TCW

INSIGHT

SECURITIZED SPOTLIGHT

Agency MBS Coupon Selection Matters!

JEFFREY T. KATZ & GORDON LI, CFA | 7 AUGUST 2024

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Mr. Katz is a Securitized Product Specialist in the Fixed Income group. He joined TCW in 2012 and brings the firm extensive experience with prior roles at Western Asset Management Company (WAMCO) and Pacific Investment Management Company (PIMCO). At WAMCO he served across multiple functions including Senior Portfolio Manager, Trader, and Research Analyst, in addition to co-heading the RMBS team. Prior to that, Mr. Katz was a Senior Portfolio Associate at PIMCO. Mr. Katz began his career at Republic National Bank of New York as Closing Analyst. Mr. Katz graduated with Honors from the University of Florida with a BS in Finance and holds an MBA in Finance from the UCLA Anderson School of Management. He holds FINRA Series 7 and 66 licenses.

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Mr. Li is an Analyst in the Fixed Income group, specializing in mortgage-backed securities. Prior to joining TCW in 2019, he was a trader at HSBC Global Banking and Markets focused on asset-backed securities. Mr. Li earned a BS in Finance and Mathematics from the New York University Stern School of Business and a MS in Financial Economics from Columbia Business School. He is a CFA charterholder.

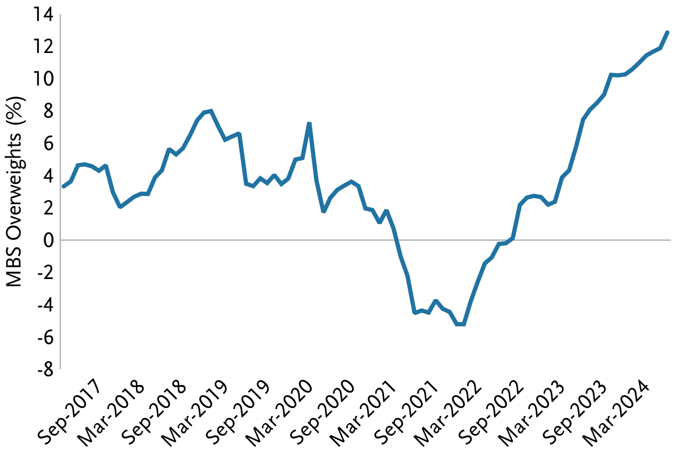
Not all mortgage overweights are expressed the same.

As the money manager community has come to recognize the compellingly attractive value proposition presented by the agency mortgage basis, the question to be asked is: "How are managers expressing this overweight? And how will it perform as the Federal Reserve normalizes monetary policy?"

As we've written, agency mortgage valuations reside in historically cheap territory, and money managers have certainly taken notice. Per Citibank's analysis of public funds, money manager aggregate mortgage-backed securities (MBS) overweights have reached record highs, currently at 12.9% market value, a sharp reversal from a 6% underweight at the start of 2022. Indeed, this record overweight to agency MBS comes as the *Investment Grade Credit (IG)-Current Coupon MBS (CC MBS) basis* remains in deeply negative territory and has stayed in negative zip-codes for now close to two years. As of July month end, the IG-CC MBS basis, as measured by IG spreads (+93 basis points (bps)) relative to CC MBS nominal spreads (+142 bps), sits at -49 bps. Over the last decade, CC MBS has traded roughly 20 bps narrower than IG credit given the absence of default concerns, therefore the relationship is approximately 70 bps inverted.

