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.

Welcome to the Tortoise Credit weekly podcast, I am Jeff Brothers, senior portfolio manager for Tortoise. The bond markets are off to a roaring start for the year with the fixed income sectors recovering much of the underperformance from the devastating fourth quarter selloff. As we begin 2019, we wanted to focus this week's podcast on the recent performance and the latest developments in the agency mortgage market.

The mortgage market ended January with yields spreads declining six basis points to 72 basis points over U.S. Treasuries and are now at the lowest levels since October. Through January, mortgages have generated 32 basis points of excess returns over comparable U.S. Treasuries, recovering approximately 60% of the losses from the dismal fourth quarter. Excess returns for the agency mortgages have lagged the rebound in investment grade credit and high yield, but also did not fall as far during the fourth quarter. The mortgage sector's performance has benefited from a combination of the rebound in risk assets, a decline in interest rate volatility and seasonally low new issue supply. News that China, despite the trade war uncertainty, continues to purchase agency mortgages also helped drive performance. The most important news, however, was the dovish shift from the Federal Reserve. Last week's Fed meeting provided the mortgage market with additional clues concerning the direction of monetary policy and the balance sheet normalization.

In their first meeting of 2019, the Fed delivered a very dovish statement, taking away guidance for "some further gradual hikes" and reiterating their "patience" on future adjustments. They cited the uncertainty of global economic growth and financial developments, along with muted inflation pressures, as the key reasons for caution. Of particular interest to the agency mortgage market was the Fed update on the balance sheet normalization.

In support of the financial system and the housing market, the Fed accumulated $2.5 trillion in U.S. Treasuries and $1.5 trillion in agency mortgages through its quantitative easing program. At its peak, the Fed was the dominate buyer of mortgages, purchasing much of the available supply, which helped push 30-year mortgage rates to record lows. With the improved U.S. economic performance and record low unemployment rates, the Fed began to reduce their stockpile of assets at the end of 2017. The Fed's mortgage holdings declined by $150 billion in 2018 and expectations are for an additional $200 billion to runoff in 2019. One of the biggest questions entering the new year was would the agency market need to cheapen further to absorb the Fed mortgage runoff. In December, Chairman Powell spooked the market by appearing tone deaf to concerns about the balance sheet normalization. He said the balance sheet was on "autopilot" and reiterated the Fed's view that the reduction was designed to be as "interesting as watching paint dry." Things have become much more interesting because now the Committee states it "would be prepared to adjust any details for completing the balance sheet normalization in light of economic and financial developments." Chairman Powell also stated the normalization of the size of the portfolio will be completed sooner and with a larger balance than previous estimates. The consensus now sees the balance sheet runoff finishing by as soon as the end of 2019. The financial markets cheered the news, but unfortunately, for the mortgage market the composition of the balance sheet may be more relevant than overall size.

The Fed has expressed a preference in the long-run of returning to a pre-crisis balance sheet comprised of U.S. Treasuries only. The Fed added agency mortgages to the balance sheet to support the struggling housing market. As a result, barring a significant down turn in the housing market, the mortgage runoff may continue even at the end of the normalization process, with the additional mortgage pay downs reinvested into U.S. Treasuries.

Despite the uncertainty around the Fed's balance sheet normalization, we believe agency mortgages will outperform U.S. Treasuries this year. The sector should benefit from attractive valuations, strong liquidity and high credit quality. To start the year, the credit markets are outperforming, but when the rebound is over, investors may find the safer yield in the agency mortgage market compelling – and with the Fed switching off the autopilot, the mortgage market should be at least more interesting than watching paint dry.

Thank you for listening, we will talk to you again next week

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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