COULD THE FEDERAL RESERVE NEED TO START QE AGAIN?

Russell Clark's Market Views

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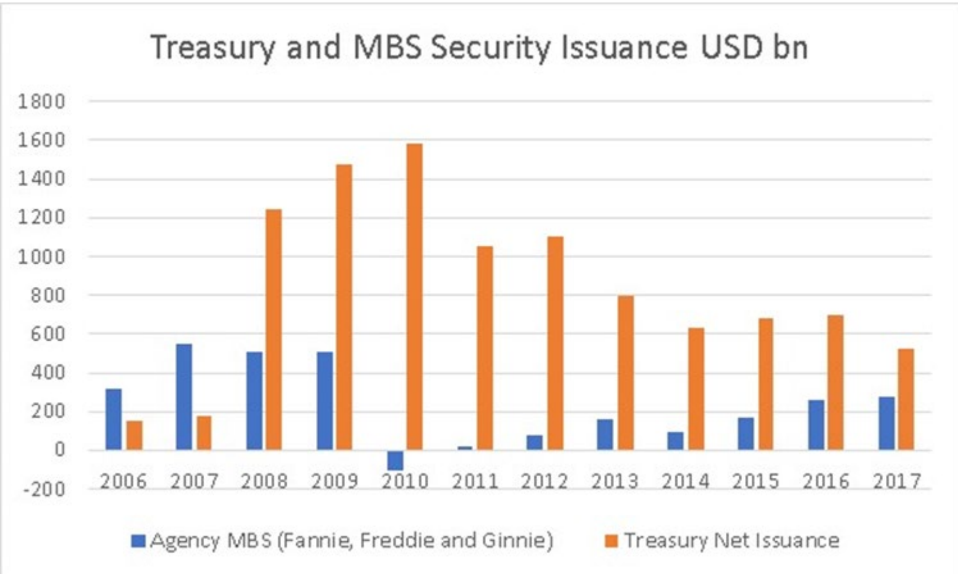
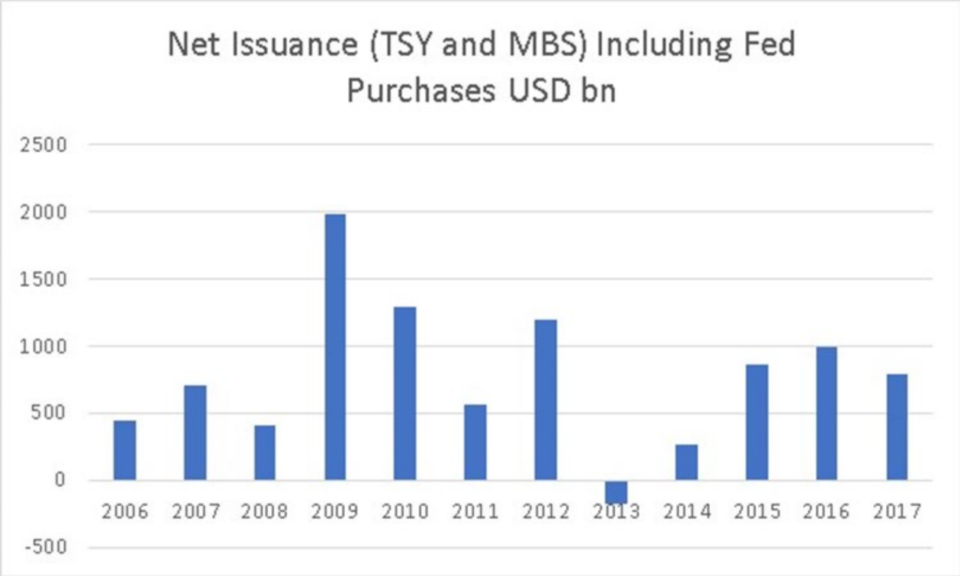
After almost ten years of low rates and large-scale asset purchases by the Federal Reserve, the market now expects the Federal Reserve to begin reducing the size of its balance sheet. The problem is that the Fed is reducing its balance sheet at a time when the supply and demand for these assets is already worrisome, and higher 30-year rates are at levels that have historically begun to impact the housing market.

