DoubleLine®

Agency Mortgage-Backed Securities

Thoughts From the Trading Desk

Kunal Patel, CFA & Alex Shvartser | January 2025

As 2025 kicks off, DoubleLine presents its assessment of the Agency mortgage-backed securities (MBS) market and provides an update on where the asset class has been and where it could be headed. As DoubleLine has highlighted in the past (in May 2023 and October 2023 pieces) the Agency MBS market has experienced elevated spreads relative to history over the past few years. While excess returns of Agency MBS have been strong since the last updates – 163 basis points (bps) from May 2023 through December 2024 and 174 bps from October 2023 through December 2024 – there is more room for mortgages to rally.[1]

Executive Summary:

Since the beginning of the Federal Reserve's hiking cycle in 2022, and resulting higher interest rates and interest rate volatility, Agency MBS have experienced some of their lowest returns in history.

The factors that have been headwinds for Agency MBS over the last few years could turn into tailwinds, and there are reasons for optimism about the potential for strong future Agency MBS performance.

While the Agency MBS market still sits at relatively elevated spread levels, there are green shoots emerging that could tighten spreads in many potential market and economic environments.

Agency MBS represent significant value over other spread products such as corporate bonds.

[1]Excess returns are total returns less the return due to a duration-matched U.S. Treasury position. For Agency MBS, excess returns are calculated using the Bloomberg US MBS Index, unless noted otherwise.

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It was the "just okay" of times, it was the worst of times…

With apologies to Charles Dickens, it has become pretty much a cliché to note that the Agency MBS market has experienced a very challenging period over the last few years. There have been several meaningful headwinds in that period:

- **Rate Volatility:** The fastest Fed hiking cycle in history started in 2022, and it dramatically increased rate volatility and drove Agency MBS spreads to historically wide levels. Because Agency MBS holders are short an embedded prepayment option, and that option can be very sensitive to interest rates, increased interest-rate volatility caused Agency MBS securities to exhibit significantly negative excess returns. Average interest-rate volatility between 2022 and December 2024 was 55 bps higher than the average between 2019 and 2022. Excess returns since 2022 stood at negative 140 bps as of December 2024. *(Figures 1 and 2)*
- **Quantitative Tightening:** The Fed ballooned its ownership of Agency MBS in response to the COVID-19 crisis, with holdings peaking at around $2.7 trillion in 2022. At the same time the Fed was hiking interest rates, it started to roll off its Agency MBS holdings via the Fed's quantitative tightening policy, and its holdings have declined to approximately $2.2 trillion via paydowns as of Dec. 25, 2024.
- **Reduced Bank Participation:** Banks, a traditional buyer of Agency MBS, have been going through a period of earnings volatility, higher funding costs, deteriorating balance sheets and increased likelihood of more stringent regulation after the expected adoption of Basel III Endgame measures.
- **2023 Bank Failures:** The collapse of Silicon Valley Bank and Signature Bank resulted in large liquidations of retained Agency MBS portfolios by the Federal Deposit Insurance Corp. over most of 2023. While this was a headwind to the market initially, it ultimately had the effect of validating the liquidity available in both pass-through mortgages and the collateralized mortgage obligation (CMO) subsector of Agency MBS, thereby bringing in a wider investor base.
- **Inverted U.S. Treasury Curve:** An inverted curve results in more securities with negative carry, inhibits CMO creation, disincentivizes banks to add Agency MBS and worsens model convexity as lower, versus higher, forward rates lead to higher projected prepayments due to more borrowers being "in the money" on their mortgages.
- **Very Low Realized Prepayments:** Turnover – the natural prepayment behavior due to life events – and refinancing activity dramatically slowed down in the face of much higher primary mortgage rates, effectively locking borrowers into their existing mortgages.

