Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Hello and welcome to the Tortoise Credit weekly podcast. I am Jeff Brothers, Senior Portfolio Manager for Tortoise. The agency mortgage market, one of the largest, most liquid fixed income sectors, has been struggling in 2018. For today's podcast, we wanted to take a closer look at the recent performance and share our outlook for the agency mortgage market.

The agency mortgage sector performed very poorly in October, underperforming U.S. Treasuries by 37 basis points. Despite the high quality and strong liquidity of the sector, the mortgage market turned in its worst monthly performance in two years. Yield spreads versus U.S. Treasuries moved 10 basis points wider in October to 85 basis points and are now at the widest levels since the middle of 2016. The recent underperformance can be attributed to the sharp rise in interest rates, higher volatility and a general market risk aversion. With improved valuations and mostly favorable fundamentals, we believe the key to the outlook going forward will depend on the uncertain supply and demand technicals.

Although modestly below 2017 levels, net mortgage supply remains very heavy, with expectations for $275 billion in 2018. With higher mortgage rates, a reduction in the homeownership tax benefit, and rising home prices, the overall housing market has started to slow. With a slower pace of new and existing home sales, we would expect a modest decline in supply for 2019. Unfortunately, despite the moderation in supply, the market will also have to contend with the mortgage supply running off the Federal Reserve's balance sheet. The Fed accumulated $1.8 trillion in agency MBS through the quantitative easing program in support of the housing market and now the tide is rolling back out. Given the current level of mortgage rates, we would expect an additional $200 billion in supply to run-off the Fed's balance sheet in 2019. The Fed through outright purchases and reinvestment of principal has also been the most consistent buyer of mortgages since the QE program started seven years ago. The Fed ended outright purchases in 2014 and steadily reduced the amount of mortgage reinvestment each quarter since the end of 2017. With the monthly cap on mortgage run-off moving to $20 billion in October, and monthly mortgage pay downs expected to range between $15 and $18 billion going forward, we may have seen the last of the Fed's reinvestment buying. The mortgage market for the first time will now be operating without the safety net buying from Fannie Mae and Freddie Mac prior to the financial crisis or from the Federal Reserve post crisis.

We also expect challenges from the demand side of the mortgage market. Money managers and international buyers have done their part in absorbing the heavy supply with net additions year-to-date of $140 and $83 billion, respectively. Both, however, may face headwinds going into 2019. Money managers may find the current valuations attractive, but are already overweight the sector and international buyers face prohibitive hedging costs. Domestic banks were a significant buyer last year, but have failed to maintain the pace in 2018. Banks are expected to add only $60 billion in 2018 versus net purchases of $110 billion in 2017. A variety of reasons may keep bank purchases subdued, including strong loan growth, regulatory constraints and weak deposit growth.

Putting all the pieces together, we maintain our defensive outlook for the agency mortgage market. With the most recent sell-off, mortgage valuations have improved and yields spreads are at the widest levels in over a year. The fundamentals are also mostly positive with low refinancing and extension risk offset by higher interest rate volatility. Unfortunately, the negative supply and demand technicals and the overhang from the Fed's portfolio runoff will dominate the market. We do not expect another terrible month like October, but the market will probably need to cheapen up a little more to bring supply and demand back into balance.

Thank you for listening and hopefully you will join us for next week's edition.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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