GUGGENHEIM

Agency Mortgage-Backed Securities

Agency MBS Spreads Normalize from Historical Wides

Fairly valued in the short-term but offering long-term value.

Agency MBS spreads narrowed relative to benchmark Treasurys in the fourth quarter of 2022 from historically wide levels in the third quarter as the market formed a consensus on the terminal fed funds rate for the hiking cycle, which lowered interest rate volatility and stabilized long-term Treasury yields. Option-adjusted spreads ended the quarter at 51 basis points, 19 basis points tighter quarter over quarter, helping the Bloomberg U.S. MBS Index post a total return of 2.14 percent. Demand for MBS improved, with inflows for both passive index-tracking funds and active fixed-income managers more than offsetting mortgage supply entering its typical winter lull. Agency CMBS posted fourth quarter total and excess returns of 1.29 percent and 0.14 percent, respectively. With full-year excess returns of -0.33 percent, the sector continued to benefit from reduced supply and a superior convexity profile compared to single-family mortgage MBS.

Agency MBS, which appear fairly valued in the short term given their recent spread tightening, continue to offer long-term value. Spread levels are generally in line with the 2018–19 period of Fed quantitative tightening but remain higher than the averages since the Global Financial Crisis. In addition, with virtually the entire MBS universe well out of the money for refinancing, the sector exhibits low callability and prepayment risk and a higher certainty of cashflows than is typical. We expect cashflow stability to continue and the sector to outperform as the real economy cools and rates move lower. The long-term value proposition in the sector arises from both spread tightening and a reduction in option costs, which remain at elevated levels. We expect this to be achieved by either a steepening of the yield curve, a drop in interest rate volatility, or both. Agency RMBS passthroughs and low pay up-specified pools appear attractively priced in such an environment. In contrast, valuations in the supply-constrained Agency CMBS sector appear rich. Instead, we see better value in the long-duration space from collateralized mortgage obligation (CMO) structures with lockout periods for principal payments, which offer both wider spreads and higher all-in yields.

By Aditya Agrawal and Louis Pacilio

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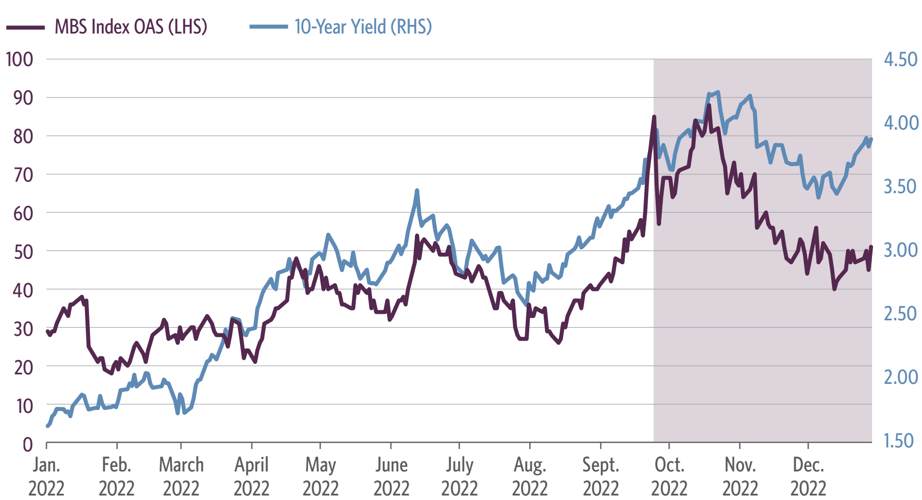
Mortgage Spreads Tightened in the Fourth Quarter of 2022



Source: Guggenheim Investments, Bloomberg. Data as of 12.31.2022.