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MACRO-CONSIDERATIONS & TWO-SIDED MORTGAGE RISK

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Summary

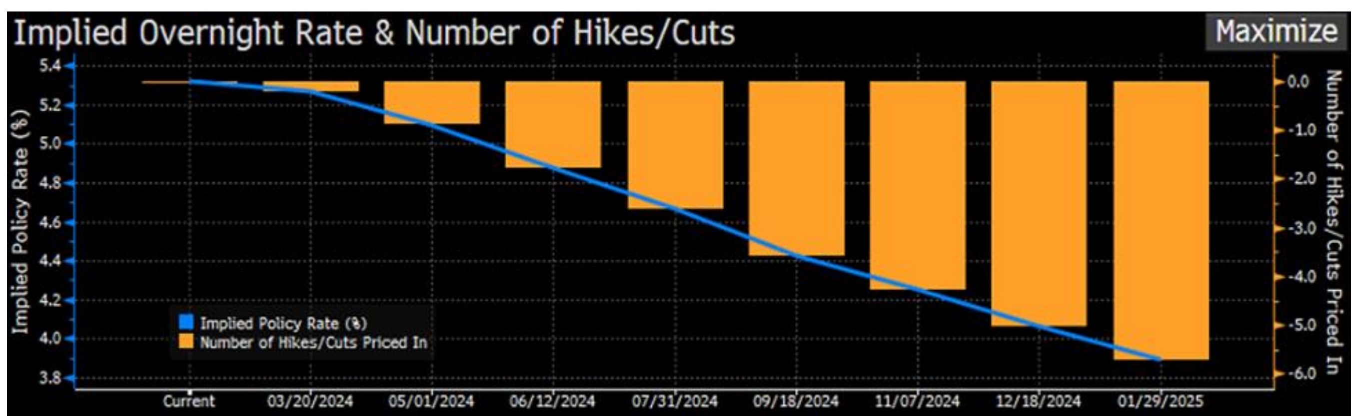
In this article, we look at recent macro developments, the discrepancy between the Fed's view and the rate path views embedded in Fed fund futures and discuss some potential scenarios that could evolve over the course of the year. We finish by looking at the agency coupon stack and the potential implications of these scenarios.

Macro Backdrop

After the most recent Federal Reserve meeting, Chairman Jerome Powell surprised the markets by stating that Fed easing at the March meeting was not part of the current base case scenario (this message had broad reach, as it was repeated on CBS's *60 Minutes*). Later that week, strong payroll numbers, revisions to past payrolls, and wage growth numbers definitively ended the short-term rally of the yield curve that had begun with New York Community Bank's loan loss provision disclosure and dividend cut.

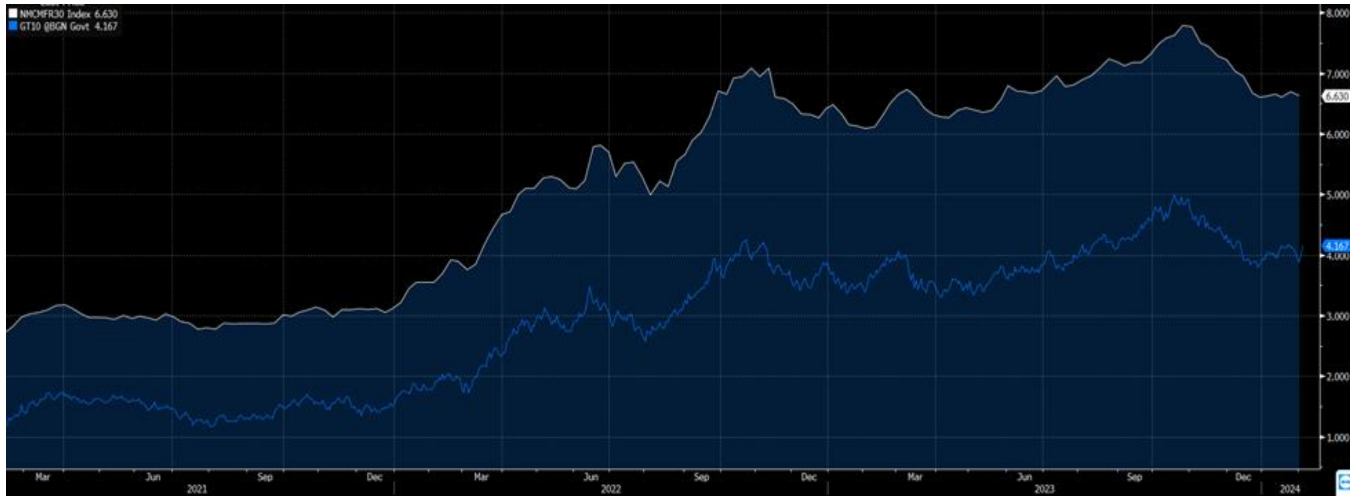
As Figure 1 shows, the Fed fund futures market has definitively taken March cuts off the table.

