Structured Credit—Navigating Ahead

2017's Strengths in Domestic Housing, Credit, and US Economy to Hold Strong

SUMMARY: All-time highs in stock market indices, all-time lows in stock market volatility, and persistently low long-term interest rates characterized a market that expects a business-friendly Trump administration and a continued dovish Fed to promote ongoing strength in economic fundamentals, corporate profits, and credit availability. Structured credit markets also benefited greatly from realized and expected further improvement in credit fundamentals, greater credit availability, expected easing of post-crisis regulation, and further enhancements to new origination in the non-agency securitization market.

In our view, 2017 marked the beginning of a transition from a post-crisis distressed recovery trade to a more typical, efficient market as evidenced by broader economic conditions as well as specific structured credit sector performance.

SECTOR HIGHLIGHTS:

- **Legacy Residential Mortgage-Backed Securities (RMBS)** – The sector continued to perform well, as increases in home prices helped keep delinquency pipelines moving, and gave previously trapped performing borrowers the ability to voluntarily prepay their loans. Also notable were the total return opportunities created by the resolutions of various Reps & Warranties settlements, in addition to the previously overlooked risks due to trustee litigation reserves taken by Wells Fargo. ***We expect the current trends to continue with further increases in home prices and in credit availability.***

- **Credit-Risk Transfer (CRT)** – CRT has come of age as an asset class, and we believe it will be increasingly important to the structured credit marketplace. Highlights for the sector include the first MACRS (Modifiable and Combinable REMICS, an option to exchange securities backed by the same cash flows) options being utilized and the first test of the credit enhancement in the aftermath of hurricanes Harvey and Irma. The agencies also announced structural changes that will make the asset class bankruptcy remote from agency restructuring as well as REIT eligible. ***Given the size of the market and growing supply, we expect this sector's profile to continue to grow and to create significant total return opportunities.***

- **Single Family Rental (SFR)** – Another excellent performing sector, this asset class enjoys the benefit of cross collateralization as well as corporate guarantee(s). Of note, since 2010, the top 10 operators of multifamily real estate in Freddie K deals control approximately 50-70% of the market, and SFR has even greater benefits from scale yet remains below 1% of residential rentals nationally. ***We expect continued growth and consolidation in this sector.***

- **"RMBS 2.0" (Post-Crisis mortgage origination) and NPL/RPL securitizations** – RMBS 2.0 continues the move forward in resolving the lack of standardization within the sector. Securitizations of non-performing and reperforming ("NPL/RPL") loans performed very well and continue to offer short, stable investments**. *While we expect the supply of NPL/RPL to wane as the Agencies work through their holdings, post-election originations of non-QM (Quality Mortgage) loans have increased dramatically and we expect this trend to continue.***

- **Legacy Commercial Mortgage-Backed Securities (CMBS)** – With the size of this market shrinking quickly with the maturity of the 2007 originations, this sector continued to be plagued by negative surprises in retail sales, lack of demand for suburban office space, and tighter underwriting standards on new issue conduit CMBS loans in general. ***We expect the few remaining loans to be worked out over the next 1-2 years and it will be interesting to see how changes to 2.0/3.0 structures fare as they approach their balloon dates in coming years.***

- **Asset-Backed Securities (ABS)** – Issuance hit a post-crisis peak in 2017, driven by broad-based demand, with auto ABS comprising about 1/3 of the market, followed by credit card and esoteric at around 20% each. Subprime auto-backed deals continued to see strong performance, despite early-year fears of used car price declines. A consistent theme throughout the year in ABS has been continued strong new-issue demand, especially down the capital structure. ***We continue to prefer shorter, faster deleveraging structures, and we continue to monitor for fundamental credit shifts across ABS sectors.***

- **Agency MBS** – A relatively less attractive sector, the consistent high-quality underwriting standards and the low rate environment have resulted in a product with relatively long duration, very negative convexity (even by Agency MBS standards), and relatively low yield. We also find so-called Agency Derivatives – Interest Only (IO), Principal Only (PO), and Inverse Floating securities – to be relatively unattractive as is typically the case when the underlying collateral is unattractive. ***We will be monitoring Agency collateral for entry points but given where we are in the rate cycle, the long duration, and negative convexity, we do not expect this to be likely in 2018.***

- **Non-bank Lending and FinTech** – This sector saw meteoric growth as investors sought higher yields and more diversified product revenue channels. Among the products that dominated the landscape, consumer unsecured lending (aka “marketplace” loans) continued to mature as a sector although net performance has been below expectation. Cryptocurrencies also saw enormous interest along with a wave of new ICOs (Initial Coin Offerings) and BitCoin hit all-time highs. ***We continue to prefer loans collateralized by hard assets and/or more predictable cashflows with clear intrinsic value, and legal and regulatory standing.***

- **High Yield** – Default rates in the U.S. High Yield space were heightened in 2016 reaching nearly 4%, largely driven by Energy and Metals & Mining credits. Default rates started 2017 at 3.6% and are now at 1.2%, well below the 25-year historical average of 3%. We expect default rates to remain muted going into 2018 and currently fail to see any immediate drivers for that to change. ***We continue to monitor the new issue market for signs of increased PIK toggle or dividend deals that can be an indicator of a weakening credit market.***

