Seelaus Asset Management
MBS Market Commentary

January 9, 2026

SEELAUS ASSET MANAGEMENT

Spreads Tightening: Despite "Driving Through Fog"

The broader U.S. economy in Q4 2025 continued to decelerate in an orderly fashion, though visibility into the macro backdrop was impaired by the government shutdown during the quarter. Labor market conditions softened further, with job gains moderating and the unemployment rate drifting modestly higher. Wage growth continued to ease as labor demand normalized. Inflation data remained generally constructive, with headline CPI and core PCE trending lower, although several releases were delayed or incomplete during the shutdown period. Consumer spending slowed into year-end as higher borrowing costs from prior years and depleted excess savings weighed on discretionary demand.

Overall, the macro narrative remained intact, but the shutdown introduced doubts over quality of the data collection. Several high-frequency indicators were either delayed, revised later, or released with reduced confidence. As a result, investors increasingly relied on market-based signals—such as financial conditions, rates volatility, corporate earnings and credit spreads—rather than official data prints. This lack of clarity contributed to a more cautious policy tone from the Federal Reserve and reinforced the market's focus on trends rather than point estimates.

On the policy front, several important developments shaped markets during Q4:

- **Fed Easing Amid Data Uncertainty –** Following the initial "hawkish cut" in September, the Fed delivered two additional rate cuts in Q4. Policymakers explicitly acknowledged the limitations of incoming data during the shutdown and emphasized a risk-management approach. With inflation pressures easing and financial conditions stable, the Fed was comfortable continuing its gradual easing cycle despite reduced data visibility.

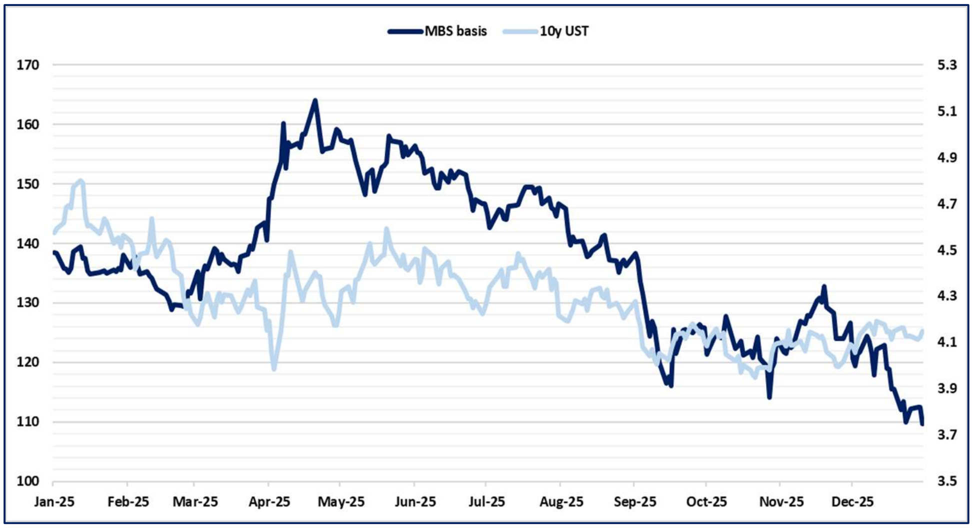
- **Balance Sheet Policy Shift –** While the Fed did not formally restart quantitative easing, it "unofficially" eased financial conditions by reinvesting balance sheet runoff proceeds into Treasury bills. This shift helped stabilize front-end funding markets during the shutdown period, supported liquidity, and indirectly benefited spread products, including agency MBS.

- **Declining Rate Volatility –** With fewer data surprises, clearer Fed communication, and diminished inflation risk, rates volatility compressed to the lowest levels of the year. The shutdown paradoxically contributed to this dynamic by suppressing short-term macro catalysts, improving mortgage convexity profiles and lowering hedging costs.

- **Housing Policy Rhetoric Continues –** The Trump administration maintained its focus on housing affordability into 2026. Despite the long end of the treasury curve still pressured to higher levels, consistent messaging around supporting lower mortgage rates and housing market stability reinforced expectations that policymakers would remain sensitive to excessive MBS spread widening.

