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American Capital Agency Corp (AGNC) Earnings Report: Q3 2015 Conference Call Transcript

The following American Capital Agency Corp conference call took place on October 27, 2015, 11:00 AM ET. This is a transcript of that earnings call:

Company Participants

- Katie Wisecarver; American Capital Agency Corp. ; Director of IR
- Peter Federico; American Capital Agency Corp. ; SVP & CRO also SVP & CRO American Capital AGNC Management LLC
- Gary Kain; American Capital Agency Corp. ; President & CIO also President American Capital AGNC Management LLC
- Chris Kuehl; American Capital Agency Corp. ; SVP Agency Portfolio Investments also SVP American Capital AGNC Management LLC

Other Participants

- Doug Harter; Credit Suisse ; Analyst
- Mike Widner; Keefe Bruyette & Woods ; Analyst
- Rick Shane; JPMorgan ; Analyst
- Brock Vandervliet; Nomura Securities ; Analyst
- Jim Young; West Family Investments ; Analyst
- Stephen Laws; Deutsche Bank ; Analyst
- Ken Bruce; BofA Merrill Lynch ; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to the American Capital Agency third-quarter 2015 shareholder call.

(Operator Instructions)

Please note, this event is being recorded.

I would now like to turn the conference over to Katie Wisecarver in Investor Relations. Please go ahead.

Katie Wisecarver (Director of IR):

Thank you. Thank you all for joining American Capital Agency's third-quarter 2015 earnings call. Before we begin I'd like to review the Safe harbor statement.

This conference call and corresponding slide presentation contain statements that, to the extent they are not recitations of historical fact, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

All such forward-looking statements are intended to be subject to the Safe Harbor protection provided by the Reform Act. Actual outcomes and results could differ materially from those forecast due to the impact of many factors beyond the control of AGNC. All forward-looking statements included in this presentation are made only as of the date of this presentation and are subject to change without notice.

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An archive of this presentation will be available on our website and the telephone recording can be accessed through November 10 by dialing 877-344-7529 or 412-317-0088 and the conference ID number is 10073277.

To view the slide presentation, turn to our website, AGNC.com, and click on the Q3 2015 earnings presentation link in the upper right corner. Select the webcast option for both slides and audio or click on the link in the conference call section to view the streaming slide presentation during the call.

Participants on today's call include Malon Wilkus, Chair and Chief Executive Officer; Sam Flax, Director, Executive Vice President and Secretary; John Erickson, Director, Chief Financial Officer and Executive Vice President; Gary Kain, President and Chief Investment Officer; Chris Kuehl, Senior Vice President of Mortgage Investments; Peter Federico, Senior Vice President and Chief Risk Officer; and Bernie Bell, Vice President and Controller. With that I will turn the call over to Gary Kain.

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Thanks, Katie, and thanks to all of you for your interest in AGNC. Significant volatility across a broad spectrum of financial assets dominated the third quarter. Concerns over weakness in China and other emerging market economies intersected with uncertainty about the timing and future trajectory of Fed rate hikes to weigh heavily on the market.

Even though the Fed chose not to raise short-term rates in September, the majority of key FOMC members continue to communicate their desire to raise rates in 2015. However, despite the Fed's communication, the market sees growing probability that global economic headwinds and weaker than expected US job growth and manufacturing data will ultimately prevent or significantly limit the Fed's ability to raise short-term rates.

This uncertain backdrop led to meaningful declines in equity markets and significant widening in spreads on most fixed income securities including agency MBS. Spread widening was the main driver of the decline in our book value during the quarter.

As we discussed last quarter, it is important to remember that while wider MBS spreads negatively impact current period book value, actual cash flows are not affected. And this value will be recaptured in the form of higher returns if the positions are held to maturity.

More importantly given the widening in agency spreads over the last couple of quarters, returns on new investments are now materially higher than they have been in quite some time. In response we began to increase our leverage during the quarter for the first time since the end of last year.

Looking ahead, if spreads widen further, or as we get more comfortable around the interest rate landscape, we will likely add more MBS and move our leverage back to more normal operating levels.

Before covering the highlights for the quarter I want to briefly discuss a relatively small modification to our investment guidelines that we disclosed in our press release. Specifically our Board of Directors authorized AGNC to hold up to 10% of its assets in AAA non-agency mortgage-backed securities.

