STRUCTURED FINANCE COMMENTARY

Spring 2022

IN THIS ISSUE

A NOTE FROM THE EDITOR

Methodical recently joined Stout, a global investment bank and advisory firm. But don't fret — our mission to deliver high-quality industry insight remains the same, so we'll keep these commentaries coming.

THE RISING TIDE LIFTING ALL BOATS IS SO 2021

Fundamentals impact credit, while technicals impact credit spreads. For now, the fundamentals are strong, but so are the headwinds from the geopolitical storm. Although it is hard to have a repeat act after a banner year like 2021, barely a month into the new year, structured products earned its keep as an asset class, out-performing other fixed income sectors and remaining somewhat uncorrelated during a raucous January.

However, by the time February rolled around, the technicals proved no asset class is immune to geopolitical risk, and credit spreads widened to the highest levels for most sectors since the post-pandemic tightening concluded. But that is not to say that all sectors or bonds performed the same — a rising tide lifting all boats is so 2021.

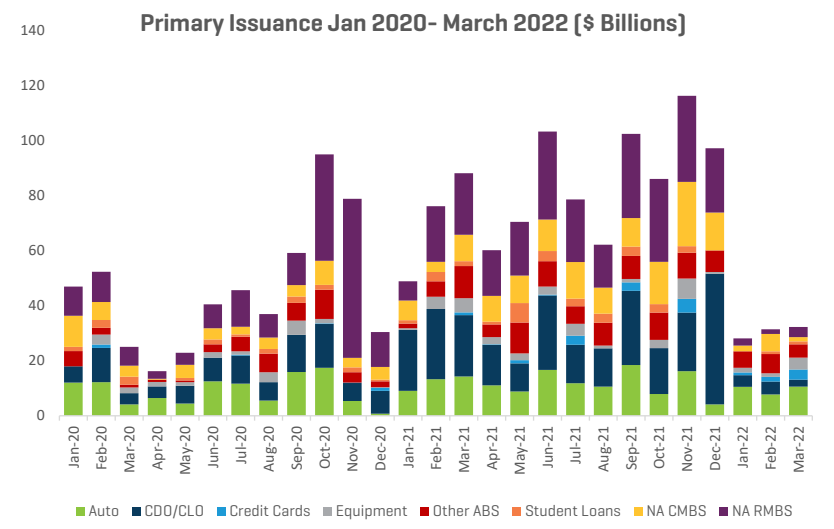
Tiering has returned — whether it's old dependables like credit quality, duration, liquidity, sponsor, and servicer or new ones to watch out for, like exposure to aircraft leased to Russian airlines.

Structured products as a whole experienced historically low defaults and some of the tightest spreads ever during a not-yet-concluded pandemic, which we all knew was not normal; any return to "normal" would include a degree of credit deterioration toward the normal curve. It is now happening.

STRUCTURED PRODUCTS UPDATE

It was not a pretty first quarter. Higher interest rates, wider credit spreads, lighter trading volumes, heightened prepay extension (and credit risk?), and, of course, duration were the main themes in Q1. Ten year treasury yields rose 80 bps QoQ from 1.52% to 2.32% and widened another 51 bps in the two weeks following the end of the quarter. The Freddie Mac Primary Mortgage Market Survey 30-year fixed rate has gone from 3.11% as of the end of the year to 5.00% in the second week of April, a rate not seen for over a decade.

