

Semper Update On GSE Credit Risk Transfer (CRT): Duration Matters



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In May 2017, Semper contended that there are many compelling reasons to focus on the CRT market, offering investors an opportunity to achieve attractive risk-adjusted returns while accessing various parts of post-crisis mortgage credit and origination. Through 2017, this asset class was among the top performers in the residential mortgage sector and continues to represent a strong value investment today. One of the continuing reasons for our focus and expectation for outperformance is the product's relationship to interest rates: CRT generally outperforms with rising rates. Today, we believe there are many merits to CRT and it remains a strong focus for our positioning.

MARKET OVERVIEW:

Following the mortgage crisis, the Federal Housing Finance Agency (FHFA) mandated several changes affecting the government-sponsored enterprises (GSEs), mainly Fannie Mae and Freddie Mac. These mandates centered on reducing the risk of losses that the GSEs may pose to taxpayers. In efforts to convey portions of previously retained credit risk for the mortgages they guarantee, the first CRT transactions were issued in 2013 by both Freddie Mac (Structured Agency Credit Risk, or STACR) and Fannie Mae (Connecticut Avenue Securities, or CAS). The collateral is newly issued (post-crisis), incorporates significant reform of origination standards, and can vary in coupon and LTV.

As of Feb. 2018, 58 CRT deals with combined security balances of \$55B (billion) have been issued since the program's inception in 2013. This represents exposure to over \$1.9 trillion of residential single-family mortgages.

The structural benefits:

- Coupons paid by the GSEs are uncapped LIBOR floaters
- Ongoing oversight of origination and servicing by the GSEs provides an additional layer of surveillance absent in pre-crisis deals
- One of the few areas investors can access post-crisis mortgage credit origination and fundamental value in size, dwarfing the origination in other residential credit markets

Duration matters:

Interest rates can have a significant impact within fixed income products. As central banks globally continue along the path of monetary policy tightening, the market must evaluate how quickly rates may rise. Global central banks do not want to move too fast or too slow since either could result in market volatility and could have a broader negative long-term impact to economic stability. There are two important areas to watch:

- **LIBOR:** This rate is highly tied to the path of short-term rates that the Fed is telegraphing and has massive implications for the trillions of dollars of instruments tied to the benchmark. The duration of a bond is defined by its price sensitivity to rates—the higher a bond's duration, the larger the price drop will be with higher rates. While Fixed-rate securities are generally positive duration, where prices drop with higher rates, Floating-rate securities—especially those referencing 1-month LIBOR—are typically low or no duration.
- **10 year rates:** This rate is often used to benchmark mortgage products, especially when setting the mortgage rates available to consumers for home purchases or refinancings. The higher the 10yr rate, the higher the mortgage rate offered to borrowers. This can slow prepayments, affecting valuations as mortgage cashflow profiles can change rapidly. For instance, higher rates and slower prepayments can increase a bond's rate sensitivity by extending its duration, further amplifying the impact of these higher rates.

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2017 outperformance:

During 2017, CRT spreads tightened significantly and prices increased—for instance Last Cash Flows (LCFs) tightened on average 40-50bps. Throughout this same time period, the benchmark 1-month LIBOR increased approximately 80bps, and positive duration bonds with fixed coupons likely fell in dollar price, ceteris paribus. Meanwhile, Floating-rate bonds with zero or negative duration, like CRT LCFs, increased in value due to the higher projected coupon rates. In fact, while spreads tightened 40-50 bps, the average coupon on these securities increased by 80bps and remained attractive with room for further tightening.

Entering 2018 with forecasts of 3-4 rate hikes by the Fed, 1-month LIBOR is projected to increase from 1.60% to greater than 2.30%, an increase of 70bps during the year. This forward rate path bodes well for CRT product and, while the sector has appreciated and tightened significantly through 2017, the runway is clear for further potential upside.

CRT can continue to tighten and outperform:

- **Uncapped floating rate:** CRT bonds are LIBOR floaters where coupons vary monthly. As bonds with Fixed-rate coupons or positive duration can trade lower with higher rates, CRT is more insulated from rate risk because of the floating coupon. In fact, CRT coupons are uncapped, meaning coupon resets can follow LIBOR through any number of rate hikes.
- **Negative duration:** Just as bonds with positive duration can fall with higher rates, bonds with negative duration, like much of the CRT investment universe, can improve with higher rates.
- **Extension:** As rates rise and prepayment speeds slow, the projected cashflow timelines of CRT bonds extend, further magnifying the value of rising coupons and increasing the potential total return of these securities.

SEMPER POSITION AND OUTLOOK:

The CRT market remains well supported, while the collateral and structural benefits are high. We believe different parts of the capital structure add relative value in our portfolio construction. Today, we repeat our 2017 value recommendations and maintain our views that the opportunity set within the CRT sector should continue: 1) Front Cash Flows (M1s), which are front sequentials—paying atop the cashflow waterfall—are low beta and stable carry, 2) Last Cash Flows (LCFs), which offer relative value versus the traditional legacy space, offer high coupons with zero or negative duration, and 3) Modifiable and Combinable (MACs), which allow for customization, adding additional value and optionality within the sector.

At Semper, we have been positioning our portfolios to address higher rates. While the market is concerned about the impact of higher rates on fixed income portfolios, there are certain sectors that will outperform in this environment, and we firmly believe that CRT offers compelling upside characteristics given its performance relative to higher rates.

*Spreads, rates, and data from Bank of America Research, JP Morgan Research, Bloomberg and Intex.

Semper Capital Management, L.P.

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