Market Recap

MBS basis vs. 10y US Treasury Yield



Agency MBS delivered strong performance in Q4. Spreads tightened steadily through the quarter, reaching the tights of the year, ~110bps as of December 31, 2025. The spreads move was driven by a combination of: 1) lower rates volatility, 2) increased confidence in the Fed's easing path, 3) strong technical demand from multiple buyer bases, and 4) continued attractive relative value versus other high-quality spread products. Importantly, swap spreads widened further during the quarter, creating a particularly favorable environment for investors hedging MBS with swaps, including banks, hedge funds, and REITs.

Demand outlook is expected to strengthen further across a variety of buyers in 2026:

- GSEs to accelerate: On January 8th, President Trump announced that he was "instructing his representatives" at the GSEs to execute a $200bn agency MBS purchase program, aimed at lowering primary mortgage rates and supporting housing affordability. Fannie Mae and Freddie Mac ramped up MBS purchases for their retained portfolios in Q4 2025, emerging as a key marginal buyer. In the absence of Fed MBS purchases, GSE's buy program increasingly resembled a "QE-like" support mechanism, helping contain spreads and support mortgage rates.
- Banks to re-activate: Banks became more constructive buyers late in the quarter as the rates path grew more certain, deregulation discussions gained traction, and wider swap spreads improved hedged returns. Agency MBS remained attractive balance-sheet assets given their liquidity and credit quality.
- REITs remained active: Mortgage REITs continued to add exposure, supported by improving capital inflows and favorable funding conditions. Lower volatility and wider swap spreads enhanced levered economics, sustaining demand even as macro data quality deteriorated during the shutdown.
- Foreign Investors to return: Overseas demand improved notably in Q4, led by Japanese and Chinese investors. Despite spread tightening, agency MBS remained attractive on a hedged basis relative to global alternatives.
- Money Managers less dominant: While still active, money managers are likely to play a less central role than in prior years, in which money managers were essentially the backstop buyers.

Supply conditions remained supportive. Housing activity cooled further in Q4 despite the administration's stated desire to bolster the market. Net MBS supply remained manageable and readily absorbed by demand. Looking ahead, we expect supply to increase modestly:

- Expected lower mortgage rates – Following the Trump administration's expected declaration of a National Housing Crisis in Q3, we expect mortgage rates to decline toward 5% over the next 12 months.
- Slower housing turnover – Towards the goal of lower mortgage rates, net issuance is likely to remain contained especially for new origination.
- Lesser Impact from Home Price Appreciation (HPA) – Cooling HPA removes a key driver of refinancing and cash-out activity, which historically generated new MBS supply.
- Limited Refinance Incentive ("Refi Burnout") – Most borrowers remain locked into historically low mortgage rates. With current rates still elevated, refinance incentives are limited, keeping prepayments low and restraining supply.

Bottom Line

Despite the strong performance of agency MBS in 2025, we believe the mortgage basis still has room to tighten. During COVID, the basis reached historically tight levels (around 50 bps) as the Federal Reserve implemented quantitative easing and added MBS to its balance sheet.

Looking ahead, we expect technicals to remain constructive for agency MBS. While the Fed continues its path toward normalizing the balance sheet to a Treasury-only portfolio, and despite being light on details about the GSE 200bn buy program, incremental structural demand from the GSEs would represent a meaningful technical tailwind for agency MBS, with the potential to drive further basis tightening over time.

Bank demand should increase as regulatory clarity improves, rate volatility subsides, and swap spreads potentially widen further. REIT demand is expected to remain resilient given favorable funding conditions, while foreign investors are likely to continue adding exposure to capture still-attractive spread levels. On the supply side, slower housing turnover and limited refinancing incentives should keep net issuance contained. Overall, we expect investors to continue favoring agency MBS for their attractive spreads and reduced downside volatility heading into 2026.

Who We Are

Our Independence Prioritizes the Client

Seelaus Asset Management, LLC is a private, women-owned investment manager providing expertise in active fixed income and equity portfolio management and designing customized investment strategies.

Our Vision

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

Our Values

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