Angel Oak
CAPITAL ADVISORS

2019 Outlook

Opportunities in structured and corporate credit

- 2019 ECONOMIC EXPECTATIONS
- MARKET VOLATILITY CREATING NEW MARKET OPPORTUNITIES
- THE RISE OF THE NEW ISSUE MORTGAGE CREDIT MARKET
- CONSUMER STRENGTH, TRENDS, AND FINDING VALUE IN THE ABS MARKETS
- RISK-REWARD IN CLOS IN 2019
- SOUND FUNDAMENTALS SUPPORTING COLLATERAL IN COMMERCIAL REAL ESTATE
- CREDIT SELECTION IS KEY FOR HIGH YIELD BOND STRATEGIES
- WELL-CAPITALIZED COMMUNITY BANKS AND DEBT VALUES

2018 Review

The year 2018 will go down as one of the most challenging years in the post-crisis period, with fewer asset classes beating inflation (Figure 1). Fears of a global and domestic growth slowdown, U.S. recession worries, and trade wars all weighed on risk assets. Most importantly, the Fed's tightening campaign, coupled with the reduction in its bond portfolio (Quantitative Tightening or QT) increased volatility and sent most global asset classes lower on the year, including risk-free alternatives that historically offset any weakness in risk portfolios. Interestingly, the current economic expansion is still robust, driven by historically accommodative monetary policy, generationally low unemployment rates and tax cuts.

FIGURE 1: 2018 RETURN

BBgBarc U.S. Agg. Bond TR	0.01%
BBgBarc U.S. Corp. IG TR	-2.51%
BBgBarc U.S. Corp. HY TR	-2.08%
S&P 500 TR	-4.38%
Consumer Price Index	1.90%

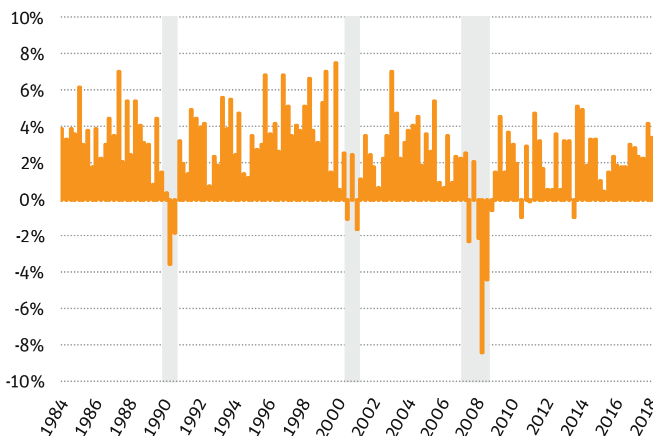
Source: Morningstar Direct as of 12/31/18.

2019 Economic Expectations

- The U.S. will not enter a recession, but growth will slow to an approximate 2%-3% annualized pace.
- The U.S. consumer position will remain healthy, driven by continued low unemployment, modest wage growth, and benign inflation.
- Fed policy will be more data-driven and will tighten at a more moderate pace than it did in 2018. We also expect the Fed to continue to shrink its balance sheet by $50 billion a month in 2019.

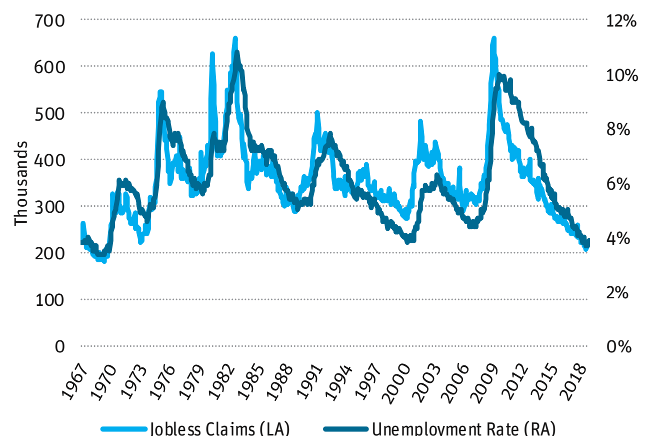
Despite recent headlines regarding an impending recession, we are cautiously optimistic about the economic outlook for 2019 and expect this expansion will continue, becoming the longest since the American Civil War.[1] While it is impossible to predict the exact timing of the end of the expansion, we expect that it will last well beyond 2019 and into 2020. Growth will likely slow into 2019 and 2020 as the impact of tax cuts and fiscal stimulus begin to fade, but we do not foresee a recession in the near term (Figure 2). We do not expect last year's pace of robust economic growth to continue, but a solid 2% growth rate is reasonable given the current data.

FIGURE 2: U.S. GDP QUARTER-OVER-QUARTER



Source: Bloomberg as of 9/30/18.
Shaded gray bars represent periods of recession.

FIGURE 3: U.S. UNEMPLOYMENT RATE AND JOBLESS CLAIMS



Source: Bloomberg as of 12/31/18.

The labor market is very healthy at the moment. The unemployment rate is at 3.9% and wages are improving at approximately 3.1% per annum. Payrolls have increased an average of 220,000 per month over the past four months, well ahead of the 100,000 per month required to continue the downtrend in the unemployment rate, which could remain below 4% throughout 2019 (Figure 3).

Market participants are closely watching the shape of the yield curve because it has historically been an excellent indicator of potential volatility in the marketplace and a recession. In the past, the Fed tended to tighten too far too fast, sending the U.S. economy into recession. We ultimately believe the Federal Open Market Committee (FOMC) will eventually tighten the U.S. into recession, but this expansion will last far longer than market participants expect. Recent rhetoric points to the FOMC dramatically slowing its pace of tightening.

As Federal Reserve chairman Jerome Powell said at the Atlanta Fed's economic conference on January 4, 2019, the FOMC will continue to

[1]BAML research.

reduce the size of the Fed's balance sheet in the form of QT but will be more data-dependent with respect to increases in the target rate. Most enlightening from the conference, he reiterated, "[The Fed] will be prepared to adjust policy quickly and flexibly, and to use all of our tools to support the economy, should that be appropriate to keep the expansion on track, to keep the labor market strong, and to keep inflation near 2%." The bottom line is that the FOMC wants to avoid overtightening in 2019, while supporting robust growth over the medium term. We think a pause in tightening for 2019 is warranted, and also believe that a re-steepening of the U.S. yield curve is quite possible if the growth picture stabilizes.

