Angel Oak
CAPITAL ADVISORS

2020 Mid-Year Outlook

Opportunities in structured and corporate credit

→ ROLLER COASTER FOR THE AGES

→ IS THIS RECESSION DIFFERENT?

→ U.S. STRUCTURED CREDIT

→ INVESTMENT GRADE CORPORATES

→ HIGH YIELD CORPORATES

→ LOOKING FORWARD

Roller Coaster for the Ages

The COVID-19 crisis reminded all market participants it's difficult to time credit cycles. Adhering to our philosophy of identifying the best relative value in U.S. structured and corporate credit to maximize risk-adjusted returns over the full credit cycle enabled us to navigate one of the most challenging environments in our careers. Targeting high-quality cash flows with favorable fundamental credit characteristics, proven to withstand even the worst of economic downturns, enabled our strategies to navigate the panic that ensued in early March after COVID-19 reared its ugly head. Moreover, adhering to our philosophy of looking beyond the full credit cycle enabled us to identify some of the best risk-adjusted opportunities since the founding of our firm in 2008.

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Heading into 2020, we believed the U.S. economy would have a soft landing and not enter a recession despite signs of being late in the cycle, notably the 2s/10s curve inversion in September 2019. Our cautious optimism about continued expansion of the U.S. economy was driven by the strength of the U.S. consumer. We went into 2020 with more of a defensive posture across all our strategies. For example, in structured credit, we had high conviction about residential mortgage credit, favoring mostly senior tranches of legacy and newly issued non-agency residential mortgage-backed securities (NA RMBS) because of their favorable credit fundamentals, high current income, and short-duration characteristics. We increased liquidity and cash levels in some of our core strategies to the highest levels since our inception, decreased our exposure to lower parts of the capital structure in collateralized loan obligations (CLOs) because of deteriorating fundamentals in corporate credit, and reduced our conduit commercial mortgage-backed securities (CMBS) exposure, where we were concerned about idiosyncratic credit risk emerging because of uncertainty surrounding areas of significant weakness, such as U.S. retail.

In traditional corporate credit we continued to overweight financials, notably regional and community bank financials and insurance companies, because of the favorable fundamental credit characteristics coming out of the global financial crisis (GFC). Going into 2020, this sector was near all-time highs from a capital and credit quality perspective, and the banking industry added significantly more equity, sharply reduced balance sheet risk, and became more utility-like because of increased regulatory oversight and scrutiny over the past decade. In high-yield corporate credit, we were focused on issuers with improving fundamentals, quantifiable risk factors, and downside protection in case the backdrop of credit deteriorated.

Despite this defensive positioning, our strategies were not immune to the indiscriminate selling that emerged across all fixed income, but our positioning did give us the ability to weather the storm, maintain high-conviction positioning, and actively source additional high-quality assets at attractive valuations amid the fallout that ensued. As we recover from the COVID-19 crisis, there are several key themes we are mindful of when looking ahead:

- The recovery is looking to be V-shaped on the heels of unimaginable stimulus.
- The cash mountain will soon find its way into financial assets.
- We remain focused on high-quality income and short duration at the zero bound.

Additionally, we expect winners and losers will emerge, and the following areas exhibit the best risk-adjusted returns over the full credit cycle:

- U.S. mortgage and consumer credit: favor residential mortgage and consumer credit over CMBS and CLOs.
- U.S. financials: banks and insurance companies.
- U.S. high yield: high-quality companies at the epicenter of the COVID-19 pandemic.

Is This Recession Different?

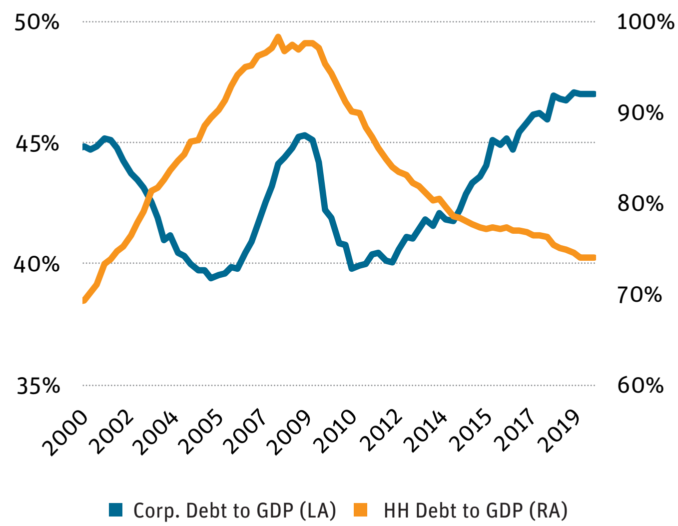
This recession is different. The sudden collapse in economic activity experienced in the first half of 2020 will be the first-ever recession caused by a government response of shutting down the U.S. economy. We also believe the severity and brevity of this recession will be unique because the unimaginable response to shut down the economy was met with an equally unimaginable response of a fiscal and monetary bazooka. Carmen Reinhart, co-author of the iconic book "This Time Is Different: Eight Centuries of Financial Folly," was recently asked on Bloomberg Radio, "is this time different?" She responded: "Yes. Obviously, there are a lot of references to the influenza pandemic of 1918, which, of course, was the deadliest, with estimated worldwide deaths around 50 million—maybe, by some estimates, as many as 100 million. So pandemics are not new. But the policy response to pandemics that we're seeing is definitely new. If you look at the year 1918, when deaths in the U.S. during the Spanish influenza pandemic peaked, that's 675,000. Real gross domestic product (GDP) that year grew 9%. So the dominant economic model at the time was war production. You really can't use that experience as any template for this. That's one difference. It's certainly different from prior pandemics in terms of the economy, the policy response, the shutdown." As devastating as the Spanish flu was, the U.S. economy never shut down. In fact, it thrived.

