

MONTHLY COMMENTARY

## April Agency MBS Update

STEPHEN K. LEECH | MAY 4, 2018



**Stephen K. Leech**  
Vice President  
Fixed Income

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.

Spring finally arrived for agency MBS relative performance in April. Persistent weakness over the opening three months reversed itself as the second quarter opened. Reduced volatility, a positive month for risk assets, and beneficial regulatory developments pushed agency MBS toward positive relative performance in April. Interest rates rose sharply, as inflation data picked up toward the Fed's long standing 2% inflation target. Late in April the 10yr U.S. Treasury yield jumped over 3%, marking the first time since 2014 U.S. Treasury rates crossed that threshold. The 30yr mortgage rate also jumped again, closing the month at 4.73%. Risk assets in the U.S. held in fairly well in spite of the move, further supporting relative agency MBS valuations. While interest rates backed up markedly across April, rate volatility actually fell. The move down in volatility erased much of the relatively modest increases seen since the beginning of the year, boosting the agency MBS basis performance but leaving investors wondering when long dormant volatility might once again return. The regulatory picture was generally accretive to mortgages in April, with positive news coming from Ginnie Mae. The end result was strong agency MBS performance despite rising rates in April. Ultimately, powerful tailwinds propelled agency mortgages to reverse nearly half of the negative performance seen year to date, while total returns continued to disappoint. In aggregate, the Bloomberg Barclays MBS Index posted positive excess returns of 18 basis points (bps) relative to U.S. Treasuries in April, bringing year to date excess returns to negative 21 bps. Total returns of -50 bps for the month added to a rough year, now registering -1.69% in total returns thus far in 2018.

Coupon stack performance was positive across the agency MBS universe in April. The rising tide of relative performance lifted all bonds during the month, benefitting higher coupon MBS in particular. In Fannie Mae 30yr (FNCL) collateral, 4.5s demonstrated strength, returning 34 bps of relative outperformance in April. FNCL 4s and 3.5s followed with excess returns of 17 and 16 bps respectively. Higher coupon MBS were buoyed by shorter durations in a rising rate environment.

## April 2018 Agency MBS Update

Furthermore, rising mortgage rates further dampened the prepayment profile of agency MBS. Strong performance of higher coupon collateral reversed much of last month's relative outperformance of lower coupon FNCL bonds. April was even stronger for Ginnie Mae collateral. Ginnie Mae 30yr (G2SF) 4.5s outperformed benchmark U.S. Treasuries by 56 bps, with 4s and 3.5s posting positive excess returns of 35 bps and 17 bps respectively. Conventional collateral typically underperforms Ginnie Mae as rates rise, due to differing borrower profiles. In addition, Ginnie Mae collateral received a boost from the continuing saga over high coupon prepayment speeds on Veterans Affairs sponsored loans. Ginnie Mae continues to work to slow down prepayment speeds in higher coupon deliverable pools. This boosted higher coupon G2SF performance for the month. While TBA rolls largely traded in line with implied carry in April, G2SF 4.5 and 5s rolls traded well above implied value throughout the month. A lack of supply of worst to deliver bonds caused the roll to spike, benefitting investors holding G2SF TBA. As the calendar turns to May, whether higher coupons can continue their strong year to date relative success will be an important subplot to monitor, especially if interest rates do not continue to provide support.

Regulatory news and updates rained down on the market in April, as two different components of the agency MBS market structure saw significant changes. The most notable development was Ginnie Mae suspending two servicers from their multi pool program. The suspension is part of the continuing effort to reduce the prepayment speeds of Veteran Affairs (VA) loans, after allegations that servicers are churning loans. Ginnie Mae has struggled to reduce the speeds of higher coupon Ginnie Mae pools, as prepayments remain elevated. After warning nine servicers that the prepayment rates of their originated loans are far too fast, Ginnie Mae suspended both Nations Lending and NewDay from participating in the G2SF multi program. While the servicers are still allowed to originate custom pools with guaranteed principal, they are barred from joining the TBA deliverable subset of each G2SF coupon until speeds on their originated loans slow down. While Nations returned to the multi program right before month end, it is becoming increasingly clear that Ginnie Mae is serious about taking the steps necessary to slow down their higher coupon prepayment

speeds. While it is not yet known whether monitoring and suspending slow servicers will be enough to overcome what is largely a problem of economic incentives, the punishing of above-cohort prepayment speeds might be enough to take the edge off of problematic prepayment prints, further benefitting higher coupon Ginnie Mae collateral.