More Volatility in 2019

We expect more risk-asset volatility in 2019. The FOMC is not only utilizing its target rate for removing monetary policy accommodation, but it is also reducing the size of its bond portfolio through QT (Figure 4). This is unprecedented in modern tightening cycles and is also occurring while the U.S. government is issuing record levels of debt to continue to finance growing deficits (Figure 5).

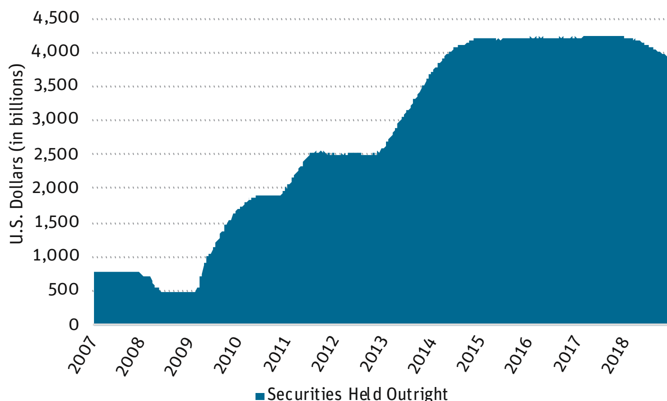
With less central bank support in the bond market, volatility should remain high, which is what we experienced towards the end of 2018. The purpose of quantitative easing (QE) was to drive investors out of safe assets and into riskier assets, and therefore QT should do the opposite. QE drove down long-term yields, and fixed income investors looking for income were driven to either increase the duration of their portfolios 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 outstanding debt and extending their liabilities. Investment-grade corporate returns are a great example of the challenges that QE and QT pose: rates moved higher and spreads shifted wider in 2018, resulting in performance of -2.51% (Figure 1).

We are increasingly cautious about government-guaranteed liabilities, due to their increased interest rate risk in the current low-rate environment. We also have concerns in overleveraged areas of corporate credit in which spreads have tightened amid worsening credit fundamentals.

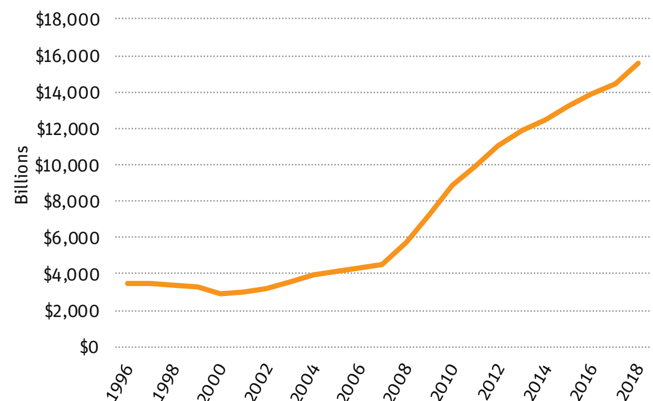
In early 2018, we improved the credit quality across our fund complex. This higher-quality positioning dampened net asset value volatility during the recent market turmoil, enabling us to rotate into more attractive assets toward quarter end. Significant opportunities have begun to emerge in various areas of the U.S. structured credit landscape. For 2019, we see the best risk-adjusted returns in legacy and new-issue non-agency RMBS, U.S. financials, and shorter-duration CMBS, CLOs, and ABS.

FIGURE 4: FED BALANCE SHEET



Source: Federal Reserve as of 12/31/18.

FIGURE 5: TOTAL AMOUNT OF U.S. TREASURIES HELD BY THE PUBLIC



Source: SIFMA as of 12/31/18.

Fixed Income Market Segment Opportunities

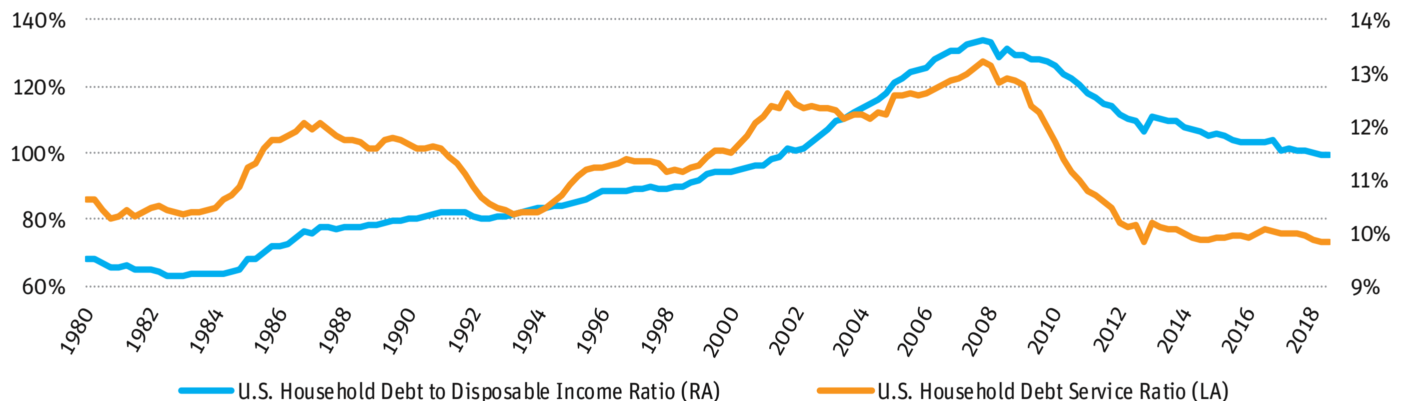
Non-Agency RMBS

The non-agency RMBS market continues to show signs of improving credit quality in the current environment despite signs of a late cycle in other areas of credit. 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 the post-crisis period for various market and regulatory reasons, and credit standards have increased dramatically, especially for borrowers not eligible under agency guidelines.

