Seeking to Improve Quality While Maintaining Income

December 2018

Angel Oak
CAPITAL ADVISORS

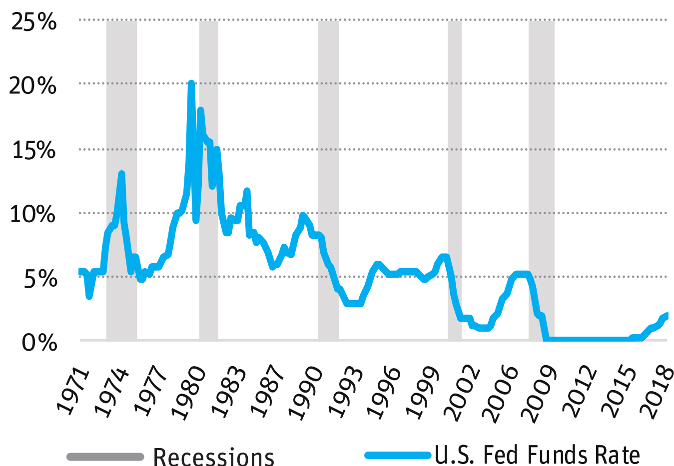
Our favored areas of exposure within the U.S. structured credit environment still lie in the most senior portions of the legacy residential mortgage-backed securities (RMBS) market and in the emerging market for new issues in the reperforming loan (RPL) and non-qualified mortgage (non-QM) markets, both of which have exhibited improving credit fundamentals, favorable supply-and-demand technicals, high current income, and attractive interest rate risk characteristics. Our reasons are as follows:

- The market for legacy non-agency (NA) RMBS may afford market participants the opportunity to target a very high-quality credit while maintaining income with predominantly floating rate characteristics that can withstand extraordinarily harsh economic scenarios as well as offer the chance for upside improvement.
- Not only could RPL be another attractive way to capture favorable residential credit trends, but it is also one of the leading subsectors of new NA RMBS issuance. According to Bank of America Merrill Lynch, gross NA RMBS supply has surpassed $100 billion in 2018, $5 billion greater than in 2017 and a post-crisis record (See Figure 12).
- According to Wells Fargo, banks and government-sponsored entities (GSEs) have approximately $200 billion of RPL on their balance sheets. Year-to-date RPL supply currently stands at approximately $58.5 billion, of which $39.2 billion is in whole loan form and $19.3 billion is in new securitizations.
- As the Federal Open Market Committee (FOMC) continues to tighten, we will continue to go up in quality with higher income. For such a requirement, structured credit, particularly residential credit, is very attractive due to the solid credit fundamentals of the U.S. consumer and to rising home equity that occurred during this great expansion.

A ROBUST ECONOMY AND CONTINUED EXPANSION

The current U.S. economic expansion, after a lackluster period from a gross domestic product (GDP) perspective, is robust on the heels of historically accommodative monetary policy, generationally low unemployment rates, tax cuts, solid earnings, fiscal spending, and deregulation. If this expansion continues until July 2019, as we expect, it will be the longest on record since the Civil War. While it is impossible to predict the exact timing of the end of the credit cycle, expectations are this expansion will last well beyond 2019 and into 2020. However, its end is inevitable, and we expect the expansion to roll over into a Fed-induced recession shortly thereafter. See Figure 1 for a historical view on how Fed tightening cycles typically end.

Figure 1: How Fed Tightening Cycles End



Source: Bloomberg.

We have been taking advantage of the current favorable credit environment throughout 2018 by improving the credit quality of the Angel Oak Multi-Strategy Income Fund (ANGIX) while maintaining income. Ironically, the Fed tightening that will ultimately lead to future weakness has increased the income of the high-quality floating rate and short-duration fixed-rate securities we target, thereby allowing us to rotate into the most senior parts of the capital structure, which enjoy the most protection from future defaults and economic weakness while maintaining high current income.