On the supply side, a decline in net issuance of treasuries has occurred due to the reduction in the US budget deficit. Mortgage backed securities (MBS) which are a close substitute (with some caveats) for treasuries saw a steep fall in issuance after the global financial crisis, but have been steadily increasing ever since. Numbers below are from Treasury and Ginnie Mae, including 2017 forecasts.



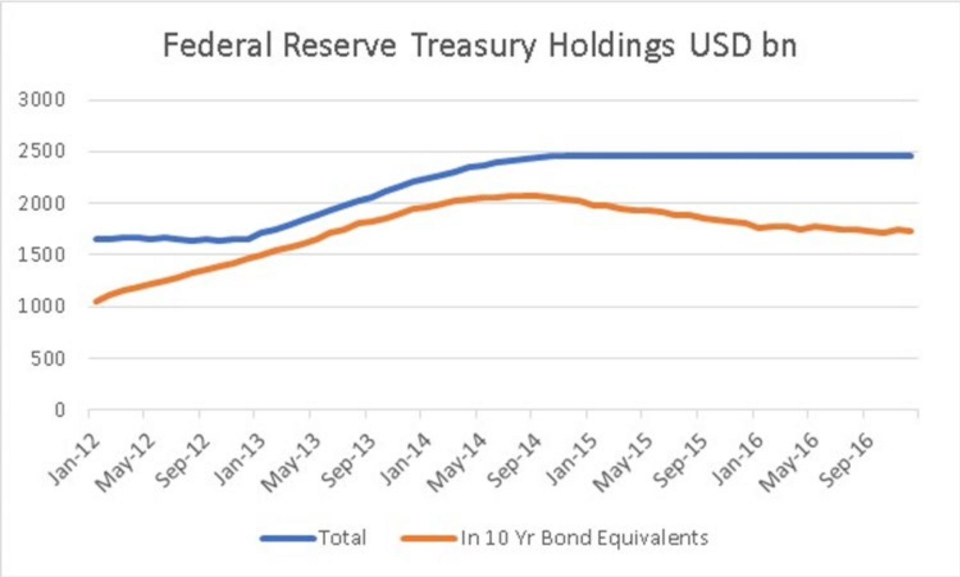
If we sum agency and treasury net issuance and then subtract the increase in the Fed balance sheet, we can then get a net issuance that the market has had to absorb.   Intriguingly we can see that 2013 saw a net contraction in the market as the Fed purchases were greater than issuance.



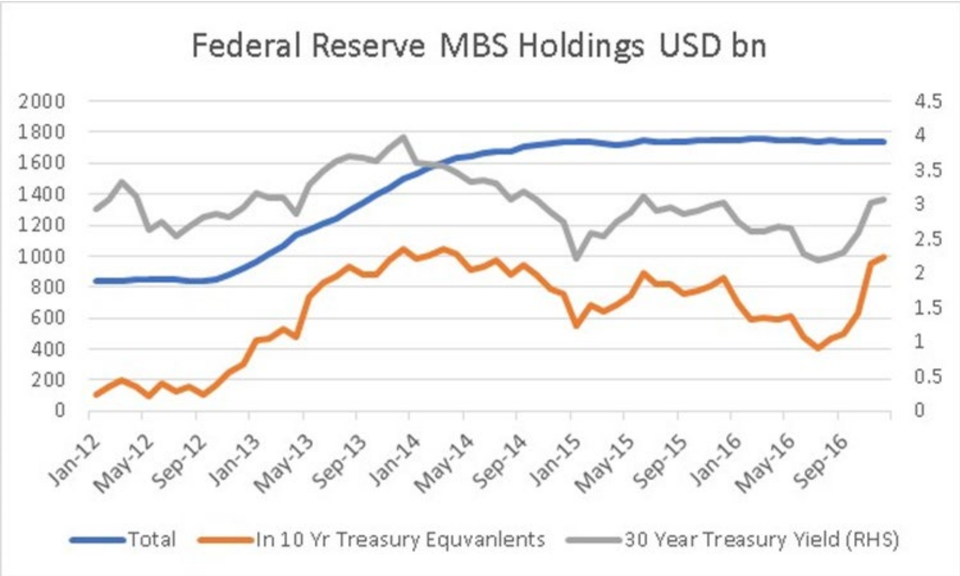
This reduction in availability of long dated debt instruments was one reason for yields in the 30-year treasury to decline through 2014 and 2015. As net issuance has begun to increase we have seen a backup in yields, but still below the levels seen in 2013.

