INSIGHT

MONTHLY COMMENTARY

November Agency MBS Update

STEPHEN K. LEECH | 6 DECEMBER 2018

The penultimate month of 2018 was a roller coaster for risk assets, as trade tensions between the U.S. and China, a gamut of speculation about Federal Reserve policy, and fear about Brexit kept market participants on high alert. Agency MBS performance ultimately ended the month quietly, but not before vacillating wildly week to week in November. After a late October swoon of risk assets caused by Federal Reserve Chairman Powell striking a hawkish tone in the face of global economic and trade uncertainties, the start of November provided the markets with some much needed relief. U.S. elections turned out largely as expected, momentarily reducing volatility and pulling agency MBS relative performance into positive territory. Interest rates inched higher, as markets returned to normalcy for a fleeting moment, yet tension and fear returned just as quickly as they had dissipated. Concern over the UK's attempt to leave the EU created broad consternation in global risk markets. Furthermore, escalating trade tensions between the U.S. and China further broadened trepidation. Interest rate volatility rose right back to month end levels, sending the agency MBS basis wider once again. After the Thanksgiving holiday, the Federal Reserve struck a more dovish note, while optimism built that the U.S. and China might be able to resolve escalating tariffs and calm rhetoric around trade. The change in tone allowed agency MBS valuations to rally back at the close of the month. Ultimately, risk markets closed close to where they had opened November, while U.S. Treasury yields fell slightly, providing the backdrop to an unchanged month. The path was neither smooth nor easy. In total, the Bloomberg Barclays MBS Index posted excess returns of zero basis points (bps) in November, leaving agency MBS relative performance unchanged at negative 43 bps year to date. A positive month of 90 bps for total returns still left year to date total returns at negative 81 bps.

Intra coupon stack was relatively quiet over the month. The slight decline in yields did little to shuffle coupon stack performance despite the month's choppiness. Fannie Mae 30yr (FNCL) 3s and 4.5s were both negative on the month, coming in at -1 bp and -11 bps respectively. The slightly worse performance in higher coupon MBS

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makes sense in the context of falling interest rates during the month, while the ever so slight underperformance of FNCL 3s relative to U.S. Treasuries was notable as a lower coupon that ordinarily would benefit from a lower interest rate environment. FNCL 3s remain well below par and thus have no production, limiting their buyer base and keeping the coupon from outperforming despite fully extended durations and the momentum toward ever higher interest rates halting for the moment. Meanwhile higher coupons held in potentially better than expected in a falling interest rate environment behind better carry and continuing production. In Ginnie Mae collateral, performance differences were starker. Ginnie Mae 30yr (G2SF) 3s and 3.5s came in at -10 bps and -4 bps respectively relative to benchmark U.S. Treasuries. This underperformance has been present most of 2018, with year to date excess returns sitting at -69 bps for G2SF 3s and -1.01% for G2SF 3.5s. An increase in the regulation of banks has propped up Ginnie Mae collateral for much of the post-crisis period. The reversal of some of these regulatory actions has taken a toll on the collateral this year, limiting the buyer base and putting tremendous pressure on lower coupon Ginnie Mae collateral. Higher coupon Ginnie Mae collateral has not been subject to the same sort of pressures as it has been bolstered by reduced speeds, the result of legislative action to temper the severe loan churning activities that plagued the market in years prior. Ultimately, with one month until the end of the year, the challenges to lower coupon Ginnie Mae collateral have yet to abate, and show no signs of slowing despite falling interest rates.

Each November the Federal Housing Finance Administration sets limits on the maximum allowable loan size for a loan to be eligible for placement into agency MBS securities. Starting in 2008, a law was passed that set the maximum limit at $417k for a single-family mortgage with loans in the more expensive areas in the country allowed at up to 150% of the maximum. These limits were not permitted to rise so long as housing prices remained below their pre-crisis peak. The limits were stable until 2016, when housing prices finally rose to pre-crisis levels, allowing the FHFA to raise the maximum loan size, based on the level of home price appreciation in the previous year. This year the FHFA determined that housing rose a strong 6.9% in 2017, raising the maximum limit to $484,350 for most Americans and $726,525 in high cost areas. These increases are significant since higher loan balance pools tend to be more sensitive to prepayment incentives than lower loan balance pools. Thus, the run-up in conforming loan sizes might make pools that are issued in 2019 more sensitive to changes in mortgage rates than new production pools in previous years. Furthermore, this sharp rise in conforming loan limits comes just as evidence begins to gather that the pace of home price appreciation is slowing. With 2019 right around the corner, increasing loan sizes in agency MBS pools just as housing might be cresting is an important trend to watch, especially given the rising economic uncertainty and the presently minimal prepayment risk in the market.

