CARRY OPPORTUNITIES ABOUND WITH CURRENT COUPON...BUT LET'S NOT GET CARRIED AWAY.

Behnood Noei — Director, Fixed Income,Andrew Okrongly — Director, Model Portfolios
12/11/2023

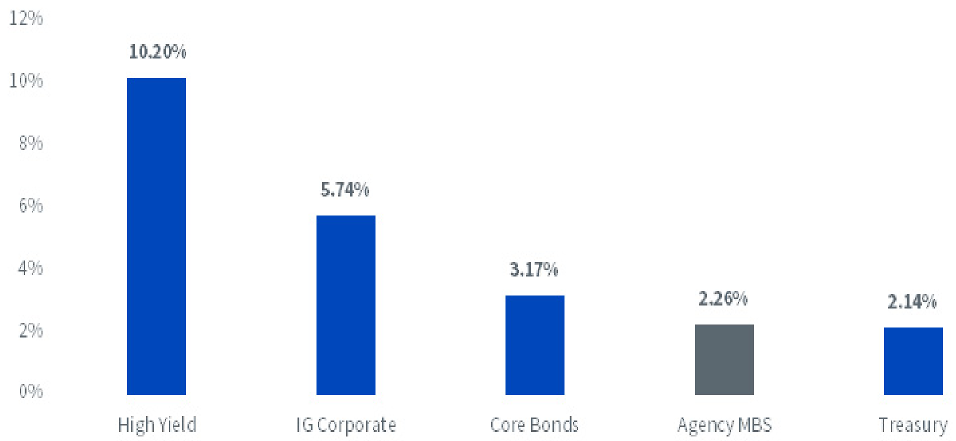
Executive Summary

- Even after the recent rally in interest rates, agency mortgage-backed securities (agency MBS) still appear attractive from both a fundamental and technical basis and offer a compelling level of yield/income compared to other fixed income asset classes
- A segment of this market that has recently garnered attention is newly issued MBS, or current coupon mortgages
- While current coupon mortgages can offer a higher level of income than other cohorts of the market, investors should be aware of the inherent risks with these bonds, namely prepayment and liquidity risks

---

As discussed in previous posts, agency mortgage-backed securities (agency MBS) have lagged other fixed income asset cl asses in performance this year. This underperformance has been driven by several factors, including rising interest rates, elevated interest rate volatility and concerns around supply/demand imbalances.

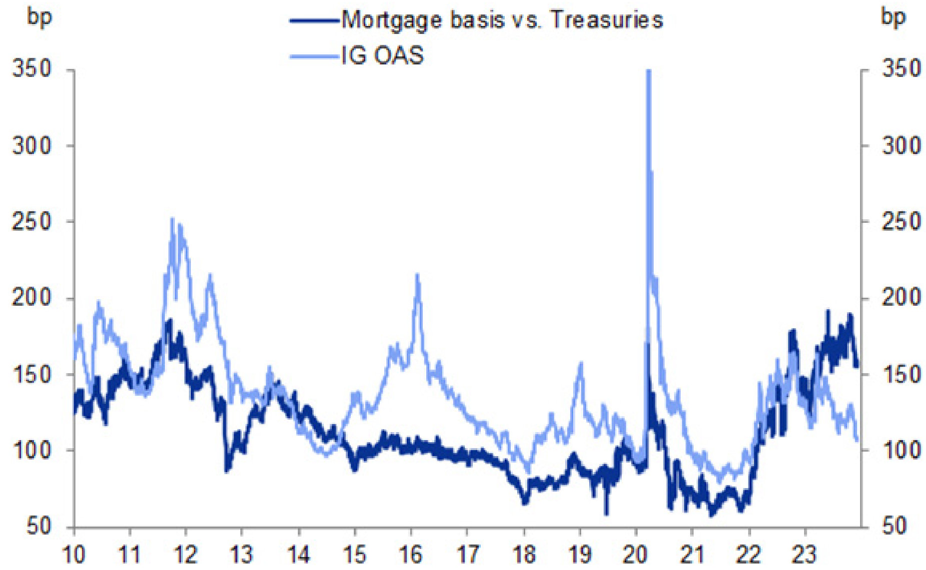
YTD Returns across Fixed Income Sectors as of 12/6/23



