Staying Short or Time to Extend?

Strong employment numbers and sticky inflation readings have combined to prompt the Fed to indicate the potential for two more Fed Funds hikes this year even though many market participants anticipate a recession within the next year. January 2024 Fed Funds futures, which at it's low in March of this year was at 3.69%, is now at 5.298%. In addition, the US Treasury is in the midst of issuing over $1 trillion of bills over the next few months. Also looming later this summer is the issuance of new notes and bonds totaling over $1 trillion in 2023 with the possibility of that issuance nearly doubling next year. The increased treasury issuance is needed to replenish cash in the wake of the debt-limit standoff and to fund a widening deficit, all putting further upward pressure on interest rates.

The question for those with money to invest is whether to extend durations now with interest rates approaching cycle highs or keep durations shorter in anticipation of a higher for longer scenario. One strategy to consider offers doing both.

The following analysis shows investing in a fixed-rate MBS GNMA 30yr 5.50% combined with a monthly reset FNMA floating rate DUS. The three Bloomberg screens below reflect the yield table and price profile for the fixed rate MBS as well as the yield table for the floater. The floater has the price profile of a 1-month security since it reprices every month with no caps.

G2MA 30yr 5.50% YT

2 MA8801 Mtge | Actions | Export | Settings | Yield Tab

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100% G2SF 5.5 N 6.080(356)2 CUSIP 36179XX68 Pool Level As of 06/2023

6/2023	581P	2.3C	0.1B	Traits	SF, 30/360	Coupon	5.5%	Maturity	4/20/53	CA	13%	2023 100%
3Mo	--	--	--	04/01/2023	6.6MMM	LTV/HLTV	94/94	Accrual	7/1-7/31	FL	11%	2022 0%
6Mo	--	--	--	06/20/2023	6.5MMM	MAXLS	3,989,700	Next Pay	8/20/23	TX	9%	2019 0%
12Mo	--	--	--	Factor	0.99521609	WAOLS	429,078			GA	5%	2018 0%
Life	558	1.7	--	# Loans	18,600							

1) Price-to-Yield

Settle	07/20/23	0 MED	+300 MED	+200 MED	+100 MED	-100 MED	-200 MED	-300 MED
Vary	0	237 PSA	128 PSA	149 PSA	181 PSA	475 PSA	1009 PSA	1470 PSA
Price	100-07+	5.4577	5.4851	5.4798	5.4718	5.3993	5.2821	5.1906
Avg Life		6.60	9.83	9.01	7.97	3.81	2.05	1.51
Mod Duration		4.96	6.69	6.27	5.72	3.20	1.86	1.41
Prin Win	Date	8/23-2/53	8/23-2/53	8/23-2/53	8/23-2/53	8/23-2/53	8/23-1/52	8/23-11/37
	I Spread	157	175	171	165	121	59	22

Source: Bloomberg, LP / Subject to change and availability

G2MA 30yr 5.50% TRA (Total Return Analysis)
Price Profile for Changes in Interest Rates

% Prc Change Analysis for G2SF 5 ½

Settle 7/20/23 Px 100.23 | 5.459 | 237 PSA | WAM 29y 7m WAC 6.08 AL 6.60

TSY YLD SHIFTS	Avg Reinv	Pricing @ 0 mth Horizon w/			0 % yld curve adjust.		% Prc Change	
			WAL	TsySprd I	BEY	PRICE	MTGE	7Y
-300		1470 PSA	1.5	+49/AL	2.459	104.22	3.97	20.01
-200		1009 PSA	2.1	+76/AL	3.459	103.749	3.50	12.87
-100		475 PSA	3.8	+126/AL	4.459	103.338	3.09	6.21
0bp		237 PSA	6.6	+156/AL	5.459	100.23	.00	.00
100		181 PSA	8.0	+163/AL	6.459	94.8308	-5.37	-5.79
200		149 PSA	9.0	+167/AL	7.459	89.0076	-11.16	-11.20
300		128 PSA	9.8	+171/AL	8.459	83.2631	-16.88	-16.25

