

MBS Market Update: Reconsidering the Fed

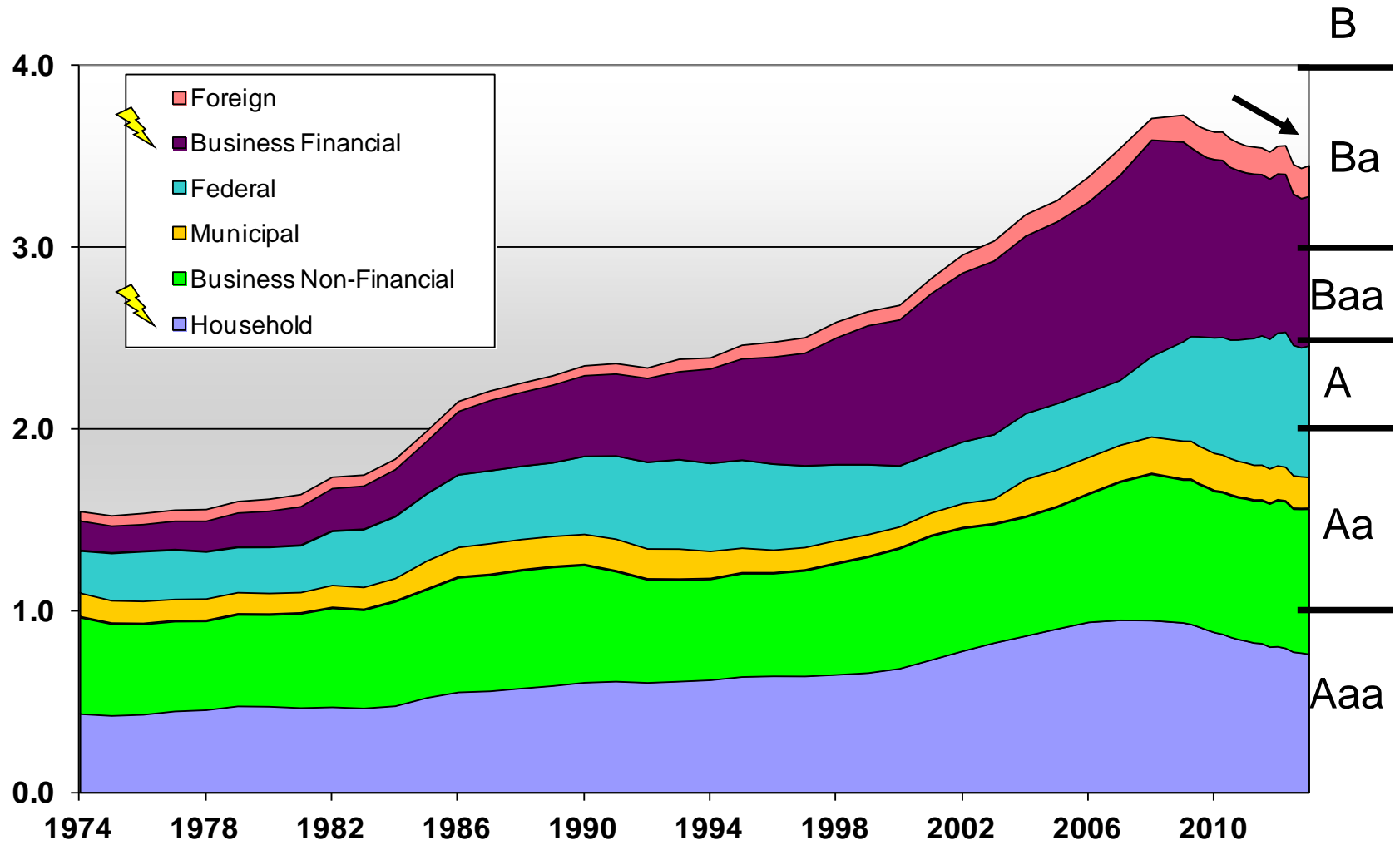
Walt Schmidt, CFA
March, 2014

Four Main Themes (While We Wait for Future)

- The Fed has BEGUN to unwind extraordinary assistance.
- Certainty about Fed tapering has REDUCED VOLATILITY.
- Curve in 2014 will likely remain STEEP, but next BIG MOVE is for a FLATTER CURVE.
- CONVEXITY and ROLLDOWN now, wider windows for 2015 and beyond.

It Takes More Than a 1/2 Decade to Work off this Debt

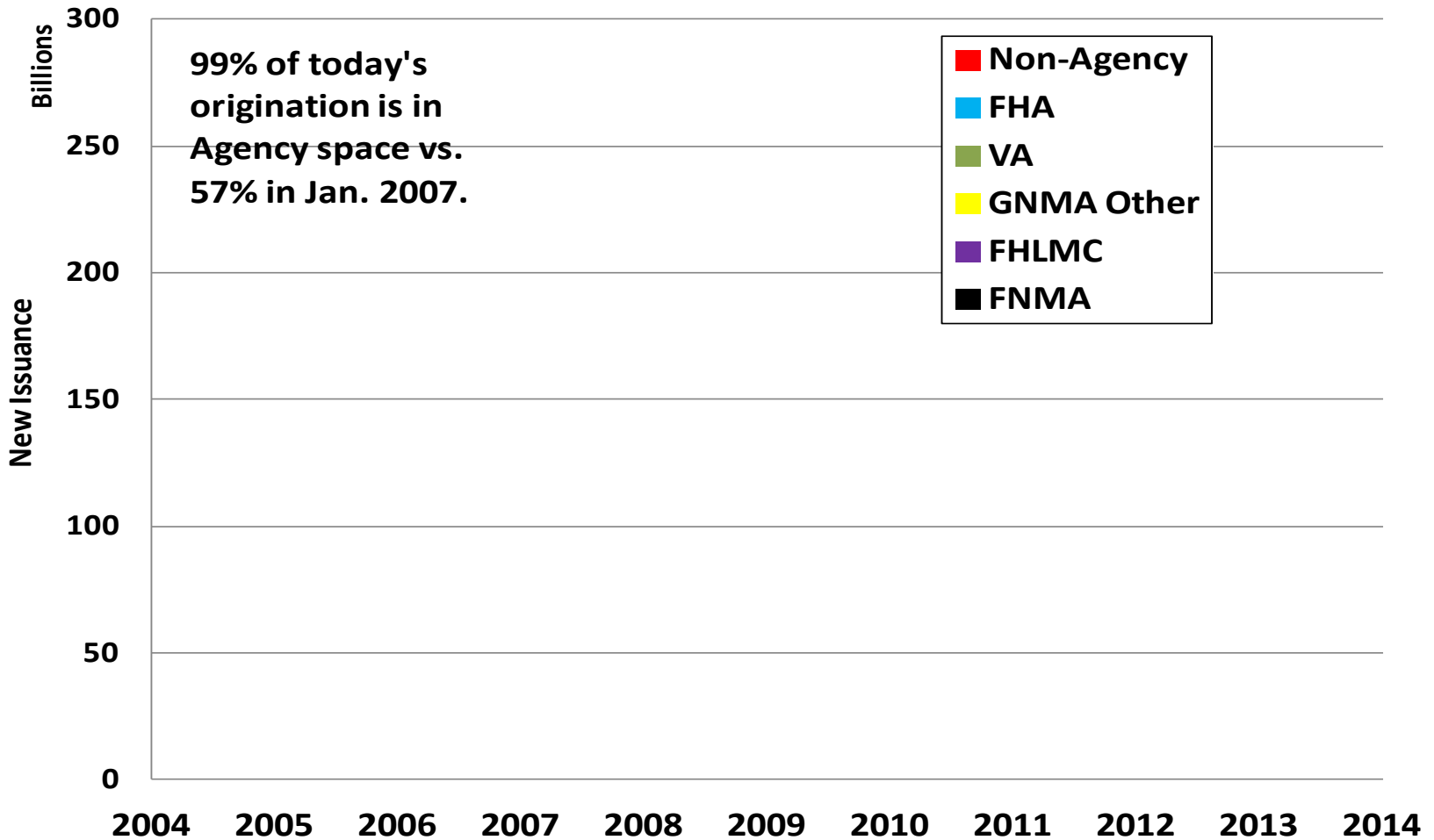
Debt to GDP in the U.S. Economy (Through Q4 for 2013)



Source: Bloomberg, Federal Reserve, US Treasury Dept.

And Over 99% of New Issue Flows

Securitized Mortgage Market Origination

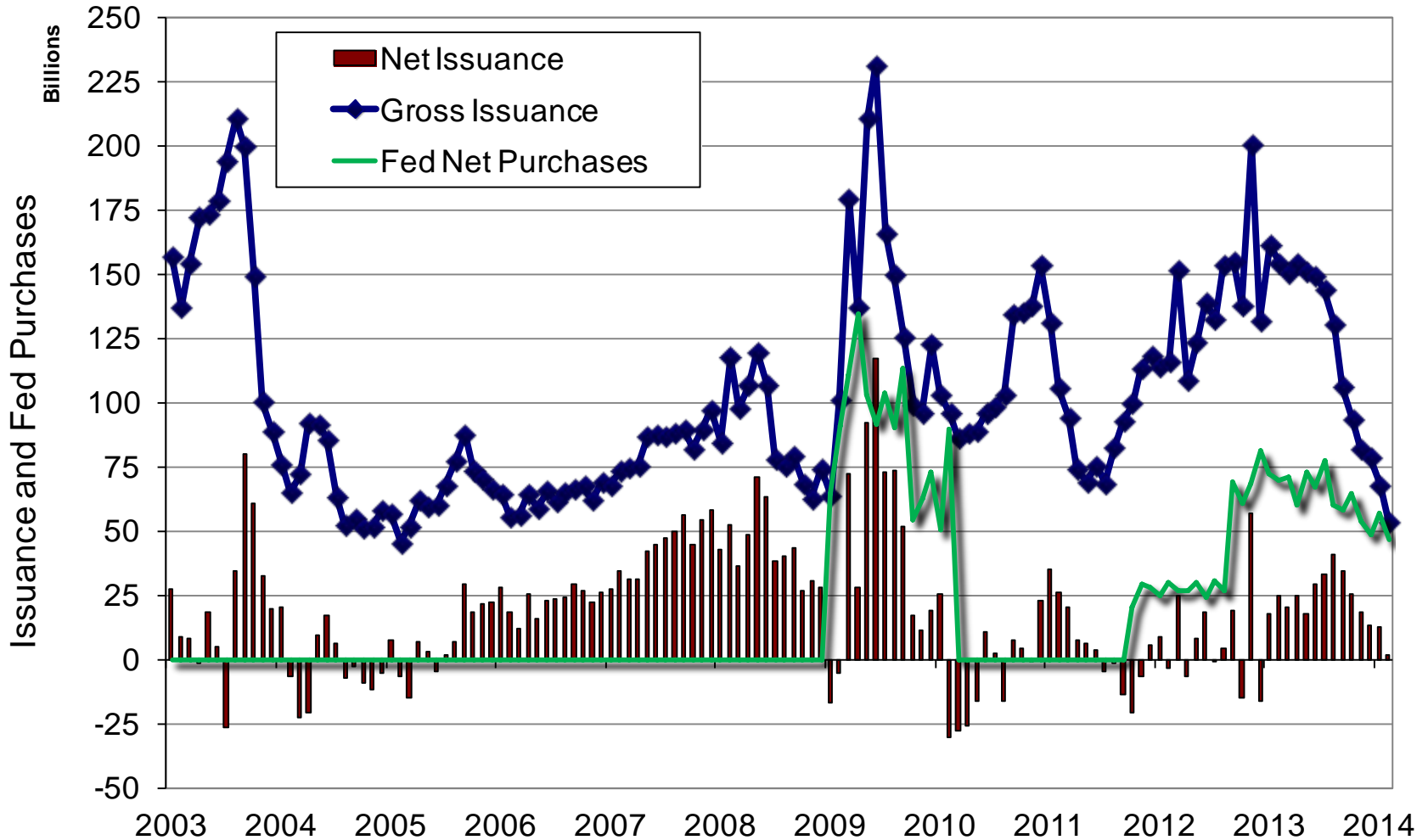


Source: Bloomberg, Federal Reserve, US Treasury Dept.

Supply Starting to Retreat with Purchases

Agency Fixed Rate Securitized Issuance

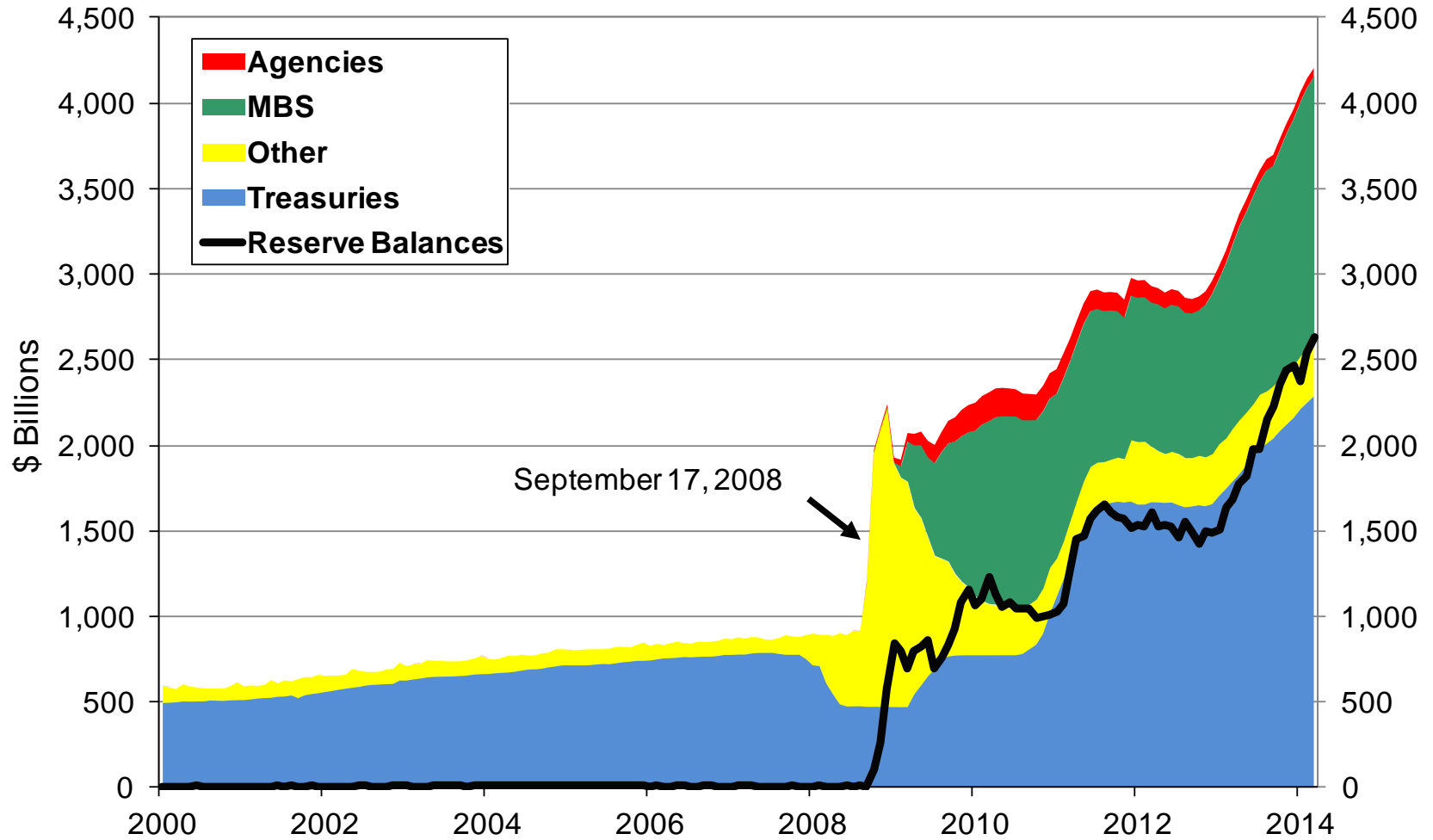
Gross Issuance (Lines) Net Issuance (Bars)



Source: FTN Financial and KDS Global

Fed's Balance Sheet Continues to Grow Outright...