Sources: WisdomTree, Bloomberg; YTD returns as of 12/6/23. High Yield returns based on the Bloomberg US Corporate High Yield Index. IG Corporate returns based on the Bloomberg US Corporate Index. Core Bond returns based on the Bloomberg US Aggregate Bond Index. Agency MBS returns based on the Bloomberg US MBS Index. Treasury returns based on the Bloomberg US Treasury Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Even after the recent decline in interest rates, the spread of agency MBS relative to Treasury bonds remains at multi-year highs. With attractive valuations and a potentially improving fundamental and technical environment, we believe that long-term investors can benefit by allocating to the asset class.

Mortgage Basis (Current Coupon Mortgage Rate – 5-/10-Year Treasury Rate) and IG OAS

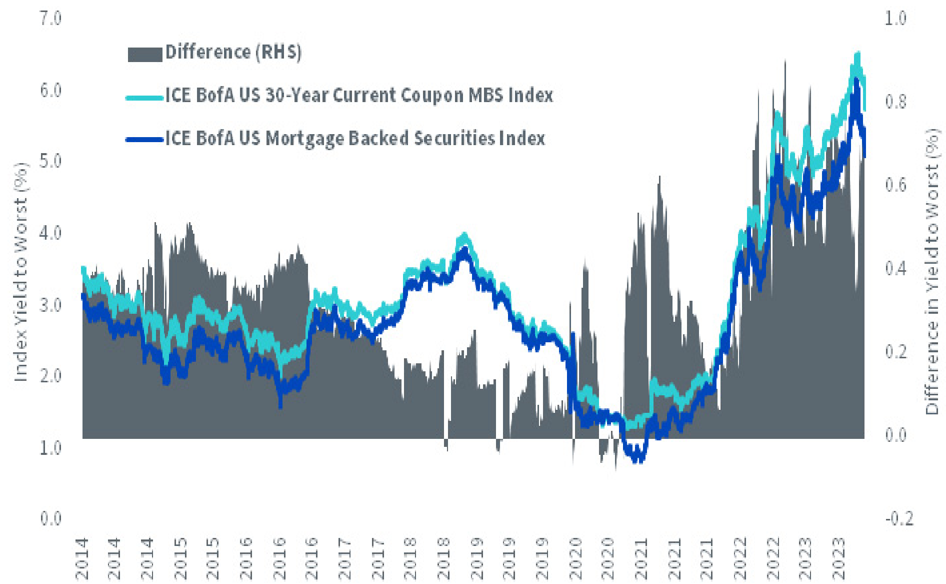


Source: Goldman Sachs Global Investment Research, as of 11/15/23.

A segment of this market that has garnered attention this year is recently issued MBS, or current coupon mortgages. Simply defined, a current coupon bond is one selling at a price at or close to its par value. These bonds usually tend to be the ones recently issued.

Broad agency MBS indexes consist of mortgages with varying coupons and vintages, or the year each MBS was issued. Current coupon mortgages tend to offer a higher yield versus the broader index. As a matter of fact, in the past 10 years, there have only been a few days when the yield on current coupon mortgages has been lower than the broader index.

Difference in Yield to Worst: Current Coupon MBS and Broad MBS Index



Source: ICE Data Indexes as of 11/30/23. You cannot directly invest in an index. Past performance is indicative of future results.

For definitions of indexes in the graph above, please visit the glossary.

As can be seen from the chart above, ever since the Fed embarked on its historical quantitative tightening process in 2022, the yield gap between the current coupon and broader index has widened significantly. Investors have noticed, as they can now get a higher level of yield/income from a product with the same credit risk as the broader index.

However, most savvy market participants know that no good opportunity comes without risks. Hence, it is prudent for investors to understand the inherent risks in current coupon mortgages, namely elevated prepayment and liquidity risks.

