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STRUCTURED FINANCE COMMENTARY

Summer 2022

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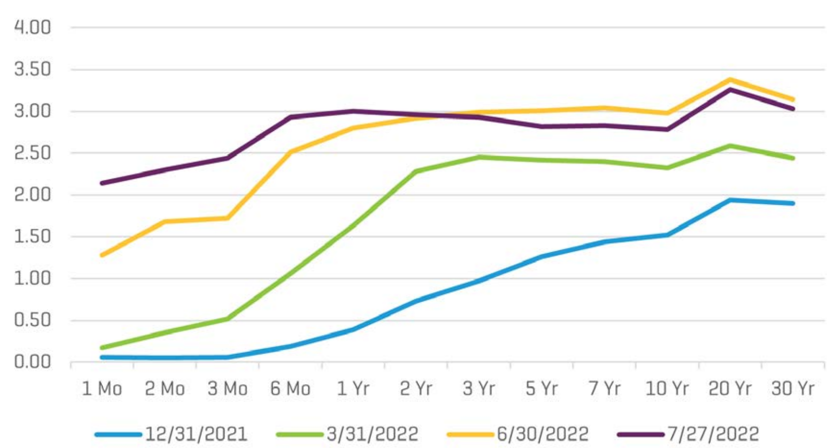
STRUCTURED FINANCE: MIX TAPE

There are a lot of mixed messages in a market that has deteriorated very quickly. Conditions in the structured finance market and the financial markets more generally have changed significantly, with rates up, spreads wider, and issuance falling off a cliff.

With the long end of the yield curve now falling, the 10-year/2-year treasury spread inverting, inflation in June continuing to surprise on the high side, stronger-than-expected payrolls for June, negative QoQ GDP growth in Q1 and Q2, and the Fed hiking rates in a decidedly non-Greenspanian manner, we will have to see how the market reacts to July CPI (where the volatile food and energy components are expected to have a negative impact). The equity markets, at least, initially responded positively to the Fed's recent rate hike.

FIGURE 1: TREASURY YIELD CURVE RISING AND FLATTENING



SUBPRIME IS DETERIORATING: WILL THERE BE CONTAGION?

Will there be contagion? A question that pre-Global Financial Crisis was answered by most with an emphatic no, to the world's detriment. The root causes of the cracks in deep Subprime — rabid inflation, depletion of household financial reserves or reduction in households' free cashflow, higher rates, and maybe some wealth effect from the falling stock market — is not unique to this section of the market. Distress manifests itself faster and with brute force on the financially vulnerable, but all households are exposed to these factors in varying degrees. So the answer is yes, there will be some contagion. A better question may be where it stops.

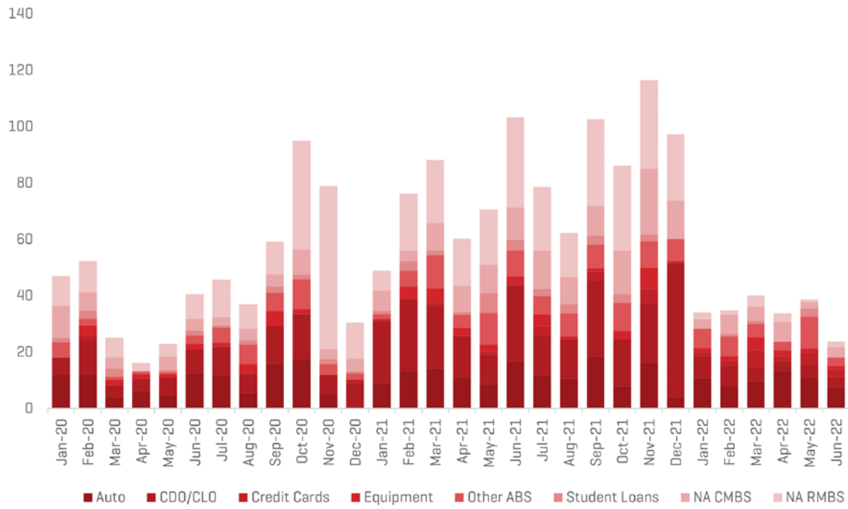
If a soft landing can be engineered by the Fed, a mean reversion scenario where rates, losses, and returns settle around historical averages is likely vs. the "stellar" performance we have come to expect in the last few years boosted by asset inflation. Though before the market returns to any kind of normalcy, we may have a long and slow reckoning of what ended up being a decade-long quantitative easing turning into a speedy quantitative tightening. Cash has been infused in every nook and cranny of the financial system. The corners of the credit box, where we find the most levered and weakest borrowers, whether it's in unsecured consumer loans, mortgages or commercial loans, are a good place to start observing the immediate impact, but scenarios where the distress we are seeing now spreads to higher credit score borrowers for the collateral and a few bonds higher in the capital stack should be considered.