FIGURE 1: PRIMARY ISSUANCE



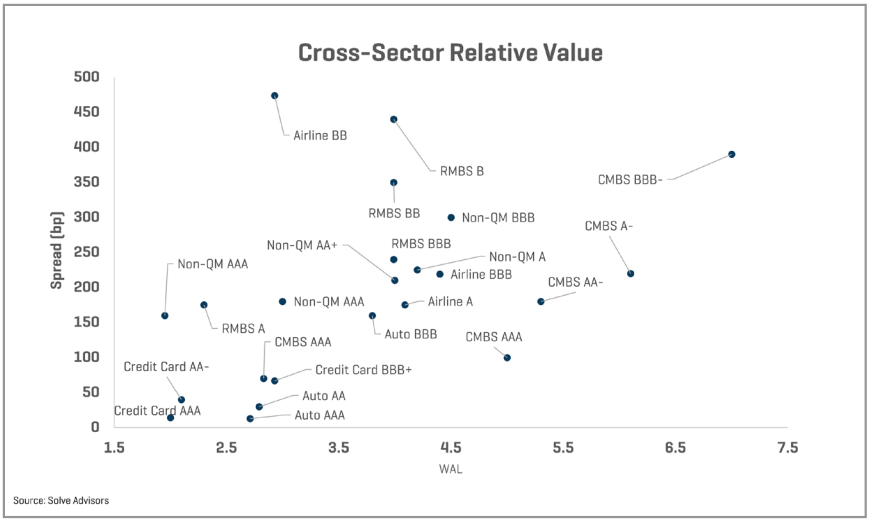
Source: SIFMA

As rates have rallied, prepays have decreased, durations have extended, long-duration assets have become longer duration assets, and anyone not fully hedged is wondering whether to start hedging and whether the pain will continue. Credit spreads on bonds were wider throughout the capital structure, indifferent to any kind of continued improvement or lack of noticeable deterioration in collateral. Trading has been light, and there were DNTs galore as market participants weighed the benefit of accepting the current moves against raising cash to redeploy. When senior bonds trade with a 10-point discount, subs on bid lists may attract only fire-sale levels, and we understand that many contemplated sales were postponed. Primary issuance has slowed, and several new deals were cancelled.

By the end of the quarter, spreads stood at year-to-date wides, and — gauging by residual pricing — loss expectations have gone up more than the delinquency roll rates would imply. Collateral performance was a mixed bag: Consumer delinquencies

worsened, but CMBS delinquencies improved. Mortgage rates are up significantly, but so are home prices, and both are expected to rise as the housing supply continues to be constrained. Rising costs of rent, gas, and food, coupled with the possibility of a coming recession, reduces consumers' ability to service debt as well as investor's returns as collateral performs worse and future P&I are worth less in real terms. All of this is happening with a backdrop of multiple hikes being priced in and Russia's invasion of Ukraine.

FIGURE 2: STRUCTURED PRODUCTS RELATIVE VALUE



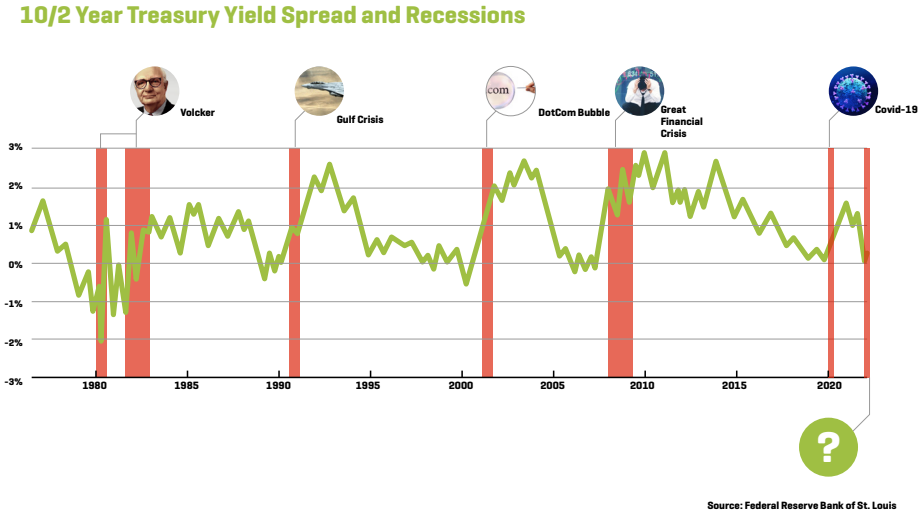
Source: Solve Advisors

AGENCIES / RATES

Don't call it Taper Tantrum 2.0, because it's not. The violent selloff in rates due to the 2013 Taper Tantrum was a result of market participants being caught offside after the Federal Reserve's announcement of future tapering of quantitative easing, which turned out to be an unjustified overreaction.

