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INSIGHT

MONTHLY COMMENTARY

January Agency MBS Update

STEPHEN K. LEECH | FEBRUARY 5, 2018

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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.

The poet Rainer Maria Rilke once wrote, "And now we welcome the New Year, full of things that have never been." While he was most certainly not referring to financial markets, it is often true that new challenges and evolving market conditions accompany the turn of the calendar. January certainly bore little resemblance to the year that was in 2017. Following stagnant interest rates much of the second half of 2017, both U.S. Treasury yields and the 30yr U.S. mortgage rate marched higher during the opening month of 2018. The 10yr U.S. Treasury yield surged to 2.71% after starting the year at 2.41%, while mortgage rates jumped to 4.41% from 4.22% at the end of December. The sharp uptick in interest rates places U.S. Treasury yields at their highest outright levels since 2014, and leaves mortgage rates at levels not seen since March of 2017. After mostly benign rate movement during the second half of 2017, the change in tone allowed long dormant volatility to percolate once again. While still at modest levels compared to historical norms, agency MBS investors have not had to confront the specter of higher volatility or extension risk in many months. The agency MBS basis widened out as a result, while the market took stock of a different set of risks than what investors confronted merely a month ago. The yield curve ceased the ever-present flattening that dominated curve discussions in the latter half of 2017, while a mishmash of regulatory news kept investors guessing for most of January. Ultimately, the year opened on a negative note for agency MBS, as both total returns and relative performance were negative in January. The Bloomberg Barclays MBS Index posted excess returns of -15 basis points (bps) relative to benchmark U.S. Treasuries in January, while total returns were a startling -1.17% for the index in the opening month.

Elevated interest rates and a steeper yield curve created significant movement in relative agency MBS performance. In Fannie Mae 30yr (FNCL) collateral, higher coupons outperformed their lower coupon counterparts. Materially higher mortgage rates reintroduced extension risk to lower coupon MBS. Meanwhile, prepayments

could be tamped down in higher coupon mortgages if elevated interest rates persist. The result was an environment that was highly conducive to outperformance in higher coupons. Specifically, FNCL 4.5s posted positive excess returns of 18bps relative to U.S. Treasuries, while FNCL 3.5s and 3s posted relative returns of -32bps and -29bps respectively. A steeper yield curve provided yet another tailwind to higher coupons, as bonds with shorter durations benefitted from the changing slope of the curve. The outperformance in Ginnie Mae assets was even starker in higher coupons. Regulatory news dominated most of the news cycle in the Ginnie Mae 30yr (G2SF) space, as the uncertainty regarding financial regulation and GSE reform continues to hang over the entire sector. Yet Ginnies did manage to mildly outperform conventional collateral across the coupon stack on the month, with significant outperformance in higher coupon MBS. G2/FN 3.5 swaps appreciated 4 ticks in January, while G2/FN 4 swap levels increased 16 ticks to close at +6 ticks. Higher coupons benefited from the regulatory tailwinds discussed below, in addition to the usual benefits rising interest rates have on the G2SF collateral. The positive month for Ginnie Mae higher coupons was a welcome respite from the tough second half of 2017. Significant moving pieces remain far from settled for market participants. The volatility of relative valuations for agency MBS means that investors will need to be particularly cognizant of intra-sector positioning to earn excess returns.

The most notable regulatory issue that continues to hang over the agency MBS universe is the unending saga over loans made under the Department of Veterans Affairs (VA) program to provide housing financing to veterans and their families. Prepayment speeds in the resulting pools have been extremely fast from refinancing activity, fomenting allegations that a number of servicers are churning loans. This activity causes extremely fast prepayments that result in higher rates of interest for all Ginnie Mae borrowers, while not necessarily providing veterans and their families with a positive overall economic benefit. The allegation resulted in a task force between Ginnie Mae and the VA, and some mild reforms to participating servicer requirements but little in the way of the material, market-moving action that was expected. January saw some positive momentum on this front, boosting higher coupon Ginnie Mae collateral. Senators Elizabeth Warren (D) of Massachusetts and Senator Thom Tillis (R) of North Carolina introduced legislation that would significantly curb the ability of servicers to refinance loans made to veterans. Specifically, the bill would institute a fairly stringent net benefit test, requiring the new loan rate to be 50bps less than the original rate, while requiring that all fees and costs be recouped within three years. Should a bill like this ultimately pass, it would significantly reduce Ginnie Mae speeds in higher coupons, as servicers would have to change the way they approach refinance activity. Further aiding the collateral was testimony by Michael Bright, the COO of Ginnie Mae, who hinted that his team might move to unilaterally slow down high coupon prepayment speeds. He hinted at the possibility of imposing a net benefit test and even potentially removing lenders with extremely fast prepayment profiles from the VA program altogether. Taken together, the comments and potential bipartisan legislation to reduce the speeds of these pools suggests that prepayments might continue to slow down in the coming year, providing significant lift to both relative and outright Ginnie Mae valuations.

