



Third Quarter 2022

Fixed-Income Sector Views

The overheated labor market, persistent inflation, and financial markets' response to the Federal Reserve's (Fed) aggressive policy decisions all dominate our third quarter 2022 Sector Views. In Rates, after five quarters of a flattening yield curve, we are beginning to look for value in the belly of the Treasury curve. Both technicals and fundamentals are a focus in investment-grade corporate bonds as spreads have widened amid investor reticence to longer duration asset classes. Recession fears have risen in high yield and bank loan markets, weighing on spreads and making individual credit selection particularly important. In structured credit, senior commercial asset-backed securities (ABS) and collateralized loan obligations (CLOs) remain attractive as, outside of March 2020, spreads have widened to levels not seen since the oil crisis of 2016; credit tailwinds continue to propel non-Agency residential mortgage-backed securities (RMBS) performance; and commercial mortgage-backed securities (CMBS) and commercial real estate continue to recover from COVID. Municipal credit quality remains strong even as performance has suffered. Finally, elevated volatility in rates markets and reduced prepaes among the increase in interest rates have made Agency RMBS spreads attractive for the first time in many years.

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Recession Risks Mount with the Fed Determined to Crush Inflation

A Fed-induced downturn will be required to bring inflation down to target.

With the labor market overheated and inflation considerably above the Federal Reserve's (Fed) target, we have entered an uncomfortable regime where good news is bad news, and the "Fed put" is deeply out of the money. For the first time in many years, the Fed is aggressively tightening financial conditions in an effort to slow the economy, keep inflation expectations in check, and bring inflation down to the 2 percent target.

The Fed's crusade to crush inflation is reverberating around the world, as the strengthening dollar is boosting inflation and inflation expectations in other countries, forcing central banks to tighten policy abruptly to avoid an erosion of their own credibility. The tightening of global financial conditions will restrain growth, which is also being hampered by supply-side constraints: the U.S. unemployment rate has fallen to just 3.6 percent, commodity markets have been roiled by Russia's war in Ukraine, and the Chinese economy has been hobbled by renewed COVID-19 lockdowns and property sector woes.

Recession risks have clearly risen, with the U.S. monthly real gross domestic product (GDP) proxy having declined at an annual rate of 1.8 percent from October 2021 through May 2022—an unusual turn of events outside of downturns. Most available employment data

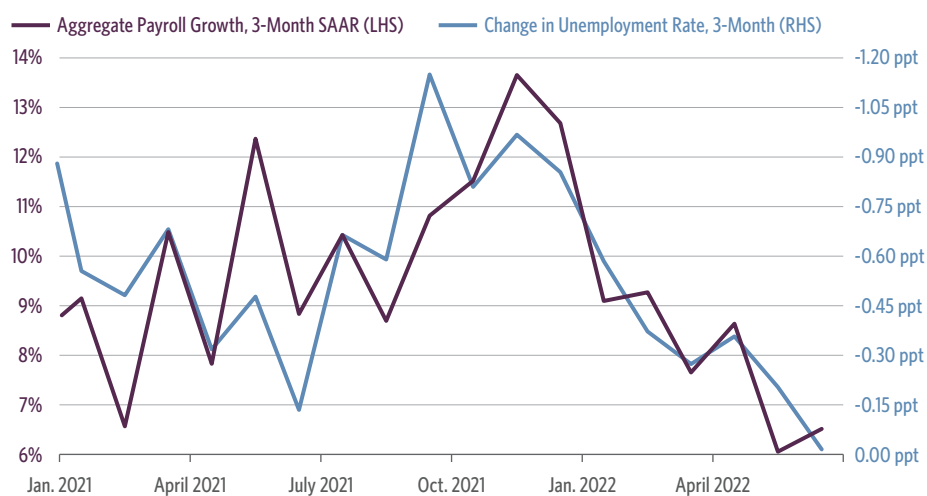
remain strong, contradicting the recession narrative, but the pace of improvement in the labor market has slowed markedly since last fall. This indicates that the labor market has already started to cool even before the full impact of tighter financial conditions has been felt. High-frequency indicators and news reports point to a further slowdown in the job market in coming months.

Inflation is a lagging indicator and continues to run far above the Fed's target. While commodity prices and other leading indicators of inflation have cooled in recent months, the all-important headline consumer price index (CPI) number sits at a cycle high of 9.1 percent year over year as of June. Our analysis indicates that a Fed-induced downturn will be required to bring inflation down to target.

By Brian Smedley, Maria Giraldo, and Matt Bush

Available employment data remain strong, contradicting the recession narrative, but the pace of improvement in the labor market has slowed markedly since last fall.

The Pace of Labor Market Gains is Cooling Rapidly



Source: : Guggenheim Investments, Haver Analytics, BLS. Data as of 6.30.2022.
Note: Aggregate payrolls reflects total employment, hours worked per employee and average hourly earnings.

Rates

Look for Long Duration Opportunities as the Fed Tightens

Given that the yield curve will likely continue to flatten, we favor buying on-the-run Treasuries between the intermediate and long end points of the curve.

This year is proving to be one of the most difficult investing environments fixed-income market participants have ever experienced. Geopolitical uncertainties, pockets of illiquidity in Treasury markets, and the continued rise in global prices have all led to unprecedented volatility.

As inflation has proven to be anything but transitory, central banks across the globe have had to act in a swift and hawkish manner to defend their credibility, even at the risk of forcing their economies into recession. For its part, by June the Fed had cumulatively raised rates by 150 basis points in 25, 50, and 75 basis point increments, while at the same time wrapped up its massive quantitative easing program.

