DoubleLine

DoubleLine News

The Future of the Fed's Balance Sheet

As of April 25, 2017

The Federal Reserve ("Fed") raised the prospect of reducing their balance sheet positions in both U.S. Treasury (UST) and Mortgage-Backed Securities (MBS) a few weeks ago. This is not the first time the Fed has mentioned reducing its balance sheet over the last couple of years. Accordingly, the mortgage market has been expecting this for quite some time. While the headlines bring investors' attention to the UST and MBS market sectors, we think Fed asset sales could have a larger impact in other fixed income sectors.

At this point, the Fed has provided no clear plan of action; the Fed's rhetoric amounts to posturing with no clear indication on how the Fed would act. Moving forward and reducing its balance sheet would give the central banks an additional tool to tighten monetary conditions. There are several unknowns for such a tool, including the possible impact on the velocity and frequency of future Federal Funds rate hikes.

At DoubleLine, we believe it is unlikely that the Fed will sell its $4.5 trillion+ UST and MBS positions outright. The Fed has hinted that a possible first step could be to let the reinvestments of MBS pay-downs to roll off its balance sheet. Based on current prepayment speeds of approximately 10 conditional prepayment rate (CPR), the Fed has been reinvesting proceeds of approximately $10-15 billion per month for MBS. At this rate, we do not expect this to have a meaningful long-term impact on the MBS market. We could see a slight uptick in spreads of around 10-20 basis points (bps). It's important to note that mortgage investors have been awaiting this event for a long time, so it is unlikely to catch investors off guard. In addition, higher absolute rates in UST and Agency MBS markets could create a domino effect, causing a sell-off of other asset classes and containment of MBS spread widening.

The actual affect on spreads depends on many factors that influence supply and demand. Supply depends on prepayment speeds. On the demand side, investors have likely been factoring in spread widening when evaluating MBS as part of their asset allocation process. Changes like these do not happen in a vacuum and can affect other investment sectors. For example, investors compare the relative cheapness of mortgages to investment-grade corporate bonds. A change in that spread relationship could cause investors to re-allocate into MBS.

Moreover, we have witnessed growing global and domestic demand for MBS. Factors affecting this demand include the relative value of MBS versus UST and other more credit-sensitive spread products. This relative value would only increase with the initial spread widening. Furthermore, the demand for safety in today's fixed income market with credit spreads tight would be supportive of Agency MBS. Agency MBS does not have the credit risk of other sectors due to the fact that the securities are either implicitly or explicitly backed by the U.S. government. The last thing to highlight is the potentially shorter duration profile of MBS versus other bond sectors in the face of potential volatility around rising interest rates.

We continue to monitor the Fed's rhetoric with an eye specifically on its outlook on the future of the MBS market. We remain vigilant with respect to all potential regulation and maintain an open dialogue with government-sponsored enterprises (GSEs) which issue these securities. We believe that the Fed will act slowly and communicate its policy changes beforehand to minimize any impacts to this multi-trillion dollar market, which influences banks, pension funds, investors and the Fed itself.

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