

Mortgages: the big picture

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2 October 2014

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- **Growth: three theories**

1. **Bulls: Cyclical surge**
2. **Bears: Secular stagnation**
3. **BAML: Rehab recovery**

BAML Forecast summary

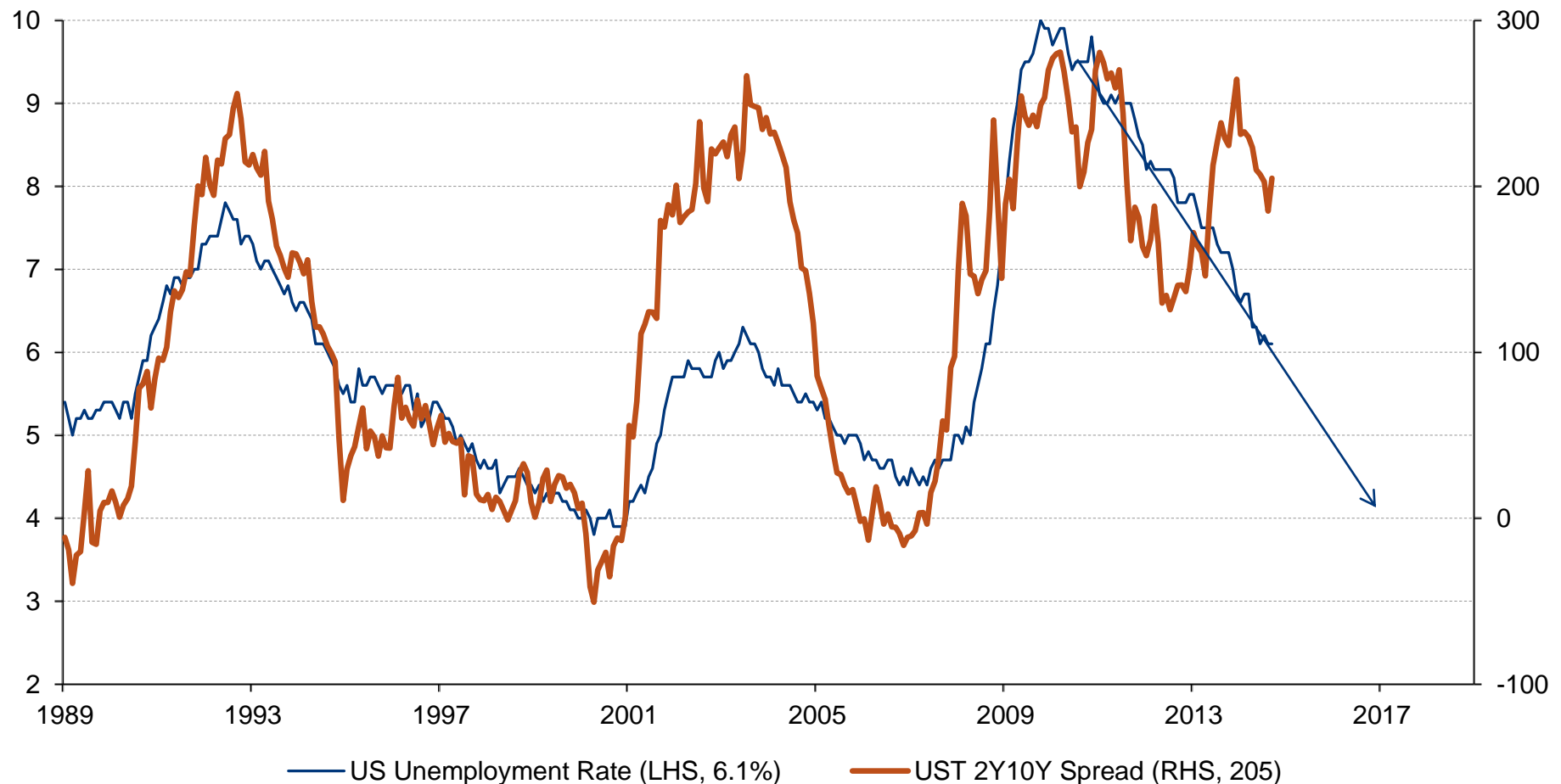
	2012	2013	2014F	2015F
Real GDP (% , 4Q/4Q)	1.6	3.1	2.1	3.2
Core PCE (% , 4Q/4Q)	1.6	1.3	1.6	1.7
Funds rate (% , eop)	0-0.25	0-0.25	0-0.25	0.75-1.00
10 Year Treasury (% , eop)	1.75	3.03	3.10	3.75
Unemployment (%)	8.1	7.4	5.9	5.5

