Agency Mortgage-Backed Securities

Compelling Income Potential in Agency MBS

Regulatory uncertainty, especially GSE reform, will be a focus for 2025.

The Bloomberg U.S. Agency MBS Index posted total and excess returns of 1.20 percent and 0.37 percent, respectively, for 2024. Agency mortgages lagged corporate bonds, which benefited from a resilient economy. Looking ahead, the bear steepening of the Treasury curve in late 2024 has enhanced the income potential of Agency MBS—which are tied primarily to the 10-year—while historically elevated spreads provide a reasonable entry point for the sector in 2025.

Sector Commentary

- Inflows to fixed-income funds over 2024 favored lower index coupons in the 2.5–3.0 percent range, while bear steepening of the Treasury term structure favored shorter-duration, higher coupon MBS of 5.0 percent and above. Notably, 30-year government sponsored enterprise-backed (GSE) MBS outperformed Ginnie Mae MBS by 60 basis points as money managers replaced banks as marginal buyers.
- Market uncertainty around the Fed's rate path and the policies of the incoming administration have kept longer-dated interest rate volatility elevated and nominal spreads remain well wide of their historical average, offering both attractive spreads and all-in yields.
- We favor mortgage bonds priced at a slight discount in the $95–100 range for their favorable performance profile under modestly lower rates. We expect returns to be driven by income rather than price appreciation until regulatory issues are resolved.

Investment Themes

- Bank regulation, specifically the unresolved status of the Basel III Endgame, remains a drag on demand. The incoming administration will most likely have a deregulatory tilt and scrap the third quarter 2024 proposal. Regardless of the result, regulatory clarity would be a positive for the sector, encouraging greater deployment of bank capital into Agency MBS.
- GSE reform is the other major policy focus. Privatization would require cooperation between the Federal Housing Finance Agency and the Treasury in addition to a significant increase in capital, a process which will take time. For MBS investors, the most important issue remains implicit versus explicit government guarantee. An explicit guarantee would compensate taxpayers for providing a backstop, favoring Fannie and Freddie over Ginnie Mae MBS, whereas an implicit guarantee would create more uncertain outcomes, benefiting Ginnie Mae MBS.

By Louis Pacilio

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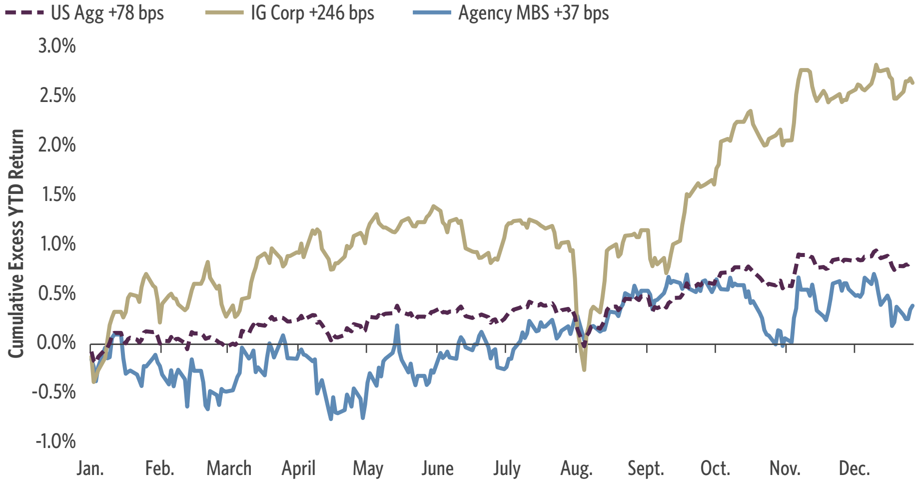
Agency Mortgages Lagged IG in 2024, But We See Income Potential Ahead

Cumulative Excess YTD Returns



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2024.

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Investing involves risk, including the possible loss of principal. In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. During periods of declining rates, the interest rates on floating rate securities generally reset downward and their value is unlikely to rise to the same extent as comparable fixed rate securities. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations ("CLOs"), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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