GUGGENHEIM

Agency Mortgage-Backed Securities

Short-Term Headwinds Persist and the Sector Remains Cheap

Stabilized rate volatility is key to the sector's long-term value proposition.

Agency MBS market sentiment experienced a notable improvement in the second quarter following successful FDIC auctions from forced bank selling that attracted significant buyer interest. Performance confirms this shift, with the Bloomberg MBS Index option-adjusted spread tighter by 11 basis points and excess returns of 0.76 percent in the second quarter. We expect this momentum to continue in the third quarter as market focus shifts from the FDIC sales to the overall favorable macroeconomic environment and relative valuation.

Our long-term bull case for Agency MBS spreads revolves around a stabilization of interest rate volatility. Agency MBS still carry wider spreads than before the Silicon Valley Bank collapse in March, despite a broad market recovery. With inflation showing signs of easing, we anticipate a further reduction in rate volatility this year, which should lower the compensation required for the embedded prepayment option in Agency MBS and contribute to further spread tightening. Within the Agency MBS sector, we favor current production coupon passthrough securities. These typically have higher coupons, are priced around par, and have higher option costs embedded in their high current yield and spread. We believe they offer better total return potential as rate volatility abates. We have increased our exposure in our strategies to this profile and have added more broadly to the sector.

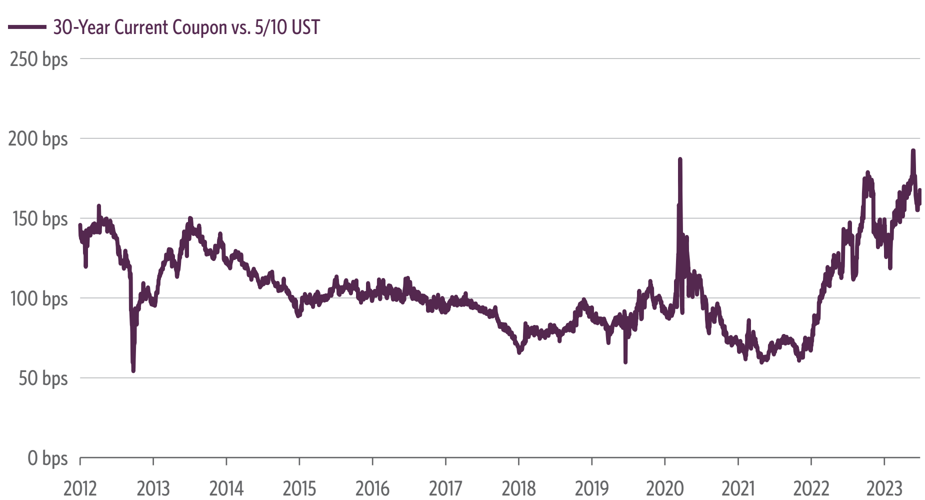
We see a possible headwind in the structural shift in the buyer base of the mortgage market: This year will mark the first in over a decade that neither the Fed nor banks are actively buying, which means there is a need for continued reallocation by money managers from other assets to the mortgage sector to absorb current supply volumes. These flows can be fleeting, and are likely to keep spreads more rangebound in the short term. Current spread levels, which remain attractive relative to history, and the Agency-backed nature of the sector should be enticing to crossover buyers from the corporate credit space where spreads are even tighter. This is especially true for investors who are concerned about the mounting risk of recession, during which Agency MBS tend to outperform credit-sensitive assets.

By Louis Pacilio

Current spread levels, which remain attractive relative to history, and the Agency-backed nature of this sector should entice crossover buyers, especially those concerned about recession risk.

Current MBS Spread Levels Are Attractive Relative to History

30-Year MBS Nominal Spreads



Source: Guggenheim Investments, Bloomberg. Data as of 6.30.2023.