GRANT'S
INTEREST RATE OBSERVER®
Vol. 40, No. 3b 233 Broadway, New York, New York 10279 • www.grantspub.com FEBRUARY 18, 2022

Rates on roofs

On Dec. 1, 2021, Vishal Garg, CEO of the online mortgage lender Better.com, fired 900 employees. Because he chose to deliver the hurtful message on a mass Zoom call, the Better.com board of directors ordered him home for a weeks-long spell of self-reflection. And yet, muses Christopher Whalen, publisher of *The Institutional Risk Analyst*, maybe Garg, knowing what we now know about the subsequent course of mortgage rates, "had the right idea."

The clash between interest rates and housing activity is one strand of this unfolding analysis. The perils of the option bombs called mortgage-backed securities is the second. And the opportunity for turning the volatility of those option-laden instruments to profit—or, at least, to a reasonable stream of income—is the third. As to the immediate future of the white-hot residential real estate market, we anticipate more sizzling.

Not many things are rising faster than consumer prices, but the cost of servicing a mortgage is a contender. Since the start of the year, the average rate for a 30-year fixed mortgage has jumped to 4.2% from 3.27%. In consequence of that lurch, the monthly mortgage nut for the occupants of a median-size American home (which bears a $361,700 price tag) has jumped by 12.1%, to $1,768.78 from $1,578.11 on Dec. 31.

Higher mortgage rates have already crushed the refinance market. According to John Burns Real Estate Consulting, 19% of mortgagees have borrowed at rates below 3% and another 38% at rates between 3% and 3.9%. Another way of looking at these facts is that 57% of borrowers would be out of pocket if they refinanced today. No surprise, then, that the Mortgage Bankers Association's weekly index of mortgage applications plunged by 42% between Jan. 29, 2021 and Feb. 4, 2022.

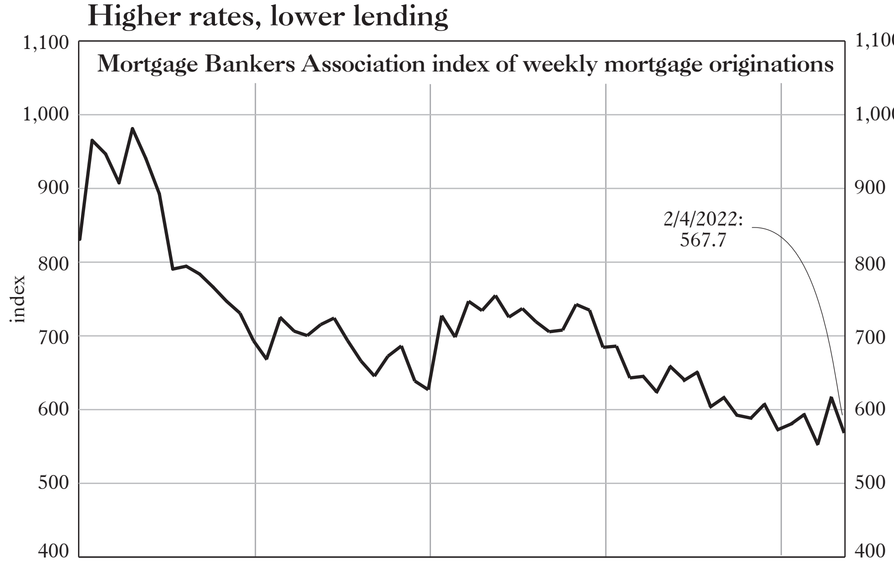
"The shops that were focused on making loans rather than retaining [mortgage] servicing [rights] are going to feel it very much, and they already are: United Wholesale, Rocket and loanDepot," Whalen tells *Grant's*. In the fourth quarter, loanDepot, Inc.'s revenues fell by 46% year over year as net income collapsed by 97%. Mr. Market is giving loanDepot the signal to shed costs, including staff: Since going public on Feb. 10, 2021, the lender's shares have slumped by 70%.

The fact is that it's much more profitable to refinance a loan than to make one. A mortgage originator must appraise the value of the property, scrutinize the borrower's credit and pay a loan officer a portion of the fees. "A refi loan goes through a call center," Whalen notes. "The person who takes the application is not working on commission but an hourly employee."

Meanwhile, the median price for a previously lived-in ("existing") house jumped by 14.6% in January. December featured the lowest level of inventory—1.8 months' worth at the current sales rate—since the National Association of Realtors began tracking the series in 1999. In better-balanced markets, inventory typically stretches to between four and six months.

Consumer sentiment is none the

Higher rates, lower lending



source: The Bloomberg

better for this arithmetic. According to Fannie Mae's latest National Housing Survey, only 25% of those polled said it was a good time to buy a home, the lowest reading in the survey's dozen-year history and down from 52% of respondents one year ago. On Feb. 11, the University of Michigan's consumer survey found that 26% of Americans expect their financial prospects to deteriorate, the highest proportion since 1980, when mortgage rates averaged 13.7%—and the CPI climbed by 12.5%.