The pace of the recent selloff has been just as violent, but we have had bouts like this in the past (post-Brexit), and we didn't call those events a taper tantrum. The current environment is very different, includes an inverted (or close-to-inverted, depending on the day) 10/2 Year treasury curve, and a very different absolute starting point.

FIGURE 3: 10/2 SPREADS



The selloff in rates brings a whole host of issues:

- Lower trading volumes
- Higher share of purchase loans in MBS production
- Higher funding rates
- Lower demand from overseas as local rates and hedging costs increase
- Higher rates for new loans, both secured and unsecured
- Looser underwriting standards to make up the loss of production

We'll steer clear of whether the yield curve is foreshadowing a recession or not, but we do see a continued selloff at the short end of the curve and at least three 25-bps increases by the end of the year.

In summary, the selloff on the short end should continue, and investors should be mindful of their hedges, the cost of hedges, the quality of new production, and the possible worsening of consumer credit. At least originators may see some boost to the value of their MSR books to partially offset unhedged losses on loans held for sale.

NON-AGENCY RMBS

Light trading volumes, extension risk, and anemic supply are the main concerns here.

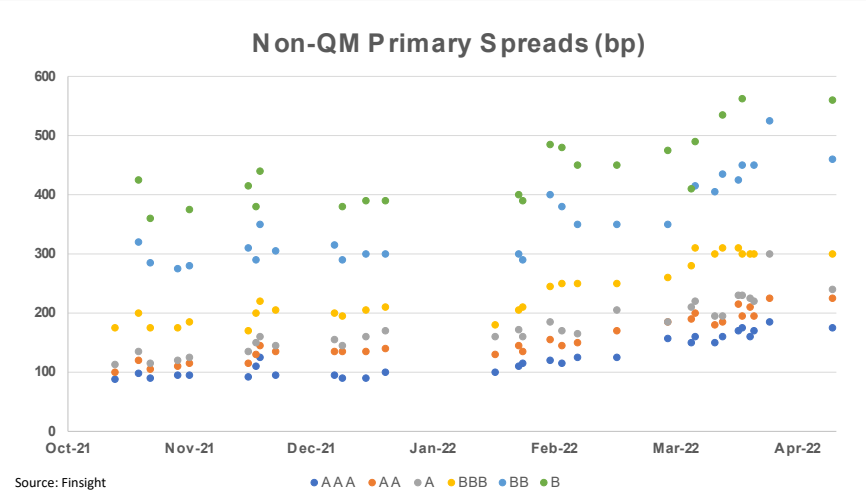
Some sectors with collateral less sensitive to macro events (like Non-QM and RPL/NPL) proved to hold up somewhat better as a defensive position. HPA projections are still positive, ranging from 8-10% in 2022 but slowing to 5% in 2023. While interest rates are higher, the supply of housing remains low, pushing home prices higher (housing units started have continued their upward trajectory since the doldrums of 2010, but there has been no substantial nationwide response on the supply side to the spike in home prices).

The pace of deals being called should also slow down as issuers see diminishing value in collapsing transactions as reissuance costs have risen and market sentiment has retrenched.

On the SFR land, the last two deals issued in 2021 (PROG 2021-SFR11 and HPA 2021-3) had AAA spreads in the 85-90 bps area, yielding 2.2-2.3%, with bonds issued down to 12.5% credit enhancement. Fast forward to PROG and HPA deals issued in mid-late March and early April, and bonds were issued at a discount to par with the AAAs yielding approximately 4.2%, and no bond sold to third parties had credit enhancement below 19%.

By retaining bonds, issuers seem to think the market's reaction may be overblown, but their need for term funding forces them to take the hit on more senior bonds. We believe that the market may have overreacted, given SFR deals' support from strong past and expected HPA and strong rent growth. We would need sustained strongly negative HPA, renting falling out of favor, and a lack of effective property management/sponsorship for these bonds to take losses.

