TCW

Manager of the TCW, MetWest, and TCW Alternative Fund Families

INSIGHT

MONTHLY COMMENTARY

May Agency MBS Update

STEPHEN K. LEECH | JUNE 3, 2016

Stephen K. Leech
Assistant Vice President
U.S. 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.

Agency MBS performance was once again positive in May, as low volatility and slightly higher interest rates contributed to the sector's third consecutive month of outperformance. The spread between agency MBS and U.S. Treasuries did not kick off the month on a strong note however, as ongoing global growth distress and fast prepayment concerns (from March) continued to hamper agency MBS valuations early on. An underwhelming non-farm payroll report (+160k actual vs. +200k expected) provided little to no support to the agency MBS basis, also putting downward pressure on risk assets. Soft economic data early in May sent the U.S. 10yr Treasury yield to a low of 1.70%, albeit the risk off tone did not last long. Strong retail sales and better-than-expected home sales data soon followed, buoying the hopes of risk investors. Furthermore, the Fed continued to provide mixed signals in regards to their next interest rate hike and the ensuing pace of rate normalization, while the April prepayment report showed speeds came in modestly slower than expected. In combination, these factors helped the agency MBS basis edge back tighter. Sustained bouts of low realized volatility continue to benefit agency MBS investors, who have yet to see volatility near 2015 highs year to date. Ultimately, in what turned out to be a quiet month, the agency MBS basis managed to close in positive territory in May, as persistently low volatility and range bound interest rates helped offset the possibility of economic concerns hampering agency MBS valuations going forward. In aggregate, the Barclays MBS Index outperformed benchmark U.S. Treasuries by 17bps in May, with the year to date return inching closer into positive territory at -4bps.

May was the third consecutive month in which the agency MBS basis generated positive returns, helping to bring the negative year to date performance brought on primarily by the first six weeks of 2016 closer to flat as of May month end. Despite this recent outperformance, there are still underlying signs of mortgage weakness visible beneath the surface. The most notable of these is the prolonged deterioration in TBA roll levels. Roll valuations have continued to languish since the middle of last year and that trend carried well into May. The Fannie Mae 30yr (FNCL) 3.5 roll dropped half a tick (from 5 ⅝ to 5 ⅛), while the 15yr (FNCI) 2.5 roll fell ⅝th tick (from 7 ⅛ to 6 ½). With TBA rolls no longer trading special, investors have looked to less liquid instruments in an attempt to capture better carry and generate higher returns. While not problematic from a carry perspective per se, it's important to note that a less agile and sophisticated investor could be vulnerable in a more volatile market environment in which these better carrying (but less liquid) instruments fall victim to wider bid/offer pricing. Across the coupon stack, the most liquid coupons underperformed during the month despite the low volatility. FNCL 3.5s underperformed their 10yr hedge ratios (HRs) by 2 ticks. FNCL 4s fared only slightly better, trading flat to 10yr

