

## ECONOMIC NEWS

# Mortgage-backed securities are likely to be hurt when the Federal Reserve stops its reinvestments

The Federal Reserve's (Fed) March 15 meeting is highly anticipated since it is difficult to know whether a new increase in U.S. key rates will be ordered. While the speed of the increase in key rates will remain a key issue for the bond market, the question of the Fed's balance sheet is likely to get more and more attention over the coming months. Note that the Fed made massive purchases of Treasuries and mortgage-backed securities (MBS) following the financial crisis, which exploded the value of its assets from less than US\$1,000B in 2007 to about US\$4,500B at year-end 2014. This level has since stabilized, because the Fed reinvests all maturing securities and principal payments on mortgage-backed securities. This reinvestment is especially large for mortgage-backed securities, the Fed had to purchase around US\$30B of this type of securities a month during the past year to keep its balance sheet unchanged.

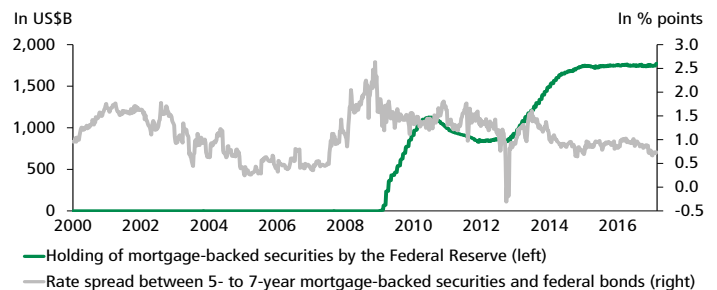
Such a massive holding of financial securities by a central bank is difficult to justify under normal circumstances. Janet Yellen recently repeated that the Fed wished to reduce its balance sheet over the next few years and would go back to holding mainly federal bonds. While the Fed appears very reluctant to sell securities directly, the reduction of its balance sheet is likely to be achieved mainly by stopping to reinvest maturing securities. If stopping reinvestments is unlikely in 2017, as Fed leaders want to first get key rates well away from zero, discussions on the strategy to be used have already begun and will probably intensify over the coming months. A decision on the date for stopping or reducing reinvestments could even come fairly soon, to give investors sufficient time to prepare.

### IMPLICATIONS

Through its massive bond holdings, the Fed has become a key player on the Treasury and, especially, the MBS markets. Even though it will be very gradual, the elimination of over US\$1,750B in mortgage-backed securities from the Fed's balance sheet is likely to have an impact. This amount represent about 20% of

### GRAPH

**Rate spreads between mortgage-backed securities and federal bonds are currently low**



Sources: Federal Reserve, Merrill Lynch and Desjardins, Economic Studies

all U.S. MBS outstanding. An increase in rate spreads between mortgage-backed securities and federal bonds, currently low, could be required to ensure that private demand take over from the Fed. Any decision to stop reinvestments is therefore likely to lead to upside pressure on these rate spreads and on mortgage rates.

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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