# NEWPERSPECTIVES

**Commentary from New Century Advisors**
**September 2017**


## The Fed Slims Down – Mortgages at Risk

Having purchased $4.23trn in securities over the last 8 years, the Fed has indicated that they will formally announce their plan for balance sheet reduction at their next FOMC meeting, September 19th & 20th. The Fed's holdings are dominated by over $2.3trn in nominal Treasuries and $1.8trn in Agency MBS. Currently, as the securities the Fed holds pay coupons and mature, these cash flows are reinvested back into the Treasury and mortgage markets.

### Treasuries

The Fed reinvests proceeds from maturing Treasuries as "add on" purchases to Treasury's regular auctions. For instance, when Treasury issued $23bn new 10yr Notes on August 9th, the Fed purchased an additional $6.9bn of the issue. Thus, including the Fed's SOMA (Securities Open Market Account) purchases, Treasury sold nearly $30bn new 10yr Notes in August. Those SOMA purchases add up: the Fed recycled $212bn back into the Treasury market in 2016 and is on pace to buy over $190bn this year. Without the Fed, Treasury would need to make up the funding gap through increased issuance. **So what happens to those purchases – and the support they bring to the rates market - when the Fed starts to run down its balance sheet? It turns out not much, at least not for a couple of years.**

The Fed's holdings are largely front-loaded, with nearly $415bn in Treasuries maturing in 2018 (twice the pace of maturities of the past two years) followed by $365bn in 2019. The Fed has indicated that once balance sheet reduction starts, they will allow up to $6bn/month in maturing Treasuries to roll off without reinvestment. This balance sheet reduction 'cap' will increase by $6bn/month each quarter until it reaches a maximum of $30bn/month in Q4'18. **But given how much of the Fed's Treasury holdings mature next year, even with the rising caps the Fed will most likely reinvest over $186bn back into Treasuries in 2018.** That will actually be slightly more than their purchases this year ($172bn, given an expected $18bn run-off in Q4.) Even in 2019, with fewer maturing securities and higher reduction caps (maxed out at $30bn/month to start the year), the Fed will still reinvest $110bn.

The following table summarizes the projected Fed balance sheet run-off and reinvestment flows by year:

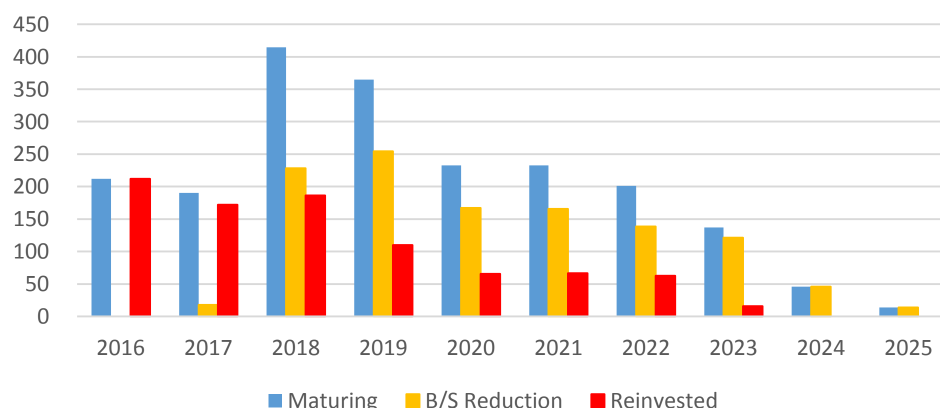



www.newcenturyadvisors.com
research@ncallc.com

| Year | Maturing* | B/S Reduction* | Total Run-Off* | Reinvested* |
|---|---|---|---|---|
| 2016 | 212.1 | 0.0 | 0.0 | 212.1 |
| 2017 | 190.2 | 18.0 | 18.0 | 172.2 |
| 2018 | 414.7 | 228.1 | 246.1 | 186.6 |
| 2019 | 364.6 | 254.6 | 500.8 | 110.0 |
| 2020 | 232.8 | 167.1 | 667.9 | 65.7 |
| 2021 | 232.5 | 165.6 | 833.5 | 66.9 |
| 2022 | 201.2 | 138.7 | 972.2 | 62.5 |
| 2023 | 137.2 | 121.2 | 1,093.4 | 16.0 |
| 2024 | 45.8 | 45.8 | 1,139.1 | 0.0 |
| 2025 | 14.2 | 14.2 | 1,153.3 | 0.0 |

*All figures in $bn. Source: Federal Reserve & Federal Reserve Bank of New York

Here is a graphical representation, for those of you who like pictures:




Source: NY Fed and New Century Advisors

## MBS

It is a different story for the Fed's $1.8trn in mortgages, equivalent to about 30% of outstanding MBS. **At just under $6bn/week, Fed reinvestments have averaged ~25% of gross mortgage issuance in 2017.**

