



Two Harbors Investment Corp.
First Quarter 2023 Earnings Call Transcript

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PRESENTERS

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Q&A PARTICIPANTS

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Kenneth Lee – RBC
Bose George – KBW
Trevor Cranston – JMP Securities
Arren Cyganovich – Citi
Eric Hagen -- BTIG
Rick Shane – J.P. Morgan

PREPARED REMARKS

Operator Good morning. My name is Diego and I will be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors' First Quarter 2023 Financial Results Conference Call.

All participants will be in a listen-only mode. After the speaker's remarks, there will be a question-and-answer session.

I would now like to turn over the call to Maggie Karr.

Maggie Karr Good morning, everyone, and welcome to our call to discuss Two Harbors' first quarter 2023 financial results. With me on the call this morning are Bill Greenberg, our President and Chief Executive Officer, Nick Letica, our Chief Investment Officer, and Mary Risky, our Chief Financial Officer.

The earnings press release and presentation associated with today's call have been filed with the SEC and are available on the SEC's website, as well as the Investor Relations page of our website at twoharborsinvestment.com. In our earnings release and presentation, we have provided reconciliation of GAAP to non-GAAP financial measures, and we urge you to review this information in conjunction with today's call.

As a reminder, our comments today will include forward-looking statements, which are subject to risks and uncertainties that may cause our results to differ, materially, from expectations. These are described on Page 2 of the presentation and in our Form 10-K and subsequent reports filed with the SEC. Except as may be required by law, Two Harbors does not update forward-looking statements and disclaims any obligation to do so.

I will now turn the call over to Bill.

Bill Greenberg

Thank you, Maggie. Good morning, everyone, and welcome to our first quarter earnings call. This morning, I will provide color on our quarterly performance and the market environments. Mary will provide information around our financial results and Nick will discuss our portfolio activity and positioning.

Please turn to Slide 3 for an overview of our quarterly results. Our book value at March 31 was \$16.48 per share, representing a negative 3.6% total economic quarterly return.

Our book value was impacted by the violent move lower in rates arising from the banking crisis as our portfolio had a slight short duration bias heading into March, consistent with what we disclosed in our fourth quarter earnings call.

As more regional bank headlines hit the tapes, rate volatility continued to be elevated, which caused increased hedging costs and mortgage spread widening.

Our earnings available for distribution, or EAD, was \$0.09 per share. As we've discussed on prior earnings calls, EAD does not necessarily reflect the earnings potential of our portfolio. For this reason, last quarter, we introduced the metric income excluding market driven value changes, or IXM, which we believe should better assist our investors and analysts when thinking about our earnings potential.

IXM was \$0.59 per share for the first quarter, representing a 13.3% annualized return on average common equity. This compares to \$0.73 per share in the fourth quarter.

The change in IXM, quarter-over-quarter, is mainly the result of timing differences of realized MSR cash flows. This backward looking metric of realized return is meant to be viewed in conjunction with Slide 15, which is our forward-looking and return potential slide.

Please turn to Slide 4. After beginning 2023 with two months of relative calm, the financial markets were roiled in early March by the seizure of two regional banks, Silicon Valley Bank and Signature Bank, by banking regulators, which send tremors throughout the banking system. The undercurrent of the Fed's campaign of raising rates was called into question and the market, which was already extremely sensitive, quickly reacted to the new information.

Interest rates on the front end of the yield curve plunged with the two year treasury yield declining by 109 basis points over a three day period culminating in the largest one day move ever on March 13.

Just a few days prior, the two year yield had hit a cycle high of 5.07%, its highest level since 2007.

These effects can be seen clearly in Figure 1. At the beginning of the year, the market was pricing in just one more interest rate hike with a peak fed funds rate of just over 5% and a terminal rate of 4.5% as shown by the light blue line.

By early March, the market became more bearish pricing in three rate hikes only to snap back after the SVB news broke and all rate hike expectations were replaced with rate cuts.

Despite the market's expectations, the Fed raised its benchmark rate by 25 basis points on March 22, in a continued effort to slow down the economy and drive inflation down towards their long term annual target of 2%.

