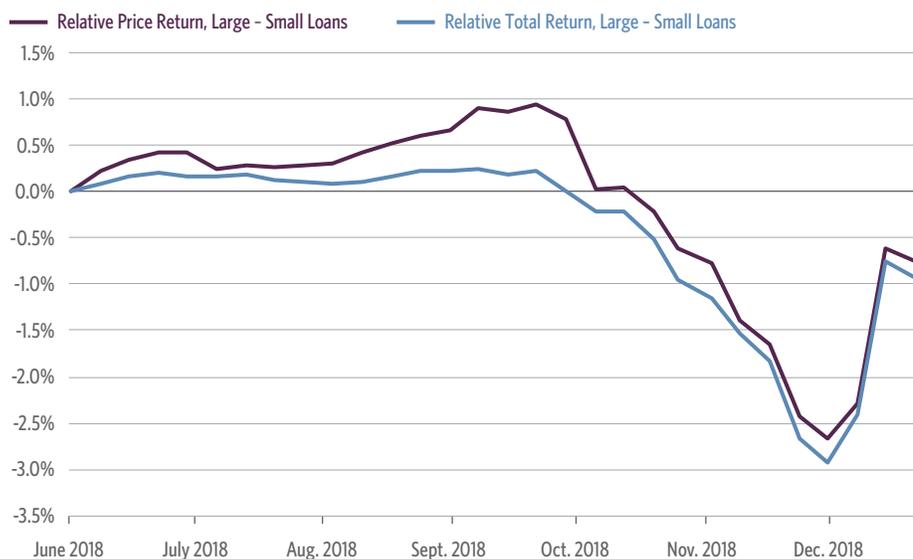


**Thomas Hauser**  
Senior Managing Director



**Christopher Keywork**  
Managing Director

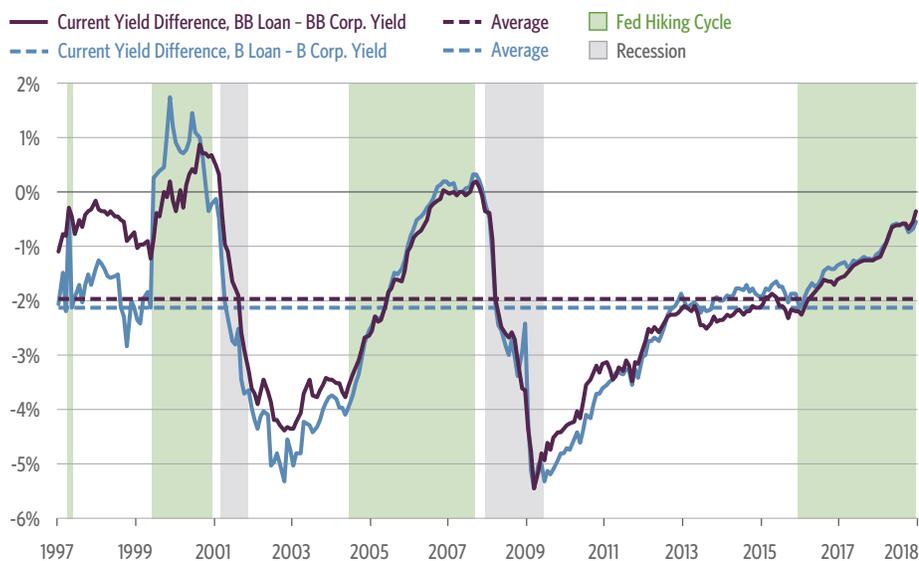
## Forced Selling from Record Fund Outflows Caused Large Loans to Underperform



Source: Guggenheim Investments, Credit Suisse. Data as of 1.17.2019. Small loans represent tranche sizes between \$200 million and \$300 million, large loans represent tranche sizes greater than \$1 billion.

Demand for floating-rate assets waned when market expectations for Fed rate hikes in 2019 fell from two to zero, resulting in record fund outflows. This repositioning caused fund managers to shed their more liquid holdings to cover redemptions, which led to larger loans underperforming smaller, less liquid loans on a price and total return basis.

## Loan Yields Look Competitive to Similarly Rated Corporates



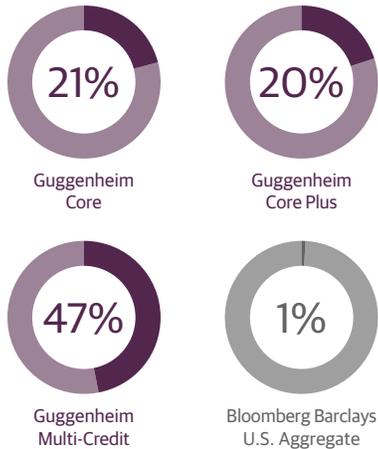
Source: Guggenheim Investments, Credit Suisse. Data as of 1.24.2019.

We think bank loans offer comparable value to high-yield corporates. The average BB loan trades at a yield below comparable corporates. This typically occurs toward the end of a hiking cycle.

## Asset-Backed Securities and CLOs

# A Wild Ride on Santa's Sleigh

### Portfolio allocation as of 12.31.2018



**Peter Van Gelderen**  
Managing Director



**Josip Zdrilic, CFA**  
Director

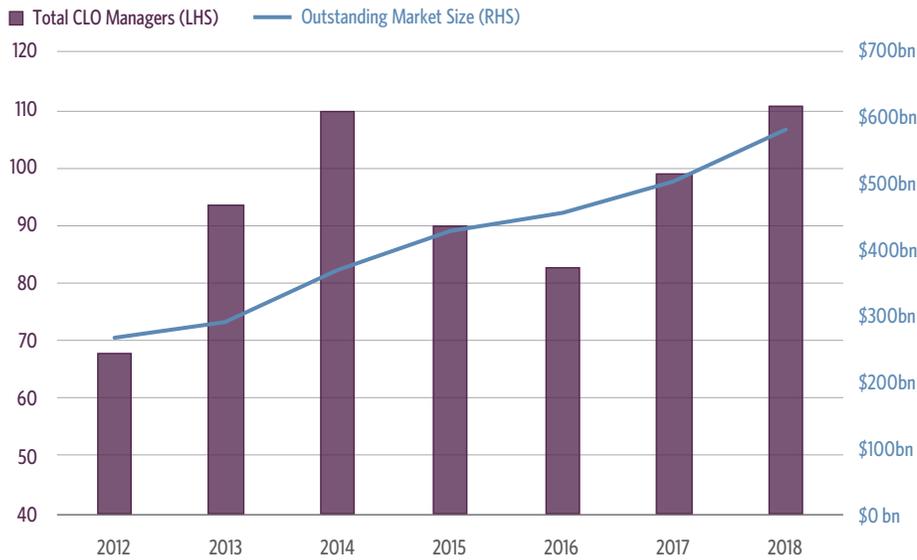
A sharp December selloff highlights the need to remain vigilant.

