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INSIGHT

MONTHLY COMMENTARY

January Agency MBS Update

STEPHEN K. LEECH | 5 FEBRUARY 2019

Agency MBS performance shot out of the gate quickly in the New Year and posted positive relative and absolute performance to open 2019. A dovish pivot by the Federal Reserve in December buoyed global risk markets, reducing concern that tightening monetary policy would spell the final chapter of the decade-long post-financial crisis bull market. A perceived lowering of global trade tensions further benefitted risk market valuations, with market participants judging that progress is being made in trade negotiations between China and the United States. While the United Kingdom's attempt to leave the European Union continues to pose some risk to global markets, because the ultimate result remains very much in doubt, the headwind was not enough to disrupt the positive tenor worldwide. The result was agency MBS sailing into positive territory on the back of the strong tailwinds. Further benefitting agency MBS investors, interest rate volatility dropped markedly in the month of January. With U.S. Treasuries staying in a tight range, agency MBS received the benefits of reduced volatility in concert with rising global risk market valuations. The Federal Reserve reiterated at the end of the month that it does not plan to adjust its balance sheet in the near term. After the release of minutes of the FOMC's December meeting stoked fear that the Fed might actually sell some of their MBS holdings at some point, any action on this front now appears slightly farther off, benefitting agency MBS collateral. While the market is awaiting a slew of regulatory actions and decisions that may have far reaching effects on both the structure and valuations in the agency MBS universe, for now powerful tailwinds on agency MBS performance were enough to propel both relative and absolute valuations into positive territory. The Bloomberg Barclays MBS Index ended January strongly, posting positive excess returns of 32 basis points (bps) relative to benchmark U.S. Treasuries, with total returns coming in at positive 79 bps in the month.

Coupon stack performance was generally positive across the board in January, however both the lowest and highest coupons slightly outflanked production coupon MBS. In Fannie Mae 30 yr (FNCL) collateral, FNCL 3s were the strongest performing coupon, posting excess returns of 40 bps relative to benchmark U.S. Treasuries. FNCL 3s benefitted from the Federal Reserve putting interest rate increases on hold,

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reducing the risk that increasing interest rates would cause the coupon to become a deep discount coupon with no production going forward. FNCL 3.5s and 4s were the laggards in January, posting excess returns of 25 bps each. Interestingly, higher coupons did slightly better, with FNCL 4.5s and 5s coming in up 32 bps and 34 bps respectively. The story was similar in Ginnie Mae MBS. 30 yr (G2SF) 3s led the charge, coming in at positive 50 bps on the month. Higher coupon Ginnie Mae MBS performed admirably as well. G2SF 4.5s and 5s posted excess returns of 31 bps and 44 bps respectively. Higher coupon G2SF benefitted from continuing efforts by regulators to reduce prepayment speeds on up-in-coupon Ginnie Mae collateral. The servicer loanDepot was suspended from Ginnie multi-pooling for six months, after Ginnie Mae determined that its prepayment speeds were coming in faster than tolerance levels. The removal of loanDepot at the end of the month marked the first servicer to be removed since former Ginnie Mae President Michael Bright stepped down, and shows that Ginnie Mae will continue to punish servicers they believe are churning loans. While there is some reason to doubt the efficacy of the particular tactic, the show of force from Ginnie Mae benefitted higher coupon performance because investors can take solace that efforts are being made to reduce prepayments speeds in the collateral. Overall, intra coupon stack performance remained relatively muted, with minimal changes in interest rates and a market that is awaiting information on a host of regulatory issues holding much of the relative performance in check.

GSE Reform Update

Among the many regulatory issues before the market is the fate of the two GSEs. Fannie Mae and Freddie Mac have been under government conservatorship since the financial crisis of 2008. In that time, market participants often wondered whether any long-term resolution would be reached, however little to no progress has been made. Thus, when the acting director of the Federal Housing Finance Agency (FHFA) gave a speech stating that the Trump administration was going to release a plan to take the two GSEs out of conservatorship in the near term and most likely without the aid of Congress, a litany of questions was raised. Days later, the Trump administration suggested it will also attempt to work with Congress on a legislative resolution to the decade-long drama over the GSE's fate. However, what the solution looks like remains very much in the air given the large-scale ramifications of any changes. The major question the administration must tackle is how to re-capitalize the two entities, each of which has only $3bn of its own capital to draw from and is required to sweep all profits to the U.S. Treasury as part of the revised 2012 agreement with the FHFA. Allowing them to retain their own earnings would be a start, however, it is estimated they need to hold between $150bn and $200bn against potential insurance losses. So merely allowing the two entities to raise capital by themselves will not enable them to come out of conservatorship quickly, which is the administration's preference. Therefore, the administration may need to continue to extend the $200bn credit line from the U.S. Treasury. This would enable the entities to operate without the necessary capital buffer until retained earnings can be accumulated. Given that this may be possible without Congressional authorization, a regulatory action of this type is a distinct possibility in the coming months.

