STRUCTURED CREDIT OFFERS SOLID CASH FLOWS

BY GREG PARSONS

The structured credit universe continues to present ongoing investment opportunities. While the various sectors of this market – legacy non-agency residential mortgage-backed securities, commercial mortgage-backed securities, and specialty finance – all have different characteristics, challenges and opportunities, the structured credit universe continues to offer managers the opportunity to identify and capitalize on asset-backed cash flows that possess a number of advantages relative to other portions of the fixed income universe. These advantages include diversification of collateral supported by improving U.S. real estate and consumer credit fundamentals, positive supply/demand technical, and relatively high yield and low interest rate sensitivity.

As volatility in the capital markets continues to increase as a function of geo-political pressures, global economic and monetary policy uncertainty and the overhang of a highly contested general election and the subsequent political and fiscal policy direction of the U.S., we believe that the structured credit universe provides uniquely targeted investment opportunities to find value isolated from many of these dynamics.

Overall, legacy non-agency RMBS spreads have slightly tightened year-to-date, despite some widening in January and February during the height of the global risk off trade, and are close to the post-crisis tights reached in early 2015. Much of this sector offers loss-adjusted yields of 4-7% currently, however, underneath the surface, this legacy RMBS market has become a dichotomy. This dichotomy is between relatively liquid high dollar priced, large, senior securities that benefit from strong real money demand; and smaller, lower dollar price, higher credit risk non-agency sectors that have suffered rising liquidity premiums, from a combination of declining sponsorship from larger investors, hedge fund redemptions, and further regulatory uncertainty.

The market is also wrestling with the emerging theme of a significant pullback in positioning of these securities by broker dealers, the result of the regulatory landscape and the subsequent challenge to liquidity: primary dealer non-agency net holdings have declined from $17bn to $9bn year-over-year while trading volumes are down 35% relative to last year. New issuance of non-agency and related securities remains a far cry from the pre-crisis level, and, in fact, is significantly lower than last year, with $26bn of gross issuance year-to-date, compared to $60bn in 2015. The growing divergence in pricing across the non-agency sector combined with greater constraints on overall market liquidity drives an ever increasing need to identify value at a security specific level, led by robust loan level credit analytics.

Looking ahead, we believe the non-agency RMBS sector will continue to be supported by both strong credit fundamentals, as well as technical dynamics. From a fundamental credit perspective, real estate continues to strengthen, with home prices up 6% nationally year-over-year according to both Case-Shiller and Core Logic home price indices, and are expected to appreciate 4-6% in 2016.

Home prices are now close to their pre-crisis levels, with hundreds of thousands of homes flipping from negative to positive home equity each quarter. Collateral credit metrics are expected to continue improving overall across RMBS collateral types. Importantly, we have seen steady increase in voluntary prepayments across most collateral types for the last several quarters, a sign of improving credit quality and a welcome result for investors in this sector which generally still trades significantly below par.

From a technical standpoint, supply continues to shrink ~10-15% per annum, and bid lists, long the source of most paper, have continued to decline to less than 1/3 of levels just two years ago. As important, there remain many tactical drivers of ongoing demand. Demand is being supported by favorable insurance industry credit ratings, with approximately three-quarters of the universe now rated NAIC-1, permitting purchase of these securities by insurance companies looking for substantial yield pick-up, along with real money buyers in search of higher yielding less-correlated investments.

June's long-anticipated $7.9bn Countrywide Rep & Warranty settlement payments to investors provide a tactical tailwind to demand for RMBS, as these proceeds are likely to be reinvested back in the sector. Given continued improvements in fundamentals and strong technical support, Semper believes that investors will continue to be appropriately compensated for acting as liquidity providers in the current RMBS market. Brexit and its global macro spillover effects may amplify liquidity challenges for many RMBS products but are unlikely to cause any meaningful spread widening, as US structured credit products stand to benefit from their safe haven status in attracting net inflows.

The legacy CMBS market has been much more mixed year-to-date with, on average, a negative bias to both market receptivity and pricing. Deal and collateral specific credit issues, as well as liquidity concerns, continue to act as an overhang over the market, given the recent and continuing wave of maturities. More recently, the CMBS credit curve has steepened with CMBS 2.0/3.0 assets tightening to year-end 2015 levels, while lower rated mezzanine and subordinated having widened in spread and declined in price significantly. Liquidity in CMBS has been challenging with limited sponsorship for profiles deep in credit and the bulk of trading activity has been in CMBX which has made the index much more liquid than cash.

We expect market participants to remain cautious within the CMBS space over the next year, and expect liquidity to remain muted as the market works through a number of refinancing challenges and digests new issuance. Overall, CRE prices are 15% higher than pre-crisis levels, largely driven by lower cap rates, but performance between specific collateral types varies greatly. While we expect CRE fundamentals to remain strong in the short term, we don't believe NOI growth will offset cap rate widening over a longer time frame. Expected 2.0/3.0 defaults appear understated as loose underwriting, lower LTVs, higher cap rates and higher conduit loan rates have the potential to cause price corrections.

Pending changes and implementation of risk retention rules will have significant impact on the opportunities within the CMBS space moving forward. These dynamics are just now starting to play out. This December's new risk retention rules, requiring sponsors to retain a 5% slice of new deals, will have an impact on deal economics and pricing. Depending on market pricing of the new opportunities and which type of retention occurs (horizontal or vertical), supply of credit paper remains an unknown, and it remains unclear how high conduit loan rates will rise for CRE borrowers following the implementation of these rules.

Specialty finance is going through somewhat of a renaissance in the midst of an intersection of two critical industry shifts. The new bank regulatory paradigm has materially reduced the availability of capital from traditional banking sources for many lending and investment activities. At the same time, advances in technology and sophistication of data interconnectivity have made it possible to access information and thereby transact in asset classes and scales previously not possible.

Advances in fintech reach far beyond marketplace lending and incorporate a broad set of opportunities. For example, software systems allow property managers to acquire and maintain large numbers of single family rental properties; allow a fix-and-flip lender to more easily manage risk across a portfolio of properties and access more opportunities; and allow a general contractor to easily access project financing via a streamlined underwriting process.

These emerging avenues of finance and many more require a capital provider in some capacity, and without the specific backing of the banking system, such technological advances in the finance space should continue to create opportunities for alternate capital providers to earn an attractive risk-adjusted rate of return in the space. Investors who have developed credit analysis skills and tools to analyze mortgage and asset-backed securities may be well positioned to trade some incremental liquidity in return for similar assets offering greater control and the potential for higher yields and lower price volatility.

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