INSIGHT

MONTHLY COMMENTARY

May Agency MBS Update

STEPHEN K. LEECH | JUNE 5, 2018

Agency MBS performance was slightly negative in May as gathering global storm clouds cast a long shadow over the market. The first part of the month was characterized by higher interest rates, the result of increasing optimism in the pace of U.S. growth. At 4.86%, 30yr mortgage rates reached their highest level since 2011. Stocks rallied as volatility fell, benefitting agency MBS investors. However, the positive excess returns were not destined to remain through month end. Confidence in emerging markets and belief in the strength of European data eroded in the last two weeks of the month. Political turmoil in Italy roiled global markets while 10yr U.S. Treasury yields rallied from 3.11% to 2.86% over the final two weeks of May. Volatility spiked to the highest level witnessed since February, as concern percolated across the globe. While earlier in the year agency mortgages traded better when conditions indicated that interest rates would remain low for a longer period, the script was flipped somewhat throughout May. While extension is not beneficial for mortgage investors, previous duration extension in the MBS Index reduced the perils of slightly elevated interest rates. So long as the macro picture buoys risk markets and keeps volatility near historically low levels, slower prepayment speeds associated with higher rate levels could benefit agency MBS relative valuations. Over the last two weeks of May, as rates rallied on fear of a global slowdown, volatility percolated, causing agency MBS to give back about 19 basis points (bps) of relative excess performance. In the end, the agency MBS basis closed on a down note, the Bloomberg Barclays MBS Index underperformed Benchmark U.S. Treasuries by 5bps in May. Year-to-date excess returns now stand at -27bps, while year to date total returns are -1.00%.

The poor May performance was primarily reflected in the struggles of higher-coupon, conventional MBS. Fannie Mae 30yr (FNCL) higher coupons closed with negative returns relative to U.S. Treasuries. FNCL 4.5s returned -19bps with FNCL 4s coming in at -7bps. While the yield curve was largely flat across the month despite some fairly significant fluctuation, lower incoming mortgage rates negatively impacted up-in-coupon coupon collateral. While part of the negative performance

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.

was due to higher coupons giving back previous relative gains, the specter of lower mortgage rates going forward undercut performance in the month of May. Lower coupons, on the other hand, benefitted from both lower interest rates and previous underperformance. FNCL 3s outperformed benchmark Treasuries by 2bps in May, the only coupon to see positive relative performance in FNCL collateral. Ginnie Mae collateral performance was slightly better than conventional MBS across the board despite the usual underperformance when interest rates fall. Lower coupon Ginnie Mae 30yr (G2SF) collateral outperformed benchmark U.S. Treasuries in May, with even G2SF 4s outperforming by 3bps. Performance was slightly better than conventional MBS in higher coupons as well, where the negative impact of coming lower mortgage rates was mitigated by continuing positive regulatory news. G2SF 4.5s underperformed benchmark U.S. Treasuries by 11bps in May, outperforming conventional collateral and only giving back some of the largely positive performance thus far in 2018. While lower coupon MBS outperformed higher coupon MBS in May, higher coupons have powerfully outperformed year to date. Gradual balance sheet reduction by the Federal Reserve has been part of the story, along with mortgage rates that have inched higher thus far in 2018. Furthermore, demand has shifted toward higher coupons as fears that lower coupons might become orphaned has picked up. Whether higher coupon MBS can continue to outperform will be a key trend to watch as the calendar flips to the second half of 2018.

A month rarely goes by anymore without the continuing saga of higher coupon Ginnie Mae collateral writing another chapter, and May was no different. After elevated high coupon Ginnie Mae prepayment speeds caught the ire of multiple U.S. Senators and Ginnie Mae alike in the fall of 2017, there has been continuing movement toward reducing the prepayment speeds of Veterans Affairs (VA) loans. In May, the newest addition was the passage of banking reform legislation signed by the President, which included a bill known as the "Protecting Veterans from Predatory Lending Act." The passage of the legislation and announcement that Ginnie Mae will be implementing all of the components immediately should pay dividends for Ginnie Mae collateral. The new rules require that new loans made to Veterans and their families now be subject to a net benefit test, fee recoupment rules, and new seasoning requirements. In concert with Ginnie Mae's ongoing efforts to keep individual servicers from churning loans by removing them from multiple servicer pools, it appears as though most of the necessary hurdles have been cleared to seriously reduce the churning of Veteran borrower's loans. While G2/FN 4.5 swaps were still negative at the end of May, continuing efforts to reduce VA prepayments caused swaps to appreciate markedly over the past eight months. The end result is that the prepayment speeds on higher coupon Ginnie Mae collateral should decrease significantly due to reduced prepayments on VA collateral going forward.