The prospect of Fannie Mae and Freddie Mac coming out of conservatorship raises the question of what a large scale GSE reform would entail for the market. If the entities are simply spun out and allowed to retain capital without any other changes, the result would most likely be slightly positive for Ginnie Mae collateral on a relative basis. The market reaction would likely be muted though because the implicit guarantee of Fannie Mae and Freddie Mac borders on explicit in the aftermath of the financial crisis where neither entity was allowed to fail. Therefore, spinning the GSEs out with minimal other changes would likely draw only a small market reaction. The more important change would come if Congress altered the nature of the guarantee entirely. The various options include, removing the implicit guarantee of the two GSEs, explicitly guaranteeing securities issued by both entities, or doing something in between. The first scenario seems incredibly unlikely due to the litany of problems it would create, and the very low appetite of Congress to make home loans far more expensive for millions of Americans. Either explicitly guaranteeing GSE MBS or just having Ginnie Mae wrap all the securities of the GSEs to create the same effect is an actual possibility. However, both guarantee proposals would almost certainly require that the divided Congress agree to add a lot of risk to the government balance sheet, which would be a tough hill to climb politically. Finally, Congress could come up with some in-between solution that allows either some or all the

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securities to be government guaranteed through a higher loan rate, or by investors paying for an outright guarantee on any securities the investor holds. While both have their potential pitfalls, it is possible that if Congress chooses to finally tackle GSE Reform in the next year or two, some type of guarantee change could occur. Thus investors will need to remain vigilant, because an alteration of this type could significantly affect the valuations of both Ginnie Mae and GSE collateral, providing little warning before markets react and adjust.

UMBS Update

The regulatory stories that dominated January were not limited to changing Fed policy and GSE reform percolating once again. The coming of UMBS continues to be on the forefront of agency MBS investors' minds. UMBS is the plan to replace the TBA of Fannie Mae and Freddie Mac with a single TBA contract going forward. The first UMBS delivery date is slated for June of this year. However, the TBA is far from the only part of the market impacted. Changing the payment delay of Freddie Mac from 45 to 55 days requires all new securities with Fannie Mae tickers to be issued for every Freddie Mac pool in existence. Investors will also have the option of converting from legacy Freddie Mac 45 day pools to the 55 day Freddie Mac securities that will have Fannie Mae tickers and a fee that makes the value even. Furthermore, investors will be able to create SUPERs, securities containing collateral issued by either or both GSEs. The stated purpose of this entire endeavor is to increase market liquidity. Secondarily, there are undertones that GSE reform may be easier once the two GSEs are more homogeneous. To that end, making the GSEs mutually deliverable requires their prepayment speeds to match in all cohorts, making it impossible for the two GSEs to compete with each other on price, which was the original purpose of having two separate GSEs rather than just Fannie Mae. Unfortunately, the FHFA has still not finalized the rule regarding how the FHFA will keep two competing entities from having divergent prepayment speeds. The FHFA also has not given guidance on how the two GSEs cross guaranteeing the collateral of the other through SUPERs will work, especially if they are out of conservatorship and back to attempting to compete and maximize profits. These and a myriad of other questions remain, as the entire industry attempts to prep for a change that it is between mildly and strongly opposed to. How the FHFA and market participants choose to prepare for the coming changes, with just four months until implementation, will be biggest logistical hurdle the market has to clear in the first half of 2019. Furthermore, the market will be seeking clarity and answers sooner rather than later, given the shockingly short runway for this initiative to get airborne and the litany of questions that still need to be answered before implementation.

Coupon Stack Performance

30 Yr FNMA	January Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	January Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$98.23	0.74	0.40	16.4	-3.6
3.5	$100.50	0.60	0.25	20.4	-2.9
4.0	$102.37	0.51	0.25	25.3	-4.2
4.5	$103.91	0.47	0.32	47.5	-6.3
5.0	$105.18	0.55	0.34	79.2	-9.8
5.5	$106.21	0.73	0.24	115.9	-9.7
6.0	$107.70	0.25	-0.02	134.7	2.4
15 Yr FNMA					
2.5	$98.41	0.75	0.38	9.8	-9.4
3.0	$100.14	0.39	0.10	10.3	-2.7
3.5	$101.85	0.67	0.37	14.9	-10.9
4.0	$102.86	0.55	0.36	17.2	-17.8
4.5	$101.77	0.13	0.32	106.9	11.0
5.0	$101.58	0.03	0.00	142.3	8.2
5.5	$101.58	0.28	0.00	90.2	3.4

Source: TCW, Bloomberg Barclays

Benchmark Performance

	January Month End Price	January Month End Yield	December Month End Yield	Change (bps)
2 Yr Treasury	$100.08	2.46%	2.49%	-3.02
5 Yr Treasury	$100.29	2.44%	2.51%	-7.46
10 Yr Treasury	$104.24	2.63%	2.68%	-5.49
30 Yr Treasury	$107.43	3.00%	3.01%	-1.89
2/10 Curve		16.96	19.23	-2.27
2 Yr SWAP Spread		14.88	16.50	-1.63
10 Yr SWAP Spread		2.75	2.75	0.00
1y*10y Swaption Vol		60.80	69.86	-9.06
5y*10y Swaption Vol		69.41	74.03	-4.62

Source: TCW, Bloomberg

Issuer Performance (ticks)

	January GNMAII/FNMA	Monthly Price Change	January GOLD/FNMA	Monthly Price Change
3.0	32.00	2.50	1.25	1.75
3.5	23.75	0.50	1.50	2.25
4.0	16.00	0.75	1.38	1.88
4.5	-4.00	-1.25	1.63	3.38
5.0	-25.00	-2.25	-1.00	1.25
5.5	-32.00	8.00	-8.00	-8.63

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	Jan 31, 2019	Dec 31, 2018	Dec 29, 2017
FN 3% LLB	10	10	17
FN 3% MLB	8	7	13
FN 3% HLB	6	6	10
FN 3% 125 LTV	20	20	-8
FN 3.5% LLB	19	17	32
FN 3.5% MLB	15	13	27
FN 3.5% HLB	11	10	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	39	36	61
FN 4% MLB	32	30	52
FN 4% HLB	26	22	42
FN 4% 125 LTV	18	18	24
FN 4.5% LLB	69	58	97
FN 4.5% MLB	59	51	81
FN 4.5% HLB	52	41	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

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