Interest Rate Volatility Increased Dramatically and Stayed Elevated From 2022

January 2019 through through December 2024

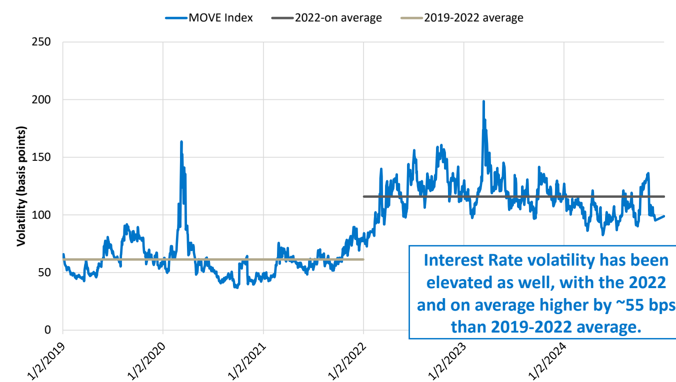


Figure 1

Source: Bloomberg, ICE

U.S. MBS Cumulative Excess Returns

January 2022 through December 2024

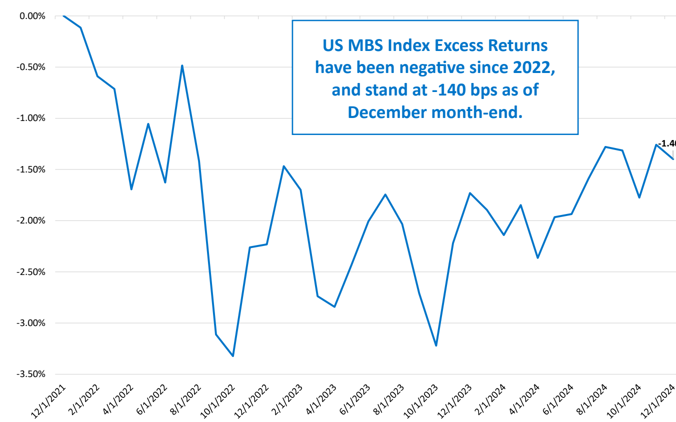
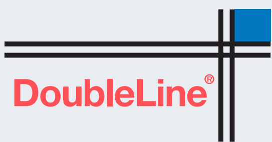


Figure 2

Source: Bloomberg



Where Do We Go From Here?

As 2025 begins, there are reasons to be cautiously optimistic about Agency MBS performance. The economy exhibits signs of both strength and weakness, with a range of predictions from recession to soft landing being supported by various data prints. Currently, Agency MBS are priced at attractive levels in many reasonable scenarios that could take place in the broader economy.

One can think of the primary mortgage rate as the 10-year Treasury yield plus the cost that secondary mortgage investors demand for the additional prepayment and volatility risk over the 10-year Treasury bond (current coupon spread) in addition to the cost of originating the mortgage (known as the primary-secondary spread). As of this writing, the 10-year yield was 4.57%, the current coupon spread over the 10-year yield was 1.26%, and the primary-secondary spread was approximately 1.0%, adding up to a primary mortgage rate of about 6.83%. For secondary mortgage market investors, a mortgage rate rally implies either a fall in yields, such as that of the 10-year Treasury, or a tightening of the spread to Treasuries, which for new-issue mortgages would mean a tightening of the current coupon spread. In regard to the 10-year Treasury yield, any weakness in the economy should result in falling Treasury yields along the curve which should then be reflected in a broad Agency MBS rally, with longer-duration structures benefiting the most. If rates stay where they currently are, we think Agency MBS bonds can offer advantageous carry relative to other spread products.

Since the November elections, rate volatility has declined, and DoubleLine's expectation is that it will continue to fall as both Fed policy and the post-pandemic economy continues to find their steady-state configurations. While current coupon spreads remain elevated relative to history – the average spread over the 10-year Treasury yield is less than 100 bps since 2008 – any reduction in interest rate volatility should translate to lower current-coupon spreads. This should result in an Agency MBS rally, especially in higher coupon mortgages most sensitive to such changes. A tightening current-coupon spread tends to be a tide that lifts all boats, and mortgages in the middle and lower coupon ranges should perform well in this scenario, as demand for those mortgages would likely remain strong.

Of course, if rates sell off meaningfully and yields rise, or volatility increases and current coupon spread widens, Agency MBS will likely underperform. Perhaps the biggest risk to realizing such a scenario is the Fed restarting an interest-rate hiking cycle in the face of re-accelerating inflation. While this is by no means DoubleLine's base case, it does represent the most direct risk to Agency MBS.

