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INSIGHT

MONTHLY COMMENTARY

June Agency MBS Update

STEPHEN K. LEECH | JULY 5, 2018

An eventful opening half of 2018 came to a close in June, with agency MBS performance staying relatively quiet despite percolating global volatility. Both equities and U.S. Treasury yields were close to flat on the month despite some increased tensions over trade; however, emerging markets were far from quiet. Concern about a number of emerging economies has sent those markets tumbling, negatively impacting both emerging risk assets and currencies. The tremors have kept volatility elevated, holding agency MBS valuations back despite the lack of severe mortgage rate movements or negative headlines. The U.S. yield curve flattened, as front end yields continue to rise. The Fed continues to raise interest rates, while longer dated U.S. Treasuries have held their ground, suggesting the market is beginning to price in the latter stages of the credit cycle. Following the second half of 2017, where record low volatility boosted valuations, four of the first six months of 2018 saw relative underperformance. Higher volatility, in concert with rising interest rates and Federal Reserve tightening have held down relative and absolute valuations in the first half. The underperformance for the year was less evident in the second quarter, with agency MBS flashing positive relative returns in April, and using a late June push to close the first half of the year on a less dour note. Ultimately, the Bloomberg Barclays MBS Index posted positive excess returns of 3 basis points (bps) in June, bringing year to date relative performance to -24bps. Year to date total returns now stand at -95bps, after June inched into positive territory with 5bps of total returns.

The coupon stack was similarly quiet in June. In 30yr conventional collateral, lower coupons outperformed higher coupons by the slimmest of margins. Fannie Mae 30yr (FNCL) 3s posted excess returns of 6bps in June, while FNCL 4s and 4.5s returned 3bps each. The quiet end to the first half came as a welcome respite to lower coupons, because higher coupon FNCL have outperformed significantly over the first half. Slight curve flattening has not been enough given the sharp reduction in prepayment

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speeds in higher coupon MBS. FNCL 4.5s returned a positive 10bps year to date, while FNCL 3.5s underperformed benchmark U.S. Treasuries to the tune of -43bps in the opening half. The year to date data is much more starkly seen in Ginnie Mae collateral, where the addition of a strong dose of regulatory tailwinds caused Ginnie Mae 30yr (G2SF) valuations to appreciate considerably. While in June both G2SF 3.5s and 4s came in at a positive 2bps, the year to date numbers are much different. G2SF 3.5s have returned a brutal -62bps in the opening six months, while G2SF 4.5s have returned a strong 83bps. Lower coupon Ginnie Mae securities have been hindered by a lack of foreign sponsorship and changing bank regulation that makes it less beneficial for banks to add Ginnie Mae collateral. Meanwhile, the move to materially reduce prepayment risk in higher coupon Veterans Affairs (VA) loans has pushed the collateral sharply higher thus far in 2018, benefitting investors. Looking toward the second half of the year, the path toward further outperformance of higher coupon Ginnie Mae collateral could become more challenging, with G2/FN coupon swaps approaching flat after being sharply negative for the past couple years.

The dominant regulatory story in the market right now is the ongoing saga of efforts to slow down VA loan prepayment speeds. On the very first day of the month, Ginnie Mae announced that Freedom VA loans will be banned from the multi-pools that are deliverable into G2SF TBA effective July 1. The punishing of servicers that have exorbitant speed profiles is the key tool that Ginnie Mae is using to eradicate the churning issue that has plagued the collateral in recent years. The six month ban from the multi-pools is a fairly severe punishment for the company, and makes Freedom one of three servicers that are currently restricted. While Federal Housing Administration (FHA) loans are unaffected by the changes and will continue to prepay quickly, the continued pressure on servicers to hold prepayments in check should continue to drag down higher coupon G2SF speeds going forward.

A less current regulatory issue, but one that will continue to rise in importance, is the question of how best to re-capitalize and reform Fannie Mae and Freddie Mac going forward. The two government sponsored enterprises have been under the control of the Federal Housing Finance Administration (FHFA) since they were taken into conservatorship during the economic crisis of 2008. The entirety of both entities profits is swept to the U.S. Treasury currently. This arrangement left the two entities undercapitalized. The FHFA released a report this month outlining their proposed future capital rules for the two GSEs. The report calls for the GSEs to have a 3.25% capital buffer, an increase from current low levels but less than banks in the U.S. are required to have. While the proposed rules would not go into place until such time as the GSEs were no longer under conservatorship, implementing the rules might cause guarantee fees to rise, making it slightly more expensive for borrowers to get loans in the future. While reforming the GSEs and removing them from conservatorship is a goal many share, this is an early stage of what will be long arduous process. It is likely that any proposal, including this one, will be subject to a myriad of changes and alterations before becoming a reality. That being said, it is important for investors to at least prepare for future turbulence over the role and requirements of the GSEs in the agency MBS space.