FIGURE 4: NON-QM PRIMARY SPREADS



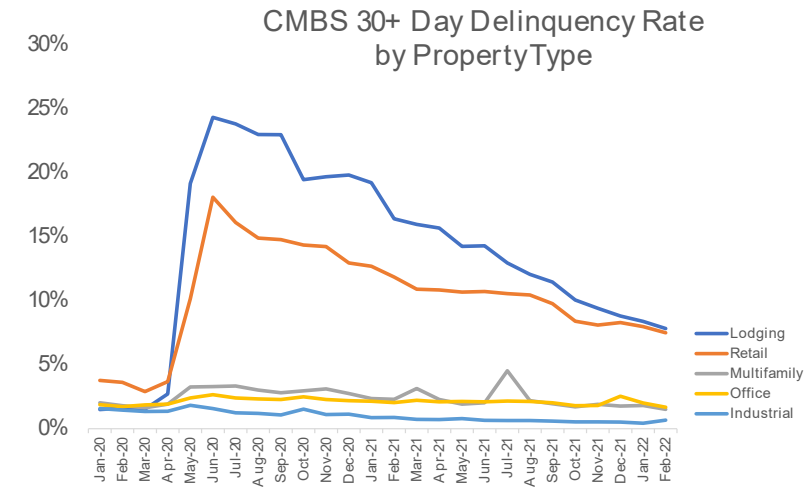
CMBS

Weighing in at $600+ billion of UPB outstanding, non-agency CMBS is a big market that attracts deep-pocketed investors. The top of the capital stack competes for allocation with investment-grade corporates for investors expressing macro views, and credit spread can widen or tighten in sympathy with overall market sentiment and sector allocation regardless of how the underlying loans are performing.

B-Pieces are where the rubber meets the road in terms of the market's perspective on underlying credit. There's no sympathy at the bottom. Key themes include the following:

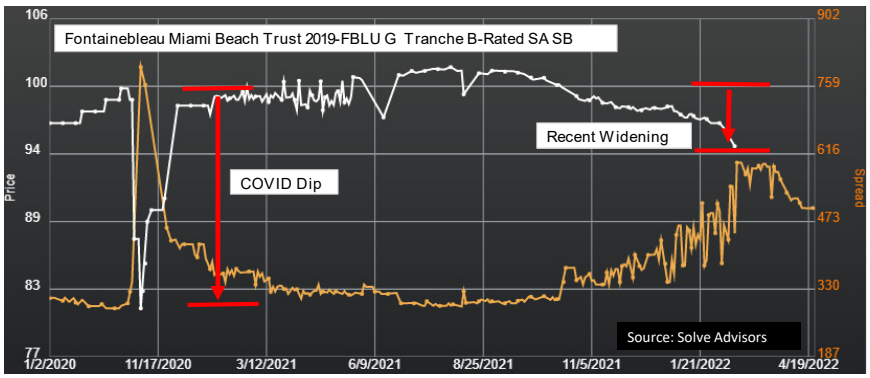
- The potential for loan losses tends to focus investors' minds on performance of the underlying loans.
- Lodging and retail delinquencies remain elevated and must be dealt with before too long.
- Delinquencies are getting better, but we are still seeing prices at the bottom of the capital stack trend lower.
- Price action is most easily observed in SASBs given exposure to a single property, for example, the CRE loan collateralizing the Fountainebleau Hotel in South Beach that hosts some of our industry conferences. Hotel is securitized in a SASB deal, and the B-rated tranche (which dipped more than 20 points and then recovered during COVID) has once again started softening.

FIGURE 5: CMBS DELINQUENCIES



Source: Trepp

FIGURE 6: FOUNTAINEBLEAU HOTEL



UNSECURED CONSUMER LOANS

Consumer loans continue to perform relatively strong, but we wonder how long performance can remain at these levels. Keep in mind we are coming out of a surreal two-year experience where consumers' pockets were stuffed with cash from stimulus checks, which was followed by a relatively rapid jobs recovery and the pent-up demand after the reduction of discretionary spending during the early pandemic. Savings do not seem to be depleted yet, but inflation is outpacing wage growth, student loan payments are scheduled to resume in August (maybe), and increasing gas/rent prices are creating a concern for credit deterioration – especially for subprime borrowers.

