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Rate Moves Put Mortgage Bonds at Risk

There are fewer people sitting on ultracheap home loans than you might think

At Labor Day picnics this year, millions fewer Americans could brag about having a sub-3% mortgage than a few years ago.

That might be a relief for frustrated home buyers sick of hearing about it. But it is an ominous sign for investors.

Many homeowners and home buyers locked in superlow borrowing rates during the pandemic. Even though mortgage rates have since risen sharply and slowed new borrowing, life has continued. Firsttime buyers still bought. Older mortgages were paid off. People gave up low-cost mortgages to move for family or work. And so on. There were nearly 15 million active primary mortgage loans in the U.S. with rates under 3% as of the end of 2021, according to Intercontinental Exchange data. As of this July, there were under 12 million.

The market shift has been stark in dollar terms. At the end of 2022, around 10% of unpaid principal balances were on mortgages with rates of 5% or higher, according to ICE. As of this July, 5%-plus mortgages represented more than 40% of unpaid balances.

This has economic consequences. Many homeowners were shielded from surging interest rates in 2022 with locked-in rates. Today, rising yields mean that home buyers who had to borrow at higher rates will have to wait a while longer to refinance and enjoy lower monthly payments.

The shift also has investment implications. A much bigger portion of the mortgage market is now eager to refinance if rates fall and will be put off from doing so by rising rates. That is a crucial dynamic for investors in mortgage-backed securities, or MBS.

Fixed-income investors who have lived through tough years recently as rates have surged could turn to government-backed mortgage bonds to earn extra yield while still avoiding credit risk.

The iShares MBS ETF holds bonds issued by government-sponsored enterprises such as Fannie Mae and Freddie Mac that pool individual home loans. The MBS ETF has returned an annualized 4.3% over the past three years, about 1.2 percentage points more than the iShares U.S. Treasury Bond ETF, according to FactSet data.

One reason that mortgage bonds typically yield more than Treasuries—about 5.8% for the AGNC ICE UMBS 30-Year Current Coupon Index, versus just under 5% for 10-year Treasuries—is the risk around early prepayments of mortgage loans via refinancing.

Image



The steady rise in mortgage rates has slowed down borrowing. A house for sale in California. KYLE GRILLOT/ BLOOMBERG NEWS

yields for a period of time can be disappointed one way or the other.

With a shorter life, that money has to be reinvested at lower yields. At a longer life, mortgage bonds' trading price becomes even more sensitive to higher rates.

"With mortgage bonds, you can get more yield than Treasuries," explains Harley Bassman, author of The Convexity Maven website and creator of the MOVE index. "But the trade-off is that you can lose more when rates are rising, and make less when rates are falling."

At the moment, there seems little prospect of rates falling, with Treasury bonds under pressure and the Federal Reserve poised to tighten. But if long-term bond yields do start coming down, perhaps following some kind of cyclical downturn in the artificial-intelligence sector, holders of mortgage bonds could be surprised at the pace of repayments.

That risk was subdued when rates surged. Mortgages at 2% or 3% weren't going to be refinanced by borrowers at 6%, or at 7%. And, of course, rates were in no danger of going below those pandemic-era levels.

Now, the market has tilted more toward mortgages at rates that very well could refinance at realistically lower rates. This means the risk of mortgages getting prepaid either much faster or much more slowly is once again a major consideration for investors.

That can either lengthen the life of a mortgage bond, if fewer refinancings happen, or shorten it, if a lot do. So investors thinking they are locking in mortgage bonds' solid

Walt Schmidt, mortgage strategist at FHN Financial, has noted that average loan balances have risen, today's borrowers also have higher credit scores, and more loans are serviced by nonbank firms. Those firms aim to refinance their customers aggressively be--cause they make money from volume.

"The market is currently very complacent about the potential for faster speeds," FHN strategists wrote in a July note.

Technology plays a role, too. Morgan Stanley strategists recently considered the potential impact of using AI to speed up mortgage refinancing, which is often a very laborious process. They suggested that could lead investors studying past behavior to "misprice this option that borrowers will be more inclined to exercise."

One possible consolation for people who didn't get superlow mortgage rates: the opportunity to invest in higher-yielding mortgage bonds. But nothing lasts forever. Even 30-year mortgages often have much shorter lives.

—Telis Demos

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