TCW

# INSIGHT

MONTHLY COMMENTARY

## November Agency MBS Update

**STEPHEN K. LEECH** | DECEMBER 1, 2016

The economist Herbert Stein once said, "If something cannot go on forever, it will stop". This sentiment was applicable to global markets in November, which were roiled by the surprising U.S. Presidential Election outcome and resulting market fallout. The agency MBS basis came into November riding high, with positive returns relative to benchmark Treasuries in four consecutive months through October. Yet the subdued tone the market took heading into November was not to be, as the penultimate month of 2016 took a surprising turn with the results of the U.S. Presidential Election. Going into election night, markets and political observers were generally confident that Hillary Clinton (D) would win the Presidency, bringing a fairly similar set of policies as the current administration. Instead, U.S. voters elected Donald Trump (R), which set off a chain reaction in global markets that had yet to abate as the month of November drew to a close.

The market reaction to the election was swift. U.S. Treasuries sold off severely while global risk markets rallied. The 10yr Treasury backed up to yield levels not seen since 2015, going from 1.83% to 2.36% at month end. The Treasury curve also steepened, with longer maturity Treasuries selling off more than shorter duration bonds. The result was very poor performance for Agency MBS. The 30yr mortgage rate rose precipitously, starting November at 3.75% and rising to 4.23% at month end, the highest quoted rate in 2016. Prepayment risk was seemingly removed for the foreseeable future due to increased interest rates home buyers now face. However, higher implied volatility, the possibility of less constructive Fed Policy, a higher term structure of interest rates, and an extension in MBS average lives combined to roil agency MBS valuations. Performance started weak and continued to slide, with the market beginning to price in less regulation and more economic stimulus going forward. The aggregate result was negative excess returns, which reversed all of the gains made by the agency MBS basis since the beginning of 2016. In aggregate, agency MBS was hammered early and often in the month of November, with the Barclays MBS index posting excess returns relative to benchmark U.S. Treasuries of negative 47 basis points (bps). The performance marks the worst month of excess returns for agency MBS this year, and brings year-to-date excess returns to negative 17bps.

The carnage in agency MBS was visible in almost every subset of the sector, as mortgage valuations were under pressure throughout November. The most troublesome part of the 30yr coupon stack was lower coupon MBS. Fannie Mae (FNCL) 3s took the crown for worst performing coupon, returning -93bps relative to U.S. Treasuries. The swift interest rate move caused the dollar price of the pools to fall under $100; making the 3% coupon the most vulnerable to long term extension risk should interest rates not rally back toward previous levels. FNCL 4s and 4.5s declined far less, closing with excess returns of -43bps and -52bps respectively. Seasoned higher coupons were the only

**Stephen K. Leech**
Assistant Vice President
U.S. Fixed Income

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.

sector that saw positive performance, and even in FNCL 5 and above coupons the outperformance was scant. Ginnie Mae collateral easily outperformed conventionals, with performance across the coupon stack demonstrating similar trends to their FNCL counterparts. The positive relative performance is not too surprising since GNMA collateral does tend to outperform in rising rate environments due to shorter effective durations, yet the differences were notable. GNMA 3s posted excess returns of -81bps, right in line with FNCL 3s, however GNMA 4 and 4.5 coupons ended up posting positive performance relative to Treasury hedges. The one true positive for middle of the stack coupons is the extent to which prepayment rates could decline if these newly higher rate levels hold. More than half of all agency MBS borrowers at the start of November could have potentially refinanced to a lower interest rate, and that option is now gone for the majority of people. The slower prepayment speeds that could result from the shift may temper the poor performance that occurred in agency MBS in November. That being said, high volatility and a steeper Treasury yield curve may continue to drag on valuations going forward.

The evolution of the market reaction to prepayments was perhaps the most glaring example of the shifting tone of the agency MBS space in November. The October prepayment report showed that for the second consecutive month, speeds declined less than expected. FNCL coupons in aggregate fell just 5%, which had the market fearing that prepayments might remain elevated for longer than many investors hoped. Yet by the end of the month it appeared that the days of elevated prepayments could be numbered. The faster-than-expected speeds still are worth surveillance, as the higher mortgage rates will not be reflected in prepayment speeds for a couple of months. Within the report, lower coupons slowed down more than cuspy coupons, with FNCL 3s dropping 11%, and FNCL 4s and above coming in virtually unchanged. Ginnie Mae speeds fell in line with their conventional counterparts, as 15yr MBS dropped in stride. Given the slightly lower day count in the month, the higher than expected speeds do suggest that refinance capacity has expanded, which could lead to a couple more fast prints before speeds slow considerably should mortgage rates remain elevated. In aggregate, higher mortgage rates suggest that the refinance wave that characterized the last few months will abate as many borrowers are no longer able to access lower rates of interest.

