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MBS Players Sing "Help!"

"Help. I need somebody. Help. Not just anybody…Won't you please, please, help me!" Such is the old Beatles tune that many mortgage backed securities (MBS) investors may be singing right now as long-term interest rates have increased almost 100 basis points in just one month. Clearly, it is no surprise that the increase has led to the MBS market recording a negative excess return of -22 basis points versus treasuries for the first 18 days of July. And, this is just the beginning of the pain!

As we all know, the bond market has been making history over the past 18 months. As yields hit 40 year lows, many strange and unusual relationships evolved in many of the fixed income sectors. We've read about the dramatic spread widening, significant downgrades, record defaults and recent spread tightening of corporate bonds. Corporates made numerous headlines and were the subject of two DHJA monthly newsletters. But behind the scenes, MBS were approaching their own "perfect storm."

As background, MBS are pools of mortgage loans on the homes of regular people like you and me with similar characteristics. Thus, the investor who owns the MBS receives the scheduled principal and interest payment that we make, as well as any principal prepayments. Mortgage prepayments happen regardless of the level of interest rates. They occur because of normal demographic trends such as job relocations, moving to a new home, death, divorce or because some people just want to pay down their principal early. But, prepayments increase substantially when mortgage rates fall, creating an opportunity for us to save money by refinancing at the lower rate. We refer to this as our old mortgage being "in the money." When one refinances and pays off their old mortgage loan, the principal payoff is a prepayment to the holder of the MBS containing that individual loan.

Since the modern MBS market didn't start until the late 1970's, it has never experienced low interest rates like today's. Thus, it is no surprise that prepayments skyrocketed to unimaginable levels in this current cycle. In fact, some pools saw their prepayments increase 300% in just a few months, with a few reaching the unthinkable 90% CPR (constant prepayment rate). High prepayments cause MBS to have unusually short average lives and, in turn, very short effective durations (price sensitivity to changes in interest rates). The table below is good illustration of the impact of low interest rates on the $2.6 trillion MBS fixed rate agency market.

	Lehman Aggregate Index Duration	Lehman Mortgage Index Duration	10-Year Treasury Yield
1999	4.92	4.27	6.49
March 2003	3.85	1.11	3.79
May 2003	3.84	0.58	3.35
July 2003	4.17	1.83	4.00

As recently as 1999, the mortgage market had a similar effective duration as the overall broad fixed income market as measured by the Lehman Brothers Aggregate Index. At that time, they both had an approximate price sensitivity of a 5-year treasury note. As rates plunged, prepayments skyrocketed. Thus, in May 2003, the mortgage index's duration declined from 4.27 to .58! In other words, the mortgage market began to trade not like a 5-year treasury but something less than a ONE-YEAR! Because the MBS market represents 34% of the Aggregate Index, this caused the Aggregate's duration to drift down from 4.92 to 3.84. To keep up with this duration shrinkage, many mortgage players had to buy longer securities to maintain their duration target. This added enormous fuel to the treasury rally.

Like musical chairs, what happens when the music stops? In the bond market, it appears that somebody recently stopped the music and the market is scrambling for all the remaining chairs. Long-term interest rates have risen almost 100 basis points since mid-June. Over this time period, the percent of fixed-rate agency mortgage pools that are at least 75 basis points "in the money" for the homeowner has plunged from 83% to 59%. Thus, it is no surprise that the market is adjusting to what will be significantly lower prepayments in the future. With slower prepayments comes the dreaded mortgage "perfect storm"-dramatic extension! Already, the mortgage market duration has extended from its 0.58 low in May to 1.83.

As before, mortgage players have to adjust quickly. This time, they are selling securities to maintain their duration targets as their mortgage portfolios extend. In fact, this phenomenon has exacerbated the treasury sell-off. If you look at this extension, it is the equivalent of the market having to sell approximately $380 billion of 10-year notes to stay duration neutral. What's worse, if rates rise just another 70 basis points, the percent of mortgages 75 basis points "in the money" declines to just 26%. In this scenario, it is estimated that the mortgage index duration would extend to 3.10 adding further pressure to a fragile bond market. The estimated equivalent in additional sales of 10-year treasury notes needed to stay duration neutral is another $410 billion!

Like all storms, ultimately the clouds will clear. Thus, we see the recent mortgage underperformance as an enormous opportunity and have been purchasing mortgage pools known as balloons. These balloons are just like regular mortgage pools except they have stated final maturities of less than seven years and, in some cases, less than five years. Thus, the extension risk is minimal under any interest rate increase. We at Davis Hamilton recognize that it may be a "long and winding road" before we "get back" to pre-treasury bubble markets. Until then, we are always looking for ways to add value to our clients.

-Gilbert A. Garcia
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A copy of our Form ADV, Part II is available upon request.
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