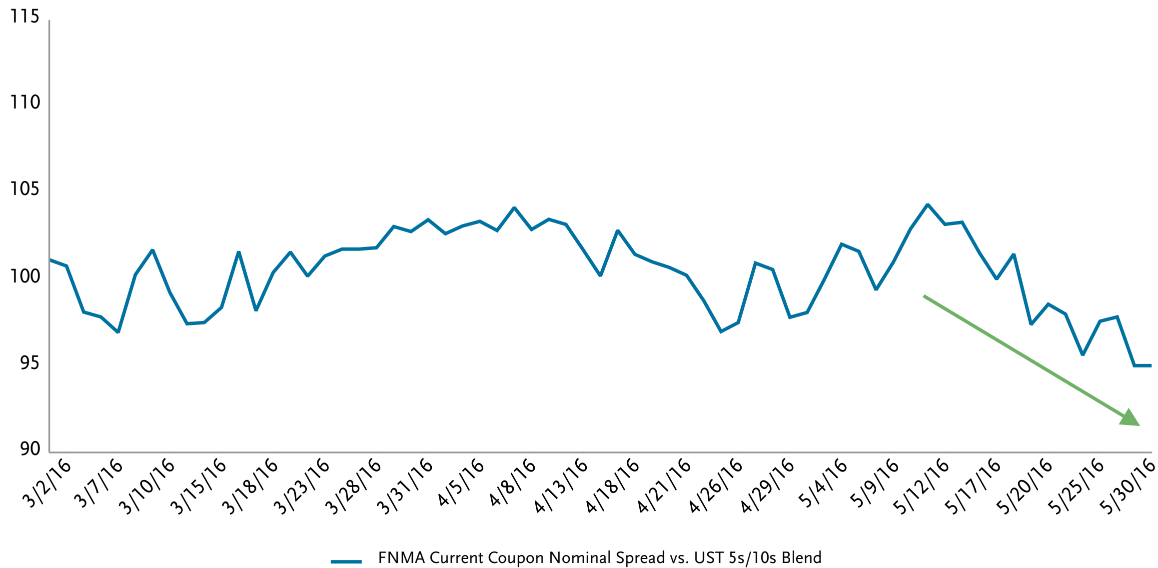
HRs. Of the coupons deemed "liquid", FNCL 4.5s performed the best, outdueling their 10yr HRs by 1 tick. While Ginnie Mae (G2SF) performance was slightly better than that of Fannie Mae, owing mainly to rising interest rates seen near month end, G2SF lower coupons still only outperformed their 10yr HRS by 1-3 ticks; G2SF 3s and 3.5s were better by 2+ and + tick, respectively. During the month, performance excelled the most in less liquid seasoned super premium coupons (5s and up). For the month, FNCL 5s came in up 8 ticks relative to their 10yr HRs, while FNCL 5.5s were up 6 ticks. One of the main drivers of higher coupon outperformance has been evidence of a high degree of burnout among the more seasoned borrower base in these premium coupons. Even low but steady rates seen since February have not caused prepays within these coupons to rise much because of burnout, lending itself to stronger valuations as of late. These stronger valuations were the primary driver behind agency MBS basis outperformance during the month. For the agency MBS basis to continue to outperform however, it would appear that there would need to be better returns in production coupon agency MBS than investors saw in May.

The April prepayment report showed that speeds generally slowed last month, a welcome respite for investors after a fast March report. One of the variables plaguing the agency MBS basis has been the potential for a prepayment wave brought on by low rates that have persisted since February. Speeds rose 50% in March, causing consternation that another month of faster than expected prepayments might be on the way. However, the April report showed that speeds actually dropped 5% in April, with Fannie Mae 30yr (FNCL) prepayments falling to 14.8CPR (from 15.6CPR in March). All coupons except FNCL 4.5s were slower in April, demonstrating that speeds came off in nearly all vintages. Furthermore, the coupons that saw unexpected speed increases in March, namely 2014 and 2015 production coupons, actually experienced decreases, further easing prepayment fears. Some of the decline can be attributed to a lower day count, with two fewer business days in April vs March, but it was plausible to think that seasonal factors would cancel out that effect. Seasoned premium coupons continued to prepay slowly, indicating that the level of burnout in these vintages is high. Ginnie Mae coupons saw similar decreases, as overall G2SF collateral has prepaid in line with its conventional counterparts in recent months. The aggregate prepay picture seems far rosier for the moment with April speeds in the rearview mirror. Range bound interest rates that have lingered since the risk off move during the first six weeks of 2016 have looked somewhat similar to 2015, which saw a big prepayment wave. Two factors thus far have contributed to 2016 not experiencing a similar uptick to 2015 in terms of prepays. The first is that many borrowers who might have been able to refinance this year due to lower mortgage rates already did in 2015 (ie., burnout), leaving fewer borrowers with a significant refinance incentive one year later. The second major factor is the lack of a regulatory catalyst in 2016 that came in 2015, in the form of the Federal Housing Administration cutting the monthly insurance premium (MIP) that eligible borrowers pay as part of their mortgage. The MIP cut helped magnify the prepayment wave in 2015, and thus far has not been repeated in 2016. Overall, while the April report was beneficial to most agency MBS investors, and current projections have the upcoming prepays remaining at or near current levels, vigilance continues to be warranted.

