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AI - Q3 2019 Arlington Asset Investment Corp Earnings Call

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Jason Stewart

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PRESENTATION

Operator

Good morning. I'd like to welcome everyone to the Arlington Asset Third Quarter 2019 Earnings Call. (Operator Instructions) .

I would now like to turn the conference over to Richard Konzmann. Mr. Konzmann, you may begin.

Richard E. Konzmann - *Arlington Asset Investment Corp. - Executive VP, Treasurer & CFO*

Thank you very much, and good morning. Rich Konzmann, Chief Financial Officer of Arlington Asset.

Before we begin this morning's call, I would like to remind everyone that statements concerning future financial or business performance, market conditions, business strategies or expectations and any other guidance on present or future periods constitute forward-looking statements that are subject to a number of factors, risks and uncertainties that might cause actual results to differ materially from stated expectations or current circumstances. These forward-looking statements are based on management's beliefs, assumptions and expectations, which are subject to change, risk and uncertainty as a result of possible events or factors. These and other material risks are described in the company's annual report on Form 10-K and other documents filed by the company with the SEC from time to time, which are available from the company and from the SEC, and you should read and understand these risks when evaluating any forward-looking statements.

I would now like to turn the call over to Rock Tonkel for his remarks.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Thank you, Rich. Good morning, and welcome to the Third Quarter 2019 Earnings Call for Arlington Asset. Also joining me on the call today is Brian Bowers, our Chief Investment Officer.

During the third quarter, the continuation of a weakening global economic outlook, ongoing trade tensions and declining inflation expectations, led the Federal Reserve to lower its target Fed funds rate twice during the quarter, and once again, at the end of October. Despite these actions by the Fed, the yield curve continued to flatten during the quarter.

The 2- to 10-year treasury curve declined by 22 basis points to 4 basis points as of quarter end, as the weakening economic outlook drove long-term interest rates meaningfully lower, leading to heightened interest rate volatility. Intra-quarter, the 10-year treasury rates fell 55 basis points to 146 basis points in early September before retracing some that rally to close at 1.66% as of September 30, a decline of 35 basis points during the quarter. Prepayment speeds on mortgages increased significantly during the quarter in response to the strong rally in interest rates through the course of the year as well as normal seasonal patterns.

In mid-September, a much publicized market dislocation in the refill funding markets, led to a substantial spike in overnight government repo rates. The Fed responded by adding substantial liquidity to stabilize repo funding markets through its open repo market operations and announcing its intentions to expand its balance sheet, a very positive step for funding in our business.

High prepayment at speed expectations, heightened interest rate volatility and a flat interest rate curve, led to an increase in risk premium in mortgages resulting in agency MBS, underperforming interest rate hedges during the third quarter. While the company shift in investment concentration towards lower coupon and specified agency securities mitigated the impact of the company's results for the quarter, both higher coupon and generic TBA agency securities underperformed lower coupon and specified agency MBS, with favorable prepayment characteristics during the quarter.

Since September 30, Agency MBS performance relative to interest rate hedges has been flat to modestly improved. The continued flattening of the interest rate curve, elevated prepayment speeds and higher repo funding rates relative to LIBOR had the effect of compressing net interest spread returns on levered agency MBS during the quarter. However, while these pressures continue to weigh on portfolio returns since September 30, funding conditions have eased and return opportunities on new investments have improved as yield curve has steepened, repo funding rates have declined materially and agency MBS spread widening during the third quarter is captured on new investments.

Turning to our actual results for the quarter. We reported a GAAP net loss of $0.23 per share and core operating income of $0.18 per share. As of September 30, book value was $7.35 per share, reflecting the modest widening of Agency MBS spreads relative to benchmark interest rates.

Short-term recourse leverage, measured as the company's repo financing and TBA commitments less cash to total investable capital, was 9.9x as of September 30. The decline in core operating income from the second quarter was due primarily to lower average leverage and lower average asset yields, partially offset by more favorable net funding costs.

The company's average leverage during the third quarter was 10.1x, a decrease of over 1.5 turns from the prior quarter. The weighted average CPR for our specified agency MBS was 12.85% during the third quarter, an increase from 10.16% during the prior quarter. As a result of these higher prepayment speeds as well as the shift to lower coupon agency securities, the weighted average effective asset yield on our Agency MBS portfolio was 2.96% for the quarter, a decline from 3.21% in the prior quarter.

The company's weighted average CPR for October and November was 13.46%, which we expect could result in a weighted average effective yield of approximately 2.78% for that period. Given current interest rate levels, we expect continued elevated prepayment speeds, but our transition to additional lower coupon specified pool securities with lower premiums should moderate increases in prepayment speeds going forward.

