NAVIGATING SHIFTING TIDES:

MARKET DYNAMICS IMPACTING MORTGAGE-BACKED SECURITIES

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Senior Securitized Analyst/ Government Bond Portfolio Manager

In this interview, GW&K's Senior Securitized Analyst/Government Bond Portfolio Manager, Brendan Doucette, shares his analysis of the recent trends and dynamics in the mortgage-backed securities (MBS) sector. These include some of the reasons behind wider spreads in this sector, the impact of rate volatility, and the shift in the buyer base from the Federal Reserve and banks to money managers.

He also explores the outlook and potential for outperformance in the MBS sector, which accounts for a large portion of the market — over 25% of the Bloomberg US Aggregate Index — and highlights factors that could drive spreads back to longer-term averages.

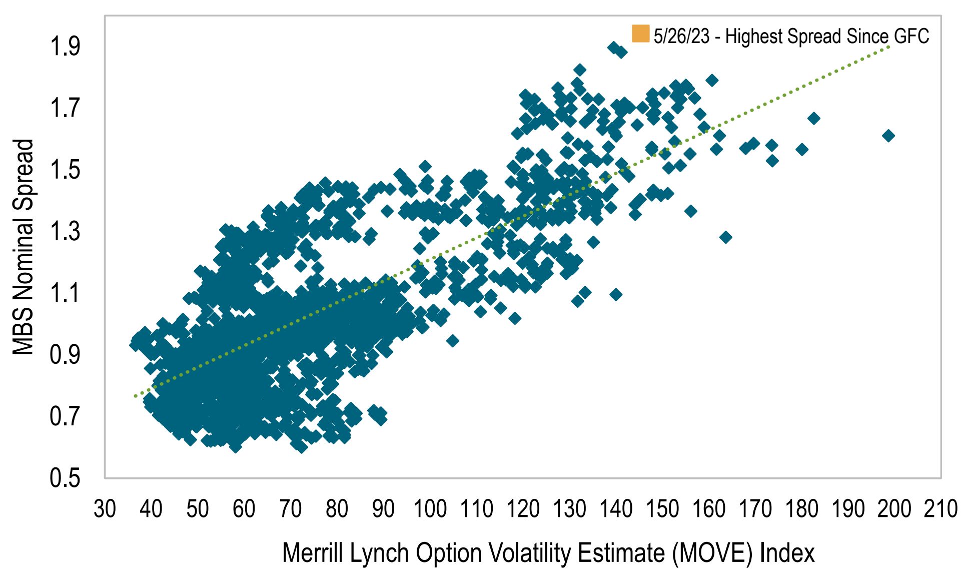
Q: Why have spreads in the MBS sector remained wide relative to other sectors over the past couple of years?

Brendan: MBS spreads moved substantially wider in 2022 when the US Federal Reserve (Fed) began tightening monetary policy. A higher federal funds rate and a shrinking Fed balance sheet shifted the buyer base from the Fed to money managers. Unlike the Fed, which is typically an uneconomic buyer, money managers are valuation-driven investors.

Additionally, uncertainty about the direction of interest rates heightened rate volatility. Borrowers can prepay mortgages at any time, and increased volatility raises the likelihood of prepayment, putting pressure on MBS spreads and causing them to widen. Thirty-year spreads are currently at 150 basis points (bps), down from their peak of 194 bps in May 2023 (**Figure 1**), but still far above their cycle lows of 60 bps in 2021.

FIGURE 1

10-Year Chart: MBS Spread/Rate Volatility Regression



Sources: GW&K Investment Management and Bloomberg. Data from May 28, 2013 – May 26, 2023.

Q: Is this the new level?

Brendan: No, MBS spreads will revert to longer term averages over time. Our view is that rate volatility will subside with further clarity on the Fed rate path, while Fed cuts will steepen the curve. This steepening is expected to boost demand from banks and mortgage real estate investment trusts (REITs), which had scaled back their activity in recent years due to the inverted yield curve. We saw these factors drive MBS spreads lower in the third quarter, while recent macro events — including a resilient job market and the US election — have increased rate volatility and driven spreads wider, creating an attractive opportunity.

Q: How are you positioned in the securitized sector?

Brendan: We are overweight MBS and asset-backed securities (ABS) as they are high-quality sectors trading at wide valuations to longer-term averages. We increased our allocation to the ABS sector in the first half of the year due to its low correlation with rate volatility and its shorter-duration maturities, which are expected to benefit from Fed rate cuts.

"We are overweight MBS and ABS as they are high-quality sectors trading at wide valuations to longer-term averages."

Within MBS, we are overweight in the middle to higher part of the coupon stack, which stands to benefit the most from lower rate volatility. We remain underweight lower coupon pools that continue to face headwinds from bank balance sheet restructuring activity.

Q: What has changed in the types of MBS pools you buy?

Brendan: The underlying collateral has changed. The higher rate environment pushed most MBS coupons on the stack to a discount. In fact, the average value of our holdings is 95 cents on the dollar, which has shifted our collateral preference. When buying MBS at a discount, we identify collateral prone to faster prepayment speeds as principal returned faster at par will increase total return. For instance, we prioritize collateral with higher exposure to mortgage brokers (instead of large banks), or states with higher turnover like Florida or Texas.