Extension risk has not been a major topic in the agency MBS universe since the early part of last year. Coming off the surprising results of the U.S. Presidential election, interest rates gapped up sharply, creating the potential for extension across the agency MBS universe. Although in 2017 mortgage rates ultimately fell back to earth, keeping extension in check, it is far from clear that the same will happen in 2018. Speeds remain subdued across most of the agency MBS universe, with aggregate FNCL prepayments running at about 10.7CPR. In the event that interest rates continue to ratchet higher, speeds on higher coupon pools might begin to fall, causing the bonds to extend in duration. The result could be a longer duration and slower paying index than what investors have dealt with over the past few years. This could pose significant challenges to both relative and absolute agency MBS performance should the market continue to slide higher in yields.

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Coupon Stack Performance

30 Yr FNMA	January Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	January Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$97.98	-2.06	-0.29	13.1	-3.3
3.5	$100.92	-1.81	-0.32	16.7	-0.3
4.0	$103.30	-1.31	-0.03	34.6	-5.4
4.5	$105.39	-1.03	0.18	45.6	-7.7
5.0	$106.77	-0.72	0.32	55.4	-13.3
5.5	$108.70	-0.91	0.35	66.0	-11.6
6.0	$111.33	-0.53	0.17	58.5	-12.6
15 Yr FNMA					
2.5	$98.61	-1.31	-0.10	-1.4	-5.3
3.0	$100.48	-1.41	-0.22	20.6	-17.3
3.5	$102.33	-0.91	0.11	81.1	1.6
4.0	$102.27	-0.19	-0.28	128.2	-30.8
4.5	$100.83	-0.44	-0.25	157.6	-29.3
5.0	$101.02	-0.66	0.00	135.5	-11.7
5.5	$99.42	-0.28	0.00	72.7	-16.3

Source: TCW, Bloomberg Barclays

Benchmark Performance

	January Month End Price	January Month End Yield (%)	December Month End Yield (%)	Change (bps)
2 Yr Treasury	$99.72	2.14	1.88	25.76
5 yr Treasury	$99.35	2.51	2.21	30.75
10 Yr Treasury	$96.10	2.71	2.41	29.96
30 Yr Treasury	$96.33	2.93	2.74	19.49
2/10 Curve		56.04	51.84	4.20
2 Yr SWAP Spread		18.83	18.75	0.08
10 Yr SWAP Spread		-1.13	2.88	-4.01
1*10 Swaption Vol		69.00	59.99	9.01
5*10 Swaption Vol		71.00	66.42	4.58

Source: TCW, Bloomberg

Issuer Performance (ticks)

	January GNMAII/FNMA	Monthly Price Change	January GOLD/FNMA	Monthly Price Change
3.0	32.50	3.75	-1.25	-1.50
3.5	27.50	4.25	0.88	0.50
4.0	5.75	16.00	1.38	1.38
4.5	-29.25	17.25	-2.25	-0.25
5.0	-48.00	-22.50	6.00	8.00
5.5	-64.00	-12.12	-8.00	0.00

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	Jan 31, 2018	Dec 29, 2017	Dec 30, 2016
FN 3% LLB	14	17	11
FN 3% MLB	10	13	9
FN 3% HLB	8	10	7
FN 3% 125 LTV	-8	-8	-8
FN 3.5% LLB	21	32	30
FN 3.5% MLB	18	27	24
FN 3.5% HLB	14	21	18
FN 3.5% 125 LTV	12	8	10
FN 4% LLB	47	61	48
FN 4% MLB	38	52	38
FN 4% HLB	31	42	30
FN 4% 125 LTV	16	24	22
FN 4.5% LLB	86	97	62
FN 4.5% MLB	73	81	48
FN 4.5% HLB	54	65	38
FN 4.5% 125 LTV	44	44	26

Source: TCW, Credit Suisse, Citi

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