Who Moved My Bonds?

Short supply of popular bank investments requires some searching

By Jim Reber

Have you heard? Borrowers in these United States are engorged in debt. It’s a ticking time bomb as asset bubbles persist and debt loads are growing, so lenders beware. Or is it? The truth of the matter is there are some debt categories that have shown dramatic, if not shocking, growth in the last decade, but they are departures from the mean. Two of the outliers have gotten plenty of documentation. The first, and most chronic, is the debt owed by the U.S. Treasury. Our government’s direct indebtedness stands at more than $13 trillion and has nearly tripled in just the last decade. We will address why Uncle Sam continues to borrow at very low rates in just a minute.

The other burgeoning debt load is piling up on college students and their parents. As tuition continues to grow at a pace far exceeding general inflation, the cost of a college diploma is increasingly being financed. Student debt long ago passed auto loans as the biggest non-housing debt sector, and it stands at $1.3 trillion. It too has nearly tripled since 2006.

The impact of the growth in these sectors on community bank investment portfolios is only peripheral, so far. Banks don’t own many Treasury securities, because Treasuries don’t have yields that excite portfolio managers. Securitized student loan pools have limited supply, and even if their credit quality is enhanced, their liquidity can be tenuous. That leaves a set of debt securities whose quality and liquidity are fine, but whose supply is small or shrinking. Let’s see how these stories have unfolded.

Government agencies
First we must mention Treasury yields. Even as supply has grown, there has been enough demand to sop up all the new issues, and many investors have long-term needs. These include, of course, foreign governments that are trying to offset currency risk created by their trade surpluses with America. Also, by far the biggest holder of our sovereign debt is the Federal Reserve, which still owns nearly 20 percent of all Treasuries as part of its Quantitative Easing strategy. All of these factors have tamped down the yields.

Debt securities issued by Fannie Mae, Freddie Mac and the Federal Home Loan Banks are highly influenced by yields on Treasury securities. Depending on their structure, agencies will yield slightly to moderately more than Treasuries of similar maturity. This “spread” has been shrinking as these three have been issuing smaller amounts of debt over the last decade. Fannie and Freddie in particular have been scaling down their balance sheets. At December 2015, their aggregate borrowings were $1.7 trillion, compared with $3 trillion in 2008.

Mortgage-related securities
The mortgage-backed securities (MBS) volume issued by Fannie, Freddie and their cousin Ginnie Mae has also seen a decline. We are still, nationally, seeing housing prices that are only 88 percent of their highs in 2006, and there are fewer owner-occupied residences. This has caused the population of MBSs to be off its peak, which was in 2008.

Since then, the total outstanding principal balance of MBSs has dropped from $9.5 trillion to $8.7 trillion, which is about an 8 percent decline. This is so, even as the percentage of multifamily MBSs has grown. This means that the old benchmark, which is 30-year fixed rate securities collateralized by single-family residences, has shrunk even more.

As of June 2016, a 30-year MBS with a 3.5 percent coupon was valued at about 105.50, which is very near its all-time high. Other, shorter maturities and lower coupons were also near record levels, which means spreads are near all-time lows.
Bank-qualified munis
The subject of bank-qualified (BQ) munis was discussed in greater detail in last month’s column, but the supply factor deserves more color. Again, the counties, townships and school districts that borrow through the BQ market have been demonstrating austerity.

Recall that there was a two-year increase in the size of a BQ issue for 2009 and 2010, in which the limit was raised from $10 million to $30 million. Since that time, the total annual issuance of BQ munis has averaged about $22 billion. For the years of 2007 through 2011, the annual average was $24 billion. This, however, doesn’t tell the full story about how few new issues are being printed.

For the entire $3.7 trillion municipal market, only 59 percent of the issuances since 2012 have been “new money.” The remainder is refinancings of old deals, many of which were issued between 2002 and 2011, when interest rates were much higher. Prior to 2012, the new money percentage was about 82 percent. This illustrates the dearth of municipal offerings in general, and in BQ paper in particular.

A final comment is a reminder about what yield spreads tend to do as interest rates rise: they narrow. That would mean your market values might be able to withstand a couple of rate hikes without too big of a wallop.

Webinar Series Continues
ICBA Securities’ webinar series “Community Banking Matters” continues on Aug. 16 at 10 a.m. (Central time). James Plunkett with Vining Sparks will present “The Mortgage Market with a Focus on CMGs.” The supply/demand variables of the mortgage-based securities market also will be discussed.

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