Interestingly, however, by late April, the market was again predicting a forward path of Fed activity almost exactly as it had been on December 31.

If an investor had slept through it, they wouldn't have known that a 300 basis point round trip in fed expectations had even occurred. This kind of interest rate volatility, especially for maturities inside of one year, are breathtaking and are good reminders of why we keep our interest rate exposures low, across the curve.

Moving to Figure 2, I'd like to change gears and expand upon a subject that may be underappreciated in the market, which is the float income component of MSR.

Float income refers to the interest that is earned on principal and interest and taxes and insurance, before those monies need to be remitted to the relevant investors. While MSR and fixed coupon interest only or IO bonds share many similarities and risks, MSR is not a bond.

It has important additional cash flows that include cost to service and compensating interest, which detract from the overall cash flow, as well as additive cash flows like float income, late fees and ancillary income and recapture. In different interest rate environments, these components will add more or less to the value of servicing.

Looking at the chart in Figure 2, you can see in the light blue line that in a rising rate environment, an IO extends as prepayment speeds slow, which causes the price to increase. At very high rates, the prepayment speeds can't go any slower which, ultimately, results in an IO acquiring positive duration and decreasing in price as rates increase.

In contrast, the float component of MSR behaves differently. You can see this in the navy blue line on the charts in Figure 2.

The price goes up for two reasons, as rates rise. First, like an IO, MSR extends as rates rise and prepayments slow, causing the price to rise. Second, as rates rise, the effective coupon of float income also increases since the cash flow is based on the short-term earnings rate on those custodial balances.

At very high rates, even when the prepayment speeds can't slow anymore, the effective coupon of this component continues to rise, which causes the price of this component to continue to increase.

In Figure 2, as you can see, in higher rate environments, these additional cash flows caused the value of MSR to outperform the IO. While in a normal rate environment, the float components of MSR can contribute about 50% of the duration of the MSR asset, when rates are higher and the MSR is deeply out of the money, the float components can contribute closer to 80% of the duration of the entire MSR asset.

Main point here that float income, which is essentially uncapped, adds materially to the negative duration of out of the money MSR and is now the primary reason why MSR multiples could continue to rise, somewhat, in a further sell off.

Moving forward, we are cautiously optimistic about the investing environment. With high interest rate volatility and with the FDIC selling larger amounts of bonds, spreads on RMBS are at historically attractive levels.

Nevertheless, there remain uncertainties in the market from potential follow-on effects from the banking crisis to political uncertainty related to the debt ceiling debate. As a result, while fundamentally, we might expect that an overweight position in mortgages is justified, we think a more neutral posture is prudent, given the technical backdrop.

Furthermore, with banks likely on the sidelines of the MBS market for the time being and with the Fed and GSEs out of the markets, we think that wide spreads available in the market can persist for some time. Wider for longer suits us just fine, as we believe those spreads are attractive for our portfolio and should be supportive of our ongoing earnings generation.

With all of that said, we are committed to and confident in our portfolio construction of Agency RMBS paired with MSR, and we believe that our portfolio with less mortgage spread duration than portfolios without MSR is very well positioned to benefit from the current environment.

Now, I will turn it over to Mary to discuss our financial results in more detail.

Mary Risky

Thank you, Bill, and good morning, everyone. Please turn to Slide 5. For the first quarter, the company incurred a comprehensive loss of \$63.2 million, or negative \$0.69 per weighted average share.

Our book value was \$16.48 per share at March 31, compared to \$17.72 at December 31. Including the \$0.60 common dividend, results in a quarterly economic return of negative 3.6%, results primarily reflect mortgage spread widening in March and increased hedging costs.

Moving to Slide 6, I'd like to add some detail around IXM. In the first quarter, IXM was \$0.59 per share, representing an annualized return of 13.3%. This quarter, we refined the calculation of IXM for determining expected price changes to use the realized forwards methodology, which is a change from Q4 when we use the unchanged term structure methodology.

Standing on that, the methodology for determining expected price changes may be computed based on either of two commonly assumed scenarios-realized forwards and unchanged term structure.

