Non-Agency Residential Mortgage-Backed Securities

Rally Fatigue

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The long-running rally has emboldened dealers while investors have tempered their risk appetite.

Non-Agency RMBS spreads have rallied with only short pauses since the first quarter of 2016 and reached post-crisis tights in early second quarter 2018 (see chart, top right). We remain constructive on the intermediate-term prospects for the sector due to healthy housing fundamentals, improving borrower credit performance, and negative net supply, but we expect future gains to come at a slower and more irregular pace than those realized over the last 24 months. Increased dealer risk appetite aided the last leg of the rally of early 2018 and crowded out fundamentals-based investors. When dealers subsequently looked to normalize their inventory, softer investor demand, along with a flurry of new issuance, acted to widen spreads moderately in the latter half of the second quarter. Unlike all other major fixed-income credit markets, pre-crisis non-Agency RMBS has no new issue pricing, quoted markets, or widespread trade reporting to validate valuations. Market participants instead rely on their cash flow projections and market intelligence aggregated during secondary trading to establish prices. When multiple dealers looking to add risk actively compete with investors, as they did early in the second quarter, the narrow channel for price discovery creates a self-reinforcing feedback loop: aggressive dealers transmit their prices to the market, then other dealers recursively revise their price opinions upward to remain competitive. End investors who instead value bonds based on their intrinsic cash flows (the natural dampers to this positive feedback loop) ultimately provide support to the market at lower price levels.

New issuance totaled approximately $17 billion in the second quarter and represented a meaningful increase from the first quarter's $11 billion. New issue was comprised of $4.4 billion of nonperforming and reperforming loans (NPL/RPL), $4.6 billion of credit-risk transfer (CRT) securities, and $7.7 billion of recently originated prime and non-prime RMBS (see chart, bottom right). A flurry of non-Agency RMBS issuance in May and June contributed to spread widening late in June. Despite the recent dealer inventory dynamics and new issue headwinds, non-Agency RMBS outperformed the Bloomberg Barclays Aggregate index and posted a 1.8 percent total return in the second quarter. Total return stands at approximately 3.5 percent year to date.

Despite recent incremental spread widening, non-Agency RMBS spreads remain near post-crisis tights. We continue to favor shorter-maturity senior tranches for their lower prospective price volatility as well as pass-throughs backed by credit-sensitive Alt-A and subprime collateral, which should contine to benefit from improving credit fundamentals.

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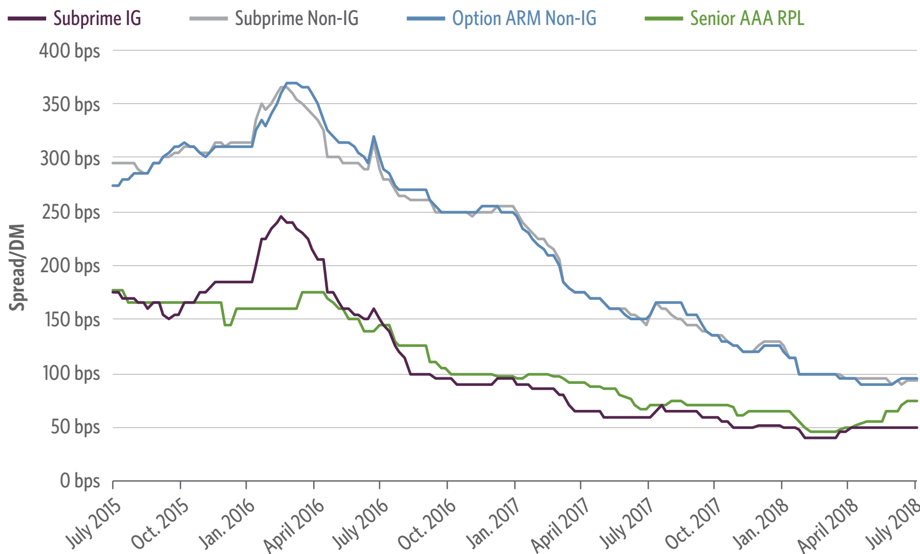
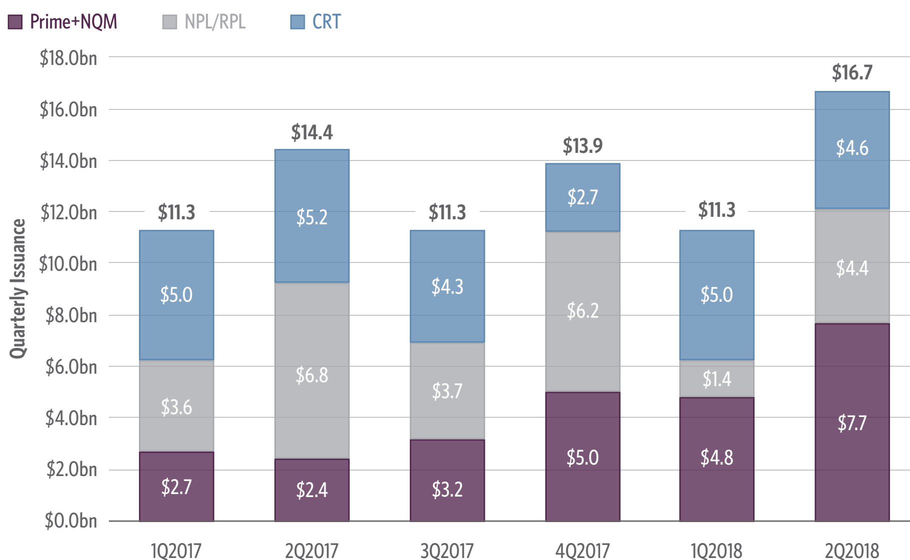
Non-Agency RMBS Spreads Remain Tight



Source: Wells Fargo Securities, Guggenheim Investments. Data as of 7.19.2018.

Non-Agency RMBS spreads have rallied with only short pauses since the first quarter of 2016 and reached post-crisis tights in early second quarter 2018. Fundamental trends inform our constructive intermediate-term view for the sector.

Increased Non-Agency RMBS Issuance in the Second Quarter Weighed on Spreads



Source: Bloomberg, Guggenheim Investments. Data as of 6.30.2018.

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