This recession was not caused by an overleveraged area of the economy suddenly bursting but rather by an act of God and a draconian response to shut down the economy. Typically, leveraged bubbles bursting have painful long-term consequences that take years to heal. For example, the GFC recession caused by an overleveraged housing market and U.S. consumer lasted 18 months, a post-World War II record.[1] Moreover, it took nearly two years for GDP to catch up to pre-GFC levels.[2] Going into the COVID-19 crisis, the U.S. economy—and notably the U.S. consumer, which drives approximately 70% of U.S. GDP—was in excellent shape. The U.S. consumer continued to deleverage prior to COVID-19, as illustrated through the decline in the ratio of household debt to GDP (Figure 1).

The U.S. consumer was also making more money, as the secular tight labor market was finally pushing wages higher. Encouragingly, the U.S. consumer was starting to use the fruits of the longest expansion in U.S. history to not only deleverage but also save (Figure 2).

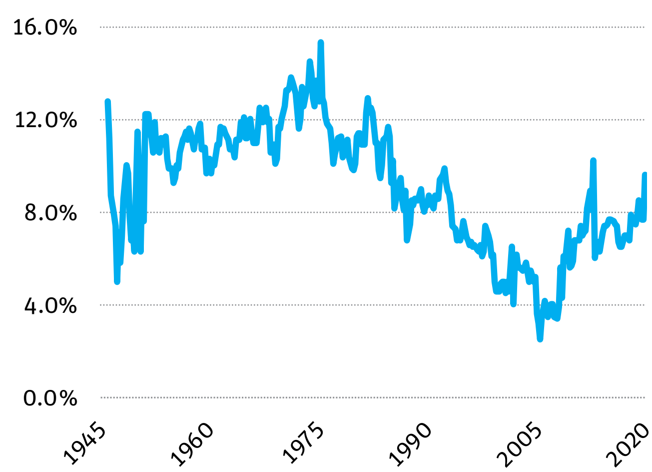
The corporate sector, which releveraged prior to the COVID-19 pandemic, was arguably the weakest link in the pre-COVID-19 economy, but it wasn't the culprit in the economic collapse.

FIGURE 1: HOUSEHOLD DEBT TO GDP



Source: Federal Reserve, Bureau of Economic Analysis as of 12/31/19.

