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INVESTORS

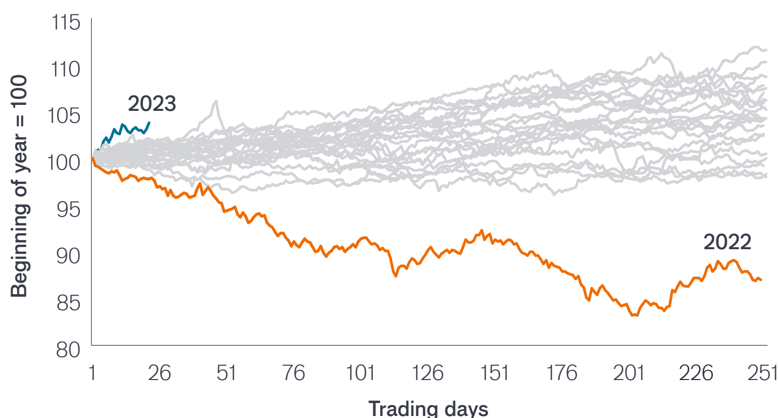
MORTGAGE-BACKED SECURITIES: PRICED FOR IMPERFECTION?

March 2023

Head of U.S. Securitized Products John Kerschner and Portfolio Manager Nick Childs explain why they believe key risks are now largely priced in to fixed income markets, with selective areas – particularly mortgage-backed securities (MBS) – presenting an opportunity to provide favorable risk-adjusted returns.

Fixed income investors have welcomed a positive start to 2023 after a very tough year in 2022. Last year, as inflation soared, bond prices were hit simultaneously with rising interest rates and widening credit spreads. The trifecta of upward inflationary pressure, hawkish central banks, and the negative impact of the Russia/Ukraine conflict resulted in the Bloomberg U.S. Aggregate Bond Index (Agg) registering its worst year since 1999, as shown in Figure 1.

Figure 1: Annual trajectory of U.S. Agg returns since 1999



Source: Bloomberg, Janus Henderson Investors, as of January 31, 2023.
Past performance is no guarantee of future results.

John Kerschner
Head of U.S. Securitized Products

Nick Childs, CFA
Portfolio Manager

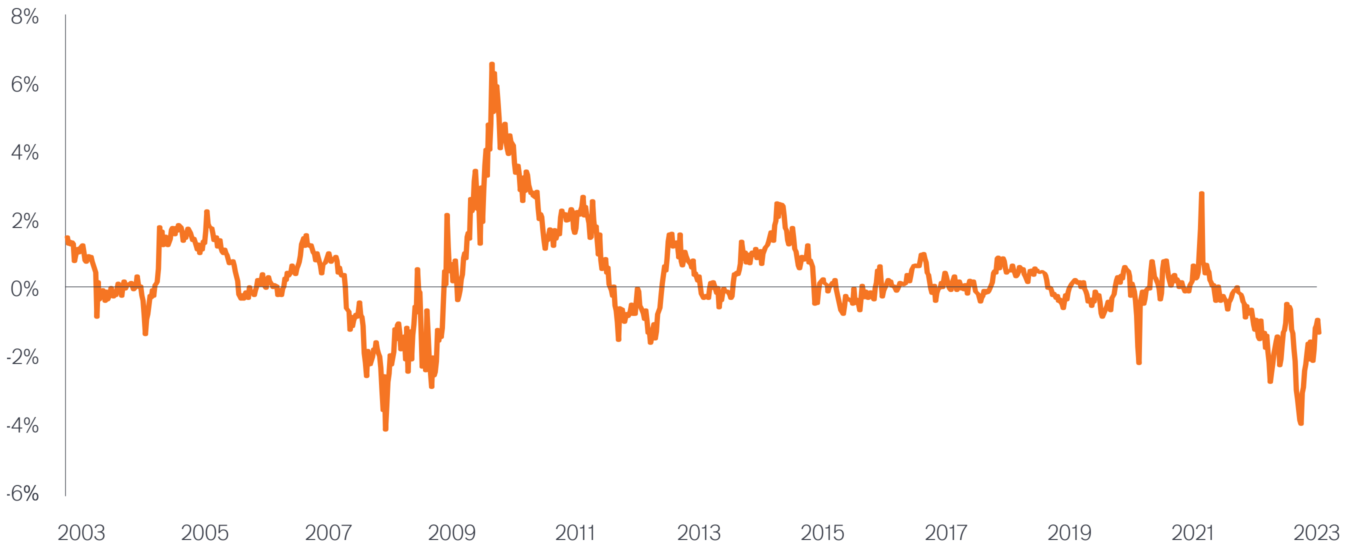
Key takeaways

- Following an increase in yields and a widening of credit spreads, MBS are now pricing in a lot of bad news.
- While risks like interest rate volatility and supply concerns weighed on returns in 2022, we think the sell-off in MBS has been overdone.
- In our opinion, the additional income offered by MBS relative to U.S. Treasuries, combined with the potential for normalization of valuations, makes the asset class attractive from a valuation perspective.

