Structured Products

Market Outlook & Reflections

Dear Investor,

As discussed in our 2018 year-end letter, the US bond market's tone and tenor changed dramatically since last October when 10-year Treasury rates briefly hit a high of 3.25% and sentiment favored continued Fed policy tightening.

There were several factors both domestically and abroad that contributed to the market's rather sudden change in trajectory. These include benign inflation in the U.S., European and Asian economic slowdowns with renewed monetary policy stimulus, low and declining global rates, and global macro uncertainty on the heels of escalating trade wars and their impact on an uncertain economic outlook. Fast forward to today, the 10-year dropped to below 1.5% before mid-September's reversal, and the Fed is likely to reduce the target Fed Funds rate for the second time later this month.

Despite this volatility, we are pleased to report that our funds have behaved as we expected and had outlined to clients. Further, under current market conditions, we believe Semper's suite of mortgage-centric offerings is well-positioned given our focus on shorter duration non-Agency MBS profiles for the following reasons:

- Treasury Yields Are Low: A reversal (sell-off) in rates is likely to result in a positive total return for shorter duration assets while proving problematic for longer duration ones. While the markets are predicting additional small rate cuts in the short-term, in the longer-term, rates have more upward mobility than they do downward mobility.

- Agency MBS Yields Are Low, Negative Convexity Is High: If yields continue to decline, significantly eroded duration will result in less price appreciation making the risks of longer duration portfolios outsized relative to the potential upside. If yields rise, duration will rapidly extend and create increasingly large price declines.

- Investment Grade and High Yield Credit: Bond prices have largely kept pace with Treasuries. If rates continue to drop in sympathy with declining economic growth, it is likely that credit spreads will widen (risk-off environment), leading to stalled or declining prices. This effect could be exacerbated if today's highly levered corporations begin to get downgraded, leading to headwinds in corporate credit. If rates rise, prices should decline from relatively long duration.

Semper's funds perform against the backdrop of the US residential real estate market, and this market continues to show supportive fundamentals. Post-crisis, we have seen lower Loan-To-Value ratios, a continued decline in default rates and rising Home Price Appreciation (above inflation). Further, newly originated post-crisis mortgage credit has exhibited strong performance and low delinquency rates, a testament to the collateral's stronger underwriting and improved credit quality given supportive employment, housing prices, Loan-To-Value, and delinquencies metrics. The continued strength of this market falls in contrast to several other markets where we see growing headwinds, such as global and US equities, corporate credit and emerging markets. Please refer to "US Housing Market: Supportive Credit Fundamentals" for relevant data.

Given the Fed's recent rate cut – the first in over 10 years – plus market predictions of another easing move later this month, many have asked how our portfolios will react. In a declining interest rate environment, we expect mortgage prepayment speeds to increase, which they have and will continue to do if rates continue to decline. We view this broadly as a fundamental positive for housing. This is also a positive for the significant portion of our portfolios that trade below par, notably legacy bonds, and for several non-Agency MBS structures with less-sensitive collateral and pre-payment protection. Bonds collateralized with reperforming, non-performing, and multi-family housing loans aren't expected to have as much prepayment sensitivity as other types of mortgages. Importantly, our portfolios are designed to have low rate sensitivity, which are typically made up of bonds with lower effective duration. Thus, the relative impact of declining interest rates is lower for us than for a typical bond fund.

In a lower rate environment, the underlying credit fundamentals for non-Agency bonds improve as excess spread increases from lower coupons and accelerated loan prepayments, resulting in faster de-levering. We expect these increased levels of credit enhancement to lead to credit rating agency upgrades and corresponding price appreciation for several security types, as they have done historically. And any declines in yield experienced in floating rate securities can be offset by additional trading opportunities arising from this environment.

Lower mortgage rates also provide a supportive tailwind to the housing and residential mortgage credit sector by increasing affordability and access to financing for borrowers.

Long duration strategies and highly credit sensitive strategies have generally outperformed this year as a result of the rally in US Treasuries given the global macro uncertainty and hunt for yield. However, Semper has maintained its long-standing principle of investing primarily in the higher quality, more liquid and shorter duration profiles within mortgage sectors, which we view to be most prudent over the long term and especially during these uncertain market conditions.

As we look ahead, we remain encouraged by the growth and evolution within the mortgage credit sector, and we continue to see attractive opportunities to invest in new and bespoke securities. Given our over 20 years of experience in the mortgage arena, we have increasingly seen opportunities to negotiate with many securities' originators in order to invest a portion of our assets in more bespoke, higher yielding, higher return-potential bonds[1]. This gives us the ability to source and drive the creation mechanism, and to invest in securities that are best aligned with our investment objectives that seek to deliver alpha to our clients.

We welcome any questions or feedback and as always, thank you for your continued support.

