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October Agency MBS Update

STEPHEN K. LEECH | NOVEMBER 2, 2016

Recent agency MBS excess performance slowed considerably in October, as cross winds and a changing market landscape left returns flat on the month. The nearly yearlong trend of falling interest rates abruptly reversed in October. The 10yr U.S. Treasury rate went from 1.60% to 1.84% during the month, bringing yields back to levels not seen since June of this year. While this development was positive for agency MBS investors leery of elevated prepayment risk brought about by low mortgage rates, the nature of the sell-off kept performance in check. Notably, the U.S. Treasury curve steepened, which dampened the carry profile of agency MBS relative to benchmark Treasuries. The result was nominal spread tightening but total returns that were not as strong as one might anticipate. A second tailwind that continued to aid the agency MBS basis in October was volatility falling further from already depressed levels seen in September. The positive effects of the low volatility buoyed agency MBS valuations; however, the positive effects were negated somewhat by higher than expected prepayments and a shifting market landscape. Most notably, global central banks led by Japan expressed a willingness to allow their yield curves to steepen, giving investors around the world the ability to find higher carry than what was available merely a month ago. In addition, despite mixed monthly economic data, there were some signs of life in the U.S. economy in October. GDP came in at 2.9% for the third quarter and home prices continue to appreciate, reducing the possibility of a recession near term and leaving the Fed on pace to raise interest rates one more time in 2016. In aggregate, the Barclays MBS Index posted excess returns of just 2 basis points (bps) in October, bringing year to date excess returns to positive 32bps, and marking the fourth consecutive month of agency MBS outperformance.

Despite the overall meager returns for agency MBS investors in October, the first month of the fourth quarter saw fairly variable returns throughout the coupon stack. The main outperformer was high coupon MBS. Fannie Mae 30yr (FNCL) 3% coupons returned -14bps, while FNCL 4 finished down just 1bp. Part of the better excess returns in higher coupons were their relatively shorter durations as compared to lower coupon MBS. The weaker returns in conventional collateral were offset by a very good month in GNMA MBS. The G2/FN 3.5 swap appreciated 7+ ticks on the month, closing at 29 ticks. The strong month was fairly typical for a rising interest rate environment, and allowed GNMA collateral to be the best performer in October. In aggregate GNMA 3s finished up 3bps, while GNMA 4s outperformed benchmark treasuries by 25bps. High coupons, those 4.5 and above, continue to do well for both conventional and GNMA collateral. The higher coupons in older vintage loans are subject to significant prepayment burnout among borrowers. That has allowed the collateral to perform well despite serially low interest rates. TBA rolls have not performed well the last six plus months, as technical conditions and Federal Reserve sponsorship that bolstered roll levels has

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dissipated. That trend was once again evident in October, as roll levels fell slightly during the month of October. Ultimately, a more dynamic coupon stack made agency MBS performance slightly more volatile than in September, in spite of overall returns close to that of benchmark Treasuries.

The prepay report for September was released at the beginning of the month, and speeds surprised the market by not slowing nearly as much as many expected. Aggregate prepayment speeds came in down 6%, bringing overall prepayments to 20CPR for FNCL collateral. The vote by UK voters to leave the European Union and the resulting interest rates at levels near all-time lows created a prepayment wave that peaked in August. Expectations were for the September report to decline 15% due to a lower day count and reduced seasonal factors. The decline of just 6% meant that after adjusting for the fewer business days in September, prepayments were in fact slightly higher in September than in August on a rate basis. This development was concerning to many investors who believed prepayment risk was somewhat contained despite persistent low rates seen during the summer. The declines were most pronounced in lower coupons, with FNCL 3s dropping 13% overall to 12.5CPR. The rest of the coupon stack was mostly in line, with FNCL 3.5s down 4% and FNCL 4s down 2%. Recent vintages remain among the fastest paying cohorts in the coupon stack, with 2014 remaining the fastest vintage. The last two months of the year should provide more clarity as to whether prepayments can continue at their elevated pace or if September speeds were the outlier to the expected trend.

