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INSIGHT

MONTHLY COMMENTARY

June Agency MBS Update

STEPHEN K. LEECH | JULY 6, 2017

A relatively benign interest rate picture in combination with persistent low volatility was not enough to keep the agency MBS basis afloat in June, as mortgages closed the first half of 2017 with negative excess returns relative to U.S. Treasuries. The agency MBS basis struggled from the outset, as weaker than expected non-farm payrolls spooked investors, dragging mortgage valuations wider relative to Treasuries. Performance was further hampered by the looming specter of the Federal Open Market Committee (FOMC) meeting in the middle of the month. The FOMC's prominence in agency MBS valuations has increased in recent months, the result of the first interest rate hiking cycle in the past 10 years and uncertainty regarding the Fed's multi-trillion dollar balance sheet. The FOMC sought to provide clarity to investors at the meeting, raising interest rates once again and providing a detailed plan for how the Fed will seek to unwind asset purchases from the post-crisis period. While the exact start date of balance sheet normalization remains uncertain, comments by Chair Yellen suggested the runoff is likely to begin this year. The agency MBS basis sold off on the news. Relative returns in agency MBS continued to struggle toward the close of June, possibly the result of investors expecting a less active Federal Reserve in the mortgage market and forecasting the return of long absent volatility. Mortgages began to re-find their footing in the final days of June, yet the damage had been done. In total, the Bloomberg Barclays MBS index posted negative excess returns of -20 basis points (bps) relative to U.S. Treasuries, closing the first half of 2017 with -20bps of excess returns.

The dispersion of negative excess returns in June was highly dependent on the macro and regulatory factors that overlay mortgage valuations. The most notable development was Ginnie Mae collateral underperforming conventional counterparts. Fannie Mae 30yr (FNCL) collateral on the whole underperformed benchmark U.S. Treasuries by 13bps in June, while Ginnie Mae collateral underperformed by 32bps. Ginnie Mae collateral has come under pressure the last few months as much of the excess demand from banks and Asia has subsided. Valuations in Ginnie Maes are usually higher than conventional coupons due to the explicit government guarantee of payment. In recent years, demand for Ginnie Mae collateral has been further buoyed by capital rules that make it advantageous for banks to place government guaranteed collateral on their balance sheets. A report from the U.S. Treasury suggested that some of the Obama era capital rules might be on their way out the door. Such a change in regulatory requirements could significantly alter the market for Ginnie Mae collateral, leaving a negative mark on performance in the second half of 2017. The macro interest rate picture was also disruptive of agency MBS performance in June. The Federal Reserve chose to raise interest rates in the middle of the month, sending benchmark interest rate corridors to 1% and 1.25%. This action came despite inflation readings that continue to run under the Fed's 2% target. The result was a

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fairly substantial flattening of the yield curve, which negatively impacted shorter duration MBS, specifically conventional 15yr collateral. In aggregate, Fannie Mae 15yr collateral came in at -18bps relative to U.S. Treasuries, with FNCI 3.5s posting excess returns of -26bps. The movement between Ginnie Mae, 15yr, and conventional 30yr collateral stood in contrast to performance of FNCL coupons as a whole, where excess returns were within a few bps of the cohort overall. FNCL 3s and 4.5s slightly underperformed relative to FNCL 3.5s and 4s.

The primary regulatory story was the FOMC meeting in June, specifically the release of the detailed plan to reduce the Fed's holdings of both U.S. Treasuries and agency MBS. The Fed plan sets monthly caps on the amount of agency MBS and Treasuries that will be allowed to roll off of the balance sheet. Prepayments and maturations that are in excess of the caps will be reinvested into the Federal Reserve's portfolio. The result will be a slow drawdown of agency MBS and U.S. Treasuries. Specifically, the Fed will begin by allowing $4bn in agency MBS to roll off each month, raising that by $4bn each quarter until the Fed hits $20bn a month. Treasuries will begin at $6bn a month, rising by $6bn each month until they reach $30bn a month. The result of the policy will be such that agency MBS purchases by the Fed will slow down and then eventually cease all together, barring a change in market conditions. The drawdown will be an extremely long process, taking years, and as always with Fed policy, will be subject to change at the whim of the FOMC. So long as the Fed sticks to the announced policy, the caps should make it fairly easy to predict the amount of the Fed's purchases and composition of their balance sheet. Agency MBS as whole will experience a TBA float with an increase in the volume of faster prepaying pools in the deliverable, as the Fed will no longer be taking the worst to deliver bonds into its own portfolio. This will adversely impact the carry profile of agency MBS, just as the overall float will increase as the Fed ceases its long-running buying program.