CLO spreads, under pressure since the first quarter of 2018, gapped wider in the last months of the year with other risk assets. CLO spreads ended the year 20-200 basis points wider compared to the start of the year (depending on tranche rating) and CLOs ended the year roughly flat on a total return basis. The soft pricing environment did not discourage issuers: 2018 set the high watermark in new issuance at around \$130 billion, and there are now 111 CLO managers, up from 68 in 2012 (see chart, top right). New issuance supply in 2019, however, may be negatively affected by less attractive pricing and fewer CLOs exiting their non-call period. From a collateral perspective, leveraged loans continue to feature no or low covenant structures. In 2018, 85 percent of leveraged loan issuance was covenant lite, resulting in 79 percent of all outstanding leveraged loans either having no or low covenant packages (see chart, bottom right). Nonetheless, CLOs offer good value in the medium term, given a short average life profile that contributed to better performance relative to corporate credit of comparable quality.

Esoteric ABS spreads also marched wider in the fourth quarter. While fundamental credit performance remained sound across esoteric ABS subsectors, the general risk-off environment negatively affected price performance in the space. Commercial ABS experienced strong levels of issuance in 2018, with commercial and financial ABS sectors issuing over \$25 billion. Current expectations call for a similar issuance in 2019. We are becoming more selective, as many market participants fail to distinguish credit quality and structural nuances within each sector. For example, new structural features in certain aircraft ABS were developed in 2018 that permit the syndication and trading of equity certificates. While this structural evolution has been met with enthusiastic demand from hedge funds, we are sensitive to the potential coordination and agency problems syndicated equity may present in times of distress and/or the transaction's scheduled maturity.

While spreads have recovered from the December wides, our focus remains on short, amortizing senior securities. Aircraft finance and esoteric commercial ABS will remain a focus in 2019.

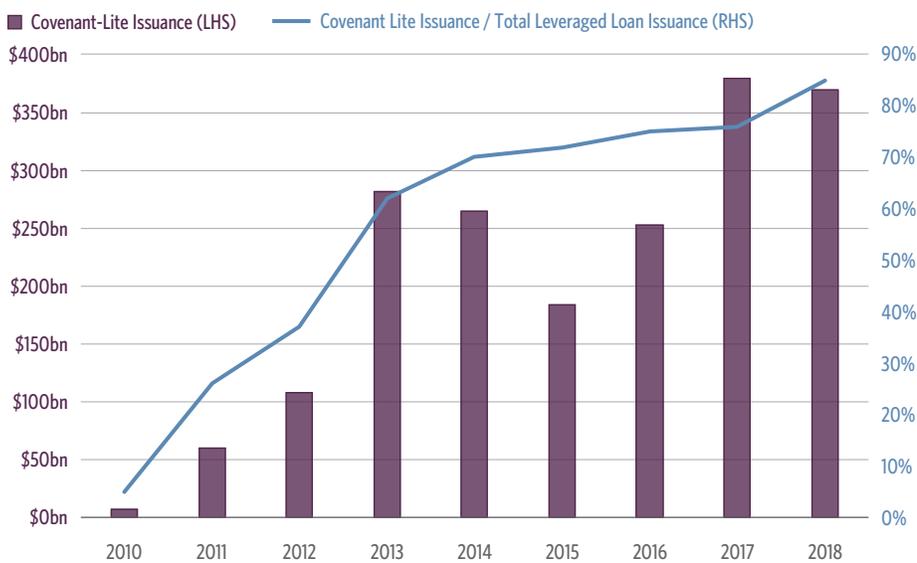
## 2018 Set Record for CLO Issuance and Managers



Source: Guggenheim Investments, Wells Fargo. Data as of 12.31.2018.

2018 set the high watermark in CLO new issuance at around \$130 billion, while total CLO managers now stand at 111, up from 68 in 2012.

## Most Leveraged Loans Lack Investor Protections

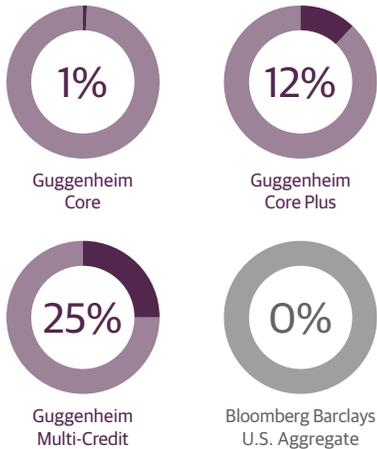


Source: Guggenheim Investments, S&P LCD. Data as of 12.31.2018.

In 2018, 85 percent of leveraged loans issuance was covenant lite.

# Non-Agency Residential Mortgage-Backed Securities Tread Lightly

## Portfolio allocation as of 12.31.2018



**Karthik Narayanan, CFA**  
Managing Director



**Roy Park**  
Director



**Alex Zhang**  
Vice President

Wider spreads and inconsistent liquidity belie positive long-run fundamentals.

Late-cycle credit market volatility in the fourth quarter and elevated RMBS dealer inventories weighed on non-Agency RMBS spreads and market liquidity. The credit tailwinds of healing borrower credit performance, favorable demographic trends, and limited housing inventory remain in place, but proved no panacea to higher risk premiums demanded by investors in the face of an aging credit cycle. Looking ahead, the rally in Treasury yields has reduced mortgage borrowing costs by 0.5 percent since November and should improve housing affordability and turnover, providing incremental upside to credit performance.

