Non-Agency Residential Mortgage-Backed Securities

The Slow Reboot

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Value remains in select pre-crisis RMBS, but market focus is shifting to new issue.

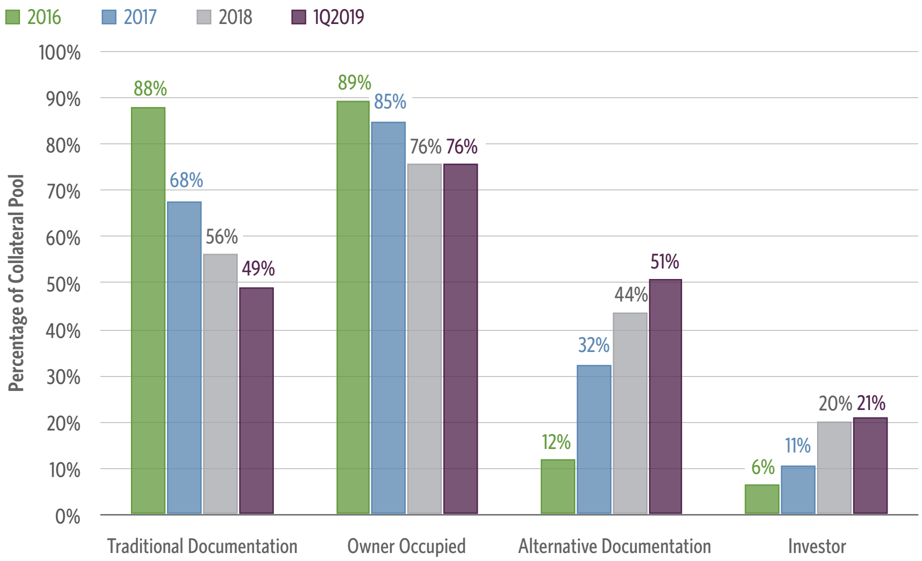
Non-Agency RMBS exhibited positive performance in the first quarter of 2019, returning 3.5 percent and outpacing the Bloomberg Barclays U.S. Aggregate Bond index. However, this performance only represented a partial retracement of underperformance experienced in the fourth quarter, and performance lagged that of other credit sectors. Non-Agency RMBS has experienced similar performance lags in prior risk-off periods due to the spotty trading volumes and slow transmission of price information in the market. The relative value resulting from this pricing dislocation, combined with constructive housing and consumer fundamentals, continue to underpin our constructive outlook.

With light trading in pre-crisis RMBS, market focus has shifted toward new issuance. First quarter 2019 gross issuance was approximately $17 billion, representing a 15 percent year-over-year increase. Deals backed by non-qualified mortgages (non-QM) drove this change as issuance rose from $2.4 billion to $6.8 billion year over year. At the market's inception in 2015, non-QM loans focused on individuals recovering from financial difficulties arising from the Great Recession. Since that time, the level of distress among borrowers has declined, a securitization market for non-QM was established, and originators moved away from credit-blemished borrowers and toward investor properties and self-employed borrowers (see chart, top right) to grow origination volumes and fulfill credit demand unmet by traditional, government sponsored enterprise-oriented mortgage loans. With this shift in borrower type comes a move away from traditional tax-return based underwriting toward bank statement or rental income-based qualification. More recently, individual non-QM issuers have begun to diverge in their collateral credit profiles and a corresponding increase in dispersion of senior credit support has emerged (shown on a no-names basis in the chart at bottom right). Although these changes are typical of a young and developing market and overall credit standards remain quite stringent relative to the excesses of 2005–2007, we remain vigilant for issuer-to-issuer credit variability and excessive late-cycle credit drift.

We are constructive on the performance prospects for non-Agency RMBS as borrowers continue to benefit from the favorable consumer-credit and housing fundamentals. Bonds show the potential for positive price improvement in the event that spread levels simply track the recent behavior of broader credit markets. 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 rising home prices and moderating default rates.

Non-Qualified Mortgage Deals Are Migrating Away from Traditional Borrowers

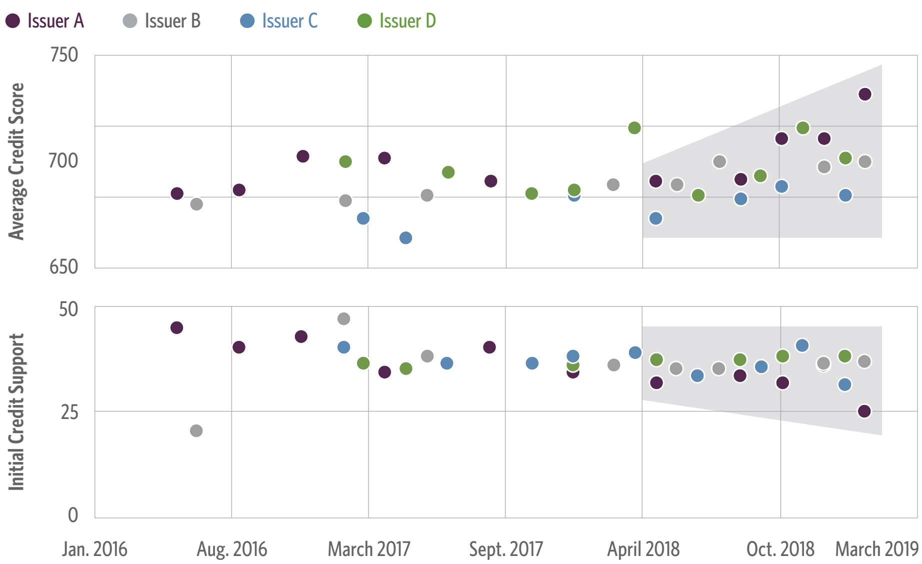
% of Mortgage Issuance by Borrower Attribute



Source: Guggenheim Investments, Wells Fargo. Data as of 3.31.2019. Alternative documentation includes bank statements, asset depletion, and investor cashflows underwriting.

At the market's inception, non-QM loans focused on individuals recovering from financial difficulties arising from the Great Recession. Collateral composition and borrower attributes have shifted as the market has evolved, and issuance volumes increased. Deals backed by alternative forms of documentation represent 51 percent of issuance so far this year.

Credit Scores and Structural Support Have Begun to Diverge



Source: Guggenheim Investments, Bloomberg, Deal Prospectuses. Data as of 3.31.2019. Issuer data is represented anonymously.

The collateral credit profiles of individual non-QM issuers have begun to diverge, and a corresponding increase in the dispersion of senior credit support has emerged. Lender differentiation is typical for a maturing market, but investors should remain vigilant around credit variability and late-cycle excesses.