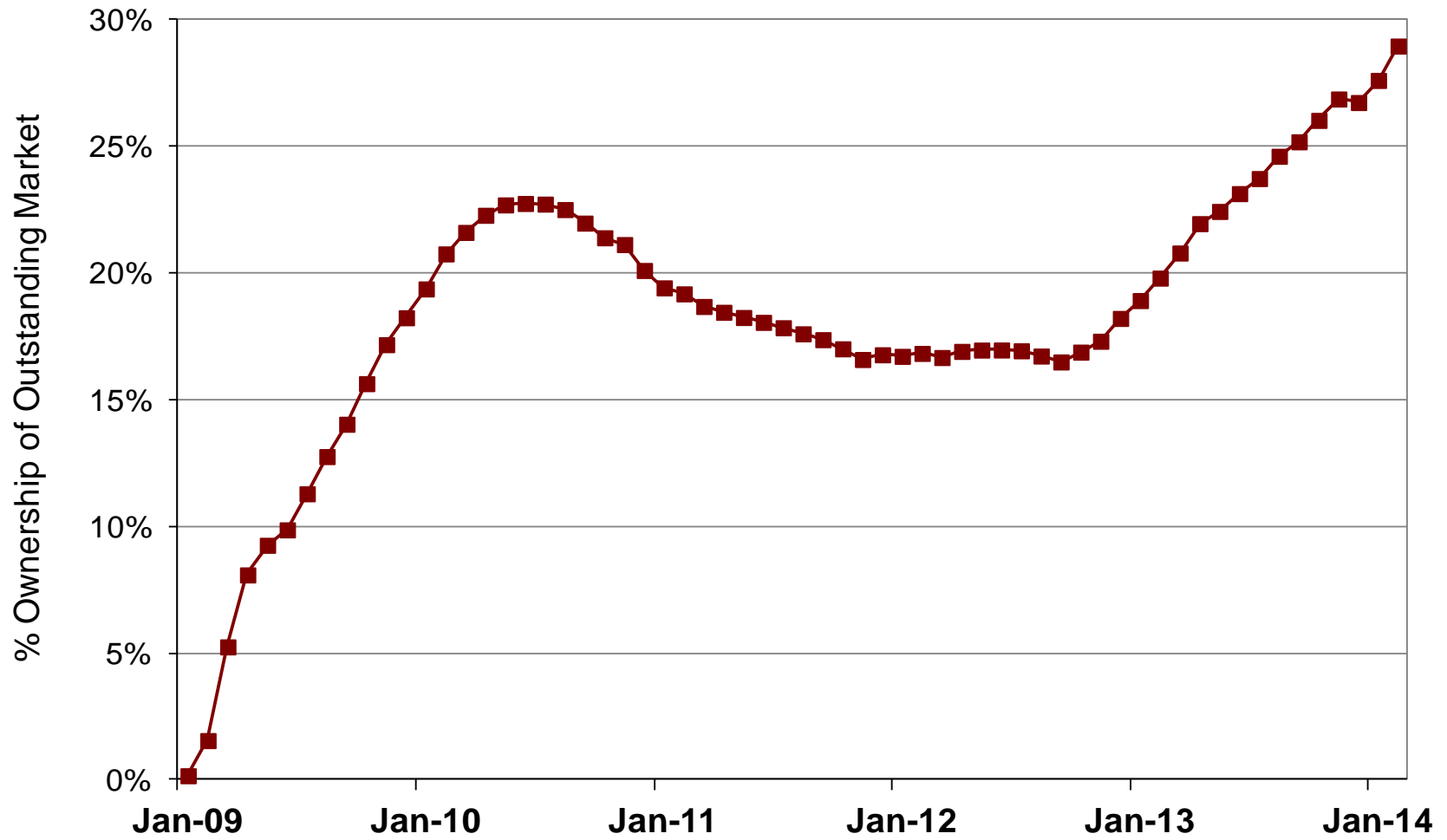
U.S. Federal Reserve Balance Sheet



Source: FTN Financial and the NY Fed

...And As a Percentage of Overall MBS Market

Fed Ownership of Outstanding Fixed MBS Market
January 2009 - Current



Source: FTN Financial, NY Fed and KDS Global

Bank Holdings Have Flat-Lined Since 2012

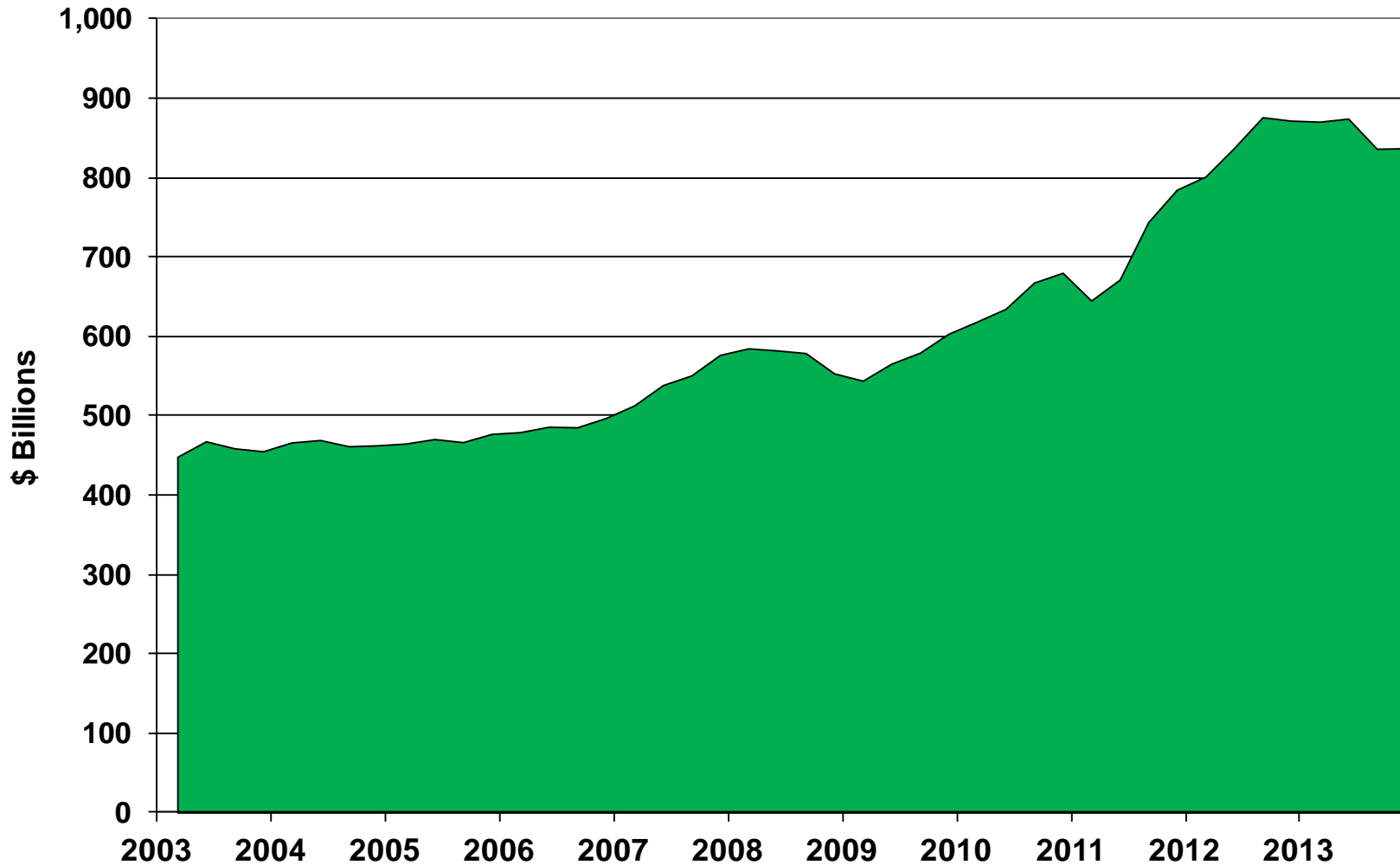
U.S. Commercial Bank Agency MBS Holdings



Source: FTN Financial, NYFRB

Money Managers Turned Cautious in 2013

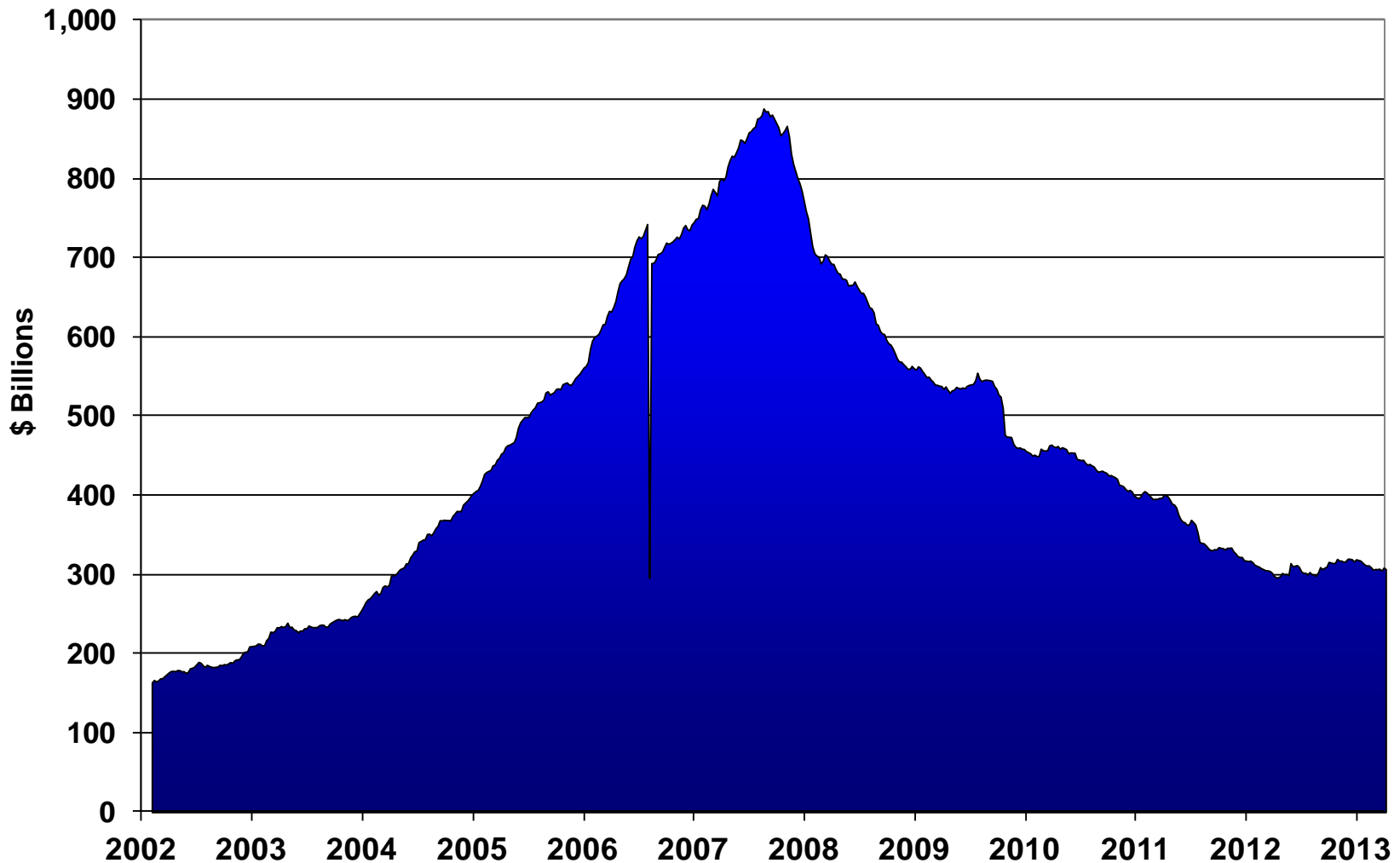
Mutual Fund Holdings of MBS and Agencies



Source: FTN Financial, NYFRB

Foreign Holdings Have Flat-Lined, As Well

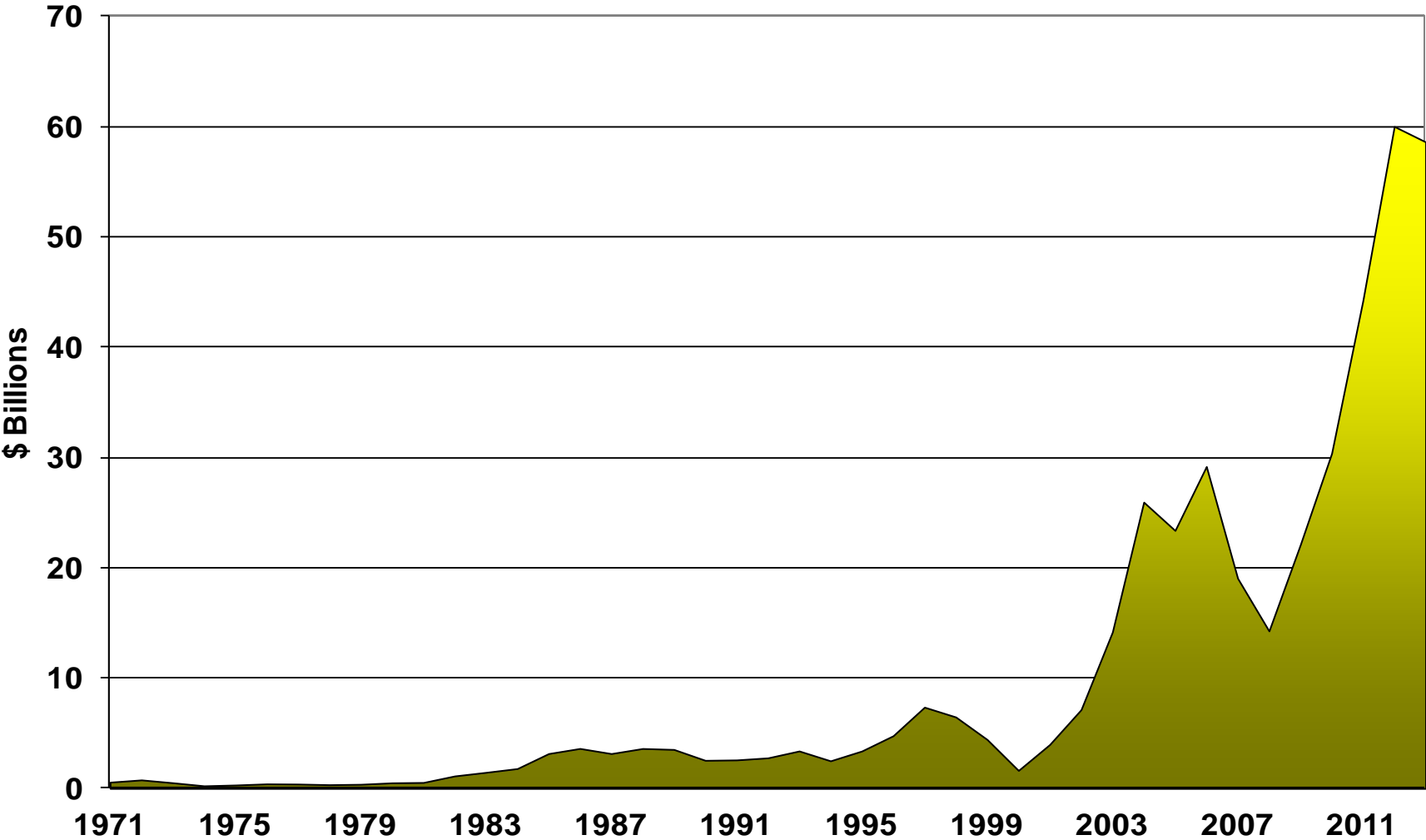
Foreign Official Holdings of MBS and Agency Securities



