Mortgage REITs To Remain Pressured

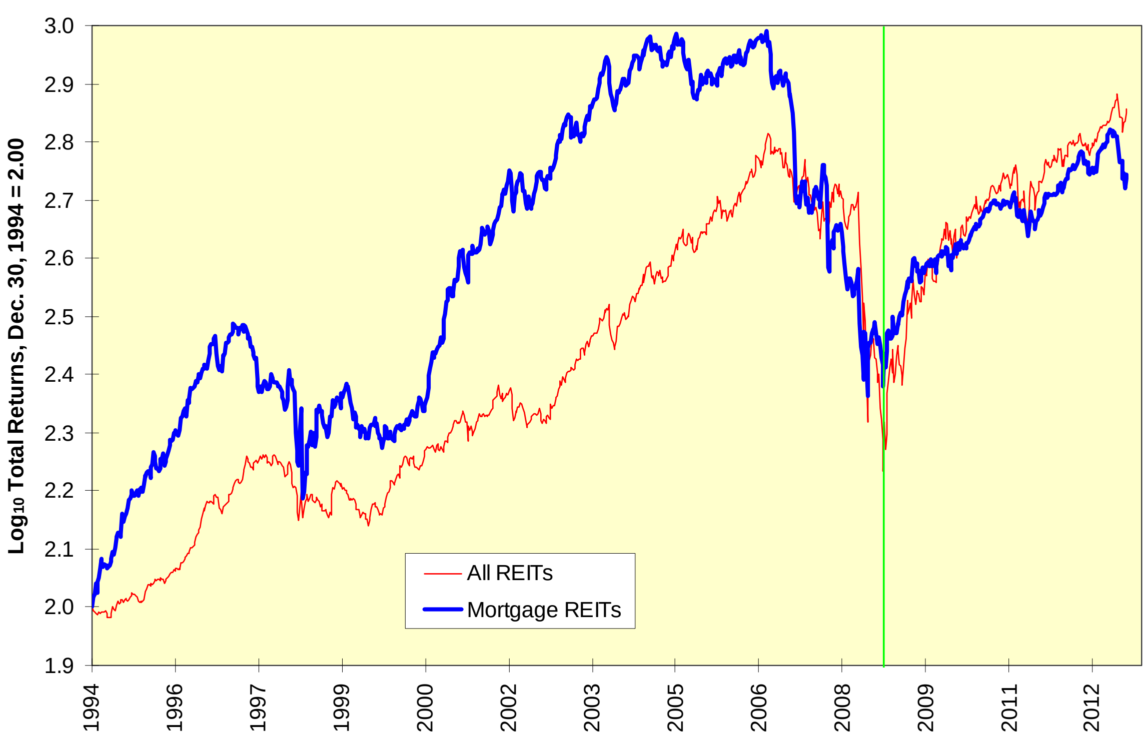
Eighteen years ago this October, long before the Asian and Russian/LTCM crises, long before the dotcom implosion and long before the 2008-2009 financial crisis, I penned this corker:

> *We can understand losses caused by bad bets on market direction, but those have surprisingly limited potential for disaster: Barring a Kidder Peabody or Barings-like breakdown in controls (or someone willing and able to meet a margin call greater than the firm's capitalization), there's a limit to just how wrong your clearing firm will allow you to be.*
>
> *Instruments like collateralized mortgage obligations (CMOs, the exploding cigars of the financial world) allowed David Askin to lose a cool $600 million in a matter of days, but are so obscure and complex that spectators have to be told that a wreck just occurred.*

