Invesco

Investment Insights

Agency MBS is an attractive opportunity for long-term Investors

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Overview

- Agency MBS offer implicit US government credit quality and attractive spreads relative to corporate bonds
- Normalization of monetary policy should reduce interest rate volatility and provide a supportive backdrop for the Agency MBS sector.

The consensus outlook for the US economy calls for a benign slowdown accompanied by modest cuts in the Federal Funds target rate beginning in the 2nd half of 2024. Given this backdrop, combined with currently attractive all-in yields but relatively tight spreads on most fixed income securities, there is a preference to stay up in quality and own assets with strong liquidity.

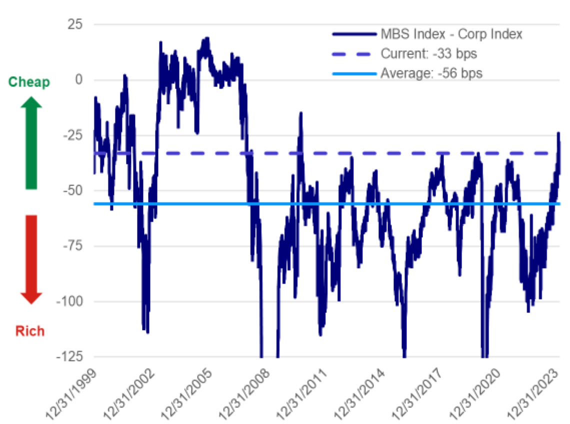
Two large and important fixed income asset classes come to mind when filtering for high quality and liquidity: investment grade corporate bonds and Agency mortgage-backed securities (MBS). While both can represent attractive options, they have very different risk profiles that should be considered when comparing the two. For example, investment grade corporates are subject to default risk and are inherently leveraged to the strength of the economy, while Agency MBS have limited default risk (thanks to an implicit US government guarantee) and often benefit from a “flight-to-quality” in times of economic stress. However, Agency MBS do have risk related to the prepayment behavior of the underlying borrowers in the mortgage pools, referred to as prepayment risk, which can negatively impact the performance of the investment during times of heightened interest rate volatility.

Opportunity in Agency MBS relative to Investment Grade Corporates

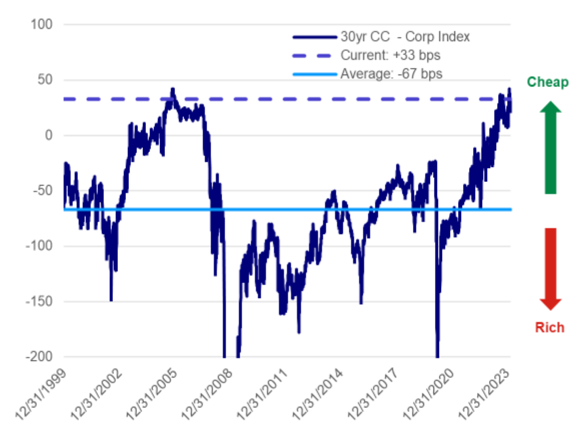
Comparing current valuations of both investment grade corporates and Agency MBS relative to long-term historical averages reveals the former is trading rich while the latter is more attractive. We find the most relevant valuation metric for comparison of the two asset classes in the current environment is the zero volatility (ZV) spread. ZV spread is the yield difference relative to US Treasuries with similar duration, in basis points, unadjusted for both default and prepayment risk.

The two graphs below highlight the relative value currently available in Agency MBS vs. investment grade corporates. The chart on the left illustrates the ZV spread differential between the Bloomberg Agency MBS Index vs. the Bloomberg US Investment Grade Index, while the chart on the right displays higher coupon Agency MBS relative to the same investment grade corporate index. Currently, the ZV spread of the Bloomberg US Investment Grade Corporate Index is in the 7th percentile vs. the last 10 years, while the ZV spread of the Bloomberg US Agency MBS Index is in the 55th percentile over the same period. Furthermore, recently issued, higher coupon Agency MBS are even more attractive, with a ZV spread currently in the 90th percentile over the past 10 years.

MBS Index ZV – IG Corp Index ZV (bps)



30yr Current Coupon ZV – IG Corp Index ZV (bps)



Source: JPM DataQuery
As of: March 15, 2024

Why are Agency MBS currently attractive?

