INSIGHT

MONTHLY COMMENTARY

July Agency MBS Update

JAE LIM | 6 AUGUST 2019

Jae Lim
Vice President
Fixed Income

Mr. Lim is a member of the Fixed Income group who specializes in agency mortgage-backed securities. Prior to joining TCW in 2017, he was at Citigroup where he covered institutional investors specializing in money market securities, investment grade corporate bonds, and securitized products. Mr. Lim earned a BA in Economics from University of California, Berkeley.

Agency MBS posted its strongest performance of the year in July as the rally in risk assets continued, fueled by investors' belief that the Fed will sustain economic expansion via interest rate cuts. Strong U.S. economic data, along with expectations for a series of interest rate cuts, buoyed risk assets earlier in the month with the S&P 500 breaching 3,000 to hit another all-time high. The move to lower rates marks a pivot in Fed policy from last December's rate hike, which triggered a market selloff at the time. Since then, market participants have widely anticipated a policy reversal and had priced in over 100 basis points (bps) of cuts through 2020. The 25bps cut announced by the Fed on the last day of July would appear to be the first installment in that series. However, Fed Chairman Powell's easing guidance seemed intended to temper rather than bolster expectations. He emphasized that the cut should be viewed as a "mid-cycle adjustment" rather than the start of a full cutting cycle. As this called into question market expectations for a series of cuts, risk assets began to sell off as the yield curve flattened. For agency MBS, July performance still remained strong as prepayment concerns were contained with higher rates while the risk on rally drove performance. The Bloomberg Barclays MBS Index posted excess returns of 43bps over benchmark U.S. Treasuries, its strongest monthly performance of 2019, bringing YTD excess returns up to 34bps. Total return remains strong at 4.59% in 2019.

Agency MBS coupon stack performance reversed its recent trend favoring lower coupon securities as higher coupons outperformed for the month. Marginally higher rates left the Freddie Mac Primary Mortgage Market Survey (PMMS) 30yr fixed mortgage rate stable throughout the month and it ended the month unchanged at 3.75%. The slower than expected speed print further helped ease prepayment concerns and the entire coupon stack delivered positive excess performance to benchmark USTs in July. Conventional higher coupons performed best with FNCL 5.0s and 4.5s posting 83bps and 67bps of excess return, respectively. Lower coupons lagged but still delivered strong performance with FNCL 3.0s up 34bps. Ginnie Mae (GNMA) MBS largely lagged its conventional counterparts for the first time in two months as the carry profile deteriorated in the higher coupons and speeds remained elevated.

Ginnie Mae performance was still positive largely led by the outperformance in G2 4.0s that posted 45bps of excess returns as the roll specialness in the coupon kept it well bid. Specified pool performance was rather flat throughout the month despite seeing some selling pressure in the higher coupons.

In the News:

GNMA published an RFI (Request for Input) report on its stress testing framework for non-bank issuers under a variety of scenarios. Since the financial crisis, the share of non-bank lenders participating in GNMA's lending programs has increased significantly while traditional banks have stepped back. These non-bank lenders tend to have faster prepayment speeds which are detrimental to GNMA securities that are mostly trading at a premium. Along with the Federal Housing Administration (FHA) announcement in May to attract banks to offer more loans to their borrowers, the RFI is probably a positive as it seems like GNMA is making an effort to improve its program.

On July 25th, the Consumer Financial Protection Bureau (CPFB) released an Advance Notice of Proposed Rulemaking (ANPR) stating that it will allow the GSE patch to expire at the currently scheduled date of January 10, 2021. The GSE patch is a loophole made back in 2013 when the CFPB set the Qualified Mortgage (QM) rule that gave special treatment to loans eligible for purchase by Fannie and Freddie. While the rule originally had a qualification that the Debt to Income (DTI) ratio could not exceed 43% to become a QM loan, the GSEs (Fannie and Freddie) were granted an exception to this rule and were allowed to produce loans with DTI above the 43% limit and still have them granted a QM label. This exception, also known as the GSE patch, then created an incentive for originators of high-DTI loans to deliver them to the GSEs. The CFPB is now considering revisions to the original QM definition and there can be a few implications that can be made if this were to happen. According to CFPB's own estimates, about 31% of loans guaranteed by the GSEs in 2018 exceeded the 43% DTI ratio and were originated under the GSE patch. Once the patch expires, there are largely three possible alternatives for existing borrowers with DTI above the 43% limit. Some borrowers could apply for FHA-guaranteed loans which allow higher DTI. However, it is a question of how much the FHA will be willing to increase its high-DTI exposure as more than 55% of recent FHA origination has been high DTI. Another option is for borrowers to shift to the private market where non-agency origination could provide funding. The last option is for some lenders to continue underwriting high DTI loans despite losing the QM designation. This would result in increased origination costs as well as potential litigation risk that could possibly be passed on to the borrowers in the form of higher interest rates. As for now, January 2021 is still a long way off and we expect the CPFB to come out with more details before the patch expires.

July 2019 Agency MBS Update

Coupon Stack Performance

30 Yr FNMA	July Month End Price	June Month Price	Monthly Price Change (points)	Monthly Performance vs. Benchmark UST (%)
2.5	$98.77	$99.17	-0.41	-0.22
3	$100.86	$100.70	0.16	0.36
3.5	$102.39	$102.17	0.22	0.55
4	$103.48	$103.36	0.13	0.48
4.5	$104.80	$104.48	0.31	0.67
5	$106.20	$105.73	0.47	0.83
15 Yr FNMA				
2.5	$100.48	$100.61	-0.13	0.09
3	$101.86	$101.89	-0.03	0.22
3.5	$103.17	$103.14	0.03	0.24
4	$103.73	$103.77	-0.03	0.24
4.5	$102.42	$102.23	0.19	0.07

Source: TCW, Bloomberg, Barclays

Benchmark Performance

	July Month End Price	July Month End Yield	June Month End Yield	Change (bps)
2 Yr Treasury	$99.76	1.87%	1.75%	11.72
5 Yr Treasury	$99.63	1.83%	1.77%	6.08
10 Yr Treasury	$103.18	2.01%	2.01%	0.93
30 Yr Treasury	$107.29	2.52%	2.53%	-0.42
2/10 Curve		14.03	24.82	-10.79
2 Yr SWAP Spread		4.07	4.94	-0.87
10 Yr SWAP Spread		-4.25	-7.00	2.75
1y*10y Swaption Vol		59.36	63.62	-4.26
5y*10y Swaption Vol		60.65	62.32	-1.67

Source: TCW, Bloomberg, Barclays

Issuer Performance (ticks)

	July GNMAII/FNMA	June GNMAII/FNMA	Monthly Price Change
3	39.75	42.50	-2.75
3.5	30.25	33.50	-3.25
4	10.25	10.25	0.00
4.5	-21.75	-8.25	-13.50
5	-49.00	-36.00	-13.00

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	July 31, 2019	June 28, 2019	May 31, 2019
FN 3% LLB	29	29	17
FN 3% MLB	25	25	14
FN 3% HLB	21	21	11
FN 3.5% LLB	64	69	46
FN 3.5% MLB	57	58	39
FN 3.5% HLB	46	48	30
FN 4% LLB	111	116	80
FN 4% MLB	93	100	67
FN 4% HLB	77	84	54
FN 4.5% LLB	150	152	115
FN 4.5% MLB	129	132	100
FN 4.5% HLB	95	100	76

Source: TCW, Citi

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