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INSIGHT

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October Agency MBS Update

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Mr. Leech joined the TCW Fixed Income group in 2015 as an Analyst specializing in Agency mortgage-backed securities. Prior to joining TCW, Mr. Leech was an Analyst at The Royal Bank of Scotland. At RBS, Mr. Leech concentrated on investment grade credit. He focused on credit research. He also worked with clients in executing corporate bond trades. Prior to that, Mr. Leech worked in the Debt Capital Markets Group at RBS. He worked as part of a team charged with bringing new issue corporate bond offerings. Mr. Leech holds a BBA from the Goizueta Business School at Emory University. He is a CFA charterholder.

The coming of Halloween spooked financial markets in October, as agency MBS struggled to the worst month of excess performances since November of 2016. Risk assets tumbled sharply, as fears took hold that the confluence of an aggressive Federal Reserve and global economic weakness might combine to halt the long-term run up in risk asset prices. The result was a drawdown in risk assets that saw the S&P 500 drop a whopping 6.9% in October alone, the worst one-month loss on the index since 2011. Interest rates first climbed and then fell, as strong U.S. data bolstered interest rates and expectations for interest rate hikes, sending the 10yr U.S. Treasury yield at midmonth to 3.23%, its highest level since 2011. It then dropped back as the decline in risk assets took hold. The increase in interest rate volatility, combined with a sharp decline in risk assets, was a toxic cocktail for agency MBS performance. Increasing volatility of interest rates is particularly painful to agency MBS performance because sharp increases in interest rates extend MBS durations while acute drops in mortgage rates can bring prepayment risk back to the fore. A relatively benign prepayment outlook currently, along with years of low volatility in mortgage rates, suggests that the agency MBS basis is particularly sensitive to a pickup in overall volatility. In October, the increase in volatility and a pullback in risk assets were too much for the market to overcome. The Bloomberg Barclays MBS Index posted excess returns of negative 37 basis points (bps) versus benchmark U.S. Treasuries in October, sending year-to-date excess returns to negative 43bps on the year. Overall performance also suffered, with total returns now standing at negative 1.7% for 2018.

The challenges to agency MBS collateral were not evenly distributed across the coupon stack in October. Interest rates shifted up over the course of the month, allowing higher coupon collateral to outperform lower coupon MBS. Fannie Mae 30yr (FNCL) 3s and 3.5s posted excess returns of -40bps in October, as longer duration assets generally underperformed. The pain was less evident in higher coupons,

with FNCL 4.5s coming in down just 15bps. Higher coupon securities have outperformed lower coupon MBS on a relative basis throughout 2018, as rising rates have continually applied pressure to lower coupon collateral. The Fed's tightening of monetary conditions may continue to negatively impact lower coupons, as reduced issuance, fully extended durations, and a limited buyer base limit the value proposition of out of the money MBS at present. Ginnie Mae collateral also struggled mightily in October. Ginnie Mae 30yr (G2SF) 3s came in down a whopping 59bps relative to benchmark U.S. Treasuries, with G2SF 4s and 4.5s posting -46bps and -25bps of relative performance respectively. Despite interest rates moving higher over the course of October, Ginnie Mae collateral actually underperformed conventional MBS during the month. Typically, higher interest rates benefit Ginnie Mae securities, as differences in underlying collateral help Ginnie Mae securities pay faster when mortgage rates rise. In October, regulatory changes dragged on Ginnie Mae returns, as changes to bank capital rules weighed on potential future sponsorship of Ginnie Mae securities. Ultimately, the start of the fourth quarter was a rough one for the entire coupon stack. While higher coupons outperformed lower coupon MBS, increasing volatility and the challenges facing risk assets kept any part of the coupon stack from getting close to positive relative performance.

The major regulatory story in October was the move by the Federal Reserve on Halloween to propose a set of rules changing the capital requirements for banks in the United States. Required by Congress to look for ways to help ease the strain on community and small banks that some of the post-crisis regulations created, The Fed finally released their proposals for relieving the regulatory burden. While the proposals have many facets, the most notable change for the agency MBS market is the change in Liquidity Coverage Ratio (LCR) requirements for certain, mostly smaller banks. LCR rules generally lead to banks holding excess Ginnies due to better regulatory classification and capital treatment. Reducing the need for higher quality assets means that banks will likely have to hold fewer assets such as U.S. Treasuries and Ginnie Mae securities. The proposed rules would allow certain types of banks to take more risk, potentially letting banks reduce their Ginnie Mae portfolios and allocate more capital to slightly more risky assets. While the rules still require a comment period and are unlikely to be finalized for many months, the result could devalue Ginnie Mae collateral overall. Ginnie Mae valuations have been boosted for years by regulatory rules that made them particularly advantageous relative to conventional MBS, almost regardless of valuations for many financial institutions. Therefore, the movement to reduce capital requirements and undo past regulations may decrease the relative desirability of Ginnie Mae collateral over time.