The year thus far in agency MBS has seen negative total and relative performance. Higher rates, rising volatility, and concern over the Federal Reserve balance sheet unwind have pressured mortgage spreads wider and damaged valuations. Agency MBS yields relative to U.S. Treasuries have widened out despite very low prepayment risk and volatility that remains below historic norms. This makes it appear that agency MBS valuations are more attractive than before this market turmoil. While it is widely expected that volatility will pick up as the Federal Reserve continues to hike interest rates and let the balance sheet wind down, the uptick in volatility thus far has been relatively modest. While past performance says nothing about future results, it is always possible that volatility could remain low into the near future. However, caution is always warranted. The roiling of emerging markets, continuing trade tensions, and the potential for slowing economic growth pose significant risks for markets moving forward into the final month of 2018 and the year beyond. The guaranteed principal component provides agency MBS a bulwark against market downturns, and means mortgages will remain a vital piece of fixed income portfolio construction despite rising risks in markets around the world.

Coupon Stack Performance

30 Yr FNMA	November Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	November Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$95.34	0.85	-0.01	19.9	4.5
3.5	$98.08	0.84	0.05	24.8	-1.1
4.0	$100.59	0.71	-0.02	28.5	-9.1
4.5	$102.83	0.57	-0.11	40.7	-9.4
5.0	$104.63	0.39	-0.19	64.8	-1.5
5.5	$106.44	0.62	0.08	79.7	1.0
6.0	$107.67	0.16	0.04	99.3	8.3
15 Yr FNMA					
2.5	$96.44	0.77	0.32	9.8	-0.8
3.0	$98.69	0.68	0.08	3.8	-6.0
3.5	$100.27	0.46	0.00	16.0	-17.7
4.0	$101.86	0.38	-0.07	20.5	-10.4
4.5	$101.95	0.53	-0.30	59.7	-2.8
5.0	$102.02	0.50	0.00	107.9	-11.0
5.5	$101.55	0.50	0.00	57.4	0.4

Source: TCW, Bloomberg Barclays

Benchmark Performance

	November Month End Price	November Month End Yield (%)	October Month End Yield (%)	Change (bps)
2 Yr Treasury	$99.93	2.79%	2.87%	-8.04
5 yr Treasury	$100.29	2.81%	2.97%	-16.24
10 Yr Treasury	$101.16	2.99%	3.14%	-15.56
30 Yr Treasury	$101.59	3.29%	3.39%	-10.09
2/10 Curve		19.94	27.26	-7.32
2 Yr SWAP Spread		17.38	20.25	-2.88
10 Yr SWAP Spread		6.53	4.85	1.68
1y*10y Swaption Vol		65.70	68.95	-3.25
5y*10y Swaption Vol		72.80	73.84	-1.04

Source: TCW, Bloomberg

Issuer Performance (ticks)

	November GNMAII/FNMA	Monthly Price Change	November GOLD/FNMA	Monthly Price Change
3.0	29.50	-3.25	-0.63	-0.38
3.5	24.75	-3.50	0.00	-0.25
4.0	20.25	0.00	0.25	-0.13
4.5	9.75	3.25	-0.13	-1.13
5.0	-9.50	2.50	-0.50	-2.50
5.5	-40.00	0.00	-3.00	3.00

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	Nov 30, 2018	Oct 31, 2018	Dec 29, 2017
FN 3% LLB	13	13	17
FN 3% MLB	10	10	13
FN 3% HLB	8	8	10
FN 3% 125 LTV	20	20	-8
FN 3.5% LLB	16	16	32
FN 3.5% MLB	13	13	27
FN 3.5% HLB	9	9	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	27	25	61
FN 4% MLB	22	22	52
FN 4% HLB	17	18	42
FN 4% 125 LTV	18	18	24
FN 4.5% LLB	47	49	97
FN 4.5% MLB	40	40	81
FN 4.5% HLB	33	32	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

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