Mortgage Market Review

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Week in Review

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The Treasury yield curve flattened over the week since, as evidenced by the well-received 30-year Treasury auction, jitters about inflation seemed to subside. The 2- to 10-year spread narrowed by 12 bp to 176 bp. Mortgages rallied across coupons, with the largest price increases occurring in the lower coupons. This strength in the lower coupons is generally attributed to the flattening of the yield curve. Thirty-year MBSs increased an average of 0/15, with 7.5s to 8.5s increasing by approximately 0/22 and high coupons increasing by about 0/10. Alternatively, 15-year MBS prices increased on average by 0/03.

Cash flow yield spreads tightened on all 30-year MBSs, especially in conventional 10.5s and above, which tightened more than 10 bp. This apparent richening of these high coupons reflects the flattening of the Treasury yield curve rather than a change in relative value. High coupons are priced off the 3-year Treasury, which increased by 2 bp, while lower coupons are priced off the 7- or 10-year Treasury, which declined by 9 and 10 bp, respectively. On an OAS basis, conventional 30-year coupons tightened by about 4 bp across the board. OASs on 30-year GNMAs were unchanged and on 15-year MBSs were about 5 bp wider, except for 10s and 10.5s, which remained unchanged.

The continuing technical factor driving the pass-through market is the CMO bid, which has been propping up spreads all year. This week $4.34 billion of new issuance came to market. GNMA collateral continues to be attractive because relatively slower GNMA prepayments make IOettes collateralized by GNMAs more attractive than those collateralized by conventionals. In addition, the recent pickup in prepayment speeds has favored CMO arbitrage in GNMA-backed deals.

The ARMs market was quiet all week. Prices were generally unchanged. The technical factors shaping this market continue to be lack of supply and fears of fast prepayments. We saw some RTC selling of AA ARMs, but this added little pressure on Agencies.

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Understanding the TED Spread: Implications for Floating-Rate Assets

This week's *Mortgage Market Review* focuses on the Treasury to Eurodollar (TED) spread (the difference in yields between U.S. Treasury Bills and Eurodollar LIBOR deposits of similar maturity) and examines how an understanding of its determinants can allow market participants to choose the optimal index sector in which to participate in the floating-rate debt markets. Such an understanding has implications for both investors and issuers. Based on our analysis, we prefer LIBOR-based floating-rate assets over Treasury-based securities.

The TED Spread

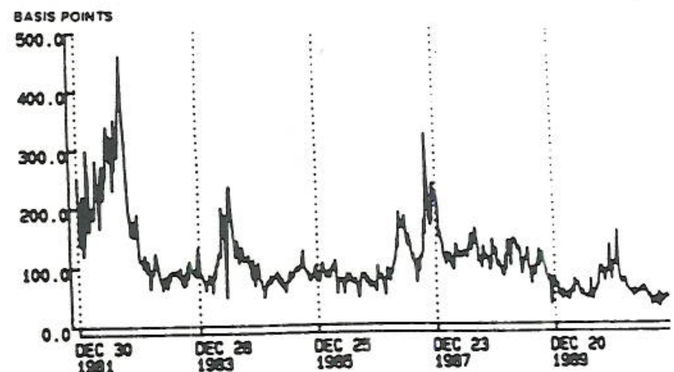
The TED spread is a key money market credit spread that links the short-term riskless yield of U.S. Treasury Bills with LIBOR, the basic short-term rate in the credit markets. This spread fluctuates greatly and thus can offer incremental returns for those who accurately time their investments between the LIBOR-based and Treasury-based floating-rate debt sectors. It has even greater implications for leveraged investors, who typically borrow on a LIBOR basis and might be exposed to significant basis risk if they invest in Treasury-indexed floating-rate coupons.

At 39 bp, the TED spread is currently close to its tightest levels since 1982, up slightly from its recent low of 26 bp. Since 1982, it has been as wide as 461 bp, with an average spread over the period of 108 bp. Isolating low volatility periods, the 1983-1986 period had an average TED spread of 90 bp, while the post-1987 period has had an average spread of 87 bp, with highs in the 200 bp region. The pre-Resolution Trust Corporation (RTC) period from January 1988 to June 1989 had an average spread of 118 bp, while the post-RTC period from July 1989 shows a marked tightening, with an average spread of 63 bp (see Exhibit 1).

