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Singing "Help"
Part Deux

In mid-July, we referenced several Beatles tunes as we wrote extensively about the mortgage backed securities (MBS) market in our monthly letter entitled MBS Players Sing "Help!" In that letter, we described how the MBS market was heading for its own perfect storm as record prepayments were causing the entire MBS market to trade near the same duration (price sensitivity) as a one-year treasury note. Thus, we highlighted that the MBS market was vulnerable to significant underperformance and extension risk as soon as interest rates began to increase. And as Paul Harvey says, "now, the rest of the story."

By late July, market psychology changed as economic statistics showed an improving economy and many began to expect higher interest rates. As a result, the duration of the MBS Index increased from a low of .58 in May to 3.05 by month-end July. This increase in MBS durations increased the entire Aggregate Index's duration from 3.84, close to its all-time low, to a more normal 4.48. But what should have been a small, secular rise in interest rates turned into a rout as MBS players began to sell longer treasuries to keep their durations neutral. As shown below in Figure 1, it was as if $830 billion in 10-year treasury notes hit the market in two months. Try that for new supply! Thus, the 10-year treasury yield rose to 4.41% by month-end July, a 130-basis point increase from the lows of June 13.

Figure 1	MBS Index Duration	10 Year Yield (%)	Equivalent Sale of 10-Year Notes	Cumulative Total Sale of 10-Year Notes
May2003	0.58	3.37		
June 2003	1.02	3.52	$145 billion	$145 billion
July 2003	3.05	4.41	$685 billion	$830 billion

With this market backdrop, it should be no surprise that MBS recorded their worst monthly performance in July, with an excess return of -1.53%. Even sophisticated investors could have easily gotten the MBS market wrong this summer, as it had never experienced such an interest rate scenario. It should also be no surprise that investors began to question the interest rate risk and hedging capabilities of FHLMC and FNMA-the World's largest MBS holders.

Since our July letter, we have received numerous calls and comments from both clients and consultants. Few ever realized that the MBS market could have such an impact on the treasury market. So, let's review some background. When the Lehman Brothers Aggregate Index (LBAI) started in 1976, the bond market had a market value of almost $460 billion, with treasuries representing 32% of the Index and MBS representing 5%. Thus, the MBS market was like a small tail of a much larger dog.

Several things happened between 1976 and today. First, the bond market increased to today's $7.8 trillion market value. Second, MBS became a widely accepted asset class as CMO's and other derivatives brought new buyers into the sector. Third, the budget surpluses of the 1990's led to a shrinking treasury market. Now, the MBS market is 35% of the market value of the LBAI while treasuries make up only 22%! Thus, what started as the "dog wagging the tail" has evolved into the "tail wagging the dog."

Logically, one frequently asked question we received from both clients and consultants was "when will all this MBS stuff end and how high could it drive interest rates?" Or, as a Beatle fan might ask, when will this MBS stuff start "getting better?"

The MBS Index duration ended July at 3.05, not too far from today's 2.99. As illustrated in Figure 2 shown below, a more normal MBS Index duration level based on past experience is closer to 4.05, with a more normal Aggregate Index duration closer to 4.70. To get to these duration levels from here, the treasury market will again come under extreme pressure from MBS participants who will be looking to sell duration in the face of another wave of MBS extensions. We estimate that such a duration extension would add another $340 billion of pressure of 10-year treasury note sales on the market, driving the 10-year treasury yield higher to a level near a 5.25-5.50% equilibrium range.

Figure 2	MBS Index Duration	Aggregate Index Duration	10 Year Yield (%)	Equivalent Sale of 10-Year Notes	Cumulative Total Sale of 10- Year Notes
Yr end 1989	4.11	4.56	7.94		
Yr end 1999	4.27	4.92	6.44		
May 2003	0.58	3.84	3.37		
June 2003	1.02	3.95	3.52	$145 billion	$145 billion
July 2003	3.05	4.48	4.41	$685 billion	$830 billion
Stabilization?	3.75-4.25	4.45-4.95	5.25-5.50	$340 billion	$1,170 billion

So, by the time MBS players start singing "here comes the sun," the 3.11% low on the 10-year treasury yield on June 13 could end up in a 5.25%-5.50% trading range. Between here and there, the market will have experienced hedging pressure of almost $1.2 trillion in 10-year treasury notes, an amount close to 70% of the entire treasury sector in the Aggregate Index. It is no wonder the rate increase could be one of the most surprising in history.

-Gilbert A. Garcia
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