FIGURE 2: U.S. PERSONAL SAVINGS AS % OF DISPOSABLE INCOME

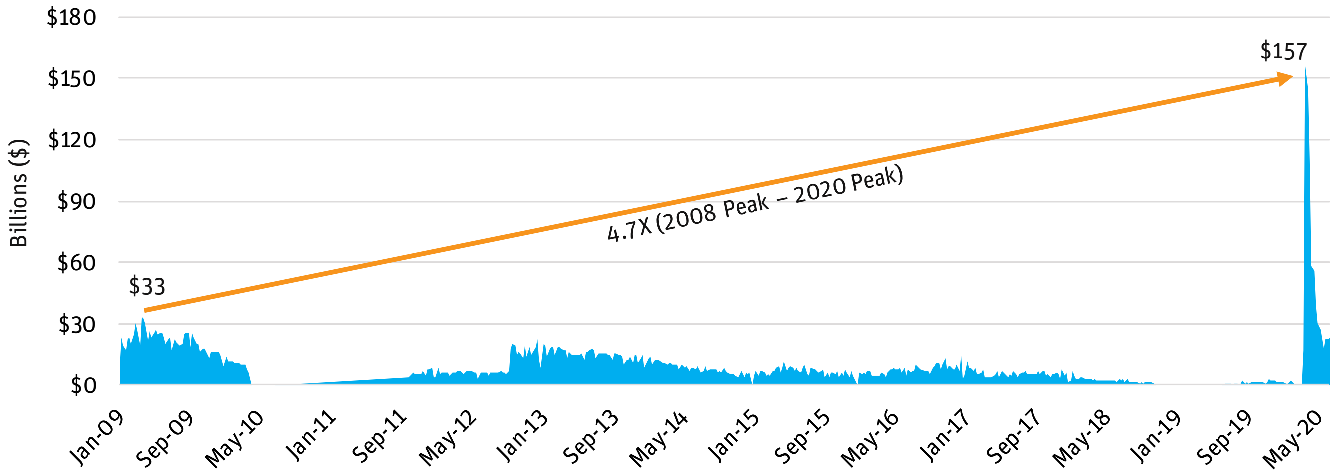


Source: Bloomberg as of 3/31/20.

Going into the COVID-19 crisis, the U.S. economy—and notably the U.S. consumer, which drives approximately 70% of U.S. GDP—was in excellent shape.

[1]Deutsche Bank. [2]Bloomberg.

FIGURE 3: FED NET WEEKLY PURCHASES OF MBS

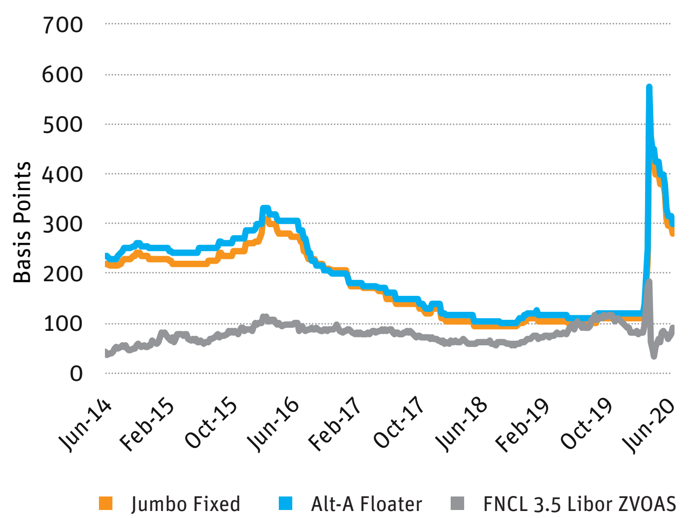


Source: Bloomberg as of 6/17/20.

The uniqueness of the current recession has been met with an equally unique fiscal and monetary response. In the first three months of QE4, the Fed bought more Treasury bonds than it did in the first two years of QE. Even more astounding, at the current pace, the Fed is projected to own approximately 40% of the agency RMBS market by year-end[3] (Figure 3).

This is an incredible amount of monetary stimulus, and the effects are powerful. In the early days of the COVID-19 crisis, panic and fear of the unknown created an incredible amount of outflows in high-grade fixed income and indiscriminate selling across all fixed income. Agency RMBS, known for their superior liquidity characteristics, were sold in earnest to meet money manager redemptions. Coupled with the largest refinance wave in the post-crisis period, this selling overwhelmed banks and put significant pressure on agency RMBS and leveraged mortgage real estate investment trusts (REITs). While the Fed was too late to stave off the subsequent detonation of the mortgage REITs, it was extraordinarily successful in collapsing agency mortgage spreads and collapsing interest rate volatility after the initial panic. As we have articulated in prior commentaries, it's immensely powerful when the Fed buys agency mortgages, especially at the zero bound. It's an incredible volatility suppressant, as it is an uneconomic buyer of a negatively convex fixed-income product that they do not hedge. By some estimates, the Fed is on pace to own approximately $1.3 trillion of the $1.7 trillion of agency RMBS supply this year. Buying 76% of this year's agency RMBS production, not hedging the interest rate risk, and committing rates to the zero bound for years to come were the ultimate volatility crushers, and they were incredibly supportive for risk markets (Figures 4 and 5).

FIGURE 4: LEGACY NON-AGENCY & AGENCY MORTGAGE SPREADS



Source: BofAML as of 6/19/20.

FIGURE 5: ICE BOFA MOVE INDEX

Source: Bloomberg as of 6/26/20.

[3]Bloomberg, Morgan Stanley.

FIGURE 6: PUBLIC SECTOR & PRIVATE SECTOR "DRY POWDER"

	$ Billions	% GDP
Coronavirus Preparedness & Response Act	$8	
Families First Coronavirus Response Act	$192	
CARES Act	$2,700	
Paycheck Protection Program and Health Care Act	$733	
Fiscal Stimulus	**$3,633**	
Asset Purchases	$1,600	
Liquidity Measures	$2,000	
Emergency Lending Programs and Facilities	$2,000	
Federal Reserve COVID-19	**$5,600**	
Total Public Sector "Dry Powder"	**$9,233**	**43%**
Institutional Money Market Cash	$3,220	
Retail Money Market Cash	$1,568	
Total Money Market Cash	**$4,788**	
Private Equity Undeployed Cash (Est.)	**$2,000**	
Total Private Sector "Dry Powder"	**$6,788**	**32%**

Source: Fundstrat.

