

Agency MBS: Still Attractive for Now

By Ian Anderson, Portfolio Manager, Agency MBS Strategist

KEY TAKEAWAYS

- We foresee modestly positive excess returns for agency MBS versus Treasuries over the next 6 to 12 months.
- The Fed is withdrawing from the MBS market, but we believe reinvestment will continue through summer 2018.
- Refinancing incentives remain muted; a prepayment wave appears unlikely.
- The market will have to absorb additional MBS supply starting mid-2018. What spread level will marginal buyers demand?

At its June meeting, the Federal Open Market Committee announced intentions to implement a balance sheet normalization program later this year using roll-off caps to gradually withdraw from the agency mortgage-backed securities (MBS) market.

We do not think the Fed's balance sheet contraction will mean significant downside for the agency MBS market over the next 6 to 12 months. We favor a modest overweight agency MBS stance versus Treasuries for the remainder of 2017 and into the first half of 2018.

Positive factors supporting agency MBS include attractive duration-hedged adjusted carry, continued reinvestment of Fed balance sheet paydowns even after the introduction of the new MBS caps, and low refinancing risks. The largest negative we see is the additional MBS supply the market will need to absorb starting in mid-2018.

We discuss these positive and negative factors on the following pages.

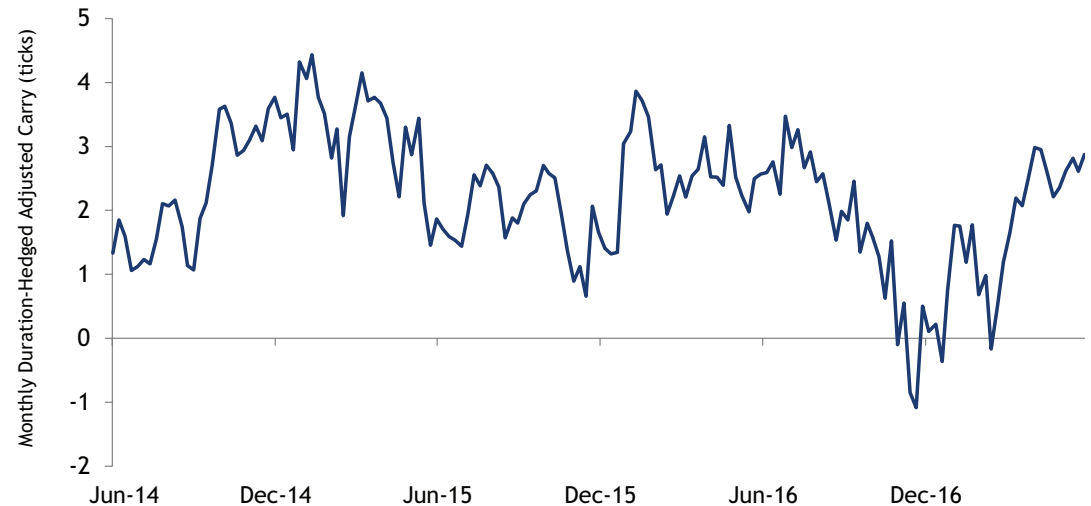


Positive: Duration-Hedged Adjusted Carry

The excess carry of agency MBS versus Treasuries has increased since the beginning of the year and currently sits at the top of the three-year range. As shown below, the duration-hedged adjusted carry for 30-year Fannie Mae 3.5% to-be-announced (TBA) bonds is now more than 3 ticks per month.

FANNIE MAE 30-YEAR 3% TBA DURATION-HEDGED CARRY VS TREASURIES

Source: JP Morgan, data as of June 12, 2017.



Contributing to the higher carry is a recovery in TBA dollar roll specialness from the beginning of the year. The Fed may be pulling back from the TBA market going forward into 2018, but in the short term, it is still taking delivery in TBA from the worst-to-deliver collateral. This aids in keeping dollar rolls well bid. The continuing flattening of the yield curve is another factor. As the yield curve flattens, the roll-down cost of short Treasury positions becomes less onerous. This bolsters returns on the short Treasury-hedged position versus long TBAs.

Positive: Continued Fed Reinvestment

Although the timing on the initiation of the gradual cessation of Fed MBS reinvestments remains uncertain, the June Fed meeting provided a clear template for the magnitude. The paydown cap will initially be \$4 billion and increases in additional \$4 billion increments quarterly until it reaches a target of \$20 billion.

For example, if in the future the Fed target is a \$10 billion paydown cap and realized MBS paydowns are \$25 billion during the month, the Fed will reinvest only the difference, or \$15 billion.