Prepayments jumped in the June report, as mortgage rates that have ground lower have started to bump speeds off their post-election lows. FNCL prepays came in up 18%, the result of a higher day count, seasonal factors, and a slight upside surprise. All conventional coupons prepaid roughly 2CPR faster than in the prior month. On a percentage basis, FNCL 3s rose 26% to lead the way. Higher coupons saw much smaller percentage increases in prepays, with FNCL 4s and 4.5s rising just 16% and 11% respectively. Speeds remain benign for the time being, with most borrowers nationwide holding mortgages that cannot be refinanced economically to a lower rate loan. The slow decrease in mortgage rates since late November has begun the process of eroding what looked like serially low speeds for the foreseeable future after the post-election interest rate shock. Should mortgage rates decrease further, prepayments could once again rise in importance for agency MBS investors.

Relative agency MBS performance in the first half of 2017 was negative despite both implied and actual volatility dropping to near record low levels over the same period. Due to the fact that the imbedded options in agency MBS make the sector highly sensitive to increases in volatility, negative relative performance, despite a highly constructive volatility picture, is instructive. Low volatility has caused option adjusted spreads to widen out, while yield based spread levels began to follow in June. Should volatility remain near all time low levels for an extended period of time, current widening of the agency MBS will look like an opportunity for buying and short covering. However, extending this run of muted implied and realized volatility will require a lack of market dislocations in the agency MBS space, as well as a lack of macro events that might cause the market outlook to change substantially. Given low volatility only remaining low until it doesn't, it remains imperative for investors to expect the unexpected as the calendar flips to the second half of 2017.

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Coupon Stack Performance

30 Year FNMA	June Month End Price	Monthly Price Change (pts)	Monthly Performance vs. Benchmark U.S. Treasury (%)	June Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$99.83	-0.66	-0.17	29.8	1
3.5	$102.67	-0.56	-0.10	33.1	1.5
4.0	$105.14	-0.47	-0.12	42.7	1.8
4.5	$107.27	-0.50	-0.14	53.5	3
5.0	$109.30	-0.63	-0.23	46.9	4.7
5.5	$110.77	-0.63	-0.06	66.5	2.9
6.0	$112.61	-0.66	0.04	71.8	6.9
15 Year FNMA					
2.5	$100.48	-0.50	-0.16	15.7	0
3.0	$102.61	-0.50	-0.16	41.3	6
3.5	$104.05	-0.59	-0.26	87.5	14.5
4.0	$103.45	-0.44	-0.20	166	-11
4.5	$101.77	-0.63	0.17	174.6	-6.2
5.0	$101.92	-0.66	0.00	185.6	-8.2
5.5	$100.27	-0.69	0.00	126.2	-13.3

Sources: TCW, Barclays, Bloomberg

Benchmark Performance

	June Month End Price	June Month End Yield	May Month End Yield	Change (bps)
2 Yr Treasury	$99.74	1.38%	1.28%	9.99
5 Yr Treasury	$99.34	1.89%	1.75%	13.68
10 Yr Treasury	$100.62	2.30%	2.20%	10.09
30 Yr Treasury	$103.30	2.83%	2.86%	-2.86
2/10 Curve		91.80	91.70	0.10
2 Yr SWAP Spread		23.33	22.78	0.55
10 Yr SWAP Spread		-5.88	-2.38	-3.50
1*10 Swaption Vol		72.20	71.88	0.32
5*10 Swaption Vol		78.30	78.10	0.20

Sources: TCW, Bloomberg

Issuer Performance (ticks)

	June GNMAII/FNMA	Monthly Price Change	June GOLD/FNMA	Monthly Price Change
3.0	37.5	-7.25	-2.5	-1.75
3.5	28.25	-5.5	1	0.25
4.0	3	-3.75	1.13	-1.13
4.5	-32	-8	-4	-2.13
5.0	-64	0.25	-14	-9
5.5	-62.5	3.25	-14	-9

Sources: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	June 30, 2017	May 31, 2017	Dec 30, 2016
FN 3% LLB	18	18	11
FN 3% MLB	14	14	9
FN 3% HLB	10	10	7
FN 3% 125 LTV	-2	-4	-8
FN 3.5% LLB	31	32	30
FN 3.5% MLB	25	27	24
FN 3.5% HLB	20	20	18
FN 3.5% 125 LTV	14	12	10
FN 4% LLB	54	53	48
FN 4% MLB	47	48	38
FN 4% HLB	36	36	30
FN 4% 125 LTV	26	24	22
FN 4.5% LLB	84	80	62
FN 4.5% MLB	66	66	48
FN 4.5% HLB	53	52	38
FN 4.5% 125 LTV	42	40	26

Sources: TCW, Credit Suisse, Citi

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