The legacy mortgage-backed securities that contributed to the 2008 crisis and ultimately to QE have continued to decrease in size in the post-crisis period. We believe this asset class could be an area of lower volatility for fixed income investors looking for high-quality income with less interest rate sensitivity as we approach the end of this cycle.

The banking system was penalized substantially for poor mortgage lending practices that exacerbated the housing crisis. Since then, regulations addressing residential mortgage lending have become far more stringent. Only the best borrowers have had access to mortgage credit in the post-crisis period, constraining the amount of leverage in the residential mortgage market.

FIGURE 6: U.S. HOUSEHOLD SPENDING ACTIVITY



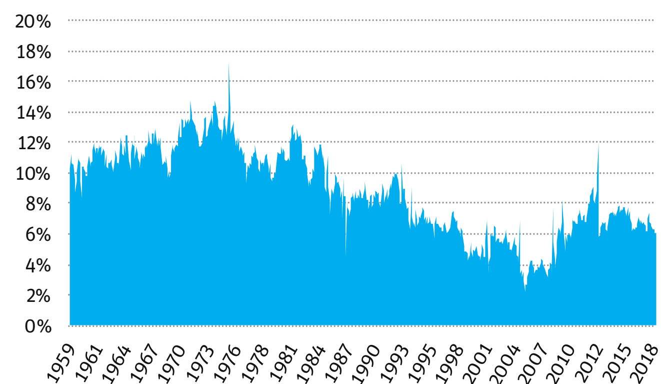
Source: Bloomberg as of 6/30/18.

In addition to lower levels of leverage, U.S. consumer and residential borrowers have also increased their savings. For example, U.S. household debt-service ratios are at levels last seen during the late 1970s (Figure 6), and the personal savings rate is at levels last seen in the 1990s (Figure 7).

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.

After years of continuous improvement in single-family housing fundamentals, softness in the housing data began to emerge in late 2018. We attribute the recent slowdown to lower affordability driven by rising mortgage rates and robust home price appreciation since 2012. We also view this slowdown as temporary and believe that the longer-run health of the housing cycle is sustainable for the foreseeable future. It is important to remember that this is not 2007, and investors should be very careful when comparing the time frames.

FIGURE 7: U.S. PERSONAL SAVINGS RATE

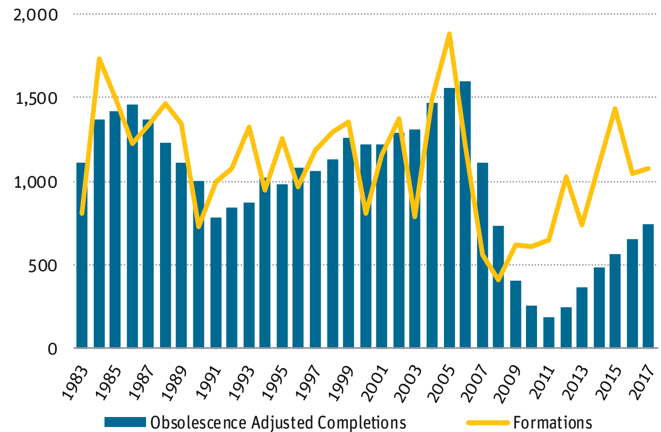


Source: Bloomberg as of 11/30/18.

For example:

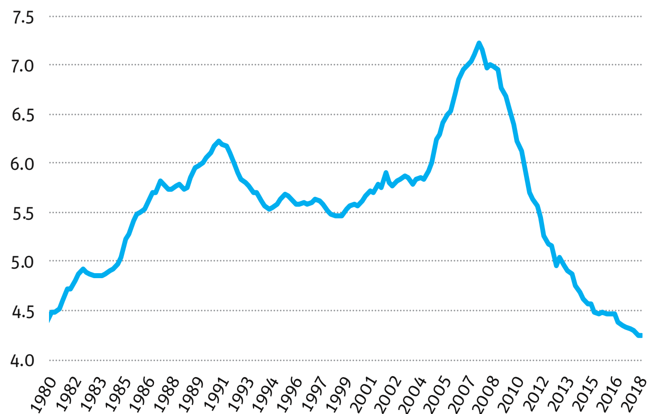
- Housing measured as a percentage of GDP is at approximately 4% of GDP compared with 6.5% in the pre-crisis period.[1]
- Housing supply is low, while demand, especially from millennials, is expected to gain strength (Figure 8). In our view, home price appreciation will revert back to the growth rate of U.S. household income.
- Despite affordability concerns, we are still optimistic from a supply and demand perspective. We see the market solving the issue of an oversupply of higher-priced homes and shifting to first-time homebuyer products amid a broader push to build more affordable homes for millennials.
- The U.S. consumer has delevered in the post-crisis period. Households remain healthy, as mortgage payments, a percentage of total income, are at 40-year lows (Figure 9).

FIGURE 8: FORMATIONS VS. COMPLETIONS



Source: Morgan Stanley.

FIGURE 9: MORTGAGE DEBT SERVICE PAYMENTS AS A PERCENT OF DISPOSABLE PERSONAL INCOME



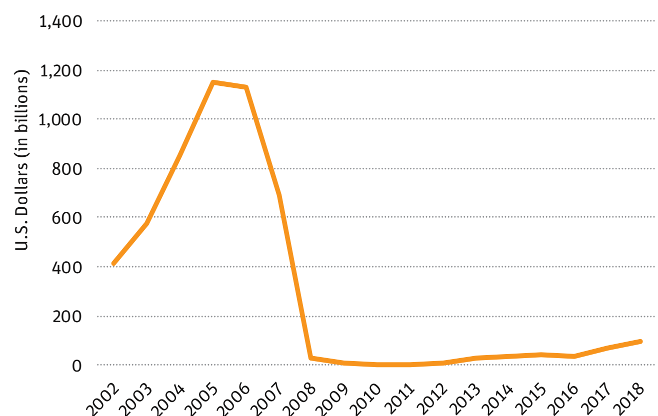
Source: Bloomberg as of 6/30/18.