The Fed's policy actions led to a bear flattening of the yield curve and a significant move higher in Treasury yields. In the first half of 2022, two-year Treasury yields increased by 220 basis points, and 10-year Treasury yields increased by 150 basis points, narrowing the spread between them to just 5 basis points at quarter end. Treasuries have experienced their worst first-half returns in the past 50 years, with the index down 9.1 percent through June. Compounding an already challenging environment, liquidity thinned with the Fed no longer buying Treasury securities, which caused bid/offer spreads to widen materially across the curve and magnify the impact of price movements.

We believe that front-end Treasuries will continue to underperform as the Fed carries on its tightening campaign, and that the yield curve will likely flatten further. For this reason, we favor buying on-the-run Treasuries between the intermediate and the long end points of the curve. Further, with the significant underperformance of the 20-year sector, it is possible that the Treasury Department will announce additional cuts to 20-year bond issuance in August, creating an attractive relative value opportunity in that part of the curve.

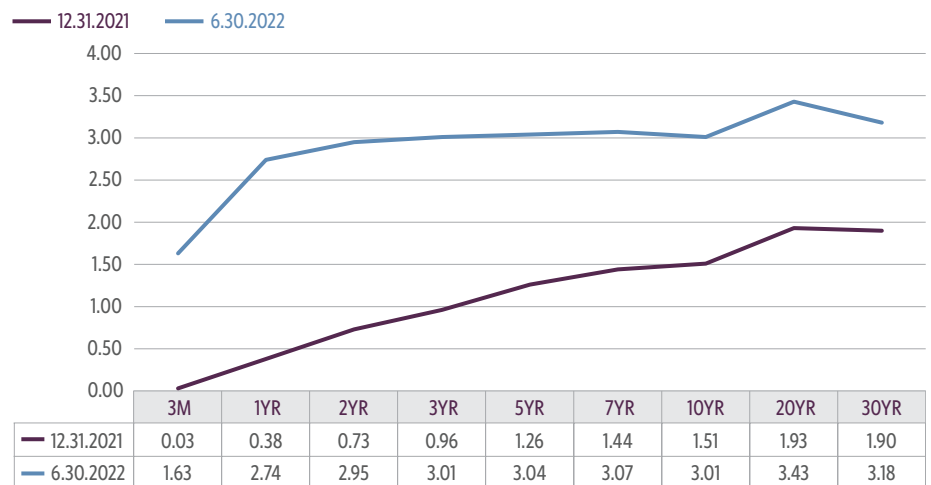
Looking to the remainder of the year, the Fed's forward guidance has the market expecting an additional 90 basis points of tightening to a terminal fed funds rate of about 3.25 percent. However, the shift to a more data-dependent stance amid rapidly evolving economic conditions will likely present the Fed with some policy decision challenges which upend the planned pace of tightening.

By Kris Dorr and Tad Nygren

We believe that front-end Treasuries will continue to underperform as the Fed carries on its tightening campaign, and that the yield curve will likely continue to flatten. For this reason, we favor buying on-the-run Treasuries at the long end of the curve.

Front-End Treasuries Will Continue to Underperform as the Fed Tightens

Treasury Yield Curves 12.31.2021 vs. 6.30.2022



Source: Guggenheim Investments, Bloomberg. Data as of 6.30.2022.

Investment-Grade Corporate Bonds

Signs of Life After Worst First Half in History

Continued rate volatility due to Fed policy and economic data will provide entry points throughout the quarter.

The investment-grade corporate debt markets continued to struggle in the second quarter, as volatility in rates and equities, coupled with recessionary fears and uncertainty around Fed monetary policy, remained heightened. Technicals such as fund flows and overseas buying started to deteriorate, though fundamentals remained stable.

Investment-grade corporate credit spreads continued to widen in the second quarter, resulting in the worst half performance for investment-grade credit in history. Over the quarter, the Bloomberg U.S. Investment-Grade Corporate Bond Index widened by 40 basis points to 155 basis points, resulting in -7.26 percent total return and -2.24 percent in excess return. This brought the total return performance for the first half of the year to -14.19 percent.

Investment-grade weekly fund flows were negative every week in the second quarter. We would expect these outflows to continue throughout the third quarter, albeit at a declining rate. Overseas buyers, both euro and yen denominated, experienced a dramatic increase in hedging costs, which resulted in muted demand for corporate bonds. These deteriorating technicals put outsized pressure on the intermediate credit curve, while support for longer duration credit remained strong.

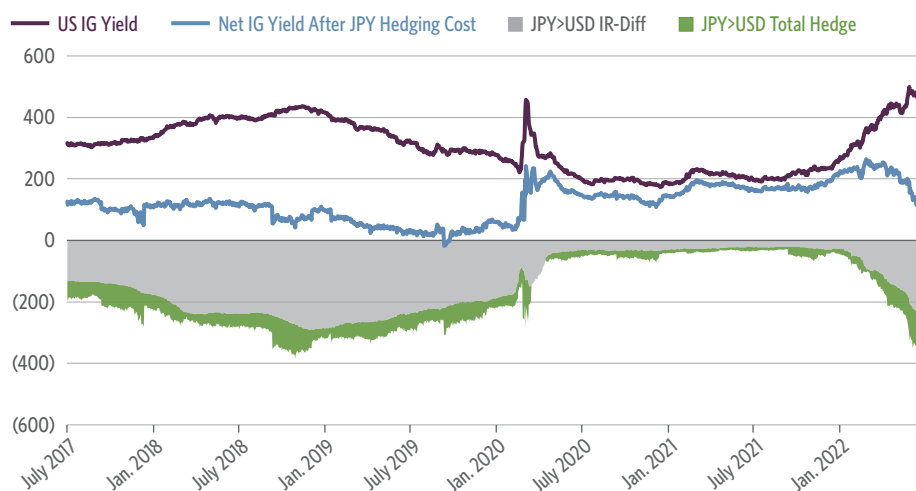
Corporate bond liquidity also struggled in the first half. Year-to-date cash volumes were down 1 percent while derivative/exchange-traded fund (ETF) volumes were up 37 percent year over year as of June 30. Derivatives and ETFs tend to be used for more macro hedging, while cash trading typically addresses fundamental concerns. The dichotomy in these volumes highlights investors' concerns over the macro backdrop versus the micro/fundamental backdrop.

