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INSIGHT

MONTHLY COMMENTARY

April Agency MBS Update

STEPHEN K. LEECH | MAY 3, 2016

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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.

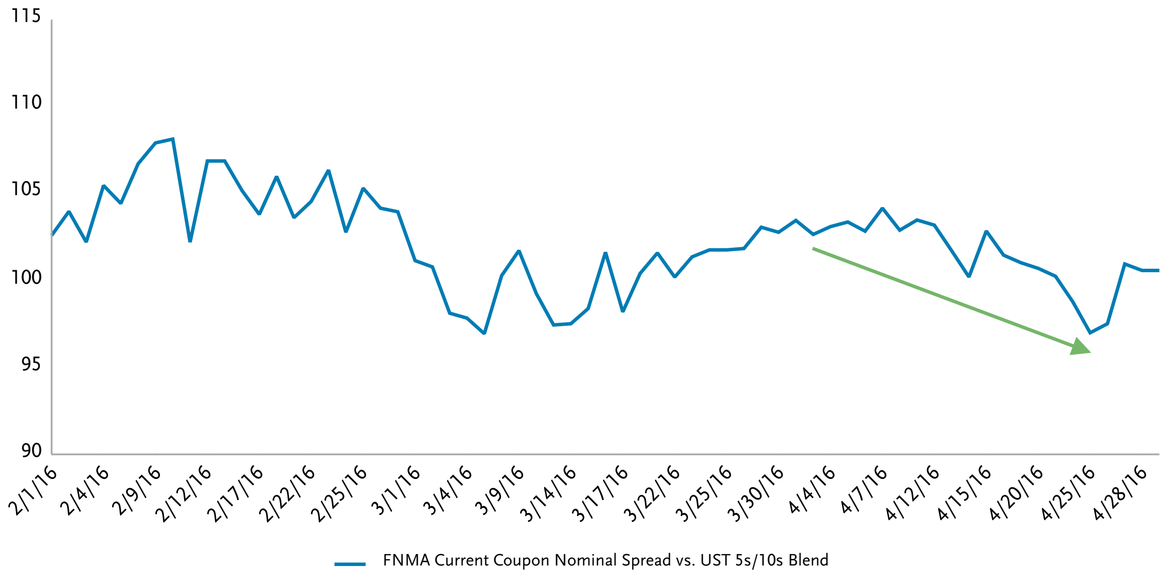
The fear that spooked investors at the beginning of 2016 was tempered somewhat to open the second quarter of 2016, as decreasing volatility helped agency MBS to post positive returns in April. The month got off to a rocky start, as the week of April Fools did nothing to ease worried investors minds. Federal Reserve reassurances that interest rates will remain low for a protracted period of time helped drive U.S. Treasuries lower, increasing concern of faster prepayment speeds as a result. Further consternation came in the form of a very fast prepayment report, which saw speeds increase 50% over February levels. Yet as quickly as fear began to percolate the storm clouds parted for the time being. A strong month for global risk assets and oil helped push interest rates back higher. In addition, first quarter GDP (0.5%) came in lower than expectations and economic data remains weak enough to allow monetary policy that is supportive of agency MBS valuations to remain in place for some time both here and abroad. These developments bolstered a comeback by the agency MBS basis during the back half of April. The decreased volatility, coupled with increasing prices of risk assets and nominally higher treasury yields drove outperformance by agency MBS in April. The Barclays MBS Index posted excess returns relative to U.S. Treasuries of 16 basis points, bringing underperformance in 2016 down to -21 basis points year to date.

Despite the 16 basis points of outperformance, it is notable that the agency MBS basis only slightly outperformed U.S. Treasury hedge ratios (HRs) in April. Given a confluence of factors that should have been supportive of agency MBS valuations, namely low volatility and close to unchanged interest rates, the relatively light returns are somewhat troubling. The details of April coupon stack performance reveal numerous reasons to be cautious going forward. The most notable is the continuing decline of the levels of TBA rolls. Roll levels fell again in April, and the Fannie Mae 30yr (FNCL) 3.5s closed the month at 5+ after trading at almost 8+ in the beginning of this year. The collapse of roll levels can be seen across the agency MBS coupon stack and has been a recurring theme over the past nine months. Many investors have reacted by searching for specified pools that will outperform the reduced carry of TBA positions. The pervasive challenge is finding pools at attractive valuations as payups begin to rise, and the carry profile of the larger agency MBS universe has eroded due to increased prepayments. In addition, the hunt for specified pools caused Freddie (FG) Fannie (FN) swaps to converge toward zero as the increased liquidity of FN collateral was cast aside for slightly better pool construction of the FG coupon stack. The FG/FN 3.5 swap which opened at the month at -5 increased to -2 ticks. Furthermore, the coupon stack reveals little in the way of large-scale performance variation. All FNCL collateral had positive performance, with FNCL 3s closing up 10 ticks and FNCL 4s finishing at 6+ relative to their UST HRs. Looking at hedge adjusted coupon swaps, higher coupons were slight outperformers, with the FNCL 4.5/4 performing the best at +3 ticks. In Ginnie Mae (G2SF) collateral, lower coupons outperformed while higher coupons underperformed HRs. Despite the discrepancy in relative returns, valuations remained close to home, with G2SF 4s closing up 1+ ticks. The G2/FN 3.5 swap also demonstrated limited price action, closing off 1 tick. The limited movement within the coupon stack could change at the drop of the hat, though the quiet month suggests that investors did not find large-scale relative value opportunities in agency MBS in April. In aggregate, the slight outperformance belies some challenges that agency MBS investors will have to face as the year marches on.