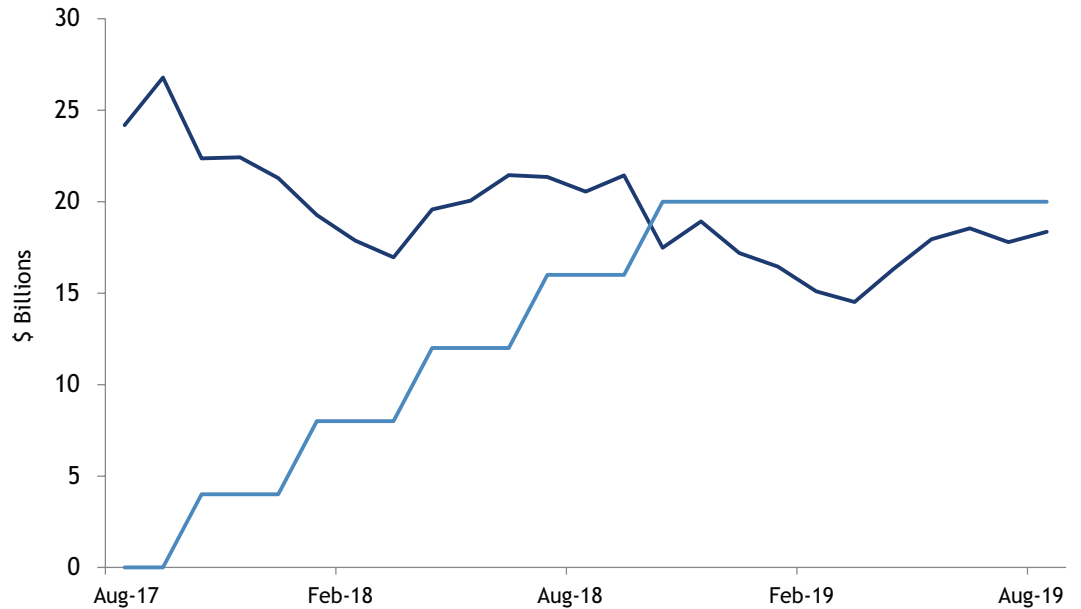
The following chart depicts the MBS caps versus the projected Fed MBS paydowns assuming rates follow the forwards. The caps are assumed to be implemented in the fourth quarter of 2017.



FED MBS PAYDOWNS VS PROJECTED MBS CAP

Source: Citigroup Yieldbook Projections, data as of June 14, 2017.

- Monthly Paydowns
- MBS Cap



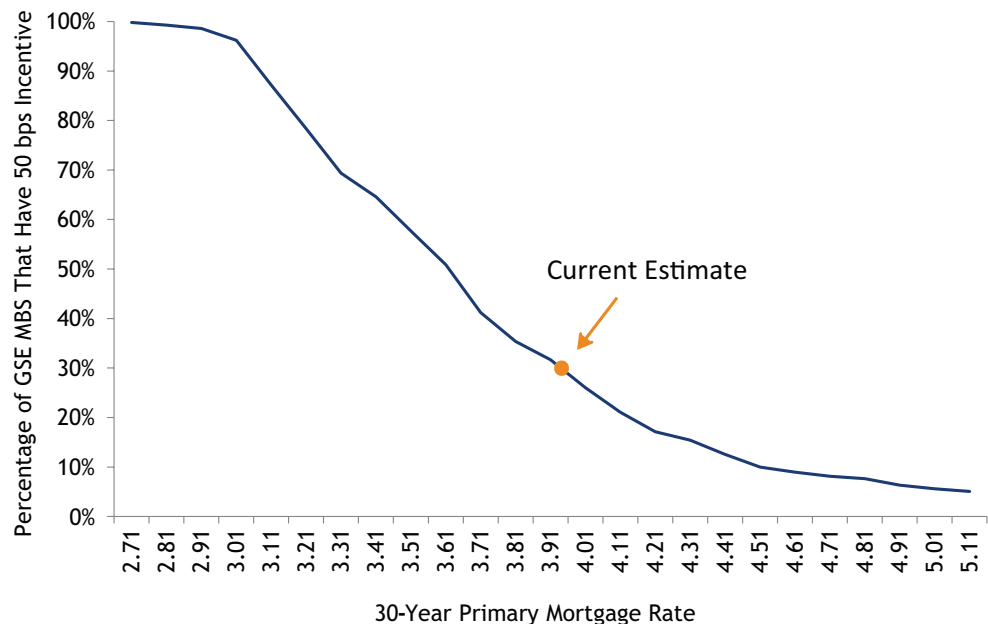
Even with the caps increasing, the Fed will likely still reinvest close to \$175 billion cumulatively through August 2018. Only after that period will paydowns underwhelm the cap, engaging the Fed in 100% passive runoff.

