Agency Mortgage-Backed Securities

Opportunity Within One of the Cheapest Sectors

We favor income over price appreciation, specifically production coupons that offer the widest spreads and highest yields in the sector.

The Bloomberg U.S. MBS Index posted total and excess returns of 5.44 percent and 0.75 percent during the third quarter interest rate rally, pushing both measures into positive territory for the year. Positively convex index coupons (2.5–3.5 percent), which are insulated from prepayment concerns, outperformed higher coupon MBS. Recent underperformance of newly produced MBS with 5.5–6 percent coupons leaves them with the highest spreads and yields in the sector.

Sector Commentary

- Refinancing concerns resurfaced for the first time in recent memory as primary mortgage rates temporarily breached 6 percent. While we expect elevated prepayments are likely temporary, moving exposure into specified pools in premium coupons mitigates some risk.
- Bloomberg U.S. MBS Index year-to-date excess returns briefly exceeded those of the Bloomberg U.S. Investment-Grade Corporate Bond Index in early August during a sharp risk-off move. Since then, this move has largely reversed as a string of healthy economic data has greatly alleviated hard landing concerns. If this trend continues, we anticipate some rotation out of corporates and into other fixed-income sectors, including Agency MBS.

Investment Themes

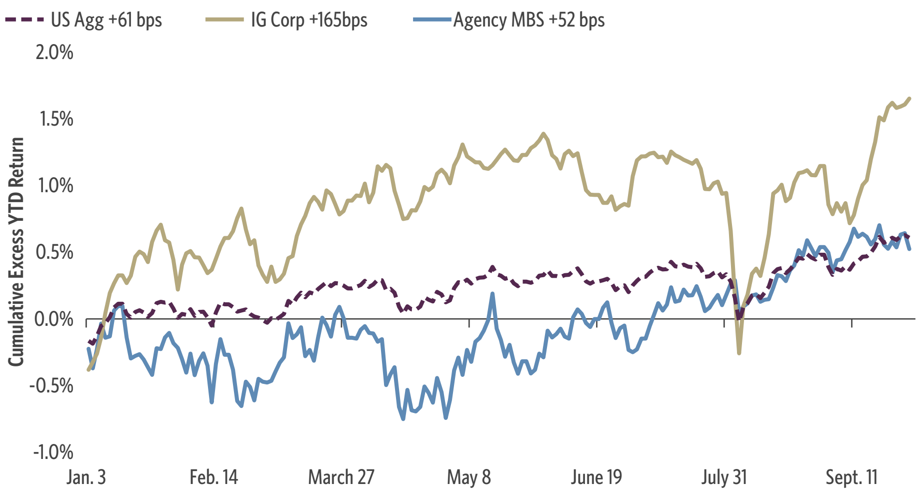
- Looking ahead, we continue to favor income over price appreciation, specifically production coupons that offer the widest spreads and highest yields. This segment of the market will benefit if the rates market holds the low end of the current range or retraces above 4 percent on 10-year Treasurys.
- The steepening of the yield curve along with the richness of 15-year MBS valuations have revitalized short-duration, fixed-rate collateralized mortgage obligations. Sequential deals off production coupons provide banks with improved current income relative to legacy lower-coupon holdings and limit extension risk. The corresponding long duration structures also offer value, with significantly higher yields than long duration Agency CMBS alternatives.

By Louis Pacilio

Bloomberg U.S. MBS Index year-to-date excess returns briefly exceeded those of the Bloomberg U.S. Investment-Grade Corporate Bond Index in early August during a sharp risk-off move. Since then, this move has largely reversed as a string of healthy economic data has greatly alleviated hard landing concerns.

Agency MBS Excess Returns Lagged IG Corporates in 2024's Risk-On Environment

Cumulative Excess YTD Returns



Source: Guggenheim Investments, Bloomberg. Data as of 9.30.2024.

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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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