The company's continued shift towards lower coupon securities that carry lower premiums and prepayment risk, increase the company's agency MBS concentration in lower coupon, 2.5%, 3% and 3.5% MBS to 57% of its total investment portfolio at September 30, an increase from 27% as of the prior quarter end. The company also increased its portfolio of concentration of specified agency MBS, with low prepayment characteristics during the third quarter, while significantly decreasing its exposure to generic agency TVA that carry higher prepayment risk. As of quarter end, 98% of the company's agency MBS portfolio is comprised of specified agency MBS compared to 86% as of the prior quarter end.

While repo rates were lower during the third quarter, reducing interest expense on unhedged repo, repo rates relative to LIBOR remains somewhat elevated and above the receive rate on the company's interest rate swaps, offsetting the repo interest benefit in that period. During the third quarter, the company's weighted average repo rate was 2.46%, an improvement from 2.64% in the prior quarter. However, as a result of the Fed's actions to both lower the federal funds rate by 75 basis points since the start of the third quarter and to provide substantial liquidity to the repo markets, current repo funding rates and conditions have improved materially. Today, 1 month repo funding rates have improved to approximately 185 basis points versus the average rate on our repo balance at September 30, up 235 basis points.

As a reminder, the company enters into interest rate swaps for which it paid the fixed rate and receives a variable rate based on 3-month LIBOR in order to lock in its funding cost for a portion of its repo funding for the length of the swap. From late in second quarter through the third quarter, the interest rate swap market priced in expectations for multiple federal reserve cuts, leading to a significant inversion in the short end of the interest rate swap curve versus repo funding costs. The company took advantage of this opportunity by increasing its short-term rate swap positions by approximately $1.1 billion during that period to effectively lock in much of the market's previously anticipated Federal Reserve cuts into its net funding costs. As of September 30, 81% of the company's repo funding was hedged with interest rate swaps. And as a result, the company's weighted average fixed pay rate of its interest rate swaps was 1.82% during the third quarter, a decrease from 2.1% during the prior quarter.

While spread pressures for Agency MBS do remain, the outlook for return opportunities on new investments today has improved for several reasons. First, the Fed's 3 rate cuts since the start of the third quarter of lower current funding costs appreciably. Second, the Fed's recent actions to stabilize the repo markets have improved repo rates relative to LIBOR, benefiting net funding costs for Agency MBS. Third, the widening of 1 month to 3-month LIBOR since quarter end also benefits net hedged funding costs. Fourth, the yield curve has steepened, with a 2- to 10-year treasury widening over 20 basis points since September 30. And fifth, the mortgage prepayment speed expectations have begun to moderate.

In summary, the company is positioned to benefit from improvements in current net spread opportunities in Agency MBS, which should allow the company to deliver attractive returns to its shareholders.

Operator, I would now like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Now comes from Jason Stewart with Jones Trading.

Jason Stewart

On the leverage on the -- in the quarter. I mean net settlements, it looked like, took leverage down on average through the quarter. But at period end, we're sort of heading into this environment where you've listed a lot of positives. Leverage is already up. I guess my question is are you comfortable with where it should average out during the fourth quarter based on September 30? Or is there more opportunity to increase leverage based on your view of the investment environment.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

I think, Jason, there's certainly the potential to increase leverage some. I'm not sure I would suggest people expect that. I think we may -- I think it's just as likely that we remain about where we are or about where we sort of were at the beginning of the quarter, which was somewhat increased from the third quarter -- excuse me, from the second quarter, but roughly in line with the third quarter end. And with the potential, as spread opportunities improve, that we may increase that at the margin. And I would say -- I would emphasize at the margin. We've been clear over time that we expected that no one should be surprised if, over time, leverage came down. I think that's been the case. I think we're comfortable approximately where we are. But we do have a flexibility to move up a little bit if we deem it best given spread opportunities.

Jason Stewart

Understood. Understood. And then on the repo funding, we typically see some pressure going into year-end as dealers deal with inventories. This year is a little bit different. I think your average repo was a little less than 30 days. Have you started taking anything over year-end? In your comments, it sounded very positive that the markets were functioning well. I'm just wondering if you've executed over year-end in seeing any prints in that market over that date?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

There is, year-end, over year-end repo available. I wouldn't say it's a massively thick market. From what we can tell right now, we have started that process. We expect to increase that process over the course of the month and the quarter. So we've gotten underway. But it's not yet clear how deep that market is through year-end. And I think the potential for some pressure over quarter end still does exist. I think the overall repo market is far healthier than it was. But there are still -- there's still the potential for pressures around year-end. We are working on alleviating that ahead of time as best we can, and we've begun that process.

