

## MONTHLY COMMENTARY

## June Agency MBS Update

STEPHEN K. LEECH | JULY 5, 2016

The sentiment, “May you live in interesting times,” is considered to be both a blessing and a curse. So it would seem for investors this month, as yields around the globe dropped precipitously due to growth concerns and Britain’s unexpected decision to divorce itself from the European Union. No sooner had agency mortgages clawed back their underperformance from the beginning of the year when, once again, fixed income markets were thrown into turmoil. The first shoe to drop was a weak non-farm payroll report which saw the economy add just 38k jobs in June. The sour data discouraged the Federal Reserve from increasing the target federal funds rate, and also made the committee reconsider the future path toward funds rate normalization. As a result, the forward projections of the funds rate by Fed staff members were marked significantly lower than previously. The fundamentals that precipitated the Fed decision drove the basis wider over the first half of June as U.S. Treasuries rallied.

The agency MBS basis recovered somewhat over the next week, as markets focused on the United Kingdom’s referendum on whether or not to remain in the EU. The mortgage basis rallied going into the referendum, as most market observers expected voters in the UK to remain in the EU due to both the length and breadth of that relationship. The script was flipped on voting day, as voters in the UK rejected remaining in the EU by a 52%-48% margin. This result sent shockwaves through global financial markets. The yield on 10-year U.S. Treasuries dropped 30 basis points (bps) overnight, while stocks fell 5% over two days. The agency MBS basis lurched wider, as rates fell near all-time lows (10-year at 1.47%) and volatility surged. The combined risk of faster prepayments and higher volatility brought on by the vote was harmful to agency MBS valuations. While mortgages managed to shake off some of the damage as fear abated in the closing week of June, the results were still poor for the month. In aggregate, the Barclays MBS index underperformed benchmark U.S. Treasuries by 40 bps in June, with 2016 year-to-date underperformance falling to negative 45 bps.

The rejection of their membership in the EU by voters in the UK is the type of event that exposes the risks that the agency MBS basis faces moving forward. Despite the fact that agency MBS performance had crept back near even relative to U.S. Treasuries going into June, agency MBS performance was concerning in light of relatively stable rates and low volatility. With U.S. Treasury rates approaching their all-time low yield levels, agency MBS investors must now prepare for the possibility of an elevated prepayment environment in the coming months. This new reality was visible in the coupon stack performance where 30 year Fannie Mae (FNCL) on the run coupons performed poorly. FNCL 3s underperformed their 10-year U.S.



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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.

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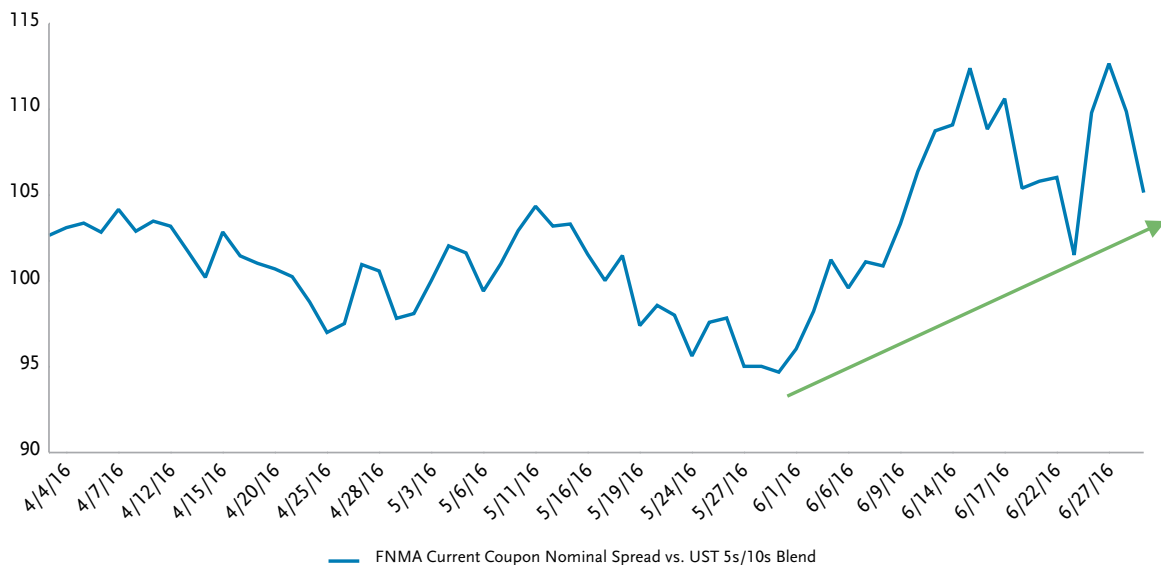
Treasury hedges (HRs) by 7 ticks, while FNCL 4s ended up trailing their HRs by 7+ ticks. Ginnie Mae collateral had an even worse month, following the traditional pattern in underperforming in lower rate environments. 30-year Ginnie Mae (G2SF) 3s underperformed HRs by 15 ticks, while even G2SF 4s were off 12 ticks. The relative underperformance is further demonstrated by the G2/FN 3.5 swap which fell 9 ticks in June. 15-year Collateral also struggled, as FNCL 2s finished 9 ticks back of their HRs. Furthermore, TBA roll levels continued to come under pressure, capping a month in which there was very little in positive performance to buoy the spirits of beleaguered market participants. While agency MBS held up better than numerous other asset classes in the ‘Brexit’ aftermath, future global uncertainty could continue to weigh on agency MBS valuations.

