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Markets Cheer Fed's Reinvestment Plans

Although markets entered the week on the lookout for more political headlines, it was the Fed that ended up taking center stage. The Minutes from the early May Fed meeting contained important details on the Fed's plan to slowly **decrease** the amount of bonds on its balance sheet. This ended up being good news for both stocks and bonds. Here's why...

The Fed began buying mortgage-backed-securities (MBS) at the onset of the financial crisis in order to restore investor confidence in the shaken sector. Until then, mortgage rates were **like a train car that had detached** from the rest of the bond market and the Fed's efforts are largely responsible for preventing the mortgage market from going totally off the rails.

As the depth of the crisis became more evident, the Fed began expanding its buying program to include US Treasuries. With the Mortgage market reattached to the broader bond market train, any benefit to Treasuries ("the locomotive," basically) also **helped pull mortgage rates lower**. It was a synergistic system that played a key role in getting mortgage rates to all-time lows by the end of 2012.

These bond buying programs were referred to as quantitative easing, or QE. While QE programs were active, the Fed was **growing** the size of its balance sheet by adding the bonds it was buying as **assets** and incurring **liabilities** it owed to depository institutions (essentially the "debt" used to pay for the new bonds).

The "**taper tantrum**" in 2013 resulted from the Fed hinting that its balance sheet expansion would soon come to an end. The Fed began adding fewer and fewer assets/liabilities until its balance sheet stopped expanding.

Despite this new equilibrium, the Fed **continued to buy** substantial amounts of bonds through its **reinvestment** policy. In simple terms, the Fed bought a lot of loans. It was a lender who collected principal and interest payments, much like a mortgage lender would. Any principal repaid was subsequently REINVESTED back into the market of origin.

To break this down even further, let's imagine the Fed buys YOUR $300,000 mortgage. The Fed's liabilities increase $300,000 as do its assets. Let's say your payment is $2000/month with an average of $1500 interest and $500 principal. When you make your payment, the Fed COULD use your $500 of principal to reduce its liabilities and assets. Instead, under the reinvestment policy, it took that $500 and **bought more mortgages** with it. That's another $500 in liabilities and assets for the Fed. The balance sheet

National Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.07%	+0.02	0.00
15 Yr. Fixed	6.45%	0.00	0.00
30 Yr. FHA	6.51%	+0.02	0.00
30 Yr. Jumbo	7.26%	0.00	0.00
5/1 ARM	7.02%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.86%	-0.01	0.00
15 Yr. Fixed	6.16%	+0.03	0.00

Rates as of: 6/28

Market Data

	Price / Yield	Change
MBS UMBS 6.0	100.06	-0.11
MBS GNMA 6.0	100.23	-0.10
10 YR Treasury	4.4400	+0.0420
30 YR Treasury	4.5966	+0.0326

Pricing as of: 7/1 8:55AM EST

Recent Housing Data

		Value	Change
Mortgage Apps	Jun 12	208.5	+15.58%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%
Builder Confidence	Mar	51	+6.25%

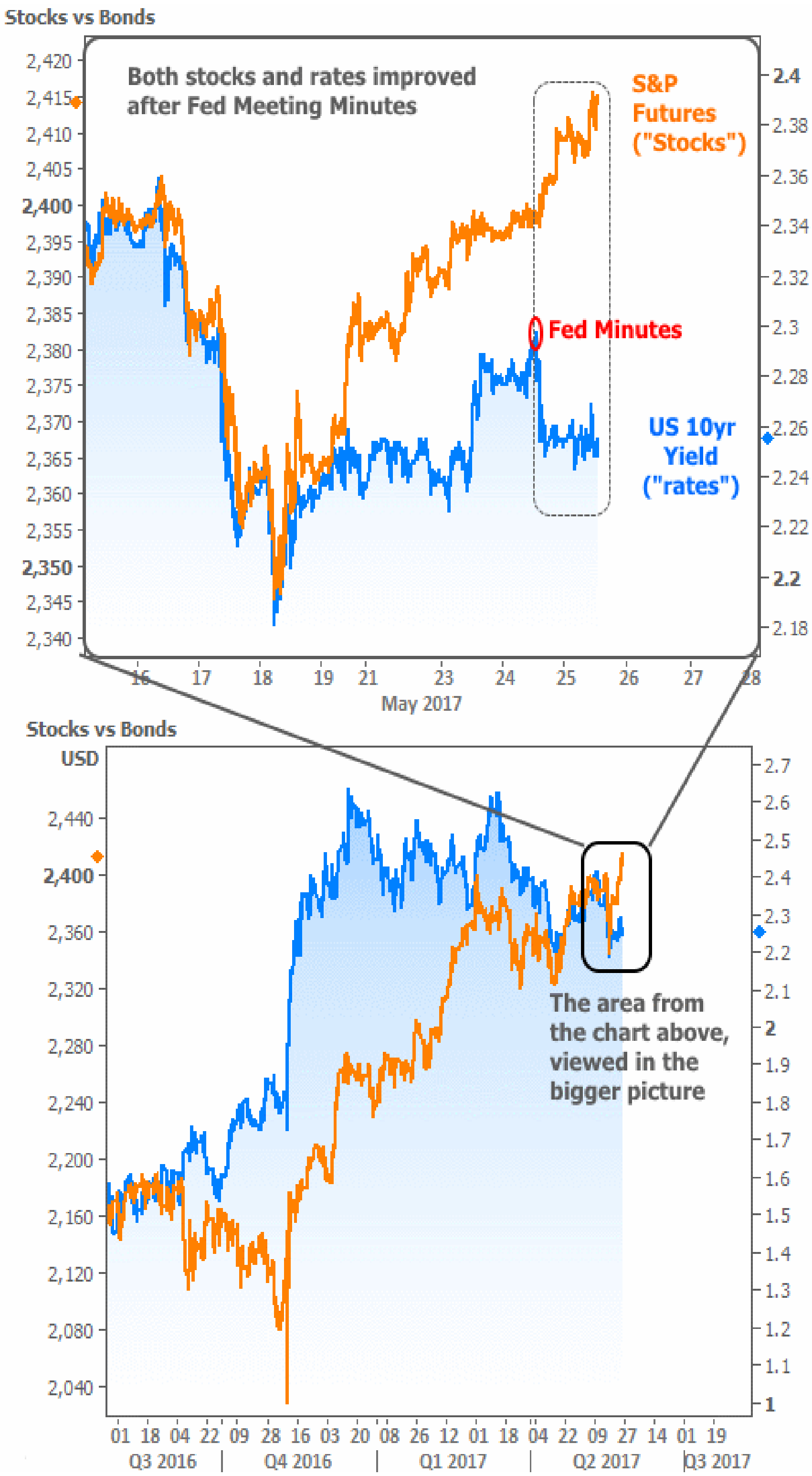
remained unchanged.

