TCW

INSIGHT

MONTHLY COMMENTARY

March Agency MBS Update

STEPHEN K. LEECH | 4 APRIL 2019

Stephen K. Leech, CFA
Vice President
Fixed Income

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. He is a CFA charterholder.

Relative agency MBS performance struggled in March, as rapidly shifting global market dynamics, rising volatility, and the changing sector landscape proved too much to overcome. The first two months of 2019 were characterized by strength in risk assets and diminutive levels of volatility, which compressed spreads and buoyed agency MBS relative valuations. March opened in similar fashion. Interest rates dropped slightly while volatility continued to fall. Mid-month, interest rate volatility hit multi-decade lows when the Federal Reserve came in more dovish than expected. The Fed signaled it will not hike interest rates for the remainder of 2019, in addition to officially announcing the end of balance sheet reduction this fall with the proceeds from MBS runoff currently in process of being reinvested in U.S. Treasuries. The eerie calm that permeated markets was quickly shattered mid-month as slowing growth in Europe and China caused interest rates to fall sharply and volatility to pick up significantly. The percolating fear sent the 10yr U.S. Treasury rate from 2.73% at the beginning of March all the way to 2.36% before it recovered slightly to close the quarter at 2.43%. The accompanying drop in mortgage rates brought fear of a coming increase in prepayments back to the forefront of concern, hindering agency MBS relative performance. The coming of UMBS and increasing news regarding GSE reform further pressured agency MBS valuations, as an asset class that thrives in stable waters continued to see storm clouds gathering. Ultimately, the Bloomberg Barclays MBS Index posted negative excess returns of 11 basis points (bps) relative to benchmark U.S. Treasuries in March, sending year-to-date relative performance back to a positive 28 bps. Total returns were strong, with year-to-date total returns now standing at 2.17% after a positive 1.46% in March.

The sharp drop in interest rates propelled lower coupon MBS to relative outperformance. Fannie Mae 30yr (FNCL) 3s were the only coupon to finish in positive territory, closing up 8 bps relative to benchmark U.S. Treasuries. The rest of the coupon stack provided negative excess returns, as rising volatility and increasing prepayment risk undercut performance. FNCL 4s came in at -19 bps, while FNCL 4.5s came in at -28 bps. The drop in mortgage rates has brought prepayment risk back to the forefront of the agency MBS market after stable interest rates kept the risk of increased speeds largely at bay. Close to one quarter of the market can now refinance mortgages economically, up from less than 10% in the fall of 2018. While not a large percentage, the downtick in interest rates will lead to recent production MBS pools

paying faster than previously, dragging on higher coupon MBS collateral. In Ginnie Mae collateral, lower coupons stayed close to their 30yr conventional counterparts, but higher coupons struggled mightily. Ginnie Mae 30yr (G2SF) 4.5s finished at -39 bps of excess returns, while G2SF 5s closed down a whopping 61 bps. After allegations were made in the summer of 2017, claiming servicers were churning military veteran borrowers, regulators and Congress alike have both attempted to curb prepayment speeds. The results have been mixed. The primary tool deployed has been punishing servicers whose pools prepay much faster than each cohort. Despite the attempted changes, the only thing that has significantly tempered higher coupon Ginnie Mae speeds is elevated interest rates. With mortgage rates falling, the risk that peak speeds on Ginnie Mae pools will increase markedly is back, pressuring valuations. Yet lower interest rates are just one of a few powerful forces impacting performance within agency MBS.

UMBS is now just around the corner, and with it, much of the agency MBS universe is undergoing immense upheaval in a condensed time frame. Mandated by the Federal Housing Finance Authority (FHFA), UMBS is creation of a single TBA contract and a single security platform for both Fannie Mae and Freddie Mac collateral to be delivered into. This effort has been ongoing for well over five years, and is just a few months away from coming to fruition. The first UMBS TBA contracts settle in June, and trading on the forward contracts has already begun. While the stated rationale is to increase liquidity, the clearer goal seems to be to pave the way for reform of both government sponsored entities (GSEs), by creating a TBA that in theory other competitors could sell pools into. While that functionality is still some time off, the more tangible changes are upon the market already. Most notably, specified pools of all types continue to rally precipitously relative to all TBAs and TBA deliverable pools. There are two primary reasons for this occurring. The most front and center reason is that the worst bonds of each GSE will now be placed into a single deliverable. Therefore, the new TBA will have the worst prepayment characteristics possible for each MBS coupon. Thus, any pool that does not fit into the deliverable now is split out with a pay-up. Perhaps more importantly, because the two GSEs have been forced to align their policies and procedures and currently their profits are swept to the U.S. Treasury, the two GSEs are trying to compete for market share. In doing so, the GSEs have made it more attractive for mortgage originators to pool loans with higher rates into lower coupon MBS pools, making the securities more sensitive to prepayment risks should rates drop. The GSEs are now targeting something close to 80 bps in spread between the loan rate and the pool coupon in aggregate, which should keep this problem from getting even worse than it already is. However, the spread was closer to 50 bps through much of last year, making the newer production bonds more likely to prepay quickly should rates drop. The result of both these changes has been a rapid repricing of the market, benefitting specified pools at the expense of TBA-deliverable pools. With UMBS being the new TBA in just two months' time, market participants must be attuned to the possibility that further changes are coming, whether desired or not.