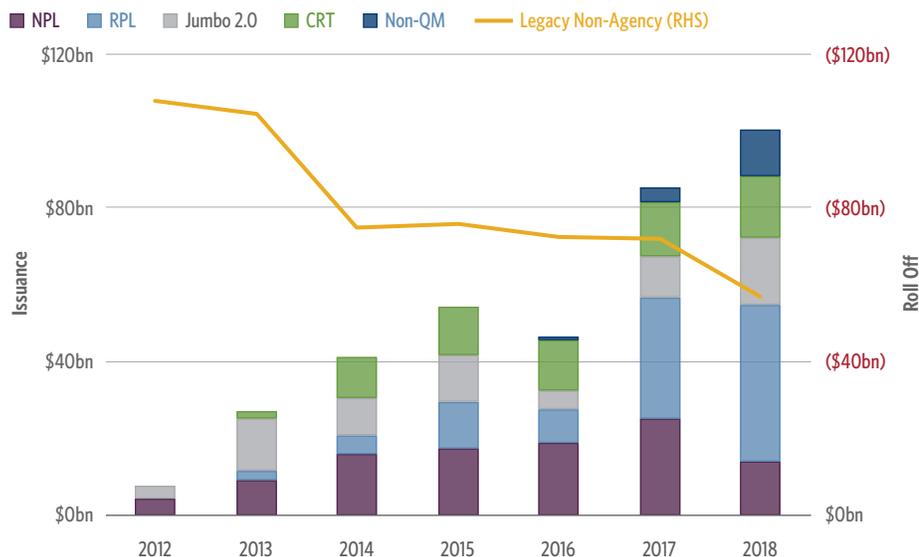
Despite posting negative -2.2 percent total return in the fourth quarter, non-Agency RMBS completed 2018 with a 3.3 percent total return and outpaced broader credit markets. New issuance tapered over the fourth quarter in response to deteriorating market conditions but completed 2018 at a post crisis high of \$100 billion. Post-crisis RMBS subsectors are demanding greater investor focus as new issuance volumes increase and the pre-crisis market continues to roll off (see chart, top right).

While securitizations backed by non- and re-performing loans (NPL/RPL) drove much of the growth since 2013, NPL issuance decreased in 2018. Issuance is expected to decrease further in 2019 as increasing funding costs in the short end of the yield curve as well as strengthening U.S. housing fundamentals diminish distressed supply. Instead, supply of RPLs, prime, and non-prime (also referred to as non-qualified mortgage, or non-QM) RMBS are expected to increase. Recent credit spread widening had an adverse impact on securitization economics. Spreads on RPL AAA (see chart, bottom right) as well as on other loss-remote, recently issued tranches have drifted wider by 60 basis points since March 2018—a 133 percent increase—which has meaningfully eroded securitization profitability for sponsors. For securitizations of new loans, particularly in the case of the non-QM market where loans are made in a relatively inelastic market, the higher cost of securitized debt can be transmitted to new loan pricing to preserve profitability. In NPL/RPL markets, in which sponsors aggregate loans over time, widening spreads and inconsistent liquidity create a headwind to issuance.

Balancing our constructive outlook on non-Agency RMBS fundamentals is our expectation of ongoing market volatility and irregular liquidity, emphasizing shorter maturity and structurally senior tranches for their lower prospective price volatility. We also favor pass-through structures backed by seasoned credit-sensitive collateral that stands to benefit from improving credit fundamentals.

## New Non-Agency RMBS Issuance Sets a Post-Crisis High

Gross Issuance by Sector

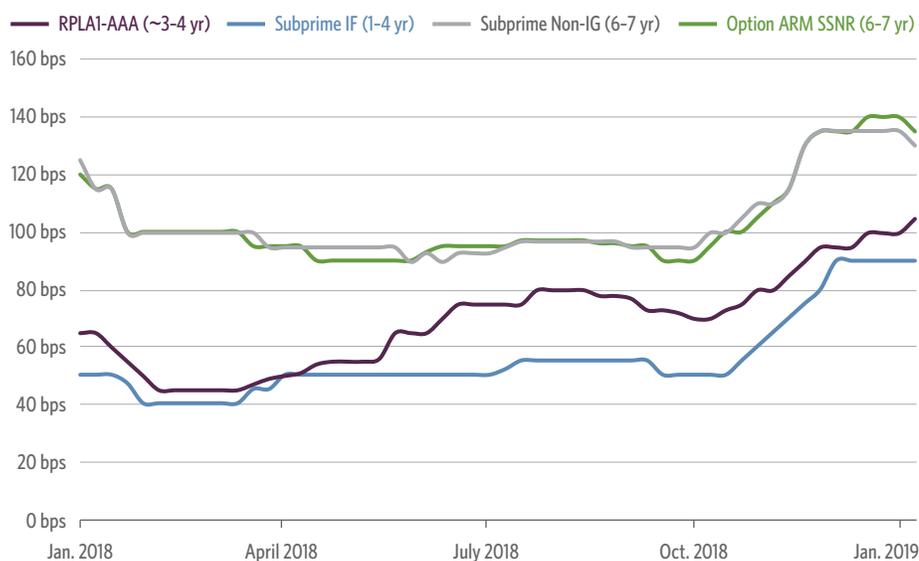


Source: Guggenheim Investments, Nomura. Data as of 12.31.2018.

New issuance reached \$100 billion in 2018 and is garnering greater investor focus as the pre-crisis RMBS subsector continues to roll off.

## Spreads on Recent-Issue AAAs Have Underperformed Other Sectors

Credit Spreads



Source: Guggenheim Investments, Wells Fargo. Data as of 1.12.2019.

Spreads on re-performing loan AAAs have widened by 60 basis points—a 133 percent increase—since the tightens of March 2018. This change will create headwinds for new issuance.

## Commercial Mortgage-Backed Securities Defensive Play

### Portfolio allocation as of 12.31.2018



Guggenheim  
Core



Guggenheim  
Core Plus



Guggenheim  
Multi-Credit



Bloomberg Barclays  
U.S. Aggregate



**Shannon Erdmann**  
Director



**Phil Hoehn**  
Vice President



**Darragh Murphy**  
Vice President

Volatile market conditions call for a focus on loss-remote, amortizing bonds and CRE-CLO deals with proven sponsors.

