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February Agency MBS Update

STEPHEN K. LEECH | MARCH 5, 2018

On the second day of February, Punxsutawney Phil, the world's most famous weather predicting groundhog, came out of his lair and saw his shadow, foretelling another six weeks of winter. Agency MBS took the prediction with malice, as the spread between agency MBS and U.S. Treasuries widened in February. The pervasive calm that permeated risk assets throughout the second half of 2017 is gone, replaced by a jittery market for risk assets. Global stock markets actually fell in February, as fears that global growth could create a more hawkish monetary regime both in the U.S. and abroad put pressure on global stocks. U.S. Treasury yields rose sharply during February, reaching their highest levels since 2014. The fear was most palpable at the beginning of the month, with the U.S. stock market posting sharp declines on multiple days. The U.S. Treasury curve steepened early on, with investors concerned that longer term inflation expectations might pick up. The sharply steeper yield curve negatively impacted agency MBS relative and absolute valuations, driving mortgages wider in the early part of February. The Federal Reserve, turning more hawkish as the month progressed, did erase most of the yield curve steepening, however the damage was mostly done to mortgage valuations. The 30yr mortgage rate climbed to 4.64%, its highest level since January of 2014. Higher rates, a slightly steeper yield curve, and a tough month for risk assets proved far too much for agency mortgages to overcome in February, as both absolute and relative returns were negative for the second straight month. In aggregate, the Bloomberg Barclays MBS Index produced excess returns of negative 10 basis points (bps) relative to benchmark U.S. Treasuries, sending year-to-date relative returns to negative 25bps and total returns to a startlingly negative 182bps.

Intra coupon agency MBS valuation was highly fluid in the month of February. Interest rates ratcheting upward thus far in 2018 has put pressure on lower coupon MBS. The Bloomberg Barclays MBS Index has extended markedly as a result, while production is beginning to shift to higher coupon MBS. Fannie Mae 30yr (FNCL) 3.5s and 4s struggled, posting excess returns of negative 13bps and negative 5bps, respectively. Higher coupons are benefitting from the elevated rate environment, as prepayment risk is reduced and the possibility of new production has breathed life

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into some long dormant coupons. In particular, FNCL 5s and 5.5s posted excess returns of 55bps and 64bps, respectively. The result was FNMA in aggregate posted negative February returns of just 3bps relative to benchmark U.S. Treasuries. Ginnie Mae securities took the brunt of the damage during February. The poor February performance of mostly lower coupon Ginnie Mae securities, primarily collateral that benefits from higher interest rates, is a concerning sign. Ginnie Mae 30yr (G2SF) 3s posted excess returns of -29bps, while G2SF 3.5s struggled to a tally of -39bps. This contrasted with higher coupon Ginnies such as G2SF 4.5s, which earned excess returns of 5bps on the back of a steeper yield curve. Part of the challenge to lower coupon G2SF securities is that they are persistently priced higher than their conventional counterparts. The explicit guarantee of payment means that, holding all things constant, Ginnie Mae MBS should be more valuable than Fannie Mae or Freddie Mac securities. Regulatory benefits for foreign and bank buyers have pushed the collateral farther afield from intrinsic valuations however. Recently, there has been increasing noise about the possibility of the government providing an explicit guarantee to conventional MBS. While no announcements have been made, most GSE reform bills include a provision that would take that step. Losing their most-favored regulatory legal status would be a major blow to Ginnie Mae valuations, as both foreign entities and domestic banks have concentrated their buying in Ginnie Mae securities largely for regulatory reasons. An easing of domestic regulatory constraints, or an explicit government guarantee of conventional collateral, would put further pressure on lower coupon G2SF valuations going forward.

The shortest month of the year brought back perhaps the longest running current regulatory issue in the agency MBS marketplace – the implementation of Single Security. Five years ago, the Federal Housing Finance Agency (FHFA) set out to make the TBA of both Fannie Mae and Freddie Mac mutually deliverable, with the stated goal of improving liquidity in the mortgage market. Since both entities remain in conservatorship post the 2008 housing crisis, both agreed to go along with the FHFA's directive. The result has been a slow march through the many hurdles necessary for the two GSEs to have similar-enough characteristics and systems to make each entity deliverable into a single TBA. An update on their progress was released in February and showed that there is still a lot of work to be done to meet the planned second quarter 2019 launch date. In particular, while the plan is for Fannie Mae and Freddie Mac to trade as one single TBA, unless the vast majority of market participants are fully set up to trade and handle the new security, there will be legacy markets that need to remain. This development might actually dampen liquidity rather than increase it, as is the stated goal of the initiative. Furthermore, while increasing liquidity is an understandable goal, aligning Fannie Mae and Freddie Mac such that they can no longer compete with each other from a product differentiation standpoint might cause more long term challenges than it is likely to solve. The issuance of a more homogenous mortgage pool necessary to support Single Security is counter to the initial 1970 mandate of Freddie Mac to compete with Fannie Mae while increasing the availability of housing finance and home ownership. Getting every mortgage market participant ready to change the entire fashion in which conventional MBS are traded in the next 12 months will be a very tall task, and one that investors will have to keep a close eye as 2018 progresses.

