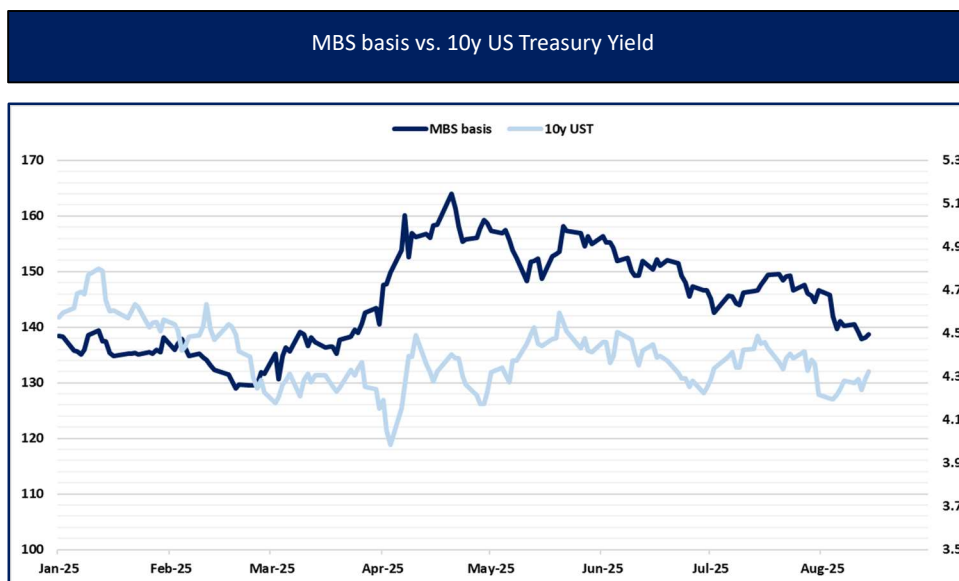


Spreads Tightening: From Surviving to Thriving...

Despite an eventful start to 2025 the MBS market is right back to where it was at the end of 2024. There were a few moments where it felt like markets priced in worst case assumptions, mainly around government spending, and the impact of tariffs on inflation and the economy, however those periods were short lived, and markets quickly returned to more optimistic assumptions, pushing most assets back to the tights of the year. Below are some of the top issues driving valuations in the MBS market in the first half of 2025:

- **No Cuts in 2025** – Fed speakers have become more dovish over the course of the year. The labor market continues to show signs of early weakness, offset by concerns about tariff-driven inflation. The market has been pricing in around 2 cuts in 2025 since the start of the year. With Powell's replacement likely to be significantly more dovish, the market is now pricing in 5 cuts by end of 2026 (up from 3 cuts by end of 2026 at year end 2024). The recent PPI data and persistent fears about inflation represent the biggest risk to risk assets which have tightened significantly in recent months.
- **Liberation Day, Tariffs and Trade War** – On April 2nd, the administration rolled out a wave of reciprocal tariffs, shocking global and domestic markets. Agency MBS found itself caught in the crossfire with current coupon basis widening to 170bps (from 135bps at year end 2024). Markets quickly rebounded, despite tariffs on many key counterparties still not finalized.
- **US Debt Concerns** – With deficits ballooning and Treasury supply surging, the long-term sustainability of US debt is becoming impossible to ignore. The market began pricing in fiscal risk, pushing the curve steeper and real yields higher. Imminent tax cuts further complicate the solution to the US government's deficit issues.
- **GSE Privatization** – During Trump's 1st term, he attempted to bring both Fannie Mae and Freddie out of conservatorship as private companies. The effort ultimately died due to the complexity of the transaction. Now there are renewed discussions about returning the GSEs to private ownership. Bill Pulte, a businessman and philanthropist best known as the grandson of PulteGroup's founder, was appointed as the new FHFA director. Since appointment, Pulte quickly ousted several board members of Fannie and Freddie while named himself the chairman of both entities. Despite headlines about privatization of the GSEs have been increasing, the complexity of the transaction will likely result in the same result this time, despite Trump going as far as suggesting a ticker for the NYSE listed Fannie/Freddie entity.
- **Bank De-Regulation** - Midway through the year, regulators announced to lift the asset cap limit for Wells Fargo. Further guidance on Basel Endgame is expected to be announced soon, aiming to encourage the bank community to re-engage with the market. The MBS Asset class stands to benefit if banks re-enter the market aggressively.

Market Recap



Mortgage spreads were relatively unchanged post 2024 election until the Liberation Day tariff uncertainty sent MBS and other risk assets into a free fall. Par coupon MBS traded as wide as 164bp over UST briefly, before tightening back to 139bp. MBS spreads are now back in the pre-Liberation day range (130-140bps).

The drastic move tighter in mortgages was largely due to 1) lower rates volatility, 2) consistent inflows from banks in shorter duration MBS and hedge funds in long MBS basis trades, 3) favorable valuations versus IG corporates, and 4) increased hedging demand.

