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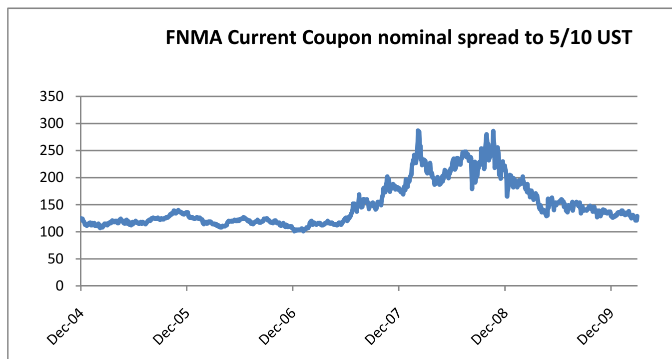
Fixed Income Research Update

Agency MBS: First Quarter 2010 Update

First Quarter in Review

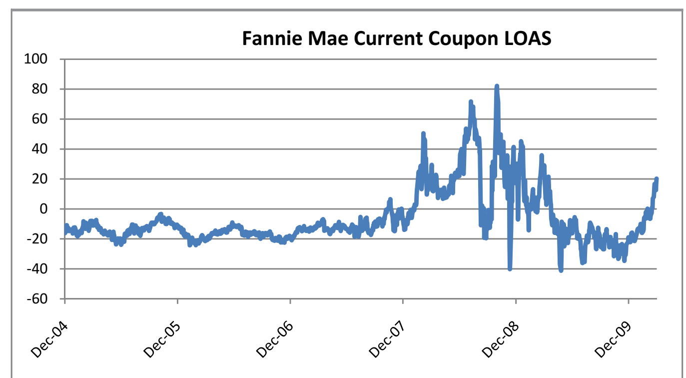
Over the last quarter, the agency MBS market was driven primarily by continued Fed participation, the long awaited completion of its purchase program, and the timing of the much anticipated buyouts of delinquent loans by Fannie Mae (FNMA) and Freddie Mac (FHLMC). The Fed's $1.25 trillion purchasing program that began in January of 2009 was completed on March 31. In total, 90% of the purchases were conventional mortgages and 61% were 4.5% coupons and below. In total the Fed, Government Sponsored Enterprises (GSEs) and U.S. Treasury now own approximately 44% of the outstanding $5.3 trillion of agency MBS.



Source: UBS

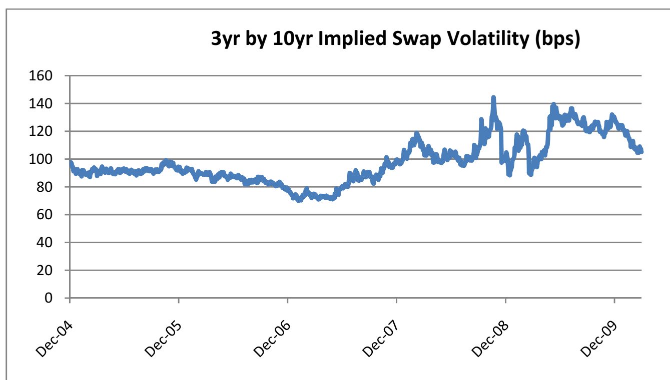
On February 10 FNMA and FHLMC announced that they would buy out loans greater than 120 days delinquent. While the eventual buyouts were expected, the swiftness of action surprised the market: FHLMC bought out all delinquent loans in March, while Fannie Mae will buy out delinquent loans over roughly three months beginning in April. High coupon and "affordability" loans (interest-only, 40-year amortization, and hybrid ARMs) are most significantly impacted by the current action and are expected to experience somewhat elevated prepayments going forward as new delinquencies are continuously bought out. While sharp spikes in prepayments reduced the balances of premium coupons, causing some modest underperformance, the post-buyout FHLMC premium collateral traded to all-time high prices.

Current coupon agency pass-through nominal spreads to Treasuries ended flat for the quarter at about 130 basis points over the 5/10 year blended Treasury yield. On the other hand, LIBOR option-adjusted spreads (LOAS) on agency MBS widened in the waning days of the first quarter from a historically tight level of -21 bps at year-end to +20 bps at quarter-end, far wider than the "pre-crisis" average of approximately -15 bps. This widening trend is



Source: UBS

due to a continued decline in implied volatility. For example, 3 year into 10 year implied basis point swap volatility fell from 130 bps at year-end to 115 bps at the end of the first quarter. Declining volatility reduces the value of the prepayment option, an option the mortgage investor is economically "short"; thus, declining volatility increases the expected future return of a mortgage.



