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INSIGHT

MONTHLY COMMENTARY

July Agency MBS Update

STEPHEN K. LEECH | AUGUST 3, 2018

The second half of 2018 opened with mortgages demonstrating strength, as continued low volatility helped agency MBS erase nearly all of the year to date underperformance. After a first quarter that saw agency MBS valuations struggle behind higher volatility and sharply increasing interest rates, the second quarter was characterized by quieter movement in mortgages. July was a story unto itself. The agency MBS basis tightened most of the month, shrugging off concerns about emerging markets and global central bank policy. Federal Reserve meeting minutes, released at the beginning of the month, intimated that all reinvestments in agency MBS may end before the year is out, marking the potential end of the largest intervention in mortgage markets in history. Given the telegraphing and tapering of purchases, the market is as prepared as it can be for the removal of government support. However, due to the size and scope of the operation, it cannot be assumed that no unintended consequences will materialize as the government attempts to slowly wind down its agency MBS balance sheet. Late in July, quiet summer markets gave way to news that the Bank of Japan may be changing their yield curve management strategy, causing longer term U.S. Treasury rates to increase 10 basis points (bps) over the month. Impressively, the increase in yields did little to stem the tide of positive agency MBS performance. Mortgage rates are not far from where they were just a few months ago, keeping prepayment concerns on the backburner and further extension risk manageable. The lack of broad based concern over interest rates in July bolstered agency MBS valuations, which further benefitted from a strong month for global risk assets. Ultimately, the confluence of positive factors propelled the agency MBS basis into solidly positive territory for the month. In aggregate, the Bloomberg Barclays MBS Index outperformed benchmark U.S. Treasuries by 20bps in July, bringing year to date underperformance to just negative 4bps. Total returns remain negative, with another slightly negative month sending year to date total returns to negative 1.06%.

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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.

Performance was positive across the coupon stack in July, as the strong month for the agency MBS basis lifted valuations across the sector. Mildly higher interest rates did not cause much in the way of extension fears, as lower coupons performed in line with higher coupon collateral. Fannie Mae 30yr (FNCL) 3s posted positive 18bps of excess returns in July, with FNCL 4s coming in up 18bps as well. With the yield curve largely unchanged over the month, and 10yr yields closing right around the levels seen in mid-June, the coupon stack has gotten a welcome respite from the kinds of interest rate volatility shocks that can wreak havoc on valuations. While prepayment risk and further extension risk remain muted for the time being, there have been multiple interest-rate-volatility shocks over the past few years, making it important for investors to be mindful of unforeseen risks. Ginnie Mae (G2SF) collateral outperformed conventional counterparts, with G2SF 3s coming in +32bps versus benchmark U.S. Treasuries, and G2SF 4s finishing up 27bps. The outperformance was not surprising, as collateral differences usually benefit Ginnie Mae valuations when interest rates rise. Higher coupon Ginnie Mae collateral also outperformed, as slower-than-expected prepayment speeds in higher coupon Ginnie Mae securities caused G2/FN swaps to appreciate. The G2/FN 4.5 swap finally moved into positive territory, after years of trading negative. Regulatory efforts to curb speeds in higher coupon Ginnie Mae collateral seem to be paying dividends, as G2SF 4.5s and 5s peak prepayments have slowed significantly recently. Ultimately, if speeds remain slow, further regulatory efforts may not be necessary to keep Ginnie Mae prepayments in check.

The effort to reign in prepayment speeds of military veteran borrowers remains the key regulatory story of 2018. However as prepayment speeds have come down over the past two months, the story has retreated to the background for now. However, Fannie Mae did announce that they will be creating a new program for high LTV borrowers. Dubbed the Enterprise Paid Mortgage Insurance Option, the program will allow high LTV borrowers to get mortgage insurance by dealing directly with Fannie Mae rather than having to work with a separate mortgage insurance provider. The primary effect of this will be a slight reduction of credit standards. Smaller servicers will be able to provide higher LTV loans more easily, making it easier for borrowers to take out loans with less equity and more leverage. Freddie Mac has a similar program, which has resulted in a relatively small number of loans made through it. Thus, this one program is unlikely to materially alter MBS collateral characteristics. That being said, the continued loosening of credit is an important trend to monitor as we enter the final stages of the credit cycle.