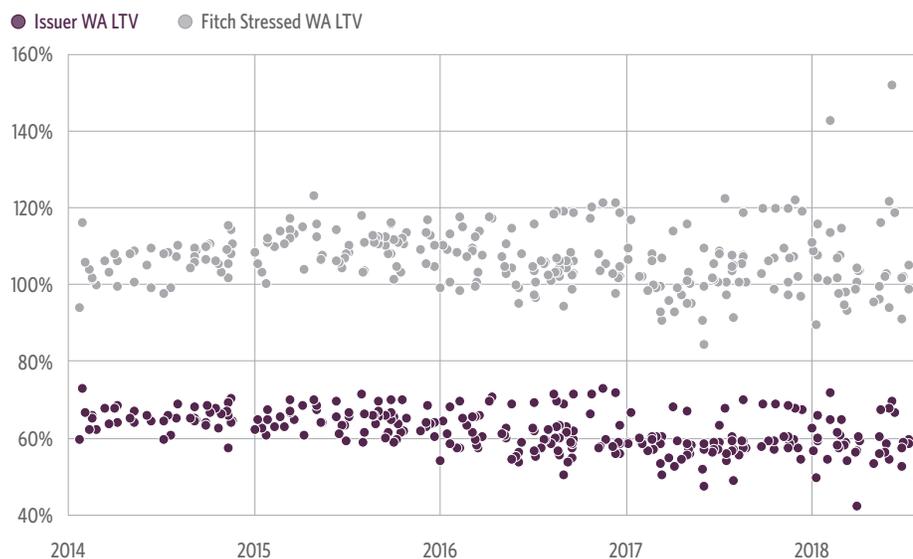
The fourth quarter of 2018 provided a stark reminder of the precarious nature of the current market environment. Concern over global growth and the policy risks around trade and foreign policy led to a spike in volatility. Given the prevailing investment environment, and with the commercial real estate (CRE) recovery entering its ninth year, we continue to favor more defensive, loss-remote, principal-bearing bonds. We also favor senior interest-only bonds in conduit CMBS and both static and managed CRE-CLO investments with proven deal sponsors at spreads similar to or better than conduit spreads.

In 2018, conduit issuance dropped to \$40.2 billion from the \$47.4 billion issued in 2017 and the \$47.6 billion issued in 2016. Despite this decline in conduit issuance, partly precipitated by the rise in issuance of CRE-CLOs, CMBS conduit remains the largest asset class in the private commercial real estate securitized market. CRE-CLO issuance had a record year in 2018, growing over 90 percent year over year. However, in 2019 the CRE-CLO market may struggle if investor demand for wide spreads on the liabilities persists. In late 2018, the spreads on the underlying loans did not widen as much as the spreads on the bonds, so issuing a CRE-CLO during that time did not make economic sense.

Conduit underwriting has remained relatively disciplined since the financial crisis, providing higher quality collateral pools. Average new-issue conduit underwritten loan-to-value (LTV) ratios rose 0.9 percentage point to 60.3 percent in 2018, but are down from 65.7 percent in 2014. Underwriters' restraint regarding LTV ratios has largely been driven by investor preference, as issuers who have come to market with higher LTV conduit deals have suffered from softer demand and wider spreads. While some market skeptics fear the potential for manipulation of valuations in the underwriting process, there is no arguing that LTVs have decreased in recent years. Fitch Ratings Stressed LTVs can also be seen trending downward (see chart, top right).

We also continue to favor seasoned conduit bonds to the extent they are available in the secondary market. These often trade at the same spread as new-issue bonds with less spread duration, especially at the junior AAA to single-A rating level (see chart, bottom right). This, along with the flat swap curve, results in similar yields for the seasoned bonds. Additionally, the underlying properties in the collateral have enjoyed several years of significant price appreciation along with amortization of the loans, resulting in a decline in leverage.

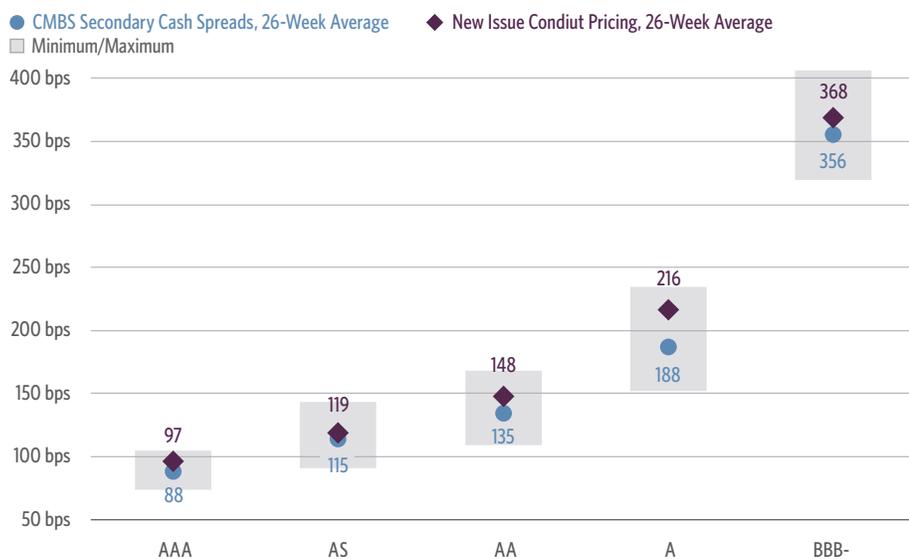
## New Issuance Reflects Investor Preference for Lower Loan-to-Value Ratios



Source: Guggenheim Investments, Fitch Ratings. Data as of 12.31.2018

While some market skeptics fear the potential for manipulation of valuations in the underwriting process, LTVs have decreased in recent years. Fitch Ratings Stressed LTVs can also be seen trending downward.

## CMBS Conduit Spreads Have Become Flatter in Higher Tranches

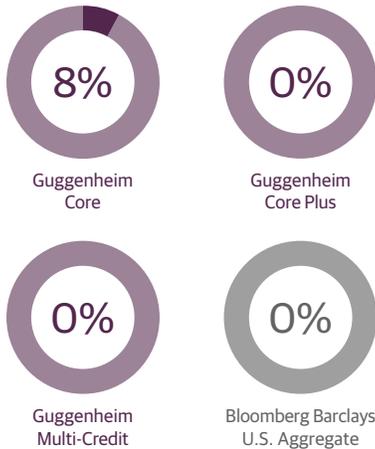


Source: Guggenheim Investments, J.P. Morgan Research. Data as of 2.8.2019. Secondary cash spreads are based on the J.P. Morgan cash spreads represented in CMBX 9 (2015 vintage conduit CMBS). These are JP Morgan estimates and may not reflect levels where we can obtain bonds. Minimum/maximum = 10.19.2018-2.8.2019.

We favor seasoned conduit bonds to the extent they are available in the secondary market. These often trade at the same spread as new-issue bonds with less spread duration, especially at the junior AAA to single-A rating level.

