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Eventual Fed MBS exit leaves open seat for new buyers

But it's unknown who will takeover when the time comes

By: Christina Mlynski - September 19, 2013

The housing sector has been gearing up since May for the **Federal Reserve** to eventually taper its acquisitions of Treasurys and mortgage bonds.

All of that changed this week, when the **Federal Open Market Committee** stayed the course, committing itself to ongoing monthly purchases of $85 billion in assets.

Nonetheless, there will come a time when the Fed begins to taper its bond-buying program, and the market is struggling to figure out who will take over once the central bank backs out of the space.

"With the government-sponsored enterprises reducing portfolios, the Fed is currently providing the ‘backstop bid’ in the market and as of now, traditional accounts are quiet," explained **Royal Bank of Scotland** (RBS) MBS analyst Jeana Curro.

She added, "We think this could have been one of the reasons (along with the higher rates) that the Fed decided not to taper in yesterday’s meeting."

However, the market also needs to consider that even when the central bank decides to begin tapering, it may not include a decline in MBS purchases since the Fed wants to support lower interest rates and foster a housing recovery. The alternative would be a situation where the Fed decides to carve back on Treasury acquisitions first.

"Rates are higher now, so while the Fed is sucking up the supply of MBS, you have to remember that new mortgage originations and refinance volumes are lower than before, so that hole may not be as big to fill when they start to pull out," explained **FBR Capital Markets** research analyst and vice president Dan Altscher.

Nonetheless, there will have to be entities to take over, and mortgage real estate investment trusts will be a player in some way, shape and form.

While it’s true that agency mREITs have scaled back leverage, the firms have lowered their ratio and increased hedges to respond to the volatility of the market. This means that when these companies are ready to come back into the MBS market, they will be properly leveraged, Altscher pointed out.

The interesting players that are likely to step back into the agency MBS market will include other sectors of REITs, including nonagency REITs and hybrid REITs because they have complete flexibility to allocate across various assets like commercial mortgage-backed securities and MBS.

"It’s all going to depend on the flavor of the week," Altscher said. "mREITs will be there because that is their business model. Unless it’s the death of the mREIT, they’ll need to come back into the market."

It’s important to note that even if mREITs come back into the market, these entities will not be able to handle the paper by themselves.

As a result, other entities that are likely to stake a claim in the market. Those firms could include commercial banks, mutual funds and insurance companies, said Mark Calabria, the **Cato Institute's** director of financial regulation studies.

Although banks are currently facing a lot of regulatory uncertainty and awaiting the final interpretation in liquidity ratios — if this were to be favorable and rates were more attractive — there could potentially be a return of bank demand.

Furthermore, if rates reset higher and the market starts to function more rationally, there could be an increase in flows from traditional players, Curro argued.

On a similar note, Altscher agrees that banks, insurance companies – both life insurance and property causalities, pension funds and foreign sovereign debt funds will get back into the market.

"Just because the Fed won’t eventually be there doesn’t mean there will not be others in the market who will take over, especially the nonbank players," Altscher concluded.