Jennison Associates
Agency MBS Overview: A Crucial Link in the US Economy and Housing Market
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Audio Starts

[00:00:06] **Alex:** Hey everyone. Welcome back to Clipping Coupons with Jennison Associates. My name is Alex Chansky, and I'll be your host of the show. Today I'm hosting Dimitri Rabin, who has been on the show before and is head of structured products here at Jennison Associates.

Last time, he was on the show, Dmitri and I spoke about the health of the US consumer. Dmitri, great to see you again.

[00:00:27] **Dmitri:** Alex, very good to see you. And the consumer market and the mortgage market are related. So we're sort of, uh, approaching some of the same, some of the same topics and questions, but, uh, very excited to be back.

[00:00:38] **Alex:** Wonderful. And Dmitri, could you once again give us a brief 32nd introduction about yourself and the work that you do here?

[00:00:45] **Dmitri:** Yeah. So I'm now about 25 years into my, uh, investing career. I think after 25 plus or years, you just say 25 plus you stop, you stop mentioning the years.

Um, I've been at Janssen for about six years and I oversee everything that we do in structured finance, which includes. Store of consumer related sectors include certain kind of more corporate related sectors, includes, um, agency mortgages is a very important part of it. But anything that is within kind of the, uh, securitized space, um, I look at to together with the team.

[00:01:18] **Alex:** Fantastic. Okay. Thank you so much. So yeah, ready to jump into things here. as head of structured products, I know you look at kind of a variety of. asset backed securities and mortgage backed securities. Today we want to talk to you a little bit about agency mortgage backed securities.

Mm-hmm. Agency MBS

starting with the broad question here, as investors, why do we care about the agency MBS market?

[00:01:41] **Dmitri:** Yeah. I would say we should care both as investors in this kind of voters and consumers because it's a market that's. Really a crucial underpinning, to the US economy and, uh, also how, how people live.

So to, to explain why we care. The first reason we care is it's a very large market. The agency MBS market is about $9 trillion, which makes it the second largest, uh, market globally after US treasuries. in the fixed income, in the bond space, um, the market offers a spread above treasuries. So it is sort of a sector where you're able to earn some spread, while also having a guarantee from the government sponsored enterprises, which then themselves have a guarantee from the US Treasury and that guarantee is implicit or explicit.

So something will, uh, come back to and talk about a little more. and then from a consumer perspective and the economic perspective, the agency MBS market provides the largest source of financing for the US housing market. Which is itself absolutely crucial. So that market today, the value of US Homes is about $30 trillion, which is an enormous number to think about with about 65% of US households owning their home, and most of them owning it with a mortgage, with the agency market being the largest source of that funding,

[00:02:59] **Alex:** [00:03:00] Perfect. And then, one level deeper into this then, can you tell us a little bit about how the agency MBS market works?

[00:03:07] **Dmitri:** Yeah, so the US mortgage market is actually quite different from how it works pretty much anywhere else in the world. We have the advantage of having the 30 year mortgage, meaning that when the consumer takes out a mortgage, they basically have a payment that is laid out, a flat payment for 30 years as principal and interest.

Um, and the interest rate of that does not change. now in order to do that, there, there's a bunch of things that the capital markets have been able to do and innovate in the United States to make that possible for the US consumer. That mortgage is also prepayable at any point. So on any given day, if that consumer decides to move or they decide that they don't wanna have a mortgage anymore, or importantly, if they find that they're able to borrow money more cheaply, they can simply prepay that mortgage, whatever the principle is.

And, and be done with it. what that means is it creates repairability or rate incentive. If you take out today a 6.5% mortgage, let's say, and tomorrow rates are 7.5%, you probably are not looking to refinance that into a new mortgage. On the other hand, if tomorrow rates are 5%, well now you have a positive rate incentive, meaning that.

You could take out a new mortgage at 5% with a significantly lower payment and pay off your mortgage at 6.5%. And the primary risk that we as investors take in the mortgage market, it's not credit risk because of the guarantee from the, uh, government sponsored enterprises, Fannie, Freddie, and Ginny. it is this prepayment risk.

