AGENCY MORTGAGE-BACKED SECURITIES

# Carry-Driven Returns Amid an Asymmetric Backdrop

*This report is excerpted from the Third Quarter 2026 Fixed-Income Sector Views.*

We favor par coupon bonds, where attractive yields can offset modest spread widening.

Agency MBS has posted modest year-to-date gains, with the Bloomberg U.S. MBS Index delivering 1.01 percent total return and 0.45 percent excess return. Spreads have proven resilient despite the bear flattening, supported by weak net issuance and healthy demand for structured cash flows. We view the sector as a defensive carry vehicle, though near-term risks may outweigh rewards given that the Merrill Lynch Option Volatility Estimate Index is near recent lows, and various latent catalysts suggest a higher volatility environment.

## Sector Commentary

- Agency MBS spreads held firm as the yield curve flattened during the second quarter. The data-dependent Fed pivot should raise the floor on rate volatility, but that has yet to manifest, keeping the carry trade alive and well for now, albeit with added risks on the horizon.
- Several factors—including a more data dependent Fed, low implied rate volatility, a flatter yield curve compressing bank net interest margins, and latent macro risks such as the weakening yen and Middle East tensions—skew the risk/reward profile to the downside.
- Despite this, ongoing government-sponsored enterprise support, persistently weak net issuance, and strong fund inflows have kept a lid on any episodes of spread widening. The muted reaction also reflects interest rate volatility concentrated around key economic data releases, with minimal realized volatility between those events.

## Investment Themes

- A flatter yield curve is a mixed signal for Agency MBS. The bear flattening reallocates rather than eliminates the embedded cost of the homeowners' prepayment option: As prepayment risk declines, extension risk increases, benefiting premium-priced Agency MBS, hurting discounted securities, and leaving 5.0–6.0 percent production coupons most exposed to duration whipsaw risk.
- Carry is doing the heavy lifting. We favor par coupon bonds, where attractive yields can offset modest spread-widening events. Agency MBS has lagged investment-grade corporates recently, so a rotation out of investment grade could be an eventual tailwind, though a downturn in global equities is likely required for that to materialize.
- On the defensive side, 15-year par coupons now out-yield collateralized mortgage obligation floaters. It would take two Fed hikes to reverse this dynamic, and the shift may pull bank demand out of floaters and into 15-year fixed bonds.

*By Louis Pacilio*

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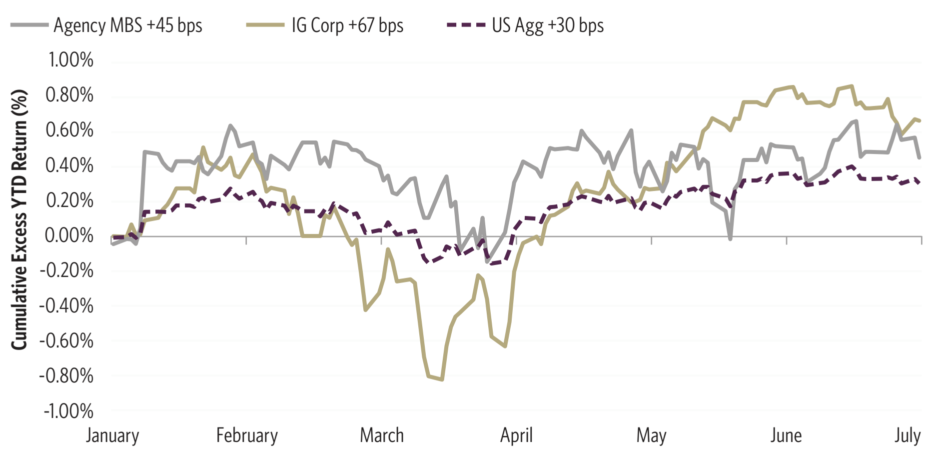
**While Lagging Investment Grade, Agency MBS Has Posted Modest Gains**

Cumulative Excess Returns (2026)




Source: Guggenheim Investments, Bloomberg. Data as of 6.30.2026.

One **basis point** is equal to 0.01%.

**Carry** is the difference between the cost of financing an asset and the interest received on that asset.