Figure 1. Fed Fund Futures



Meanwhile, Figure 2 shows we have been in a range for treasury and mortgage primary rates since September 2022, with mortgages fluctuating between 6% and 8% and 10-year Treasuries in the 3.5% to 5% range. The most recent decline has begun reversing in the last few days, with an additional surge following the release of hotter than expected core CPI numbers.

Figure 2. Mortgage Rates & 10-Year Treasury

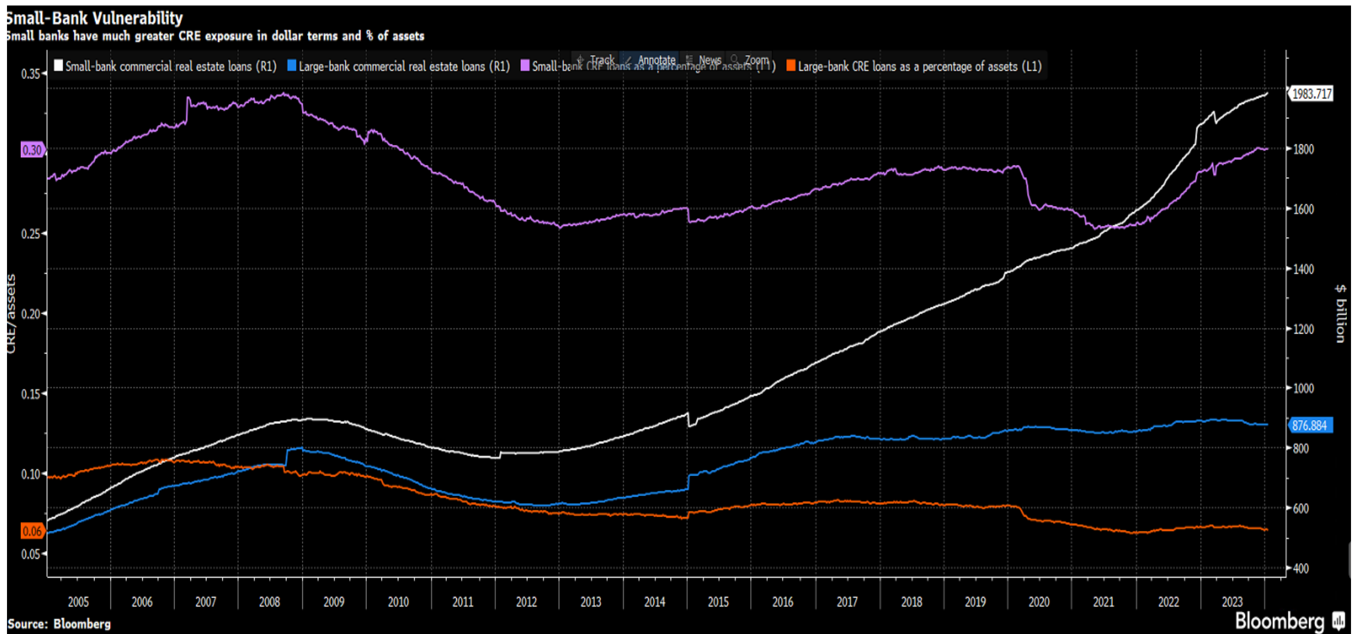


At first glance, the Fed fund futures market appears to be pricing in rapid rate cuts once they commence, totaling six cuts by next January. However, the number of cuts is not consistent with the Fed's most recent dot plot (i.e., the median of individual Fed governors' forecasts), which indicated three or four cuts assuming inflation continues to drop and the economy begins to slow. Rather than viewing the path implied by Fed fund futures as a single market forecast, it may be better to think of it as the average of two fairly divergent views of the potential forward path of the economy, with very different outcomes along each path.

The first view comes from extremely positive wage, GDP growth, and sentiment data coupled with declining inflation, which may nevertheless settle in the 2.5%–3% core PCE range. This could be called the "no landing" scenario, a continuation of which would resemble the economy of the late 1990s (except for the unusually large fiscal deficit) and somewhat lower rates than in the 1990s but a significantly higher rates regime than in the aftermath of the global financial crisis (GFC).