Positive: Low Refinancing Risks

With most MBS securities trading at a premium dollar price, refinancing activity represents the biggest risk as paydown proceeds are returned at par. Currently, with mortgage rates just under 4%, Credit Suisse estimates only 30% of the GSE universe has a 50-basis-point incentive to refinance. It would take an additional 40-basis-point rally in rates to give 50% of the agency MBS universe a 50-basis-point incentive and induce a substantial increase in prepayment speeds.

PERCENTAGE OF GSE MORTGAGES WITH 50 BPS REFINANCING INCENTIVE

Source: Credit Suisse estimates, data as of June 16, 2017.





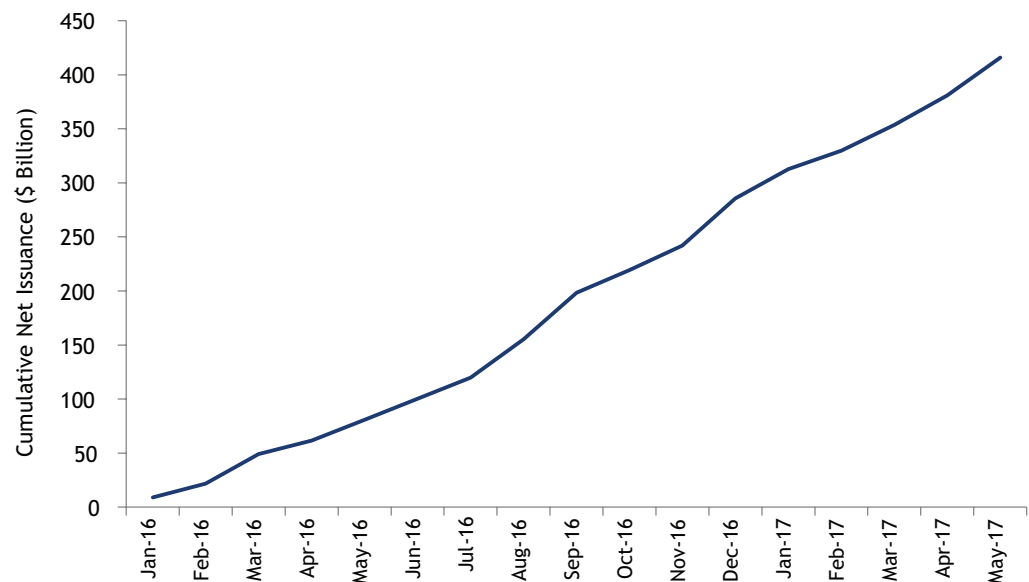
With our base case interest rate forecast keeping the 10-year Treasury above 2% and mortgage rates at 4% for the foreseeable future, we believe the likelihood of a refinancing wave remains remote. Even if rates rally, it would take 10-year Treasury rates of 1.5% over an extended period of time before mortgage rates hit the 3.5% threshold needed to accelerate prepayment speeds.

Negatives: Net Supply Growing

The organic growth of the agency MBS market plus projected supply emanating from the Fed currently keeps our Agency MBS team from a full overweight relative to Treasuries. Higher home prices and purchase activity has increased the size of the agency MBS market by \$416 billion cumulatively since December 2015 and shows no signs of abating.

CUMULATIVE NET MBS ISSUANCE

Source: Credit Suisse, data as of June 16, 2017.



With home prices projected to increase through 2018 and robust purchase activity, organic growth is predicted to be \$200 billion in 2018 and 2019. As the Fed engages in full passive runoff beginning in the summer of 2018, this will potentially add another \$100 billion of issuance. The biggest question is who will be the marginal buyer for the additional \$300 billion supply? Foreign demand has been relatively tepid year to date, and banks have only been adding modestly. Money managers will need to fill the residual demand, and higher spreads may be needed to make agency MBS attractive compared to other asset classes.



Conclusion

In conclusion, over the next 6 to 12 months, we foresee modestly positive excess returns for agency MBS versus Treasuries. Carry remains attractive with TBA dollar rolls still trading moderately special and reduced hedging costs due to the flattening yield curve. Although the Fed is withdrawing from the MBS market, our projections suggest it will still reinvest through the summer of 2018. A prepayment wave appears very unlikely as refinancing incentives remain muted. The growth in net supply is the major negative to consider. Spreads will need to widen in order to entice money managers to accumulate MBS, the question is to what level.

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About Risk

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