Source: UBS

Money managers overall maintained an underweight in agency MBS, potentially awaiting further spread widening upon the Fed's exit. A recent poll done by JP Morgan indicated that over 50% of money managers surveyed were underweight agency MBS versus their benchmark. With so much expectation of underperformance, agency MBS continued to favor the contrarians and outperformed U.S. Treasuries by 69 bps during the quarter, with the Barclays MBS index returning 1.54%. Much of the outperformance was found in 30yr GNMAs as well as conventional 15yr pass-throughs.

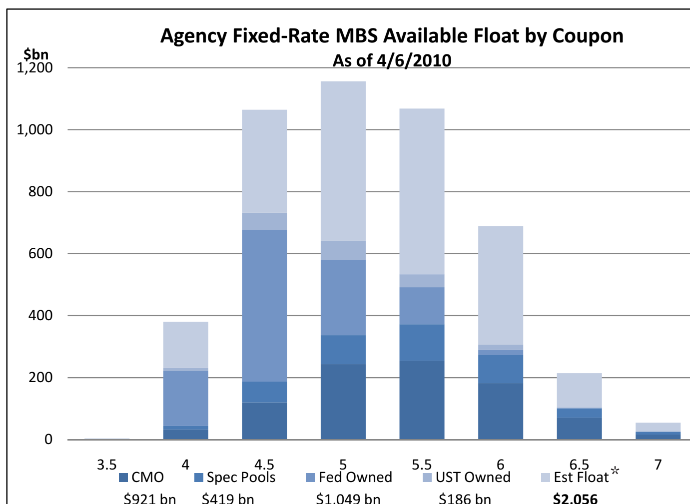
The Road Ahead

The dominant theme going forward is the limited supply and available float of agency MBS. By itself, the Fed currently owns 24% of the agency MBS market and has indicated that it plans to let the securities pay down rather than quickly selling them off; the GSEs and U.S. Treasury own an additional 20% of the market. During the second quarter, we expect GSE buyouts to further decrease tradable float in an amount comparable to the Fed's purchasing rate in recent months. Additionally, tighter underwriting will continue to dampen new origination, most of which will come from FHA originations finding their way into Ginnie Mae (GNMA) MBS.

On the demand side of the equation, we expect increased investment from banks should MBS yields rise. Money managers may also look to shed their underweight position should nominal spreads widen moderately with the Fed's exit. This additional participation should decrease the likelihood of an outsized move in spreads. Overseas investors represent a wild-card as they look for ways to diversify their holdings away from dollar-based assets. Nonetheless, there have been signs of investment from Japanese institutions in the first few days of April, a period which represents the beginning of their new financial year.

We anticipate that post-buyout conventional prepayment speeds will be elevated relative to late 2009 prints, as FNMA and FHLMC have committed to repurchasing loans as they transition to severe delinquency. In particular, high coupon or credit-sensitive collateral may experience much higher involuntary prepayments than previously, while the impact to low coupon loans will be more muted. GNMA was buying out delinquent loans for much of 2009 and we anticipate that they will continue to do so. Due to tighter underwriting standards across all of the GSEs as well as weak housing market fundamentals, voluntary prepayments are likely to stay low without additional government intervention. Because of the increased GSE buyout activity we maintain a cautious view on higher coupon impaired collateral, for which transitions to delinquency suggest elevated prepayments. With the use of proprietary loan-level models of the housing market, TCW/MetWest is able to seek out value within the agency MBS universe. We continue to find significant value in pools and CMOs backed by well-seasoned loans, as well as loans with lower average principal balances,

as both investment opportunities provide much more predictable prepayments that are less sensitive to new and ever-changing government programs implemented to restart the sluggish housing market. We continue to overweight lower coupon GNMA versus FNMA due to their better convexity, and we find value in intermediate term CMOs with locked-out principal cash flows that will roll down the continued steep yield curve.



Source: Barclays Capital
* Including GSE holdings.

Conclusions

Despite the recent tight nominal spreads in agency MBS, we continue to find areas of opportunity. In our view, the recent and continuing GSE buyouts are beneficial to the market, improving clarity and prepayment predictability and stability going forward. With the yield curve likely to remain steep for the remainder of this year, we suggest that a significant widening will present an opportunity to add to the agency MBS position.

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