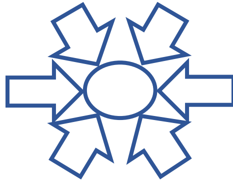

GSE Activity Report

Wednesday, January 11, 2023

An Implacable Problem with a Policy Solution

Summary

As the Fed has hiked interest rates, mortgage rates have of course also gone up, sending a sudden chill through the residential market and putting home ownership even more out of reach for all but those for whom the home equity they still have after prices correct suffices for long-term wealth accumulation. However, mortgage rates have often risen higher than expected from usual yield spreads and thus Fed tightening is even more excruciating not just for the mortgage market, but also for FHFA's equitable-finance mission and the Fed's hoped-for soft landing. In this analysis, we assess the dynamics of recent mortgage pricing and what might be done about it.

Analysis

Historically, mortgage rates hover about 175-200 bps above the ten-year Treasury. With ten-year paper hovering around 3.5%, this would put the mortgage rate below six, which of course it isn't. Instead, mortgages are pricing off MBS because the equation of mortgage-funding costs and lagging market MBS demand skewed historic spreads into the far wider range necessary to ensure market liquidity.

Why? It's QT combined with capital requirements explains this disconnect and why it's come so fast. The Fed has of course been the world's dominant buyer of agency MBS, picking up at least 38 percent of the market through QE. Now, of course, there's QT with the Fed determined to let all of its MBS run off even faster than its Treasury holdings. Fed flow-of-funds data also show that banks generally bought the MBS the Fed left behind during QE. Now, they aren't doing so in large part because the biggest banks are rebuilding regulatory capital even as deposit outflows at a time of rising rates offer better RAROCs on central-bank deposits. Govvie MMFs are also basking in the glow of the ONRRP and thus need fewer MBS to house investor funds.

What to do? The Fed won't reverse QT nor will it give banks capital mercy or redesign the ONRRP. As a result, mortgages are likely to price higher than usual in volatile ranges even as all of these rates crowd out first-time and lower-income borrowers. The Fed may ease its rate increases over the first half of 2023 and even begin to drop them a bit later in the year, but even the FOMC clearly doesn't know what it will do when more than a week or two in advance.

As a result, mortgage demand will be unnaturally suppressed, house prices will drop more than anticipated, and stresses will rise because borrowers facing delinquency will have a hard time finding above-water buyers especially for post-pandemic purchase and cash-out refi loans.

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FHFA may already be contemplating limited market intervention through the pricing channel – as we noted last week, the agency is demanding that Fannie and Freddie cut prices where they can. In our view, there aren't very many ways they actually could do so and yet achieve FHFA's sacrosanct goal of capital accumulation, but some pricing adjustments on the margin for targeted borrowers are possible.

What more could be done? Could FHFA soften this blow and dampen market volatility? Yes, but the only way we can think of is for the GSEs to reopen their portfolios and agree to purchase mortgages that meet specified criteria at below-market prices to support at least a small secondary-market for lower-rate loans for higher-risk households. A new GSE portfolio would put more pressure on long-term capital accumulation absent massive amounts of CRT as well as reopen the wounds of the 2008 debacle but purchases now of slightly lower-rate loans could be sold on as rates drop, possibly yielding a positive return as seasoning yields increase investor appetite for loans that might soon provide an above-market return.

Outlook

The extent to which FHFA facilitates mortgage loans at lower rates to us seems wholly political. GSE funding costs are always lower than the market's, making holding lower-rate loans more of a profitable proposition than private investors are able to match. When the portfolio consisted of subprime mortgages and agency MBS, this was both extremely profitable and very dangerous. Better managed with an eye to mission and total exposure, a new portfolio might make a meaningful dent in mortgage credit availability unless or until yield normalization allows the GSEs to return to the buy-and-sell function FHFA has long stipulated.

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