As painful as this sharp drawdown was for investors' portfolios, in our view, a lot of bad news is now priced in. While there is potential for more volatility, we believe there are opportunities in selective areas of fixed income, particularly in mortgage-backed securities (MBS). As shown in Figure 2, relative to U.S. Treasuries, MBS underperformed in 2022 to a degree not seen since the Global Financial Crisis (GFC). Further, MBS spreads have widened significantly relative to alternative investment-grade credit, as highlighted in Figure 3.

Figure 2: MBS Index excess return over U.S. Treasuries (rolling 12m)

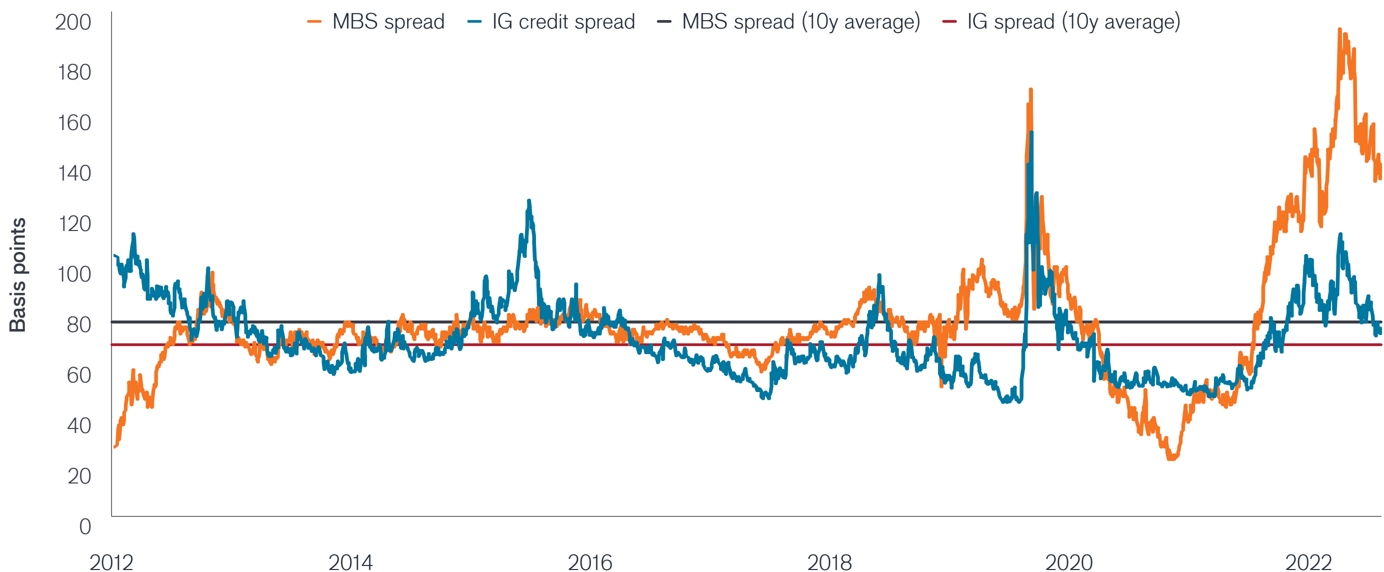
Extent of MBS underperformance in 2022 not seen since 2008.



Source: Bloomberg, Janus Henderson Investors as of January 31, 2023. Bloomberg U.S. MBS Index excess return (12-month) versus the U.S. Treasury curve.
Note: Market-value weighted average 12-month excess return. Measure of performance of a spread security over that of an equivalent Treasury security.
The 12-month return is calculated using the previous month end.
Past performance is no guarantee of future results.

Figure 3: MBS current-coupon spreads relative to investment-grade (IG) credit spreads

Valuations on MBS look attractive relative to investment-grade alternatives.