Continued rate volatility due to Fed policy and economic data will provide entry points throughout the quarter. The 10/30s credit curves flattened over the second quarter due to rising Treasury yields and strong buying from investment companies, pension funds, and other institutional investors. We believe this trend will continue in the third quarter, with a focus on long duration, low-dollar price corporate bonds. Sector-wise, unsecured bank paper looks attractive relative to industrials. We saw banks underperform on a spread basis versus industrials on the heels of overwhelming primary issuance in the first half. We believe that technical has been largely absorbed. With banks maintaining strong capital ratios, the bank preferred market looks historically attractive as well. As rate volatility subsides, we believe that the preferred market should start to see positive inflows and outperform.

By Justin Takata

Overseas buyers, both euro and yen, experienced a dramatic increase in hedging costs, which resulted in muted demand for corporate bonds.

Muted Demand from Foreign Investors as Hedging Costs Rise



Source: Guggenheim Investments, Credit Suisse, BAML, Bloomberg, ICE BofA. Data as of 6.30.2022. Net yield is from the perspective of a Japanese investor who is hedging currency risk.

Limited Spread Dispersion Creates Credit Picking Opportunities

High-yield corporates that we deem creditworthy and are trading at a discount to par present an attractive opportunity.

The combination of high inflation, the market pricing in the most aggressive Fed tightening path since the 1990s, Russia's invasion of Ukraine, and continuous China COVID-related lockdowns led the high-yield corporate bond market to suffer a loss of 14 percent in the first half of 2022—the worst first half on record—of which 8.4 percentage points were driven by credit spreads widening relative to Treasuries.

No sector has offered shelter from losses this year. Even those benefiting from high inflation, such as energy and materials, posted -3.9 and -3.8 percent excess returns, respectively. This performance has been unusual against the backdrop of default rates near historical lows, but it does reflect rising recession probability. It is still unclear what the next recession will look like, so we have not seen much spread dispersion across industries. With index spreads at 550 basis points, we would normally expect the range of the tightest-to-widest industry spreads to be about 700 basis points. But that range sits at just 300 basis points as of July 14, with utilities offering the tightest spread of 367 basis points, and telecom offering the widest at 667 basis points.

Limited industry dispersion relative to history has two possible explanations. First, unlike past experiences when market stress was concentrated in a particular industry, such as in telecom during the

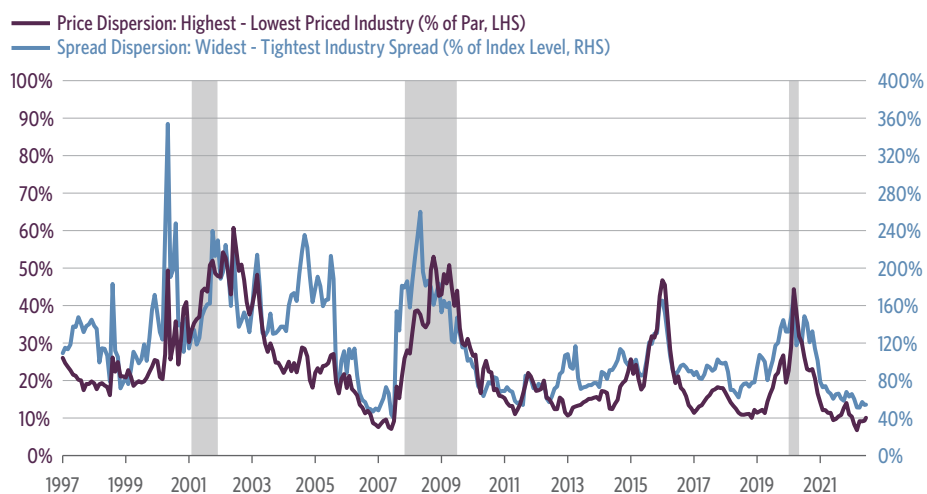
late 1990s, financials and real estate in the 2000s, and energy in the last decade, markets expect stress to arise across all industries in the next recession without any one industry being a focal point. Alternatively, something is driving sellers to de-risk without differentiating credit worthiness. If the latter is true, then some credits are already oversold, which we believe should yield strong future returns for credit pickers.

There have been few chances in recent history when 9 percent average yields have coincided with sufficient market liquidity for investors to take advantage of these levels. And although we expect the next six months to see more default and downgrade activity, spreads sitting around the 70th percentile of historical observations offer a nice cushion, but we are still cautious in our credit selection. Nonetheless, with most of the high-yield market trading at discounts to par, creditworthy bonds have the potential for price appreciation once they approach maturities.

By Thomas Hauser and Maria Giraldo

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Very Little Industry Dispersion in the High-Yield Index



Source: Guggenheim Investments, Bloomberg, ICE Index Services. Data as of 7.14.2022. Shaded areas represent recession periods.

Bank Loans

Rising Rates and Recessionary Risk Suggest a Focus on Loan Quality

Higher-rated bank loans have outperformed as the Fed's aggressive interest rate policy pressures lower-rated borrowers.

