Agency Mortgage-Backed Securities

Prepayment Risks Rise as Mortgage Rates Drop

Aditya Agrawal, CFA
Director

Louis Pacilio
Vice President

Prepayment risk for recently originated mortgages is high.

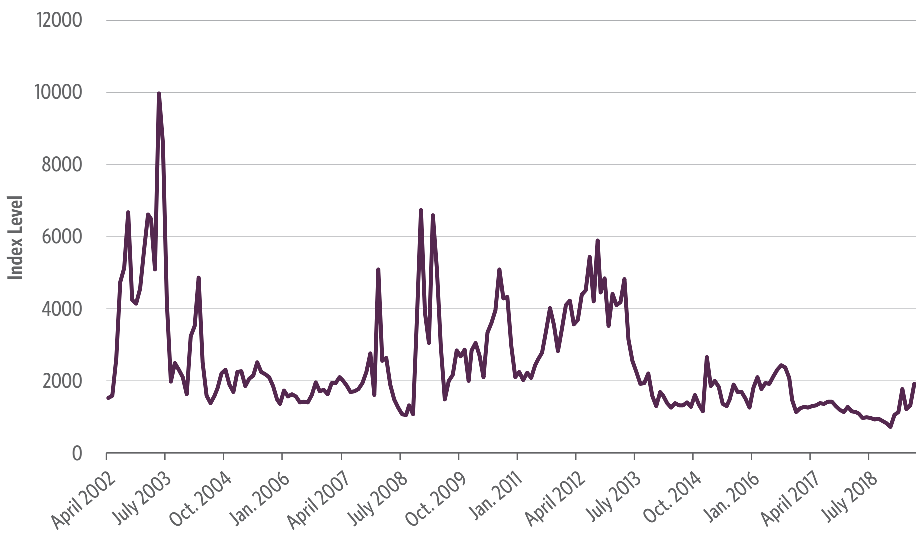
Agency MBS underperformed risk assets in the second quarter due to lower mortgage rates and a pickup in interest rate volatility. The Bloomberg Barclays U.S. MBS index posted a 2.0 percent total return for the quarter. Both option-adjusted and nominal spreads were wider over the quarter and are currently near the widest levels of the year.

The Mortgage Bankers Association Refinancing Index, a leading indicator of prepayment volumes, breached its first-quarter high (see chart, top right) as 30-year mortgage rates broke through and sustained sub-4 percent levels. While currently about 45 percent of 30-year mortgages are in the refinance zone, most of this prepayment risk remains concentrated in mortgages originated since 2018. This fast-paying subset of the mortgage universe, the rollout of single-security in June (a common single mortgage-backed security backed by issuance from both Fannie Mae and Freddie Mac), and the continued reduction in the Fed's balance sheet holdings have all led to worsening performance of cheapest-to-deliver collateral and widening residential MBS valuations (RMBS). Conversely, less-negatively convex options, such as Agency multifamily bonds and better call-protected pools, have benefited. Looking ahead, the near-term technical picture remains challenging as supply picks up over the summer and incremental prepayment risk remains elevated (see chart, bottom right). Despite these concerns, a dovish Fed and RMBS valuations near the widest levels of the year may provide a positive backdrop for the sector.

We continue to favor investments where either the collateral or structure offers some cash flow stability at reasonable spreads. Accordingly, we find select subsectors attractively priced in the current environment, including longer-maturity Agency multifamily, better call-protected pools, and some collateralized mortgage obligation structures. These investments have performed well, and we expect them to continue their performance in scenarios where interest rate volatility rises, interest rates decline sharply, or the Fed continues down the path of reducing its MBS holdings.

Prepayment Risk Rose as 30-Year Mortgage Rates Dipped Below 4 Percent

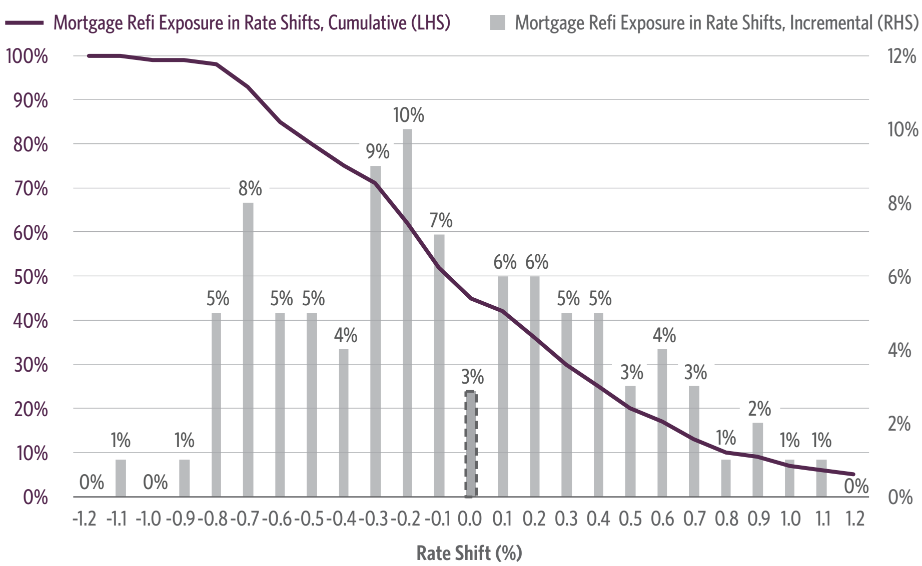
Mortgage Bankers Association Refinancing Index



Source: Guggenheim Investments, Bloomberg, Mortgage Bankers Association. Data as of 6.30.2019.

The Mortgage Bankers Association Refinancing Index, a leading indicator of prepayment volumes, rose as 30-year mortgage rates broke through and sustained sub-4 percent levels.

Mortgage Refinancing Risk Is Likely to Remain Elevated in the Near Term



Source: Guggenheim Investments, Credit Suisse. Data as of 6.28.2019. Assumes 50 basis-point rate incentive. Includes 15-year and 30-year MBS.

The near-term technical picture remains challenging as supply picks up over the summer and incremental prepayment risk remains elevated. About 45 percent of 30-year mortgages are currently in the refinance zone.