Daily Themes **28 January 2008**

Is the MBS rally over?

Mortgage-backed securities (MBS) were the fixed income star of late 2008. Anticipating the implementation of the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF), there was a strong rally from agency MBS (i.e., mortgage bonds issued principally by Fannie Mae and Freddie Mac). That undid over half of their credit-crunch-related sell-off relative to Treasuries and took US mortgage rates to their lowest for 50 years.

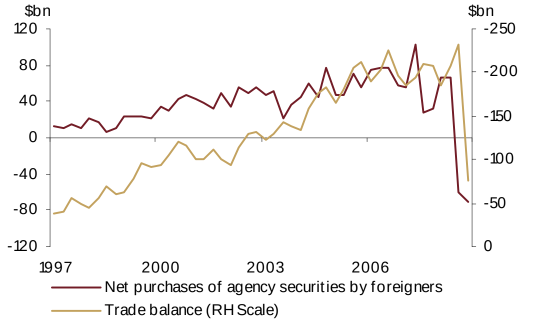
Over the past two weeks, however, the rally has stalled, as government bonds have sold off and spreads over Treasuries have moderately widened. Retail mortgage rates, which were at 3.7% earlier in January, are now back over 4.0%. So, if you blinked and missed the mortgage rally, is it already over?

Investors' concerns about the viability of banks around the world have increased in recent weeks. The intensification of these concerns has served to raise banks' funding costs. Five-year swap spreads, which were 43 basis points (bps) in mid-January, are currently 66 bps. As banks are such a critical player in the MBS market, a rise in their funding costs will, all else being equal, result in them being less willing to hold MBS at existing valuations. Hence, short-dated bank funding costs have a powerful feed-through to MBS valuations.

However, with bank equities all around the world reversing some or all of last week's sharp declines, the level of concern about the banking sector appears to have eased – though it has certainly far from disappeared. This improvement in sentiment should benefit swap spreads and so provide a fillip to the MBS market over the coming weeks.

Foreign purchasers have also been a key player in MBS, and their buying has fallen away over recent months as weak US domestic demand has narrowed the trade deficit and reduced the inflow of foreign capital. The US trade deficit is likely to continue narrowing, as domestic demand growth remains below global demand growth. During less risk-averse episodes, however, foreigners are unlikely to be as willing to sell MBS in order to maintain flows into T-bills and Treasuries.

A combination of risk aversion and a declining external deficit has hit foreign demand for MBS



Source: US Treasury, Datastream

Dominating all of these factors is the fact that the Fed's TALF purchasing of MBS has only recently got under way. By 23rd January, the Fed had purchased $52.6 billion MBS, $47.7 billion of which has been targeted at the 30-year maturity sector and, within this, $28.5 billion from the 4.5-5.0% coupon stack. This is the maturity and coupon make-up that new mortgages will have and so is where policy-makers can get the most bang for their buck in terms of the feed-through to retail mortgage rates. Crucially, this is only the start of the Fed's programme – around 10% towards reaching the $500 billion target by mid-year.

The funding environment will favour MBS in the short run, as swap spreads stabilise and possibly narrow. In addition, the underlying support offered by official purchases, when compared with the $876 billion of gross issuance in 2008, is massive. The MBS rally probably has some way to run yet.

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