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MONTHLY COMMENTARY

November Agency MBS Update

STEPHEN K. LEECH | DECEMBER 5, 2017

The penultimate month of 2017 was a quiet one for the agency MBS basis. Yield curve flattening and volatility pressing against all-time lows were the primary stories in November, with mortgages producing a muted reaction to the proceedings. The eerie calm that descended on the agency MBS space in October continued unabated as the calendar flipped to November. Risk assets benefitted from a positive tenor globally, with stock indices continuing their push to all-time highs. The U.S. Treasury yield curve flattened sharply, with tempered inflation expectations keeping longer duration yields in check, while improving economic conditions and a likely Fed tightening in December led to an increase in short term Treasury yields. Aggressive yield curve flattening can be a warning sign for risk asset valuations, but thus far the market has not taken it as such. Overall mortgage performance was largely unaffected by the move, despite movement within the coupon stack. One benefit of the quiet month was volatility toying with new all-time lows. The recent demise of realized volatility has been a fascinating subplot this year in agency MBS. Both the failure of volatility to pick up, and the modest outperformance by mortgages despite the powerful tailwind created by low gamma have left a lasting impression on the story of 2017 performance. As November wound to a close, the most pressing question in global markets was the fate of the Republican Party's tax plan, which would reduce corporate tax rates, as well as change a number of the deductions individual tax payers can take. The impact on agency MBS would be modest, keeping with the broader theme of performance in November. Ultimately, the Bloomberg Barclays MBS Index finished with positive returns of just 4 basis points (bps) relative to benchmark U.S. Treasuries in November, bringing year-to-date excess performance to positive 36bps.

The flattening yield curve was the primary driver of relative performance in the agency MBS coupon stack in November. Lower coupons were the primary beneficiary of the yearlong trend, as longer durations allow them to benefit from the changing U.S. interest rate structure. Long-dated interest rates remained range bound in November, allowing the excess carry of agency MBS to provide for outperformance in lower coupons. Specifically, Fannie Mae 30y (FNCL) 3s and 3.5s posted positive excess returns relative to U.S. Treasuries of 8bps and 16bps respectively. Higher coupon MBS posted slightly positive returns, with FNCL 4s outperforming benchmark U.S. Treasuries by just 2bps during the month. The flattening term structure of interest rates also negatively impacted 15y agency MBS and Ginnie Mae collateral in November. The persistent yield curve flattening over month and year overall has put a lot of pressure on both shorter duration collateral and Ginnie Mae securities. Ginnie Mae collateral has been further marred by challenging regulatory news and reduced global demand. However as market participants are often reminded, past performance is not indicative of future results, meaning investors should remain conscientious about the ever changing landscape and its impact on coupon stack performance.

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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.

It has now been a full year since interest rates spiked after the surprising results of the 2016 presidential election. In that time, the 30y mortgage rate has not fallen below 4%. The 12-month range runs from 4.46% in February to a low of 4.03% in September. The volatility of mortgage rates has diminished still further over the past six months. The tight range has kept speeds in a relatively narrow band, with very few surprises in monthly prepayment reports. The extraordinarily stable interest rate environment has been beneficial to the overall coupon stack and especially to lower coupon MBS where borrowers are 'out of the money' and cannot refinance their homes economically. This rare period of stagnant interest rates and low volatility is highly beneficial to relative MBS performance overall. Yet the 36bps in excess returns in the Bloomberg Barclays MBS Index is not an incredibly strong showing for close to a full year of returns. This is in part due to other headwinds that have hindered agency MBS performance throughout the year. The looming specter of a less active Federal Reserve, continuing regulatory cloud cover, and generally elevated relative valuations continue to weigh on performance. This trend can be seen in November, where nary a negative headline and a drop in volatility from already paltry levels still failed to buoy the agency MBS basis. As investors prepare for 2018, whether or not long dormant volatility will return to the fore might end up being the dominant question the agency MBS market faces.