I want to be clear that this change should not in any way be viewed as a departure from our primary focus as an agency REIT. This framework is consistent with keeping credit risk to a minimum and ensuring that our portfolio remains highly liquid. That is exactly why non-agency investments are limited to AAA

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securities and the UPB of these investments will not exceed 10% of total holdings.

We made this change because limited quantities of these instruments do offer incremental return potential and have very little credit exposure given the quality of the underlying collateral, higher subordination levels and the strong underwriting. Similar to agency MBS, the bulk of the spread on these instruments is derived from interest rate or funding risk.

While a strong case can be made for a more diversified business model that includes substantial credit exposures, when you think about a mortgage REIT's investments in isolation, those benefits are far less compelling when viewed in a portfolio context where the vast majority of an investor's other holdings are typically concentrated in procyclical equity or credit centric exposures. The equation gets muddied further when weighed against the very real benefits of a liquid and transparent agency REIT.

Now if you turn to slide 4, I want to briefly review some results for the quarter before turning the call over to the team to discuss the portfolio. Comprehensive income equated to a loss of $0.43 per share while economic returns were negative 1.7%. Net spread income inclusive of dollar roll income totaled $0.51 per share when we back out catch up am.

The decline in net spread income relates to the combination of average leverage of 6.2 times, faster prepayment projections and higher funding costs, the latter being comprised of higher repo costs, a higher percentage of swaps and weaker dollar roll levels.

As we have highlighted on the past several earnings calls, there is a near-term cost to low leverage and higher hedge ratios with respect to current period income. That said, we believe that the elevated market volatility warranted a defensive position and we were very transparent about this mindset.

The good news is that we see a light at the end of the tunnel as the tension between global headwinds and the Fed will likely play out over the next several months. This clarity should facilitate a return to more normal risk positions and significantly reduce the current headwinds resulting from our defensive interest rate and leverage positioning as we enter 2016.

In the third quarter we continued our buyback program repurchasing another $45 million of our common stock.

On slide 5 I just want to point out that our at-risk leverage increased during the quarter from 6.1 times to 6.8 times at quarter end. I also want to clarify the drop in our reported average NIM during the third quarter as the headline numbers are not reflective of the true change in the earnings power of the portfolio.

Our average NIM in the third quarter was 114 basis points, down from 174 basis points in the second quarter. This sizable drop is mostly a function of large swings in our catch-up amortization from a 24 basis point benefit in the second quarter to a 23 basis point expense in the third quarter.

Excluding the catch-up amortization in both quarters our average NIM in the third quarter was 137 basis points, down from 150 basis points in the second quarter. As I mentioned earlier, the remaining 13 basis point decline was driven by our higher swap hedge ratio, higher funding costs and faster prepayment projections.

At this point let me turn the call over to Chris to discuss market developments in our investment portfolio.

Chris Kuehl (SVP Agency Portfolio Investments also SVP American Capital AGNC Management LLC):

Thanks, Gary. Turning to slide 6 I will briefly review what happened in the markets during the quarter. The third quarter was quality and, generally speaking, not kind to risk assets. And while agency MBS did not

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perform well on an absolute basis, it was one of the better performing sectors within fixed income.

As you can see on the table on slide 6, agency MBS widened approximately 14 basis points while investment-grade corporates widened 23 basis points and AAA CMBS ended the quarter wider by 19 basis points. High-yield and EM especially hard hit with spreads widening 148 and 73 basis points respectively.

Let's turn to slide 7 for a more detailed look into how agency MBS performed versus treasury and swap benchmarks. As you can see in the tables on the top half of this slide, rates rallied significantly with 5- and 10-year treasury rates lower by 26 and 27 basis points.

More notable, however, was the move in swap spreads and swap rates, the 10-year swap rate rallied 43 basis points or roughly 16 basis points more than the 10-year treasury note. So while mortgages performed fine versus treasuries, they underperformed the (inaudible) swap rates which our funding and hedges are largely tied to.

For example, in the lower right table you can see that 30-year 3.5 increased in price during the quarter by a little over 1.25 points or 1.29%. 30-year 3.5s have a duration of a little more than 50% of the 10-year.

So versus the 10-year treasury note, which was up in price by 2.42 points, 30-year 3.5s did fine with a price change roughly equal to what its duration would have implied. However, a 10-year swap hedge was up in price by approximately 4 points and versus this important benchmark mortgages performed poorly.

