Semper's Outlook for Non-Agency RMBS in Light of a March Rate Hike

Summary

We believe that the Federal Reserve's March 15th rate hike will not dampen demand in the non-agency RMBS market. Both demand and outlook for RMBS products will continue to be strong as the sector offers attractive loss-adjusted yield and total return potential on the back of improving economic fundamentals.

Strengthening real estate credit fundamentals and the low interest rate sensitivity of the legacy non-agency RMBS market along with mid-single digit yields combine to offer a compelling risk adjusted return profile relative to other fixed income asset classes.

A strengthening economic backdrop: a strong boost to our positive outlook on the sector

The US economy continues to improve with falling unemployment and an increasing labor force, along with continued improvements in manufacturing and production. To the extent that these trends continue, we anticipate multiple additional rate hikes in 2017.

Continued home price appreciation has led a broad range of strengthening fundamentals, along with improvements in the underlying credit strength of homeowners. In fact, HPA has accelerated into 2017. Separately, credit availability and the opportunities for domestic homeowners to refinance have improved. Home prices are expected to continue to increase buoyed by a lack of supply and increasing demand, combined with home affordability which has remained high. We believe these factors will more than offset any effects of rising rates on RMBS valuations, particularly given the sector's lower sensitivity to interest rates relative to other credit and fixed income asset classes.

Non-Agency RMBS continue to offer attractive yield in current environment

The hunt for yield has been a strong, recurring theme among investors, and we expect it to continue. This sector currently offers loss-adjusted yields in a range of 3% to 7% or more, with a broad universe of bonds ranging from highly liquid senior cash flows with significant downside price protection, to less liquid subordinated, long spread duration securities retaining optionality to real estate fundamentals.

The sector's low sensitivity to rising interest rates has been demonstrated over the last 8 months, as the 10-year Treasury yield has nearly doubled from 1.35% to 2.60%. The reasons are numerous, including:

- A large portion of the non-agency RMBS sector is comprised of securities with floating rate coupons, with adequate credit support to maintain price
- Cash flows are seasoned, with more than 10 years of paydowns, shortening the remaining average lives of many bonds
- The sector still trades at a discount to par, and much of it continues to trade on a dollar price rather than on a yield spread
- Despite rising rates, subprime borrowers have actually been increasingly refinancing mortgages, shortening cash flows and generating gains

We believe these factors will afford non-agency RMBS investors significant downside protection relative to other fixed income asset classes given the current pace of continuing monetary tightening, and expect the sector to generate attractive positive and relative total returns in 2017.

SEMPER CAPITAL MANAGEMENT, L.P.

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