Mortgage Debt Service Ratio Is At Historic Lows

The non-agency RMBS sector had another strong year in 2018 after several years of post-crisis outperformance. The fundamental tailwinds of the broad-based housing recovery have resulted in solid improvement in home equity in the U.S. The combined effect of increased home equity and ongoing amortization has resulted in LTVs falling below 60% for our legacy RMBS exposure. This has resulted in higher Sharpe ratios for non-agency RMBS as they continue to exhibit high current carry and lower spread volatility amid broader market spread-widening events such as Q4 2018. Across all fixed income, 2018 was a year defined by supply, and non-agency RMBS were no different. It was the busiest supply year in the post-crisis period, with over $115 billion of new issue coming to market. In fact, it was the first year since the crisis in which the non-agency RMBS market actually grew in the total amount of bonds outstanding. Heavy supply weighed on spreads across fixed income, and prices moved slightly lower on the year within the space. However, that was more than offset by positive high-quality floating-rate carry, resulting in a positive total return for the asset class. We sought to be at the senior part of the capital structure in Alt-A and Option ARM, which benefited from the continued move higher in LIBOR and increased prepayment rates.

Looking ahead to 2019, legacy non-agency RMBS will continue to play a major role across our portfolios, but we expect to see a further increase in our allocations to new-issue non-agency RMBS. Within the new-issue non-agency RMBS sector, we favor whole loans and bonds backed by non-qualified mortgages (non-QM) and reperforming mortgage loans (RPLs).

FIGURE 10: TOTAL NON-AGENCY RMBS ISSUANCE



Source: BAML Global Research as of 12/31/18.
Non-agency RMBS: Legacy, Jumbo 2.0, Non-QM, NPL

An area of encouraging growth in new issue supply, and a focus for relative value in the non-agency 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 other factors that distinguish QM from non-QM lending. Positive

[1]Citi research.

housing fundamentals and strengthening consumer credit are also driving investors to embrace new-issue non-QM given their potentially favorable yield and credit characteristics.

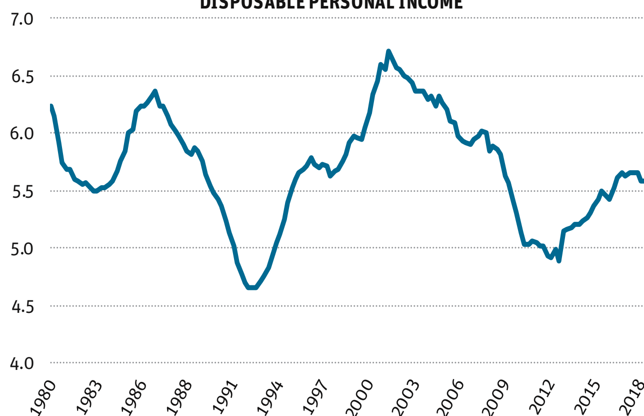
We believe favorable market conditions will continue to improve and pave the way for sustainable growth of non-agency RMBS supply in two key areas of the non-agency RMBS market: non-QM and RPL (Figure 10). We expect the new non-QM market to grow to approximately $100 billion over the medium term. Only $3 billion of non-QM bonds were issued in 2017, a fraction of the approximately $1 trillion of non-agency RMBS issued annually in 2005 and 2006, but we saw approximately $9.5 billion issued in 2018, in line with our expectations. The government-sponsored enterprises 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. 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 offer exceptional relative value and total return potential.

Asset-Backed Securities

Given our outlook of heightened volatility in 2019, we believe certain segments of the traditional ABS markets should outperform. For 2018, total returns across most ABS sectors were positive, as tighter spreads broadly across structured credit and strong underlying fundamentals within ABS collateral both provided positive tailwinds for the asset class. Fundamentals across various U.S. ABS sectors have actually outperformed what most strategists had predicted. This backdrop has led to 2018's gross issuance of $240 billion, eclipsing 2017's post-crisis record of $239 billion. From an outstanding total market size perspective, ABS now represents approximately 25% of the $2.8 trillion structured credit market.

We believe ABS sectors should be an outperformer relative to both U.S. corporate credit and longer-duration structured products.

FIGURE 11: CONSUMER DEBT SERVICE PAYMENTS AS % OF DISPOSABLE PERSONAL INCOME



Source: Bloomberg as of 6/30/18.

We are finding the most relative value in investment grade, shorter-duration sectors of ABS. The credit curve flattened 30-50 basis points within benchmark tranches of ABS last year, making the higher-quality tranches more attractive on a risk-adjusted basis. Additionally, given their short-duration nature and a flattening yield curve, attractive opportunities with yields of 3.5%-4.5% are now available in IG-rated auto ABS with maturities of 1-2 years.

We have seen improving credit fundamentals in recent years. Auto loan originators tightened lending standards in 2016 and 2017, creating a more favorable credit environment for 2017, 2018, and 2019 vintage deals. Additionally, used-vehicle prices reached a recent bottom over the past 18 months after declining approximately 10% in 2015-2016.

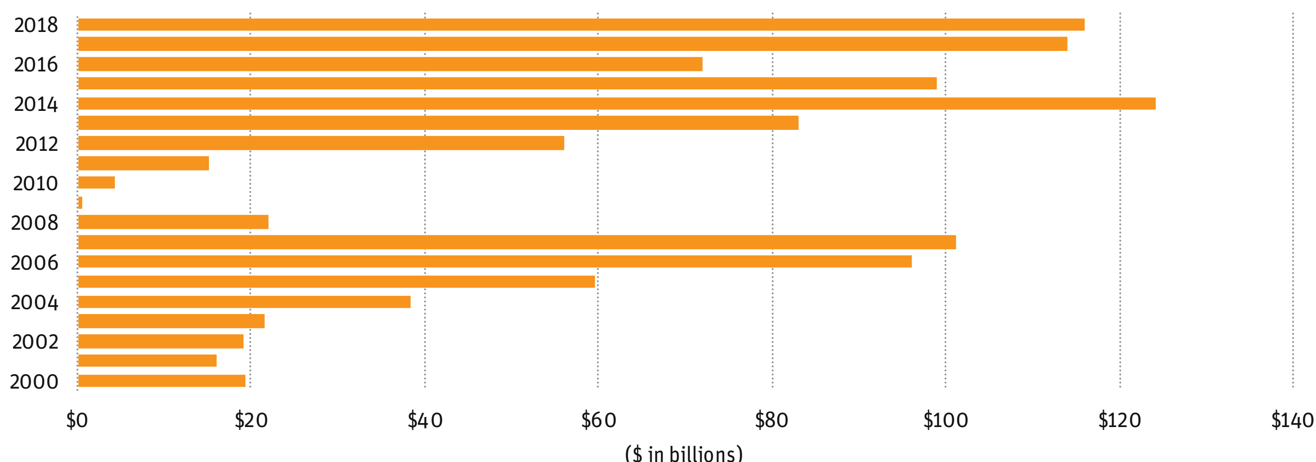
The U.S. consumer continues to be the bright spot in the U.S. economy, with low leverage (Figure 11), low unemployment, and rising wage inflation. Given this backdrop, we are finding the best opportunities in short-duration auto ABS. We believe this sector provides attractive total return opportunities and has exhibited less price volatility than similarly rated corporate credit. Additionally, the deal structures provide ample credit enhancement to senior bondholders, while the short-duration nature of the asset class limits price volatility.