The agency MBS basis has struggled year to date from both a total and excess return perspective. While total returns have been maligned by an overall market selloff, the continuing widening of the agency MBS basis is important. Volatility has picked up from the historically low levels seen late in 2017, hindering agency MBS performance. Despite the increasing gamma, volatility still remains low by historic standards, which makes further escalation quite possible. With the Federal Reserve running off the mortgage pools on its balance sheet, there is a fairly widespread expectation that the removal of the Fed as a buyer of agency MBS will increase volatility further in the space. Meanwhile as markets move into the latter phases of the credit cycle, it is very possible that both rate and risk asset volatility may increase further. A move toward historic averages would be a fairly substantial jump for agency MBS valuations to absorb. Thus, the subdued gamma environment that has permeated the market in the post-crisis period may need to continue for agency MBS to offer significant outperformance as the calendar flips to the summer months.

May 2018 Agency MBS Update

Coupon Stack Performance

30 Yr. FNMA	May Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	May Month End LIBOR OAS (bsp)	LIBOR OAS Monthly Change (bps)
3.0	$96.96	0.68	0.03	14.2	-0.1
3.5	$99.66	0.57	0.05	21.2	-0.5
4.0	$102.16	0.50	0.08	30.9	0.1
4.5	$104.38	0.44	0.14	42.5	1.4
5.0	$106.01	0.02	0.16	55.8	10.3
5.5	$107.37	-0.71	0.22	75.9	25.4
6.0	$110.02	-0.63	0.05	65.0	29.0
15 Yr. FNMA					
2.5	$97.41	0.27	-0.12	4.8	6.4
3.0	$99.46	0.39	-0.02	11.1	3.3
3.5	$101.34	0.33	0.04	18.2	3.2
4.0	$102.79	0.40	0.05	20.3	5.7
4.5	$100.64	0.16	-0.02	132.0	5.9
5.0	$101.39	0.69	0.00	174.1	13.3
5.5	$101.05	2.00	0.00	68.9	12.4

Source: TCW, Bloomberg Barclays

Benchmark Performance

	May Month End Price	May Month End Yield (%)	April Month End Yield (%)	Change (bps)
2 yr. Treasury	$100.14	2.43%	2.49%	-6.05
5 yr. Treasury	$100.25	2.70%	2.80%	-10.10
10 yr. Treasury	$100.13	2.86%	2.95%	-9.45
30 yr. Treasury	$101.95	3.03%	3.12%	-9.84
2/10 Curve		42.71	46.11	-3.40
2 yr. SWAP Spread		26.55	25.63	0.93
10 yr. SWAP Spread		3.25	5.23	-1.98
1y10y Swaption Vol.		69.45	65.01	4.44
5y10y Swaption Vol.		72.48	69.53	2.95

Source: TCW, Bloomberg

Issuer Performance (ticks)

	May GNMAII/FNMA	Monthly Price Change	May GOLD/FNMA	Monthly Price Change
3.0	30.00	-1.75	-1.75	0.13
3.5	26.00	-1.00	-0.13	-1.01
4.0	14.75	0.75	0.50	-0.50
4.5	-11.50	0.75	-0.75	0.13
5.0	-27.00	8.00	-4.75	1.75
5.5	-56.00	8.00	-8.00	-3.50

Source: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	May 31, 2018	Apr 30 2018	Dec 29, 2017
FN 3% LLB	18	17	17
FN 3% MLB	14	13	13
FN 3% HLB	10	9	10
FN 3% 125 LTV	20	20	-8
FN 3.5% LLB	25	22	32
FN 3.5% MLB	20	17	27
FN 3.5% HLB	14	12	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	35	32	61
FN 4% MLB	29	26	52
FN 4% HLB	24	21	42
FN 4% 125 LTV	18	18	24
FN 4.5% LLB	62	56	97
FN 4.5% MLB	52	46	81
FN 4.5% HLB	44	39	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup