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TWO - Q3 2016 Two Harbors Investment Corp Earnings Call

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CORPORATE PARTICIPANTS

Tim Perrott *Two Harbors Investment Corp - Senior Director of IR*

Tom Siering *Two Harbors Investment Corp - President & CEO*

Brad Farrell *Two Harbors Investment Corp - CFO*

Bill Roth *Two Harbors Investment Corp - CIO*

CONFERENCE CALL PARTICIPANTS

Bose George *Keefe, Bruyette & Woods, Inc. - Analyst*

Doug Harter *Credit Suisse - Analyst*

Mark DeVries *Barclays Capital - Analyst*

Trevor Cranston *JMP Securities - Analyst*

Joel Houck *Wells Fargo Securities, LLC - Analyst*

Jessica Levi Ribner *FBR Capital Markets & Co. - Analyst*

PRESENTATION

Operator

My name is Bridgette and I'll be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors' third-quarter 2016 financial results conference call.

(Operator Instructions)

I would now like to turn the call over to Tim Perrott, Senior Director of Investor Relations for Two Harbors.

Tim Perrott - *Two Harbors Investment Corp - Senior Director of IR*

Thank you, Bridgette. Good morning to everyone. Thank you for joining our call to discuss Two Harbors' third-quarter 2016 financial results. With me on the call this morning are: Tom Siering, our President and CEO; Brad Farrell, our CFO; and Bill Roth, our CIO. After my introductory comments, Tom will provide a brief recap of our quarterly results and an overview of our strategy. Brad will highlight key items from our financials. Bill will review our portfolio performance.

The press release and financial tables associated with today's call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website or on the SEC's website at sec.gov. In our earnings release and slides, which are now posted in the Investor Relations section of our website, we have provided a reconciliation of GAAP to non-GAAP financial measures. We urge you to review this information in conjunction with today's call.

I would also like to mention that this call is being webcast and may be accessed on our website in the same location. Before I turn the call over to Tom, I would like to remind you that remarks made by management during this call and the supporting slides may include forward-looking statements. Forward-looking statements reflect our views regarding future events and are typically associated with the words such as anticipate, expect, estimate and believe or other similar words.

We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties and the actual results may differ materially from expectations. We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on the SEC's website

at sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate. I will now turn the call over to Tom.

Tom Siering - *Two Harbors Investment Corp - President & CEO*

Thank you, Tim. Good morning, everyone. We hope that you had a chance to review our earnings press release that we issued last night. As you can see, we delivered strong results in the quarter and made significant progress on our strategic initiatives. We drove solid increases in book value, core earnings, and comprehensive income.

Our success this quarter is reflective of our team's disciplined approach to risk management and smart portfolio choices, both of which are key aspects of our value proposition to our shareholders. In support of our strategy, we also made progress on several of our initiatives focused on streamlining the business model, redeploying capital to maximize returns, and improving efficiencies. All these efforts place us in an excellent position as we head toward the end of the year and into 2017.

Looking at the highlights of our financial results as reflected on slide 3, we delivered a total return on book value of 4.2% and comprehensive income of $136.5 million or $0.39 per share. GAAP net income was $0.34 per weighted average share and core earnings were $0.24 per weighted average share. Our rates, credit, and commercial strategies all contributed to our performance, as Bill and Brad will detail for you later.

I would like to spend a few moments discussing our strategic mindset and current areas of focus. This is shown on page 4. Simply put, we employ a flexible model that allows us to allocate capital in a manner to maximize shareholder returns over the long-term. The most important component of our approach is the way we manage risk. We focus on generating high returns leading to strong dividends while keeping a conservative risk profile and protecting investor's capital.

In fact, despite all the recent discussions regarding a potentially higher interest rate environment, we are largely insulated to changes in rates not only in terms of book value but also in terms of income and earnings. Bill will provide more on this later in the call. This aspect of our approach is the primary reason we have outperformed our peer group by over 40% in total shareholder return over the past seven years since we became a public company and doing so with less volatility to book value. We are finishing the year strong.

We have even more opportunity to increase our earnings power going forward as we head in to 2017. In support of our strategy, we are focused on the following. Firstly, we will continue to thoughtfully manage our agency portfolio and build our MSR position by adding high quality new issue conventional MSR at low coupon rates. As we stated before, we view MSR and agency RMBS as paired assets generating better returns with lower overall risk. High quality MSR exhibits negative duration and positive yield and is a natural hedge to mortgage basis and interest rate risk.

