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Non-QM tipped as 'next opportunity'

Last year marked the beginning of a transition from a post-crisis distressed recovery trade to a more efficient market for the US securitisation sector, underpinned by robust performance and favourable economic conditions. Against this backdrop, mortgage credit and private credit financings are expected to remain a strong source of risk-adjusted returns.

Greg Parsons, ceo of Semper Capital Management, characterises the post-crisis period as comprising three chapters: the distressed credit chapter, dominated by uncertainty around credit impairment; the recovery trade chapter, in which uncertainty remained around economic sustainability; and the active recovery chapter, to which the ABS market is now transitioning. "The opportunity has shifted from capitalising on uncertainty around a transitional market to stability. Securitisation asset classes remain well bid, but the market structure still allows active managers to drive value," he explains.

He continues: "Where we're deploying capital, we're long biased in residential mortgage credit. US economic growth and rising home prices - which have returned to pre-crisis highs - means it is possible to make isolated, clean bets in terms of analysing credit."

Indeed, the emergence of credit risk transfer (CRT), single-family rental (SFR) and non-performing/re-performing loan transactions has provided new ways of capitalising on the re-underwriting of the residential market. In particular, CRT has come of age as an asset class, according to Parsons.

He points to the first MACRs (modifiable and combinable REMICs) options being utilised (see also SCI 17 May 2017), as well as structural changes that make the asset class REIT-eligible and bankruptcy-remote from GSE restructuring. Additionally, CAS and STACR deals have successfully weathered the first test of their credit enhancement in the aftermath of hurricanes Harvey and Irma.

"We're yet to see fundamental credit impairments in the CRT sector, following the hurricane damage sustained in Florida, Houston and Puerto Rico. Indeed, the asset class continues to perform well," says Parsons.

The average CAS and STACR loan exposure to Hurricanes Harvey and Irma is 7.2%, according to Fitch figures. The rating agency calculates that 30-plus day delinquencies across the two programmes rose from 1.04% on 1 October to 5.60% on 1 December for hurricane-affected areas only. In contrast, 30-plus day delinquencies across the entirety of both pools rose from 0.71% to 0.84% respectively.

Fitch expects the GSEs to provide affected loans with maturity extensions corresponding to the number of delinquent payment months, with most modifications likely to be accepted by the end of January. Consequently, CRT performance should show signs of improvement by late spring/early summer.

Underlining CRT performance, in a review of 82 CAS and STACR bonds issued from 2013 to mid-2017, Fitch last week upgraded 56 classes - 10 of which rose to investment grade - and affirmed the ratings on the remainder. The agency notes that the rating actions reflect improvements in the relationship of credit enhancement to expected pool loss.

On average, CAS and STACR last cashflow tranches were upgraded by 1.5 and 2.1 notches respectively, according to Wells Fargo figures. Further up the capital structure, 14 first cashflow and 13 middle cashflow classes were upgraded, by an average of close to three notches.

Meanwhile, as the supply of NPL/RPL assets declines as the GSEs work through their holdings, non-QM RMBS is emerging as the next opportunity set in the residential mortgage space. "Post-election originations of non-QM loans have increased dramatically, with demand for capital driving the growth of this sector. Regulatory constraints on banks have allowed private market solutions to fill the gap," Parsons observes.

He continues: "However, if there are enough incentives and the economics work, banks may begin addressing the perception of regulatory risk. The current administration is more pro-deregulation and if the regulatory constraints diminish, banks will likely step into the non-QM space."

Away from mortgages, Semper is pursuing opportunities in private credit asset-backed financings across assets such as NPLs, merchant financing and bridge lending. "These transactions are undertaken on a tri-party basis, whereby Semper is the capital partner with another firm that is actively involved with the assets, such as an NPL workout specialist. The aim is to structure a financial relationship with operating partners," Parsons explains.

Such investments are typically more appropriate for funds with a multi-year lock structure. As such, liquidity is traded for increased yield.

Looking ahead, 2018 could prove to be the year that the 'risk-on' environment switches to 'risk-off'. "Tensions in South East Asia and Europe, plus questions around stock market valuations, the current administration and rates are all potential triggers for significant volatility that is unrelated to the economy and housing. Nevertheless, volatility provides technical opportunities to find value. We're positioning to be in the more liquid and senior credits, with less duration, so if one of these factors triggers volatility, we can take advantage," Parsons concludes.

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