Source: BofA Merrill Lynch Global Research

- 2-3 year yield curve flattening has likely begun; housing very vulnerable to rate shock
- Credit and vol tend to be well behaved in flatteners
- Supply of and demand for residential mortgage credit remains very weak
 - The direct result of past five years of regulation, litigation, and government intervention
 - Creates need for continued monetary accommodation: QE winds down, ZIRP continues through Q2 2015
 - Very positive for market technicals
- Supply of and demand for other credit – commercial, corporate, consumer – far more normalized
- Real estate continues to benefit from low interest rates and foreign capital flows
- Yield compression trade still has more to go
- Yields in 3%-6% range in CMBS, non-agency MBS, and CLOs relatively attractive for now.
- Agency MBS adjusting to QE wind down: tactical allocations. Neutral.
- Mortgage banking industry fragmentation has reduced prepayment risk

The flattening cycle has begun

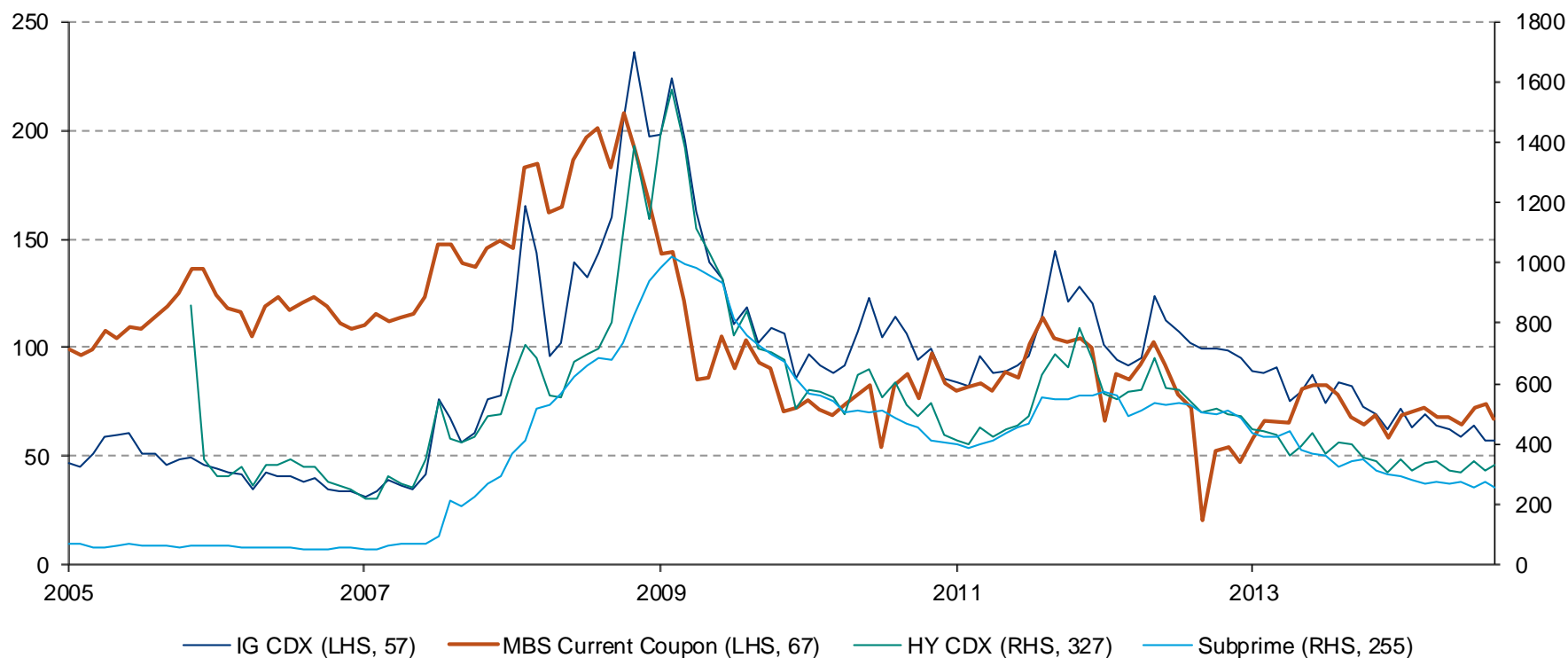
- Declining unemployment rate – 5% 2015, 4% 2016 – usually accompanied by flatter curve
- 2yr 10yr spread at zero by end of 2016