## Commercial Real Estate Debt Nearing the Peak

### Portfolio allocation as of 12.31.2018



**Jennifer A. Marler**  
Senior Managing Director



**William Bennett**  
Managing Director



**Ted Jung**  
Director

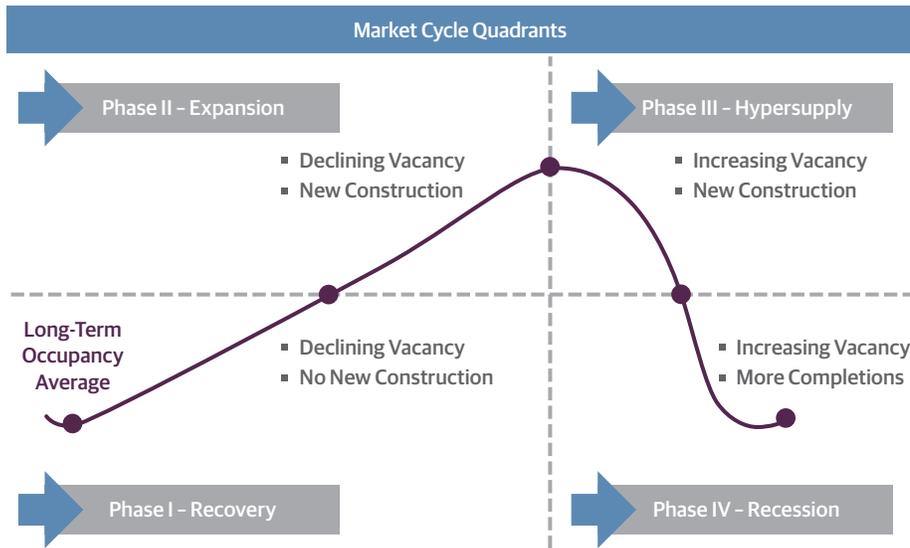
As we near the end of the current expansion cycle, investors will continue to see attractive real estate debt opportunities.

Commercial real estate cycles tend to flow from recovery to expansion, peak after a period of new construction and declining vacancies, and then turn from hyper-supply into a recessionary period as construction declines and vacancies start to rise (see chart, top right). As we begin 2019, we are climbing toward a cycle peak, but not yet ready to descend from the mountain.

Vacancies across all real estate sectors remain low, even as we are starting to see net income growth beginning to slow (see chart, bottom right). Absorption of new product continues to be strong. Dodge Data & Analytics forecasts that total U.S. new construction starts in 2019 will total approximately \$808 billion, in line with total new construction starts for 2018. However, Dodge notes that the rate of expansion in the U.S. construction industry has moderated over the past three years, consistent with historical patterns that typically emerge as an expansion matures. Dodge's proprietary Momentum Index, which measures the initial report for commercial building projects in planning, is also falling, indicating that planned projects likely to lead to new construction spending are declining.

Real estate investors are beginning to face headwinds, but the market is unlikely to see any material downward cycle trend until supply begins to overtake demand. With 10-year U.S. Treasury yields falling and the yield curve flat, loan terms of five and seven years are more attractive for lenders. Unique value-added opportunities, such as the planned conversion of the former Westside Pavilion Mall in Los Angeles into creative office space for Google, are also allowing investors to unlock value in underused properties in attractive locations and create debt opportunities for higher-yield bridge financing investments. Respondents to the Mortgage Bankers Association's 2019 Commercial Real Estate Outlook Survey predicted strong demand from both borrowers and lenders for mortgage loans in 2019, albeit a bit weaker than in 2018, and capital sources remain plentiful for real estate investors.

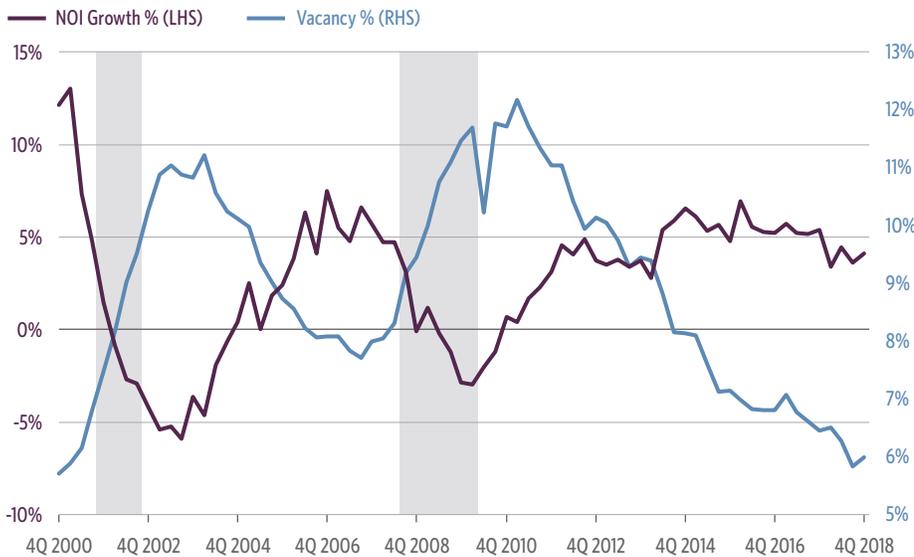
## The Commercial Real Estate Sector Has Room to Run



Source: Mueller, Real Estate Finance, 2016.

Commercial real estate cycles tend to flow from recovery to expansion. As we begin 2019, we are climbing toward a cycle peak, but not yet ready to descend from the mountain.

## Vacancies Remain Low Even as Net Operating Income Growth Slows



Source: Guggenheim Investments, NCREIF, Morgan Stanley Research. Data as of 12.31.2018. Shaded areas represent periods of recession.

Vacancies across all real estate sectors remain low, even as net income growth has slowed.

## Municipal Bonds Weather Ready

### Portfolio allocation as of 12.31.2018



Guggenheim  
Core



Guggenheim  
Core Plus



Guggenheim  
Multi-Credit



Bloomberg Barclays  
U.S. Aggregate



**James Pass**  
Senior Managing Director



**Allen Li, CFA**  
Managing Director



**Michael Park**  
Vice President

Municipal bonds weathered fourth quarter volatility better than other fixed-income sectors, but careful selection remains key.

