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BNP Paribas Asset Management

Why US Agency MBS? Why now?

When the US Federal Reserve starts to cut rates, the US yield curve should steepen pushing prices of front-end bonds higher. It will, in our view, be a good time for investors to take more duration risk. In this environment, US Agency Mortgage-Backed Securities (MBS) with limited duration will benefit from the steeper curve and lower volatility leading to high income and capital appreciation.

We believe the time is now to own US Agency MBS. MBS are cheap and are positioned to perform well when the Fed starts to cut rates. As we are near the end of the higher-for-longer interest rate cycle, investors will enhance returns by extending duration and moving out the curve.

US Agency MBS are a compelling option for investors offering the highest credit quality, solid current income, and limited duration. They will benefit when yields come down.

Current coupon MBS are producing high yields for investors at 6% while offering +150 basis points (bps) of spread over US Treasuries. The yield advantage over US Treasuries with no credit risk is very attractive for investors searching for income and high-quality bond yields.

There are strong tailwinds for the sector including improving technical landscape of low net issuance and stabilised prepayments. New mortgage origination rates are above 7%. This is limiting housing activity which in turn is limiting new MBS origination supply.

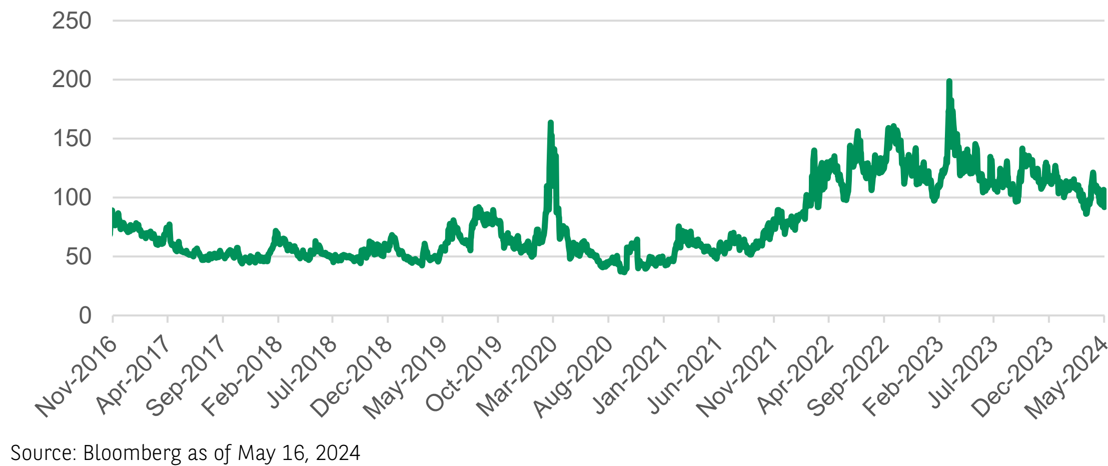
On the demand side, banks have started to add MBS at the margin but are still mostly on the sidelines. Bank demand is expected to pick up once regulatory rules (Basel III Endgame) are finalised in August and once the Fed commences rate cuts. The Fed is no longer a big driver of MBS demand as the balance sheet runoff continues. During the Covid-19 pandemic quantitative easing (QE) programme, the Fed actively bought almost USD 2 trn of US Agency MBS. During that time, Fed demand regularly exceeded new origination supply. The Fed's overwhelming demand drove interest rate volatility lower and tightened current coupon nominal spreads all the way to +50 bps.

The current environment of quantitative tightening (QT) has MBS rolling off the Fed's balance sheet. Having the Fed so much less involved in the MBS marketplace today provides many more relative value opportunities for active managers and for improved alpha generation through security selection ideas.

We expect the yield curve steepening to resume as the start of the cycle of rate cuts approaches. When that happens, front-end yields will fall and it will be a good time to extend duration out the curve. The current duration of the Bloomberg US MBS index is at 6 years so the duration component of the index is in a sweet spot. Yields will also be higher in the longer end of the curve which will be impacted by supply concerns as the US Treasury will need to ramp up debt issuance to fund ongoing deficit spending.

In all, the positive supply/demand dynamics coupled with a steeper curve and an expected moderation in fixed income volatility, will provide a constructive backdrop for the MBS asset class going forward.