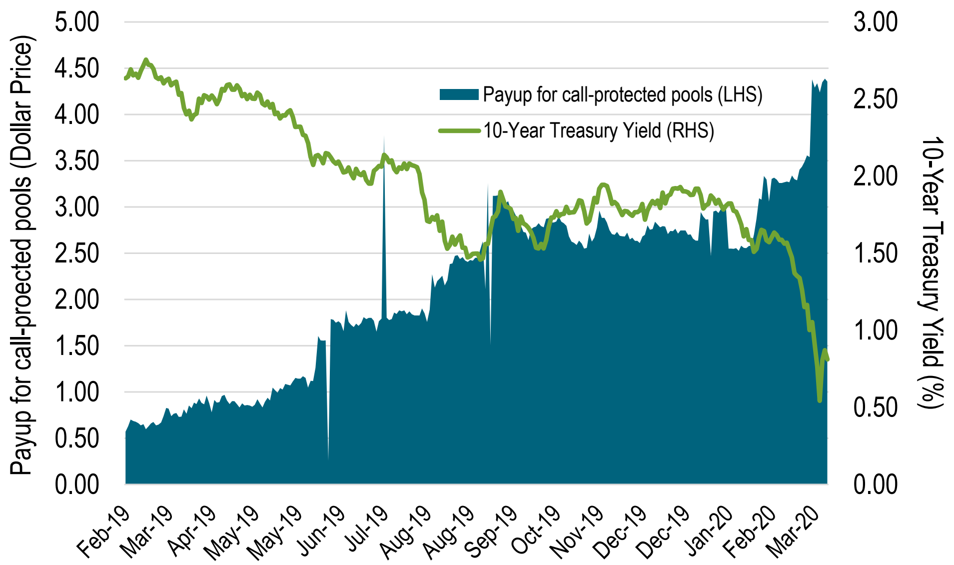
In premium coupon MBS, we favor pools with low loan balances that prepay slower when rates fall. Given the prepayment protection provided, these trade at a higher price than generic pools. This price increases relative to generic pools when interest rates fall. **Figure 2** shows how the payup, or the amount investors pay above generic pools, went from

Figure 2 example: 30-year 3.5% $150,000 loan balance pool

The amount investors paid above generic pools went up by 3.75 points when the 10-year Treasury rallied by 200 basis points leading up to the pandemic.

FIGURE 2

When Interest Rates Move Lower and Prepayment Speeds Increase, Investors Pay More for Call-Protected Pools



Sources: GW&K Investment Management and Bloomberg. Data from February 19, 2019 – March 12, 2020.

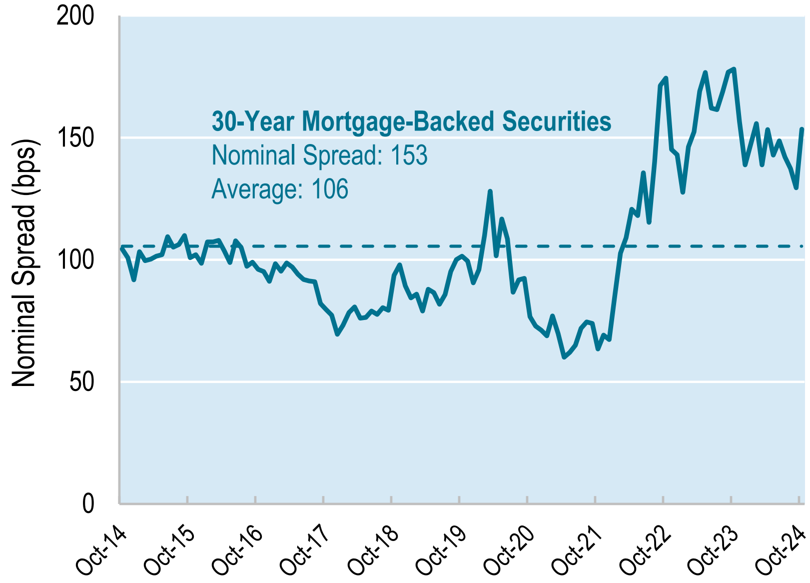
around a half a point to four and a quarter points when the 10-year Treasury rallied by 200 basis points leading up to the pandemic. The duration of a portfolio with this type of collateral will lengthen relative to the Bloomberg US MBS Index into a rally and shorten into a selloff in rates, which is exactly what investors want.

Q: What is your outlook on the securitized sector?

Brendan: The securitized sector offers considerable value, and we anticipate it will outperform as we move past the short-term event-driven volatility. Within the MBS sector, spreads remain wide relative to historical averages, making them attractive compared to other high-quality sectors. The technical outlook has improved, with minimal net supply for conventional mortgages and increased bank demand following Fed bank capital proposals that proved less onerous than feared. Given this backdrop, we see MBS spreads as 40 bps wide of fair value and maintain a positive outlook on the sector, expecting mean-reversion in spreads (**Figure 3**).

FIGURE 3

30-Year Mortgage-Backed Spreads



Source: Bloomberg. Data from October 31, 2014 – October 31, 2024.

We also favor ABS as a high-quality sector less correlated with rate volatility and Fed policy. ABS has lagged the spread tightening seen in other sectors, providing an attractive entry point. The sector's duration is concentrated at the front end of the yield curve, which stands to benefit from Fed rate cuts and curve steepening.

Overall, we prefer spread product over Treasuries in the current carry environment. Although rates have retreated from recent highs, they remain appealing relative to post-GFC levels, and any significant weakness is likely to be capped by investors drawn to compelling absolute yields.