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Fed Is Slowly Making Its Way Toward the Exit

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Highlights

- Fed officials seem to be preparing the markets for the time when the central bank is no longer the primary player in the mortgage space.
- The Fed undoubtedly wants to avoid a disruptive rise in mortgage rates when that day comes.
- The mortgage program has been one of the most successful aspects of the Fed's credit easing.

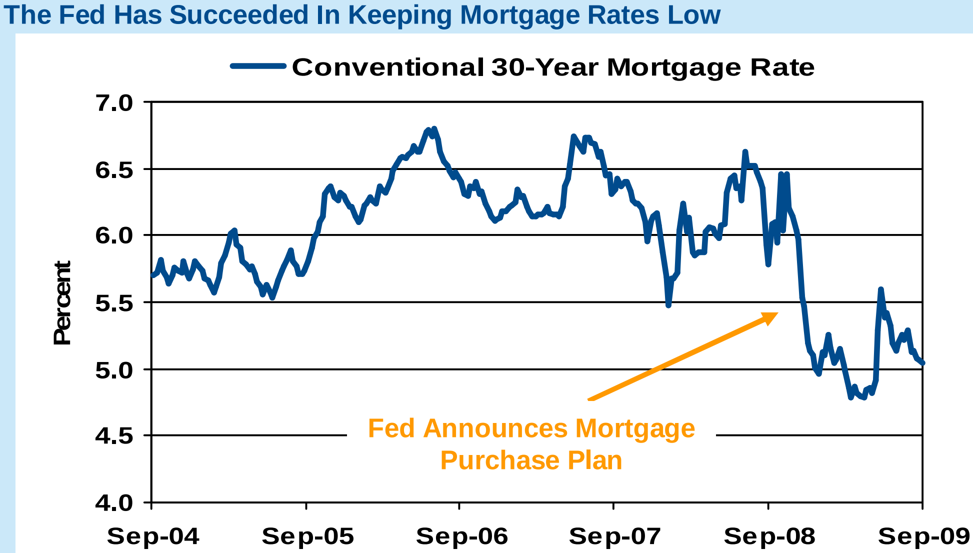
At the conclusion of its September policy meeting, the Federal Reserve acknowledged that "economic activity has picked up." Although the central bank reiterated its position that an exceptionally low level of interest rates would likely be warranted for an "extended period", the Fed also sent clear signals that it is preparing to exit from parts of its credit easing. We believe these signals are the first in a series of steps that will eventually lead to the Fed hiking short-term interest rates in the latter half of 2010.

Following its August meeting, the Fed informed us that it would end its purchases of Treasuries in October. Today, the Fed said it will "gradually slow" its purchases of agency mortgage-backed securities. While the central bank did extend the duration of the mortgage purchase program until March 2010, Fed officials seem to be preparing the markets for the time when the central bank is no longer the primary player in the mortgage space. The Fed undoubtedly wants to avoid a disruptive rise in mortgage rates when that day comes. At that stage, the Fed will own $1.25 trillion in mortgages or roughly 20% of the agency mortgage market.

The Fed originally announced its intention to buy mortgages from Fannie Mae, Freddie Mac and Ginnie Mae in December 2008 as a means of supporting the housing market and improving overall conditions in financial markets. The central bank initially allocated $500 billion toward this purpose, but quickly increased this amount to about $1.25 trillion after its March 2009 policy meeting. The mortgage program has been one of the most successful aspects of the Fed's credit easing. Mortgage rates have fallen sharply since Fed officials first mentioned the idea of buying mortgages as a means of driving down private sector borrowing costs in November 2008, when the interest rate on a 30-year fixed rate conforming loan stood above 6%. By the time the mortgage purchase plan was up and running in February, the rate had dropped to 4.75%. Today, it stands just over 5%.

The marked improvement in a number of housing-related indicators has likely given the Fed some confidence that it can begin backing away from its mortgage purchase plan without derailing a nascent recovery in the housing market as well as the broader economy. If the data begin to disappoint in the coming months, the central bank could always reverse course. However, if the economy continues to progress as it has in recent months, the next question will be what the Fed should do with its massive portfolio of mortgages.

The Fed Has Succeeded In Keeping Mortgage Rates Low



Source: The Federal Reserve