GUGGENHEIM

Fourth Quarter 2022

Fixed-Income Sector Views

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From the Desk of the Global CIO

While the path to get us here has been painful, yields for investment-grade assets are in the 5–6 percent range.[1] In more speculative grade assets, which tend to be more cyclically sensitive and carry more credit risk, we are seeing yields in the 8–10 percent range.[2] These levels have the potential to meet the return objectives of pension plans, insurance companies, or other investors that may have been sitting on the sidelines—or taking undue risk within fixed income in a reach for yield. The message from our sector teams is that it is now possible for many investors to potentially generate the income they require without taking excessive credit or duration risk.

One of the most compelling points for credit right now is the starting health of corporate borrowers as the downturn begins. Corporate issuers have been able to borrow cheaply for a long period of time, which enabled them to lower their cost of capital and improve their debt service and leverage ratios. This means that they should have a greater ability to absorb a higher cost of interest and a degradation of earnings that will come from a recession. In structured credit, rising home prices over the past few years have lowered loan-to-value ratios for borrowers, which is credit-positive for mortgage-backed securities.

Continued on page 2

1. Bloomberg U.S. Corporate Bond Index as of 9.30.2022.
2. Bloomberg U.S. Corporate High-Yield Index as of 9.30.2022.

From the Desk of the Global CIO

Continued from page 1

As always, we have to be mindful with credit selection and maintain a healthy amount of defensive skepticism in our allocations, particularly with the Federal Reserve (Fed) still hiking and a recession looming (if it isn't already here), but our risk appetite is relatively strong right now. Our conviction is strengthened by the historically wide spreads and low dollar prices available in the market.

While credit spreads may widen more from here, history shows that peaks in credit spreads are often transient and short-lived. Market timers might find it productive to wait for a spike in credit spreads, but investors risk missing the opportunity to add investment-grade credit at historically cheap levels relative to U.S. Treasury securities. We believe current high-yield spreads of 450 basis points are compensating investors for a market-implied default rate of 4.5 percent, which is significantly above the current default rate of 1.1 percent and above our expectation for a rate of 3.5 percent next year. However, if our expectation that a 2023 recession stretches into 2024 comes to pass, we believe defaults should rise to 7 percent. This would suggest that high yield may be susceptible to further deterioration should signs of a prolonged recession emerge. Additionally, defaults, especially for investment-grade and higher quality below investment-grade debt, are not likely to reach the peaks of prior cycles due to the extended period of financial repression that has enabled companies to lock in long-term rates at low levels and, more recently, to improve their balance sheets, which may reduce the impact that rising rates will have on corporate cash flows. Nevertheless, attractive yields may provide an income cushion that could reduce the impact if spreads should widen from here. We believe long-term investors are being compensated to take that risk.

The future is all that matters to investors, and these market conditions have the potential to offer good compensation for the range of risks that we see, as well as a relatively high starting point for total returns going forward. Duration has been everyone's enemy this year. We appreciate that it has driven down absolute returns for investors across the fixed-income universe—and it probably will for a while longer. But if the Fed is close to slowing the pace of rate hikes, as we expect, then the terminal rate for this cycle will also come closer into view and duration could again be a tailwind for returns.

Scott Minerd
Chairman of Guggenheim Investments and
Global CIO of Guggenheim Partners

Macroeconomic Update

Fed to Get the Recession It Wants in 2023

The Fed will likely overdo it with rate hikes, viewing a recession as the least bad outcome for the economy.

The Fed has abandoned talk of a soft or even "softish" landing, with the September Summary of Economic Projections pointing to a 90-basis point rise in the unemployment rate to 4.4 percent by end-2023, an increase consistent with a recession. The seemingly endless string of upside inflation surprises has cemented the Fed's view that the labor market needs to soften and aggregate demand needs to weaken further, which will require keeping policy restrictive for some time.

Signs are piling up that the economy is heading in the direction the Fed wants. While gross domestic product (GDP) rebounded in the third quarter to an inflation-adjusted 2.6 percent, private domestic demand (consumption and fixed investment) continued to slow, growing just 0.1 percent. The slowdown was led by a collapse in housing activity, historically the first sector to be hit by rising rates, cutting about 1.4 percentage points from GDP's growth rate. The sharp tightening in financial conditions means a broader economic slowdown lies ahead, which should help to loosen up the labor market. Early signs of this can be seen in slower wage growth, job openings and quits trending down, and monthly job growth in October coming in at less than half the pace of early 2022.

Inflation remains unacceptably high, but several factors point to a substantial downshift in 2023. Goods prices have started to drop, and supply chain improvement along with input and import costs suggest further deflation in the goods sector lies ahead. Services inflation is now the main price stability concern, but even the Bureau of Labor Statistics and several Fed speakers have acknowledged that the lagged data on home rental prices doesn't reflect the sharp slowdown in market rents that has taken place (and that will start to show up in the data next year).

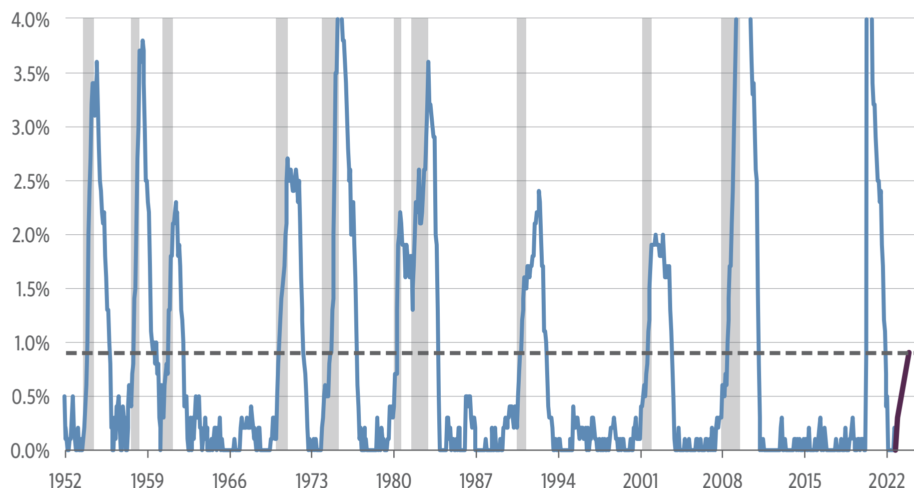
With the economy cooling and inflation likely to fall, we expect that rate hikes will be winding down in coming months, particularly with rising strains in global markets. But having been repeatedly burned by expectations that inflation would cool—and fearing a replay of the "stop-start" rate hike campaigns of the 1970s—the Fed will likely err on the side of overdoing it with rate hikes, viewing a recession as the least bad outcome for the economy. With a recession likely in 2023 and the bond market already pricing in a terminal fed funds rate near 5 percent, we think high quality fixed income looks attractive.

