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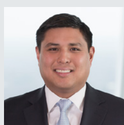
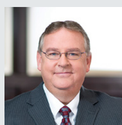
Mortgage-Backed Securities: A Timely Opportunity

INSIGHTS

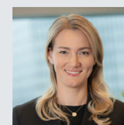
Uncertainty over the direction of interest rates has led to a significant widening of spreads in the agency mortgage-backed securities market, creating a potentially attractive opportunity for investors.



Alan Alegado
Senior Director,
Securitized Trading



Doug Trevallion II, CFA
Head of Global Securitized
& Liquid Products



Yulia Alekseeva, CFA
Portfolio Manager & Head of
Securitized Credit Research

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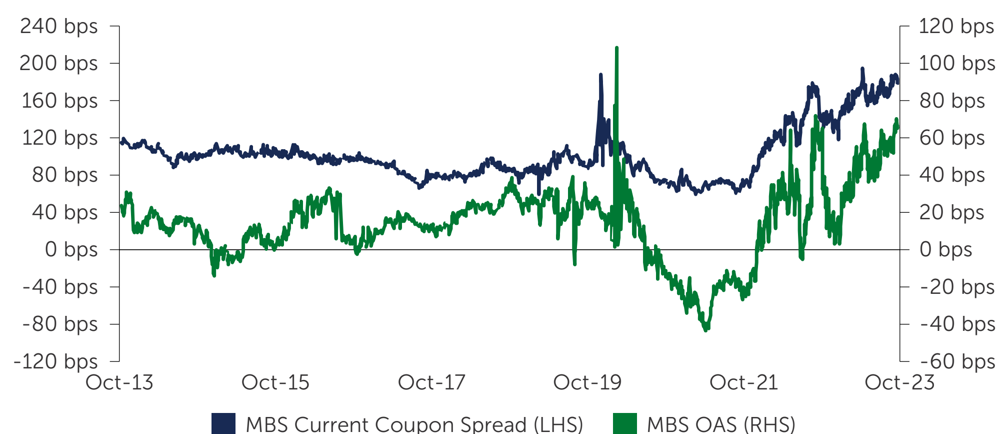
Powerful but oscillating technical forces have driven the mortgage-backed securities market in recent years. First, in the wake of the pandemic in 2020 and 2021, the U.S. Federal Reserve (Fed) and banks added roughly $2 trillion in mortgage-backed securities (MBS), crowding out other investors. In 2022, as the Fed reversed course and began raising rates to douse escalating inflation, relative value buyers began to dominate demand. Today, with the Fed taking a steadier course, and with MBS spreads and yields at or near their most attractive levels in more than a decade, we believe valuations are at a level that create a timely opportunity.

Where the Market is Now

The Fed's 18-month hiking cycle and uncertainty around the effects of that policy on economic growth and inflation have led to a sustained period of interest-rate volatility. This has significantly widened agency MBS spreads versus U.S. Treasuries and corporates, presenting an attractive opportunity for investors to increase agency MBS weightings in core asset allocations. Currently, agency MBS represents about 20% of the U.S. fixed income market, second only to U.S. Treasuries in size and liquidity; it also represents about 25% of the Bloomberg Barclays Aggregate Index.

MBS spreads[1] versus Treasuries have been trading between 160 and 190 basis points (bps), versus a 10-year average spread of 103 bps, levels that are exceedingly unusual (in the 99th percentile)[2]. Option-adjusted spreads (OAS), which account for the embedded options in which investors are short, currently are at about 65 bps, versus a 10-year average of 14 bps, putting that measure in the 99th percentile. Valuations rarely have been this wide, and we have only seen these levels twice since the global financial crisis—when pandemic shutdowns began, and during the spate of regional bank failures in early 2023.

Figure 1: Agency MBS Spreads



Source: MS Research. As of October 31, 2023.

1. Current coupon MBS is derived from MBS coupons that trade above and below par. Current coupon 30Y MBS spread is quoted vs. a blended 5 and 10-year U.S. Treasury rate.
2. As of October 31, 2023.