Prepayment Risk

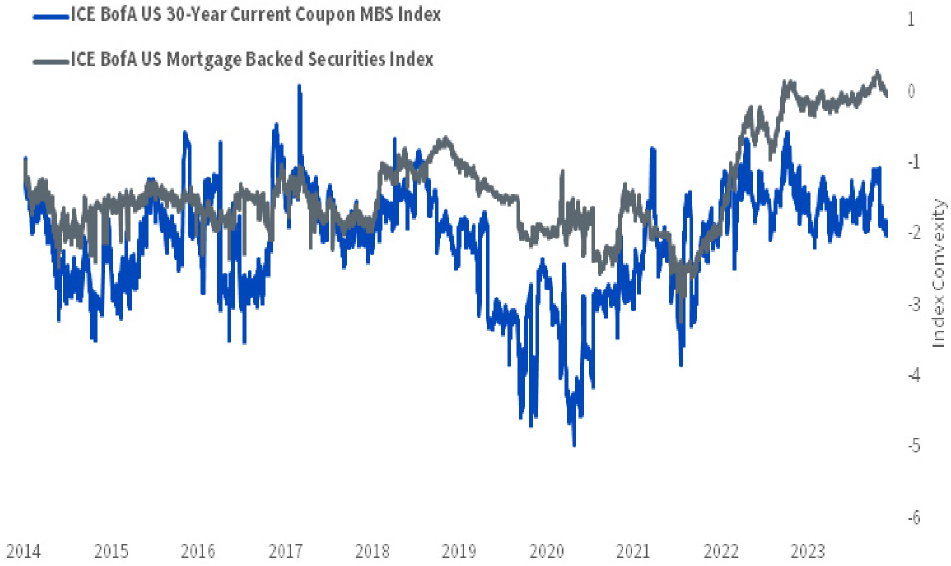
Like most mortgages, current coupon mortgages come with prepayment risk. From an investor's standpoint, this is the risk that you receive your principal back earlier than planned and may need to reinvest that principal at lower prevailing interest rates.

The level of prepayment risk can be quantified by a fixed income risk metric called convexity. Convexity is the curvature in the relationship between bond prices and interest rates. It reflects the rate at which the duration of a bond changes as interest rates change. In mathematical terms, convexity is the second derivative of changes in a bond price compared to changes in the interest rate.

Agency MBS tend to have negative convexity at most times. This is because mortgage borrowers have the option to prepay their outstanding balance when rates fall (refinance their mortgage at a lower rate). As a result, when rates fall, MBS investors won't enjoy the same price appreciation that investors in a similar-duration Treasury bond would.

However, as can be seen from the chart below, the broader MBS index currently has slightly positive convexity, something that hasn't happened in years.

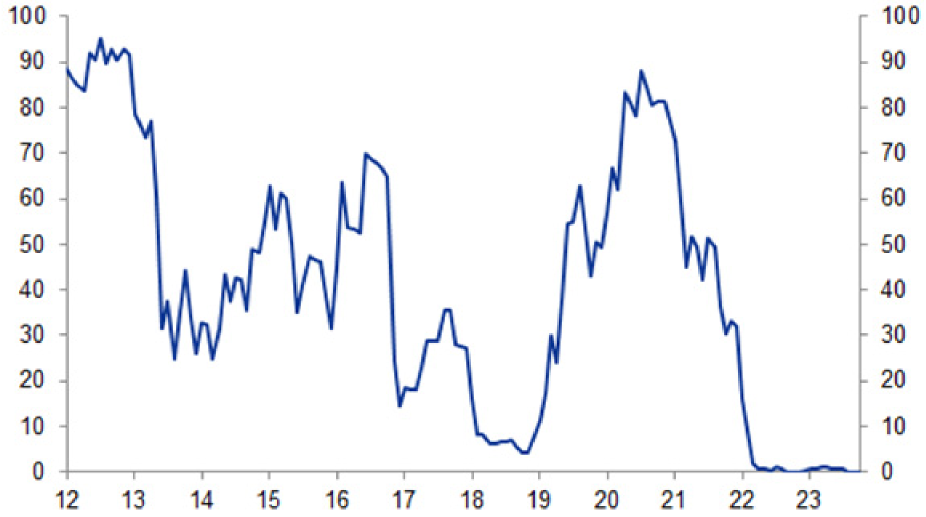
Difference in Index Convexity: Current Coupon MBS and Broad MBS Index



Source: ICE Data Indexes as of 11/30/23. You cannot directly invest in an index. Past performance is indicative of future results.

