Mortgage REITs

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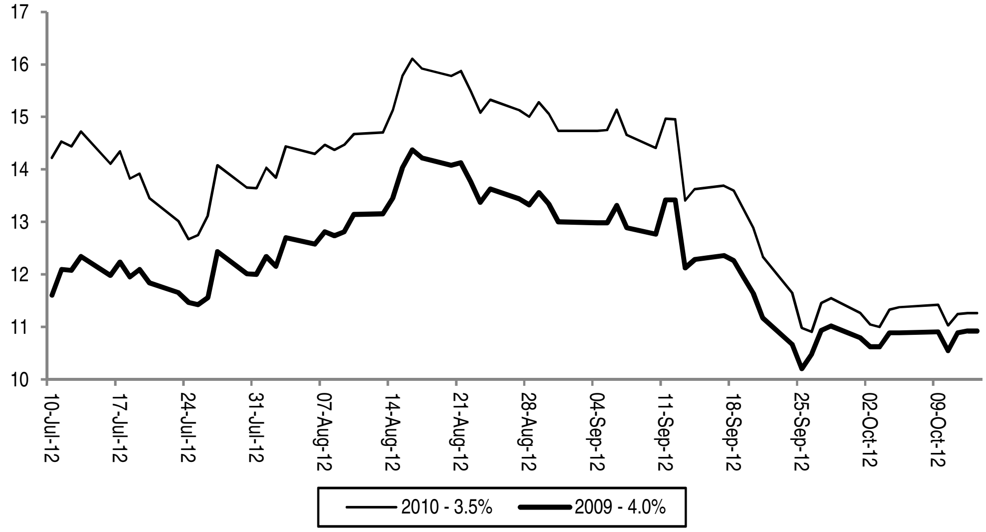
SECTOR REVIEW

While Lower, Returns Still Attractive in Current Rate Environment; Favor Hybrids

The mortgage REITs have come under pressure in the past week as equity investors have renewed concerns about lower reinvestment rate available in the post QE3 environment and increased refinance activity. While we acknowledge these issues will continue to cause returns to drift lower, we continue to see the return environment as relatively favorable in the current low interest rate environment.

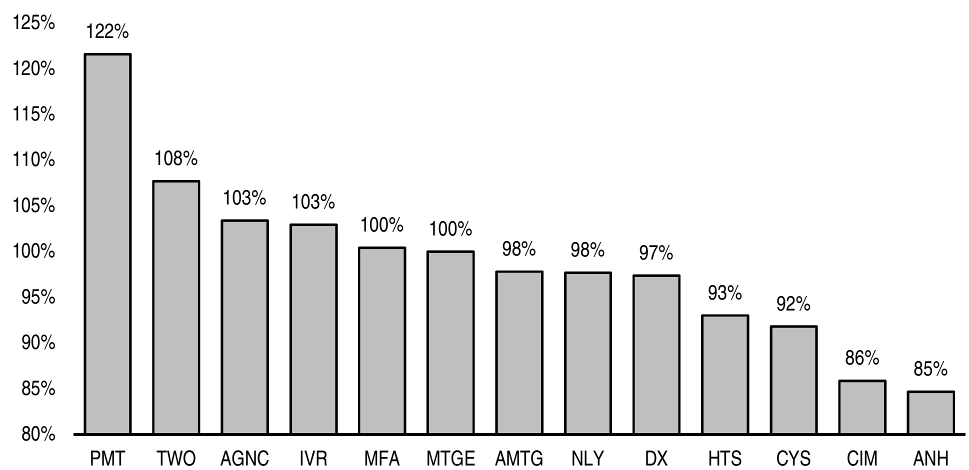
- **Return environment:** Agency MBS yields have compressed 50 bps since the Fed's QE3 announcement as the mortgage spread has tightened. We see the available yield around 2.0% on 30-year Agency MBS and 1.2% on 15-years (hybrid ARMs are likely in this neighborhood as well). Using 7-8x leverage this can still generate an 11-13% gross ROE on 30-years and high single digit on 15-years. Non-Agency MBS yields are in the 4-6% today, which can also still allow for returns in the 10-12% range.
- **Refi expectations:** Following the expected decline in prepayments in September, we continue to expect prepayment activity to increase in the fourth quarter as a result of the decline in mortgage rates. Using IOS pricing as a proxy, the MBS market's perception of refinance risk has not changed in the past 2 weeks (see Exhibit 1.) That being said we continue to favor the mortgage REITs with prepayment protected portfolios as they will have more stable cash flows given lower reinvestment needs.
- **Valuation:** The mortgage REITs on average are trading at a 2% discount relative to estimated third quarter book value, with seven of the names trading below book value (see Exhibit 2.) The only sustained period that the mortgage REITs traded below book was 2005-2007, a period marked by a flat yield curve and rising short-term rates. This resulted in an 3.7% average dividend yield over that time frame (see Exhibit 3), well below the 8-10% we see as sustainable given current returns available today. In addition given the favorable supply/demand technicals in the mortgage market we have increased confidence in the stability of book value in the current environment. This leads us to have confidence that the mortgage REITs should continue to trade at a modest premium to book value.
- **Favor hybrids:** While we see the mortgage REIT sector as a whole as more attractive today given the recent weakness we continue to favor the hybrids over the Agency-only REITs. This combined with our preference for prepayment protected securities result in IVR, MTGE, and AMTG as being our top picks today.

