Impact of Tapering on MBS Markets

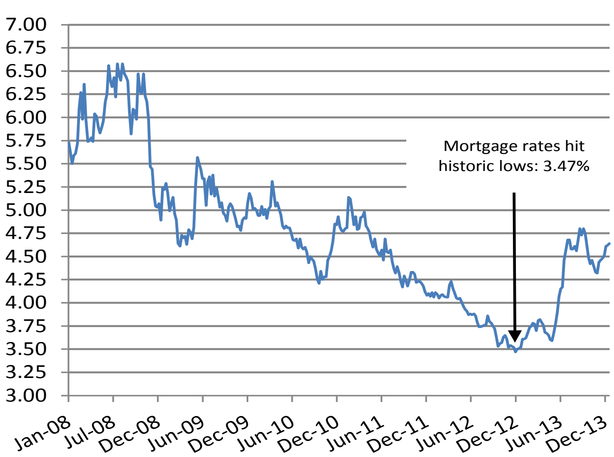
January 17, 2014

Introduction

Agency MBS greatly benefited from the third round of the Quantitative Easing (QE3) announced in September of 2012. The Federal Reserve's $85bn a month bond buying program ($40bn/ month in Agency MBS and $45bn/ month in Treasuries) was designed to keep long-term interest rates low, aid the housing market, and help the overall economy. This positive supply/demand dynamic brought an unprecedented bid to the Agency MBS market which resulted in price increases across the coupon stack. One of the intended consequences of QE was successfully achieved as mortgage rates reached historical low levels by Jan 2013 (Chart 1) and directly contributed to the recovery in the housing market.

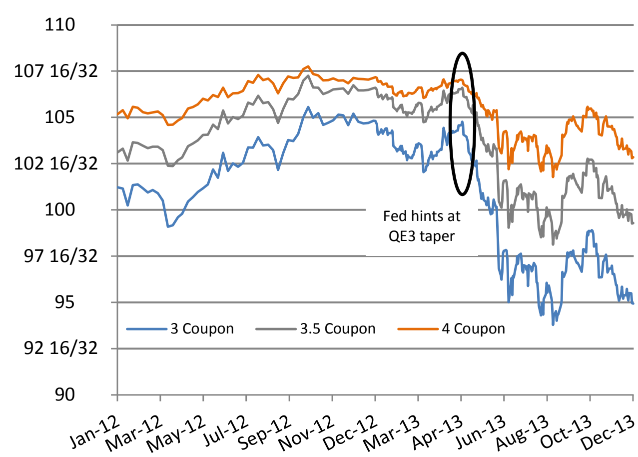
All that changed in May 2013, when Federal Reserve Chairman Ben Bernanke discussed the possibility of tapering of both MBS and Treasuries purchases. The unexpected news led to a sell-off in rates and mortgages, put upward pressure on yields and spreads as market participants adjusted their convexity hedges, and resulted in substantial increase in price volatility (Chart 2). Agency MBS prices rallied again when the Fed decided not to taper at their September meeting. Finally, on December 18th, the Fed announced the first taper of the QE3. The reduction in monthly Agency MBS purchases was only $5bn a month (with remittance pay-down reinvestment left unchanged), but it brought up a very important question: **What will happen to Agency MBS prices and mortgage rates going forward?** In order to answer it, we need to look at the overall size of the market, the role that the Fed played over the recent years and the future demand for the product.

Chart 1: 30-Year Fixed Rate (%)



Source: JPMorgan, FBC

Chart 2: FNMA 30-Year Agency MBS Prices ($)



Source: JPMorgan, FBC

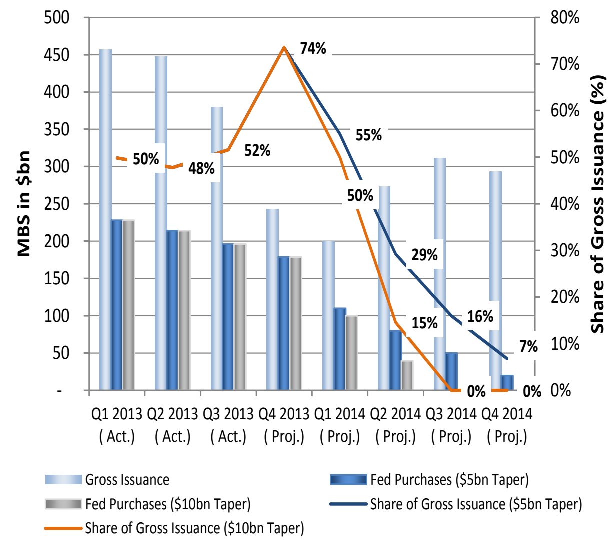
Current size of the Agency MBS Market

According to Barclay's report ("US Securitized Product Outlook 2014"), total Agency MBS market is approximately $5.45trn. A portion, roughly $1trn, is held in CMOs (more structured and less liquid form), and $300bn is locked in held-to-maturity accounts that are unavailable for trading at this time. At almost $1.5trn (not including any future purchases), **Fed currently holds a very substantial portion of the liquid and available-for-sale product on its balance sheet, roughly 36%. Knowing the potential adverse impact on prices of liquidating these purchases,** the Fed will most likely refrain from selling Agency MBS to avoid unintended price shock to the sector and hold all QE related MBS purchases till maturity.

