Angel Oak
CAPITAL ADVISORS

2020 Outlook

Opportunities in structured and corporate credit

- 2019 REVIEW AND EXPECTATIONS FOR 2020
- IMPROVING CREDIT FUNDAMENTALS IN NON-AGENCY RESIDENTIAL MORTGAGES
- SELECTIVE OPPORTUNITIES IN ASSET-BACKED SECURITIES
- LATE-CYCLE VALUE IN CMBS
- SCOURING FOR QUALITY IN THE SENIOR CLO MARKET
- COMPELLING RISK-REWARD IN FINANCIALS
- FUNDAMENTALS AND CREDIT SELECTION IN HIGH YIELD

2019 Review

Despite investors' persistent fear of recession, risk and risk-free assets had a banner year in 2019, thanks to the Powell Pivot and a subsequent mid-cycle easing campaign. The Federal Open Market Committee (FOMC) realized it had tightened too far, too fast after nine rate hikes. The last hike, in December 2018, was clearly a mistake; fortunately, the FOMC reversed course, abandoned the Phillips curve, and eased three times in 2019. More important, the FOMC eased while growth was still positive and sent real rates into negative territory (Figure 1). This proved to be quite the elixir for risk and risk-free assets in 2019. The S&P 500 is on pace for one of the best total returns of the post-crisis period. Traditional fixed income benchmarks such as the Bloomberg Barclays U.S. Aggregate Bond Index (known as "the Agg") have had an exceptional year, primarily due to the significant amount of interest rate sensitivity in the composite. Plunging rates and stable credit spreads sent the Agg soaring in 2019 to approximately 8.54% total return year-to-date (Figure 2).

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FIGURE 1: REAL RATES*

*Fed Funds Minus Core CPI.
Source: Bloomberg as of 11/30/19.

For 2020, we believe we will be firmly in the soft landing, not the recession, camp.

FIGURE 2: 2019 RETURN

BBgBarc U.S. Agg. Bond TR	8.54%
BBgBarc U.S. Corp. IG TR	14.34%
BBgBarc U.S. Corp. HY TR	14.10%
S&P 500 TR	31.05%
Core Consumer Price Index	2.30%

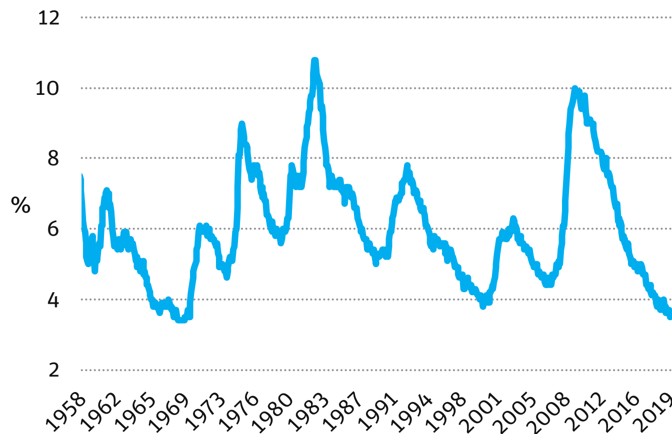
Source: Morningstar Direct as of 12/20/19.

2020 Economic Expectations

For 2020, we believe we will be firmly in the soft landing, not the recession, camp. Buoyed by a robust consumer, an accommodative FOMC, and easing trade tensions, growth is expected to average a 2.0% pace next year. We expect the labor market to remain robust and historically tight in 2020 and the lack of inflation to persist, which will further corroborate a historically accommodative FOMC. All should bode well for continued consumer strength (Figures 3–5). Consumers will continue to take advantage of the longest expansion on record to delever, and we do not see this tailwind for mortgage and consumer credit abating anytime soon (Figure 6). While the debate on the length of the longest expansion in U.S. history will rage on into 2020, we continue to favor high-quality areas of U.S. credit with improving credit fundamentals and relatively short-duration profiles. We expect the following areas to continue to exhibit the best risk-adjusted returns over the full credit cycle:

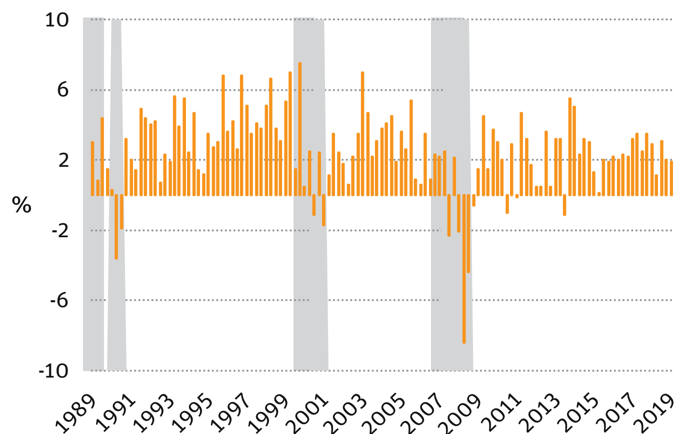
- U.S. mortgage and consumer credit
- U.S. financials
- Deleveraging ABS and CLO tranches
- Below-investment-grade corporate issuers with improving balance sheets

FIGURE 3: U.S. UNEMPLOYMENT RATE



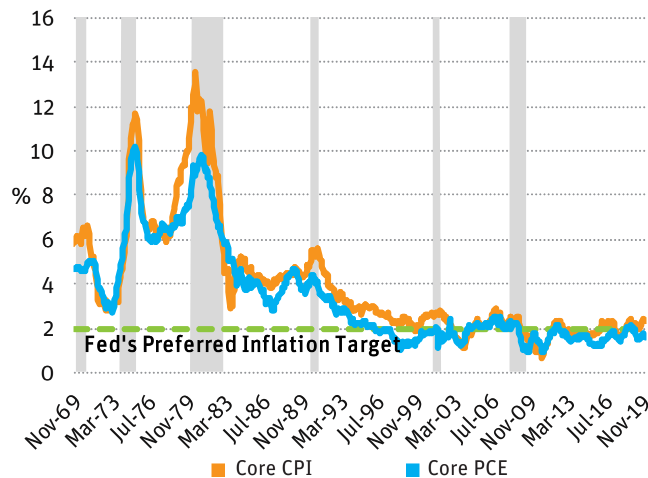
Source: Bloomberg as of 10/31/19.