As if Treasury and agency RMBS purchases were not enough, the Fed added investment-grade corporate bonds to the list. We think this is perhaps even more significant, as it potentially crowds out more private sector investors at the zero bound. The Primary Market Corporate Credit Facility and the Secondary Market Corporate Credit Facility (SMCCF) were established on the heels of the equity provided by the Treasury Department as a result of the CARES Act in March. On June 15, the Fed finally released details of the program in a revised term sheet. It will begin buying individual corporate bonds, assemble a diversified portfolio of U.S. corporate bonds, and build an index. While this is simply detailed follow-through on otherwise old news, it is very encouraging to see the Fed executing on its emergency programs implemented during the darkest days of the COVID-19 crisis. Unlike the aftermath of the GFC, when it shelved announced programs prior to implementation, the Fed seems to be following through on COVID-19 crisis initiatives even though risk markets are improving. For example, the S&P 500 has retraced approximately 75% of its down move, and investment-grade credit spreads have retraced approximately 75% of their widening. But as Chairman Powell highlighted on June 16 in front of the Senate Banking Committee, the Fed is concerned about the long-run economic damage from the COVID-19 crisis and is committed to restoring growth. Powell said, "it's out of an excess of caution to preserve these gains for market function by following through." In other words, the Fed is committed to delivering on its plans announced in March and will not pause as some market participants would argue is appropriate amid the risk rally. So far, it has purchased only $5.5 billion of corporate bond exchange-traded funds (ETFs), but we commend the Fed for moving forward on $250 billion of capacity of investment-grade purchases in the SMCCF. Fortunately, the SMCCF and other crisis-era initiatives will be vital to restoring business activity and employment to pre-COVID-19 levels, but unfortunately, their initiatives will continue to crowd out the private sector and further increase the global hunt for yield at the zero bound.

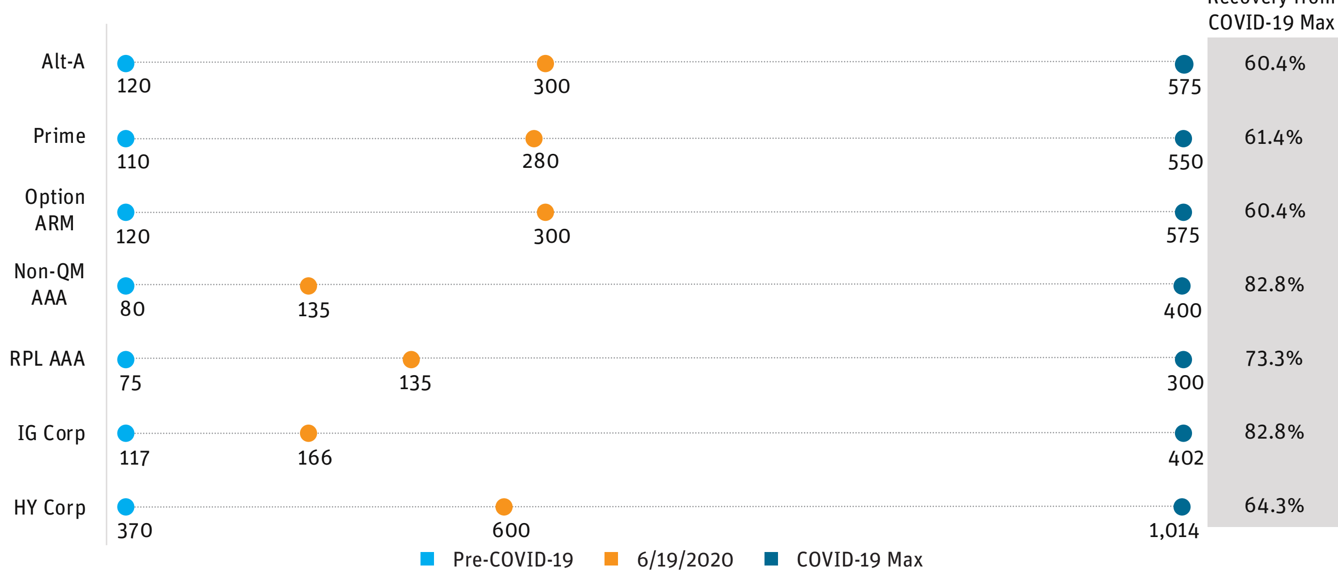
Interestingly, structured credit has been largely left out in the cold again from most of the Fed's emergency COVID-19 programs. While the Fed's emergency programs don't have a direct impact on most of our strategies, we should continue to indirectly benefit from the implementation of and follow-through on many of the COVID-19 crisis programs. Encouragingly, during the House Financial Services Committee testimony on June 17, Powell said the Fed was considering NA RMBS as a part of the Term Asset-Backed Securities Loan Facility program. This would be very supportive for NA RMBS if it happens.