The demand for Agency MBS is slowly yet surely turning from a headwind to a tailwind, with green sprouts emerging as both banks *(Figure 3)* and overseas investors start to increase their holdings after a lengthy period of reduction. Money managers and other investors continue to maintain robust Agency MBS demand, and additional inflows will drive spreads tighter in the sector. DoubleLine does not expect the Fed to be a meaningful participant in the market going forward, and the Fed should continue an orderly winding down of its Agency MBS portfolio, which has already been priced in by the market.

Change in Agency MBS Held by Banks
As of Fourth Quarter 2024

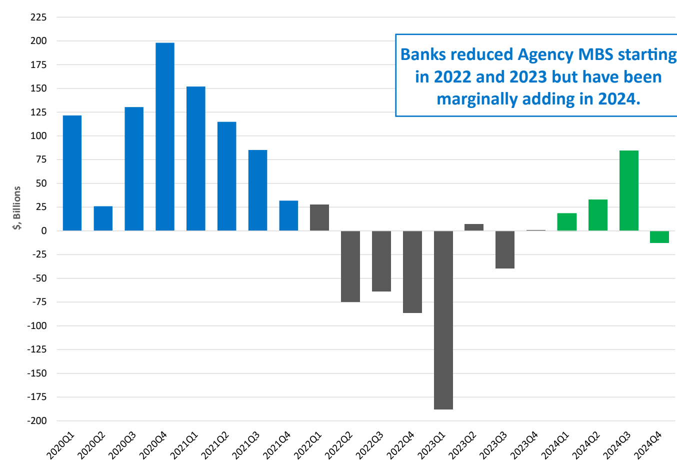


Figure 3
Source: Federal Reserve, H.8

Relative to corporate bonds, Agency MBS remain cheap. While both asset classes are affected by volatility, they respond to different types of pressure. As we note above, Agency MBS are sensitive to interest rate volatility. In contrast, equity volatility is more relevant to corporate bonds. In fact, the relationship between interest rate and equity volatility – proxied by the ratio of the ICE BofA MOVE Index to the Volatility Index (VIX) – has been elevated since 2022, with the 2022-December 2024 average at 6.3 versus a 4.3 average between 2008 and 2022. *(Figure 4)*

Interest Rate (MOVE) vs. Equity (VIX) Volatility
December 2007 through December 2024

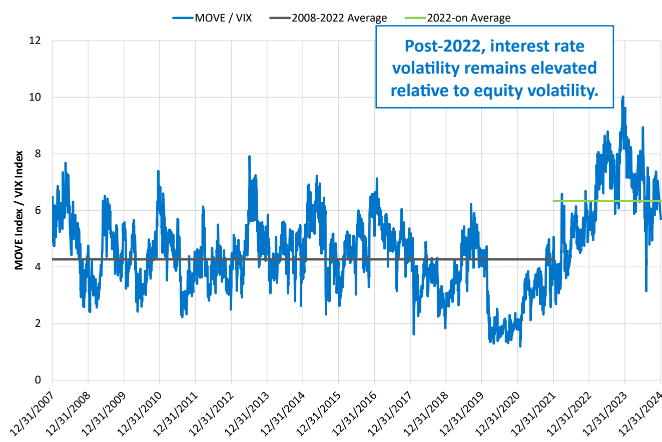


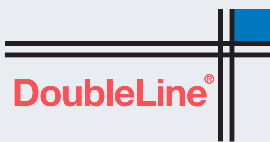
Figure 4
Source: Bloomberg, ICE, CBOE

This dynamic explains why mortgages have underperformed corporate bonds in terms of excess return over the last few years relative to their historical norms. In *Figure 5*, we present the rolling excess return on a one-, two- and five-year basis of Agency MBS minus the excess return of investment grade (IG) corporate bonds, as measured by the Bloomberg US Corporate Index. We consider a long history of returns here, going back to 2000. Agency MBS underperform corporates because they exhibit significantly lower excess return volatility. However, compared to median performance, current levels of underperformance are extreme.

Returns from Jan. 2000 through Dec. 2024 (%)	1 yr. Rolling	2 yr. Rolling	5 yr. Rolling
12/31/2024	**-2.08**	**-3.11**	**-1.97**
Minimum	-21.18	-12.84	-8.34
25th Percentile	-3.26	-2.54	-2.02
50th Percentile	-0.72	-1.08	-1.23
75th Percentile	0.89	0.31	-0.25
Maximum	20.00	11.23	5.06
Corporates Excess Return Volatility	5.81	5.30	4.56
MBS Excess Return Vol	1.25	1.34	1.23
Excess Vol Ratio	**4.64**	**3.97**	**3.72**

Figure 5
Source: Bloomberg
Agency MBS Excess Returns Less IG Corporate Excess Returns. All returns in %. Returns and volatility are annualized for comparison. IG corporates are represented by the Bloomberg IG Corporate Index.

