- As reported in an earlier research note (Review of Fed Tightening Cycles) and highlighted in Figure 1, Fed Fund Rate increases observed during prior monetary tightening cycles averaged ~ 2.9% and subsequently resulted in a ~3% rise in unemployment.
- Given this empirical evidence, significant volatility in equity and credit markets ensued in the first half of 2022, as Federal Reserve increased rates by a combined 225bps and started to reduce the balance sheet by imposing caps on reinvested Treasury and MBS securities.
- By some estimates, U.S. economy could have already experienced some job losses. On the contrary, approximately 3.2 million jobs have been created since the Fed tightening cycle began in March 2022. (Figure 2)
- Most industries have recovered the vast majority of job losses occurred during the Pandemic related Recession. (Figure 3)
- Persistent nominal wage growth has provided a sound foundation for strong housing credit performance. (Figure 4)

Figure 1: Fed Funds Rate and Unemployment Rate.

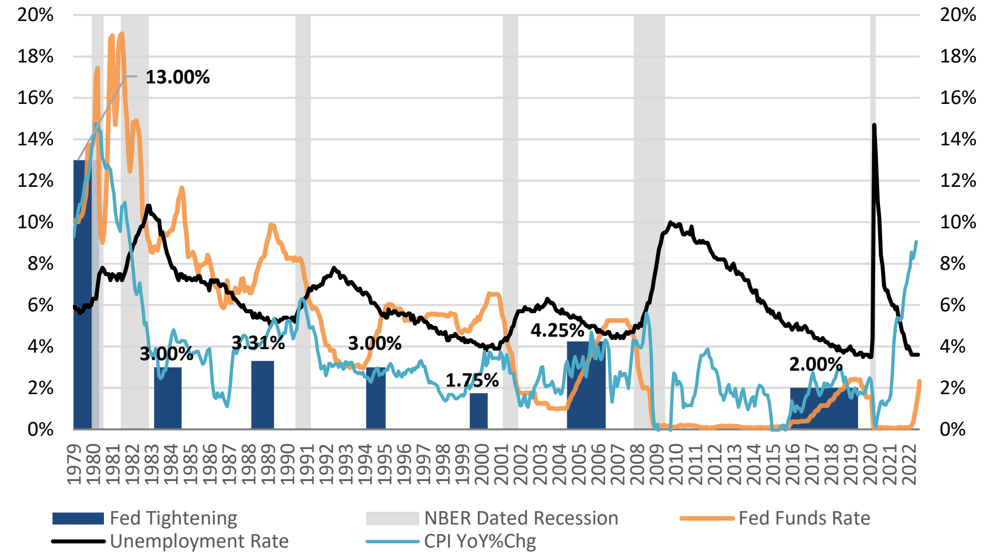


Figure 2:

Number of Jobs (000s) added YTD July 2022

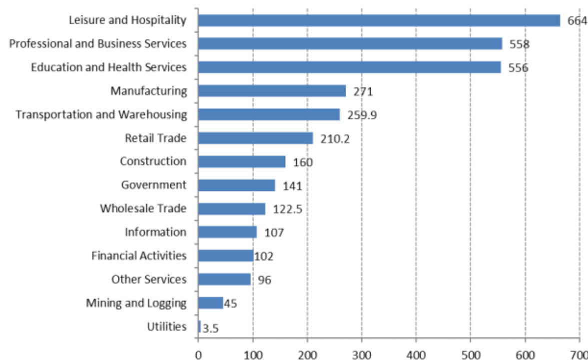


Figure 3:

Number of Jobs (000s) added/Lost in Mar2020-Jul2022

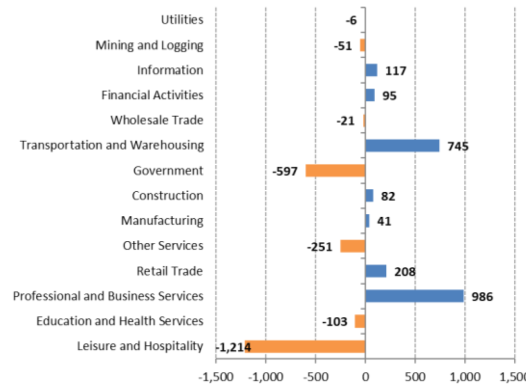
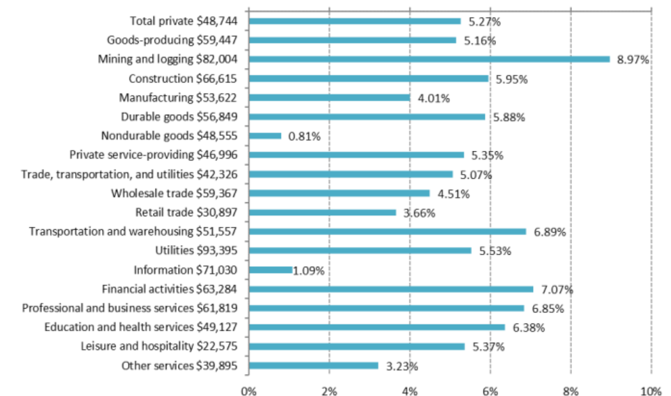


Figure 4:

Est.Annual Earnings and YoY%Chg by Industry Sector - July 2022



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Source: Bureau of Labor Statistics, Falcon Bridge Capital.

