Market Review

Recent U.S. economic data demonstrate that the expansion is being helped by lower rates. New homes sales have risen at a double-digit year-over-year pace for four consecutive months since August, spurred by lower mortgage rates but also base effects. Manufacturing production rose in both November and December, corroborating the signal seen in improving manufacturing surveys. Nonfarm payroll gains averaged 184,000 in the fourth quarter, above underlying labor force growth. Income gains and a positive wealth effect are also flowing through into retail sales, where "core" sales recovered in December after three months of declines.

The latest evidence suggests that the Federal Reserve’s (Fed’s) easing efforts have given the U.S. economy the extra gas it needed to extend the cycle. Furthermore, the new year kicks off with some clarity on U.S.-China trade policy. The eleventh-hour Phase 1 U.S.-China trade agreement may give U.S. companies some comfort that they can expect tariffs on either side to remain where they are for now. This should help support U.S. manufacturing activity, especially if China steps up purchases of U.S. goods as promised.

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Market Review (Continued)

Over the next several months, we expect the Fed will stay on hold as it watches incoming data to ensure that the current level of fed funds remains appropriate. Monetary policy acts on the economy with a lag, so the effects of the last rate cut in October 2019 might not be apparent until mid-2020. More economic data improvements may come as low rates flow through to consumers and to the credit markets.

Encouraged by positive data, market participants welcomed the new decade with cautious optimism. Credit spreads are near historical tights, but the CCC-BB spread in high-yield corporates and bank loans remains above their five-year averages. 10-year Treasury yields, while off their 2019 lows, have failed several times to rise above 2 percent. This reminds us that while the Fed has successfully pushed off a recession, 2020 arrives with many risks worth watching, including the U.S. presidential election, U.S.-Europe trade negotiations, the potential for a military conflict between the U.S. and Iran, and rising corporate and local government defaults in China.

Much of the global growth in this cycle has been driven by an accumulation of debt, which has a declining marginal return. Without a down cycle to deflate some of the bubble, easy credit availability at this stage keeps the weakest companies on life support as low rates force investors to provide capital to borrowers teetering on the brink of downgrade or default. In this environment, even if the CCC-BB spread compresses back to historical tights, it is not a credit rally we would chase.

Economic data suggest the Fed has successfully pushed off a recession by cutting rates and injecting significant amounts of liquidity. After tightening notably at the end of 2019, we expect credit spreads to move sideways over the next quarter. We remain concerned that credit excesses will balloon as a result of global central bank liquidity that is pushing on a string. Given tight spreads and high prices, it remains prudent to invest where we assess creditworthiness to be solid and where spreads adequately compensate for risk.

Summary:
• Recent U.S. economic data demonstrate that the expansion is being helped by lower rates. New homes sales have risen at a double-digit year-over-year pace for four consecutive months since August, manufacturing production rose in both November and December, and nonfarm payroll gains averaged 184,000 in the fourth quarter. Income gains and a positive wealth effect are also flowing through into retail sales.
• The eleventh-hour Phase 1 U.S.-China trade agreement may give U.S. companies some comfort that they can expect tariffs on either side to remain where they are for now. This should help support U.S. manufacturing activity, especially if China steps up purchases of U.S. goods as promised.
• The Fed’s easing efforts have given the U.S. economy the extra gas it needed to extend the cycle. Over the next several months, we expect the Fed will stay on hold as it watches incoming data to ensure that the current level of fed funds remains appropriate.
• Credit spreads are near historical tights, but the CCC-BB spread in high-yield corporates and bank loans remains above their five-year averages. 10-year Treasury yields, while off their 2019 lows, have failed several times to rise above 2 percent. While the Fed has successfully pushed off a recession, risks remain.
• Much of the global growth in this cycle has been driven by an accumulation of debt. Without a down cycle to deflate some of the bubble, easy credit availability keeps the weakest companies on life support. In this environment, even if the CCC-BB spread compresses back to historical tights, it is not a credit rally we would chase.

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Performance Review

The fund returned -0.63 percent for the fourth quarter, while the benchmark (Bloomberg Barclays U.S. Aggregate Bond Index) returned 0.18 percent. The quarter saw continued global central bank easing, balance sheet expansion and a flood of liquidity drove risk assets higher. The primary driver of relative underperformance was the fund’s underweight to investment grade corporate credit as spreads tightened over the month and ended 9 basis points from their post-crisis tights at year-end. That underperformance was tempered by outperformance resulting from the fund’s underweight duration positioning as long-end rates rose over the period. The fund also benefitted from excess income versus the benchmark.

Strategy and Positioning

The Fed with its shift in policy has decreased the odds of a recession near term and has likely extended the expansion. Within the US economy weakness in manufacturing data looks to be bottoming, the consumer is in good shape, and the labor market remains extraordinarily resilient. The recovery in the U.S. is also helping to drive a pickup in global economic activity.

Fed Chair Jerome Powell referred to the first cut as a brief “mid-cycle” rate adjustment, as opposed to the beginning of a lengthy cutting cycle. The Fed’s 1998 mid-cycle adjustment resulted in a liquidity driven rally that caused the Nasdaq index to double within a year before the bubble finally burst. It also led to a significant widening of credit spreads well in advance of the economy rolling over.

With that in mind and with corporate credit spreads near cycle tights the fund continued to focus on income and capital preservation in a market where the risk/reward trade-off looks to be bottoming, the consumer is in good shape, and the labor market remains extraordinarily resilient. The recovery in the U.S. is also helping to drive a pickup in global economic activity.

Non-agency residential mortgage-backed loan securities (non-agency RMBS), which constituted 12 percent of the fund at quarter’s end, contributed positively as lower rates and improving credit fundamentals drove higher prepayments for discounted dollar price holdings. Limited home inventory and improving labor market conditions should support home prices and mortgage credit performance. Pre-crisis RMBS investment has benefited from a supply shortfall caused by ongoing paydowns and a lack of new issuance.

Collateralized loan obligations (CLOs), which constituted 8 percent of the fund at quarter’s end, contributed to performance despite minor spread widening over the year. New issue supply and intermittent weakness in the loan market led the sector to underperform other credit sectors. However, spreads remain considerably wider than many other asset categories, particularly those with a similar credit profile or spread duration. We continue to favor senior CLOs with short spread durations, as they offer a compelling spread pickup to similarly rated corporates.

Asset-backed securities (ABS), which constituted 8 percent of the fund at quarter’s end, generated positive total returns as the investor base for structured credit, including aircraft securitization and other commercial ABS, continues to grow. Lease and renewal rates for midlife aircraft (those securitized in aircraft ABS) are expected to be supported by new aircraft supply disruptions and relatively low fuel prices.

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 CMBS. Agency CMBS has some spread tightening potential 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).

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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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