The most powerful tailwind to the auto ABS asset class is the rapid deleveraging of the underlying deal structures. As bonds season in auto ABS, tranches delever by building credit enhancement each month; thus, the credit risk will actually decrease over time at the tranche level. This is in direct contrast to traditional areas of U.S. credit. We find particular value in IG-rated auto ABS in our short-duration allocations across the fund complex.

As the Fed continues to remove monetary accommodation, we expect both credit and liquidity risk premiums to rise throughout next year. Our focus is to allocate toward low-duration, high-quality ABS sectors that are less susceptible to changes in credit spreads. This positioning is more defensive in nature and should provide the opportunity to rotate into sectors that underperform in 2019. While we believe 2019 is biased toward higher spread and price volatility across risk assets, there are attractive sectors within ABS that can offset broader market disruptions.

Collateralized Loan Obligations

FIGURE 12: CLO ISSUANCE



Source: Wells Fargo as of 12/31/18.

New-issue (including refi and reset) supply (Figure 12) was the main headwind for CLO returns in 2018. Demand for floating-rate assets in general, and Japanese bank demand for AAA CLOs especially, has fueled the CLO new-issue machine. Spreads started leaking wider from the post-crisis tights we set earlier in 2018 amid high supply. General corporate credit spread widening contributed to this phenomenon. Spread widening was orderly until late October, at which point spreads started to widen rapidly into year-end. Macro weakness, poor year-end liquidity, and forced selling from fixed income funds facing redemptions exacerbated this latest widening move.

In anticipation of a more volatile market due to a more aggressive Fed and continued froth in the bank loan market, we began shifting our credit exposure in CLOs up the capital stack from BBB/BB to AAA/AA over the past 12 to 18 months. The CLO market has a high "beta" with spread moves that exceed moves in investment grade and high-yield corporate bond spreads, particularly during spread-widening episodes, and the recent widening was no different. Moving higher up the capital stack softens the volatility in prices, and it helped us outperform versus the broader CLO market returns in 2018. Spreads across the capital stack are now back to levels we saw at the end of 2016.

Generally speaking, CLO spreads look attractive versus corporate bonds; in particular, if rates keep rising in 2019. With investment grade corporate bonds at a spread of 150 basis points and high-yield spreads at 525 basis points, we would prefer to go long on corporate credit risk in CLOs. We would expect to maintain a small and nimble allocation to CLOs to continue take advantage of these dislocations. For example, we felt the quick loan price decline of about 4% over the last two months of 2018, coupled with rapid spread widening into year-end, provided a buying opportunity to start 2019. Rotating down in credit to target short-defensive IG-rated profiles allowed us to capitalize on dislocated market technicals as default and recovery assumptions from market participants have since returned to pre-November levels.

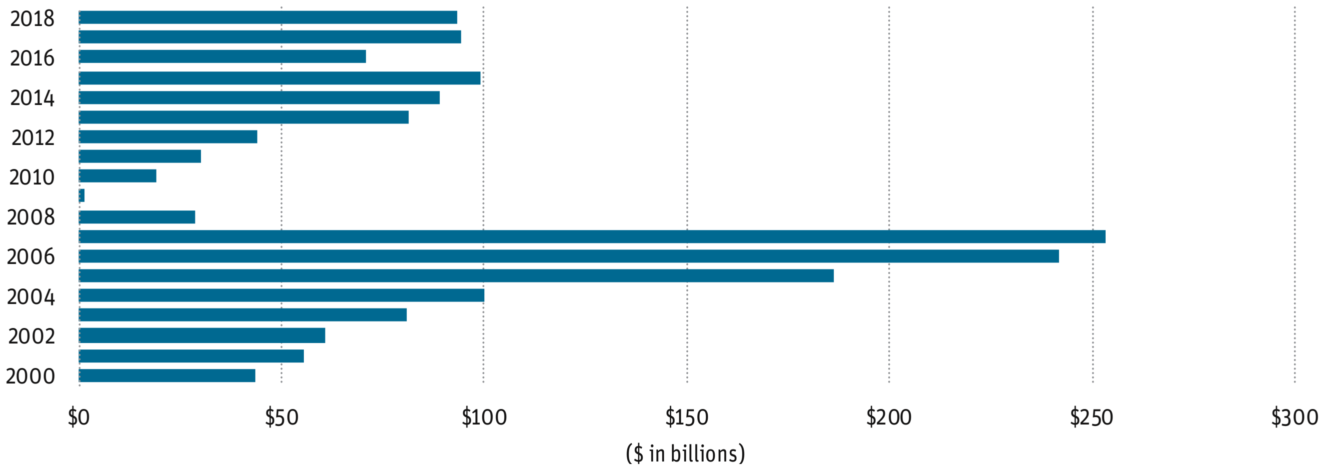
We think this defensive positioning in CLOs will lead to continued outperformance. As late-cycle concerns mount, investors will want to be paid for higher defaults and volatility. The downside risk in prices is much larger for CLO mezzanine in a market-bottom scenario, which is why we would be very selective in adding any risk there even at current spreads. Overall, further spread widening caused by new-issue supply of CLOs outstripping demand and continued secondary selling pressure continues to be a risk. Fundamentals are not alarming for the short term, and we remain aware of "yellow flags." The ballooning size of the overall market, weaker documentation, lack of junior debt, record-high leverage ratios, generous EBITDA add-backs, and a high percentage of B3-rated loans are among the risks. Still, it would be surprising to see a spike in defaults and downgrades in 2019 if the economy continues to grow (albeit at a slower pace) and earnings growth keeps interest coverage healthy.