The unchanged term structure methodology assumes that the term structure of the yield curve is unchanged, day over day. The realized forwards methodology assumes that rates follow the one-day forwards.

Q4 IXM under both methods was a return per weighted average share of \$0.73. Quarter-over-quarter, IXM decreased to \$0.59 from \$0.73, which can almost entirely be attributed to timing differences in the realization of certain MSR cash flows. The service fee that is collected depends on the precise day of the month that borrowers make their mortgage payments.

There's also a seasonality component to float income, as some of the custodial balances, like taxes and insurance, are due to be remitted once, twice or four times per year.

Finally, certain servicing costs also fluctuate from period-to-period, such as non-recoverable advances and interest on escrows. IXM takes into account these natural cash flow timing variations.

As a result, the difference between Q1 and Q4 does not reflect significant degradation in the earnings power of the portfolio, but rather a reflection of the realization of MSR cash flows.

Slide 15, our return outlook slide, is the forward-looking version of IXM, and those prospective return ranges are consistent, albeit wider, with the prior quarter.

Please turn to Slide 7. We thought that it would be helpful to provide investors and analysts a comparison of GAAP and non-GAAP measures. GAAP comprehensive income, excluding realized and unrealized gains and losses and non-recurring expenses, as compared to EAD and IXM. In future quarters, this comparison will be included in the appendix slide, but we would like to highlight a few things, this quarter.

As you see on this page, the actual cash flows for income and expense are the same in all three measures with a few minor exceptions. For example, if you look at the RMBS section, coupon income and funding expense are the same, across all three.

This is also generally true for MSR servicing income, float and ancillary, servicing expenses and funding expenses. The primary differences in the measures result from the amortization lines are what we refer to as price changes.

IXM for RMBS and MSR is based on market value and expected return, which is different from GAAP and EAD amortization. For RMBS, GAAP and EAD amortization is based on amortized cost and yield to maturity at purchase.

For MSR, GAAP amortization is based on the percentage of principal paid, multiplied by the beginning market value. And for EAD, amortization is based on amortized cost and the original pricing yield.

We hope that this disclosure helps reconcile the differences between our GAAP and non-GAAP measures.

Please turn to Slide 8. Earnings available for distribution was \$0.09 per share, compared to \$0.26 for the fourth quarter. As a reminder, we expect EAD to continue to diverge from expected ongoing earnings power. The decline in EAD this quarter was primarily driven by changes in interest income and expense.

Interest income increased by \$17.3 million, primarily due to four things: higher rates on cash holdings and reverse repo balances, an increase in the size of our RMBS portfolio, rotation to higher net yielding RMBS, and slower prepayment speeds.

Likewise, interest expense increased by \$26.9 million on higher financing rates and higher borrowing balances on RMBS, partly offset by lower borrowing balances on MSR financing.

Turning to Slide 9. The portfolio yield increased 17 basis points to 5.09%, due to the rotation to higher net yielding RMBS, lower agency CPR and a higher proportion of the portfolio invested in higher yielding assets.

Our net realized spread in the quarter narrowed by 45 basis points to 0.52% from 0.97%, primarily due to higher rates on financing. As a reminder, the portfolio yields in this table are EAD based calculations and not market based measures.

Please turn to Slide 10. Let's spend a moment talking about financing and what we are seeing in the repo markets. Despite the extreme volatility and news about the banking crisis, funding in the repo market remains liquid and well supported.

Spreads on repurchase agreement financing for RMBS improved in January and February from year end but increased in March, following the news of bank failures.

At the end of the quarter, spreads on repurchase agreements were coming back in and were still 4 plus 15 to 20 basis points, with no signs of balance sheet stress.

The finance at MSR across four lenders with \$1.5 billion of outstanding borrowings under bilateral MSR asset financing facilities and \$400 million of outstanding five-year MSR term notes.

We maintained access to diverse funding sources for MSR with a total of approximately \$606 million unused MSR financing capacity at quarter end.

I will now turn the call over to Nick.

Nick Letica

Thank you, Mary. Please turn to Slide 11. I'd like to focus my opening comments on the supply and demand dynamics for mortgage backed securities which, in our minds, is the primary narrative in our market.