The Fed has indicated that once balance sheet reduction begins (in Q4) they will allow $4bn/month in maturing securities to roll off. That balance sheet reduction 'cap' will increase by $4bn/month each quarter until it reaches a maximum of $20bn/month (in Q4'18). At current prepayments speeds, the Fed

would be expected to reinvest ~$21bn/month in Q4, declining to ~$17bn in Q1'18, and eventually reaching a steady state of ~$5bn/month in Q4'18.

| Quarter | Monthly Prepayments* | B/S Reduction | Reinvested |
|---|---|---|---|
| Q3'17 | $25bn | 0 | $25bn |
| Q4'17 | $25bn | $4bn | $21bn |
| Q1'18 | $25bn | $8bn | $17bn |
| Q2'18 | $25bn | $12bn | $13bn |
| Q3'18 | $25bn | $16bn | $9bn |
| Q4'18 | $25bn | $20bn | $5bn |
| Q1'19 | $25bn | $20bn | $5bn |
| Q2'19 | $25bn | $20bn | $5bn |

*Assumes no change in current prepayment speeds

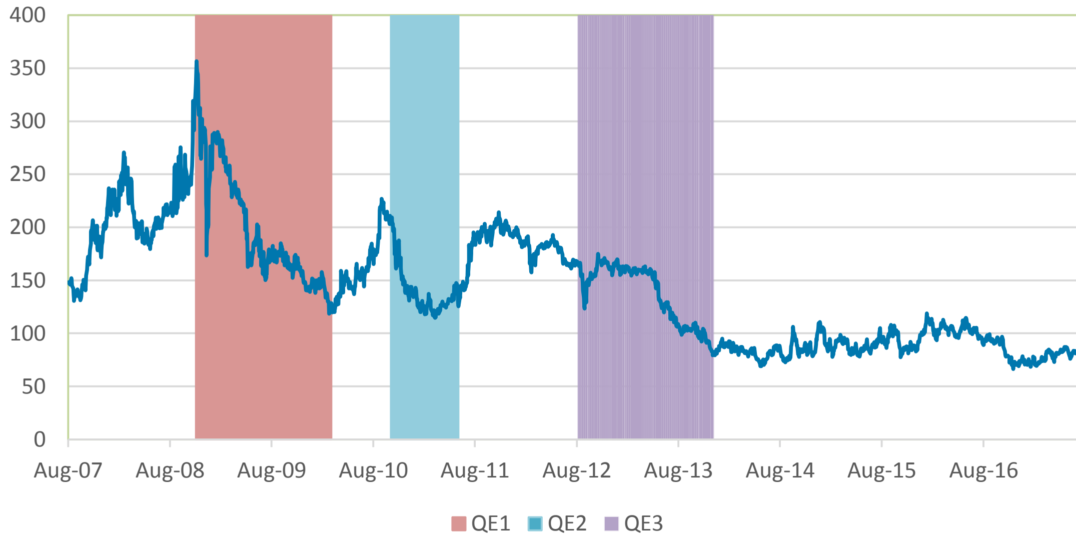
Source: Federal Reserve & Federal Reserve Bank of New York

However, unlike the Fed's Treasury holdings which have known maturities, the actual pace of balance sheet reduction and reinvestment of the Fed's MBS holdings will depend on prepayment speeds. Mortgage prepayments are driven by the level of rates: if interest rates increase, principal prepayments will decrease – possibly below the existing portfolio run-off cap – and vice versa. As such, both the pace of run-off and reinvestment can decrease below the schedule outlined above in a rising rate environment. Likewise, while the portfolio run-off cannot exceed the schedule above, reinvestments could continue at a higher than anticipated pace should rates rally, leading to faster prepayment speeds.

## Conclusion

We do not expect much of a market reaction in the Treasury market when the Fed announces the balance sheet reduction plan later this month. For one, the Fed has largely pre-announced the plan and so there should be little market surprise. In addition, the plan will not have a material impact on the level of Treasury reinvestment relative to current levels for the next couple of years. **Indeed, the coming glut of Treasuries maturing from the Fed's balance sheet is one of the reasons the Fed is determined to begin balance sheet reduction this year: it allows them to do so without materially disrupting their current pace of Treasury purchases.**

We do, however, see potential for an eventual market reaction in MBS, if not immediately upon announcement. **In this case, a major buyer is stepping away from the market which could in turn put upward pressure on mortgage spreads over the coming year. As the chart below shows, spreads are hovering near the more than 10-year low reached at the end of last year. As such, we see a significant risk that mortgages could underperform next year.**