MARKET HIGHLIGHTS:

- **GDP** – Measures have been volatile and far from inflation-fear inducing but solid enough to encourage the Fed to begin more clearly removing stimulus from the economy. ***Given the withdrawal of stimulus we expect growth to continue at an unimpressive pace.***

- **Interest Rates** – With few exceptions, the 10-Year Treasury spent the year in a 40 bps range between 2.10 and 2.50%, and flattened to just 62 bps from 2s-to-10s (as of November 20th), down from a high of 291 bps in Feb 2010. ***Slow growth and accommodation have been the global policy these last years, and we expect this trend to continue. Meanwhile, investors have been rewarded for taking a "wait and see" approach to positioning for higher rates, and we expect this to trend to continue as well.***

- **Federal Reserve** – The selection of Jerome Powell to serve as the next Chairman removed uncertainty from the market and returned expectations to the status quo given his dovish reputation. ***Looking forward, we believe the Fed will not only cease withdrawing liquidity via higher rates and balance sheet sales, but reverse course if their current telegraphed path results in market turbulence. We also expect the curve to continue to flatten and possibly invert in the near term, although it is difficult to predict the impact of $4.5 Trillion in Fed balance sheet sales.***

- **Retail Sales** – Regional malls, Amazon, and grocery stores became one of the most interesting credit stories of 2017 as weaker retail outlets continued to falter, while the ease of use and growth in online commerce continued to advance. Amazon's quick strike into the supermarket business should cause concern in any retail segments that don't offer a specialty product and can be replaced through online efficiency. ***This trend has continued to drag down the retail segment of CMBS performance and had a significant impact on high yield, and we expect it to continue to get worse before it gets better (if it gets better) in 2018.***

- **Energy** – Oil prices stabilized during 2017 in the mid $50s level and have provided a tail wind to the high yield market. The Energy industry comprises 15% of most high yield indices with the next largest industry being Healthcare at 9%. Oil prices have a direct impact on the broader high yield market as evidenced by the Fall of 2014 and the Summer of 2015. Although less significant, this strengthening has also helped real estate prices in energy industry-concentrated areas. ***Looking forward, given the enormous investment that took place at higher energy prices it appears that will be difficult for prices to move higher without significant increases in growth.***

- **Volatility** – One of the biggest sources of consternation we hear about is the low level of market-implied volatility, particularly relative to recent market events. However, geopolitical concerns in Asia, ongoing terrorism, weather related devastation with wildfires and hurricanes, all have had a muted impact on the US economy and real estate through 2017. ***While important to continue to position for possible shocks, US markets have been proving resilient, and we continue to approach them opportunistically.***

OUTLOOK FOR 2018:

Semper believes the trends of 2017 will continue in the coming year, including ongoing strength in domestic housing, credit, and more broadly, the US economy. Ongoing policy reform negotiations regarding Dodd-Frank, potential tax reform, and Obamacare may lead to bouts of volatility and create risk-off buying opportunities.

We continue to believe that the biggest risks to the structured credit markets are government and policy-related. Foremost, either increasing the fed funds rate or unwinding QE too quickly may derail the recovery. However, unlike under the prior administration, regulatory risks related to financial services and consumer protection now appear to be muted, or even possible sources of opportunity for structured credit investors. Risks are present, but the current administration seems to be quite focused on accommodation in policy, regulation, and growth.

While we don't expect material risk-off or rate increase scenarios, the low correlation, low downside credit risk, and low rate sensitivity of much of the structured credit space adds to its attractiveness among fixed income sectors. In addition, Legacy RMBS continues to pay down, making it increasingly a market for smaller, more nimble players, while new issuance of RMBS is now effectively offsetting the decline in legacy outstanding and creating new relative value and total return opportunities.

Semper continues to see opportunities in trading relative value and investing in attractive risk-adjusted risk returns in both legacy structured credit and amidst the next generation of US housing and structured product sectors.

Recent Publications (available at www.sempercap.com) :

- Non-Performing Loans/Re-Performing Loans: Attractive Exposure to U.S. Post-Crisis Housing Market (August 2017)
- Semper on GSE Credit Risk Transfers (CRTs) (May 2017)

SEMPER CAPITAL MANAGEMENT, L.P.

Semper Capital is an independent investment management firm specializing in mortgage- and asset-backed securities, asset-based lending, and other structured credit investments. Semper Capital offers institutional and high net worth investors access to multiple securitized debt-centric investment platforms, ranging from private absolute return and index-based strategies to registered mutual funds and custom managed accounts. Semper Capital has been an SEC-registered investment advisor since 1992.

CONTACT INFORMATION

Semper Investor Relations
212-612-9102
InvestorRelations@sempercap.com

Semper Capital Management, L.P.
52 Vanderbilt Ave, Suite 401
New York, NY 10017
www.sempercap.com

Media Inquiries
WT Blase & Associates, Inc.
info@wtblase.com
212.221.1079