Figure 1 shows current coupon spreads, since the beginning of last year. Spreads are, unquestionably, wide with nominal and OAS spreads, respectively, in the 92nd and 82nd percentiles of the long term history generating attractive levered returns in the low to mid-teens, as shown in our return potential a few slides forward.

Despite these positive signals and a strong belief that over a longer horizon, this time period will be viewed as a great entry point.

Our enthusiasm is tempered by the belief that over the short to medium-term, supply is likely to keep mortgage spreads wider than long term averages and could, potentially, push them wider than their already generous levels. In fact, we have seen spreads widen into the beginning of this quarter.

In addition to \$200 million of projected net organic supply for 2023, the FDIC, through BlackRock, has commenced auction of the assets seized from Silicon Valley Bank and Signature Bank, which will likely persist for the next six months.

With the sales of the lower coupon, deep discount, Agency RMBS and CMO positions, total approximately \$85 billion.

Inclusive of these sales, other bank selling and Fed pay downs, which are effectively in other form of supply, the total net supply for Agency RMBS is projected to top \$500 billion for 2023 with the bulk of the supply, ahead of us.

In an environment where many banks are either on the sidelines or perhaps selling, it will be up to relative value accounts like money managers, REITs and hedge funds to absorb the bulk of the supply. This group of investors typically demands a higher risk premium than depository institutions. As such, it is reasonable to assume that spreads will remain wider than long term averages.

Figure 2 provides some historical context of the relationship between option adjusted spreads and who is buying and who is selling. The blue bars are institutional accounts like banks, the Fed, or the GFCs, while the gray bars are relative value accounts, like money managers and REITs. The line is the option adjusted spread of the MBS index

as measured by Bloomberg at the end of each year and for 2023 at the end of the first quarter.

In periods in which institutional demand dominates, spreads tend to be tighter or tightened. Conversely, in periods when relative value accounts for the buyers and institutional accounts for the sellers, spreads widen.

There are several periods that we could point to, but the most recent experience of tightening was the 2020 to 2021 period with strong bank and Fed buying. Then into 2022 to 2023, the Fed and Bank stepped back from buying, which drove the spreads wider by over 30 basis points to what now are historically attractive levels.

To sum this up, spreads have already reacted to the shift in the buyer base and the anticipation of excess supply and at present levels, are supportive of our strategy. That said, it remains to be seen whether these effects are fully priced into the market, as the thick of the supply is still ahead. The FDIC bank related selling has made lower coupon MBS valuation more attractive.

Post quarter end, we have moved some of our mortgage exposure down in coupon but have plenty of dry powder to do more of that trade and/or increase our spread exposure, as opportunities present themselves in the coming months.

Now let's turn to Slide 12 and discuss our portfolio in the first quarter. At March 31, our portfolio was \$15.8 billion, up from \$14.7 billion at the end of the fourth quarter. On the top right of the slide, you can see a few bullet points about our risk positioning and leverage.

From a risk perspective, we opportunistically moved about 30% of our hedges from treasury futures to swaps to take advantage of deeply negative swap spreads in the quarter.

Given the macroeconomic uncertainty, we are keeping exposures low, across a wide range of interest rate and current scenarios. You can see more detail on our risk positioning by looking at Slide 17, 18, 28 and 29 in the appendix.

Our debt-to-equity ratio increased slightly to 6.5 times maintaining a neutral leverage position, as we were balancing the wide nominal spreads available in the market versus historically high volatility and the supply demand dynamics that we just discussed.

In terms of portfolio activity, in February, we completed a common stock capital raise for net proceeds of \$176 million. In line with our stated objective at that time, we settled \$11 billion UPB of MSR through a bulk purchase paired with an additional \$1 billion of current coupon TBA.

We have committed to acquire an additional \$15 billion UPB of MSR to settle in the second quarter. Given the subsequent widening of mortgage spreads, this capital allocation proved to be the right one.

In the quarter, we were active in moving positions between TBA and specified pools, as highlighted in the bullets under portfolio activity. We moved \$2 billion of higher coupon TBAs into loan balance, credit and geo pools to capture relative spread pickup and mitigate future prepayment risk.

