MORTGAGE CAPITAL MANAGEMENT

Hedge Commander Review

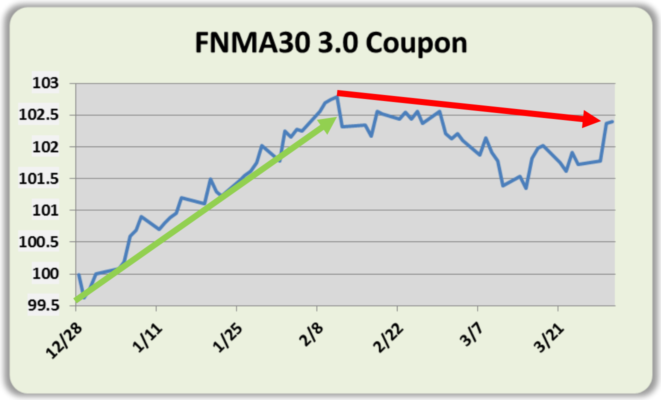
www.mortcap.com

MAR 2016

Welcome to mortgage capital management's newsletter. Though we produce a daily market commentary for clients, we felt it would be useful for our team to review trends, projects, principles of pipeline management, and fundamentals on a quarterly basis.

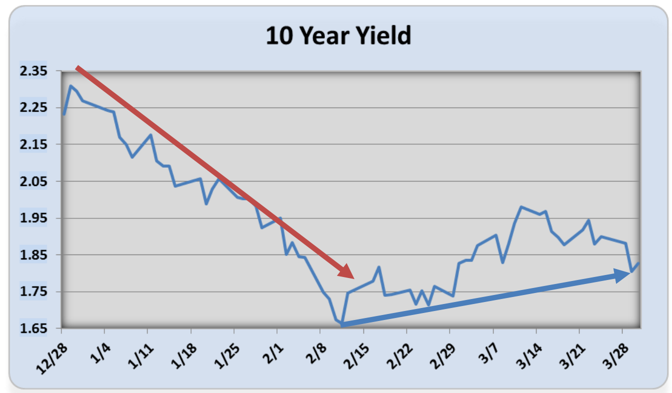
In This Issue:

Technicals & Fundamentals



The first quarter of the year saw a nice rally in bonds and mortgages as oil prices sank during the first two months of the year. Non-Farm Payrolls dropped off in January adding fuel to the fire and assisted prices to rally higher. The price of the FNMA30 3.0 coupon finally met resistance at the 102.75 price level at February 11th and then moved gradually lower into the end of the quarter. Prices did manage a bump higher after the March FOMC meeting and specifically following Chairwoman Yellen's dovish comments following the release of the Fed minutes, The price of the 3.0 coupon ended the quarter higher, but still below the level from February 11th. Lower highs were the trend after the peak but not in any kind of dramatic style. Investors seem to be poised to wait for additional economic data into the next quarter especially after Yellen's dovishness.

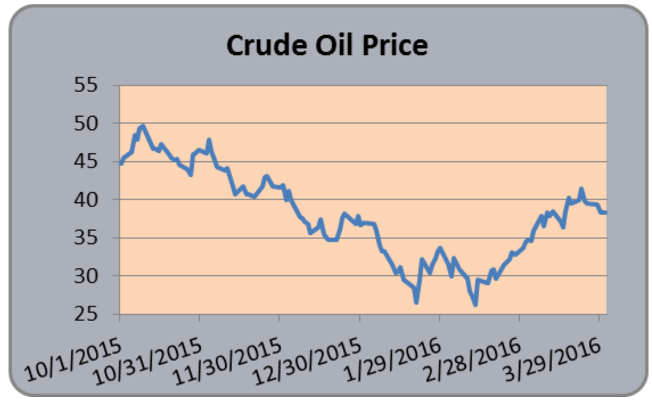
Through the 4th quarter the current coupon had been the FNMA30 3.5, however that changed as we entered February of the new-year and the 3.0 coupon price moved higher bringing fresh lower rate loan production into lender's pipelines. The drop from 104.50, relinquished nearly all the gains over the previous quarter. The level of price for the FNMA30 3.0 coupon rose above levels not seen since early May of 2015.