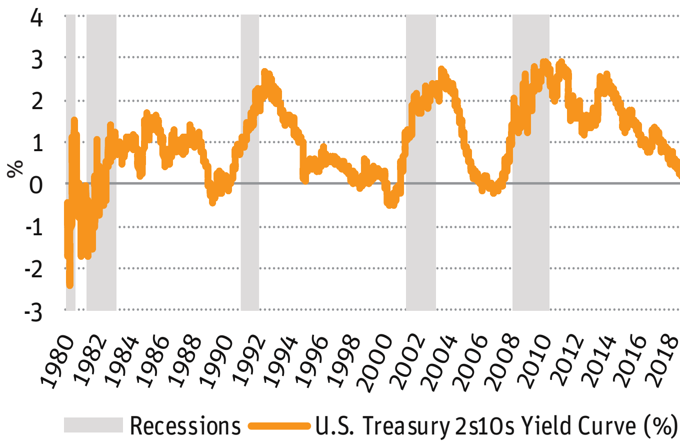
WE MAINTAIN OUR OUTLOOK FOR STEADY CURRENT INCOME

While we expect the expansion to last far longer than do most market participants, there are some interesting signs pointing to late-cycle characteristics including the flattening yield curve, U.S. equity valuations, U.S. corporate leverage, and global leverage. For example, the difference between the 10-Year Treasury and the 2-Year Treasury is currently at 0.27%, and if this time isn't different, once the curve drops below 0.40%, there is no turning back on the path to inversion. See Figure 2 which depicts the yield curve in relation to past U.S. recessions. Moreover, if this time isn't different, the recession will begin 18-24 months after the yield curve inverts. In addition to the curve's shape, there are other late-cycle signs. BAML recently noted, "As of August 22, 2018, the S&P 500 bull market became the longest of all time." Perhaps one of the most concerning signs is the inordinate size of the balance sheet of U.S. corporate assets in light of a tightening FOMC. According to BAML, "U.S. financial assets as a percentage of GDP are at 5.5 times, a record high."

If the current U.S. economic expansion continues until July 2019, as we expect, it will be the longest on record since the Civil War.

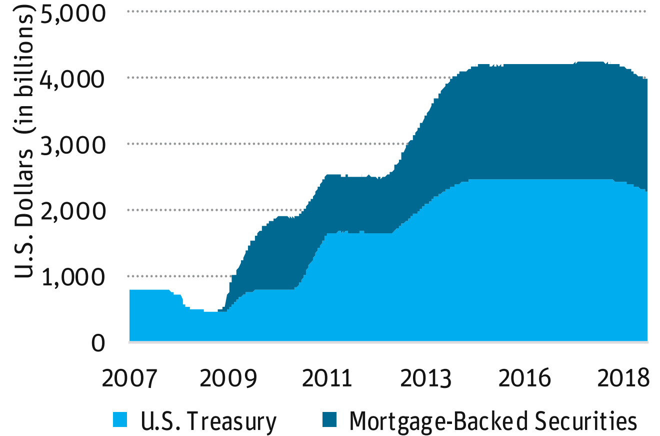
Not only is the FOMC raising its target rate, but it is also reducing the size of its bond portfolio in an exercise known as quantitative tightening (QT). See Figure 3, which depicts the amount of U.S. bonds in relation to mortgage-backed securities and treasuries.

Figure 2: U.S. Recessions and the U.S. Yield Curve



Source: Bloomberg.

Figure 3: Fed Balance Sheet



Source: Bloomberg.

This is unprecedented in modern tightening cycles and is also being done while the U.S. government is issuing record levels of debt to continue to fund growing deficits (Figure 4).

With less central bank support in the bond market, volatility should increase across markets, which is what we have seen so far in 2018. The purpose of quantitative easing (QE) was to drive investors out of safe assets into riskier assets, and therefore QT should do the opposite. QE drove down long-term yields, and fixed income investors looking for income were driven to either increase the duration within their portfolio, or move further down in credit to enhance yield. Investment grade corporations, high yield corporations, and the U.S. government took advantage of the low-interest-rate environment by increasing their amount of debt outstanding and extending their liabilities (Figure 5).