Source: Bloomberg

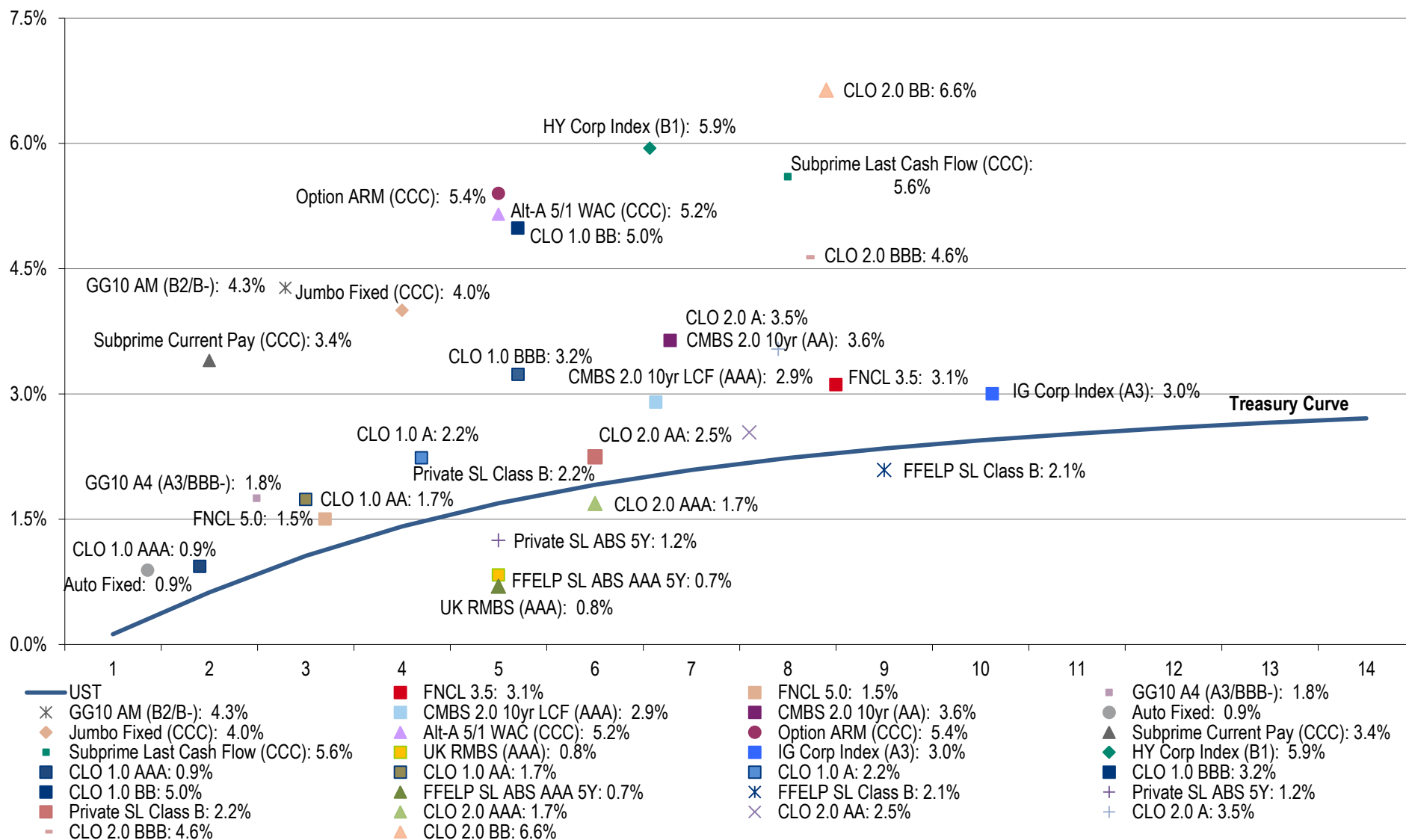
Fixed Income spreads still compressing after the crisis

