Fixed Income Weekly

FOR PROFESSIONAL INVESTORS

Fed balance sheet runoff and the outlook for MBS

June 19, 2017

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Key takeaways

- The media has been speculating about the Federal Reserve's (Fed) balance sheet and what the future path toward normalisation may look like
- The release of meeting minutes following the March Federal Open Market Committee (FOMC) meeting shed light on the Fed's potential tapering of its reinvestments, but there were no surprises from the recent June FOMC meeting
- Longer term, we believe the MBS sector offers good value relative to other spread sectors

Full commentary

Speculation about the Fed balance sheet — and specifically, what the future path towards its normalisation may look like — has been a popular topic in the news, Wall Street research and speeches by Fed members. The Fed's total balance sheet stands at USD 4.2 trillion, of which USD 1.7 trillion is in mortgage-backed securities (MBS). The Fed views any reduction in the size of its balance sheet as monetary tightening, so to maintain the balance sheet at its current size it has been re-investing all US Treasury maturities and MBS principal pay-downs bought during its quantitative easing (QE) programme back into those sectors.

The release of the meeting minutes and member speeches following the March FOMC meeting shed light on the Fed's potential tapering of its reinvestments. The minutes from the Fed's May meetings were consistent with those in March. They indicated that balance sheet run-off may begin later in 2017 and conducted at a gradual and predictable pace so as to not overly influence spreads.

There were no surprises from the recent June FOMC meeting. The FOMC announced initial caps in the amount of Treasuries and MBS that will be allowed to run off each month of USD 6 billion and USD 4 billion, respectively. Security repayments that exceed the caps will continue to be reinvested each month. The caps will be raised by these amounts on a quarterly basis until they reach USD 30 billion for Treasuries and USD 20 billion for MBS. The caps will remain at this level until the Fed's balance sheet is normalised. The missing piece of information from the FOMC is timing. The relatively low starting level of the caps, as well as Chair Yellen's comment in the press briefing that run-off could start 'relatively soon', suggest that the Committee is targeting a September start date.

Importantly, a steady state cap at USD 30 billion may still be binding on Treasury securities — in many months, Treasury maturities are markedly higher. So it is possible that the Treasury portfolio could eventually have a higher cap (USD 40–USD 50 billion), depending on how quickly the FOMC wants to right-size the balance sheet. As for MBS, a USD 20 billion cap would be more than sufficient — monthly portfolio pay-downs will average less than this over the next several years. There are reasons to keep this cap at a modest level. For example, if the economic outlook worsens and yields fall, prepayments on MBS that the Fed owns would increase. With a high cap, this scenario would lead to more rapid portfolio shrinkage (i.e., policy tightening) just when the outlook requires an easier policy stance.

We expect the FOMC to rely on changes to overnight policy rates as its main monetary policy tool, with balance sheet run-off happening on autopilot in the background. We thus see only limited scope for the FOMC to make more frequent adjustments to the run-off caps in response to economic conditions. There could be two exceptions to this, however:

- If the outlook suddenly worsens, the FOMC will quickly stop the balance sheet run-off. It would not make sense to continue tightening policy through the balance sheet when conditions suggest that policy easing — including QE — might soon be required.
- If overall financial conditions do not tighten as the Fed withdraws policy accommodation, it could move to a faster pace of interest rate increases and portfolio run-off. There is certainly precedent for financial conditions to ease even as the FOMC raises rates. In the prior expansion, as the Fed raised rates beginning in 2004, overall financial conditions eased — longer-term interest rates stayed low, the dollar weakened, credit spreads tightened and equities continued to gain. Should this scenario repeat itself during the current tightening cycle, the FOMC may respond by speeding up the pace of balance sheet normalisation.

Fed holdings as a percentage of the MBS and Treasury markets

We do not expect a major repricing of the MBS sector. It is our stance that many of the concerns have been reflected in the spread widening we have seen in the MBS sector late last year and so far this year.

