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Tortoise QuickTake Podcast

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

Welcome to the Tortoise Credit Strategies weekly podcast. I'm Jeff Brothers, Senior Portfolio Manager for Tortoise Credit. In today's podcast we will recap the highlights from the bond market over the past week and share our views on the agency mortgage market following the Federal Reserve's recent announcement to begin normalizing their balance sheet.

The biggest news over the past week was the White House releasing the long awaited plan for tax reform. Although the administration's outline lacks important details and will certainly face stiff challenges, the news set off a renewed "reflation trade", reminiscent of the hopeful enthusiasm when Trump first took office. The reaction was deja vu all over again as Yogi Berra once said, with higher stock prices, a stronger dollar, and a selloff in the bond market. The 10-year U.S. Treasury yield, which earlier in September touched 2.02% yield, ended the week sharply higher at 2.34%. Adding to the bearish tone in the bond market was Janet Yellen's hawkish commentary, which indicated the Fed was ready to forge ahead with its two pronged strategy of balance sheet normalization and gradual rate hikes. Finally, the economic news was mixed over the past week with better than expected durable goods orders and ISM manufacturing, but weaker new home sales and continued soft inflation from the core PCE inflation report.

In our special topic, we wanted to share our current views on the agency mortgage market given the much anticipated announcement that the Fed would begin to normalize their balance sheet. The Fed plans to begin to reduce their balance sheet in October with a monthly reduction of $6 billion in U.S. Treasuries and $4 billion in agency mortgages. Through multiple quantitative easing plans, the Fed currently holds $1.7 trillion in agency mortgage securities, almost a third of the overall market. Going forward, they will allow their mortgage portfolio to gradually decline as principal on the mortgages is paid down or refinanced. The initial $4 billion monthly reduction will grow quarterly by $4 billion to a final cap of $20 billion per month.

With the Fed laying the groundwork for months prior to the announcement, the actual news turned out to be a complete non-event. For all the concerns over another "taper tantrum", the agency mortgage market has actually been on a roll leading up the announcement and continued to rally following the Fed meeting. The good news for the mortgage market is the reduction will start with a very modest amount and at the same time, other buyers have recently stepped up purchases to offset the upcoming Fed supply. Both domestic banks and overseas investors have added mortgages to their portfolios with almost $100 billion in net purchases in the first half of 2017. Money managers have also recently been adding to MBS as mortgages have started to look attractive relative to competing asset classes such as investment grade credit. The net result is that the lead into balance sheet normalization turned out to be a great month for agency MBS with the sector, outperforming U.S. Treasuries by 35 basis points in September.

So far, so good for the mortgage market and the Federal Reserve, but again to borrow from Yogi Berra, "The future ain't what it used to be." We believe the calm of today's market could turn more turbulent as we head into 2018. First, the modest monthly portfolio runoff turn more daunting by the 1Q of 2018 with $12 billion and by 3Q up to $20 billion by the third quarter. Secondly, the valuations for agency MBS are very rich from a historical perspective, driven in large part by the Fed's dominate market position. Agency mortgages have averaged a yield spread over U.S. Treasuries of 75 basis point over the past four years compared to an average spread of 115 basis points? in the period prior to the financial crisis and prior to the Fed purchasing agency MBS. At a current yield spread of only 64 basis points, the lowest level in four years, the market valuation doesn't provide much room for error. A lot can change in the supply and demand equilibrium between now and the first quarter of next year, but our view is that current, rich valuations will have to cheapen to attract new buyers to absorb the future Fed portfolio runoff.

Thank you for listening, we'll talk to you 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@tortoiseinvest.com.

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