- Investment grade: 57bps. MBS: 67bps
- High yield: 327bps. Subprime: 255bps



Source: BofA Merrill Lynch Global Research, Bloomberg

Securitized products entering the final yield compression phase; duration barbell recommended



Source: BofA Merrill Lynch Global Research, Fannie Mae, Freddie Mac, Markit, Bloomberg

MBS issuance share of fixed income is declining

US Fixed Income Gross Issuance (\$bn)

	TSY	Munis	Agency Debt*	Agency MBS	Non-Agency MBS	CMBS Conduit	Consumer ABS	US CLO	USD HG Corps	US HY Corps	USD Inst. Lev Loans	EM Corps	EM Sov	US Fixed Income Issuance	Agency MBS share	TSY Share
2008	911.0	389.5	1,892.4	1,140.1	29.8	10.6	134.3	20.5	748.4	44.2	71.2	48.5	30.7	5,471.3	20.8%	16.7%
2009	2,109.0	409.7	1,763.6	1,667.1	7.5	-	174.1	2.6	986.0	133.1	38.7	134.2	77.9	7,503.7	22.2%	28.1%
2010	2,247.0	433.2	1,808.6	1,320.2	5.0	5.1	128.4	4.4	745.0	227.5	158.0	202.3	75.3	7,360.0	17.9%	30.5%
2011	2,135.0	287.0	1,377.8	1,131.1	5.3	24.5	124.4	13.6	769.6	189.3	231.3	182.5	63.7	6,535.0	17.3%	32.7%
2012	2,153.0	363.1	1,130.4	1,663.5	10.6	32.1	200.6	57.6	968.6	280.5	295.1	302.4	90.4	7,547.8	22.0%	28.5%
2013	2,140.0	322.2	884.2	1,544.3	33.8	53.1	179.0	86.4	1,024.2	270.3	455.5	329.1	89.2	7,411.3	20.8%	28.9%
2014 Forecast	2,057.0	330.0	600.0	820.0	43.0	60.0	205.0	110.0	1,000.0	230.0	450.0	330.0	103.0	6,338.0	12.9%	32.5%

US Fixed Income Net Issuance (\$bn)

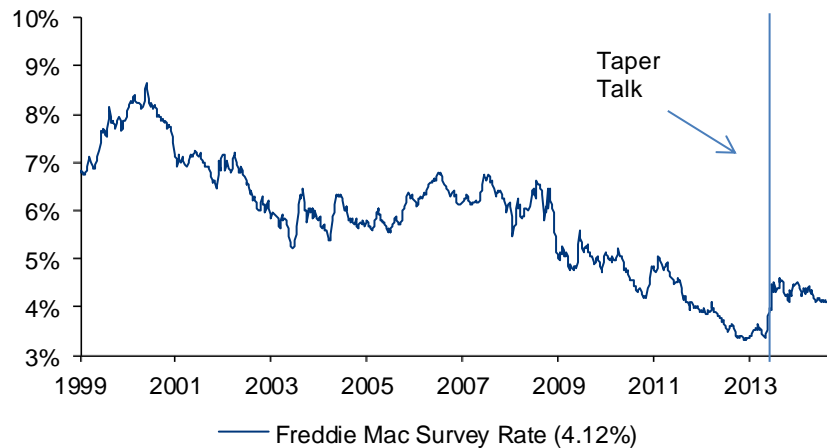
	TSY	Munis	Agency Debt*	Agency MBS	Non-Agency MBS	CMBS Conduit	Consumer ABS	US CLO	USD HG Corps	US HY Corps	USD Inst. Lev Loans	EM Corps	EM Sov	US Fixed Net Income Issuance	Agency MBS share	TSY Share
2008	497.2	57.8	225.0	504.3	(321.9)	(32.6)	(74.6)	5.9	309.2	(75.4)	39.8	(27.1)	(37.9)	1,069.7	47.1%	46.5%
2009	1,550.7	96.6	(472.0)	437.8	(325.3)	(36.4)	(30.7)	(7.9)	391.6	(51.5)	(65.6)	50.4	28.7	1,566.4	27.9%	99.0%
2010	1,606.4	107.9	(205.0)	(144.8)	(240.5)	(44.4)	(101.6)	(15.8)	206.6	32.4	(31.1)	107.1	23.0	1,300.2	-11.1%	123.6%
2011	1,241.1	(12.7)	(207.0)	14.7	(203.9)	(40.7)	(47.0)	(12.8)	268.2	(12.9)	19.4	87.3	1.8	1,095.5	1.3%	113.3%
2012	977.7	(53.4)	(245.0)	32.8	(202.0)	(45.1)	(0.6)	23.2	232.5	48.1	33.6	199.1	24.0	1,024.9	3.2%	95.4%
2013	834.4	(21.8)	(52.6)	236.5	(149.9)	(20.5)	(12.2)	26.1	570.1	60.9	131.3	204.2	7.1	1,813.6	13.0%	46.0%
2014 Forecast	596.0	(30.0)	(50.0)	50.0	(68.0)	(4.0)	30.0	65.0	513.0	50.0	154.9	200.0	51.9	1,558.8	3.2%	38.2%