By Brian Smedley, Maria Giraldo, and Matt Bush

The sharp tightening in financial conditions means a broader economic slowdown lies ahead, which should help to loosen up the labor market. Early signs of this can be seen in slower wage growth, job openings and quits trending down and monthly job growth in October less than half the pace of early 2022.

Fed's Unemployment Rate Forecast Suggests a 2023 Recession Is Likely

Increase from Trailing Two-Year Low



Source: Guggenheim Investments, Haver Analytics. Data as of 9.30.2022.

Duration Opportunities as Rates Rise

Despite the challenging environment, several compelling investment opportunities are materializing in the government sector.

Persistent job strength and stubbornly high core inflation data have prompted significant revisions to interest rate hike expectations by market participants and given the Fed little reason to deviate from its hawkish policy. Market expectations for another 175 basis points of tightening in this cycle were realized in November with the fourth consecutive 75 basis point hike, bringing the fed funds rate from a range of 3–3.25 percent to 3.75–4 percent. However, the impact on the economy of the 375 basis points in tightening that the Fed has already delivered is beginning to be felt in the economy, with the Fed noting in its statement that, "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy." This leads us to believe that there is a good chance that the Fed will downshift the pace of tightening in December.

The decrease in Treasury market liquidity and increase in market volatility has compounded the impact of the sharp increase in the fed funds rate this year. Liquidity has remained challenging amid the continued global tightening cycle, due in part to the lack of Fed purchases of Treasurys and the decrease in participation by foreign investors, exacerbating price swings. All told, the resulting increase in Treasury yields drove the Treasury index down 4.3 percent for the third quarter, and down 13.1 percent year to date. These returns are the worst seen in at least 50 years, and have made for a very difficult year for fixed-income investors.

Despite the challenging environment, several compelling investment opportunities are materializing in the government sector. With long-end Treasury yields hovering around 4 percent and a terminal fed funds rate of near 5 percent already priced in, we believe this is an opportune time to consider adding duration at these levels. As recession risk rises with more deterioration in economic data, longer dated bonds stand to benefit as the market pivots from pricing in rate hikes to pricing in rate cuts. Additionally, low coupon, callable Agency bonds with maturities in the 15- to 20-year range offer spread pickup to similar maturity current coupon bullet securities and offer attractive total return potential due to their discounted price.

By Kris Dorr and Tad Nygren

The decrease in Treasury market liquidity and increase in market volatility has compounded the impact of the sharp increase in the fed funds rate this year. Liquidity has remained challenging amid the continued global tightening cycle, due in part to the lack of Fed purchases of Treasurys and the decrease in participation by foreign investors, exacerbating price swings.

The Decrease in Liquidity Has Compounded the Impact of Rate Hikes

Bloomberg Treasury Market Liquidity Index

Source: Guggenheim Investments, Bloomberg, data as of 10.2.2022. The Liquidity Index is a measure of prevailing liquidity conditions in the US Treasury market. This Index displays the average yield error across the universe of U.S. Treasury notes and bonds with remaining maturity 1-year or greater. When liquidity conditions are favorable, the average yield errors are small. Under stressed liquidity conditions, dislocations from fair value result in large average yield errors. A higher index level indicates more stressed liquidity conditions.

Investment-Grade Corporate Bonds

Focus on Long Duration at Attractive Valuations

While yields are attractive, macroeconomic uncertainty will continue to spark volatility.

Consistent credit fundamentals and higher yields kept spreads unchanged for the investment-grade Bloomberg U.S. Corporate Bond Index (the IG Index) in the third quarter. Yields increased 107 basis points to 5.69 percent. For context, these yields are well above the highs seen during the COVID outbreak in 2020, and similar to the average yield during the Great Financial Crisis (GFC).

While third quarter corporate earnings results could be in line with expectations, weaker earnings and economic forecasts for the fourth quarter suggest credit fundamentals are susceptible to deterioration, especially with rising funding costs due to higher interest rates. This could pressure yields and spreads a bit higher, but we think the downside is more limited now.

Historically high all-in yields of the IG Index relative to the S&P 500 dividend yield have prompted buying of investment-grade corporate bonds by domestic insurance companies, pension funds, and traditional asset managers. At the same time, overseas buying by Asian investors in particular has slowed materially due to increases in hedging costs. Nevertheless, the market has drawn support from domestic investors attracted by higher yields and low dollar prices across the investment-grade corporate bond universe. The average dollar price in the IG Index closed the quarter at around $86, while the long duration portion closed at around $80. The historical mean for both is $96. This dollar price is attractive because it offers a buffer in the event of a negative credit event, and the discount will typically "pull to par" as it approaches maturity.

From a technical perspective, lower supply of new investment-grade bonds should support prices in the near term. Issuance of new supply (primary market issuance) was very choppy during the third quarter, with several lulls followed by days of overwhelming issuance. The third quarter set a record with over 50 days with zero issuance. When there is limited new issuance, coupon reinvestments and other regular inflows are forced to find opportunities in already-outstanding bonds (the secondary market), which supports secondary market prices and credit spreads. But in our experience, a very long period of low new issuance could negatively impact the information flow necessary for investors and traders to know where spreads should be.

