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Income with strings attached

Evan Lorenz writes:

The deflating everything bubble does have a silver lining: It is easier to generate investment income. High-grade corporate bonds are priced to yield 6.1%, junk bonds 9.3% and the common shares of AGNC Investment Corp. (AGNC on the Nasdaq) a towering 18.2%. No, that last item isn't a typo.

As long-time readers know, AGNC is a mortgage real-estate investment trust. It invests in mortgage-backed securities, mainly the ones issued by wards-of-the-state Fannie Mae and Freddie Mac. It leverages those securities in the repurchase market to generate a yield. As of Sept. 30, the REIT's investment portfolio footed to $61.5 billion; management employed $8.70 of leverage for every dollar of equity.

The yield surge on AGNC's common stock isn't the result of a pickup in income—the dividend is unchanged from a year ago—but of a collapse in net worth and the share price. Tangible book value plummeted by 45% year over year as of Sept. 30 and by an additional 15% in the first three weeks of October, management disclosed on the Tuesday earnings call. As we go to press, shares trade at 102% of tangible book.

That dismal performance likewise features in the bull case that CEO Peter Frederico expounded on the same call: "Spreads [over Treasurys] are at unprecedented levels, the supply outlook is very favorable and, finally, agency MBS are guaranteed by the U.S. government and thus do not have…credit exposure." The mortgage-backed asset class, declared Frederico, is "undeniably attractive."

But perhaps, speculates our friend, Christopher Whalen, the founder and creator of Institutional Risk Analyst, not so attractive as it will eventually become. People set the coupons on individual mortgage loans, and markets determine bond spreads. The up-tempo surge in the 30-year mortgage rate—to 7.3% from 3.3% at the start of the year, a pace, we think, never before seen—has discombobulated the market and disconnected the people within it. The gap between the two constituents may widen further if the Federal Reserve, as expected, hikes rates by an additional 1.25 percentage points before year end.

"It's going to take us another six months to normalize pricing," Whalen says. "In the mortgage-backed securities markets, you're going to continue to take mark-to-market losses."

Of course, that is the case if interest rates remain elevated and volatile. If Fed Chairman Jerome Powell dials back in the face of a severe recession, AGNC common would stand to benefit from rebounding MBS values.

For investors looking for income—and a good night's sleep—there are always the AGNC Series C perpetual preferreds, which are priced at $22.88 (versus a par value of $25) to yield 10.1%.

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Wrecked by rates

source: The Bloomberg