FIGURE 4: QUARTER-OVER-QUARTER U.S. GDP GROWTH



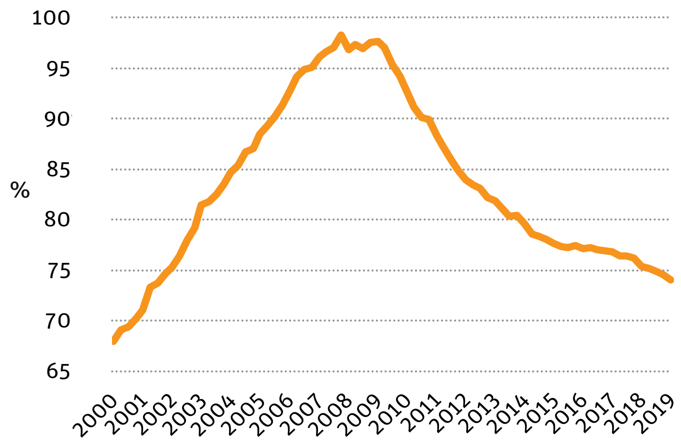
Source: Bloomberg, BofA Global Research as of 9/30/19.

FIGURE 5: CORE PCE AND CORE CPI



Source: Bloomberg as of 11/30/19.

FIGURE 6: HOUSEHOLD DEBT TO GDP



Source: Federal Reserve, Bureau of Economic Analysis as of 6/30/19.

Non-Agency Residential Mortgage-Backed Securities

We continue to have a high degree of conviction toward U.S. residential mortgage credit because of improving credit fundamentals and high-quality, stable income. Despite concerns that the economy is in the late cycle, the U.S. consumer and mortgage credit fundamentals are in excellent shape, and we do not see these trends ending over the medium term. Household debt to GDP has declined from nearly 100% pre-crisis to approximately 75% today. U.S. residential mortgage debt to GDP has dropped from a high of 74% in 2009 to approximately 51% today (Figure 7), and the U.S. aggregate mortgage debt service ratio is at a 40-year low of 4.1% (Figure 8). Finally, mortgage delinquencies as a percentage of total loans are at a post-crisis low of 3.97%, a level last seen in 1995 (Figure 9).

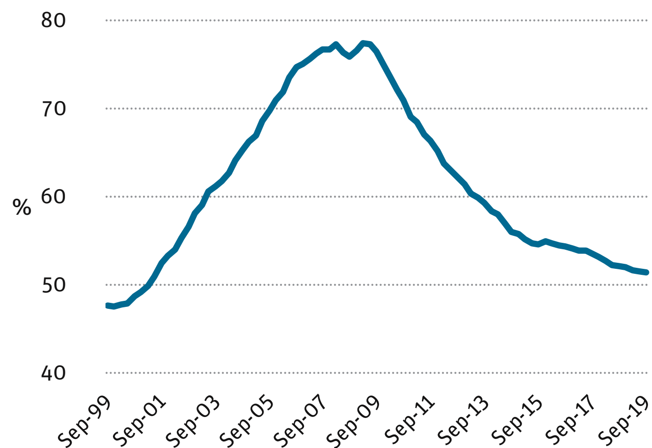
We believe legacy NA RMBS continue to be an excellent allocation to potentially benefit from these positive residential mortgage credit fundamentals. It may offer an attractive loss-adjusted yield profile with potential upside. Scenario improvement, forbearance recovery assumptions, and potential cleanup call activity are reasons why we continue to believe the best risk-adjusted return profile in today's credit markets continues to be legacy NA RMBS, as explained below.

Scenario Improvement: Strong housing and credit fundamentals are lowering future loss expectations. Collateral performance has been better than underwritten loss expectations, resulting in additional total return upside potential for legacy NA RMBS. For example, in our legacy NA RMBS portfolio, the three-month moving average of voluntary prepayment speeds (VPR) recently increased approximately 12% year-over-year, the three-month moving average of constant default rate (CDR) fell 12% year-over-year, and the three-month moving average of severity (SEV) fell 17% year-over-year.

Forbearance Recovery Assumptions: During the post-crisis period, servicers actively modified loans backing legacy NA RMBS. Approximately 60% of the legacy NA RMBS market has been modified.[1] Previously missed principal and interest payments were often forborne and added to the principal balance of the loan. Market participants conservatively assumed the forborne principal balance would never be recovered. This has not actually been the case, and recent forbearance recoveries are surprising to the upside, further enhancing total return assumptions. We estimate our legacy NA RMBS portfolio is currently experiencing greater than 75% recovery of forborne principal and interest.

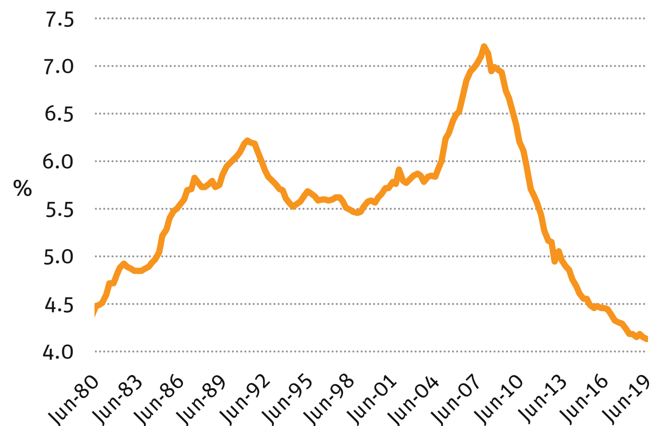
Cleanup Call Activity: Market participants have accumulated cleanup call rights, which enable them to collapse legacy NA RMBS and subsequently acquire a pool of seasoned residential whole loans. Cleanup call economics continue to improve, and call activity is expected to increase going forward. Given current market conditions, we estimate that the collateral in more than 50% of our holdings lies in the money to be called. (Figure 10. See next page).