Secondly, we will continue to capitalize on the fundamental and technical factors that support our non-agency position. We've seen an uplift in recovery expectations and believe that this is sustainable for the foreseeable future with potential upside. Interest rates remain low, economic performance is strong and housing prices continue to appreciate. Each PA and the age of our portfolio in respect to principal payments give upside to pre-payment speeds. Therefore, we positioned the portfolio to benefit from these tailwinds.

Thirdly, we'll continue to increase capital allocated to our commercial strategy and grow our portfolio of high quality loans with attractive rates and structures. The fundamentals underling the commercial real estate market remain positive, providing attractive return opportunities, particularly for non-traditional lenders, who can provide capital that is harder for bank and CMBS lenders to provide, given changes in the regulatory environment for them.

We'll continue to be very selective in our investments and pursue opportunities that are diversified across both geographies and property types. Fourth and finally, we'll continue to streamline and simplify our business model with the goal of driving efficiencies and redeploying capital to maximize returns.

We've made significant progress in this area and expect to reap the benefits beginning in 2017. For example, during the quarter, we sold substantially all of our Ginnie Mae MSR position, which enhances operational efficiencies and allows us to focus on acquiring conventional new issue MSR. Also,

we remain on track to wind down our mortgage loan conduit business by the end of the year. As we outlined on our second quarter earnings call, this reduces our operating complexity and costs and positions us to redeploy capital to areas of our business that we believe will generate stronger returns for shareholders.

We estimate the combination of cost savings and incremental investment income from this decision alone will be about $20 million next year. Overall, our strong results this quarter are reflective of solid execution of our plans. Not only are we excited about what we delivered in the quarter, we're even more encouraged about the momentum we are building for 2017. I will now turn it over to Brad to discuss our financial results.

Brad Farrell - *Two Harbors Investment Corp - CFO*

Thank you, Tom. Let's turn to slide 5. Our book value at September 30 was $10.01 per share, which represents an increase from June 30 book value of $9.83 per share. Comprehensive income increased to $136.5 million this quarter, driven by higher leverage and strong underlying yields across our RMBS and commercial loan portfolios and favorable valuation gains in our non-agency RMBS. Bill will expand upon this overall portfolio performance in a moment.

Please turn to slide 6. Core earnings were $0.24 per share in the third quarter, representing a $0.02 per share increase over the prior quarter. Core earnings principally benefited from higher overall leverage in the portfolio and lower expenses. Our average debt to equity increase from 3.6 times to 4.1 times quarter-over-quarter as we continue to find investment opportunities in agency RMBS, MSR, and CRE.

Offsetting our net interest income growth, we realized higher MSR amortization, consistent with our expectations in an increased prepayment speed environment. I would also note that our other operating expenses were $14.8 million compared to $17.6 million in the second quarter of this year. This nominal decrease of $2.8 million and the correlated drop in expense ratio from 2.1% to 1.7% was driven by lower amortization of restricted stock awards quarter-over-quarter and some early reduction in compensation charges due to GAAP accounting for the restructuring.

The other operating expenses do not include $1.2 million of recognized restructuring costs included in the financials. Consistent with our prior-quarter earnings discussion, the full effects of the discontinuation of the mortgage loan conduit and other expense efficiencies across our business will not be fully realized until 2017. With that in mind, we continue to anticipate our expense ratio in 2017 to stabilize in the 1.6% to 1.8% range, as we support our investment opportunities including our remaining operational businesses of MSR and CRE.

Please turn to slide 7. We continue to maintain flexibility across our financing profile with a diversified counter-party mix and lengthy maturity profile. The repo markets continue to function efficiently for us. We had $10.6 billion of outstanding repurchase agreements at September 30, up from $9.7 billion at June 30, due to purchases of agency RMBS. Consistent with our historical practice, we have rolled the majority of our repo maturities out past year end to avoid potential strain around that time.

This approach, combined with our longer dated FHLB advances, allows us to be well positioned heading into year end. A highlight of the third quarter was the addition of financing for mortgage servicing rights. You will note we added a line item on our balance sheet captioned revolving credit facilities. This $30 million facility represents our initial step forward on obtaining financing on our MSR portfolio. Initial terms are favorable with advance rates of approximately 60% and a spread of 375 basis points off LIBOR.

