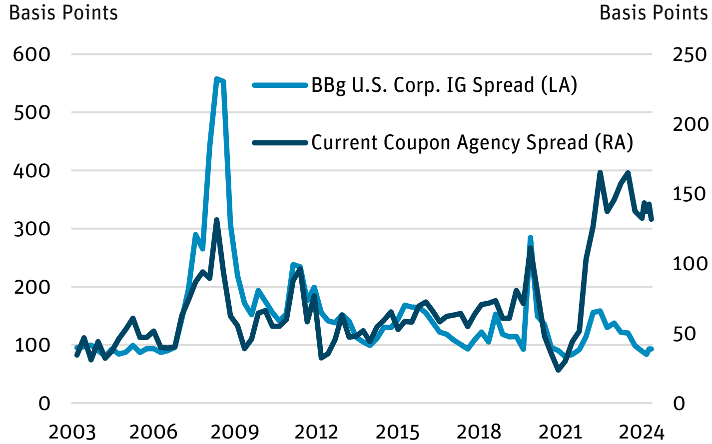
Mortgage-Backed Securities: A Historic Opportunity in 2024

As inflation appears to be under control, with the economy slowing toward a soft landing and lower rates on the horizon, we believe 2024 is setting up to be a historic opportunity to increase fixed-income allocations. With rate declines expected over the course of the next year, high-quality fixed-income portfolios of intermediate duration have the potential to generate total returns that are greater than current yields and to help mitigate reinvestment risk. Given current valuations, we believe there is an opportunity to add mortgage-backed securities (MBS) at some of the most compelling spreads and yields seen in decades.

Figure 1 shows spreads in agency RMBS are trading wider than investment-grade (IG) corporate credit for the first time in more than 20 years. Corporate credit spreads (both IG and HY) are trading at cyclical tights and provide less of a relative value versus agency and non-agency (NA) RMBS securities that are trading wider to historical averages (Figure 2). MBS may offer compelling relative value due to strong fundamentals, conservative underwriting, and a resilient housing market.

Figure 1: Current Coupon Agency Spread Wider Than IG Corp. Spread



Source: Bloomberg as of 7/31/24.

Remember, agency mortgages are guaranteed, whether explicitly or implicitly, by the U.S. government, but corporate credit is not. Although agency MBS are historically attractive, when it comes to a normalization of the MBS basis, investors may find the best relative value opportunity within NA RMBS. Spreads in new-issue areas of the non-agency market are trading at or near historic wides to similarly rated corporate bonds (Figure 3). As mortgage spread means revert, we see more upside potential from a price perspective. Total return opportunities in mortgages are rare, given their callable nature and premium dollar prices during normal times. In today's market, however, value potential is historic due to these assets trading at steep discounts.

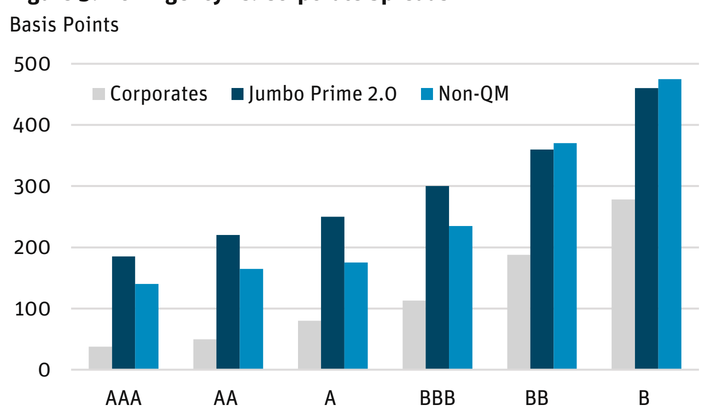
Figure 2: Historical Spreads

Securitized		Current Spread (bps)	YTD Change (bps)	Percentile Since 2018
Agency RMBS	Fannie Mae/Freddie Mac Current Coupon	127	-1	75%
Non-Agency RMBS	Non-QM AAA	130	-20	51%
	Prime 2.0 Jumbo Sub A	235	-10	61%
Corporate Credit		**Current Spread (bps)**	**YTD Change (bps)**	**Percentile Since 2018**
Corp. Index	BBg U.S. Corp. IG Index	93	-6	19%
	BBg U.S. Corp. HY Index	304	-18	14%

Source: Bloomberg, Wells Fargo, Bank of America as of 7/31/24.

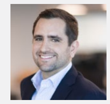
The Federal Reserve's historic 2022 hiking cycle combined with the subsequent sustained period of interest rate volatility and bank failures resulted in two of the largest holders of MBS – the Fed and banks – moving out of the market. This weakening technical demand has resulted in significantly widened MBS spreads versus U.S. Treasuries and corporates, presenting an attractive opportunity for investors to increase MBS weightings in core asset allocations. We believe now is the time for investors to lock in higher yields with historic total return opportunities.

Figure 3: Non-Agency vs. Corporate Spreads



Source: Bloomberg as of 7/31/24.

Agency Mortgage-Backed Securities (AMBS): Securities issued or guaranteed by the U.S. government or a GSE.
Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
Bloomberg U.S. Corporate High Yield Bond Index: An unmanaged market value-weighted index that covers the universe of fixed-rate, non-investment-grade debt.
Bloomberg U.S. Corporate Investment Grade Index: An index that measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.
Current Coupon: Refers to a security that is trading closest to its par value without going over par. In other words, the bond's market price is at or near to its issued face value.
Duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the duration, the greater the price change relative to interest rate movements.
Morgan Stanley 30Y Conventional Current Coupon ($100) ZV Index: The index represents the ZV (zero volatility) spread for the hypothetical $100-priced 30-year conventional mortgage over time.
Mortgage-Backed Security (MBS): A type of asset-backed security which is secured by a mortgage or collection of mortgages.
Non-Qualified Mortgage (Non-QM): A loan that does not meet the standards of a qualified mortgage and uses non-traditional methods of income verification to help a borrower get approved for a home loan.
Prime Jumbo: Prime jumbo mortgages are non-agency loans typically because the lending amount exceeds the conforming loan limits. These tend to be high-quality mortgages with high credit scores that, for the most part, comply with agency mortgage underwriting guidelines.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Yield Curve: The U.S. Treasury yield curve refers to a line chart that depicts the yields of short-term Treasury bills compared to the yields of long-term Treasury notes and bonds.



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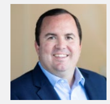

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