The end of the credit cycle, while impossible to pinpoint in advance, often comes with warning signals. The yield curve provides the most famous of these warning indicators. When short term interest rates trend higher than long term interest rates, inverting the yield curve, it signals that near term borrowing may be more risky than longer term borrowing. Volatility generally falls in concert with the flattening curve, as investors get lulled into a false sense of security right when vigilance and caution are most needed. While the curve has not yet inverted, and was largely unchanged in July, at mid-month it dipped to its lowest level since 2007. For agency MBS investors, flat yield curves hinder the performance of seasoned collateral since longer duration assets outperform as the curve grinds toward inversion. While the yield curve is not yet inverted, the spread between 10yr and 2yr U.S. Treasury yields broke below 30bps briefly in July, signaling that we are closer to the end of the flattening than we are to the beginning. Therefore it is prudent for investors to be mindful of what the end of the cycle might look like for the agency MBS universe. Investors should be prepared for volatility to increase, but should remain wary of the idea that agency MBS can be fully eschewed, as other asset classes may react far more grievously to the curtain closing on the current bull market. Furthermore, even negative yield curves can persist for some time. Therefore, it is imperative that agency MBS investors be mindful that while the status quo may not be fleeting, a closing curtain can open to a new act at any moment.

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Coupon Stack Performance

30 Yr FNMA	July Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	July Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$96.41	-0.32	0.18	10.3	-3.0
3.5	$99.11	-0.29	0.19	18.8	-2.6
4.0	$101.58	-0.23	0.18	29.5	-2.1
4.5	$103.74	-0.22	0.11	42.4	-1.3
5.0	$105.63	-0.11	0.17	53.5	0.2
5.5	$106.86	-0.19	0.05	76.5	1.9
6.0	$108.52	-0.56	0.25	81.1	7.7
15 Yr FNMA					
2.5	$96.81	-0.32	-0.03	4.7	0.1
3.0	$99.11	-0.20	-0.01	5.5	-1.3
3.5	$100.89	-0.21	0.09	17.3	2.9
4.0	$102.38	-0.10	0.13	20.3	1.2
4.5	$100.83	-0.09	0.08	112.0	-10.7
5.0	$100.67	-0.22	0.00	155.9	-10.5
5.5	$101.11	-0.34	0.00	55.9	-4.0

Source: TCW, Bloomberg Barclays

Benchmark Performance

	July Month End Price	July Month End Yield (%)	June Month End Yield (%)	Change (bps)
2 Yr Treasury	$99.91	2.67%	2.53%	14.12
5 Yr Treasury	$99.54	2.85%	2.74%	11.01
10 Yr Treasury	$99.27	2.96%	2.86%	9.97
30 Yr Treasury	$100.82	3.08%	2.99%	9.32
2/10 Curve		28.63	32.79	-4.15
2 Yr SWAP Spread		20.91	26.19	-5.28
10 Yr SWAP Spread		7.38	6.66	0.72
1y*10y Swaption Vol.		65.45	67.20	-1.75
5y*10y Swaption Vol.		71.10	71.50	-0.40

Source: TCW, Bloomberg

Issuer Performance (ticks)

	July GNMAII/FNMA	Monthly Price Change	July GOLD/FNMA	Monthly Price Change
3.0	35.50	4.75	-2.25	0.25
3.5	30.50	3.75	-1.38	0.50
4.0	20.75	4.25	-1.50	-0.50
4.5	3.25	9.50	-1.25	0.38
5.0	-25.00	6.50	-7.50	1.00
5.5	-40.00	10.13	-7.50	0.00

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	July 31, 2018	June 29, 2018	Dec 29, 2017
FN 3% LLB	14	15	17
FN 3% MLB	11	12	13
FN 3% HLB	8	9	10
FN 3% 125 LTV	20	20	-8
FN 3.5% LLB	21	23	32
FN 3.5% MLB	16	18	27
FN 3.5% HLB	12	13	21
FN 3.5% 125 LTV	18	18	8
FN 4% LLB	31	32	61
FN 4% MLB	27	27	52
FN 4% HLB	21	20	42
FN 4% 125 LTV	18	18	24
FN 4.5% LLB	52	54	97
FN 4.5% MLB	42	44	81
FN 4.5% HLB	33	34	65
FN 4.5% 125 LTV	40	40	44

Source: TCW, Credit Suisse, Citi

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