Agency MBS occupy a unique place in the broader fixed income universe. While mortgages benefit from lower volatility associated with increasing risk asset valuations, agency MBS also has properties associated with safe haven assets. While loans insured by Fannie Mae and Freddie Mac are not explicitly guaranteed by the federal government, the credit risk of agency MBS is minimal. Therefore agency MBS have the potential to outperform other asset classes in times of market stress. This means that despite headwinds that plague agency MBS, namely continued extension as interest rates rise, and persistent concern that increasing volatility will unseat agency MBS valuations, it is unclear that either will be a harbinger of relative value doom for the space. The vast majority of homeowners in the United States cannot currently refinance to a lower interest rate loan, keeping prepayment risk under control. Furthermore, volatility may unseat other sectors to a greater extent than agency mortgages. The end result is a sector that while battered in the opening half of the year, may be more resilient in the face of market stress than much of the fixed income universe. While an increase in future volatility would hamper agency MBS valuations, investors would be wise not to discount the potential of agency MBS to be a bulwark against whatever comes next as the calendar turns to the third quarter of 2018.

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Coupon Stack Performance

30 Yr FNMA	June Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	June Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$96.82	-0.03	0.06	13.3	-0.9
3.5	$99.51	-0.04	0.05	21.4	0.2
4.0	$101.95	-0.07	0.03	31.6	0.7
4.5	$104.13	-0.09	0.03	43.7	1.2
5.0	$105.93	0.07	0.15	53.3	-2.5
5.5	$107.10	-0.20	-0.07	74.6	-1.3
6.0	$109.14	-0.78	0.17	73.4	8.4
15 Yr FNMA					
2.5	$97.20	-0.14	0.01	4.6	-0.2
3.0	$99.41	0.04	0.11	6.80	-4.3
3.5	$101.20	-0.04	0.00	14.4	-3.8
4.0	$102.59	-0.06	-0.08	19.1	-1.2
4.5	$100.98	0.06	0.15	122.7	-9.3
5.0	$100.98	0.47	0.00	166.4	-7.7
5.5	$101.52	0.53	0.00	59.9	-9.0

Source: TCW, Bloomberg Barclays

Benchmark Performance

	June Month End Price	June Month End Yield (%)	May Month End Yield (%)	Change (bps)
2 Yr Treasury	$99.94	2.53	2.43	10.08
5 Yr Treasury	$99.47	2.74	2.70	4.16
10 Yr Treasury	$100.12	2.86	2.86	0.15
30 Yr Treasury	$102.65	2.99	3.03	-3.63
2/10 Curve		32.79	42.71	-9.93
2 Yr SWAP Spread		26.19	26.55	-0.36
10 Yr SWAP Spread		5.23	7.38	-2.15
1*10 Swaption Vol		67.20	69.45	-2.25
5*10 Swaption Vol		71.50	72.48	-0.98

Source: TCW, Bloomberg

Issuer Performance (ticks)

	June GNMAII/FNMA	Monthly Price Change	June GOLD/FNMA	Monthly Price Change
3.0	30.75	0.75	-2.50	-0.75
3.5	26.75	0.75	-1.88	-1.75
4.0	16.50	1.75	-1.00	-1.50
4.5	-6.25	5.25	-1.63	-0.88
5.0	-31.50	-4.50	-8.50	-3.75
5.5	-50.13	5.87	-7.50	0.50

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	June 29, 2018	May 31, 2018	Dec 29, 2017
FN 3% LLB	15	18	17
FN 3% MLB	12	14	13
FN 3% HLB	9	10	10
FN 3% 125 LTV	20	20	-8
FN 3.5% LLB	23	25	32
FN 3.5% MLB	18	20	27
FN 3.5% HLB	13	14	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	32	35	61
FN 4% MLB	27	29	52
FN 4% HLB	20	24	42
FN 4% 125 LTV	18	18	24
FN 4.5% LLB	54	62	97
FN 4.5% MLB	44	52	81
FN 4.5% HLB	34	44	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

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