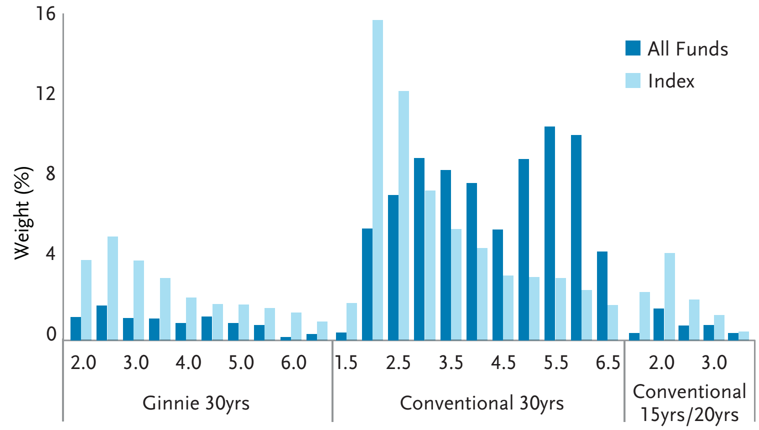
That said, while market value overweights have reached record levels, money managers may not be as overweight on a spread-duration basis given the duration differences between current and lower coupons. Indeed, the Bloomberg U.S. MBS Index has a dollar price in the high 80s and 6 years of spread duration due to the preponderance of low coupon issuance coming in 2020 and 2021 (deep discount coupons from a lower rate regime). More recent issues have higher coupons and much shorter durations – with a sample 5.5% coupon coming in around 3 years of duration. Consequently, a 10% **market value overweight** expressed in the current coupons (5.5s or 6.0s) would result in a **spread duration underweight** of between 0.2 to 0.4 years relative to the Index due to the composition of the Index being heavily skewed toward deep discount coupons with longer durations. Keep in mind, a meaningful portion of the discount coupon available float is locked-up due to the Fed's quantitative easing (QE)/balance sheet expansionary program. Money managers who didn't have the foresight of TCW are left to express their agency mortgage overweights using higher coupons resulting in significant negative convexity to their portfolios on the precipice of a Fed easing cycle. TCW positioning favors lower and belly coupons (discount dollar price) relative to current or higher coupons.

MBS Overweights Were at a Record High



Source: Citi Research, Fund Filings

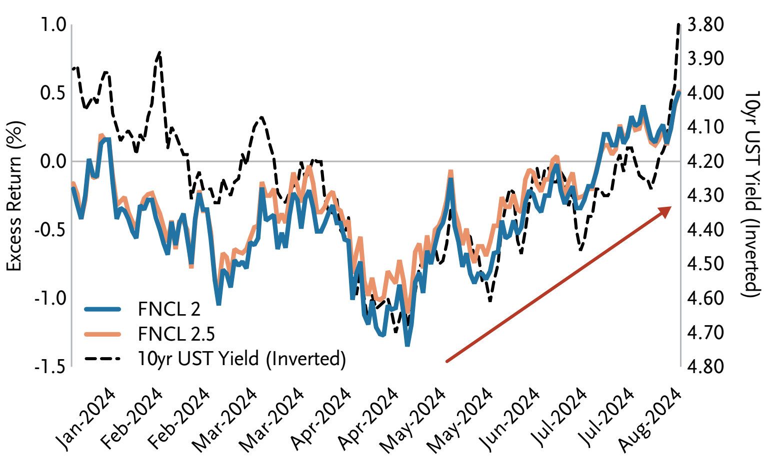
Money Managers Tilted Higher Up in Coupon Versus the Index



Source: JP Morgan, IPREO

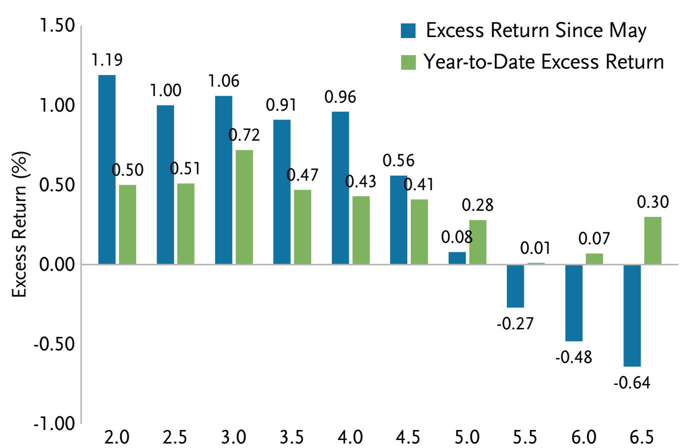
As rates moderate, many investors may find themselves “whacked” by negative convexity given their lack of lower coupon ballast, not to mention the spread duration shortening that will accompany a rate rally. Such a landscape further sets the stage for asymmetric benefits for the lower and belly coupons. Mortgages continue to perform directionally with rates, and July was nothing short of a great month. With the rally in rates, the “duration effect” has dominated, and discount profiles across lower and belly coupons have outperformed, meaningfully outperforming the higher coupons as convexity concerns crept to the forefront. Higher coupons led performance for the first four months of the year when the rate narrative was “higher for longer,” however, this has significantly reversed course as the market reassesses the state of the economy and the prospect for lower rates. As we move forward, being overweight mortgages won’t be enough to differentiate performance, the second-order effect of coupon selection will dominate the narrative and performance. ■

Excess Return Year-to-Date



Source: Bloomberg

Excess Return by Conventional 30yr Cohort



Source: Bloomberg

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