Quarterly Commentary—Q3 2019

Investment Grade Bond Fund

Market Review

The third quarter of 2019 ushered in the first U.S. rate cuts since 2008, with the Federal Reserve (Fed) explicitly stating that its focus is now on sustaining the economic expansion. This not-so-subtle shift implies that policymakers will do whatever it takes to ensure that the expansion continues. Although there has been considerable dissent among Fed policymakers about whether monetary easing is warranted at this stage, Chair Powell seems to have the full support of Vice Chair Clarida and New York Fed President Williams, adding credibility to Powell’s focus on supporting growth.

The Federal Open Market Committee (FOMC) delivered two rate cuts of 25 basis points (bps) each in the third quarter. These cuts were positioned as an effort to guard against downside risks and came even as unemployment sits at a 50-year low and inflation is moving back toward the Fed’s 2 percent target. The market seems convinced that the Fed’s commitment will not waver, with futures putting the fed funds rate another 65 basis points lower by December 2020. But the FOMC has been reluctant to commit to more easing, so it is still unclear whether the Fed will deliver the aggressive and preemptive policy action that may be needed to prolong the current expansion.

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Market Review (Continued)

Recent economic data have been mixed, and with monetary and trade policy in flux, uncertainty about the economic outlook is higher than usual. On the positive side, we saw a pickup in the housing market as measured by housing starts and home sales. Additionally, the unemployment rate fell to a new cycle low of 3.5 percent in September, despite a continued moderation in payroll gains.

On the negative side, the ISM manufacturing index and most major subcomponents fell below 50 in August and plunged further in September to 47.8, the weakest reading since June 2009. The ISM non-manufacturing index also came in well below expectations at 52.6 last month, the lowest since August 2016. The non-manufacturing survey’s employment component is now barely above 50 while the manufacturing employment sub-index stands at 46.3, well into contraction territory. Combined, the outlook for output and hiring has dimmed, potentially signaling trouble ahead for the labor market and consumers.

Much of the weakness in manufacturing data is owed to the ongoing trade dispute between the United States and China. A second-order effect of this trade dispute is its impact on consumer sentiment. Sentiment surveys show that fewer consumers believe now is a good time to buy homes, vehicles, and household durables, and headline consumer confidence measures have fallen over the past year. In addition to trade policy, we believe political concerns also weigh on sentiment, and both are set to ramp up further. Additional U.S. tariffs on China are due to take effect on Dec. 15, and the U.S. House of Representatives is pressing forward with its impeachment inquiry into President Trump. If both issues are resolved favorably, consumer spending is likely to power ahead with help from still-solid income growth, a year-to-date rally in the equity market, and lower borrowing costs. Alternatively, if these continue to weigh on sentiment, and the equity market fails to rally in the fourth quarter when seasonal trends are favorable, it will be a sign of more trouble brewing.

Our recession forecasting tools indicate that the economy remains in a vulnerable place. Our U.S. Recession Dashboard continues to point to a recession beginning sometime in the first half of 2020. Our Recession Probability Model indicates a 50 percent chance that a recession will come before mid-2020, and a 70 percent chance that it will arrive by mid-2021. Avoiding a recession now may take more policy action than has been delivered at this stage. It is difficult to say whether the Fed will succeed in its efforts to keep the expansion going, but we judge that risk assets are not compensating investors for the possibility that it will not.

Summary:

- The third quarter of 2019 ushered in the first U.S. rate cuts since 2008, with the Fed explicitly stating that its focus is now on sustaining the economic expansion. These cuts were positioned as an effort to guard against downside risks and came even as unemployment sits at a 50-year low and inflation is moving back toward the Fed’s 2 percent target.

- The FOMC has been reluctant to commit to more easing, so it is still unclear whether the Fed will deliver the aggressive and preemptive policy action that may be needed to prolong the current expansion.

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Performance Review
The fund finished the third quarter up 1.63 percent, while the benchmark (Bloomberg Barclays U.S. Aggregate Bond Index) was up 2.27 percent and the Morningstar peer group was up 1.94 percent. Positive absolute return was driven largely by duration and carry.

Strategy and Positioning
The fund’s primary allocation strategy remains to focus on loss remote investments that will exhibit minimal spread volatility and stable returns under a variety of credit and rate environments. This should produce more stable and less volatile performance for the fund.

The fund’s yield advantage and lower portfolio spread duration aided relative performance over the quarter. Credit spreads widened moderately, specifically among investment grade corporates, as US-China talks stalled and global growth concerns rose.

Interest rates across the curve fell between 20 and 40 bps and the curve flattened over the quarter, which led to comparative underperformance given the Fund’s duration underweight. We have added approximately three-quarters of a year of duration since the beginning of August to close some of the underweight.

The first increase to duration came in the beginning of August following the re-escalation of the trade war post the Federal Reserve’s July meeting. At that point we decided to shorten the underweight at the front end of the curve given the risk that the Fed could be forced to ease quicker than the market expected given exogenous threats to growth from increasingly combative trade policy.

The second increase to duration targeted the long-end of the curve in mid-September. Following the severe rally in rates during August, the 30-year Treasury yields rose 40 bps over the first two weeks of September. We took advantage of this backup by further adding duration; though the fund remains underweight overall duration and positioned for a steeper yield curve.

Should the Fed be successful in prolonging the business cycle akin to 1998, this should increase inflation expectations and term premium, bear steepening the yield curve. Under this scenario, our underweight duration should help buffer client portfolios from negative absolute returns if interest rates climb higher.

If the economy is heading towards a recession, the Fed will need to ease significantly more than the market is pricing in, resulting in a steeper yield curve led by the front-end rallying alongside credit spread widening.

Over the quarter all credit sectors contributed to total return with no negative performers. Within our credit exposure we continue to favor structured credit over corporate credit given generally a compelling spread pickup to similarly rated corporates while providing defensive positioning in the event of another December-like swoon.

Within structured credit senior CLOs with short spread duration, non-agency residential mortgage-backed securities (RMBS) (both legacy and some recent issue categories) and commercial asset-backed securities (ABS) remain the largest weightings. Each added to performance in Q3 as spreads were flat or just marginally wider.

In order to maintain our defensive positioning and short portfolio spread duration our longer duration holdings continue to be allocated to treasuries and agency debt, including agency commercial mortgage-backed securities (CMBS). Agency CMBS has some spread upside should credit spreads broadly tighten but has much less downside should spreads widen.
One basis point is equal to 0.01%.

Risk Considerations This fund may not be suitable for all investors. • Investments in fixed-income instruments are subject to the possibility that interest rates could rise, causing the value of the fund’s holdings and share price to decline. • Investors in asset-backed securities, including collateralized loan obligations (“CLOs”), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly. • Investments in loans involve special types of risks, including credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate. • High-yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. • The fund’s use of leverage, through borrowings or instruments such as derivatives, may cause the fund to be more volatile and riskier than if it had not been leveraged. The more a fund invests in leveraged instruments, the more the leverage will magnify any gains or losses on those investments. • Investments in reverse repurchase agreements expose the fund to many of the same risks as leveraged instruments, such as derivatives. • You may have a gain or loss when you sell your shares. • Please read the prospectus for more detailed information regarding these and other risks.

Index Definitions The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

The referenced fund is offered in multiple share classes. Please read the prospectus for information on fees, expenses and holding periods that may apply to each class.

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Read the fund’s prospectus and summary prospectus (if available) carefully before investing. It contains the fund’s investment objectives, risks, charges, expenses, and other information, which should be considered carefully before investing. Obtain a prospectus and summary prospectus (if available) at GuggenheimInvestments.com.

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