On the bottom of the slide we have a longer time series of quarterly average option adjusted spreads to LIBOR. You can see that spreads have widened significantly since the beginning of the year with much of the widening occurring over the last two quarters.

Let's turn to slide 8 to review our asset portfolio composition. As you may recall, we entered the third quarter with record low leverage despite the widening of spreads in Q2 as we remained concerned that MBS valuations still were not attractive enough given a number of significant global market risk factors.

While many of these risks remain in place today mortgage valuations have (technical difficulty) materially. And given the relatively attractive spread levels we were willing to increase leverage from 6.1 to 6.8 during third quarter. If risk adjusted returns continue to improve due to either wider spreads or more clarity with respect to market risk factors, we will continue to move towards a more normal risk position.

As you can see on slide 8, the asset portfolio increased to $62.2 billion as of September 30. The majority of our purchases were in 30-year MBS as we continued to reduce our weighting in shorter, lower yielding instruments.

Lastly, I want to highlight the fact that our specified mortgage holdings should provide incremental performance if rates either rise or fall given the combination of seasoning and favorable collateral characteristics. I will now turn the call over to Peter to discuss funding and risk management.

Peter Federico (SVP & CRO also SVP & CRO American Capital AGNC Management LLC):

Thanks, Chris. I will begin with our (technical difficulty) up from 45 basis points the previous quarter.

The increase in cost was due to a number of factors including dealer balance sheet constraints, the probability of a Fed hike before year end, and the slightly longer term of our repo funding which increased to 201 days from 177 days. Some of these pressures have since subsided leading to slightly lower repo cost at this point in the fourth quarter.

During the quarter we increased our usage of Federal Home Loan Bank advances. We continue to

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believe that our business aligns very well with the mission of the Federal Home Loan Bank system and, that being the case, we are hopeful that FHFA will eventually approve our captive insurance subsidiary as a permanent Federal Home Loan bank member.

On slide 10 we provide a summary of our hedge portfolio. Given the volatile interest-rate environment we chose to operate with a larger hedge balance during the quarter. As a result our hedge ratio increased to 96% of our liabilities at quarter end, thus largely protecting our repo costs against Fed rate hikes.

Lastly, on slide 11 we provide a summary of our duration gap and duration gap sensitivity. Given the significant rallying in swap rates and corresponding reduction in asset duration, our net duration gap naturally shortened during the quarter. In aggregate our net duration gap at quarter end was close to zero, down from the one-year duration gap that we reported at the end of the second quarter. With that I will turn the call back over to Gary.

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Thanks, Peter. And at this point let me ask the operator to open up the line for questions.

QUESTIONS & ANSWERS

Operator:

Doug Harter, Credit Suisse.

Doug Harter (Analyst - Credit Suisse):

Gary, can you talk about what -- how you think about what the normalized level of leverage is kind of as you look to add risk?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Sure. Look, realistically, I mean if you look back at the history of AGNC and for that matter kind of a lot of the other agency centric REITs, I think what you come up with is something in the we will call it 7.5 to 8.5 or 7.5 to 8 kind of times area as being kind of a normal starting point. So what I would say is I think that is what we view as a normal kind of leverage position over the long run.

Doug Harter (Analyst - Credit Suisse):

Got it. And can you talk about the attractiveness of the AAA opportunities today versus agency?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Sure. Look, I think what is important to keep in mind, the way you can -- the best way to think about AAAs is that they trade -- they are currently trading we will call it 3.5 points give or take behind agency. So a comparable coupon AAA security will be 3.5 points lower in price, that translates to a little over 50 basis points more in yield.

Now some of that is compensation for increased negative convexity because jumbos tend to have more negatively convex prepayment characteristics. But let's say you are still looking at even adjusting for that close to 50 basis points more in yield on those positions.

But on the other hand you also have to keep in mind that if you have a large position in these you are going to have to fund them in the repo market and then funding costs are 50 basis points higher as well with generic repo counterparties. So that is one of the reasons.

I mean, so if you are looking at this position as a good use of securities that aren't hedged on repo, then

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it makes a lot of sense. There are also some opportunities to fund these securities at good levels with the Federal Home Loan banks.

But I want to be clear about is the -- it's a definite -- it is definitely a good tool to increase returns, but it is not something that if we did 20% or 30% of our portfolio that that would help. Does that help clarify your question?

Doug Harter (Analyst - Credit Suisse):

That makes sense, thank you.