Exhibit 1: The MOVE Volatility Index is in downward trend since peak in March 2023



Source: Bloomberg as of May 16, 2024

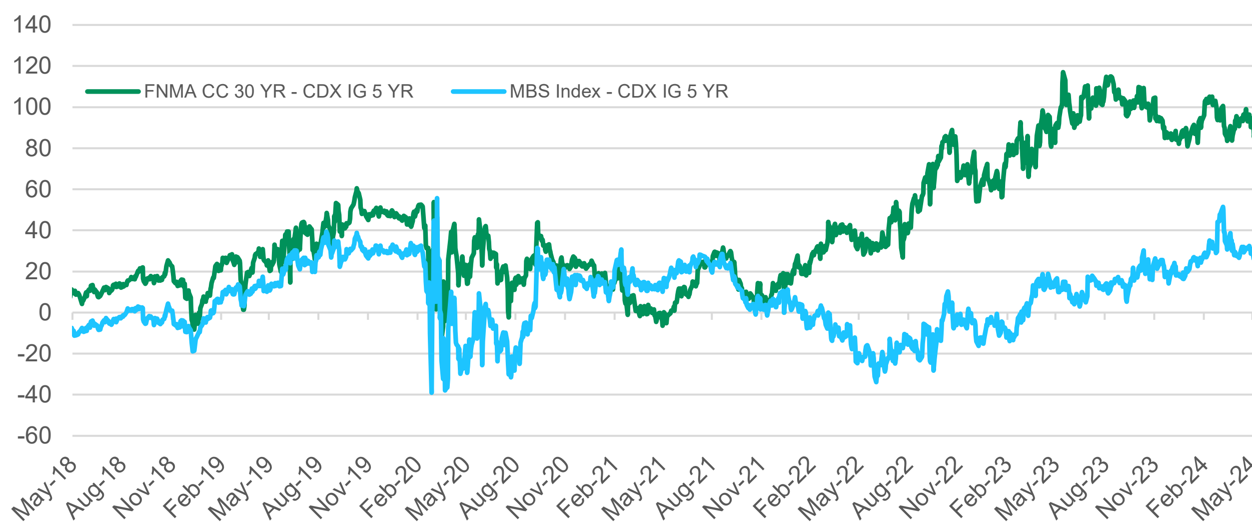
The anticipated Fed rate cuts provide a catalyst for investors to lock in yields and spreads at these attractive levels leading to solid returns. And at this moment, as MBS investors wait for rate cuts, they are earning +150bps over US Treasuries (UST) with limited duration risk. Looking at the graph below, the long-run trend for current coupon nominal spreads is to be in the range of +100bps. As was mentioned, spreads tightened all the way to +50bps in 2021 when the Fed was actively involved in the market and aggressively buying agency MBS. In the absence of that Fed demand we do not expect spreads to return to such low levels. We do think, however, that current coupon spreads will get to +125bps in the near term and to +100bps in the long term.

Exhibit 2: Fannie Mae 30-year Current Coupon Nominal Spread

Source: Bloomberg, BNPP AM, as of May 2024

In our view, from a relative value perspective, US corporate credit is looking rich compared to US Agency MBS. Corporate credit spreads remain at exceptionally tight levels and the Bloomberg Investment Grade (IG) index spread to UST has only rarely been tighter in the post-Global Financial Crisis (GFC) era. In our multi-sector fixed income strategies, we maintain a relative value preference for the US Agency MBS market (vs developed market IG corporate credit) given the significant tightening experienced in the developed credit market and deteriorating fundamentals in credit. The best days of the corporate credit cycle are likely behind us not in front of us.

Exhibit 3: US Mortgages look cheap to us versus similar duration Investment Grade Corporates



Source: J.P. Morgan data as of May 2024

Agency MBS provide a predictable source of income for investors: Because homeowners make regular monthly mortgage payments, Agency MBS provide investors with a strong degree of cash flow certainty. In the event of an agency mortgage borrower defaulting, the issuer repurchases the loan from the MBS pool at par, resulting in a prepayment event for MBS investors with no principal loss, unlike the default risk in corporate credit.

Concerning the state of the US housing market, elevated mortgage rates and home prices coupled with record-low housing inventory continue to make homeownership affordability a challenge for buyers. Near-record home prices continue to stall the market during the prime selling season. Prepayment speeds therefore remain subdued reflecting high mortgage origination rates. Nearly all outstanding mortgages are so deeply out of the money, there is no economic incentive for these borrowers to refinance. In all, we are in an environment of very low prepayment risk.

Government-guaranteed US Agency MBS are also a compelling option for investors who are concerned about risks to the US outlook arising from political risk, fiscal spending, persistent inflation, or a slowdown in growth or employment. The high credit quality, high liquidity, and high income of US Agency MBS also provides a flight-to-quality investment with an attractive risk/return profile that outperforms other risk assets in times of market stress.

To sum up, we see US Agency MBS as an attractive asset class for fixed income investors right now due to its cheap valuation, strong income, positive supply/demand dynamics, and its ability to outperform when the Fed's cutting cycle commences. We believe investors will not want to miss the opportunity to earn higher income and enhance their portfolio returns. As a safeguard, its high liquidity and quality profile also means US Agency MBS can withstand market stress if the path to rate cuts does not move in a straight line.

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