Tortoise QuickTake Podcast

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

Hello and welcome to the Tortoise Credit Strategies weekly podcast. I'm Jeff Brothers, Senior Portfolio Manager on the investment team at Tortoise Credit and I am responsible for setting the strategy for the securitized products sectors within the portfolio. For today's podcast, we'll start with a brief review of the fixed income markets over the past week and then shift gears and discuss an important topic in the bond markets today – The Federal Reserve's monetary policy and specifically focus on the upcoming reduction to the Fed's balance sheet and how it could potentially impact the agency mortgage market.

So, starting with a quick recap of the fixed income markets. The big news for last week was the escalating geo-political risks with bombings in Syria and also Afghanistan and sabre rattling in North Korea. We also had economic news which for the most part was weaker-than-expected and showed some signs of moderating inflation pressures. Most notable was the soft retail sales report on Friday with the March headline declining 0.2% and February's report was revised from a gain of 0.1% to a decline of 0.3%. The weakness in retail sales was primarily attributable to auto sales which fell 1.2% for the month, further reinforcing the idea that auto sales have peaked for the cycle. Lastly, in terms of economic news, the March CPI report showed a moderation in inflation pressures with the headline measure declining 0.3% and the core inflation down 0.1% which was actually the first monthly decline in core inflation since January of 2010. The net result for the markets was U.S. interest rates fell on a flight-to-quality bid with the 10-year U.S. Treasury yield moving below the recent trading range to end the week at 2.24% and in general riskier assets underperformed on the heightened geo-political risk.

Next turning to our special topic of the week, the Fed's balance sheet reinvestment and its potential impact on the mortgage market. To start, some brief background on the Fed's balance sheet. Following the financial crisis in 2008, the Federal Reserve moved aggressively to ease monetary policy in support of the economy, but quickly came up against the zero bound of interest rates and was unable to continue to cut rates to stabilize the economy. At this point, they embarked on the unconventional and unprecedented policy tool of quantitative easing. The plan was to purchase U.S. Treasuries and agency mortgage backed securities for the Fed's balance sheet with a goal of lowering mortgages rates, supporting the housing market, and promoting a stronger pace of economic growth. At the peak of the purchase program, the Fed was exerting a very powerful technical force on the markets, especially in the agency mortgage market. With monthly MBS purchases as high as $40 billion, the Fed buying actually exceeded the available new issue supply in the market. By 2014, with the economy stabilizing, the Fed ended net additions to their portfolio but maintained the size of the balance sheet through reinvestment of maturing U.S. Treasuries and monthly principal paydowns in the mortgage market. The end result of the quantitative easing was the balance sheet grew from approximately $800 billion prior to the crisis to $4.5 trillion today with $2.5 trillion in U.S. Treasuries and $1.8 trillion in Agency MBS.

The plan for reducing the Fed's balance sheet is still being developed, but we have received some guidance including the recent minutes from the March Fed meeting. In terms of timing, the Fed has stated they would address the balance sheet once they were along the path towards normalizing interest rates. With three rate hikes on the books and expectations for two more this year, the Fed appears closer to achieving that objective. In the recently released Fed minutes, they indicated that reductions could start as soon as the end of this year. They have also stated a preference for a gradual and predictable approach in order to avoid surprising the market. If possible, they would like to also avoid outright asset sales, but rather allow the portfolio to run off with maturities and principal paydowns. The market was expecting the Fed to begin by reducing agency mortgages to start, but from the recent minutes we learned the reductions could come from Treasuries and agency mortgages concurrently and the reinvestments would likely be tapered rather than outright ended.

Now let's tie everything back to the investment implications for the agency mortgage market. The most direct impact will come from the supply and demand balance in the agency mortgage market. As mentioned, at the peak of the asset purchase program, the Fed was buying in excess of the available net supply thereby lowering mortgage rates and increasing mortgage security valuations. To put the magnitude in context, the Fed's balance sheet went from holding no mortgages to being the second largest holder only behind domestic banks. Their $1.8 trillion portfolio today represents approximately 30% of the overall agency mortgage market. Even with the shift from net additions to now only reinvestment, their monthly purchases have been sizable, ranging between $15 and $40 billion depending on the level of mortgage refinancing activity. Using a conservative approach based on the current purchases between $15 and $20 billion per month and a gradual approach to tapering the reinvestment – the mortgage market could possibly need to absorb approximately $100 to $150 billion in net supply from the Fed's portfolio in 2018. Again, to put the numbers in context, expectations for 2017 are for slightly over $200 billion in new supply so the Fed's balance sheet runoff could have a significant impact on the market supply and demand technical for the mortgage market. Our view is that mortgage valuations, which are already on the rich side, would need to cheapen to attract new buyers to absorb the additional supply from the Fed's portfolio runoff. So far, the markets have largely shrugged off the approaching reduction in the balance sheet, but just as the tide rolled in for the mortgage market and the Fed buying lifted valuations, the tide is now rolling out and as Warren Buffet famously said "Only when the tide rolls out do you discover who has been swimming naked. "

Thank you for listening to the Tortoise Credit podcast 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@tortoiseinvest.com.