TCW

INSIGHT

MONTHLY COMMENTARY

May Agency MBS Update

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Ms. Morrison joined TCW in 2017 as a member of the Fixed Income group, specializing in agency mortgage-backed securities. Previously, Ms. Morrison was an Assistant Vice President with the Barclays Group where she provided institutional sales coverage for the firm's Macro platform which included interest rate, foreign exchange, and commodity derivative products. She began her career as an Analyst focused on mortgage-backed and asset-backed securities with Barclays' Securitized Products group. Ms. Morrison holds a BS in Civil Engineering from Duke University. She holds FINRA Series 3, 7, and 63 licenses.

Against the backdrop of a broad risk-off move driven largely by heightened trade tensions, agency MBS posted their worst monthly excess returns since November 2016. Prior to this month, global markets had enjoyed a relative calm in 2019 as interest rate volatility remained historically low and global economic data was largely positive. This environment was suddenly disrupted at the beginning of May, as trade tensions between the U.S. and China took center stage and only escalated over the month while the market moved largely in one direction. The 10yr U.S. Treasury (UST) rallied 38 basis points (bps) over the month, the largest month-over-month move since November 2016. The sharp move lower in interest rates and concurrent increase in interest rate volatility caused risk assets to struggle. The S&P 500 declined 6.6% in May just after the index reached all-time highs at the end of April. In addition to the U.S.-China trade conflict, there was an announcement of the Trump administration's intent to impose tariffs on imports from Mexico beginning in June, and also news that UK Prime Minister Theresa May would step down, all fueling the flight-to-quality sentiment in the market. Concerns around global growth spiked, and the market began to price in interest rate cuts by the Federal Reserve this year. Mortgage rates declined along with broader market rates, and by the end of the month the Freddie Mac Primary Mortgage Market Survey (PMMS) 30yr fixed mortgage rate reached 3.99%, its lowest level since January 2018. As a result, fears of heightened prepayment speeds have risen, weighing on premium agency MBS valuations. With global macro events providing headwinds to agency MBS performance, the Bloomberg Barclays MBS Index posted excess returns of negative 40 bps versus benchmark USTs in May, bringing year-to-date (YTD) excess returns to negative 13 bps. However, the market rally aided total returns which stand at 3.4% for 2019.

The significant rally in interest rates led higher coupon MBS to relative underperformance versus lower coupons, as concerns about faster prepayment speeds drove coupon stack performance. Fannie Mae 30yr (FNCL) 3.0s and Ginnie Mae 30yr (G2SF) 3.0s were the best performers among the tradable coupons this month, posting negative 23 bps and negative 19 bps of excess returns, respectively. They are the only coupons with positive excess performance YTD. FNCL 4.0s and 4.5s were both down by 50 bps or more, while G2SF 4.0s and 4.5s performed just slightly better. Prepayment risk was at the forefront of investors' minds this month, as the April prepayment speed report reflected faster than expected speeds, particularly for the 2018 cohorts of production coupon FNCL 3.5s and 4.0s. Prepayment speeds are expected to continue to rise, given the drop in mortgage rates as we head into the summer months, which typically provide a natural uptick in refinance activity. With mortgage rates hitting recent lows at the end of May, approximately 36% of the outstanding MBS universe is economically incentivized to refinance.

Amid the volatile macro landscape in May, the Agency MBS market transitioned to the UMBS regime as June marks the first month where Fannie Mae and Freddie Mac will both issue MBS pass-throughs deliverable into UMBS TBA. As the size of the deliverable float for UMBS has increased, the carry and convexity of the "worst-to-deliver" TBA pools have deteriorated. In this environment of lower rates, heightened volatility, increased prepayment concerns and worsening TBA profiles, specified pools outperformed yet again, continuing the significant payup appreciation across call-protected pool stories thus far in 2019.