Like much of the benign November news cycle, the regulatory picture as it relates to agency MBS was relatively quiet. Yet the key battle in Washington, the Republican Party's planned overhaul off the U.S. tax code, will mildly impact the agency MBS space if it is signed into law. While the key market-moving aspect of the proposal involves reducing corporate income taxes, largely benefitting stocks and related risk assets, a few of the individual provisions will impact agency MBS valuations. The key change would be reducing the cap on mortgage-interest deductibility to $500,000, the proposed limit under the House version of the plan, from the previous level of $1 million, which would be retained under the Senate version. Furthermore, a $10,000 limit on the deductibility of state and local property taxes and an increase in the standard deduction will create some changes in the market. In particular, the proposal is a negative for home price appreciation, as owners of homes valued between $500,000 and $1 million will not be able to deduct as much of their interest under the House bill. The impact for borrowers with less money outstanding on their mortgage will be harder to tease out, but an increase in the standard deduction will most likely cause fewer homeowners to deduct their mortgage payments overall. This will leave the homeowners in this cohort slightly more sensitive to refinance incentives, as their interest payments will not reduce their tax bill as much as under current law. Should the bill be passed and signed into law, pools with low loan balances will most likely speed up mildly, while the reduction in the rate of home price appreciation will likely limit speeds on jumbo collateral. The conclusion of the drama surrounding the tax bill is likely by the end of the year, leaving December to unpack the final result, and look to the year ahead in agency MBS.

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Coupon Stack Performance

30 Year FNMA	November Month End Price	Monthly Price Change (pts)	Monthly Performance vs. Benchmark U.S. Treasury (%)	November Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$99.77	-0.25	0.08	17	-0.9
3.5	$102.55	-0.22	0.16	16.7	0.3
4.0	$104.52	-0.41	0.02	40.9	3.9
4.5	$106.39	-0.50	0.02	52.3	3.7
5.0	$108.14	-0.44	0.16	56.5	4.9
5.5	$110.05	-0.38	0.24	71.3	0.9
6.0	$111.98	-0.28	0.35	67.8	-1.3
15 Year FNMA					
2.5	$99.80	-0.59	-0.23	5.8	6
3.0	$101.89	-0.53	-0.12	38.2	4
3.5	$103.33	-0.53	-0.09	86.7	7.1
4.0	$102.83	-0.44	0.25	159.5	-1.9
4.5	$101.64	0.31	0.23	189.6	-10.7
5.0	$101.52	0.00	0.00	149.6	-12.7
5.5	$99.70	-0.28	0.00	93.8	-16.9

Sources: TCW, Bloomberg Barclays

Benchmark Performance

	November Month End Price	November Month End Yield	October Month End Yield	Change (bps)
2y Treasury	$99.93	1.78%	1.60%	18.23
5y Treasury	$99.35	2.14%	2.02%	12.10
10y Treasury	$98.59	2.41%	2.38%	3.04
30y Treasury	$98.44	2.83%	2.88%	-5.25
2/10 Curve		62.37	77.56	-15.19
2y SWAP Spread		19.01	22.05	-3.04
10y SWAP Spread		-2.88	-0.38	-2.50
1*10 Swaption Vol		63.05	70.17	-7.12
5*10 Swaption Vol		71.89	75.70	-3.81

Sources: TCW, Bloomberg

Issuer Performance (ticks)

	November GNMAII/FNMA	Monthly Price Change	November GOLD/FNMA	Monthly Price Change
3.0	33.5	-2.25	0.25	-0.63
3.5	28.75	-1.5	0	-0.38
4.0	-1.25	-3	-0.63	-0.13
4.5	-33.25	-3.5	-2.25	0.75
5.0	-31.75	8.25	-12	0
5.5	-50.63	9.25	-12	1

Sources: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	Nov 30, 2017	Oct 31, 2017	Dec 30, 2016
FN 3% LLB	16	18	11
FN 3% MLB	11	14	9
FN 3% HLB	7	10	7
FN 3% 125 LTV	-8	-8	-8
FN 3.5% LLB	31	33	30
FN 3.5% MLB	26	28	24
FN 3.5% HLB	20	23	18
FN 3.5% 125 LTV	8	8	10
FN 4% LLB	60	60	48
FN 4% MLB	52	54	38
FN 4% HLB	42	43	30
FN 4% 125 LTV	24	24	22
FN 4.5% LLB	93	94	62
FN 4.5% MLB	78	80	48
FN 4.5% HLB	62	63	38
FN 4.5% 125 LTV	44	36	26

Sources: TCW, Credit Suisse, Citi

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