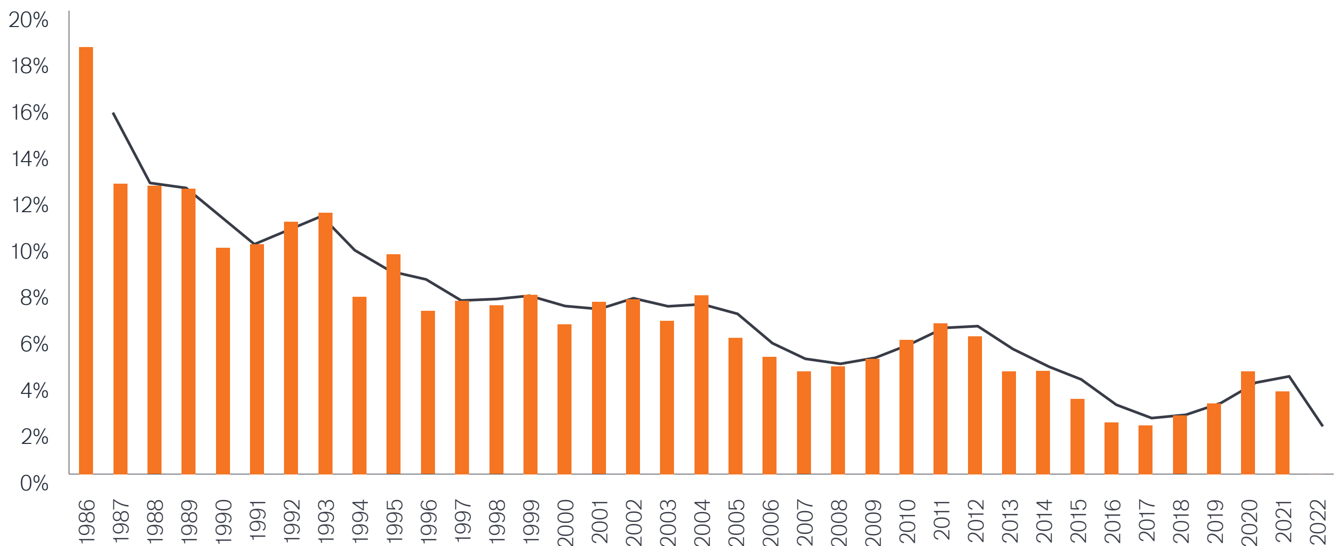
Source: Bloomberg, Janus Henderson Investors. Current coupon MBS spreads versus Market CDX North America Investment-Grade Index, as of January 31, 2023.

The (un)intended consequence of expansionary monetary policy

The structural bull market in bonds that began in 1980 (when the 10-year U.S. Treasury yield touched 16%) has provided a consistent tailwind for fixed income returns for over four decades. Following the GFC, we entered a period that was to become a new normal for monetary policy, with zero benchmark lending rates (known as zero interest rate policy, or ZIRP) and aggressive quantitative easing (QE) programs aimed at injecting liquidity into the economy. The new normal drove interest rates ever lower, and with each move downward, the capacity for bonds to provide income has been further diminished, as illustrated in Figure 4.

Figure 4: U.S. Agg 5-year rolling returns

As rates have fallen, fixed income's capacity to provide income has diminished.



Source: Bloomberg, Janus Henderson Investors, as of December 31, 2022.
Past performance is no guarantee of future results.

The pièce de résistance came in March 2020 when, in response to the COVID-induced shutdown, the Federal Reserve (Fed) deployed its self-termed “"bazooka." The central bank dropped its benchmark lending rate back to 0% and embarked on an aggressive bond buying program that swelled its balance sheet from $4.1 trillion to almost $9 trillion in under two years.

While the Fed's decision to fire the bazooka to calm COVID-related fears achieved the desired outcome, in our opinion, the support they provided post-crisis was overdone. Enter the (un)intended consequence: inflation. Amid COVID-related supply disruptions and record stimulus, the proverbial sleeping dragon awoke (and didn't go back to sleep, as the Fed had hoped). The Fed eventually acknowledged that the inflation problem was, in fact, not a self-correcting one, and made a hawkish pivot in 2022, raising interest rates and signaling their intent to move quickly to quantitative tightening (QT). The Fed's hawkish pivot, coupled with the swift move to QT, precipitated the sell-off that has created, in our view, the opportunities we see today in MBS.