How We Got Here

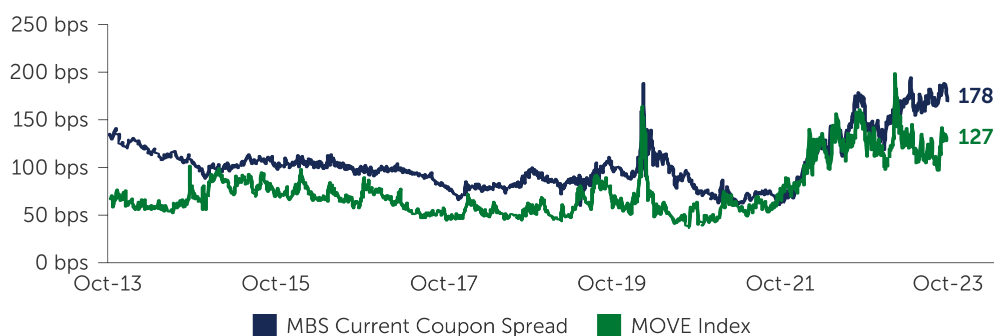
In 2022, as the Fed began one of its most aggressive hiking cycles in history and started taking steps aimed at quantitative tightening, the central bank allowed the size of its balance sheet to shrink without paydown reinvestment. The subsequent selloff in rates and inversion of the yield curve culminated in the failures of Silicon Valley Bank and Signature Bank in March 2023. Given its exposure to rates and interest rate volatility, the agency MBS sector was heavily buffeted by monetary policy tightening and shifting supply/demand technical forces.

In April, FDIC liquidations began after the insurance fund began to sell the $114 billion in MBS assets kept in receivership after the bank failures.

As the two largest holders of MBS—the Fed and banks—moved out of the market, the bulk of the responsibility to absorb the organic MBS supply, as well as the FDIC liquidations of regional bank portfolios, fell to relative value buyers including asset managers, hedge funds, and REITs. The market was able to absorb the supply surprisingly well given money managers' underweight positioning in the sector. The coupons that were sold by the FDIC were a large portion of the MBS index, and money managers were able to use this supply to cover shorts, moving positioning to 8%–10% overweight MBS and 24% underweight Treasuries as of September.[3]

Today, given current valuations, we believe there is an opportunity to add agency MBS at some of the most compelling spreads and yields seen in over a decade. The technical factors that have driven valuations are subsiding, and for investors with a medium to longer-term time horizon, current conditions present a potentially attractive entry point. In addition, given that agency MBS is considered a "short volatility" asset, buying mortgages is one way to express the view that interest rate volatility will come down over time, which should benefit MBS valuations.

Figure 2: Agency MBS Spreads vs. Rate Volatility

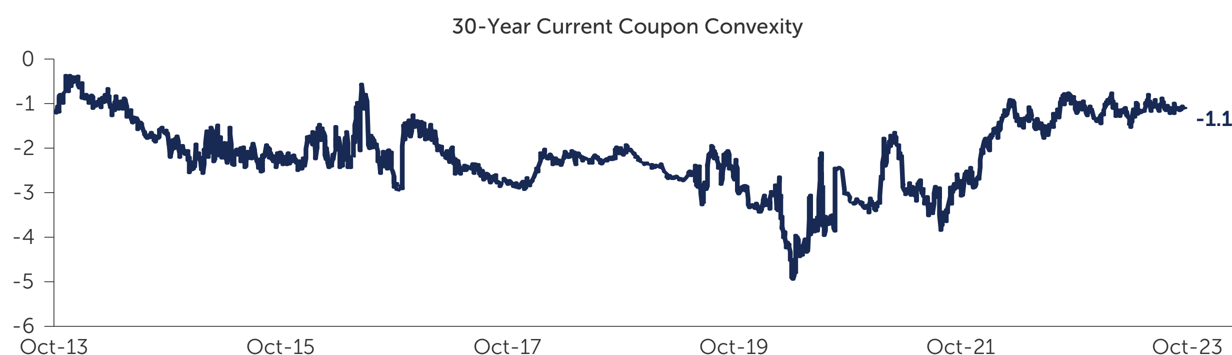


Source: The MOVE Index measures U.S. bond market volatility by tracking a basket of OTC options on U.S. interest rate swaps. The Index tracks implied nominal yield volatility of a yield curve weighted basket of at-the-money one-month options on the 2-year, 5-year, 10-year and 30-year constant maturity interest rate swaps.

3. Citi Research, Multi-Asset Strategy. As of October 20, 2023.

Supply technicals are improving as well. FDIC sales are complete, new-home building has slowed to multi-decade lows and the rise in mortgage rates to 7.72%[4] has virtually eliminated refinance activity. Organic supply is expected to remain muted if interest rates remain at current levels, making the supply picture even more manageable. As a result, the negative convexity of agency MBS is more favorable now as a higher interest rate environment should limit prepayment risks.

