Mortgage Market Update

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Rich E. Blanchard
Managing Director, RICH Home Loans LLC
NMLS: 492461
1550 Wewatta St., 2nd Floor Denver, CO 80202

Office: 720.619.9900
Mobile: 303.328.7047
Fax: 214.975.2874
richblanchard@richhomeloans.com
View My Website

UPDATE: More Detail on Reinvestment Policy

Here's the official verbiage from the Fed:

> System Open Market Account Reinvestment Policy Participants continued their discussion of issues related to potential changes to the Committee's policy of reinvesting principal payments from securities held in the SOMA. The staff provided a briefing that summarized a possible operational approach to reducing the System's securities holdings in a gradual and predictable manner. Under the proposed approach, the Committee would announce a set of gradually increasing caps, or limits, on the dollar amounts of Treasury and agency securities that would be allowed to run off each month, and only the amounts of securities repayments that exceeded the caps would be reinvested each month. As the caps increased, reinvestments would decline, and the monthly reductions in the Federal Reserve's securities holdings would become larger. The caps would initially be set at low levels and then be raised every three months, over a set period of time, to their fully phased-in levels. The final values of the caps would then be maintained until the size of the balance sheet was normalized.

Translation:

They're going to specify an amount by which reinvestments will decrease. That amount **stays the same** no matter the balance of principal payments coming in (until it's changed 3 months later, but the point is it stays the same for 3 months at a time). In other words, if they set the cap at $5bln per month and then receive $70bln, $75bln, and $72 bln per month, those three months would then be reduced to $65bln, $70bln, and $67bln of total reinvestments respectively.

By doing this, the Fed **avoids putting a limit** on how much in can reinvest (because amounts vary month to month). It's a more predictable option for market participants who can bank on an exact amount of reduction in demand in the marketplace.

Moreover, by referencing the "final values" of the caps, the Fed is implying that **reinvestments will continue** to some extent. We don't know to what extent at the moment, but something is better than nothing. MBS had to wrestle with the notion that the "something" would be more favorable for Treasuries (as several Fed speakers have mentioned in the past). This could account for MBS illiquidity following the Minutes release (and the volatile

MBS & Treasury Market Data

	Price / Yield	Change
MBS UMBS 6.0	100.61	+0.22
MBS GNMA 6.0	100.74	+0.21
10 YR Treasury	4.2818	-0.0784
30 YR Treasury	4.4857	-0.0440

Pricing as of: 7/5 5:59PM EST

Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.03%	-0.05	0.00
15 Yr. Fixed	6.44%	-0.01	0.00
30 Yr. FHA	6.50%	-0.05	0.00
30 Yr. Jumbo	7.24%	-0.01	0.00
5/1 ARM	7.05%	-0.02	0.00
Freddie Mac			
30 Yr. Fixed	6.95%	+0.09	0.00
15 Yr. Fixed	6.25%	+0.09	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	7.03%	+0.09	0.62
15 Yr. Fixed	6.56%	+0.09	0.54
30 Yr. FHA	6.90%	+0.11	0.95
30 Yr. Jumbo	7.11%	-0.01	0.50
5/1 ARM	6.38%	+0.11	0.54

Rates as of: 7/5

price action that resulted from it).

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Rich E. Blanchard