Angel Oak
CAPITAL ADVISORS

Mortgage Credit Update Amid Recent Market Volatility

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In light of the recent market volatility, we wanted to update our investors and give some insight and perspective into recent fund performance. Structured credit, specifically non-agency RMBS, was holding up relatively well early in the COVID-19 crisis, but last week began to fall under pressure. We view the recent deterioration in performance as more technical in nature rather than due to credit fundamentals.

Technicals Diverged from Fundamentals

Last week, market participants witnessed an incredible amount of outflows in high grade fixed income and indiscriminate selling across all fixed income, regardless of credit quality or sub sector. For example, agency RMBS, known for their superior liquidity characteristics, were sold in earnest to meet money manager redemptions. This coupled with the largest refinance wave in the post-crisis period, overwhelmed banks and put significant pressure on leveraged mortgage REITs. Forced selling from mutual funds with high-beta RMBS sectors such as credit risk transfer (CRT) and mezzanine tranches of subprime non-agency RMBS has further contributed to the weakness.

In addition to last week's technical liquidity crunch, growth expectations were revised sharply lower by market participants. Despite plummeting growth expectations and rising unemployment amid the COVID-19 crisis, we want to assure investors that the RMBS we target, predominantly at the very top of the capital structure, have fundamentally sound credit characteristics and can withstand very harsh economic outcomes in our view. The majority of our RMBS positions are senior tranches backed by borrowers with payment histories of 13-15 years and with very low loan to value ratios. Our conviction that consumer-backed mortgage credit assets would outperform in the next recession has only increased given the timing of this recession.

This has been an unprecedented three weeks. Fear of the unknown, panic, and radically different work-from-home environments have affected communication and trading activity. The wave of forced selling from mortgage REITs and $35 billion of redemptions in high-grade mutual funds last week, an all-time high and five times higher than the previous record outflow, overwhelmed traditional buyers of structured credit: banks, insurance companies, and money managers. This was evident in ETFs significantly underperforming as investors were selling indiscriminately, as well as in closed-end funds where prices were at significant discounts to NAV.

Large price drops in all asset classes caused substantial margin calls to leveraged investors over the past few weeks. These technical forced selling events appear to be near the end in our view based on the limited data available. We also see the Fed's recent resumption of many crisis-era actions, including the resumption of mortgage purchases as critical to normalizing the Treasury and agency RMBS markets. We are also optimistic about the Fed's commercial paper purchases and its support of money market funds through financing programs, which now include short-term municipal bonds. Moreover, the Fed established the Primary Dealer Credit Facility, which went online Friday. These are important steps to restoring liquidity and the functioning of the broader credit markets.

The Fed's recent actions are critical and should reduce the wave of forced selling that emerged last week. We also believe recent Fed actions will restore confidence and improve liquidity, but we are mindful that these actions may take time.

Best Opportunities Since 2008 Are Here

The emerging opportunities in U.S. fixed income look to be some of the best relative value we have seen since 2008. With respect to our strategies and positioning, we were very defensively positioned heading into this environment, and we recently increased liquidity and cash levels in some of our core strategies to the highest levels since our inception. Our allocation strategy continues to focus primarily on senior positions in legacy non-agency mortgages and higher quality, short duration allocations in recently issued securities. We have looked to lower our allocations to more sensitive areas of corporate credit and shifted higher up the capital stack in structured credit. Historic lows in mortgage rates continue to shorten our exposure as prepayments are expected to continue to increase which will further bolster our liquidity. Although our strategies have not been immune to the significant indiscriminate redemptions happening in the broader market, this enhanced liquidity may give us the ability to be an active participant in the secondary market, looking to source high quality assets at distressed prices.

Crucially, many fundamentals still look positive for the U.S. homeowner. Solid consumer balance sheets for U.S. homeowners leading up to the crisis, increased savings rates, record levels of home equity, falling mortgage rates, and lower prices at the pump should support credit performance over the near term despite the expected increase in unemployment. Looking forward, the consumer will benefit rapidly from fiscal stimulus measures and we expect that high quality mortgage credit assets will recover more quickly from the technically depressed market prices.

At today's valuation levels, we see extraordinarily attractive loss-adjusted yields and unequivocally the best opportunity for investing in structured credit since the founding of Angel Oak in 2008. Some of the best examples of relative value opportunities today include:

1. Certain parts of legacy non-agency RMBS loss-adjusted yields of 6%-10%.
2. Investment grade, short duration, consumer-centric asset-backed securities ("ABS") trading at yields of 5%-15% for 1- to 2-year assets.
3. Agency CRT with effective maturities of 1-4 years and yields of 15-20% and non-QM RMBS (AAA/AA/A rated) with effective maturities of 1-3 years and upside yields of 5%-10%.

We do expect volatility to continue in the coming weeks. This is one of the key reasons we are still maintaining our overweight to liquidity and cash. Similar to our portfolio management style at the founding of Angel Oak in 2008, being patient in deploying cash and selective in purchasing securities has the potential to set us up for the best risk-adjusted returns in 10 years. Our more conservative positioning over the last few years and high liquidity profile should allow us the ability to selectively invest in fundamentally sound mortgage credit assets at historically attractive prices.

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