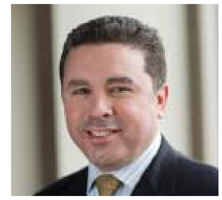
William Blair

February 2017
Market Update
Fixed Income

# Q&A:
# What Happens When FedTrade Ends?



Paul Sularz
Portfolio Manager

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While most Fed watchers are focused on what the policymakers will do with the federal funds rate, a more interesting topic may be the so-called FedTrade, which is keeping certain agency mortgage-backed securities' risk spreads at artificially low levels. But what happens when the Fed decides to stop? In this timely commentary, Paul Sularz, a portfolio manager for our Fixed Income team, and Tom Brennan, the Fixed Income team's portfolio specialist, share their thoughts.

## What do you think the Fed will do with the federal funds rate in 2017?

In some ways, 2017 feels a bit like 2015 and 2016 did at the same point in time during those years. In both of those years, Fed officials and futures markets were predicting three to four rate hikes, yet only one hike occurred, both times in December. The federal funds futures markets imply that two rate hikes will occur during 2017, the first in June. This is consistent with what the Fed is telegraphing with its so-called dot plot, which policymakers use to signal their outlook for the path of interest rates. It is unclear how many rate hikes ultimately occur, and we are not in the business of predicting exact interest rate changes, but we have structured our portfolios to be defensive from the impact of rising rates by focusing on sectors that provide higher income opportunities, such as high-coupon agency mortgage-backed securities, corporate bonds, and asset-backed securities. Within our Low Duration strategy, we are employing floating-rate corporate and asset-backed securities that carry ratings of Aor better—at or above A3/A-.

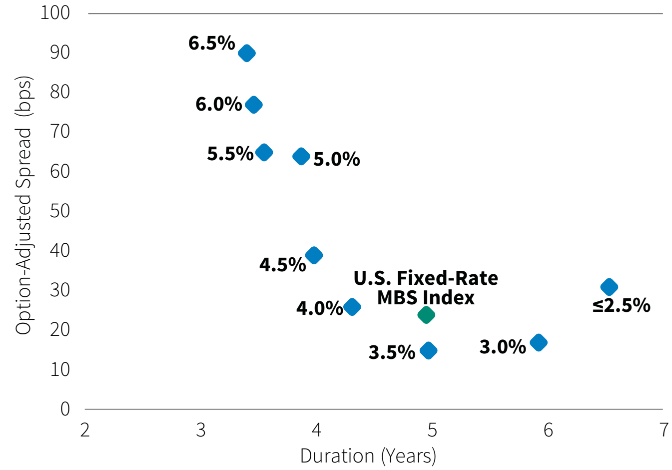
## Do you think there is a more interesting topic about the Fed that is not being widely discussed?

Yes. As I mentioned, the Fed has increased the federal funds rate twice since 2015. And much attention has been placed on what the Fed will do with the federal funds rate. At the same time, the Fed continues to purchase agency mortgage-backed securities on a daily basis, which helps keep mortgage rates low, thereby promoting homeownership and home-price appreciation.

With this so-called FedTrade, the Fed has purchased pools of mortgages that have current coupons (3.0%, 3.5%, and 4.0%). These large-scale asset purchases have affected the valuations of 30-year agency mortgage-backed securities, as figure 1 illustrates. These purchases have supported the prices of mortgage-backed securities with the goal of keeping mortgage rates lower than they might have been otherwise. As you can see, there is very little compensation, as measured by option-adjusted spread (OAS), or risk spread over U.S. Treasuries, in the mortgage pools that the Fed has purchased. This is how the Fed has manipulated mortgage rates to remain at lower levels.

The big question is what will happen when the Fed decides to stop purchasing agency mortgage-backed securities, allowing mortgage rates to be determined by private investors. There is a rich debate occurring about whether the Fed will need to sell securities from its balance sheet, and any decision to sell securities—or even a market expectation that the Fed will sell securities—could result in more broad-based volatility. Regardless, we expect that when the Fed decides to end FedTrade, current-coupon mortgage spreads will increase by 10 to 25 basis points versus U.S. Treasuries.