Source: BofA Merrill Lynch Global Research, SIFMA, Intex, Bloomberg, Fannie Mae, Freddie Mac, FHLB. ReREMICs / EM Corp includes bonds issued in EUR and USD / 2013 net issuance data for Consumer ABS are quarterly / 2014 July data for Non-Agency MBS and US CLO are estimated.

Mortgage production down after taper talk and higher rates

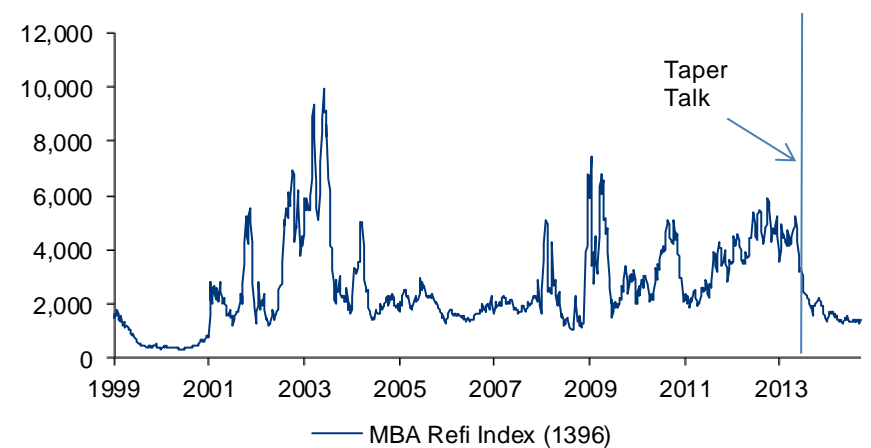
- Housing has not recovered from 2013 rate shock; vulnerable to additional shocks