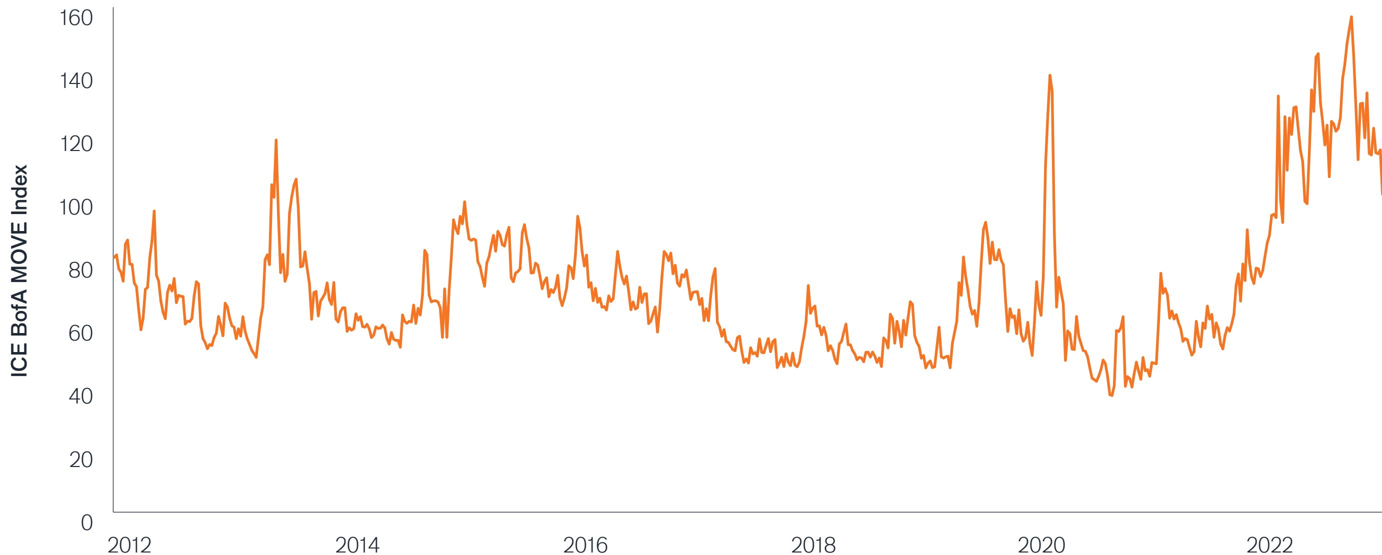
What is currently priced into MBS?

1. High levels of interest rate volatility

MBS performance is largely affected by interest rate volatility. Higher volatility equates to greater uncertainty around refinancing and mortgage prepayments, which is the primary fundamental risk for MBS. With so much uncertainty surrounding QT, inflation, and expected rate hikes, interest rate volatility has been above historical norms since early 2022. Figure 5 shows that the ICE BofA MOVE Index, a measure of interest rate volatility, has been elevated above 100 for the longest stretch seen in the last decade.

Figure 5: Interest rate volatility as measured by the ICE BofA MOVE Index (2012-2023)

If interest rate volatility continues to come down, it should be a positive for MBS.



Source: Bloomberg, Janus Henderson Investors, ICE BofA MOVE Index, as of January 31, 2023.

The MOVE Index has crossed over the 100-point mark only three times in the last 10 years, and only for brief periods. During such times of high volatility, the prices of bonds with embedded or theoretical options (like MBS) are affected to a greater degree than comparable non-option bonds, because the prepayment option (the ability to refinance the mortgage) held by the borrower increases in value with higher interest rate volatility.

We think that as the market gains more clarity around the trajectory of inflation and the Fed's future rate hikes, it is likely that rate volatility will recede to more normalized levels. To the extent that MBS are penalized in a higher volatility environment, all else being equal, their optionality should provide a tailwind for price appreciation if we move back to lower levels of volatility.

