INVESTMENT GRADE FIXED INCOME

Two Things We Know about Agency MBS

By: Alexander Payne, CFA | October 17, 2022

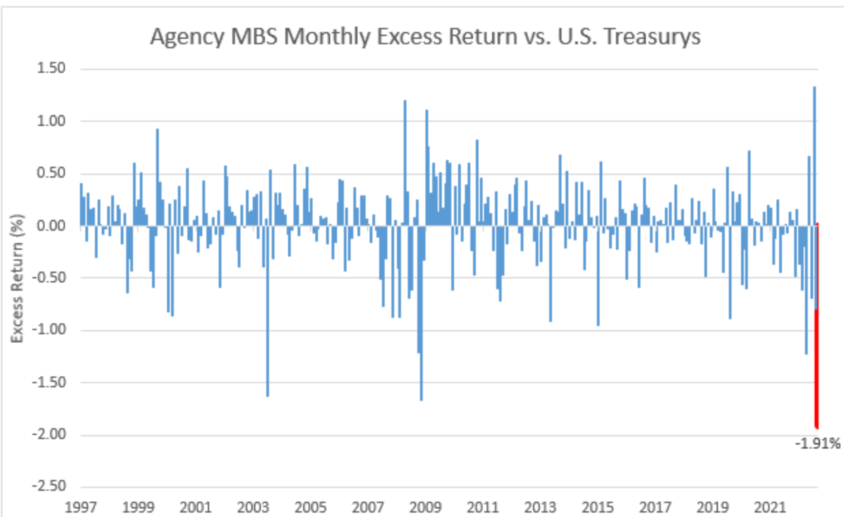
Boston - There are a lot of unknowns in markets these days. Has inflation peaked? Is the economy entering a recession? Will the Federal Reserve pivot to a more dovish stance? On the government bond desk we have strong opinions on all these macro topics, but in this piece prefer to focus on two things that we know for sure.

1. The agency mortgage-backed securities (MBS) market just experienced its worst month *ever* in September.
2. Government-guaranteed agency MBS have *never* posted a loss over the 12-month period following the start of a recession.

We believe those facts, taken together, suggest that an overweight to a historically cheap, government-guaranteed asset class might make sense as recession risks are priced in.

Agency MBS are historically cheap

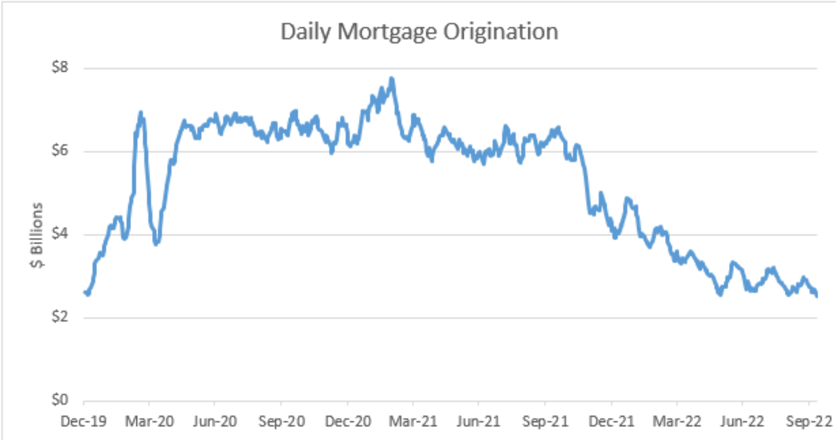
In September 2022, Agency MBS excess returns versus Treasurys experienced a move greater than five standard deviations — handily surpassing the depths of the financial crisis in 2008 and even the internet-driven refinancing wave of 2003.



Source: Bloomberg data as of 9/30/2022. Agency MBS represented by the ICE BofA U.S. MBS Index.