While official statistics on last month's activity won't be released until after this issue has gone to press, "the market didn't slow at all in January," Rick Palacios, Jr., the director of research at John Burns, tells *Grant's*. "Nothing at all. It was fantastic." Yes, prospective buyers are increasingly getting sticker shock, but there are still two cohorts looking to close deals: "fence-sitters," i.e., house hunters who began their search before rates lurched higher, and institutional investors.

While Palacios expects the pool of fence-sitters to dwindle shortly, institutional investors, who accumulate portfolios of single-family residential homes for rent, have staying power. "Every single week there is one or two announcements saying, 'We've raised $1 billion or $2 billion' and 'We are going to grow our portfolio by 1,000 or 2,000 [houses],'" says Palacios. "These are groups that are funded by pension funds, sovereign wealth funds, all kinds of groups. They are in it for the long haul." According to Mark Zandi, chief economist for Moody's Analytics, professional investors accounted for 26% of single-family home purchases in the third quarter, up from 15% in the same period of the previous year.

The combination of low inventories, equivocating buyers and well-financed investors is likely to support home prices through June at the earliest. After which comes what?

Among the known unknowns is the arc of interest rates, the course of the CPI and the likely volatility in both. Brian Ye, a mortgage-backed securities strategist for BMO Capital Markets, cites another risk: namely, the chance that the Federal Reserve, harking to the cries of such hawks as James Bullard, president of the Federal Reserve Bank of St. Louis, takes the unusual step of dumping MBS from its $2.7 trillion mortgage-backed portfolio. It's a small risk, Ye judges, but a potentially disruptive one.

. . .

"We've had a rising-tide environment for housing for quite a while now," says Palacios. "We are now officially at this inflection point where rates are moving. . . . We are going to have a lot of supply coming on in the back half of this year and into the first half of 2023 [from new construction]. That's a backdrop that we haven't really had to struggle with."

As noted, the 30-year mortgage comes with an embedded prepayment option. Low rates reward the mortgagee with the incentive to refinance loans. High rates punish the mortgagor, whose portfolio of low-yielding loans takes on a life of its own—a much longer life than originally anticipated, because homeowners have every incentive to stand pat.

Even so, from the position of the mortgage real-estate investment trust, there is one compensating factor, at least: Most mortgage REITs hold securities at costs above par. When consumers refinance, they receive par and nothing more. AGNC Investment Corp., for example, registered an average cost of $103.50 on its portfolio of MBS as of Dec. 31, 2021.

"Higher rates in particular are not that problematic for leveraged mortgage investors," Peter Federico, 55, president and CEO of AGNC, tells *Grant's* (Gary Kain, Federico's predecessor, remains at the firm as executive chairman). "You can be well hedged for that environment, and, ultimately, in a higher rate environment, you can have very attractive leveraged investment return opportunities.

"What tends to be problematic for mortgages and all other fixed income is the transition period you go through in order to get to that rate regime, whatever it may be," Federico goes on. "That is the challenge of the market today."

Case in point: AGNC can hedge its funding costs, but not its investment portfolio. At the end of the fourth quarter, the REIT had hedged 101% of its funding liabilities for an average of 3.8 years. However, Federico says, spreads on mortgages above swap rates have increased by 50–60 basis points since last May. While this may make mortgages a better investment today, the spread-widening dragged down AGNC's book value by 4% in the three months through December and by 5% in January.

Hedging isn't the only tool at AGNC's disposal. The REIT has reduced its leverage, as measured by the ratio of investments to equity, to 7.7 times at year end from 9.4 times in the fourth quarter of 2019. While this is still a substantial amount of borrowing, it is below that of well-managed commercial banks such as JPMorgan Chase & Co., which showed a ratio of assets to equity of 12.7 times at year end.

For investors with the stomach for such volatility, AGNC trades at 93% of book value and offers a 10.4% dividend yield versus the 5.6% on offer from high-yield bonds. Since its May 15, 2008 initial public offering, AGNC has generated a 12.1% annualized return including reinvested dividends versus 10.9% from the S&P 500. However, book value per share over the same span has sunk to $14.91 from an IPO price of $20.

For income-seekers with a different temperament, there are preferred shares to consider. We last highlighted the value in AGNC's Series F 6⅛ cumulative preferred stock in the depths of the Covid selloff (*Grant's*, March 20, 2020), and it continues to be well-protected. Junior to the preferred is $8.8 billion of common equity, a sum equal to 10.7% of AGNC's investment portfolio.

Priced at $23.55 for a yield of 6.5%, the Series F doesn't offer quite the same commanding value it did two years ago. However, with its resettable coupon, it boasts a feature that may still entice the income-seeking investor in this time of upwardly mobile short-term interest rates. On April 15, 2025, the shares will pay three-month Libor (currently 0.46%) plus a spread of 4.697%, and the coupon resets thereafter on a quarterly basis. And if Libor indeed goes away, as regulators demand that it must, AGNC itself will poll a quorum of money-center banks to determine a suitable new benchmark.

•