Agency Mortgage-Backed Securities

Short-Term Headwinds Prevail For Now

Lower rate volatility is a key to the long-term value proposition.

The Agency MBS market has many short-term crosscurrents to contend with, but there are reasons to be positive longer term and our strategies have broadly increased their exposure to the sector given attractive valuations. In the short term, volatility headwinds abound. Market consensus for terminal fed funds rate was thrown into question in the first quarter due to persistent inflation and strong employment data. This uncertainty weighed on mortgages with the Bloomberg U.S. MBS Index posting total and excess returns of 2.53 percent and -0.50 percent, respectively, in the first quarter. The banking sector turmoil helped put a lid on terminal rates but then introduced the headwind of portfolio sales, which has driven mortgage spreads to nominal levels only seen a handful of times in the last decade.

With regard to the FDIC portfolio sale, we expect passthrough sales to go smoothly due to the large, structural underweight of index-tracking funds. As these sales will come in deep discount coupons, we prefer MBS exposure via production coupon passthroughs (new securities based on the current mortgage rate) that are not directly impacted. In contrast, we remain cautious on the collateralized mortgage obligations and Agency CMBS subsectors due to both the lack of natural index-tracking buyers for FDIC portfolio bonds and limited dealer capacity to warehouse risk of this magnitude.

We also see a headwind in the structural shift in the buyer base of the mortgage market. This year will mark the first time in over a decade that neither the Fed nor banks are actively buying. While this is undoubtedly a negative, current spread levels and the Agency-backed nature of the sector should be enticing to crossover buyers from the corporate debt space. This is especially true for investors like us who are concerned about the mounting risk of recession. Our long-run bull case for mortgage spreads revolves around a normalization of interest rate volatility. We believe that clarity around the Fed's terminal rate will be the biggest driver of a reduction in rate volatility. As this becomes clear to the market, it will favor production coupon passthrough securities that are priced at par and have higher option costs embedded in their high current yields.

By Aditya Agrawal and Louis Pacilio

The banking sector turmoil helped put a lid on terminal rates but then introduced the headwind of portfolio sales, which has driven mortgage spreads to nominal levels only seen a handful of times in the last decade. Current spread levels and the Agency-backed nature of the sector should entice crossover buyers from the corporate debt space.

Portfolio Sales Drive Nominal Mortgage Spreads Higher Relative to Treasurys

30-Year Mortgage Nominal Spreads

Source: Guggenheim Investments, Bloomberg. Data as of 3.31.2023.