It is this idea of negative convexity, which is that if rates rally meaning interest rates come down, um, the borrowers are. Likely to prepay in larger number than otherwise.

[00:04:49] **Alex:** Okay, great. so then that segues in really nicely to the next question I have here, uh, which is gonna be about the government sponsored enterprise guarantees.

So, Ginnie Mae mortgage backed securities typically offer explicit guarantees while Fannie and Freddie have implicit guarantees. Um, yeah. Do you wanna talk to me a little bit about the difference between those.

[00:05:08] **Dmitri:** This has been in the news a lot recently, and for many people, this is a new topic for those of us who are sort of lived through the '08 cycle.

this is sort of a repeat of a, of something that, brings back a lot of memories, but to understand Ginnie Mae is part of the US government. It is, its debt, is explicitly guaranteed by the US government. Fannie Mae and Freddie Mac are private entities Historically. Which, however, had something which was called an implicit guarantee, which is, they were not guaranteed, but there was an understanding that they were so important to the US government that the market treated them as if they were almost guaranteed when 2008 came and the companies ran into trouble because home prices dropped and they had higher losses.

Um, we tested that guarantee, and what in fact happened was the US government put the entities into conservatorship, meaning [00:06:00] they wiped out the equity and they guaranteed the debt. Through a swap line from the US Treasury, and that's where things have now been for almost 20 years. And part of what is happening today with the Trump administration, there's a path forward.

We're recording this on August 14th, so some of the news is already out. Um, there's a path forward to making the entities private again, generating some equities from that and so on. But that also means that. The question of the guarantee and whether or not the guarantee will stay in place becomes really important, right?

[00:06:39] **Alex:** Yeah.

[00:06:40] **Dmitri:** So when we looked at this, we started thinking about this about a year ago, last August, and at the time what we found was, hmm, the market wasn't really treating Fannie, Freddie, and Ginnie right to one with an explicit guarantee. Two, without any differently. And in fact, we could buy certain Ginnie bonds, which historically were difficult to source.

They were being sold by some foreign buyers because of some technicals in the market, we could actually buy 'em quite cheaply, even compared to Fanny and Freddy. And so when we saw an opportunity to get same or better spread with, um, potentially less risk around this issue, we took advantage of them build up the position sort of through really the end of 2024.

Mm-hmm. And so now we're starting to see the headlines come out. Um, there's still a lot of uncertainty as to whether or not. We are going to end up with a guarantee for Fannie and, Freddie or not. But the way that we're thinking about is if we're not getting fully paid for that risk, we would rather hold a little less than we otherwise would and not be exposed to the potential headlines while the mechanics of how the new entities are gonna function are being hammered out.

Because investors who bought this paper, particularly foreign investors, particularly banks, they definitely bought it with the idea that this has a government guarantee. And so any change to that can be pretty violent in the markets.

[00:08:02] **Alex:** Okay, great. so it sounds like you were able to buy Ginnies at, a, very similar pricing as Fannie and Freddie with the idea that privatization might make Fannie and Freddie riskier, basically making the Ginnies worth more in comparison.

[00:08:21] **Dmitri:** Absolutely, and that was certainly the case. It's gotten a little harder. That was certainly the case. Last year in 2024, right? Q3, Q4 of last year, um, we were seeing a lot more opportunities. It's gotten a little harder now because people are starting to think about this possibility a little bit more explicitly.

Mm-hmm.

[00:08:39] **Alex:** great. So then I guess the next question for you after that is going to be about performance in the agency MBS market. how have these, how these securities performed recently, and uh, where do you see value in them going forward?

[00:08:52] **Dmitri:** Yeah, so the agency MBS market, we're always thinking in excess return terms, meaning, do we perform better than us treasuries? There's a [00:09:00] certain amount of interest rate movement. US treasuries move with that, and we wanna know, did we do better than us treasuries for taking this additional incremental, uh, risk.

