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ASSET MANAGEMENT

# Monthly Fixed Income Insight
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## Opportunity in Agency Mortgage-Backed Securities

The agency MBS market has undergone an incredible transformation. Prior to the financial crisis of 2008 the MBS market was supported, and indeed backstopped, by the GSE's Fannie Mae and Freddie Mac to maintain a liquid and well-functioning mortgage market. The goal of this support was to facilitate mortgage lending to achieve the best possible rate to borrowers. After the financial crisis the GSE's ceased buying MBS, however, they were effectively replaced by the federal reserve as MBS were purchased directly from the market during quantitative easing cycles. Now that the fed funds rate is comfortably off the zero lower bound the need for quantitative easing (QE) has passed, and indeed, we are in a period of quantitative tightening. For the mortgage market this means that government sponsored purchases of MBS have stopped for the first time in decades. This has resulted in a repricing of the MBS market.

The table below shows which investor types have historically purchased MBS supply.

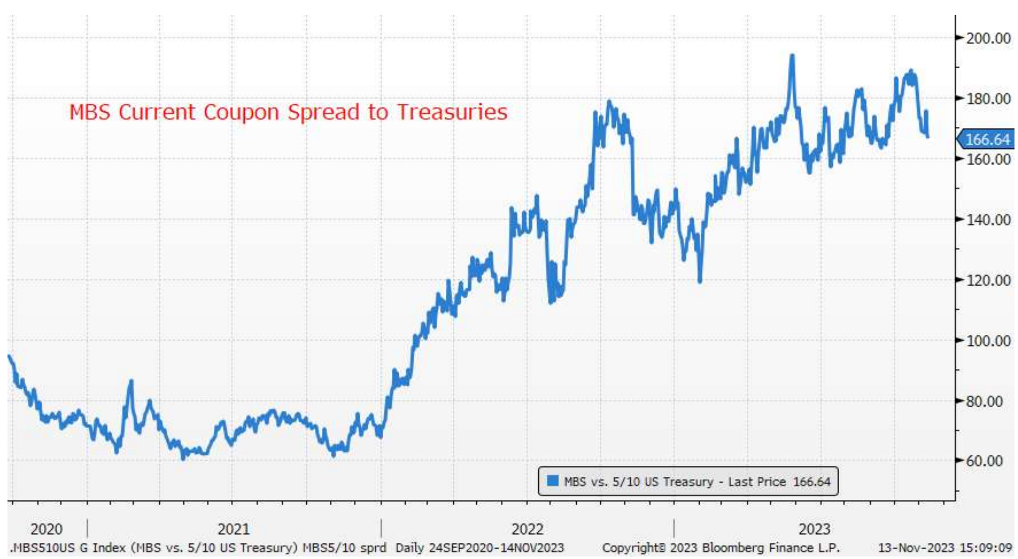
**Historical supply/demand breakdown by investor type ($bn)**

| | *All mortgages* | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2014** | **2015** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** | **2023 FY** | **2024 Est** |
| Gross Issuance | 923 | 1,251 | 1,472 | 1,304 | 1,171 | 1,532 | 3,161 | 3,484 | 1,701 | 1,000 | 1,050 |
| **Net Issuance** | **69** | **163** | **229** | **315** | **281** | **224** | **506** | **868** | **539** | **250** | **300** |
| **Demand** | | | | | | | | | | | |
| GSEs | -46 | -42 | -43 | -5 | -15 | 0 | -61 | -26 | -37 | -2 | 0 |
| Overseas | 44 | 31 | 107 | 62 | 90 | 76 | -30 | 102 | 167 | 150 | 175 |
| Fed +Treasury | 247 | 11 | -6 | 24 | -128 | -217 | 610 | 577 | 27 | -220 | -210 |
| Banks | 11 | 177 | 220 | 140 | 70 | 86 | 522 | 326 | -57 | -100 | 75 |
| REITs | 8 | -18 | -1 | 40 | 21 | 36 | -101 | -22 | 2 | 25 | 25 |
| Money Managers/ Others | -208 | 5 | -48 | 48 | 196 | 198 | -435 | -89 | 437 | 397 | 235 |
| **Net Demand ex Fed/Tsy/GSE** | **-132** | **195** | **278** | **296** | **423** | **441** | **-42** | **317** | **550** | **472** | **510** |

Source: Treasury, Federal Reserve, Fannie Mae, Freddie Mac, REIT and bank company filings, Morgan Stanley Research forecasts

There are a couple of points to make from this table. First, the Fed and the banks were huge buyers of MBS in 2020 and 2021 as QE and bank deposit growth exploded. Money managers and REIT's sold into this extraordinary demand even as issuance grew. Interestingly, money managers stepped up their purchases as the government and banks became net sellers drawn into the sector by better valuations and looking to reduce underweight positions. In effect, money managers have become the new marginal buyer of MBS. Both the government and to some extent banks are price insensitive buyers, money managers are the opposite. This rotation was very disruptive to the MBS market, causing volatility and underperformance relative to duration matched treasuries.


In reality, MBS have struggled in the post financial crisis years as can be seen in the above chart. We would attribute much of this lack of performance to the direct, price insensitive, government purchases during periods of QE. Looking forward, we anticipate a return to more "normal" performance for the sector as pricing is set by active market participants. The mortgage market has repriced in a significant manner and now, in our estimation, presents attractive risk adjusted yields to investors. Looking back over the past 10 years using Citibank Yieldbook data, the average OAS of the current coupon mortgage is approximately +17.9bps while the current OAS (as of 11/10/2023) is +57.3bps. The standard deviation of the OAS spread over that time is 18.8bps, which means the current OAS is 2.08 standard deviations cheap to this historical period. It should be noted that the standard deviation calculation includes the incredibly wild gyrations around the start of the pandemic. To lend some perspective to the degree of cheapening experienced by the MBS market in the last three years, the chart below shows the greater than 100bps of widening in spread the current coupon mortgage has experienced.



In summary, MBS makes a compelling case for investment given the changing dynamics of the investment landscape, i.e., little to no government involvement, and the significant repricing to cheaper levels over the past three years. As far as catalysts for MBS outperformance in the coming months and quarters we would point to stable monetary policy, which would create a lower interest rate volatility environment, a definite tailwind for MBS performance. The MBS market should also benefit when the FOMC begins to cut interest rates, which we expect in the second half of 2024. Historically, MBS has been considered a "flight to quality" sector given its lack of credit exposure. In the event of an economic downturn, it is our expectation that MBS will act as a safe haven vis a vis the corporate bond market. And finally, technically, the return of bank purchases in a meaningful way will definitely benefit MBS performance.