2024 Outlook: Agency Mortgage-Backed Securities

By: Andrew Szczurowski, CFA | December 8, 2023

Limited Supply to Support Agency MBS Market in 2024

KEY POINTS
1. Agency mortgage-backed securities (MBS) spreads sit over 100 basis points (bps) wider than their 2021 lows. While spreads have been at historically wide levels for the last two years, an improving technical landscape in 2024 will likely pave the way for tighter spreads.
2. The average mortgage rate of existing homeowners with a mortgage sits at just 3.74% as of December 1, making it uneconomical for existing mortgage holders to move or refinance, dampening supply in the agency MBS market in 2024.
3. We expect the focus to shift in the agency MBS market from extension protection to call protection in 2024. With the specter of recession and credit defaults on the horizon, money manager demand for agency MBS is set to pick up in 2024.

What We Are Seeing

We expect the economic slowdown which began in Q4 2023 to gain steam in 2024. For the first time in over a decade, we expect investors will have to contend with a true credit default cycle in 2024. Under this scenario, bond selection will be critical.

Active investment managers began to go from underweight agency MBS relative to corporates, to overweight over the past few quarters to prepare for an economic slowdown. While many (including us) were early to the trade, the ability to go up in quality and yield at the same time is too good of an opportunity to pass up at this point in the economic cycle.

The other important variable for the agency MBS market in 2024 is the supply outlook. There are two real sources of supply in the agency MBS market, home sales and refinances. Given the average mortgage rate of existing mortgage holders sits at 3.74%, compared with 7.50% today for a new mortgage, refinancing supply in the agency MBS market will remain next to nothing. This leaves home sales as the only source of market supply. Existing home sales have fallen to near multi-decade lows due to record unaffordability, caused by the dramatic rise in mortgage rates over the past two years. It is uneconomical for the bulk of existing mortgage holders to move out of their homes at today's mortgage rates, which means the frozen housing market will keep supply muted in 2024.

What We Are Doing

Given our view that the economy will continue to slow and the talk of rate cuts will gain steam over the coming months, we believe mortgage rates will be a good bit lower a year from now. Accordingly, we think investors in agency MBS should look to lock in today's spreads via call-protected, high-coupon specified pools and agency collateralized mortgage obligation (CMO) bond structures, which have more protection from prepayments and better convexity[1] in a declining yield environment.

We continue to avoid low-coupon agency MBS, which make up the bulk of the MBS index, because they trade nearly 100 bps tighter than higher-coupon agency MBS. While we believe mortgage rates will decline over the coming year, we think the borrowers in low-coupon mortgages would need rates to fall nearly 450 bps from their current levels before seeing a substantial prepayment pickup in these deep-discount bonds. We expect home-price growth to be flat due to record unaffordability, further suppressing the speed of prepayment of deep-discount bonds, lowering their potential returns. Meanwhile, investors in specified pools of high-coupon MBS can benefit by targeting stories which are less likely to refinance, despite declining mortgage rates, offering investors a chance to earn even greater carry than models currently project.

We think agency MBS investors can generate more alpha over the coming year via the CMO bond market, which offers investors an opportunity to pick up longer duration structures comparable to low coupons, at substantially wider spreads.

What We Are Watching

Money market flows: Whether investors who placed trillions of dollars into Treasury-bills and money market funds the past two years will take advantage of the now-steeper yield curve and move out the interest rate curve and risk spectrum.

Bond fund flows: If investors pour money back into bond funds over the coming quarters like we expect, it is a very positive sign for agency MBS spreads.

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 60 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-rated agency MBS—as economic growth slows. Historically, agency MBS have produced positive total returns in periods following the onset of a recession, and, on average, agency MBS have outperformed investment-grade corporates by nearly 400 bps.[2]

U.S. home sales: Given 97% of the mortgage market is out of the money from a refinance perspective, almost all the supply over the coming year will have to come via new and existing home sales. If home sales over the coming year come in as weak as we expect due to the mortgage lock-in effect, organic supply will remain low.

Fed: While we don't expect any change to the Fed's quantitative tightening (QT) program over the short term, if the economy begins to slow at a more dramatic pace, the pace of QT is something the Fed might consider. This would certainly be a positive tailwind for MBS, after years of headwinds.

Data as of 12/5/2023 and source of data is Morgan Stanley Investment Management, unless otherwise noted.

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.**

Index definitions:

ICE BofA MBS Index tracks the performance of U.S. dollar-denominated, fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. Agencies in the domestic market.

ICE BofA US Corporate Index tracks the performance of U.S. dollar-denominated, investment grade corporate debt publicly issued in the U.S. domestic market.

Risk Considerations: *Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes. Mortgage and asset-backed securities are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest-rate risks.*

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