INVESTMENT GRADE FIXED INCOME | OUTLOOK

2023 Investment Outlook: Agency MBS

By: EV Forward | December 14, 2022

As Investors Shed Risk, Demand for Agency MBS Likely to Pick Up

KEY POINTS

1. With the specter of recession and credit defaults on the horizon, money manager demand for agency MBS is set to pick up in 2023.
2. Higher-coupon agency MBS yields are now close to 6% for the first time since the early 2000s.
3. To mitigate against the risk to our higher-coupon theme from prepayments in 2023, we are moving to specified pools that can offer pay-up convexity[1] on top of attractive spreads.

What We Are Seeing

For the first time in over a decade, we expect investors will have to contend with a true credit default cycle in 2023. Under this scenario, bond selection will be critical.

Fortunately, investors are once again receiving attractive yield from high-quality bonds. Fourteen years of central bank policies setting artificially low rates have ended with government-sponsored, agency MBS yields at levels not seen since before the global financial crisis.

In our view, supply of agency MBS is set to fall significantly in 2023, as mortgage rates approaching 7% have dramatically slowed U.S. home sales and eliminated any cash-out refinance supply.

Declining supply in 2023 should more than offset the absence of the Federal Reserve in the MBS market, providing a nice technical tailwind for MBS spreads.

Short duration now means more yield: The Fed's ongoing battle to cool inflation has led to the most inverted Treasury curve since the early 1980s. Investors can now pick up over 70 basis points (bps) by staying at the short end of the yield curve.

2022 marked the worst year on record for the MBS market. On the upside, we believe this has created an attractive entry point for intermediate- or long-term investors, as high starting yields and wide spreads have historically preceded periods of strong total returns.

What We Are Doing

After spending nearly an entire decade below 3%, higher-coupon agency MBS yields are now close to 6% for the first time since the early 2000s.

We expect mortgage interest rates to decline in 2023 from their two-decade high, as spreads narrow from their 2022 wides.

We continue to believe that the best value in the sector can be found in higher-coupon MBS, which offer an attractive combination of higher yields, wider spreads and shorter durations.

To mitigate against the risk to our higher-coupon theme from prepayments in 2023, we are moving to specified pools that can offer pay-up convexity on top of attractive spreads, which we believe will offer some insulation as mortgage rates decline.

What We Are Watching

MBS spreads. Spreads are wide relative to other fixed income sectors, such as investment-grade corporates. Despite increasing concerns of a recession on the horizon, lower credit quality, A-rated corporate bonds are trading nearly 30 bps tighter than higher-coupon, AAA-rated agency MBS.

Crossover buyers. We will watch the pace of demand from crossover buyers in core bond funds who are looking to move up in quality — out of investment-grade corporates and into AAA agency MBS—as economic growth slows.

Demand for agency MBS. As investors are now paid to help mitigate against the risk of a recession, we expect to see demand for agency MBS to pick up — especially among money managers who may seek to shed credit risk before defaults begin to escalate. Historically, these securities have produced positive total returns in periods following the onset of a recession. On average, agency MBS have outperformed investment-grade corporates by nearly 400 bps.[2]

Bond market volatility. We expect a significant decline in volatility across the bond market as more clarity on the direction of inflation emerges, with less uncertainty around the amount of Fed tightening required.

Andrew Szczurowski, CFA
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Portfolio Manager

[1] Convexity measures the sensitivity of a bond's duration to changes in yield.

[2] Source: Bloomberg. Agency MBS represented by the ICE BofA MBS Index, investment-grade corporates represented by the ICE BofA US Corporate Index; measured over six recessions since the creation of MBS in the late 1970s, from 1980 to 2020.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

ICE BofA U.S. MBS Index is an unmanaged index of U.S. mortgage-backed securities.

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