

# MORTGAGE-BACKED SECURITIES

## Maximizing Today's Credit Market Momentum To Gain The Equity Advantage



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### Is it safe to go back into the water?

After a difficult 2008, the mortgage market is well on its way to recovery, with interesting and attractive opportunities. Last year, investors seemed reluctant to make new commitments to Mortgage-Backed Securities (MBS) strategies — especially Non-Agency Credit MBS — despite attractive valuations. The fear was that housing prices had not bottomed, and redemptions on levered MBS strategies would continue to force spreads wider and bond prices lower.

Since that time, however, trends have developed that have led to a gradual change in investor perception, starting with the government's introduction of several new programs that have helped to support the market.

As shown in **Figure 1**, during the fourth quarter of 2008, Agency MBS spreads approached their all-time widest levels. As a result of government concern about how badly these wide spreads would impair the housing market through poor affordability measures, the Federal Reserve introduced a program to purchase up to US \$1.2 trillion in Agency MBS during 2009. (Actual purchases through July 2009 have totaled US \$702 billion.) Consequently, mortgage spreads have tightened by more than 50 basis points since the introduction of this program.

Another program that has had a positive impact on the MBS market is the Term Asset-Backed Securities Loan Facility, commonly known as TALF. The TALF program was designed to spur investor purchases of AAA-rated Consumer ABS (Credit Cards, Auto and Student Loans) by providing government-guaranteed, non-recourse term loan financing. This program has also had a positive impact on underlying spreads within the ABS market.

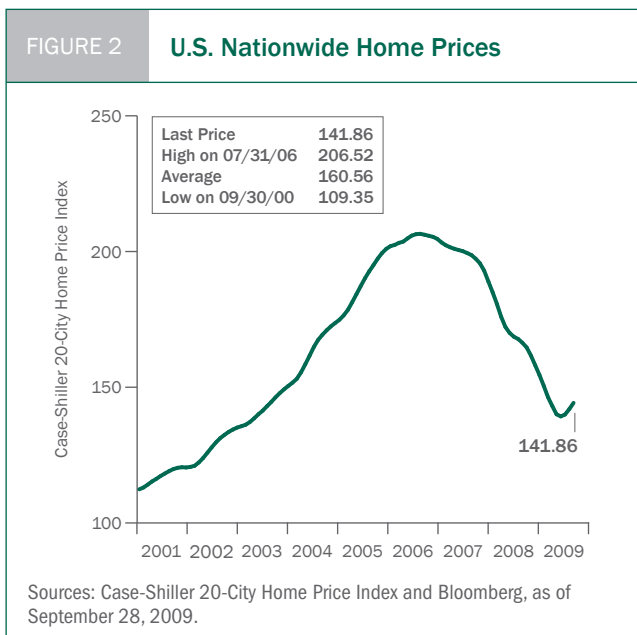
**FIGURE 1 Mortgage Spreads Still Look Attractive**



Source: Bloomberg, as of September 28, 2009.

FIGURE 2

## U.S. Nationwide Home Prices



Recently, the TALF program was expanded to include Non-Agency MBS and CMBS bonds. Non-Agency MBS spreads have also tightened due to the introduction of the Public-Private Investment Program (PPIP). PPIP named nine investment managers that have the exclusive rights to manage private investor pools. These opportunistic-minded investor pools can invest in “toxic assets” using government non-recourse term financing.

Both the TALF and PPIP programs have increased investor appetite to consider structured products investment strategies, such as investing in TALF-only funds and mortgage opportunity funds, since the use of leverage has again magnified potential returns in these sectors.

Other factors that have improved investor sentiment are the relaxation of the mark-to-market rules (FASB 157) impacting insurance companies and banks. This change has improved the investor outlook by removing the

“supply overhang” associated with the mark-to-market-related sales.

Further, the aforementioned spread-tightening has resulted in improved fund performance, which, in turn, has curtailed sales due to lower hedge fund redemption requests. In recent months, investors had become very bearish on the sector due to concerns that hedge fund and money manager redemptions would result in more asset sales, and, consequently, lower prices. The recent improvement in asset prices reflecting tighter sector spreads has helped to mitigate these investor concerns.

Finally, the housing market is beginning to show signs of recovery. For example, as shown in **Figure 2**, the Case-Shiller 20-City Home Price Index was positive in May for the first time since 2006. This trend is also confirmed by the increase in existing home sales and the reduced overall supply of unsold homes in realtor inventories.

This positive trend in housing prices adds momentum to the growing belief that the housing market is improving, and potential credit-related losses may be currently overstated by bond market investors.

Taking all of these indicators into account, we believe the outlook for the mortgage sector means that it is time for investors to finally get back into the water and take advantage of time-sensitive opportunities in this asset class. While spreads have tightened from their 2008 wide levels, investor sentiment and market liquidity are vastly improved, and this confluence of factors is adding up to a broader array of solid opportunities. Furthermore, the underlying housing market is showing signs of recovery, which, in turn, should lead to continued sector outperformance relative to Treasuries and swaps, making long-term prospects bright for this attractive asset-allocation tool. ■

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