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INSIGHT

MONTHLY COMMENTARY

February Agency MBS Update

STEPHEN K. LEECH | MARCH 2, 2017

The shortest month of the year also proved to be a quiet one, as the agency MBS market treaded water amid a dynamic market landscape. Concern that a new administration and a more hawkish Federal Reserve might be negative developments for agency MBS investors sent the agency MBS basis wider in January. However, in February, the script did not repeat itself as agency MBS valuations were slightly improved. The stock market continued its steady upward march, benefitting from an above expectations employment report and strong retail sales print which signaled the U.S. economy might be beginning to pick up extra momentum. The above expectations data in the U.S. has raised the possibility that the Fed will hike interest rates in March, with the market pricing in an over 50% chance of an interest rate hike at month end. The path of interest rate hikes will impact the timing of the Fed's anticipated reinvestment taper, but anxious MBS investors received little clarity in February. The FOMC's plans remain nebulous despite Chairwoman Yellen giving semi-annual testimony to Congress as well as multiple speeches from committee members. Further complicating matters, The U.S. Treasury Curve flattened despite rising inflation data. Parsing through the data left agency MBS close to unchanged in February, as a late positive move took relative returns ever so slightly into positive territory for the month. In aggregate, the Barclays MBS Index posted positive results of 3 basis points (bps) of excess returns in February relative to benchmark U.S. Treasuries, bringing year to date performance to -21bps.

Positioning in the coupon stack remained fairly close to home in February, as agency MBS market participants did not receive news that significantly altered the intra-sector picture. In the 30yr space, Fannie Mae 30yr (FNCL) 3s and 4.5s saw a touch of underperformance, while FNCL 3.5s and 4s outperformed their U.S. Treasury hedges. Given the return of a move toward slightly lower overall interest rates in February, the outcome was not too surprising to the market. Shorter duration assets had a bad month overall, hindering valuations among higher coupons, with FNCL 4.5s coming in at -14bps relative to benchmark U.S. Treasuries. FNCL 3s and 3.5s posted positive excess performance. This was due in part to a powerful slowdown of prepayment speeds that was less pronounced in higher coupons. Ginnie Mae performance was roughly in line with conventional collateral in February. The G2/FN 3.5 swap appreciated one tick during the month, with the late-month interest rate rally taking back a few ticks of outperformance. In aggregate however, G2SF collateral slightly underperformed conventional MBS, posting -1bp in excess outperformance relative to U.S. Treasuries. Shorter 15yr collateral also saw a small amount of outperformance, with shorter duration assets struggling relative to 30yr MBS in aggregate, but managing to post positive excess performance nonetheless. Going forward, we expect the evolving market landscape and new prepayment picture to shape coupon stack performance.

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Mr. Leech joined the TCW Fixed Income group in 2015 as an analyst specializing in Agency mortgage-backed securities. Prior to joining TCW, Mr. Leech was an Analyst at The Royal Bank of Scotland. At RBS, Mr. Leech concentrated on investment grade credit. He focused on credit research. He also worked with clients in executing corporate bond trades. Prior to that, Mr. Leech worked in the Debt Capital Markets Group at RBS. He worked as part of a team charged with bringing new issue corporate bond offerings. Mr. Leech holds a BBA from the Goizueta Business School at Emory University.

The much anticipated prepayment report from January was released at the beginning of the month, finally giving the market a look at what the new speed outlook will portend. The result was 30yr collateral dropping 31% overall, with FNCL 3s slowing down 35% and FNCL 3.5s dropping a hearty 39% month over month. FNCL 4s dropped from 21.5 CPR to 14.5 CPR, demonstrating the powerful effect that 30yr mortgage rates rising 40bps had on underlying speeds across the sector. The prepayment declines were most pronounced in production coupons, with higher coupons slowing far less than their production counterparts. FNCL 5s dropped 16%, while FNCL 6 coupon speeds fell a mere 7% due to burnout. The declines were also less pronounced in 15yr mortgages, where on the whole prepayments dropped 22%. The speed declines in aggregate were primarily driven by the higher interest rates from the later part of 2016, and were aided by a declining day count and lower seasonal factors. While the factors present will consistently return and raise speeds mildly, the new prepayment reality is not due to change meaningfully with interest rates on loans close to unchanged since December. The resulting prepayment picture provides some meaningful support to a sector that is plagued by increased uncertainty on a number of fronts. Going forward, as long as mortgage rates remain near current levels, the outlook for prepayments will most likely remain somewhat benign as the calendar moves into spring.