Source: FTN Financial, NYFRB

Growth in REITs Looks To Be Over

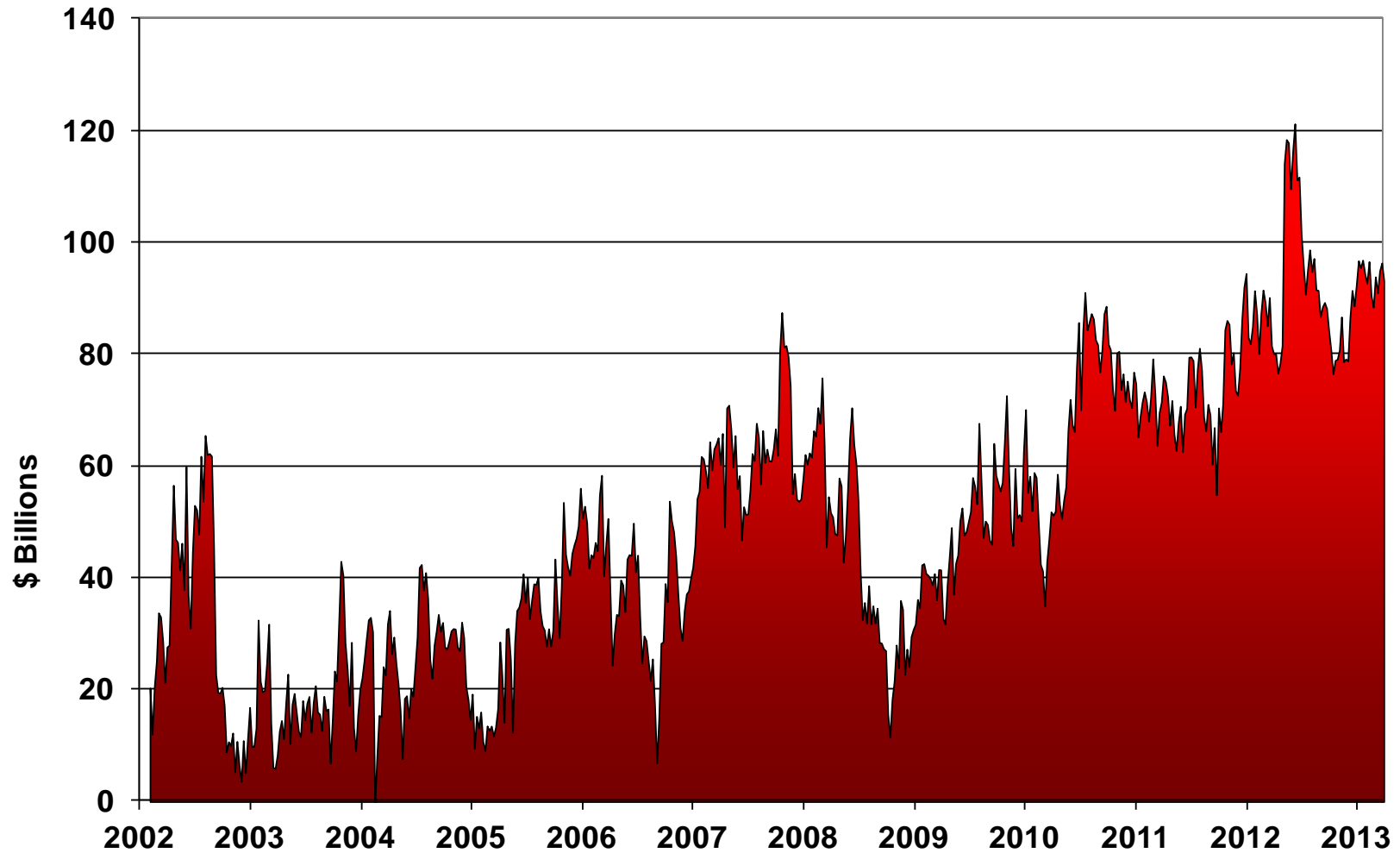
Mortgage REIT Market Capitalization



Source: FTN Financial, NYFRB

Dealers Are Very Involved Currently – Steep Curve

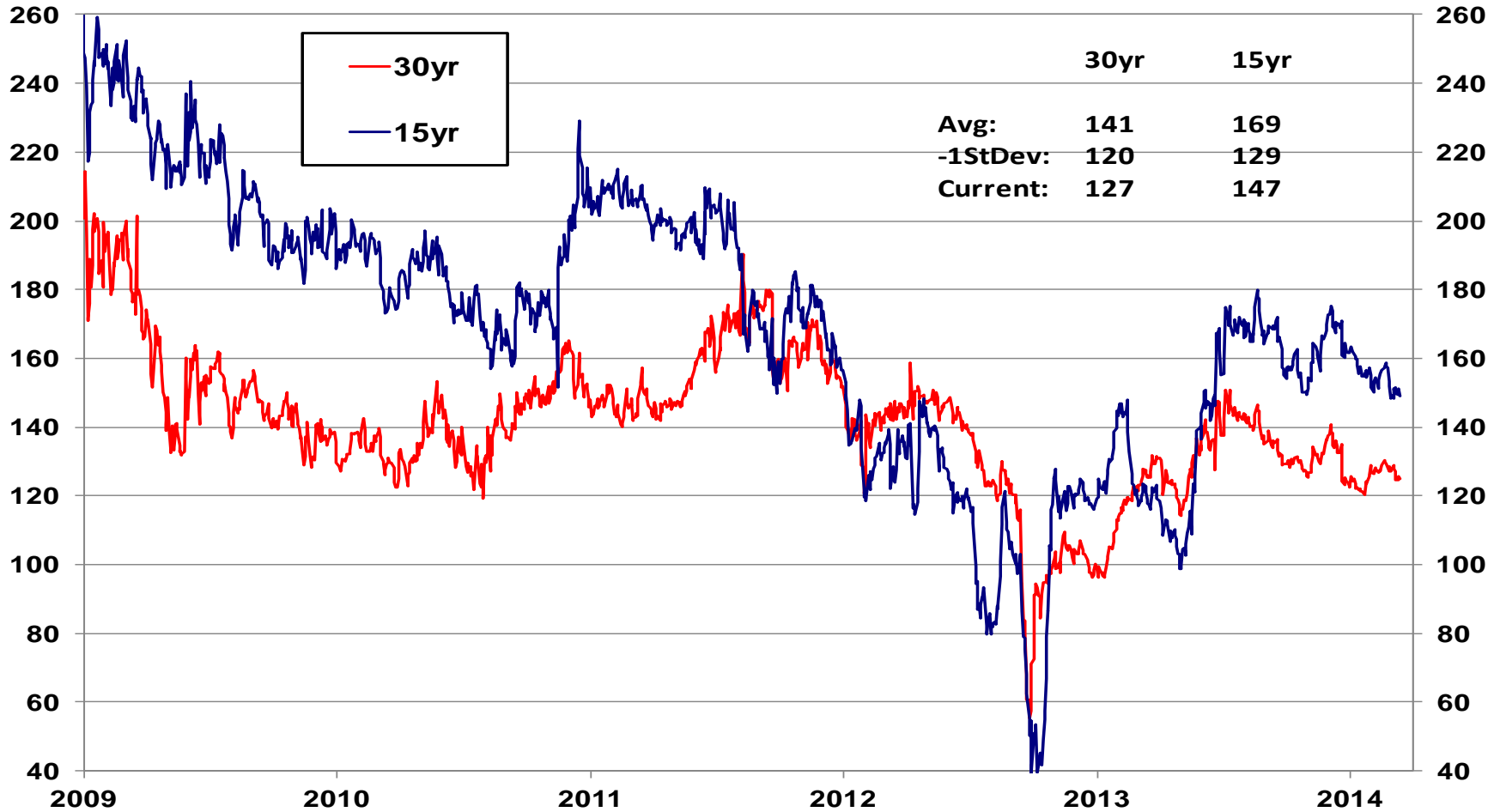
Dealer Holdings of MBS Securities



Source: FTN Financial, NYFRB

MBS Spreads Now “Fair”?

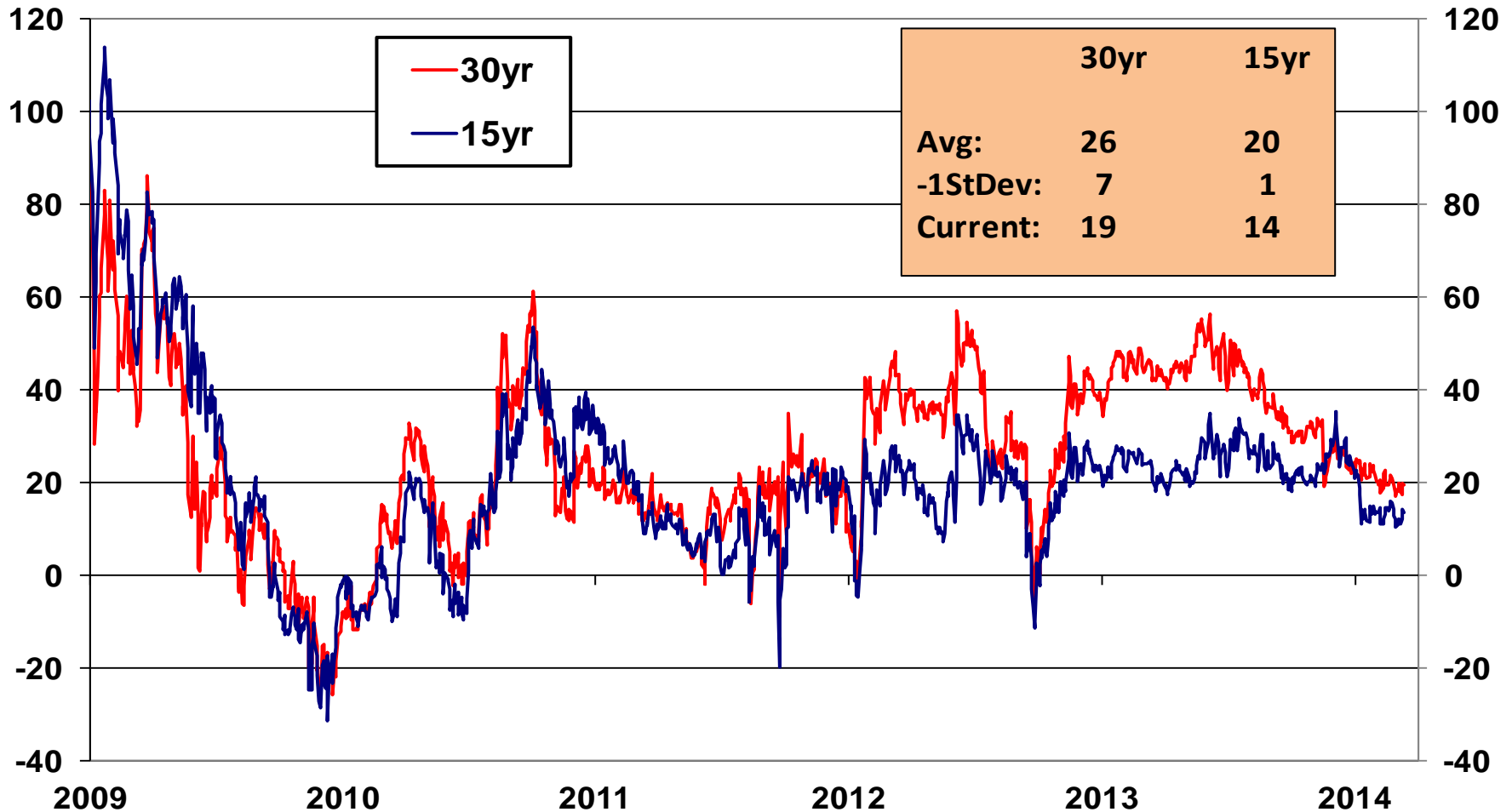
FNCL MBS Static Spreads
30yr Current Coupon vs 5/10 UST Blend
15yr Current Coupon vs 2/5 UST Blend