Commercial Mortgage-Backed Securities

After a strong start to 2018 in the CMBS market, spreads gave back their gains in the fourth quarter and ended the year wider across the credit curve. 2018 new-issue volumes finished at $93.11 billion (Figure 13), in line with 2017 volume of $94.3 billion,[1] a very healthy technical for us to observe. In summary, CMBS investors digested over $90 billion of new bonds, and the risk-retention structures of these bond transactions continue to be well received as spreads in September reached their tightest levels in a 10-year span.

[1]BAML research.

FIGURE 13: CMBS ISSUANCE



Source: BAML Global Research as of 12/31/18.

Commercial real estate (CRE) fundamentals should continue to support strong collateral performance in 2019. However, rising interest rates may put pressure on capitalization rates, which may lower net operating income growth or at least moderate the growth potential. Recent CRE origination exhibits lower leverage versus CRE originations prior to the financial crisis of 2008, and delinquency trends remain low. As of October 2018, vintage deals recorded the highest cumulative 60+ day delinquency rates at 1.2%, while all the other vintage years from the CMBS 2.0[1] recorded cumulative 60+ day delinquency rates between 0.2% to 1.0%.[2]

If there is a possible area of disruption on the horizon, it would be the retail property sector, which is still perceived as the riskiest area of CRE markets. Retail properties are still vulnerable to lower valuations due to pressure from e-commerce shopping trends and shrinking business margins. For more than 20 years, Amazon has modified consumer behavior with a focus on both helping consumers spend less time shopping and delivering options more customized to individual spending habits. Retailers will still need to adapt to this Amazon model in order to match the ease and instant gratification of e-commerce shopping. Some REITs/mall operators have initiated multibillion-dollar plans to update their centers and are focusing on creating experiences not found through shopping online. The broader trend is to transform the traditional mall into a town center that offers dining, recreation/entertainment, and boutique shopping. However, there are still potential headwinds for 2019 stemming from new store closure announcements.

We positioned our CMBS portfolios in a defensive posture throughout 2018. We focused on reducing risk, avoiding bonds that included higher concentrations of retail property type risk, moved higher in the capital structure, and improved underlying credit quality. Our reduced allocation in this sector will enable us to be opportunistic in 2019. Assuming headlines about retail property continue to be negative in 2019, CMBS bond prices will likely soften. We think waiting for a better absolute entry point for BBB- securities and a steeper credit curve is a prudent approach. In the interim, we will also continue to focus on the single-asset/single-borrower sector of the CMBS market, which are generally floating rate securities backed by higher-quality assets or borrowers. These bonds are shorter in duration, have built-in structural protection, and lack any tail risk.

> With the recent pullback in the high-yield sector along with other risk assets, valuations look more attractive than they did at the end of the third quarter.

Finally, we want to mention the agency CMBS market, which are bonds backed predominantly by multi-family properties. Despite the length of this cycle for apartments, the general undersupply of housing units in the U.S. continues to drive strong performance by the underlying collateral. With over $155 billion of issuance in 2018, we expect that opportunities will continue to emerge as the market is faced with heavy supply.

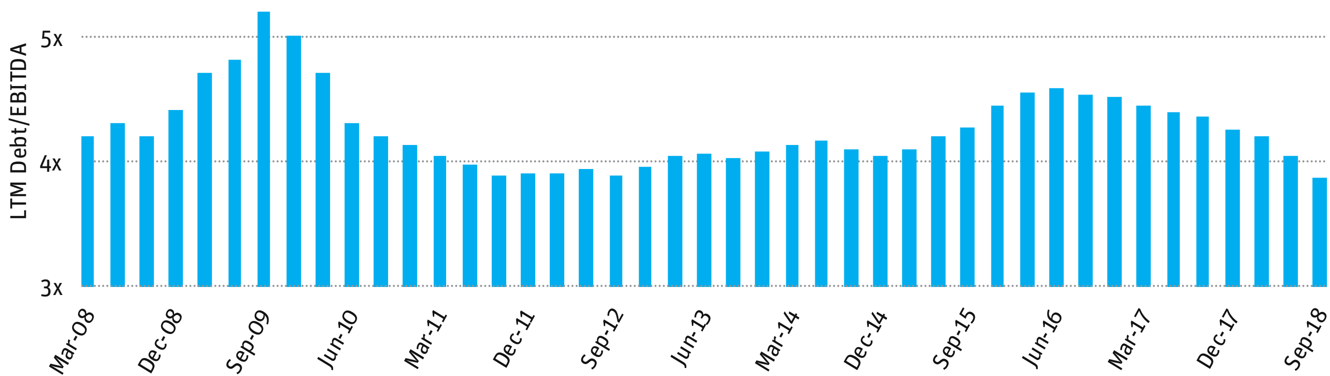
High-Yield Corporate Bonds

There are three main drivers in the high-yield sector that impacted the market in 2018. The first is that throughout most of 2018, high-yield corporates benefited from the strong underlying economy and tax cuts passed at the beginning of the year. GDP improved over the course of the year, from 2.3% in the fourth quarter of 2017 to 3.5% for the third quarter of 2018. The strong economic performance translated into growth in revenue, margins, and cash flows, and in improvement in the credit profile of high-yield issuers in aggregate. J.P. Morgan's credit

[1]CMBS 2.0 is defined as securitized commercial transactions beginning in 2010.
[2]Morgan Stanley research.

fundamentals update for the third quarter of 2018 showed improvement continuing for the ninth consecutive quarter: higher revenue, higher EBITDA, lower leverage, and higher interest coverage (Figure 14).