Volatility patterns should ultimately revert to the mean – either interest rate volatility will decline or equity volatility will increase (DoubleLine believes that the former is more likely). As that happens, Agency MBS and IG corporate bonds should also mean revert in terms of their performance. While the appeal of IG corporates to all-in yield investors is understandable, DoubleLine believes that exposure to Agency MBS products with virtually no credit risk, some of which offers nominal spreads of 120 bps to 150 bps, should not be overlooked. ■



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Portfolio Manager
Structured Products

Mr. Patel joined DoubleLine in 2016 as a Mortgage Trader specializing in Agency RMBS and was later promoted to Portfolio Manager in 2021. Prior to DoubleLine, he worked as a Managing Director responsible for CMO and specified pool trading at Cantor Fitzgerald. Prior to that, Mr. Patel worked as a CMO, ARMs and Specified Pool Trader and Deal Structurer at Morgan Stanley, BNP Paribas and RBS Greenwich Capital. He holds a B.A. in Economics from Cornell University. Mr. Patel is a CFA® charterholder.

Alex Shvartser
Analyst
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Mr. Shvartser joined DoubleLine in 2020 as an Analyst on the Agency RMBS team. Prior to DoubleLine, he was with TCW as a Senior Vice President, Investment Analytics. Prior to TCW, Mr. Shvartser was a Quantitative Analyst at ICE Canyon. Prior to ICE Canyon, he was Vice President at BlackRock in the Financial Modeling Group. Mr. Shvartser holds a B.S. in Electrical Engineering from the California Institute of Technology and an M.S. in Mathematics in Finance from New York University.

Definitions

Agency – Refers to mortgage-backed securities (MBS) whose principal and interest are guaranteed by a U.S. government agency such as Fannie Mae (FNMA) or Freddie Mac (FHLMC).

Basel III Endgame – Reform measures to be adopted by the international banking sector in 2025 that are intended to improve regulation, supervision and risk management.

Basis Points (bps) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Bloomberg US Corporate Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg US Mortgage-Backed Securities (MBS) Index – This index measures the performance of investment grade, fixed-rate, mortgage-backed, pass-through securities of the government-sponsored enterprises (GSEs): Federal Home Loan Mortgage Corp. (Freddie Mac), Federal National Mortgage Association (Fannie Mae) and Government National Mortgage Association (Ginnie Mae).

CBOE Volatility Index (VIX) – This real-time market index represents the market's expectation of 30-day forward-looking volatility and is derived from the price inputs of S&P 500 Index options. Calculated and published by the Chicago Board Options Exchange (CBOE), the index is also known by such names as the "Fear Gauge" or "Fear Index."

Collateralized Mortgage Obligation (CMO) – Refers to a type of mortgage-backed security that contains a pool of mortgages bundled together and sold as an investment. Organized by maturity and level of risk, CMOs receive cash flows as borrowers repay the mortgages that act as collateral on these securities. In turn, CMOs distribute principal and interest payments to investors based on predetermined rules and agreements.

ICE BofA MOVE Index – This index is a measure of U.S. interest-rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on two-, five-, 10- and 30-year Treasuries.

In the Money – In the context of mortgage-backed securities, the phrase means that a borrower's existing mortgage rate is higher than mortgage rates available in the market. So, borrowers can save money by exercising their option to prepay mortgages.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

Mortgage-Backed Securities (MBS) – Investment similar to a bond that is made up of a mortgage or bundle of mortgages bought from the banks that issued them. Investors in MBS receive periodic payments similar to bond coupon payments.

Pass-Through Security – Pool of fixed income securities backed by a package of assets. A servicing intermediary collects the monthly payments from issuers and, after deducting a fee, remits or passes them through to the holders of the pass-through security (that is, people or entities who have invested in it).

Quantitative Tightening (QT) – Reverse of quantitative easing (QE); a central bank that acquired financial assets under QE undertakes steps to reduce its balance sheet.

You cannot invest directly in an index.

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