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Investment Grade Fixed Income

Fed buying to continue as major force in 2021 MBS market

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Boston - Looking ahead through 2021, the U.S. Federal Reserve will likely continue to be a major force in the MBS market. In 2020, the Fed purchased over $1.3 trillion in agency mortgage-backed securities (MBS), and it is expected to continue purchasing at a pace of roughly $40 billion per month for the balance of 2021, which would come to a total of around $480 billion in demand for the calendar year.

That $480 billion exceeds the expectations of nearly all Wall Street desks for new supply hitting the market in 2021. Add to that the potential additional demand from other buyers like banks and money managers, and it appears as though the supply/demand dynamic in the market could look much more favorable this year than last. We expect that to prevent spreads from any sort of meaningful widening throughout 2021.

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Democrats taking unified control

The surprise victories by Democratic candidates in Georgia handed unified control of the White House and Congress to the Democrats, which boosts the outlook for greater fiscal stimulus. Even before this outcome, net Treasury issuance (after accounting for Fed purchases) was expected to dwarf that of the last several years. An even greater increase in the supply of Treasury debt hitting the market would likely lead to a backup in longer-term rates, which may eventually translate into higher mortgage rates as well.

Democratic control in Washington also means that no major changes with Fannie Mae and Freddie Mac are likely. Both have remained in U.S. government conservatorship since the Financial Crisis, and there does not appear to be any political will from the Democrats to change that, so their government guarantee should be here to stay (Fannie and Freddie securities are implicitly backed by the U.S. government).

Mortgage forbearance delaying prepayments

On the forbearance front, Fannie Mae and Freddie Mac forbearance rates have dropped from roughly 6.5% in early June to around 3.2% in mid-January. As a reminder, under the CARES Act, homeowners were given the opportunity to receive forbearance, or the ability to pause or reduce their mortgage payments for a limited period of time.

The forbearance program has prevented many mortgages from becoming delinquent and being bought out from MBS pools at par, which has in effect delayed prepayments. While these borrowers may still eventually be pulled out from our pools, the decreased percentage of loans in forbearance means there's unlikely to be a meaningful impact in either direction.

Looking for protection against refinancing activity

In early 2021, mortgage rates still sit near record lows, so prepayments are likely to remain elevated before eventually burning out as the year progresses and mortgage rates rise. We continue to focus on specified pools of agency MBS that we believe can provide greater protection against high refinancing activity, while still offering attractive yields versus Treasurys. Today's MBS spreads are near their longer-term averages, but they're still noticeably wider than other high-quality alternatives, such as AAA-rated and AA-rated corporate bonds.

Bottom line: To reiterate the view we have held for more than a year, investment-grade corporate debt doesn't offer adequate compensation for the underlying credit risk — invsetors can move up in both quality and yield by considering agency MBS.

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