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Andrea F. Pringle
Financial Strategist/MBS Analyst
APringle@GoBaker.com

A New Era for the Mortgage Market?

The mortgage-backed securities (MBS) market has long been supported by a "buyer of last resort," propping up demand without being motivated by purely economic concerns. Until the global financial crisis (GFC), that role was largely held by the government sponsored enterprises (GSEs). After the GSEs were taken into conservatorship in September 2008, the Federal Reserve (Fed) stepped in as the dominant investor. But since September 2022, the Fed has no longer been an active buyer in the market. And with the Fed's expressed desire to shift its portfolio holdings to include only Treasury securities, the mortgage market has entered a new era—perhaps one without a stabilizing source of demand.

At the onset of the GFC, the MBS market seized up. Investors saddled with sour mortgage assets became hesitant to purchase new mortgage securities. Originators, worried they may not be able to offload a newly inked mortgage and fearful of getting stuck holding a loan backed by a depreciating asset, became hesitant to make new loans as well. The GSEs, facing increasing losses and depleting capital, had less capacity to buy MBS. Then, once in conservatorship, they were restricted in their ability to buy MBS as part of an effort to de-risk the entities. With the foundations of housing finance becoming increasingly shaky, the Fed stepped in to stabilize the market. The Fed's presence as a major buyer instilled confidence among secondary market investors. The increased demand from the Fed's purchases also drove MBS yields and, consequently, primary mortgage rates down.

During the pandemic, the Fed's impact on the MBS market doubled. Once again, the Fed stepped in during a time of crisis, buying large amounts of MBS and injecting liquidity into the market. The Fed's action helped MBS yields and primary mortgage rates fall to record lows in 2020 and 2021. But when the Fed shifted to a more restrictive monetary policy stance in early 2022 to combat rising inflation, those rates quickly reversed. And when the Fed stepped away from the MBS market entirely by the fall of 2022, mortgage rates climbed further, hitting levels not seen in more than twenty years. MBS spreads, which reflect the additional yield of an MBS above a benchmark yield, also widened to levels not seen since the GFC.

Without the GSEs or the Fed to act as a buyer of last resort, the mortgage market finds itself in different territory these days. Especially as demand from commercial banks has ebbed in the wake of the spring 2023 banking turmoil and overall tight liquidity across the industry. Without a buyer of last resort and commercial banks on the sidelines, investor demand has become more influenced by relative value investors.

The motives of relative value-oriented investors, such as mutual funds and hedge funds, are purely economic. They aim to buy whichever asset class they deem to be undervalued relative to other asset classes. Value-oriented investors tend to require higher spreads than the big historical MBS buyers. The GSEs, the Fed, and commercial banks all purchase MBS to fulfill specific objectives that cannot be met by another asset class. That is not the case with relative value investors, they go where the value is, and their influence on the market has helped reset spreads at higher levels.

For MBS investors not on the sidelines, this new era may mark a positive turn in the market as the absence of a non-economically motivated buyer may well keep spreads wider than they have been for much of the past fifteen years. A shift to less restrictive

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monetary policy and rate cuts from the Fed may also bring commercial bank demand back in notable size as conditions improve for the banking industry. However, for borrowers, primary mortgage rates may have a hard time reaching the lows seen when the big buyers were in the game. If the Fed can stay out of the mortgage market like it apparently prefers, those conditions may persist. But there is always the chance another economic crisis drags the Fed back into the game once more.

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Andrea Pringle
Financial Strategist/MBS Analyst
The Baker Group LP

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