Further concerning investors was the March prepayment report, which when released at the beginning of the month was faster than many were expecting. Based on the increasing day count and lower rates from early this year, speeds were expected to rise. The basis did widen on the release of the report due to the potential that this report could be the beginning of a prepayment wave caused by the low interest rates seen in January and February of this year. Fannie Mae 30yr (FNCL) speeds were up 50% going from 10.5CPR (Feb) to 15.6CPR (Mar). Recent vintage current coupons rose sharply, with 2014 FNCL 3.5 pools rising sharply to 15.CPR (Mar) from 6.1CPR (Feb). The rise was matched in Freddie Mac pools but did not fully carry thru into Ginnie Mae (G2SF) and 15yr collateral. In Ginnie Mae pools, there was still a significant speed increase of 39%. Speeds on 2015 vintage G2SF pools did speed up less than 2014 loans, which was a repeat of a trend seen in FNCL collateral. One exception to this trend was 2015 FNCL 3s, which rose sharply. The rise in 3% coupons, mirrored with the sharp increase in 2014 collateral does suggest that there is a real possibility that the rest of the 2015 vintages will speed up relative to their compatriots in the upcoming report. Looking ahead to the April prepayment report, there is very little consensus as to whether speeds increase or decrease relative to this month. Seasonal factors point to an increase while a lower day count may mitigate those effects. The results will be important for investors looking to obtain a better understanding of the depth of a potential prepayment wave.

The regulatory news in April was sparse. The most notable regulatory announcement appears to have close to no discernable impact on agency MBS valuations. The Federal Housing Finance Agency released its long awaited plan on the topic of principal reduction for underwater home borrowers. A subject that had been debated since the crisis, the FHFA released their guidelines which will allow up to thirty three thousand borrowers to obtain some principal relief. The plan will only allow borrowers who were 90 days delinquent as of March 1st, 2016 to seek relief, and will only be available for those with an unpaid principal balance of less than $250,000. The end result is that there will not be any chance for borrowers to opportunistically become delinquent to obtain relief. Furthermore, the relative difficulty of qualifying for the program combined with the rules the various GSE's follow in regards to buying delinquent loans out of pools will result in close to no impact to agency MBS. This continues a multiple month streak in which regulatory hurdles were cleared rather than erected. This trend is a welcome one for agency MBS investors, but only time will tell if it can continue going forward.

FNMA Current Coupon Nominal Spread vs. UST 5s/10s Blend



Source: Barclays, Bloomberg

Coupon Stack Performance

30 Year FNMA	April Month End Price	Monthly Price Change (ticks)	Monthly Hedged Performance Vs. 10 Year Treasury (ticks)	April Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	102-04	-6.25	1	17.8	-3.4
3.5	104-16	-4.25	1	17.4	-2.9
4.0	106-21	-2	1+	11.4	-2.5
4.5	108-25	0	2	31.2	-4.3
5.0	110-18	-1	1	3.5	-4.2
5.5	111-27+	-1	+	13.6	6.6
6.0	113-26	-1	+	5.7	-3.8
15 Year FNMA					
2.5	102-14	-3+	1+	10	-8.6
3.0	104-07	-2+	1	12.7	-5.8
3.5	105-17+	-+	1+	22.1	-10.4
4.0	103-27+	-+	1	-68.9	-4.7
4.5	102-26	-+	+	18.9	-4.9
5.0	102-12+	-+	1	192.5	2.7
5.5	102-20+	-+	1	178.7	-6.3

Sources: TCW, Barclays, JPMorgan

Benchmark Performance

	April Month End Price	Monthly Price Change	April Month End Yield	Change (bps)
2 Yr Treasury	99-31	-0-10	0.792	4
5 Yr Treasury	100-15	0-10	1.319	6
10 Yr Treasury	98-09	-0-9	1.864	4
30 Yr Treasury	96-22	-0-28	2.717	4
2/10 Curve			105	0
2 Yr SWAP Spread			14	2.5
10 Yr SWAP Spread			-11.8	1.8
1*10 Swaption Vol			81.6	0.8
5*10 Swaption Vol			83.8	-1.2

Sources: TCW, Citigroup

Issuer Performance (ticks)

	April GNMAII/FNMA	Monthly Price Change	April GOLD/FNMA	Monthly Price Change
3.0	1-0	-0-01+	-0-02+	0-03+
3.5	0-26	-0-01	-0-02	0-03
4.0	-0-03	-0-01+	-0-01+	0-02
4.5	-1-22	-0-09	-0-04	0-01+
5.0	-2-16	-0-08	-0-25	0-00
5.5	-2-08	0-00	-0-26	0-00

Sources: TCW, Credit Suisse, JPMorgan

Loan Balance Pay-up Grid (ticks)

Coupon	Low Loan Balance	Medium Loan Balance	High Loan Balance
3	20	16	12
3.5	42	33	25
4	66	56	42
4.5	98	82	54
5	88	80	52
5.5	48	56	32

Specified Pool Pay-up Grid (ticks)

Coupon	Investor	20 Year	FICO	CK
3	0	36	0	-38
3.5	4	18	6	-46
4	16	16	16	-80
4.5	8	16	24	-80

MHA/LTV Pay-up Grid (ticks)

Coupon	80-90	90-95	95-100	100-105	>105	>125
3	0	0	0	0	4	-2
3.5	1	4	6	8	12	14
4	6	14	20	24	26	32
4.5	10	20	32	40	44	48
5	16	24	32	40	44	52

Sources: Goldman Sachs, Deutsche Bank and Credit Suisse as of 4/29/2016
Indication Only

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