INVESTMENT OPPORTUNITY

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SEMPER® CAPITAL MANAGEMENT

www.sempercap.com

CURRENT OPPORTUNITY:

Invest in subsectors of the U.S. non-agency RMBS space that suffered disproportionate price dislocation as a result of the supply / demand mismatch that crashed through the sector in March / April, with current prices far below fundamental value

SET UP:

Global market volatility, that began in early March, worked its way down into the RMBS sector and over a 15-day period, a tsunami of technical pressures, distressed selling in market, and evaporation of demand resulted in extreme price volatility in our space. Our markets were caught up in this unprecedented illiquidity event triggered by massive bond mutual fund redemption activity, closely followed by accelerating repo counterparty margin call activity impacting both mortgage REITs and mortgage hedge funds. We have seen over $10 billion of forced non-agency RMBS selling by mortgage REITs and liquidations by their counterparties. In addition to this glut of supply from mortgage REITs, bond mutual funds and hedge funds operating in states of stress/distress, traditional demand for product evaporated as “risk off” environment gripped the natural buyer base.

The Fed responded to the crisis by expanding its balance sheet by about $2 trillion in the last month, with another several trillion dollars expected. They have initiated programs including Treasury and agency MBS purchases, recreating several financial crisis era credit support programs including the TALF program (Term Asset-Backed Loan Facility) and its PDCF program (Primary Dealer Credit Facility). These programs have directly supported virtually every bond sector other than the non-agency RMBS market that Semper invests in. A week ago, they revised the PDCF program to include investment grade agency credit risk transfer (CRT) bonds, providing less expensive financing to dealers for this portion of the CRT market. This is the first, albeit minor, inclusion of a portion of our sector in a Fed program. They also announced a change to the TALF program to include certain CMBS and CLO bonds to its list of eligible assets, which will provide indirect support. We are optimistic that there will be additional program announcements to directly benefit non-agencies.

EXPECTATION:

Federal and state legislation is providing more direct support to the housing market, requiring servicers to offer mortgage payment forbearance and imposing foreclosure moratoriums. We expect this to significantly reduce near term pressure on homeowners and home prices, while fiscal stimulus provides financial support to temporarily unemployed homeowners and tenants. During this period, servicers are generally required to advance mortgage payments to bondholders, and the Fed and GSEs are actively monitoring the health of the servicer industry.

A recent Fannie Mae economic forecast provides two important data points pointing to stronger performance of non-agencies during this current environment. First, they are projecting that average home prices nationally will not fall during 2020, and will resume their rise in 2021. This is very supportive of continued low loss severities that should minimize impact on bondholders’ principal if defaults rise. Second, they are projecting rising levels of refinancing activities to $1.4 trillion in 2020 and $1.2 trillion in 2021. This will lead to faster delevering and paydowns of RMBS, increasing prices and shortening average lives.

While the COVID 19-related seismic economic event has led to unprecedented downward pressure on prices in the non-agency RMBS market, Fed action and the beginnings of firmness in the sector are now positioning the bonds in the sector to move back up in price and value. The non-agency RMBS sector of the market entered the volatile period with strong underlying credit metrics, strong U.S. real estate ecosystem and ability to withstand economic shocks to the collateral. Semper Capital expects significant price recovery as the residential real estate market begins to gear up demonstrating its fundamental and structural strength, as targeted monetary and fiscal policy continues, and as demand re-emerges in the RMBS market.

We believe that the majority of the forced selling has occurred, leaving most RMBS prices anywhere from 10% to 75% below February levels and yields in a broad range of 6% to 15%, up from the 3% to 4% range in February. We expect that most of this price dislocation is technical rather than being representative of a fundamental change in credit quality. Based on stress scenario analyses using a range of current Wall Street economic and market expectations, we believe that about 95% of this recent price dislocation should be recovered.

Near-term source of support for the sector will come from a significant increase in demand. Over a dozen investment firms, including some of largest fixed-income money managers, have announced over $10 billion of new opportunistic funds being raised currently to invest in this sector. As this new demand enters the market over the next two to three months, we expect price strength to result, similar to the market’s strength in mid-2009 following the introduction of PPIP funds targeting non-agency RMBS and CMBS.

SUMMARY:

The price dislocation that occurred over the last 6 weeks is not a reflection of changing credit profiles of the assets but simply the effect of the supply / demand tsunami that hit the RMBS space. Even in stressed, forward looking economic scenarios we believe these bonds perform from a credit perspective and that the dislocation is “value slippage” vs. “value destruction”. Forward looking return expectations are robust based on speed / timing / amount of price that is recaptured and additional investment opportunities in the sector.

FIRM OVERVIEW

- Semper Capital Management, L.P., SEC- registered investment adviser, established in 1992
- Offer range of structured product investments, primarily focused on mortgages
- Recognized as a Minority/Veteran owned business by the National Minority Business Council, Inc // Minority Business Enterprise (MBE) certified by the NY & NJ Minority Supplier Development Council
- Firm Assets: $2.42 Billion

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FUND MANAGEMENT

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Co-Founder, Chief Investment Officer
Industry Experience: 35 years
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