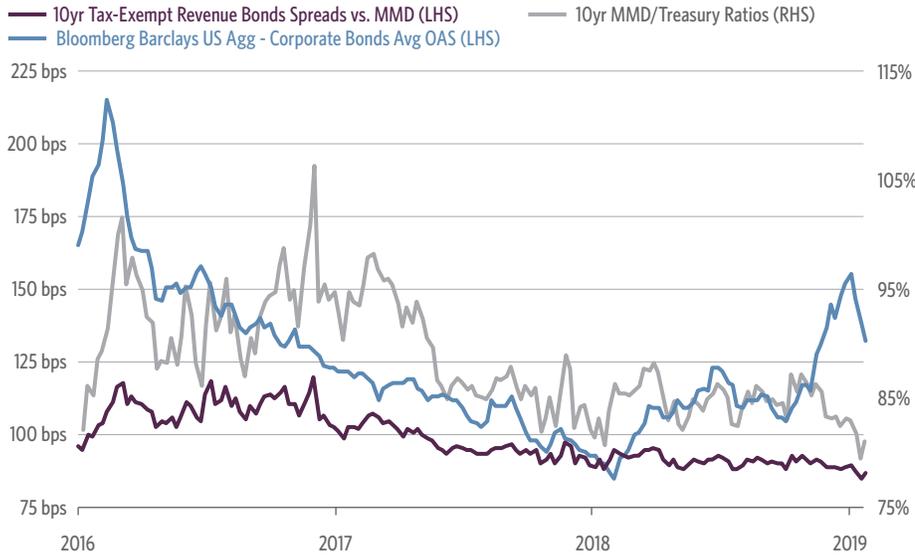
The municipal market reasserted itself as a safe haven in the fourth quarter of 2018 amid elevated volatility driven by a wide spectrum of concerns. Municipal bonds have been characterized as low-volatility securities as credit spreads hovered near the trough of post-financial crisis levels (see chart, top right). Unlike Treasuries, municipals did not experience a bear flattening in 2018 and compensated investors who assumed duration risk.

Heading into 2019, implications of the Tax Cuts and Jobs Act and midterm elections help anchor expectations of relative outperformance. In response to lower corporate tax rates, institutional investors executed tax-motivated selling in 2018. Offsetting this reduced demand going forward, the inaugural limit on state and local tax deductions is expected to attract demand from disproportionately impacted states such as California and New York (see chart, bottom right). Meanwhile, the midterm elections produced a divided Congress whose political gridlock will keep federal infrastructure programs (i.e., new supply) on the sidelines and maintain expanded Medicaid funding.

With cautious optimism ahead of the next downturn, we stress the need for diligence to combat the natural information lag of issuers. Municipalities are often afforded a nine-month delay to report financials and an additional year for pension figures. As a result, market performance based on reporting of tax collections and pension health may fail to reflect economic conditions in a timely manner.

While maintaining a defensive position to weather the next recession, we anticipate that idiosyncratic opportunities will emerge as credit spread volatility increases with the reintroduction of Puerto Rico bonds to the indexes. As ensuing political pressure mounts on state and local governments to make hard choices to favor either bondholders, pensioners, or taxpayers, we place a premium on budget flexibility and robust structural protections.

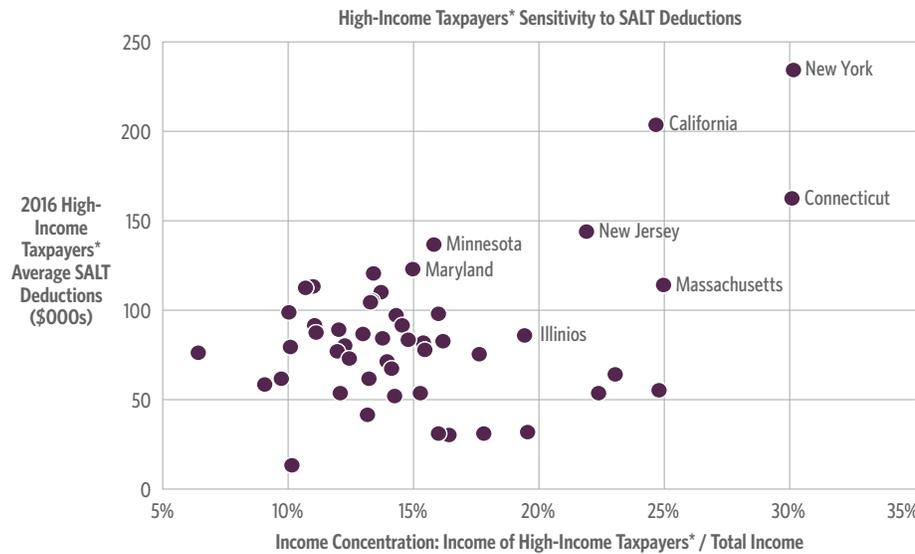
## Muni Spreads Tighten to Post-Crisis Lows Despite Broad-Based Volatility



Source: Guggenheim Investments, Bloomberg, Municipal Market Data (MMD). Data as of 1.25.2019.

Municipal bonds have been characterized as low-volatility securities as credit spreads hovered near the trough of post-financial crisis levels. Unlike Treasuries, municipals did not experience a bear flattening in 2018 and compensated investors who assumed duration risk.

## SALT Deduction Limits Stem Tax-Motivated Selling in High-Tax States

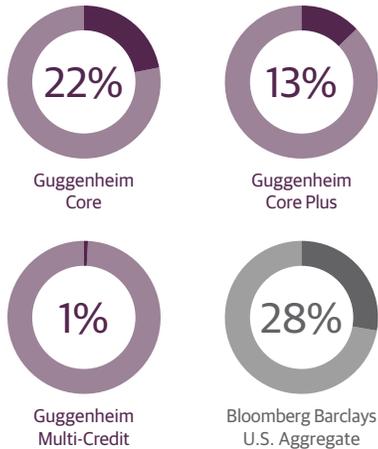


Source: Guggenheim Investments, Internal Revenue Service. Data as of 12.31.2016. Note: \*Tax filers with adjusted gross income greater than \$500,000.

The inaugural limit on state and local tax deductions is expected to attract demand from disproportionately impacted states such as California and New York.

## Agency Mortgage-Backed Securities Flight to Quality

### Portfolio allocation as of 12.31.2018



With solid fundamentals and fair valuations in a period of weak technical factors, select Agency MBS appears relatively attractive.

Agency MBS outperformed other major credit sectors in the volatile fourth quarter of 2018, which ended with lower rates, a flatter 2s/10s yield curve and higher implied interest rate volatility. The Bloomberg Barclays U.S. MBS index posted a 2.1 percent total return for the quarter and 1.0 percent return for 2018. Option-adjusted spreads were 7 basis points wider over the quarter and 10 basis points for the year. Aggregate prepayment speeds continued to slow to historic lows.

