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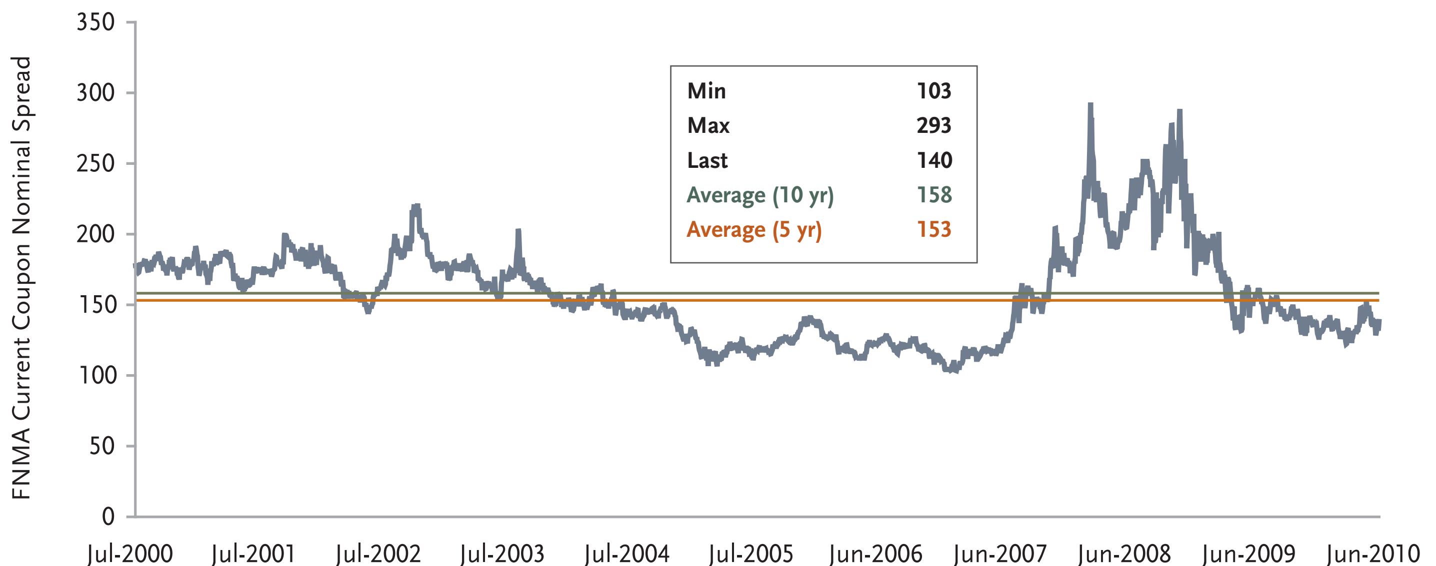
Fixed Income Commentary
Agency MBS 2Q10 Review and Outlook

Second Quarter in Review

The rising tide of the U.S. Treasury market seemed to lift all boats during the second quarter of 2010, as concerns regarding European economies and weak economic fundamentals here at home drove a flight-to-quality in domestic high-grade fixed income. Nonetheless, some asset classes floated at the top with Treasuries better than others. The agency MBS market held its own, actually outpacing a duration-matched Treasury portfolio with an excess return of 1 basis point for the quarter.

Current coupon agency pass-through nominal spreads-to-Treasuries ended slightly wider for the quarter at 140 basis points over the 5/10 year blended Treasury yield. However, mortgages performed well on a LIBOR option-adjusted (LOAS) basis, tightening from 20 bps at the beginning of the quarter to 7 bps at the quarter's end (wider than the long term historical average of -6 bps). Agency MBS participated in the recent rally as a "quality" sector, tracking more with the Treasury market than credit markets: mortgage option-adjusted spreads tightened by 24 bps versus industrials and 48 bps versus financials over the quarter. Implied volatility, as measured by 3-year into 10-year implied basis point swap volatility, increased temporarily in May due to the southern European debt crisis but ended the quarter roughly unchanged.

