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MONTHLY COMMENTARY

August Agency MBS Update

STEPHEN K. LEECH | SEPTEMBER 2, 2016

The typical late summer malaise in financial markets did not prevent the agency MBS basis from posting its best month of 2016 thus far. Sparse news and subdued interest rate volatility combined to help the agency MBS basis tighten in August. Globally, the recurring theme of U.S. growth outpacing that of the rest of the world continued unabated during the month. A strong non-farm payroll report (+255k), combined with some above expectations housing data, helped inch the Federal Reserve in the direction of another hike in the federal funds rate. This stands in contrast to conditions globally, where yields remain near all-time lows, with countries such as Japan and the United Kingdom continuing or expanding their experiments with negative interest rates and quantitative easing. The depressed global yield environment continues to buoy agency MBS as foreign investors seek out markets with higher relative yields. The solid data and paltry news cycle resulted in relatively stable markets that saw the 10yr U.S. Treasury back up 10bps on stronger than expected economic data to finish the month at 1.57%. Further benefitting the agency MBS basis, the Refinance Index was relatively stable after dropping off the highs seen in mid-July. Furthermore, the 30yr mortgage rate has stabilized for the time being at 3.67%. The lack of rate volatility and a stabilization of mortgage interest rates have benefited agency MBS valuations by relieving fears that the coming prepayment wave will be worse than expected. The end result was an August that was supportive of agency MBS valuations despite the lack of a clear catalyst. In aggregate, the Barclays MBS index posted excess returns of 32 basis points relative to benchmark U.S. Treasuries, bringing the year to date performance into positive territory at +11 basis points.

The performance of agency mortgages in August was positive on all levels, as the macro tailwinds filtered throughout the sails of the agency MBS coupon stack. Digging into Fannie Mae 30yr (FNCL) bonds, positive performance was evident everywhere one looked. FNCL 3s came in with returns of 24bps relative to benchmark U.S. Treasuries, as FNCL 4s were up 37bps, and FNCL 4.5s finished up a full 66bps relative to U.S. Treasuries. Ginnie Mae collateral did not have as strong a month, but also saw higher coupons outperform lower coupons on a relative basis. One explanation for the positive performance in higher coupons has been the potential for burnout as many of the borrowers who could have refinanced their mortgage into a lower coupon have done so already. One notable long term trend is that Freddie Mac (FG) collateral continues to show signs of strength. The FG/FN 3.5 swap sits at just -2.25 ticks at month end, up from around -6 ticks last year. While the two should theoretically trade in tandem, the

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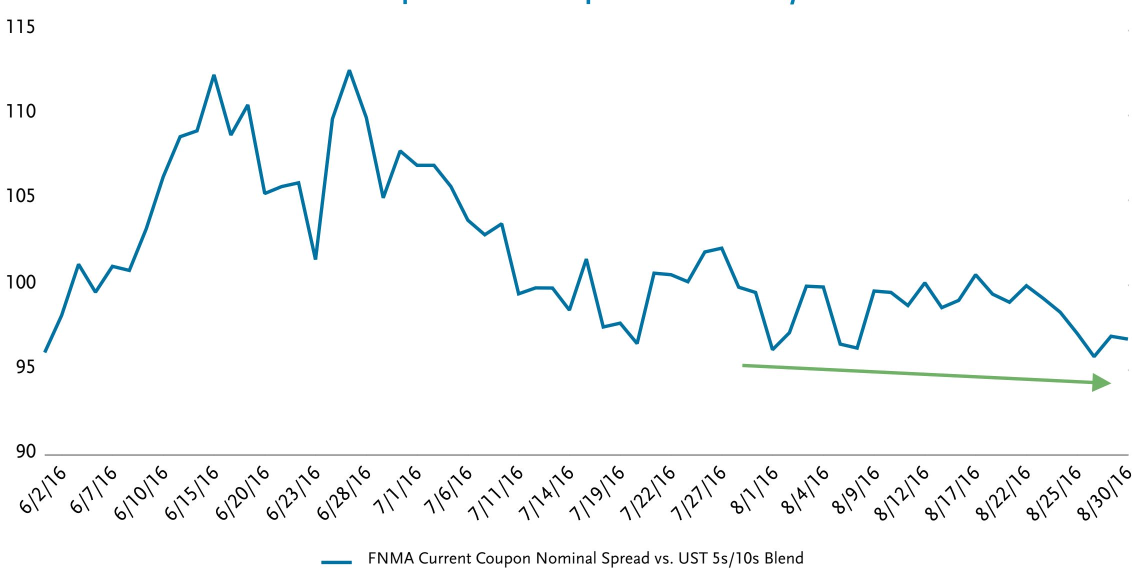
liquidity premium of Fannie Mae, which has more outstanding collateral, has caused a recurring valuation differential in the past. The coming of a single security, which would make both FG and FN collateral mutually deliverable into a single TBA by the end of the decade, as well as a push by Freddie Mac to make more investor-friendly pools, has helped reduce the differential. Looking to TBA rolls, the trend of cheapening roll levels was put on hiatus for the time being, as roll levels stayed reasonably close to home during the month of August. In aggregate, concerns about excessive agency MBS valuations were cast aside in for the month, as macro factors aided the entire coupon stack.