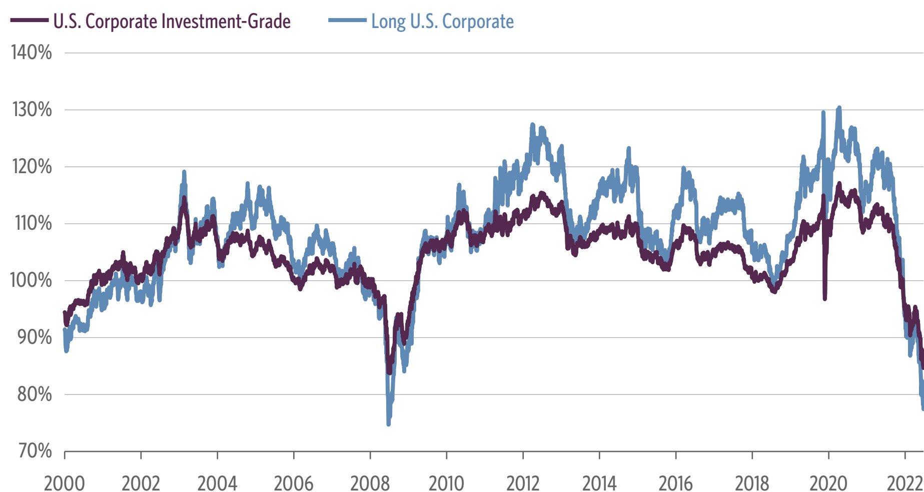
Investment-grade bond yields appear attractive around these levels, but macroeconomic uncertainty will continue to create volatility for spreads. The market has been operating in an orderly fashion, but spreads will likely remain under pressure throughout the fourth quarter. We continue to favor long duration, low dollar price corporates for longer-term investment.

By Justin Takata

The market has drawn support from domestic investors attracted by higher yields and low dollar prices across the investment-grade corporate bond universe. The average dollar price in the IG Index closed the quarter at around $86, while the long duration portion closed at around $80. The historical mean for both is $96.

Low Dollar Prices Have Drawn Investor Support

Average Bond Price as a % of Par



Source: Guggenheim Investments, Barclays, Bloomberg. Data as of 10.20.2022.

High-Yield Corporate Bonds

Priced for a Net Downgrade and Default Cycle

Higher yields and discounted bond prices offer an attractive opportunity, but investors must remain mindful of downside risks.

With a total return of -14.7 percent through September, the Bloomberg U.S. Corporate High-Yield index delivered its worst year-to-date third quarter performance on record. Yields approached 9.5 percent, the highest since April 2020 and near peaks last seen during 2011 and 2016. The environment has reset the opportunities available in fixed income and created many attractive entry points, effectively bringing yield back to "high-yield."

With credit spreads near 460 basis points (the 56th percentile of historical valuations), the market-implied default rate over the next 12 months is 4.5 percent if we assume 250 basis points compensates for just liquidity risk. We think the default rate could be closer to 3.5 percent, given that it is currently 1.1 percent and the rate increased by an average of 2.4 percentage points in the first year of the three recessions prior to the pandemic. There is already some cushion in the market-implied default rate. However, these views do not rule out further spread widening since once a recession is in full force, expected defaults could rise even further and markets can move into oversold territory as they often do.

In addition to defaults, the next 12 months will likely see a mild downgrade cycle as corporate earnings growth slows and turns negative, given our forecasts for weaker U.S. GDP growth and a likely recession in 2023. For now, however, we remain encouraged by the financial results we see across a large portion of the credit market. High-yield debt issuers are heading into this slowdown with sufficient cash generation to cover annual interest expense at least five times over, and more cash cushion than in 2019 when our strategies were more defensively positioned. Meanwhile, some areas of spread decompression (i.e. a steepening credit curve) are near peaks. For example, B-rated bonds are trading 210 basis points wider than BB-rated corporate bonds, which is the 84th percentile of historical levels and the 96th percentile of the last decade. We interpret this to mean that many single B downgrades are already priced in.

While there may be credit stresses along the way, we believe the default cycle will be less severe than in recent recessions. Given solid credit fundamentals, we view yields and discounted bond prices as offering an attractive opportunity for portfolios to add yield, but investors must remain mindful of downside risks as spreads can widen further depending on how a recession takes form next year.

By Thomas Hauser and Maria Giraldo

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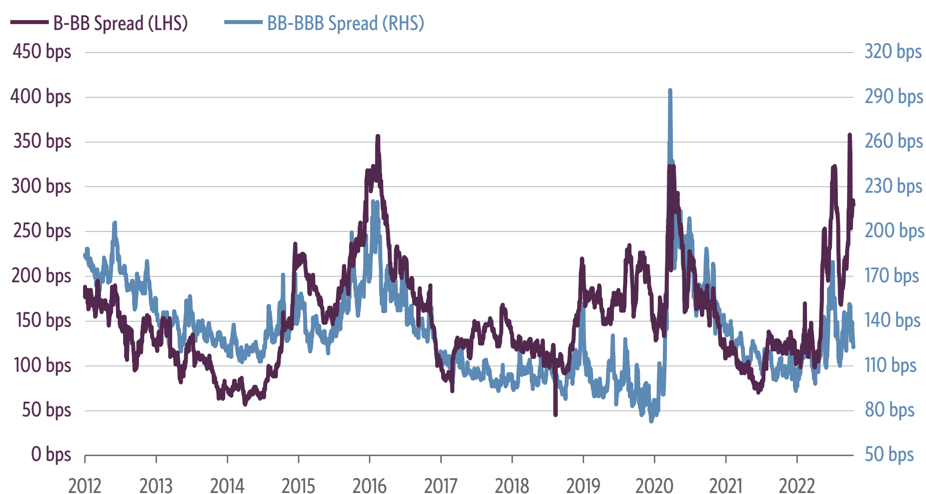
A Steep B/BB Credit Curve May Reflect an Upcoming Downgrade Cycle

Difference Between BBB-rated, BB-rated, and B-rated Spreads



Source: Guggenheim Investments, Bloomberg. Data as of 10.19.2022.

