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Interest Rate Strategy

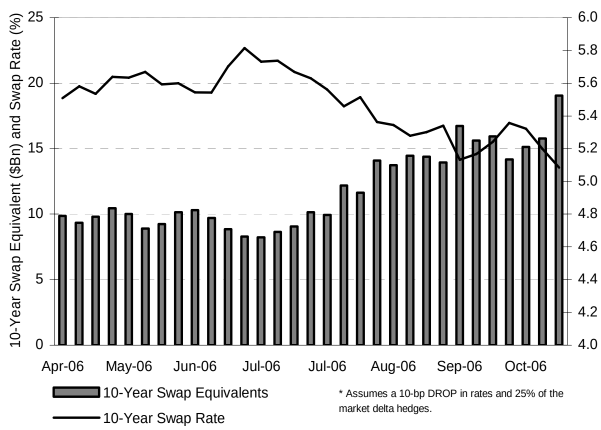
North America

Mortgage Convexity Needs at Recent Highs

The rally over the past few days has increased mortgage convexity needs to levels higher than witnessed recently. Currently a 10 bp drop in rates would imply a $19 billion 10-year equivalent convexity hedging demand, while in late September we noted that number to be around $16.26 billion, for 25% mortgage hedging needs. Exhibit 1 shows the weekly move in convexity hedging demand based on a 10 bp move lower in rates expressed in 10y Swap equivalents, while Exhibit 2 shows the distribution of the mortgage WACs with the latest primary mortgage rate.

Exhibit 1

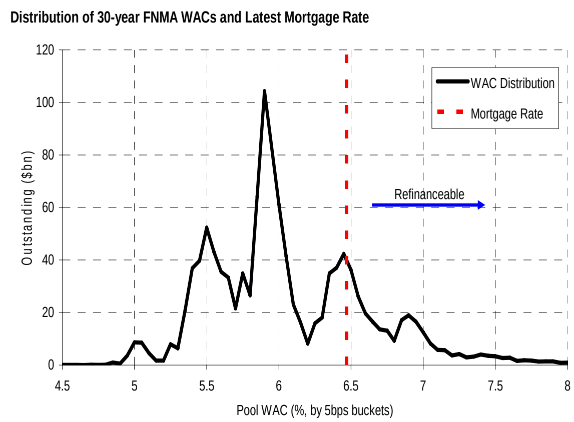
Mortgage Market Convexity Hedging Demand



Source: Morgan Stanley, The Yield Book

Exhibit 2

Distribution of 30-year FNMA WACs and Latest Primary Mortgage Rate



Source: Morgan Stanley, eMBS

Exhibit 2 shows that FN30 6s (corresponding to a 6.5% WAC) are on the cusp of being refinanceable, which given the distribution of mortgage WACs makes 20% of the mortgage universe currently refinanceable (anything to the right of the red line in Exhibit 2). The biggest coupon continues to be the 5.5 coupon, which is about 50 bps away from being refinanceable.

However, any rally from here that takes us below recent lows in yields could prompt convexity receiving to emerge. This demand could be especially acute if there is some pent-up demand for convexity hedging in anticipation of the current range holding. This suspected lack of convexity hedging activity recently could help explain the breakdown in spread directionality over the past month.

Thus any break lower in yields could be particularly damaging to swap spreads as this pent-up convexity hedging emerges. We continue to recommend spread tighteners as a hedge for any short positions.

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