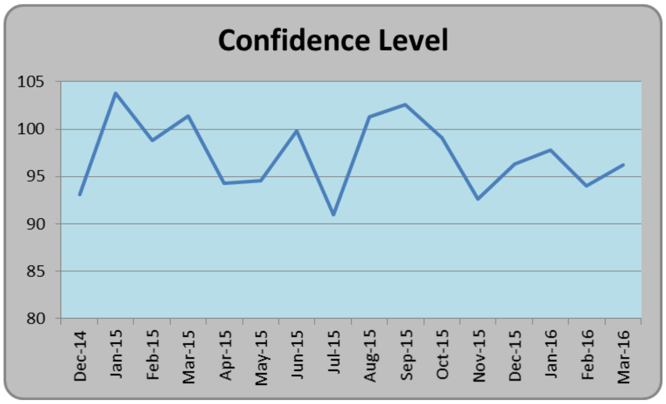
The 10-year treasury yield has an inverse relationship to the price of the FNMA30 3.0 coupon price chart. A similar type story but in a reverse fashion versus the FNMA30 3.0 coupon chart. The chart is showing a downward trend-line pattern dating back to late December of the 4th quarter. The yield fell from 2.30% down to a low of 1.65% in just over a month before it gradually moved higher for the remainder of the quarter. The yield remained below 2.0% and ended the quarter at 1.83%. The chart is suggesting that rates are on the increase, but only gradually.

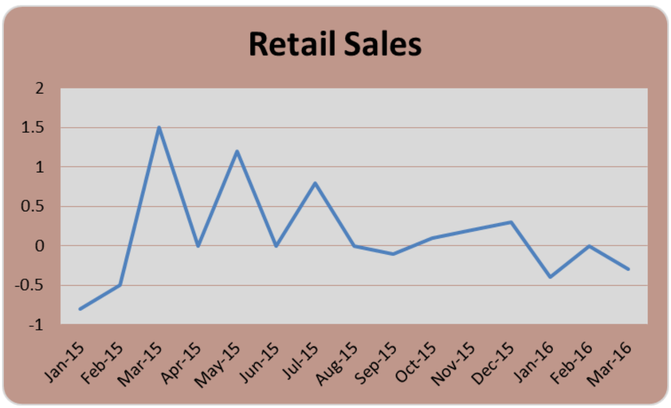
Fundamentals

- With one quarter under our belts, there was not a lot of change in economic conditions that allowed the Fed to increase rates any further. Global concerns and further drop in oil prices helped support prices for bonds and mortgages. Prices once again reversed trend course from the previous quarter and headed higher with upward tending prices. The Fed held rates in check at both the January and March meetings, sighting global concerns and lack of inflation in both cases. Chairwoman Yellen gave very dovish remarks after the March meeting. At the December meeting, the Fed projected 4 rate hikes in 2016, however that projection was reduced to two by the March meeting. The inflation target of 2% is still just that, a target that now may not be hit during 2016. The price of Oil and energy in general continued to play a key role in keeping inflation in check once again, but oil did muster a bounce in March. . The unemployment rate ticked down by .1% during the quarter, but underemployment continued to be a concern. The consumer continues to be conservative even with lower gas prices.
- There have been some signs of wage inflation, but overall inflation continues to remain below the Fed's target rate of 2%. A large part of the lower inflation has been the lower price of oil. The unemployment rate seemed to stall at 4.9% and new jobs seem to be more part time than full time or individuals are underemployed. Consequently, the economy is not seeing the degree of wage inflation that the Fed wanted to see.