**Figure 1:**
30-Year MBS Valuations




Source: William Blair, Bloomberg, Barclays, BlackRock Solutions, as of Feb. 8, 2017.

## What are the implications for fixed income investors?

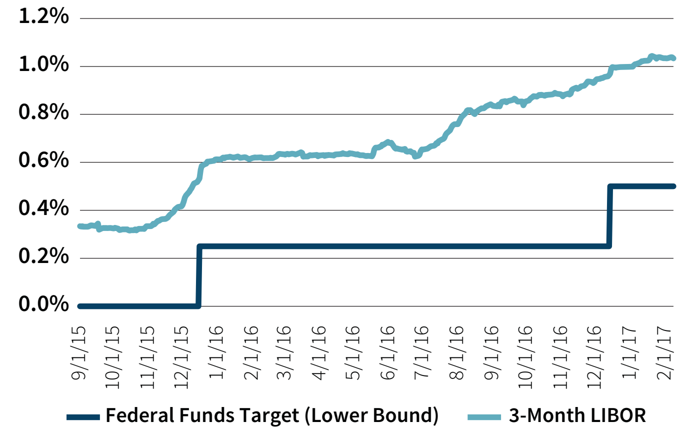
We are finally off the zero-interest-rate path, so there are returns to be earned by fixed-income investors. Three-month LIBOR increased to more than 1.00% in January 2017, as figure 2 shows. This means investors are being compensated by short-term investments.

We believe predictions of two to three rate hikes from 2017 through early 2018 are reasonable. In this environment, high-quality, floating-rate bonds—which have coupon rates that adjust every one to three months to either one- or three-month LIBOR—may be of interest in strategies in which such instruments are appropriate. At current yields, these securities are attractive on a stand-alone basis, and they could benefit from future short-term rate interest rates by providing higher coupons and maintaining stable prices.

Although we do not try to time long-term interest rates (in strategies in which such instruments are appropriate), we believe there are some attractive opportunities in corporate bonds with longer maturities. However, for reasons noted above, we are actively avoiding the current-coupon mortgage-backed securities

> **"We are actively avoiding the current-coupon mortgage-backed securities the Fed is purchasing under FedTrade, given that they have longer durations and unattractive valuations."**
>
> — Paul Sularz

**Figure 2:**
Short-Term Interest Rates (9/1/15 - 2/8/17)




Source: William Blair, Bloomberg, ICE Benchmark Administration, as of Feb. 8, 2017.

the Fed is purchasing under FedTrade, given that they have longer durations, unattractive valuations, and are prone to extension risk. Although primary dealers who were recently surveyed expect the program to end in early 2018—and we believe that is a reasonable estimate—we employ none of these current-coupon mortgage pools, as higher-coupon pools offer more attractive risk spreads and higher income. In fact, we have the ability to hedge interest-rate risk through mortgage TBAs, or "to be announceds," which track those current-coupon pools by selling them forward.