FIGURE 14: LEVERAGE RATIOS DECREASED TO A POST-CRISIS LOW



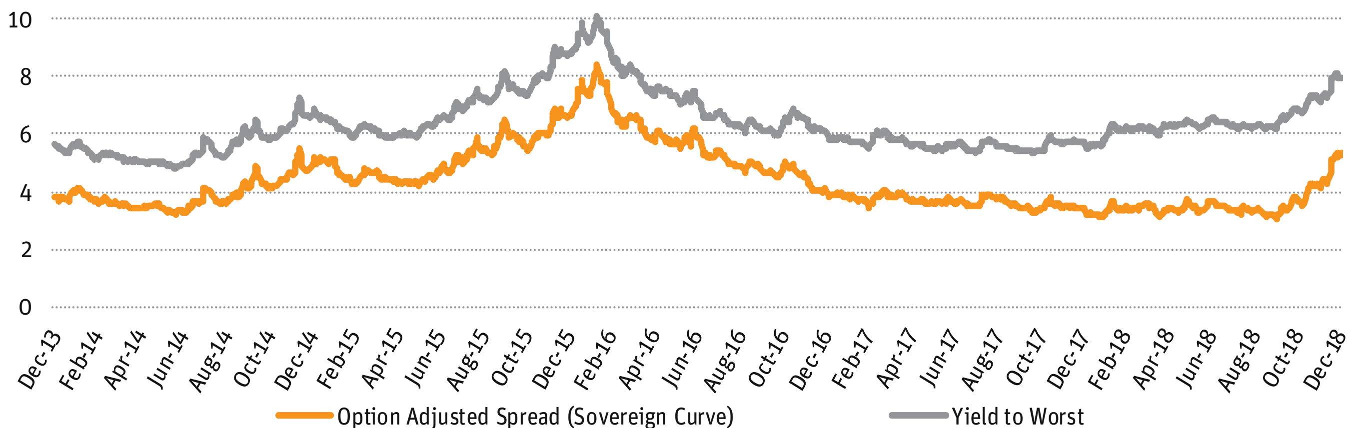
Source: J.P. Morgan and Capital IQ as of 9/30/18.

The second driver is because of their shorter maturities and higher coupons, high-yield corporates are generally less sensitive to rising rates. This was very apparent in 2018; through the end of November, the return on the Bloomberg Barclays U.S. Corporate High Yield Index was slightly positive, while the Bloomberg Barclays U.S. Corporate Index was down 3.9%. Prior to the financial crisis, high-yield interest rate sensitivity averaged about 75%-80% of investment grade corporates, but that has dropped to just over 50% as investment grade corporates took advantage of low interest rates to expand their balance sheets, extend maturities, and lock in low coupons. In addition to lower sensitivity to rising rates, high-yield corporates offer more than three times the credit spread pickup of investment grade corporates.

The third factor contributing to the performance of high-yield in 2018 is more of a technical factor as opposed to fundamental: the sharp drop in supply. Companies are constantly bringing new debt issues to market for various purposes, from refinancing maturing bond issues to financing acquisitions and even fund stock buybacks and dividends. However, in 2018, the number of high-yield bonds issued declined more than 40% from 2017. This translates into fewer high-yield corporate bonds available for high-yield investors to reinvest proceeds from coupon payments and maturities. That can be a positive contributor to the overall stability of valuations at the margin.

Our outlook for the high-yield sector can be summed up as cautiously optimistic. In aggregate, high-yield corporate credit fundamentals are positive, with growth in revenue and cash flow and with leverage measures down for nine consecutive quarters. Both S&P and Moody's forecast continued benign, if not lower default rates in the coming year. The fundamental backdrop is positive, with unemployment at a historically low 3.7% and forecasted to continue to decline, with wages continuing to gradually accelerate and are up 3.05% year-over-year. Plus, the consumer appears to be in solid shape, with household balance sheets in the strongest position since at least the early 2000s based on the percentage of disposable income allocated to debt service payments, and total debt as a percentage of disposable income. Credit spreads and yields have backed up over the past three months to their most attractive levels since mid-2016 (Figure 15). Within that context, we remain overweight in sectors leveraged to positive economic growth, but are focused on risk reward and are emphasizing higher-quality credits that generate positive free cash flow and have improving credit profiles.

FIGURE 15: HIGH-YIELD SPREADS



Source: Bloomberg as of 12/31/18.

Bank Debt

We believe the bank debt market offers one of the most compelling risk-return profiles, particularly in the smaller bank space. We are in a unique environment, where the banking industry is near all-time highs from a capital and credit quality perspective compared with the broader corporate market.

Regulation has been the driver of this bifurcation, where legislation has required banks to increase their capital base by more than 30% since the 2008 crisis, limiting banks' ability to hold what are deemed to be riskier assets. Increased levels of regulatory oversight have turned banks into near-utilities. The banking industry today is extremely healthy relative to the past 50 years given improvements on both sides of the balance sheet, and we feel that we are investing in high-credit-quality institutions at yields normally associated with high-yield corporate credit (Figure 16).

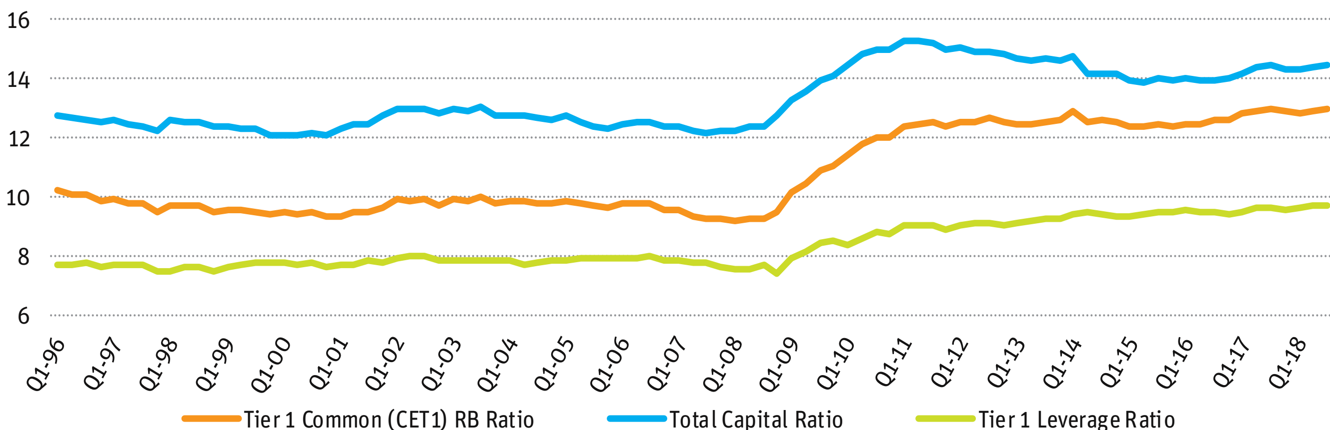
We also anticipate continued consolidation given the need for scale and the overbanked nature of the U.S. financial system. Historically, larger banks have acquired smaller banks, with the debt of the smaller bank being assumed by the larger bank. This outcome typically generates sizable price appreciation. In 2018, the banking sector benefited from several positive tailwinds: (1) higher interest rates drove net interest margin expansion, (2) continued strong credit trends resulted in lower non-performing assets and lower loan loss provisioning, (3) a lower corporate tax rate enhanced earnings growth, 4) increasing consolidation drove price appreciation in senior and subordinated bank debt.