The Definition of "Prime" and "Subprime"

Exactly which loans match this "subprime" designation remains fluid, with credit scores at the top end of this bucket hovering between 619 and 669 FICO, depending on whom you ask. Prime, on the other hand, is generally accepted to start around 700 FICO. A

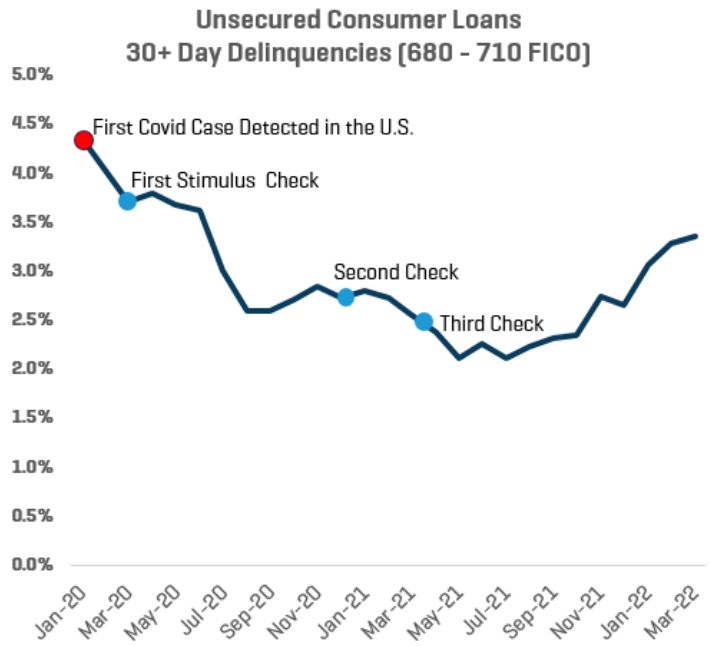
borrower migrating from Prime to Subprime can easily be caused by a single 30-day missed payment, which would knock 50 points off FICO, or by maxing out a credit card, which can knock off 40 points.

Size of the Subprime Market

The size of the subprime population, and whether the pandemic obfuscated true credit scores, is of more significance than a strict definition of "subprime." As of Q1 2021, 30% of U.S. consumers have credit scores in the subprime range (defined here as under 670). This is a large contingent, and there will be contagion if things go south. We are already seeing cracks in subprime performance. If we are seeing cracks in the remittance reports now, then the actual deterioration must have started a couple months ago given the delay in reporting.

This seems counterintuitive — unemployment is at record lows, so why the surge in delinquencies? Essentially, full employment does not mean prosperity for subprime borrowers when inflation outpaces wage growth. Note that median household income is $67,000, with an average household size of 2.5. It is not hard to see how money can get tight when gas prices and rents surge. To keep things in perspective, delinquencies are increasing from a very low base, but one should keep in mind both the magnitude and the trend.

