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MARCH 17, 2020

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Agency MBS market stands to benefit from Fed's return


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Boston - Investors looking for a high quality parking place to sit out these volatile markets may want to revisit one of the best performing sectors during the financial crisis of 2008, the agency mortgage backed security (MBS) market.

Thanks to the US government backing, agency MBS is a AAA-rated market that offers investors a highly liquid place to invest while taking on less credit risk. And it would be a mistake to confuse government guaranteed agency MBS with their non-government guaranteed counterpart from the pre-crisis era.... sub-prime MBS.

The US Federal Reserve (Fed) on Sunday announced a new round of quantitative easing, committing to purchase "at least" $500 billion in Treasuries and $200 billion in agency MBS, all on top of a 100-basis-point cut in the federal funds rate. For the agency MBS market, the announcement was welcome news, as spreads over Treasuries sit at their widest levels since 2013.

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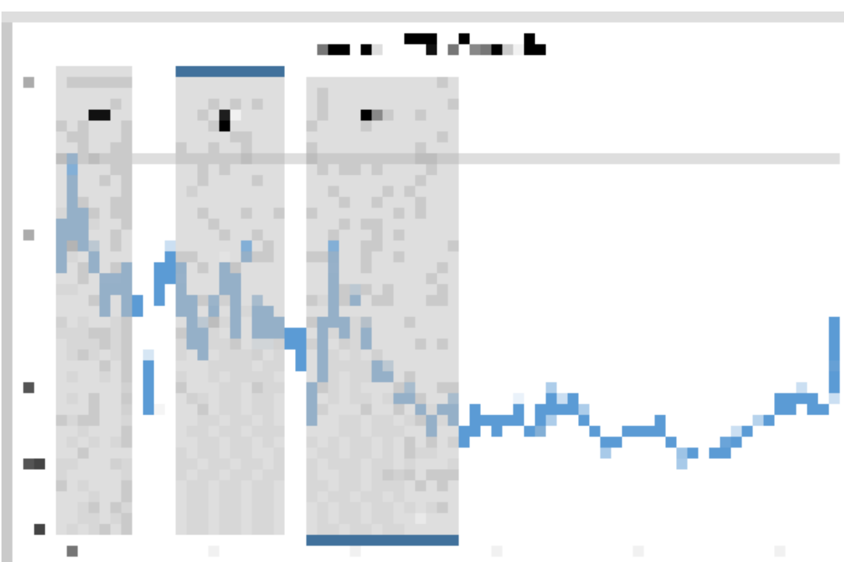

Source: WM/Reuters Closing Mid Spot Rates and Forward Rates as of March 16, 2020.

The Fed's announcement was also a sharp turnaround from the current policy, which was allowing roughly $20 billion of agency MBS to roll off their balance sheet each month. The Fed has essentially gone from releasing $240 billion of supply into the market over the next year, to buying $200 billion during the next few months alone, with the potential for the program to be extended. That's a $440 billion swing in just one day! The purchase over the coming months will likely amount to roughly 50% of all supply that comes into the market.

With many employees at banks across the country working from home, and consumers also quarantined in their houses, we are likely to see a dramatic decline in new home sales and refinancing activity. This might mean that supply in the agency

MBS market could actually see a substantial decrease in the coming months, despite the recent decline in mortgage rates. Such a decline in supply in the coming months could mean the Fed's purchases might amount to an even larger share of the market, which would be even more supportive of agency MBS spreads.

Bottom line: The key takeaway from all this is that the largest single holder of agency MBS has re-emerged, thus helping to ensure a liquid and orderly mortgage market.

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