

Reuters

Mortgage havoc wrecks 100-yr storm on bond markets

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NEW YORK, Aug 1 (Reuters) - Nightmares became a reality this week in the massive fixed-income sector as one of the worst bond market plunges in the past decade only got worse. Traders and investors alike fear the trouble isn't over and, come Monday morning, the turmoil could continue.

Everyone blames the same culprit: the \$4.9 trillion mortgage-backed securities market and the hedging of those bonds, which battered Treasuries, the agency debt of housing giants Fannie Mae and Freddie Mac and the interest rate swaps market.

"This has been the biggest challenge to managers of mortgage portfolios or really any portfolio we've seen in quite some time," Franklin Raines, chief executive of Fannie Mae, said earlier this week. Fannie Mae is the country's largest mortgage financing company, with an \$812 billion portfolio of mortgage loans and securities.

Raines called the recent big jump in interest rates a "hundred-year storm."

The pain has been so severe and widespread that analysts are starting to wonder how the big losses have hurt the many commercial and investment banks that have made money holding all these bonds. Top financial stocks, led by J.P. Morgan Chase & Co.(NYSE:JPM - News), Bear Stearns Cos. (NYSE:BSC - News) and Lehman Brothers Holdings Inc.(NYSE:LEH - News), fell sharply over the past two days on worries about these losses.

With markets stabilizing somewhat after early turmoil on Friday, many investors hoped the worst of the selling had passed. But those traders who deal with the big mortgage portfolios at the heart of the havoc said there was probably more to come.

Yield spreads on agency debt and interest rate swaps, benchmarks for many bond portfolios, have widened about a quarter of a percentage point this week -- an almost unprecedented weekly move for those markets.

Even as Treasuries plunged for much of the week, investors dumped agencies, mortgages and even corporate bonds at an even faster pace. By some measures the volatility is the worst since the crisis of the huge hedge fund Long-Term Capital Management in 1998, when it was forced to liquidate its big leveraged positions that brought markets to a near standstill. Rumors have circulated of other banks and hedge funds in trouble.

The wreck in Treasuries began just six weeks ago and accelerated after the Federal Reserve began to play down the risk of deflation and the possibility it would buy government bonds as a way of conducting monetary policy.

Benchmark 10-year yields have spiked a whopping 1.5 percentage points -- and much of the ongoing rout can be blamed on the mortgage market, whose hedging needs overwhelm the U.S. government bond market and have in recent years exacerbated interest rate moves.

After falling all the way to 3.07 percent on June 13, U.S. 10-year yields soared to 4.57 percent before settling late Friday at 4.40 percent.

The mortgage problems stem from what is known as duration, which is the average life of a bond portfolio and its sensitivity to changes in interest rates.

The record refinancing wave of recent years changed the face of the mortgage market, magnifying the interest rate-related risks. The fall in benchmark Treasury yields to 45-year lows has left the mortgage bond market with securities pooling loans with low coupons, which are much more vulnerable to any rapid jump in interest rates.

Just how sensitive mortgage bonds are to higher rates is evident in a widely watched bond index.

As of July 31 the Lehman Mortgage Backed Securities Index's duration stood at 3.05 years, compared with 1.02 years on June 30 and 0.58 year on May 30.

With the mortgage market now so huge, all kinds of portfolio managers have been forced to unload Treasuries and swaps in a way that has destabilized the broader market. As a result, selling begets more and more selling.

"This looks like the 'perfect storm' with everyone rushing for the door at the same time," said Robert Gay, global head of fixed-income research at Commerzbank Securities.

(With additional reporting by Svea Herbst and Lynn Adler)