Agincourt Capital Management, LLC

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INVESTMENT UPDATE

With interest rates on the rise, the mortgage-backed securities (MBS) market is an interesting place these days. Last time we visited the MBS market (the July 2003 Investment Update) we noted that the saw-tooth bond market of last spring and summer was giving the average bond portfolio manager fits, as simply assigning a maturity or duration to the average mortgage bond was like trying to pin a tail on a wild donkey.

While things haven't really settled down that much in the intervening period, interest rates have risen to the point where we have a much better idea of MBS' durations (hint: they're longer!). As you may know, the mechanics of MBS are such that when interest rates rise, homeowners' incentive to refinance subsides and the effective maturity of the average home mortgage lengthens. With ten year Treasury yields now in the 4.75% area (up more than 1.50% from last summer and 0.75% higher than just two months ago), less than 20% of outstanding mortgages can be refinanced at a lower rate to the homeowner. As a result, the average MBS today has a price below par (i.e., below 100 cents on the dollar) and an effective duration of approximately four and one-half years, almost four years longer than during the mad scramble of last summer's ultra-low rate refinancing wave.

As we have mentioned before, US Agency MBS are almost the perfect fixed income security: They have quality (with a guarantee that's either implied, or in the case of GNMA direct from the US Government), they have yields well in excess of other Agency securities, and they have excellent liquidity—one can buy or sell hundreds of millions of Agency pass-throughs with very little transactions cost. But what makes them "imperfect" is that they have prepayment risk. From a valuation standpoint the difference between making and losing money in the MBS market almost always comes down to getting the prepayment outlook right.

Many MBS investors have been forced to sell MBS over the past few weeks as market dynamics have left them involuntarily overexposed in mortgage duration. This has created an opportunity for astute investors who have the ability (and inclination) to ferret out specific mortgage securities whose prepayments might, for various reasons, remain fast, even though interest rates have risen. Fast prepay bonds bought at prices below par represent the best of both worlds—the combination of low dollar prices and early return of principal at par produces instant gains.

Two recent studies offer somewhat different conclusions on the value of discount MBS in the current environment. The first, offered by UBS Research, warns that today's speedy prepayments for certain MBS are illusory and will soon disappear. Bear Stearns, on the other hand, argues that prepayments could remain somewhat elevated for an extended period, despite higher interest rates. Let's look at each point of view.

First, the folks at the brokerage firm UBS (lead by MBS strategist Laurie Goodman) point out that we are at the tail end of a huge refinancing wave. In looking at similar periods in the past, they discovered that "cash-out refi's" (i.e., refinancing driven by the homeowners' desire to extract equity from their homes) accelerate during these periods, as homeowners who have been "on the fence" finally climb down and refinance, in order not to miss the last chance to do so in a rising rate environment. The UBS mortgage research team is quick to note, however, that this last gasp of refinancings can distort the overall level of prepayments and trick investors into believing that prepayment rates may remain elevated for a protracted period. The reason investors can be misled is that even MBS that appear to be "out of the money" (that is, cannot be refinanced at a lower rate) are still being refinanced, since many homeowners' propensity to cash out equity (which is, after all, real money) outweighs the slightly higher monthly mortgage payments.

UBS makes the point that these heightened prepays are real but transitory, and are warning investors not to expect anything more than a 3-6 month blip in prepayment speeds before all the fence-sitting homeowners take action. Furthermore, if rates continue to drift higher, this phenomenon will burn out even faster. Their conclusion: factor in a fairly rapid decline in the level of prepays coming from these "cash-out" refinancers and don't pay up for fast-paying specified pools that will quickly lose their luster.

Bear Stearns, meanwhile, takes a wider view of the mortgage market. By putting mortgages into the context of the US economy they come to a slightly different conclusion, namely, that there are certain factors in today's mortgage market that should sustain an elevated

prepayments over the next few quarters. Dale Westhoff and his team, in observing past periods of rising mortgage rates, found that the underlying strength of the housing market had a significant impact on MBS prepayment rates.

