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INSIGHT

MONTHLY COMMENTARY

September Agency MBS Update

STEPHEN K. LEECH | OCTOBER 3, 2017

The agency MBS basis closed the third quarter of 2017 with a flourish, as positive headlines, a strong tenor in risk assets, and stable interest rates broke relative agency MBS performance into positive territory for the year. Agency MBS valuations did not open the month on such positive footing. Fears of percolating tensions between North Korea and the global community, and a lackluster non-farm payroll number (156k) caused agency MBS relative valuations to open poorly. The damage was quickly undone as Korea headlines faded to the background. Reduced tensions allowed asset prices to resume their ascent while U.S. Treasury yields increased in lockstep. The rise in yields, after multiple months of downward pressure, helped improve the relative valuations of agency MBS and shelved prepayment risk for the foreseeable future. The upward trend in yields was one of many tailwinds to agency MBS valuations in September. The long-expected announcement that the Fed will taper its holdings of agency MBS securities, as well as a portion of its Treasury securities, came as expected and went seemingly without a hitch. Furthermore, while hurricanes Irma, Harvey, and Maria rained down significant devastation, the damage did little to negatively impact the agency MBS space. The lack of negative headlines, in concert with the FOMC following the most predictable course of action, helped spark a strong few weeks for agency MBS investors. Furthermore, positive regulatory headlines benefitted Ginnie Mae securities, further igniting the rally. The result was by far the strongest month of 2017 for the agency MBS basis. In aggregate, the Bloomberg Barclays MBS Index closed with excess returns of 35 basis points (bps) relative to U.S. Treasuries in September, concluding the penultimate quarter of 2017 with 27bps of year-to-date excess returns.

The strong performance seen across the agency MBS coupon stack was most notably concentrated in Ginnie Mae collateral. On the whole Ginnie Mae securities provided excess returns of 46bps in September, clawing back more than half of the negative excess performance produced prior to the month. Two headlines served as the catalysts for the excellent September in Ginnie Mae MBS. The first was a letter written by Senator Elizabeth Warren of Massachusetts to the President of Ginnie Mae asking the government sponsored enterprise to address complaints about loans made under the U.S. Department of Veterans Affairs Program to help veterans and their families obtain home financing. Warren's concern is that loan servicers, which issue qualifying loans under the program, are aggressively soliciting veterans and their families shortly after issuing them a new mortgage, in order to 'churn' their loans. The alleged goal of the servicers is to generate fees associated with a new loan even in situations where a new mortgage is not economically advantageous for the borrower. Higher coupon Ginnie Mae 30yr MBS pools (G2SF) have taken the brunt of the elevated prepayments associated with this churning activity. Despite the official guarantee of repayment, G2SF 4s and above were trading noticeably behind their conventional counterparts prior to the letter and its aftermath, in

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large part due to elevated prepayments. While Warren's letter provided much needed momentum to Ginnie Mae collateral in September, the response from the president of Ginnie Mae added even greater velocity to the recovery. The return letter surprised market participants with its specificity, announcing a task force to investigate lender abuse and develop specific policy steps to mitigate the churning issue. The sharp reduction in Ginnie Mae speeds that could result over time from reducing or eliminating the churning of loans was powerful for collateral performance. The two coupons most impacted by the churning issue, G2SF 4s and 4.5s, posted excess returns of 74bps and 86bps, respectively, versus benchmark U.S. Treasuries while leading all Ginnie Mae coupons to positive performance in September.

The second major story in agency MBS relative valuations was a strong showing of all conventional collateral, particularly higher coupons, during the month of September. For most of the summer interest rates slowly fell, providing lower coupon MBS securities with a boost as the market reacted to the potential for increasing prepayments in higher coupon MBS. The month of September saw a slight trend in the opposite direction. In Fannie Mae 30yr collateral (FNCL), FNCL 3.5s, 4s and 4.5s all posted positive excess performance just shy of 40bps. FNCL 3s trailed, coming in at positive 23bps of excess returns. Mortgage rates remain elevated relative to levels seen for most of 2016. The decline in interest rates over the past few months did create some concern for investors. The move culminated in the 30yr mortgage rate hitting a year to date low of 4.03% during the first week of September. As of month end 30yr rates have backed up to 4.11%; a small change, but one that brings lending rates back to where they stood through much of the summer. Stable interest rates should help keep prepayment risk at arm's length for agency MBS investors, leaving the potential for increased volatility, either through headline risk or some other unforeseen challenge, as the key concern going forward.

