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MONTHLY COMMENTARY

July Agency MBS Update

STEPHEN K. LEECH | AUGUST 2, 2017

The agency MBS basis bounced back in July, as stable interest rates and the absence of negative headlines erased the poor relative performance seen in June. As investors wait for the Federal Reserve to begin its long awaited tapering program, a quiet calm has enveloped global markets. The two potential flies in the low-volatility, stable-interest-rates ointment in July were the release of the minutes of the Federal Reserve's June meeting, and developments from the Fed's July meeting, held near month end. Neither event roiled markets enough to change the tone that dominated mortgages during July. The minutes of the June meeting showed that officials remained divided over when to begin winding down the $4.4 trillion dollar balance sheet, however comments from the July meeting hinted that the program may begin in October. Low unemployment numbers and risk markets flashing all-time high valuations suggest that tighter conditions are warranted from the Fed, while stubbornly low inflation highlights the benefits of a cautious approach. For agency MBS investors, now that the particulars of the plan are known, the precise start to balance sheet reduction is no longer driving significant movement in the basis. Thus the market finds itself a rather peculiar situation. A remarkably stable interest rate picture, demonstrated by 30yr mortgage rates staying in a 10 basis point (bp) range over the past three months, has tamped down prepayment fears. Furthermore, both implied and actual volatility continue to scrape historically low levels. In spite of these positive forces, excess returns for agency MBS have been virtually flat for the year relative to Treasuries. The question this poses is will mortgages provide excess returns in the 2nd half as relative valuations are driven higher by continued low volatility? Or perhaps the FOMC unwinding its balance sheet, negative headlines, or some other unforeseen event will bring back volatility and push back on agency MBS valuations that remain elevated relative to historic norms? In July, the positive tailwinds won the day, with the Bloomberg Barclays MBS Index outperforming benchmark U.S. Treasuries by 24bps, sending year to date excess returns to positive 4bps.

The trend of relative outperformance by lower coupon MBS from the first half of the year continued in July. In Fannie Mae 30yr (FNCL) collateral, FNCL 3s outperformed benchmark US Treasuries by 33bps, while FNCL 4.5s posted positive returns of 6bps. Lower coupons have outperformed in part due to stable rates and the fact that most borrowers are currently unable to refinance to lower interest rate loans. The result has been a relative boon to lower coupons. These looked to be to be in dangerous shape after the late November rate selloff, yet have outperformed thus far in 2017. A far more challenged sector of the agency MBS universe has been Ginnie Mae collateral (GNMA). A brutal first half of the year saw GNMA collateral buckle under the pressure of weaker global demand and valuations that had overshot fundamentals. Yet the government-guaranteed collateral rebounded in July. GNMA 3s outperformed benchmark Treasuries by 42bps, with GNMA 4s coming

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in up 10bps. Despite the potential for new capital rules to negatively impact GNMA collateral, the constant pressure may have created some opportunities to be seized as valuations stabilize. TBA rolls figure to be another sector that investors will be monitoring as the Federal Reserve begins reducing its balance sheet. MBS purchases by the FOMC have been particularly constructive to TBA roll valuations, due to the Fed taking delivery of the fastest prepaying bonds in the agency MBS universe. This led to rolls trading 'special', since the worst-to-deliver pools that comprise the TBA float were taken in by the Federal Reserve, allowing investors to earn excess carry on a month-to-month basis. With the Fed about to commence the withdrawal of this support, the response of TBA rolls will be a key determinant of whether mortgages outperform US Treasuries. Should the float of TBA coupons deteriorate, investors will have to seek out opportunities elsewhere, either in other pockets of agency MBS, or in alternative areas of the fixed income universe.

The prepay report in July remained close to in line with analyst expectations, with speeds elevating largely due to seasonal factors. FNCL prepayments came in up 7% on the month, the result of a typical summer uptick in prepayments. Lower coupon speeds increased more sharply than higher coupon cohorts, as FNCL 3-4 speeds jumped between 1-2 CPR, while higher coupons saw smaller increases. FNCL 4.5 speeds came in up just 3%, far less than FNCL 3 prepayments which were up 13%. The slightly faster speeds can most likely be attributed to a small increase in refinance activity. In aggregate, prepayments remain muted despite slightly lower driving mortgage rates in the month, the result of the majority of borrowers not presently being able to refinance economically to a lower interest rate mortgage. With the day count decreasing in the upcoming prepayment report, a drop in speeds is the most likely result despite driving mortgage rates continuing to tick lower.