Our major themes from last year played out as anticipated, and we are planning for a similar market environment. Fundamentals remain strong, with most borrowers having no rate incentive to refinance. Valuations look reasonable, with current spreads around long-term average levels and wider than post-crisis averages. Supply/demand technicals are likely to remain challenging now that the Fed is no longer an active market participant, and uncertainty remains about who will pick up the demand deficit. So far, it seems MBS funds have picked up at least some of the market's rotation out of corporate credit. One example of this is the iShares MBS ETF (MBS), with \$15 billion in assets, which saw \$2.9 billion in inflows since the start of October, whereas the iShares iBoxx Investment-Grade Corporate Bond ETF (LQD), with \$32 billion in assets, experienced net outflows of \$2.4 billion over the same period. Furthermore, any spread widening as a result of the Fed's withdrawal will likely be moderate, since this withdrawal has been well telegraphed and gradual (see chart, top right).

The U.S. Treasury and corporate debt markets have witnessed significantly higher issuance in the past few years compared to Agency MBS (see chart, bottom right). While MBS supply may be higher now and possibly growing further if the recent rally in mortgage rates drives home sales higher, its share of widely followed benchmarks like the Bloomberg Barclays U.S. Aggregate index is still low compared to other major fixed-income sectors. Better relative liquidity may continue to attract more reallocation from credit sectors to Agency MBS as we enter a late-cycle phase. We continue to favor investments in which either the collateral or structure offers some cash flow stability at reasonable spreads. We find select subsectors attractively priced in the current environment, including longer-maturity Agency multifamily bonds, better call-protected pools, and some collateralized mortgage obligation structures.



**Aditya Agrawal, CFA**  
Director



**Louis Pacilio**  
Vice President

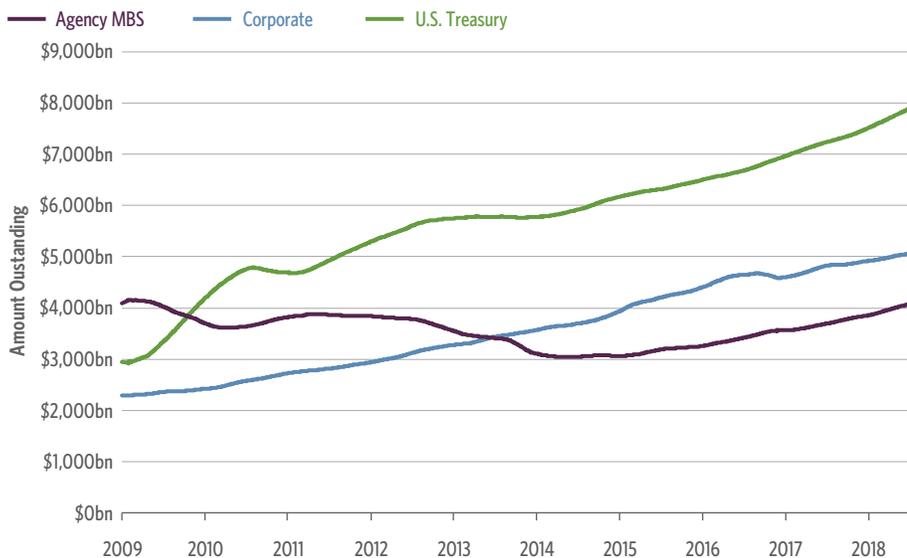
### The Pace of Monthly Net Fed MBS Purchases Has Slowed



Source: Guggenheim Investments, JPMorgan, Federal Reserve. Data as of 1.22.2019.

Any increase in risk premia will likely push MBS spreads wider as the Fed continues to tighten monetary policy. However, any spread widening will likely be moderate as the Fed's withdrawal from the market has been well-telegraphed and gradual.

### Agency MBS Issuance Is Increasing, But the Sector Remains Relatively Small



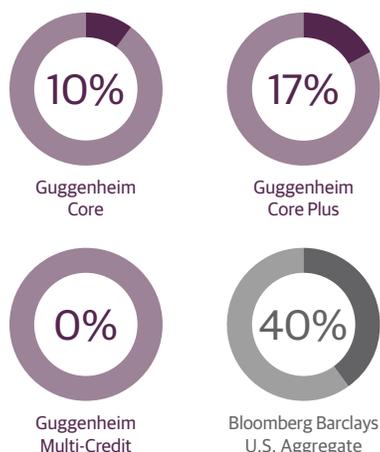
Source: Guggenheim Investments, Bloomberg Barclays. Data as of 1.16.2019. Note: Amount outstanding in the Bloomberg Barclays U.S. Aggregate Bond index, excluding Federal Reserve holdings. Agency MBS: Bloomberg Barclays U.S. MBS Index; Corporate: Bloomberg Barclays Investment-Grade Corporate Bond Index; U.S. Treasuries: Bloomberg Barclays Treasuries Index.

The U.S. Treasury and corporate debt markets have witnessed significantly higher issuance in the past few years compared to Agency MBS. While MBS supply may be higher now, and possibly further if the recent rally in mortgage rates drives home sales higher, its share of benchmarks is still relatively low compared to other major fixed-income sectors.

## Rates

# The Beginning of the End

### Portfolio allocation as of 12.31.2018



With one more rate hike expected by our macro research group, we believe this is the beginning of the end of the upward move in rates.

The fourth quarter of 2018 experienced a substantial increase in capital market volatility. The poor performance of risk assets drove a flight to quality. Treasury yields declined 20–45 basis points across the curve, with the belly outperforming as forward-dated FOMC rate hikes were priced out of the market (see chart, top right). Nominal yields declined more than real yields, as the broad move lower in commodity prices drove a decrease in breakeven inflation rates (see chart, bottom right).

The significant move lower in U.S. Treasury yields generated strong returns for the asset class, delivering a total return of 2.6 percent for the quarter and resulting in a total return of 0.9 percent for the year. Meanwhile, the Agency index produced a total return of 1.9 percent for the quarter, and a total return of 1.3 percent in 2018. Longer maturity Agency auction bonds were not immune to the selloff, as they cleared 20–30 basis points wider in spread than comparable Treasury bonds.

Fed Chair Powell stated that the December hike put short-term rates at the lower end of the FOMC's estimate range for the neutral rate. Recent experience shows a high sensitivity of modest rate changes on economic activity, supporting this statement. Previous work from our Macroeconomic and Investment Research Group found that given the level of nonfinancial corporate debt to gross domestic product, U.S. corporates could only support rates somewhere in the range of 2.50–3.25 percent before the increase in borrowing costs makes it difficult to continue to service heavy debt burdens. Thus, our Macroeconomic and Investment Research Group's forecast of one more rate hike in the second half of 2019 suggests this could be the beginning of the end of the upward move in rates for the cycle. One more rate hike implies that 30-year Treasury yields, currently 3.00 percent, will peak below 3.25 percent. It also leaves some room for the Treasury yield curve to flatten, but most of the flattening we expected to see in this cycle is behind us. The 2s/10s and the 10s/30s Treasury yield curves have flattened by 113 and 38 basis points, respectively, against 225 basis points of monetary policy tightening since December 2015. Once the hiking cycle is over, we think more attractive buying opportunities will materialize around the belly of the curve.

