Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

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In-Focus Look at Non-Agency CMBS

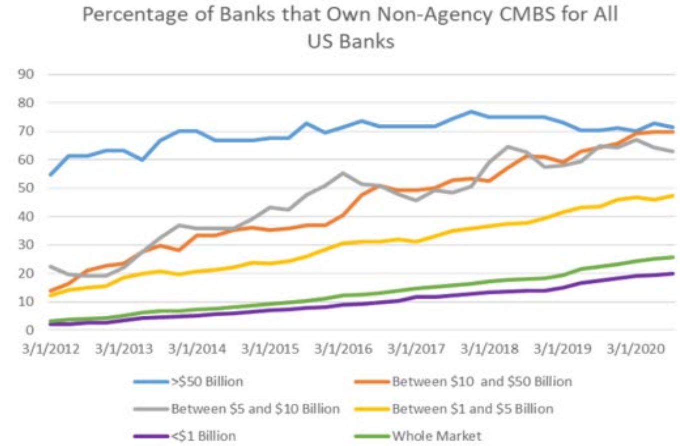
Please see this week's ***Rate Sheet*** *and* ***Yield Curve Opportunities****.*

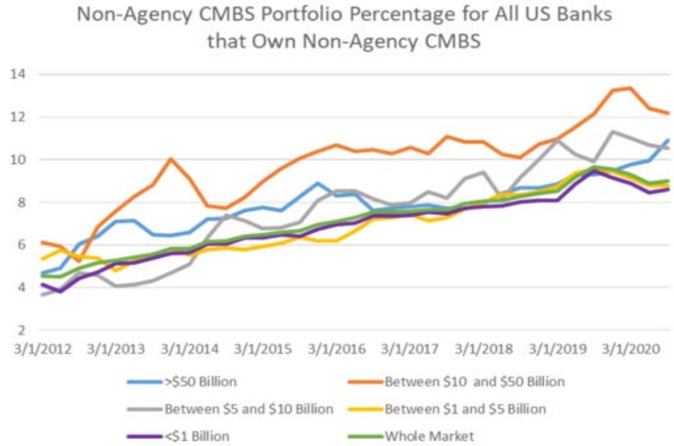
Depositories are still facing a dearth of credit risk on the balance sheet, along with excess liquidity that feels more permanent as each month goes by. Now that the 10yr UST yield has essentially doubled since year-end, we are seeing institutions beginning to feel more comfortable employing many of the extension strategies we outlined in a BSI from earlier in the year.

The conundrum fixed income investors currently face is one of sector allocation. We can go capture the term premium on bullet-like fixed-rate assets, but are we being compensated for credit risk, or selling optionality? Given most high-grade asset classes are at, or near, all-time low spreads, the argument for allocating capital into spread products is not overly enticing when we could simply buy a US Treasury note.

This week we take a dive into one of the values we see in fixed income markets: non-agency CMBS. Outside of a relative value conversation, we will also provide a high-level overview of the structure and collateral backing these deals, as well as pertinent investor considerations. In terms of the collateral, investors should think of this asset class like they would a Fannie DUS, or a Freddie K certificate; the main differences being the underlying properties backing non-agency deals tend to look like “trophy” properties (CBD office property, hotel, apartment, etc.), and since there is no agency backing the credit risk, these bonds have a “top-down” waterfall structure for principal pay-downs and a “bottom-up” structure to create credit enhancement. Non-agency CMBS deals predominantly take two forms: SASB, which stands for single-asset/single-borrower; and Conduit, which are multiple loans pooled together from a number of borrowers to diversify concentration risk (think Freddie K vs FN DUS). The loans themselves have fairly defined principal repayment terms and generally have some form of call protection (i.e., defeasance or yield maintenance).

Bank sponsorship in this sector has increased markedly as the industry has gained confidence in the new risk retention rules for securitizations and the credit enhancement via structural protection and lower LTVs on the properties. In the figure below, we see banks increased their allocation to CMBS despite loan growth firing on all cylinders. . Credit quality is also of the utmost importance. A large driver of bank’s confort in increased buying has been that AAA bonds have not taken a single dollar of principal loss post-financial crisis.





Source: Piper Sandler Fixed Income trading desk

NA CMBS Losses by Rating and Vintage

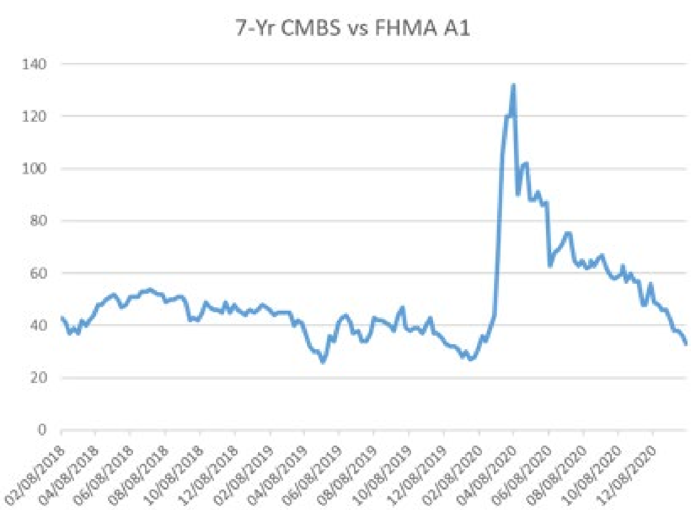
- AAA Tranches have not taken a loss
- Structural changes post-crisis protect bondholders

	AAA (30%)	AAA (20%)	AA	A
2000	0%	0%	0%	0%
2001	0%	0%	0%	0%
2002	0%	0%	0%	0%
2003	0%	0%	0%	0%
2004	0%	0%	1%	7%
2005	0%	0%	8%	22%
2006	0%	0%	37%	69%
2007	0%	0%	56%	75%
2008	0%	6%	66%	77%

	AAA (30%)	AAA (20%)	AA	A
2010	0%	0%	0%	0%
2011	0%	0%	0%	0%
2012	0%	0%	0%	0%
2013	0%	0%	0%	0%
2014	0%	0%	0%	0%
2015	0%	0%	0%	0%
2016	0%	0%	0%	0%
2017	0%	0%	0%	0%
2018	0%	0%	0%	0%

Source: Piper Sandler Fixed Income trading desk

The relative value discussion of CMBS is equally important when making an investment decision. As we mentioned earlier, this is one of very few asset classes that pick up spread without selling a lot of optionality. So the question is: are we being paid for the credit risk relative to other sectors? In general, 7 year AAA LCFs are trading somewhere between 68-73 bps over Treasuries, depending on whether the deal in question is a conduit or SASB deal. The next best value, in our opinion, would be taxable munis. 7yr AA taxable munis yield ~70bps over Treasuries. The spread is similar, but the bonds are rated one notch lower, and taxable muni issuance is still relatively sparse, making it hard to put cash to work quickly and efficiently. The other obvious comparison would be to Agency CMBS. Spreads in the sector are near all-time tights. Despite the spreads on AAA non-agency CMBS over Freddie K tightening in, we still think there's enough spread pickup to an agency alternative that makes this asset class worth considering...



Source: Piper Sandler Fixed Income trading desk

Adapting it for the Balance Sheet

As we've mentioned previously regarding a few other assets we've presented, these sectors may make sense as options for financial institutions looking to deploy excess liquidity, while they wait for loan growth to pick up. They also make good reinvestments in transactions that require the institution to take a loss. Selling low performers, whether yield, credit, or prepay offenders, and reinvesting into higher-yielding longer bonds remains a proactive way that institutions are using this yield curve to emerge with a better structured investment portfolio. For an institution that truly understands the credit and structure they're investing in, CMBS is one of the few pockets of value left. If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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