Notes From The CIO

25 July 2022

SEMPER CAPITAL MANAGEMENT

- Last week we witnessed spread tightening across RMBS subsectors, led by Agency CRT. Investors appeared to return from the Vegas conference with a modestly positive outlook based on continued robust RMBS credit quality and borrower resiliency despite the increased chance of a recession; an estimated 50% decline in the rate of new issuance in the second half relative to the first half; and the likelihood that inflation has peaked or is peaking

- We are seeing some stability in bond mutual fund flows, after very high redemption activity for much of the first half of the year helped to drive RMBS spreads wider in combination with elevated new issue supply

- Today's launched Freddie Mac Agency CRT deal is providing additional support to the market. Freddie is retaining the deal's subordinated classes, and we've seen existing on the run and seasoned subordinated B1 and B2 bonds generally move higher in price in response to both the decrease in new supply and continued strength in residential housing credit fundamentals. As of Monday early afternoon the senior and mezz bonds are several times oversubscribed despite lower expected spreads versus announced initial price thoughts (IPTs)

- One additional source of investment grade RMBS underperformance has been a widening Agency basis. Banks have actively reduced their demand for Agencies and have instead focused on growing capital in advance of the potential economic slowdown. The Fed of course ended QE, reducing demand for Agencies. Banks have made progress on enhancing their balance sheets, while forecasts for Fed balance sheet selling of Agency MBS have declined. This appears to be allowing Agencies to do better on a relative basis, which in turn has and will support spreads for investment grade RMBS in our view

- The large contingent of floating rate coupon RMBS are resetting higher today in response to last month's Fed hike. The Fed is likely to raise the Fed Funds rate another 75 basis points this week, providing yet another large boost to RMBS carry beginning in a month. Combined with our expectation for spread compression, this higher interest income will make RMBS increasingly attractive in our opinion