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What the Federal Reserve Bank Owns

Perspectives

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Quantitative Easing Policy: Treasury and Agency Mortgage Debt Purchases

Perpetua Phillips
Sr. Portfolio Manager

The intent and implementation of the Federal Reserve Bank's (Fed) monetary policy over the last five years has been widely debated. In broad terms, the Fed has sought to increase employment through renewed economic growth and return inflation closer to its 2% annualized target. The tools used by the Fed include maintaining short term rates near 0% and purchasing Treasury and Agency Mortgage-Backed Securities (MBS) in historic proportions.

After initially signaling last summer that it might start tapering its bond purchases in September, the Fed surprised the markets and maintained its current program in the face of perceived market weakness and fiscal instability.

Now that the current fiscal crisis has temporarily abated and the economy continues its gradual recovery, expectations for Fed tapering are likely to return. To better understand the potential market implications of such a move, it is helpful to consider the scope of the Fed's balance sheet and the scale of its involvement in purchasing Treasury and Agency MBS.

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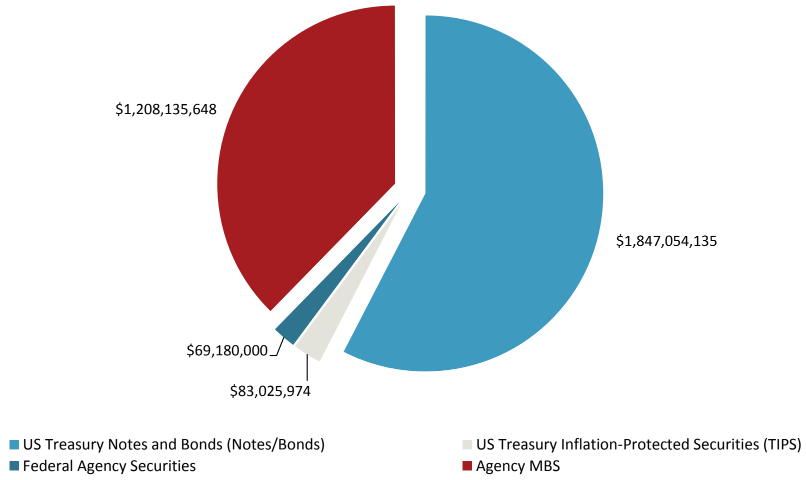
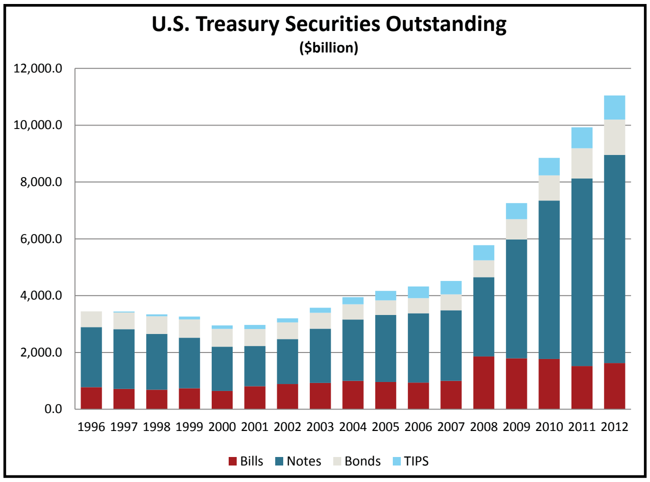
Federal Reserve Bank of New York
System Open Market Account Holdings



The Fed's balance sheet has swollen to almost $3.8 trillion as of September 30, 2013. The majority of its holdings, over $3 trillion, as shown above, are represented by Treasury debt and Agency MBS. Since early this year, the Fed has been purchasing $85 billion of Treasury and Agency MBS each month as part of its ongoing Quantitative Easing (QE2) program.



Total publicly available Treasury debt outstanding is $11.97 trillion as of September 30, 2013. Fed purchases have targeted just Notes and Bonds, which total $8.87 trillion. The Fed owns over 20% of the outstanding Treasury Notes/Bonds. We would note that the U.S. debt burden does include another $4.76 trillion in Intragovernmental Holdings, increasing total outstanding U.S. obligations to over $16.7 trillion.

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Agency MBS issuance has been averaging around $150 billion per month gross and $15 billion per month net. If the backup in primary 30 year mortgage rates reaches 4.5%, that could come down to $100 billion and $10 billion, respectively. Therefore, the Fed's purchase of $40 billion per month outright in MBS during QE3 has been swallowing up all net issuance and then some. This means the remaining supply of MBS to the Fed has been coming from sales by other investors (mainly the government sponsored entities (GSEs), whose books have been declining by about $100 billion per year via sales and paydowns) as well as some selling by overseas investors. An interesting corollary to this is that as MBS gross issuance is reduced by higher mortgage rates, the Fed's purchases would be an even larger share of gross monthly issuance (if they keep purchases at $40 billion per month – the market cynic could say that might be part of the reason the Fed may accelerate the timeline for tapering, as it doesn't want the market distortions from its MBS purchases to be magnified as MBS issuance shrinks).

The $9.9 trillion total MBS debt outstanding includes all mortgage debt (agency/non-agency, securitized/raw loans, single family). The Fed has focused its purchases in the Agency MBS market alone, which totals $4.5 trillion. The Fed's QE mortgage purchases have been focused on FNMA, FHLMC, and GNMA 15 and 30 year MBS in pass-through securities. The Fed now owns approximately 25% of these holdings.

It doesn't appear to be the Fed's plan to reduce its balance sheet through sales, at least on the MBS side. Chairman Bernanke noted, following the June Federal Open Market Committee (FOMC) meeting, that the Fed did not intend to sell its MBS holdings, but rather let them roll off via paydowns. The current MBS portfolio held by the Fed has been throwing off paydowns of around $25-$30 billion per month. It is not known how or when the Fed will unwind these programs, only that they must. Whenever and however that takes place, it will undoubtedly be a contributing factor in fixed income pricing for an extended period of time.