MARCH 2017

Debt Market Monitor

National Debt Capital Markets Services

Market faces Moby Dick of government-owned debt

One of the latest concerns racking the financial markets and the topic of increasing interest rates is the much discussed "mortgage-bond whale." This figurative Moby Dick refers to the massive unwinding of the U.S. Federal Reserve Board (the Fed) monetary policy experiment of quantitative easing, which has left the Fed owning more than $4.5 trillion of bond holdings. The Fed bought bonds stemming from the financial crisis in order to inject liquidity into certain areas of the market while keeping interest rates low. The sell-offs of these holdings will not occur overnight, or even over a year. They will be spaced in an orderly fashion. Nevertheless, when the sale starts, the market will feel an impact. The effect will be like trying to let only a little water out of the dyke while knowing that you need to drain the entire reservoir eventually.

Reports indicate that the Fed could start the unwinding process as early as this calendar year with an initial focus on the $1.75 trillion of mortgage-backed securities (MBS). MBS contains debt related to residential mortgages only, unlike CMBS, which refer to commercial-mortgage-backed securities. The Fed is currently the largest source of demand for U.S. government-backed mortgage debt, owning roughly a third of the overall market. Selling off these holdings, even in a methodical fashion, is likely to have implications for home buyers through an increase in interest rates over and above what the Fed is planning to do via its funds rate. The result: Compounding interest rate increase could put a crimp in the housing market and trickle out to all associated areas of the market and, of course, the economy.

Just a slowing of the MBS acquisition process, without an unwinding, has the likes of JP Morgan strategists estimating that lending spreads could widen as much as 25 basis points, or a quarter of 1%. A reduction in government MBS-bond purchases will likely occur before an actual unwinding of current holdings. The Fed is the largest single buyer in this space, so it is a bit of an unknown as to by whom, how and when the slack will be taken up.

At the end of 2016, U.S. home-loan rates nearly hit a three-year high, up 75 basis points, without any action by the Fed to unwind holdings. This spike in rates has already resulted in a slowdown in housing demand. Housing is one of the fundamental cylinders on which the U.S. economy runs; without housing demand, the economy will experience a sputtering effect. Another perspective on the Fed's decision to unwind MBS and other bond holdings was offered by Morgan Stanley, which estimated that the Reserve's $325-billion bond reduction could have the same impact as nearly two additional rate increases.

However, there is a silver lining. Less buying by the Fed means that there will be more debt available for purchase in the private market, where some demand exists. It is all about the quantum and the timing.

The whale is just one more thing for the Fed to throw into the hopper to determine when, and by how much, to raise rates.

Fiscal Snapshot

Bank of Canada Rate

	BoC Rate	Bank Prime Lending
February 2017	0.75	2.70
One month ago	0.75	2.70
One year ago	0.75	2.70

Government of Canada Benchmark Bond Yields

	5-Year	10-Year	Long
February 2017	1.05	1.62	2.34
One month ago	1.11	1.75	2.41
One year ago	0.66	1.18	1.97

Indicative Commercial Mortgage Spreads* Over Government of Canada Bond Yields

Conventional	5-Year	10-Year
February 2017	1.75 - 2.10	1.85 - 2.35
One year ago	1.65 - 1.90	1.90 - 2.25
Insured	**5-Year**	**10-Year**
February 2017	0.90 – 1.10	1.00 – 1.10
One year ago	0.75 - 1.25	0.80 - 1.25

*Spreads are indicative of high quality real estate in major Canadian markets.

Highlighted Transaction

Asset Type	Suburban Office
Location	Major Canadian city
Facility Details	A senior term facility for $15.3M was arranged for a 5 year term and 25 year amortization, at a competitive rate of interest. Funds were deployed to repay an existing maturity.

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Please contact our National Debt Capital Markets team for more details related to debt financings or real estate transactions.

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