A second parcel of regulatory news from April is important to the broader agency MBS market, although it will probably not impact investors until 2019. The Federal Housing Finance Authority (FHFA) announced that they will implement their long running Single Security initiative on June 3<sup>rd</sup> of 2019. The result of a mandate by FHFA, Single Security will make both Fannie Mae and Freddie Mac TBA deliverable into one single TBA labeled UMBS. Under the stated auspices of creating more liquidity in one of the most liquid markets in all of fixed income, the plan is to have investors convert their existing Freddie Mac pools into "mirror" securities that contain the same underlying collateral as they currently do. The mirror securities will resemble Fannie Mae pools in terms of payment delay. Once converted, the pools of either entity can be delivered into UMBS TBA. Ideally, having more bonds that are deliverable will make TBA Rolls less likely to trade special, while eliminating the difference between Fannie and Gold TBA swaps. The challenge is that real life is often far from ideal. The lack of differences in Freddie and Fannie Mae deliverability could discourage both entities from innovating, as neither will have much of an incentive to compete to better their relative valuations. The result could be that while the basis between the two entities is reduced, overall valuations might be as well, harming the entire TBA market despite the best efforts of the FHFA. In addition, the IRS has not ruled on the taxability of exchanges yet, leaving investors in the lurch about what the changes might mean for their portfolios. Meanwhile, market participants are still working through a whole host of operational questions that will need to be finalized well in advance of the June 3<sup>rd</sup> go-live date. Thus while the change is a year away, investors should be cognizant that the market could look quite different in just a year, and it is not clear anyone will like what they see when we arrive there.

## April 2018 Agency MBS Update

## Coupon Stack Performance

	April Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	April Month End LIBOR OAS (bsp)	LIBOR OAS Monthly Change (bps)
<b>30 Yr. FNMA</b>					
3.0	\$96.39	-1.01	0.06	14.3	-2.3
3.5	\$99.23	-0.84	0.16	21.7	-1.6
4.0	\$101.80	-0.64	0.17	30.8	-2.2
4.5	\$104.11	-0.43	0.34	41.1	-4.8
5.0	\$106.16	-0.48	0.23	45.5	-1.3
5.5	\$108.12	-0.52	0.44	50.5	-6.2
6.0	\$110.70	-0.41	0.35	36.0	-13.9

**15 Yr.  
FNMA**

2.5	\$97.25	-0.62	0.08	-1.6	-4.5
3.0	\$99.17	-0.60	0.14	7.8	-3.7
3.5	\$101.16	-0.62	-0.10	15.0	7.4
4.0	\$102.53	-0.24	0.16	14.6	-2.7
4.5	\$100.61	-0.13	0.16	126.1	-7.4
5.0	\$100.73	-0.25	0.00	160.8	-4.6
5.5	\$99.08	-0.22	0.00	56.5	-12.4

Source: TCW, Bloomberg Barclays

## Benchmark Performance

	April Month End Price	April Month End Yield (%)	March Month End Yield (%)	Change (bps)
2 yr. Treasury	\$99.78	2.49%	2.27%	22.18
5 yr. Treasury	\$99.78	2.80%	2.56%	23.52
10 yr. Treasury	\$98.27	2.95%	2.74%	21.42
30 yr. Treasury	\$97.60	3.12%	2.97%	15.00
2/10 Curve		46.11	46.88	-0.77
2 yr. SWAP Spread		25.63	30.75	-5.13
10 yr. SWAP Spread		3.85	3.25	0.60
1y10y Swaption Vol.		65.01	69.15	-4.14
5y10y Swaption Vol.		69.53	71.72	-2.19

Source: TCW, Bloomberg

## Issuer Performance (ticks)

	April GNMAII/FNMA	Monthly Price Change	April GOLD/FNMA	Monthly Price Change
3.0	31.75	4.50	-1.88	-0.88
3.5	27.00	2.75	0.88	0.50
4.0	14.00	8.00	1.00	0.37
4.5	-12.25	9.75	-0.88	-0.50
5.0	-35.00	17.00	-6.50	-4.50
5.5	-64.00	0.00	-4.50	1.00

Source: TCW, Credit Suisse

## Specified Pool Pay-Up Grid (ticks)

Coupon	Apr 30, 2018	Mar 29, 2018	Dec 29, 2017
FN 3% LLB	17	18	17
FN 3% MLB	13	14	13
FN 3% HLB	9	10	10
FN 3% 125 LTV	20	16	-8
FN 3.5% LLB	22	25	32
FN 3.5% MLB	17	19	27
FN 3.5% HLB	12	14	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	32	36	61
FN 4% MLB	26	31	52
FN 4% HLB	21	26	42
FN 4% 125 LTV	18	18	24
FN 4.5% LLB	56	64	97
FN 4.5% MLB	46	53	81
FN 4.5% HLB	39	46	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2018 TCW