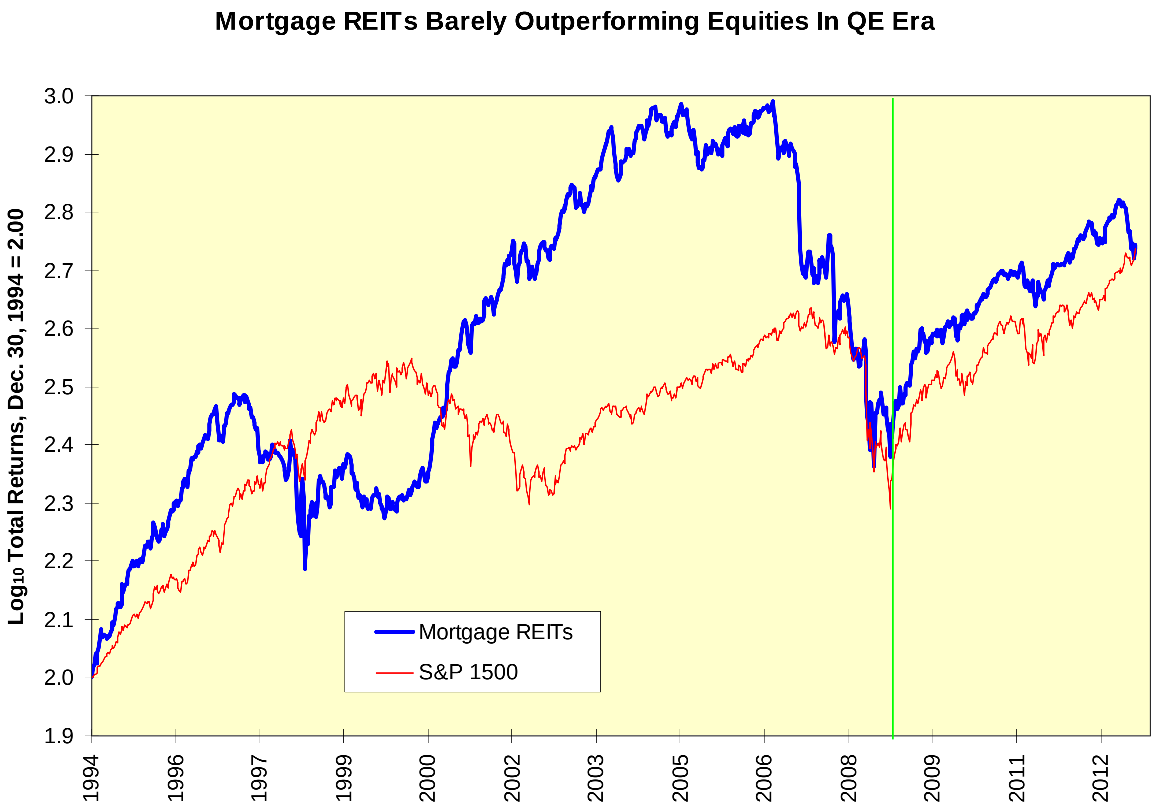
Mortgages still retain their power to unleash pain and suffering on all involved; there is a reason the word itself comes from the Norman French "death pledge." The Normans and their kinsmen now populating the residual royal families of Western Europe may have been Vikings with manners, but even before modern financial alchemists started flavoring everything with nitroglycerin, they understood there was more to lending against a piece of property than met the eye.

Punchbowl Removal Society
Mortgage REITs, the largest of which are Annaly Capital Management (NLY), American Capital Agency (AGNC), Starwood Property (STWD), Chimera Investment (CIM) and Two Harbors Investment (TWO), were among the intended beneficiaries of QE1 and QE3. Both of these monetary expansions were executed in large part by the Federal Reserve buying mortgage-backed securities in an attempt to drive mortgage rates lower and offset the reticence of lenders to get back into the residential real estate market. Let's ignore the obvious side-effect of this policy, how lower rates were capitalized into housing prices and therefore reward sellers at the expense of first-time buyers and focus instead on mortgage REITs prospective returns. Incredibly, mortgage REITs have underperformed the broad REIT index since March 2009.

Mortgage REITs Underperforming In QE Era



Mortgage REITs had been outperforming the S&P 1500 Supercomposite over the QE era rather handily until the end of April, but have given up virtually all of their performance advantage since then.



The obvious culprit in this performance downturn has been the prospective change in U.S. monetary policy. While the Federal Reserve has been making it up as they go along, everyone knows the next move in interest rates is unlikely to be lower. The result has been for the yield curve of REIT bonds has steepened relative to the Treasury yield curve; this means the cost of long-term REIT financing now incorporates the very real possibility the large, price-insensitive buyer from Washington, D.C., will disappear.

Even as the Federal Reserve has reiterated no policy changes are imminent, the yield curve of REIT bonds has not flattened back to its previous relationship vis-à-vis the Treasury yield curve. Four years of good old-fashioned money-printing went down the drain and took mortgage REITs with it. As no QE5 is on the horizon, the group is going to wander in the wilderness for a while.