AN OFF-PUTTING HALF

Recent sentiment and trading have pointed to risk off, with a recalibration of expected cumulative net losses on some unsecured consumer loan deals leading to some trading. Higher rates and spreads contributed to many planned securitizations being called off. Primary issuance has been down substantially as tracked by SIFMA, and secondary trading is generally slow. On the bright side, structures adapt and deals get done, albeit with wider cost of funds and thicker subs that may be retained.

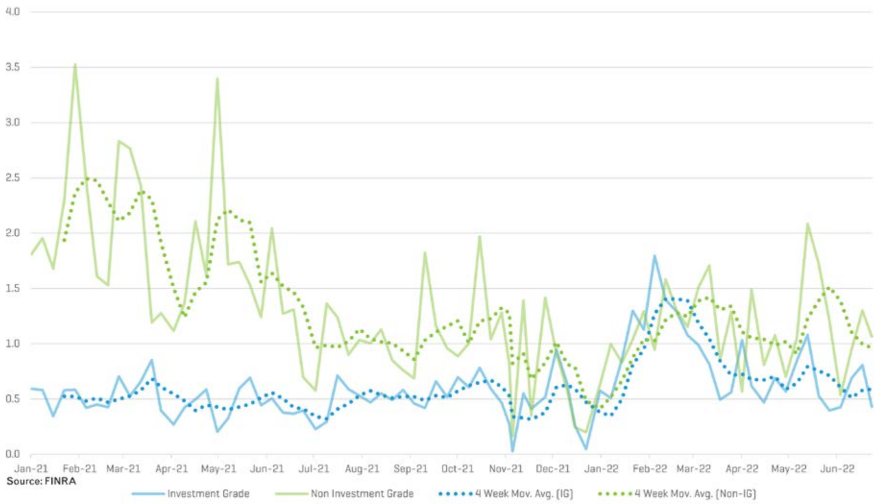
So what's a safe haven from the dual storm of market interest rates and spreads? Not much, but if it's any consolation, MBS and ABS index returns have been higher than Corporates and Treasuries. As sobering as it may be, maybe our sector is the safe haven, but waters are choppy in the harbor.

FIGURE 2: NON-AGENCY ISSUANCE JAN 2020-JUN 2022 ($ BILLIONS)



Source: SIFMA

FIGURE 3: WEEKLY NON-AGENCY RMBS TRADING VOLUME ($ BILLIONS)