Operator:

Mike Widner, KBW .

Mike Widner (Analyst - Keefe Bruyette & Woods):

Gary, let me just follow up on Doug's questions. I guess what non-agency assets like specifically would you be -- you look out there and you see anything interesting today? I mean we have seen a lot of mortgage REITs moving to CMBS, not a whole lot happening on the non-agency RMBS front, but some moving to jumbos. So is that the kind of thing you are talking about or something else?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

No, that is absolutely -- I think you have covered what we are talking about. What I would say is I would prioritize or say the first obvious candidate for this position would be jumbo AAAs. We would certainly look at CMBS, AAA CMBS as well. And those are really the two main candidates for this bucket.

I also want to just point out, this is -- we are not in some huge hurry to add these assets. We wanted to first communicate, again, this adjustment to the guidelines. And I would be -- I would expect our purchases in this sector to be pretty slow, actually.

Mike Widner (Analyst - Keefe Bruyette & Woods):

Well, there hasn't been a whole lot of jumbo issuance lately, so it is probably good that you are moving slow. I guess just another question on sort of the leverage, taking it higher. I mean, as you said, spreads have widened. I mean, has there been any movement on leverage like subsequent to quarter end?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

It hasn't moved that much, it is not material in terms of move and things bounce around a little bit. But no major moves since quarter end at this point.

Mike Widner (Analyst - Keefe Bruyette & Woods):

Okay. And then I guess the final question, you guys did declare an October dividend just a couple weeks ago -- maintained the $0.20 level or $0.60 a quarter and obviously earnings this quarter a fair bit lower than that. Just how do you think about those two things?

And the Fed really hasn't raised yet, you did add swaps this quarter. So, how should we think about the dividend level with respect to current earnings power? And then again, the dividend you already declared for October?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

I think what I would point you to is that I think you and other analysts have asked this question frequently

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over -- at different points over the last five or six years. And I would say we don't obsess about the net spread income number and haven't in the past.

Look, I think the big picture issue around the earnings power of the portfolio is what I tried to stress in sort of my opening remarks. Two of the biggest variables that we control are the amount of leverage and what type of hedging and what type of duration gap we are running.

And then there are factors that we don't control such as the level of interest rates and what our prepayment projections are and other things around like the composition of hedges and so forth.

And when you think about that in its entirety, when we go forward, as I mentioned, we see a lot of scenarios where leverage is probably higher and where -- and a number of scenarios where over the next let's say three to six months duration gap is likely larger as well or percentage of hedges is down, whichever way you want to look at that.

Both of those are beneficial in terms of kind of the overall earnings power of the portfolio. So what I would say is it is just too -- from our perspective we want to see how things transpire from that perspective and we don't obsess about kind of short-term changes in that net spread income number.

Mike Widner (Analyst - Keefe Bruyette & Woods):

Okay. Yes, I mean for better or worse investors do obsess about dividends and in particular dividend sustainability and what to anticipate as we get into 2016.

So I mean I suppose you are not going to comment further on the dividend, but -- I hear what you are saying, but investors really do question -- it is the most common question I get is what do you think happens to the dividend. So I think that is the reason a lot of us ask the question.

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

No, I understand the question and we don't have a practice of kind of giving guidance around dividends.

Mike Widner (Analyst - Keefe Bruyette & Woods):

Yes, well I appreciate the comments as always. Thanks.

Operator:

Rick [Chen], JPMorgan .

Rick Shane (Analyst - JPMorgan):

Well, they usually get my name right, it is pretty easy. A question in terms of -- I'd love to hear you sort of talk through right now your investment opportunities and the calculus you go through between buying back stock and new investments.

Gary, one of the things we have heard you talk about in the past is that you actually factor in where OAS is and the relative value of mortgages into your thesis on whether or not you should be buying back stock at any point. How are you looking at this now? What is the balance between managing for book value and managing for the dividend?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Sure, and good questions across the board. I will start with a -- we'll call it a balance between share repurchases and kind of we will call it portfolio activity or kind of asset -- purchases of assets and returns and so forth.

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Just first on the share repurchases, the two of those are very much independent decisions. In other words, that we are going to make our share buyback decisions, as we have discussed in the past, which are a function of (inaudible) priced at book discount.

They're also a function of other things such as our view about the sustainability of discounts, market factors, (technical difficulty) or cheapness of the underlying product, level of interest rates and so forth. So I think we have covered kind of those decisions.