Bank Loans

The Loan Dilemma of Higher Interest Rates

The pros and cons of short-term interest rates going deeper into restrictive territory.

Average prices declined by 0.4 percent in the third quarter, but coupon income helped total returns for the bank loan sector to bounce back with a return of 1.2 percent. This partially reversed the 4.4 percent loss in the second quarter, bringing the Credit Suisse Leveraged Loan Index return to -3.3 percent as of Sept. 30.

Demonstrating that loans are not immune to the Fed's rate hikes, discount margins tightened 100 basis points from June through mid-August and then widened 100 basis points from mid-August through September as the Fed prepped the market for, and then delivered, its second 75 basis point rate hike at the end of the quarter. Three-year discount margins, the conventional way to express risk premium in loans, ended the quarter at 668 basis points, the 92nd percentile of historical valuations dating back to 1992, and 200 basis points above the historical average. Part of the reason that discount margins are wide versus history is due to the sector's weakening credit profile (i.e. more single Bs than ever before), but even controlling for ratings, we find risk premiums are wide. As the Fed goes further into restrictive territory, the negative credit impact to loan issuers will worsen as interest payments rise.

Our analysis finds that the median loan interest coverage ratio (the ratio between annual cash flow and interest expense) could fall to less than 3.0x if the fed funds rate rises to 5 percent and earnings growth slows to 5 percent. A near threefold increase in the loan market default rate, from 1.3 percent to 3.5 percent in the next 12 months, is our base case expectation. Looking through the full cycle, we believe defaults could peak around 6-7 percent of the market in 2024 based on the lagged effects of tightening financial conditions and a U.S. recession. This would exceed the COVID peak default rate of 4.6 percent and would be comparable to the 2008 default cycle in terms of length. Since investors typically recover about 60 percent of their loan value in default situations, we estimate the cumulative credit loss rate in loans to be around 4 percent in the next two years. Discount margins at 668 basis points, some of which compensates for limited market liquidity, exceed our loss estimate.

We believe loans remain a compelling place for credit exposure due to attractive yields and discounted prices. We are increasingly selective on new purchases as recession risks rise heading into 2023, and look to make defensive allocation adjustments as the end of this cycle comes more clearly into view.

By Christopher Keywork and Maria Giraldo

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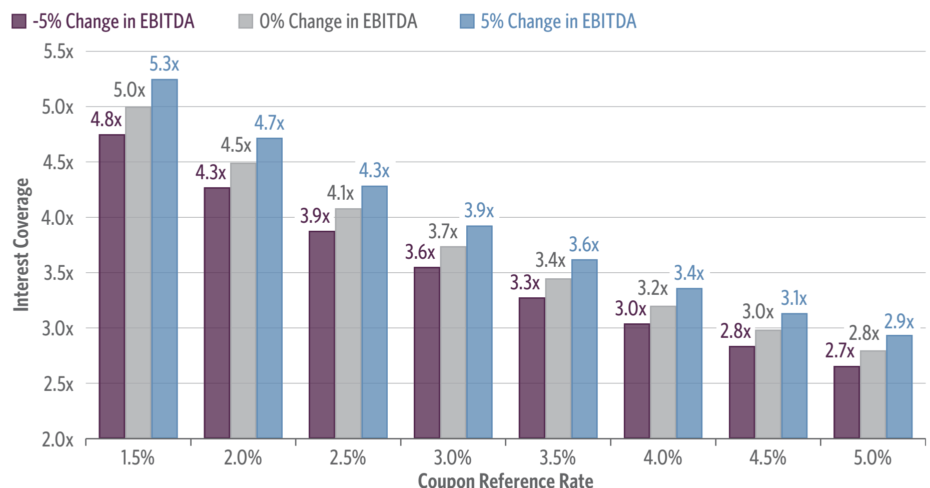
Bank Loan Interest Coverage Ratios

Interest Coverage for Given Coupon Reference Rate



Source: Guggenheim Investments, S&P LCD. Data as of Q2 2022. EBITDA - earnings before interest, taxes, depreciation, and amortization.

Municipal Bonds

Differing Values in Taxable vs. Tax Exempt Munis

Avoid negative convexity in tax exempts, and in taxables focus on value in non-indexed securities.

With the rise in Treasury yields continuing to dominate the fixed-income market in the third quarter, Bloomberg Municipal Bond Index Total Return Index returns fell 3.5 percent for the quarter, bringing returns to -12.1 percent year to date as of Sept. 30, while Bloomberg Municipal Index Taxable Bonds Total Return Index returns declined 6.2 percent for the quarter and -19.3 percent year to date. Taxable municipals underperformed tax exempts due to their longer duration.

Tax exempt mutual funds faced outflows for most of the quarter, and year-to-date redemptions exceeded $100 billion—higher than any previous full year total. However, we suspect that there has been a slow reversal of this trend as the two largest municipal ETFs began experiencing consistent inflows near the end of the quarter. Tax loss swapping likely drove this activity, as investors realized losses on their mutual funds before rolling the proceeds into ETFs in order to maintain exposure to the muni market and gain intraday liquidity. Combined with an anemic new issue calendar, ETF activity depressed muni/Treasury yield ratios. Taxable muni spreads widened in conjunction with other credit sectors, but as of the end of the third quarter, index-eligible (i.e. investment grade) taxable munis traded at tighter spreads than investment-grade corporate bonds as year-to-date issuance volumes declined 48 percent compared to the same period last year.