In this instance, there was not a single smoking gun, but rather numerous detractors that weighed on the market. Among them, we would highlight mortgage REIT deleveraging, quarter-end balance sheet constraints for banks, and originators flushing the last of the 6% mortgage rate loans through their pipelines.

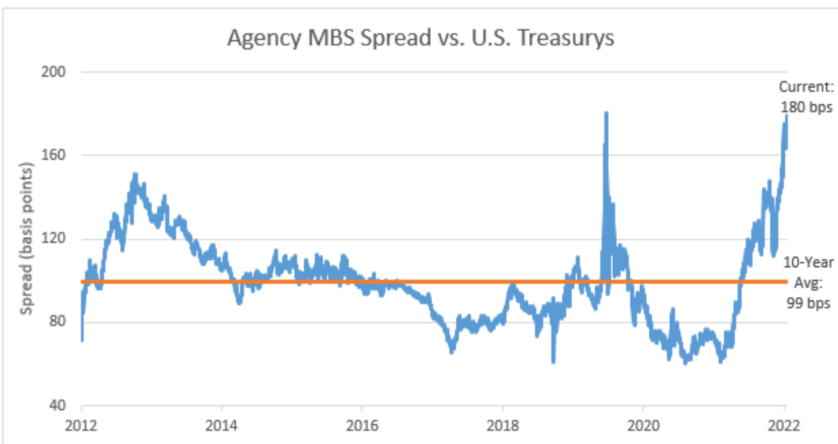
Now with mortgage rates above 7%, the supply outlook going forward could become much more favorable. Daily originations are expected to drop below $2 billion per day, down from almost $8 billion per day at the peak in 2021. This would help keep supply and demand balanced, as the Fed's balance sheet runoff is projected to be roughly $20 billion per month, or $1 billion per day.



Source: Citi Velocity data as of 10/11/2022. Daily origination shown as a 20-day moving average.

In addition, despite concerns regarding potential selling of agency MBS by the Fed, Chair Powell said at the most recent FOMC meeting in September that "the time for turning to it has not come and is not close." If there is one place in which the Fed has been successful in stemming out inflation, it's been the U.S. housing market via 7% mortgage rates.

Recent pain in the MBS market has left agency MBS spreads at levels not seen since the onset of the pandemic. Today's spreads are 180 basis points (bps) over Treasurys — nearly double the 10-year average. To put that into context, this time last year, BB-rated high-yield bonds had a spread over Treasurys of less than 190 bps. Today, government-guaranteed agency MBS can get you almost that much spread.



Source: Bloomberg data as of 10/11/2022. Agency MBS spread reflects the current coupon spread over a 5/10 year U.S. Treasury blend.

Add the MBS market's spread widening to the equally impressive move higher in Treasury yields this year, and you have a Ginnie Mae 6% bond trading at a discount — despite being guaranteed to mature at par.

Agency MBS have outperformed in recessions

Since the creation of the mortgage-backed security in the late 1970s, there have been six recessions. In every case, the Agency MBS Index had a positive total return over the 12-month period following the onset of the recession. Importantly, government-guaranteed Agency MBS have outperformed investment grade corporate bonds by 370 bps on average in these rough markets.

Recession Start Date	Agency MBS 12-Month Total Return
1/1/1980	0.47
7/1/1981	14.07
7/1/1990	12.32
3/1/2001	8.25
12/1/2007	6.75
2/1/2020	3.47

Source: Bloomberg. Agency MBS represented by the ICE BofA U.S. MBS Index.

Intuitively, we think this makes sense, as investors typically shed credit risk to buy higher quality, government bonds when default risk increases. We are well aware of the old saying that "economists have predicted nine of the last five recessions," but when you can also pick up spread as you go up in quality, it may pay to be cautious.

Bottom line: With all the uncertainty in markets today, we would argue for owning what you know. And that could be a 6% coupon, trading at a discount, with a bald eagle on the prospectus.

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Alexander Payne, CFA
Portfolio Manager
Agency MBS

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