We anticipate expanding upon this source of financing in the future as we work with other counter-parties and the GSEs. Our FHLB advances totaled $4 billion September 30 with a weighted average borrowing rate of 67 basis points. In addition, we have two facilities in place for financing commercial real estate and have continued to expand usage of these in the third quarter. We've provided some additional details on our borrowings on appendix slide 25. I will now turn the call over to Bill for a portfolio update.

Bill Roth - *Two Harbors Investment Corp - CIO*

Thank you, Brad. Market conditions were favorable for our strategy during the third quarter, which helped drive both strong core earnings and an increase in book value. Looking at slide 8, you will see that our portfolio allocation was relatively stable quarter-over-quarter. We continued to

increase our capital commitment to the commercial strategy and expect that credit capital allocation will decrease slightly going forward as we wind down the mortgage loan conduit. As of September 30, our portfolio was $17 billion with 54% of capital allocated to rate, 31% to credit, and 15% to commercial.

Moving to slide 9, let's cover a few of the drivers of our portfolio performance. During the quarter, rates drifted higher and both agency and mortgage credit spreads tightened, positively benefiting both our rates and credit strategy. Consistent with expectations, the rates yield which includes MSR, was modestly lower as prepay speeds increased in the quarter. Relatively low rates and seasonal factors contributed to faster speeds during the summer, although we do expect prepays to begin to slow as we move through the fourth quarter.

Residential credit performed well also and our legacy non-agency holdings delivered an attractive 9.1% yield. This higher realized yield was due to strong underlying credit performance and an increase in prepayments as well as from the continued release of credit reserves over the past few years. Consistent with last quarter, our commercial real estate lending strategy, which is comprised predominantly of first lien commercial loans delivered a strong yield of 6.2%.

Please turn to slide 10 to discuss our rates positioning and activity in the third quarter. Consistent with our philosophy of sustaining an overall conservative risk profile, we have maintained a very low exposure to interest rate. We are focused not only on preserving book value in changing interest rate environment, but also on our income generating ability.

For example, as you will see in our 10-Q, which will be filed later today, in an immediate interest rate shock scenario of rates up 100 basis points, our book value would move only about 3.5% lower. More importantly in this scenario, we expect that our income would be relatively unchanged due to our hedge positioning and from MSR realizing a higher yield from slower prepayments and additional float income.

To summarize, we believe that rising rates will have a de minimus effect on our earnings generating capabilities or book value. In that light, it is worth noting that with the recent rise in interest rates over the past few weeks, our book value is relatively unchanged from quarter end. With respect to activity during the quarter, we continue to improve our prepayment characteristics on agency RMBS. As of September 30, approximately 65% of our agency holdings have some form of prepayment protection.

In servicing, we added approximately $10.6 billion UPB of new issue conventional MSR largely from flow sale arrangements during the quarter. This brings our total portfolio to $55.1 billion. We also sold substantially all of our Ginnie Mae position, as it was not the best fit with our overall strategy of focusing on new issue, high quality, conventional MSR, which pairs better with our agency holding. Looking forward, we anticipate near-term flow sale MSR volumes of around $3 billion per month.

Let's move to our credit strategy highlighted on slide 11. We are very pleased with the performance of our legacy non-agency portfolio and are seeing strong tailwinds for residential credit going forward. Our portfolio is positioned to benefit from these fundamental trends, which we have started to see reflected in the strong yield this quarter. Given that performance continues to be better than our initial expectations, we have again this quarter been able to release credit reserves against this portfolio.

As a result, we anticipate maintaining strong yields for our legacy non-agency and, with an average market price of about $75, we believe that there continues to be future upside. With respect to the discontinuation of the mortgage loan conduit, we completed Agate Bay 2016-3 in August. We are in a good position to redeploy the conduit capital to strategies with higher expected returns, particularly MSR combined with agency pools and CRE as we're seeing good opportunities in both areas.

Please turn to slide 12 to discuss our CRE strategy. We grew our portfolio to $1.1 billion in the third quarter as we added four senior loans. As of September 30, these assets had an averaged stabilized LTV of 65.1% and an average spread over LIBOR of 482 basis points. It's an excellent time to be a CRE lender due to attractive returns and strong fundamental. We are excited about continuing to grow this opportunity.