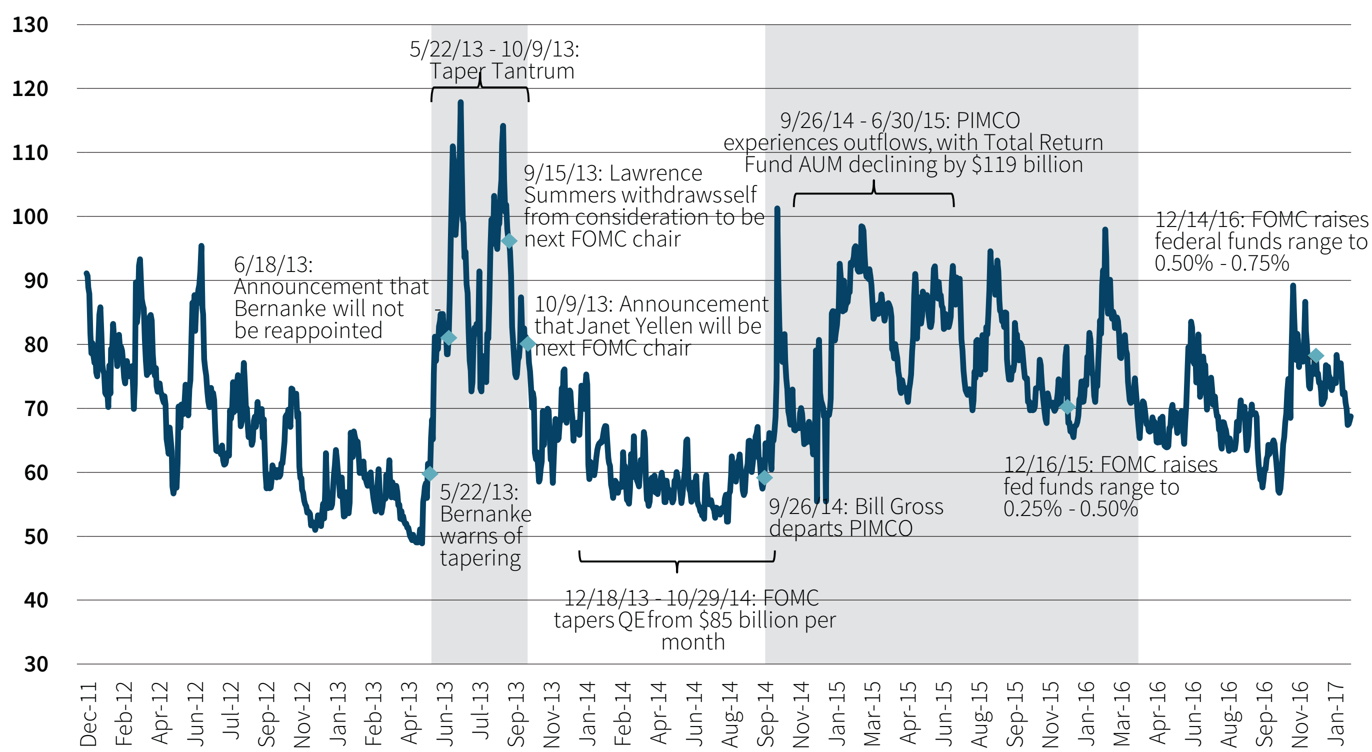
**What are some market metrics that you are following to gauge some of the risks you mentioned?**

One metric that has guided our decision-making over the past few years is the Bank of America/Merrill Lynch MOVE Index, which measures implied volatility of U.S. Treasury rates across the yield curve. Conceptually, it is similar to the CBOE Volatility Index (VIX), a popular measure of the implied volatility of U.S. stocks.

The Bank of America/Merrill Lynch MOVE Index has increased due to the fear of large-scale selling during the past few years, as figure 3 illustrates. One bout of volatility occurred in 2013 with the "Taper Tantrum," when market participants feared that a new Fed leader would sell securities from the Fed's balance sheet, ending quantitative easing. Another episode occurred during the end of 2014 and beginning of 2015, when there were large-scale redemptions (and therefore large-scale selling) from the world's largest actively managed bond mutual fund. These periods are shaded in figure 3.

However, this index did not react as violently to events at the end of quantitative easing or the Fed's two rate hikes because those activities were well-telegraphed and did not involve large-scale selling of securities. Thus, we think the Bank of America/ Merrill Lynch MOVE Index will continue to be instructive to follow, as it may indicate when market participants fear an unexpected change in the Fed's policies regarding FedTrade. ■

**Figure 3:**
Bank of America/Merrill Lynch MOVE Index (12/30/11 - 2/8/17)




Source: William Blair, Bank of America/Merrill Lynch, as of Feb. 8, 2017

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