The FDIC's recent review of the third quarter of 2018 highlights some of the drivers of our positive outlook on banking sector fundamentals:

- → Net income for the sector was up 29.3% from the year-ago quarter due to higher revenues, a lower effective tax rate, and lower loan-loss provisions.
- → The average return on average assets increased by 0.29% to 1.41%, the highest quarterly level reported by the industry since the FDIC's Quarterly Banking Profile began in 1986.
- → Net interest margin continues to expand relative to the year-ago quarter, as the average yield earned on loans increased faster than average funding costs.
- → Loan growth remains moderate at 4% annual growth, down slightly from 4.2% annual growth in the second quarter.
- → Credit remains strong, with better nonperforming loan trends (improved to 1.02% from 1.06% in the second quarter of 2018).
- → Finally, the number of banks in the "Problem Bank List" continues to decline, down from 82 institutions in the second quarter to 71 institutions – the lowest number since the third quarter of 2007. There were no bank failures.

The key risk within the bank debt space remains deteriorating credit quality. However, credit quality across the sector remains pristine, with non-performing assets/total assets improving by 12 basis points relative to the year-ago quarter. We have seen a lot of volatility in the equity markets lately, and banks, particularly smaller banks, have been no exception. We closely monitor earnings and equity market trends for the read-across impact to bank debt, though we note that equity markets are typically more influenced by the rate of change of future earnings growth, while bank debt is more correlated with asset quality trends.

FIGURE 16: CAPITAL RATIOS



Source: S&P Global Market Intelligence as of 6/30/18.

DEFINITIONS

ARM: Adjustable-rate mortgage.
EBITDA: Earnings before interest, taxes, depreciation and amortization. It is a measure of a company's financial performance and is used as an alternative to earnings or net income in some circumstances.
Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
Beta: A measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.
Bloomberg Barclays U.S. Aggregate Bond Index: An unmanaged index that measures the performance of the investment-grade universe of bonds issued in the United States. The index includes institutionally traded U.S. Treasury, government sponsored, mortgage and corporate securities.
Bloomberg Barclays U.S. Corporate High Yield Bond Index: An unmanaged market value-weighted index that covers the universe of fixed rate, non-investment grade debt.
Bloomberg Barclays U.S. Investment Grade Corporate Index: An index that covers the publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.
Cash Flow: The net amount of cash and cash-equivalents being transferred into and out of a business, especially as affecting liquidity.
Consumer Price Index (CPI): An index that measures the changes in the price of a certain collection of goods and services bought by consumers in an effort to measure inflation.
Credit Spread: The difference in yield between two bonds of similar maturity but different credit quality.
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.
Free Cash Flow: A measure of how much cash a business generates after accounting for capital expenditures. This cash can be used for expansion, dividends, reducing debt, or other purposes.
Household Debt Service Ratio: The ratio of total required household debt payments to total disposable income.
LIBOR: A benchmark rate that some of the world's leading banks charge each other for short-term loans. It stands for Intercontinental Exchange London Interbank Offered Rate and serves as the first step to calculating interest rates on various loans throughout the world.
Return on average assets (ROAA): The ROAA measures the efficiency with which a business utilizes its assets to generate a profit.
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.
Sharpe Ratio: A statistical measure that uses standard deviation and excess return to determine reward per unit of risk. A higher Sharpe ratio implies a better historical risk-adjusted performance. The Sharpe ratio has been calculated since inception using the 3-month Treasury bill for the risk-free rate of return.
Tier 1 Common Capital (CET1) RB Ratio: Measurement of a bank's core equity capital compared with its total risk-weighted asset that signifies a bank's financial strength.
Tier 1 Leverage Ratio: The relationship between a banking organization's core capital and its total assets.
Total Capital Ratio: The percentage of a bank's capital to its risk-weighted assets.
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.
Yield to Worst: The lowest potential yield that can be received on a bond without the issuer actually defaulting.

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.

Index performance is not indicative of the funds' performance. Past performance does not guarantee future results. Current performance of the funds can be obtained by calling 855-751-4324.

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 non-rated 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 Funds, please see the Prospectus.

Bond ratings are grades given to the bonds to indicate their credit quality as determined by rating agencies including, but not limited to, S&P and Moody's. The firm evaluates a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters, ranging from AAA, which is the highest grade, to D, which is the lowest grade. In limited situations, when a rating agency has not issued a formal rating, the adviser will classify the security as non-rated.

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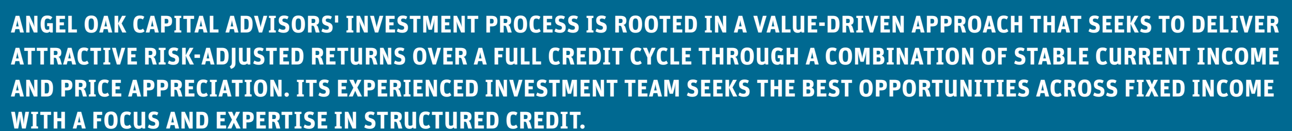
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