BY BILL BERLINER

The MBS Market after QE3 and Sandy

The MBS markets underwent a major revaluation in mid-September with the announcement of a huge new program of MBS purchases (QE3) by the **Federal Reserve**. The after effects of Hurricane Sandy, while less obvious, will also influence levels in the mortgage and MBS markets over the next few months and into 2013.

The third round of quantitative easing committed the Fed to indefinite monthly purchases of about $40 billion of agency MBS. The massive size and open-ended nature of the program stunned traders and pushed MBS prices sharply higher. After initial resistance, primary mortgage rates sank to new all-time lows, initiating another round of refinancing activity; they also facilitated a pop in housing starts and new home sales by improving affordability.

In my December 2011 column entitled "Optimizing Fed MBS Purchases," I wrote that the Fed could best lower consumer mortgage rates by buying large amounts of 3% passthroughs. The objective was to support a coupon that, while illiquid and lacking defined investor clienteles, was critical in allowing zero-point mortgage rates to push below the 3.75% level. (Because of standard pooling practices, 3.75% is the lowest rate that can be securitized into a 3.5% MBS.) The Fed's purchases have accomplished this goal; by purchasing or committing to purchase more than 75% of the estimated $110 billion float in 30-year 3% securities currently available, it helped make 3s the primary hedging and delivery coupon for lenders.

A comparable situation currently exists with 30-year 2.5% passthroughs. As with 30-year 3s, there is minimal demand from either buy-and-hold or intermediate-term investors for the security because its coupon is simply too low. Continued declines on mortgage rates require not just an upward move in MBS prices but a downshift in the "current" security coupon. Because of the pooling rules noted above, 3.25% is the lowest rate that can be pooled into a 3% coupon. For 30-year rates to fall further, lenders will need to be able to securitize loans into 2.5% MBS, and the only natural buyer for them is the Fed. Therefore, Fed purchases should be directed toward developing a market for 30-year 2.5s while maintaining liquidity in 30-year 3s.

Hurricane Sandy will also exert a subtle but profound influence on the MBS market. However, the storm is unlikely to have a noticeable effect on MBS prepayment speeds despite the widespread property damage. Since an insurance claim itself does not extinguish an existing lien, there is a slim likelihood that prepayments will experience a short-term pop or, conversely, investors that hold relatively senior private-label securities (trading at a discount) will receive unexpected windfalls.

The impact on mortgage lenders with a significant presence in the affected areas will, however, be much more significant. Closings on numerous rate locks in lenders' pipelines will be either delayed or cancelled entirely. Lenders are already requiring virtually all locks in regions with storm damage to undergo reappraisals of the associated properties. At best, many locks that would have been expected to close in early November (and delivered into December TBAs) will now be delayed by the reappraisal process into early 2013. Widespread delays in fundings due to reappraisals could put upward pressure on dollar rolls over year-end, as originators will need to push their hedges forward in time.

Moreover, locks on properties that experienced damage (determined through the reappraisal process) cannot close until repairs are completed, and are typically rejected after significant damage is identified. This means that many loans currently hedged in pipelines will ultimately fall out, requiring their hedges to be repurchased. This will likely put renewed upward pressure on MBS prices, possibly pushing them back to their recent peaks by early December.

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