Source: FINRA

RATES AND MORTGAGE ORIGINATORS

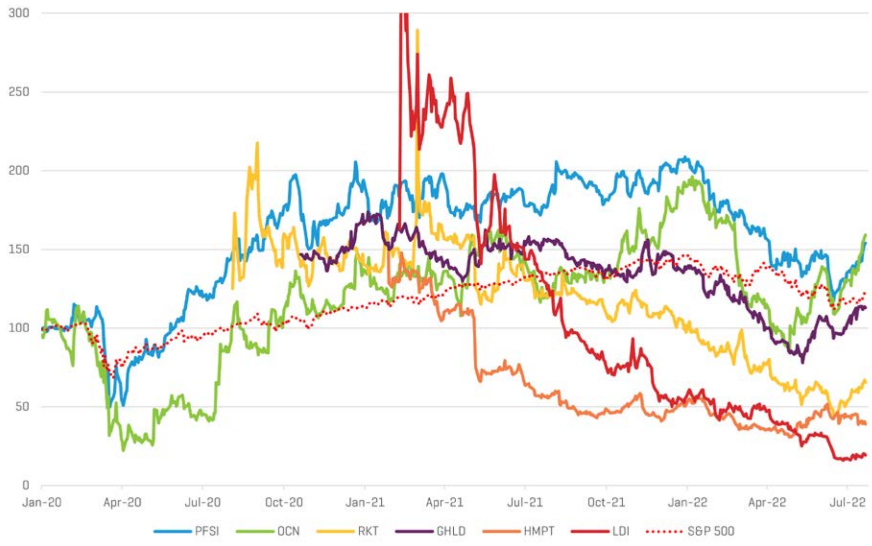
While the market largely expected and got a 75-bps hike at the July 27 Fed meeting, maybe more would have been better — we're not quite sure why a 100-bps increase would be a showstopper. The Fed has a very small needle eye to maintain its credibility as an inflation fighter while avoiding pushing the economy into a recession — the hoped-for "soft landing."

Long-term treasury rates have fallen somewhat since June, and the 5-year breakeven inflation rate has fallen back to about 2.5-2.6%, which is in line with pre-GFC levels but still notably above the sub-2.0% average from 2012-2019. Perhaps the Fed should err on the side of caution by hiking rates more, not less. Freddie Mac Primary Mortgage Market Survey mortgage rates have also fallen since peaking at their highest rates since 2008 in late June, although they are still higher than they have ever been since mid-2009.

Equity investors are in risk-off mode as shown by equity prices, ETF flows, and SPACs expecting to not close deals. We see risk off, if you want to call it that, in the mortgage industry as well. Almost every originator has or is planning to lay off employees, and several have shuttered. The media reports this as very dire news, but those of us in the business know that this is a cyclical business, and these events are inevitable as rates retreated higher in the spring and early summer.

If anything, some originators were smart enough to sell into the peak of the stock market and cash out, which should have been an indicator of the froth. Maybe some mortgage company employees who were not originators three years ago will go back to their previous occupation, and hiring in other roles will become less difficult.

FIGURE 4: MORTGAGE ORIGINATOR STOCK PRICES
(NOTE: PFSI, OCN, AND S&P ARE INDEXED TO JANUARY 2020 VWAP. OTHERS ARE INDEXED TO AVERAGE OF PFSI AND OCN ON THEIR IPO DATE.)



Source: Bloomberg

NON-AGENCY RMBS

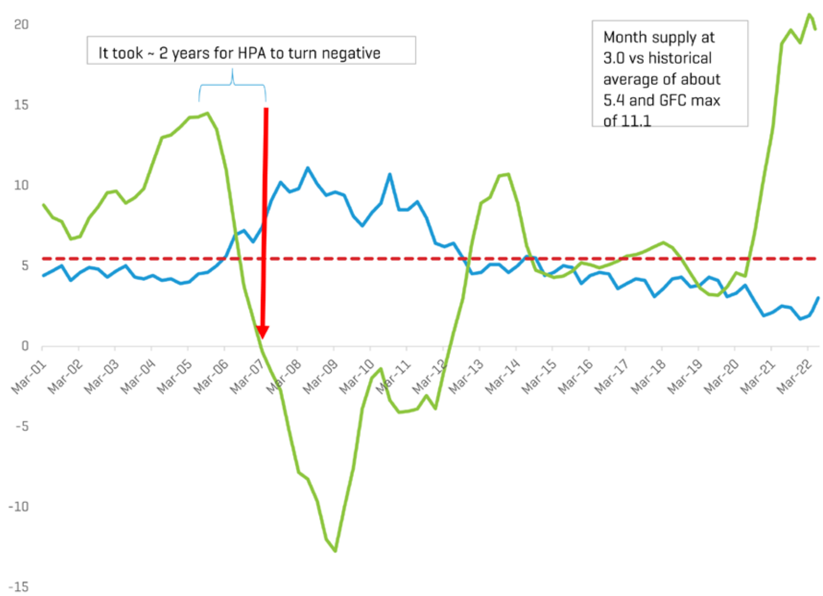
Merciless. On all fronts. Long-duration, negative convexity assets are not going to fare well in a rising-rate environment. Issuers have had to face the grim reality of AAAs pricing at the same yields as BBs had at the beginning of the year. Rates rising meant the turnaround time from interest rate lock commitment to issuance was a bloodbath. Inflation continuing to surprise on the high side and thus expectations of necessary Fed tightening continuing to push interest rates up only exacerbated this dynamic.