This positive convexity for the broader agency MBS index is driven by mortgage borrowers having little to no incentive to refinance their mortgages. Putting it in more technical terms, the prepayment option sold to borrowers by investors is out-of-money. As can be seen from the chart below, the share of borrowers with a 50+ basis points (bps) rate incentive to refinance their mortgages is near zero.

Percentage of Borrowers with a 50+ bps Refinance Incentive (%)



Source: Goldman Sachs Global Investment Research, as of 11/15/23.

On the other hand, this can't be said for borrowers who have recently taken out mortgages at today's high interest rates, which are the mortgages predominantly backing current coupon MBS.

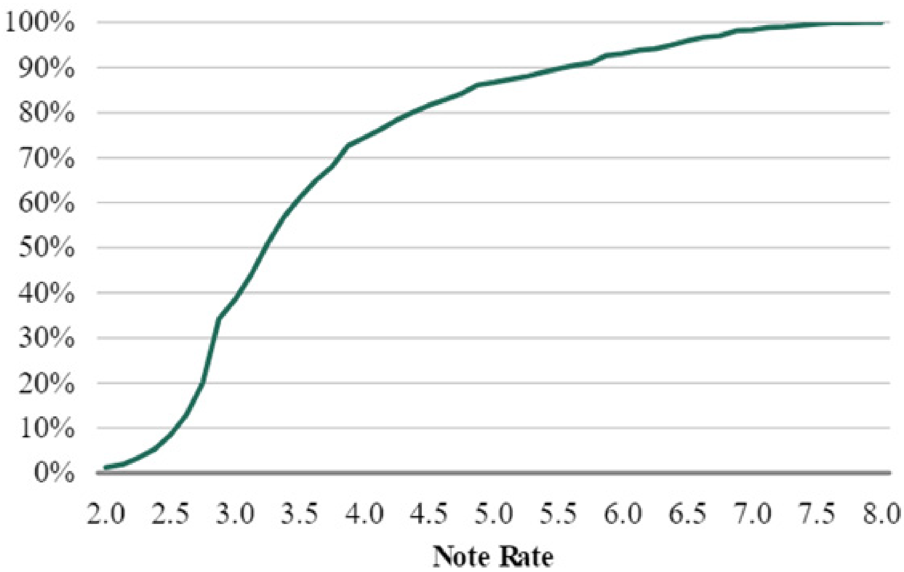
This segment of the agency MBS market is still negatively convex. As a result, if interest rates were to decline in the near future, current coupon investors would be more likely to suffer the prepayment/reinvestment risk associated with negative convexity and might end up underperforming the broader agency MBS index as a result.

Liquidity Risk

The other important risk to consider with current coupon mortgages is the liquidity of these bonds if interest rates decline and borrowers refinance their debt at a lower rate.

More than 98% of the conventional fixed-rate agency MBS universe has a mortgage rate below 7%. In other words, current coupon mortgages make up only around 2% of the universe. And, as explained above, these mortgages are most susceptible to prepayment risk. Falling interest rates could, therefore, leave an even smaller number of these current coupon mortgages outstanding, potentially creating liquidity challenges that could further impact market pricing.

Percentage of Conventional Borrowers below a Given Rate



Sources: Morgan Stanley Research, eMBS, as of 11/30/23.

Conclusion

Current coupon agency MBS offers an attractive level of yield compared to other segments of the MBS market and even compared to other highly rated AAA corporates. However, they also could experience elevated prepayment and liquidity risks in a falling interest rate environment.

Prudent investors need to be aware of these risks before getting carried away by the allure of higher yields offered by this segment of the market.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Blogs

+ An Attractive Entry Point for Agency Mortgage-Backed Securities (MBS)?

Related Funds

+ WisdomTree Mortgage Plus Bond Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Treasury bond : A government bond issued by the U.S. Treasury.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Coupon : The annual interest rate stated on a bond when it's issued. The coupon is typically paid semiannually. This is also referred to as the "coupon rate" or "coupon percent rate.&rdquo.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Quantitative Tightening : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.

Convexity : A measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields.

Basis point : 1/100th of 1 percent.

AAA credit rating : This is the highest issuer credit rating assigned by Standard & Poor's, signaling strong confidence that the issuer will be able to maintain its payment obligations.