FIGURE 7: UNSECURED CONSUMER LOANS



Source: KBRA Tier 2 Marketplace Consumer Loan Index

ABS

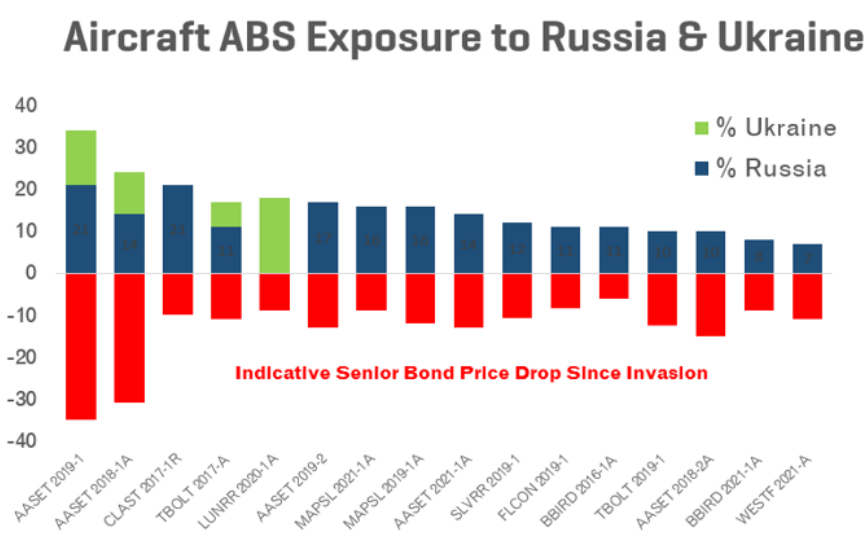
Before the pandemic, the ABS market was pretty orderly, to the point of almost boring. A-rated seniors from rental car and consumer deals had spreads around 80-90 bps for a 3-5 year WAL, and more esoteric sectors (such as Containers, Aircraft, and Railcars) traded around 180-200. Each sector kept in its lane, and there was enough demand (and issuance) for all.

On March 22, 2020, ABS spreads were disrupted as the pandemic began. Even during that chaos, rental and consumer deals widened in tandem to about 5X the pre-pandemic spread — trading in 500/600 spreads which meant prices in the $80 compared to par a few weeks earlier. Container and rail deals also widened in tandem to about 4X pre-pandemic.

The Aircraft sector was the exception, as it widened to four-digit spreads. The risk then was how long the lockdowns would last and whether we would ever rent cars, fly, borrow, spend, or eat at a fast-food restaurant as much as we did before. As the market received more clarity on these issues, spreads tightened to levels not seen before, with the exception of Aircraft, which has settled around a 300 spread since domestic travel volume remains relatively low.

This was compounded with Russia's invasion of Ukraine. Aircraft ABS deals are generally backed by leases on the airframes and engines, and indicative bond levels on deals backed by equipment leased to Ukrainian or Russian operators started to reflect the likelihood of future lease payments, whether planes with missed lease payments could be repossessed, and whether insurers (and re-insurers) are on the hook for any losses.

FIGURE 8: AIRCRAFT EXPOSURE

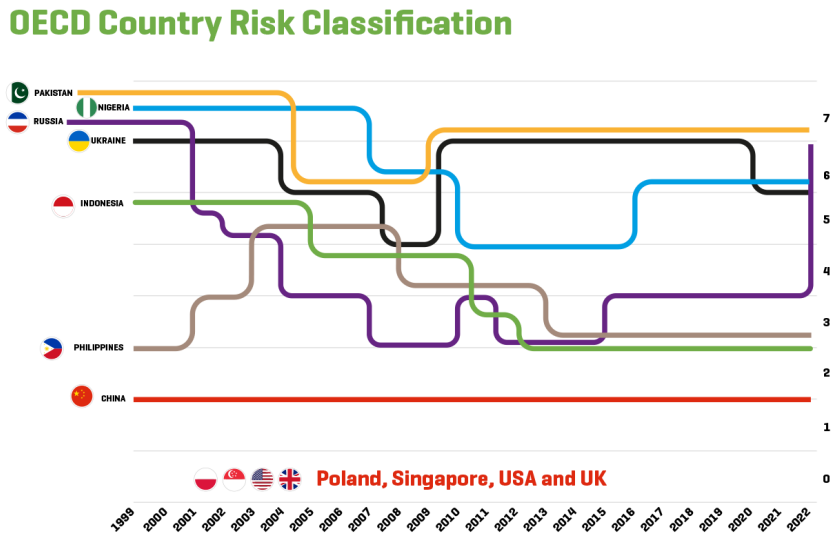


Source: Solve Advisors, Bloomberg, KBRA, FINSIGHT

We have seen color that some IG bonds have traded below $50, with no word yet on first-loss pieces (whose subordination can vary substantially). However, there are plenty of deals that have 0% U.S. exposure but high concentrations (50%+) in Asia or Africa.