Future supply of treasuries and MBS looks substantial. Firstly, according to the US Treasury's survey of primary dealers, borrowing needs in 2018 will be USD 880bn and USD 920bn in 2019. The Treasury also expects the Federal Reserve to shrink its balance sheet by USD1.3 trillion over the next 4 years, implying around 300bn reduction per year.

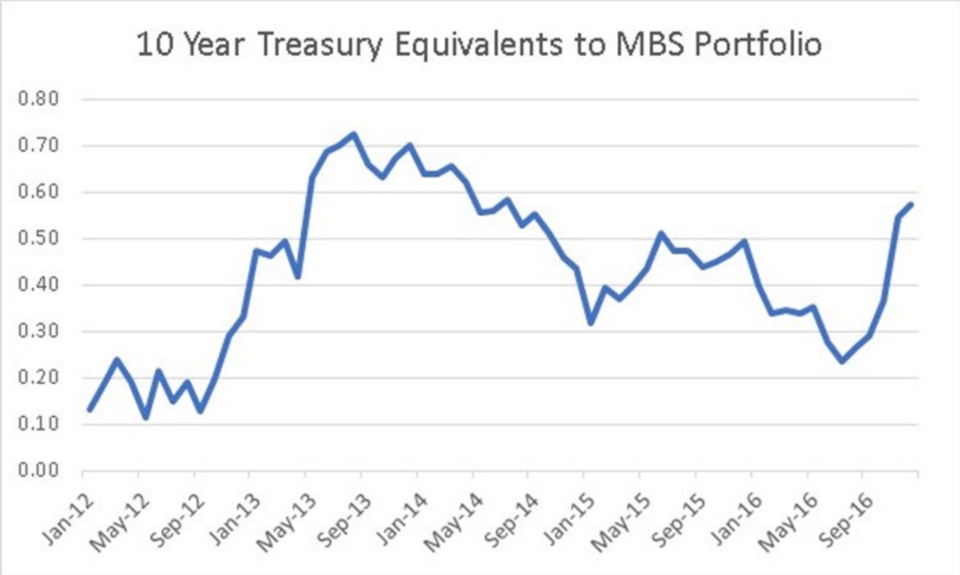
We also need to factor in the potential increase in long dated securities, as prepayments on mortgage back securities reduce with higher interest rates. MBS are among the most difficult fixed income products to analyse. The main reason is that when interest rates fall, many home owners will refinance their homes at lower interest rates. When they do this, the existing MBS is repaid. Hence in a period of falling interest rates, MBS will often repay most or all of the principal in one or two years. However, in rising interest rates borrowers will not refinance at all, and hence the MBS will take much longer to repay. Essentially, in periods of falling yields, MBS act like short dated bonds, and in periods of rising yields they act more like longer dated bonds. Quantifying this effect is always difficult, but the 2016 Annual Report from the NY Federal Reserve (NY Fed) offers some insights. The NY Fed looks at its treasury holdings in terms of 10yr bond equivalents. While the NY Fed portfolio of treasuries has not declined in size in nominal terms; in 10-year equivalents it has fallen, as 30-year treasuries bought 4 years ago are now only 26-year treasuries.