Regulatory developments remain in short supply since the new administration took over in January, yet speculation continues about what might happen in a market that is intertwined with numerous rules and regulations from a variety of regulatory agencies. The result is market participants trying to read the tea leaves of policy makers in an attempt to divine the future direction of regulation in the agency MBS market. While always a fraught exercise, it does appears that GSE reform is not near the top of the president's priorities based on the relative absence of the issue in the campaign, as well as the president not mentioning housing reform during his address to a joint session of Congress on the last day of February. That is not to say that the agency MBS market will remain entirely unaffected by the new administration. To the contrary, the President did order a complete review of the regulations contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act. Passed by Congress just after the financial crisis of 2008, the law created a series of regulations that mostly affected the banking industry. The myriad of rules that resulted from the Act and the regulatory agencies empowered to implement and interpret the law have come under intense scrutiny and criticism from Republicans. Their primary argument is that the regulations that have been put in place since passage of the law are too stringent and should be dialed back. By putting the entire regulatory apparatus of the law on review, significant questions about which regulations will remain for the banking industry, and which might change, could create significant uncertainty for Wall Street and the banking system, and might have spillover effects on the agency MBS market. While the end result of the review is not close to being known, it is a potentially overlooked issue that could impact the agency MBS market and valuations moving forward.

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Coupon Stack Performance

30 Year FNMA	February Month End Price	Monthly Price Change (pts)	Monthly Performance vs. Benchmark U.S. Treasury (%)	February Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$99.11	0.22	0.00	25.9	-4.8
3.5	$102.27	0.13	0.06	24.1	-6
4.0	$104.92	0.06	0.04	29.2	-4.7
4.5	$107.36	-0.16	-0.14	33.6	-1.7
5.0	$109.48	0.41	0.47	6.8	-19.1
5.5	$111.23	0.16	0.25	-1.7	-13
6.0	$113.05	0.16	-0.77	-14.4	-7.1
15 Year FNMA					
2.5	$100.05	-7	0.10	12.9	-5.1
3.0	$102.64	-0.5	0.11	10.7	-3.6
3.5	$104.14	-7	0.11	73.9	-13.7
4.0	$102.89	-2	0.05	88.6	14.8
4.5	$102.14	2	-0.36	48.4	-4.2
5.0	$102.14	8	0.00	101.4	-8.1
5.5	$101.23	5.5	0.00	121.4	-7.3

Sources: TCW, Barclays, Bloomberg

Benchmark Performance

	February Month End Price	February Month End Yield	January Month End Yield	Change (bps)
2 Yr Treasury	$99.73	1.26%	1.20%	5.57
5 Yr Treasury	$99.74	1.93%	1.91%	1.65
10 Yr Treasury	$98.76	2.39%	2.45%	-6.32
30 Yr Treasury	$100.08	3.00%	3.06%	-6.60
2/10 Curve		112.79	124.47	-11.69
2 Yr SWAP Spread		34.81	28.97	5.84
10 Yr SWAP Spread		-9.00	-1.60	-7.40
1*10 Swaption Vol		83.20	84.70	-1.50
5*10 Swaption Vol		83.40	83.30	0.10

Sources: TCW, Bloomberg

Issuer Performance (ticks)

	February GNMAII/FNMA	Monthly Price Change	February GOLD/FNMA	Monthly Price Change
3.0	59.5	-0.25	-3	0.13
3.5	46.5	1	-0.5	2
4.0	23	-2.25	-0.13	0.25
4.5	-20	-11	-2.75	-0.25
5.0	-58.75	-9.75	-4	2.25
5.5	-62.75	-0.5	-4	4

Sources: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	Feb 28, 2017	Jan 31, 2017	Dec 30, 2016
FN 3% LLB	14	10	11
FN 3% MLB	11	8	9
FN 3% HLB	9	6	7
FN 3% 125 LTV	-20	-20	-8
FN 3.5% LLB	31	30	30
FN 3.5% MLB	25	24	24
FN 3.5% HLB	18	18	18
FN 3.5% 125 LTV	4	-4	10
FN 4% LLB	47	46	48
FN 4% MLB	41	38	38
FN 4% HLB	33	30	30
FN 4% 125 LTV	18	16	22
FN 4.5% LLB	69	64	62
FN 4.5% MLB	53	52	48
FN 4.5% HLB	45	40	38
FN 4.5% 125 LTV	27	28	26

Sources: TCW, Credit Suisse

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