Source: FTN Financial and Bloomberg

LOAS Levels Very Close to QE Averages

MBS LOAS Since 2009 FNCL 30yr and 15yr LOAS

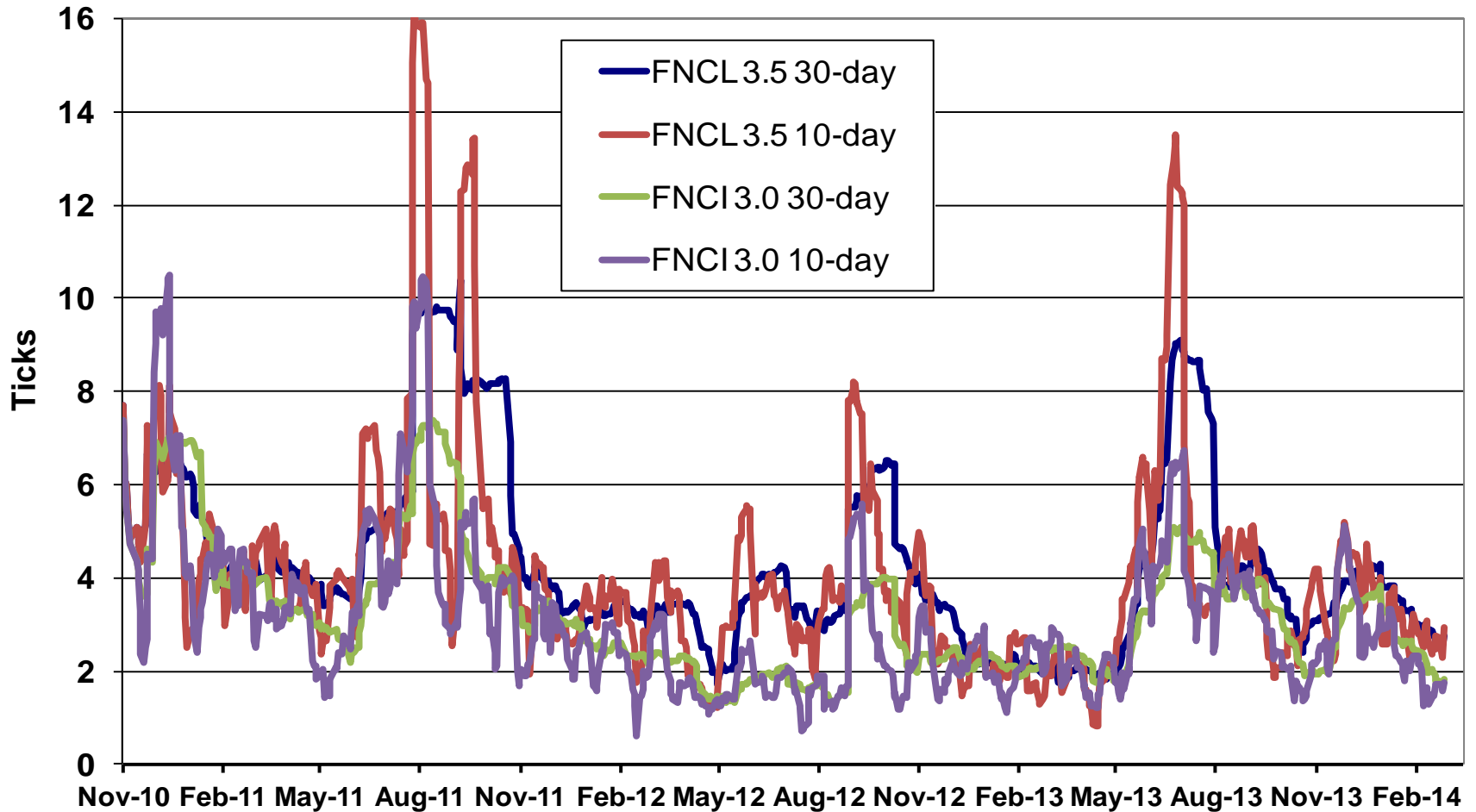


Source: FTN Financial and YieldBook

Vol Has Plummeted In Light of Fed Clarity

Standard Deviation of MBS Performance

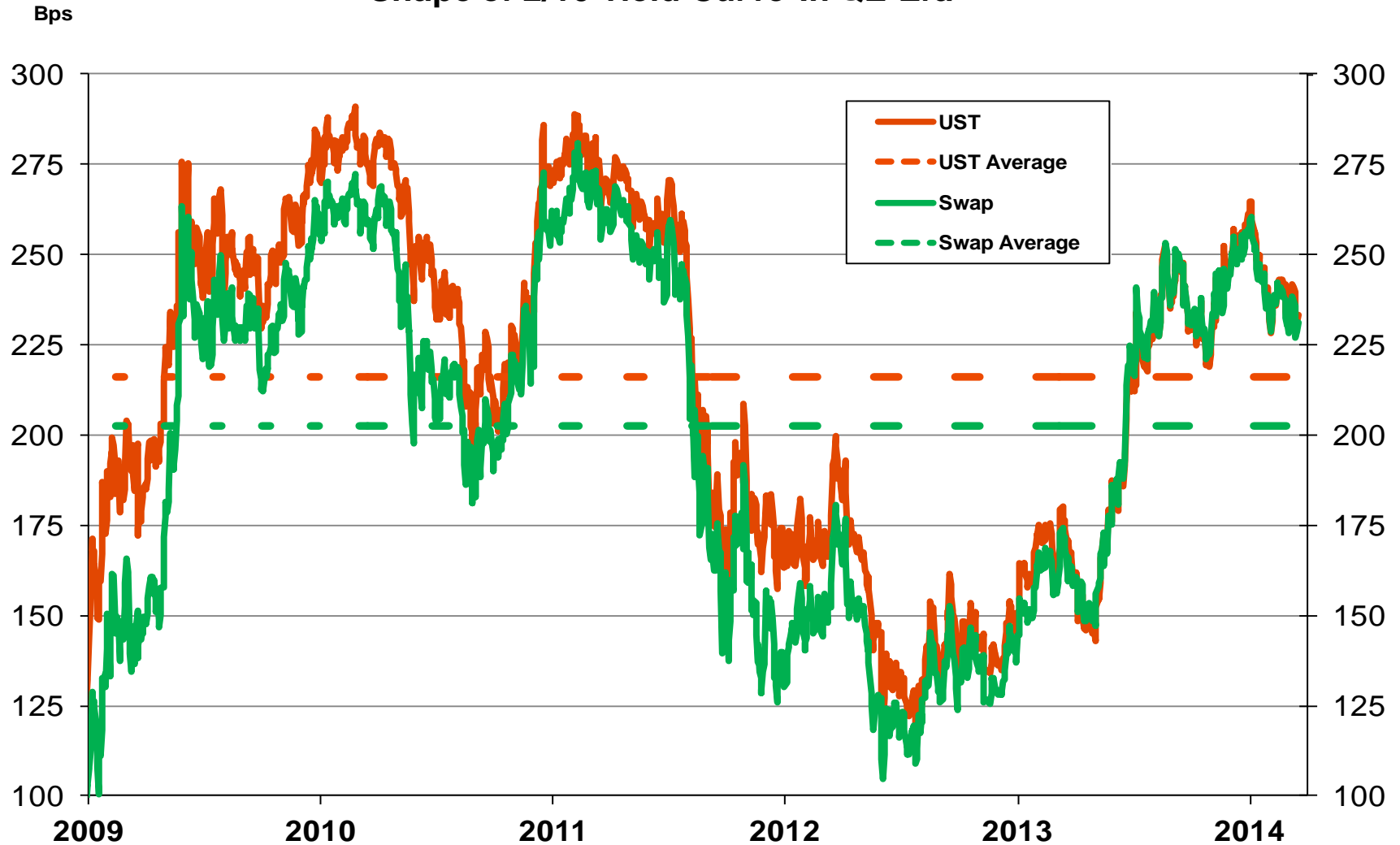
FNCL 3.5 and FNCL 3.0 vs 2/5/10 UST Curve



Source: FTN Financial and TradeWeb

Curve Still VERY Steep

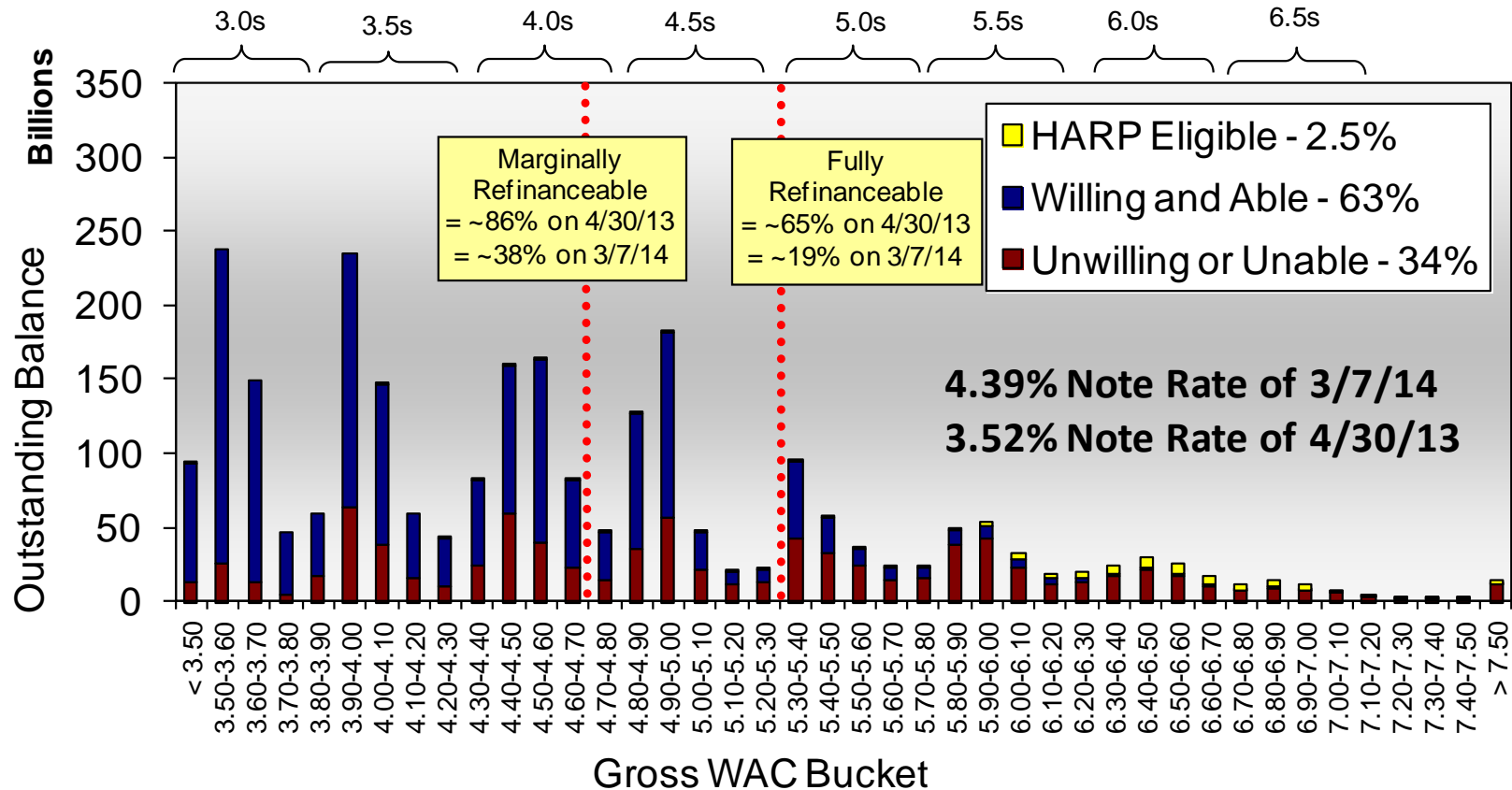
Shape of 2/10 Yield Curve In QE Era



Source: FTN Financial and Bloomberg

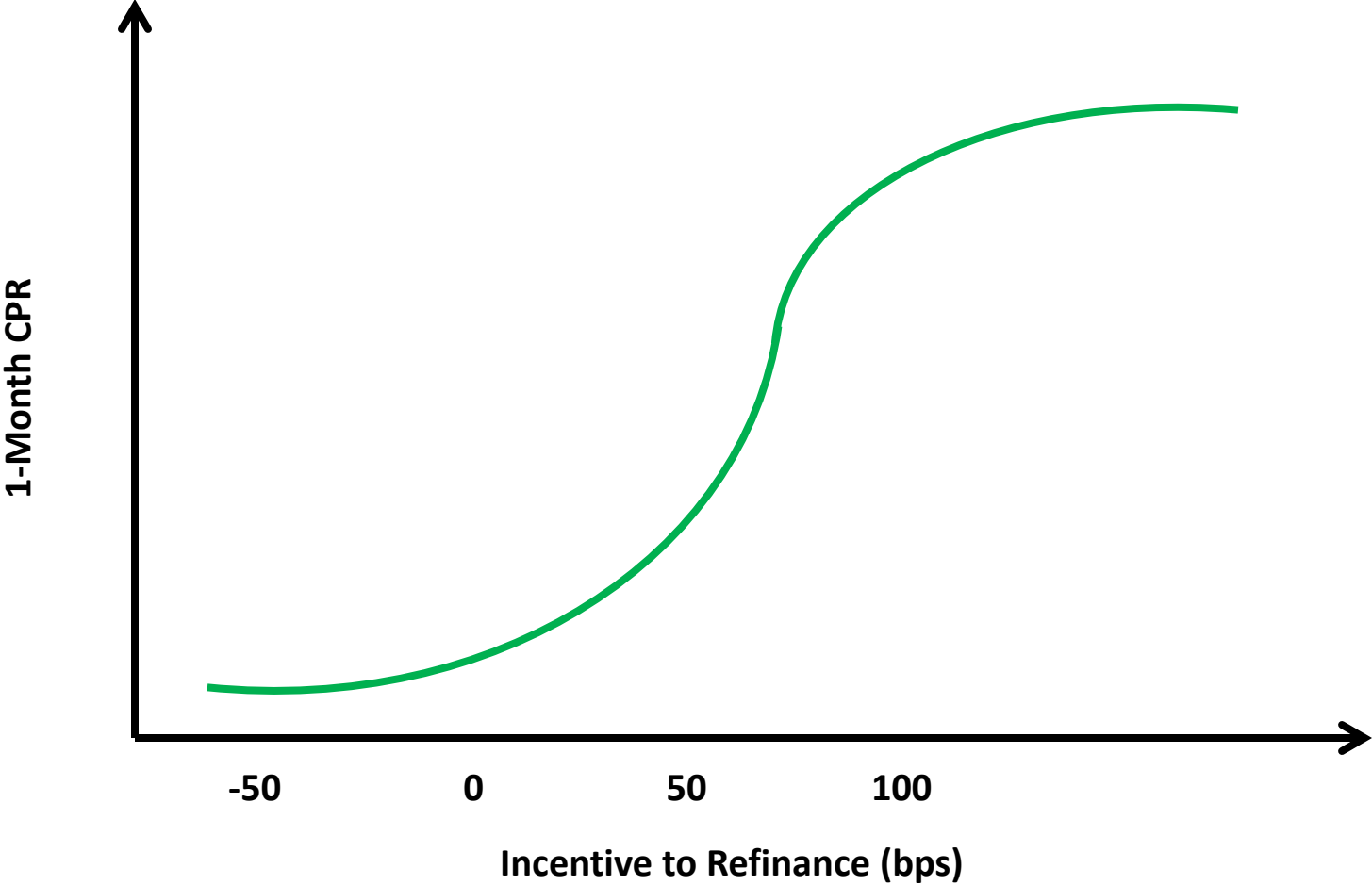
“Money-Ness” Of the MBS Market Has Changed