The loan market experienced a volatile May and June this year, with total returns of -2.5 percent and -2.1 percent, respectively—their worst monthly performances since March 2020. For the second quarter bank loans were down 4.3 percent in total return, bringing year-to-date returns to -4.4 percent. We continue to see opportunities in loans, but with the Fed set to raise short-term interest rates into restrictive territory, we are closely watching how this affects individual issuers.

Loan issuers kicked off 2022 on strong footing, fundamentally speaking, with median interest coverage ratios around 4.7x, though rate hikes are likely to erode interest coverage as coupon payments increase. If short-term rates rise to 3.5 percent, we estimate that median coverage would fall from 4.7x to 3.0x assuming no earnings growth, a harsh assumption given public loan issuer earnings were up 15 percent year over year in the first quarter. A 3x interest coverage ratio would still be viewed as healthy for a single issuer, but it hides peripheral stress if this is the index median. History shows that when the loan market median interest coverage is near 3x, about 10 percent of loans had coverage of less than 1.5x and approximately 37 percent had coverage between 1.5x-2.9x. As interest coverage fades,

net positive credit rating migration will turn increasingly negative. The second quarter was the first three-month period where downgrades outpaced upgrades since January 2021.

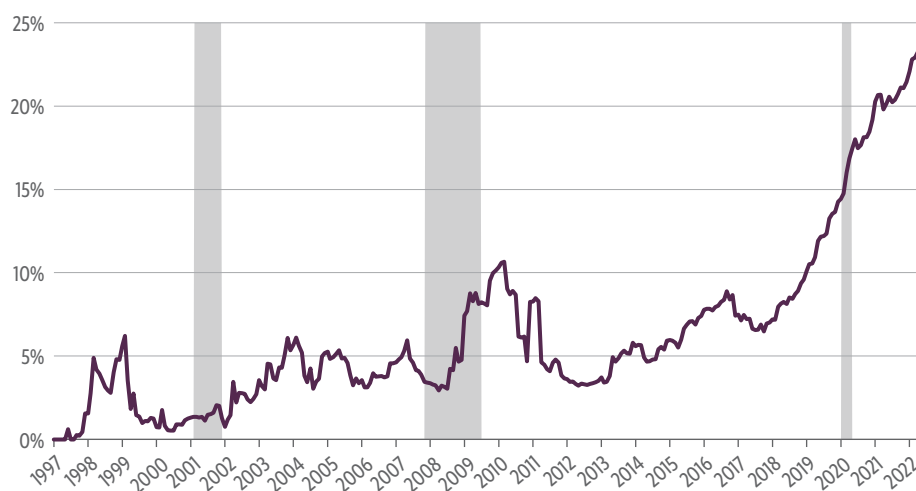
For several reasons, including issuance trends and the economics of collateralized loan obligations, the leveraged loan market has seen a dramatic increase in loans rated just one notch above CCC+ since 2018. Historical data show that the three-year cumulative default probability of a B- loan and CCC+ loan is the same at 9 percent, but it increases to 19 percent for CCC-rated loans. That jump in default probability is the reason why these loans tend to see prices drop substantially at the end of cycles. This concentration in lower B-rated issuers presents a risk to the sector as recession probability rises.

Our portfolios are defensively positioned, and we have been focusing on staying up in quality. Higher-rated loans have outperformed lower-quality year to date, leaving our portfolios in what we believe to be a good position to look for relative value in the secondary market. We regard opportunities in discretionary and/or cyclical overlevered businesses with caution given the heightened risk of recession.

By Christopher Keywork and Maria Giraldo

The leveraged loan market has seen a dramatic increase in loans rated just one notch above CCC+ since 2018. Historical data show that the three-year cumulative default probability of a B- loan and CCC+ loan is the same at 9 percent, but it increases to 19 percent for CCC-rated loans.

Share of Loans Rated B- Has Risen Substantially Since 2018



Source: Guggenheim Investments, S&P LCD. Data as of 6.30.2022.

Municipal Bonds

Muni Volatility Overshadows Strong Sector Fundamentals

Munis represent an opportunity for tax-averse investors to generate long-term income streams.

Technical factors continued to dominate the municipal market through the second quarter, during which tax-exempt munis declined by 2.9 percent, taking year-to-date returns as of June 30 to -8.98 percent. Taxable munis returned -6.2 percent in the second quarter and -14.0 percent year to date.

Tax exempt munis faced a buyers' strike for most of 2022, as fears over inflation prompted mutual fund outflows totaling \$77 billion—on pace to exceed previous totals for full year 2021. Despite a manageable new issue supply of \$166 billion as of June 30, 2022, just 3 percent less than the same period last year, funds have had to sell positions to meet redemptions. Consequently, the market's less-liquid segments, including sub-5 percent coupon bonds and high-yield, have materially underperformed other sectors. A brief respite came in late May, when municipal/Treasury yield ratios reached 12-month highs and a couple of large deals cleared the market at attractive spreads, drawing in crossover buyers. However, the selloff resumed as rate volatility returned, with tax exempts down 1.8 percent in June.

Taxable municipals suffered worse returns than tax exempts this year due to their longer duration, and their spreads widened in conjunction with other credit sectors. As of June 30, index-eligible

taxables still trade tighter than corporates, as year-to-date issuance volumes dropped 45 percent versus 2021.

