

## The Case for Investing in Non-Agency RMBS in a Time of Rising Interest Rates and Strengthening Economic Conditions

### Summary

The past year has been characterized by growing concerns with regard to the near term path for interest rates and continued uncertainty regarding the Federal Reserve's stance on monetary policy. Donald Trump's election in November 2016 led to a sudden, upwards revision in interest rate expectations and prompted sweeping price declines across more interest-rate sensitive fixed-income assets, including agency MBS. Since then, many investors have shifted their focus to asset classes and profiles that are more resilient in the face of sudden and unexpected shifts in interest rates. With good reason, non-agency RMBS have received a great deal of attention with this new theme in mind. We believe that rising interest rates should continue to have a minimal impact on the non-agency RMBS market for a number of reasons:

#### **Continued home affordability measures, resulting from continued improvement in the US economy, including:**

- Home prices continue to remain affordable and can withstand significant additional home price appreciation and/or mortgage rate increases before affordability levels return to the pre-crisis range;
- Personal income continues to rise and unemployment continues to trend lower which should provide additional pressure on incomes to rise in the future, adding financial strength to homebuyers; and,
- Credit availability has increased and is expected to further increase under the new administration as the implementation of existing legislation is softened or even potentially repealed and replaced by more lender-friendly legislation.

#### **Increased mortgage prepayment activity: underlying collateral performance benefitting from a strong economy**

Home prices have returned to 2006 pre-recession levels on a nominal basis. The US economy continues to improve, with a strengthening job market, increased consumer spending, and growing production. To the extent that these trends continue, more borrowers are expected to:

- Refinance their mortgages as home price appreciation results in positive equity on their home loans for the first time since the housing crisis, and,
- Pay off their loans as unemployment declines, employment mobility increases, and income rises, resulting in overall default rate decrease.
- Increased principal repayments on these largely discounted bonds are a source of price support and shorten interest rate sensitivity.

#### **Structure of Non-Agency RMBS market: allows for economy-based cash flow appreciation, not just market price changes**

Non-Agency RMBS are often purchased at a discount to par in part due to the assumed default rate of underlying borrowers. As the economy improves, lower-credit borrowers may be able to refinance their homes — or simply make their monthly payment, bringing these securities closer to par value. As opposed to high-grade corporate bonds, many of which are currently priced at or above par value, we continue to believe that there is significant upside for discount-priced non-agency RMBS in a strengthening economy.

## Low duration: a decreased sensitivity to interest rates makes Non-Agency RMBS attractive among other fixed income sectors

The majority of non-agency RMBS we hold are legacy securities originated in the mid-2000s prior to the downturn. These bonds have already paid down significantly, and their remaining cash flows have shortened relative to the overall fixed income market. Additionally, around 50% of the non-agency RMBS have variable coupons. As rates rise, these coupons reset higher and cash flows increase, generally providing support to bond prices, as long as credit quality does not decline. This is in contrast to the wider universe of fixed coupon bonds, including agency MBS, which can exhibit a large negative correlation to interest rates.

We believe these factors will afford a portfolio of non-agency RMBS with support relative to other fixed income asset classes should the current pace of monetary tightening continue or accelerate.

### Definitions:

**Cash flow:** An item on the cash flow statement that reports the aggregate change in a company's cash position resulting from any gains (or losses) from investments in the financial markets and operating subsidiaries and changes resulting from amounts spent on investments in capital assets.

**Par:** The face value, or value at which the bond will be redeemed at maturity.

**Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

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