Exhibit 1

The TED Spread

Three-Month LIBOR versus Three-Month U.S. Treasury



Source: Morgan Stanley

We believe that the current narrowing of the TED spread is temporary and that it will revert back to wider levels. Based on the statistics in Exhibit 2, we expect the "normal" long-term level for the TED spread to be in the vicinity of 90-100 bp, suggesting a potential for TED spread widening of 50-60 bp, given that the level is currently 39 bp.

Exhibit 2

Historical TED Spreads for Low Volatility Periods

In Basis Points

Period	Average	Median	Max	Mi
01/01/82 - 11/12/91	108	93	461	[illegible]
01/01/83 - 12/31/86	90	85	234	[illegible]
01/01/88 - 11/11/91	87	90	200	[illegible]
01/01/88 - 06/30/89	118	116	200	[illegible]
07/01/90 - 11/11/91	63	55	156	

Source: Morgan Stanley

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Determinants of the TED Spread

The TED spread can be thought of as a measure of the credit risk of the banking system, as it tends to fluctuate with sentiments about the banking system's soundness. However, a number of other fundamentals influence the demand and supply in the Eurodollar and Treasury Bill markets, which can affect their relative yields and, thus, the TED spread. These are summarized in Exhibit 3.

Exhibit 3

Fundamental Factors Affecting the TED Spread

Factor	Expected Reaction of the TED
Reduction of Confidence in the Banking System	Widen
"Flights to Quality" from Other Markets to Treasury Bills	Widen
Treasury Bill Supply Increases	Narrow
Euro Financing Decreases	Narrow
Interest Rates Decline	Narrow

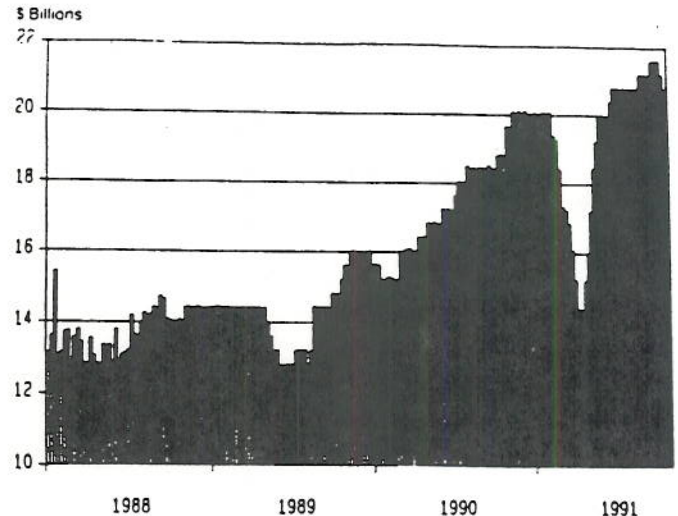
Source: Morgan Stanley

RTC Spending and the TED Spread

We believe that the current narrowing of the TED spread is primarily the result of the ballooning in the available supply of Treasury Bills caused by the spending activities of the RTC (see Exhibit 4). The RTC spends money for two purposes: (1) to cover losses (the gap between assets and liabilities) in institutions they close, sell or merge and (2) to provide working capital for the RTC to finance the assets of institutions it has taken over until those assets can be sold. The "loss" funds are not replaced once they are spent, while working capital is supposed to be paid back over time as asset sales occur. Spending for losses was originally financed through the old REFCORP bond program. When the $30 billion of authorization for REFCORP ran out, Congress approved an additional $50 billion of RTC spending. This directly boosted the federal deficit budget and, combined with working capital needs, has been financed through Treasury Bill auctions. This extra Treasury Bill supply supported Treasury Bill yields while other money market rates were declining, resulting in a narrowing of the TED spread.

Exhibit 4

Weekly Treasury Bill Auction Size



Source: Federal Reserve Board

The recent cuts in Treasury Bill auction size are primarily a result of the RTC having reached its current $80 billion loss funds limit, resulting in a small temporary widening in the TED spread from its recent low of 21 bp. We are expecting the savings and loan and bank deposit insurance crises to create a need for Treasury Bill financing that should peak in 1992 at $115 billion and should last into 1994 (see Exhibit 5). In addition, the TED spread should have widened by then as a result of a permanent decline in the rate of seizure by the RTC and FDIC. Improvements in the economy prior to 1994 should improve the health of most financial institutions, reducing RTC and FDIC asset disposition and financing needs even earlier.