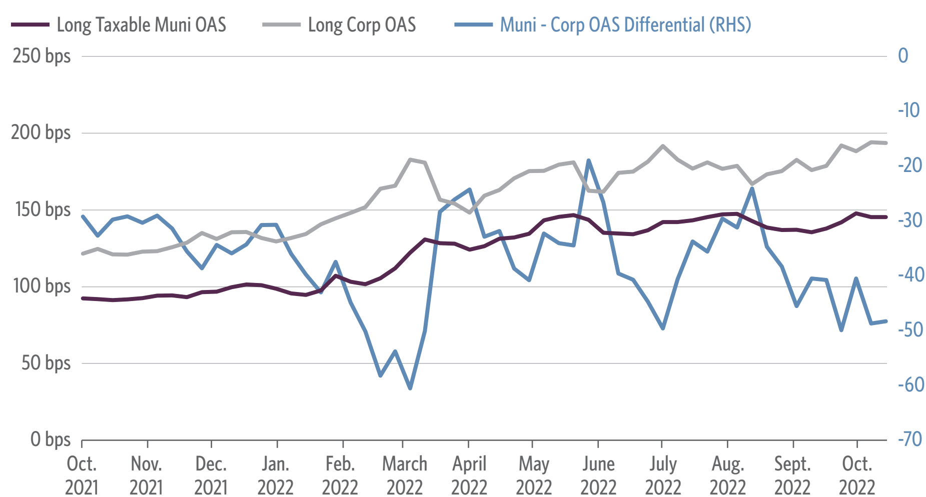
Municipal bond credit quality remains strong: States' rainy-day funds are expected to stay high for fiscal year 2023, and American Rescue Plan funds have yet to be fully spent. However, municipalities with a higher proportion of market-sensitive revenues, such as capital gains taxes, have started missing top-line forecasts. This portends possible challenges in the 2023–24 budget season.

Tax exempt muni investors should focus on reducing negative convexity, which causes bonds to underperform in most rate scenarios. For example, products such as 5 percent coupon bonds with very short par call dates give issuers the option to call if rates fall but stick investors with rate volatility if rates rise. On the taxable side, while index-eligible bonds are trading at tighter spreads than investment-grade corporate bonds, non-index paper remains relatively attractive. Differences in liquidity between index- and non-index securities have narrowed amid current market volatility.

By Allen Li and Michael Park

Taxable muni spreads widened in conjunction with other credit sectors, but as of the end of the third quarter, index-eligible (i.e. investment grade) taxable munis traded at tighter spreads than investment-grade corporate bonds as year-to-date issuance volumes declined 48 percent compared to the same period last year.

Taxable Muni Spreads Tighten Relative to Corporates



Source: Guggenheim Investments, Bloomberg, data as of 10.18.2022. OAS - option-adjusted spread.

Asset-Backed Securities and CLOs

Relative Outperformance Amid Volatility

Opportunities to add attractive spreads and all-in-yields at discount dollar prices in the secondary market.

During the third quarter, CLO spreads widened: AAA through A tranches widened by 20–55 basis points, while BBB tranches and BB tranches widened by 50 and 100 basis points, respectively. Despite higher spreads, floating-rate coupons and shorter maturities insulated CLO performance, with AAAs and BBBs returning 0.2 percent and -1.4 percent, respectively. [1]

Although CLOs' corporate bank loan collateral is starting to see downgrades and default rates increase from historically low levels, CLO structures are positioned defensively as performance test thresholds have nearly recovered to healthy pre-COVID levels. For example, CLOs' exposure to CCC loans has fallen to 4 percent from a COVID peak of over 10 percent, while junior overcollateralization (OC) cushions—the measure of losses CLO collateral can take before cash flow diversion—is back close to 5 percent after falling to near 2 percent. In addition, CLO managers are actively adjusting exposures by avoiding or reducing exposure to riskier borrowers and industries and by upgrading overall portfolio quality. The new issue market is challenging for issuers as investor demand for AAA CLOs is tepid and capital is readily available for only the most heavily resourced and established CLO managers. We expect new issue activity to slow into year end. At the same time, we are seeing secondary market opportunities to purchase discounted investment-grade tranches with the potential for price appreciation and a low likelihood of being called before maturity. We continue to prefer senior CLO tranches from higher tier managers with a proven track record of navigating difficult market environments.

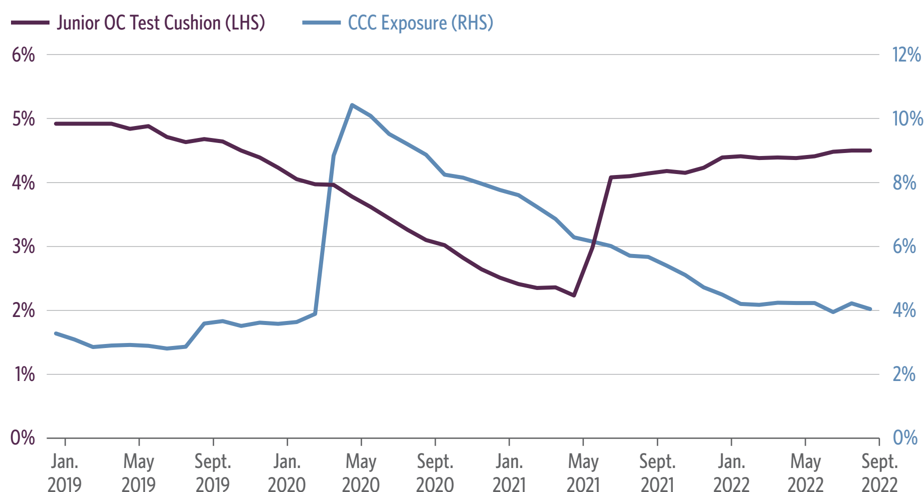
Esoteric ABS (which includes such collateral types as shipping containers, railcars, cellular towers. and whole business franchises) exhibited unchanged credit spreads in the third quarter and outperformed broader credit markets, with the ICE BofA AA-BBB ABS Index returning -2.1 percent. After brisk issuance in the first half of the year, ABS issuance slowed in the third quarter by 24 percent year over year, down 2 percent year to date from the same period last year. Notable new deals came in utility, whole business, and music rights securitizations, but risks remain as we also saw certain transactions in triple-net lease and whole business ABS pre-marketed and then pulled due to lack of investor demand. We expect new supply to remain subdued in the near term.