We then moved some four and four and a half specified pools, which we believe were fully valued into TBA.

Finally, we covered a short position of Fannie Mae 2 TBAs, after the sharp underperformance of the lower coupons in March.

Moving to Slide 13, our specified pool portfolio was predominantly positioned in higher coupon, loan balance and geo pools at quarter end. Mortgages had mixed performance across the coupon stack in the quarter with low coupon 2 and 2.5s, widening about 0.5 point, driven primarily by supply concerns from FDIC related sales.

Current coupon RMBS wind by a similar magnitude, given their persistent supply. The belly coupons of 3s to 4.5s, remains roughly unchanged, without the supply pressures felt by the lower and higher coupons. In the quarter, specified pools modestly outperformed TBAs, as you can see in Figure 2. Specified pool prepayment speeds also declined line to 5.3% CPR, as you can see in Figure 3.

Please turn to Slide 14. Our MSR portfolio was \$3.1 billion at March 31, comprised entirely of Agency MSR. We saw a 35% increase in supply of MSR in the quarter for the reasons we discussed on our last earnings call. As rates have risen, originations have slowed and mortgage companies are selling MSR to fund their ongoing businesses.

This is occurring at the same time as several large MSR holders announced their intentions to step back from the MSR market.

As previously discussed, we added four bulk purchases, opportunistically, taking advantage of the selling in the market. Our price multiple modestly decreased to 5.4 times, which incorporates the effect of the settled bulk purchase.

As anticipated and providing a tailwind for our MSR, prepayments continued to slow, coming in at 4.1% CPR in the first quarter.

Finally, please turn to Slide 15, our return potential and outlook slide. The top half of this table is meant to show what returns we believe are available in the market. We estimate that about 61% of our capital is allocated to hedged MSR, with a market static return projection of 14% to 17%.

The remaining capital is allocated to hedged RMBS with a static return estimate of 12% to 14%.

The lower section of this slide is specific to our portfolio with a focus on common equity and estimated returns, per common share. With our portfolio allocation shown in the top half of the table and after expenses, the static return estimate for our portfolio is between 10.4% to 13.1%, before applying any capital structure leverage to the portfolio.

After giving effect to our outstanding convertible notes and preferred stock, we believe that the potential static return on common equity falls in the range of 12.3% to 16.6%, with a prospective quarterly static return per share of \$0.50 to \$0.69.

Thank you very much for joining us today and now, we will be happy to take any questions you might have.

Q&A

Operator

Our first question comes from Doug Harter with Credit Suisse.

Doug Harter

Thanks and good morning. Hoping you could talk a little bit about how you're thinking about when the time might be to want to increase your mortgage basis exposure kind of given your comments that spreads are towards the wider side and kind of what are the factors you'd be looking at?

Bill Greenberg

Good morning, Doug. Thanks very much for the question. As Nick said in his prepared remarks, on a fundamental basis, the spreads are certainly attractive there. They are at historical wide levels, but there's just so much out there that we see that tempers our enthusiasm. The banking crisis stuff out there is still ongoing, even with the resolution of First Republic.

So, there's a lot of uncertainty there and of course, we have some debt ceiling stuff coming up this month to be resolved. And there's a whole bunch of stuff in the market that seems like, it's not giving the all clear sign and so, we're going to wait a little bit to see how that, how that unfolds.

As I said, with--or as Nick said, with the banks out and with the GSEs out, we think there's-- that it's more likely than not that spreads can stay at these levels for quite some time here. And so, that's sort of our outlook and that's what we're looking for and we think that suits us fine.

Doug Harter

I guess just given that uncertainty, I guess, how would you characterize the risk for further widening versus how much of that's kind of those risks are kind of priced into the market.

Nick Letica

Hey, Doug. This is Nick. Yeah, very good question, something that, honestly, we grapple with day-in and day-out, these days. It's not as though, as we said in the comments,

where spreads are right now and when you see our return potential it is very, very supportive of our strategy to generate a high level of return and income.

