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March Agency MBS Update

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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 slow and steady widening of agency MBS spreads that has characterized 2018 thus far continued throughout March. Interest rates ticked up sharply in the first six weeks of the year, causing the duration of the Bloomberg Barclays MBS Index to extend. Relative and absolute valuations struggled across January and February as a result. The impetus for further weakness in agency MBS was different as the calendar flipped to March. After having reached their highest levels since 2014, 30 year mortgage rates halted their increase as yields on 10 year U.S. Treasuries fell across the month. While seemingly a positive development for the agency MBS basis, pressure on risk assets and volatility simmering just beneath the surface kept agency MBS valuations in check yet again. A slightly more hawkish than expected FOMC meeting, in which the Fed hiked interest rates as expected, did nothing to stem the tide. The continued unwinding of historically supportive monetary policy continues to be a negative for agency MBS, with the mortgage pools on the balance sheet set to slowly run off over the next few years. The tepidly negative reaction by mortgages to a relatively benign interest rate picture suggests that the lack of significant interest rate volatility might not be enough to hold in relative agency MBS valuations in the current market environment. In aggregate, the Bloomberg Barclays MBS Index posted excess returns of negative 14 basis points (bps) in April, sending year-to-date excess performance to negative 39 bps, with year-to-date absolute total returns recovering slightly to end the quarter at negative 1.19% overall.

Performance within the agency MBS coupon stack was largely what one would expect from a quiet month punctuated by a flatter yield curve and lower U.S. Treasury yields. In Fannie Mae 30 year (FNCL) collateral, lower coupons slightly outperformed their higher coupon counterparts. FNCL 3 posted excess returns of -9 bps relative to benchmark U.S. Treasuries, while FNCL 4s and 4.5s came in at -22 bps and -29 bps, respectively. Lower coupons rode the back of a flatter yield curve and a rally in long-term rates, enabling higher coupons to outperform on a relative basis for the first time in 2018. The fact that lower coupons still underperformed U.S. Treasuries on a relative basis despite conditions that were conducive to success suggests investors remain wary of longer duration MBS assets and potential extension risk. Ginnie Mae

performance was largely in line with FNCL collateral in March, as the sharp swings in performance between conventional and Ginnie Mae MBS that have characterized much of the last six months did not materialize. Ginnie Mae 30 year (G2SF) 3.5s underperformed by 12 bps while 4s came in at -34 bps on the month. Headlines were minimal in higher coupon G2SF, but the market continues to search for further regulatory relief from the scourge of extremely fast speeds due to aggressive refinance activity. Finally, TBA rolls struggled as March wore on, as a sharp uptick in short-term credit rates such as the London Interbank Offered Rate (LIBOR) dragged on TBA valuations across the coupon stack. While the exact cause of the short-term financing rate increase are numerous and not simply related to the Fed hike, fluctuations in LIBOR give investors another reason to be wary of TBA rolls.

With the regulatory outlook surprisingly quiet, the most notable market development was a sharp unforeseen widening of LIBOR/OIS (Overnight Indexed Swap) spreads. Since the start of the year, the 3 month LIBOR/OIS swap has widened from 25 bps out to 58 bps. LIBOR/OIS is a spread that attempts to measure the difference between private short-term interest rates and short-dated risk-free borrowing rates. Historically, when the spread widens sharply, it is a sign that money is tight and there is potentially a lack of systemwide liquidity. The 58 bps month end spread is the largest since the middle of the global financial crisis. While investment grade credit spreads have widened and stocks have struggled over the past three months, there is no clear sign of systemwide contagion. One of the primary causes of the move is tax reform. Part of the 2017 tax law change was the implementation of the Base Erosion and Anti-Abuse Tax (BEAT). BEAT creates a 10% minimum tax for some large corporations with more than $500mm in income. The tax has forced some large banks to use unsecured funding for cash rather than currency swaps, increasing the supply of short term commercial paper. Furthermore, repatriation from the new tax bill has caused corporate treasurers to change their buying patterns, further eroding the supply demand picture in short-term corporate markets. The higher funding rates have repercussions for agency MBS. Specifically, higher funding costs should weigh down TBA roll levels, and hinder agency MBS basis performance. While different investors fund at differing levels, it is hard to concoct a scenario where sharply higher LIBOR OIS spreads are positive overall for agency MBS valuations going forward.