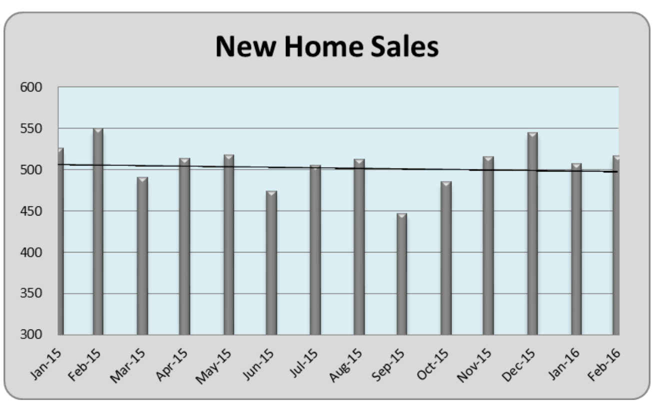


- Consumer Confidence has remained at levels below 100 for the quarter. Consumers continue to be wary about a strengthening economy going forward. Even with Oil in decline for most of the quarter and the lowest levels at the gas pump in some time, the consumer has been cautious when it comes to spending money. The price of oil dropped throughout the quarter to as low as $26 per barrel. Gasoline prices fell to recent historic lows as well which acts as a tax credit for consumers putting more spending money in the pocket book each month. Nonetheless, consumer spending continues to be lack luster.



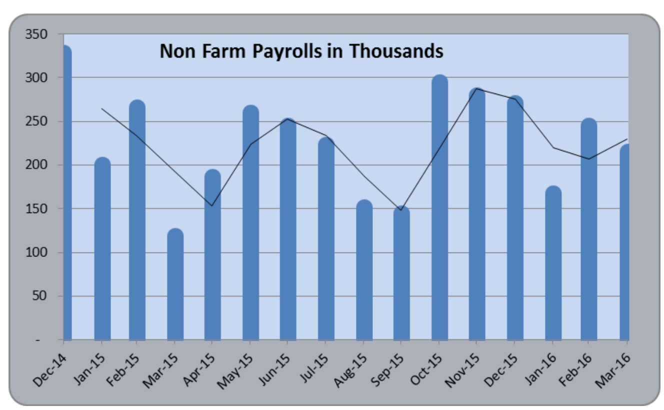


- Home Sales during the first quarter continued to show some resilience, and the general trend has stabilized with all months in the quarter coming in at above 500,000 units on an annualize basis. It has not been overwhelming, but Home Builders are feeling more confident as a whole.



- Manufacturing improved a little during the 1st quarter. After a year and a half of declines, manufacturing had its first positive quarter. The big question will be is this just a pause in the downward trend or is there some life in the sector?

- Payrolls from Non-Farm are starting the year very similarly to the 1st quarter of 2015. January saw a drop then a rebound in February and then a drop in March. Payrolls never topped the 250K level so all reported months were weaker than the worst month in the last quarter of the year. The lower growth along with other factors mentioned has kept the Fed on the sidelines for another rate hike at this point. After the December meeting and with such strong payroll numbers the Fed anticipated raising the discount rate 4 times in 2016. After the March meeting they reduced that to two hikes during the year. Many believe there may only be one.



The FOMC, which seemed poised to raise rates multiple times during this year have changed their tune. Chairwoman Yellen, after the release of the March minutes gave a very dovish outlook siting continued concerns of fragile world economies. In addition to those effects on the US economy moving forward she also continued to stress the inability to get inflation to move to the 2% level. Not all Fed Presidents were in the same camp as Yellen though. Some of the more Hawkish members of the Fed followed up with comments of their own indicating they feared inflation may begin to grow too rapidly with the lower rate environment. They fear that it may be hard to stop without having to drastically raise rates down the road. They feel a gradual increase now would result in a better outcome for the future. Most Fed governors seem to feel that the job growth is strong enough, but continue to be baffled as to why the consumer is so reluctant to spend. Is it possible this may be a more generational issue that may require more understanding of the new work force and their views on spending? Or could it just be that the consumer is not confident enough and would rather out some money away for a rainy day?

Market Volatility and Basis Risk

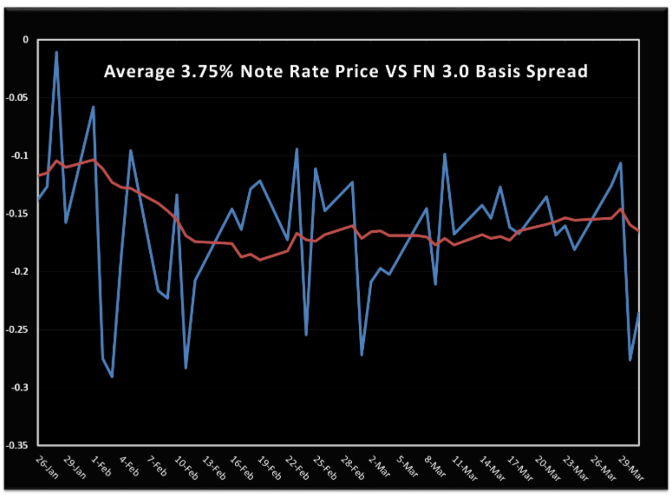
The month of February could have proven to be a tough month for profitability for many mortgage bankers. Higher levels of volatility were prevalent through most of the month. Prices of mortgage backed securities rallied to recent highs during the early part of the of the month causing many locks from January to either leave and go elsewhere for a loan or to come knocking at the lenders door to request a lower rate. Either case would lead to a lower profit margin. In addition, execution of selling loans was less favorable because basis spreads widened out. That is a double whammy to a mortgage banker's profitability.

