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### Investment Grade Fixed Income

## 2022 Outlook: Changing Rate Environment in 2022 Could Benefit Active MBS Investors

**Boston** - 2021 is a year most agency Mortgage-Backed Securities (MBS) investors will be happy to have in the rearview mirror. The agency MBS market underperformed nearly all other U.S. fixed-income sectors in 2021 and suffered only its second negative year over the past 25 years, as measured by the Bloomberg U.S. Mortgage Backed Securities (MBS) Index. Both negative years (2013 and 2021) were actually the byproduct of the same event, eight years apart... tapering of the Fed's quantitative easing programs.

While most agency MBS investors expected the Fed to taper its MBS purchases before 2021 was over, the real surprise of 2021 was the seemingly never-ending amount of supply, which hit the market month after month.

The agency MBS market began 2021 with one very solid technical, the Fed absorbing almost 100% of new net issuance early in the year as mortgage rates rose. Coming into 2021, many expected supply for the year would be somewhere around \$400 billion, meaning the Fed would be taking out 100% of net supply. After rising nearly 50 basis points (bps) in the first quarter, mortgage rates leaked lower for the rest of the year. Lower mortgage rates, a hot U.S. housing market and trillions in pent-up home equity all combined to create record supply in the agency MBS market.

To put it in context, in 2021, the MBS market saw nearly three times the supply it has seen on average over the last 20 years. Despite being a government-backed sector, and the Fed purchasing over \$400 billion of bonds during 2021, more than \$800 billion of supply was too much for the agency MBS market to handle without widening spreads.



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"We believe that agency MBS investors could potentially outperform in the rising rate environment we foresee by moving up in coupon."



Markets are also forward looking, and they price in spread widening long before events actually occur. Of course, past behavior is no predictor of future results, but we have seen a similar scenario play out before. The 2013 taper tantrum produced the last rising yield and spread widening event, resulting in the only other negative year for MBS in the last 25. The following year (2014), as the tapering process was ongoing, agency MBS spreads actually ground tighter, and the sector rose by over 6%.

While monetary policy across the globe in 2022 will ultimately depend to a large extent on the path of the pandemic, we believe our economy learns to cope better with each new wave. In 2022, we expect the long end of the yield curve — long maturity bonds with yields that are 10 years or greater — to wake up to the fact that inflation is not as transitory as it initially seemed. Although we don't expect inflation to stay at the 7% annualized rate, we do expect it to stay well above the Fed's 2% target for the foreseeable future. While transitory inflation components will eventually work their way through as the year progresses, higher wages and elevated home price appreciation could potentially keep inflation well above target for the foreseeable future.

With elevated inflation, we expect to see continued rising bond yields across the curve. Although the Treasury curve always flattens during Fed tightening cycles, we also expect the market to price in a much higher terminal rate — a rate that is consistent with full employment and capacity utilization and stable prices — than it is currently reflecting, which will allow the long end to leak higher. As it stands now, the market expects the terminal fed funds rate for this cycle to be around 1.5%; however, elevated inflation will mean this number should be significantly higher and something the bond market will have to reprice in 2022.

We believe that agency MBS investors may outperform in the rising rate environment we foresee by investing in bonds with higher coupons. The elevated prepayment speeds of 2021 in higher coupon pools are likely to slow in 2022, and these coupons offer less extension risk than lower-coupon agency MBS. Investors in the agency MBS market can also protect themselves from extension risk by investing in the collateralized mortgage obligations (CMO) market, which can offer more structural protection than typical pass-through securities, which are a pool of fixed-income securities backed by a package of assets. Last but not least, we expect the floating-rate CMO market to also become a more attractive place for agency MBS investors to hide out from rising bond yields as the Fed hiking cycle gets underway.

**Bottom line:** Elevated inflation has forced the Fed's hand to remove accommodation from the bond market much earlier than originally anticipated. As the Federal Reserve winds down its quantitative easing (QE4) program in Q1 2022 and removes the training wheels from the bond market, look for added volatility across the Treasury market and risk assets in 2022. Agency MBS investors should look to protect themselves from rising bond yields and mortgage rates by migrating up in coupon to pools that stand to benefit more from a possible slowdown in prepayments.

**ICE BofA U.S. MBS Index** tracks the performance of U.S. dollar-denominated investment-grade asset-backed securities publicly issued in the U.S. domestic market.

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