Specifically, the current US housing market is characterized by a short supply of available housing, very strong appreciation in home prices, a rapid housing turnover rate and a strengthening economy with rising consumer confidence in future conditions. Taken together, these factors imply that US homeowners will continue to "trade up" in housing, bolstered by strengthened personal balance sheets due largely to the 25% appreciation in US housing prices over the past three years. The turnover in housing is what's important here.

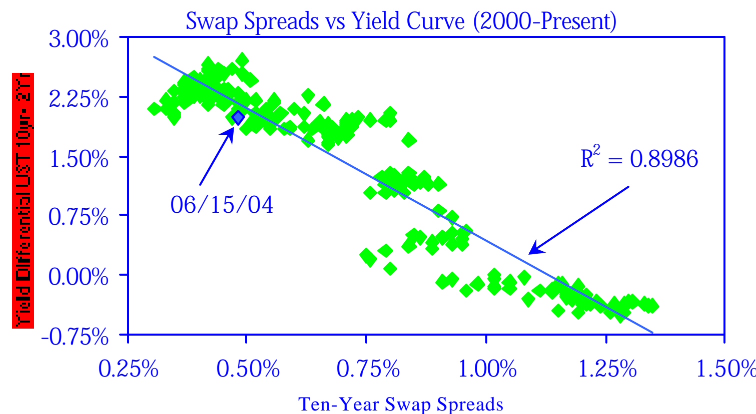
Bear Stearns believes that prepayments on MBS should continue to remain higher than normal, not from refinancing (which, as we've seen, will dwindle over the next few months) but from consumers *paying off their existing mortgage loans when they sell their old home* and trade up. Of course, this phenomenon is dependent on interest rates remaining fairly stable; if we have a dramatic spike in mortgage rates, the financing of a new, pricier house becomes prohibitively expensive and homeowners will simply stay put.

But we believe that interest rates are likely to take a rather leisurely upward trajectory, and consumers will continue to trade up for the next year or so. We'll be on the lookout for bonds trading well below par that possess the potential for continued fast prepayments. Of course, we're not alone in this search and there's always the danger that "The Street" will try to overcharge us for attractive bonds, but our firm's modest size allows us the advantage of being able to buy the bonds we need without disturbing the market or calling attention to ourselves. As always, we'll pick our spots, but move quickly and decisively when the opportunity is present.

As a follow-up to a piece we wrote some time ago, we thought we'd update you on the topic of the yield curve and its relationship to the interest rate swaps market.

As a quick refresher, the yield curve has been unusually steep for quite some time now, with the yield pick-up from two- to ten-year Treasuries consistently above 2% since late 2001. This steep yield curve is a direct result of the Federal Reserve's aggressive lowering of short-term rates to stimulate the economy. One by-product of the steep yield curve is that it allows arbitragers to make higher than normal profits by taking a "long" position in higher yielding longer-term bonds and financing this position by borrowing inexpensive short-term money. This has a direct impact on the market for interest rate swaps, contracts which express the relationship between these yield curve bets—the steeper the yield curve, the lower the rate is for an interest rate swap contract, since the demand for these profitable trades is inflated.

As you would expect, the rate on interest rate swaps is very low in today's steep yield curve environment (see the chart on this page). However, as the Fed moves from a highly stimulative monetary policy to one that is more neutral, if not restrictive, the yield curve is almost guaranteed to flatten. As the chart demonstrates, the recent correlation between the yield curve and swap spreads is very strong; we have every reason to expect that swap spreads should move higher as the curve flattens.



Wider swap spreads are likely to put upward pressure on the yield spreads of non-Treasury securities. Swap spreads are used as a high quality benchmark (and synthetic-bond substitute) for many investors, especially those running leveraged portfolios. As they are substitutable for "real" bonds, wider swap spreads will place the most pressure on US Agency and other ultra-high quality securities and, to a lesser extent, could mean wider yield spreads for corporate bonds. Even lower-quality bonds have some sensitivity to the level of swap spreads.

While there are other factors that play a big role in the determination of yield spreads for non-Treasury securities, swap spreads are the first consideration for quality-minded investors. With Fed policy shifting and swap spreads rising, corporates, MBS and (especially) US Agencies will look less attractive in our valuation models. We will keep you posted.