By Lynn Adler Reuters.com

MORTGAGES/AGENCIES-SPREADS WIDEN ON DEEPENING SUPBRIME FALLOUT

16 July 2007
NEW YORK (Reuters)

U.S. agency and mortgage debt prices firmed but lagged Treasury market gains on Monday on widening subprime market worries that fueled demand for safer assets.

Agency and MBS spreads expanded as Treasuries rallied on new lows in the benchmark ABX index, used by investors to hedge subprime mortgage risks.

Investors are skittish even in the safer spread products, despite two days of narrowing at the end of last week when some accounts bought at cheapened levels.

"We're really staying on the very defensive side," said Lance Pan, director of credit research at Capital Advisors Group in Newton, Massachusetts.

"Agencies have definitely been an underperformer," he said. "It just gives us more reason to pause, not adding exposure to that market — not that they have any fundamental credit issues, it's more of a valuation play and we want to wait out this current correction."

Agency yield spreads widened on Monday by up to 1.5 basis points. Benchmark 10-year Fannie Mae notes of June 2017 were bid around 48.5 basis points and offered 48 basis points over Treasuries.

Ten-year benchmark Treasuries <US10YT=RR> rose 13/32, dragging the yield down to 5.04 percent.

The yield premium on Fannie Mae 10-year notes crested at about 50 basis points last week, and remains well above the 39 basis-point spread quoted just six weeks ago.

"We think eventually they should recover as people come to recognize that agency debt is the most secure of all the mortgage market, and people are waiting for an entry point," Pan said.

On the issuance side, Fannie Mae followed its $5 billion of benchmark 2-year and 10-year issuance last week with a $1 billion 30-year non-benchmark offering on Monday.

The new Fannie Mae debt was priced by underwriters led by Goldman Sachs and Lehman Brothers to yield 5.67 percent, or 54 basis points more than 30-year Treasuries. The agencies seldom tap the 30-year sector.

This issue was "the first time we have seen a 30-year bullet in quite some time ... We think there is more demand for long-term pension assets," Andrew Brenner, co-head of the structured product group at Man Financial, said in a client note. "With many pensions well funded, we look to long-term money needs keeping yields in check as stock to bond allocations take place."

Freddie Mac is next in the queue, announcing its July reference note issuance plans on Wednesday. Market consensus is that the agency will sell 10-year notes and likely also a shorter-term issue, most probably a 3-year offering.

Prices of agency 30-year mortgage-backed securities with 6 percent and 6-1/2 percent coupons rose 3/32 to 6/32 on Monday. Fifteen-year agency MBS with 6 percent coupons climbed 1/32.