Agency Mortgage-Backed Securities

Smooth Sailing

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Steady performance despite market volatility in the first half of 2018 validates the sector's defensive profile.

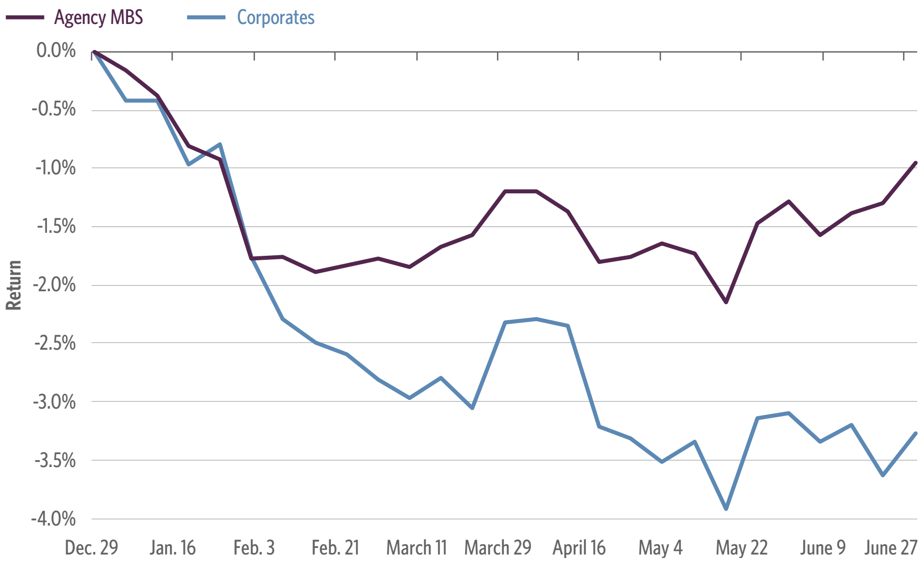
Agency MBS spreads have the potential to modestly widen as levels are still historically tight, and 2018 net supply is expected to exceed that of the previous few years, but carry remains attractive and could absorb most of our expected spread widening. We expect the sector to continue to provide diversification and lower volatility within a broad fixed-income portfolio, as the current environment of range-bound rates, low volatility, and reasonable valuations relative to credit sectors will result in support from investors continuing to look for opportunities to add high-quality spread assets. Moreover, relatively steady performance despite market volatility in the first half of this year validates the sector's defensive profile (see chart, top right).

Agency MBS performance was positive in the second quarter despite headwinds in the form of higher rates and a flatter yield curve. The Bloomberg Barclays U.S. MBS index posted a 0.24 percent total return. Yields ended the quarter at 3.41 percent, wider from the previous quarter, while option-adjusted spreads were roughly 1 basis point tighter over the quarter (see chart, bottom right). Conventional MBS underperformed GNMA, 30-year MBS outperformed 15-year MBS, and lower coupons underperformed higher coupons. Prepayments speeds increased marginally over the quarter.

We continue to favor less negatively convex assets where either the collateral or structure offers some cash flow stability. 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. We continue to avoid assets, such as Ginnie Mae MBS, where valuations are relatively stretched and may be affected more by the Fed's policies or changes in regulatory regime.

Agency MBS Performance Has Been Relatively Stable Amid Higher Volatility

Cumulative Year-to-Date Total Return

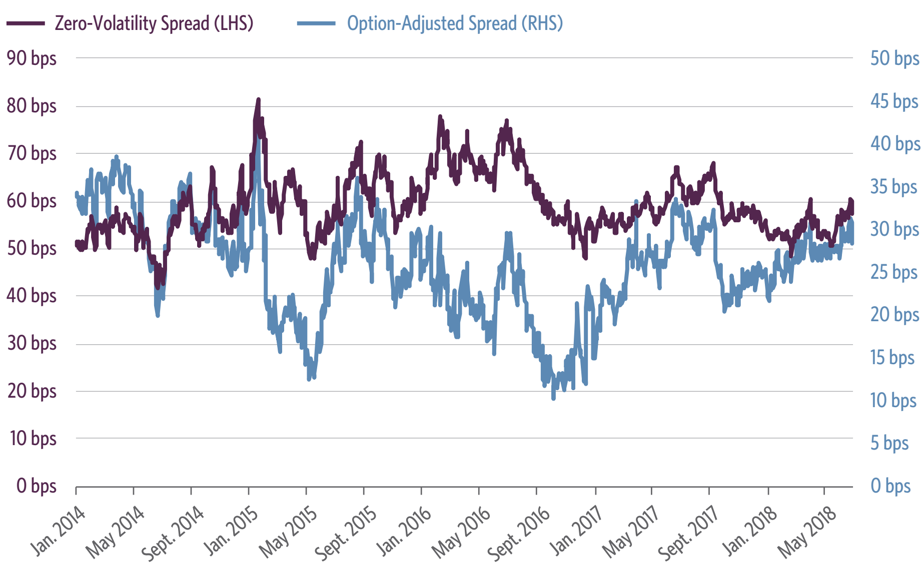


Source: Bloomberg, Guggenheim Investments. Data as of 6.27.2018.

Relatively steady performance in Agency MBS relative to corporates despite market volatility in the first half of this year validates the sector's defensive profile.

Agency MBS Spreads Hold Steady in the Second Quarter of 2018

Bloomberg Barclays U.S. MBS Index Spreads



Source: Bloomberg Barclays Indexes, Guggenheim Investments. Data as of 6.29.2018. The zero-volatility spread measures the spread that an investor will receive over the entire Treasury spot rate curve. LHS = left hand side, RHS = right hand side.

Despite market concerns that the Fed's balance sheet normalization would cause spreads to widen significantly in Agency MBS this year, we have seen option-adjusted spreads only a little wider since October 2017, and spreads range-bound on a zero-volatility basis. Yields ended the quarter 3.41 percent, higher than the previous quarter, while option-adjusted and zero-volatility spreads are one basis point tighter quarter over quarter.