Non-Agency Residential Mortgage-Backed Securities

Credit Tailwinds Remain in Place

Karthik Narayanan, CFA
Managing Director

Roy Park
Director

Favorable fundamentals should improve cash flows in select subsectors.

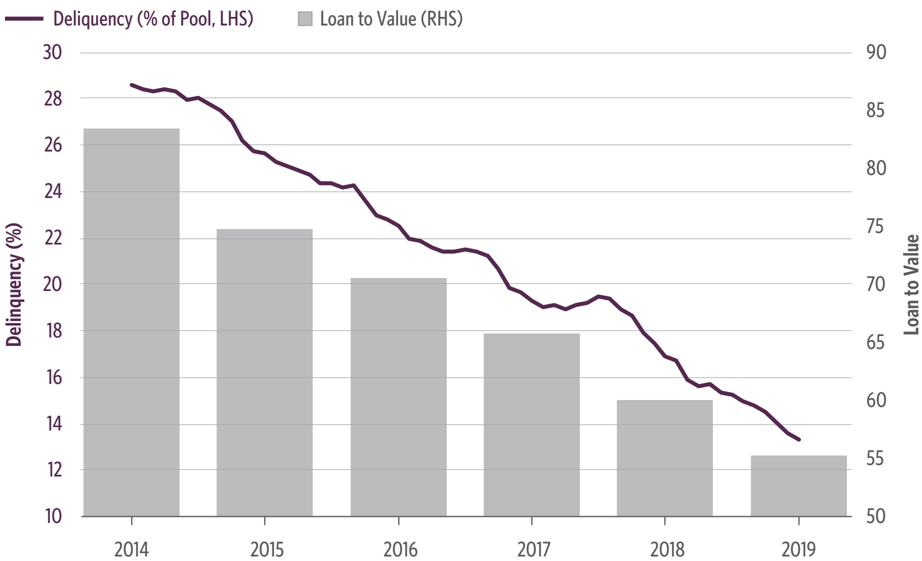
Non-Agency RMBS generated positive performance so far in 2019, returning 2.3 percent in the second quarter and 5.0 percent year to date. Although performance was directionally positive, the sector's moderate interest rate sensitivity and spread volatility resulted in weaker performance than the Bloomberg Barclays U.S. Aggregate index and other credit sectors.

Dealer inventories remained historically low in the second quarter, and investor participation and overall secondary trading volumes were light. New issuance has trended above 2018 with year-to-date issuance of $35 billion and second quarter issuance of $18 billion. After 10 years of negative net issuance, 2019 issuance is expected to exceed paydowns from the outstanding securities in the market, resulting in positive net supply. Newly issued securities have received steady demand from investors in the second quarter. Notably, sponsorship for deeply subordinated tranches increased over the quarter as risk-seeking investors repositioned into high beta and higher yielding RMBS tranches in response to expectations of a more accommodative Fed and an extended economic cycle.

The high default rates and depressed home prices experienced in 2009–2012 are a distant memory, as home prices have recovered and significant credit curing has occurred among pre-crisis loans in the non-Agency RMBS market. At present, pre-crisis Alt-A and subprime deals comprise a $375 billion market. The confluence of loan amortization, defaults of weaker borrowers, and home price appreciation (HPA) has decreased the average ratio of mortgage loan balance to property value (LTV) and, correspondingly, reduced borrowers' propensity to default. The LTV of these sectors is now less than 60 percent, and delinquencies have fallen (see chart, top right). The average age since modification for Alt-A and subprime loans has trended above 60 months (see chart, bottom right), which increases the likelihood of prepayments as borrowers may more easily qualify for traditional mortgages. As expectations for future losses decline, recoveries on previous forbearance modifications, which are not well-researched or priced consistently in the market, begin to contribute materially to future bond cash flows on selected deals.

We remain constructive on the performance prospects for non-Agency RMBS as borrowers continue to benefit from the favorable consumer-credit and housing fundamentals, which should translate to improvements in bond cashflows over time. We continue to favor senior, shorter maturity classes for their lower price volatility as well as selected credit-sensitive, pre-crisis passthroughs that should benefit from the credit improvements described above.

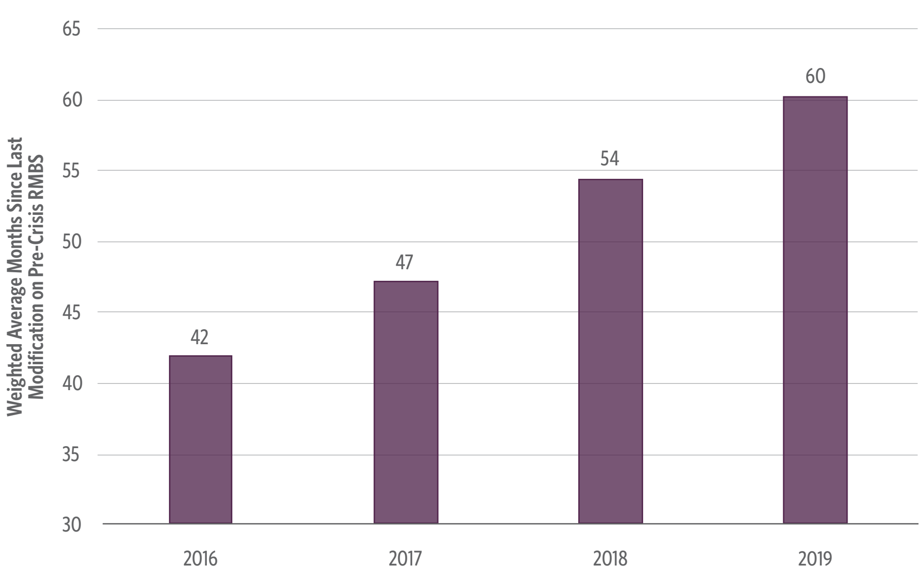
Credit Curing of Pre-Crisis RMBS Has Resulted in Lower Delinquencies



Source: Guggenheim Investments, JP Morgan, Credit Suisse. Data as of 6.30.2019.

The confluence of loan amortization, defaults of weaker borrowers, and HPA has decreased the average LTV and, correspondingly, reduced borrowers' propensity to default. The LTV of pre-crisis Alt-A and subprime sectors is now less than 60 percent, and delinquencies have fallen.

Age of Loan Modification Rises, Increasing the Likelihood of Future Prepayment



Source: Guggenheim Investments, Intex, CoreLogic, Citi Research. Data as of 6.30.2019.

The average age since modification for Alt-A and subprime loans has trended above 60 months, which increases the likelihood of prepayments as borrowers may more easily qualify for traditional mortgages.