So the good news is, year to date agency mortgages have actually performed quite well. Um, within that, if we think about different coupons and there's a conversation about. Borrowers with higher rates versus lower rates, depending on when they took them out. Um, the higher coupons have outperformed. Um, that that has been sort of a good position for us.

But it also means that there's less opportunity today than there was earlier. Um, and to give you a sense for how the volatility compares and how we think about the world in April when we had. Liberation day and significant volatility in the market, you could go from February to May and say, well, how did this compare to corporates?

And in excess return terms, corporates returned approximately minus 1.5% and agency mortgages returned approximately minus 0.5%. So that gives you a sense of kind of beta to the overall risk markets into, uh, a particular sort of risk off event. if we look at it today, um, mortgage index looks historically fair to maybe slightly attractive to treasuries, and at the same time, the corporate sector looks quite tight to treasuries.

[00:10:25] **Alex:** So the corporate sector's looking pretty expensive.

[00:10:27] **Dmitri:** Yes, it's historically, um, historically it's looking quite expensive. And so there's this debate in the markets about, well, if mortgages are about fair to treasuries. Should you still own a lot of mortgages because corporates are even richer? Um, I think if, from our perspective, it's a little bit of a matter of degree right now, we think that mortgages have tightened to a point where only a very small overweight, very close to a neutral position mm-hmm.

Um, is prudent versus three to six months ago, the answer would've been, uh, would've been quite different, but they, they've performed and they've tightened quite a bit. Mm-hmm. Um, from our perspective, just the incremental spread. It doesn't make quite as much sense and we like being positioned near neutral in certain situations.

So if there is a shock of some sort and they do come around occasionally, we're able to quickly react and have a lot of reserves. Perfect.

[00:11:21] **Alex:** And then, how does that fit into the past three to four years of extreme rate volatility?

[00:11:28] **Dmitri:** Yeah. If you think about mortgages, mortgages used to be a very boring product. Um, and the last, let's say five years, that's really not been the case. If we go back to COVID, um, again, we talked about the fact that mortgages have this prepayment component.

Their duration, um, sort of moves around quite a lot. We went into COVID, the Federal Reserve, cut rates to zero, and also started buying securities. So interest rates dropped to generational lows. You could get a mortgage at two and a half. To 3% in that environment, [00:12:00] many, many borrowers prepaid.

[00:12:01] **Alex:** Mm-hmm.

[00:12:02] **Dmitri:** Fast forward to 2022.

Inflation had picked up. The Fed started raising rates very quickly. So the assumptions about borrowers with a 3% mortgage and thinking, well, these people are sort of, maybe they'll prepaid, maybe they won't. All of a sudden the interest rate was four, five, 6% and you went from maybe they prepared to. No, they're really not going to prepay.

That's convexity coming in and that can be quite damaging. If you think back to that period, that's when Silicon Valley Bank failed and, and you had some fairly significant volatility in the financial markets around the idea that people who bought these securities thinking that they're going to be shorter into a very large interest rate rise, found that they were owning longer bonds just as.

Um, interest rates were going up and owning direct duration became difficult. Mm-hmm. So mortgages have been sort of a, in some ways, a difficult asset class now for five years because interest rates went first very low and then very high in that environment. We think it is an asset class that really does benefit from active management, uh, and thinking through, through the risk.

So that one can take a step back and say, well, you know, the Federal Reserve is buying a trillion dollars of these. At prices, which don't make sense to anyone else. Maybe we should own a little less than we would otherwise. Mm-hmm. So things like that, as simple as that, and some more complicated things that we're able to do, um, where we think active management in the sector has really proven itself out.

Sure. Great.

[00:13:32] **Alex:** And then, I know you talked about this a little bit already, uh, hammering into it a little bit more. Within the MBS market, is there anything specifically that looks attractive to you that you wanted to talk about today?

[00:13:44] **Dmitri:** Yeah, so for this you really need to think a little bit about do you want your mortgages to prepay or not.

And the simplest way to think about it is if you take out a mortgage and some of the higher coupon borrow with higher rates, those might be trading at a $105 price. If a borrower prepays, you get back par, so you lose that five points. At the same time, some of the mortgages issued in 20 21, 20 22, and in 2020 those are trading at an 80 to $90 price.

