

## Structured Credit: Semper's Mid-Year Outlook

**Summary:** We believe the structured credit universe continues to present ongoing investment opportunities to identify and capitalize on asset-backed cash flows that possess a number of advantages relative to other portions of the fixed income universe. In the first half of the year, rates have remained low, credit availability continued to broaden, and house price appreciation remained strong. With volatility low, the Fed still accommodative by historical comparison, and with no expected significant changes on the horizon, we remain positive on structured credit. Below are some sector themes and our half-year outlook:

**Residential Mortgage-Backed Securities (RMBS):** For the first half of 2017, the theme has been one of relative value and tighter spreads. Benefitting from the tailwinds of low mortgage rates, continued home price appreciation, and low macro volatility, the outlook in residential mortgage sectors remained strong and the outlook remains robust.

### Legacy RMBS:

- Outstanding float is \$500-525 billion and continues to amortize at ~12-15% a year
- Recent positive technicals include modification recoveries and the rise of optional redemption probabilities as performance improves and the RPL loan market is trading well
- TRACE reporting has recently been introduced for trades at or below \$1 million original face (net impact unclear)

**Non-Performing Loans (NPL)/Re-performing Loans (RPL):** NPL/RPL loan trading and security issuance has been strong through the first half and we expect it to remain steady through 2017. We expect RPL issuance to pick up, coming primarily from the GSEs' (government sponsored entities) reduction of mortgage risk on their balance sheet and the ongoing optional redemptions in Legacy RMBS.

- In NPLs, sales have continued through first half 2017 but have slowed from the prior year's pace. Security issuance remains high as re-levers have picked up driven by the strong demand for short duration product and spreads have tightened sharply over the last 6-12 months
- In RPLs, the GSEs are pushing to establish systematic issuance programs in the space. Growth has primarily come from Freddie's SCRT and SLST programs, and Fannie's Whole Loan Sale program. Also, supply has come from 'seasoned' deals (mainly from 2005 and prior) which have entered an optional redemption period where call right owners can collapse the securitization for the loans

**Agency Credit Risk Transfers (CRT):** GSEs are continuing to originate in large scale, while trying to promote stability and increase the investor base. This remains a significant investment vehicle for accessing post-crisis mortgage origination and housing credit. For a deeper overview and details on the sector, please see [Semper on GSE Credit Risk Transfers \(CRTs\)](#).

**Jumbo 2.0/Non-Qualifying Mortgage (QM):** We expect issuance to continue. Collateral performance is performing at a high level, as underwriting standards remain tight and the housing market continues its march forward, and expect this to continue.

**Single Family Rental (SFR):** The first agency SFR deal, FNGT 2017-T1, came out this year. Execution lagged typical non-agency SFR, and while this alternative remains in early stages, this will be something to consider going forward. Secondary spreads in the sector are tight given the lack of supply in the sector.

**Agency RMBS:** All eyes remain on the Fed with minor and steady tapering being priced in, but many investors are cautious of potential rate or program surprises.

**Commercial Mortgage-Backed Securities (CMBS):** The CMBS market is almost over its widely followed maturity wall. At the end of 2015 there was ~\$150B of legacy pre-crisis CMBS maturing through 2018, and today that number now stands at ~\$30B. We expect net supply of private label CMBS to turn positive in the second half of the year (i.e., new issuance will exceed pay downs) with full year private label issuance coming in at \$65B (year-to-date: \$28B).

**Demand exceeds supply:** We are seeing heavy demand for short duration and floating rate assets at current US Treasury rates, and spreads reflect it:

AAA Conduit 10yrs: -10bps YTD

BBB- Conduit 10yrs: -75bps YTD

We expect tiering to continue in the market based on credit quality, issuer liquidity, and risk retention approach.

**Risk Retention:** Risk retention is in full effect with approval of market participants.

- Good mix of retention styles:
  - Vertical: Retain a 5% piece of every tranche in a deal
  - Horizontal: Retain the most junior 5% of the deal
  - L-Shaped: A combo of both Vertical and Horizontal that total 5% of the deal
- Conduit Transactions: 7 Vertical, 5 Horizontal, 5 L-Shaped
- Single Asset, Single Borrower (SASB): 7 Vertical, 8 Horizontal

**Retail Trade:** Store closures are weighing on the market, placing a heavy focus on malls with only top tier retail assets finding sponsorship in the CMBS market. CMBX.6, a synthetic CMBS index with the most mall exposure, has been used throughout 2017 as the asset of choice to express opinions on malls from within the CMBS market. It has staged a recovery in Q2 because of the expensive nature of the short and the realization that the timing of defaults, if they occur, is not imminent. We believe it will remain volatile as longs wait it out and shorts react to negative headline.

- a) BBB- tranche: -4.4% total return YTD; -8.4% total return at the lows (in March)
- b) Of the other 4 post-crisis series of CMBX, BBB-.7 is the next worst performer at -0.4%. The other 3 (series 8-10) are all positive for the year

\*Data represents performance and deal flow as of May 31, 2017.

**Asset-Backed Securities (ABS):** With the continuation of spreads generally grinding tighter, the market continues to bid up deeper credit, highlighted by the bottom of capital structures on new issue deals becoming over-subscribed multiple times. This is apparent in virtually every sector in ABS, including subprime autos, where BB tranches are regularly 5x - 10x over-subscribed, despite general headline concerns related to performance in the space. Supply across the ABS space has been fairly healthy across sectors including aircraft, auto, unsecured consumer, whole business securitization, and other esoteric ABS.

- a) Subprime auto saw some weakness towards the end of the first quarter of the year on renewed concerns related to fear of declines in used car prices and headlines of higher default rates. Such fears have yet to materialize in compromising the structures themselves, and as a result, subprime auto bonds have more than made up the softness experienced in the space earlier in the year. We expect this trend to continue into the second half of the year, as used car prices are likely to continue historical trends and remain stable outside of a recessionary period and subprime auto deals tend to have substantial enhancements and ability to withstand very high stresses and loss scenarios.
- b) Other esoteric ABS transactions continue to provide compelling value with outsized yields relative to other products combined with fairly short average life profiles and substantial enhancements. Rating agencies continue to be conservative in their assumptions for newer, less proven securitization products, providing substantial downside structural protection.

**Collateralized Loan Obligations (CLOs):** With original CLO 2.0 transactions having ~4 year reinvestment periods, early vintage CLO 2.0 deals originated in 2012 and 2013 are just starting to roll off their reinvestment periods, driving additional refinancing and reset transactions as well as general deleveraging in these structures. We believe this trend will accelerate in the coming months and years as new issue volume picked up into 2014, and these deals will begin to roll off in the next ~18 months.

- a) The CLO product continues to be well bid as floating rate assets remain an attractive asset class in a rising LIBOR world, and underlying leveraged loan performance remains relatively resilient
- b) New CLO issuance remains steady at ~8bn-10bn per month with continued healthy demand

### Semper Capital Management, L.P.

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