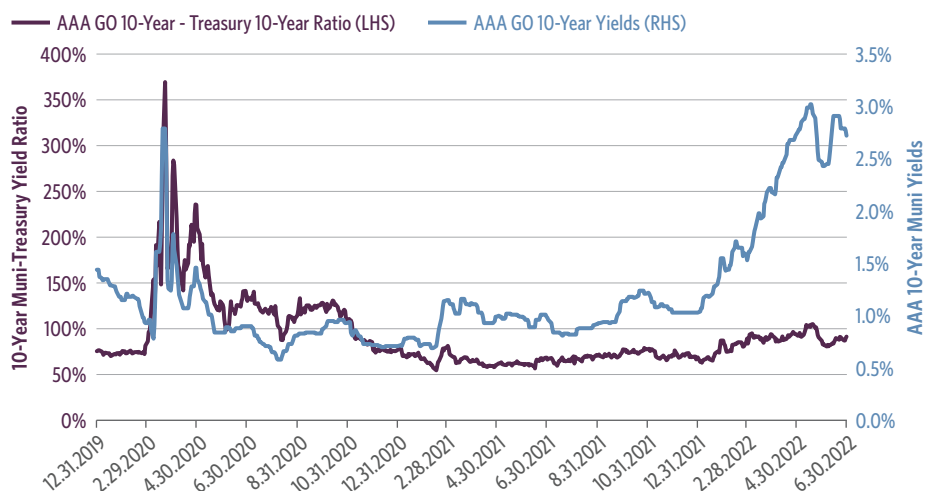
Performance aside, municipal credit quality remains strong. Upgrades consistently outnumber downgrades, and defaults are low. At the state level, rainy day funds are expected to remain high for fiscal year 2023 despite lackluster revenue expectations, as states draw down funds from the American Rescue Plan.

In our view, tax-exempt investors should focus on liquid structures, such as callable 5 percent coupon bonds, ideally with a non-call period beyond five years to minimize the negative convexity profile. Tax averse, income-oriented investors should consider allocations at current market levels, despite municipal/Treasury ratios having recovered from their one-year wides. While 10-year ratios hover around 91 percent, the 2.7 percent yield on 10-year AAA munis is in line with late March 2020, when ratios hit a record high of 370 percent. Municipal credits are bespoke and trade mostly by appointment, so we believe investors should view the sector as an opportunity to lock in satisfactory income over time rather than waiting for short-lived turning points like late May 2022.

By Allen Li and Michael Park

While 10-year ratios hover around 91 percent, the 2.7 percent yield on 10-year AAA munis is in line with late March 2020, when ratios hit a record high of 370 percent.

10-Year AAA Yields Mirror March 2020, When Muni/Treasury Ratios Peaked 30-Year Current Coupon vs. 5/10-Year U.S. Treasury



Source: The Municipal Market Monitor (TM3), Data as of 6.30.2022.

Challenging Market Conditions Create Pockets of Opportunity

With volatility and rising rates pressuring issuance, lower supply is creating opportunities to buy high-rated debt from seasoned managers.

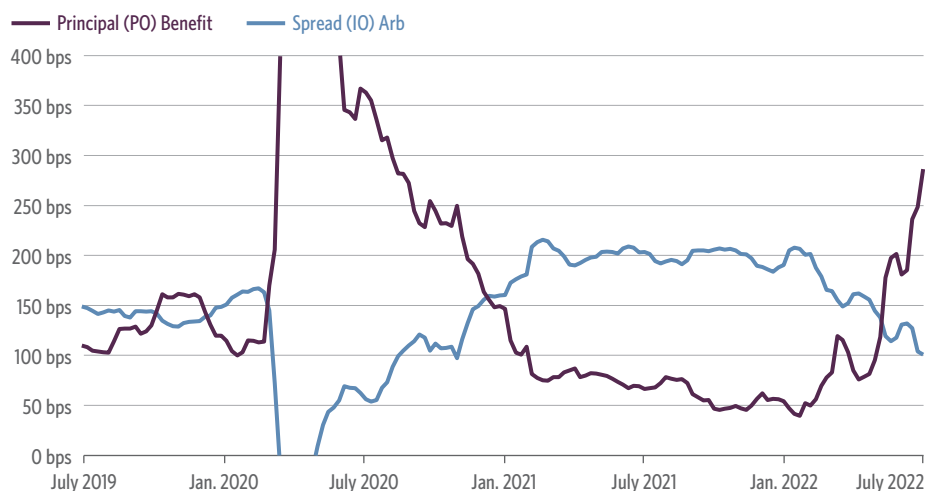
CLO spreads widened in the second quarter, although new issuance remained resilient amid increasing volatility and uncertainty in the markets. As of June 30, U.S. CLO new issuance was \$72 billion, while CLO refi/reset volumes were \$22 billion. During the quarter, CLO spreads were 70-110 basis points wider for AAA through A tranches, BBB tranches widened by 180 basis points, and BB tranches widened by 215 basis points. There has been increased dispersion in the primary markets, as established managers with a deeper investor base have been able to lock in liabilities at more favorable levels. The discounted prices in the leveraged loan market have created an interesting dynamic for CLO equity. Even though the traditional spread arbitrage has compressed as CLO liability costs have increased more than spreads on the underlying loan assets, loans have sold off and can be purchased at a meaningful discount to par. This has created a principal benefit from the expected pull to par of the loans that is at a post-COVID high, resulting in "print and sprint" type of transactions pricing. However, AAA demand has dampened, and we expect slowing issuance through year end. We prefer senior tranches from up-in-quality managers with a proven track record of navigating difficult market environments.

