

Non-Agency Residential Mortgage-Backed Securities

Rising Fundamentals Are Supportive Despite Macroeconomic Challenges

We remain constructive on the credit prospects for non-Agency RMBS, but our performance outlook is tempered by market volatility and macro headwinds.

In the second quarter, non-Agency RMBS performance was adversely impacted by market volatility and corresponding spread widening. RMBS 1.0 and RMBS 2.0 subsectors posted -3.0 percent and -2.8 percent returns, respectively, but both subsectors outpaced the Bloomberg U.S. Aggregate Bond Index. RMBS spreads now stand at post-COVID wides. We believe that the sector should benefit from recent home price growth and positive consumer credit fundamentals, but return prospects are likely to take cues from broader risk markets and remain volatile.

New issuance slowed in the second quarter, and year-to-date issuance is slightly off the pace from 2021. For the full year, net issuance is projected to remain positive due to the slowdown in the runoff of outstanding mortgages. Securitizations backed by prime jumbo and non-prime qualified mortgage (non-QM) loans drove robust primary issuance to start 2022. However, rising rates and credit-spread widening have caused securitization economics to deteriorate, and have had an adverse impact on issuer profitability. Because issuers aggregate loans over time, there is a delay in the pricing feedback from the capital markets to the primary origination market, thereby further exacerbating the problem.

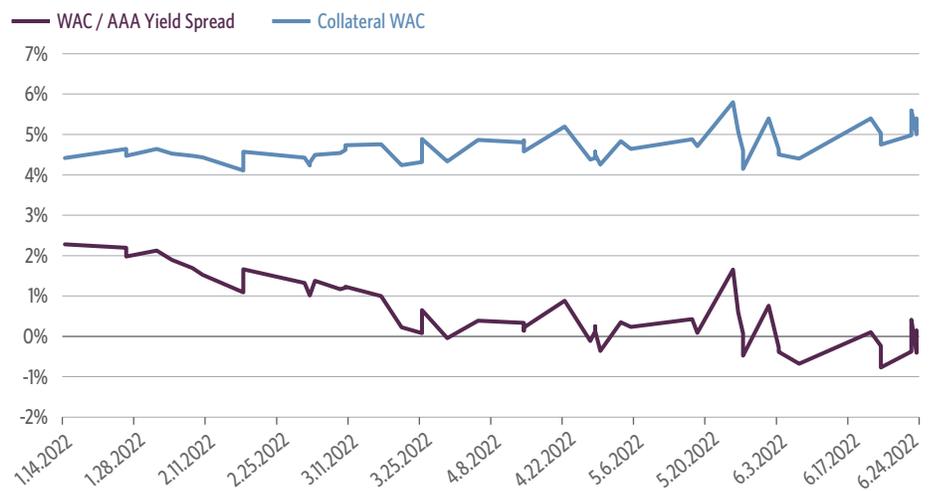
For instance, the spread between the loan pool weighted average coupon (WAC) and the pricing yield of the AAA-rated class for non-QM transactions have tightened significantly since the beginning of the year, demonstrating reduced attractiveness of securitization financing. For issuers to maintain profitability, origination coupons would have to increase to both offset the recent rise in Treasury yields as well as the widening in credit spreads. Consequently, rising rates and credit spread widening are expected to provide significant headwinds to primary issuance for non-Agency RMBS for the remainder of the year.

While we remain constructive on the credit performance prospects for non-Agency RMBS, our performance outlook is tempered by the ongoing market volatility and macroeconomic headwinds. For this reason, we continue to favor selected RMBS 2.0 mezzanine and senior tranches for their loss-remoteness and limited weighted average life variability, as well as selected credit-sensitive, pre-crisis passthroughs that we believe should benefit from recent home price growth and moderating default rates.

By Karthik Narayanan and Roy Park

The spread between the loan pool WAC and the pricing yield of the AAA-rated class for non-QM transactions have tightened significantly since the beginning of the year, demonstrating reduced attractiveness of securitization financing.

WAC/AAA Yield Spreads Have Tightened as Rates Have Risen



Source: Guggenheim Investments, BofA Global Research, Bloomberg. Data as of 6.30.2022.

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