Mortgage Market Comment – Benefits from any QE3 MBS purchases should be small

MBS Strategy

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The FOMC decision last month to reinvest MBS paydowns into MBS was a surprise to the market. Now, some members appear to be preparing the groundwork for potential MBS purchases if the economy weakens[1].

Expectations for sharp MBS outperformance on the heels of this news appear premature. The potential for additional MBS purchases by the Fed remain some distance away, in our view.

Benefits of any such program to the housing market and the broader economy are likely to be modest. At the margin, lower mortgage rates could increase investor purchases by improving potential returns.

Rather than a broad-based MBS purchase program, any Fed buying could be more suited to absorbing large scale supply from a high volume government refi program, which we view as a highly challenging and economically questionable goal (*Mortgage Market Focus*, 14 July 2011). A TALF-like program to spur institutional investor purchases of GSE-owned foreclosed properties (REO) could deliver a stronger marginal impact, in our view (*ABS & RMBS Credit Strategy*, 12 August 2011).

If the Fed were to embank on a QE3 program, we believe that MBS purchases would almost certainly be a part of it, in order to allow the Fed to target mortgage rates directly and minimize the risk of a liquidity disruption in Treasuries if the entire operation were conducted in that sector.

For now, two important hurdles remain: (1) the Fed needs to conclude that QE3 is necessary, and (2) the potential dislocations to the MBS market from large scale Fed purchases need to be considered.

To overcome the first obstacle, there needs to be meaningful additional weakness in economic conditions. It seems to us that muddling along may not meet that threshold.

The second issue is more challenging than it appears at first blush. The Fed currently owns roughly 15% of all Agency MBS, and just over 20% of fixed-rate conventional pass-throughs. If the Fed were to buy $500B of MBS as part of QE3, the numbers would jump to 25% and 34%, respectively. Fails problems, which dogged QE1, could be a significantly larger challenge under QE3. With the fails charge that is scheduled to take effect in February 2012, the risk of negatively affecting MBS liquidity is high in a QE3 scenario. The bulk of supply to the Fed will likely come from money managers, similar to QE1.

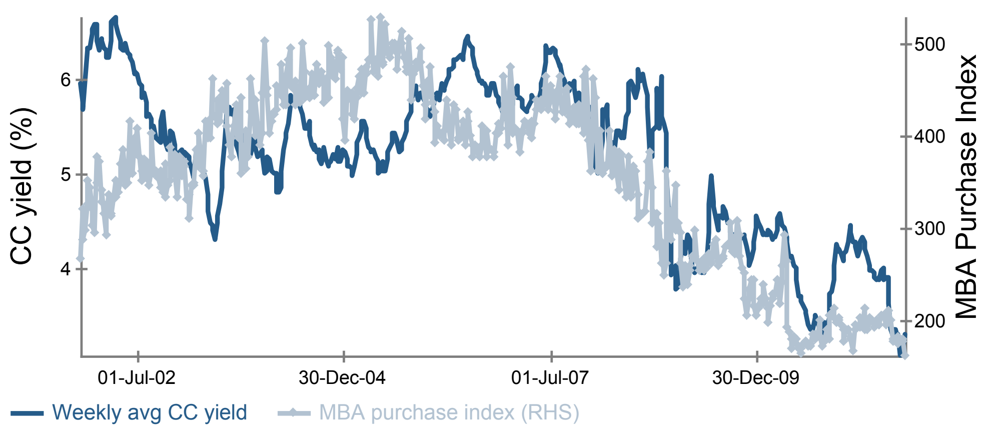
1 http://online.wsj.com/article/SB10001424052970203752604576643510352250474.html?mod=WSJ_hp_LEFTWhatsNewsCollection

Direct benefits of yet another MBS purchase program appear to be modest, in our view. Mortgage rates are already at record lows, so the prospects of large scale incremental benefits generated by even lower rates are questionable. Moreover, the Fed's securities purchases would not fully translate into lower mortgage rates since originator capacity constraints will likely remain. There should nevertheless be a fair amount of incremental refinancing activity, mostly benefiting the strongest borrowers and resulting in minimal changes to broader economic metrics.

Mortgage rates could drop to a 3.00% to 3.50% range under a $1T QE3 scenario evenly split between Treasuries and MBS. This could trigger an additional $400B-500B in paydowns over 12 months, resulting in roughly $4B-5B in incremental annual savings.

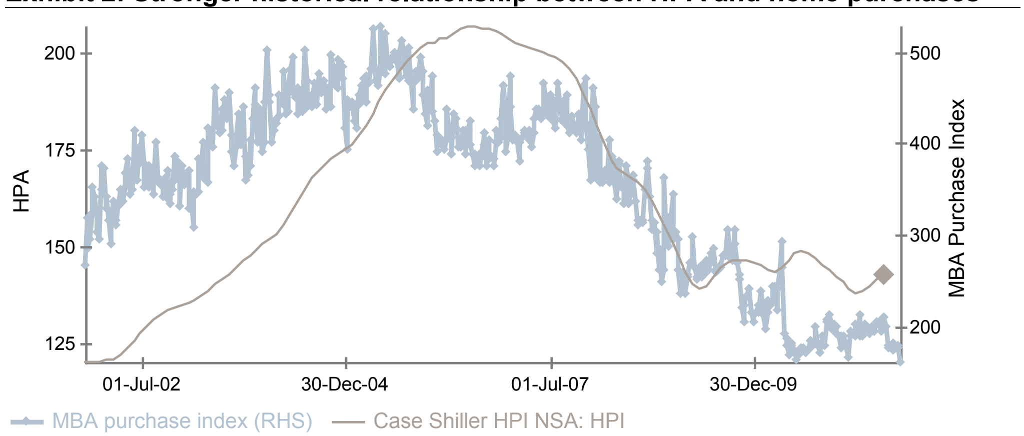
Prospects for an increase in home purchases due to lower mortgage rates remain muted. We note the historically weak relationship between mortgage yields and home purchases, and the perversely inverse correlation (not causation) more recently (Exhibit 1). Although affordability remains at a historical high, buyers remain on the sidelines largely due to concerns about potential further home price declines and/or the unfavorable employment outlook (Exhibit 2). At the margin, investor purchases could increase modestly due to higher carry as a result of lower rates.

Exhibit 1: Weak historical relationship between mortgage yields/rates and home purchases



Source: Credit Suisse Locus, MBA

Exhibit 2: Stronger historical relationship between HPA and home purchases



Source: Credit Suisse Locus, Case Shiller, MBA

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