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Investment Grade Fixed Income

MBS market priced in the Fed taper, but did anyone else?

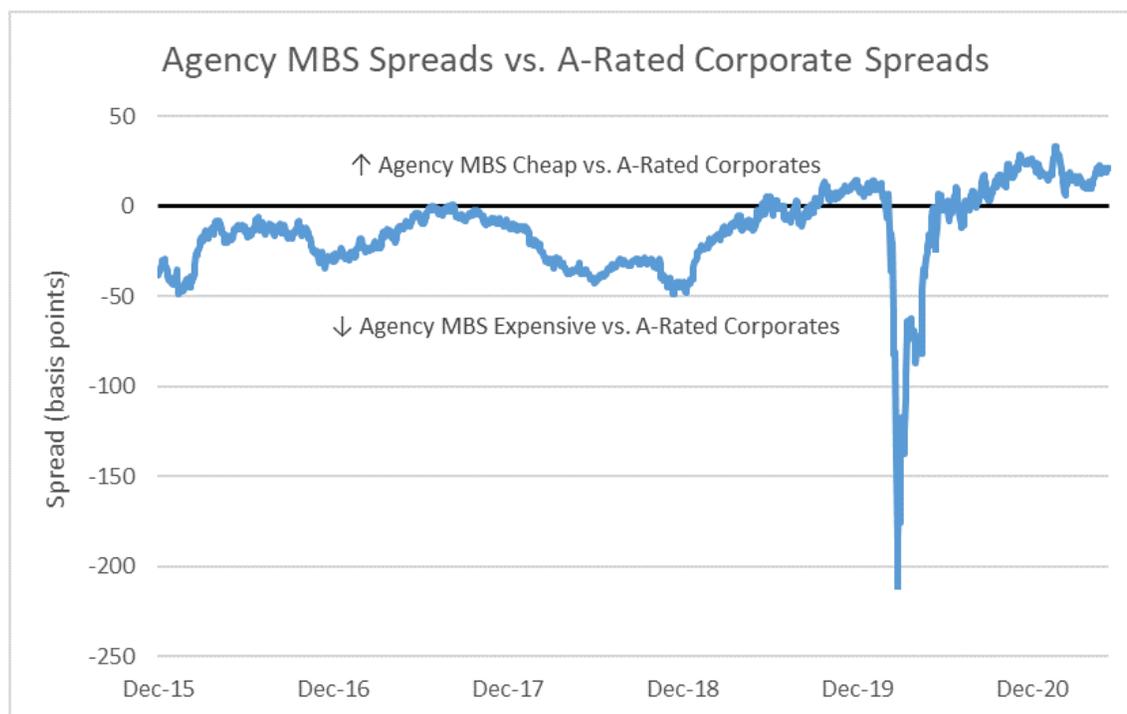
By: Andrew Szczurowski, CFA | & Chip Driscoll, CFA | June 14, 2021

Boston - Over the past several weeks, there has been increasing chatter among U.S. monetary policymakers regarding the possibility of tapering the Federal Reserve's asset purchases. This pickup in taper talk has created some concerns in the agency mortgage-backed securities (MBS) market about reduced demand from the Fed, causing spreads to widen by 15 to 20 basis points.

As a reminder, the Fed has been purchasing roughly \$80 billion in Treasurys and \$40 billion in agency MBS each month in response to the COVID-19 crisis. Consensus estimates had been for tapering to begin in early 2022, but improving economic data and higher inflation numbers have pushed up that timeline for some market participants.

Interestingly, spreads across most other investment-grade segments of the fixed income markets have barely budged, which is equally frustrating for MBS investors. Corporate bonds, asset-backed securities and commercial mortgage-backed securities are actually a few basis points tighter over the last month.

The move in agency MBS spreads has been so pronounced that **A-rated corporates are now trading more than 20 basis points tighter than AAA-rated agency MBS** — meaning investors can go up in credit quality and up in yield by shifting to agency MBS.



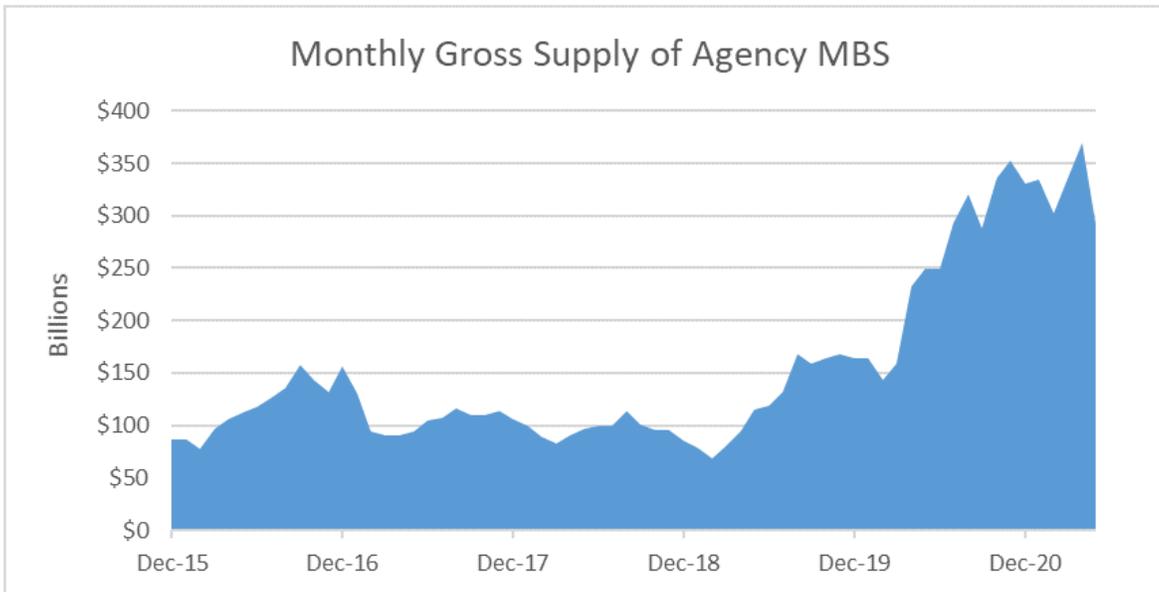
Source: Intercontinental Exchange, Bloomberg Barclays as of 06/08/2021.

Agency MBS represented by Bloomberg Barclays U.S. MBS Index.

A-Rated Corporates represented by ICE BofA Single-A U.S. Corporate Index.

If, when and by how much the Fed will taper its asset purchases are questions only the Fed can answer. But the backdrop that would prompt tapering will likely be an environment of stronger economic growth, higher inflation and higher Treasury yields/mortgage rates. If mortgage rates do in fact rise from here, that would help slow prepayment activity and lead to **lower MBS supply from the current elevated level** — thereby making it easier for the market to digest a reduction in demand from the Fed.

Monthly Gross Supply of Agency MBS



Source: JPMorgan as of 05/28/2021.

Bottom line: Recent volatility in the MBS market has also created opportunity, as spread widening has resulted in more attractive reinvestment yields and cheaper valuations for MBS compared to other lower-quality parts of the investment-grade corporate space.

Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index measures agency mortgage-backed pass-through securities issued by GNMA, FNMA and FHLMC.

ICE BofA Single-A U.S. Corporate Index is an unmanaged index of A-rated investment-grade U.S. corporate bonds.

*It is not possible to invest directly in an index. **Past performance is not a reliable indicator of future results.***

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