30yr Conventional Fixed Thresholds: 80 LTV, 720 FICO, and 150k LB



Source: FTN Financial and KDS Global

The “S” Curve: Essential View of Prepayments



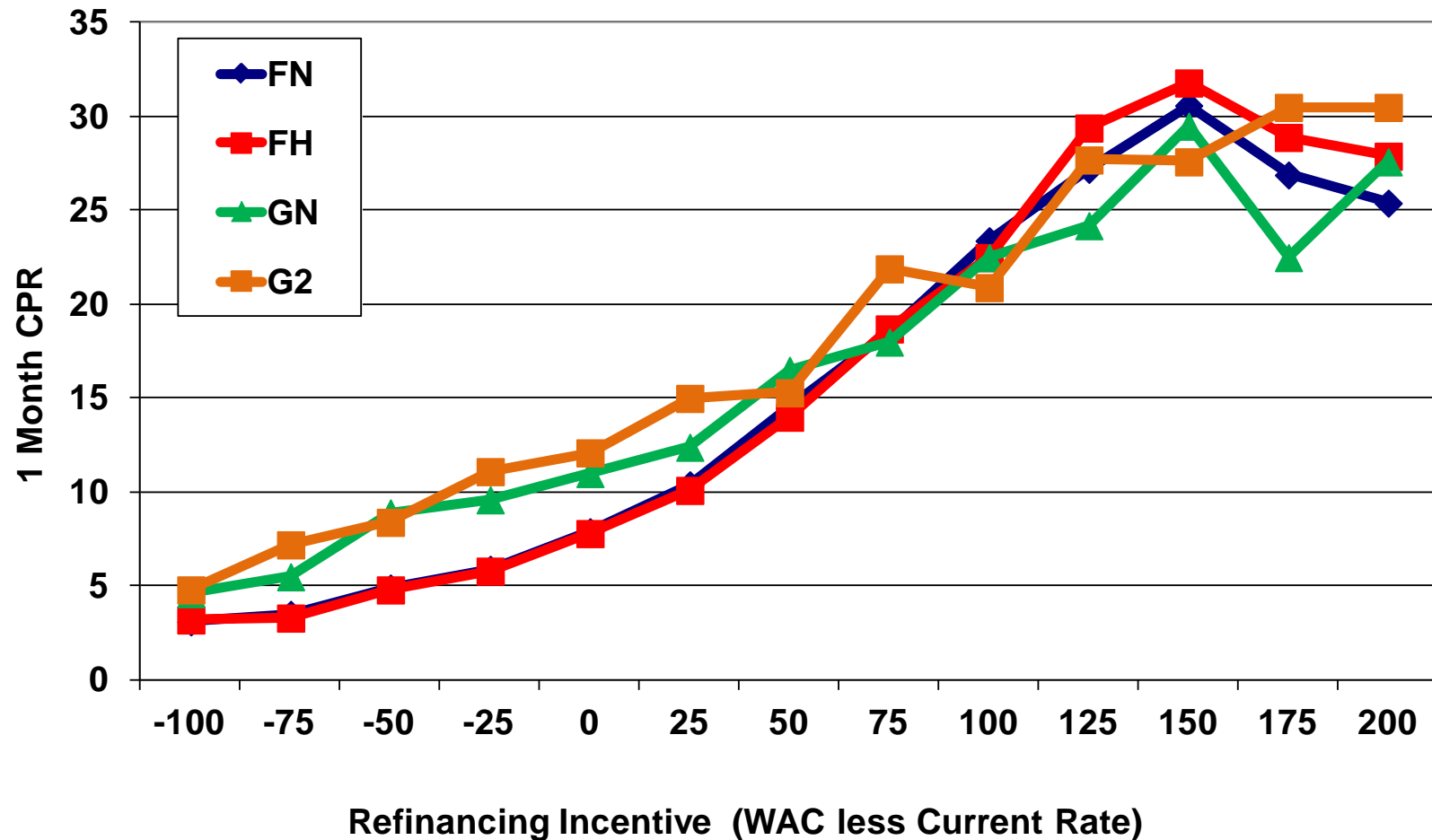
Source: FTN Financial



Baseline S-Curves for 30yr Fixed Product

S-Curve Analysis | Last 12 Months

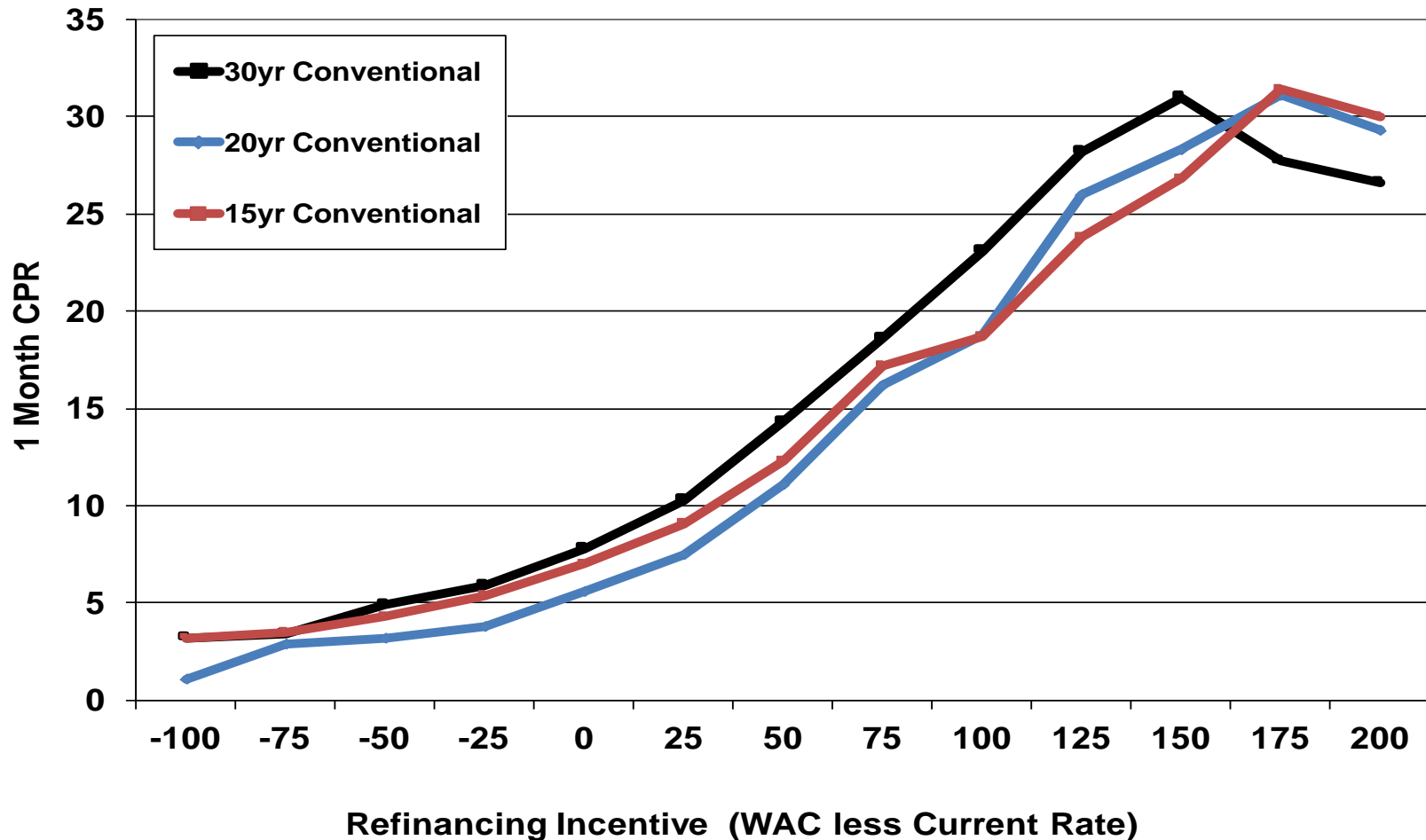
30yr Fixed MBS , 12-48 WALA



Source: FTN Financial and KDS Global

Baseline S-Curves for Conventional by Am Schedule

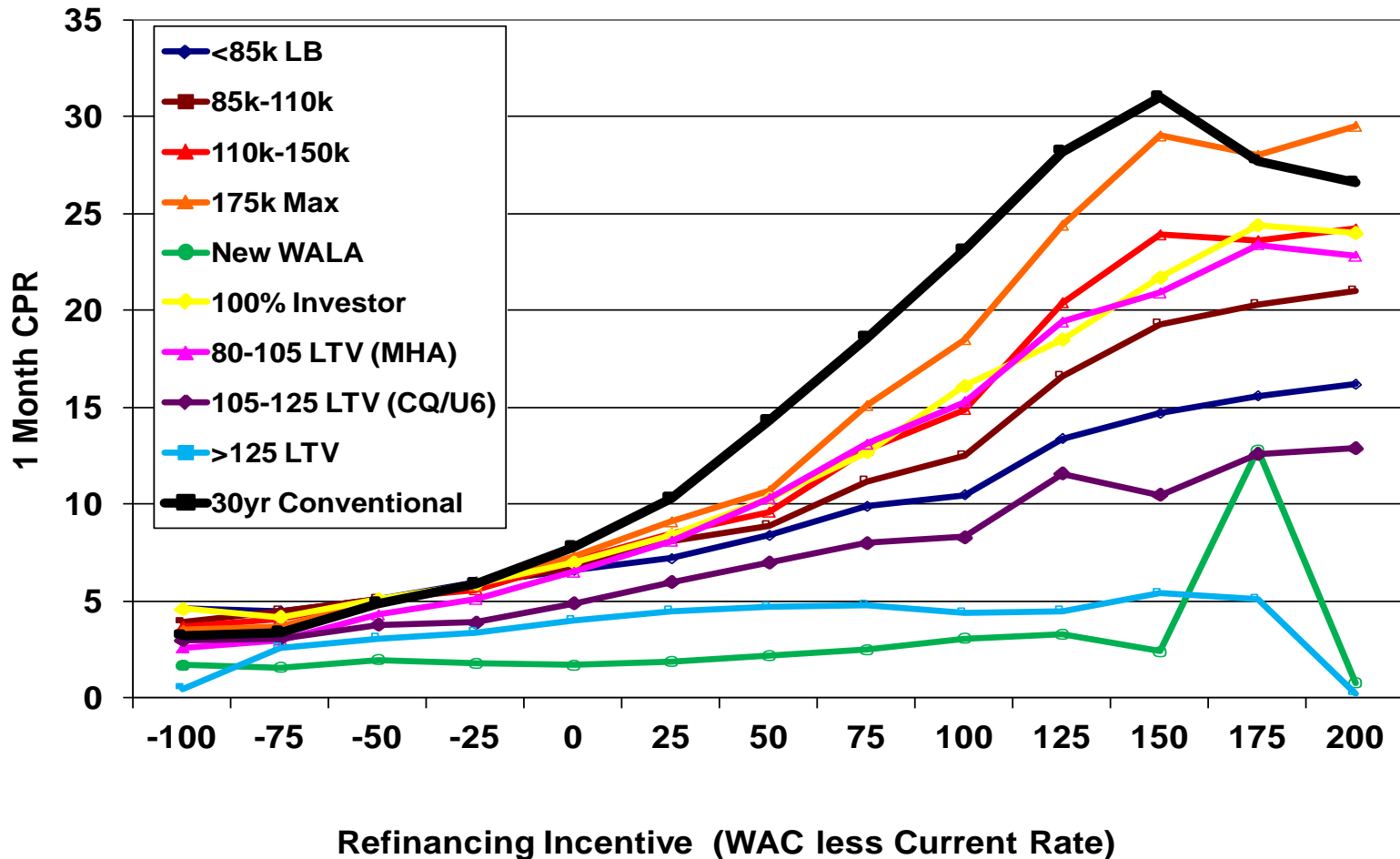
S-Curve Analysis | Last 12 Months
Conventional Fixed MBS (12-48 WALA Except "New WALA")



Source: FTN Financial and KDS Global

The Flatter the S-Curve, the Better the Convexity

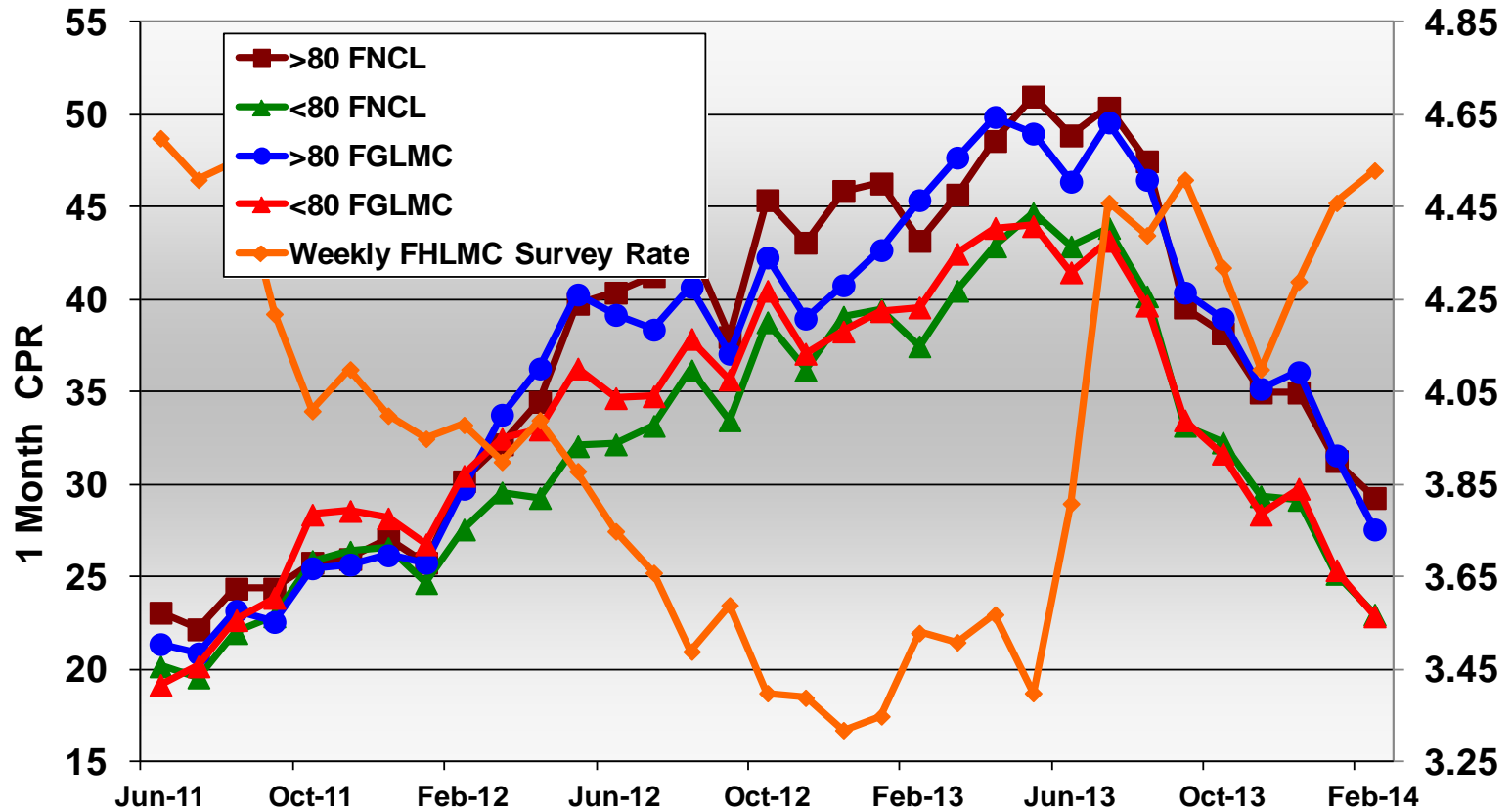
S-Curve Analysis | Last 12 Months 30yr Conventional Fixed MBS (12-48 WALA Except "New WALA")



Source: FTN Financial and KDS Global

HARP-Eligible Still Faster Despite Slowdown

All Conventional 5.0s thru 6.5s
1mo CPR by LTV (May 2005 - May 2009 Origination)

