

Mortgage REITs Benefiting From Yield Gap

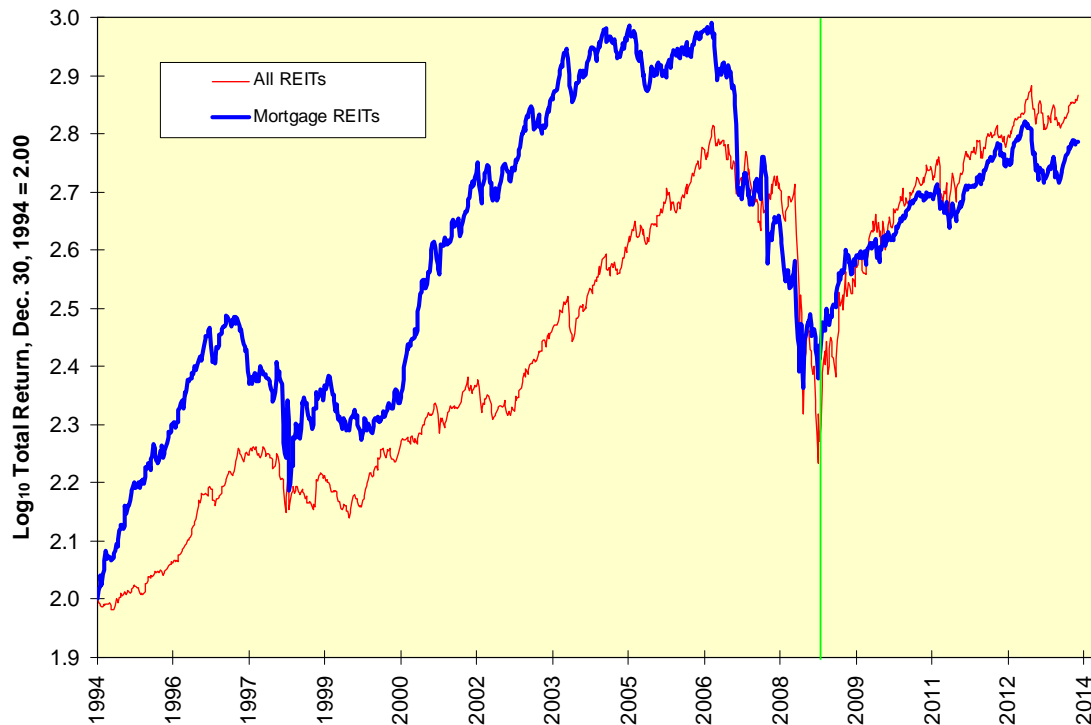
Gandhi was alleged to have replied to a question what he thought of Western civilization, “I think it would be a good idea.” I am getting to that point on the question of free markets after watching years of central bankers acting like central planners. At least the Federal Reserve finally has adopted the pretense they are doing anything for reasons beyond simple whim. I can do that and have the scars to prove it.

This brings me back to mortgage REITs, a topic I last wrote about in [July 2013](#). The largest of this group are Annaly Capital Management (NLY), American Capital Agency (AGNC), NorthStar Realty Finance (NRF), Starwood Property (STWD), Chimera Investment (CIM) and Two Harbors Investment (TWO), were among the intended beneficiaries of QE1 and QE3. I noted at the time this group was facing the strong headwind of its bond yield curve steepening relative to the Treasury yield curve. Worse, years of artificially low mortgage rates and other housing subsidies were lowering the affordability of homes for buyers, something that we have seen confirmed in recent data on home sales and construction.

It's The Yield Gap, Stupid

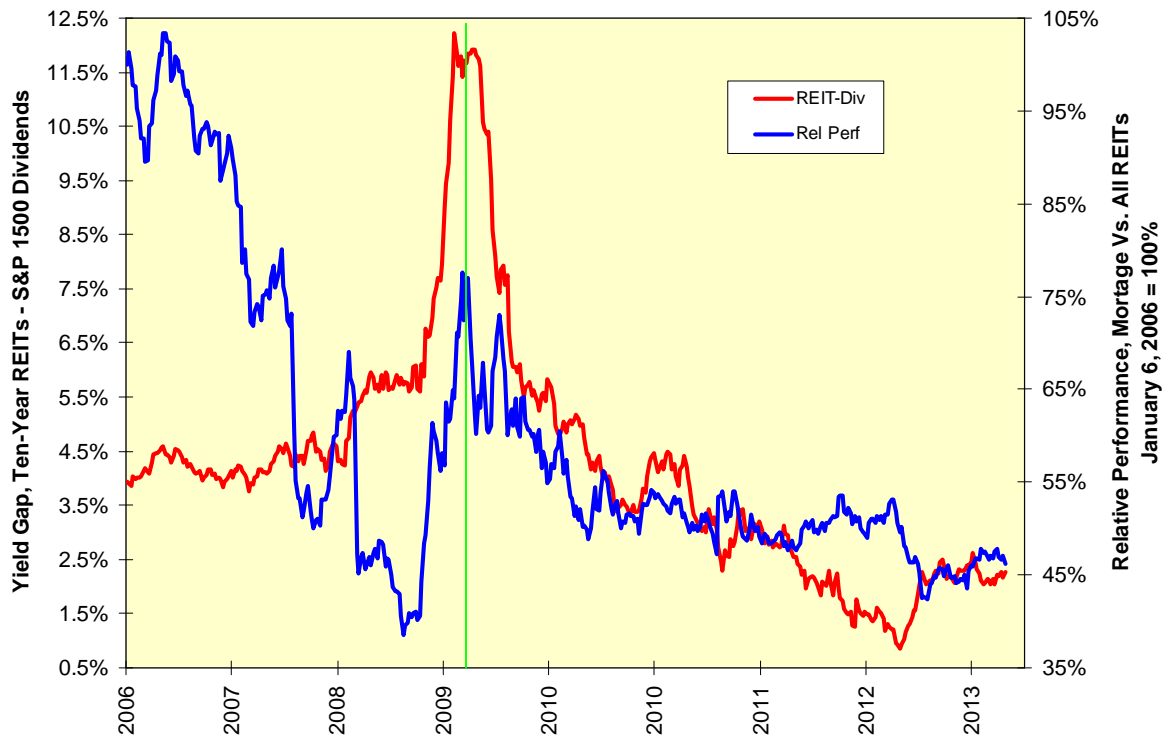
Mortgage REITs started to outperform all REITs after last September's postponed tapering of QE even though they have underperformed all REITs since QE1 began in March 2009 (Will I remember all of these QE-related dates in my dotage instead of important stuff, like where I left the house keys? Just wondering). Moreover, they have done it in the aforementioned poor environment for housing and with the yield curve for mortgage bonds still steepening relative to the Treasury yield curve.

Mortgage REITs Underperforming All REITs In QE Era



How can this counterintuitive gain in relative performance be explained? As in the case of so many things in our yield-starved age, you have to look at relative yield gaps. Let's rearrange the data in the chart above to a relative performance measure and map it against the yield gap between mortgage REIT bonds and the dividend yield on the S&P 1500 Supercomposite. That yield gap started to expand about one year ago and as it did, the mortgage REITs' performance relative to all REITs stabilized and turned higher.

Mortgage REITs Relative Performance And The Yield Gap



The sensitivity of this relative performance index to the yield gap of mortgage REIT bonds to equity dividends indicates the group is being valued more in comparison to equities than to Treasuries. As there is a long history of yield-chasing ending badly, I will have to nod in this direction and simply note this trade will end badly if and when long-term rates rise. However, this is unlikely to be a short-term concern.