Esoteric ABS spreads widened approximately 30-50 basis points in the second quarter, depending on subsector. The spread widening was generally in line with corporate bonds of similar ratings and maturity. Total ABS issuance was 10 percent higher year to date versus 2021, though esoteric ABS issuance was 40 percent lower year to date versus 2021, and 12 percent lower than the average of 2018 and 2019. Year-to-date issuance declined in whole business securitization, containers, and triple-net lease, but increased in rate-reduction ABS. Marketing periods have increased and syndicate desks look for anchor investors before engaging in broad marketing. We have seen deals pulled from marketing and downsized; correspondingly, issuers are more willing to offer spread and structural concessions in exchange for certainty of execution. Credit fundamentals remain sound across the vast majority of commercial ABS underlying asset types, and ABS continues to offer incremental spread versus similarly rated corporate credit alternatives. We remain vigilant about the potential for rollover risk as higher interest rates could pressure future asset values and debt coverage.

By Michael Liu, Scott Kanouse, Josh Erde, and Dominic Bea

Even though the traditional spread arbitrage has compressed as CLO liability costs have increased more than spreads on the underlying loan assets, loans have sold off and can be purchased at a meaningful discount to par. This has created a principal benefit from the expected pull to par of the loans that is at a post-COVID high, resulting in "print and sprint" type of transactions pricing.

Heavily Discounted Loans Push Principal Benefit to a Post-COVID High



Source: Guggenheim Investments, Credit Suisse, Bloomberg. Data as of 7.1.2022.

Non-Agency Residential Mortgage-Backed Securities

Rising Fundamentals Are Supportive Despite Macroeconomic Challenges

We remain constructive on the credit prospects for non-Agency RMBS, but our performance outlook is tempered by market volatility and macro headwinds.

In the second quarter, non-Agency RMBS performance was adversely impacted by market volatility and corresponding spread widening. RMBS 1.0 and RMBS 2.0 subsectors posted -3.0 percent and -2.8 percent returns, respectively, but both subsectors outpaced the Bloomberg U.S. Aggregate Bond Index. RMBS spreads now stand at post-COVID wides. We believe that the sector should benefit from recent home price growth and positive consumer credit fundamentals, but return prospects are likely to take cues from broader risk markets and remain volatile.

New issuance slowed in the second quarter, and year-to-date issuance is slightly off the pace from 2021. For the full year, net issuance is projected to remain positive due to the slowdown in the runoff of outstanding mortgages. Securitizations backed by prime jumbo and non-prime qualified mortgage (non-QM) loans drove robust primary issuance to start 2022. However, rising rates and credit-spread widening have caused securitization economics to deteriorate, and have had an adverse impact on issuer profitability. Because issuers aggregate loans over time, there is a delay in the pricing feedback from the capital markets to the primary origination market, thereby further exacerbating the problem.

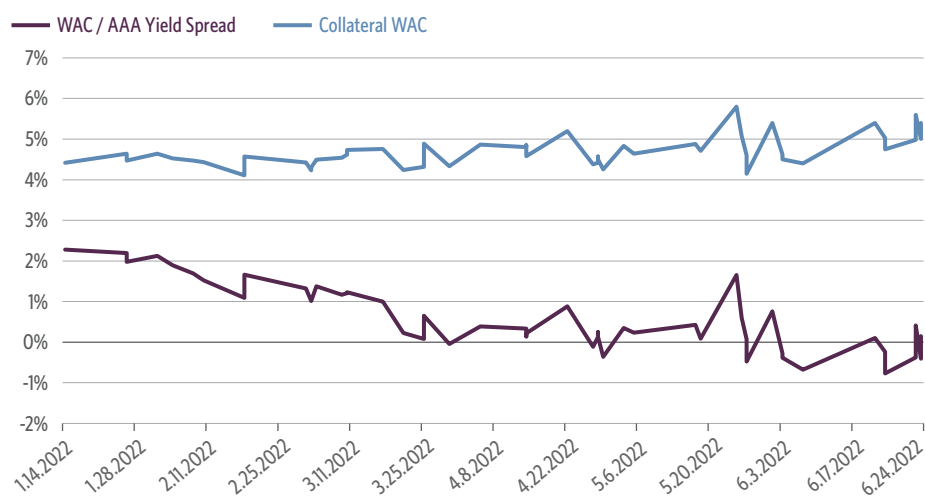
For instance, the spread between the loan pool weighted average coupon (WAC) and the pricing yield of the AAA-rated class for non-QM transactions have tightened significantly since the beginning of the year, demonstrating reduced attractiveness of securitization financing. For issuers to maintain profitability, origination coupons would have to increase to both offset the recent rise in Treasury yields as well as the widening in credit spreads. Consequently, rising rates and credit spread widening are expected to provide significant headwinds to primary issuance for non-Agency RMBS for the remainder of the year.

While we remain constructive on the credit performance prospects for non-Agency RMBS, our performance outlook is tempered by the ongoing market volatility and macroeconomic headwinds. For this reason, we continue to favor selected RMBS 2.0 mezzanine and senior tranches for their loss-remoteness and limited weighted average life variability, as well as selected credit-sensitive, pre-crisis passthroughs that we believe should benefit from recent home price growth and moderating default rates.

By Karthik Narayanan and Roy Park

The spread between the loan pool WAC and the pricing yield of the AAA-rated class for non-QM transactions have tightened significantly since the beginning of the year, demonstrating reduced attractiveness of securitization financing.

WAC/AAA Yield Spreads Have Tightened as Rates Have Risen



Source: Guggenheim Investments, BofA Global Research, Bloomberg. Data as of 6.30.2022.

Commercial Mortgage-Backed Securities

CMBS Fundamentals Continue to Recover from COVID

We continue to favor AA to BBB- rated bonds from new issue and secondary deals, with a focus on select CRE-CLO and SASB deals.