Credit quality remains sound in key sectors, including whole business, infrastructure, and container ABS, and our focus is on opportunities to add attractive spreads and higher all-in-yields at discount dollar prices in the secondary market.

By Dominic Bea, Rafsun Faiz, Scott Kanouse, and Michael Liu

CLO structures are positioned defensively as performance test thresholds have nearly recovered to healthy pre-COVID levels. For example, CLOs' exposure to CCC loans has fallen to 4 percent from a COVID peak of over 10 percent, while junior overcollateralization (OC) cushions—the measure of losses CLO collateral can take before cash flow diversion—is back close to 5 percent after falling to near 2 percent.

CLO CCC Exposure Has Fallen to Pre-COVID Levels



Source: Intext, Guggenheim Investments. Data as of 9.30.2022.

1. Palmer Square CLO Senior Debt Index (AAA) and Palmer Square CLO Debt Index (BBB). Data as of 9.30.2022.

Non-Agency Residential Mortgage-Backed Securities

Select Opportunities in RMBS Despite Cooling Housing Market

Value remains in favored pre-crisis RMBS and shorter duration senior RMBS tranches.

Non-Agency RMBS spreads widened in the third quarter to post-COVID wides due to market volatility, despite light dealer positioning and modest trading volumes. RMBS 1.0 and RMBS 2.0 subsectors—RMBS issued pre- or post-GFC—posted third quarter returns of -0.5 percent and -6.4 percent, respectively, according to Citi Research. Returns for the sector are likely to follow broader risk markets and remain volatile in the near term.

New issuance slowed by 45 percent in the third quarter relative to the third quarter of 2021, and year-to-date issuance is 25 percent below the same period last year. With mortgage rates rising from 3.3 percent to 7 percent year to date and an average mortgage rate of 3.5 percent on the outstanding stock of loans, housing purchase and refinancing activity fell to historical lows and suppressed creation of new loans that would be pooled into new MBS. Additionally, rising rates and spread widening curtailed economic benefits of securitization. Therefore, we expect new issuance will be challenged in the near term.

The strength of the housing market in recent years has created meaningful differences in home equity levels across subsectors. Properties securing older loans have experienced greater price appreciation than those securing younger loans. Consequently, older loans have de-levered more, and have lower loan-to-value ratios and lower risk of loss. Thus far, these differences in credit risk have been reflected in an orderly way in market pricing. The chart shows how closely single-family rental securities' pricing tracks the implied leverage of the underlying pool of homes. Similar linear credit curves exist in RMBS backed by non-qualified mortgages and reperforming loans. Despite a cooling housing market, the strength of this relationship demonstrates that current bond pricing reflects limited expectations for material distress.

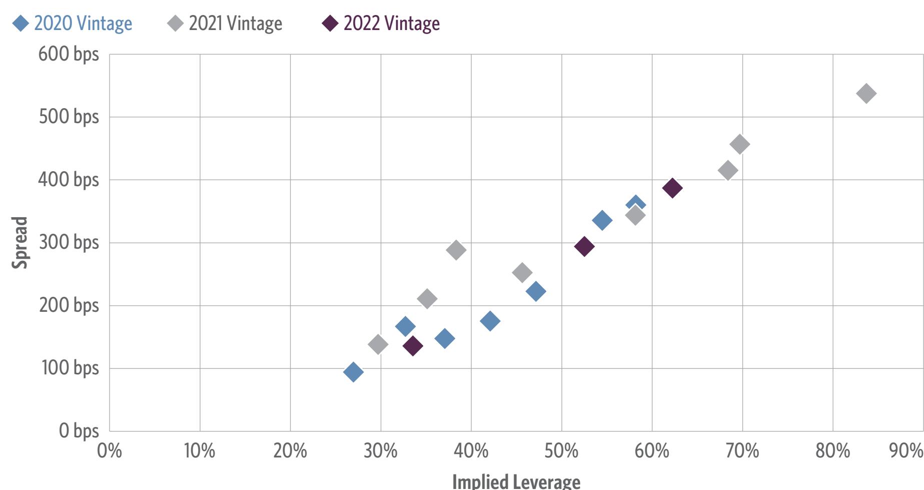
Conservative mortgage underwriting, favorable consumer and labor market conditions, and an excess demand for shelter in the United States underpin our constructive view on RMBS despite softening prospects for home prices. We favor non-qualified mortgage RMBS 2.0 mezzanine and senior tranches with stable weighted average life profiles, reperforming loan deals, and RMBS 1.0 backed by loans with significant home equity.

By Karthik Narayanan and Roy Park

Single-family rental securities' pricing tracks the implied leverage of the underlying pool of homes. Similar linear credit curves exist in RMBS backed by non-qualified mortgages and reperforming loans.

Current Bond Pricing Reflects Limited Expectations for Material Distress

Single-Family Rental Pricing vs. Leverage



Source: Guggenheim Investments, FINRA, Bloomberg, Data as of 9.30.2022.

Commercial Mortgage-Backed Securities

Balancing Negatives and Positives

We favor CMBS transactions backed by quality assets, strong sponsorship, and structural protections.

CMBS spreads widened in the third quarter in sympathy with broader fixed-income credit markets: JP Morgan CMBS Index 10-year conduit AAA bond spreads ended the third quarter at 147 basis points, compared to 132 basis points for the second quarter and 72 basis points at year-end 2021. The first order effect of wider spreads and higher volatility has been a decrease in issuance: non-Agency CMBS year-to-date issuance of $91.5 billion was down compared to $97.5 billion for the same period last year, as owners holding properties with stable cash flows have a reduced incentive to refinance or transact given higher interest rates and lower clarity of execution in today's more volatile capital markets.

A number of cyclical and secular pressures are affecting commercial real estate (CRE) values. Higher interest rates have already increased borrowing costs and will increase the cap rates used to value CRE assets. Office space demand is being challenged by a shift to hybrid work patterns, while more operationally intensive real estate businesses like lodging could face higher expenses from inflationary pressures. These challenges are affecting credit availability. The most recent Federal Reserve Senior Loan Officer Survey on Bank Lending Practices shows tightening commercial real estate lending standards and decreased aggregate demand for CRE loans. For the same reasons, competition from non-bank lenders has also faded materially.