Current Coupon Agency MBS Spread to 5/10 yr UST Blend

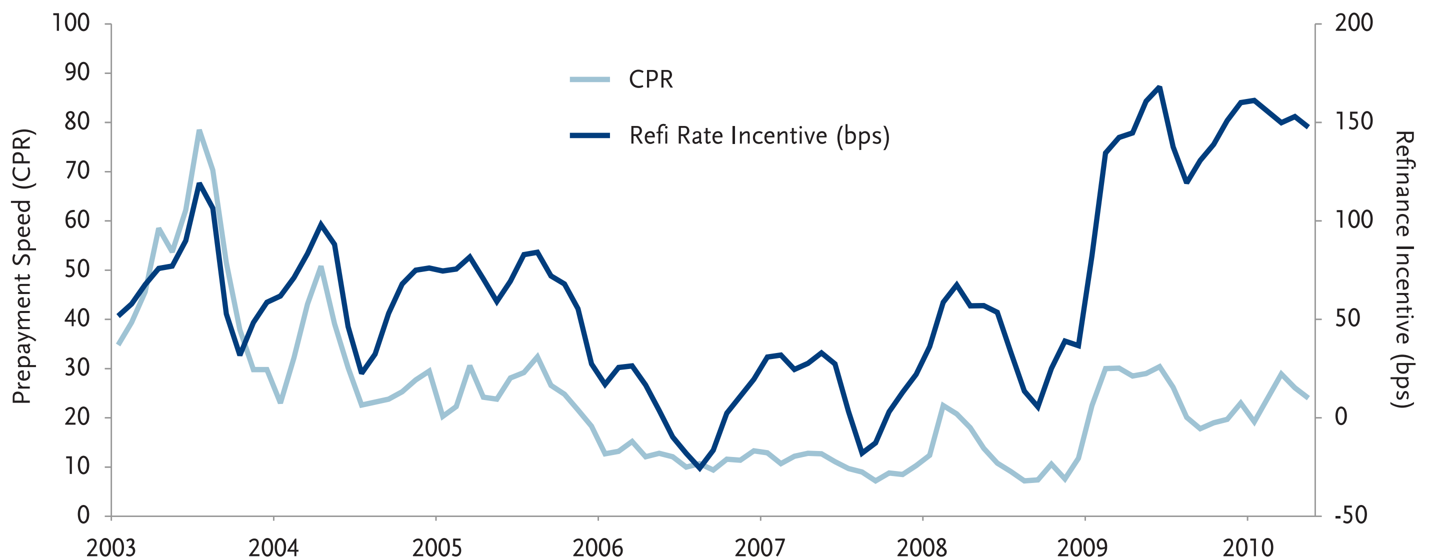


Source: Bloomberg

The second quarter saw all-time high prices in agency MBS across the coupon stack, with lower coupons outperforming higher coupons. As is typically experienced during a period of falling interest rates, primary mortgage rates given to borrowers lagged the secondary agency mortgage markets. The spread between primary rates and secondary agency pass-through yields increased from 52 basis points to 84 basis points over the quarter. The Freddie Mac weekly survey of 30-year fixed-rate mortgage rates hit an all-time low of 4.58% as the quarter closed, pushing the yield on the current coupon agency pass-throughs to 3.75%.

Despite low mortgage rates, few borrowers are able to take advantage of them. The government's extended tax credit for home purchase temporarily increased sales of both new and existing homes, but the most recent data disappointed yet again. In May, existing single-family home sales reached an annualized rate of 5 million, well below the September 2005 peak of 6.34 million. New single-family home sales came in at a disappointing rate of 300,000 annualized – a new all-time low since the Census Bureau began tracking this data in 1963 and less than one quarter the rate of new home sales at the height of the housing bubble.