We are very pleased to have delivered such a strong third quarter on both an earnings and book value basis. We're enthusiastic about our portfolio and the investment opportunities in front of us and believe we are well positioned to drive shareholder value for the balance of the year and into 2017. I will now turn the call back over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Bose George, KBW.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Good morning. The first question is just on the agency MSR side, can you remind us how many partners you work with there for the flow business? Also on the bulk side, do you see any value? Or is that an unlikely place for you to participate?

Bill Roth - *Two Harbors Investment Corp - CIO*

Bose, good morning. Thanks for joining us. We have roughly mid teens number of flow sale partners that we work with. The thing we like about the flow sale is typically we're able to get that a little bit cheaper than the bulk. Now that being said, we don't mind looking -- well, we look at a lot of bulk opportunities. We do bid on some and occasionally, we'll win some. But it would have to be consistent with the value we see in the flow sale arrangements. The other thing I was just going to add, from a capital allocation standpoint, it works really well because we do about $3 billion a month. It's a nice way to deploy capital on a steady basis.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. That makes sense. Then actually switching to the Ginnie Mae, the decision to exit that. Is that purely just the better match on the portfolio hits that you mentioned? Or are there any sort of regulatory reasons where it's easier not to be in that market?

Bill Roth - *Two Harbors Investment Corp - CIO*

Not really on the regulatory side. Frankly, the new issue conventional is very high quality. The coupon rates that we're getting there are quite low in a historical sense, somewhere around 3.7%. It's actually a really good -- that really pairs much better with the agency pool. Ginnie Mae was a fairly small part of the portfolio. It had gotten relatively seasoned. It was not as good as a hedge from that standpoint.

Tom Siering - *Two Harbors Investment Corp - President & CEO*

Bose, it's Tom, good morning. Also there's some operational complexity to Ginnie Mae but it's not perhaps a conventional MSR. As we think about streamlining our business, small wins like that are meaningful.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, thanks. That makes sense. Just one more on the MSR. The mark that you took, the $33.5 million, can you just explain that with some of it towards just a normal averages -- reduction to value of the asset?

Brad Farrell - *Two Harbors Investment Corp - CFO*

Yes, I think it's going to be a combination of -- the biggest driver is going to be your runoff. Prepayment behaviors were higher coming off the summer months. There was some element of a small amount of market move combined with the Ginnie Mae sale, but the runoff because of prepayment behaviors was definitely the biggest driver of that.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. Great. Thanks.

Operator

Doug Harter, Credit Suisse.

Doug Harter - *Credit Suisse - Analyst*

Thanks. Good morning. Wondering how much of the capital the last Agate Bay deal freed up from the conduit? How much is still to be freed up?

Bill Roth - *Two Harbors Investment Corp - CIO*

Hey, Doug. Good morning. Yes, so the last Agate Bay deal, the amount of capital to that was relatively small. If you think about it, it was $360 million or so securitization and typically the amount of capital to any one securitization sort of in that 2% to 4% range. So really fairly small. Just to give you sort of an update on that, we're on target with our plan to have the conduit wind down substantially complete by the end of the year. We're in the process of redeploying the capital currently. That will probably continue in to the first quarter. So we're right on track with the plans that we discussed in our last call.

Doug Harter - *Credit Suisse - Analyst*

I guess along the lines of redeploying the capital, as we look forward over the next -- the coming quarters, given the MSR flow and the attractiveness of CRE, how much of that capital comes from the conduit versus incremental leverage versus kind of needing to reduce either the agency or non-agency MBS portfolios?

Bill Roth - *Two Harbors Investment Corp - CIO*

Yes, so if you think back to what we talked about before, we said somewhere around $150 million, $175 million of capital in the conduit. So CRE, if you look at slide 8, that's been going up about 2% per quarter. MSR is a little bit less than 1% a month, so let's call that 2% a quarter. So combined is about 4%. So you should expect to see the credit strategy which was 31%. That will probably go down to the mid 20s or so. You can probably see the rate strategy of the agency part of that will probably come down slightly.

Doug Harter - *Credit Suisse - Analyst*

Got it. Thank you, Bill.

Bill Roth - *Two Harbors Investment Corp - CIO*

Thanks, Doug.