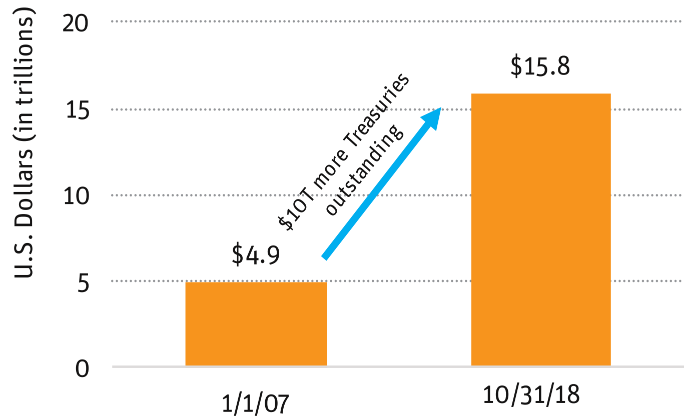
We are increasingly cautious toward both government-guaranteed liabilities due to the increased amount of interest rate risk of these securities in the current low-rate environment, as well as in overleveraged areas of corporate credit in which there have been tightening spreads amid worsening credit fundamentals (Figure 6).

Ironically, the mortgage assets that led to the crisis and ultimately to QE have continued to decrease in size in the post-crisis period and could be an area of safety for fixed income investors looking for high-quality income with less interest rate sensitivity as we approach the end of this cycle.

CREDIT QUALITY CONTINUES TO IMPROVE

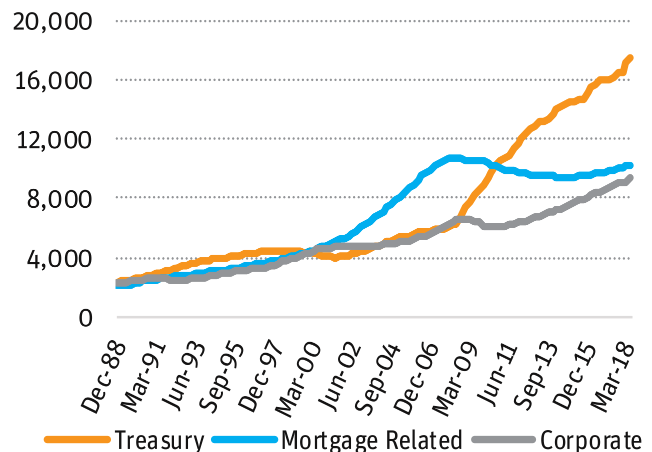
The legacy NA RMBS market and the new-issue non-agency market continue to show signs of improving credit quality in the current environment amid other signs of a late cycle. In fact, the U.S. residential mortgage credit cycle is showing signs of being in the early stages. Residential credit growth has been constrained in

Figure 4: Total Amount of U.S. Treasuries Held by the Public

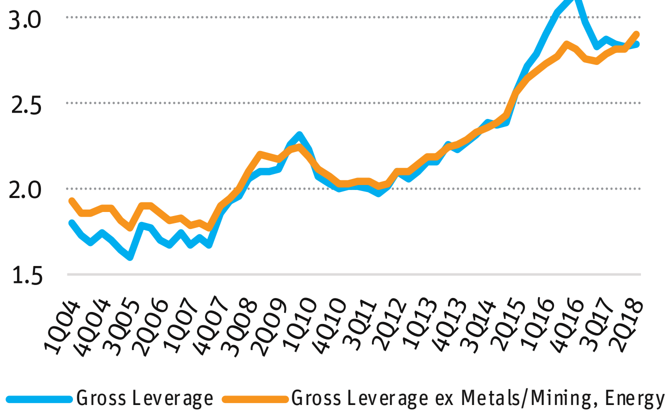


Source: U.S. Treasury, Haver Analytics, DB Global Markets Research.