This policy means the Fed can be a **big** buyer of Treasuries and MBS. That **excess demand** in the marketplace pushes bond prices higher and rates lower--something the Fed judged necessary to the facilitate its goals of rekindling employment and inflation.

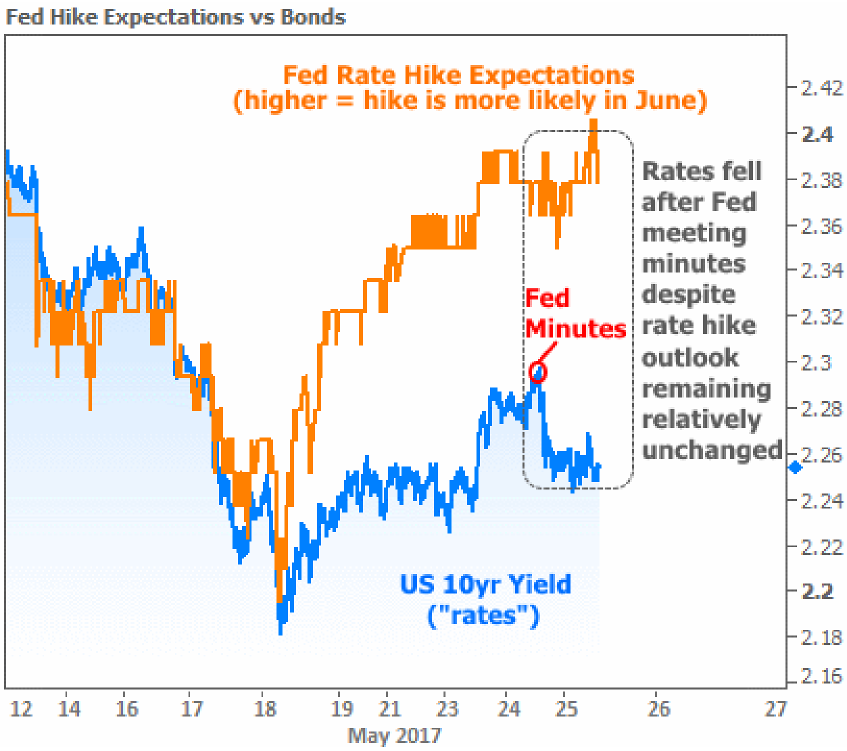
While some experts may disagree, the Fed feels it's close enough to achieving its goals that it can begin removing some of that excess demand. It will remove this demand by **slowly** decreasing its reinvestments. That's what this week's Fed meeting Minutes were all about.

The Fed already broached this topic in the last meeting back in mid-March, but this time they went into greater detail. Market participants anticipated this, but the details ended up being a **bit more market-friendly** than expected. For example, the Fed will only adjust its reinvestment caps every 3 months, as needed, until it feels the balance sheet is where it should be. In contrast, the tapering plan in 2013 laid out a set reduction of new bond buying at every Fed meeting until **new** bond buying was completely eliminated.