Operator

Mark DeVries, Barclays.

Mark DeVries - *Barclays Capital - Analyst*

First, I just wanted to clarify the guidance around the savings from the exit of the conduit business. Is that $20 million, first of all, that's intended to be a full net benefit, so expenses plus the benefit from redeploying capital?

Tom Siering - *Two Harbors Investment Corp - President & CEO*

Good morning, Mark, it's Tom. Yes, that's correct.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Are you still ramping to that as you enter 2017? Or is $5 million a quarter kind of a good way to think about the benefit?

Tom Siering - *Two Harbors Investment Corp - President & CEO*

Well, it will depend upon a few things including capital redeployment. So we think that's good guidance for 2017, but there can be some quarterly vagaries in that depending upon primarily the capital redeployment.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it. Next on your CRE business, are you seeing any benefit yet from banks pulling back from the market as a result of some of the comments from the Fed around CRE concentrations?

Bill Roth - *Two Harbors Investment Corp - CIO*

Mark, it's Bill. Yes, we've kind of -- we haven't discussed that explicitly in the last few quarters. But clearly that is a trend that we've seen. Probably the biggest evidence of that is the fact that if you look at the loans that we're making today, I've talked about this before, we're getting higher spreads for the same LTV or similar spreads for lower LTV than we saw, say, same time last year.

So that's directly a result of a combination of the fact that there's a lot of activity going on as well as the fact that the CMBS market has a smaller footprint and the banks have a smaller footprint. So it's actually a combination of things. We think it's a great time to be a lender in the space, given the credit quality that we can write and the spreads that we're able to get.

Tom Siering - *Two Harbors Investment Corp - President & CEO*

One thing I would add to that, Mark, there's a misconception around these regulatory changes that are affecting the banks. People think this is a commentary or a recent commentary by the regulators on the state of the market. In fact, these changes were enacted years ago and are just now coming in to place. So I think there's some confusion in the market around that and something that we've tried to disabuse people of. In other words, this has been years in the making and these changes are just kicking in now.

Mark DeVries - *Barclays Capital - Analyst*

Got it. Then just one last question on your credit strategies. Where are you seeing the most attractive return opportunities? Are you looking at any kind of new investments in that area?

Bill Roth - *Two Harbors Investment Corp - CIO*

So on the credit strategy, I think probably the most exciting thing from the way we see it, if you look at the yield that you've got this quarter -- this is on slide 9 -- was 9.1%, which was up 80 basis points. The thing about that and we've talked about the tailwinds supporting the credit strategy for, I don't know, a long time. But basically, the continued good performance, higher prepays, and the release of credit reserves have driven that increase in the yield. Furthermore, we think that those yields -- that yield should be fairly consistent on a go-forward basis.

I spoke last quarter that the average life of our holdings is somewhere in that seven to eight-year range, so we're very bullish on that part of our strategy on the credit side. Now, in terms of new opportunities going forward, the other thing I would say is that we are still finding some opportunities in the residential space. Although certainly not what we saw years ago.

So I'd say that, in terms of going forward, that's really what we're most excited about. I'd like to make one last point on that. The other thing that's interesting about that credit strategy is predominantly all of the bonds are floating rate. So that's one of the contributors, I mentioned on the call, about our income generating capability in a higher rate environment. That's one of the things that contributes to that as well as some of the other things like CRE and our swap position, et cetera.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Got it. Thank you.

Bill Roth - *Two Harbors Investment Corp - CIO*

Thanks, Mark.

Operator

Trevor Cranston, JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

Thanks, good morning. Question on the MSR portfolio. As that's expected to continue to grow in to next year, can you talk about how you guys think about the size of that portfolio relative to the current size of the agency book? Also how you think about kind of the optimal mix in terms of balancing the MSR versus the swap book as a hedge? Thanks.

Bill Roth - *Two Harbors Investment Corp - CIO*

Trevor, good morning. I guess I'd say a couple things, we're at a obviously at a very low rate environment and have been. The MSR we're getting every month is -- are very low coupons, which we would expect to be around for a long time and would obviously be a great benefit to us in a higher rate environment, not only from an increase in value but just slower prepays are going to drive higher income. So we're very excited that we're ramping this at roughly $3 billion a month of notional.

