

In Focus

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Scott Simon Discusses PIMCO's Views on Agency Mortgage Backed Securities



W. Scott Simon

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Mr. Simon joined the firm in 2000 from Bear Stearns & Co. in New York, where he was a senior managing director and co-head of MBS pass-through trading. He also authored The Daily MBS Commentary. Mr. Simon has seven times been named to positions on the Institutional Investor All-America Fixed-Income Research Team, including first place in MBS pass-throughs and overall MBS strategies. He has twenty-four years investment experience, and holds a bachelor's and master's degrees in industrial engineering from Stanford University.

Scott Simon is head of PIMCO's mortgage and asset backed securities team. In the interview below he discusses the opportunities PIMCO sees in Agency mortgage backed securities amid the general turmoil in the mortgage and housing markets.

Q: Bill Gross recently singled out Agency mortgage backed securities as one of the high quality sectors that have underperformed Treasuries and should offer compelling value. Can you elaborate, given what's going on in the market and at the Agencies?

Simon: Agency MBS are yielding more relative to Treasuries, swaps and Agency debt than they have in over 20 years. These are extremely high quality securities that are collateralized by single family homes, and carry guarantees by government sponsored enterprises (GSEs) or the full faith and credit of the U.S. government in the case of GNMA. Although there has been a run of bad news coming from Fannie and Freddie relating to credit losses and capital positions, PIMCO is not concerned about their ability to provide guarantees for MBS. So the wider spreads between Agency MBS and Treasuries in the wake of the recent mortgage market selloff are primarily the result of a systemic credit crisis and an absence of liquidity in all securities as banks and investment banks have reduced risk significantly in the face of their own losses on CDOs and other subprime-backed assets. This presents a historic opportunity to invest in Agency MBS relative to Treasuries.

Q: Can you explain why the losses that Fannie Mae and Freddie Mac each reported in the third quarter will not effect the credit quality of Agency MBS?

Simon: Fannie- and Freddie-guaranteed mortgages are primarily the higher quality loans to the higher quality borrowers, unlike many of the non-Agency issued sub-prime mortgages. So this means that their losses will naturally be lower than the rest of the mortgage market's. Perhaps most importantly, Agency MBS are collateralized primarily by houses, not by the Agencies' balance sheets. There is no question that the downturn in housing is negative for the Agencies' earnings, and has widened their debt spreads. But we do not expect Agency MBS guarantees to be threatened, even if the housing recession becomes more severe.

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The Agencies have several layers of credit protection in place to support the MBS guarantee. The average current loan-to-value ratio, which is basically the amount of money that you have loaned against the value of a property, for Fannie and Freddie's guaranteed mortgages is 59%. This 41% borrower equity provides an important cushion against significant home price declines. Also, the surplus capital reserves of each Agency are approximately \$8 billion, and both Agencies have regular access to debt markets to raise additional capital.

Both Agencies recently announced increases in realized credit losses for the bulk of 2007 due to the housing downturn. Fannie said losses were 4 basis points and Freddie pegged its losses at 2 basis points. But these increases are relative to losses that have historically been close to zero – the 10-year average Agency credit losses are only 1.4 basis points! While the percentage increases may look very large, the absolute losses are still manageable for both companies. The Agencies have indicated that losses should peak in 2009, and could reach as high as 11 basis points. If that is correct, it will likely keep earnings low, but should still not pose a major threat to the companies, and should have no impact on their ability to guarantee MBS. It is important to remember that the Agencies collect a fee to guarantee loans – currently averaging 23 basis points, which is historically ample coverage for credit loss.

And finally, even though Fannie and Freddie MBS do not carry an explicit U.S. government guarantee, a default by the Agencies would be catastrophic for the U.S. economy. This view is the basis for most investors' belief that the U.S. government would not allow them to fail.

Q: If the credit quality of Agency mortgage backed securities has not been degraded, why have MBS spreads widened as much as they have?

Simon: Spreads are wider for a host of reasons right now, but all of them are related to the credit crisis. The big problem currently is the lack of balance sheet availability in the global banking system, but in addition you have increases in Agency MBS supply, the Agencies themselves selling MBS out of their portfolios in order to raise capital, and an increase in implied volatilities. None of these things are helpful for MBS spreads, but we believe the market's concerns are overdone.

There's no doubt that Agency MBS supply is high and will probably stay high into 2008. This is primarily because earlier in the year, when the MBS rate curve was flatter, ARMs appeared less attractive than fixed-rate loans, leading to increased fixed-rate MBS production. Second, Agency supply increased as the economics for non-Agency securitization channels broke down. As the subprime sector deteriorated and market participants became more risk averse, it became increasingly difficult to sell non-Agency MBS, and new issue spreads widened significantly. So many conforming loans that previously might have been securitized in the non-Agency market were sold through Agency channels instead.