Jason Stewart

Right. And that's really normal. But it's fair to say that you didn't see much impact from the hiccup, and you're not necessarily expecting to see much impact outside of normal seasonality going into the fourth quarter. Is that fair?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Yes. That's fair. And I would say this. We've been pleasantly surprised by the over year-end levels that we have seen so far.

Operator

Our next question comes from Mikhail Goberman with JMP Securities.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Mikhail? Okay. If you've got a question, Mikhail, and you can hear us, you can feel free to call us off-line.

Operator

We'll take our next question from Christopher Nolan with Ladenburg Solman.

Christopher Whitbread Patrick Nolan - *Ladenburg Thalmann & Co. Inc., Research Division - EVP of Equity Research*

Rock, given the migration to mid-coupon RMBS, is the guidance that you gave last quarter for low double-digit, high single-digit returns on book value still hold? Or is there a change on that?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Well, there's a lot of variables in that, as you well know, forward curve, how fed funds and repo spreads play out, those are important. And I think the prior question-and-answer sort of responded to part of that equation. Speeds are a relevant portion of that. Speeds continue to be elevated, and we'll see how that progresses over the course of the fall -- the rest of the fall, pardon me. And when the seasonal patterns start to kick in, there may still be a bit of pent-up refinancing that flow through the system in the next month or so. And then maybe after that, we start to see the seasonal effects come into play and help out on the yield side, with somewhat reduced prepayments at that stage.

I think, overall, that arena for ROE returns is probably fair. I think, today, at the margin, they would probably be -- and based on these conditions, at the higher end of that range for new investments. But we've also seen that return opportunities have moved around over the course of the last few months as the market has adjusted the new Fed policy. Today, they are, in fact, at the higher end of that range. And those are the -- based on the key points that we pointed out in our script.

Operator

(Operator Instructions) Our next question comes from Mikhail Goberman with JMP Securities.

Mikhail Goberman - *JMP Securities LLC, Research Division - VP & Research Analyst*

Gentlemen, can you hear me?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Yes. We can.

Mikhail Goberman - *JMP Securities LLC, Research Division - VP & Research Analyst*

Excellent. Sorry about that. Not sure what happened there. Could you potentially give an update on book value performance in the fourth quarter so far, what you're seeing?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

I think it tracks what I said in the script, mortgage performance through the -- maybe the middle part or maybe a little later part of October was weaker and since that time, has been considerably stronger to the point that I'd say, overall, since September 30, performance is flat to modestly improve.

Mikhail Goberman - *JMP Securities LLC, Research Division - VP & Research Analyst*

Great. And maybe some thoughts on what you're seeing in TBA versus spec pools today?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Well, today, we would still favor spec fulls. The prepayment risk in the TBA side continues to be somewhat challenging. And returns are [embodied] through the coupon stack, shall we say. Some are negative, and some are slightly positive but the -- but carry pretty meaningful prepayment risk from the universe, the broader universe. So we would still continue to favor effect pools here for the prepayment protection.

Mikhail Goberman - *JMP Securities LLC, Research Division - VP & Research Analyst*

Right. And I apologize if you had covered this before. My line cut out for a minute or 2 earlier, but what is your outlook for prepay speeds in the fourth quarter? A lot of your -- a bunch of your peers have sort of mentioned that October was pretty high. November could be pretty high as well, but you expect kind of a huge seasonal drop in December. But as a whole, what do you expect for the fourth quarter?

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

I sort of hit on that with my prior response. I think our best judgment around it would be that, first of all, the October and November speeds, meaning September and October that were reported in early October, November, we're about the same. They're about relatively flat, and we alluded to that in the script at about 13 -- a little under 13.5% for us. And we wouldn't be surprised if those elevated speeds continued for a bit later into the year this year than maybe in some others as a consequence of the pipeline of financing activity, mortgage financing activity, that's built up in the system. So there might be still some of that volume to come through from the lower rate environment over the next month or maybe two, but we would expect after that to see the seasonal effect take place and late in the year, those speeds to come down seasonally and through the first quarter. All of that would depend on rate levels, of course. So rate levels lower probably equates to higher speeds and the rate levels higher probably equates at somewhat lower speeds. But I think from a calendar perspective, we would see elevated speeds through the fourth quarter and then moderating late in the fourth quarter and into the first.

Operator

Mr. Tonkel, there are no more questions at this time.

J. Rock Tonkel - *Arlington Asset Investment Corp. - President, CEO & Director*

Okay. Well, thank you very much, everyone. We appreciate your time. If you have any further thoughts or questions, please share them off-line. Thank you.

Operator

Thank you, ladies and gentlemen. This concludes today's teleconference. You may now disconnect.

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