FIGURE 7: MORTGAGE DEBT SERVICE PAYMENTS AS % OF GDP



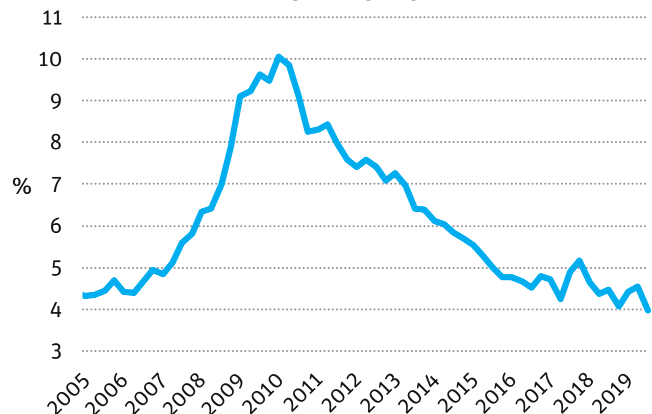
Source: St. Louis Fed, HAVER as of 9/30/19.

FIGURE 8: MORTGAGE DEBT SERVICE PAYMENTS AS % OF DISPOSABLE PERSONAL INCOME



Source: Federal Reserve Board of Governors (U.S.) as of 6/30/19.

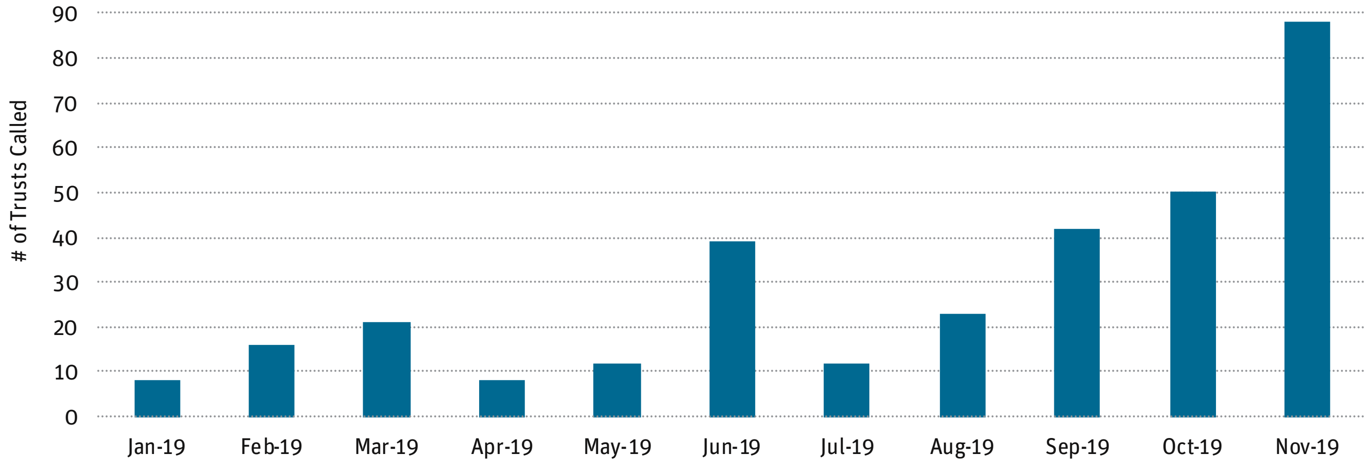
FIGURE 9: RESIDENTIAL MORTGAGE DELINQUENCIES AS % OF TOTAL LOANS



Source: Bloomberg as of 9/30/19.

[1]Morgan Stanley Global Research.

FIGURE 10: RECENT LEGACY DEALS CALLED



Source: Citi as of 11/30/19.

After a dearth of supply during the post-crisis period, new-issue NA RMBS re-emerged in meaningful size in 2018 and 2019 and created a variety of opportunity sets. Angel Oak has embraced the re-emergence of this new NA RMBS asset class for its favorable yield and credit characteristics and as an excellent complement to our legacy NA RMBS allocation. It's also an additional way to potentially benefit from the positive residential mortgage credit fundamentals. Issuance in 2019 is on pace to exceed $130 billion, up from $125 billion in the prior year. Interestingly, the non-qualified mortgage (non-QM) market subsector is on pace for approximately $25 billion in new issuance in 2019, which is two and a half times the pace of issuance in 2018 (Figure 11). We expect non-QM issuance to reach $50 billion in 2020, the seventh straight year of more than 100% growth in non-QM issuance. Moreover, Angel Oak continues to pioneer new and emerging opportunities in the non-QM market. As one of the largest securitizers of non-QM in the marketplace today, we have a unique perspective on the opportunity set. Non-QM loans have been purchased by a variety of opportunistic fixed income investors and subsequently securitized into primarily rated tranches. Low defaults, high prepayment speeds, and sequential structures offer a variety of different tranches that may be attractive from a total return perspective. The quickly evolving marketplace requires a deep understanding of mortgage credit to identify relative value. Angel Oak has a unique understanding of mortgage origination and associated regulatory constraints. Our focus is on deals with high-quality sponsors, proven credit underwriting track records, and low loan-to-value ratios. As we look ahead to 2020, legacy NA 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 NA RMBS going forward.