1. Tight underwriting and proportion of borrowers with high FICO scores has remained consistent post-GFC. (Figure 5)
2. Underlying fundamentals in mortgage credit performance continue to improve with significant build-up in owner equity. (Figure 6)
3. Substantial improvement in CRT reference loan pools' serious delinquencies (90+ days) across the U.S. (Figure 7) is also a reflection of available delinquency work-out options (including payment forbearance, payment deferral and loan modification) and persistent strength of the labor market.

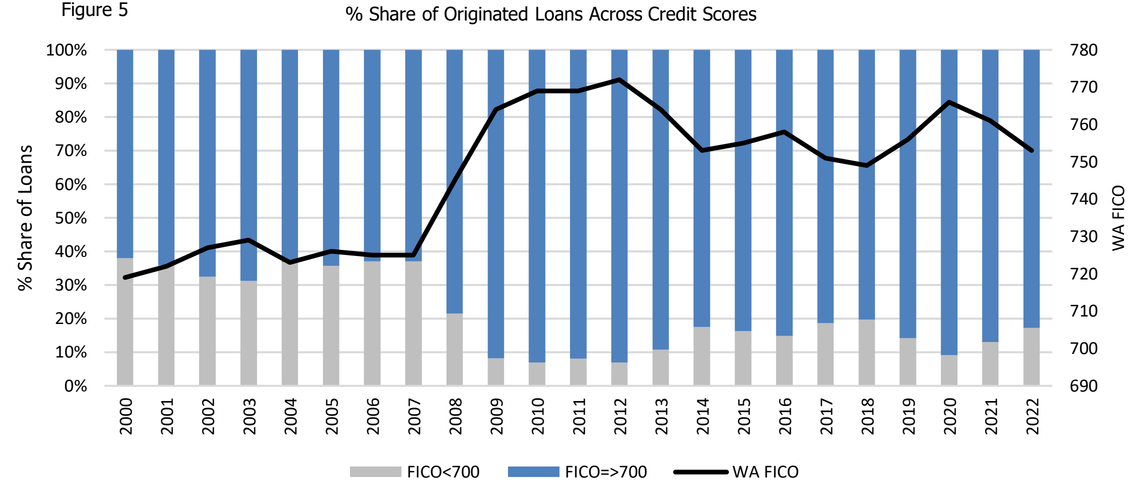


Figure 6 Current Equity by Origination Vintage, [Freddie Mac High and Low LTV Deal]

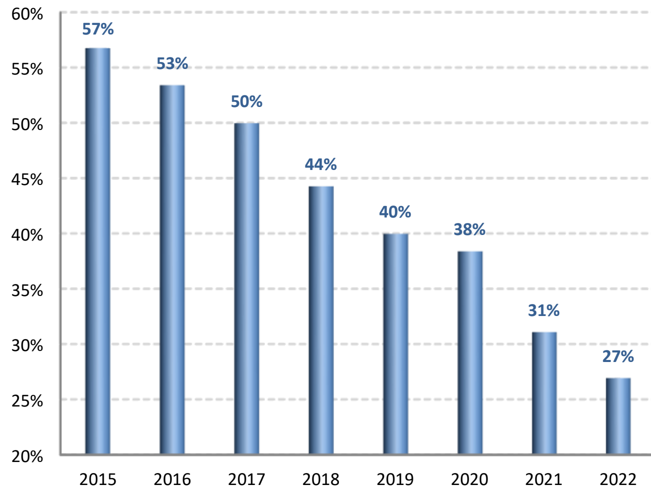
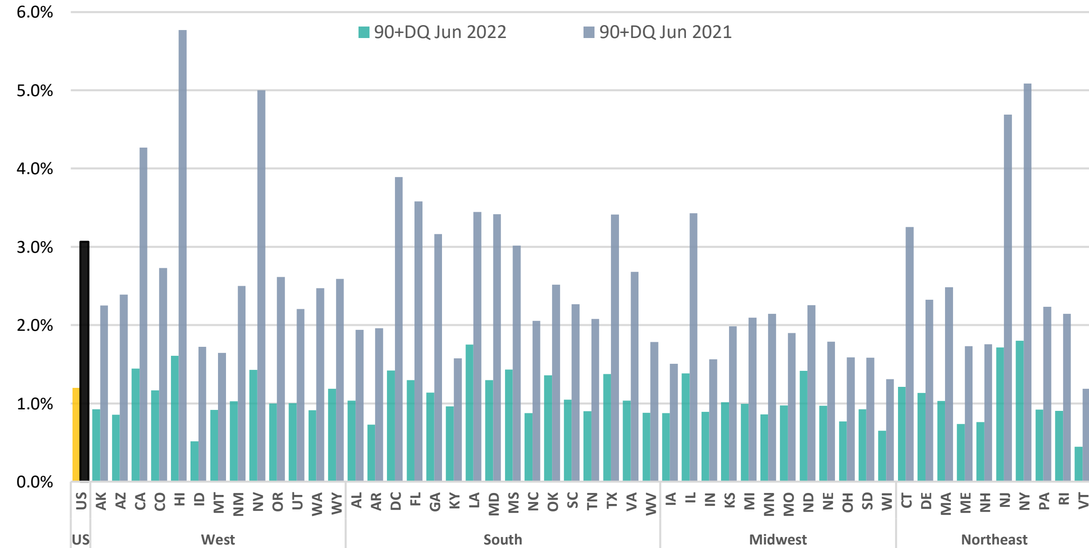


Figure 7 90+ Serious Delinquencies Declining Across All Geographies



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Source: 1010Data, Falcon Bridge Capital. Note: 90+DQ data based on STACR deals issued in 2013-2020.

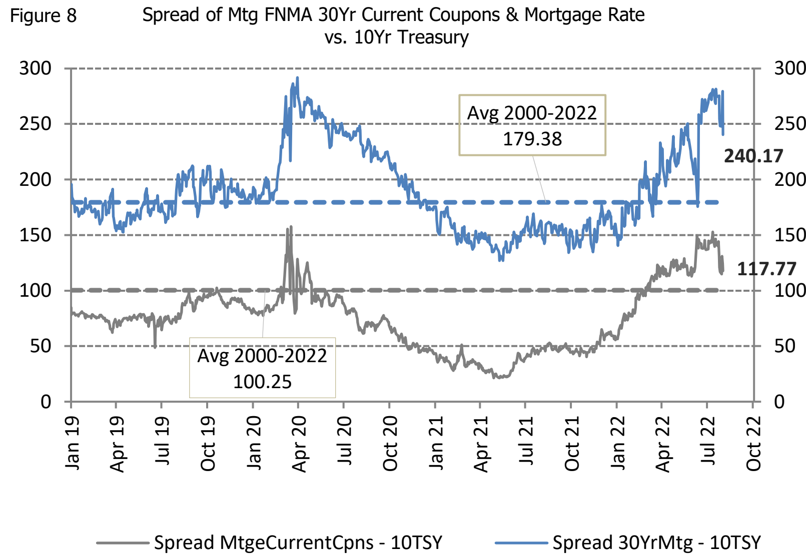
1. Primary mortgage rates have declined since June by approximately 50bps - 75bps, with Conventional rates levelling off at 5.0% for an average borrower.

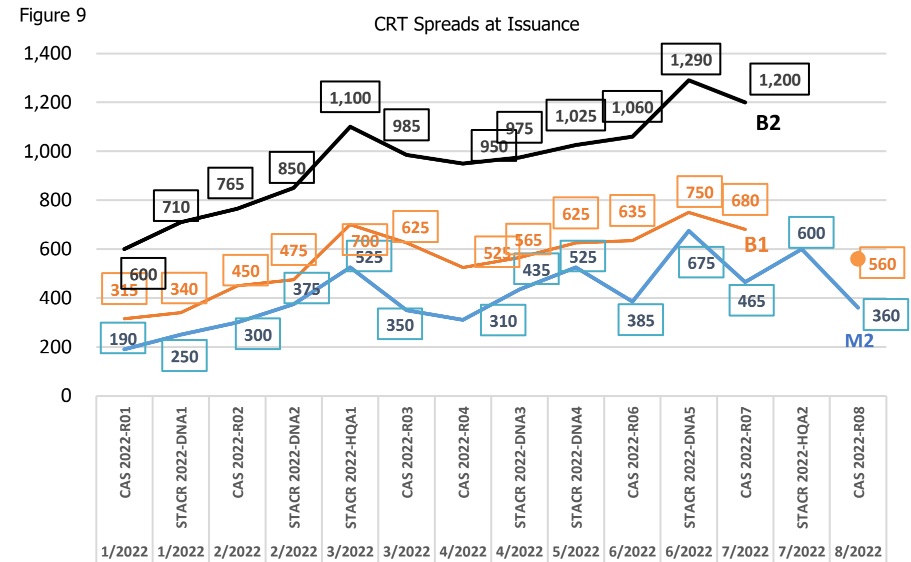
2. Mortgage Basis: MBS Primary Coupon vs. 10yr Treasury remained rangebound after a better-than-expected unemployment report. Furthermore, spread between the Primary rate and 10yr Treasury started to revert to long-term norms, as concerns related to Fed's aggressive sale of the MBS portfolio eased. (Figure 8 below)

