GUGGENHEIM

Agency Mortgage-Backed Securities

What a Difference a Quarter Makes

Positioning for rates to decline over a medium- to long-term horizon.

Agency MBS salvaged 2023 with an impressive fourth quarter performance. The sharp decline in interest rates and the December Fed pivot provided welcome relief to underwater bank portfolios, and reduced fears of further fixed-income fund outflows. While mortgages trailed other subsectors of the Bloomberg U.S. Aggregate Bond Index for the entirety of 2023, investors who allocated to the sector at the end of the third quarter when valuations were historically attractive were able to capture significant outperformance as the Bloomberg U.S. MBS Index total and excess returns went from negative territory to 5.05 percent and 0.70 percent, respectively. MBS valuations have since normalized relative to recent wides but as of Jan. 30, still yield 5–5.5 percent, roughly 1.4 percent above Treasurys.

Rather than focusing on the timing and extent of future Fed rate cuts, we recommend positioning for the eventual realization of lower short-term interest rates over the medium to long term. We favor 5–5.5 percent coupon MBS at $95–$100 prices, which offer wider nominal spreads, higher yields, and more favorable exposure to falling interest-rate volatility relative to the lower coupon MBS that dominate the index. If rates move lower, 5–5.5 percent coupon MBS allow for price appreciation due to their lower sensitivity to increases in prepayment rates relative to MBS currently priced above $100. Since these MBS are priced to relatively low prepayment speeds, they also carry less extension risk if mortgage rates retrace their recent highs.

Among $95–$100 priced MBS, we also see an opportunity to monetize the price appreciation in MBS-specified pools—MBS backed exclusively by loans with favorable prepayment attributes—that occurred over the past quarter. Selling specified pools in favor of buying generic, new production MBS pools both potentially boosts yield and increases exposure to falling interest rate volatility. Meanwhile, in contrast to single-family mortgage MBS, spread volatility in Agency CMBS has been muted, which has limited relative value opportunities. Supply has shifted into shorter tenors and the dearth of long duration origination has flattened the spread curve in the sector. As a result, we favor adding long duration via single-family collateralized mortgage obligation (CMO) structures that offer both wider spreads and higher yields relative to multifamily offerings.

By Louis Pacilio

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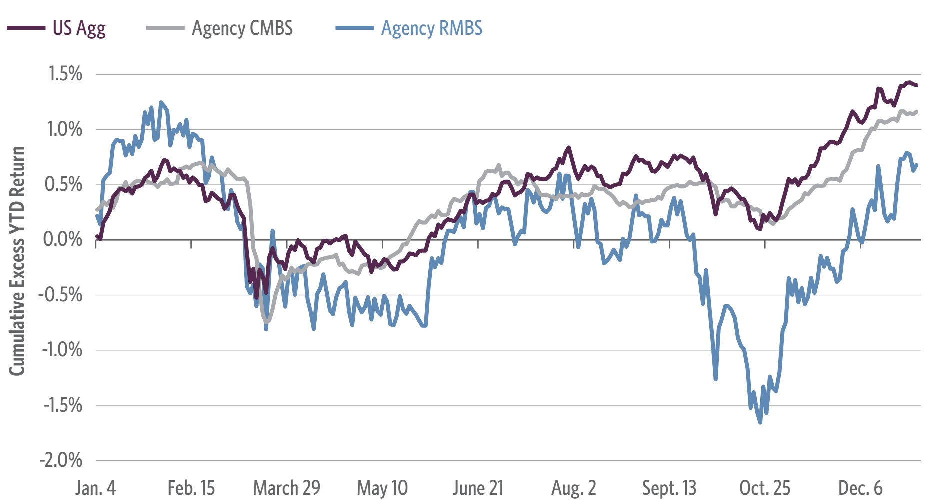
Agency RMBS Cumulative Excess Returns Turned Positive in Q4 2023



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2023. Past performance does not guarantee future returns.

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