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## Fixed Income Commentary Agency MBS Monthly Update



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Agency mortgages continued their strong performance against both swaps and Treasuries this past month. In light of the significant rate volatility and 10-year Treasuries approaching new recent lows, mortgages have benefited from the “flight to quality” trades, as investors are choosing prepayment risks over sovereign risk, credit risk, and currency risk within the fixed income markets. Furthermore, a combination of weak origination and strong demand from overseas buyers and domestic money managers ensured that technicals remained very favorable for agency MBS. Over the month, the 10-year Treasury rallied 35 basis points (bps) and FNMA current coupon LIBOR option-adjusted spreads (LOAS) tightened by 3 bps; 2-year swap spreads tightened 11 bps and implied volatility came off as well, all of which contributed to mortgages’ solid performance. Across the coupon stack, lower coupons outperformed higher coupons, supported by the duration bid from the originators. FNMA 4s and 4.5s outperformed the 10-year Treasury by 13 ticks and 12 ticks, respectively, using a 30-day empirical hedge ratio, while FNMA 5.5s and 6.0s only outperformed 2 ticks and 9 ticks, respectively, using the same 10-year Treasury-hedge basis.

With Fannie Mae cleaning up the delinquent loans in 5.0s and 5.5s coupon pools, aggregate speeds on the belly of the 30-year coupon stack doubled, going up to a 27.3 conditional prepayment rate (CPR) and 48.6 CPR, respectively. Overall, the aggregate fixed rate 30-year Fannie Mae prepayments dropped 3% from 28.9 CPR to 28.1 CPR. Aggregate Freddie Mac 30-year fixed rate prepayment speed fell 12% to 14.4 CPR. The decline was due to the combination of lower delinquency, marginally lower refinancing activity, and two less collection days in May. Ginnie Mae speeds bounced back this month. GN I 30-year fixed rate prepayments rose 14% in May to 13.1 CPR and GNII’s 30-year speeds were up 9% reaching 12.9 CPR. Delinquency buyouts by Chase were the key driver.

June gross agency pool issuance increased slightly at approximately \$99 billion. So far this year, agency collateralized

mortgage obligation (CMO) issuance has been around \$228 billion or roughly \$38 billion per month. This is a significant pick up over the past two to three years. Generally, the 2/10 curve is the main driver of CMO issuance. A steeper curve leads to higher CMO production. In June, as the 2/10 curve flattened approximately 20 bps, CMO issuance was down another 30%, from \$32.7 billion in May to \$23.2 billion in June. The lack of new CMO issuance and a higher percentage of gross issuance of agency MBS in conventionals versus Ginnie Maes, caused the GNMA/FNMA 4.5s swap to close the month at its cheapest level since the Fed ended its agency MBS purchase program in March 2010.

Specified pool pay-ups remained under pressure this month as quarter-end balance sheet constraints exist, attractive TBA dollar roll financing rates continue, and a lack of CMO activity continued to drag down demand. Over the past months, the pay-ups have come off substantially, and money managers and insurance accounts are slowly creeping back into the specified space, adding both seasoned and specified loan balance paper. On June 26, the Fed announced its intention to initiate a coupon swap operation to address fail issues related to its unsettled MBS purchases. In this program, the Fed plans to swap out approximately \$9.2 billion of unsettled FNMA 5.5s for other coupons, which could be positive for the specified pool market given a weakened outlook for dollar rolls.

On June 16, the Federal Housing Finance Agency directed Fannie Mae and Freddie Mac to delist their common and preferred stock from the NYSE and any other national securities exchanges. This voluntary delisting is not a reflection of performance related to the GSEs and should have no impact on the agency MBS market. On June 23, Fannie Mae announced its policy changes designed to prevent strategic defaulters from getting another Fannie Mae loan for seven years. While the concept is appealing, its effectiveness on strategic default is still in question.

# Fixed Income Commentary

## Agency MBS Monthly Update (cont'd)

According to the MBA weekly survey, for the week ending June 25, the purchase index came in at 172.1, a 7% decrease from May 21. Meanwhile, the Refinance Index was up 8% to 3613.1. The average contract interest rate for a 30-year fixed mortgage decreased 13 bps to 4.67% over the month. This is the lowest 30-year fixed rate recorded in the survey since the week ending April 24, 2009. The average contract rate for a 15-year fixed rate mortgage was 4.06%, which is the lowest 15-year contract rate ever recorded in the survey.

The number of newly started trial modifications dropped again in May to 30,000, a 36% decline from April. The number of permanent modification started increased by 47,724 to 346,816. However, the number of conversions to permanent status decreased by 30% from last month. Of the 1.2 million trials started, 28% have been converted into permanent modifications and 35% have been canceled.

### Coupon Stack Performance

30 Year FNMA	June Month End Price	Monthly Price Change	Monthly Performance Vs. 10 Year Treasury	June Month End Libor OAS	Libor OAS Monthly Change
4.0	101-08	65/32	13/32	+19.4bp	-1.4bp
4.5	103-20	51/32	12/32	+7.9	-7.3
5.0	105-25	36/32	9/32	+0.7	-8.4
5.5	107-10	21/32	2/32	-45.4	-26.8
6.0	108-15	25/32	9/32	-79.1	-44.2
6.5	109-16	23/32	11/32	-114.2	-47.4

Source: TCW, Barclays, Bank of America

### Benchmark Performance

	June Month End Price	Monthly Price Change	June Month End Yield	Yield Change
2 Yr Treasury	100-00	2/32	0.62%	-0.15%
5 Yr Treasury	100-12	8/32	1.79%	-0.31%
10 Yr Treasury	104-21	95/32	2.95%	-0.35%
30 Yr Treasury	108-05	97/32	3.91%	-0.31%
2/10 Curve			233bp	-0.20%
2 Yr SWAP Spread			35.7bp	-0.11%
10 Yr SWAP Spread			6.4bp	-0.02%
1*10 Swaption Vol			109.3bp	-0.09%
5*10 Swaption Vol			104.3bp	-0.06%

Source: TCW, Citi

### Issuer Performance

	June GNMA/FNMA	Monthly Price Change
4.5	17/32	-2+/32
5.0	23/32	-1/32
5.5	22+/32	4+/32
6.0	17/32	2+/32
6.5	7/32	-2+/32

Source: JPM, TCW

### Agency Debentures

	Month End Spread to UST	Monthly Change in Spread	Month End Yield
2 Yr	+13bp	-11bp	0.75%
5 Yr	+12	-8	1.91%
10 Yr	+20	-5	3.16%

Source: GS indications only (mid)

### Seasoned Pool Pay-up Grid

FNMA 30 Yr Coupon	Weighted Average Life (WALA)			
	20 Months	40 Months	60 Months	80 Months
4.5	2/32	12/32	23/32	36/32
5	0	2/32	5/32	13/32
5.5	0	0	6/32	15/32
6	1/32	8/32	28/32	46/32
6.5	1/32	0	28/32	48/32

### Loan Balance Pay-up Grid

Coupon	Low Loan Balance	Medium Loan Balance	High Loan Balance
4.5	12/32	8/32	4/32
5	19/32	12/32	4/32
5.5	32/32	19/32	9/32
6	48/32	38/32	18/32
6.5	50/32	38/32	18/32

### Specified Pool Pay-up Grid

Coupon	Investor	20 Year	JUMBO	10/20
4.5		34/32	-18/32	-34/32
5	6/32	15/32	-30/32	-34/32
5.5	18/32	15/32	-48/32	-42/32
6	16/32		-54/32	-42/32
6.5	16/32			-42/32

Source: GS as of 6/30/2010

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