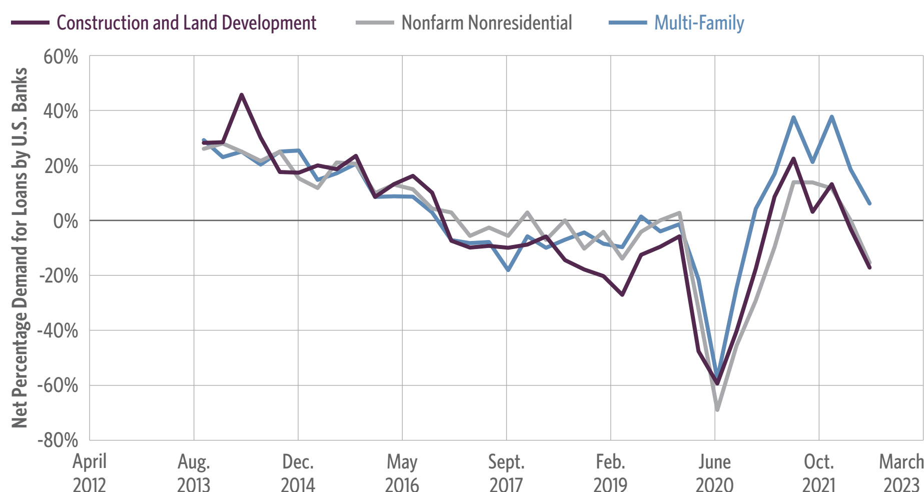
On the positive side, real estate operating performance has recovered since 2020, and operating cash flows are more than adequate to cover debt service across the CMBS universe. The debt service coverage ratio for all conduit CMBS bonds ended the quarter at 2.20x, up from the 2020 trough of 1.84x. The 60+ day delinquency rate is now 3.5 percent, versus the summer 2020 peak of 6.5 percent.

Global repricing of fixed-income assets has led to wider spreads and higher yields. Active managers doing fundamental credit analysis on CMBS are better positioned than in the last 15 years to explore opportunities to source bonds backed by stabilized collateral at attractive spreads as well as historically high spread premiums for transitional property-backed bonds. We continue to favor select CMBS transactions backed by quality assets with strong sponsorship and structural protections, with a focus on AA to BBB- rated single asset-single borrower and CRE-CLO securities.

By Tom Nash and Hongli Yang

The most recent Federal Reserve Senior Loan Officer Survey on Bank Lending Practices shows tightening commercial real estate lending standards and decreased aggregate demand for CRE loans. For the same reasons, competition from non-bank lenders has also faded materially.

Aggregate Demand for CRE Loans Has Decreased



Source: Guggenheim Investments, Board of Governors of the Federal Reserve System, data as of 6.30.2022. Note: A negative reading indicating that a net share of banks reported weaker demand for loans, and a positive reading indicating that a net share of banks reported stronger demand for loans.

Agency Mortgage-Backed Securities

Historically Wide Spreads Signal Long-Term Value

Looking for Agency RMBS passthroughs, low pay-up specified pools, and locked-out CMOs.

Agency MBS spreads widened over the third quarter, driven by a hawkish Fed navigating an uncertain macroeconomic environment. Option-adjusted spreads ended the quarter at 69 basis points, 23 basis points wider than the prior quarter. The Bloomberg U.S. MBS Index third quarter total and excess returns were -5.35 percent and -1.69 percent, respectively. Notably, September's returns were among the worst on record. Negative market conditions finally caught up with Agency commercial MBS, which had been relatively stable in the first half of the year. They posted third quarter total and excess returns of -4.64 percent and -0.62 percent, respectively.

Two factors have conspired to create the recent challenging market environment. First, the pace of the increase in benchmark interest rates over the third quarter exceeded that of the 2013 Taper Tantrum, with knock on effects for the pricing and hedging of MBS that are inherently sensitive to volatility. Second, changes in September to the Fed's allowable monthly reinvestments in MBS, along with falling mortgage prepayment rates, put an end to Fed purchases of MBS. These fundamental and technical pressures resulted in periods of illiquidity and have driven spreads to levels not seen outside of the GFC.

We expect to continue to see significant short-term volatility in the Agency MBS markets, but we view the current backdrop as favorable for increasing allocations to Agency MBS as a long-term investment.

With spreads at crisis levels, prices below par, declining origination, and limited convexity concerns, Agency MBS offers an attractive up-in-credit quality alternative to other intermediate investment-grade fixed-income assets. In addition to realizing higher income from historically high yields and spreads, an eventual normalization in interest rate volatility would further enhance total returns. In our view, discount-priced Agency RMBS passthroughs (where principal and interest payments flow to the MBS holder) are attractive because if rates reverse course and move lower, there is plenty of room for their discounted price to increase before rates reach a level where prepayment risk negatively impacts the bond price (a phenomenon called negative convexity). For similar reasons, we think low pay-up specified pools (where the pool of mortgages has more stable cash flows due to favorable loan characteristics), and locked-out collateralized mortgage obligation (CMO) structures (which offer structural protection from principal amortization for an initial period) also appear attractively priced because compared to more generic MBS alternatives their structures typically reduce prepayment risk and offer more price upside even at very low interest rate levels.