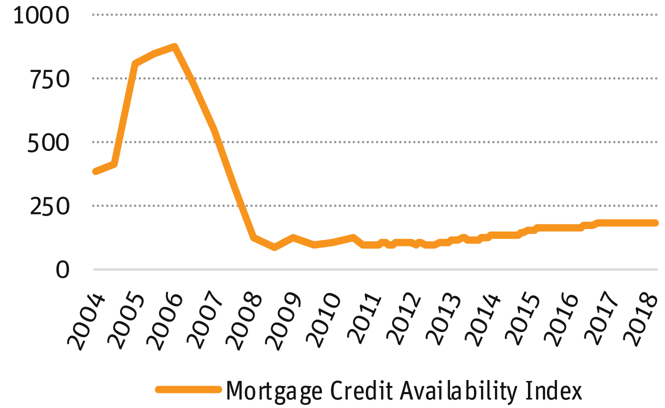
Figure 5: Outstanding U.S. Debt



Source: Bloomberg.



Source: JPM.



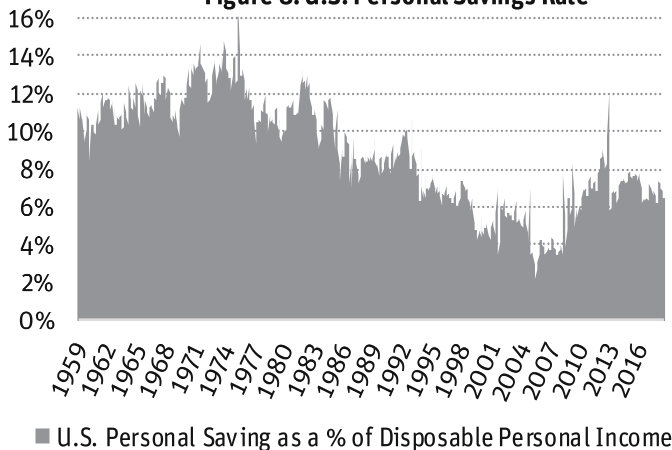
Source: MBA. Higher Index = More Credit Available. Lower Index = Less Credit Available.

the post-crisis period due to various market and regulatory reasons, and credit standards have increased dramatically, especially for borrowers not eligible for agency guidelines (Figure 7).

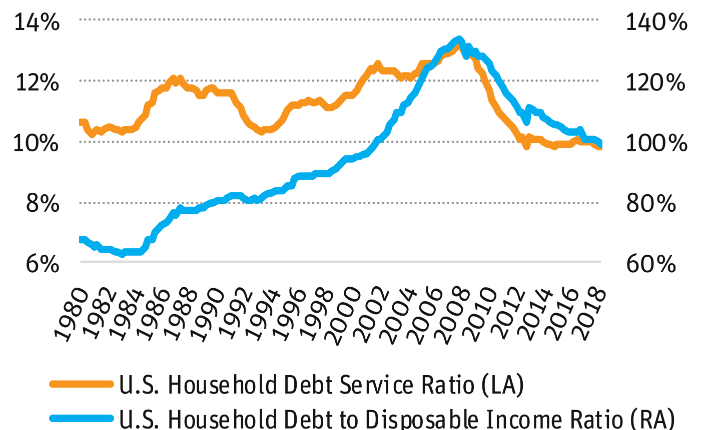
The banking system was penalized for its pre-crisis mortgage lending practices and has been under heavy regulatory scrutiny in the post-crisis period, causing banks to be very stringent when it comes to residential mortgage lending. Only the best borrowers have had access to mortgage credit in the post-crisis period, keeping the residential mortgage market less leveraged during this period. In addition to the lack of credit, U.S. consumer and residential borrowers have continued to demonstrate improved savings and leverage characteristics. For example, the personal savings rate (Figure 8) is at levels last seen in the 1990s and U.S. household debt-service ratios (Figure 9) are at levels last seen during the late 1970s.

Other strong residential mortgage credit fundamentals include generationally low unemployment levels, lower loan-to-value ratios (LTVs) due to increasing home prices, improving wage growth, and improving voluntary prepayment rates, which are particularly helpful for our legacy non-agency holdings.