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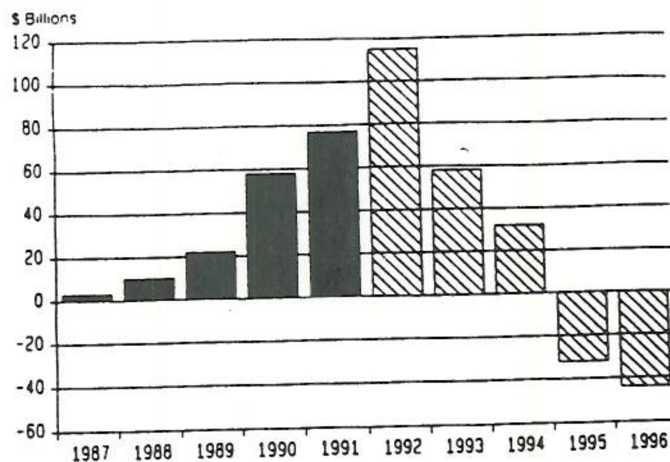
Exhibit 5

RTC and FDIC Federal Budget Outlays*

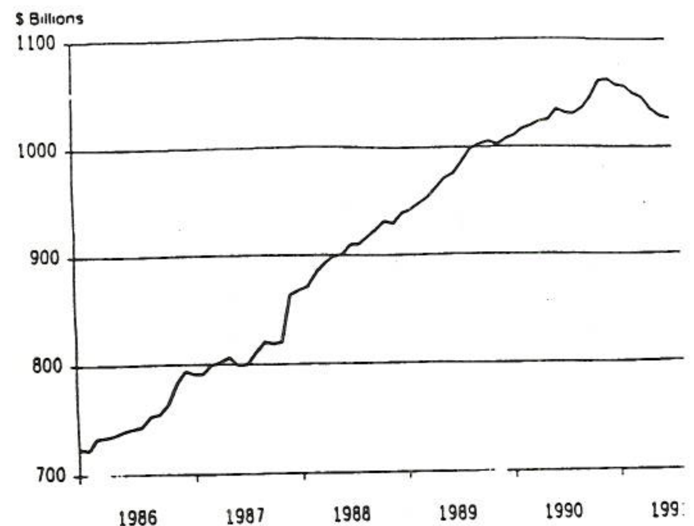


*1992-1996 CBO Estimates

Source: Federal Reserve Board, Congressional Budget Office

Exhibit 6

Large Commercial Bank Lending



Source: Federal Reserve Board

Commercial Bank Lending and the TED Spread

The decline in bank lending has also undoubtedly contributed to the narrowing of the TED spread (see Exhibit 6). This would have affected the TED spread by diminishing the need for marginal funding in the money markets, driving Eurodollar rates lower. This can also be observed in the debt issuance activities of finance companies, which have slowed. As the economy improves, we would expect the demand for bank credit, and financing in general, to increase, which would increase the need for Eurodollar funding by these institutions and likely result in a widening of the TED spread.

We expect Euro financing activity to begin to pick up ir 1992/1993. Morgan Stanley Economics anticipates rea GNP to rise to an above 4% growth rate in the middl two quarters of 1992, with an average GNP growth o about 3% for 1992. This should translate into a widenin of the TED spread as Eurodollar debt supply increases.

Conclusion

We have examined the TED spread and described tl primary factors that we believe are responsible for i current narrowing. Based on our analysis, we specula that it will widen back to its "normal" level of betwe 90 and 100 bp, a 50-60 bp widening. This spre widening would lead LIBOR-indexed floating-r coupons to perform relatively better than Treas Bill-based floating-rate coupons, by the amount of widening. This leads us to prefer the LIBOR sector o the Treasury Bill sector. Therefore, we would curren recommend issuing Treasury Bill-based floating-r debt for financing leveraged portfolios wl recommending the LIBOR sector for investm purposes.

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