Aside from the continuing saga of the market trying to time the FOMCs commencement of balance sheet reduction, the most important regulatory topic in August was the decision by the Financial Accounting Standards Board (FASB) to allow banks to better hedge the interest rate exposure on prepaying assets. The specifics would entail allowing banks to use hedge accounting to manage interest rate risk in agency MBS as well as CMBS. Furthermore, banks will be given the opportunity to make a one-time reclassification of held to maturity assets into available for sale assets when the rule is adopted. While the rule is not yet final, the result should be to increase bank demand for agency MBS and other prepaying assets Furthermore, as banks will have more leeway to enter the market when valuations are attractive, as opposed to basing their transactions on their held to maturity needs. While banks may not be able to perfectly hedge their agency MBS exposure under the new rules, allowing banks to better manage their exposure via derivatives should make it more likely that banks invest in agency MBS. This development is an unexpected and positive one for the sector going forward as the calendar flips to the end of summer. ■

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Coupon Stack Performance

30 Year FNMA	July Month End Price	Monthly Price Change (pts)	Monthly Performance vs. Benchmark U.S. Treasury (%)	July Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$100.17	0.34	0.33	27.1	-2.7
3.5	$102.95	0.28	0.26	21.3	-11.8
4.0	$105.30	0.16	0.17	40.7	-2
4.5	$107.39	0.13	0.06	51.3	-2.2
5.0	$109.30	0.00	-0.04	48.6	1.7
5.5	$110.73	-0.03	-0.18	73.4	6.9
6.0	$112.61	0.00	0.27	76.1	4.3
15 Year FNMA					
2.5	$100.83	0.34	0.19	5.4	-10.3
3.0	$102.86	0.25	0.14	40.7	-0.6
3.5	$104.23	0.19	0.09	98.1	10.6
4.0	$103.64	0.19	0.07	166.4	0.4
4.5	$102.30	0.53	-0.06	175.4	0.8
5.0	$102.05	0.13	0.04	183.2	-2.4
5.5	$100.42	0.16	0.00	129.4	3.2

Sources: TCW, Barclays, Bloomberg

Benchmark Performance

	July Month End Price	July Month End Yield	June Month End Yield	Change (bps)
2 Yr Treasury	$100.05	1.35%	1.38%	-3.26
5 yr Treasury	$100.18	1.84%	1.89%	-5.28
10 Yr Treasury	$100.70	2.29%	2.30%	-0.95
30 Yr Treasury	$101.97	2.90%	2.83%	6.51
2/10 Curve		93.91	91.80	2.11
2 Yr SWAP Spread		24.72	23.33	1.39
10 Yr SWAP Spread		-2.38	-4.60	2.22
1*10 Swaption Vol		69.20	72.20	-3.00
5*10 Swaption Vol		78.10	78.30	-0.20

Sources: TCW, Bloomberg

Issuer Performance (ticks)

	July GNMAII/FNMA	Monthly Price Change	July GOLD/FNMA	Monthly Price Change
3.0	41.25	3.75	0.25	2.75
3.5	30.75	2.5	2.38	1.38
4.0	0.75	-2.25	1.75	0.62
4.5	-36.75	-4.75	-3.13	0.87
5.0	-59.5	4.5	-13	1
5.5	-59.5	3	-14	0

Sources: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	July 31, 2017	June 30, 2017	Dec 30, 2016
FN 3% LLB	17	18	11
FN 3% MLB	13	14	9
FN 3% HLB	10	10	7
FN 3% 125 LTV	-2	-2	-8
FN 3.5% LLB	30	31	30
FN 3.5% MLB	24	25	24
FN 3.5% HLB	19	20	18
FN 3.5% 125 LTV	14	14	10
FN 4% LLB	56	54	48
FN 4% MLB	49	47	38
FN 4% HLB	39	36	30
FN 4% 125 LTV	26	26	22
FN 4.5% LLB	88	84	62
FN 4.5% MLB	71	66	48
FN 4.5% HLB	60	53	38
FN 4.5% 125 LTV	42	42	26

Sources: TCW, Credit Suisse, Citi

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