Freddie Mac Survey Rate



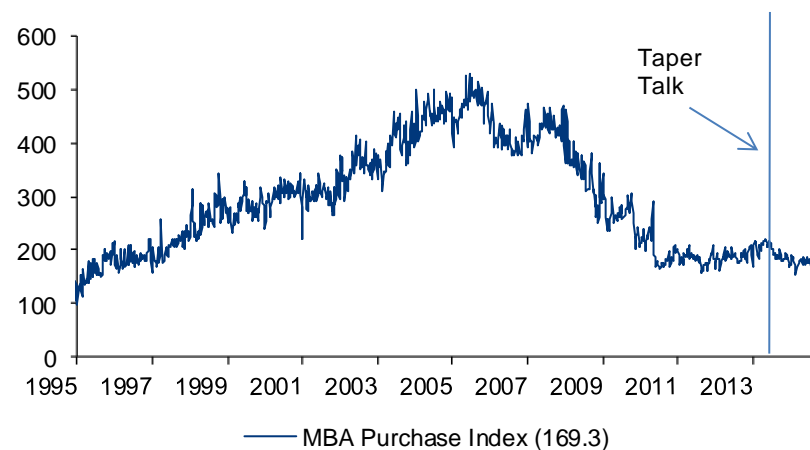
Source: Freddie Mac

MBA Refinance Index



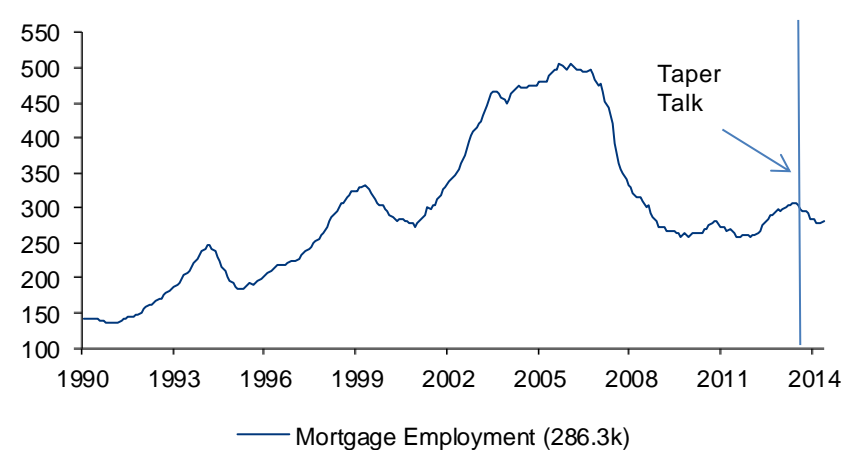
Source: Mortgage Bankers Association

MBA Purchase Index



Source: Mortgage Bankers Association

Mortgage Employment

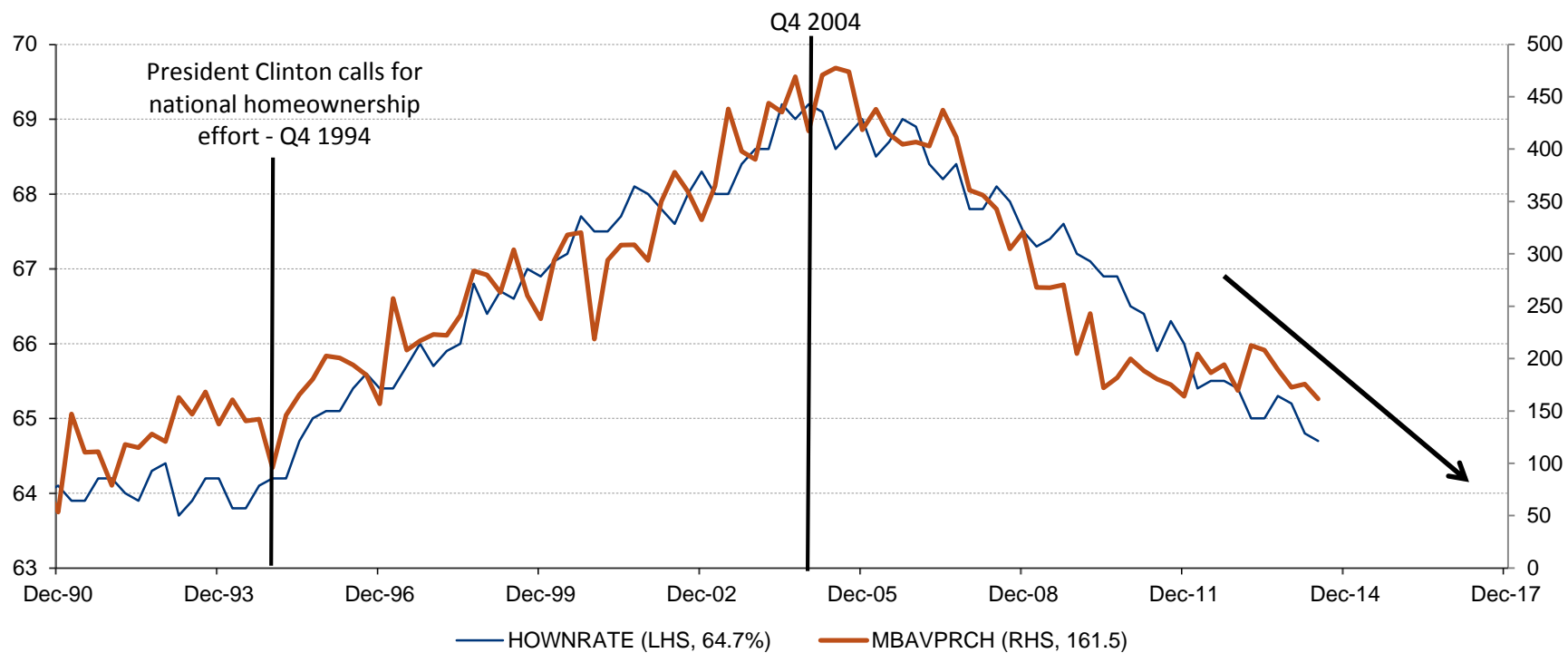


Source: BofA Merrill Lynch Global Research, BLS

Declining homeownership means declining purchase applications

- Homeownership boomed due to 1994 Clinton initiative; housing policy is now profoundly ambivalent
- Peaked at 69.2% in Q2 2004; now at 64.7%
- Seeking equilibrium at 62.5%
- Benign MBS technical