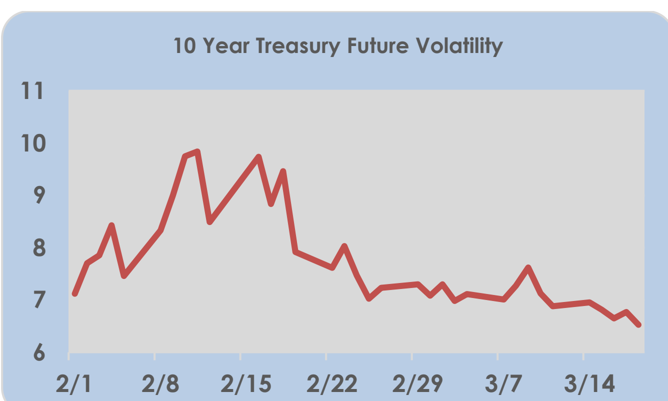
During this period of time the move higher in prices was accompanied by increased volatility that did not begin to subside until the end of the month. The fear and uncertainty in the market led mortgage investors to be cautious in pricing out to the street and in their bidding of bulk packages. Many mortgage bankers only think of basis risk as hedging with a different instrument than their standard TBAs that match the note rate of the loan. They believe that as long as they are hedging with matching TBAs there is no basis risk. Yet, when there is volatility and investors do not price in accordance with the movement in the TBA market, this is basis risk.

To illustrate the basis risk, the 1st chart below shows investor average pricing for a 3.75% note rate versus the securitized 3.75% note rate in a FNMA30 3.0 coupon at matched initial pricing points. Basis spreads moved daily. In addition, the volatility movement during the same period of time is shown in the 2nd chart. During the periods of high volatility from February 1st to February 24th, there were 7 days where spreads were worse by 20 basis points or more. You can also see that when volatility subsided, investor price levels improved in relation to securitize pricing.

Couple basis risk and volatility together with increased fall out/renegotiations and reduced profit margins will be the result.

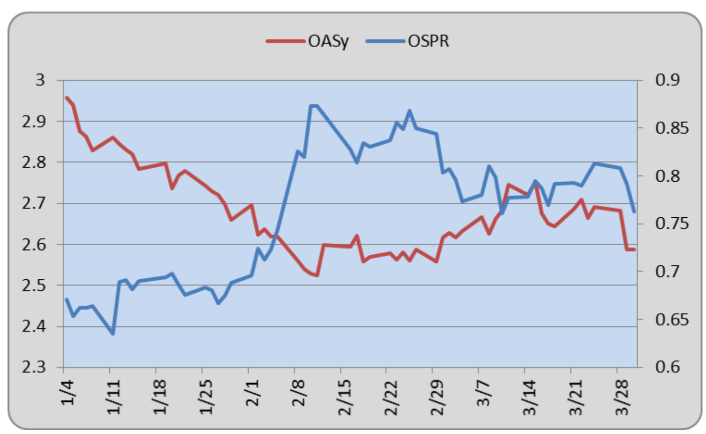
At Mortgage Capital Management we promote monitoring basis spreads between investor pricing and securitized TBA pricing, and market volatility to determine if it is a good time to sell loans. In addition, close daily monitoring of potential loan fall out is a critical daily activity. Mortgage Capital Management provides tools and daily coaching to assist in managing these risks. Management of these risks will lead to more consistent marketing gains and prevent the double whammy.