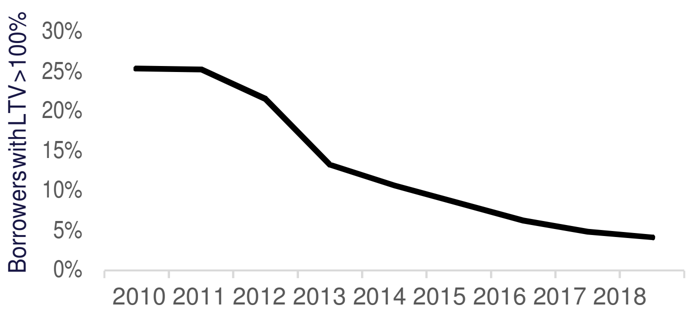
Greg Parsons, CEO

[1] All bonds added to Semper portfolios in a manner consistent with the procedures outlined in Semper's allocation policy and consistent with each portfolio's mandate.

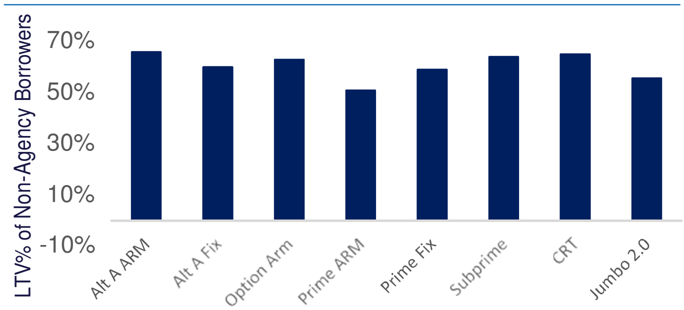
US HOUSING MARKET: SUPPORTIVE CREDIT FUNDAMENTALS

The credit fundamentals supporting the US real estate market remain favorable with declining LTVs, low delinquencies, projected positive HPA, and a current uptick in home ownership rates.

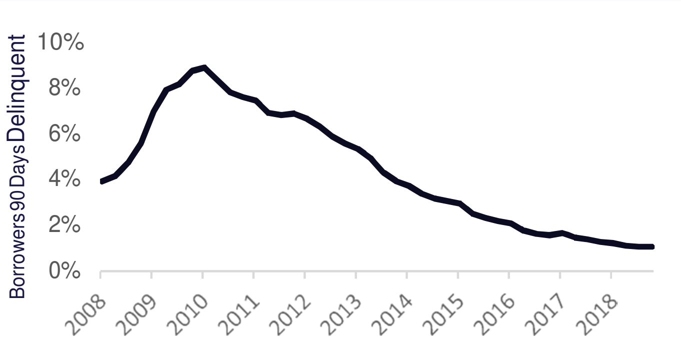
Declining Loan-To-Value (LTV) Ratios Post-Crisis



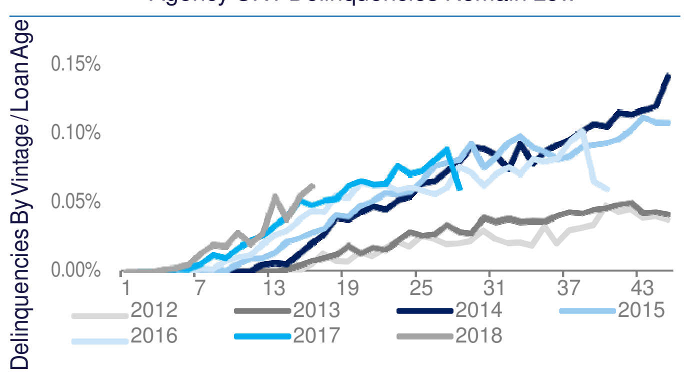
Current RMBS LTV Snapshot[1]



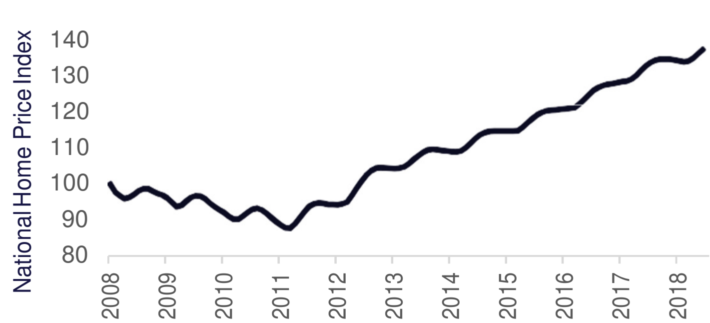
Default Rates



Agency CRT Delinquencies Remain Low



Historical HPA[2]



Sources: JPM, Zillow, Nomura, US Census Bureau Home Ownership, S&P/Case-Shiller U.S. National Home Price Index

[1] Current Non-Agency RMBS LTV data as of March 2019 (Nomura)

[2] Values based on Case Shiller National Home Price Index with December 2008 set as benchmark (at 100).

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