3. **CRT Spreads tightened (Figure 9) in response to Fannie Mae and Freddie Mac's recent announcement that they would slowdown the pace of CRT issuance, and specifically, B1 and B2 tranches. Spread tightening that begun in July has continued into early Aug, stabilizing volatility across CRT tranches.**

4. Despite recent spread tightening, CRT continues to offer very attractive relative value across securitized product as easing concerns of a deep recession have resulted in a significant rally across other credit sectors. 5yr CDX HY Spread tightened 125bps since the widest levels reached in mid-June.

5. Affordability headwinds are likely to significantly slow down the pace of home price growth and potentially lead to mild price corrections in select areas over the next few years but are not expected to negatively affect defaults or losses in CRT reference pools given the strength of the underlying borrower, tight underwriting standards and effective loss mitigation.



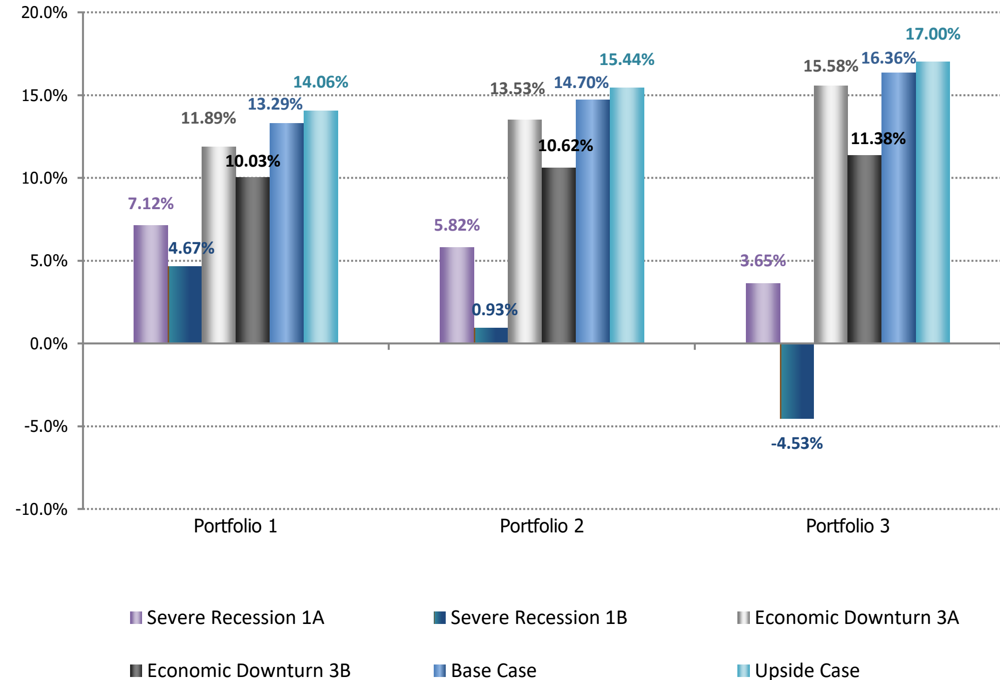


Source: Bloomberg, Falcon Bridge Capital. Note: CAS and STACR Structure differences contribute to the variance in DM levels.

Key Themes:

1. U.S. Housing Agencies' mandate from Congress in 2012 to transfer credit risk from their portfolios to private capital investors is creating a unique opportunity to reinsure Fannie Mae and Freddie Mac (Government Sponsored Agencies, "GSEs").[1]
2. Post-crisis tight underwriting has contributed to a strong housing environment allowing investors to re-insure GSEs at attractive risk-adjusted returns. Underwriting and origination processes have substantially mitigated defect and underwriting risk resulting in potential outsized returns on investment strategy.
3. Floating rate structure remains very attractive, given the potential of higher short-term rates in the near-term. 100% of the CRT sector is floating rate.

1. Active Secondary market for securities allows investors to gain exposure in the U.S. Housing credit on a large scale.
2. Recent market volatility is creating an attractive entry point ***relative to other sectors of fixed income and structured products.***



Source: FNMA, FHLMC, FBC. Bond prices assumed as of August 5th, 2022. Projections based on modeling assumptions by Manager. Detailed presentation and scenario assumptions available on request.

Notes: Scenario 3A assumes all bonds Held-to-Call; typically, 5 years.

- Projections assume 30-Day SOFR @ 3.50% by year-end 2022.
- Portfolios 1 through 3 have differing allocations across CRT tranches and their expected returns adjusted for loss projections. **Please see detailed discussion in accompanying presentation.**

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08.2022