US Homeownership rate and MBA purchase index



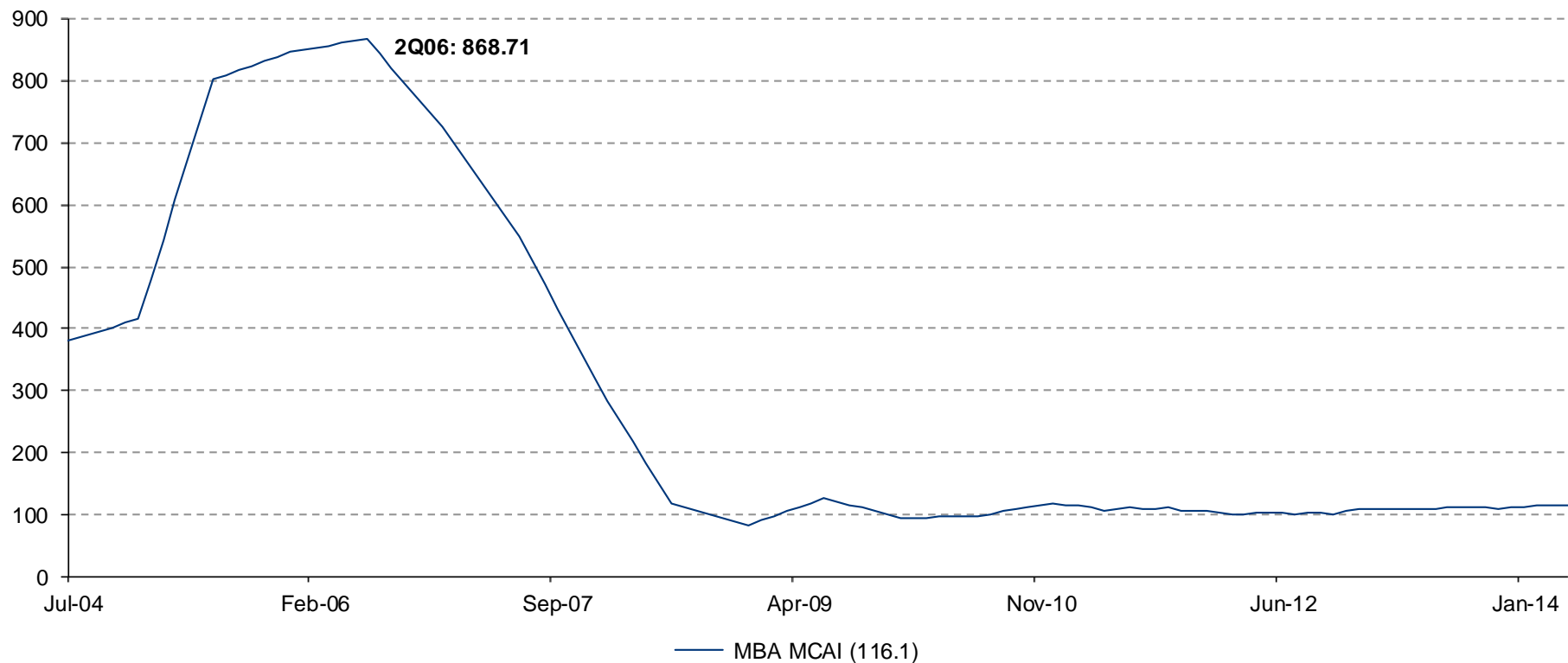
Source: Bloomberg, US Census

- Origination challenged by government takeover of mortgage market and years of litigation. Credit thaw will still take a few years.
 - Conservatorship
 - GSE portfolio reduction
 - QE, which has set rates artificially low and crowded out private lending
 - Litigation (>\$100B)
 - Attorney General National Mortgage Settlement
 - Private Label R&W Settlements
 - FHFA, DOJ, FDIC, NCUA
 - Dodd-Frank: “the very purpose of the statute was in fact to bring about changes in a number of areas in our financial life, residential mortgages foremost among them.” – Barney Frank, July 2014
 - Bank capital requirements, including MSR capital requirements
 - NYS Regulator Servicer Scrutiny
 - QM
 - CFPB: tough enforcement
 - and so on