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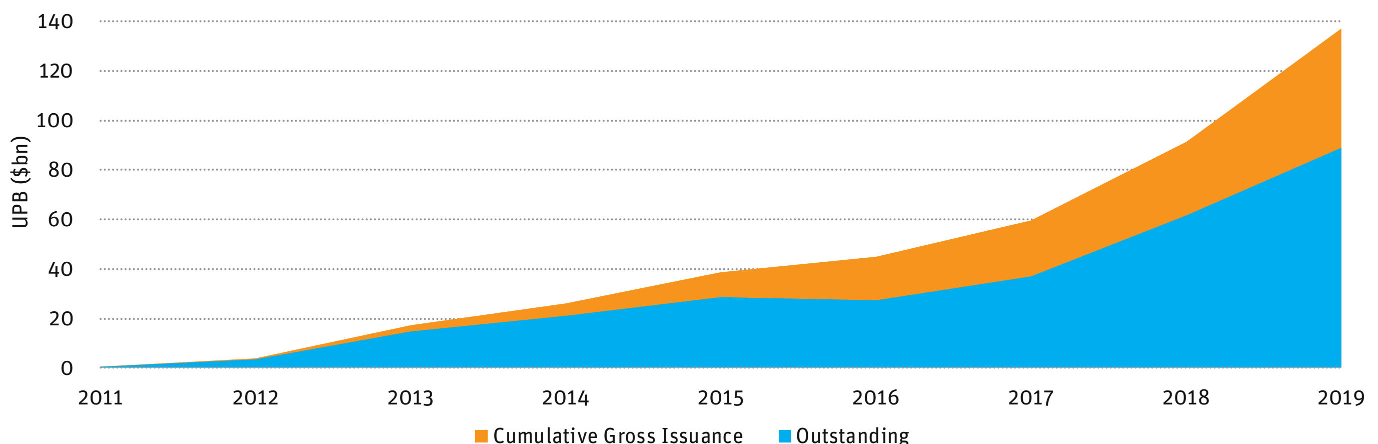
FIGURE 11: JUMBO AND NON-QM OUTSTANDING



*Jumbo 2.0 & Non-QM.
Source: BofA Global Research, Intex, Bloomberg.

Asset-Backed Securities

OPPORTUNITIES ABOUND, BUT BE SELECTIVE IN ABS MARKETS IN 2020

→ **Income:** Current coupon and rolldown provided positive excess returns in 2019.

→ **Structures matter:** Credit selection should be the key driver of outperformance among ABS sectors in 2020.

→ **Overweight:** ABS sectors are most attractive for short-duration allocations compared with agency and corporate credit.

Excess returns were positive across ABS in 2019. However, spreads largely underperformed corporate credit in 2019, as AAA-rated tranches were near unchanged, while below AAA tranches were wider across most ABS sectors. The upward-sloping credit curve provided positive total returns through higher current income and rolldown spread compression, but primary market spreads ranged from unchanged to wider across the ABS marketplace. Given this backdrop, short-duration ABS look cheap compared to short-duration financial corporates on a relative value basis, providing a tailwind to spread performance for the sector in 2020. In our portfolios, we have been overweight ABS within our short-duration strategies, sourcing total return opportunities across the space.

In our view, investors need to be selective within the ABS markets. Structures matter in a potentially more volatile 2020. ABS represent approximately 28% of the U.S. structured credit market, or $850 billion. We break down the sector into four main categories: auto ABS (includes equipment ABS), credit card ABS, student loans, and a large "other" catchall category. This other category includes cash flows backed by containers, aircraft, structured settlements, and franchise receivables. We consider auto, credit card, and student loans as "the big three," as they represent approximately 75% of the asset class and are the most liquid sectors.

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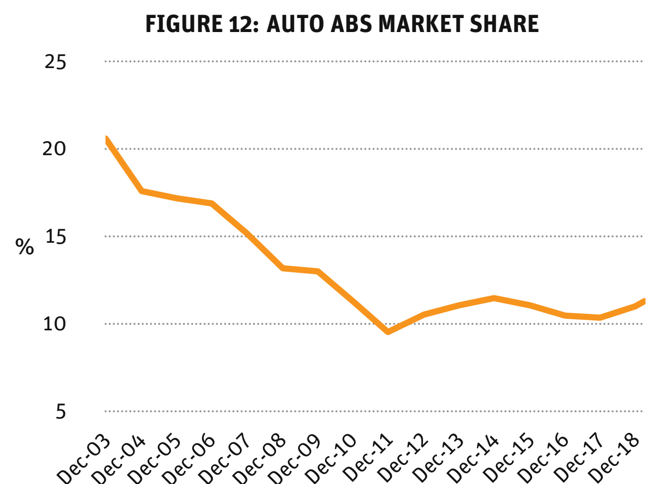
We believe the best opportunities lie within deleveraging structures of ABS, particularly consumer loan and auto ABS. These structures are the most robust, as rating agencies have increased their expected loss assumptions and credit cushions as compared with those of the pre-crisis era. Credit boxes have been reshaped in the post-crisis era, with more debt being extended to the near-prime and subprime consumer within consumer ABS markets as opposed to the mortgage market. Given the lessons learned from the financial crisis, non-prime consumers have been blocked from credit access in NA RMBS but have found credit within auto ABS and consumer ABS. However, given the rapid deleveraging structures and conservative underwriting assumptions from the rating agencies – also a product of the financial crisis – we believe those sectors provide the best opportunities within ABS. Furthermore, auto ABS issuers have further diversified their funding mix, and securitized pools represent a smaller percentage of the overall auto loan market. Market share for securitized pools has fallen from 15%-20% pre-crisis to 10%-12% in 2019 (Figure 12).

FIGURE 12: AUTO ABS MARKET SHARE

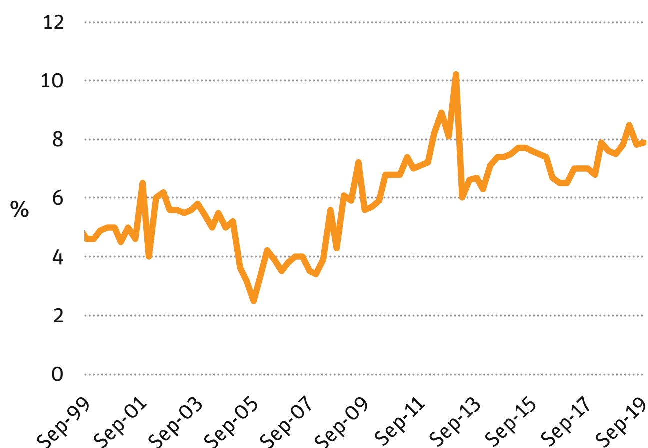


Source: NY Fed, SIFMA as of 12/31/18.