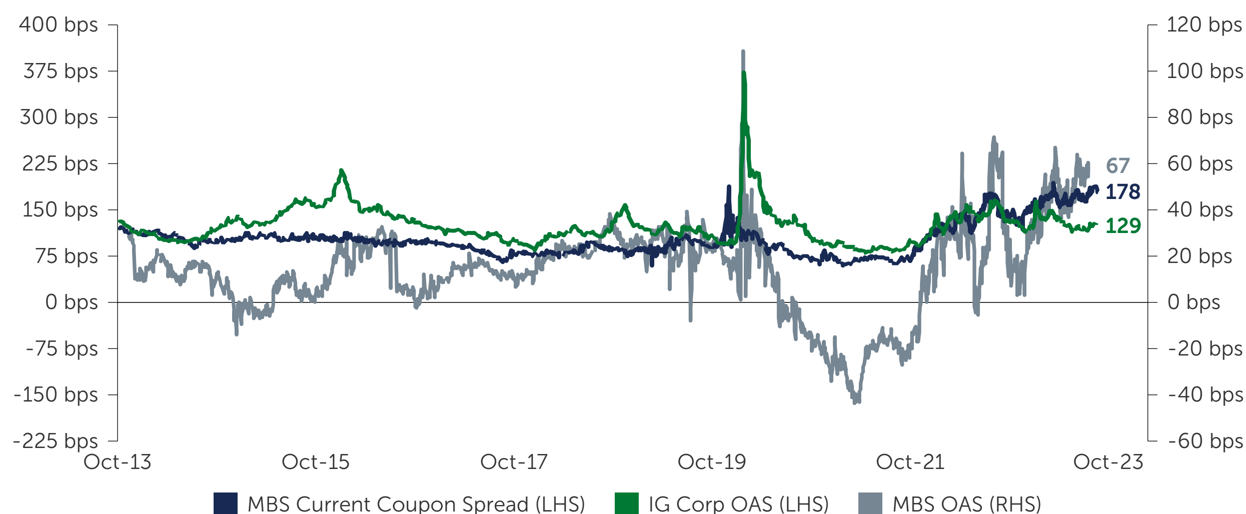
Figure 3: The Negative Convexity of Agency MBS is More Favorable vs. History



Source: Citi Velocity. As of October 31, 2023.

Given the current environment, agency MBS looks particularly compelling when compared to investment grade (IG) corporates. When comparing IG corporate option-adjusted spreads to MBS current coupon spreads and MBS option-adjusted spreads, both MBS comparisons to IG flash cheap. Over a 10-year period, IG corporate spreads have picked, on average, 21 bps when compared to MBS current coupon spreads—but are now trading 50 bps inside of MBS (2nd percentile). When comparing IG corporates to MBS option-adjusted spreads, IG corporates have picked, on average, 110 bps but are currently only picking 62 bps (1st percentile). Should rates remain higher for longer and the U.S. tip into a recession, the liquidity and government guarantee should benefit agency MBS relative to corporate bonds.

Figure 4: Agency MBS Spreads Look Attractive Relative to IG Corporates



Source: MS Research. As of October 31, 2023.

4. Source: Freddie Mac U.S. Mortgage Market Survey, 30-Year Homeowner Commitments.

Risk Considerations

While the current picture for agency MBS is appealing, two risks stand out: inflation surprises to the upside and continued strength in the consumer and labor markets that would lead the Fed to resume rate hiking. These scenarios would keep interest rate volatility elevated for longer than expected, posing a continued headwind for agency MBS. From an investor positioning standpoint, given that money managers are already overweight MBS versus Treasuries, we would need to see continued fixed income flows or a further reallocation from corporates to maintain current levels of MBS demand and to keep spreads from widening further. Lastly, given the recent move higher in rates, it is unlikely that bank demand will resume anytime soon. Banks also are likely to be conservative with paydown reinvestment until more clarity comes to regulation in the wake of the regional bank failures. While bank deposit outflow have moderated, which could lead to a recovery in bank demand, the timing of that recovery is uncertain.

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Key Takeaway

With growing expectations that the Fed will take a steadier course in the months ahead, we believe the current environment has given way to a timely and potentially compelling opportunity in agency MBS—particularly given the improving technical backdrop and historically high yields and spreads currently on offer.

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