The final prepayment report before the materially lower mortgage rates of the summer kick in saw a broad-based speed decline. FNCL coupons declined 8% overall to end up at 15.5% CPR on the month. FNCL 3s dropped 7% while FNCL 4s fell 9% to 19.0% CPR. The decline in prepayment speeds was primarily driven by a drop in the day count by two business days in July. However the initial signs of the speed increases, which are due to hit the market in the upcoming prepayment report, did begin to appear on the margins. In particular, FNCL 3s issued in 2015 saw speeds increase 13% to finish at 12.4% CPR. A vintage that could lead any prepayment wave, the spike this month is one worrisome indicator for investors concerned about the upcoming report. Ultimately, this report was generally supportive of agency MBS valuations but the next few reports will provide a much clearer outlook for market participants as to the effects of this low interest rate environment on future prepayments.

The regulatory news was not sparse in August as the plan for replacing the Home Affordable Refinance Program (HARP) was finally announced. Originally created to give homeowners, who were adversely impacted by the financial crisis of 2008, the ability to refinance loans with high loan to value (LTV) ratios, HARP was set to expire at the end of 2016. The Federal Housing Finance Agency, which is responsible for administering HARP, released their plan for replacing HARP with an ongoing program that will allow borrowers with high LTV loans to refinance eligible loans. One notable facet of the announcement is that HARP itself will be extended nine months until the end of September 2017 to allow more time for the replacement program to be implemented. Furthermore, as promised, borrowers who used HARP to refinance will not be eligible to refinance under the auspices of the new program. This protects investors who bought pools created with the understanding that borrowers would not be able to use HARP to refinance more than once, destroying the value of the high LTV pools. As for the new program, borrowers wishing to participate must be current on their payments up to six months and have an income stream in order to be eligible. Given the housing price appreciation seen since the crisis, this program will be a very small subsection of the agency MBS universe. In addition, the extension of HARP for nine more months should have a negligible impact on HARP pools as the burnout among HARP eligible borrowers is high at this point. In aggregate, the news was helpful to investors as it provides clarity that has long been sought after over the long-term structure of high LTV financing.

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



Source: Barclays, Bloomberg

Coupon Stack Performance

30 Year FNMA	August Month End Price	Monthly Price Change (ticks)	Monthly Performance vs. Benchmark U.S. Treasury	August Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	103-24+	-8	0.24	6.2	2.3
3.5	105-12+	-6+	0.17	6.0	3.6
4.0	107-04+	-2	0.37	15.0	1.4
4.5	109-07+	6+	0.66	10.7	-8.7
5.0	110-26+	4	0.53	-4.1	-8.9
5.5	112-19	10	0.90	-8.0	-18.1
6.0	114-19	11	0.80	-28.9	-17.0
15 Year FNMA					
2.0	101-08	-13	0.19	0.0	0.0
2.5	103-10	-9+	0.22	5.9	-3.1
3.0	104-22	-7+	0.23	8.0	-2.4
3.5	105-19+	-10	0.17	18.6	-2.9
4.0	103-18	0	0.38	-47.2	-18.0
4.5	102-11	-1	0.31	7.3	-12.5
5.0	102-22	15	0.15	176.9	-14.9

Sources: TCW, Barclays, JPMorgan

Benchmark Performance

	August Month End Price	August Month End Yield	July Month End Yield	Change (bps)
2 Yr Treasury	$99.89	0.81%	0.66%	14.99
5 Yr Treasury	$99.64	1.20%	1.02%	17.40
10 Yr Treasury	$99.26	1.58%	1.45%	12.69
30 Yr Treasury	$100.38	2.23%	2.18%	4.93
2/10 Curve		77.07	79.38	-2.31
2 Yr SWAP Spread		24.40	22.37	2.03
10 Yr SWAP Spread		-10.06	-13.31	3.25
1*10 Swaption Vol		76.69	77.56	-0.87
5*10 Swaption Vol		80.10	80.74	-0.64

Sources: TCW, Bloomberg

Issuer Performance (ticks)

	August GNMAII/FNMA	Monthly Price Change	August GOLD/FNMA	Monthly Price Change
3.0	33	0.13	-0.38	2.25
3.5	24	2.13	-2.25	0.38
4.0	-8	5.25	-3.5	1.63
4.5	-47	15.75	1.75	3.63
5.0	-80	-7.62	-17	4
5.5	-73.5	11.5	-20	1

Sources: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	Aug 31, 2016	July 29, 2016	Dec 31, 2015
FN 3% LLB	30	31	8
FN 3% MLB	26	27	6
FN 3% HLB	20	23	4
FN 3% 125 LTV	4	8	-2
FN 3.5% LLB	72	68	22
FN 3.5% MLB	60	52	16
FN 3.5% HLB	48	44	10
FN 3.5% 125 LTV	40	38	2
FN 4% LLB	114	100	42
FN 4% MLB	94	86	34
FN 4% HLB	68	57	24
FN 4% 125 LTV	84	64	16
FN 4.5% LLB	120	110	72
FN 4.5% MLB	94	94	60
FN 4.5% HLB	68	66	42
FN 4.5% 125 LTV	100	60	42

Sources: TCW, Credit Suisse

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