We are underweight esoteric ABS sectors such as aircraft and containers and have no student loan ABS exposure. This sector is primarily government-backed and of longer duration, and valuations are very tight on a risk-adjusted basis.

Within consumer ABS markets, loss of employment is the primary driver of default and loss rates. With the headline unemployment rate at a half-century low and jobless claims, a leading indicator of the unemployment rate, also near 50-year lows, we do not see a meaningful increase in consumer default rates in 2020.

FIGURE 13: PERSONAL SAVINGS % OF DISPOSABLE INCOME



Source: U.S. Bureau of Economic Analysis as of 9/30/19.

Furthermore, savings rates remain elevated. Personal savings as a percentage of disposable income are approximately 8%, well above the pre-crisis average range of 2%-5% (Figure 13). Simultaneously, the growth in consumer debt has slowed. Household debt grew 3.3% year-over-year, according to the New York Fed's Q3 2019 Quarterly Report.

Auto ABS loss rates are expected to be higher than previous vintage pools; however, credit enhancement requirements have increased alongside the recent extension in credit terms. From a positioning perspective, investors should look to investment-grade-rated bonds to limit tail risk in auto ABS. Rapid-deleveraging structures and shorter weighted-average life (WAL) bonds should outperform next year, providing attractive and stable current income.

Commercial Mortgage-Backed Securities

Since the global financial crisis, core commercial real estate (CRE) prices have recovered 127% compared with 114% for housing.[2] Multifamily has experienced the greatest recovery at 335% during the same time period, followed by central business district office and industrial at 211% and 188%, respectively.[2] While prices have increased, there has not been significant construction or excess supply nationally, keeping U.S. CRE fundamentals firm.

The global low-rate environment has prompted a search for yield, especially in CRE, which provides longer-term, consistent cash flow. Institutional investors have doubled their allocation to CRE to 10%, and private real estate funds had invested $334 billion of cash as of 10/31/19 compared with $300 billion as of year-end 2018.[3] While cap rates have decreased from a post-crisis peak of over 7% in 2010 to a historic low of approximately 6% in 2018,[2] they have moderated over the past few quarters. In fact, this decline has primarily been driven by the fall in U.S. Treasury yields, as cap rates still represent a spread of over 400 basis points compared to a sub-2% 10-year U.S. Treasury yield. U.S. cap rates are still higher than cap rates in some developed countries, including Canada and Japan.

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The retail property sector comprises $1.7 trillion of the $7.6 trillion CRE market.[2] Within CMBS, retail represents approximately 28% of the outstanding market. Retail bankruptcies, such as Toys "R" Us in 2017, Sears in 2018, and Barneys and Forever 21 in 2019, have caused some disruption to the market. This has created opportunity, as all retail properties have been painted with the same brush. While shopping malls have experienced losses within legacy CMBS transactions, grocery-anchored properties and lifestyle centers have performed better. Nonetheless, the sector will continue to see disruption as e-commerce gains market share. In our CMBS allocations, we have been underweight the conduit market, as the credit curve has sharply flattened (Figure 14), and to limit exposure to the retail sector.

While we don't expect losses in conduit transactions to reach 10%-14%, which occurred in 2006-2008, the risk-adjusted returns are not compelling given current valuations. We see more value in the single asset single borrower (SASB) market. Unlike conduit deals, which are backed by a pool of commercial properties, SASB CMBS deals are backed by one loan or a portfolio of similar assets with strong national sponsors. SASB CMBS transactions are higher in quality and have a more "defined path to exit," as characterized by lower LTVs and higher actual sponsor equity. These favorable characteristics help reduce credit risk. Moreover, the average loan balance within SASB deals is approximately $500 million, compared with a conduit pool of 50 to 60 loans with an average

FIGURE 14: CMBS SPREADS

DATE	CMBS AAA	CMBS BBB-*	DIFFERENCE
11/29/2019	91	310	-219
12/31/2018	100	435	-335
12/31/2017	75	480	-405
12/31/2016	100	560	-460
12/31/2015	135	515	-380
12/31/2014	95	385	-290

*Non risk-retention compliant deals.
Source: BofA Global Research.

[2]Preqin. [3]Trepp.

loan balance of $20 million. Property types include office, hospitality, industrial, multifamily, and retail. The bonds are typically floating rate, with a WAL between two and seven years, compared with 10 years for a conduit transaction. Most important, SASB investors are able to conduct a more in-depth analysis during the underwriting process of one single loan (or portfolio of similar assets) compared with a conduit pool of 50 to 60 various loans.

Moreover, SASB deals have higher credit enhancement compared with conduit deals, due to the punitive treatment by rating agencies for their lack of diversification. Historically, collateral within SASB deals has seen lower loss rates. For example, from 2004 to 2018, there were six SASB loans out of 394 deals that defaulted, with a cumulative loss of 1.4%.[4] During that same time frame, 7,598 loans out of 609 conduit deals defaulted, with a cumulative loss of 45.9% and an average deal loss of 3.3%.[5] Underwriting credit quality for conduit has been declining over the past few years. Most recent net operating income (NOI) declined 13.5% and 15.5% for 2018 and 2017, respectively, compared with underwritten NOI.[6]

Due to emerging late-cycle risks, we favor higher-quality CRE transactions that offer consistent and stable cash flow opportunities with less tail-risk scenarios.

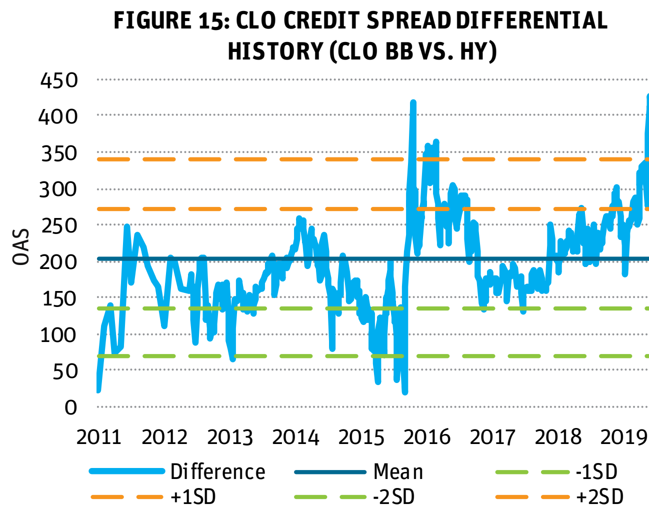
Due to emerging late-cycle risks, we favor higher-quality CRE transactions that offer consistent and stable cash flow opportunities with less tail-risk scenarios. We expect this opportunity to continue within SASB transactions that have a defined path to exit. We will be selective in 2020 and continue to focus on high-quality areas of SASB with improving credit fundamentals, higher credit enhancement, and spreads commensurate with conduit CMBS.