The legacy non-agency market has benefited from the post-crisis fundamental tailwinds in the residential market and continues to be an area of focus for ANGIX. We expect the quality of the portfolio to improve while maintaining stable income. For example, the prime, Alt-A, and option ARM legacy NA RMBS we target at the top of the capital structure are still at deep discounts relative to par at approximately 86 cents on the dollar. The broad-based housing recovery has resulted in solid improvement in home equity in the U.S.

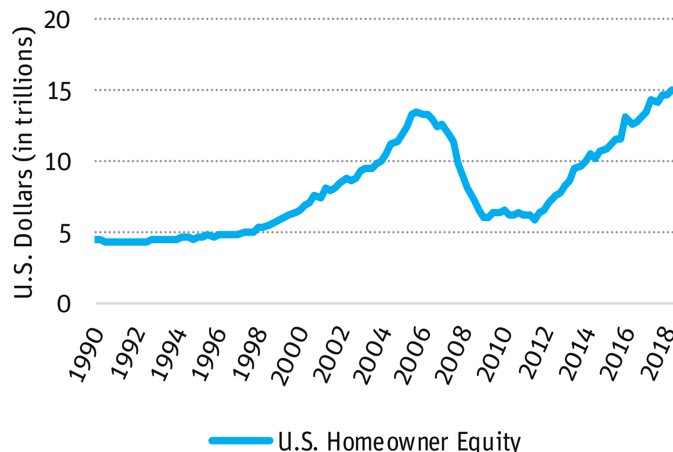


Source: Bloomberg.

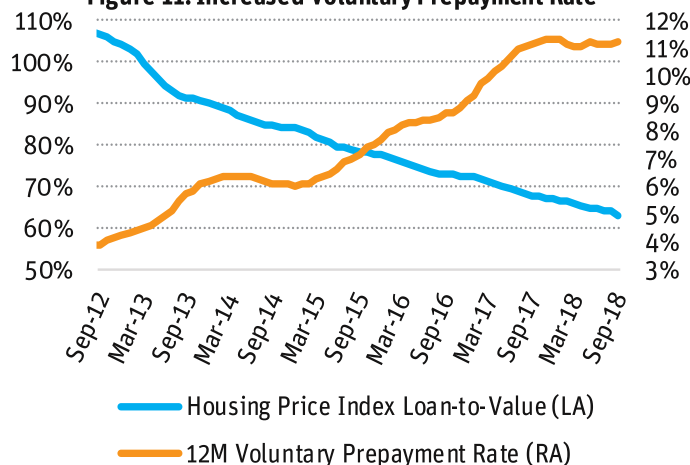


Source: Bloomberg.

(Figure 10), and the combined effect of increased home equity and ongoing amortization has resulted in ANGIX's LTVs falling below 60% (Figure 11). This continues to improve legacy NA RMBS borrowers' ability to refinance and enjoy the benefits of housing turnover in the U.S. (e.g., moving, upsizing, or downsizing homes).



Source: Citi Research.



Source: Bloomberg.
As of 9/30/18. Angel Oak Multi-Strategy Income Fund Holdings.

NEW ISSUANCE AND VOLUNTARY PREPAYMENT ARE PROMISING CREDIT TRENDS

Increased refinance and housing turnover activity in the U.S. is best illustrated by the increased voluntary prepayment rate (VPR) of our legacy holdings. VPRs increase the bond principal cash flow, which shortens the weighted average life and improves the credit quality (Figure 11).

In our view, this will be the catalyst for continued appreciation in the legacy NA RMBS allocation. RPL is another area of focus for capturing the fundamental improvement in the residential credit markets and has been a key area of growing new-issue non-agency supply.

Not only is RPL another attractive way to capture favorable residential credit trends, but it is also one of the leading subsectors of supply of NA RMBS new issuance. Gross NA RMBS supply is expected to end 2018 at $119 billion. Including the amortization of the various subsectors, the net supply in 2018 is expected to be slightly positive for the first time in the post-crisis period (Figure 12).