Exhibit 1: IOS Prices



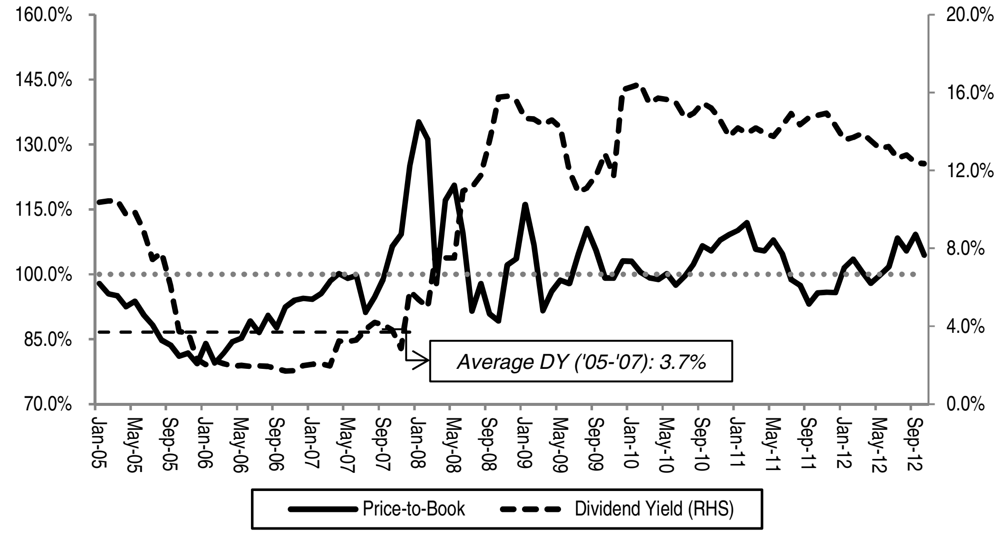
Source: Company data, Credit Suisse estimates

Exhibit 2: Price to Third Quarter Estimated Book Value
As of October 12, 2012 – current price is adjusted for the accumulated dividend



