Notes From The CIO

25 February 2022

SEMPER
CAPITAL MANAGEMENT

- Market technicals and challenged liquidity continued to pressure prices across all risk sectors – including non-agency RMBS. The Bloomberg Aggregate Index is now down -4.18% year to date, the Bloomberg HY Index is down -4.61%, and the Bloomberg MBS Index is down -3.17%. Uncertainty surrounding inflation, the Fed's rate hike path and balance sheet unwinding plans are continuing to impact the bond markets. The Russia/Ukraine war may be impactful to the extent that it fuels commodity price inflation expectations. Chairman Powell testifies on March second and third on Capitol Hill, and the FOMC meets 2 weeks after that

- The RMBS sector is still being pressured by new issue supply, and buyers are demanding wider spreads. Secondary trading has been slow, to the point where a single hedge fund seeking liquidity or a dealer preparing a month early for quarter-end balance sheet reporting can sell a bond down several percentage points in a vacuum, causing an entire cohort to reprice lower. We have seen this a handful of times in recent days, despite credit fundamentals' steady march stronger. We have seen some improvement in prices following these one-off trades

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- This technical weakness will pass, and bond prices will be supported by strong fundamentals, delevering and shortening profiles, and sharply higher spreads and yields. Cash is building on the sidelines – RMBS investors received about $6-7 billion of principal and interest payments this week from monthly remittance payments and another $1.7 billion was received from a recent tender of CRT bonds from the market – this cash now building on the sidelines will eventually be put to work

- This month's remittance data that has begun coming in for the RMBS sector is continuing to trend positively. The 2 graphs below show credit enhancement, loss coverage ratio (the ratio of credit enhancement divided by projected lifetime collateral losses), and Loan-to-Value (LTV) – the lower this is, the more home equity the underlying homeowners have, for a bond we have highlighted in recent presentations

- This 2020 vintage Agency Credit Risk Transfer bond, STACR 2020-DNA4 B2, has delevered and built meaningful credit enhancement in under 2 years, with C/E more than doubling and the Loss Coverage Ratio more than tripling while the collateral has delevered, with the current LTV dropping well over 10%

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- In this current remittance period, credit enhancement rose another 2 basis points for the one month, and the LTV declined further (and is now below 60%), while loan performance remained strong and delinquencies have remained very low
- Meanwhile, despite this improved credit profile, the bond has declined in price by over 3% year to date and its yield to maturity and yield spread have increased from 6.6% / 530 basis points to 8.7% / 670 basis points. The key takeaway is that the relative value of this and similar bonds has increased dramatically

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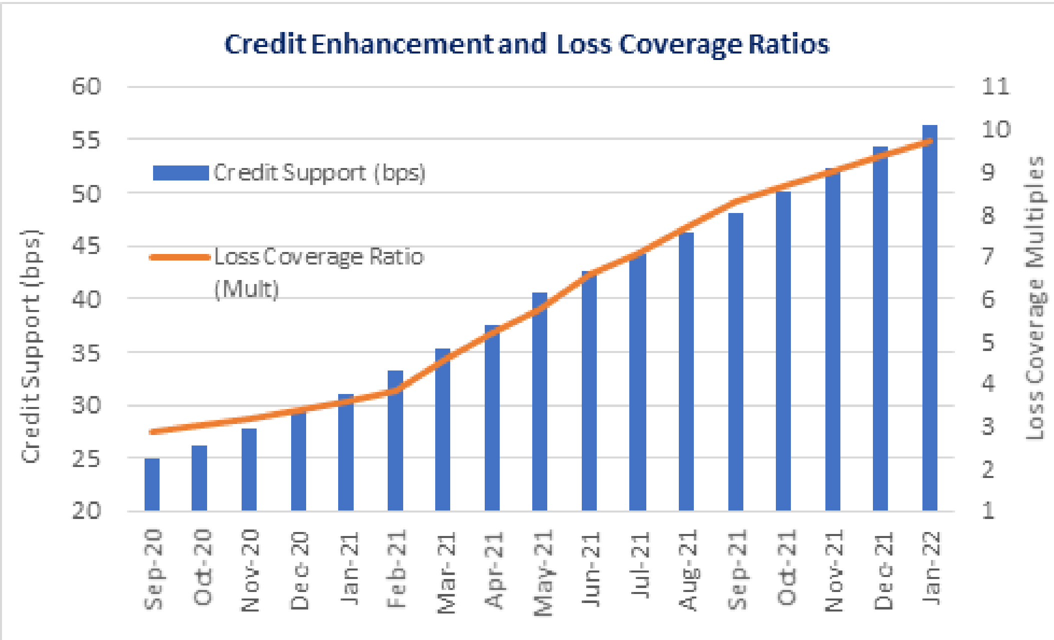

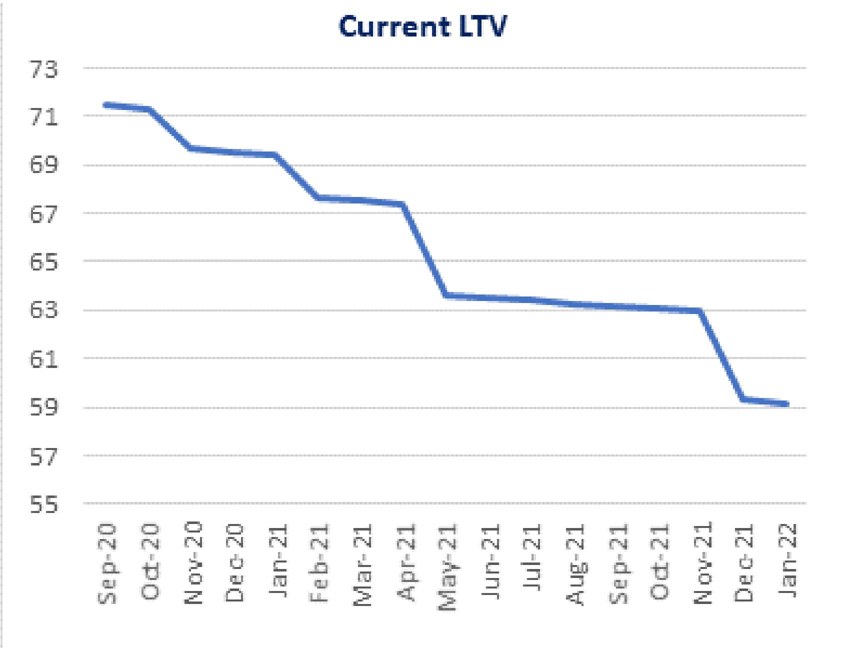

Source: Semper Capital, Bloomberg

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