Mortgage IOs

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Chief Investment Office Americas, Wealth Management
Leslie Falconio, Senior Fixed Income Strategist Americas, leslie.falconio@ubs.com

- Mortgage IOs do not need a lot to outperform but do need rising interest rates.
- We discuss the performance of mortgage IOs during the first half of 2017, what they provide, and what they add to a diversified fixed income portfolio.
- With the Fed on deck to begin unwinding its balance sheet, greater supply of Treasury and MBS may push US interest rates higher.

Within the investable world of fixed income, mortgage interest-only securities (IOs) offer the rare opportunity to benefit from rising interest rates while also boasting attractive yields and high credit quality. When added to an otherwise diversified fixed income portfolio, the negative correlation of IOs to other bond holdings can provide portfolio risk mitigation and return enhancement characteristics.

As yields rise in the US Treasury market, prices in agency mortgage IOs rise (see Fig. 1), resulting in a positive return. For this reason, we believe this asset class offers investors unique diversification within their fixed income portfolios. Securities such as regular mortgage-backed securities or investment grade corporates have positive duration and their prices will therefore fall as interest rates rise. Including a portion of agency mortgage IOs mitigates the duration exposure of a portfolio without having to raise cash and forfeit yield.

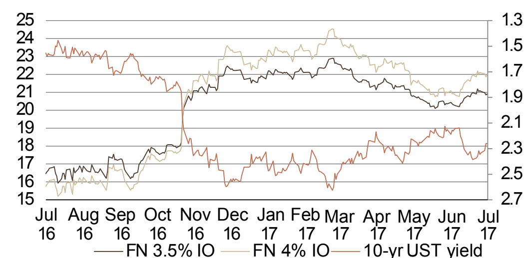
An improving landscape

At this time last year, investors were faced with the Brexit aftermath which pushed the 10-year US Treasury yield to 1.31%, a historic low. Since this low yield, interest rates have been rising both domestically and abroad. This increase in Treasury yields has benefited mortgage IOs. In fact, FN 3.5% IO has returned around 32% since the low in Treasury yield last summer.

With improving growth and inflation in the US and abroad, we anticipate interest rates to rise over the next several months. The potential impact on interest rates from the Fed's balance sheet unwinding is yet to be seen. However, given that increased Treasury supply will be entering the marketplace, a rise in Treasury yields is more likely than a decline, all else equal.

Given the potential for rates to rise, combined with IOs having unique characteristics (AAA asset class with no credit risk), we feel

Fig. 1: IO prices move higher as US yields move higher
FN 3.5% and 4% IO price in USD (LHS); 10-year yield (RHS, reversed, in %)



Source: Bloomberg, UBS, as of 18 July 2017

Fig. 2: CIO WM interest rate forecast
Yield in %

US Treasury	19-Jul-17	3 mths	6 mths	12 mths
USD 3-month Libor	1.3	1.5	1.6	1.8
USD 2-year Treas.	1.3	1.6	1.8	2.0
USD 5-year Treas.	1.8	2.1	2.2	2.3
USD 10-year Treas.	2.2	2.5	2.5	2.5
USD 30-year Treas	2.8	3.1	3.1	3.1

Source: UBS, as of 19 July 2017

it is still warranted to diversify a portion of a fixed income portfolio with agency mortgage IO.

Appendix

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