Expanding mortgage credit fueled the bubble

- Credit expanded even after homeownership peaked
- Credit availability ultimately collapsed; has barely increased in 6 years

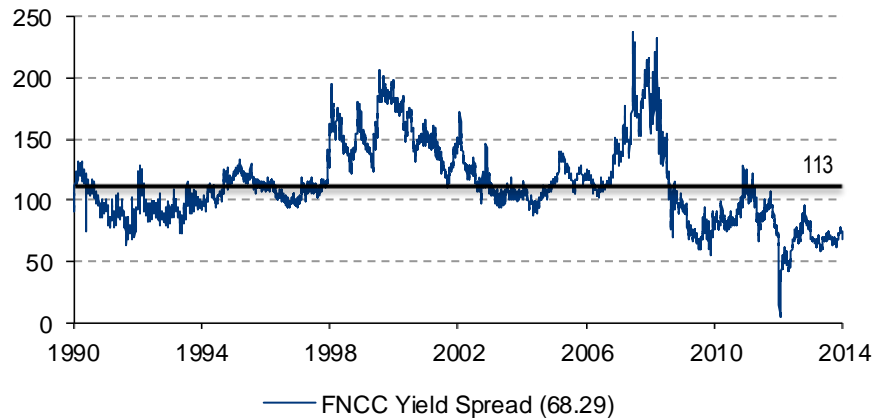
MBA Mortgage Credit Availability Index



Source: MBA

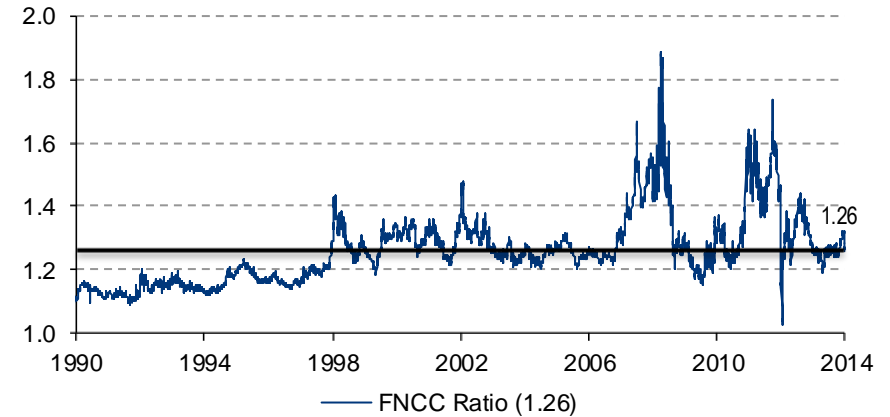
Stable, low MBS spreads and low volatility seem to be the new normal

Fannie Mae current coupon yield spread to 10yr Treasury yield



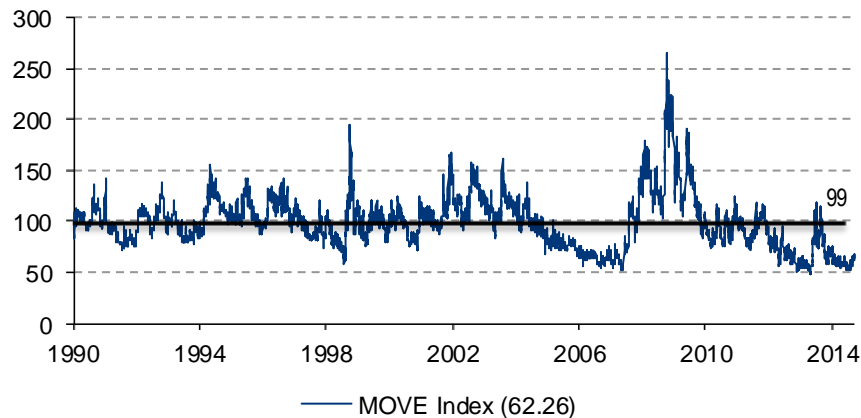
Source: Bloomberg

Fannie Mae current coupon yield ratio to 10yr Treasury yield



Source: Bloomberg

MOVE Volatility Index



Source: Bloomberg

- Low supply is the driver
- Neutral on MBS

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