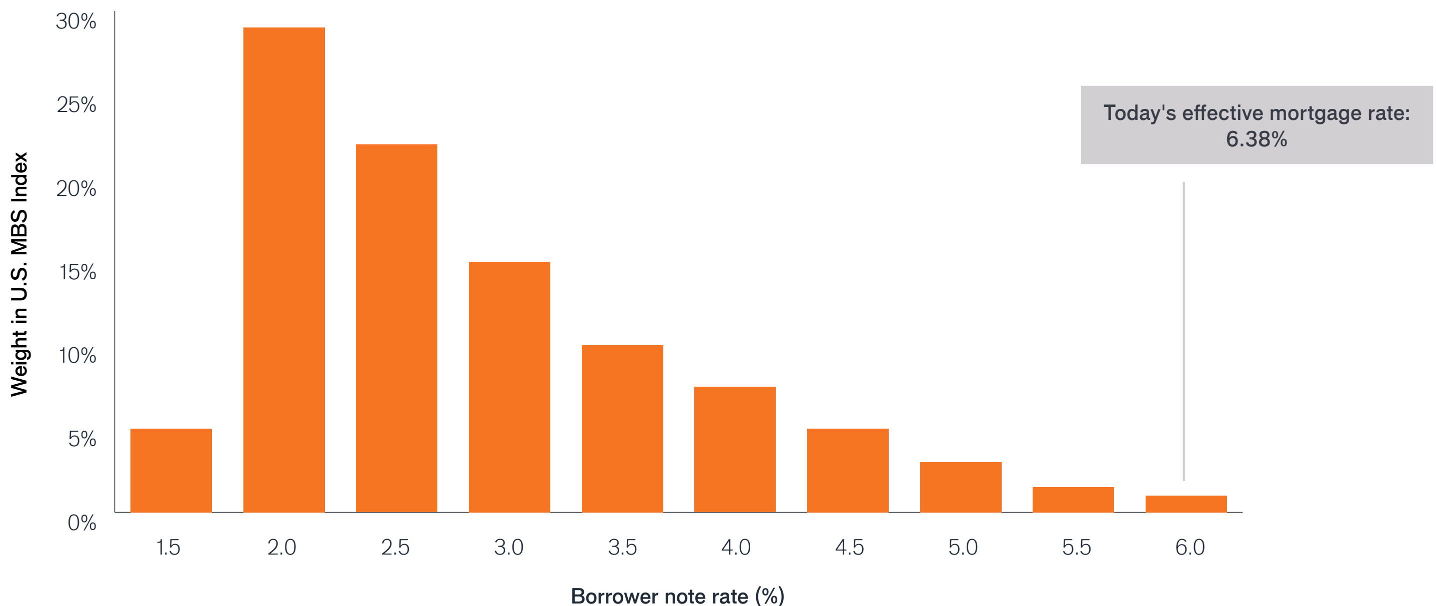
2. Fundamental risks

Fundamental risks are different for MBS relative to other fixed income assets. While credit risk is typically the fundamental risk associated with non-government issued debt, the major risk factor for MBS is prepayment risk.

When mortgage rates plummeted in 2020 and 2021, record numbers of borrowers refinanced their existing loans at historically low rates. Since then, mortgage rates have risen sharply to well over 6.00%. As a result, less than 1% of outstanding government-sponsored entity (GSE) mortgages have a rate incentive to refinance, because their existing rate is below the current mortgage rate, as shown in Figure 6. Considering that 99% of the mortgage universe has a significantly lower mortgage rate than what is available today, prepayment risk and convexity risk are at all-time lows, as shown in Figure 7.

Figure 6: Distribution of outstanding agency mortgages by borrower note rate

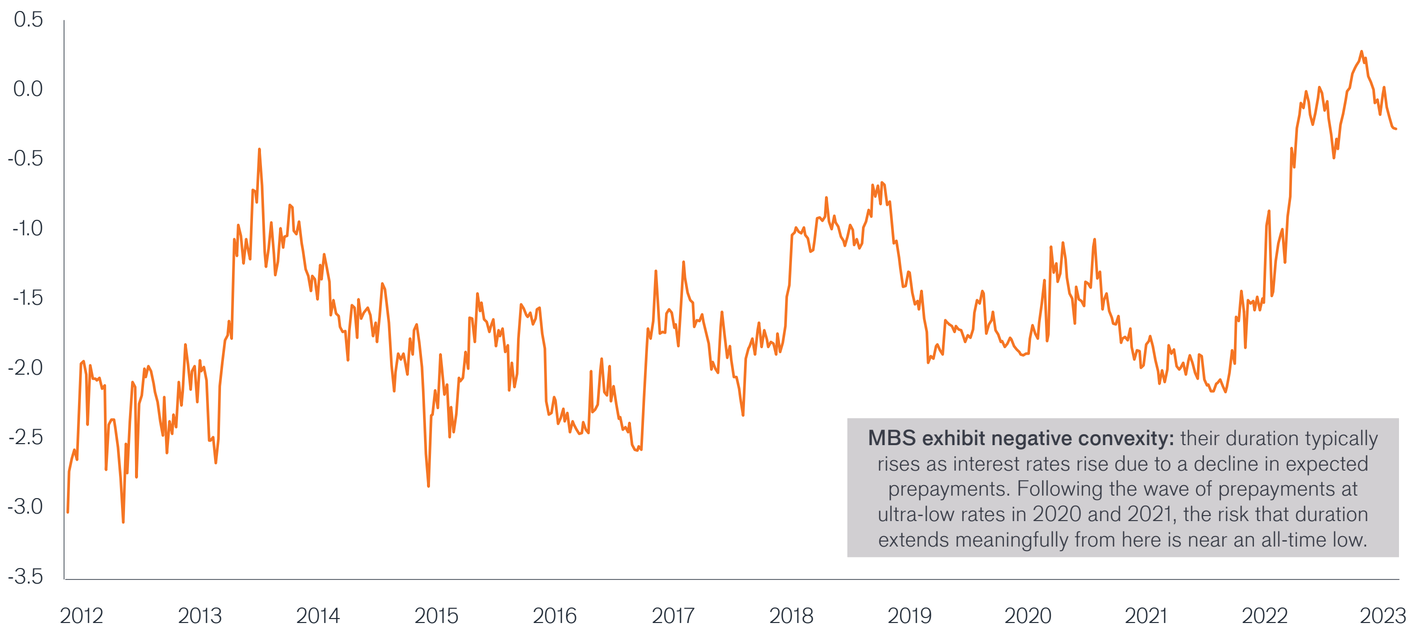
The current mortgage rate is much higher than the rate on existing mortgages.