I want to be clear though that, again, we have the capacity to execute those transactions and will independently of let's say how we position the rest of the portfolio. So those decisions in a sense are executed independently.

I will have Chris talk to kind of the way we see what we see in terms of ROEs on kind of new investments at current market levels.

Chris Kuehl (SVP Agency Portfolio Investments also SVP American Capital AGNC Management LLC):

Sure, so just for example, yields on 30-year 3.5s are around 2.75% using a reasonable lifetime CPR assumption. And with call it 7 times leverage and a one-year duration gap on marginal purchases that generates gross spot return on equity solidly in the double digits at this point.

Rick Shane (Analyst - JPMorgan):

Okay, great. That is actually very helpful. To follow up I guess it was probably 18 months ago now when the industry multiples were roughly at these levels and spreads were relatively wide. You guys made a controversial decision to buy equities in some of your peers. It was a decision frankly that we liked and were supportive of.

I am curious, given where you see relative values between MBS and stock prices, is life too short to do that again or is that something you would consider?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Look, we would certainly consider it. I don't think we have found that equation as compelling as it was the last time around for a number of reasons. But I mean there are certainly kind of price to book discount levels where we would significantly ramp up our share repurchases and where we would -- and where we might consider purchases of other [re-shares]. But I would say that that kind of decision is not imminent and it would require kind of further repricing in the market.

Rick Shane (Analyst - JPMorgan):

Okay, thank you.

Operator:

Brock Vandervliet, Nomura Securities.

Brock Vandervliet (Analyst - Nomura Securities):

If you could just talk a little bit more about some of the balance sheet (technical difficulty) that we saw this quarter. I noticed the end period portfolio obviously increased, but the average was down quite a bit in the quarter. It looked like you had maybe de-risked right around the time of the Fed hike. Not sure if that was the driver or not. But could you talk to that?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

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Well, I guess what I would say is the ending balance of the portfolio was higher. We sort of calculate -- I mean there is no exact way to do it, but we calculate an average leverage which was not so dissimilar from our starting leverage of 6.1. Again, it was around 6.2.

We closed the quarter at 6.8 in terms of leverage, which (inaudible) all of that information sort of to your point tends to kind of have -- our purchases be, we will call it, back loaded in the quarter.

And I think that is consistent and some of that related to time and getting a little more comfortable with the risk position. Some of it related to the widening that transpired sort of later in the quarter as well. But hopefully that gives you a little more color on that.

Brock Vandervliet (Analyst - Nomura Securities):

Okay. And I guess on the flipside with the increase in the hedge ratio, when did you add those hedges? Sort of late in the quarter as well to pick up that ratio?

Peter Federico (SVP & CRO also SVP & CRO American Capital AGNC Management LLC):

Hey, Brock, this is Peter. No, I would say that our hedge ratio was reasonably high for the entire quarter. I mean we operated at 96% ratio hedge ration which is really at the upper end of where we have operated.

I wouldn't look at that as being the new standard going forward. But we felt like it was appropriate in the third quarter given the volatility in the marketplace. And I would say that for the most part we had the -- those hedges on for the entire quarter.

Brock Vandervliet (Analyst - Nomura Securities):

Okay, got it. That is helpful, thank you.

Operator:

Jim Young, West Family Investments.

Jim Young (Analyst - West Family Investments):

Gary, hi. Could you please share with us how had repo costs performed since the end of the quarter? And also your outlook with respect to the dollar rolls and how attractive they are at the current time?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Repo rates have come down a little bit. I mean there were a number of factors going on. One of the obvious ones that have been rumored in the market was selling from overseas central banks. And that kind of put a lot of government paper into the market at one time. Again, that is hard to confirm, but that clearly was a factor.

Dealer balance sheets pressures seemed kind of stronger or higher than they typically are. So those were factors as well as I mean realistically capital requirements at banks kicking in. So there were a number of factors that pushed things higher toward quarter end, things have eased a little bit. You also had the uncertainty around the Fed hike.

I mean obviously the Fed didn't hike in September, but throughout the quarter there was varying amounts of uncertainty around that that also kind of affected repo rates. So I think again that was sort of the situation there. Again, they have improved somewhat as we look this quarter.

The dollar roll levels clearly weakened in the third quarter and they remain kind of weaker at this point.

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And we feel like that is probably going to be the near-term at least kind of norm. There may be coupons in areas where dollar roll levels kind of are reasonably special.

