GSE Activity Report

Monday, October 13, 2023

30-10 or Bust

Summary

With smaller lenders today joining MBA, NAR, and HomeBuilders' campaign to squeeze the 30-10 spread, we take a look at the odds the White House, Fed, or Treasury will do as hoped. We think it more than possible that the PSPA could be revised with FHFA consent to allow the GSEs to hold more of their own MBS as a spread stabilizer; whether the GSEs will do so unless forced is another question given the considerable capital cost this would exert.

Impact

All of these letters plea for action – pretty much any action – to lower the 30-10 spread and thus reduce mortgage rates by as much as 150 bps. Here, we review the options proposed and the possibility they could come to pass:

- **End QT MBS Run-Off**: The letters urge the Fed to stop selling agency MBS, but it is in fact not doing so. Quantitative tightening is accomplished only by gradual run-off, with MBS heading off the Fed's hands faster than Treasuries due to the refi wave along with natural amortization. Could the Fed purchase new agency MBS to replace run-off? Yes, but it could also do the same for Treasury obligations, where the Fed's decision not to purchase USG obligations contributes mightily to liquidity stress and high yields in this super-systemic arena. The only thing that would cause the Fed to suspend QT is a financial crisis or clear signs of a near-term hard landing.

- **Fed MBS Purchases from the Banking Sector:** The idea here is that the Fed would reduce pressure on banks with HTM burdens by taking low-rate mortgages off their hands, but this is at best dubious. The Fed's statutory authority to purchase MBS derives from its monetary-policy mandate. Using the Fed's power to purchase assets directly from banks isn't for monetary-policy purposes – just for sector relief. It also treads hard on a longstanding aversion and, some believe, statutory prohibition against credit allocation resulting from Fed interventions. Once the Fed starts buying MBS, what's to stop it from buying solar-panel loans or any other asset one or another group believed good for the planet? Not much and the Fed thus won't do it. And, even if it did, it's not at all clear what good that would do to MBS pricing given that it's just moving the MBS, not creating more market demand for them.

- **GSE Portfolio Holdings:** Here, we see considerable potential to move the spread needle, at least a little. GSE MBS purchases or retention would reduce supply, surely leading to more demand to hold 30-year and narrower spreads paper. However, meaningful spread impact would require sizeable purchases that at least offset the $30 billion or so a month the Fed is allowing to run off. The GSEs in very short order would be holding a large MBS portfolio that

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puts a lot of pressure on compliance with their leverage ratio requirements. When the GSEs acted as market shock absorbers before the 2008 crisis, they did this as much to arbitrage the market and profit thereby as to stabilize it, enabled by super-low capital requirements to outbid the market for whatever the GSEs wanted whenever they wanted it. Now, of course, their hegemony no longer reigns supreme. As a result, MBS purchases are possible, but FHFA would need to adjust some key moving parts to make them meaningful.

Outlook

Would Treasury press FHFA to do this and FHFA then comply? Not now because the pain of wide spreads is largely felt by the industry. Yes, mortgage affordability is at an awful low, but that's no different for mortgage borrowers than it's been ever since rates went up. Their problem is worse now, but it was super-bad before and – essentially the difference between being unable to afford a median-priced home and being even more unable to afford a median-priced home.

But, mortgage-market pain could well become a political imperative closer to the election as the ravages of inflation become a major political football. Inflation may ease more by mid-2024 and the Fed could drop rates a bit in a soft-landing scenario, allowing the White House to come in with a high-profile plan to enhance mortgage affordability right before the election without running the risk of a Federal Reserve conniption. In a hard landing, rates will fall, QT will end, and macro policy will change, making the need for GSE MBS purchases at best academic and at worst still riskier if Fannie and Freddie tremble along with the rest of the financial market.

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