The **bottom line** is that investors can hold out a bit of hope that economic conditions will evolve in such a way that the Fed won't be overly-aggressive in reducing its balance sheet. This leaves more excess demand in the marketplace. That benefits both stocks and bonds (aka "rates"), and both responded to this week's Fed Minutes accordingly.



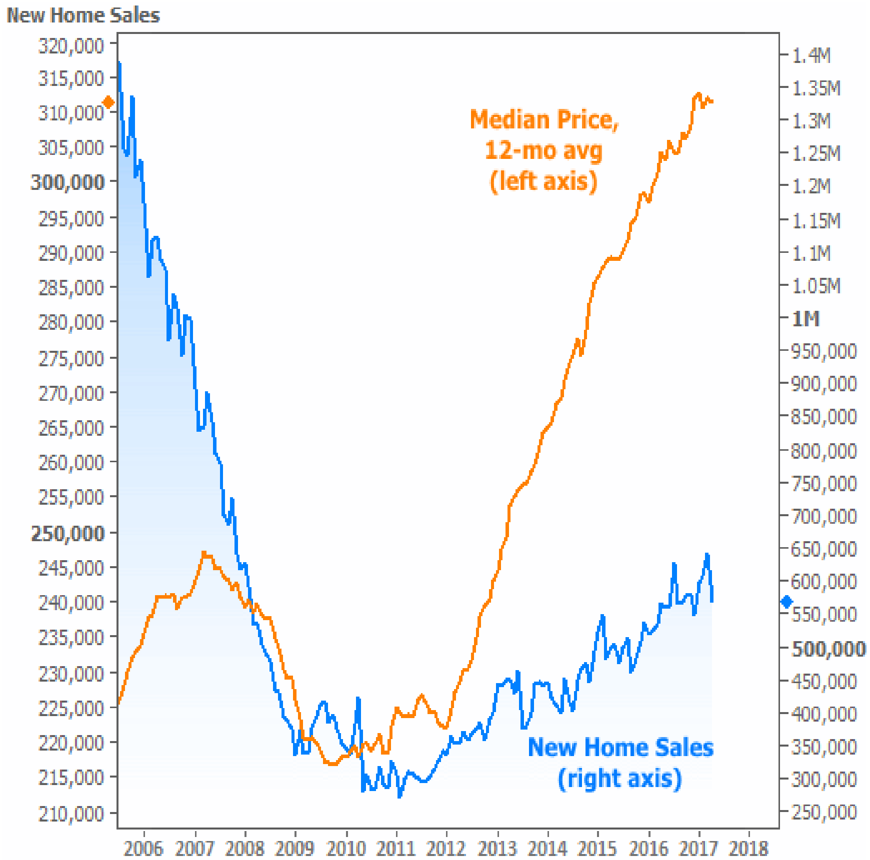
To be sure, this "reinvestment" topic is the more esoteric part of the Fed Minutes, but it's clearly the **bigger deal** for financial markets. Mainstream media tends to focus on rate hike expectations, implying that the Fed Minutes reduced rate hike potential. Trading levels in Fed Funds Futures (which measure rate hike expectations) tell a different story.



Bottom line: the Fed finally broke the news on its reinvestment strategy and both sides of the market took it in stride.

In housing-specific news, this week's key data release was the Existing Home Sales report from the National Association of Realtors (NAR). Although Existing Sales fell short of the median forecast calling for an annual pace of 5.65 mln units, the 5.57 mln unit result **wasn't far off**. The overall trajectory of sales growth remains positive despite some cooling in the pace of price gains.

Sales data released by the Census Bureau also missed the mark, but by a much wider margin. The annual pace of New Home Sales fell to 569k from an upwardly revised 642k last month. The median forecast had been 610k.



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Real Talk

At The Rate Shop, we're not your average mortgage banker. We specialize in bringing you ridiculously low interest rates that will make you wonder what the other guys are doing. In fact the ONLY objection we ever hear is “your rates sound too good to be true”. Well they’re not, and here is why…

After 15 years in the retail banking world I was frustrated with the high interest rates that came from that business model. As I looked around at all the bloated layers of management and their expensive salaries and the overhead of running a larger company (think rent costs, employee health and benefit costs, payroll taxes, and on and on) it dawned on me that I was a part of the problem, and the solution, for me at least, was so easy to see.

Start my own mortgage brokerage shop. No expensive executive salaries, no expensive building to pay rent at, no unnecessary employees and all the costs that are associated with that. What happens when you cut out all the fat? You can provide lower rates and lower closing costs. It’s simple. Now here is the best part, you still get great service from a local Kansas City Lender. My mission is to let everyone know that low rates and great customer service are NOT mutually exclusive.

Thanks for coming along on this journey where Low Rates meet Great Service. The two do NOT have to be mutually exclusive. It’s just a lie that the big box mortgage companies have been telling you for years. Don’t believe me? Give me a call or shoot me a text on my personal cell phone today and compare my rates and costs up against any other lender in the country, and be prepared to be blown away.

Mike Baker