Figure 12:

Sector	2018 Gross Forecast	2018 Net Forecast	2019 Gross Forecast	2019 Net Forecast
Legacy Non-Agency RMBS	-	-60	-	-50
Non-Qualified Mortgage (Non-QM)	9	6	14	9
Credit Risk Transfer (CRT)	18	11	17	14
Non- and Reperforming Loan (NPL/RPL)	60	35	43	17
Jumbo Prime	24	16	35	31
Single Family Rental (SFR)	8	2	6	2
Total	119	10	115	23

Source: BofAML.

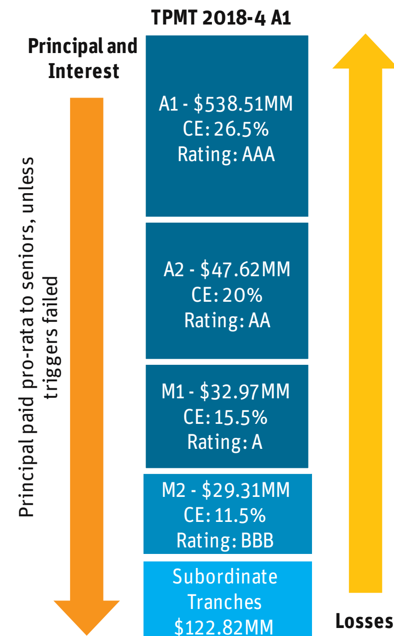
The market for RPL is where we have seen robust supply and where we have a lot of conviction in the new-issue NA RMBS market. These loans are very similar to the exposure in our existing legacy NA RMBS holdings. They were made prior to the credit crisis to borrowers that ultimately fell delinquent. The lender holding the non-performing loan subsequently modified the loan, and under the new terms, the borrower is now current. Large banks and GSEs, e.g., Fannie Mae and Freddie Mac, have been the largest sellers of their modified RPLs to the marketplace, and the RPL market has been well-received by market participants due to its seasoning, stable credit performance, high current spreads, attractive LTVs, and favorable interest rate characteristics. Our rigorous bottom-up credit selection process utilized for the legacy NA RMBS market is well-suited to analyze the collateral characteristics of the RPL market and is an exciting opportunity as robust supply, particularly from the GSEs, is expected to continue.

RPL exposure can be accumulated in either whole loan form or new and existing securitizations backed by a pool of RPL collateral. According to Wells Fargo, banks and GSEs have approximately $200 billion of RPL on their balance sheets. Market participants expect RPL supply to continue to grow through programmatic loan sales from the GSEs and banks and through subsequent securitizations sponsored by the RPL buyers. New-issue RPL securitizations provide a good overview of the typical characteristics of RPL collateral as well as what market participants are using to influence future performance assumptions.

POTENTIAL PROTECTION AGAINST FUTURE LOSSES

These characteristics of RPL new issuance are similar to the legacy non-agency market and provide attractive risk-adjusted return potential. While RPL securitizations don't enjoy the benefit of deeply discounted dollar prices of the legacy non-agency market, they do enjoy a favorable structural feature common in legacy NA RMBS: sequential payment structures. This gives senior bondholders a generous amount of protection from future losses in the form of credit support of the subordinate bonds in the capital structure. We favor the senior portions of both rated and unrated RPL securitizations. Senior rated RPL securitizations can have approximately 26.5% credit enhancement. As illustrated in Figure 13, this gives senior bondholders an inordinate amount of protection from future losses.

Figure 13:



Unlike the majority of the legacy non-agency market composed of floating rate bonds, RPL senior tranches are fixed-rate bonds. However, they are relatively short cash flows with low interest rate sensitivity and conservative prepayment assumptions. In addition to senior tranches of RPL securitizations, Angel Oak also favors purchasing RPL whole loan packages in which investors can pay deep discounts for a package of loans that have yet to be securitized. These discounted dollar prices should provide investors with not only protection from future losses, but also potential upside from future voluntary prepayments generating return potential that is commensurate with the legacy NA RMBS opportunity. These loan packages are unique in that they come in large sizes and allow investors to put significant amounts of capital to work in an area of credit exposure that has consistently been shrinking for bond market participants in the post-crisis period.