Source: Bloomberg, Janus Henderson Investors, data and current mortgage rate as of January 31, 2023.

Figure 7: U.S. MBS Index negative convexity

Convexity risk in MBS is at an all-time low, offering a much clearer duration picture.



Source: Bloomberg, Janus Henderson Investors, Bloomberg U.S. MBS Index, as of January 31, 2023.

Given the current convexity profile and how far we are from a refinancing event (mortgage rates would have to fall substantially to incentivize mortgage-holders to refinance), agency MBS hold a higher quality of duration than what is typically exhibited in the asset class.

If mortgage rates do rally in the future, we do not believe valuations will be adversely affected for most of the move. Further, if mortgage rates rally to such an extent that prepayments increase significantly, we think that would only happen under a very challenging macroeconomic environment, in which case we believe the Fed would pause its QT program, relieving some of the supply concerns that have negatively affected MBS valuations.

3. Supply concerns

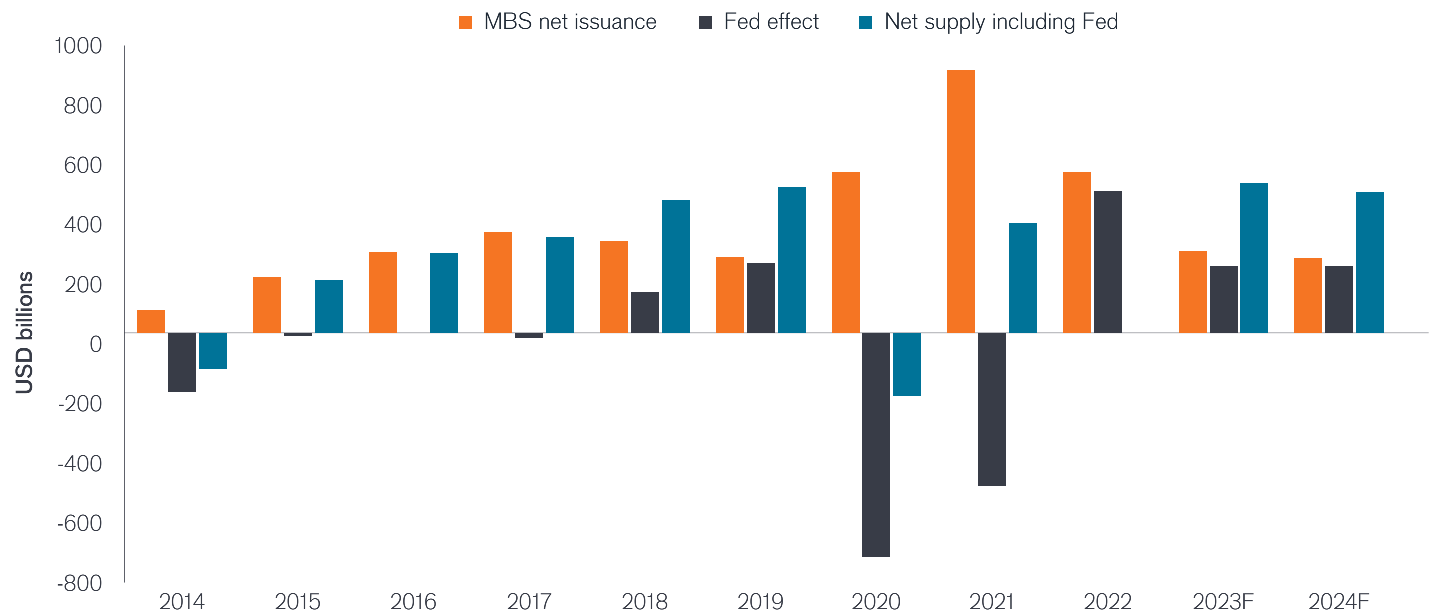
In the minutes of its May 2022 meeting, the Fed provided clarity on how and when it would begin reducing the size of its balance sheet. After a three-month phase-in period following its June 2022 start date, the central bank has since allowed up to US$60 billion in Treasuries and US$35 billion in MBS to roll off its balance sheet each month.

We believe these supply concerns are broadly priced in and this risk poses minimal further downside to the asset class. In terms of forward supply forecasts, our expectations (including Fed runoff) are comparable to 2018-2019. During 2018-2019, spreads on current coupon mortgages averaged 86 basis points, while spreads in 2022 averaged 130 basis points.

To hit the monthly cap of US$35 billion on prepayments alone, the Fed's US$2.6 trillion portfolio would require a prepayment rate of roughly 15%. Due to the higher rate environment, there is concern among investors that prepayment rates may be lower than 15%, which raises the question: Would the Fed start selling MBS to hit its monthly cap if prepayments alone do not get them there? In our opinion, we think it is extremely unlikely that the Fed would ever sell MBS, for two reasons. First, it expressly addressed the issue in 2022, saying it was not considering selling MBS anytime soon as part of its QT program. Second, we do not believe there is any compelling reason for the Fed to start selling MBS (particularly as economic growth begins to slow) considering it has made steady progress in reducing the size of its balance sheet since commencing QT in June 2022. We think supply concerns are likely to subside over time and, as such, we would expect the pricing of this risk into asset prices to unwind.

Figure 8: Historical and forecasted agency mortgage net supply, including Fed effect

Even with Fed runoff, we do not forecast supply in 2023-2024 being materially higher than 2018-2019.



Source: Bloomberg, Janus Henderson Investors, as of January 31, 2023.
Note: 2023 and 2024 are forecasts.

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What an active approach brings to MBS

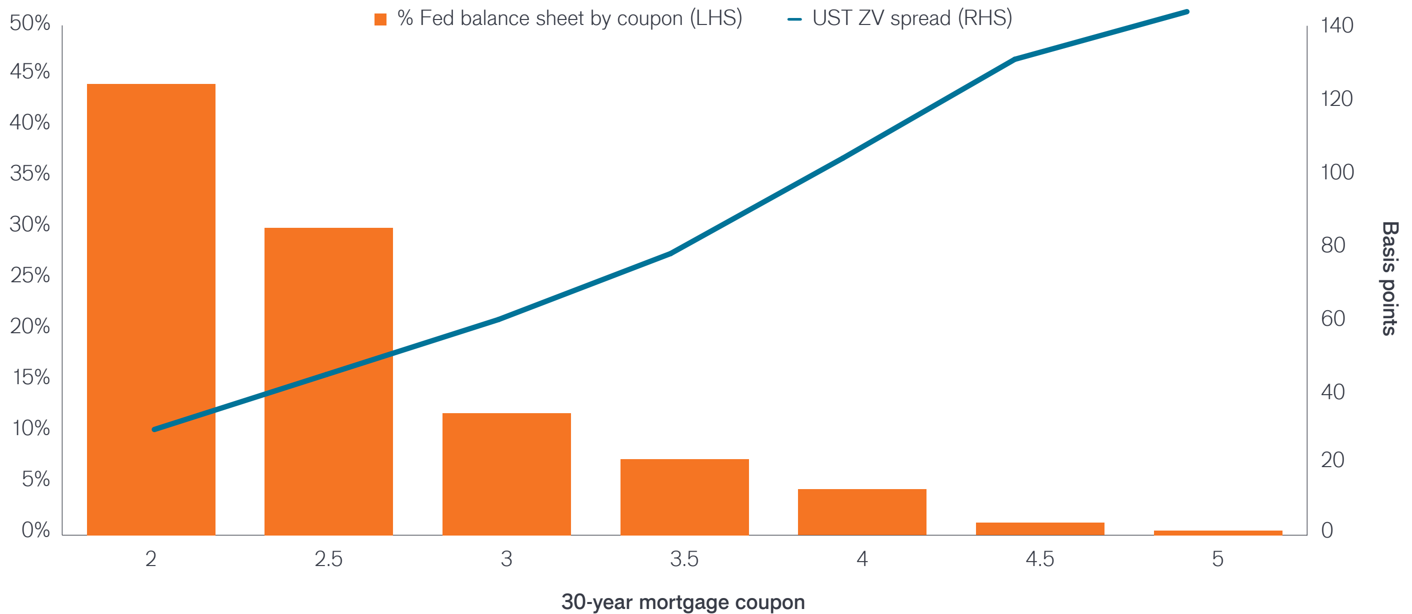
In our opinion, the MBS market is well suited to an active management approach for two reasons. First, the $9 trillion mortgage market is large in scale, while the individual mortgages are not homogenous because each mortgage is originated under a set of circumstances that is unique to the borrower. This creates the opportunity for the active investor in MBS to search for and identify subsets of the investment universe that offer better risk-adjusted returns relative to the universe as a whole. Second, buyers of MBS – which might include money managers, depository institutions, foreign banks, or the Fed – have varied goals and objectives and may have little bias toward tracking a mortgage index. The Fed's objective might be to control interest rates and liquidity, a bank might be looking at capital constraints, or an asset-liability manager may simply be focused on net interest margins. We believe these divergent investor objectives can create pockets of price imbalances in the market for active managers in search of alpha.

