How and Why the Fed Should Tweak QT

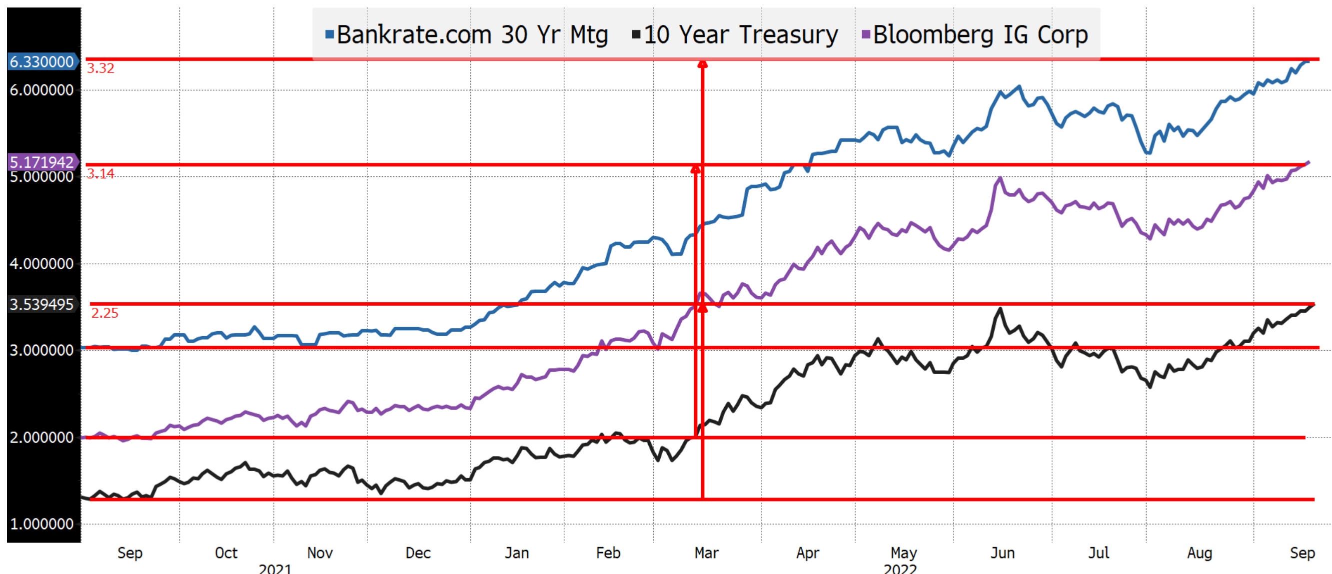
We touched on **reshaping quantitative tightening** in this weekend's Trader of the Year report (though it may have gotten lost in the shuffle of the awards themselves).

Yesterday we briefly touched on how the market could trade on QT vs Stagflation.

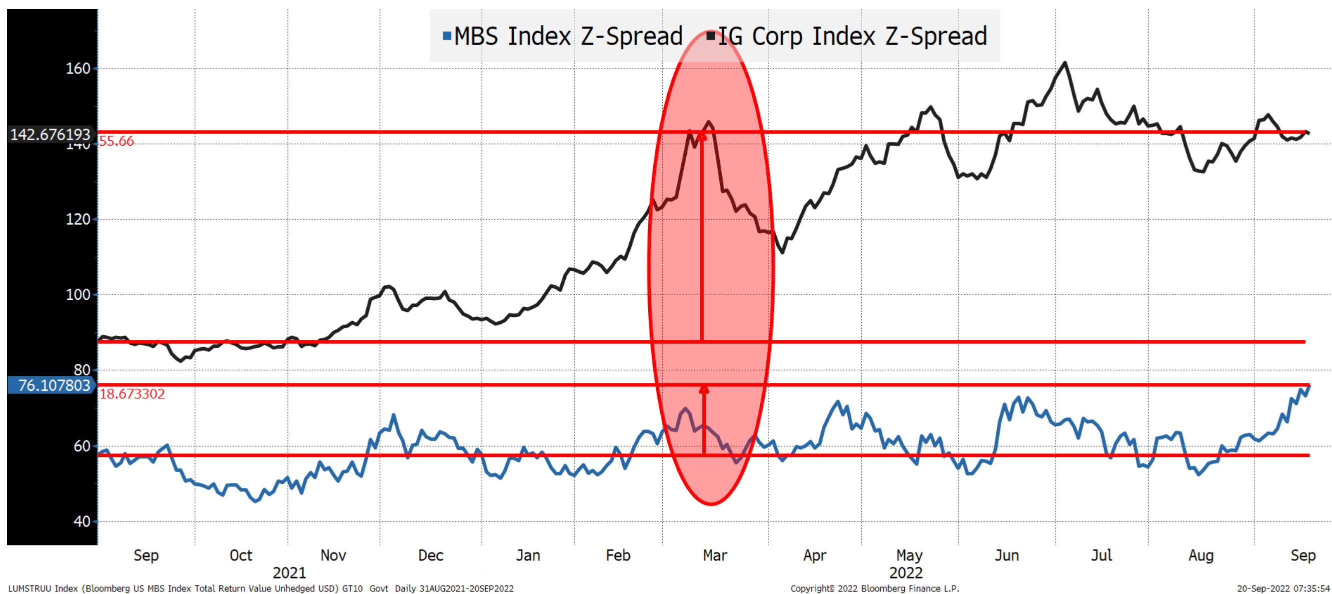
Today we will address why the Fed should tweak quantitative tightening and how easy it is to do that.