So, as Bill said, I don't--we don't feel pressed to increase leverage or exposure, given all the uncertainties are ahead of us.

And as I said in my comments, we have seen spreads widen since quarter end and that's amidst some technicals that have not moved in the same direction. For example, longer-term volatility has pretty much moved sideways.

We had a strong correlation between those things, prior to the event in March with the banks and, but since then given the supply concerns, we've since seen spreads kind of widen out in a fairly flat volatility environment. So, we're watching it. We'll see where things go, but it's a very hard thing to predict, right now.

Doug Harter

Okay. Thank you.

Operator

Our next question comes from Kenneth Lee with RBC Capital Markets.

Ken Lee

Good morning. Thanks for taking my question. Just one on the static returns, prospectively. Just wondering if I could just get a little bit more thoughts around potential volatility there and what could be sort of the key drivers that you think, over the near term, that could drive some of that volatility in terms of the static returns there? Thanks.

Nick Letica

Hi, Ken. That's great, question. And as you can see, if you compare our--the range of our assumption--range of our results compared to this quarter versus last, you can see that we actually have a wider range than we did last time. And that is reflective of the volatility we're seeing in the market and the assumptions that go into this analysis and, of course, a big component of it is just a spread level in the market, right.

So, as to the extent that spreads are wider and more volatile, you're going to see a wider variation these numbers, but it takes into account all the assumptions that you would expect in a levered mortgage return. Obviously, prepayments are a big part of it, funding levels are a part of it, all of those things. And we feel like this range that we have this quarter that we're giving a \$0.50 to \$0.69 range does incorporate a wider variation in the underlying assumptions that could drive these numbers.

Ken Lee

Got you. Very helpful there. And then just one on the hedging strategy. There were some changes in the book value sensitivity to rates, but just wanted to get a higher level. What's the best way to think about your current hedging strategy? What kind of scenarios are you positioning yourself for? Thanks.

Nick Letica

We're really trying to be very balanced, right now. We are not--we are trying to be pretty agnostic with regard to direction of rates or curve shape. Just given all the variabilities that are in the market, right now. And as a path, I think ahead of the--the

banking crisis we had in March was probably a little bit more predictable than it is, right now.

The effects of what the bank crisis will do to the economy and how much work that's actually going to do for the Fed are all things that are, I think, very, very hard to judge. So, we're trying to stay pretty neutral, across the curve.

I think if you look at our exposures they are pretty balanced in, as I said, across the curve and in various curve scenarios. We're trying not to take a strong view on one way or the other.

Ken Lee Gotcha. Very helpful. Thanks again.

Bill Greenberg Thank you.

Operator Our next question comes from Bose George with KBW.

Bose George Hey guys. Good morning. Actually just on sticking to Slide 15, as your allocation to MSR increases, does the prospective range of that return go up just as that hedged MSR percentage increases?

Bill Greenberg Yeah. Well, I think just from a--thanks for the question, Bose. Good morning. Yeah. I think if you look at the top of Slide 15, the higher the percentage to MSR, given the fact that the static return estimates for MSR is higher than that from the RMBS right now that would increase that results, the more that we did that.

Bose George And how high could that percentage, the hedged MSR percentage potentially go, this year?

Bill Greenberg Well, we don't have a set number in mind. It depends on market opportunities and such things. We do see value even aside from it being, as we show here, a higher static return potential than RMBS. We do think there's value in having some RMBS and RMBS portfolio as a balance here. And so, it can go higher, but you're unlikely to see it be 100%.

Bose George Okay. Great. And then actually switching, just wanted to ask about book value. Can you just give us an update on book value, quarter-to-date?

Bill Greenberg Yeah. You bet, Bose. So, as Nick said during his comments, as well as in the Q&A here, spreads have been volatile. They've been wider in the month of April.

For the first half of the month, through the 21, we were rolling down between 1% and 2%, but in the last week of the month with FDIC sales and First Republic noise, spreads have been pretty rocky here. And as of Friday, we were down about 4%.

Bose George Okay great. Thank you for the update.

