DUCENTA SQUARED
ASSET MANAGEMENT

# Monthly Fixed Income Insight

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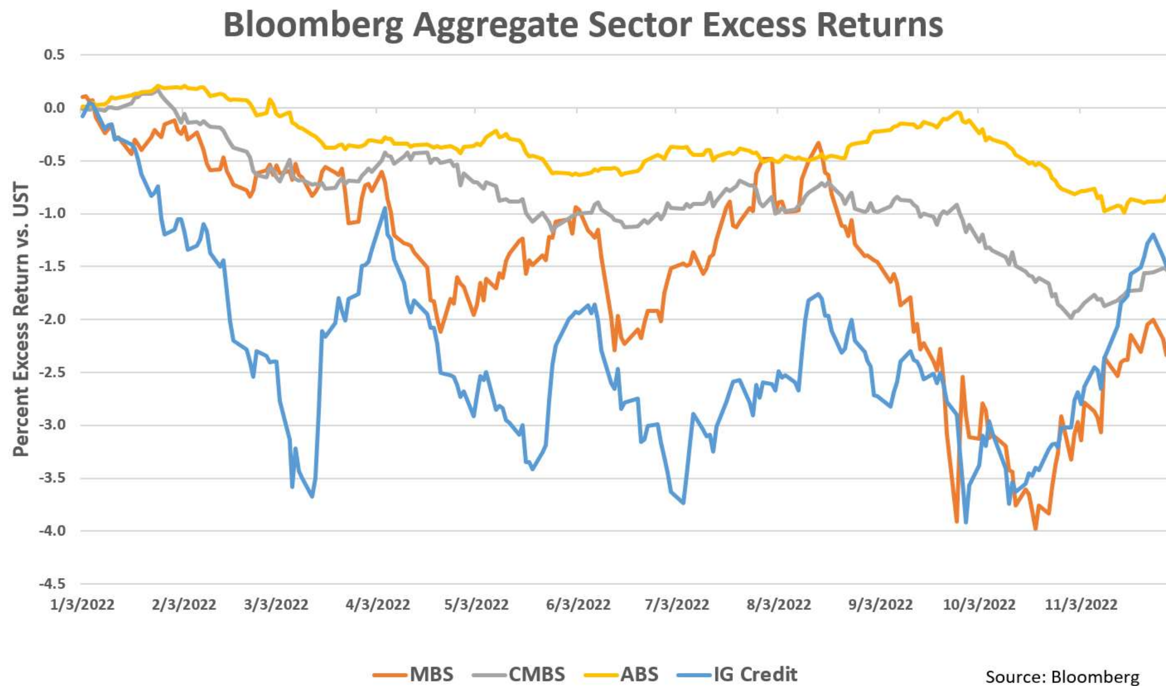
## Are Agency Mortgage Bonds Poised for Outperformance in 2023?

The year 2022 was an extremely challenging period for the fixed income markets and especially for agency mortgage-backed securities (MBS). We believe 2023 should be a good year for the overall bond market, but will we also see a rebound in the beaten-up agency MBS sector?

