For Professional Advisers Only

Notes From The CIO

27 October 2022

SEMPER CAPITAL MANAGEMENT

Floating Rate and Seasoned RMBS are increasingly attractive investment opportunities

- While the bond market anxiously awaits the next Fed rate hike on November 2nd, a large swath of Non-Agency RMBS stands to benefit from another coupon reset higher in late November. Currently, interest rate future markets have fully priced in a 75 basis point increase in the Fed Funds rate at the upcoming FOMC meeting.
    - As the Fed has hiked rates, the large portion of the RMBS sector comprised of floating rate bonds including Agency CRT, Mortgage Insurance, CRE CLO, Legacy, and some SFR and Prime 2.0 bonds has had coupons reset about 3% higher so far this year, with another 1% to 1.5% likely this year with more in early 2023.
    - In addition to higher carry and YTM, higher rates will be supportive of RMBS valuations as lower mortgage originations and deal issuance create an attractive RMBS supply/demand imbalance. This phenomenon will be even more supportive for the seasoned profiles we focus due to the superior credit profiles that they exhibit.
- The impact of higher interest rates and reduced home affordability has begun to show up in home pride data and other housing metrics. We expect several points of home price declines over the remainder of 2022 until housing affordability realigns – with the numbers varying across local markets.
    - The loan to value cushion enjoyed by seasoned bonds supported by mortgages with an average ~50% LTVs will increasingly lead to tiering among RMBS bonds, to the benefit of bonds issued in 2019 – 2021 and earlier which have had substantial home equity plus credit enhancement growth from delevering.

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RMBS investors, traders, and issuers returned to their desks a week ago following the most recent ABS East conference. Consensus at the conference was that the fundamental credit quality of the RMBS sector remains sound and compares favorably to other sectors in credit markets.

- The quality of the RMBS sector and the housing market have been reinforced by 15 years of conservative mortgage underwriting, post-GFC enhancements to bond structures, and 15 years of significant under supply of housing inventory. Growing demand from continuing demographic shifts will support the need for housing and subsequently home prices as affordability normalizes.

- As the Fed approaches its terminal rate, RMBS valuations are poised to improve as clarity on the housing market, the broader economy, and capital markets are established.

Our early review of October loan remittance data validates the continued fundamental credit strength in RMBS. Delinquencies remain close to historic lows, while the vast majority of homeowners enjoy their locked in low fixed rate mortgages and significant levels of home equity.