CMBS spreads widened in the second quarter along with broader fixed-income credit markets: 10-year conduit AAA bond spreads ended the quarter at 132 basis points, wider than their 100 basis point spread at the end of the first quarter, and 72 basis points at the end of the fourth quarter of 2021. First quarter 2022 set a post-Great Financial Crisis record with \$45 billion in issuance, 83 percent higher than first quarter 2021's \$24 billion, but the challenging macroeconomic backdrop reduced second quarter 2022 issuance to \$30 billion, a 28 percent drop from first quarter 2021's \$42 billion. Wider spreads and elevated volatility will likely continue to suppress issuance in the near term.

Market conditions also raise questions about commercial real estate valuations. Signals from the public and private markets are conflicting: while real estate investment trust equity-implied cap rates are 120 basis points higher versus the end of last year, private market indexes show cap rates moved much less.

While risk markets have been volatile, CMBS refinancings were orderly. Some 78 percent of CMBS loans were repaid on time as of June 30, 2022, in line with the 10-year average of 81 percent. Near-term CMBS maturities are relatively limited: of the \$2.3 trillion in commercial real estate (CRE) mortgages maturing in 2022-2027, only 7 percent are held by CMBS.

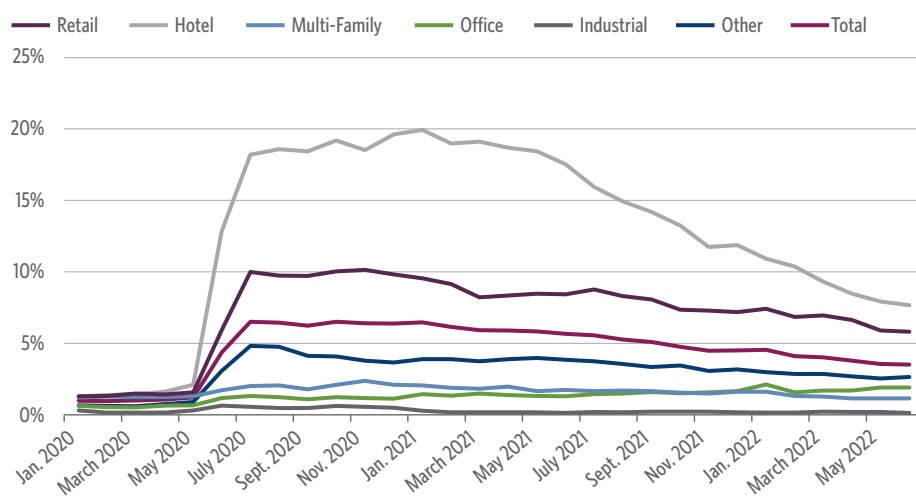
CMBS fundamentals have continued to recover since the height of the COVID-19 pandemic. The 60+ day delinquency rate for the conduit CMBS universe was around 3.5 percent in June, down from 4.0 percent in first quarter 2022 and 6.5 percent from the peak in summer 2020.

We believe CMBS performance will vary based on the unique collateral, structure, and sponsorship within each transaction. The continuation of the broad-based COVID recovery remains encouraging for commercial real estate investors, though longer-term secular changes such as the change in office use as well as higher borrowing costs will apply pressure to certain borrowers over the months and years to come. We continue to favor AA to BBB- rated bonds from new issue and secondary deals, with a focus on select CRE-CLO and single asset-single borrower (SASB) deals with strong sponsorship and fundamentally supported property types.

By Tom Nash and Hongli Yang

CMBS fundamentals have continued to recover since the height of the COVID-19 pandemic. The 60+ day delinquency rate for the conduit CMBS universe was around 3.5 percent in June, down from 4.0 percent in first quarter 2022 and 6.5 percent from the peak in summer 2020

The 60-Day CMBS Delinquency Rate Decreased from COVID High



Source: Guggenheim Investments, Bank of America, JP Morgan, Morgan Stanley. Data as of 6.30.2022.

COVID Recovery by Hotels Remains Slow

While the U.S. hospitality industry is moving toward pre-pandemic levels, full recovery is still several years away.

The COVID-19 pandemic created unprecedented challenges for the U.S. hospitality industry. At the low point in March 2020, occupancy dipped to 19.2 percent nationwide and the average daily room rate (ADR) declined to \$76.96 on the same day, eventually hitting a low point of \$71.62 in April 2020. The American Hotel & Lodging Association (AHLA) estimates that hotels lost a collective \$1.1 billion in room revenues alone during the two-year pandemic period.

As restrictions began to ease in 2021, both occupancy and ADR steadily climbed, led by pent-up demand for domestic leisure travel from consumers with savings to spend after the lockdown, although hotels experienced some setbacks during the 2021 holiday season and first quarter of 2022 as COVID variants surged. Since then, 2022 trends turned positive, with both occupancy and ADR predicted by Oxford Economics to return nearly to 2019 levels.

The hotel industry faces headwinds as it works toward a full recovery from the pandemic. Hotel operators remain challenged by the labor market, with employment at the end of 2022 predicted by AHLA to be down 7 percent from pre-pandemic levels in 2019. According to AHLA, business travel is expected to remain more than 20 percent less than in 2019, and less than 60 percent of meetings and events are expected to return in 2022. Non-room ancillary revenue remains well below historical levels, as the demand (and ability to staff) for