Refinance Incentive and Actual Prepayment Speeds



Source: RBS

The Mortgage Bankers Association refinance index is currently at half of its peak value during this cycle, achieved in January 2009 when mortgage rates were 43 bps higher than the present rate. The muted borrower response is largely due to borrower constraints. Over a quarter of all U.S. home borrowers are underwater (have negative equity). Additionally, tougher underwriting standards and an increase in upfront fees that were imposed in the wake of the recent housing crisis have made it difficult to get a loan or refinance an existing loan.

Also during the quarter, the GSEs completed their purchase* of severely delinquent loans from pools. The buyouts manifested to investors as prepayment spikes and resulted in short term underperformance by high coupon collateral and securities containing substantial "affordability" loans (interest-only, 40 year amortization, and hybrid ARMs). Though elevated prepayments may persist in these areas as the GSEs purchase loans which transition to 120 days delinquency, the overall impact to the agency MBS market going forward is positive due to increased transparency and cleaner post-buyout, high coupon collateral.

*Mortgage servicer Taylor, Bean & Whitaker ceased operations on August 5, 2009 and its servicing operations for Ginnie Mae securitized loans were taken over by Ginnie Mae's master subservicer. Severely delinquent TBW loans have not yet been bought out and no timeline has been announced by Ginnie Mae.

This past quarter saw a continued shortage of available float in several coupons, resulting in dollar roll levels trading at or through fail (negative implied financing rates) for most of the quarter. While the Federal Reserve finished its purchases of MBS last quarter, it has yet to take delivery of all the purchases. Specifically, the Fed has almost $20 billion in purchases yet delivered in FNMA 4.5%, 5.0%, and 5.5% coupons. That dynamic, along with good demand for collateralized mortgage obligations (CMOs) for most of the quarter resulted in the shortage of available collateral. As a result, payups for specified pools, and in particular seasoned collateral, compressed. However, on June 28, the Federal Reserve announced that they would start using coupon swaps to facilitate the timely settlement of their agency MBS purchases. The Fed stated that they plan to sell their unsettled FNMA 5.5% coupons and buy other agency MBS that are more readily available for settlement. The recent low supply of FNMA 5.5s available in the market has caused failed delivery of the coupon, of which the Fed owned $9.2 billion in unsettled purchases. The Fed's action may alleviate the issue of failed deliveries and improve market functioning. The immediate reaction by the market resulted in an underperformance of higher coupons, and in particular FNMA 5.0% and 5.5% coupons.

Looking Ahead

Given the challenges facing borrowers and much stricter underwriting standards, we expect voluntary prepayments to remain muted going forward; however, a further rally is likely to provide additional economic incentives which may set off a refinance wave. If that were to occur, it would be most significant among recent buyers (who have substantial equity due to market level purchase prices and large down payments required). The 2009 and 2010 originated conventional (FNMA and FHLMC) 4.5% and 5.0% coupons would be most at risk of prepayments. On the other hand, persistent high unemployment and continued stagnation or declines in the housing market increase the risk of higher involuntary prepayment for at least the remainder of this year, with particular impact on higher coupons. Specifically, higher coupons backed by "affordability" loans are most at risk.

Nonetheless, the technical dynamics for agency MBS are excellent. The supply of agency MBS will likely remain low relative to demand as new home sales languish. While the Fed is no longer absorbing that supply, both domestic and overseas investors are likely to step into the market at any sign of spread widening. Additionally, with the Federal Reserve policy likely to be on hold for the foreseeable future and a yield curve likely to remain steep for at least the remainder of the year, agency MBS continue to provide excellent carry relative to Treasuries and other high quality fixed income assets.

In light of tight spreads, high dollar prices, and the steep yield curve environment, it is more critical than ever to exercise caution and perform diligent analysis when investing in agency MBS. As always, judicious selection of collateral and security structure provide the best defense against potential yield curve flattening or higher interest rate volatility resulting in mortgage spread widening.

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