Achieving the worst month of relative performance since November of 2016 is a notable development in what otherwise has been a relatively quiet year to date for agency MBS. Often more stable than other asset classes, the agency MBS basis widened considerably, as pain in global risk markets and an increase in rate volatility hurt agency MBS valuations. While spreads are wider, the significant spike in volatility still leaves volatility below historic norms, although up noticeably from recent months. Meanwhile, the drop in risk assets comes after stock markets hit all-time highs and the U.S. economy still appears to be quite strong. Thus, while agency MBS valuations appear more compelling than previously, volatility and risk market turbulence may be far from over. This presents a challenge for agency MBS investors, who must weigh the ever present possibility of negative performance stemming from a significant increase in rate volatility with the perils of risk assets that may have overshot intrinsic valuations. Ultimately, with the Bloomberg Barclays Index durations looking extended and less than 10% of borrowers eligible to refinance their loans in an economically advantageous fashion, tepid optimism seems warranted. While agency MBS can be subject to small eruptions like the one witnessed in October, the high quality of collateral in combination with the excess spread relative to U.S. Treasuries can be beneficial in this late cycle environment. Despite the challenging month for agency MBS performance, poor returns on good collateral should make agency MBS more appealing going forward.

Coupon Stack Performance

30 Yr FNMA	October Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	October Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$94.59	-1.00	-0.40	15.4	2.7
3.5	$97.34	-0.97	-0.40	25.9	4.4
4.0	$100.00	-0.85	-0.36	37.6	5.7
4.5	$102.41	-0.62	-0.15	50.1	4.9
5.0	$104.37	-0.48	-0.07	66.3	7.9
5.5	$105.96	-0.64	-0.21	78.7	13.5
6.0	$107.61	-0.41	1.26	91.0	6.9
15 Yr FNMA					
2.5	$95.74	-0.66	-0.38	10.6	8.0
3.0	$98.14	-0.53	-0.24	9.8	7.0
3.5	$99.93	-0.50	-0.25	33.7	15.0
4.0	$101.62	-0.30	-0.18	30.9	7.2
4.5	$101.42	0.22	0.37	62.5	-19.4
5.0	$101.58	0.09	0.00	118.9	-16.8
5.5	$101.11	0.16	0.00	57.0	4.2

Source: TCW, Bloomberg Barclays

Benchmark Performance

	October Month End Price	October Month End Yield (%)	September Month End Yield (%)	Change (bps)
2 Yr Treasury	$100.01	2.87%	2.82%	4.81
5 yr Treasury	$99.54	2.97%	2.95%	2.20
10 Yr Treasury	$97.74	3.14%	3.06%	8.23
30 Yr Treasury	$92.70	3.39%	3.21%	18.52
2/10 Curve		27.26	23.83	3.43
2 Yr SWAP Spread		20.25	16.67	3.58
10 Yr SWAP Spread		5.94	6.53	-0.59
1y*10y Swaption Vol		68.95	63.83	5.12
5y*10y Swaption Vol		73.84	70.60	3.24

Source: TCW, Bloomberg

Issuer Performance (ticks)

	October GNMAII/FNMA	Monthly Price Change	October GOLD/FNMA	Monthly Price Change
3.0	32.75	-4.50	-0.25	0.13
3.5	28.25	-4.00	0.25	-0.13
4.0	20.25	-2.25	0.38	0.25
4.5	6.50	0.50	1.00	-0.50
5.0	-12.00	6.00	2.00	1.75
5.5	-40.00	0.00	-6.00	1.50

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	Oct 31, 2018	Sep 28 2018	Dec 29, 2017
FN 3% LLB	13	12	17
FN 3% MLB	10	9	13
FN 3% HLB	8	7	10
FN 3% 125 LTV	20	20	-8
FN 3.5% LLB	16	18	32
FN 3.5% MLB	13	14	27
FN 3.5% HLB	9	10	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	25	32	61
FN 4% MLB	22	27	52
FN 4% HLB	18	23	42
FN 4% 125 LTV	18	16	24
FN 4.5% LLB	49	60	97
FN 4.5% MLB	40	50	81
FN 4.5% HLB	32	40	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

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