- Bill Greenberg** Thank you.
- Operator** Our next question comes from Trevor Cranston with JMP Securities.
- Trevor Cranston** Hey. Thanks. The question on the float income you guys talked about earlier in the presentation, a couple of things there, I guess. Number one, do you have the average balance of custodial funds was in the first quarter.
- And also, I was wondering if you could--Mary talked about the seasonal impact of tax payments on float income. I was wondering if you could provide any sort of numbers around the estimated seasonal impact for the first quarter? Thanks.
- Bill Greenberg** So, thank you for the question and good morning. We don't have those numbers handy as to what the average balances; we can circle back on that. In terms of the seasonality that Mary mentioned, some states require interest and escrows; some states don't. Some states require the remittances to be done annually, some are derived semi-annually. Some do it monthly and so forth. And so, that provides a natural seasonality among the states.
- And the balances that exist between the states between when things need to be remitted and how long you can hold onto it for. So, that's a very detailed question. It's not as simple seasonality like you have in prepayments, where it's slower in winter and faster in summer. It's a more complex shape than that, if you were to graph it out.
- Trevor Cranston** Okay got it. Thank you.
- Bill Greenberg** Yeah. Thank you.
- Operator** Our next question comes from Arren Cyganovich with Citi.
- Arren Cyganovich** Thanks. Just kind of following up on Doug's earlier question about spreads and when they could, potentially, tighten. What are the kind of scenarios that would likely lead to tighter spreads? Would it be--would we have to enter into a recession and see generally lower rates and slower kind of growth, overall, to bring folks back to wanting to get, I guess, more demand for RMBS assets?
- Nick Letica** Hey, Arren. Yeah. Thank you for that question. Look the traditional drivers for tighter mortgage spreads are lower volatility and generally speaking, steeper yield curve and a rally. I mean, those are the--historically, have been the elements to drive spreads tighter.
- Very interesting, the market that we're in right now with this--this lack of bank buying and potentially, a little bit different response then from the banking community than we've seen.

In the past, given the focus on bank portfolios in duration of bank portfolios and what that means, really, that's what's driving our comments and belief that we're going to see spreads wider than long term averages for a long period of time.

But I think to answer your question, as usual, I think more predictability on the path of rates, the movement of the Fed should drive mortgage spreads tighter and just the passage of time a little bit here as we get through the supply that that is in front of us, both from inorganic nature of some of the higher coupon production numbers, which are not like overwhelmingly large, but big and--but large enough in the current market, especially with--without banks buying and then, the dual effect of this the slug of lower coupon supply that's coming into the market.

What I would say is, what has held mortgage spreads in and one of the reasons that we were very optimistic about mortgage spreads earlier in the year has been just the amount of retail flow that's come into fixed income that has been supportive of all fixed income and mortgages, and that's flowing through the money manager channel.

So, the state of spreads here, in many ways, is sitting with the money management community and how much they can absorb of the supply that's coming into the market.

Arren Cyganovich Okay. And do you think that whenever the Fed does pivot and provide kind of, instead of a tightening guide path to a kind of loosening guide path with lower short-term rates. Would that be enough on them to likely lead to tighter spreads, as you kind of get away from this inverted yield curve.

Nick Letica I mean, it should be helpful. The one thing that's been set in the market, which I think is an interesting point, is that with these sales coming from the FDIC and through BlackRock, there is, potentially, some market sensitivity to those sale levels and that if rates rally and prices go up, it could cause potentially, an acceleration of those sales.

That might temper mortgage performance in that kind of scenario. But overall, I would agree with your--I would agree with the assertion that if we see a turnaround and a little bit more predictability out of the Fed, that should be positive for mortgage spreads.

Arren Cyganovich And then my last question is, Slide 7, you have kind of the listed various GAAP and non-GAAP earnings. Which one of these is setting your dividend policy? I fully understand like the IXM is kind of more illustrative of what your earnings power can be, and--but we're struggling a little bit with trying to figure out where we're dividend might go, relative to the potential earnings power and the actual earnings that you're producing?

Mary Risky Hi, Arren. This is Mary. So, we obviously consider several measures, and I think that what I would point you to is Slide 15. That is probably the most significant factor in determining where we think return potential is and where we set the dividend.