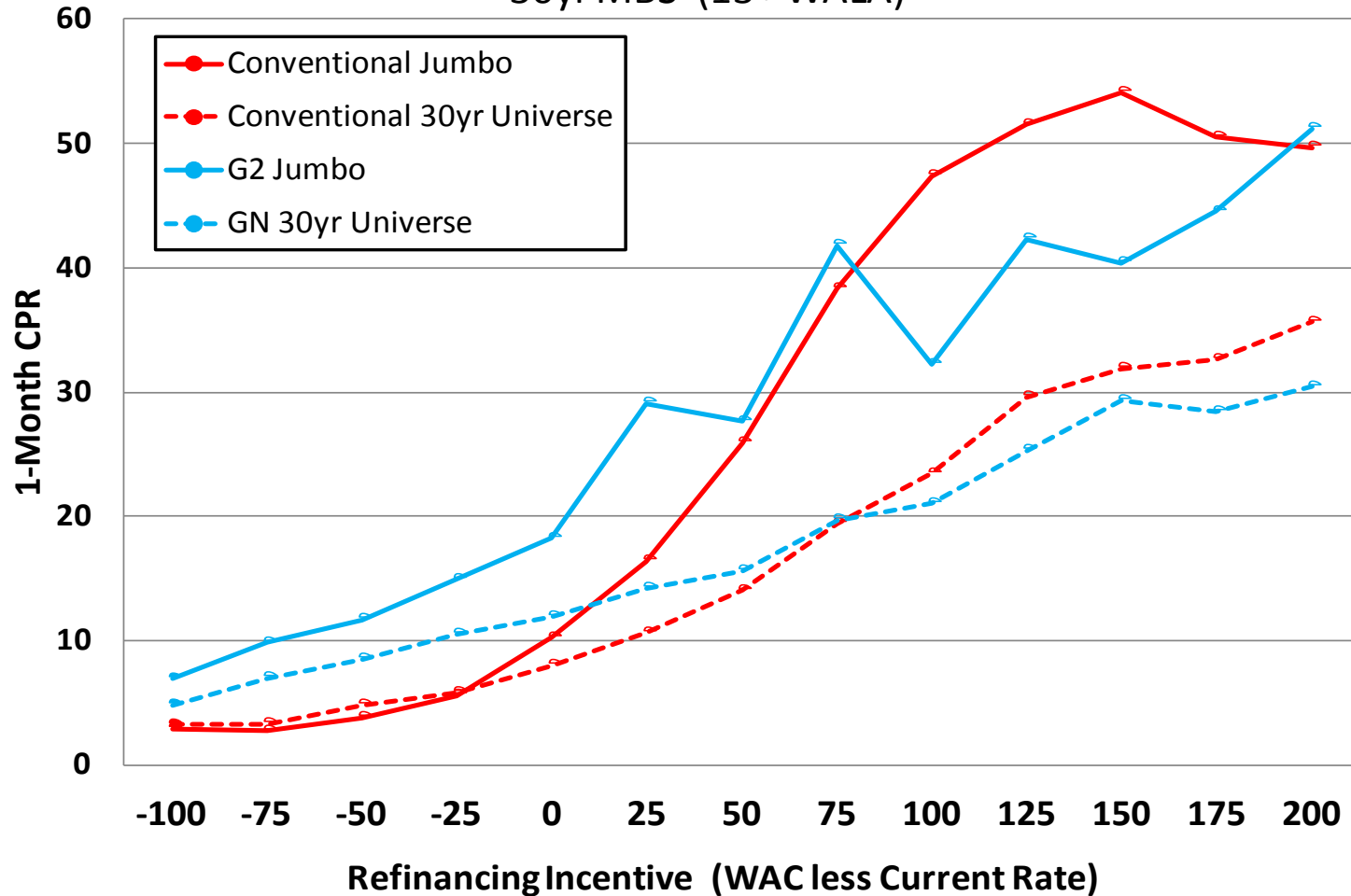


Source: FTN Financial and KDS Global

Conforming Jumbo Negatively Convex

S-Curve Analysis | Last 12 Months

30yr MBS (13+ WALA)

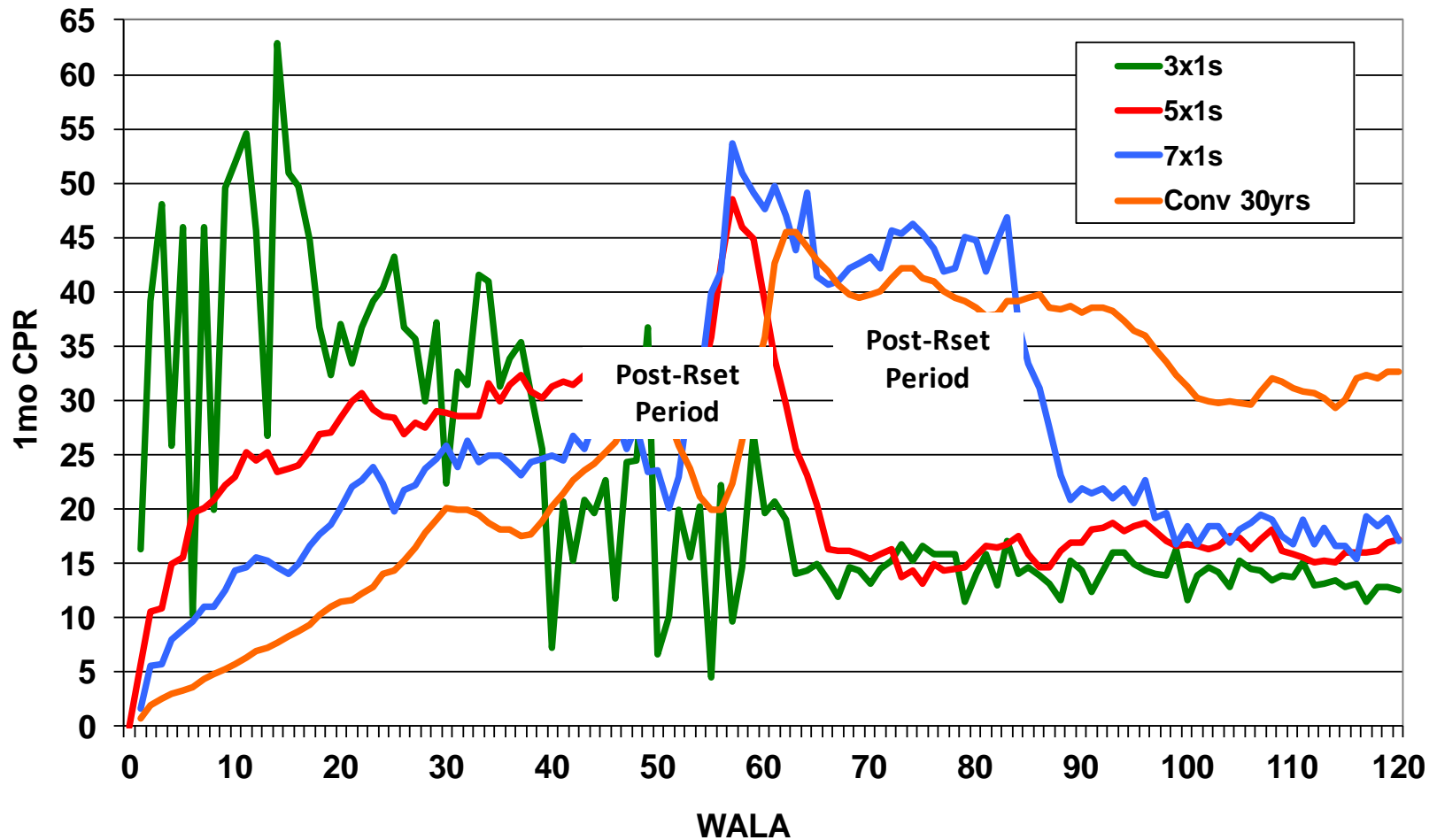


Source: FTN Financial and KDS Global

Post-Reset Hybrid ARMs Very Slow

Aging Curve Analysis | Last 12 Months

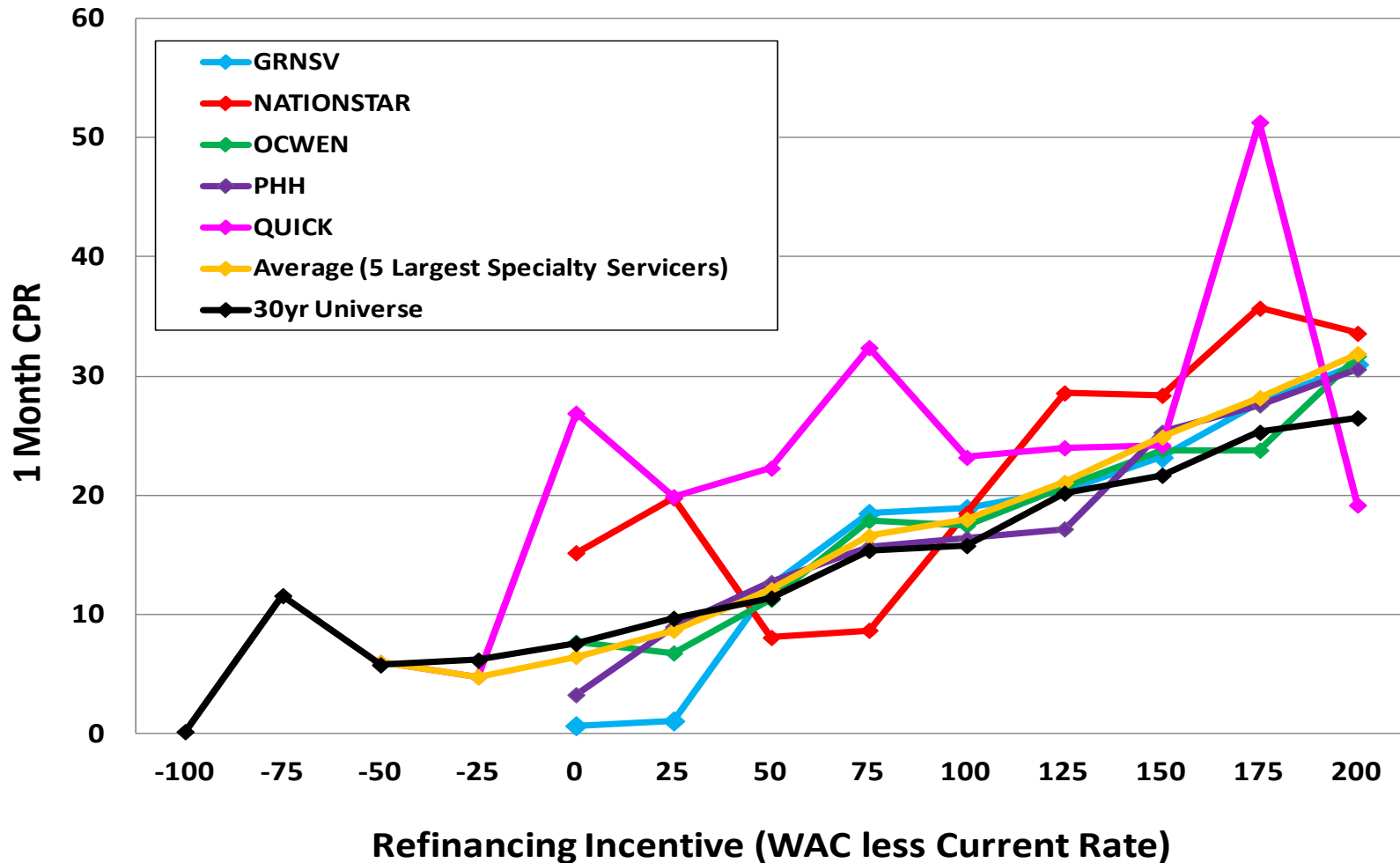
Conventional Hybrid ARMs and 30yrs



Source: FTN Financial and KDS Global

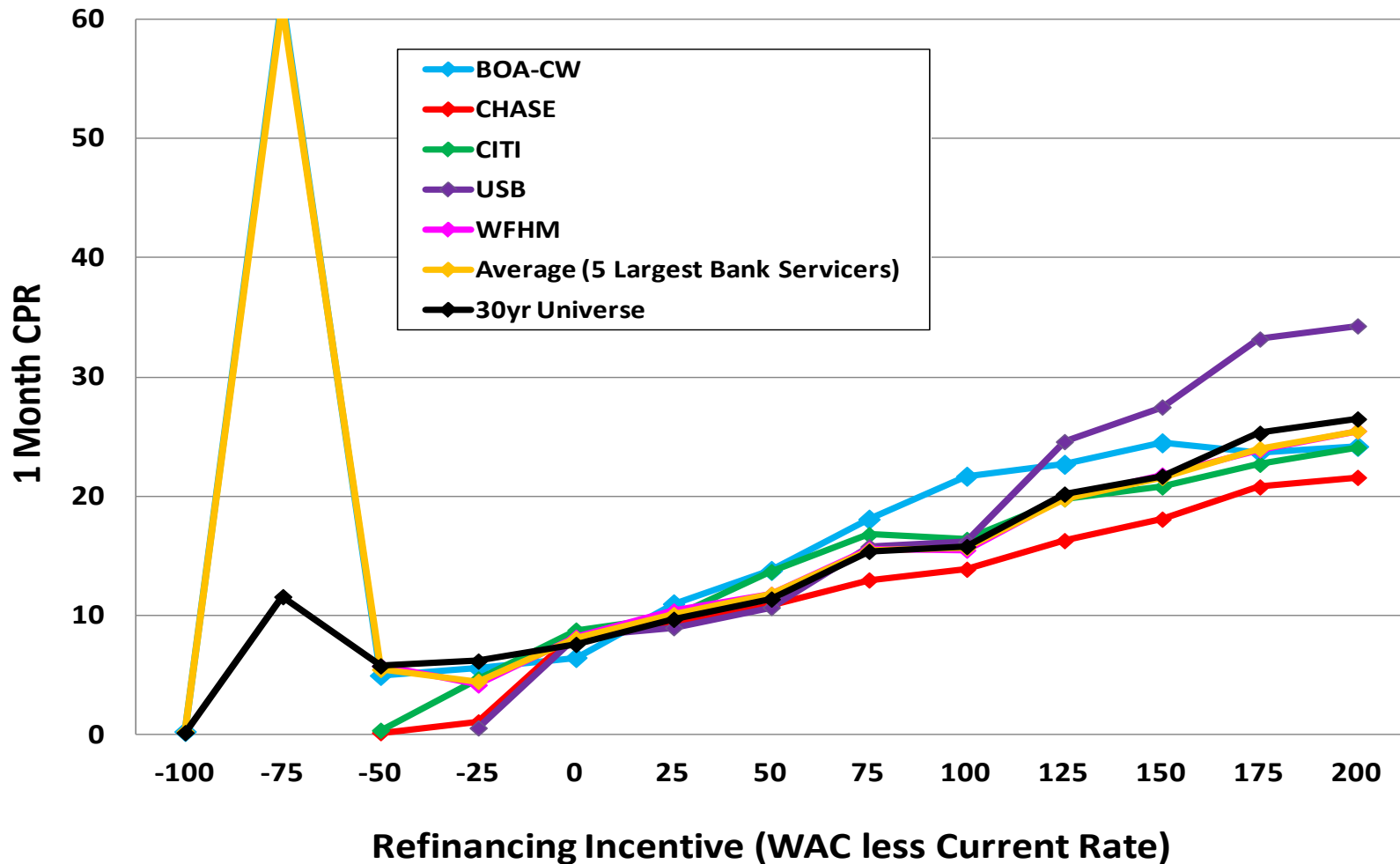
Specialty Servicers Volatile for <2010 Vintage

S-Curve Analysis | Last 3 Months
30yr Fixed MBS (49+ WALA)



Bank Servicers More Consistent

S-Curve Analysis | Last 3 Months
30yr Fixed MBS (49+ WALA)