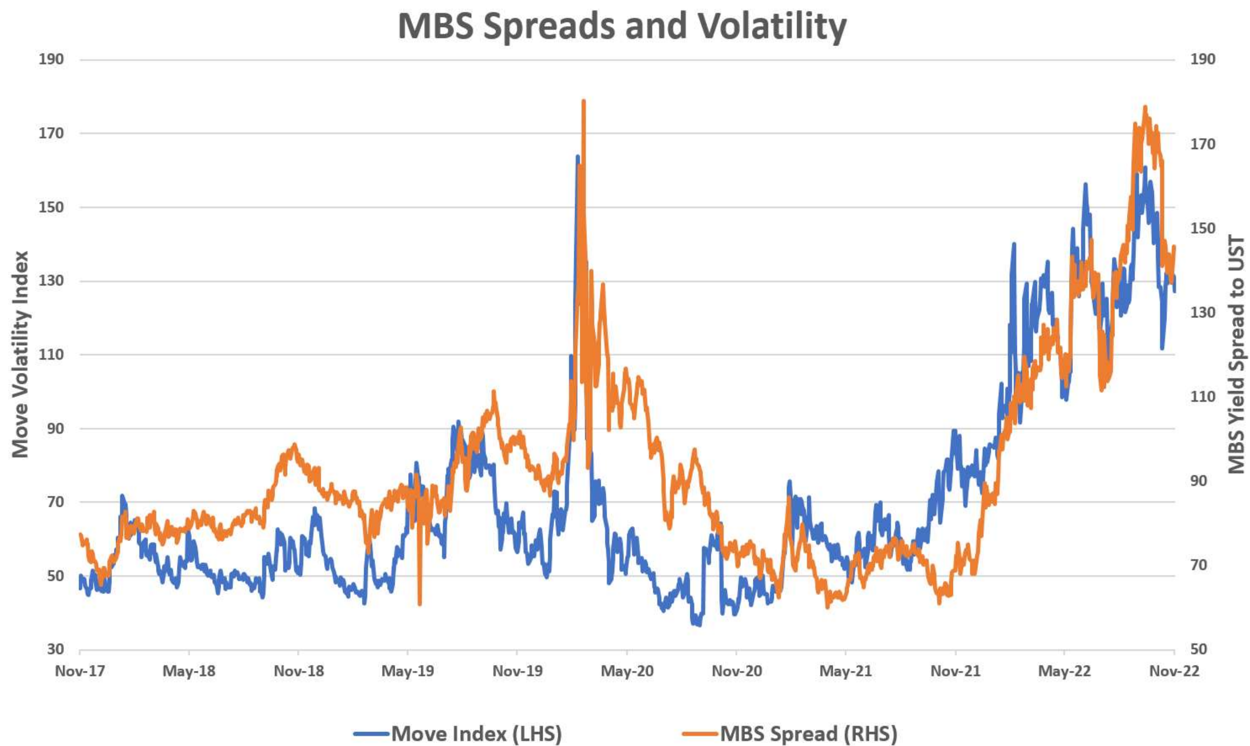
**Review of MBS Performance in 2022**

A perfect storm of higher interest rate volatility, weak supply and demand technicals, and the transition by the Federal Reserve to quantitative tightening all weighed heavily on mortgage performance. Below, the graph of excess returns for the major fixed income sectors versus comparable duration US Treasuries highlights the poor performance of the overall market in 2022. Through November, agency MBS is the worst performing sector, lagging US Treasuries by 2.26% and investment grade credit by 0.84% on an excess return basis.




**Mortgages Struggle with Elevated Volatility**

One of the principal drivers of the mortgage underperformance in 2022 was the elevated interest rate volatility created by a combination of inflation uncertainty, aggressive Federal Reserve rate hikes, and poor market liquidity. Mortgage-backed securities, which include an embedded option allowing homeowners to refinance, are particularly vulnerable to bouts of high volatility. The graph below shows the negative impact of record-high volatility on mortgage yield spreads and the currently attractive valuations for the sector.




**The Tide Rolls Out on Federal Reserve Mortgage Purchases**

Another important cause of the MBS underperformance was the shift by the Federal Reserve from purchasing mortgages through its quantitative easing program in support of the pandemic to quantitative tightening by allowing mortgage holdings to run off its balance sheet in response to persistently high inflation. During the quantitative easing phase starting in March of 2020, the Federal Reserve was the dominant buyer of mortgages, purchasing $40 billion in agency MBS per month. The Fed's cumulative $1.3 trillion of mortgage purchases during the program pushed mortgage valuations significantly richer. With inflation pressures on the rise, the Federal Reserve stopped adding mortgages in March of 2022 and by September was allowing up to $35 billion in mortgages roll-off its balance sheet. With inflation at a 40-year high, the prospect that the Fed would be forced to outright sell mortgage holdings into a very fragile market increased the pressure on MBS valuations.

**Cheap Valuations but No Buyers**

Throughout 2022, the mortgage market strained to find a replacement buyer for the previously dominant Federal Reserve. US banks, a traditionally large buyer of MBS, were sidelined by slowing deposit growth and concerns over rising interest rates. Overseas buyers in Japan and China were absent, while money managers remained on the remained underweight until valuations became more attractive later in the year. Somewhat offsetting the lack of demand was the decline in mortgage supply as mortgage rates touched 7% and the housing market slowed dramatically.

**Our Outlook for 2023**

We enter the new year still defensive and underweight the mortgage sector but believe opportunities to add to our MBS holdings will emerge in the first half of 2023. We anticipate a decline in interest rate volatility as inflation pressures gradually subside and the Federal Reserve ends the hiking cycle. We

currently expect the Federal Reserve to conclude raising rates in March and hold steady for the balance of the year. Next, we do believe mortgage valuation are attractive with yield spreads 1.45% above US Treasuries, which is near pandemic levels and well above the five-year average of 0.93%. We also believe the market technicals should improve with continued low supply and a potential return of bank buyers on an increase in deposits, slower loan growth, and a peak in interest rates. Lastly, we expect agency MBS, which lack credit risk, to benefit relative to investment grade credit, as economic growth contracts in 2023 and credit fundamentals deteriorate.

**Past performance is no guarantee of future results.**

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