On the collateral front, the trillion-dollar question is home price appreciation. U.S. real estate is the largest asset class in the world, and, as such large asset classes do, it has inertia. Additionally, the Case-Shiller index, although it is released monthly, is a three-month average with a two-month lag — so the values released at the end of July include transactions from March, April, and May, which feels like an eternity ago.

Meanwhile, months supply (total number of homes for sale over the number of homes sold in one month) is still historically low, although it has ticked up in 2022. A repeat of the housing price crash of 2007-2012 this is not. Prices have been supported recently by low mortgage rates, household formation, and tight supply, not by loose underwriting standards in the face of high homebuilding. Case-Shiller HPA was 19.75% in May, and months supply was 3.0 in June, still below the 2016-2019 average of about 4.0.

While higher interest rates hurt home prices, the freedom to refinance means that any expected future declines in interest rates can support home prices today. Additionally, general inflation being as high as it has been also acts to support home prices. We expect house price increases to decelerate, but nothing like the outright broad-based declines of 2008-2012. The process of home price declines is long enough to provide the opportunity to think strategically about second liens, HELOCs, and ARMs.

FIGURE 5: YOY %HPA AND MONTHS SUPPLY

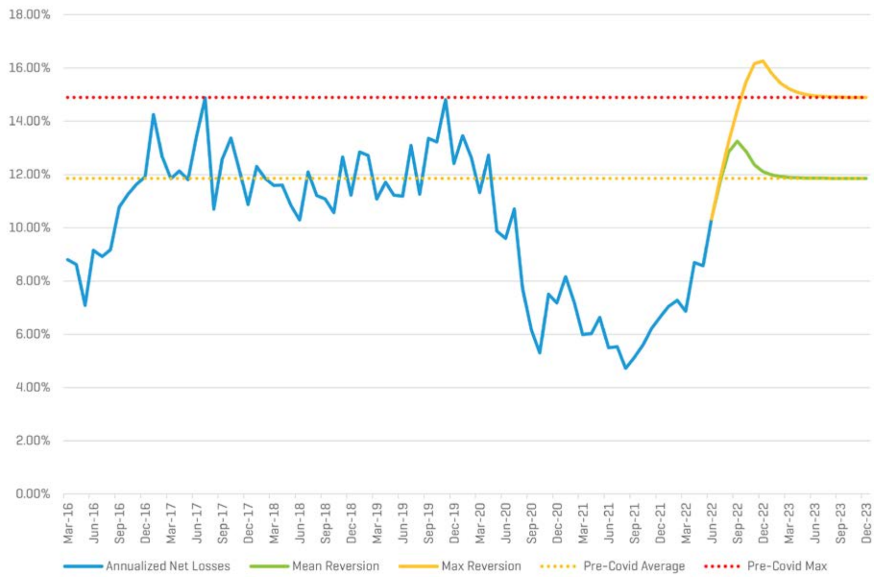


CONSUMER ABS

Delinquencies and cumulative net losses are increasing as one would expect with expiration of stimulus, forbearance, and moratoriums. We should expect deterioration to appear first in lower FICO borrowers. Also, no surprises there.