Another area of encouraging growth in new issue supply, and a focus for relative value in the NA RMBS space, is the new-issue non-QM market. We expect non-QM supply to continue to increase as nonbank lenders improve their familiarity with the Consumer Financial Protection Bureau requirements to evaluate a borrower's ability to repay and the factors that distinguish QM from non-QM lending. Positive housing fundamentals and strengthening consumer credit are also driving investors to embrace new issue non-QM, given their potentially favorable yield and credit characteristics. Current non-QM non-agency mortgage loans are similar to pre-crisis vintages, and market participants have begun viewing non-QM collateral as being similar to the Alt-A collateral characteristics of the pre-crisis period (Figure 14).

Figure 14:

	Non-QM	2003 Alt-A	2003 Subprime	CRT[1]	Prime Jumbo
Orig. FICO	697	710	640	750	770
Orig. LTV	74	73	80	83	75
Loan Size	$400K	$230K	$150K	$235K	$650K
Full Doc (%)	25	32	64	100	100
Weighted Average Debt-to-Income	37	N/A	N/A	34	33
Adjustable Mortgage (%)	65	34	63	0	25
AAA Enhancement (%)	35	15	20	N/A	10
Purchase (%)	80	40	31	64	50
Prior Credit Events (%)	45	Predominantly Clean Pay		0	0

[1]CRT offerings are split into low LTV (≤80 LTV) and high LTV (>80 LTV) pools. High LTV borrowers have mandatory MI requirement.

Sources: BofAML, Kroll.

The key difference between pre-crisis Alt-A collateral and today's non-QM origination is the overall quality and integrity of the mortgage underwriting process. Investors are more confident that newly originated non-QM loans are higher-quality than pre-crisis Alt-A collateral due to heightened underwriting requirements. While Angel Oak has historically focused on the most senior tranches in the legacy NA RMBS market, more subordinated tranches in the new issue non-QM securitizations are attractive from a relative value perspective. Currently, they yield approximately 4.50%, which is higher than IG Corporates and Agency mortgages with a potentially shorter-duration profile. This meaningful spread pickup versus comparable corporate bonds and agency RMBS offers significant relative value, especially considering the strong credit quality of the loans.

ANGEL OAK IS POISED TO CAPITALIZE ON WHAT WE BELIEVE TO BE A ROBUST PRIMARY MARKET

We believe favorable market conditions will continue to improve and pave the way for sustainable growth of NA RMBS supply in two key areas of the NA RMBS market: RPL and non-QM. The GSEs and large banks are expected to continue to sell RPL exposure to the tune of

approximately $75 billion in net supply per year over the next two years. We also expect the new non-QM market to grow to approximately $100 billion over the medium term. Only $3 billion of non-QM bonds were issued in 2017, a fraction of the approximately $1 trillion issued annually in 2005 and 2006, but we have seen approximately $9.5 billion issued year-to-date in 2018, in line with our expectations. The emergence of these two favorable areas of non-agency RMBS has enabled market participants like Angel Oak to target high-quality areas of residential credit we believe will prove to be more resilient in risk-off environments. It is also an area in which we could have the ability to improve the quality of the portfolio while maintaining income. As the FOMC continues to tighten, we will continue to go up in quality with higher income, which makes structured credit, particularly residential credit, more attractive due to the solid credit fundamentals of the U.S. consumer and equity creation that occurred during the great expansion. Therefore, we will continue to let the FOMC do the work for us and target high-quality floating rate and short-duration fixed-rate securities predominately backed by legacy NA RMBS and the emerging RPL and non-QM markets. This will continue to enable us to rotate into the most senior parts of the capital structure, which enjoy the most protection from future defaults and economic weakness while maintaining high current income.