Collateralized Loan Obligations

The CLO market in 2019 was defined by persistent underperformance versus traditional corporate credit and other structured products. As interest rates staged an impressive rally to start the year, floating rate assets fell out of favor with investors. The loan and CLO markets that had grown substantially in previous years struggled to find demand to match supply. Despite the fact that the economics of CLO creation have deteriorated over the course of 2019, CLO supply has continued unabated during the year. This dynamic of continued CLO creation in the face of a weak arbitrage between CLO and loan spreads has been a major headwind for CLO spreads.

In addition to the interest rate outlook and subsequent weak technicals, we've also seen deteriorating fundamentals following years of slipping lending standards. Earnings misses and a wave of downgrades sent loan prices much lower in some sectors in 2019. As a result, tail risk rose materially in CLO portfolios as the percentage of loans trading at distressed prices doubled. The increase in stressed and distressed loans further contributed to the bifurcation seen in high-yield corporates in 2019 (Figure 15). The lower-rated weaker credits have underperformed stronger credits across both high-yield bonds and loans. We see a similar story in CLOs, where deals with more tail risk have significantly underperformed cleaner deals. This is true across all CLO tranches, but especially for lower-mezzanine CLOs. Following the recent price decreases, CLO spreads sit at the wide end of their 12-month trading ranges. These wider spread moves stand out even more when compared with relative moves in corporate bonds, as this differential between various CLO tranches and investment-grade and high-yield corporate bonds sits at multiyear wides.

FIGURE 15: CLO CREDIT SPREAD DIFFERENTIAL HISTORY (CLO BB VS. HY)



SD = Standard Deviation. OAS refers to Option Adjusted Spread.
Source: Citigroup as of 11/30/19.

Our current CLO allocation consists almost exclusively of seasoned investment-grade CLOs, with a bias toward single A- and AA-rated tranches. Recognizing the challenges the CLO market faced in 2019, we did not expect spread tightening across the board. However, we wanted to benefit from the wide spreads offered by the CLO market. We accomplished this by staying invested in senior tranches, which still provide spread pickup over our core allocation in NA RMBS, but also exhibit commensurate spread volatility compared with NA RMBS. Furthermore, we focused on CLOs that were seasoned by several years and were either out, or close to, being out of their reinvestment periods. We were able to accomplish this without giving up much spread when compared with CLOs with longer maturities, as the term structure in CLO tranches has remained very flat. After exiting reinvestment as the underlying loans prepay or mature, CLOs start to delever by paying down tranches in order of seniority. This means CLO tranches start seeing an increase in their

[4]Morgan Stanley Global Research. [5]Preqin. [6]Trepp.

cushions against losses, and as a result, the risk substantially decreases over time. As a result of delevering, some of our CLO tranches have started getting upgraded, and we expect this tailwind to continue. While substantial decreases in leveraged loan prices have made the early redemption of CLOs less likely, we are still able to potentially earn attractive returns on these very-short-maturity CLO profiles that should continue to pay down and derisk.

As we look forward into 2020, this core allocation of seasoned senior CLO tranches will continue to serve us well in an environment where low rates push investors to seek high-quality assets that provide attractive yield. Consensus forecasts are for CLO issuance to slow down materially in 2020. The CLO market does tend to surprise to the upside from a new issuance point of view. However, if discipline does indeed return to CLO equity investors' decision-making and volumes do drop, this would remove one of the most important headwinds for spread tightening in senior CLO tranches. If we see evidence of this scenario materializing, we could potentially extend the spread duration of the CLO portfolio to capture spread tightening upside.

We also expect bifurcation to be a continuing theme in 2020. Despite a tumultuous 2019, it is difficult to call the all-clear on idiosyncratic issues in the leveraged loan market after a long run of weaker borrowers and structures coming to market. We expect more borrowers to run into issues, and as a result, many CLOs will show increasing tail risk. This will also present opportunities. Senior CLO tranches can withstand enormous default rates even with very low recoveries. Furthermore, CLOs with weaker portfolios may actually delever more quickly than clean deals, making the senior tranches in these weaker seasoned deals particularly appealing. This is likely an area where we will continue to allocate, assuming the spread pickup to mortgage credit remains attractive.

We expect to continue to make investments in defensive profiles, building on the existing allocation with a consistent approach of evaluating relative value across structured products.

The CLO market has endured two difficult years in a row, leaving spreads wide and prices low. After trading at a premium for an extended period of time, attractive investments in senior tranches of CLOs with substantial price discounts can now be found.