While the Fed was too late to stave off the subsequent detonation of the mortgage REITs, it was extraordinarily successful in collapsing agency mortgage spreads and collapsing interest rate volatility after the initial panic.

The second bazooka came in the form of fiscal policy. The historic fiscal response came in four pieces of legislation, most notably the CARES Act. According to Fundstrat, the dry powder created by the Fed, the fiscal stimulus, and cash on the sidelines in privately held accounts equates to approximately $16 trillion of dry powder or 75% of GDP (Figure 6).

While this recession will be severe, it will be brief because of the unimaginable amount of stimulus coupled with the historic amount of dry powder in the private sector. Not only will this cash mountain corroborate a swift recovery, but it is also beginning to find its way into financial assets, driving risk assets higher, spreads tighter, and yields even lower. Therefore, we continue to invest in attractive income opportunities where the Fed is not doing so, such as in U.S. structured credit, predominantly NA RMBS, consumer asset-backed securities (ABS), U.S. financials, and names in high yield at the COVID-19 epicenter (Figure 7).

FIGURE 7: CREDIT SPREAD RETRACEMENT – SELECT SECTORS



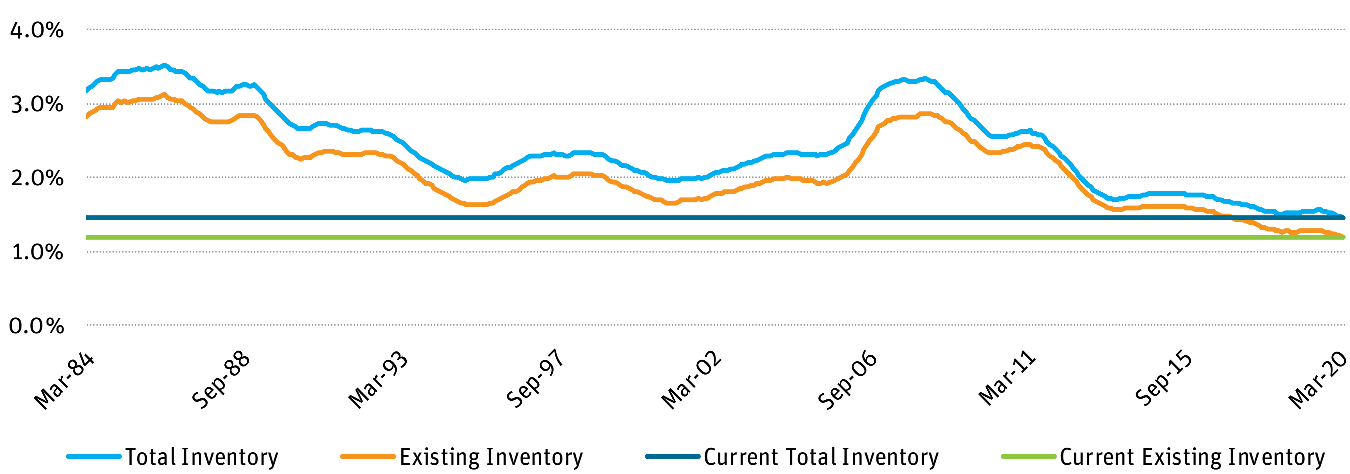
U.S. Structured Credit

Before the arrival of COVID-19, we were bullish on the fundamental and technical credit characteristics of U.S. mortgage and consumer credit over CMBS and CLOs. After COVID-19, we are even more so. NA RMBS and consumer credit should benefit from the following:

- Tight supply and rising demand for U.S. housing
- All-time lows in mortgage rates
- Sweeping government programs—such as foreclosure moratoriums and mortgage forbearance
- Better-than-expected mortgage performance due to underwriting improvements driven by the Dodd-Frank Act
- Secular lows in gasoline prices and rising demand for cars

Conversely, CMBS and CLO fundamentals are challenged by COVID-19. CMBS face underwriting uncertainty with the lack of cash flow integrity related to retail, hospitality, and office. CLO fundamentals will continue to face headwinds from the severity of the coming default cycle and managers' ability to weather the storm. After COVID-19, we will continue to underweight CMBS and CLOs and target positive fundamental characteristics of NA RMBS and areas of consumer ABS. We favor bonds with the ability to withstand harsh economic outcomes but also with attractive total return potential if we experience a more likely V-shaped recovery.

FIGURE 8: SINGLE-FAMILY INVENTORY AS % OF TOTAL HOUSEHOLDS



Source: Morgan Stanley as of 3/31/20.