The regulatory news was rather sparse with the Presidential election looming just ahead, however, there was one minor development of note for agency MBS investors. One of the longer term trends in the agency MBS market has been the rise in non-bank originators. Major banks have ceded market share to smaller specialized competitors over time. A few of these non-bank servicers have very high prepayment speeds due to their tendency to allow their customers to refinance more quickly than their major bank competitors. This has been particularly magnified in new issue G2 4.5 multi-issuer pools, which have seen very fast speeds due to servicers submitting loans to the pools and then immediately refinancing them, causing them to prepay at a torrid pace. The issue has crept down the G2 coupon stack as well; so to combat the issue, Ginnie Mae announced that beginning in February, originators must ensure that borrowers have made six months of consecutive payments on their last loan before they can refinance into a new G2 multi-issuer pool. This adjustment should cause these pools to have slower speed ramps in 2017 by closing the loophole that was hindering valuations on G2 multi-issuer pools by ratcheting up prepayments. While a minor change, the policy shift should give investors more clarity on prepayments in this subset of the agency MBS universe.

Coupon Stack Performance

30 Year FNMA	October Month End Price	Monthly Price Change (ticks)	Monthly Performance vs. Benchmark U.S. Treasury	October Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	102-30+	-32	-0.20	12.1	7.4
3.5	104-31+	-18+	-0.00	13.6	6.8
4.0	107-02+	-10	0.01	23.3	10
4.5	109-09+	-7	0.00	26.3	17.3
5.0	110-24	-10	0.04	-1.1	4.8
5.5	112-21	-1+	0.39	-7.8	-1.4
6.0	114-20+	-1+	0.39	-30.2	-1.5
15 Year FNMA					
2.0	100-10+	-+	0.06	0	0
2.5	102-28+	-21+	-0.35	7.7	4.6
3.0	104-20	-11+	-0.11	5.9	2.2
3.5	105-11	-2	0.12	-116.5	-145.8
4.0	103-08	2	0.42	119.5	169.8
4.5	102-09	-1+	0.34	135.8	134.3
5.0	102-13	-+	0.14	122.1	-63.2

Sources: TCW, Barclays, JPMorgan

Benchmark Performance

	October Month End Price	October Month End Yield	September Month End Yield	Change (bps)
2 Yr Treasury	$99.82	0.84%	0.76%	7.90
5 Yr Treasury	$99.72	1.31%	1.15%	15.75
10 Yr Treasury	$97.09	1.83%	1.59%	23.11
30 Yr Treasury	$93.16	2.58%	2.32%	26.44
2/10 Curve		98.06	82.86	15.20
2 Yr SWAP Spread		23.58	24.92	-1.34
10 Yr SWAP Spread		-14.04	-14.25	0.21
1*10 Swaption Vol		76.29	74.62	1.67
5*10 Swaption Vol		80.12	79.76	0.36

Sources: TCW, Citigroup

Issuer Performance (ticks)

	October GNMAII/FNMA	Monthly Price Change	October GOLD/FNMA	Monthly Price Change
3.0	38.75	12.75	-0.5	0.25
3.5	29.38	7.38	-1.5	-1
4.0	1	8.25	-3.75	0.25
4.5	-44.25	7.25	-0.5	0
5.0	-81.5	6.5	-3	5
5.5	-73.25	-0.75	-8	0

Sources: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	Oct 31, 2016	Sep 30, 2016	Dec 31, 2015
FN 3% LLB	25	30	8
FN 3% MLB	19	24	6
FN 3% HLB	15	20	4
FN 3% 125 LTV	2	4	-2
FN 3.5% LLB	66	72	22
FN 3.5% MLB	53	60	16
FN 3.5% HLB	42	50	10
FN 3.5% 125 LTV	38	38	2
FN 4% LLB	98	108	42
FN 4% MLB	80	88	34
FN 4% HLB	60	64	24
FN 4% 125 LTV	74	82	16
FN 4.5% LLB	112	116	72
FN 4.5% MLB	88	92	60
FN 4.5% HLB	62	64	42
FN 4.5% 125 LTV	92	96	42

Sources: TCW, Credit Suisse

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