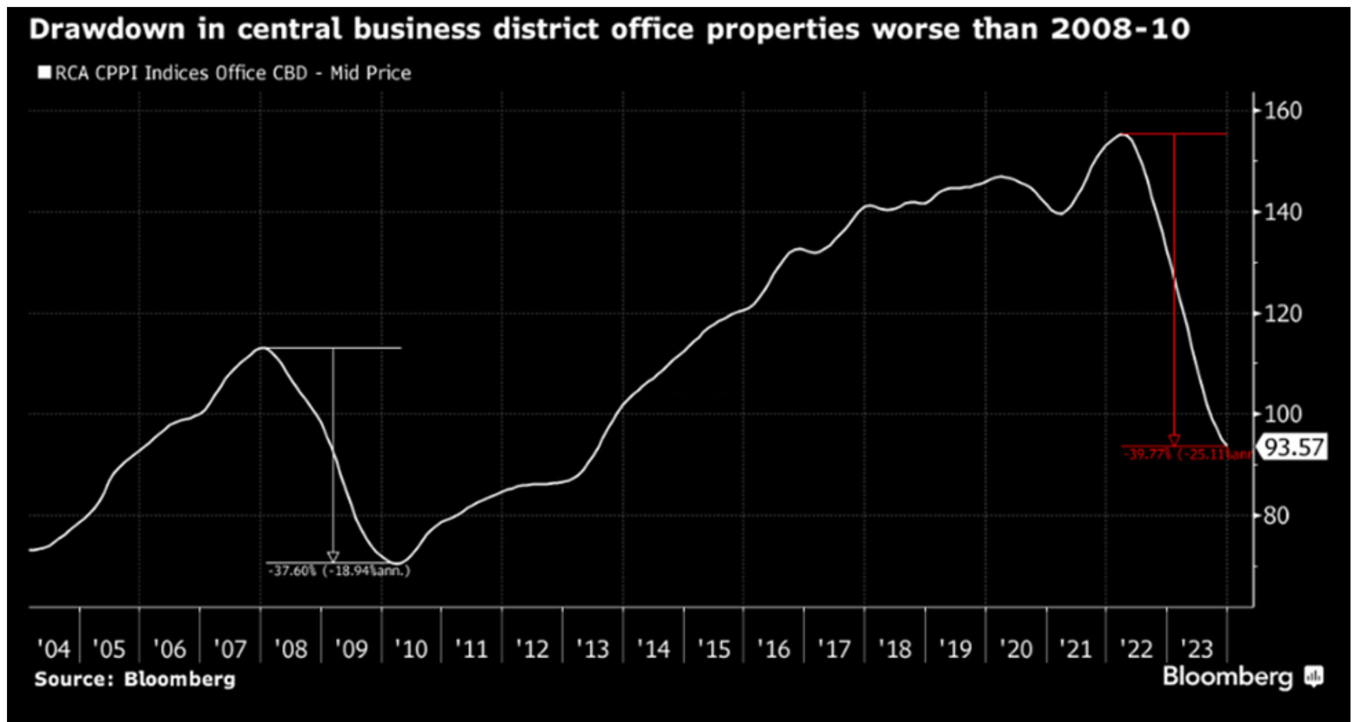
The second view looks ahead at emerging threats to the economy after a long period of low rates at this higher rate level. Figure 3 shows the commercial real estate (CRE) exposure of small and large banks, with small banks having grown their exposure considerably.

Figure 3. CRE Exposure: Large vs Small Banks



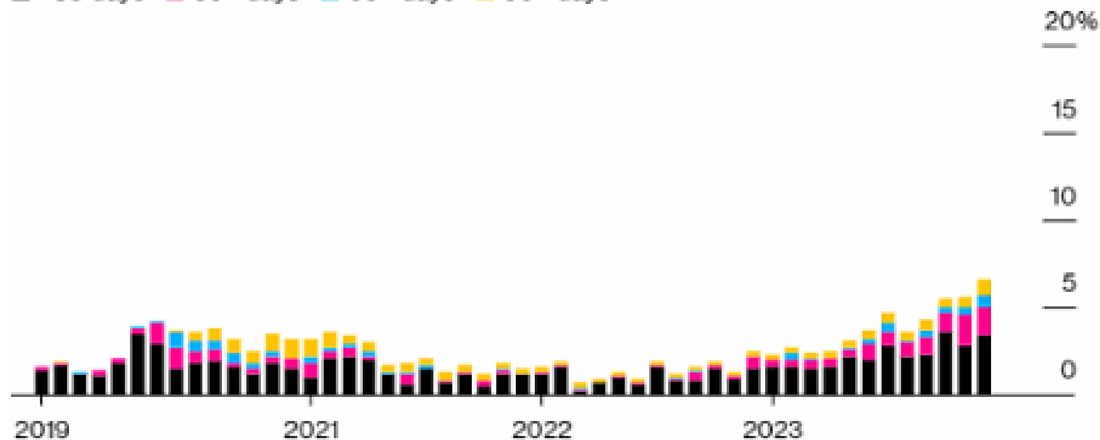
Within the CRE market, the collateral underlying the office segment has, on average, already dropped in value more than it did during the GFC, as shown in Figure 4, which zooms in on central business districts.