As we have highlighted to many of our investors before, the underlying assets securing NA RMBS are mortgages backed by single-family homes in the U.S., and there is a significant supply and demand imbalance in single-family housing. After COVID-19, there will be new trends we believe will make this even worse. COVID-19 is very bullish for the suburbs. Fear of lockdown, a second wave and the ability to work from home will potentially reverse the migration to major metropolitan areas in favor of affordability, space, and less restrictive local governments. More importantly, the millennial generation, the largest generation in U.S. history, is forming households, and their demand for housing is robust. Their average age is 30, and they are 96 million strong. Unfortunately, their parents—the boomers, the second-largest generation in American history—are reluctant to sell. Lockdowns and fear of COVID-19 made this even worse. Boomers are staying put in the near term. Single-family inventory as a percentage of total households has never been this low, reducing supply, and the millennials are forming households in earnest, increasing demand (Figures 8 and 9). This should bode well for U.S. home price stability and allow U.S. home prices to not only remain stable during the coming default cycle but also possibly even rise.

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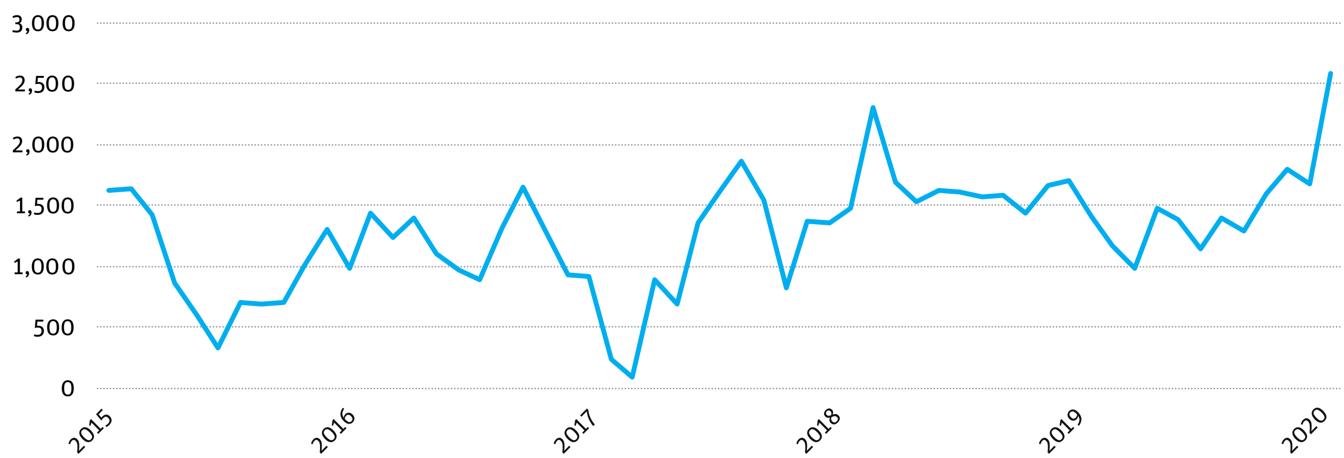
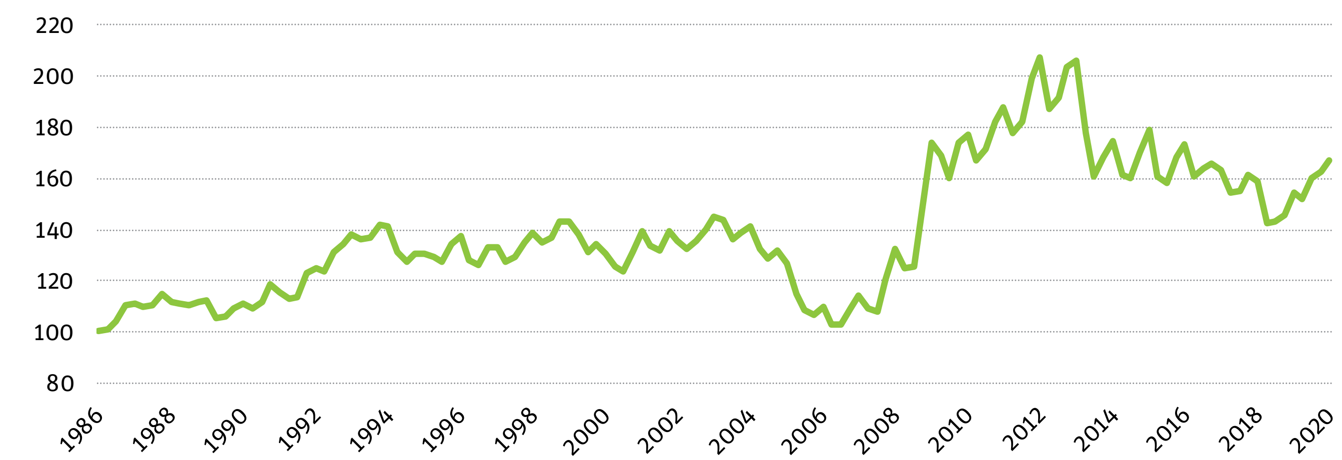
One challenge housing faced prior to COVID-19 was affordability. Affordability was challenged in 2018 and early 2019 because of rising mortgage rates and rising home prices. Fortunately, one of these variables has improved dramatically, thanks to the Fed—mortgage rates have plummeted to secular lows, and housing affordability has improved dramatically (Figure 10). Moreover, there is significant room for mortgage rates to fall even further as the primary/secondary spread narrows off recent highs (Figure 11).