The agency MBS space has struggled in both relative and absolute terms since the turn of the calendar to 2018. Belief in pervasively low inflation has eroded while volatility has picked up off nearly all-time low levels. Meanwhile, risk assets have at least momentarily halted the upward trajectory that has characterized much of the last few years in financial markets. The regulatory picture remains nebulous across most of the agency MBS space, while the Bloomberg Barclays MBS Index has extended markedly in duration. Yet even the negative news above comes with caveats and undercurrents which suggest there are silver linings. A fully extended MBS Index does not leave a lot of room for further extension, while clearing the regulatory picture may include some positive elements for much of the space. Thus, while the prevailing winds in agency mortgages remain negative and caution is certainly warranted, panic is neither a strategy nor a solution. Thus, in spite of the headwinds that continue to exist across the agency MBS universe, there remains a case to be made for the sector, while remaining vigilant in the face of pending challenges.

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Coupon Stack Performance

30 Yr FNMA	February Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	February Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$96.95	-1.03	0.02	13.1	-3.3
3.5	$99.86	-1.06	-0.13	16.7	-0.3
4.0	$102.45	-0.84	-0.05	34.6	-5.4
4.5	$104.73	-0.66	0.03	45.6	-7.7
5.0	$106.70	-0.06	0.55	55.4	-13.3
5.5	$108.64	-0.06	0.64	66	-11.6
6.0	$111.11	-0.22	0.43	58.5	-12.6
15 Yr FNMA					
2.5	$97.55	-1.06	-0.24	-1.4	-5.3
3.0	$99.61	-0.88	-0.17	20.6	-17.3
3.5	$101.70	-0.63	-0.20	81.1	1.6
4.0	$102.39	0.13	0.20	128.2	-30.8
4.5	$100.58	-0.25	0.18	157.6	-29.3
5.0	$101.05	0.03	0.00	135.5	-11.7
5.5	$99.27	-0.16	0.00	72.7	-16.3

Source: TCW, Bloomberg Barclays

Benchmark Performance

	February Month End Price	February Month End Yield (%)	January Month End Yield (%)	Change (bps)
2 Yr Treasury	$100.00	2.25%	2.14%	10.94
5 yr Treasury	$99.93	2.64%	2.51%	12.62
10 Yr Treasury	$99.03	2.86%	2.71%	15.56
30 Yr Treasury	$97.58	3.12%	2.93%	18.94
2/10 Curve		60.66	56.04	4.61
2 Yr SWAP Spread		28.38	18.83	9.55
10 Yr SWAP Spread		2.88	1.58	1.30
1*10 Swaption Vol		69.61	69.00	0.61
5*10 Swaption Vol		71.22	71.00	0.22

Source: TCW, Bloomberg

Issuer Performance (ticks)

	February GNMAII/FNMA	Monthly Price Change	February GOLD/FNMA	Monthly Price Change
3.0	28.00	-4.50	-1.88	-0.63
3.5	24.25	-3.25	2.13	1.25
4.0	7.00	1.25	0.63	-0.75
4.5	-21.50	7.75	0.38	2.63
5.0	-44.00	4.00	7.00	1.00
5.5	-64.00	0.00	-6.00	2.00

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	Feb 28, 2018	Jan 31, 2018	Dec 29, 2017
FN 3% LLB	16	14	17
FN 3% MLB	12	10	13
FN 3% HLB	8	8	10
FN 3% 125 LTV	16	-8	-8
FN 3.5% LLB	20	21	32
FN 3.5% MLB	16	18	27
FN 3.5% HLB	13	14	21
FN 3.5% 125 LTV	18	12	8
FN 4% LLB	38	47	61
FN 4% MLB	30	38	52
FN 4% HLB	25	31	42
FN 4% 125 LTV	18	16	24
FN 4.5% LLB	63	86	97
FN 4.5% MLB	53	73	81
FN 4.5% HLB	42	54	65
FN 4.5% 125 LTV	40	44	44

Source: TCW, Credit Suisse, Citi

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