Ginnie Mae MBS generally outperformed their 30yr conventional counterparts in May, despite the move to lower yields which tempered demand from yield-based buyers who are typically active in G2SF MBS. At the beginning of the month, officials at Ginnie Mae announced that they were exploring further restrictions to cash-out refinance activity on loans taken out by veterans. Fast prepayment speeds on these loans have been an ongoing issue for Ginnie Mae, as the prepayment activity indicates the possibility that servicers are churning these loans, and the borrowers are using cash-out refinances as a source of short-term funding. While the actions that Ginnie Mae will take as a result are yet unknown, the announcement was positive for Ginnie Mae MBS as it reaffirmed the agency's commitment to curbing fast prepayment speeds. The Federal Housing Administration (FHA) also made a policy announcement this month in an effort to attract banks to offer loans to their borrowers. Since the financial crisis, the share of non-bank lenders participating in FHA's lending program has increased significantly, while traditional banks have stepped back. Non-bank lenders are typically characterized by faster prepayment speeds, so an increased share of bank lenders would also be positive for premium coupon Ginnie Mae MBS. Finally, there were several headlines surrounding the newly appointed director of the Federal Housing Finance Agency (FHFA), Mark Calabria, who commented on his intent to release Fannie Mae and Freddie Mac from government conservatorship. It was also reported that the Trump administration is working on a proposal for GSE reform that is expected to lay out a plan to recapitalize and release the GSEs from conservatorship. Despite the apparent focus on housing reform by the administration and Calabria, there are significant political hurdles to achieving GSE reform, making the path forward highly uncertain. Congressional approval would be required to guarantee the collateral of Fannie Mae and Freddie Mac. If the GSEs were released without an explicit government guarantee, Ginnie Mae MBS would likely outperform their conventional counterparts issued by the GSEs.

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Coupon Stack Performance

30 Yr FNMA	May Month End Price	Monthly Price Change (pts)	Monthly Performance vs. Benchmark U.S. Treasury (%)	May Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$100.45	1.72	-0.23	29.7	-0.4
3.5	$102.02	1.13	-0.47	31.7	-4.6
4.0	$103.23	0.69	-0.56	36.9	-3.3
4.5	$104.48	0.50	-0.50	75.2	10.1
5.0	$105.58	0.28	-0.66	117.5	22.9
5.5	$106.98	0.28	-0.97	144.1	22.3
6.0	$108.58	0.50	0.39	169.5	24.1
15 Yr FNMA					
2.5	$100.08	1.22	-0.05	29.2	9.2
3.0	$101.48	1.00	-0.19	30.4	4.3
3.5	$102.73	0.66	-0.38	36.9	6.3
4.0	$103.33	0.34	-0.45	49.7	19
4.5	$102.05	0.19	0.04	155.9	33.7

Source: TCW, Bloomberg Barclays

Benchmark Performance

	May Month End Price	May Month End Yield	April Month End Yield	Change (bps)
2 Yr Treasury	$100.39	1.92%	2.27%	-34.40
5 Yr Treasury	$100.42	1.91%	2.28%	-36.73
10 Yr Treasury	$102.23	2.12%	2.50%	-37.72
30 Yr Treasury	$106.37	2.57%	2.93%	-36.03
2/10 Curve		20.02	23.37	-3.35
2 Yr SWAP Spread		5.44	11.23	-5.79
10 Yr SWAP Spread		-1.25	-4.25	3.00
1y*10y Swaption Vol		66.47	56.33	10.15
5y*10y Swaption Vol		65.16	60.11	5.06

Source: TCW, Bloomberg

Issuer Performance (ticks)

	May GNMAII/FNMA	Monthly Price Change	May GOLD/FNMA	Monthly Price Change
3.0	35.25	5.25	2.25	2.00
3.5	25.75	1.75	2.25	0.375
4.0	7.25	-4.50	2.25	-0.125
4.5	-15.25	-4.50	3.25	-1.75
5.0	-34.25	-1.25	4.50	-0.50
5.5	-40.5	-0.50	5.50	-1.50

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	May 31, 2019	Apr 30, 2019	Mar 31, 2019
FN 3% LLB	17	17	17
FN 3% MLB	14	14	14
FN 3% HLB	11	11	11
FN 3.5% LLB	46	37	30
FN 3.5% MLB	39	33	28
FN 3.5% HLB	30	26	23
FN 4% LLB	80	66	69
FN 4% MLB	67	57	60
FN 4% HLB	54	46	50
FN 4.5% LLB	115	100	100
FN 4.5% MLB	100	86	90
FN 4.5% HLB	76	72	73

Source: TCW, Citi

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