Now, in terms of sizing, we talked over time about how this could be 20% of our portfolio fairly easily. We're not really that close to that as you can tell by the market value of the MSR is still sub $500 million and 20% would put you up around $700 million or more. We feel like we have a very good runway there. In terms of sizing, it's really -- we've talked before about approximate hedge ratio of 5 or 6 to 1 for new issue in terms of that. So we still have quite a bit of runway in terms of adding MSR vis-a-vis our agency holdings.

Trevor Cranston - *JMP Securities - Analyst*

Got it. Okay, that's helpful. Then one more question on the agency portfolio. Some of your peer companies have talked a bit this quarter about having found attractive value in the TBA dollar roll market. Can you guys comment on how you're seeing the relative value between spec pools and TBA's currently?

Bill Roth - *Two Harbors Investment Corp - CIO*

Sure. The [Fannie's three-roll] has been special for a number of months. Certainly that's something -- it's not massively special, it's a little bit special. What we do is we look at our positioning in TBA's versus specified pools in terms of how special is the roll? How long do we think it will exist? Then alternatively, how much do you have to pay for prepayment protection? As a result of the specialness of the roll, prepayment protective stories have been trading fairly cheap.

So really it's a trade-off of how long you think something is going to be around versus getting prepayment protection that will obviously be around for the life of the security. That's not typically been a huge area of focus for us relative to the MSR and pools together, which we think drives sort of a low to mid double-digits gross ROE, CRE in that same bucket. So really, we're mostly focused on really driving that as opposed to tactically trading specified rolls.

Trevor Cranston - *JMP Securities - Analyst*

Okay. Got it. Thank you.

Bill Roth - *Two Harbors Investment Corp - CIO*

Thanks, Trevor.

Operator

Joel Houck, Wells Fargo.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Thank you and good morning. If you look at the results in 2016, they're very strong and consistent with what we've seen out of others. In spreads volatility -- or I should say interest rate volatility has been well behaved particularly in the latter half of the year. Credit spreads have generally narrowed with the exception of the early part of the year and around Brexit.

So, if you're looking out into 2017, can you maybe talk about pros and cons or maybe kind of handicap spread volatility remaining low and credit spreads either remaining tight or getting tighter? How you think about those two dynamics? Obviously, you have a fairly large exposure in the rates and credit strategy. I think that would be kind of helpful to hear your thoughts on that.

Bill Roth - *Two Harbors Investment Corp - CIO*

Yes, sure. Thanks for joining us, Joel. Look, there's two parts to that question, so let me just attack each of them. First of all on the interest rates, I think it's really important that -- to reiterate what we said on the call, our interest rate exposure is extraordinarily low, not only from a book value standpoint, but also from income standpoint. We believe that as the Fed raises rates, our income will be unchanged or relatively unchanged. In a higher rate environment, we're going to -- as I said just a few minutes ago, we're going to benefit from the floating rate side of non-agencies, commercial real estate and swaps.

We're going to get positive benefits from MSR, slower prepays, as well as additional float income. So, from a rate standpoint as we look into 2017, we're very comfortable with our earnings power generating capabilities as rates move higher. Now, the second part of your question was related to spreads. I would say that, look, we like any asset manager that focuses on anything that's not a treasury, if you will, are subject to changes in spread.

The most important thing I think I would point out is that MSR is a mitigant against spread widening. So to the extent that people are expecting the spreads might widen in a higher rate environment, MSR offsets that because that's looking at the mortgage rate, not the treasury or the swap rate. So we believe that our book value volatility as spreads widen would be dampened by the fact that we have MSR in play.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Obviously, the MSR, as you pointed out earlier, is going to grow, particularly relative to the agency, at least the capital allocated agency. Is the size of the MSR now where you're comfortable in a spread widening environment? Or could it be -- I think clearly you're more comfortable now than you were a year ago, but kind of maybe talk about the relative size in terms of kind of like a macro-hedge I guess?

Bill Roth - *Two Harbors Investment Corp - CIO*

Yes, look, in the extreme, if you thought spreads were going to widen and that's all you thought, then you'd have all MSR and nothing else. But look, our belief is that agencies paired with MSR is not only a higher yielding strategy, but it's also much lower risk strategy in terms of the spread risk. So where we are now, the MSR portfolio has plenty of room to grow. That's why we're particularly focused on it. Not only because it's a great hedge but because we're getting very low coupons on the MSR. These are brand new loans, which we think will perform very well in not only a rising rate environment but also a spread widening environment.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

All right, great. Thank you very much.