Figure 4. Drop in Office Values



Enlarging our view beyond office values, in Figure 5, we look at the delinquency pipeline within all collateralized loan obligations (CLOs) consisting of commercial real estate loans. We are now well above pandemic levels, with growing later stage delinquencies and an upward trend in total delinquencies.

Figure 5. CRE Delinquencies within CLOs



In comparing the potential risk from this sector to that of the last crisis, it is important to point out some key features.

1. Office properties and retail each account for about $3 trillion in collateral value; while many locations may be unimpacted, concentration risk could certainly result in losses significant enough to impact many institutions (the total collateral in these sectors is comparable to the subprime and ALT-A total market at its peak).
2. The rise in adjustable-rate CRE loans, increase in spreads, and higher levels of interest rates combine with the balloon feature of these loans to force significant maturity walls between now and 2027.
3. We can expect the majority of default options on the part of borrowers (outside of GSE multifamily) to be ruthlessly exercised. On the other hand, it is unclear that the manner in which the distribution of risks has occurred is similar to what happened with the non-prime sector (with leverage and broad distribution causing very broad systemic issues).
4. Both rates and credit are important contributors: a 100-bp increase can result in a 10-point decline in loan or property values on rates alone while declining net operating income (NOI) results in larger declines in sectors with more exposure to declining rental income or vacancies (e.g., office, retail).

Suppose we extrapolate these trends into other interest rate sensitive sectors, assuming rates stay at current levels or go somewhat higher for much of this year. In that case, it isn't unreasonable to imagine delinquencies in auto loans (7.7% are delinquent with unemployment at 3.7%) or other consumer loans continuing to rise if wage growth or unemployment change direction.[1] Hidden in the Fed fund futures path may be a second, hard landing scenario, with more than six cuts arriving once they eventually begin. Additional risks to consider include Japan exiting its negative interest rate policy in the next few months (which is one source of demand keeping the long end of the Treasury curve lower than it otherwise might be) or a resurgence of inflation given the supply chain impacts of continuing instability in the Middle East, either of which could temporarily elevate rates to the higher end of the range in Figure 2.

[1] See C. Campbell, "Current State of Auto Market and Delinquency Trends," *The Pipeline*, no. 185 (February 2024).

Mortgage Market Impact: Two-Sided Rate Risk

In Figure 6, we show balances and the most recent 3-month conditional prepayment rates (CPRs) by coupon for agency MBS.

Figure 6. Agency Stack

Coupon	Balance (Millions)		%	CPR	
2	$	2,114,961	28.8%	3.1	
2.5	$	1,466,023	20.0%	4.0	
3	$	1,024,500	14.0%	4.7	
3.5	$	773,954	10.5%	5.3	
4	$	558,939	7.6%	5.4	$1,692,209
4.5	$	359,316	4.9%	5.4	
5	$	333,415	4.5%	4.8	
5.5	$	311,436	4.2%	5.2	$ 877,388
6	$	232,537	3.2%	6.2	
6.5	$	131,565	1.8%	7.8	$ 163,372
7	$	28,793	0.4%	9.9	
7.5	$	2,895	0.0%	7.6	
8	$	96	0.0%	10.3	
8.5	$	19	0.0%	9.1	
9	$	4	0.0%	12.3	
TOT	$	7,338,452			

Source: AD&Co MARS

At current levels of mortgage rates, only the red section (about $165 billion in MBS) has any refinance incentive or is close to cuspy. If rates were to back up to the higher levels reached this year, both the orange and yellow zones could exhibit more lock-in type CPRs. On the other hand, if rates were to decline in line with the Fed fund futures path, the orange section ($877 billion) is not likely to remain locked in, and even the $1.7 trillion yellow range of coupons could potentially see less lock-out behavior, resulting in some acceleration in turnover. Finally, a more severe recession scenario could potentially see a significant chunk of the orange section also become candidates for refinancing if mortgage rates were to fall into the 5% range.

After spending many years with an almost exclusively premium stack, followed by some time now with an almost exclusively discount stack, we may be entering a period where the market as a whole has significant exposure to both turnover and refi risks.

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