Andrea F. Pringle
Financial Strategist/MBS Analyst
apringle@GoBaker.com

2022 Key MBS Themes and the Case for Specified Pools

The mortgage market is already off to a volatile start in 2022 with Treasury yields soaring, spreads widening, and mortgage rates breaching 4%. The Federal Reserve has made clear that it will focus on a robust monetary tightening campaign to combat high inflation by ending mortgage-backed securities (MBS) purchases and likely shifting the reinvestment of mortgage paydowns from MBS to Treasuries. This comes on the heels of record home price appreciation (HPA) and expectations for prices to continue rising at a modest pace, increasing loan sizes. These factors create headwinds for MBS performance in 2022, especially for pools comprised of generic or "to-be-announced" (TBA) collateral. Pools containing "specified collateral" (described below), on the other hand, stand to outperform TBA as the Fed taper and rising loan sizes impact TBAs more directly.

Higher Supply

A record net supply of agency MBS was set in 2021 and the Fed purchased about two-thirds of it. Although net supply is not forecasted to be as high in 2022, without the biggest buyer in the market, available supply would increase even if net issuance remained level. However, 2022 supply could be boosted by continued HPA. Supply is strongly correlated with HPA and home values are projected to moderately increase in 2022. Additionally, the Fed is expected to finish adding MBS to its portfolio in March and to cease reinvesting mortgage principal paydowns this summer. All of this means the private market (ex-Fed) will have to digest significantly more supply in 2022.

It is also important to remember that the supply the Fed has been taking out of the market is TBA collateral. This is the "cheapest-to-deliver" (CTD) or "worst-to-deliver" (WTD) collateral that has been stripped of loans that offer added value to investors. Loans with certain characteristics that exhibit more predictable prepayment behavior are pulled out of TBA and pooled separately into "specified" pools. Because loans with these desirable attributes are carved out of the TBA float, what is left in TBA is the least desirable loans. Without the Fed sopping up that CTD/WTD float, supply pressure stands to impact TBAs more directly than specifieds.

Higher Loan Sizes

Higher loan sizes will also likely hit TBAs more directly. The Federal Housing Finance Agency raised the conforming loan limit by a record 18% for 2022, up to $647,000. This means some loans previously considered "jumbo-conforming" are now eligible to be securitized into TBA. That could push the average loan balance of what becomes part of the TBA float higher and hurt valuations as pricing adjusts to account for the larger loan balances.

Larger loan balances are generally less desirable to investors because prepayment behavior is highly interest-rate sensitive. The larger the loan size, the more economic benefit a borrower realizes by refinancing when rates are low and the more economic burden a borrower endures to refinance or move when rates are high. That means these loans have a tendency to perform the exact opposite way an investor hopes by prepaying fast when rates are low and extending when rates are high. By increasing the average loan size in the TBA market, the collateral skews a bit less desirable and pricing adjusts to reflect that.

Home price appreciation also organically pushes up the average loan size of new MBS. Analysts estimate home prices to appreciate around 5%–7% in 2022 after increasing nearly 20% in 2021. Additionally, with higher rates, supply will increasingly be comprised of purchase loans and fewer refi loans. Purchase loans tend to have larger loan sizes, especially when home prices are on the rise. Further, the refi loans made in this environment will also shift from primarily "rate and term" refinances, which characterize low-rate environments, towards cash-out refinances. Cash-out refis tend to have larger loan sizes because borrowers take cash out of the equity in their homes by increasing the size of their mortgage.

(Continued)

Prepayments

What these dynamics mean for prepayments may seem straightforward on the surface in that higher rates and higher loan sizes slow speeds as borrowers are less incentivized to refinance...but by how much? With rate and term refis down, turnover and cash-out refis become an increasingly important part of the picture, and both are buoyed by strong HPA. However, record low housing inventory creates a challenge for turnover activity. Excess mortgage industry capacity following the hiring surge in 2020–2021 may also incentivize mortgage lenders to target previously untapped borrowers for refis in effort to keep business elevated.

All these dynamics create some uncertainty for the mortgage market. One certainty is that these factors will not impact the entire market the same way. Some sectors will feel certain headwinds more directly than others but that should not deter investment in MBS. Investors should simply be strategic about where to direct investment dollars and consider specified pools over TBA.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact* ***Andrea Pringle at The Baker Group: 800.937.2257, www.GoBaker.com, or email: apringle@GoBaker.com.***

**The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.*

Andrea Pringle
Financial Strategist/MBS Analyst
The Baker Group LP