

## Agency Mortgage-Backed Securities Supply Yawn



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The market shrugged off the Fed's withdrawal as a buyer, but sector volatility could spike if prepayments rise.

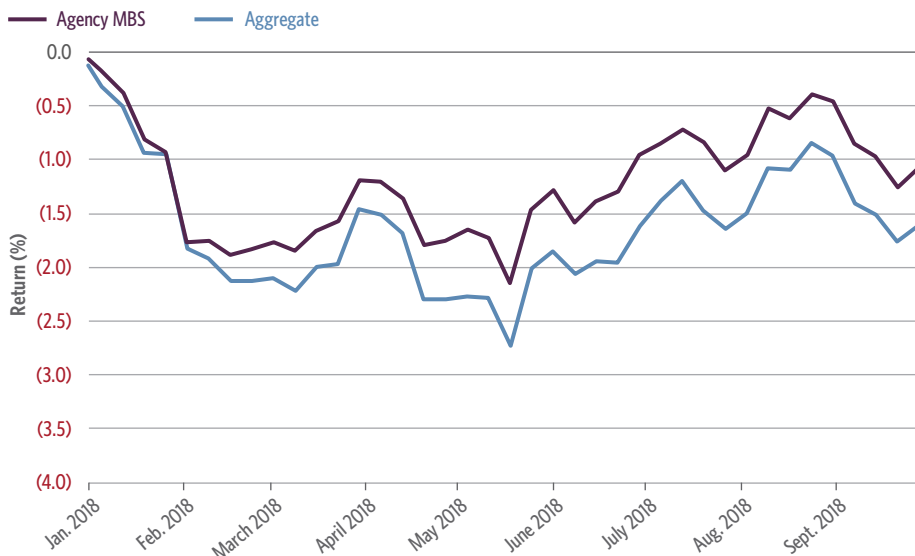
Agency MBS performance was slightly negative in the third quarter, which ended with higher rates and a flatter yield curve. The Bloomberg Barclays U.S. MBS index posted a -0.12 percent total return (see chart, top right). Yields ended the quarter at 3.59 percent, 18 basis points higher than the previous quarter, while option-adjusted spreads were unchanged over the quarter (see chart, bottom right). Conventional MBS underperformed GNMA, 30-year MBS underperformed 15-year MBS, and lower coupons underperformed higher coupons. Prepayment speeds were largely unchanged.

The market has thus far absorbed the Fed balance sheet runoff without any major issues. Supply/demand technicals have been mostly balanced for the past six months, keeping spreads steady, though the sector has been vulnerable in recent market moves along with other sector spreads. Higher rates and wider spreads may further dampen supply and prepayments, improving the near-term outlook for the sector. We are seeing the increasing float of more negatively convex generic new production bonds, however, a situation we will continue to monitor. Without the Fed as an active buyer of these bonds, the private sector must absorb them, and we expect downward pressure on prices in the sector if prepayments rise. In other words, we view the broader sector as vulnerable in a large rate rally with the Fed out of the market. Careful security selection and active management will be vital in this market going forward, but we are well positioned to capitalize on this scenario.

We continue to favor investments in which 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.

### Agency MBS Has Been Relatively Stable Amid Higher Volatility

Year-to-Date Performance

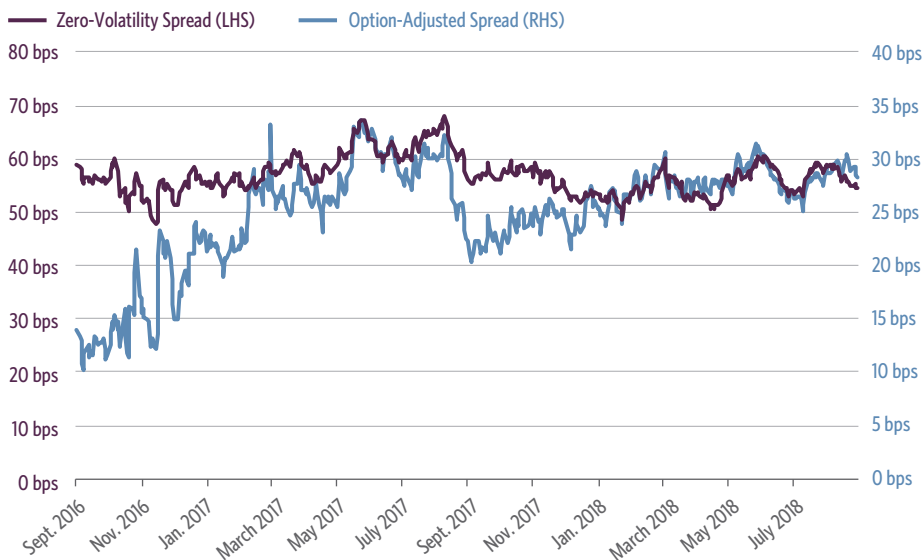


Source: Bloomberg, Guggenheim Investments. Data as of 9.25.2018.

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### Higher Rates, Flatter Yield Curve Hurt Agency MBS Performance

Bloomberg Barclays U.S. MBS Index Spreads



Source: Bloomberg Barclays, Guggenheim Investments. Data as of 9.30.2018.

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