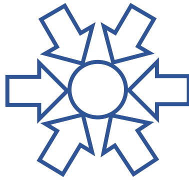


GSE Activity Report

Monday, December 05, 2022

The Big Squeeze

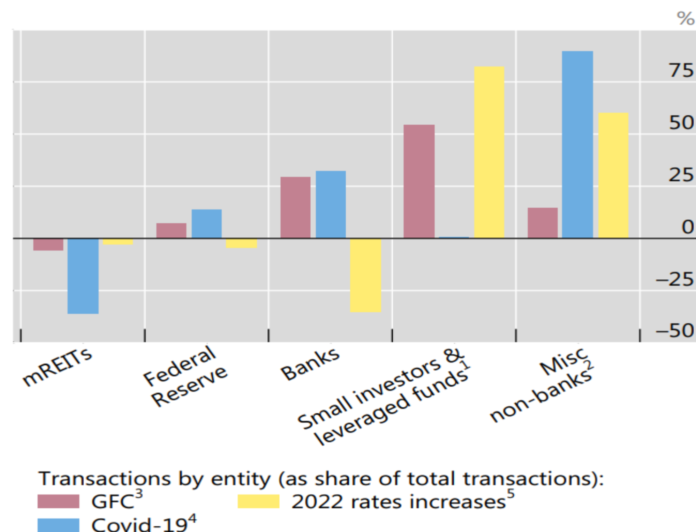
Summary

Making an important addition to the ongoing debate about Treasury-market liquidity, a new paper from the Bank for International Settlements provides sobering data on agency MBS liquidity with significant implications not only for secondary-market liquidity, but also primary-market stability. Treasury has taken some steps to enhance its market, but none of which we are aware has yet been adopted for agency paper, an omission with potentially systemic consequences if liquidity stress in this $10 trillion market turns to shove.

Impact

As the graph below makes clear, things have gone very odd in the MBS market. MBS trading volumes have dropped dramatically and spreads in 2022 are unusually volatile compared with those over the past thirty-five years. During the GFC and again in the Covid crash, banks and central banks were all-in market-makers, making about forty percent of all transactions in these two near-death experiences. Now, small investors and leveraged funds are the main MBS buyers, and mREITs are also a source of acute volatility.

As the paper notes, banks are less likely to backstop these MBS bets, a phenomenon we attribute at least in part to the resumption of the supplementary leverage ratio. And, as the paper also notes, the Fed's willingness to do so is at best uncertain due to ongoing QT.



Source: BIS Quarterly Review, p. 13

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Outlook

The paper unsurprisingly concludes that, "liquidity disruptions in the MBS market could have material systemic implications." One of these it doesn't point out will be renewed attention to mREITs and reconsideration of their systemic status once the smoke clears and FSOC re-establishes its designation construct. Indeed, the BIS paper almost calls for systemic intervention to rein in mREITs.

More immediate, of course, is the extent to which this systemic risk befalls agency paper as a near-substitute for Treasuries with smaller volumes and – for GSE obligations – less certain USG guarantees and Fed willingness to hold. If this liquidity stress doesn't materialize, thank goodness for that. If it does, the systemic fall out will extend not only to mREITS, but also to the Fed – which didn't notice this problem in its most recent financial-stability report other than by again citing principal trading firms and hedge funds as liquidity worries. The Fed will have its hands full first with rates going well outside desired ranges and then with still worse unrealized losses on its own MBS, but systemic distress will also land on its liquidity-window sill if the situation gets truly out of hand.

And, as we noted, the primary market can't power on if the secondary one seizes up. Fannie and Freddie could again come under acute liquidity stress if they can't quickly securitize mortgages and sudden drops in agency-paper demand will ricochet down to mortgage rates, spiraling them up regardless of where Fed rates may stand at the time the squeeze is on.

What to do about all this? Not much beyond ensuring more ready liquidity at the GSEs we can think of since all the forces the BIS maps are well under way. But knowledge is handy and thus we hope it is with this report.

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