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

*The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance strategy. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.*

MARCH 29, 2021

Investment Grade Fixed Income

# AAA agency mortgage-backed securities don't just outperform in risk-off environments

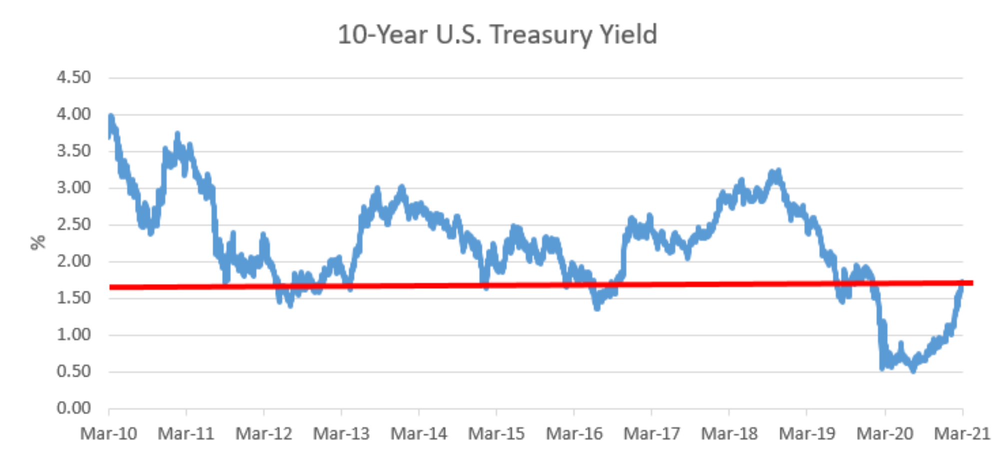

**Andrew Szczurowski, CFA**
Director of Mortgage-Backed Securities
Eaton Vance Management

**Alexander Payne, CFA**
Portfolio Manager
Mortgage-Backed Securities
Eaton Vance Management


**Boston** - *After a dramatic backup in U.S. Treasury yields in late February and early March, are we entering a new bear market? Our fixed income investment experts present their views on the environment in a series of blogs, continuing with agency MBS.*

With the Bloomberg Barclays U.S. Aggregate Bond Index (Agg) on pace for its worst quarter in 40 years, many investors may be wondering if there is a safe place in the bond market to park their cash that won't hurt them if interest rates continue to rise.

While there has been a large backup in intermediate and long-end U.S. Treasury yields, with the 10-year selling off by over 120 basis points (bps) from the lows of summer 2020, we are still at abnormally low levels historically. In fact, despite the large sell-off in intermediate and long-end Treasurys, yields have only risen to the level where the 2013 taper tantrum began.




Source: Bloomberg, Eaton Vance. As of 3/23/2021.

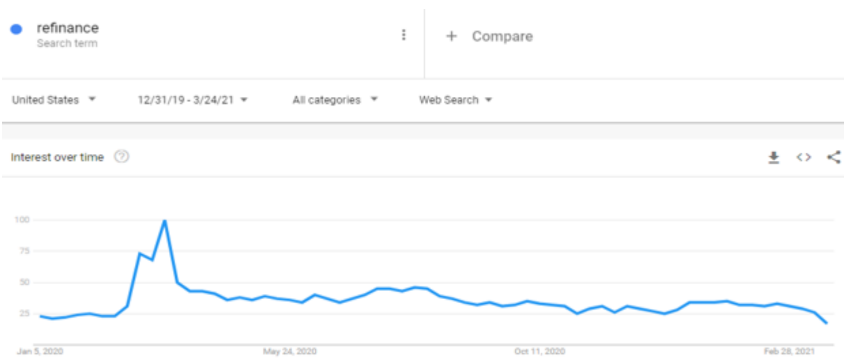
"Despite the large sell-off in intermediate and long-end Treasurys, yields have only risen to the level where the 2013 taper tantrum began."

The sell-off has been painful for many bond investors and our view on the mortgage-backed security team is that the path of least resistance for Treasury yields is higher, as the U.S. economy recovers and U.S. deficits balloon after three stimulus bills — alongwith the potential for an infrastructure package to throw even more supply onto an already bloated bond market.

From our standpoint, this backup in rates is actually welcome news. We have shown how higher mortgage rates can lead to lower refinancing activity, next we examine the link between prepayments and MBS returns. At current prices for a Ginnie Mae 2.5% pool, every 5% change in the annualized prepayment rate is worth approximately 20 bps of yield, all else being equal. Market projections have slowed by roughly that amount year-to-date, with the consensus annualized prepayment rate dropping from the high to low teens.

A quick review of Google Trends would suggest that even though the rate backup is relatively recent, it is already having an impact. There appears to be waning interest in refinancing as mortgage rates have moved up from their summer lows.

**Google Trends search activity for the term: refinance**




Source: Google Trends. As of 3/24/2021.

Google Trends is a search feature that shows how frequently a given search term is entered into Google's search engine relative to the site's total search volume over a given period of time.

**Market technicals in 2021**

Technicals in the agency MBS market will likely go from a large headwind in 2020 to a tailwind for the foreseeable future. The Federal Reserve is currently adding $40 billion agency MBS on a net basis to their balance sheet every month, which means that if they don't taper their purchases at some point, they will be buying $480 billion for the year. Further, after the recent backup in mortgage rates, supply estimates of agency MBS for 2021 have fallen to only $400 billion. Absent a taper from the Fed later this year, there could potentially be -$80 billion of net supply.

Our view is that the Fed will have to taper at some point in 2021, given the continued economic recovery and rising Treasury yields/mortgage rates. But if the taper comes at a time of even higher mortgage rates and lower supply, it would be easier for the MBS market to digest.

**Bottom line**: We believe that while the path won't be a straight line higher like it has been for the past six months, Treasury yields will continue to rise over the coming quarters as the U.S. economy returns to a slightly more normal state. In our opinion, investors may want to look to the AAA-rated agency MBS market, which has not only historically outperformed in risk-off environments, but has also traditionally outperformed investment-grade corporates *uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. Investments in income securities 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. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. Low rated or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.*