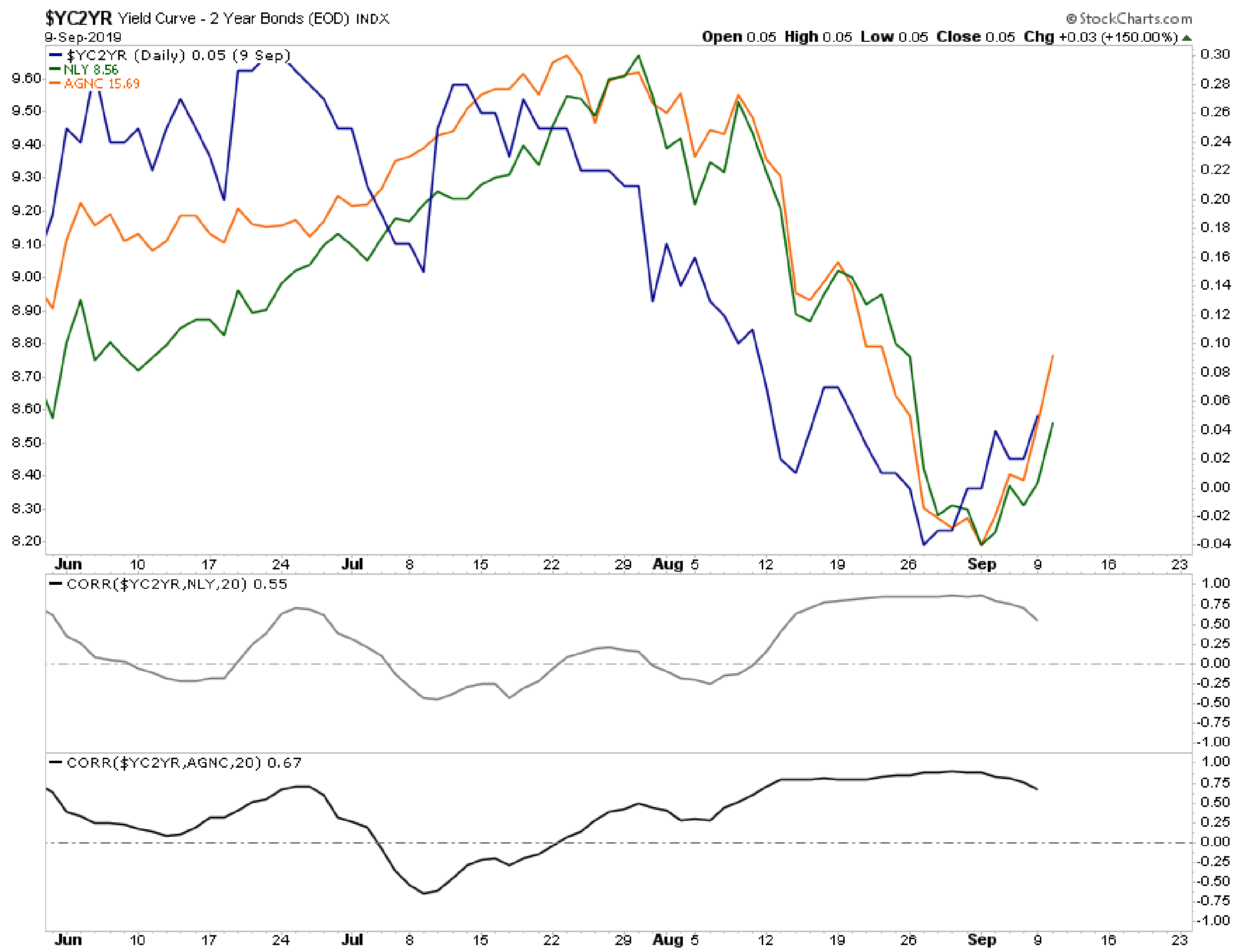
In June we wrote an RIA Pro article entitled [*Profiting From A Steepening Yield Curve*], in which we discussed the opportunity to profit from a steepening yield curve with specific investments in mortgage REITs. We backed up our words by purchasing AGNC, NLY, and REM for RIA Advisor clients. The same trades were shared with RIA Pro subscribers and can be viewed in the RIA Pro Portfolios under the Portfolio tab.

We knew when we published the article and placed the trades that the short term risk to our investment thesis was, and still is, a further flattening and even an inversion of the yield curve. That is precisely what happened. In mid to late August the curve inverted by four basis points but has since widened back out.

The graph below compares the 2s/10s yield curve (blue) with AGNC (orange) and NLY (green). Beneath the graph is two smaller graphs showing the rolling 20-day correlation between AGNC and NLY versus the yield curve.



Since writing the article and purchasing the shares, the securities have fallen by about 5%, although much of the price loss is offset by double digit dividends (AGNC 13.20%, NLY 10.73%, and REM 9.06%). While we are not happy with even a small loss, we are emboldened by the strong correlation between the share prices and the yield curve. The trade is largely a yield curve bet, so it is comforting to see the securities tracking the yield curve so closely.

We still think the yield curve will steepen significantly. In our opinion, this will likely occur as slowing growth will prompt the Fed to be more aggressive than their current posture. We also think that there is a high probability that when the Fed decides to become more aggressive they will reduce rates at a faster clip than the market thinks. As we discussed in *Investors Are Grossly Underestimating the Fed*, when the Fed is actively raising or reducing rates, the market underestimates that path.

To wit: ***If the Fed initiates rate cuts and if the data in the graphs prove prescient, then current estimates for a Fed Funds rate of 1.50% to 1.75% in the spring of 2020 may be well above what we ultimately see.*** *Taking it a step further, it is not farfetched to think that that Fed Funds rate could be back at the zero-bound, or even negative, at some point sooner than anyone can fathom today.*

Heading into the financial crisis, it took the Fed 15 months to go from a 5.25% Fed funds rate to zero. Given their sensitivities today, how much faster might they respond to an economic slowdown or financial market dislocation from the current level of 2.25%??

Bolstering our view for a steeper yield curve is that the Fed, first and foremost, is concerned with the financial health of its member banks. The Fed will fight an inverted yield curve because it hurts banks profit margins and therefore reduces their ability to lend money. Because of this and regardless of the economic climate, the Fed will use words and monetary policy actions to promote a steeper yield curve.

We are very comfortable with the premise behind our trades, and in fact in mid-August we doubled our position in AGNC. We will also likely add to NLY soon.

For more on this investment thesis, please watch the following Real Vision interview Steepening Yield Curve Could Yield Generational Opportunities.