Arren Cyganovich But in terms of the actual earnings that you have or, I mean, are you going to be end up--like if you produce a quarter like you did this quarter, are you going to be returning capital relative versus actual earnings, relative to that distribution?

Mary Risky Well, the characterization of the dividend depends on taxable income, which is different than all these measures. But I think I would point you to the cash flow information on Page 7 and, again, we believe the dividend is reflective of the return potential of the portfolio.

Arren Cyganovich Okay. Thank you.

Operator Our next question comes from Eric Hagen with BTIG.

Eric Hagen Hey. Thanks. Good morning. Hope all is going well. I think just one from me. When you think about your stock valuation and where you could trade on the near and longer term basis, how does that drive the amount of leverage that you're comfortable running? Like, how much more risk do you think you can take at your current valuation, and what scenarios do you think you could maybe trade at a higher valuation with higher leverage?

Bill Greenberg Well, thanks for the question, Eric. Good morning. I would say that we don't really think of the stock price is having an input into the amount of leverage that we run. That's really a risk question.

We're always trying to have performance so that the returns are--are high quality returns with an acceptable level of risk. And so, we're making those decisions, based on the existing portfolio and the existing assets and existing book value, rather than looking at what the stock price is. We're not trying to link the two in any way. I hope that answers your question, or no.

Eric Hagen Okay. That's helpful. Thanks.

Operator Our next question comes from Rick Shane with J.P. Morgan.

Rick Shane Thanks, everybody, and good morning. Hey, Nick, I have some questions on Slide 29, which is the interest rate swaps and swaptions.

You had talked a little bit about the hedging strategy during your comments, but can you help me understand what's going on, on this slide? It looks like a lot of netting trades but again, I think there's something much more sophisticated going on there than I understand. If you can just help us understand both the interest rate swaps and the swaptions because the notional seem to largely net out.

Nick Letica Yeah. Hey, Rick, how are you doing? Thank you for that question. So, I don't think it's actually as complicated as you may--as you may be inferring from that slide.

As we noted in our prepared remarks, we did move some of our hedges this quarter from futures to swaps, and that was really driven by the fact that there were some opportunities with some fairly deeply negative swap spreads to put that trade at levels we thought were effective and to boost our spot carry on our hedges in what we thought was an efficient way.

And as said, it's about 30% of our hedged book that moved away from futures. We like to have a mix of those hedging instruments because, as markets have moved around with the volatility in the markets and you run into potential bouts with liquidity, having both of those instruments at our disposal can be helpful when things are moving around as fast as they are.

I think what you're seeing in terms of some of that netting is just the, you're seeing the portfolio activity in the re-hedging that we did, as the quarter progressed. Rates, as you know and we discussed, rates moved an epic amount in March. And we had put some hedges on earlier on the quarter that we needed to reverse. As the market rallied and our portfolio will get shorter, we obviously have to adjust our hedges.

So, I think that's what you're seeing in those numbers. The interest rate swaptions is--was a small trade we put on to--for some protection on some rate scenarios, and that's what you're looking at on that page.

Rick Shane Got it. Okay. So, I heard the initial comment as you saw an opportunity, and I had assumed that that opportunity had persisted, and what you're saying is that there was an opportunity in terms of the curve that you saw benefited from it and then, largely, netted that trade out, as you move through the quarter.

Nick Letica Well, I wouldn't say we netted it out. We're ending the quarter with us--we ended the quarter with some of our hedging and swaps. It's just that, as we re-hedged through the quarter, some of the initial trades we did, we had to pare down along with other trades because you're--our hedge book has to move with the duration of our underlying securities.

Rick Shane Okay. Got it. Thank you very much.

Nick Letica Of course. Thank you.

Operator Thank you. There are no further questions at this time. I'll hand the floor back to management for closing remarks.

Bill Greenberg I want to thank--thank you all for those good questions. I want to thank you all for taking the time to join us today and thank you as always for your interest in Two Harbors.

Operator Thank you. And with that, we conclude today's conference. All parties may disconnect. Have a great day.

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