Agency Mortgage-Backed Securities

Keep Calm and Carry On

Agency MBS investors are playing the waiting game until the Fed starts cutting rates.

Agency MBS was the only sector of the Bloomberg U.S. Aggregate Index to post negative excess returns over the first quarter as strong economic data and three consecutive months of high inflation readings pushed out the timeline for Fed rate cuts and tighter Agency mortgage spreads. However, barring a Fed pivot away from eventual rate cuts, the medium to long-term bull case for Agency MBS remains and we have increased our exposure.

Sector Commentary

- Future performance of Agency MBS remains tied to the path of Fed rates. With the Fed doing its best to anchor the front end of the Treasury curve by projecting future rate cuts, the main tail risk remains the reacceleration of inflation, causing longer dated Treasurys to test local highs and the Fed to consider hiking rather than cutting rates.
- Despite poor performance in the first quarter, mortgage spreads have been rangebound. Yields remain at post-GFC highs due to reduced supply.
- The most negatively convex portions of the Agency MBS market have outperformed on a relative basis. We expect this outperformance to accelerate when rate cuts commence and the option cost embedded in mortgage bonds subsides.

Investment Themes

- Extending the start of Fed rate cuts has favored carry trades as spreads remain rangebound. Notably, production coupons—high coupon bonds priced near par—have outperformed lower dollar price bonds that comprise the bulk of the Agency MBS Index.
- We expect Agency MBS Index performance to be subject to the whim of rates via passive investor flows, with further selloffs met by outflows and rallies met with inflows. We prefer to avoid this game of chance by positioning in 30-year production coupons that offer higher yields than the index and compensate investors while the Fed remains on hold.
- Agency CMBS spread performance has been notably strong due to reduced supply and an investor base that is more yield focused than its single-family cohort. As a result, we continue to prefer structured cashflows in the single-family space over multifamily for any longer duration needs.

By Louis Pacilio

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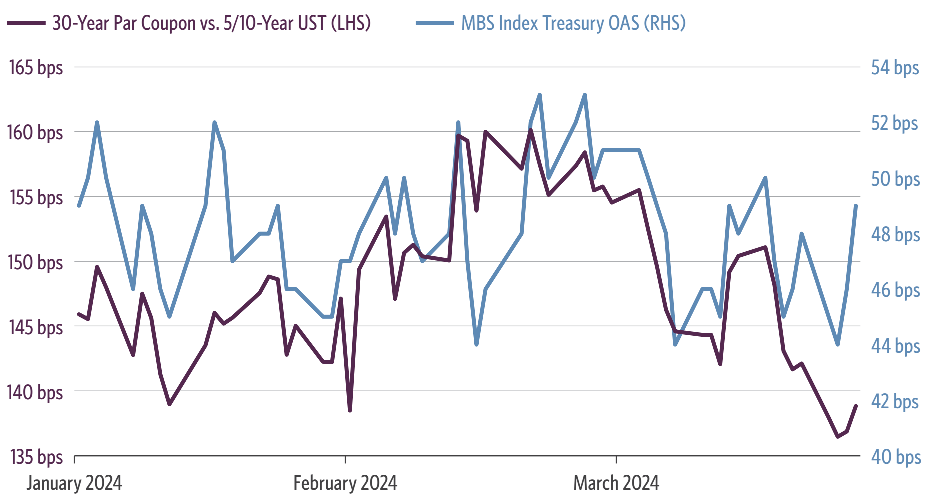
Despite Poor Q1 Performance, Agency MBS Spreads Remain Rangebound



Source: Guggenheim Investments, Bloomberg. Data as of 3.31.2024. Past performance does not guarantee future results.

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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