Low FICO and LLB Provide Best Turnover

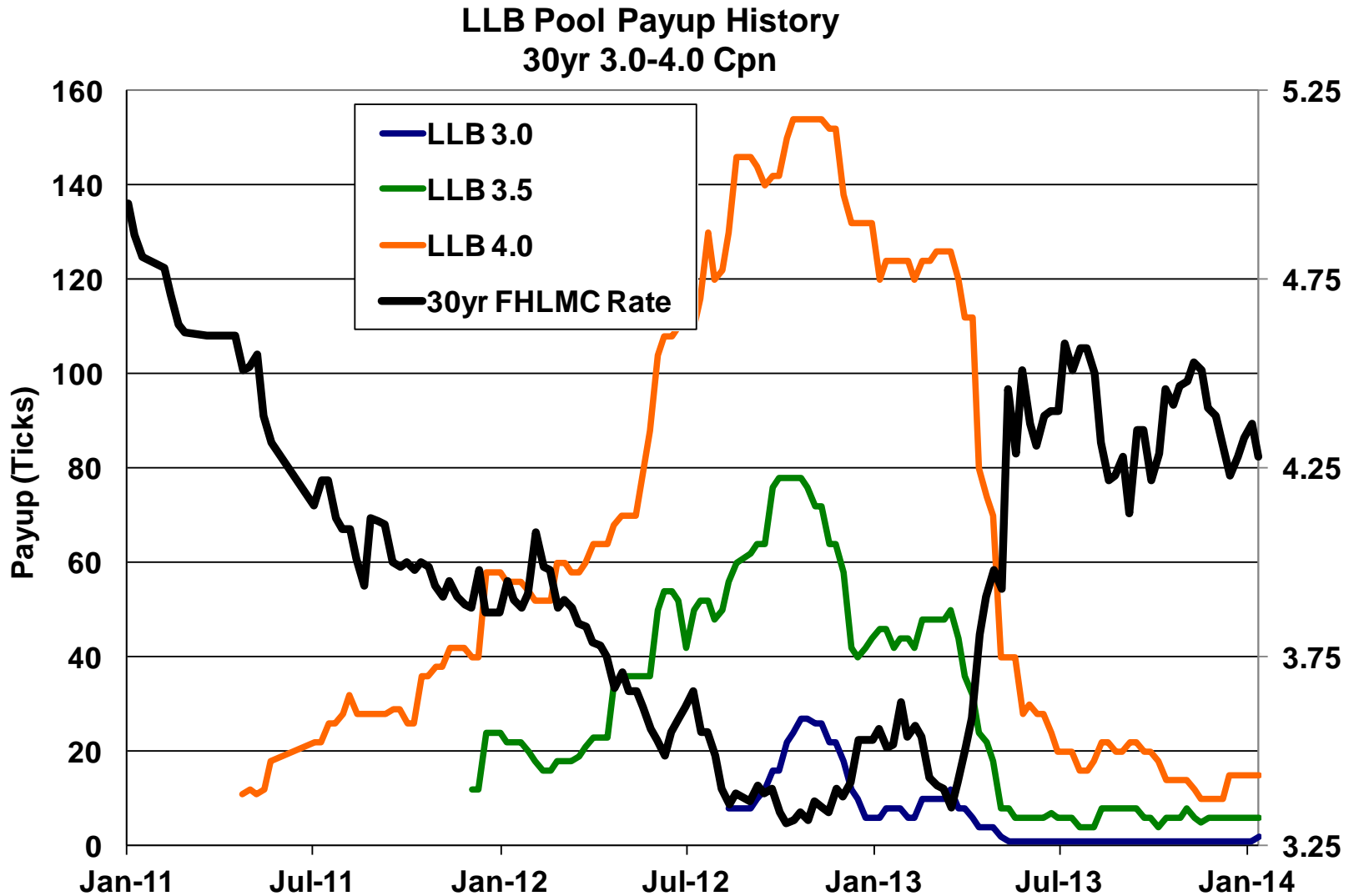
<u>FICO</u>	Incentive Less Than -50bps		Incentive -50bps to 0bps	
	5/99-5/01	5/04-12/08	5/99-5/01	5/04-12/08
0-680	9.17	10.39	10.75	13.98
681-720	7.23	9.96	9.72	12.09
721-760	6.50	7.94	9.55	10.51
760+	8.17	6.89	10.65	9.24

<u>CLTV</u>	Incentive Less Than -50bps		Incentive -50bps to 0bps	
	5/99-5/01	5/04-12/08	5/99-5/01	5/04-12/08
0-60	7.86	8.43	10.43	11.88
61-80	7.02	7.60	9.58	9.52
81-105	6.85	7.39	8.22	8.03
105+	n/a	0.52	n/a	2.98

<u>LNSZ</u>	Incentive Less Than -50bps		Incentive -50bps to 0bps	
	5/99-5/01	5/04-12/08	5/99-5/01	5/04-12/08
0-85	8.27	9.90	10.83	10.94
86-110	8.74	9.55	10.23	11.06
111-150	6.89	9.37	9.51	11.45
150+	5.97	7.98	9.34	10.92

Source: FTN Financial and KDS Global

Payups Have Collapsed – Convexity is Cheap



Source: FTN Financial

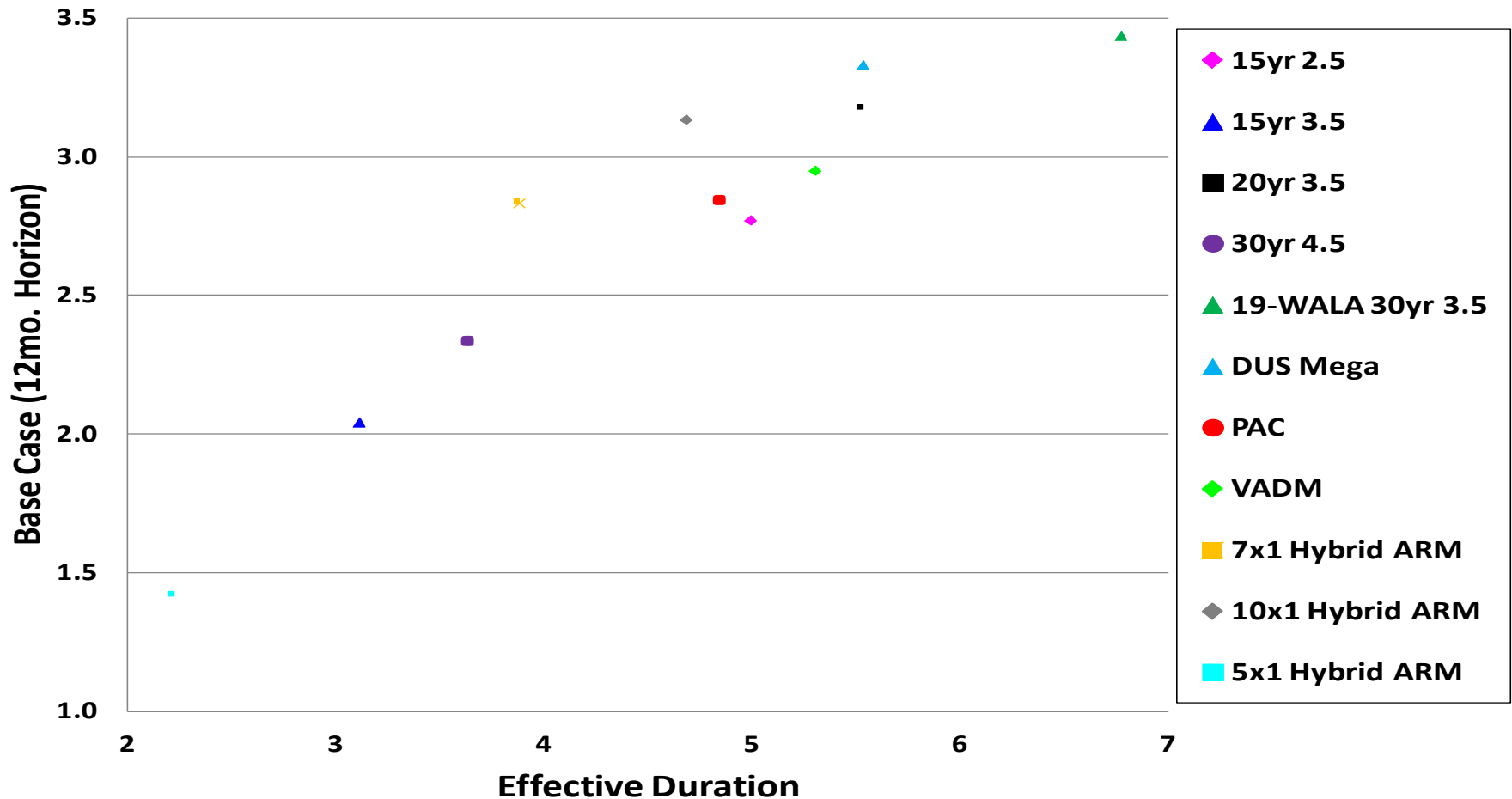
Main Relative Value Choices in Mortgage Space

Security	Description	Coupon	Price	YTM	WAL	Libor Z-sprd	Opt Cost	Libor OAS	Eff Dura	Eff Conv
FN AV9481	5x1 Hybrid ARM	2.07	103.81	1.01	4.73	32.5	22.9	9.5	2.22	-0.84
FN AL1121	15yr 3.5	3.50	105.28	1.94	3.73	19.3	11.8	7.5	3.11	-1.17
FN 932669	30yr 4.5, Low TPO	4.50	106.97	2.49	3.96	60.6	42.0	18.6	3.63	-2.72
FH 2B2236	New Issue 7x1	3.10	104.00	1.98	5.31	44.2	22.8	21.4	3.88	-1.38
FH 849257	New Issue 10x1	3.42	104.13	2.43	6.55	41.9	22.9	19.0	4.68	-2.17
FHR 4029 MC	5yr PAC, 175k Max 4.0% Collat	2.00	96.98	2.66	4.98	45.4	19.7	25.7	4.84	-0.17
FN MA1528	15yr 2.5	2.50	100.50	2.37	5.29	17.7	6.8	10.9	4.99	0.12
FHR 4301 UV	5yr SEQ, High LTV 4.0% Collat	3.50	105.86	2.41	5.95	15.7	1.2	14.5	5.30	0.40
FN MA1829	20yr 3.5	3.50	103.38	2.83	5.97	37.4	21.7	15.7	5.53	-1.11
FN AL4762	Multi Family	3.32	106.89	2.14	6.13			0.7	5.53	0.35
FN AB6086	Slightly Seasoned 3.5 30yr, 19 WALA	3.50	101.25	3.30	8.37	48.0	23.0	25.0	6.77	-0.61