But I think at this point the technical backdrop has changed a bit and it would be reasonable to assume that dollar roll (inaudible) is not going to be what it was earlier in the year.

Jim Young (Analyst - West Family Investments):

Could you just quantify how much your repo rate declined since September 30?

Peter Federico (SVP & CRO also SVP & CRO American Capital AGNC Management LLC):

Yes, this is Peter. I would say that in the market that the average decline in repo rates from Sept. 30 is somewhere between 5 and 10 basis points from 1 month out to 12 depending. But they are all in that range of 5 to 10 basis points.

That is not to say that our funding costs would be down that much. Obviously because our average maturity is close to 200 days. But nonetheless the market change is 5 to 10 basis bounce for one year less funding.

Jim Young (Analyst - West Family Investments):

Okay. Then, Gary, you had mentioned regarding the question about investing in other mortgage REITs that the equation is not as compelling for a number of reasons. Could you elaborate on those reasons, please?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Sure. I think one obvious one first off, I mean price to book ratios are going to bounce around from time -- from day to day, let's be realistic. So I won't kind of harp on that. But I would say is that, I mean most importantly is really relates to the sustainability and the kind of timing of a likely benefit from those transactions.

I mean, look, our view the last time around was interest rates were first off a lot higher, the 10-year was at 3%. We felt very good about that kind of entry point from a rate perspective. Most companies at that point were running reasonable duration gaps. We were running kind of our largest ever duration gap at that point.

To your point -- to an earlier point mortgage spreads were quite wide, but they had also just gotten there and there was unrealistic fear with respect to kind of the Fed tapering Kiwi and what the implications were going to be.

And so, we were confident that the market was overreacting to short-term conditions whereas, look, we have to be a little more practical in today's environment about -- while we still believe that the discounts are excessive in the space, I think we have to be a little more practical about the potential sustainability of them.

Jim Young (Analyst - West Family Investments):

Okay, great. And my last question just pertains to Fed policy. Can you share with us your current thoughts as to how you see the Fed proceeding and how that translates into how you are positioning the portfolio? Thank you.

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

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Very good question and obviously a timely question especially with their meeting tomorrow. Obviously we, like everyone else in the market, don't expect them to do anything tomorrow with respect to raising rates.

Look, we respected the fact that, and continue to, that the Fed really would like to raise rates in December. They continue to really communicate that. On the other hand, one thing that has been a little surprising is the relatively abrupt kind of weakening in some of the US data.

I mean obviously a lot has been discussed about overseas issues, weakness in China and other emerging markets, the currency impacts, oil and other factors.

But I think what was a surprise to the markets and to many people was the recent slowdown we have seen kind of both obviously in the employment numbers but in manufacturing data and in other kind of US centric numbers. And I think that presents an issue for the Fed. Obviously, we don't know what the November employment report will look like.

But what I would say is our central thesis over the course of the year was we thought the Fed would actually go, we thought that that was the more likely than not scenario. But we felt that they would get stomped out relatively quickly in the process.

I think with kind of the global situation and with the sort of somewhat surprising kind of near-term weakness in the data the odds of the Fed in a sense getting stomped out before they start or not being able to go has clearly increased. So I think it really sets up for a couple volatile months where the near-term data will be important.

But I want to take a step back and say that I think the one lesson again, which is not inconsistent with how we felt about this over the whole year. I think the one thing that we can take away from kind of what has unfolded over the last three to six months is that the odds of kind of a fed normalization of interest rates seems really, really low.

Especially when you put that against the backdrop of kind of more talk of easing from the ECB, obviously China has been aggressively easing. And when you put -- if you were to combine that with the Fed trying to normalize the currency moves would be massive, losing commodity prices and so forth.

I think that from so many different perspectives I think a kind of traditional normalization of interest rates whether the Fed hikes a couple of times just really seems like a very low probability at this point. So hopefully that gives you some insight there.

Jim Young (Analyst - West Family Investments):

Great, thank you very much.

Operator:

Stephen Laws, Deutsche Bank.

Stephen Laws (Analyst - Deutsche Bank):

A lot of them have been hit on, I would like to follow up a little bit on the AAA. Did I miss or did you comment on what type of leverage you are willing to put on the AAA securities versus where you run the agency portfolio?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Look, I think that in the end we don't look at leverage as a bond-by-bond leverage -- kind of calculation,

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especially when you are talking about something that is clearly going to be a smaller subset of the portfolio.