By Aditya Agrawal and Louis Pacilio

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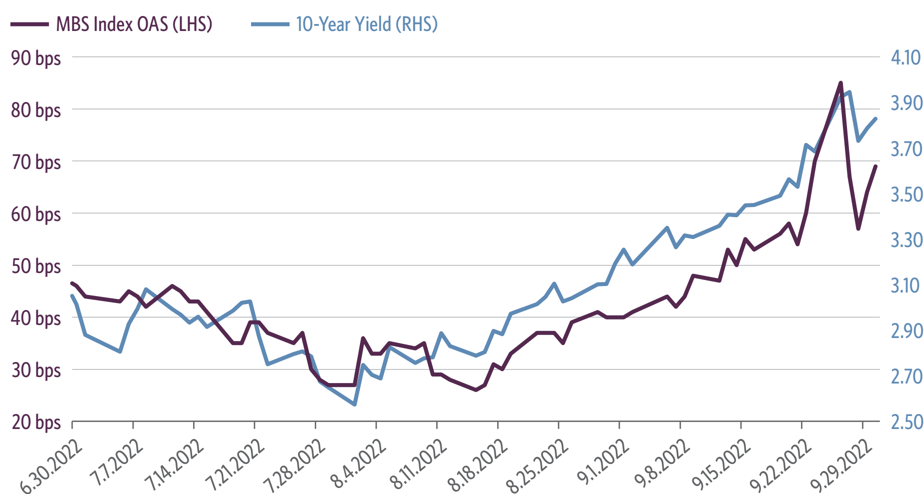
Mortgage Spreads Widen into Sharp Rate Selloff



Source: Bloomberg, Data as of 9.30.2022.

Commercial Real Estate

Calling an End to the Great Work-From-Home Experiment

The case of long-term value in office properties depends on the power of in-person interaction.

Due to the long duration of office leases, the full impact of the pandemic has yet to be realized in the office property sector. In fact, over the past year office prices have continued to increase, although price growth has begun to decelerate. This situation will change, but there are divergent opinions on what's next. The Mortgage Bankers Association predicts that a limited reduction in office demand may prevail after a period of volatility, while researchers at NYU and Columbia University predict a permanent "value destruction" of over 40 percent in markets like Manhattan where remote working trends are likely to continue. In the meantime, Kastle reports that average U.S. office occupancy remained below 50 percent at the end of the third quarter, which is exerting downward pressure on the value of office assets.

We are seeing a range of outcomes in the market. To lure workers back to the office, employers are favoring the highest quality, amenitized, energy efficient properties over more dated offices. Workers facing long commutes are more resistant to returning to downtown locations, which is bolstering suburban office demand. Investors continue to favor investment grade credit tenants and longer lease terms that offer more certainty of cash flows. The basic law of supply and demand favors markets with limited supply of existing and under-construction offices.

All of these operational facts on the ground are important for evaluating short term performance of office assets, but the longer-term health of the sector likely rests on an intangible set of sociological considerations. While we expect employers will allow more flexible work arrangements than existed before the pandemic, we believe that the benefits of having team members collaborating in offices will outweigh the short-term cost savings of reduced office space.

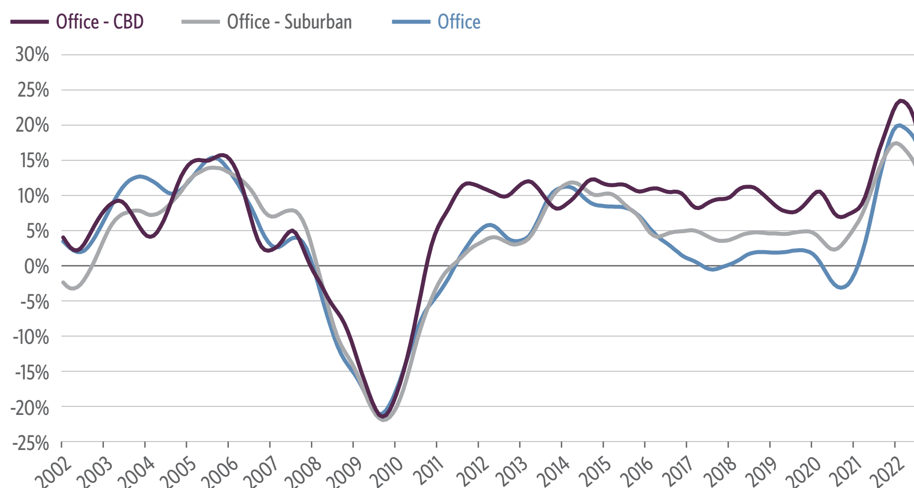
What does this mean for investors? We expect average cap rates to increase and with that, office values to fall in the near term as uncertainty persists and tenants delay making long-term decisions and commitments. However, discerning investors who understand the anticipated divergence of performance across the office market will still see attractive opportunities to invest in those properties desired by tenants and in markets where office supply is constrained. For those properties, we expect less upward pressure on cap rates with a more moderate impact to valuations. With some real estate investors sitting on the sidelines until the market settles, we anticipate there could be attractive buying opportunities while the market softens in the near term.

By Jennifer A. Marler and Farris Hughes

We expect average cap rates to increase and with that, office values to fall in the near term as uncertainty persists and tenants delay making long-term decisions and commitments. However, discerning investors who understand the anticipated divergence of performance across the office market will still see attractive opportunities to invest in those properties desired by tenants and in markets where office supply is constrained.

Office Property Prices Have Slowed Post-COVID

Year-Over-Year Change in Office Property Prices



Source: Real Capital Analytics (August 2022 CPPI Report).

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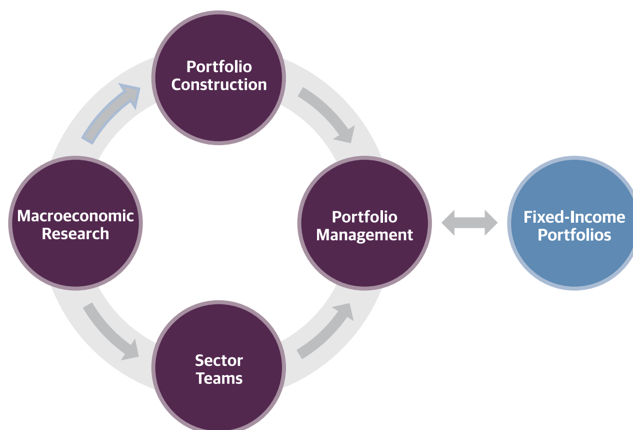

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