Late in March, the Trump administration released a memorandum on principles for GSE reform. The document is the culmination of months of deliberations by policymakers but leaves potentially more questions than it creates answers. After the acting head of the FHFA Joseph Otting proclaimed that regulatory action would be forthcoming by the Trump administration early in the year, the comments were subsequently walked back by officials. This left market participants believing an action plan was imminent, but not knowing whether the effort would be legislative or administratively based. The memorandum answer appears to be a little of both. The key points of the memo are that the administration recommends taking taxpayers off the hook for losses at the GSEs, while also increasing competition for Fannie Mae and Freddie Mac. Some of the efforts can likely be done by legislative fiat, such as allowing Freddie Mac and Fannie Mae to retain capital above and beyond $3bn each going forward. However explicitly guaranteeing the collateral of Fannie Mae and Freddie Mac will require Congress to act. All previous GSE reform attempts have failed to gain traction in Washington, leaving this attempt in peril at the moment it begins. Ideally, the administration would like to guarantee all the collateral of the GSEs, while using UMBS to create a fully privatized method for new entrants to compete with the two GSEs. This would create numerous difficulties, as the government would have to find a way to keep losses on collateral out of taxpayer's wallets, while still guaranteeing payment to investors. Furthermore, it is unclear that any non-bank will have the ability to compete with two GSEs that already have the infrastructure built up in their current business. While it initially appeared that aggressive regulatory action could be afoot immediately, it now seems as though any immediate action will be slight, with the lion's share of the responsibility for GSE reform remaining on Congress' shoulders going forward. Thus, the GSE regulatory cloud will remain on the horizon for the foreseeable future.

TCW

Coupon Stack Performance

30 Yr FNMA	March Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	March Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$99.57	1.93	0.08	17.8	-6.1
3.5	$101.38	1.42	-0.13	24.4	-4.2
4.0	$102.86	1.00	-0.19	28.1	-8.1
4.5	$104.20	0.77	-0.28	59.4	0.5
5.0	$105.70	0.94	-0.12	87.5	-5.3
5.5	$106.76	1.05	-0.15	127.0	-1.0
6.0	$107.89	0.41	-0.11	157.5	19.6
15 Yr FNMA					
2.5	$99.41	1.42	0.20	14.9	-1.7
3.0	$100.89	1.12	0.07	18.8	-0.1
3.5	$102.30	0.77	-0.20	27.0	3.6
4.0	$103.02	0.48	-0.23	36.2	8.2
4.5	$101.98	0.44	-0.02	126.3	17.1
5.0	$102.23	0.41	0.00	134.8	-1.3
5.5	$101.98	0.31	0.00	153.6	56.2

Source: TCW, Bloomberg Barclays

Benchmark Performance

	March Month End Price	March Month End Yield	February Month End Yield	Change (bps)
2 Yr Treasury	$99.98	2.26%	2.51%	-25.41
5 Yr Treasury	$99.49	2.23%	2.51%	-27.92
10 Yr Treasury	$101.91	2.41%	2.72%	-31.00
30 Yr Treasury	$103.72	2.81%	3.08%	-26.59
2/10 Curve		13.90	19.89	-5.99
2 Yr SWAP Spread		12.00	9.50	2.50
10 Yr SWAP Spread		1.13	0.25	0.88
1y*10y Swaption Vol		58.69	59.41	-0.72
5y*10y Swaption Vol		63.72	66.64	-2.92

Source: TCW, Bloomberg

Issuer Performance (ticks)

	March GNMAII/FNMA	Monthly Price Change	March GOLD/FNMA	Monthly Price Change
3.0	28.75	-3.25	1.00	-0.25
3.5	26.25	2.50	2.13	0.63
4.0	13.25	-2.75	2.63	1.25
4.5	-11.00	-7.00	5.50	3.87
5.0	-40.25	-15.25	5.50	6.50
5.5	-36.00	-4.00	10.00	18.00

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	Mar 29, 2019	Feb 28, 2019	Dec 31, 2018
FN 3% LLB	17	10	10
FN 3% MLB	14	8	7
FN 3% HLB	11	6	6
FN 3% 125 LTV	6	5	20
FN 3.5% LLB	30	20	17
FN 3.5% MLB	28	16	13
FN 3.5% HLB	23	12	10
FN 3.5% 125 LTV	16	15	18
FN 4% LLB	69	48	36
FN 4% MLB	60	39	30
FN 4% HLB	50	30	22
FN 4% 125 LTV	30	25	18
FN 4.5% LLB	100	79	58
FN 4.5% MLB	90	66	51
FN 4.5% HLB	73	55	41
FN 4.5% 125 LTV	60	46	40

Source: TCW, Citi

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2019 TCW

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup