Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

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Rising Rates Drive MBS Value

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

This week, we revisit the investment portfolio, once again hearing from our Bond Market Focus on a sector that can provide some value to financial institutions at a volatile time. Following a difficult first quarter for bonds, with the 10yr rising 83 bp and the Bloomberg Barclays Aggregate losing 3.27%, yields look more compelling. Mortgages are a standout value, assuming one can put the poor performance due to fast prepayments in the past. Mid-range profiles of 15yr and 20yr 2% mortgages, with yields reaching as high as 1.70%, look very attractive relative to other 5-7yr AAA paper oftentimes closer to a 1% yield. Additionally, the strength in housing should keep baseline prepayments relatively healthy for some time. We outline a number of options in the mortgage market for investors to consider.

Strength in Housing

As spring rolls in and the pounding of hammers on new home construction rings through home-office windows, we are reminded of the strength that housing has brought to a struggling economy. Low mortgage rates, along with the health and safety allure, have brought a hefty array of buyers into the single family home market. In that vein, the large buyer base has driven housing supply to very low levels with existing home supply dipping to the lowest level in decades at 2 months of supply in February (Figure 1).

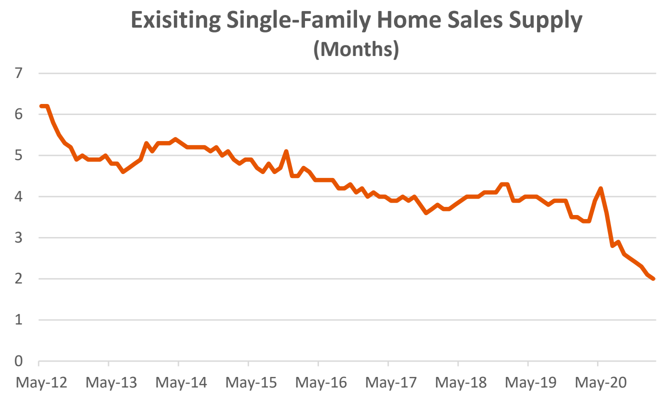
Figure 2 shows that housing prices really began to heat up after COVID economic closures created stay-at-home and work-from-home cultures. Even as economic trends improve, housing continues to roll. Case-Shiller housing data shows the average purchase price for a home in the United States increased by a fiery 11.1% through the end of January (Figure 2), with nearly half of homes selling above their asking price according to CoreLogic.

While Moody's Analytics expects the growth clip to fall closer to 3% by February of next year, additional stimulus checks could easily lengthen the trend in spite of the headwind of higher mortgage rates.

Rates Moving Higher

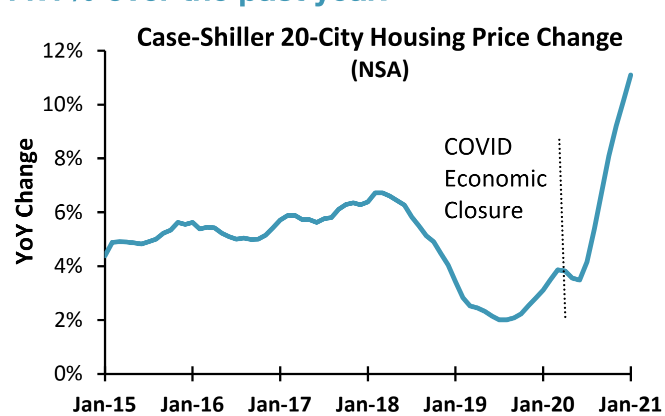
The rise in rates was substantial in the 1st quarter. According to BankRate.com, 30yr mortgage rates rose

Figure 1: The hot housing market has pushed existing home supply to record lows…



Source: National Association of Realtors, Piper Sandler

Figure 2:…as the demand for single-family homes has driven housing prices higher by 11.1% over the past year.



Source: Bloomberg, Piper Sandler

from 2.87% to 3.27% over the quarter. In the bond market, the 10yr Treasury rose from 0.9% at the beginning of the quarter to 1.73% at the end of March (Figure 3).

While the 5yr Treasury moved up a more modest 58 bp (.36% to .94%) and has begun to recover, investors felt the losses as a $100 mm portfolio invested in the 5yr would have accrued mark-to-market losses of nearly $2 mm over the quarter.

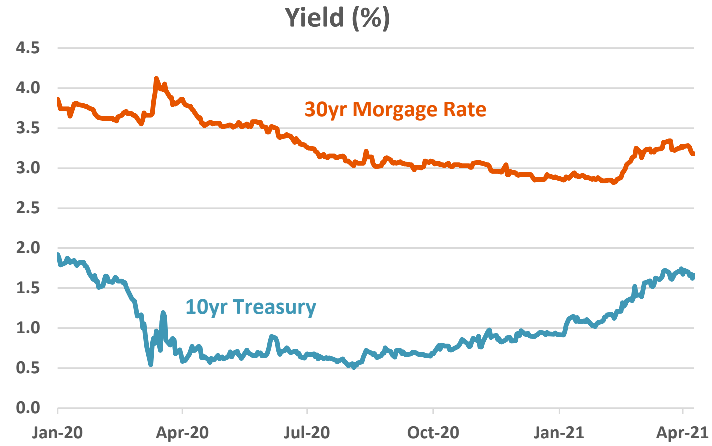
While this can create concern for investors and institutions, the reality is that bonds are more attractively priced today to create income for the future. The benefit of portfolio losses is that one has improved future income prospects due to higher purchase yields.

The question becomes: which securities are most worth purchasing? We have outlined the relative value in both taxable munis, non-agency CMBS, and corporates of late, but we find a growing number of investors adding to their mortgage positions in spite of historically heavy prepayments.

Mortgages Offer Relative Value

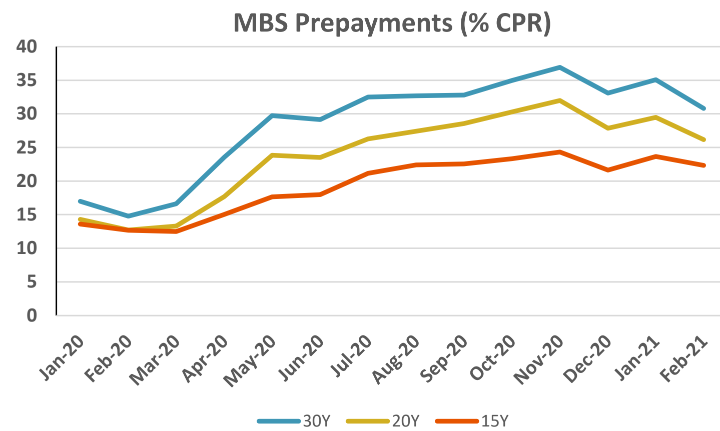
After going through a prepayment wave this past year, investors may be somewhat reluctant to add the negative convexity of the mortgage market. Prepayments rose from a sleepy 13-17CPR, before the drop in rates due to COVID, to 25-35 CPR for the better part of a year on average collateral for 15yr, 20yr, and 30yr MBS (Figure 4). However, looking at the averages does not capture the real pain that investors felt on purchases prior to COVID. For example, a popular 20yr 3.5% with a 2019 vintage pre-paid in the 40-50 CPR range during that period. With typical purchase prices in the 103-104 dollar price range in 2019 and early 2020, this definitely stung portfolio performance.

Figure 3: Interest rates rose over the quarter, with mortgage rates and Treasuries heading higher.



Source: Bloomberg, Piper Sandler

Figure 4:...which should begin to reduce prepayment speeds from very high levels.



Source: Bloomberg, Piper Sandler

As the Fed continues to support the MBS market with purchases and plans to keep short-term rates low, it fosters a positive market for mortgages. The fact that the Fed will allow inflation to move above 2% without changing its accommodative policy, as numerous Fed governors have reiterated, has already pressed inflation expectations to the highest levels in years which has allowed bond yields to rise.

This rise in yields should begin to slow prepayments, although models suggest that it could take a number of months (there is typically a several month lag between rising rates and mortgage prepayments slowdowns due to pipeline refinancing). While this is encouraging for holders of higher-coupon MBS, slowing speeds are a bit of a double edged sword for portfolios. Most mortgages are purchased at a premium, meaning that the earned book yield in the portfolio rises as speed slow. On the other side of the coin, the portfolio extension in a rising rate environment is less than ideal. Some of the lower coupons recently purchased are modeling longer than just several months ago. Now that rates have rebounded from COVID lows, we have better potential for the market to find a range going forward. At present, 15-30yr pass-through paper with fairly current coupons have effective durations similar to 5yr through 7yr bonds with modest prepayment expectations going forward. This creates an interesting comparison between mortgages and other non-callable and callable debt. 5yr AA corporates and callable agencies yield a bit over 1%, while Treasuries and agency bullets yield less than 1%. Compare this to a 20yr pass-through with a 2% coupon yielding 1.70%. The approximately 50-85 bp pick up is substantial for the associated risk, with nearly double the yield of an agency bullet for a modestly longer average life and negatively convex profile.

Similarly, investors are buying strip coupon CMOs with fairly similar yield profiles depending upon the coupon and collateral. Although projected speeds are slowing, we expect baseline prepayments to hold relatively high due to continued housing price appreciation and the still low rate environment. For investors wanting to protect against another dip in rates, principal-only strip coupon mortgages have dipped in price and can be an attractive way to hedge against high future prepayments in the broader portfolio. For example, FHS 314 PO currently has a 4.23yr average life and yields ~2.4% with current prepay projections. It has paid at a 30 CPR over the past 6 months. Even assuming prepayments fall to 15 CPR on this higher coupon collateral (3.75-4.25%), the average life remains below 5 years the yield above 2%. Yet if rates would happen to fall back down, the income would be very high to offset faster prepayments on the broader MBS portfolio. No matter what security is right for your needs, there are many ways to add value in the mortgage market. If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

CONTACTS

Scott Hildenbrand
Managing Director
Head of Balance Sheet Analysis and Strategy
Head of Piper Sandler Hedging Services
212 466-7865

Jim Armstrong
Managing Director
212 466-7978

Jean Bonatucci
Managing Director
212 466-7793

Matt C. Brunner
Managing Director
913 345-3371

Demitrios Delis, Ph.D.
Managing Director
312 267-5158

Mary Marshall
Managing Director
212 466-7890

Justin Hoogendoorn, CFA
Managing Director
312 267-5162

Jorge Puente
Managing Director
212 466-7835

Ryan Smith
Managing Director
212 466-7966

Leah J. Viault, CFA
Managing Director
212 466-7769

Al Cappelli
Director
704 342-7811

Wei Min Li, CMT
Director
312 267-5166

Peter Stettler
Director
312 267-5187

Kris E. Johnson, CFA
Vice President
612 303-0608

Kelly Hughes
Assistant Vice President
212 466-7856

Kevin Wanke
Assistant Vice President
212 466-7988

Sarah De Vries
Associate
612 303-0616

Hill Fleet
Associate
212 466-7825

Mark Clancy
Analyst
312 267-5069

Matt Earley
Analyst
212 466-7816

Jacob Singer
Analyst
646-887-4057

Meet our Team