



The view in mortgage credit

Existing home sales skimmed under forecasts on Monday (+1.2% instead of +1.7%) while new home sales jumped that threshold Tuesday (+7.8% instead of -3.5%). The FHFA home price index came in Tuesday up YoY by 5.48%. Housing continued to deliver mixed signals, although generally showing modest growth and decelerating home price appreciation.

Adding up to fair value in G2/FN

With the first month of MIP-induced prepayments behind us and agency MBS prices showing some signs of stability post the March FOMC meeting, now presents a fine time to revisit relative value in agency pass-throughs. Sticking to our fair value formula (first detailed in our special report from January 27, 2015), we find that at current levels:

- GN2/FN 4.5% looks quite rich and we recommend shorting, even though it is negative carry (~1/32 per month)
- GN2/FN 4.0% looks modestly rich, and being short is slight positive carry (<1/32 per month)

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Figure 6: Framework for evaluating fair value in Ginnie Mae II/Fannie Mae swaps

Cpn	FNCL Px	OAS	OAD	Incremental value (discount) of				Total G2/FN FV	G2/FN Act	Act - FV	Net Carry
				Pay Delay	Liquidity	Credit	Prepayment				
2.50	98-314	17	6.78	0-007	-0-114	0-281	0-161	1-016	0-300	-0-036	0-030
3.00	102-074	6	5.4	0-006	-0-062	0-232	0-086	0-264	0-234	-0-030	0-015
3.50	104-305	-3	4.14	0-007	-0-056	0-165	-0-075	0-040	0-034	-0-004	0-014
4.00	106-250	-6	2.69	0-006	-0-014	0-083	-1-015	-0-261	-0-150	0-111	-0-005
4.50	108-185	27	3.37	0-007	-0-022	0-117	-2-034	-1-251	-0-030	1-221	0-012
5.00	111-010	10	2.95	0-007	-0-080	0-091	-1-160	-1-140	-1-160	-0-020	0-001

Note: all levels indicative as of COB 3/23/15. Methodology described below. Carry assumes model hedge ratios. Source: Deutsche Bank

Fair value framework

To estimate fair value, we separate and price out the component risks (pay delay, liquidity, credit and prepayment) and then adjust the FN value to the corresponding GN2 fair value (Figure 6). We begin by running the FNCL at its market price in the DB prepay model to obtain an OAS. To calculate pay delay, we then alter the FNCL in the model to pay P&I five days sooner, matching G2SF, and price at constant OAS. For the liquidity premium FNCL carries over G2SF, we assume current GD/FN swap prices. For value of full faith and credit premium, we tighten the initial FNCL OAS by the interpolated agency debenture spread over Treasuries and then re-price in the same model (Tight OAS Price - Mkt Price = Credit value). Finally, to calculate the prepayment differential, we price FNCL at even OAS but have the prepay model treat the FNCL as G2SF. Here the model assumes an FHA/VA split of 70/30% (based on historical percentage) and assigns corresponding upfront and annual MIPs to FNCL based on WALA.

We can then sum the individual components to arrive at the fair value difference between G2 and FN, which we compare to actual GN2/FN swaps. The biggest discrepancies lie in the 4.0 and 4.5% coupon where GN2 appears overvalued by 11/32s and 1-22/32s, respectively. We note however that hedge adjusted carry for the G2/FN 4.5% short is slightly negative, but is marginally positive for the G2/FN 4.0% short.