This week's market developments

Monday, June 12

- US Monthly Budget Statement decreased to -88b for May

Tuesday, June 13

- UK CPI growth decreased to 0.3% m.o.m. for May
- UK PPI Output NSA growth decreased to 0.1% m.o.m. for May
- US PPI Final Demand decreased to 0.0% m.o.m. for May

Wednesday, June 14

- Germany CPI (final estimate) growth remained at -0.2% m.o.m. for May
- UK ILO Unemployment Rate (3Mths estimate) remained at 4.6% for April
- US CPI growth decreased to -0.1% m.o.m. for May
- US Retail Sales Advance growth decreased to -0.3% m.o.m. for May

Thursday, June 15

- US Empire Manufacturing Survey increased to 19.8% s.a. for June
- US Philadelphia Fed Business Outlook decreased to 27.6 for June
- US Industrial Production growth decreased to 0.0% m.o.m. for May

Friday, June 16

- Eurozone CPI growth decreased to -0.1% m.o.m. for May
- US Housing Starts decreased to 1.09m for May
- US University of Michigan Consumer Sentiment Index (preliminary estimate) decreased to 94.5 m.o.m. for June

Source: Bloomberg, as of May 22, 2017

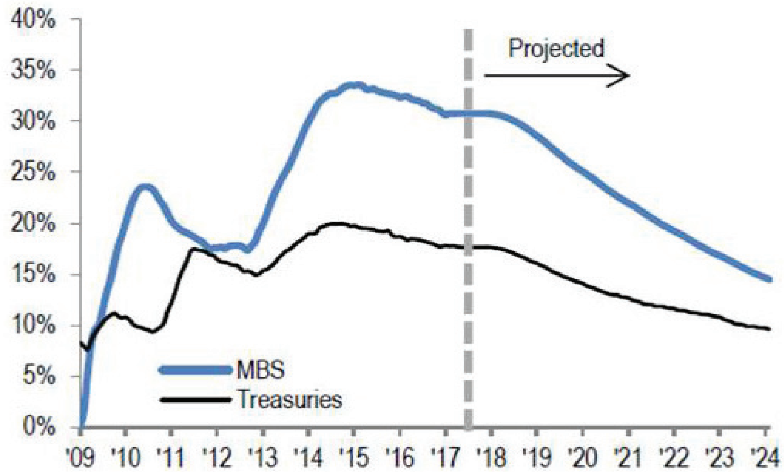
There are two types of supply in the agency MBS market: new home purchases and re-financings. The Fed has said it will taper the size of its balance sheet when rates have normalised. Higher rates mean fewer mortgage holders are incentivised to re-finance, meaning there will likely be significantly less issuance from re-financing. This implies that at the same time Fed demand is falling, MBS supply is also tightening. There should be some degree of equilibrium, although it is unlikely to be a perfectly smooth transition and we could well see some volatility and likely wider MBS spreads. Remember, though, that wider MBS spreads mean higher mortgage origination rates and in turn fewer prepayments and less supply.

Longer term, we think the MBS sector offers good value relative to other spread sectors. MBS performance has lagged that of other sectors as spreads have widened to reflect expectations of a decline in demand from the Fed later in the year.

It appears clear that the balance sheet reduction will be passive via run-off and would exclude outright asset sales. We expect a gradual rise in the term structure of US interest rates and a bias for slightly wider MBS spreads. Prepayment speeds should continue to slow in this environment so we favour higher-coupon, fixed-rate MBS and interest-only bonds. Reduced geo-political uncertainty should also help risk assets so we continue to look for an opportunity to overweight MBS versus Treasuries.

Chart of the Week

Fed holdings as a percentage of the MBS and Treasury markets



Data as at 31 December 2016. Note: Using baseline reinvestment tapering assumption of $2bn per meeting of additional runoff for MBS and $4 bn per meeting for Treasuries starting December 2017. Source: J.P. Morgan, Federal Reserve

Next week's market developments

Tuesday, June 20

- Germany PPI growth is expected to decrease to -0.1% m.o.m. for May

Wednesday, June 21

- Japan All Industry Activity Index is expected to increase to 1.6% m.om. for April
- US Existing Home Sales growth is expected to decrease to 5.54m for May

Thursday, June 22

- US Leading Index growth is expected to remain at 0.3% m.o.m. for May
- Eurozone Consumer Confidence (advance estimate) is expected to increase to -3.0 for June

Friday, June 23

- Markit Eurozone Manufacturing PMI (prelim estimate) is expected to decrease to 56.8 for June
- Markit Eurozone Services PMI (prelim estimate) is expected to decrease to 56.1 for June
- Markit US Manufacturing PMI (prelim estimate) is expected to increase to 53.0 for June
- Markit US Services PMI (prelim estimate) is expected to decrease to 53.5 for June
- US New Home Sales are expected to increase to 590,000 for May

Source: Bloomberg, as of June 19, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on September 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	March 15, 2017	0.75% - 1.00%	1.17%	July 26
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	July 20
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.04%	July 20
BoE	-25 basis points	August 4, 2016	0.25%	0.37%	August 3

Source: Bloomberg

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