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MORTGAGE-BACKED SECURITIES AFTER THE FED

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KEY TAKEAWAYS

The minutes from the FOMC's March 14–15, meeting indicated that the Fed may be interested in reducing the size of their balance sheet.

The Fed holds more than $1.7 trillion in MBS, but over 99% of those holdings mature in 10 years or more, potentially limiting the near-term impact if the Fed decides to stop reinvesting maturing bonds.

MBS generally offer the potential for higher yields per unit of duration (interest rate risk) than most other high-quality bonds, including Treasuries.

Minutes from the Federal Open Market Committee's (FOMC) March meeting confirmed that the Federal Reserve (Fed) has been actively discussing the potential reduction of their balance sheet. Some Fed officials have mentioned the possibility of selling securities outright, but outright sales could cause a disruption in the market, which the Fed explicitly is trying to avoid. For this reason, most of the discussion on reducing balance sheet size has instead been around the idea of ending the Fed's current policy of reinvesting the proceeds of maturing bonds. This method would not be completely market neutral, given that it would remove a large buyer from the market sometime later this year, but would likely be less disruptive than outright sales. Current Fed holdings (as of April 6, 2017) total $4.5 trillion, with the majority of the holdings composed of Treasury bonds, $2.5 trillion, and mortgage-backed securities (commonly known as MBS), where holdings total nearly $1.8 trillion [Figure 1].

IMPACT OF FED POLICY ON MBS MARKET

We discussed the potential impact of balance sheet normalization in this week's *Weekly Economic Commentary*, but wanted to shift the focus to the potential impact on MBS as well. The Fed originally started purchasing MBS following the financial crisis in order to push prices higher and yields lower in support of the battered sector. Over time, and several rounds of quantitative easing (QE), the Fed purchased nearly 20% of the outstanding MBS market ($1.8 trillion of $8.9 trillion outstanding at the end of the fourth quarter of 2016 per SIFMA data). Total issuance in the MBS market has averaged a little over $1.8 trillion per year over the last 5 years, so if the Fed were to sell $1.8 trillion into the market at once,

1 FED HOLDINGS OF MBS AND TREASURIES

		Maturing Within					
Asset Type	Securities Held as of 04/06/17	15 Days or Less	16–90 Days	91 Days to 1 Year	1–5 Years	5–10 Years	Over 10 Years
Treasuries	$2.4T	$460M	$59B	$202B	$1.2T	$381B	$627B
Mortgage-Backed Securities (MBS)	$1.8T	$0	$0	$0	$59M	$11B	$1.8T
Total	**$4.2T**	**$460M**	**$59B**	**$202B**	**$1.2T**	**$392B**	**$2.4T**

Source: LPL Research, Federal Reserve 04/06/17

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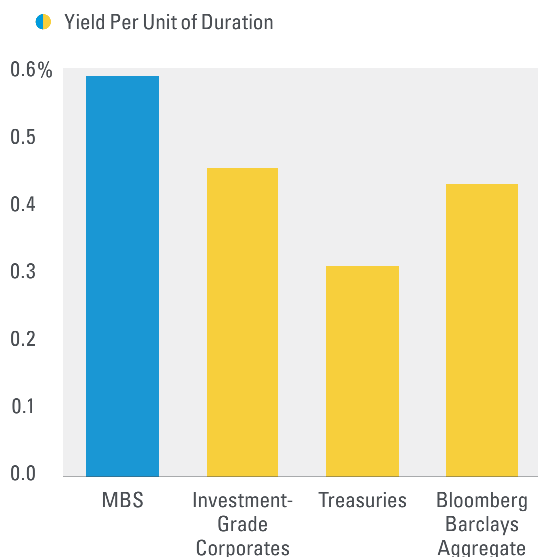
there would likely be a major impact, causing prices to fall due to a massive increase in supply. Since the Fed does not want to cause a market impact of this type it is unlikely to take this route.

The more likely way for the Fed to shrink its balance sheet would be to no longer reinvest principal when bonds mature. For a normal bond, interest payments are received over the life of the loan, and the full amount of principal is paid back at maturity. However, MBS are different than most high-quality bonds in that when income payments are received, they include both principal and interest (just as most homeowners pay both principal and interest each month when making their mortgage payments). Additional principal payments can also come when homeowners pay off their existing mortgages whether by refinancing due to lower rates, or due to selling their homes and purchasing new ones. This means that even though the majority of the Fed's MBS holdings don't technically mature for more than 10 years, the impact to markets could be felt sooner, though still at a much slower rate than if the Fed were to sell securities outright.

Overall the fundamental impact of stopping reinvestment of MBS proceeds may be relatively small in the near term. However, we don't discount the potential for markets to react emotionally ahead of time, which could put pressure on MBS if news of actual steps toward normalization began.

2 MBS STILL OFFERS ATTRACTIVE YIELD PER UNIT OF DURATION



Source: LPL Research, Bloomberg 04/07/17

Indexes referenced: MBS: Bloomberg Barclays US Aggregate Securitized MBS; Investment-Grade Corporates: Bloomberg Barclays US Credit Index; Treasuries: Bloomberg Barclays US Treasury Index.

Indexes are unmanaged index and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest rate risk or reward for bond prices.

YIELDS STILL ATTRACTIVE RELATIVE TO INTEREST RATE RISK

One of the key reasons we continue to believe MBS are attractive relative to other high-quality bonds is that they offer the potential for more yield per unit of duration (interest rate risk) than comparable quality offerings. Duration has increased from when we originally upgraded our view of the sector in September 2016, but yields have risen as well, so MBS still offer more price protection in a rising rate environment, even if the difference isn't as stark as it once was.

A general rule of thumb is that if rates rise by 1%, an investor can expect the price of their bond holdings to decrease at a level consistent with its duration in percentage terms. For example, if a bond has a duration of 5 years, it could be expected to drop approximately 5% if rates rose by 1%. There are of course complications in the math that don't make it this clean in reality, but this generalization can give investors a broad idea of how their bond holdings may perform.

Investors like to be compensated for risk and in the bond market this means receiving more yield (paying a lower price), if risk levels are higher. To measure the yield per unit of interest rate risk, we can divide the yield by duration. A higher number indicates that a bondholder is receiving more compensation per unit of risk. Using this measure, Figure 2 shows that MBS currently offers 0.13% more yield per unit of duration than higher yielding,

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but longer duration corporate bonds, 0.27% more than Treasuries, and 0.15% more than the Bloomberg Barclays Aggregate Bond Index.

CONCLUSION

The Fed's discussion of plans to end reinvestment of principal payments from maturing bonds is on balance a negative development for the bond market, though the fact that the Fed doesn't want to create market volatility means that the impact may be less severe than some may fear. For the MBS market, the current structure of the Fed's balance sheet, with more than 99% of Fed's nearly $1.8 trillion in MBS holdings maturing in more than 10 years, likely means that any fundamental impact to the MBS market would be gradual. We do caution that the forward-looking nature of markets means MBS performance could start to falter if markets begins to believe that the Fed is ready to move. However, Treasuries and, to a smaller extent, the broader bond market share this risk, and MBS still offer the potential for additional yield per unit of interest rate risk, leading us to believe that MBS continue to offer relative value. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

DEFINTIONS

Quantitative easing (QE) refers to the Federal Reserve's (Fed) current and/or past programs whereby the Fed purchases a set amount of Treasury and/or mortgage-backed securities each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth.

The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve Board that determines the direction of monetary policy. The eleven-person FOMC is composed of the seven-member board of governors, and the five Federal Reserve Bank presidents.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Barclays U.S. Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

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