

Valuation Commentary

Is the MBS Market Expensive?

by Alex Levin

Investors looking for MBS opportunities quickly come to the conclusion that the market is “expensive” in general, as witnessed by a stream of negative Libor OAS levels reported by major brokers. This may look abnormal to some investors who expect the MBS market to offer additional return over simpler fixed-income instruments. In this short article, we show that the MBS market is where it should be, given historical levels, agency rates and apparent stability of interest rates. In our view, the market is a self-learning system that, in the absence of big events, “learns itself” and reduces compensation for bearing the prepay model risk. Yet, we see some opportunities in the premium (burnt) coupon sector and related IOs.

Historical levels of LOAS for the Current-Coupon

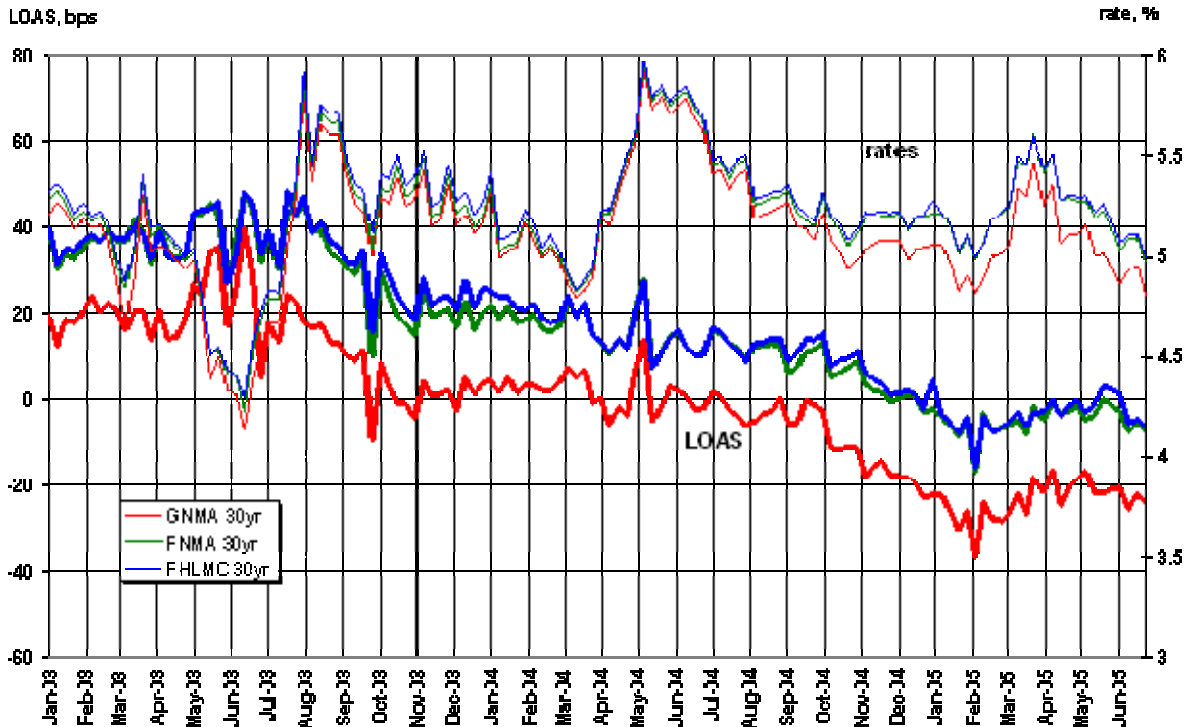
Levin [2001] studies the 1995-2000 history of Libor OAS for the current-coupon FNCL TBAs and finds it is typical to stay within a negative 20 to 0 basis point equilibrium¹. Only when the international financial system came close to the global crisis (1998), did the spreads temporarily widen.

The widest LOAS levels after 2000 were seen in May-June 2003 after rates dropped to their 40-yr record lows. See the next exhibit for the last 2.5 year history².

¹ Using an OAS system developed for The Dime Bancorp.

² Using the AD&Co OAS system (generation 5).

Current coupons and LOAS history



It is now quite apparent that LOAS levels have recently been **as tight as or wider than** the prevailing 1995-2000 range.

OAS and Prepay Model Risk

The AD&Co view at OAS as a compensation for bearing prepay model risk is known for those who read our publications regularly. The question is whether this risk is smaller today (OAS are tight) than, say, in May-June 2003 (OAS are wide). Considering the dynamics of interest rates and prepayment implications, the answer should be an unambiguous “yes”.