Source: Company data, Credit Suisse estimates

Exhibit 3: Historical Price-to-Book vs. Dividend Yield



Source: Company data, Credit Suisse estimates

Companies Mentioned *(Price as of 12 Oct 12)*
American Capital Agency (AGNC, $32.59, OUTPERFORM, TP $36.00)
American Capital Mortgage Investment Corp. (MTGE, $24.46, OUTPERFORM, TP $25.00)
Annaly Capital Management (NLY, $16.04, NEUTRAL, TP $17.00)
Anworth Mortgage Asset Corp. (ANH, $6.20, UNDERPERFORM, TP $6.50)
Apollo Residential Mortgage (AMTG, $21.22, OUTPERFORM, TP $21.00)
Chimera Investment (CIM, $2.58, NEUTRAL, TP $2.75)
CYS Investments, Inc. (CYS, $13.27, OUTPERFORM, TP $14.50)
Dynex Capital, Inc. (DX, $9.60, NEUTRAL, TP $10.00)
Hatteras Financial Corp. (HTS, $26.54, NEUTRAL, TP $29.00)
Invesco Mortgage Capital (IVR, $20.73, OUTPERFORM, TP $22.00)
MFA Financial, Inc. (MFA, $8.16, NEUTRAL, TP $8.00)
PennyMac Mortgage Investment Trust (PMT, $24.28, OUTPERFORM, TP $23.00)
Two Harbors Investment (TWO, $11.66, RESTRICTED)

Disclosure Appendix

Important Global Disclosures

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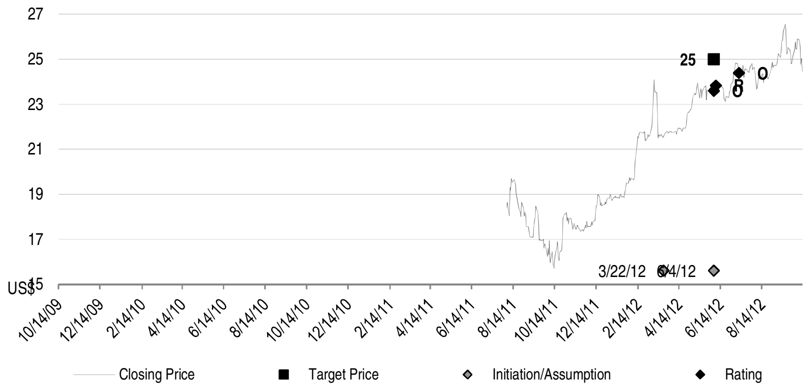
See the Companies Mentioned section for full company names.

3-Year Price, Target Price and Rating Change History Chart for MTGE

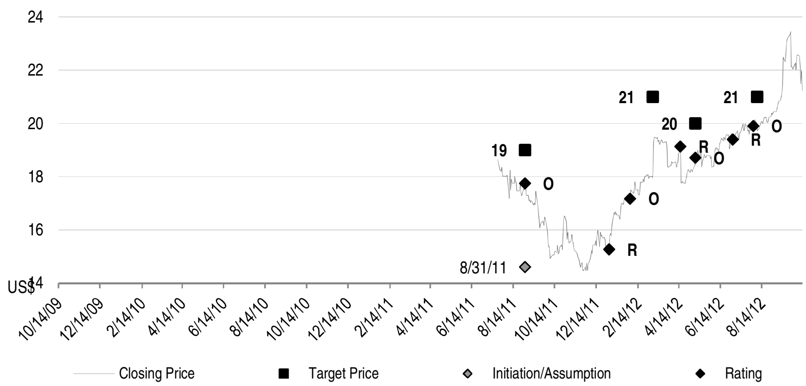
MTGE Date	Closing Price (US$)	Target Price (US$)	Rating	Initiation/ Assumption
3/22/12				X
6/4/12	23.59	25	O	X
6/7/12	23.83		R	
7/11/12	24.38		O	



O=Outperform; N=Neutral; U=Underperform; R=Restricted; NR=Not Rated; NC=Not Covered

3-Year Price, Target Price and Rating Change History Chart for AMTG

AMTG Date	Closing Price (US$)	Target Price (US$)	Rating	Initiation/ Assumption
8/31/11	17.75	19	O	X
1/2/12	15.26		R	
2/2/12	17.17		O	
3/6/12	17.96	21		
4/16/12	19.13		R	
5/8/12	18.71	20	O	
7/2/12	19.39		R	
8/1/12	19.9		O	
8/7/12	19.72	21		