One perhaps-underappreciated item is whether there will be reversion to the mean for performance based on pre-pandemic FICO scores. Per Experian, average FICO scores crawled up from 699 in 2016 to 702 in 2019, then shot up to 714 in 2021 with the effects of stimulus and a tighter-than-expected labor market. A borrower in the 680-710 FICO range today may have been in the 650-680 range pre-pandemic, and perhaps their loan performance will be closer to the pre-pandemic 650-680 benchmark than the 680-710 benchmark. This means there is a risk that near-prime pools may behave more like subprime pools and subprime pools may behave more like deep subprime. With inflation now outpacing wage gains, the cost of living may also be eating into these borrowers' ability to repay.

FIGURE 6: UNSECURED CONSUMER LOAN POTENTIAL SCENARIOS

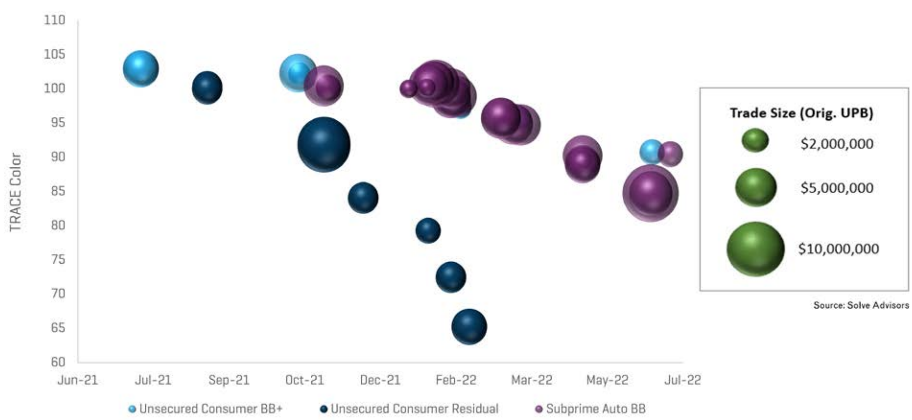


Auto loans are a messy market, with high prices at the pump eating into debt service, but continued high auto prices and tight supply making it that much more disruptive to have a car repossessed, acting as a motivator to keep paying. KBRA tracks non-prime 60+ delinquencies at 4.6% in June 2022 vs. 3.0% in June 2021, higher than any prior June reading. The rise of title loans as an alternative to payday loans in many states may also disrupt the used car market, although generally title loans are unavailable on cars with a conventional auto loan, making it a second-order effect.

Residuals (a.k.a. the equity tranche or first loss position) of securitizations are thinly traded in the secondary market even in the best of times. It is the snow leopard of structured products trading – an elusive creature, you know it's out there because deals are getting done, but issuers often retain these, and once sold to investors, they lack the liquidity. Though recent color indicates that some residuals are being sold at a loss, which would seem to indicate that sellers' loss expectations may have increased.

However, as such risky positions, they are also likely suffering from increased yield bogeys – while unsecured consumer loan residuals don't have the longest duration, they're the longest of the entire deal. Thus, any loss the seller is willing to take is an indication of losses and interest shortfall priced in by a party who knows the collateral behind these bonds well. We have seen residuals and bonds right above the residuals trade at steep discounts, north of 20%. Most of these deals are currently performing to expectations and are still some time away from serious trouble, whether it's significant collateral deterioration or structural triggers that would turbo cash flows to seniors. However, gauging from the trade color on residuals, material loss scenarios are being priced in.

