NSI MORTGAGE MARKET STRATEGY -- 6/1/93

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Security	Settlement	Speed (PSA)	Price	Spread	Change since 5/1
GN 7	June	110	100-06	+93/10-yr	-12
FN 7	June	170	100-10	+123/7-yr	-19
Dwarf 6.5	June	175	100-08	+111/5-yr	-18
FN 7-yr Bal. 6	June	250	100-19	+49/5-yr	-18

Overview

The mortgage market appears to have overcome its volatility fears during May, and has begun tightening across the board, outperforming Treasuries. There are a number of themes prevailing in the market that have led to this tightening, primarily demand from FNMA and FHLMC, who are purchasing MBSs and financing them in the Agency debt market. However, it is likely that some investors might have rationalized that the decline in interest rate volatility is responsible for the tightening, leading them to believe that mortgages might offer value at the current spread levels.

It is our belief, however, that passthroughs are fundamentally rich at current spread levels, and that investors are not being adequately compensated for the increased levels of negative convexity in passthroughs, especially conventionals. We offer numerous trade ideas that should help most portfolio managers enhance returns.

Mortgage Market Themes

- FNMA has been actively purchasing mortgages for its own portfolio, and purchased $6.6 billion of mortgages in April, increasing its retained portfolio by $2.7 billion (net of prepayments). This demand (and control of MBS supply) has caused FNMAs to outperform GNMAs, and even Golds. FNMA is funding these purchases with the issuance of callable intermediate-maturity debt at very attractive levels, effectively ballooning its balance sheet and stabilizing the spread between its funding and mortgage yields (currently around 100 bps, on the margin), with FHLMC following a similar strategy. The agency demand for MBSs is likely to continue as long as they can achieve attractive spreads, suggesting that the demand for Agency debt is driving the mortgage market to its rich levels.

- MBS supply has been waning, as mortgage bankers have cut back their sales, especially for delivery in forward months. We are hearing reports that most originators are selling significant percentages of their production directly to FNMA's and FHLMC's window, as the agencies have the best bid for collateral.

- The MBA refi. index began declining in March, from a high of 1465.6, to 921.90. This implies slower prepayments on the horizon, and also lower levels of new production MBS supply, factors often cited to justify the MBS spread tightening. However, in absolute terms, prepayments for the refinanceable coupons are likely to remain fast for some more time, as the index is still historically high.

- Mortgage borrowers have become acutely sensitive to refinancing opportunities, and can be induced to refinance for as little as a 50 bps reduction in their mortgage rate, a result of increased competition by mortgage servicers to retain servicing income, and the emergence of "no-cost/low-cost" refinancing. This contrasts with the "200 bps" rule of thumb used in the past (which assumes that it takes a 200 bps drop in rates to induce refinancings, because of transaction costs), and fundamentally changes our understanding of prepayment risk and convexity of MBSs. MBSs are now perceived to be more negatively convex that they were in the past, a recognition of which is reflected in an increased sensitivity of MBS spreads to changes in Treasury yields. The increased sensitivity of prepayments to interest rates also hinders us from fairly comparing current spread levels with historical spread levels, except to state that to be equivalently valued, MBSs today need to offer greater spread, as compensation for their increased negative convexity, than they did in the past.

- Investors have also raised their portfolio MBS allocations, in response to the tightening in passthroughs, and have begun purchasing MBSs. These have been concentrated in both current as well as premium (9.5 & higher) coupons. Structured product has also begun tightening, especially in shorter and intermediate PACs, as well as in PAC IOs off current coupons.

- The yield curve has also flattened, further reducing CMO demand for collateral (over and above what the tighter collateral spreads would imply), and CMO issuance. (This is also evident in the collapsing dollar rolls drops in the forward months.) Until structured products tighten significantly, the secondary CMO market offers good value compared to the creation cost of new PACs & Sequentials/TACs.

- Some investors have adopted an increasingly defensive outlook, with inflationary pressures limiting prospects for further declines in long term rates and expectations of Federal reserve tightening already leading to sharply higher short term rates. This has led to renewed interest in short-WAL structured products, which have tightened dramatically. (For example, 3-yr PAC spreads have tightened about 25 bps from their recent wides.) We recommend that leveraged institutions (banks and thrifts) begin hedging liability costs by lengthening liability duration, either by issuing long-term debt, or by using interest rate swaps. Alternately, they should consider shortening their asset duration risk using floaters. Within the floater universe, we believe that COFI floaters offer superior returns to LIBOR floaters.

MBS Relative Value & Trade Ideas

- Sell Collateral, Buy Structure (PACs and Sequentials)
- Sell Premium MBSs, Buy Premium X-PACs with principal lockouts
- Sell Conventional 30-years, Buy GNMAs
  - Sell FNMA/Gold 7.5s, Buy GNMA 8s
  - Sell FNMA/Gold 8s, Buy GNMA 8.5s
  - Sell FNMA/Gold 8.5s, Buy GNMA 9s
  - Sell FNMA/Gold 9s, Buy GNMA 9.5s/10s
  - Sell Conventional Premiums, Buy GNMA Premiums
- Sell Conventional 30-yrs, Buy 15-yrs
  - Sell FNMA/Gold 8.5s, Buy Dwarf/Gold 15-yr 8s
  - Sell FNMA/Gold 9s, Buy Dwarf/Gold 15-yr 8.5s
  - Sell FNMA/Gold 9.5s, Buy Dwarf/Gold 15-yr 9s
- Sell Conventional 8s & 8.5s, Barbell 7s & 10s
- Sell Passthroughs, Buy Treasuries
- Buy current coupon PACs, Sell Treasuries
- Buy 15-yr backed PACs over 30-yr backed PACs
- Buy X-PACs over Sequentials
- Buy long PAC Zs over long PACs and Treasury Strips
- Buy PAC Zs over Sequential Zs
- Buy COFI Floaters, Sell LIBOR Floaters
- Buy Short WAL COFI Inverse Floaters, Sell Short LIBOR Inverse Floaters

Analysis available on request !