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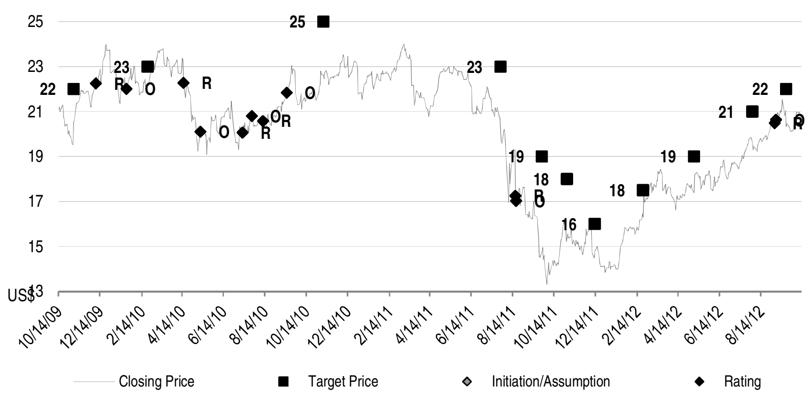
3-Year Price, Target Price and Rating Change History Chart for IVR

IVR Date	Closing Price (US$)	Target Price (US$)	Rating	Initiation/ Assumption
11/5/09	20.52	22		
12/8/09	22.25		R	
1/22/10	22.01		O	
2/22/10	22.18	23		
4/16/10	22.27		R	
5/11/10	20.1		O	
7/12/10	20.06		R	
7/26/10	20.79		O	
8/11/10	20.58		R	
9/15/10	21.84		O	
11/8/10	22.63	25		
7/27/11	20.22	23		
8/18/11	17.25		R	
8/19/11	17.02		O	
9/26/11	14.76	19		
11/2/11	15.37	18		
12/13/11	14.8	16		
2/22/12	16.31	17.5		
5/7/12	17.39	19		
8/1/12	19.63	21		
9/3/12	20.49		R	
9/5/12	20.63		O	
9/20/12	20.32	22		



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Underperform/Sell*	14%	(43% banking clients)
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Price Target: (12 months) for (MTGE)

Method: Our $25 price for MTGE is based on 13.7 % dividend yield on our expected dividend of $3.42. This targeted yield is 140 bps higher than Hybrid/Non-Agency mortgage REIT peers average. Our target price represents a 8% premium to third quarter estimated book value.

Risks: The primary risks to our $25.00 target price for MTGE are interest rate risk on the agency MBS portfolio and worse than expected deterioration in credit quality on the Non-Agency portfolio. The Agency book is subject to interest rate risk, both on the long- and short-end of the rate curve. A flattening of the yield curve will lead to a reduction in returns available on incremental investments. An increase in long-term interest rates will result in a reduction to book value.

Price Target: (12 months) for (AMTG)

Method: Our $21 target price for Apollo Residential Mortgage is based on a 3% premium to current estimated third quarter book value. Our $21 target price also represents a 14.3% annualized yield on our estimated 12 month forward dividend of $3.00.

Risks: The principal risk to our $21 target price for Apollo Residential Mortgage is interest rate risk. The investment portfolio is funded with short-term repos (repurchasse agreements) and expected to be hedged 50% with fixed-rate interest rate swaps. This leaves the net interest spread negatively exposed to rising short-term interest rates. AMTG also faces risks associated with the long-end of the interest rate curve; rising long-term interest rates would negatively impact the company's book value

Price Target: (12 months) for (IVR)

Method: Our $22.00 target price for Invesco Mortgage is based on a 10% premium to current book value. Our target represents a 12% yield on the current dividend.

Risks: The biggest potential risk to the achievement of our $22.00 target price for Invesco Mortgage is the continued deterioration in the credit quality of the underlying mortgages in the non-Agency residential mortgage securities portfolio. The Agency MBS portfolio is subject to short-term interest rate risks which could cause returns, and dividends, to be lower than expected. Invesco Mortgage is also subject to the risk from the appearance of conflict of interests for the allocation of investment opportunities with its external manager.

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