Source: Bloomberg, LP / Subject to change and availability

FNMA Floating Rate DUS (SARM) YT

FN BL2593 Mtge | Actions | LIBOR Transition | Export | Settings | Yield Table

USD Libor Transition Updates More »

US POOL 7.123(71)49 CUSIP 3140HT3B3 Pool Level As of 06/2023

6/2023 1556P93.4C B	Traits HA, Partial IO, M...	Coupon 5.773%	Maturity 5/1/29	FL 58% 2019 100%
3Mo 992 59.5 --	05/01/2019 45,198,000	LTV 72	Accrual 6/1-6/30	SC 42%
6Mo 607 36.4 --	06/26/2023 36,047,000	MAXLS --	Next Pay 7/25/23	
12Mo 337 20.2 --	Factor 0.79753529	DSCR (Curr) 1.760		
Life 127 5.4 --	# Loans 11	US0001M +0.580% Cap 98.650% Flr 0.580%		Mths to Reset 1

1) Price-to-Yield Current US0001M 5.1778

Settle	06/30/23	CF	CF	CF	CF	CF	CF	CF
Indices		C	C	C	C	C	C	C
Vary	0			100 CPP	0 CPP			
Price	99-22+			5.90	5.90			
Avg Life				5.47	5.70			
Spread Duration				4.54	4.70			
Prin Win	Date			6/24-2/29	6/24-5/29			
I Spread				195	196			

Source: Bloomberg, LP / Subject to change and availability

The combined result of investing $1mm in each of these two investments is noted below. Line 11 illustrates the combined position loses of 2.74% in the +100 scenario. That is the price risk of a 3-year Treasury note. If an investor buys a 3-year Treasury though, the yield would stay the same, whereas the yield on this combined position actually increases from 5.68% at base to 6.19% in the +100 scenario (Line 14). If rates fall 100 bps, the position has a gain of 1.60% (Line 11), almost the equivalent of a 2-year Treasury. Not only is there a gain in the -100 scenario, but the yield down 100 basis points is still where Fed Funds (EBA) is today at 5.15%. However, if the investor stayed in FF and rates went down 100, that yield goes down to 4.15% and there is no gain.

	Interest Rate Shift ($000)	-300	-200	-100	BASE	100	200	300
1	Fxd MBS Prices	104.22	103.75	103.34	100.23	94.83	89.01	83.26
2	Fxd MBS Values	1,042	1,038	1,033	1,002	948	890	833
3	Fxd MBS Chg in Value	40	35	31	-	(54)	(112)	(170)
4	Fxd MBS Chg in Value %	3.98%	3.51%	3.10%	0.00%	-5.39%	-11.19%	-16.93%
5	Floater Prices	99.94	99.86	99.78	99.70	99.62	99.54	99.46
6	Floater Values	999	999	998	997	996	995	995
7	Floater Chg in Value	2	2	1	-	(1)	(2)	(2)
8	Floater Chg in Value %	0.24%	0.16%	0.08%	0.00%	-0.08%	-0.16%	-0.24%
9	Combined Values	2,042	2,036	2,031	1,999	1,945	1,886	1,827
10	Combined Chg in Value	42	37	32	-	(55)	(114)	(172)
11	Combined Chg in Value %	2.12%	1.84%	1.60%	0.00%	-2.74%	-5.69%	-8.61%
	Yields							
12	Fx MBS Yield	5.19%	5.28%	5.40%	5.46%	5.47%	5.48%	5.49%
13	Floater Yield	2.90%	3.90%	4.90%	5.90%	6.90%	7.90%	8.90%
14	Blended Yield	4.05%	4.59%	5.15%	5.68%	6.19%	6.69%	7.20%

Source: Bloomberg, LP / Detail has likely changed since originally pulled

To summarize, this combined position has the risk profile of a 2.5-year treasury with a 5.68% current yield, around 50 bps more than what Fed Funds/EBA is currently paying. Something worth considering when market forces are pulling in opposite directions.

For more information, please contact your Country Club Bank Capital Markets Group Sales Representative.

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