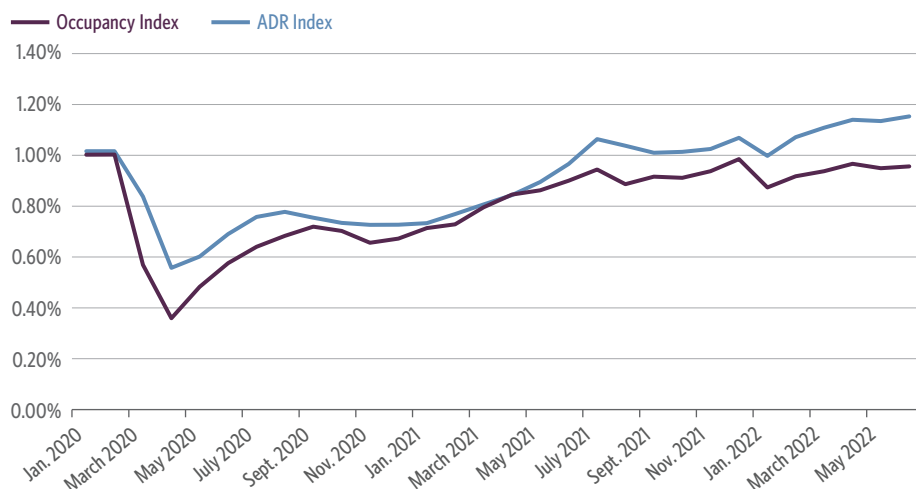
meetings, events, and food and beverage services remains lower. Inflation is challenging consumers' ability to spend for nonessential items such as travel and, when adjusted for inflation, the increased ADR is less impactful for hotel investors. Variants of the virus also remain among us, lending uncertainty to when a full recovery may be achievable.

While Smith Travel Research (STR) data show encouraging trends for the hospitality industry, a full recovery is likely still several years away. The most critical factors to recovery will be a return of business travel and events, the return of international travelers, an improved labor market, the health of the broader economy and, of course, confidence that ongoing variants of the virus will not materially affect travel choices.

By Jennifer A. Marler and Farris Hughes

Following setbacks during the 2021 holiday season and first quarter of 2022 as COVID variants surged, 2022 trends turned positive, with both occupancy and ADR predicted by Oxford Economics to return nearly to 2019 levels.

Post-COVID U.S. Hotel Occupancy and ADR Recovery Rates Are Rising
Indexed to 2019



Source: Guggenheim Investments, CoStar. Data as of 7.20.2022.

Agency Mortgage-Backed Securities

Policy and Inflation Risks Have Led to Attractive Valuations in Agency MBS

Off-the-run Agency CMBS, low pay up specified pools, and locked-out CMO structures are attractively priced in the current environment.

Much like in the first quarter, mortgage spreads underperformed in the second quarter as uncertainty over inflation and the Fed response boosted rate volatility and kept most mortgage buyers on the sidelines. Option-adjusted spreads ended the quarter at 46 basis points, 22 basis points wider quarter over quarter. The Bloomberg U.S. MBS Index second quarter total and excess returns were -4.01 percent and -0.98 percent, respectively. In contrast, Agency CMBS posted second quarter excess returns of +0.50 percent. Overall, the Agency multifamily sector has benefitted from a better convexity profile, capped issuance and reduced Fed dependency compared to the single-family sector.

The main event in the second quarter was the decision by the Fed to speed up the pace of monetary tightening. In addition to rate hikes, questions around the timing and scale of potential Fed sales of its mortgage holdings added another unknown for mortgage investors to digest. This resulted in a spike in both realized and implied rate volatility and weighed on the sector, with nominal spreads climbing to the widest since 2008, excluding the initial COVID selloff. Despite this negative backdrop, some positive developments are presenting themselves. With almost the entire mortgage-backed

securities universe out-of-the-money to refinance combined with slowing home sales, net supply forecasts continue to be revised downward. Additionally, higher rates will make the scheduled Fed runoff more manageable and well below the terminal \$35 billion per month cap. These two positive factors may make it worthwhile to increase exposure to the sector, given the historically wide nominal spread levels. A drop in rate volatility will be needed for sustained outperformance, but this is something we do not recommend trying to time given the typical rapid speed of repricing in the sector.

Against this backdrop, we favor investments in which either the collateral or structure offers some cash flow stability to buffer against potential continued elevated rate volatility. We find select subsectors, including off-the-run Agency CMBS, low pay up specified pools, and locked-out collateralized mortgage obligation (CMO) structures, attractively priced in the current environment. We believe that these investments should provide cash flow certainty in the current rate environment and continue to benefit when the market focus returns to cash flow fundamentals.

By Aditya Agrawal and Louis Pacilio

With almost the entire MBS universe out-of-the-money to refinance and slowing home sales, net supply forecasts continue to be revised downward. Additionally, higher rates will make the scheduled Fed runoff more manageable and well below the terminal \$35 billion per month cap. These two positive factors may make it worthwhile to increase exposure to the sector, given the historically wide nominal spread levels.

30-Year Current Coupons Look Attractive as Rising Rates Deter Refis

30-Year Mortgage Spread vs. Implied Rate Volatility



Source: Guggenheim Investments, Bloomberg. Data as of 7.15.2022.

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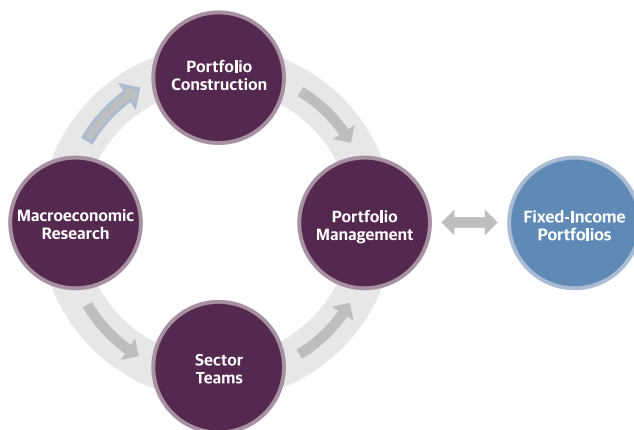
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