For the second consecutive month, there was a dearth of any major regulatory announcements within the universe of agency MBS. Even so, there are a few announcements scheduled or expected during the remaining part of the year that could be impactful to agency MBS valuations. The first is the formal announcement of a program to replace HARP which sunsets at the end of this calendar year. Thus far, the Federal Housing Finance Agency (FHFA) has signaled that the program will be fairly limited in scope and will not be eligible to borrowers who previously completed a HARP refi; however, that has yet to be set in stone and will need to be finalized before December. The second burgeoning development is the continued march toward a single security that could make the collateral of Freddie Mac and Fannie Mae interchangeable. While the merging is not close as of yet, there has been enough progression through the thicket of hurdles that perhaps the next update will give investors a clearer picture of what the timeline for a single security platform will look like. Finally, it will be worthwhile to be vigilant with respect to the FHA and their control over monthly insurance premiums (MIP) discussed previously. While the FHA last changed the MIP in January of 2015, and has not made any public pronouncements about the possibility of any future changes, any altering of the current levels would be significant for valuations going forward. Thus, while the regulatory front has been quiet in recent months, the potential to impact the agency MBS basis remains as powerful as always.

TCW

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



Source: Barclays, Bloomberg

Coupon Stack Performance

30 Year FNMA	May Month End Price	Monthly Price Change (ticks)	Monthly Hedged Performance vs. 10 Year Treasury (ticks)	May Month End LIBOR OAS (bps)	LIBOR OAS Monthly Change (bps)
3.0	102-13+	+3	+	18.6	+2.1
3.5	104-21	+	-2	16.9	+0.8
4.0	106-24+	+2	-+	18.2	-0.5
4.5	108-28+	+3+	+1	21.3	+6.8
5.0	110-29+	+9+	+8	-5.3	-9.9
5.5	112-05	+8+	+6	3.1	-8.8
6.0	114-02+	+7+	+5	-14.5	-10.5
15 Year FNMA					
2.5	102-17	-+	-4+	13.1	+3.1
3.0	104-07+	-2+	-5+	13.1	+0.4
3.5	105-17+	-+	-4+	19.2	-2.9
4.0	104-21+	-6+	-8+	-64.0	+4.9
4.5	102-24	-2+	-6	25.6	+6.7
5.0	102-18	+5	+1	177.9	-14.6
5.5	102-18	-3	-9+	165.4	-13.3

Sources: TCW, Barclays, JPMorgan

Benchmark Performance

	May Month End Price	Monthly Price Change	May Month End Yield	Change (bps)
2 Yr Treasury	100-00	+0-01	0.873%	+8
5 Yr Treasury	100-02	-0-13	1.360%	+4
10 Yr Treasury	98-05	-0-04	1.833%	-3
30 Yr Treasury	97-11	+0-21	2.629%	-9
2/10 Curve			96 bps	-9
2 Yr SWAP Spread			14.7	+0.7
10 Yr SWAP Spread			-14.5	-2.7
1*10 Swaption Vol			81.0	-0.6
5*10 Swaption Vol			83.1	-0.7

Sources: TCW, Citigroup

Issuer Performance (ticks)

	May GNMAII/FNMA	Monthly Price Change	May GOLD/FNMA	Monthly Price Change
3.0	1-02	+0-02	-0-01	+0-00+
3.5	0-28+	+0-02+	-0-03	-0-01
4.0	-0-03+	-0-00+	-0-04	-0-02+
4.5	-1-17	+0-05	-0-02	+0-02
5.0	-2-24	-0-08	-0-25	n/c
5.5	-2-16	-0-08	-0-26	n/c

Sources: TCW, Credit Suisse, JPMorgan

Specified Pool Pay-up Grid (ticks)

Coupon	Investor	20 Year	FICO	CK
3	0	34	0	-38
3.5	4	20	6	-48
4	12	25	16	-78
4.5	18	25	22	-80

Loan Balance Pay-up Grid (ticks)

Coupon	Low Loan Balance	Medium Loan Balance	High Loan Balance
3	17	13	7
3.5	44	36	28
4	72	60	46
4.5	92	72	48
5	88	80	52
5.5	48	40	32

MHA/LTV Pay-up Grid (ticks)

Coupon	80-90	90-95	95-100	100-105	>105	>125
3	0	0	0	0	0	-2
3.5	1	4	6	10	12	18
4	6	16	20	28	36	44
4.5	10	20	32	40	44	48
5	8	16	28	40	44	52

Sources: Goldman Sachs, Deutsche Bank and Credit Suisse as of 5/31/2016
Indication Only

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. © 2016 TCW

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