THE STRATEGIC ADVANTAGE

Could a Warsh Fed Create a Headwind for Agency MBS?

Federal Reserve Chair Kevin Warsh has long been critical of the Federal Reserve's expansive balance sheet and, in particular, its large holdings of agency mortgage-backed securities (MBS).

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As investors consider the potential implications of future Federal Reserve leadership, it is worth examining how a more aggressive approach to balance-sheet normalization could affect the agency MBS market.

The concern is not credit quality. Agency MBS continue to benefit from government-sponsored enterprise support and remain one of the highest-quality sectors within fixed income. Instead, the focus is on market technicals and how changes in Federal Reserve policy could affect supply and demand.

The Fed's Evolving Role in the MBS Market

For much of the past fifteen years, the Federal Reserve has been an important participant in the agency MBS market. Through multiple rounds of quantitative easing, the Fed became a significant source of demand, helping support valuations and compressing spreads.

Today, however, the environment is different. The Federal Reserve is no longer purchasing agency MBS and is currently allowing its holdings to decline through balance-sheet runoff. As a result, Fed participation is already becoming less supportive of the sector and future efforts to accelerate balance-sheet reduction could create additional headwinds.

Some market participants have discussed a "QT-for-cuts" framework, under which the Federal Reserve lowers short-term interest rates while simultaneously accelerating quantitative tightening. In such a scenario, policymakers could potentially pair rate cuts with active MBS sales as part of a broader move toward a Treasury-only balance sheet.

Federal Reserve Agency MBS Holdings

Source Bloomberg

Potential Implications for Agency MBS

The distinction between passive runoff and active MBS sales is important. Under runoff, holdings decline gradually as mortgages prepay and securities mature. Active sales would require private investors to absorb additional supply more quickly.

Historically, when a large structural holder exits a market, investors often demand greater compensation for assuming risk. In the case of agency MBS, active sales could contribute to wider spreads as the market adjusts to reduced Federal Reserve participation and increased supply.

This risk may be particularly relevant given that agency MBS spreads remain near the tighter end of their historical range. While the magnitude of any adjustment is impossible to predict, spread widening could lead to periods of relative underperformance versus other high-quality fixed-income sectors. Importantly, lower policy rates alone do not necessarily guarantee stronger MBS performance if wider spreads offset some of the benefit from falling rates.

Agency MBS Option-Adjusted Spreads: Historical Perspective

Source Bloomberg

Conclusion: One Sector That May Deserve Additional Attention - Taxable Municipals

Against this backdrop, one sector that may deserve additional attention is taxable municipal bonds. At Cumberland Advisors, we currently find taxable municipals more attractive than agency MBS on a relative-value basis.

Like agency MBS, taxable municipals generally trade at a spread to U.S. Treasuries. Their valuations are driven by issuer fundamentals, supply-and-demand dynamics, and a broad investor base that includes insurance companies, pension funds, banks, foreign investors, and individual investors.

Taxable municipals continue to offer strong average credit quality, historically low default rates, and diversification benefits such as lower correlation to equities than corporate credit. In addition, taxable municipal spreads remain attractive relative to many high-quality fixed-income alternatives, particularly on a risk-adjusted basis.

In an environment where Federal Reserve policy may increasingly influence sector-level performance, we believe taxable municipals are currently better positioned to deliver attractive risk-adjusted returns than agency MBS. For investors seeking high-quality fixed-income exposure, taxable municipals offer a compelling combination of credit quality, diversification, and relative value while avoiding some of the technical uncertainties that could emerge as the Federal Reserve continues to reduce its role in the mortgage market.

If you would like to learn more about Cumberland's taxable bond SMA strategies and the independent thinking that has driven our taxable bond performance for decades, please contact us at ClientRelations@Cumber.com.

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