Haircuts are obviously higher on them. So we would impute a lower leverage level for this component of the portfolio. But I think realistically I would just say that the 10% of the portfolio being allocated to AAA is not going to have any material impact on our aggregate kind of normalized leverage levels for the portfolio.

Again, we do think of these instruments and the market haircuts and so forth require you to lever them less if you are actually borrowing against them. But again, in aggregate it is not going to affect our kind of long run leverage targets for the portfolio.

Stephen Laws (Analyst - Deutsche Bank):

Okay, and then can you maybe tell us in your words how you would explain the difference now between AGNC and American Capital Mortgage? I believe they are at about an 80/20 mix roughly agency/non-agency.

And then with 10% of allocation, if you did get there that would be bigger than the entire portfolio of MTGE. So how do you handle the application policy among those non-agency assets as you are looking at which portfolio to put those in?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Sure, I would be happy to address kind of the differences. But not only between AGNC and MTG, but the difference between AGNC and we will say other hybrid REITs.

I want to reiterate that the only thing that we have done in expanding AGNC's kind of available investments is to allow AAA non-agencies, okay. So, no subordinate classes at this point, no credit risk transfers. You are not looking at a vehicle that has moved really away from minimizing credit risk.

So AGNC is going to allow, yes, in a sense 10% of its assets to be AAA non-agencies, but I think you can't ignore the term AAA. And when you talk about hybrid REITs, they generally have we'll say at least 40% or more of their equity, and you have to look at this on an equity basis, not an asset basis, dedicated to non-agencies and/or other credit kind of related investments.

The vast majority of those are either unrated or very low -- have BBB or lower ratings. And so, there is real and material kind of credit exposure on those investments, which agency at this point will have none of.

So, I think that there really has been almost no movement I would say with respect to kind of AGNC versus we will call it the hybrid space. And again, that is dominated by the kind of -- ensuring that those investments are AAAs.

Stephen Laws (Analyst - Deutsche Bank):

Great and should I take from that that with where MTGE is they are not as much in the AAA space and so there is not an allocation policy issue or how do you view that?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Again just to reiterate, I mean MTGE discloses kind of the composition of its portfolio and this is not an MTGE call, so I don't want to -- but I think that it is quite obvious that there is a substantial difference in the assets, the non-agency assets.

Stephen Laws (Analyst - Deutsche Bank):

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Okay, great. Thank you.

Operator:

Brock Vandervliet, Nomura Securities.

Brock Vandervliet (Analyst - Nomura Securities):

Just you noted earlier in the call some of the drivers for the decrease in the spreads, the higher swap costs or the additional swaps with higher repo costs, higher CPR. The CPR change though wasn't very significant at all and I just wonder what is driving that. Was it some of the spec pools creating some performance pressure as rates dropped or what was under the covers there?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Well again, it is not related in a sense to actual prepayments, it just relates to it. The changes in our CPR projections just relate to the change in interest rates and projecting out prepayments from there.

To your point, the difference was from 8.3 on average on the portfolio to 9, which isn't a big number. But given the cost basis of the portfolio with almost everything being at a premium that still translates to something on the order of I think maybe 3 to 5 basis points kind of in yield on the portfolio. I don't have the exact number.

But there is nothing particular about -- there is no underlying performance issues on the portfolio. As you can see, the prepayments remain very stable.

But the issue is the way that when you make prepayment projections, the way you have to calculate catch-up amortization and so forth does create -- when there is decent size changes in interest rates kind of creates these sort of nonrecurring catch-up amortization numbers, which is why we try to back them out to give you more clarity as to kind of the true underlying kind of moves.

Brock Vandervliet (Analyst - Nomura Securities):

Got it. Okay, thanks.

Operator:

Ken Bruce, Bank of America Merrill Lynch.

Ken Bruce (Analyst - BofA Merrill Lynch):

A couple of follow-up questions. In response to one of the prior questions about return potential, I think you elaborated on an investment in assets getting you a double-digit return. And you didn't really kind of get into the details of this, but how would you look at what a return on a buyback of AGNC stock would be?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Look, around share repurchases, look, obviously if we are looking at -- if we are at a meaningful discount to book then there is an advantage to repurchasing shares versus buying versus let's say kind of making other investments.

