Impact of RMBS spread widening on GCI

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Will the expected widening in senior RMBS credit spreads impact the core objectives of GCI?

The short answer is no.

GCI's investment objective is to produce regular and sustainable monthly income while safeguarding your capital. For some time now, Gryphon has been tactically positioning all portfolios (including GCI) with a strong defensive bias, in anticipation of a weaker investment environment. Although this weakening should result in the softening of credit spreads in the GCI investment universe, our analysis indicates that this softening will not have a material impact on GCI continuing to deliver on its core objectives.

We detail why below:

Background

There are several inter-connected factors which will likely result in a widening of senior AAA RMBS credit spreads from the post GFC historical tights we see today. These considerations include:

- APRA phasing out reliance on the Committed Liquidity Facility (CLF)
- ADIs having to repay the Term Funding Facility (TFF) (cheap 3-year funding provided by the RBA during the peak COVID period)
- ADIs having to issue senior unsecured debt to buy Govt Bonds to replace the CLF and to repay the TFF.

These considerations will have the following impact:

1. Reduce domestic bank investment demand for senior unsecured bank debt and Senior AAA RMBS
2. A projected material increase in the issuance of senior unsecured debt of circ $150–$175bn p.a. over the next few years.

Despite the fact that global investor demand for Australian bank debt remains robust, this material increase in debt issuance is likely to result in a widening of the credit spreads on the banks senior unsecured debt (i.e. simply put a supply / demand imbalance). Given that the AAA RMBS market is priced relative to bank senior unsecured debt, a widening on the banks senior unsecured programs should lead to a corresponding widening in AAA RMBS spreads.

Potential implications of widening of AAA RMBS credit spreads

1. ***Will a widening in AAA RMBS credit spreads result in spread widening across the RMBS capital structure i.e. non-AAA RMBS credit spreads?***

We have witnessed, almost universally, a compression in market risk premia since the onset of the pandemic crisis due to the abundant amount of liquidity pumped into the global financial system. This has led to RMBS spread levels tightening to levels not seen since pre-GFC historical lows, which is largely why the GCI NTA has increased above $2.00 per unit to current NTA of circ $2.03.

As stated earlier, the probable scenario of senior AAA spreads softening from these post GFC tights, has been incorporated into our decision making and portfolio positioning for some time now, with the expectation that a knock-on effect will also arise in the mezzanine part of the RMBS capital structure (which forms most of GCI's investment universe). Perhaps counter-intuitively, this disruption to the recent spread tightening norm will actually enhance GCI's prospects as it allows us to derive better risk adjusted returns because of our current portfolio positioning and deep knowledge advantage. You may recall how we used the market dislocations at the onset of the pandemic to reduce the risk and increase the yield of the GCI portfolio, as we took advantage of generalist investors exiting the sector.

2. ***If non-senior RMBS spreads widen, what are the implications for GCI?***

No impact on GCI's core objectives including sustainable income and the preservation of capital. In the event of RMBS spreads widening, we would normally expect a softening of GCI's NTA back towards its issued capital of circ $2.00 (from $2.03 currently). However, as a specialist investor there are several levers the team can employ to defend the GCI NTA.

One such lever/technique is finding those investments where the probability of a rating upgrade is skewed to the positive, something we have been actively doing.

Gryphon is in the business of constructing portfolios assuming the worst. As mentioned previously, the run up in the GCI NTA coupled with an unusual amount of liquidity engulfing the RMBS market has allowed the team to successfully rotate into those investments which are more defensive and therefore should insulate the portfolio from any 1st order shocks. We classify any liquidity driven AAA RMBS spread widening as a 1st order shock. Put into context, the current portfolio average maturity duration of just 1.15yrs provides protection against material downward movement in the NTA.

3. ***Are widening credit spreads a leading indicator that the credit quality of the investment is deteriorating or has the potential to deteriorate?***

Absolutely not. This is an external market factor unrelated to fundamental mortgage credit so there are no such credit alarm bells in the Australian RMBS & ABS market. In fact, the Gryphon team has rarely seen the RMBS & ABS market as robust as it is today. Mortgage rates are low and house prices have risen materially. This means borrower affordability is strong and the security package (the house) is even stronger. Our analysis reaffirms this and the stability of the Australian Mortgage market.

Overall, despite some concerns creeping into the liquidity segment of the AAA RMBS market, we don't hold any fear that the risk return equation is going to deteriorate for our investors. Quite the contrary, it will promote more opportunity to deliver on the GCI objectives.

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