Agency Mortgage-Backed Securities

Carry Is King in Agency MBS

Par Coupon MBS generated positive excess returns due to elevated spreads.

The Bloomberg U.S. MBS Index posted flat returns relative to similar duration Treasurys over the first half of the year, trailing the Bloomberg U.S. Aggregate Index. Recent production 5.5 percent and 6 percent coupon MBS generated positive excess returns by merit of elevated spreads and thus higher all-in yields, while interest rates and mortgage spreads were rangebound. Outperformance vs. corporates was pronounced in the recent selloff. Once the Fed begins to ease and the election cycle is behind us, we expect relative outperformance of recent production coupons to continue as interest rate volatility normalizes.

Sector Commentary

- The Bloomberg U.S. MBS Index outperformed duration matched U.S. Treasurys in May and June as inflation data cooled off and the uncertainty over the direction of Fed's next move has diminished.
- Rangebound rates and a benign prepay environment have favored income over price appreciation. Production coupons have offered the widest spreads and highest yields. In addition, in certain to be announced (TBA) market subsectors such as Ginnie Mae and 15-year MBS, favorable financing rates via the dollar roll market further boost total returns.
- For those with a slightly bullish rates view, it makes sense to move some exposure down into $95–$100 priced bonds. This gives up some carry but greatly reduces prepayment risk in a moderate rate rally.

Investment Themes

- The MBS market has become bifurcated into lower index coupons and higher production coupons, which offer the potential for increased returns at the expense of a worse convexity profile. At historically low convexity levels, the index continues to present a favorable duration alternative, while production coupons remain an expression of short interest rate volatility.
- Agency CMBS performance remains steady and spreads are at year-to-date tights, especially in the longer duration segments where supply is minimal and asset swappers focusing on Secured Overnight Financing Rate (SOFR) spreads have inverted the sector spread curve. As a result, we continue to prefer structured cashflows in the single family space over multifamily for any longer duration targets.

By Louis Pacilio

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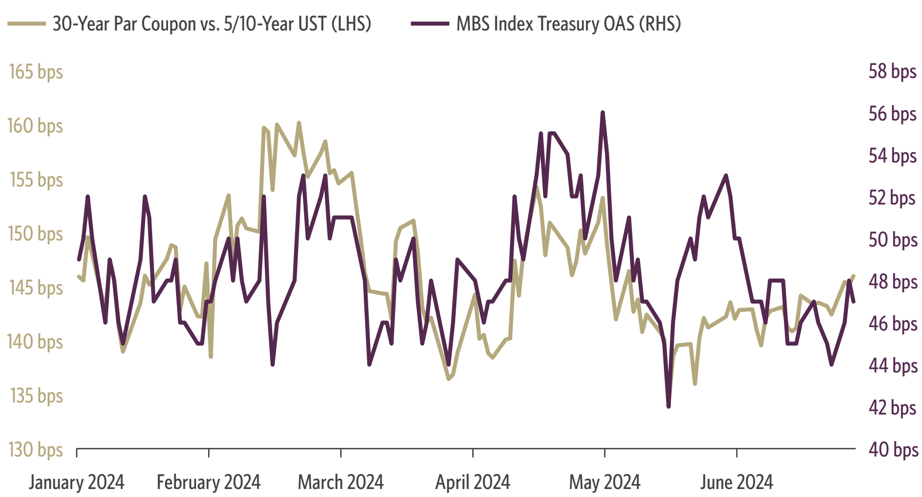
Rangebound Mortgage Spreads Favor Positioning in Higher Carry Bonds



Source: Guggenheim Investments, Bloomberg. Data as of 6.30.2024.

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