Basis Spreads

During the quarter, the spreads between the OAS10 Year Treasury Yield and the OAS FNMA30 3.0 Coupon Yield ranged between 87 basis points on the high side and 64 basis points on the low side. Spreads were on the low side for the first month of the quarter and then began to widen out to the highs during February and remained on the wider end of the range to the end of the quarter. The high and low end of the spread has been intact for multiple quarters and offers a good view as to whether pipeline hedgers that utilize options should be adding Calls or Puts. The most interesting view of the chart is what happened leading into the Fed's rate decision in the early part of February. Spreads widened out by 20 basis points in yield even though the OAS yield of the FNMA3.0 coupon remained somewhat unchanged. This indicates some flight to quality or a propensity to add more treasuries into portfolios in relation to MBSs with the Fed not moving on rates and being more dovish. Spreads have cautiously moved lower, but still not even back to the middle of the range.



1. Projects & Release Dates

At Mortgage Capital Management, Inc., we pride ourselves on having the gold standard in mortgage pipeline hedging analytics. We strive to constantly improve our product to our clients. In addition to our core analytics, we provide many other tools for our clients on our website to assist them in making decisions to sell loans at the best execution price. We currently offer a best execution-pooling tool and are well into loan level best execution analysis to enhance our pooling tool. The enhanced tool will:

- Pool Loans using a Goal Programming Method to maximize pools according to stated criteria
- Best execution based pricing for each loan and pool according to a variety of investors and executions including:
    - Assignment of Trade and Direct Trade executions
    - Mandatory Pricing
    - Agency Retained
    - Agency Released
    - Securitization
    - Bulk Pricing

The Best Execution Model will include all Loan Level Price Adjustments according to what execution turned out to be best, State Adjusters, and Investor Service Released Premiums. It will allow our Partnership Accounts the ability to upload their individual SRP schedules and Investor Rate Sheets to the website.

Other projects that are in the works include:

On line trade Blotters and Trade Tickets to track outstanding trades. It is designed to track paired off trades that have not settled in the event a client has elected to have trades removed upon assignment. These new features will provide:

- Summary of information by dealer, by product and by settlement month.
    - Tracking reports showing combined trades to indicate where the client stands in relation to their margining thresh holds.
    - Trade tickets that allows the trader to enter the trade information in a user friendly manner
- A trade blotter and entry system that creates an e-mail trade tickets and tracking mechanism that can be sent to targeted individuals.

Market Report,

Spreads & Bid Indications

With the market rally since the last quarter, payups on specified pools remained the same on the lower coupons. High balance spreads have widened out versus the last quarter making high balance loans generally more expensive.

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FN 30YR	85K	110K	150K	HLB2	20YR	10YR
3	8	6	4	2	36	15.5
3.5	36	30	20	12	18	6
4	64	56	40	24	16	1
4.5	88	72	48	24	16	1
	Payup vs FN30 yr (32nds)					vs 15 yr

DOW	**17,685**
S&P	**2,060**
GOLD	**1,234**
Oil	**38.34**
Euro	**1.1377**
Yen	**112.57**
UE Rate	**5.0%**
Mtg App	**460,500 +19%**

2. Web Based Training

Mortgage Capital Management is continually improving and creating new systems, reports, and analytics available to our clients on their individually supported and defined website. In order to assure that our clients understand all the tools, reporting and analytics available, we conduct training seminars periodically. The seminars will be web based with a question and answer period at the end of each session. Seminars will typically last 30 to 45 minutes depending on the subject matter plus a 15 minute question and answers session. Each will begin at 10:00 AM PST.

Topics will be repeated upon demand at specified dates in the future so if you miss one, chances are it will be offered again!

The next Web Based Training will be on May 12 at 10am PST.

Web Based training Schedule

12-May	Basis Risk Tools
10-Feb	Rate Sheet Generator
2-Mar	Float Down Pricing and Management
23-Mar	Builder Commitments Pricing and Management

May - 6	Website 101 + Tracking Graphs and Historical Pipeline Data
May - 20	Scenario Analysis
Jun - 10	Market Data and Analysis
Jun - 24	Data Files, error reports, and historical reports
Jun - 8	Diffusion Analysis
Jul -22	Daily Commentary and Analysis
Aug -12	Spread Analysis
Aug -26	Pooling and Stip trades
Sep - 9	Best Execution Analysis