Fed Studies Mortgage-Backed Market

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The Federal Reserve Bank of New York is studying the effect of the mortgage-backed securities market on Treasury bond prices. The study, initiated in April, was prompted by the "larger than expected" rise in Treasury note and bond interest rates, according to Patricia Mosser, one of the two Fed economists working on the project.

"One of the things we are very interested in is how interest rates interact with the economy," says Ms. Mosser. "If that is different than it used to be, we need to know." She says the Fed is trying to confirm anecdotes from traders of heavy Treasury trading by Wall Street dealers to offset mortgage positions.

The Fed's interest was piqued in mid-April by a 1.4 percentage-point increase in the yield on the government's 10-year note. That relatively large increase was unexpected, given the 0.75 percentage-point increase in short-term rates after the Federal Reserve's Feb. 4 decision to tighten monetary policy.

Economists usually expect longer-term interest rates to fall, rather than rise, when the Fed increases short-term rates. That's because higher short-term rates are supposed to damp inflation – a plus for the bond market that spurs bond-buying and thus lowers long-term interest rates.

To mortgage traders, it's no mystery why that didn't happen. "Mortgages are the tail wagging the dog," says William Gross, the fixed-income chief at Pacific Investment Management Co. in Newport Beach, Calif.

The dog-wagging is caused by the curious character of mortgage-backed securities: They become more interest-rate sensitive as rates rise, and less so as rates fall. That's because more homeowners than expected refinance when rates fall; they stop refinancing when rates rise.

As a result, investors who want to maintain a predetermined interest-rate sensitivity, or duration, must buy more Treasurys when interest rates are falling, and sell more when rates rise. These investors include insurance companies that have interest-sensitive liabilities, money managers who try to keep pace with a popular fixed-income index, and Wall Street firms.

That effect has become more pronounced, say bond-market experts, as the volume of mortgage securities has soared – to $1.6 trillion currently, up 50% in three years. Ray Dalio of Bridgewater Associates, a global bond and currency manager in Wilton, Conn., believes last summer's rally was caused in part by a "structural squeeze" of Treasurys that were being purchased by mortgage-bond holders.

All that buying has now turned into selling. Rising rates are causing mortgages to "extend" in maturity, because prepayments were grinding to a halt.

"The extension of duration has been a continous phenomenon," says William Powers, who manages the $24 billion of mortgage-backed securities at Pacific Investment Management. "That's what accounts for the relentless selling that gives the market this horrible tone."

Indeed, traders say some Wall Street firms have been obliged to sell as much as $1 billion of 10-year Treasury notes in a single day – a trading tactic known as "the lazy man's hedge" – to offset the extension of mortgage securities held in inventory. Since the 10-year note market is so much thinner than the two-year Treasury note market, this means that, as mortgage traders increasingly turn to longer-dated Treasurys, they have an increasingly large effect on Treasury prices.

In fact, initial results of the Fed study support the close connection between the two markets. Trading activity, say the Fed economists, has moved out along the curve away from the two-year debt and toward the 10-year note. Further, their analysis of price movement indicates that there was a relatively high correlation in day-to-day price moves between the 10-year Treasury and mortgages with an 8% coupon from the beginning of the year through April.