FIGURE 9: U.S. HOUSEHOLD FORMATIONS



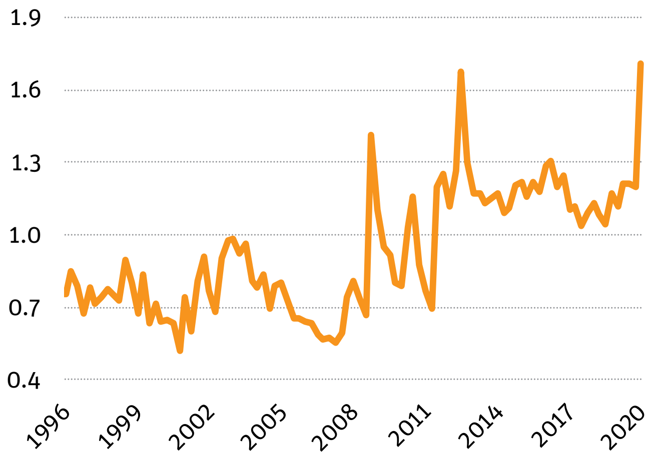
Source: Bloomberg as of 3/31/20.

FIGURE 10: HOUSING AFFORDABILITY INDEX



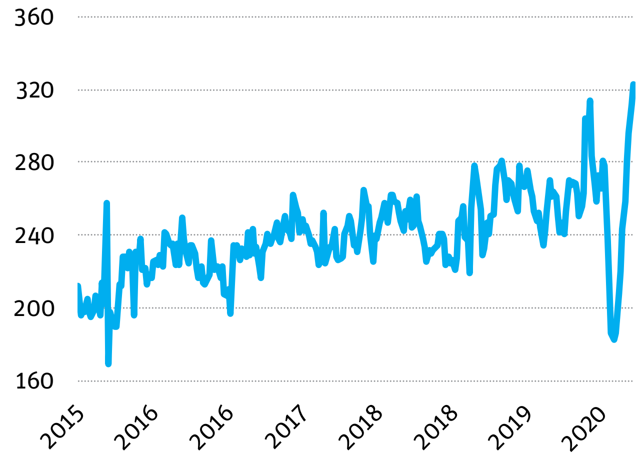
Source: Bloomberg as of 3/31/20.

FIGURE 11: PRIMARY-SECONDARY MORTGAGE RATE SPREAD



Source: Bloomberg as of 3/31/20.

FIGURE 12: U.S. MORTGAGE PURCHASE APPLICATIONS



Source: Bloomberg as of 3/31/20.

At the current zero bound, mortgage rates are at all-time lows. They are poised to fall even further as the historically high primary and secondary mortgage spread narrows. The Fed's willingness to own a significant portion of 30-year fixed-rate mortgages at the zero bound, where most private investors will not, should continue to drive this spread to historic lows, reducing borrowers' interest expense at the best possible time: amid a pandemic. Not only will this support borrowers facing hardship, but it will also further improve housing affordability. We are starting to see early signs that improved affordability is having a significant impact on purchase applications—they are surging (Figure 12).

Rising forbearance requests and foreclosure moratoriums were an initial concern for mortgage investors in the early days of the COVID-19 panic. Questions were swirling about the solvency of non-bank servicers and potential cash flow disruptions of RMBS. As borrowers miss payments, mortgage servicers are typically responsible for advancing missed principal and interest payments to the trust if they are deemed recoverable or until a limit is reached, typically six months for post-GFC NA RMBS. Fortunately, investors recognized that deal documents were written to address severe default cycles and payment disruptions of servicer advances, as witnessed in the last global financial crisis, and cash flow disruptions would be temporary for much of the NA RMBS market in a worst-case scenario. More important, the Federal Housing Finance Agency (FHFA) provided some significant servicer relief on April 21, when it limited servicer advances to four months; beyond four months, government-sponsored enterprises (GSEs) take over advancing missed principal and interest payments to mortgage investors. This removed tail risk concerns surrounding bank and non-bank servicer solvency.