Fed's Footprint

Since the inception of the bond buying program, Fed has become the dominant buyer in this sector. As depicted by Chart 3, during the first three quarters of the 2013, they purchased roughly 50% of the gross MBS issuance. Despite the reduction in the monthly purchases, Fed will continue to provide primary support to Agency MBS prices in the near term as origination volumes continue to decrease in response to higher interest rates. Based on estimates from several Wall Street dealers, in the 4th quarter 2013, Fed purchased as much as $180bn in Agency MBS (which equates to **74% of the total gross issuance**) and a total of **$817bn in 2013**. In the 1st quarter of 2014, we estimate Fed purchases to account for roughly 50%-55% of the gross issuance, depending on the Fed tapering scenario. These projections assume the Fed will decrease its monthly bond purchases by either $5bn or $10bn at each of the subsequent Fed meetings and a 30% drop in loan origination volume for the year. We also assume continued reinvestment of pay-downs from Agency MBS in the amount of $15bn/month. **Given the size of Fed's involvement, Agency MBS may face significant supply/demand imbalances upon their eventual cessation of purchases by the fall of 2014.**

Chart 3: MBS Issuance and Fed Purchases



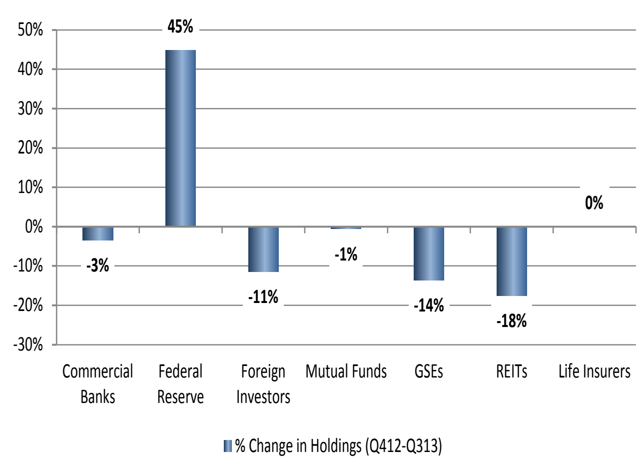
Source: JPMorgan, Amherst Securities Group, FBC

Future Liquidity

The near-term demand for MBS remains sluggish. Fannie Mae and Freddie Mac ("GSEs") continue to shrink their portfolios, bank demand remains stagnant to deal with regulatory obstacles, REITs continue to deleverage amidst concerns of higher rates, and other investors reallocate to other sectors of the market (Chart 4).

Eventually, investors of the product are expected to return as Agency MBS yields become more attractive and market volatility decreases. In the short-run however, a lack of continued Fed support for MBS due to tapering could have a significant adverse impact on the housing sector specifically and macro-economic recovery in general.

Chart 4: Change in MBS allocation by Investor*



*Investor - includes Agency MBS holders that own at least 5% of the total available product.
Source: Inside Mortgage Finance, FBC

Alternative Path for Tapering

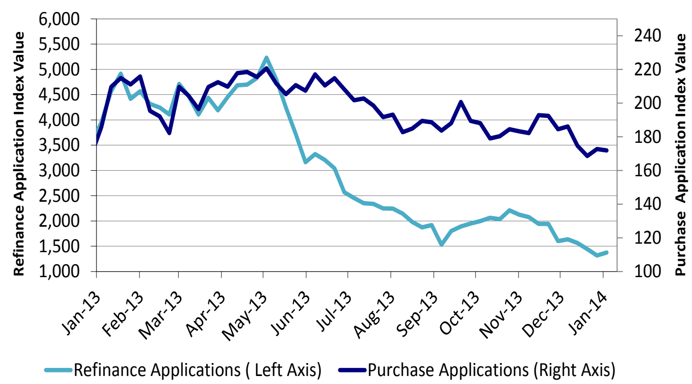
As indicated by Chairman Bernanke, we expect the actual process of tapering to be gradual, methodical and highly dependent on economic conditions as to cause minimal market disruptions. **However, we believe a different path should be followed by the Fed to ensure the sustainability of the housing market recovery that followed the 2008 crisis.** The pull back of the stimulus, even if performed carefully, will most likely result in weaker housing performance.