And as we have talked about at length, we don't disagree with buying back -- with the benefits from accretion of buying back our own shares and we have done that. On the other hand, there are obvious restrictions around when you can execute and so forth.

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And I think we have talked at length on the prior call about the structure that we have in place and kind of -- and I think the market should have some kind of feel at this point for kind of the thresholds where we have become more active.

Ken Bruce (Analyst - BofA Merrill Lynch):

Okay, well, I guess if you look at the discounts today they are pretty substantial and that math would certainly seem to hold up. What was achieved in the quarter from a buyback standpoint doesn't seem to really kind of broach any of the thresholds in terms of what you could be buying back. So I guess I have to maybe just kind of leave a question mark next to that in terms of exactly what you mean by being active in the stock over a period of time.

I guess maybe just kind of reflecting on a separate question or response to a question. You mentioned that we have to be reasonable about the sustainability of the discounts that are in the market today. And I would ask you to clarify what you meant by that. It was in Jim Young's question.

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Sure. I was differentiating kind of our view on price-to-book discounts in -- at the end of 2013 when the space had historically for a long time been at a premium. We obviously had a lot of stress in the market, again we were at highs in interest rates. There was a combination of tax loss selling and a real rotation in the investor base.

And our view back then was that the discounts and the magnitude of the discounts were likely to be much, much more temporary and they proved -- that proved to be the case. There was a pretty significant recovery in those discounts pretty quickly in 2014.

What we are saying right now is while we think the discounts are extreme, it is -- the REIT space isn't the only dividend kind of focused space that is under pressure at this point.

And there is -- let's face it, when the Fed is consistently running around saying we want to hike rates, we want to raise rates, that is the -- this is the type of environment where people have been conditioned to be defensive on the space.

So, I think what I was trying to refer to is the fact that we just have to be practical about that and the way we have seen the space trade has been sort of consistent with that.

Ken Bruce (Analyst - BofA Merrill Lynch):

I agree. And I guess maybe just two more questions if you could afford me those. What do you attribute the discounts in either this sector or other dividend sectors? How do you kind of think about that in terms of what is driving that discount relative to asset values, which are very clearly marked in today's marketplace?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Look, I think I attribute -- I don't think you need to in a sense get out your supercomputer to think of -- to try to get behind the market's thought process. I think it is really three letters, F-E-D, or the Fed.

And I think people have been conditioned to avoid or to be let's call it extremely conservative around dividend paying stocks or -- and in particular let's say the mortgage REIT backspace when they think the Fed is going to raise rates and rates are going to normalize by hundreds of basis points.

I think that that is a key driver behind the defensiveness of equity investors when they look at this space. And that is probably 95% of it.

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Ken Bruce (Analyst - BofA Merrill Lynch):

Okay, and my last question is, given everything that you said, why doesn't it make sense to sell assets and actually return capital to shareholders?

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

Look, what I would say is we are very comfortable executing those transactions. We have done them at times in the past and we will evaluate market conditions. Our assets are liquid, they can be sold. And again, we certainly consider moving lots of levers including leverage. And we have done that at multiple periods in our history.

Ken Bruce (Analyst - BofA Merrill Lynch):

Okay. Well, thank you for your candid answers. Appreciate it.

Operator:

Doug Harter, Credit Suisse.

Doug Harter (Analyst - Credit Suisse):

Thanks, Gary. I was wondering if you guys have been exploring a direct repo or any alternatives to the current repo market in addition to the FHLB.

Peter Federico (SVP & CRO also SVP & CRO American Capital AGNC Management LLC):

Hi, this is Peter. Yes direct repo is something that we have explored and we are confident that ultimately we think that that is going to happen in the marketplace, although (technical difficulty) to be a little more difficult and probably more time-consuming than we had hoped because we are obviously an unrated counterparty.

So direct counterparties have some hurdles to get over and ultimately understand the product. But we do believe that is going to happen in the money fund area and in other -- with other counterparties. I think it will just evolve over the course of time and certainly it is something that we think is going to happen over the next one to two years in a significant way.

Doug Harter (Analyst - Credit Suisse):

Great, thank you.

Operator:

We have now completed the question-and-answer session. I would like to turn the call back over to Gary Kain for concluding remarks.

Gary Kain (President & CIO also President American Capital AGNC Management LLC):

I want to thank everyone for your interest in AGNC and we will speak to you again next quarter.

Operator:

The conference has now concluded.

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