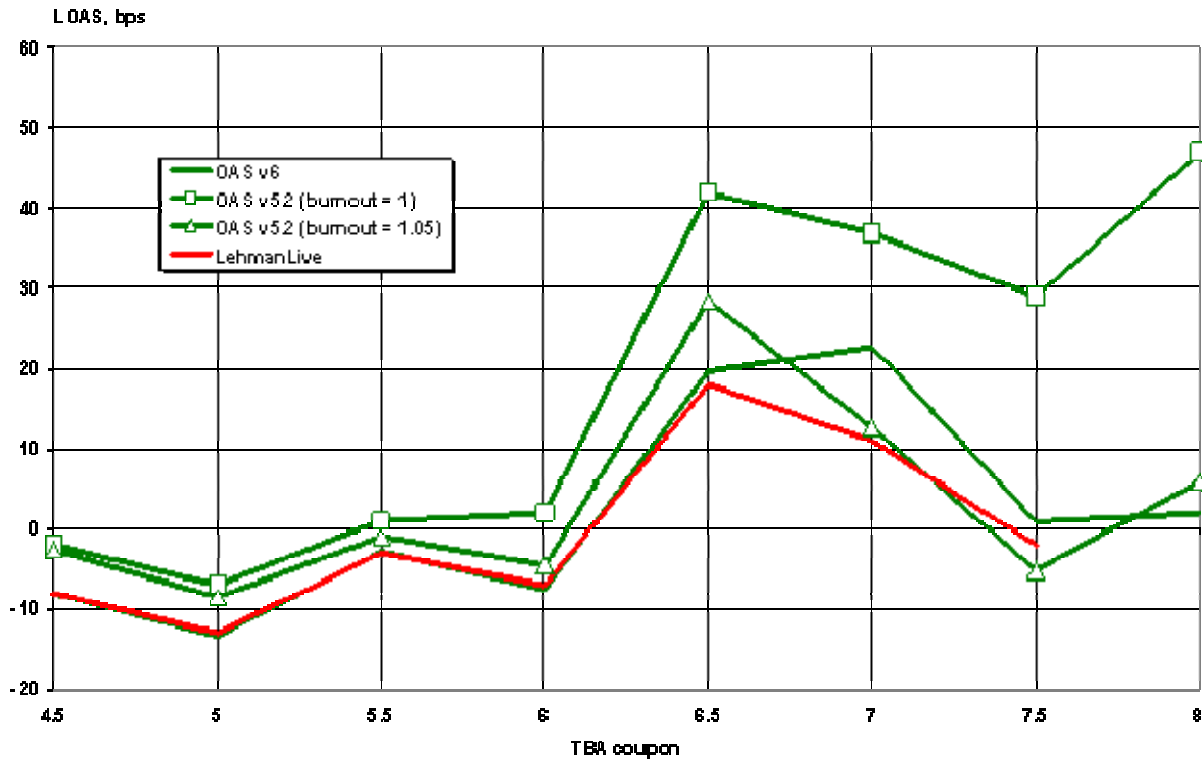
In 2003, the rates dropped to unseen historical levels causing unseen speeds. The MBS market participant had all the reasons to suspect that most prepayment views developed over the preceding higher-rate period, would likely understate refinancing explosion. This is in sharp contrast to last-year’s experience when the FNCL rate was mostly within a narrow 5 to 5.5 band. During the last 12 months, the market had all the opportunities to “learn” the modern-era prepayments and adjust prepay models accordingly. Prepay uncertainty has diminished.

Furthermore, in 2003, the drop in rates left most outstanding MBS stacks at a premium. Curiously enough, even the lowest 30-yr coupon, the 4.5, was priced at a premium. This fact made the refinancing panic even more apparent. Last year, the weighted average outstanding coupon was close to the current rate, causing much less concern over whether prepay models are perfect.

Considering Premiums and Discounts

Note that the current-coupon LOAS is not a perfect indicator of prepay model risk. In order to fully access this measure, we consider prices for the entire range of TBA coupons. Our calibration of risk-neutral prepay model tunings (see weekly analysis at http://www.ad-co.com/risk_neutral_model.htm) is tight to the richness of both premiums and discounts. For example, we have recently noticed *developing opportunity in some burnt premium coupons, such as 6.5 (but not 6.0!)*, perhaps related to the very recent move of FNCL to and below 5.0%. This cheapness is seen on several different models as proved below.

Comparative LOAS levels for FN TBAs as of 06/17/2005



Note that results produced by our recent OAS v6.0 model (operating with the active-passive decomposed 5.1c prepay library) are extremely close to those published by LehmanLive.com – certainly without any coordination or collaboration between two firms. It also seems that the 4.3.4 prepay model operating with a 1.05 burnout tuning would be closer to the 5.1c model (barring other essential differences) than the un-tuned 4.3.4 model.

In one of the next articles, I plan to present the history of risk-neutral tunings computed using a single physical prepay model.

Other Factors and Evidence

Agency-Libor spread has visibly tightened and contributes to LOAS tightening. We maintain that it is the agency curve, not the swap curve that serves as the best benchmark for the proAS valuation method (prepay risk-neutrality). Hence, the zero-risk level for LOAS should not be zero. Looking at the

agency-Libor spread term structure measured on June 17, 2005, we can see that the Libor-based prOAS target varies from -7 bps for FN4.5 to -15 bps for FN8.0. A year ago, it varied from +7 bps to -13 bps. Hence, the LOAS levels should be lower.

The market of Trust IOs and POs generally trades inline with the prepay risk considerations derived from the TBA market. Once TBA spreads tightened, IO and PO strips got much closer to each other on an OAS basis, than typically perceived. In contrast, the May 29, 2003 IO market analysis presented in Levin [2004] suggests that IOs can trade in a 1,000-1,500 bps OAS range without conflicting with TBAs. Simply speaking, the prepay risk properly measured for TBA is drastically leveraged in IOs. Today's LOAS for Trust IOs vary from negative levels (5% IO) to positive few hundreds – as they should, according to prepay risk neutrality. For example, the investment opportunities seen today in the TBA premium market are translated into IO opportunities (with refinancing risk leverage).

Concluding this article, let us suggest that the MBS market is not rich by historical standards and in light of recent stability and agency-Libor dynamics. Moreover, opportunities exist in FN6.5 and other burnt premiums.

References

A. Levin, Mortgage Spread Dynamics, in F. Fabozzi (ed.), *Professional Perspectives on Fixed Income Portfolio Management*, vol. 2, FJF Associates, 2001

Levin, Divide and Conquer: Exploring New OAS Horizons, part 3, AD&Co Quantitative Perspectives, June 2004.