Now, if a $90 price mortgage prepays, you get back par, you make 10 points.

[00:14:19] **Alex:** And those are, those are trading at a discount right now because rates have gone up since then. That's, people are unlikely to refinance that idea. Yes,

[00:14:26] **Dmitri:** they're less, much less likely to refinance. Got it. And so in the case of both of those.

Sort of situations. Um, what we think about is how, what are the market assumptions about future prepayments? This is a market where models and market assumptions really matter. Um, and within that sort of what do we think is attractive? And if we look at it again early this year, we thought higher coupons at a small premium really made a lot of sense.

There was sort of, [00:15:00] we thought that they were priced quite attractively, even when you. Factored in all the options and the lower coupons were not, if you look at it today, it looks a lot more fair. Mm-hmm. Um, you could still find some opportunities where you could own specified pools, which are pools of mortgages with specific characteristics to them that are put together where maybe you're able to get a little bit better positioning versus just the generic.

Um, and that has to do with. Some things are just naturally faster, even when they're at a discount. Mm-hmm. Um, and some things are naturally slower when they're at a premium

[00:15:37] **Alex:** due to some of the specified characteristics

[00:15:39] **Dmitri:** due to some of the characteristics of the pool. So, for example, borrowers with very low loan balances tend to be both faster when they're at a discount and slower when they're, they're at a premium.

And the reason for that, that if you think about having that interest rate differential between. What you are paying and where the market is. Mm-hmm. That matters a lot. If you have a $500,000 mortgage in dollar terms. Mm-hmm. If you have a $50,000 mortgage, it matters a lot less.

[00:16:07] **Alex:** Okay.

[00:16:07] **Dmitri:** Right. So as a result, you have sort of a, a better convexity, flatter, flatter scur product in mortgage speak.

Got

[00:16:16] **Alex:** it. So if there's, so, if there's a higher loan balance. You're more susceptible to changes in interest rate.

[00:16:22] **Dmitri:** Yeah. You have a higher incentive to refinance in terms of the real dollars of what you, of what you're paying.

[00:16:28] **Alex:** Yep. Okay. Understood. Thank you. and then is there anything else you wanted to talk about in terms of attractiveness of different mortgages?

[00:16:35] **Dmitri:** I think we covered it. as I mentioned, and this doesn't make for the most exciting headlines, we think the mortgage market is kind of fair to very moderately attractive and within the mortgage market, things are also kind of fair in an environment like this versus environments where we've taken very big overweights or underweights to different parts of the mortgage market.

The mortgage market overall, um, we think it makes more sense. To be closer to neutral in the mortgage market and then be closer to neutral across different parts of the mortgage market, um, and wait for better opportunity dislocations to come in the future. So again, August 14th, maybe it looks one way, it might look very different two weeks from now.

[00:17:15] **Alex:** Okay, great. last fun question I have for you here because you've already been on our show, uh, you've answered the question already about favorite books or movies.

do you have a good, uh, vacation spot or favorite place that you've visited that you wanted to mention to everybody today?

[00:17:29] **Dmitri:** Oh, well, I, I, I love to travel, so there's gonna be a little bit of a recency bias because there's many places that we go that we really love. Um, but we spent some time this past year in Prague.

Um, and that part of Central Eastern Europe, Poland, Prague, um, was really, really fun. It was culturally very dynamic and bringing this back for a second to the economics, which I'm always thinking about, even as I'm traveling. It was very economically dynamic. It was very interesting for me to see the way that we're now [00:18:00] 35 years removed from the fall of the Berlin Wall.

The way that that part of the world now looks. Very much like Western Europe in terms of living standards, in terms of kind of, oh, really, uh, richness of culture and so on. And that was, that was really in a world where we've had a lot of, a lot of bad news geopolitically. That's a, I think, a good news geopolitical story that doesn't, uh, doesn't get quite enough attention.

[00:18:25] **Alex:** Great. Thank you so much, Dmitri. Really appreciate your time on here and ready to wrap this up.

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