SAM DUNLAP
Senior Portfolio Manager

Sam is a Managing Director and Senior Portfolio Manager at Angel Oak Capital and serves as a Portfolio Manager for the Angel Oak Multi-Strategy Income Fund and the Angel Oak Multi-Strategy Income UCITS Fund. He is also responsible for managing the separately managed accounts for Angel Oak clients, primarily depository institutions, and focuses on building and managing strategies within the residential mortgage-backed securities market as well as managing the interest rate risk exposure across the Angel Oak Funds and managed accounts.

Sam joined Angel Oak in 2009, and serves as a voting member of the firm's public funds Investment Committee. He has also been featured as a television guest on CNBC, Fox Business, and TD Ameritrade Network as well as quoted in Bloomberg and Reuters.

DAVID WELLS
Senior Portfolio Strategist

David is a Managing Director and Senior Portfolio Strategist at Angel Oak Capital. Since inception of the firm, David has had many responsibilities including portfolio management, trading, and most recently marketing.

David has over 15 years of fixed income trading and portfolio management experience. Prior to Angel Oak, David worked at SunTrust securitizing commercial mortgage loans and managing the banks $500 million commercial conduit loan warehouse. Prior to that, he spent six years managing a $3 billion commercial mortgage-backed securities (CMBS) and $10 billion agency mortgage pass though position of the bank's investment portfolio. He also served as the Head Analyst for the bank portfolio specializing in asset-backed securities, CMBS, and residential mortgage-backed securities.

HARKARAN TALWAR
Portfolio Analyst

Harkaran is a Portfolio Analyst at Angel Oak Capital Advisors and focuses on researching and building strategies in mortgage credit, including non-qualified mortgages and residential mortgage-backed securities (RMBS).

Harkaran joined Angel Oak in 2018 from Bank of America Merrill Lynch, where he was the primary research analyst covering non-agency RMBS. Prior to Bank of America Merrill Lynch, Harkaran was part of the Structured Products research team at Barclays. He began his capital markets career in 2007, working as a Structured Credit Trading Analyst at Lehman Brothers.

DEFINITIONS:

Cash Flow: Periodic coupons received by the bondholder during their holding period.
Debt-Service Coverage Ratio: The relationship of a property's annual net operating income to its annual mortgage debt service (principal and interest payments).
Debt-to-Income Ratio: A financial measure calculated by dividing total recurring monthly debt by gross monthly income.
Duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the duration, the greater the price change relative to interest rate movements.
Federal Housing Finance Agency Home Price Index: A broad measure of the movement of single-family house prices in the U.S. Apart from serving as an indicator of house price trends, the House Price Index (HPI) provides an analytical tool for estimating changes in the rates of mortgage defaults, prepayments, and housing affordability.
FICO: Fair Isaac Corporation.
Tranche: A portion of debt or structured financing. Each portion, or tranche, is one of several related securities offered at the same time but with different risks, rewards, and maturities.
Mortgage Credit Availability Index (MCAI): The MCAI is a barometer on the availability of mortgage credit using guidelines from institutional investors who purchase loans through the broker and/or correspondent channels. Higher index values signal that credit is more available, while lower index values indicate that mortgage credit standards are tighter.
S&P 500 Total Return Index: An American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
Weighted Average Coupon (WAC): The weighted average of the underlying coupon interest rates of mortgage loans using the balance of each mortgage as the weighting factor.

As of 9/30/18, none of the Angel Oak Funds directly held the securities mentioned in this article.

It is not possible to invest directly in an index.

Must be preceded or accompanied by a prospectus. To obtain an electronic copy of the prospectus, please visit www.angeloakcapital.com.

Mutual fund investing involves risk. Principal loss is possible.Investments in debt securities typically decreases when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and nonrated securities present a greater risk of loss to principal and interest than higher rated securities. Investments in asset-backed and mortgage-backed securities include additional risks that investors should be aware of including credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. Derivatives involve risks different from, and in certain cases, greater than the risks presented by more traditional investments. Derivatives may involve certain costs and risks such as illiquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. For more information on these risks and other risks of the Fund, please see the Prospectus.

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