## INTEREST RATE OBSERVER<sup>®</sup>

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## Postscript to value

"At current discounts to visible book value," this publication opined in early July, "we judge that AGNC and Capstead constitute what used to be known as a reasonable businessman's risk." The emergence of a new fact leads us to venture that the risk-reward proposition has improved.

To recap, American Capital Agency Corp. (AGNC on the Nasdaq) and Capstead Mortgage Corp. (CMO on the New York Stock Exchange) are examples of the income-generating machines called mortgage real-estate investment trusts. They own mortgage-backed securities, a.k.a. MBS, which they finance with repurchase agreements, a.k.a. repo. You'd suppose that nothing could be easier to analyze. Subtract the cost of repo from the yield on the MBS, and multiply by a leverage factor.

Well, it isn't easy. For one thing, the American mortgagor, or homeowner, can refinance virtually at will, oftentimes when it's least advantageous for the mortgagee, or moneybags. For another thing, the cost of repo financing is variable, not fixed. In 2008, it shot through the roof.

To borrow short and lend long is the business plan of every mortgage REIT, and it's a profitable model as long as short rates remain below long rates (and homeowners don't muddy the waters by exercising their option to refinance). Let that difference narrow (or, heaven forfend, invert, such that short rates exceed long rates), and you've got trouble. Portfolio managers therefore hedge their repo expense by exchanging a floating-rate liability for a fixed-rate liability.

They execute these hedges in a market especially created to facilitate the exchange of streams of floating-rate payments for streams of fixed-rate payments (and vice versa). It's called the swaps market, and it's the biggest derivatives emporium under the sun. As face value, it's worth no less than \$381 trillion today.

So a mortgage REIT's profit margin is nothing so simple as the yield on the MBS minus the cost of the repo. It's rather that margin plus the cost of hedging (not that even these essentials exhaust all the variables).

Other things being the same—and you just know that things always are—mortgage REITs prefer a nice wide gulf between MBS yields and the 10-year swaps rate. The wider the better, is the rule. At 79 basis points, today's spread is 20 basis points wider than

the average that prevailed between the start of QE3, in September 2012, and the end of 2014.

The dawn of QE3 seemed to promise the world to mortgage investors. The Fed would buy every bond in sight, the bulls allowed themselves to imagine. The prices of MBS naturally rallied. Then, too, MBS yields naturally declined, and homeowners naturally refinanced. High-yielding mortgages were called away. Low-yielding mortgages were issued in their stead. Investors seemed not to put two and two together right away, as prices of mortgage RE-ITs actually moved higher. By and by, shares of AGNC changed hands at 125% of book value, those of Capstead at 108% of book value. The former yielded 13.6%, the latter, 10.1%.

Now look. The cost of hedging is cheaper, discounts to book value are the rule (for AGNC and Capstead, 81% and 84%, respectively) and the yields, while in one case slightly lower (12.4% and 10.1%) than they were three years ago, are perhaps more sustainable. We don't mean to soft-pedal the risks that come with the territory in a mortgage REIT portfolio, only to say that the stars seem more profitably aligned today than they have in a while.

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