FIGURE 7: UNSECURED CONSUMER / SUBPRIME AUTO SUBS TRACE COLOR



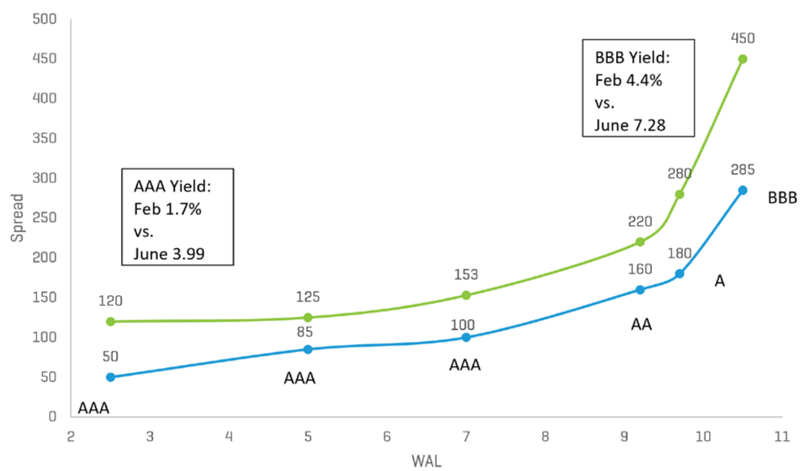
CMBS

CMBS shared the same fate as other sectors: Secondary spreads are near their widest year to date across the capital stack. The primary origination credit curve has shifted higher, and it is steeper into the BBB. June was the second time in two years CMBS delinquencies ticked higher, albeit very slightly. There are many risks for CMBS in the present market, but no two deals are alike, so it's a great time to drill down as much as possible when analyzing CMBS.

Office property should continue to be an area of investigation. We are not so sure how the whole getting-back-to-the-office thing will play out. From the looks of it, most of us are sort of infinitely work-from-home, and we cannot entirely blame COVID at this point.

If this trend persists, what does it mean for office heavy conduit or SASB deals? How much does the remaining term matter? Is the property in a central business district, and if so, can/should it be converted to condos? On a positive note, hospitality seems to be doing OK. Maybe that pent-up demand is lasting a bit longer despite inflation, as TSA figures are basically back to their 2019 levels and may be more constrained by airline capacity than demand.

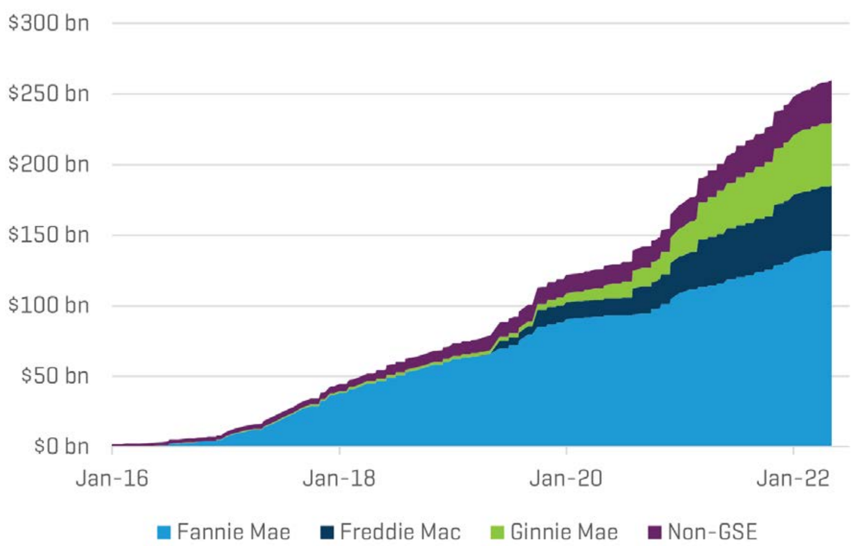
FIGURE 8: CMBS NEW ISSUE CREDIT SPREAD COMPARISON BBCMS 2022-C14 (FEB) VS C16 (JUN)



ESG: A LUXURY IN HARD TIMES OR MORE IMPORTANT THAN EVER?

The real test is now: can you actually make money investing in ESG assets in a stressful market environment? If there were indeed a "greenium" to buy ESG-labeled bonds, how do their returns compare to similar but non-ESG assets? Also, much of what we have seen on the Green MBS front has meant buildings had to be energy efficient, LEED certified, etc., which frankly should probably be standard for new construction. Will these energy efficient buildings actually lower energy costs, and thus become sought after? Time will tell.

FIGURE 9: CUMULATIVE ESG ISSUANCE



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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