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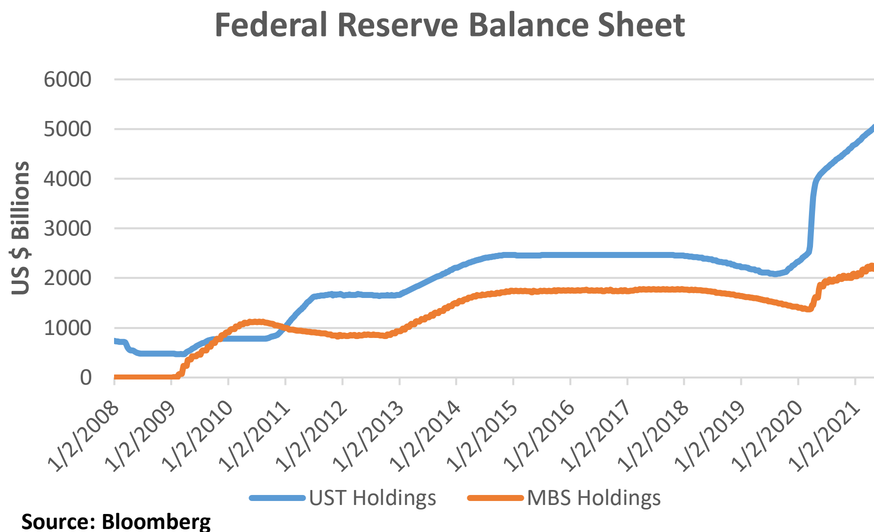
The Fed Should Taper Mortgages First

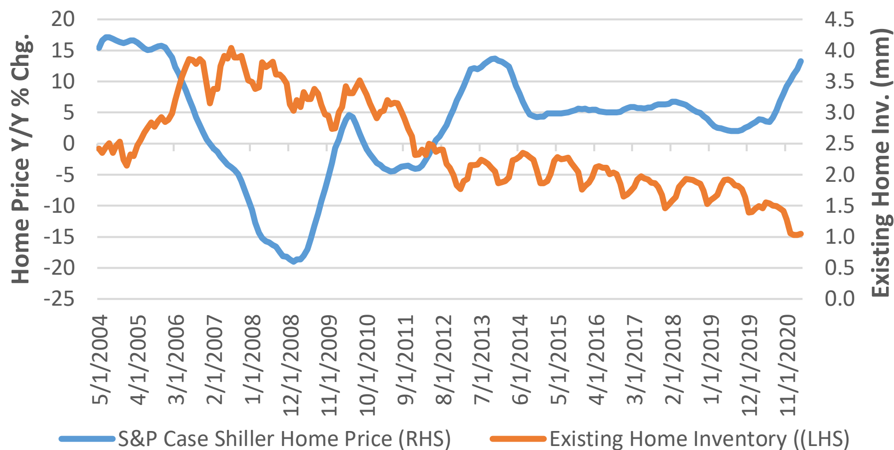
The Federal Reserve continues to purchase $80 billion US Treasuries and $40 billion mortgage-backed securities per month to support the economy following the pandemic. The Fed has indicated the current policy will remain until “substantial further progress” in their goal of maximum employment and inflation moderately exceeding 2% for some time. Despite the recent weaker than expected employment reports, the Fed will soon start discussing tapering asset purchases. In this month’s Fixed Income Insight, we will discuss more specifically the Fed’s mortgage purchases and make the case that when it is time for the Fed to scale back asset purchases, mortgages should be at the front of the line.

In late 2008, the Federal Reserve embarked on the unprecedented quantitative easing (QE) program in response to the financial crisis centered in the housing market. Through three separate QE programs, the Fed amassed $4.2 trillion in US Treasuries and agency mortgages compared to a balance sheet of $700 billion prior to the crisis. In September of 2019, the Fed began a fourth round of quantitative easing and accelerated purchases in March of 2020, this time to support the economic collapse resulting from the pandemic. The Fed’s balance sheet now exceeds $7.3 trillion.



Source: Bloomberg

One reason the Fed should consider tapering mortgage purchases is, unlike in 2008, the housing market today does not need the additional support from the Fed’s mortgage purchases. In fact, the housing market has boomed since the start of the pandemic as low interest rates and the desire to move from crowded city apartments created a surge in demand. Homebuilders, faced with shortages of materials and labor, have struggled to keep pace with demand. The recent softness in new and existing home sales is more a function of scarce inventory than reduced demand. Inventories are near record lows and Freddie Mac estimates a 3.8 million shortfall in housing units versus current demand. Given the supply shortages, home prices have appreciated at an annual rate of 13.3% through March, reminiscent of the housing bubble in the early 2000s. Continued Fed purchases of mortgages exacerbates the supply and demand imbalance and risks further inflating the growing housing bubble.



Source: Bloomberg

A secondary consideration is the expanding US Treasury supply to fund the growing budget deficit. It may make sense to shift purchases away from mortgages, where the Fed's support may be unnecessary or even harmful, to purchases of US Treasuries where the need is greater. Treasury Secretary Yellen defends the substantial fiscal spending by stating "if we ended up with slightly higher interest rate environment, it would actually be a plus for society's point of view and the Fed's point of view." Without the Fed's purchases of Treasuries, we may see something more ominous than "slightly higher" interest rates.

What is the Fed saying? Chairman Powell and many members on the committee believe it is still too soon to even start discussing tapering. However, some dissention in the ranks has emerged with Dallas Fed President Kaplan stating, "I think at this stage, as it's clear we're weathering the pandemic and making progress, I don't think the housing market needs the level of support that the Fed is currently providing and I would love to see, sooner rather than later, a discussion of the efficacy, for example, of those mortgage purchases." Federal Reserve Bank of Boston President Rosengren recently echoed the sentiment with "my own personal view is that the mortgage market probably doesn't need as much support now. And in fact, one of my financial stability concerns would be if the housing market gets too overheated." The bottom line is when the Fed does begin talking about tapering, the mortgage purchases should certainly be the first agenda item.

Past performance is no guarantee of future results.

Disclaimers:

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