Regulatory news was front and center in September, with the previously discussed move in Ginnie Mae collateral taking most of the oxygen out of the room. Lost in the shuffle was the U.S. Federal Reserve finally announcing it will commence balance sheet reduction in October. While the Fed has been telegraphing this to the market for some months, beginning in October the Fed will allow up to $4bn in MBS a month and $6bn in U.S. Treasuries to run off their balance sheet each month. The Fed will ultimately raise the monthly cap to $50bn a month in securities by late next year, with up to $20bn of agency MBS rolling off each month. The Fed has designed the process to run in the background on an ongoing basis, with no plans to stop balance sheet reduction unless forced to by a drastic change in market conditions. The goal is to use interest rates to manage monetary policy going forward, while allowing the Fed to pare down their $4.5 trillion dollar balance sheet without riling the market. Thus far in 2017, the messaging on balance sheet reduction has gone according to plan, with the market reacting very little to the looming possibility of reduced Fed buying power. However, despite the best efforts of well-meaning Fed officials, markets remain fickle creatures, capable of reacting to the unforeseen, while ignoring that which prognosticators focus on the most. Thus vigilance is always warranted, perhaps most so when it appears the market is as it should be.

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Coupon Stack Performance

30 Year FNMA	September Month End Price	Monthly Price Change (pts)	Monthly Performance vs. Benchmark U.S. Treasury (%)	September Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$100.27	-0.88	0.23	18.8	-5.5
3.5	$103.05	-0.59	0.38	15.8	-3.9
4.0	$105.27	-0.41	0.39	36.3	-6.4
4.5	$107.33	-0.25	0.38	46.6	-9.6
5.0	$109.11	-0.19	0.60	47.5	-14.7
5.5	$110.67	0.06	0.63	70.4	-16.8
6.0	$112.58	0.09	0.47	75.5	-15.7
15 Year FNMA					
2.5	$100.67	-0.72	0.18	1.7	-3.4
3.0	$102.73	-0.53	0.41	36.6	-14.3
3.5	$104.14	-0.28	0.22	82.7	-16.1
4.0	$103.27	-0.13	0.23	173.5	-3.5
4.5	$102.27	-0.03	0.00	211.7	36.9
5.0	$101.73	-0.06	0.00	173.2	-11.4
5.5	$100.11	-0.06	0.00	119.6	-15.4

Sources: TCW, Bloomberg Barclays

Benchmark Performance

	September Month End Price	September Month End Yield	August Month End Yield	Change (bps)
2 Yr Treasury	$99.78	1.48%	1.33%	15.72
5 Yr Treasury	$99.71	1.94%	1.70%	23.40
10 Yr Treasury	$99.26	2.33%	2.12%	21.66
30 Yr Treasury	$97.79	2.86%	2.73%	13.39
2/10 Curve		84.49	78.75	5.74
2 Yr SWAP Spread		25.63	20.70	4.93
10 Yr SWAP Spread		-5.23	-4.38	-0.85
1*10 Swaption Vol		67.20	70.20	-3.00
5*10 Swaption Vol		75.30	78.20	-2.90

Sources: TCW, Bloomberg

Issuer Performance (ticks)

	September GNMAII/FNMA	Monthly Price Change	September GOLD/FNMA	Monthly Price Change
3.0	34.5	4.5	0.25	1.13
3.5	28.25	6.5	0.75	-0.25
4.0	0.75	9.5	0.25	-0.63
4.5	-23	12.25	-3.75	-0.5
5.0	-60	5	-12	0
5.5	-62.63	-1.38	-13	1.75

Sources: TCW, Credit Suisse

Specified Pool Pay-Up Grid (ticks)

Coupon	Sep 29, 2017	Aug 31, 2017	Dec 30, 2016
FN 3% LLB	18	18	11
FN 3% MLB	14	15	9
FN 3% HLB	10	12	7
FN 3% 125 LTV	-8	-8	-8
FN 3.5% LLB	38	38	30
FN 3.5% MLB	30	31	24
FN 3.5% HLB	22	24	18
FN 3.5% 125 LTV	16	14	10
FN 4% LLB	64	67	48
FN 4% MLB	56	59	38
FN 4% HLB	43	46	30
FN 4% 125 LTV	34	30	22
FN 4.5% LLB	98	100	62
FN 4.5% MLB	82	86	48
FN 4.5% HLB	63	70	38
FN 4.5% 125 LTV	45	42	26

Sources: TCW, Credit Suisse, Citi

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