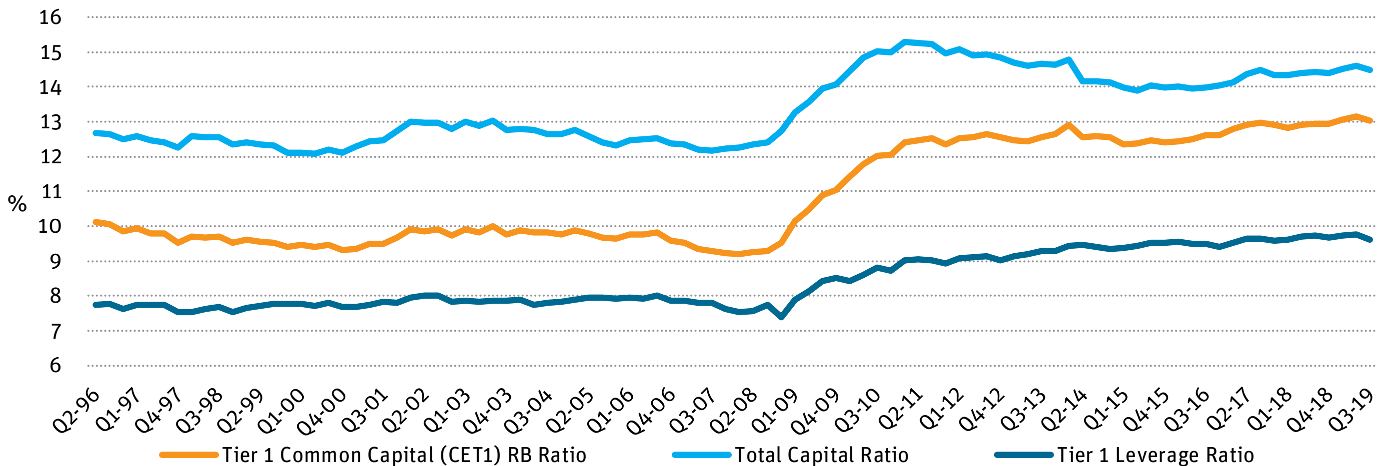
Financials

U.S. FINANCIALS

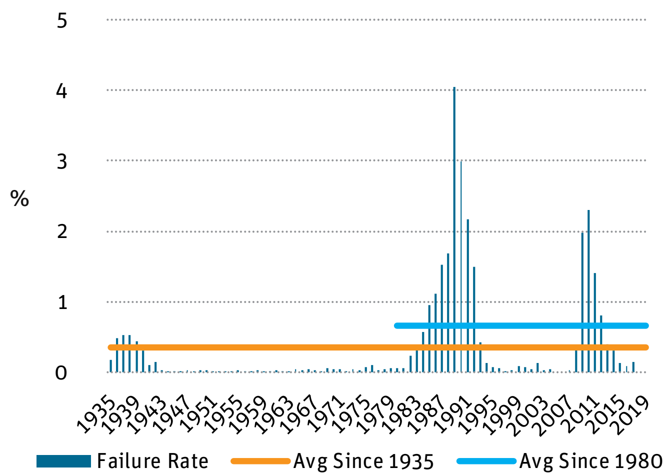
We believe the financial sector offers one of the most compelling risk-reward opportunities within corporate credit. This sector is near all-time highs from a capital and credit quality perspective. The banking industry in particular has added significantly more equity, has sharply reduced balance sheet risk, and has increased regulatory oversight and scrutiny over the past decade.

The banking sector current capital levels are nearly 250 basis points higher on a total capital basis and roughly 375 basis points higher on a common equity Tier 1 basis (CET1) compared with trough levels over the past 20 years (Figure 16).

FIGURE 16: BANK CAPITAL RATIOS



Source: S&P Global Market Intelligence as of 9/30/19.



Source: FDIC as of 9/30/19.

Additionally, due to heavier regulation, banks have restricted their activities and have become more limited in their lending practices. As a result, credit quality remains near historic highs. Non-performing assets (NPA)/assets have improved from a peak of 2.81% to 63 basis points, and net charge-offs (NCO)/average loans have improved from a peak of 3.22% to 49 basis points. Finally, bank default rates are low; since 1980, the average default rate has been below 70 basis points, and looking back to 1935, it has been below 40 basis points (Figure 17).

We expect a slowing growth environment for bank earnings in 2020 given the recent Fed rate cuts. Looking forward, net interest margin compression remains the largest headwind for the banks, though we expect higher deposit betas will help offset lower-asset yields, absent a significant increase in deposit competition. Loan growth will likely remain in the mid- to high-single digit growth range for the industry, with the smaller community banks driving higher loan growth than their larger bank counterparts. Higher fee income, largely from higher mortgage banking refinancing activity, and an increased focus on cost-cutting should help balance slower net interest income growth.

Credit conditions remain strongly favorable, with no signs of systemic deterioration and non-performing assets/total assets near historically low levels. Profitability is solid and capital levels continue to grow, providing a sizable cushion for an expected normalization of credit costs over time, as well as currency for inorganic growth opportunities.

THE VALUE IN SMALLER BANKS

We believe the best value in bank debt is in the community bank sector, which is defined as institutions with less than $30 billion in assets. Community banks operate simpler business models than their larger bank counterparts do, focusing on lending and gathering deposits within their local footprint. Community banks tend to have lower exposure to more volatile business lines such as capital markets, are funded via lower-cost core deposits, and carry higher levels of regulatory capital on average versus their larger peers.

Community banks have been using subordinated debt in the post-crisis period as a tool to optimize their regulatory capital and to fund organic and inorganic growth. The community bank subordinated debt market has over $20 billion outstanding, and annual issuance is expected to be in the $4 billion to $6 billion range for 2020. Issuance in 2020 should benefit from refinancing of deals issued in the infancy of the market in 2014-2015, as they are coming into their call period.

The community bank debt market is underrepresented in benchmarks and has little analyst coverage or institutional following. The niche market characteristics and ensuing market dislocation could allow investors to extract excess yield.

Finally, the banking sector in the U.S. is highly overbanked relative to the banking sector in other developed countries, and consolidation activity should accelerate in the current rate environment. In turn, this should drive price appreciation in the bonds of acquired institutions, typically the smaller institutions.

High Yield

AREAS OF FOCUS

Fundamental credit analysis will be an important driver of investment performance for high yield in 2020. High yield generated strong performance during 2019, driven by generally supportive, albeit slowing, economic conditions; expectations for a trade agreement between the U.S. and China; supportive rate cuts by the Federal Reserve; and stable credit metrics for high-yield companies in aggregate. High yield also benefited from strong technical factors, including large fund inflows, a manageable maturity ladder, and a well-received new-issue supply.

> Fundamental credit analysis will be an important driver of investment performance for high yield in 2020.

