# Coming and Going

## Supply of government agency debt remains low

**By Jim Reber**

Answer: The last year before 2015 that aggregate outstanding debt of U.S. government agencies totaled less than $2 trillion.

Jeopardy (double entendre) question: What is 2000?

Yes indeed, the supply of debt issued by your favorite agencies has continued to dwindle in total. These bonds have for decades been a staple of well-structured community bank investment portfolios. As your industry's profitability continues to grow, along with your bank's footings, this may present some challenges for you portfolio managers out there.

Interestingly it's not a uniform retreat by all issuers. In fact, several of the more familiar names have been growing. But as supply/demand forces collide to help define fair value, it may be useful to review what was, and is, the market for these instruments so that an informed community banker can make some good decisions on the behalf of his or her financial institution.

**Significant contribution**

It is easy to understand why this investment sector is popular. Agency bonds are simple to analyze, highly liquid, readily pledgeable, and available in virtually any maturity and callable configuration. Did I mention 20 percent risk-weighted? Their yields will of course be higher than a comparable Treasury bond, with the spread being a function of their maturity and call features. At the moment, a five-year agency that can be called in two years has an incremental yield of about 20 basis points (.20 percent) over the curve.

Still, the supply issues coupled with community banks' growing familiarity with mortgage products and increased need for tax-free income have caused the average bank's allocation to agencies to shrink. Ten years ago, about 30 percent of a typical community bank portfolio was comprised of these agencies. Today, the number is around 10 percent. Nonetheless, 10 percent of anything is significant.

**In the headlines**

What's old news at this point is the two housing government-sponsored enterprises' (GSEs') status in legal limbo. Technically both Fannie Mae and Freddie Mac are in a conservatorship, and their earnings are being swept into the Treasury coffers to compensate the taxpayers for the risk we assume as stewards. Accompanying the conservatorship is a requirement that both GSEs shrink their mortgage holdings to $250 billion apiece by the end of 2017.

As their mortgages owned have shrunk since 2008, so have their borrowing needs. Freddie Mac, for example, cut its outstanding securitized debt by over $200 billion between 2012 and 2016. Fannie Mae's debt dropped by almost $300 billion in that time. This is the major cause of the decline in the quantity of agency debt through 2016. (Total outstandings of all agencies for both 2015 and 2016 are just below $2.0 trillion.)

**On the way up**

Other agencies' borrowing needs are increasing. The largest and most visible is the Federal Home Loan Bank (FHLB) System. This consortium of regional banks makes collateralized loans to "members," which are mostly FDIC-insured depositories. In large part, loan demand at the members' institutions determines the size of the advance book of a regional FHLB. The corollary to that is the FHLBs need to borrow most of the dollars required to match-fund the advances.

FHLB debt peaked in late 2007, just as the housing bubble burst. Between 2007 and 2011 advances and debt declined each year. Since then, however, FHLB borrowings have increased by about $300 billion, which partly replaces the falloff in Fannie/Freddie supply.

**Proof in the prices**

Accompanying the shrinkage in the supply of securities was the financial crisis of 2008-2009. As we well know, interest rates were stuck at historic lows for the better part of the last 10 years. Usually, as interest rates decline, the yields on "spread product"—everything except Treasuries—will fall at a slower rate. Stated another way, spreads tend to widen.

That didn't happen on agencies between 2008 and 2016. And I must say that vindicated my faith in a free-market system in which informed buyers and sellers, and supply and demand, determine prices. The need for, and attractiveness of, these issues meant that prices rose with the benchmark Treasuries even through 500+ basis points of monetary easing.

Agency debt supply seems destined to be stable, but not grow, in the foreseeable future. As we engage a year in what appears to be in a rising rate scenario, it will be interesting to see if spreads tighten on agency debt. Since they are still at historic lows, there seems to be little room for further spread shrinkage. These are all arguments for your community bank maintaining a suitable allocation to the government agency sector.

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**Spreads Snapshot**

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