Alternative Path for Tapering (continued)

The evidence is already here. As Mortgage Rates approached 5% following the first discussion surrounding Fed tapering in May 2013, we saw a significant drop in affordability. This in turn caused sharp declines in volume of refinance and purchase applications (Chart 5), lower mortgage origination (Chart 6), and drop in Existing Home Sales (Chart 7). Furthermore, Qualified Mortgage ("QM") rules set by Consumer Financial Protection Bureau may also negatively impact future origination volumes and possibly curtail already tight lending. These effects may spill over to other sectors, conceivably hampering the economic growth that's still well below historic norms.

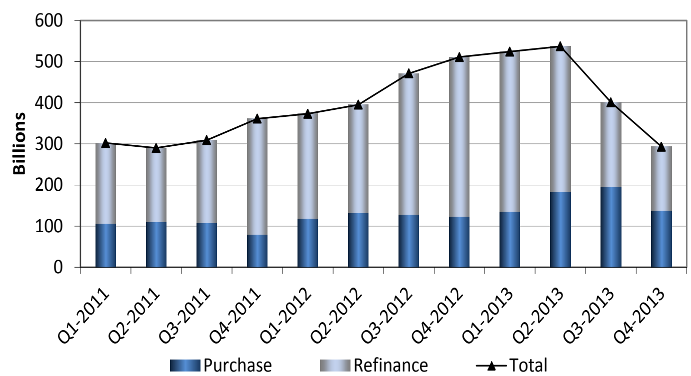
For now, if the Fed continues to taper QE bond purchases, it should consider reducing Treasury purchases **ONLY** and delay tapering any of its purchases of MBS until clear evidence suggests that housing markets are in equilibrium. This would most likely result in increased Fed absorption of the gross issuance (possibly reaching 80%) in the near term, however it would also keep mortgage spreads at current levels (or even tighter), target mortgage rates to no higher than 4.75% (slightly above today's mortgage rates available to borrowers looking to refinance or purchase), and provide liquidity to the sector until housing markets normalize.

Chart 5: Applications for Purchase and Refinance



Source: Mortgage Bankers Assocation, FBC

Chart 6: Mortgage Originations (1-4 Family)

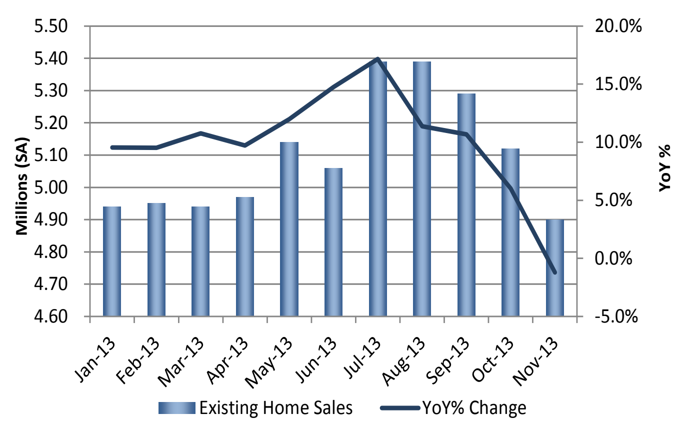


Source: Mortgage Bankers Association, FBC

Conclusion:

Although the U.S. housing market has shown strong gains in performance over the past two years, the recovery has not been uniform across the country and remains a work in progress in many places. Certain areas of the U.S. are still recovering from the oversupply of new construction and loose lending standards, and many homeowners (20%, by some estimates) are underwater on their mortgages. The Fed's actions to date supported the economy and provided much needed liquidity to revive and ensure the smooth functioning of the mortgage market. **Without the Fed's stimulus, based on recent performance (widened MBS spreads and higher interest rates), and the lack of investor interest the housing recovery may stall.** Given the magnitude and volatility of the market response witnessed in the summer of 2013, we believe the reduction in MBS purchases should be delayed until the broader investor base returns to the market under a normal housing environment.

Chart 7: Existing Home Sales



Source: National Association of Realtors, FBC

The underlying loan data is provided by CoreLogic (subscription-based data repository) for a specific subset of loans. Our access to CoreLogic data includes approximately 95% of all U.S. Option ARM, Subprime, and Alt-A securitized product. Unless specified, Prime, Jumbo, or Agency Backed loans are not includes in the graphs and charts.

Algorithms and analysis to access the information and any interpretation are proprietary to Falcon Bridge Capital, LLC.

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