Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

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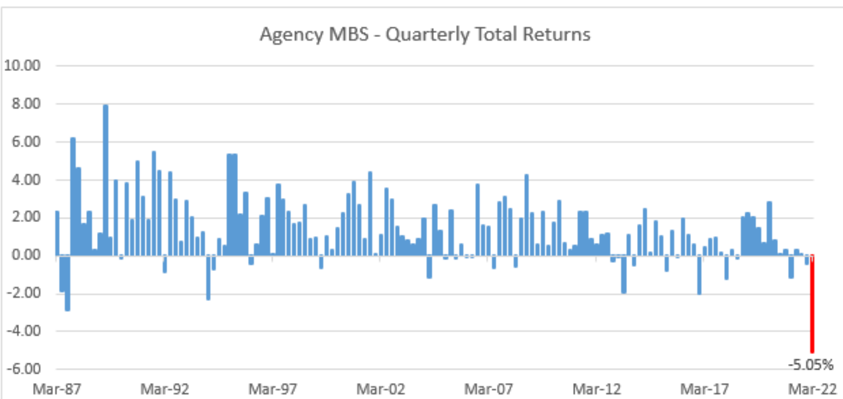
APRIL 20, 2022

Investment Grade Fixed Income

Agency MBS Risk/Reward Compelling after Worst Quarter in 35 Years

Boston - The agency mortgage-backed securities (MBS) market experienced its worst quarter in over 35 years, with the ICE BofA U.S. MBS Index falling 5% in the first quarter. We would have to go back to 1987 and 1994 to find quarters when the index was down more than 2% — not evenduring the taper tantrum in 2013.

Agency MBS first-quarter loss set 35-year record



Source: Bloomberg as of March 31, 2022. Agency MBS represented by the **ICE BofA U.S. MBS Index**, which tracks the performance of U.S. dollar-denominated investment-grade asset-backed securities publicly issued in the U.S. domestic market.

Bond markets wake up to new inflation regime

What happened? For starters, Treasury yields rose anywhere from 54 to 160 basis points (bps), depending on the position along the curve, when the bond market finally woke up to inflation not being as transitory as initially believed. This caused losses in most fixed income sectors.

Our view is that despite the large increase in yields during the first quarter, the bond market may still underestimate the potential for the U.S. economy to be in a new inflation regime. Inflation could be structurally higher than the 2% era we have lived in for the past few decades.

We suspect that investors might have a *recency bias* when it comes to the Federal Reserve. Aside from 2000, nearly every hiking cycle by the Fed ended at a lower terminal rate than the previous cycle. Based on this recent experience, investors could have expected the Fed's terminal rate this cycle to be below the 2.50% of the last cycle.

That logic may be flawed now, because this is the first time since the early 1990s that inflation is a problem — the Core Consumer Price Index (CPI) is over 6% today.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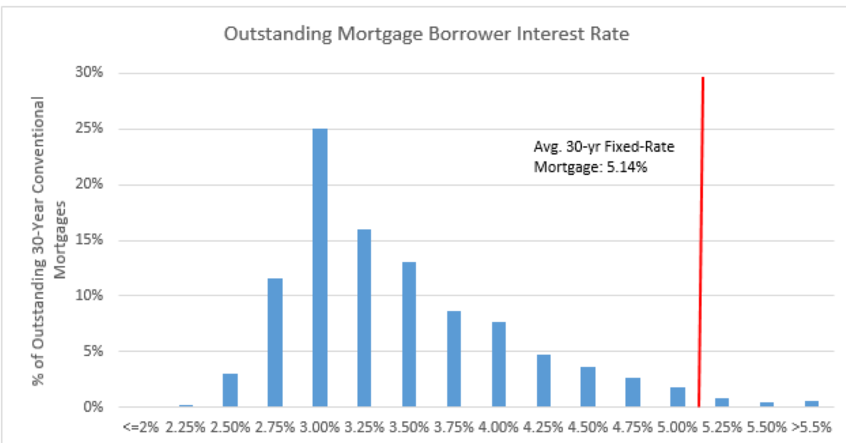
"After the recent rise in spreads, agency MBS investors can now earn yields that look extremely compelling on a historical basis compared to other high quality parts of the fixed income markets."

Most outstanding mortgages are at rates below the current rate

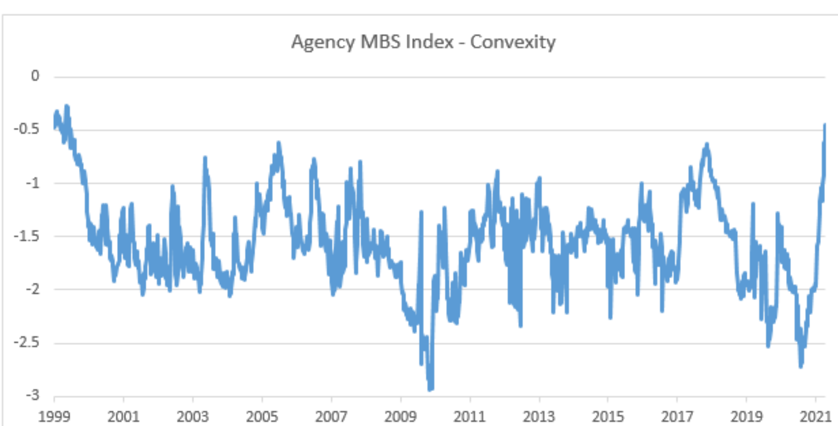


Source: RiskSpan as of April 11, 2022.

Again, agency MBS nominal spreads over Treasurys are quite elevated relative to their 5-year average. In theory, spreads should be widest when a homeowner's incentive to refinance is greatest, and MBS convexity is extremely negative.

But today, spreads are wide at a time when refinancing risk is extremely low. As the majority of the MBS market has swung from trading at a substantial premium over par to a 5-point discount, on average, prepayment risk has plummeted and the convexity of the MBS index is near record highs.

Agency MBS convexity near record highs



Source: Bloomberg as of April 11, 2022.

What that means is investors in agency MBS are now receiving higher compensation for a risk that is substantially lower — a nice tailwind for this AAA-rated, government-guaranteed asset class.

All investing involves risk, including the risk of loss.

The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. Securities with longer durations tend to be more sensitive to interest rate changes than securities with shorter durations. As interest rates rise, the value of certain income investments is likely to decline. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment and extension risk. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. U.S. Treasury securities generally have a lower return than other obligations because of their higher credit quality and market liquidity. While certain U.S. government-sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the U.S. Treasury.