Source: New York Fed, Barclays, and New Century Advisors

***For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and [ltalbot@ncallc.com](mailto:ltalbot@ncallc.com)***

**DISCLOSURES**

PAST PERFORMANCE IS NO INDICATION OF FUTURE RESULTS. THERE IS NO GUARANTEE THAT THE INVESTMENT OBJECTIVE OF THE STRATEGY WILL BE ACHIEVED. INDEX RETURNS REFLECT THE REINVESTMENT OF INCOME DIVIDENDS AND CAPITAL GAINS, IF ANY, BUT DO NO REFLECT FEES, BROKERAGE COMMISSIONS OR OTHER EXPENSES OF INVESTING. CLIENTS MUST BE PREPARED TO BEAR THE RISK OF A TOTAL LOSS OF THEIR INVESTMENT. THE THEMES AND STRATEGIES AND ASSET ALLOCATIONS HEREIN ARE NOT TO BE CONSTRUED AS RECOMMENDATIONS. THEY ARE FOR ILLUSTRATION PURPOSES ONLY AND SUBJECT TO CHANGE WITHOUT NOTICE.

CERTAIN OF THE INFORMATION CONTAINED IN THIS PRESENTATION IS BASED UPON FORWARD-LOOKING STATEMENTS, INFORMATION AND OPINIONS, INCLUDING DESCRIPTIONS OF ANTICIPATED MARKET CHANGES AND EXPECTATIONS OF FUTURE ACTIVITY. NEW CENTURY ADVISORS BELIEVES THAT SUCH STATEMENTS, INFORMATION, AND OPINIONS ARE BASED UPON REASONABLE ESTIMATES AND ASSUMPTIONS. HOWEVER, FORWARD-LOOKING STATEMENTS, INFORMATION AND OPINIONS ARE INHERENTLY UNCERTAIN AND ACTUAL EVENTS OR RESULTS MAY DIFFER MATERIALLY FROM THOSE REFLECTED IN THE FORWARD-LOOKING STATEMENTS. THEREFORE, UNDUE RELIANCE SHOULD NOT BE PLACED ON SUCH FORWARD-LOOKING STATEMENTS, INFORMATION AND OPINIONS.

THE DISCUSSION OF ANY INVESTMENTS IN THIS PRESENTATION IS FOR ILLUSTRATIVE PURPOSES ONLY AND THERE IS NO ASSURANCE THAT THE ADVISER WILL MAKE ANY INVESTMENTS WITH THE SAME OR SIMILAR CHARACTERISTICS AS ANY INVESTMENTS PRESENTED. THE INVESTMENTS IDENTIFIED AND DESCRIBED DO NOT REPRESENT ALL OF THE INVESTMENTS PURCHASED OR SOLD FOR CLIENT ACCOUNTS. THE REPRESENTATIVE INVESTMENTS DISCUSSED WERE SELECTED BASED ON A NUMBER OF FACTORS INCLUDING INVESTMENT PROCESS AND SUBJECT MATTER APPLICABILITY. THE READER SHOULD NOT ASSUME THAT ANY INVESTMENT IDENTIFIED WAS OR WILL BE PROFITABLE.

OPINIONS EXPRESSED ARE NEW CENTURY ADVISOR’S PRESENT OPINIONS ONLY AND ARE SUBJECT TO CHANGES BASED ON MARKET, ECONOMIC AND OTHER CONDITIONS AND MAY NOT ACTUALLY COME TO PASS. ANY HISTORICAL PRICE(S) OR VALUES(S) ARE ALSO ONLY AS OF THE DATE INDICATED.

ONE CANNOT INVEST DIRECTLY IN AN INDEX. THE INDEX/BENCHMARK COMPARISONS HEREIN ARE PROVIDED FOR INFORMATIONAL PURPOSES ONLY AND SHOULD NOT BE USED AS THE BASIS FOR MAKING AN INVESTMENT DECISION. THERE ARE SIGNIFICANT DIFFERENCES BETWEEN CLIENT ACCOUNTS AND THE INDICES/BENCHMARKS REFERENCED INCLUDING, BUT NOT LIMITED TO, RISK PROFILE, LIQUIDITY, VOLATILITY AND ASSET COMPOSITION. BENCHMARK AND MARKET DATA IS PROVIDED BY A THIRD PARTY. NEW CENTURY ADVISORS DOES NOT GUARANTEE OR WARRANT THE ACCURACY, TIMELINESS, OR COMPLETENESS OF THIRD PARTY INFORMATION PROVIDED AND IS NOT RESPONSIBLE FOR ANY ERRORS OR OMISSIONS.

PLEASE REMEMBER THAT DIFFERENT TYPES OF INVESTMENTS INVOLVE VARYING DEGREES OF RISK, INCLUDING THE LOSS OF MONEY INVESTED. THEREFORE, IT SHOULD NOT BE ASSUMED THAT FUTURE PERFORMANCE OF ANY SPECIFIC INVESTMENT OR INVESTMENT STRATEGY, INCLUDING THE INVESTMENTS OR INVESTMENT STRATEGIES RECOMMENDED OR PROPOSED BY NCA WILL BE PROFITABLE.