COVID-19 Impacts on Non-Agency RMBS and Housing Finance

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The US housing and mortgage markets—the primary culprits blamed for the last global downturn—do not have that dubious distinction this time. But with COVID-19 forcing near total economic shutdown, the crisis has implications for US housing and mortgage-backed securities.

We believe mortgage borrowers will receive significant support in loan servicing during this crisis, leading to substantially fewer foreclosures and less distressed inventory over the course of the cycle. The crisis should reinforce pre-existing trends in the supply of homes (tight and tighter), and long-term demand for single-family housing (high and higher). We believe these dynamics can create positive long-term fundamentals for some—but not all—sectors of the non-agency residential mortgage-backed securities (RMBS) market.

Here is a breakdown of the key points related to the housing and mortgage markets and our assessment of opportunities in non-agency RMBS.

Housing Market

- The housing market is largely frozen. It should remain that way until, at a minimum, government employees are allowed to return to work, and land registries and courthouses reopen.
- Transaction volume should slow dramatically as the country deals with a gradual reopening.
- The CARES Act created a 60-day moratorium on foreclosures effective March 18, and borrowers may seek 180 days of forbearance (and one extension of up to 180 days) for loans insured by Ginnie Mae or purchased by Fannie Mae and Freddie Mac. This should significantly limit the amount of distressed foreclosure supply that will hit the market.

- The lack of distressed supply, and fewer completions from new home builders, will likely exacerbate an already tight inventory picture. This should support home price levels broadly.

Mortgage Market

- The mortgage market is largely frozen, and some corners are substantially broken.
- Servicers, often affiliated with non-bank originators, are enduring a cash flow squeeze as they are forced to advance principle and interest payments to investors and taxes and insurance to escrow with no support from the government or the government-sponsored enterprises (GSEs).
- In addition, warehouse lines at these same entities are under significant pressure. Any loan entering forbearance prior to delivery is subject to a 5%-7% downward pricing adjustment from the GSEs.
- The prime jumbo and non-qualifying mortgage markets are largely closed. The latter likely will not re-open in the same form given the damage done to originators and aggregators as a result of the forced de-leveraging in March.

Securities Market

- **Non-Performing Loans (NPLs):** Most deals have some portion of performing collateral, which may cover senior interest and some amortization. All deals are typically structured with a four-month interest reserve, which will likely be used by certain transactions during some portion of the crisis. Sponsors are private-equity vehicles with a commitment to the underlying equity in the assets.
- **Single-Family Rental Securitization (SFRs):** Most sponsors have the liquidity to ride out a long period of tenant forbearance. Most are not actively forbearing and are waiting to assess the impact of stimulus checks once they hit. Some sponsors have been reporting an uptick in demand from people looking to leave multi-family homes.
- **Reperforming Loans (RPLs):** Transactions are resilient to large delinquency and forbearance spikes. Homes typically have significant equity, removing the moral hazard present in securitizations prior to the global financial crisis.
- **Credit Risk Transfer (CRTs):** GSEs, at the direction of the Federal Home Financing Authority, are highly motivated to keep borrowers in their homes. The new payment deferral program will help keep people in their homes, creating opportunity higher in the capital structure, at the expense of unrated and first-loss securities.
- **Valuations:** The table on the following page shows how dramatic the move has been in sectors that we believe currently offer value. Given the rally that the Federal Reserve's intervention has driven in many other risk assets, we believe these levels could look very attractive for value-based investors with a long-term horizon.

SECTOR	SECURITY	AS MULTIPLE	ABSOLUTE MOVE	AS OF 4/24/2020	AS OF 12/27/2019
Non-Performing and Reperforming Loans	Unrated Seniors	4.76x	719	910	191
	AAA Seniors	2.42x	132	225	93
	Single A Mezzanine	2.59x	230	375	145
CRT	BB/B Mezzanine	3.25x	433	625	193
Single Family Rental	AAA	2.17x	108	200	92
	BBB	2.67x	250	400	150
Corporate Bonds	Juli Single A	1.92x	89	186	97
	Juli BBB	1.90x	142	299	157
	JPM HY BB	2.48x	370	620	250

Source: Wells Fargo, JP Morgan, Loomis Sayles.

Conclusion

The non-agency RMBS market is not immune to the consequences of the current health crisis and the psychological impacts on the American consumer. Unlike the last crisis, however, the sector entered this period of stress on significantly better footing, with stronger structural protections and a less leveraged consumer. In addition, while the current crisis may fundamentally alter certain industries and some portions of the economy, we believe the housing market and the demand for shelter will remain resilient throughout these shifts. In our view, investors with a long-term outlook have an opportunity to participate at historically attractive levels in a sector distinctly positioned to weather the storm buffeting so many parts of the US economy.

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Exp. 4/30/21
LSWP169-0420

MALR025379