However, the same cannot be said for MBS. MBS holdings in 10-year equivalents moved to their highest level ever as US 30-year yields rose at the end of 2016.

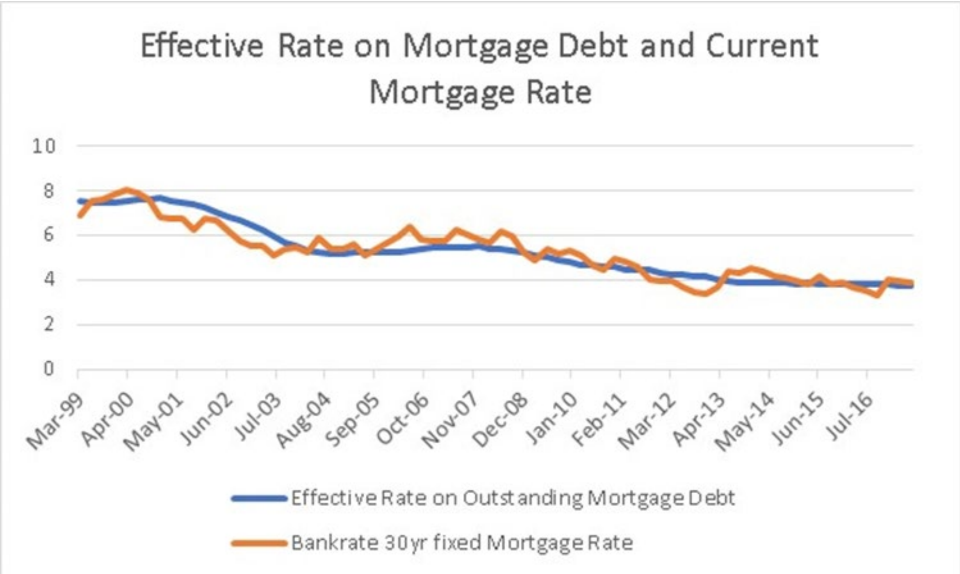


Due to prepayments and the recycling of its MBS portfolio, the Federal Reserve portfolio can be representative of the MBS market. According to Ginnie Mae, the current size of the MBS market is 6 trillion USD. Using the same NY Fed data I have calculated an adjustment factor to calculate the increase in the supply of ten year equivalents treasuries that would get from the MBS market if rates were to rise. The ratio of 10 year equivalents to Federal Reserve Total MBS portfolio is shown below.



30-year treasury rates have declined this year, so I would say the current ratio is close to 0.5. If we assume a similar selloff to that seen in 2012, then a move to ratio closer to 0.7 seems likely. With 6 trillion of MBS outstanding, that would add another 1.2 trillion of US 10-year equivalents to be absorbed by the market, on top of the increased issuance from the US treasury and reduction in the Federal Reserve Balance Sheet. The risk is that excess supply of treasuries could cause a rise in treasuries' yields, which then causes yields to rise further as more supply of long dated securities comes from the MBS market.

This could be a problem for the Federal Reserve. Since the 1970s, periods when market interest rates on mortgages are above the interest rates on existing debt, US consumption has weakened. In below graph, in 2000, 2006 and 2013 are all periods when rates offered on mortgages moved above rates on outstanding mortgage debt.



Currently the effective rate on outstanding mortgages is 3.74%. Typically, mortgage rates are the 30-year US Treasury yield plus a spread. This spread has averaged around 90bps since the financial crisis. Currently 30-year treasuries are yielding 2.8%. That means we are currently finely balanced. MBS tend to act as an accelerant on bond yield, as changing treasury yields cause them increase and decrease supply of longer dated treasuries significantly. Should there be an inflation scare and a selloff in long dated bonds the Federal Reserve may well be forced to start QE again to contain a bigger rise in yields due to changing duration of MBS.

INFORMATION

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