We expect a supportive environment for high yield in 2020, reflecting the expectation for low but stable economic growth combined with low-level interest rates, but we could experience pockets of volatility if there is deterioration in economic data or trade headlines in the context of current valuation levels. In our view, credit selection with an emphasis on balancing risk and reward will be key to performance in 2020. We are focused on issuers with stable to improving fundamental trends and quantifiable risk factors that potentially offer attractive return profiles and downside protection if the backdrop for credit deteriorates. Specific factors we focus on include defensible business positions; reliable management teams; and stable-to-improving margins, cash flow, and leverage trends.

At the margin, we have been adding to names in noncyclical sectors, including specialty healthcare, media and entertainment, and consumer products. We are overweight certain cyclical sectors, such as basic industries and capital goods, but are focused on higher-quality names that we expect to generate positive free cash flow through the cycle within those sectors. Examples include select homebuilders (a sector that benefits from lower rates), chemical manufacturers, equipment rental, and aerospace companies. Within basic industries, we hold a number of positions that are trading on a yield-to-call basis and seek to provide stable portfolio yield with less price volatility.

AREAS TO AVOID

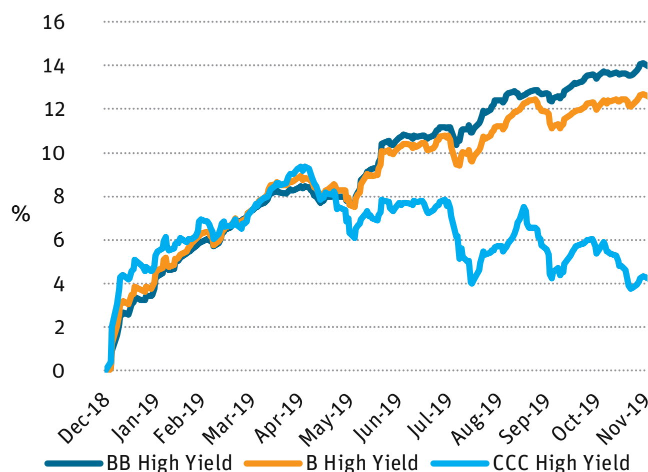
In the context of a stable but slow-growing economic environment and valuations near historically tight levels, it will be difficult for high-yield returns to repeat 2019's performance. Fundamental credit analysis that focuses on maximizing risk and reward will be crucial to identifying opportunities and avoiding idiosyncratic credit events. In 2019, there has been a divergence in performance in ratings buckets, with CCCs notably underperforming BBs and Bs as investors seek safe yield in an environment with relatively tight valuations and slowing U.S. growth (Figure 18). It will also be difficult for consolidated credit metrics in high yield to improve further from here without a specific catalyst. In addition, there have been more examples of companies with specific credit issues where bond prices deteriorated rapidly.

In the context of a stable but slow-growing economic environment and valuations near historically tight levels, it will be difficult for high-yield returns to repeat 2019's performance.

Our internal credit review framework focuses on avoiding names or sectors that exhibit some combination of the following factors: deteriorating sector fundamentals, idiosyncratic credit issues with low visibility on outcome, challenging balance sheets, and lackluster cash flow. In this environment, we are not adequately compensated to take on an elevated level of risk in companies with challenging credit profiles.

Current notable sector underweights include specific credit decisions within communications, consumer noncyclical, and banking. Within the communications and consumer noncyclical sectors, we are underweight issuers with challenging trends, including certain telecom and satellite providers as well as select hospital networks and pharmaceutical companies with notable regulatory and litigation risk. Other notable underweights include independent exploration and production companies, a sector that has been challenged by lower oil prices and a slowing global economy, as well as retail.

FIGURE 18: BB, B + CCC YTD TOTAL RETURN PERFORMANCE



Source: Bloomberg as of 11/30/19.

DEFINITIONS

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.
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.
Core PCE Price Index: An index that is defined as personal consumption expenditures (PCE) prices excluding food and energy prices. The core PCE price index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.
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.
Household Debt to GDP: Measures the overall level of household indebtedness (commonly related to consumer loans and mortgages) as a share of GDP.
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.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Tier 1 Common Capital (CET1) RB Ratio: The 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.
Weighted Average Life (WAL): Average length of time that each dollar of unpaid principal on a loan, a mortgage or an amortizing bond remains outstanding.

It is not possible to invest directly in an index.

As of 11/30/19, the securities mentioned in this piece were not owned by Angel Oak Funds.

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Angel Oak Mutual Funds. This and other important information about each Fund is contained in the Prospectus or Summary Prospectus for each Fund, which can be obtained by calling Shareholder Services at 855-751-4324. The Prospectus or Summary Prospectus should be read and carefully considered before a decision to invest.

Mutual fund investing involves risk; principal loss is possible. Investments in debt securities typically decrease 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 do 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 lead to losses that are greater than the amount invested. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested. The Fund may use leverage, which may exaggerate the effect of any increase or decrease in the value of securities in the Fund's portfolio or the Fund's net asset value, and therefore may increase the volatility of the Fund. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are increased for emerging markets. Investments in fixed-income instruments typically decrease in value when interest rates rise. The Fund will incur higher and duplicative costs when it invests in mutual funds, ETFs and other investment companies. There is also the risk that the Fund may suffer losses due to the investment practices of the underlying funds. For more information on these risks and other risks of the Fund, please see the Prospectus.

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

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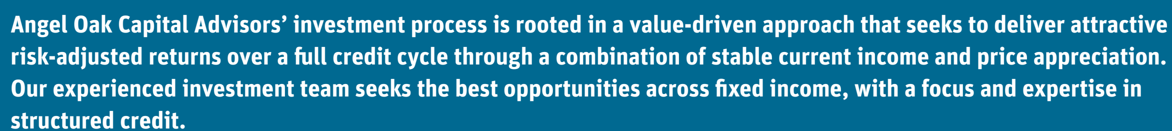
Angel Oak Capital Advisors' investment process is rooted in a value-driven approach that seeks to deliver attractive risk-adjusted returns over a full credit cycle through a combination of stable current income and price appreciation. Our experienced investment team seeks the best opportunities across fixed income, with a focus and expertise in structured credit.

For more information, or to learn how to invest in Angel Oak's structured credit and corporate credit funds, visit angeloakcapital.com.

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