The first quarter saw a sharp uptick in interest rates, followed by a plateauing in the month of March. This was in sharp contrast to the latter part of 2017, a period where interest rates were largely stagnant, volatility was low, and the yield curve was consistently flatter. Agency MBS valuations have been challenged since the winds shifted, struggling in both steepening and flattening curves, and across various interest rate levels. Meanwhile, while volatility is no longer dormant, it has yet to return to anything close to long run historical norms. The continuing drag on valuations from higher funding rates, an increasingly hawkish Federal Reserve, and increased volatility could severely hinder performance over the next three quarters. The flip side is that an already extended index leaves little room for extension risk, and elevated rate levels mean that prepayments should remain subdued even if interest rates rally sharply. Additionally, any weakness in risk assets is likely to weigh more heavily on other sectors of the fixed income universe. Thus, despite the ever present possibility of continued headwinds, agency MBS valuations may not be as concerning as many investors fear as the calendar turns to the second quarter of 2018.

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Coupon Stack Performance

30 Yr. FNMA	March Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	March Month End LIBOR OAS (bsp)	LIBOR OAS Monthly Change (bps)
3.0	$97.55	0.59	-0.09	16.6	-0.1
3.5	$100.20	0.34	-0.17	23.3	1.0
4.0	$102.61	0.16	-0.22	33.0	2.3
4.5	$104.70	-0.03	-0.29	45.9	4.7
5.0	$106.83	0.13	-0.22	46.8	1.5
5.5	$108.70	0.06	-0.25	56.7	4.4
6.0	$111.20	0.09	-0.46	49.9	3.9
15 Yr. FNMA					
2.5	$97.86	0.31	0.15	2.9	-1.4
3.0	$99.80	0.19	0.11	11.5	0.0
3.5	$101.89	0.19	0.14	7.6	-6.1
4.0	$102.83	0.44	-0.12	17.3	-17.7
4.5	$100.77	0.19	-0.10	133.5	3.6
5.0	$101.02	-0.03	0.00	165.4	1.9
5.5	$99.33	0.06	0.00	68.9	1.8

Source: TCW, Bloomberg Barclays

Benchmark Performance

	March Month End Price	March Month End Yield (%)	February Month End Yield (%)	Change (bps)
2 yr. Treasury	$99.96	2.27%	2.25%	1.61
5 yr. Treasury	$99.71	2.56%	2.64%	-7.81
10 yr. Treasury	$100.09	2.74%	2.86%	-12.17
30 yr. Treasury	$100.51	2.97%	3.12%	-15.05
2/10 Curve		46.88	60.66	-13.78
2 yr. SWAP Spread		30.75	28.38	2.37
10 yr. SWAP Spread		1.58	3.85	-2.27
1y10y Swaption Vol.		69.15	69.61	-0.46
5y10y Swaption Vol.		71.72	71.22	0.50

Source: TCW, Bloomberg

Issuer Performance (ticks)

	March GNMAII/FNMA	Monthly Price Change	March GOLD/FNMA	Monthly Price Change
3.0	27.25	-0.75	-1.00	0.88
3.5	24.25	0.00	0.38	-1.75
4.0	6.00	-1.00	0.63	0.00
4.5	-22.00	-0.50	-0.38	-0.76
5.0	-52.00	-8.00	-2.00	-9.00
5.5	-64.00	0.00	-5.50	0.50

Source: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	Mar 29, 2018	Feb 28, 2018	Dec 29, 2017
FN 3% LLB	18	16	17
FN 3% MLB	14	12	13
FN 3% HLB	10	8	10
FN 3% 125 LTV	16	16	-8
FN 3.5% LLB	25	20	32
FN 3.5% MLB	19	16	27
FN 3.5% HLB	14	13	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	36	38	61
FN 4% MLB	31	30	52
FN 4% HLB	26	25	42
FN 4% 125 LTV	18	18	24
FN 4.5% LLB	64	63	97
FN 4.5% MLB	53	53	81
FN 4.5% HLB	46	42	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

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