The Future of the Fed’s Balance Sheet
As of September 25, 2017

The Federal Reserve (the “Fed”) announced on Wednesday, September 20th that they will begin unwinding their balance sheet. The experimental tapering will be gradual and calculated to avoid dramatic reactions by the market similar to the taper tantrum. The first round of tapering will begin on October 13th (the 9th business day of each month), when the Fed will elect to avoid reinvestment of paydowns in the amount of $6 billion (bn)/month into the Treasury market and $4bn/month into the Agency Mortgage-Backed Securities (MBS) market. The Fed plans to incrementally increase these paydowns, which we refer to as a “step function”. These respective roll-off amounts are expected to increase by $6bn and $4bn every three months until reaching $30bn/month in the Treasury market and $20bn/month in the Agency MBS market as depicted in Figures 1 & 2.

The Fed owns roughly $1.7 trillion of Agency MBS. With prepayments in the range of ten Conditional Prepayment Rate (CPR), this equates to paydowns of roughly $17bn/month. However, the Fed does not know exactly what prepayment speeds will be going forward, so some assumptions will need to be made. But with all things being equal right now, with $4bn worth of paydowns not being reinvested, that means the Fed will still be reinvesting about 75% of their monthly paydowns in the first leg of their tapering plan. We believe this initial output will have little effect on MBS spreads. As this plays out, the Fed will be monitoring market conditions making sure their actions do not disrupt markets too severely. It is important to note that the Fed does not own any Non-Agency MBS, and therefore the “step function” in place should have little to no impact on the Non-Agency MBS space.

We believe that Quantitative Easing (QE) policy has helped raise asset prices and contributed to the tightening that has occurred in spread product. Therefore, it seems natural to think that the unwinding of QE will have the opposite effect. Figure 3 illustrates the MSCI World Index moving in lockstep with Central Banks’ balance sheets, which presents the question of what will happen to the black line when Central Banks are done tightening? The Fed is concerned about this and this is one of the things that they will be monitoring.

Many fixed income investors are constantly comparing and contrasting corporate bonds and MBS for investment purposes. Everything else being equal, a tightening or widening in one sector tends to cause the other sector to tighten or widen. As you might expect, there is more volatility in corporate spreads compared to mortgage spreads as there is more “credit” risk in the corporate sector. At DoubleLine, we expect MBS spreads to tighten when the Fed starts unwinding because investors will start to favor MBS over corporate bonds.
The Future of the Fed’s Balance Sheet
As of October 17, 2017

Additionally, it is too simplistic of an analysis to say that if the Fed does not reinvest their mortgages, then mortgage spreads will widen. If the Fed were to sell a lot of their mortgages in a short period of time that would be more problematic for mortgage spreads. However, if the Fed sticks to their transparent plan outlined on September 20th, the mortgage market should see little impact. If spreads do widen in the mortgage market, corporate bond spreads should widen more. Moreover, we think corporate spreads are biased to widen over time, particularly with an unwinding of QE.

The Fed doesn’t want the market to be surprised as that could cause more spread widening like we saw during the Taper Tantrum. Given where spreads are today, we feel that over time MBS relative to corporate bonds will be favored, and that there will be little impact to the MBS market.

Source: J.P. Morgan, dotted line shows JPM forecasts, Bloomberg; January 1, 2008 to June 20, 2017, Projected through 2020. YoY = year-over-year. G4 = Eurozone, U.S., U.K. and Japan. JPM = Japan. MSCI World Index is a free-float weighted equity index that includes both emerging and developed markets. GDP measures the amount of goods and services produced within a given country. You cannot invest directly in an index. Forecasts, estimates, and certain information contained herein are based upon research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate.
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