Source: FTN Financial

Hybrid ARMs, ACMBS and 20yr Roll Down Well

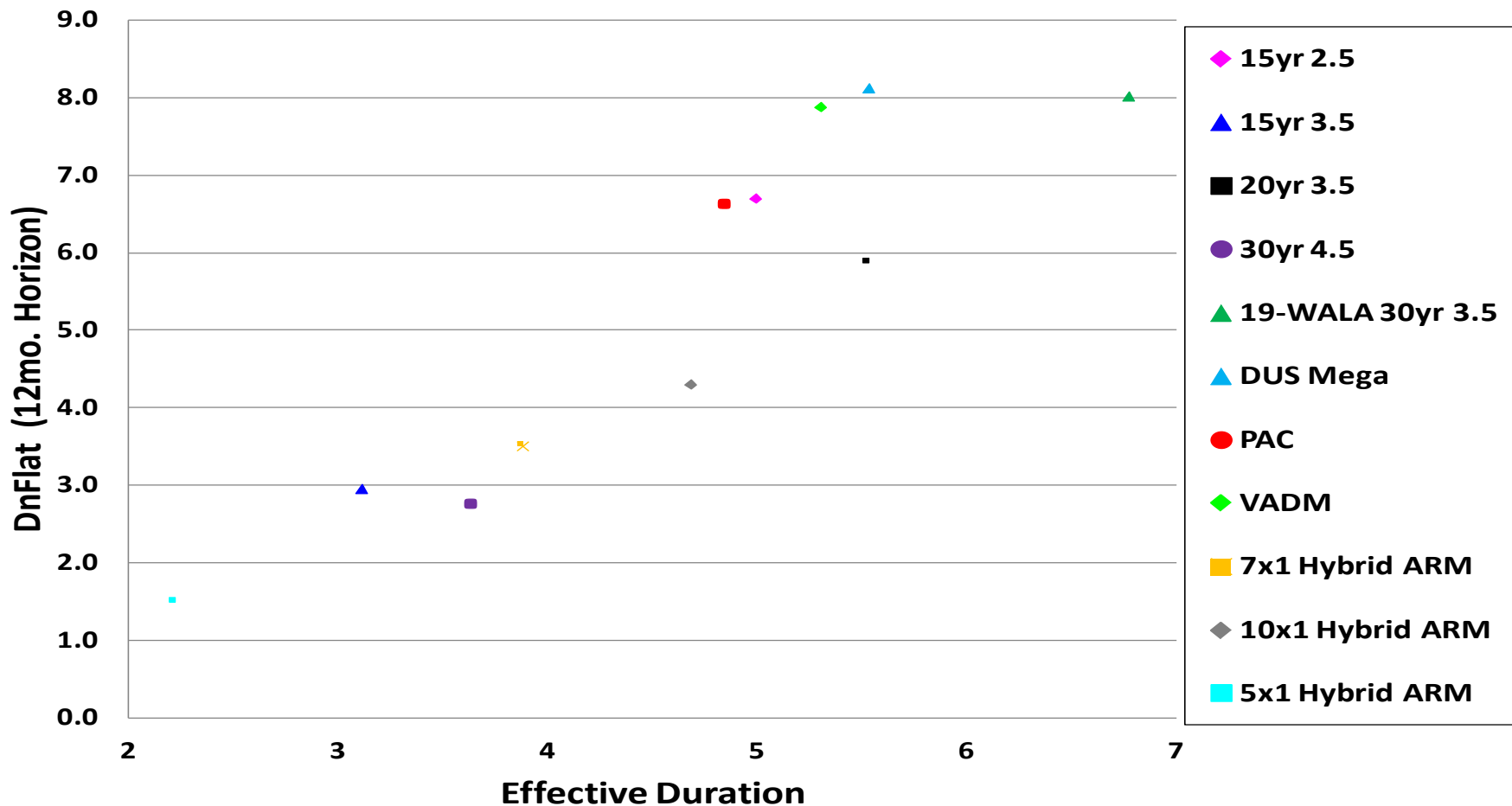
Base Case TRR vs. Duration



Source: FTN Financial and YieldBook

Need Convexity to Perform Well in a Rally

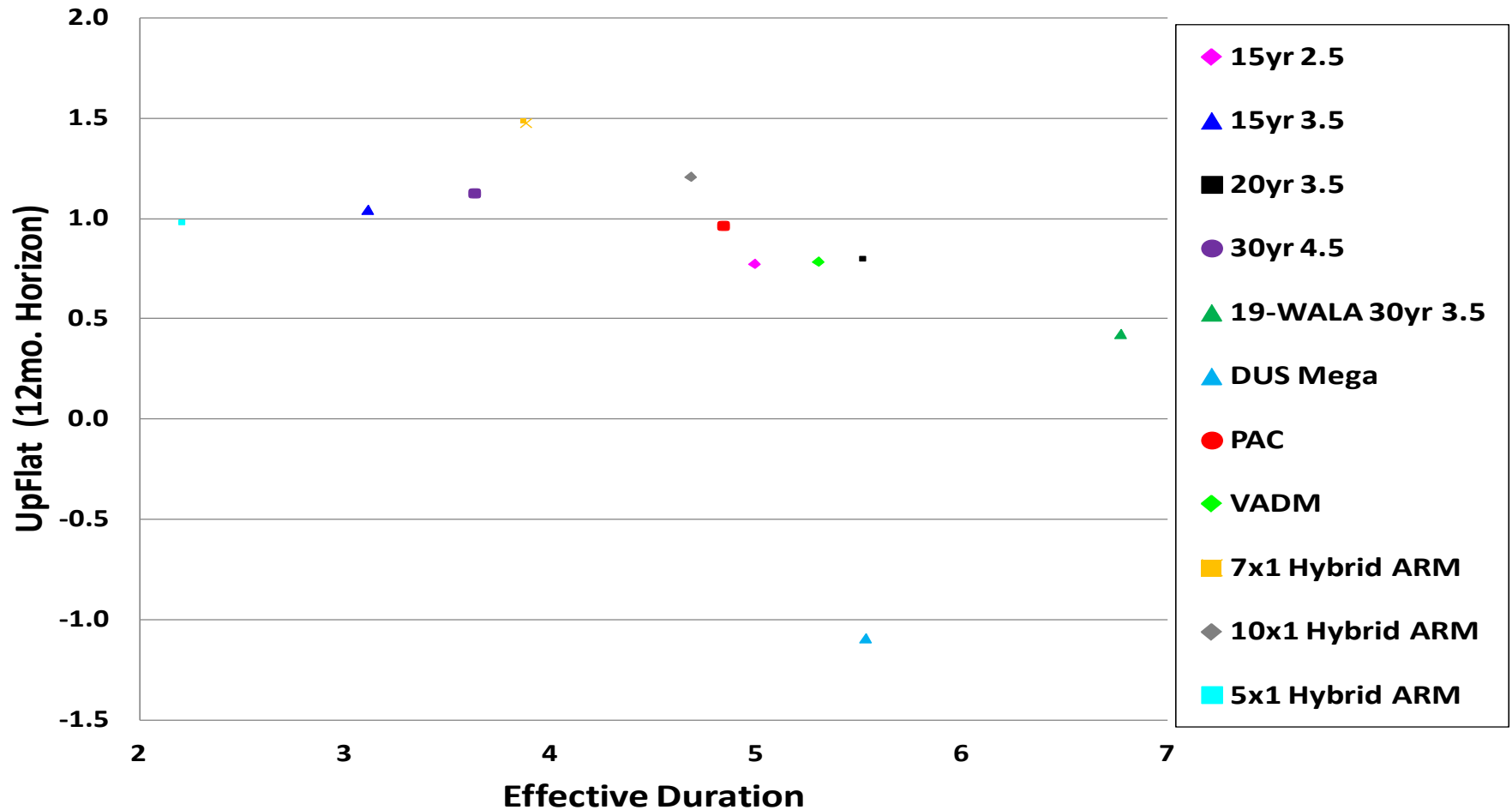
DnFlat TRR vs. Duration



Source: FTN Financial and YieldBook

Wider Windows for Bear Flattener

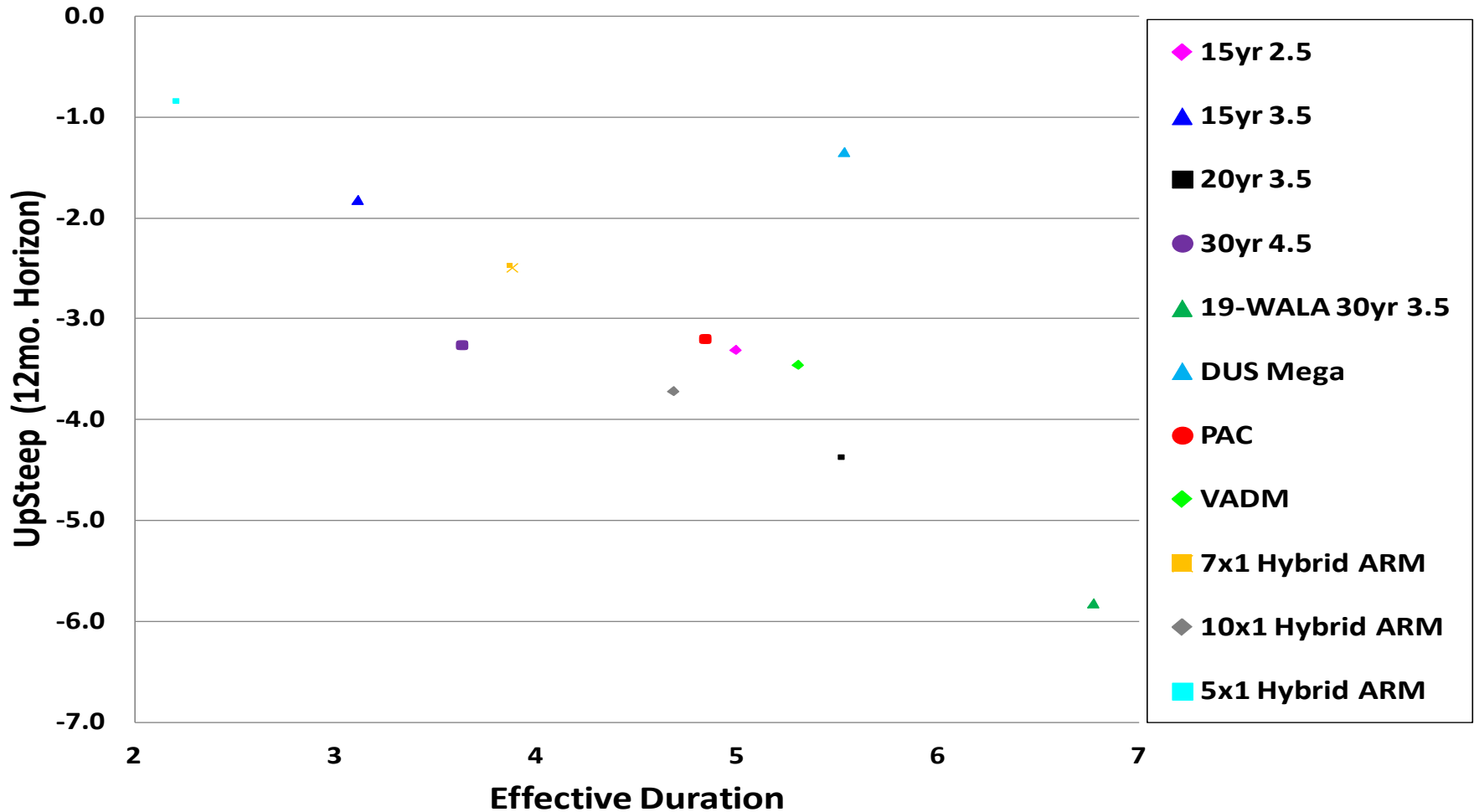
UpFlat TRR vs. Duration



Source: FTN Financial and YieldBook

Must Have Tighter Window for Any Steepener

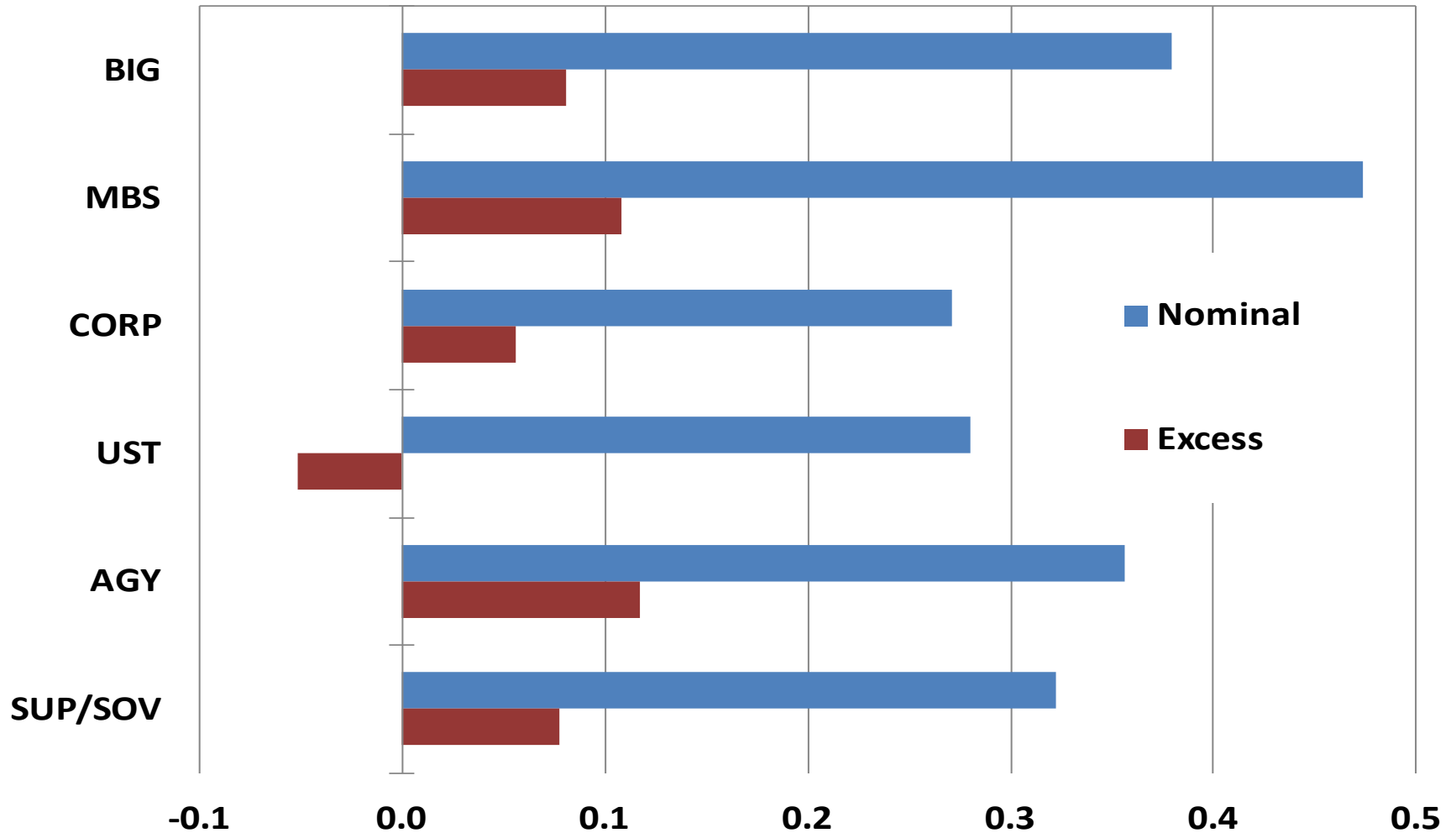
UpSteep TRR vs. Duration



Source: FTN Financial and YieldBook

MBS Hold Value Over LONG Periods

Sharpe Ratios- Citigroup BIG and Major Components
10-Year History, Monthly Data

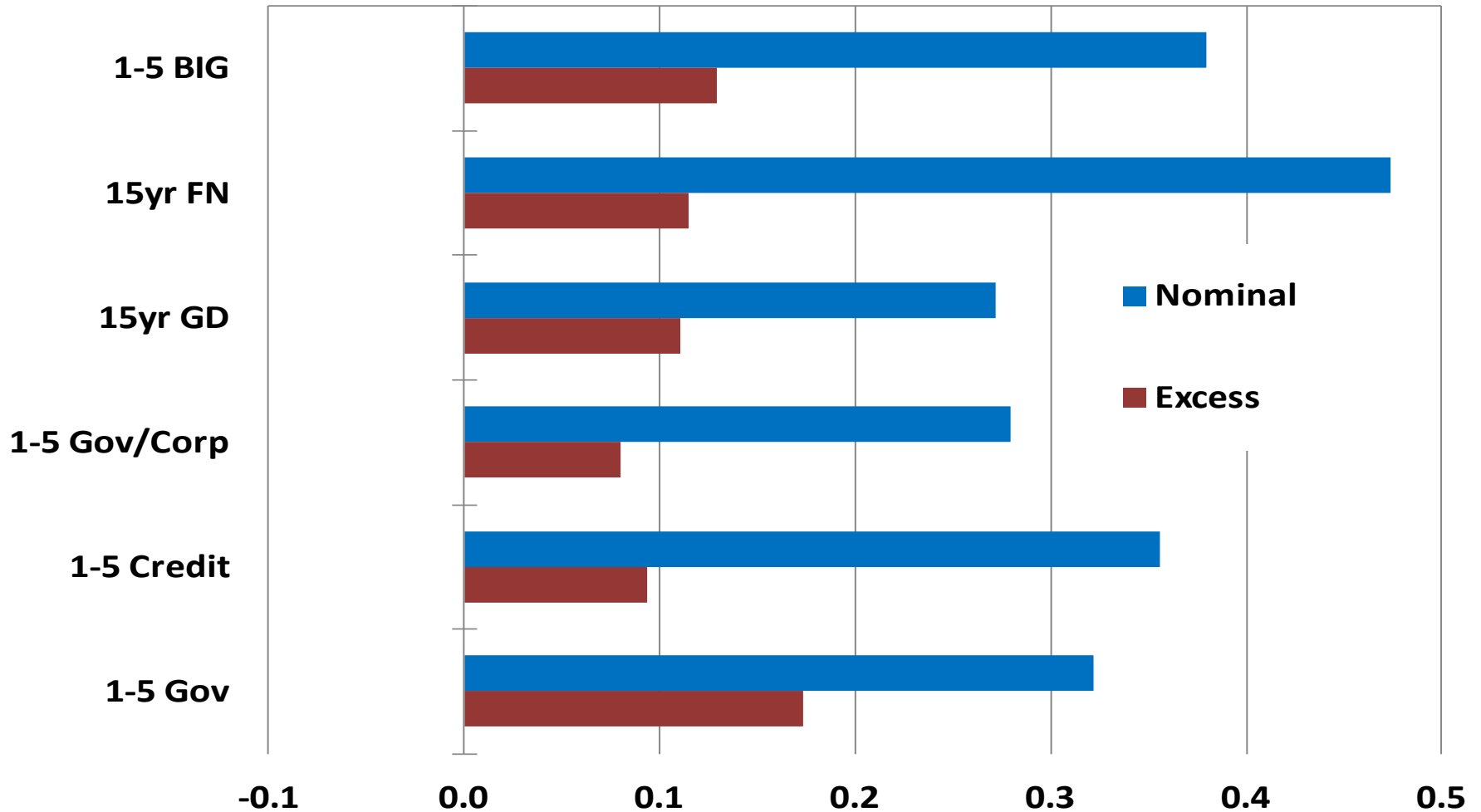


Source: FTN Financial and YieldBook

MBS Also Do Well in Short Duration Space

Sharpe Ratios- Short Duration Index Constituents

10-Year History, Monthly Data



Source: FTN Financial and YieldBook

Favorite Investment Themes in MBS

- Current & UIC 30yr Spec Pools for BEAR FLATTENER
- 12-WALA 7X1s and New Issue 10X1s
- Agency and 2011-2014 Vintage CMBS
- VADMs and other very well-structured CMOs
- Middle Coupon Coupon 20yr
- Cheap Forms of Call Protection in MBS and CMO
- Post-Reset Hybrid ARM for Short Duration \$

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- Certainty about Fed tapering has REDUCED VOLATILITY.
- Curve in 2014 will likely remain STEEP, but next BIG MOVE is for a FLATTER CURVE.
- CONVEXITY and ROLLDOWN now, wider windows for 2015 and beyond.