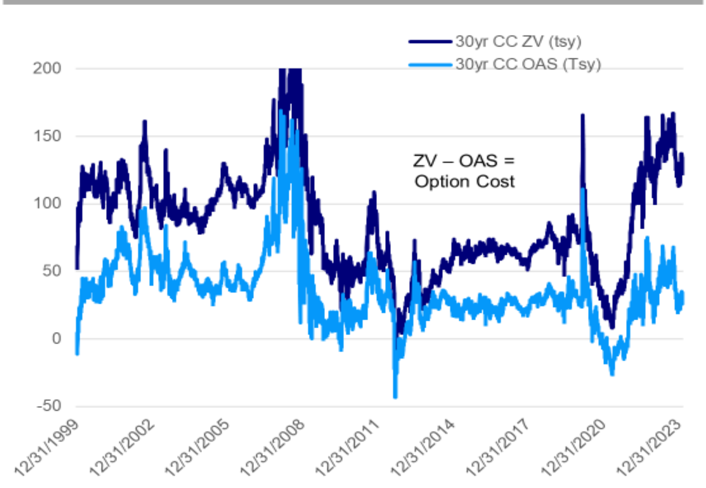
Since March 2022, the Federal Reserve has increased the Federal Funds target rate by 525 basis points. This fast pace of increases and uncertainty of near-term monetary policy resulted in elevated interest rate volatility over the past two years, which is an environment where Agency MBS tend to perform poorly due to the uncertainty of their cash flows. Given this sensitivity, the Agency MBS sector sharply underperformed both US Treasuries and investment grade corporates over that span.

The two graphs below illustrate the impact that interest rate volatility has on Agency MBS valuations by comparing two different valuation metrics: Option-adjusted spread (OAS) and ZV spread. OAS attempts to quantify the impact of interest rate volatility on Agency MBS by modeling prepayment behavior via the calculation of potential cash flows over a wide range of interest rate scenarios. The difference between the ZV spread and OAS is the option cost and is highly correlated with the level of interest rate volatility. Option costs increased significantly as volatility increased, pushing ZV spreads on recently issued Agency MBS to abnormally wide levels.

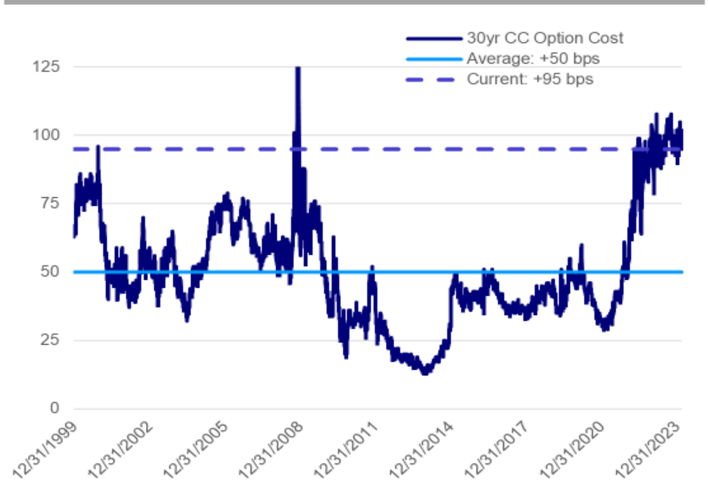
What is the next stage of the rate volatility cycle and what will it mean for Agency MBS performance?

Our medium-term outlook calls for a modest slowdown in economic growth in the US and gradual cuts in the Federal Funds target rate, resulting in a steeper yield curve and lower interest rate volatility. While cuts in the Fed Funds rate and a steeper yield curve create a favorable backdrop for most risk assets, Agency MBS stands to benefit the most from a decline in interest rate volatility as option costs normalize. As a result, we believe conditions should be more conducive to outperformance in Agency MBS as compared to other asset classes. Within Agency MBS, we prefer more recently issued higher coupons as we expect them to see the greatest benefit from normalization of monetary policy and an ensuing decline in interest rate volatility.

30yr Current Coupon ZV & OAS (bps)



30yr Current Coupon Option Cost (bps)



Source: JPM DataQuery
As of: March 15, 2024

All data as of 03/15/24. All data provided by Invesco unless otherwise noted.

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About risk

Note: Not all products, materials or services available at all firms. All data provided by Invesco unless otherwise noted. Data as of March 15, 2024, unless otherwise noted.

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Reinvestment risk is the risk that a bond's cash flows (coupon income and principal repayment) will be reinvested at an interest rate below that on the original bond.

Dollar roll transactions involve the risk that the market value and yield may decline below the price of the mortgage-related securities that have been sold and are required to be repurchased

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