Tom Siering - *Two Harbors Investment Corp - President & CEO*

Yes, Joel, just one thing -- this is Tom, I'll just add one thing about the credit book. We're really happy with our legacy non-agency portfolio. The fundamentals and the technicals in that space we think are just rock solid. What I mean, fundamentals, we've discussed why we like those so much. The age of the portfolio has many benefits. As a result of that, we're starting to see prepayment speeds increase from very modest levels to slightly higher levels.

But we're enthusiastic that those prepayment speeds may increase in the future. In respect to technical factors, the fast money crowd has totally left that space or almost entirely left that space. So who is left holding that are real money long-term holders, as a result of that, the technical factors in the market are really favorable to us. Thanks for your questions.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Thank you for pointing that out.

Operator

Jessica Levi Ribner, FBR & Company.

Jessica Levi Ribner - *FBR Capital Markets & Co. - Analyst*

Good morning, thanks for taking my question. I was wondering, I missed if you said what kind of capital allocation you could give to the CRE portfolio?

Bill Roth - *Two Harbors Investment Corp - CIO*

Jessica, thank you, this is Bill. If you think about what we talked about was roughly, if you look at slide 8, we've been pulling up about 2% per quarter. So certainly, we can be in to the 20s at this time next year, which depending on the continued opportunity which currently we see as being very attractive, we would intend to continue at that kind of a pace.

Jessica Levi Ribner - *FBR Capital Markets & Co. - Analyst*

Okay. Are there any -- I know that Bradley -- there's a lot of good opportunities, good yields with attractive LTV's and all of that. But are there any areas of the market that you're more cautious on, that you perhaps are not lending to? How can we think about that?

Bill Roth - *Two Harbors Investment Corp - CIO*

That's a great question. There's been stuff written about hotels here or there or high end condos in New York City, et cetera. If you look at the mix of what we're lending to, it's typically -- our stabilized LTV is in the mid 60s. Initial LTV is a little bit over 70. So, we're going in with about 30 points of sponsor equity. We're very focused on -- more focused on cash flow at the outset as opposed to taking more real estate risk, in other words, deals where there's not really cash flow but you're counting on the value of the property.

So while there's certain parts of -- whether it's Florida or Midtown condos, everybody likes to talk about those, we're just not really focused on those areas. We're really frankly focused on deal by deal. Does it make sense? Are the coverages there? Are we going to get a good return and get our money back?

Tom Siering - *Two Harbors Investment Corp - President & CEO*

For instance, we always keep an eye, for instance, on our hotel exposure, Jessica, because obviously that has a lot of (inaudible) to the economy generally. If you look at in our portfolio disclosure, you'll see that we have just small exposure -- small selective exposure to that space.

Jessica Levi Ribner - *FBR Capital Markets & Co. - Analyst*

Anything you like a lot?

Bill Roth - *Two Harbors Investment Corp - CIO*

Anything we like a lot?

Tom Siering - *Two Harbors Investment Corp - President & CEO*

We like the MSR opportunity is very abundant. We're very enamored of our legacy non-agency book. The commercial real estate opportunity set is abundant. We're enthusiastic about all those things. Importantly, we should note that we're quite excited about our prospects for 2017. We made a lot of progress in streamlining our business. We're redeploying capital to more lucrative spots. So despite the fact that we had a very solid quarter in my eyes, we're very enthusiastic about 2017 and the prospects for the Company, for our earnings, and for our shareholders.

Jessica Levi Ribner - *FBR Capital Markets & Co. - Analyst*

Fair enough. Thank you very much.

Tom Siering - *Two Harbors Investment Corp - President & CEO*

You bet, Jessica.

Operator

I'm not showing any further questions. I'll now turn the call back over to Mr. Siering for closing remarks.

Tom Siering - *Two Harbors Investment Corp - President & CEO*

Thank you, Bridget. We will be releasing an informative webinar on mortgage servicing rights in the next couple of weeks. So we will make you aware of when this is available. Thank you for joining our third-quarter conference call today. We look forward to speaking to you soon. Have a wonderful day.

Operator

Ladies and gentlemen, this does conclude the program. You may now disconnect. Everyone, have a great week.