The prepayment report for May showed that speeds increased 6% vs. April and did not significantly impact the agency MBS basis in June. FNCL collateral was up 0.9CPR to 15.7CPR (May). The fastest percentage increases were seen in lower coupons, with FNCL 2.5s and FNCL 3s each up over 10%. The faster speeds in lower coupons could portend prepayments picking up if mortgage rates continue to fall in the coming months. Most of the overall increase can be attributed to seasonal factors (day count unchanged). Speeds have not reacted to recent low interest rates to the extent many expected. It remains unclear if borrower indifference

will continue with the 30-year mortgage rate now down to 3.75%, the lowest level since May of 2013. The extent to which prepayments pick up over the coming months will be one of the most important developments to the sector with historically low interest rates now looming.

The regulatory picture remains murky as the calendar flips to the second half of 2016. The most notable piece of regulatory news for agency MBS valuations was the continued noise around the possibility of the Federal Housing Administration (FHA) once again cutting the mortgage insurance premiums (MIP) that borrowers pay from the current level of .85%. No actionable news has been released regarding the possibility of a cut this year. Yet the fact that for the first time since 2008 the FHA last year was able to meet the Congressionally mandated 2% threshold for the Mutual Mortgage Insurance Fund suggests that the FHA could be emboldened to cut the MIP as they did in January of 2015. The result of any cut would once again be to cause prepayments to rise in FHA loans, negatively impacting Ginnie Mae collateral. While it is uncertain whether the FHA will make the choice to cut the MIP, the possibility is worth monitoring closely. With 2016 halfway to its conclusion, the continued overhang of regulatory developments, historically low interest rates, and concerns about the global macro picture may act as headwinds agency mortgage valuations in the near future.

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



Source: Barclays, Bloomberg

## Coupon Stack Performance

30 Year FNMA	June Month End Price	Monthly Price Change (ticks)	Monthly Hedged Performance		LIBOR OAS Monthly Change (bps)
			vs. 10 Year Treasury (ticks)	June Month End LIBOR OAS (bps)	
3.0	103-24	1-18	-7	12.1	-6.5
3.5	105-15	1-0	-7	10.2	-6.7
4.0	107-07	18+	-7+	17.8	-0.4
4.5	109-05	12	-4	24.5	3.2
5.0	111-02+	8	-5	4.1	9.4
5.5	112-13	11	0	13.6	10.5
6.0	114-12	12+	2+	-6.6	7.9

15 Year  
FNMA

	June Month End Price	Monthly Price Change (ticks)	vs. 10 Year Treasury (ticks)	June Month End LIBOR OAS (bps)	LIBOR OAS Monthly Change (bps)
2.0	101-16	1-12	-9	0	0
2.5	103-15	1-4+	-1	18	4.9
3.0	104-26+	24	-1	20.5	7.4
3.5	105-30+	18+	1+	30.8	11.6
4.0	103-23+	4+	-6	-16.9	47.1
4.5	102-18	-2	-11	39.9	14.3
5.0	102-15	2	-6	202.9	25

Sources: TCW, Barclays, JPMorgan

## Benchmark Performance

	June Month End Price	Monthly Price Change	June Month End Yield	Change (bps)
2 Yr Treasury	100-02	0-2	0.59	-29
5 Yr Treasury	100-18	0-16	1.02	-35
10 Yr Treasury	101-07	3-2	1.49	-34
30 Yr Treasury	104-11	7-0	2.31	-33
2/10 Curve			90	-6
2 Yr SWAP Spread			14.8	0.1
10 Yr SWAP Spread			-10.6	3.9
1*10 Swaption Vol			79.2	-1.8
5*10 Swaption Vol			83	-0.1

Sources: TCW, Citigroup

## Issuer Performance (ticks)

	June GNMAII/FNMA	Monthly Price Change	June GOLD/FNMA	Monthly Price Change
3.0	0-24	-0-10	-0-03	-0-02
3.5	0-20	-0-08+	-0-02	0-00+
4.0	-0-10	-0-06	-0-05+	-0-01+
4.5	-1-26+	-0-09+	-0-03	-0-01+
5.0	-2-14	0-10	-0-20	0-05
5.5	-2-16	0-00	-0-26	0-00

Sources: TCW, Credit Suisse, JPMorgan

## Specified Pool Pay-Up Grid (ticks)

Coupon	June 30, 2016	May 31, 2016	Dec 31, 2015
FN 3% LLB	34	17	8
FN 3% MLB	28	13	6
FN 3% HLB	22	7	4
FN 3% 125 LTV	4	-2	-2
FN 3.5% LLB	64	44	22
FN 3.5% MLB	54	36	16
FN 3.5% HLB	44	28	10
FN 3.5% 125 LTV	30	18	2
FN 4% LLB	92	68	42
FN 4% MLB	78	60	34
FN 4% HLB	58	46	24
FN 4% 125 LTV	58	44	16
FN 4.5% LLB	102	92	72
FN 4.5% MLB	88	72	60
FN 4.5% HLB	56	48	42
FN 4.5% 125 LTV	54	48	42

Sources: TCW, Credit Suisse

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