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So supply is up, demand is down. That's never a recipe for spread tightening, but again, we believe this is temporary, thus the investment opportunity.

The Street is effectively on the sidelines in terms of their provision of liquidity to MBS and their appetite for assets on the banks' balance sheets. Their over-commitments to fee-driven leveraged buyouts, structured investment vehicles, asset backed commercial paper, and rating-driven collateralized debt obligation markets have prevented them from dedicating capital to anything else at the moment. Future downgrades of these types of assets will increase the capital requirements significantly.

Also, the GSE losses on existing credit assets resulted in under-capitalization relative to the stringent, punitive capital requirements that were instated after the accounting problems of 2001-2004. In order to raise capital, the Agencies sold assets with gains, including Agency MBS. The seizure in the non-bank financial system, the lack of confidence in the Fed's comprehension of financial system workings, and hedge funds de-levering, have all resulted in a lack of demand for high quality carry instruments.

In addition, global central banks, some of the largest holders of cash Treasuries and Agency debt have so far been slow to move into Agency MBS to take advantage of the potential higher returns. We expect them to be more active in the coming months.

Q: Are you expecting these supply and demand factors to change direction and support the performance of MBS in 2008?

Simon: Yes. PIMCO expects credit tiering will be the main theme of the 2008 mortgage market. We think the market will begin to differentiate much more carefully in mortgage credit markets. In other words, high quality assets should outperform low quality assets. Agency MBS are likely to shake off the general mortgage malaise that followed the collapse in the subprime market and the global credit crunch.

On the supply side, the deep recession in the U.S. housing market has resulted in a considerable slowdown in housing turnover. Slower housing turnover will help mitigate prepayment risk if, as PIMCO expects, rates continue to rally from here. And, since the yield curve has already steepened considerably, the trend of ARM-to-fixed refinancing should mitigate as the relative attractiveness of ARMs increases. So we expect the elevated supply levels to peak soon.

And on the demand side, foreign central banks are likely to take advantage of the wider spreads on Agency guaranteed MBS. In recent years central banks have been large buyers of Agency MBS when nominal spreads widened versus Treasuries, and we expect them to be more active in '08.

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Q: You refer to a “deep” U.S. housing recession. What is PIMCO’s outlook for the U.S. housing market in 2008, and what effect are home sales likely to have on Agency MBS?

Simon: We expect U.S. home sales volumes to continue to fall in 2008, albeit at a slower pace than we’ve seen recently. The credit crunch is going to continue into 2008, particularly for non-prime and non-conforming borrowers. Mortgage rates have not come down significantly – only prime rates are meaningfully lower – which is keeping housing affordability poor and will continue to dampen activity in the housing market.

Delinquencies and defaults should rise in 2008. And in an environment where housing inventories are already at record levels, rising defaults are likely to contribute to a continued decline in housing prices. Housing prices are down about 5% in 2007 on average, and we believe prices will fall another 5% to 10% in 2008.

If we were to see a sharp increase in unemployment, prices could fall further. That is not our base case scenario, however, because the Fed will likely ease significantly in 2008 as the U.S. economy seizes up due to the credit crunch and the dysfunctional mortgage market.

Even if the housing recession is severe, we don’t see a threat to the Agency guarantee on mortgage-backed securities. In many ways the current market and economic conditions have created an excellent opportunity to pick up high quality Agency MBS at historic discounts to Treasuries.

Q: Thank you, Scott.

Past performance is not a guarantee or a reliable indicator of future results. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally backed by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Government National Mortgage Association (GNMA) is a wholly owned government corporation within the Department of Housing and Urban Development. It helps to raise funds for the mortgage market by guaranteeing securities backed by pools of mortgages. Even though portfolios may invest their assets in U.S. government securities, the government does not guarantee the portfolios that invest in them and they will fluctuate in value as market conditions change. The guarantee is to timely repayment of interest and does not eliminate market risk. GNMA’s are a type of mortgage-backed security and may be sensitive to changes in prevailing interest rates and therefore may entail risk.

Federal Home Loan Mortgage Corporation -(FHLMC) provides a secondary Market for conventional residential mortgages. It issues a number of mortgage-backed securities. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Federal National Mortgage Association (FNMA) is a privately owned corporation, which provides a secondary market for federally guaranteed or insured mortgages as well as conventional mortgages. Its stock trades on the NYSE. It issues a number of different mortgage-backed securities, with values that are sensitive to changes in prevailing interest rates.

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