The regulatory story of November has yet to fully play out, with the new President-elect still assembling a cabinet and deciding on his priorities for the coming term. How the regulatory and policy environment shifts under the new administration will be among the most important points to watch as the year comes to a close. One notable part of the current regulatory puzzle does appear to have been solved in November. Coming into the month, there had been an increasing possibility of a cut in the monthly insurance premium (MIP), possibly in early 2017. Borrowers pay the MIP based on the rates that the Federal Housing Administration (FHA) prescribes, creating an insurance fund that is used to guarantee the loan if the borrower defaults. This fund is known as the Mutual Mortgage Insurance Fund (MMI). The fund capital ratio is supposed to come in over 2% by congressional mandate, and in for the second straight year did, coming in at 2.32%. The fund ratio coming in over expectations would have made it more likely that there would be a MIP cut next year; however, the new administration seems much less likely to reduce the MIP than the current one. Furthermore, the current administration suggested that they will not cut the MIP prior to the January transfer of power. The previous time the MIP was reduced, January of 2015, the move sparked a considerable uptick in GNMA prepayment activity. Therefore, the reduced probability of an MIP cut in 2017 should serve as a small tailwind to flagging agency MBS valuations heading into the final month of the year.

TCW

## Coupon Stack Performance

| 30 Year FNMA | November Month End Price | Monthly Price Change (ticks) | Monthly Performance vs. Benchmark U.S. Treasury | November Month End Libor OAS (bps) | Libor OAS Monthly Change (bps) |
|---|---|---|---|---|---|
| 3.0 | 99-20 | -102 | -0.93 | 35.3 | 23.2 |
| 3.5 | 102-23 | -72 | -0.41 | 33.5 | 19.9 |
| 4.0 | 105-10+ | -56 | -0.42 | 38.1 | 14.8 |
| 4.5 | 107-29+ | -44 | -0.53 | 38.2 | 11.9 |
| 5.0 | 109-22 | -34 | 0.15 | 18.5 | 19.6 |
| 5.5 | 111-26 | -27 | 0.52 | 2.7 | 10.5 |
| 6.0 | 113-26+ | -26 | 0.55 | -22 | 8.2 |
| **15 Year FNMA** | | | | | |
| 2.0 | 97-21 | -85 | -0.88 | 0 | 0 |
| 2.5 | 100-13+ | -77 | -0.59 | 23 | 15.3 |
| 3.0 | 102-27 | -57 | -0.19 | 14.7 | 8.8 |
| 3.5 | 104-06 | -37 | 0.35 | -70.6 | 45.9 |
| 4.0 | 102-19+ | -21 | 1.15 | 107.9 | -11.6 |
| 4.5 | 101-25 | -16 | 1.02 | 106.3 | -29.5 |
| 5.0 | 102-04 | -9 | -1.23 | 97.8 | -24.3 |

Sources: TCW, Barclays, JPMorgan

## Benchmark Performance

| | November Month End Price | November Month End Yield | October Month End Yield | Change (bps) |
|---|---|---|---|---|
| 2 Yr Treasury | $99.77 | 1.11% | 0.84% | 27.21 |
| 5 yr Treasury | $99.56 | 1.84% | 1.31% | 53.53 |
| 10 Yr Treasury | $96.63 | 2.38% | 1.83% | 55.54 |
| 30 Yr Treasury | $96.88 | 3.03% | 2.58% | 45.39 |
| 2/10 Curve | | 126.20 | 98.06 | 28.13 |
| 2 Yr SWAP Spread | | 20.14 | 23.58 | -3.44 |
| 10 Yr SWAP Spread | | -14.25 | -16.81 | 2.56 |
| 1*10 Swaption Vol | | 86.70 | 76.29 | 10.41 |
| 5*10 Swaption Vol | | 83.40 | 80.12 | 3.28 |

Sources: TCW, Citigroup

## Issuer Performance (ticks)

| | November GNMAII/FNMA | Monthly Price Change | November GOLD/FNMA | Monthly Price Change |
|---|---|---|---|---|
| 3.0 | 62 | 23.25 | -1.88 | -1.38 |
| 3.5 | 45 | 15.62 | -2.88 | -1.38 |
| 4.0 | 23.75 | 22.75 | -3.88 | -0.13 |
| 4.5 | -22.75 | 21.5 | -4.25 | -3.75 |
| 5.0 | -61.5 | 20 | -4 | -1 |
| 5.5 | -64 | 9.25 | -8 | 0 |

Sources: TCW, Credit Suisse

## Specified Pool Pay-Up Grid (ticks)

| Coupon | Nov 30, 2016 | Oct 31, 2016 | Dec 31, 2015 |
|---|---|---|---|
| FN 3% LLB | 14 | 25 | 8 |
| FN 3% MLB | 10 | 19 | 6 |
| FN 3% HLB | 7 | 15 | 4 |
| FN 3% 125 LTV | -6 | 2 | -2 |
| FN 3.5% LLB | 34 | 66 | 22 |
| FN 3.5% MLB | 27 | 53 | 16 |
| FN 3.5% HLB | 18 | 42 | 10 |
| FN 3.5% 125 LTV | 16 | 38 | 2 |
| FN 4% LLB | 56 | 98 | 42 |
| FN 4% MLB | 44 | 80 | 34 |
| FN 4% HLB | 34 | 60 | 24 |
| FN 4% 125 LTV | 32 | 74 | 16 |
| FN 4.5% LLB | 64 | 112 | 72 |
| FN 4.5% MLB | 48 | 88 | 60 |
| FN 4.5% HLB | 36 | 62 | 42 |
| FN 4.5% 125 LTV | 34 | 92 | 42 |

Sources: TCW, Credit Suisse

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2016 TCW

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