The Why – Mortgage Market Meltdown

Let's start with the "why." Why is the mortgage market faring worse than other bond markets?



The 30-year Bankrate.com mortgage rate has more than doubled since last summer (spiking by 3.32%), which is far more than the corporate bond index yield (which moved 3.14% higher) and the 10-year Treasury yield (which is "only" 2.25% higher). This is a reasonable comparison because all three of these have a similar duration.



Spreads have widened significantly more on mortgage bonds than corporate bonds.

The Why – Anticipated QT

There are many reasons why the mortgage markets may have underperformed, but I will blame QT for a big portion of that.

The spreads gapped in March. They have continued to widen, but there is a large and obvious gap that started in February and peaked in March – **the exact timeframe that QT was put on the table.**

There was little evidence that the economy might soften back in the spring. Housing prices were still rising and it was generally a seller's market. The Fed's commitment to hiking rates aggressively was questioned and few thought that the terminal rate would be 4% or higher. Yet mortgage spreads spiked.

The difference between mortgages and corporate bonds in the spring was that the Fed might have to sell one and not the other.

On May 4th, we got the Fed's Plan for Balance Sheet Reduction.

It discusses primarily using run-off to reduce the size of their balance sheet.

- Agency and Mortgage Debt would reduce by a "maximum" of $17.5 billion a month and that has now ratcheted up to $35 billion a month.
- **It seems impossible that on any given month the Fed will see anywhere near $35 billion of reduction in their mortgage portfolio** as maturities are long and prepayment speeds have dropped like a rock (who is prepaying 3% mortgages in a 6% mortgage environment?).
- **That has led to speculation, or concern, from the start that the Fed would have to sell mortgages** (that concern started in the spring – which we highlighted at the time). During QE, the Fed was a price insensitive (indiscriminate) buyer, so "logic" would dictate that they will just hit bids on the way out as they have behaved like price takers rather than price setters.
- **With liquidity abysmal, a potentially large, persistent, and price insensitive seller** is why the mortgage market is in disarray. No one wants to stand in front of that freight train at the best of times, let alone as further rate hikes are being priced in.
- **Fed losses would mount.** Mortgage funds seem to be down around 10% or more in the past year (and year to date). The Fed's portfolio would likely take 10% or so hits on every bond they sell. They rely on accrual accounting so their loss would be based on where it was held under that system, and not all bonds were bought at the peak, but 10% losses seem like a reasonable number. If they had to sell $35 billion a month, that would add up quickly (~$3 billion in monthly losses). Assuming they raise rates 75 bps at this meeting, the cost of funding their position would be a little over 3%, which may be enough that even on an accrual accounting basis their portfolio flips to a loss for the Treasury Department and Congress. We've discussed the Fed Profit Machine multiple times.

So Many Reasons Why To Tweak QT

My argument is that:

- QT is the main reason mortgages have underperformed by so much.
- Higher mortgage rates impact the economy, hurt housing, reduce mobility, and have so many

other negative consequences, which is why we need to be very careful here.

- Finally, and less important, is that selling will weaken the Fed's profits and that could have some consequences in DC, in the mainstream media, and for the average person on the street who doesn't understand how things work on a detailed level.

To me, it seems obvious that setting up conditions that force the Fed to sell mortgages is a really bad idea for everyone involved.

The How is So Easy!

Many problems, at the moment, are intractable. How to keep fighting inflation while not cratering the economy is just one such example.

But this one seems easy – **reduce the balance sheet by $95 billion only using maturing bonds and prepayments.**

Use mortgage payments first and cover everything else with Treasuries.

There will be very few months (if any) that mortgages cover the $35 billion, but for many months, there are more than enough Treasuries (and I believe T-Bills) to get you to the full amount.

I think that any QT acts as a headwind, but the headwind is far less from a maturing bond (zero duration) than from a bond with duration where you need to find an active buyer of the bond.

This solution would:

- Allow the Fed to pursue their headline goal of $95 billion, so they could argue that the mix of Treasuries and Mortgages is more of a technicality – so it won't be viewed as dovish or inflationary (which could happen if they reduce their target amounts).
- Likely create a strong rally in mortgages as the fear of an ongoing price insensitive seller goes away!

Bottom Line

We are unlikely to see a major shift announced tomorrow, but we might get a sense that the Fed is seeing the same things that we are:

- Selling mortgages is problematic and hurts everyone.
- Not reducing the balance sheet at the current pace will be vilified by many as inflationary.
- They have an easy solution at their fingertips that the policy wonks might disagree with, but is easily sellable to politicians, the mainstream media, and the man on the street.

Probably more of a "fingers crossed" moment for this meeting, but the logic makes a lot of sense. If they do anything like this, we should see mortgages and anything housing related rally significantly, depending on the rest of the messaging.

I do think that Powell's "Inner Dove" will come out during the press conference as that and many other subjects came up during yesterday's Bloomberg TV appearance (starting at the 57:50 mark).

Good luck with the Fed and I really wish that they would do it at 10am ET tomorrow or something less cruel than having to sit around all day second guessing ourselves.

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