The chart below shows the OECD's (Organisation for Econoi Co-operation and Development) country risk classifications. According to the OECD, "Country risk encompasses transfer and convertibility risk (i.e., the risk a government imposes capital or exchange controls that prevent an entity from converting local currency into foreign currency and/or transferring funds to creditors located outside the country) and cases of force majeure (e.g. war, expropriation, revolution, civil disturbance, floods, earthquakes)."Interestingly, Russia was not seen as high risk before the invasion.

FIGURE 9: OECD RISK CLASSIFICATION

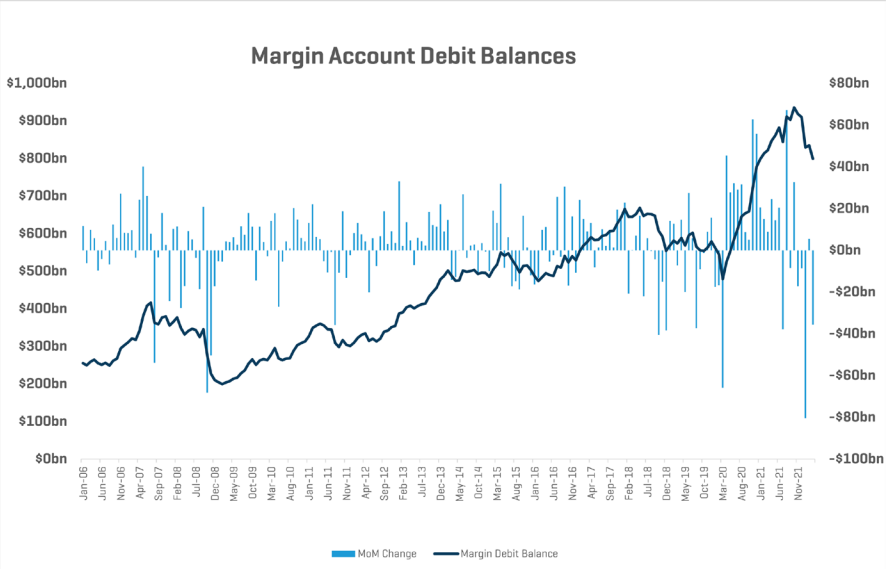


FUNDING COLOR

Overall, the absolute levels of funding rates have increased slightly. As risk premiums on securitized assets increase, funding desks can extract more from clients that borrow for leverage, and most desks have taken the opportunity to add about 10% of the widening to borrowing costs. Internal borrowing costs for repo desks have also increased by around 10 bps, and about 80% of that has been passed on to the borrower.

Lending still remains very competitive and, relatively speaking, borrowers remain in the driver's seat, and this likely feeds into the relatively low issuance volumes seen so far. One thing to note is that many desks have been switching their quotes from LIBOR to SOFR. Interesting note, the Ukraine invasion created as much de-leveraging as we saw in March 2020 at the start of COVID.

FIGURE 10: MARGIN ACCOUNT DEBIT BALANCES



OUR STRUCTURED FINANCE COVERAGE

Residential Mortgages

- Agency MBS (spec pools, IOs, CRT)
- Non-agency RMBS (reps and warranties, monoline wrapped)
- NPL/RPL whole loans and RMBS
- Jumbo, non-QM
- Manufactured housing
- Reverse mortgages
- Manufactured housing
- EBOs
- HELOCs
- MSRs

Unsecured Consumer

- Marketplace lending
- Private student loans
- Income sharing agreements
- Credit card
- POS
- Elective medical
- Travel
- Other installment loans
- Payday
- Autos
- Solar
- Microfinance
- BNPL
- Unsecured consumer loan servicing rights

Commercial

- CRE (office, retail, multifamily)
- CMBS (including B-pieces and specially serviced deals)
- Single-family rental
- Fix and flip
- Equipment ABS
- Whole business securitizations
- Merchant cash advances
- Aviation
- Containers
- Inventory financing
- Timeshares
- Tax credits

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