Non-Agency Residential Mortgage-Backed Securities

Income and Appreciation Potential with Limited Downside Risk

Strong fundamentals keep us constructive on RMBS despite the cooling housing market.

Non-Agency RMBS credit spreads reached new post-COVID wides early in the fourth quarter in tandem with broader liquid credit markets before modestly recovering in December. RMBS 1.0 and RMBS 2.0 subsectors—RMBS issued pre- or post-Global Financial Crisis—posted -0.2 percent and -1.5 percent returns, respectively, in the fourth quarter. RMBS valuations lagged the late fourth quarter rally in broader risk markets due to a lack of trading volume and reduced risk appetite from end investors and dealers, thereby leaving spreads elevated relative to liquid credit benchmarks. For example, credit spreads on AAA-rated non-qualified mortgage tranches ended the year 85 basis points higher than they began 2022, while spreads for investment-grade corporate bonds widened by 30 basis points over the same period.

Fourth quarter RMBS issuance volume declined by 75 percent quarter over quarter, from $20.7 billion to $5.3 billion, and full year 2022 issuance of $110 billion marked a 33 percent decline from 2021. Primary issuance is expected to decline even further in 2023 due to higher mortgage rates and reduced home sales activity, which is now at levels last seen during the onset of the pandemic. Additionally, refinancing activity is expected to be minimal as nearly 98 percent of outstanding mortgages have rates below the current market rate. The expectation of slow prepayments, even under moderate interest rate declines, reduces the call risk in MBS and improve their yield profiles across interest rate scenarios.

Conservative mortgage underwriting, favorable consumer and labor market conditions, and an excess demand for shelter in the United States helped to alleviate the credit concerns posed by the cooling housing market. Prior to the recent softening in the housing market, price appreciation was robust. Consequently, home equity totaled $30 trillion versus $13 trillion in outstanding mortgage debt, providing ample cushion to endure any home-price declines. We continue to favor non-qualified mortgage RMBS 2.0 mezzanine and senior tranches with loss-remote, stable weighted average life profiles, reperforming loan deals, and RMBS 1.0 backed by loans with significant home equity. These subsectors have recently traded at discounted dollar prices with 6–7 percent yields while carrying a low likelihood of principal loss.

By Karthik Narayanan and Roy Park

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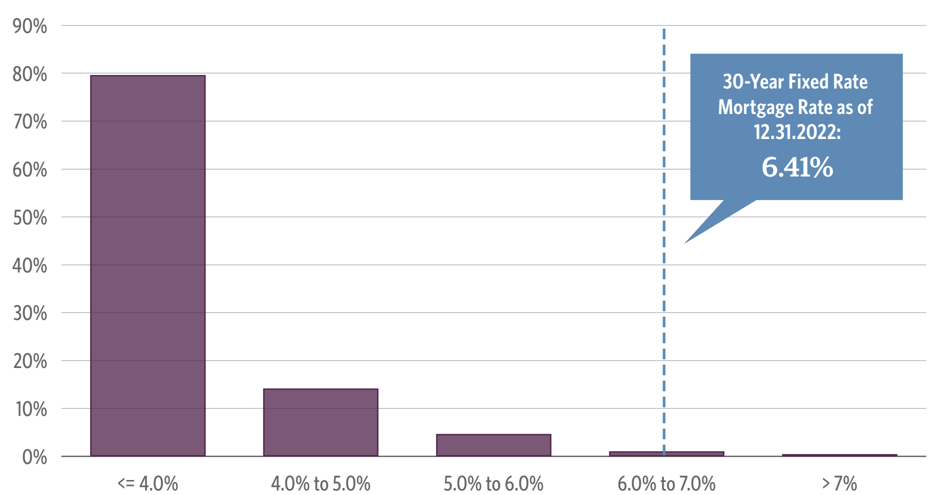
Rate Distribution of Outstanding Mortgages Will Pressure Refi Activity



Source: Guggenheim Investments, Bank of America Research, Recursion, Loan Performance. Data as of 12.31.2022.