Note: "Rates" products refer to Treasury securities and Agency debt securities. Treasury and Agency returns are represented by the Bloomberg Barclays Treasuries index and the Bloomberg Barclays U.S. MBS index, respectively.



**Connie Fischer**  
Senior Managing Director



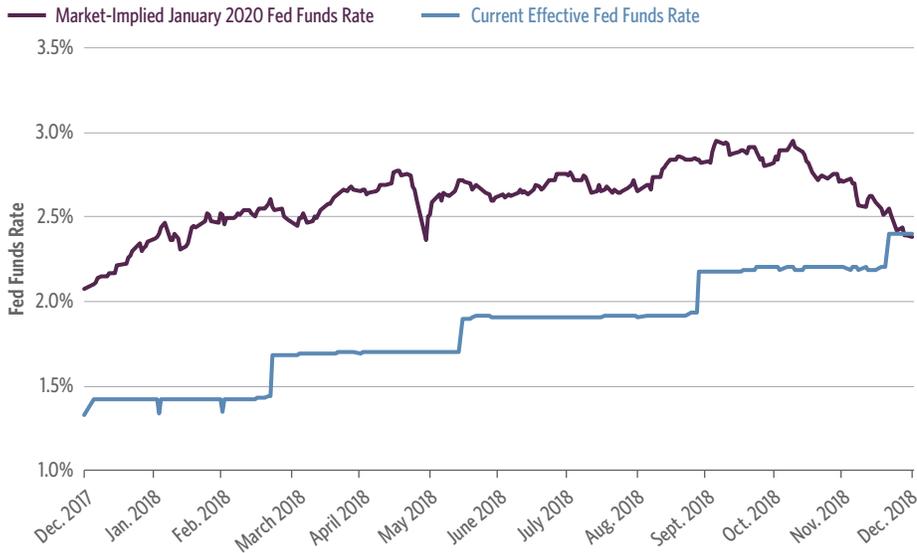
**Kris Dorr**  
Managing Director



**Tad Nygren, CFA**  
Managing Director

## Treasury Yields Declined as Market Priced Out Fed Rate Hikes

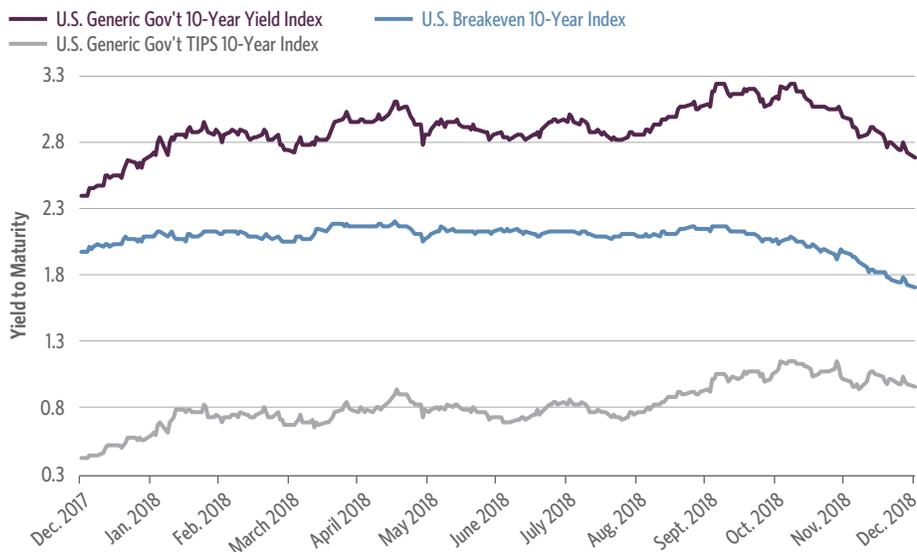
Rate Implied by Jan. 2020 Federal Funds Futures Contract



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2018.

Treasury yields declined 20–45 basis points across the curve, with the belly outperforming as forward-dated FOMC rate hikes were priced out of the market.

## Inflation Breakevens Narrowed as Nominal Yields Declined More than Real Yields



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2018.

Nominal yields declined more than real yields, as the broad move lower in commodity prices drove a decrease in breakeven inflation rates.

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**Municipal bonds** may be subject to credit, interest, prepayment, liquidity, and valuation risks. In addition, municipal securities can be affected by unfavorable legislative or political developments and adverse changes in the economic and fiscal conditions of state and municipal issuers or the federal government in case it provides financial support to such issuers. A company's **preferred stock** generally pays dividends only after the company makes required payments to holders of its bonds and other debt. For this reason, the value of preferred stock will usually react more strongly than bonds and other debt to actual or perceived changes in the company's financial condition or prospects. **Basis point:** One basis point is equal to 0.01 percent. Likewise, 100 basis points equals 1 percent. **FAANG:** Facebook (FB), Amazon (AMZN), Apple (AAPL), Netflix (NFLX), and Alphabet (GOOG).

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2. Guggenheim Partners assets under management are as of 12.31.2018 and include consulting services for clients whose assets are valued at approximately \$67bn.

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## About Guggenheim Investments

Guggenheim Investments is the global asset management and investment advisory division of Guggenheim Partners, with more than \$203 billion<sup>1</sup> in total assets across fixed income, equity, and alternative strategies. We focus on the return and risk needs of insurance companies, corporate and public pension funds, sovereign wealth funds, endowments and foundations, consultants, wealth managers, and high-net-worth investors. Our 300+ investment professionals perform rigorous research to understand market trends and identify undervalued opportunities in areas that are often complex and underfollowed. This approach to investment management has enabled us to deliver innovative strategies providing diversification opportunities and attractive long-term results.

## About Guggenheim Partners

Guggenheim Partners is a global investment and advisory firm with more than \$265 billion<sup>2</sup> in assets under management. Across our three primary businesses of investment management, investment banking, and insurance services, we have a track record of delivering results through innovative solutions. With 2,400+ professionals based in offices around the world, our commitment is to advance the strategic interests of our clients and to deliver long-term results with excellence and integrity. We invite you to learn more about our expertise and values by visiting [GuggenheimPartners.com](http://GuggenheimPartners.com) and following us on Twitter at [twitter.com/guggenheimptnrs](https://twitter.com/guggenheimptnrs).

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