Demand outlook is mixed but expected to strengthen across a variety of buyers:

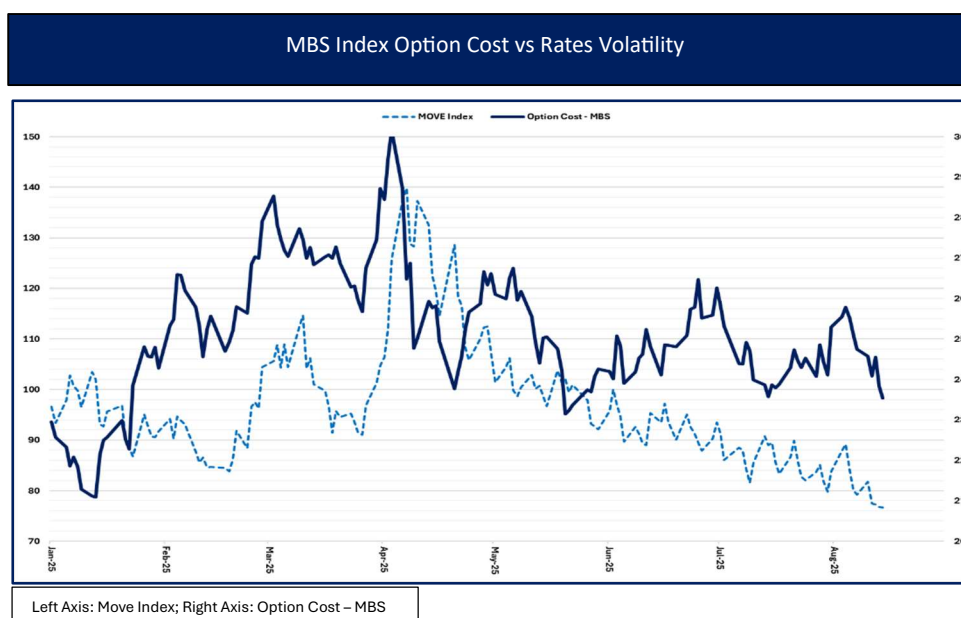
- Bank demand for short duration MBS (current coupon pass-throughs, CMOs such as floaters and fixed rate front sequential) remains consistent. With discussions of bank deregulation and potential reinstatement of capital relief measures like the Supplementary Leverage Ratio (SLR), banks may soon have more room to add high-quality assets like agency MBS into their portfolios. We anticipate a noticeable uptick in bank demand in the next 12 months.
- Money managers continue to support the sector on any weakness. We expect this buyer base to stay robust given the relative value of agency MBS vs. other fixed income spreads products.
- Demand created by hedgers rocketed. A surge in floating-rate MBS issuance led to a large amount of inverse IOs (interest-only securities) being created. To hedge the position properly, hedge funds buy par coupon pass-through MBS, helping to create sustained technical demand.

Supply further declined in Q2. We expect the supply to remain low due to:

- Elevated mortgage rates – Mortgage rates remain high compared to recent history, discouraging both home purchases and refinancing activity. This leads to a lower volume of newly originated loans available to be securitized into MBS.
- Further slowdown in home sales – With affordability at an all-time low, home sales are trending downward, suppressing mortgage origination volumes and therefore reducing the pool of loans feeding into MBS issuance.
- Lesser Impact from Home Price Appreciation (HPA) – Slower home price appreciation removes a key driver that had historically encouraged refinancing or cash-out activity, both of which generate new supply for MBS.
- Limited Refinance Incentives (“Refi Burnout”) – The majority of mortgage borrowers have locked in historically low mortgage rates. With current rates much higher, very few borrowers have incentive to refinance, which keeps prepayments low and reduces MBS supply.

Rates Volatility and Curve: Opportunities Embedded in Agency MBS

Declining Volatility: We compare the option cost embedded in the Bloomberg MBS Agg Index to an interest rates volatility proxy (MOVE Index). Historically, periods of falling rate volatility are typically accompanied by MBS spread tightening. Since Liberation Day, we’ve observed a meaningful drop in interest rate volatility, however, the option cost embedded in MBS remains elevated relative to historical norms. This reflects a lag in the repricing of MBS. As the premiums on the embedded options in MBS normalize, MBS spreads should compress.



Curve Steepening: We believe a bull steepening curve will be the most favorable scenario for MBS. Looking at historical data, agency MBS typically outperform other risk assets into a Fed easing cycle. MBS spreads should compress as demand emerges from spread/yield buyers.

Bottom Line

The debate about the macro economy and the path of rates in the near term will continue until there is further clarity around inflation and the new Administration's policy.

Despite recent spread tightening, mortgage basis looks attractive at 139bps (as of 08/15/2025) vs. the 10yr average of 109bps, given tailwinds such as bank de-regulation, limited supply, attractive performance, expected lower rate volatility and a steepening curve in the long term.

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To be a best-in-class asset manager that leads with value in a client driven, partnership model.

Our Values

- *Innovative*
- *Impactful*
- *Diverse Perspective*
- *Authentic*

Our Mission

To be an agent for change in the finance industry by demonstrating a straight line between the support we receive as a women-owned firm and the support we provide to women in the industry and in the community.

To learn more about our investment offerings, please call 212-935-0755, email ir@seelausam.com or visit <https://www.rseelaus.com/asset-management/>

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