Evidence of these imbalances can be found when reviewing the Fed's MBS holdings according to mortgage coupons. Almost 75% of the Fed's 30-year conventional balance sheet consists of mortgages with coupons 2.5% and lower, while less than 8% of its balance sheet is held in notes with coupons of 4% and higher. If mortgage rates remain in their current range, the balance of higher-coupon notes is likely to grow, while lower-coupon mortgages will become further orphaned. Because most of the Fed's buying activity has been concentrated in lower-coupon mortgages, spreads in that segment are naturally tighter. In addition, if the Fed were to sell mortgages, we believe underperformance would be concentrated in the areas where they have the greatest inventory to sell.

While MBS have recovered significantly from their worst levels in 2022, we still believe the asset class looks attractive relative to alternatives and is offering opportunities for strong risk-adjusted returns. In our opinion, the additional income offered by MBS relative to U.S. Treasuries, combined with the potential for a de-escalation of priced-in risks and normalization of valuations, makes the asset class attractive from a valuation perspective.

Figure 9: Fed's 30-year mortgage holdings and zero-volatility spreads over U.S. Treasuries

While the Fed has focused its QE efforts on lower-coupon bonds, higher-coupon bonds offer more income and higher spreads and may be less exposed to QT.



Source: Bloomberg, as of January 31, 2023.

Note: The zero-volatility spread (ZV spread) is the constant spread that makes the price of a security equal to the present value of its cash flows when added to the yield at each point on the spot rate Treasury curve where cash flow is received. Each cash flow is discounted at the appropriate Treasury spot rate plus the Z-spread.

About the authors

John Kerschner, CFA

Head of US Securitised Products | Portfolio Manager

John Kerschner is Head of US Securitised Products at Janus Henderson Investors and a Portfolio Manager on the Multi-Sector Credit strategy and the three Securitised Products ETFs - Mortgage-Backed Securities, AAA CLOs and BBB CLOs. John primarily focuses on leading the U.S. Securitised team and finding innovative ways to utilize structured products in JHI portfolios. Prior to joining Janus in 2010, John was director of portfolio management at BBW Capital Advisors. Before that, he worked for Woodbourne Investment Management, where he was global head of credit investing. John began his career at Smith Breeden Associates as an assistant portfolio manager and was promoted several times over 12 years, becoming a principal, senior portfolio manager and director of the ABS-CDO group.

John received his bachelor of arts degree in biology from Yale University, graduating cum laude. He earned his MBA from Duke University, Fuqua School of Business, where he was designated a Fuqua Scholar. John holds the Chartered Financial Analyst designation and has 33 years of financial industry experience.

Nick Childs, CFA

Portfolio Manager

Nick Childs is a Portfolio Manager at Janus Henderson Investors, a position he has held since 2018. He is responsible for co-managing the Mortgage-Backed Securities, AAA CLO and the Sustainable & Impact Core Bond ETFs. He was a securitised products analyst for both US and global multi-sector fixed income portfolios at the firm from 2017 to 2022. Prior to joining Janus, Nick was a portfolio manager at Proprietary Capital, LLC from 2012 to 2016 where he managed alternative fixed income strategies specialising in MBS, absolute return investing. He also managed all major US interest rate and MBS risks, modelling borrower behaviour and MBS deal structure, and advancing market-neutral hedging strategies. Before that, he was vice president at Barclays Capital in capital markets, where he focused on securitised products from 2007. Earlier, he was vice president at Lehman Brothers. He began his career at State Street Global Advisors in 2003.

Nick received his bachelor of science degree in finance with a minor in economics from the University of Denver. He holds the Chartered Financial Analyst designation and has 20 years of financial industry experience.

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