With forbearance-related servicer solvency concerns in the past, mortgage investors are starting to appreciate the positive characteristics of the sweeping government actions related to mortgage payment relief. Like the Fed actions, government programs to stave off foreclosures as a result of the economic shutdown and subsequent job loss from the COVID-19 crisis were extraordinarily swift. The Fed and policymakers acted quickly in areas where they could to stem a greater economic collapse, and residential mortgage credit was one of those areas. Rather than wait until things got potentially much worse, the Federal Housing Administration and the FHFA implemented a foreclosure moratorium immediately and subsequently extended it to August 31.

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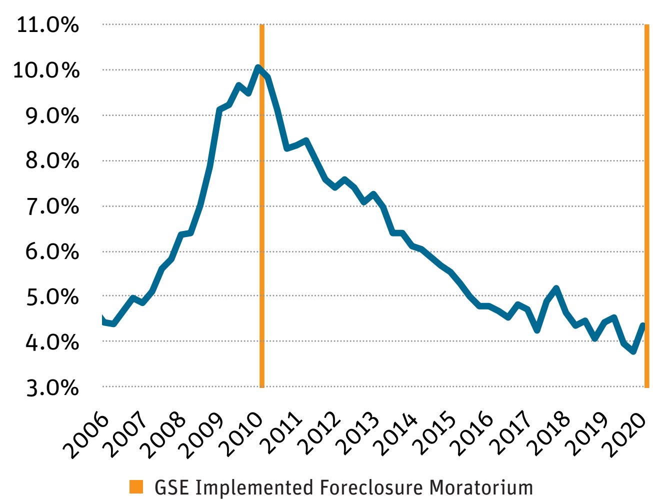
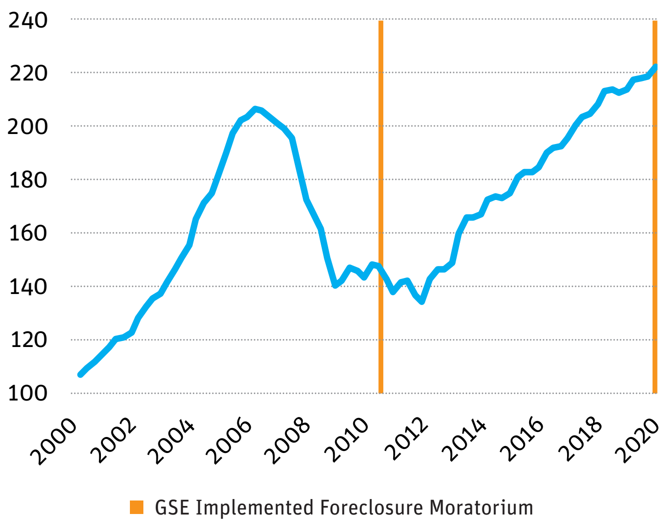
FIGURE 13: RESIDENTIAL MORTGAGE DELINQUENCIES AS % OF TOTAL LOANS



Source: Bloomberg, Morgan Stanley as of 3/31/20.

FIGURE 14: S&P/CASE-SHILLER 20-CITY HOME PRICE INDEX



Source: Bloomberg as of 3/31/20.

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As Morgan Stanley recently noted, foreclosure moratoriums didn't begin until well beyond the GFC in 2010, at the peak of delinquencies and the bottom for home prices. This time around, foreclosure moratoriums began while delinquencies were at post-crisis lows. We think these various policies and programs will reduce the downward pressure on home prices experienced after the GFC (Figures 13 and 14).

An additional positive of government programs is forbearance implementation. The U.S. mortgage market benefited from additional swift actions, learning from lessons of the past when dealing with the fallout from COVID-19. Prior to COVID-19, forbearance requests were often granted after natural disasters like hurricanes or earthquakes. As a result of COVID-19, agency and non-agency loans received unprecedented forbearance requests. Forbearance implementation is an important loss mitigation tool to stave off a wave of delinquencies that would have the potential to produce a fire sale of homes to avoid future credit impairment and foreclosure. More important, this began immediately in the early days of the COVID-19 panic and enabled borrowers to temporarily delay payments on a residential mortgage for up to 12 months because of hardship and subsequent loss of income. It's important to note that forborne principal and interest payments during the hardship period are expected to be paid in full, and many expect most of these missed payments to be added to the principal balance without the borrower having to make a lump sum payment. This should result in a fast cure rate for the loans in forbearance for most non-agency and agency loans. We expect forbearance cure rates to resemble behavior seen after other credit events, especially in a V-shaped recovery.

Forbearance programs coupled with foreclosure moratoriums should not only restrict distressed housing supply, but also improve the long-term credit performance of mortgages.

Additional support for RMBS credit performance will be driven by significant improvements in the integrity of the single-family mortgage underwriting process because of the Dodd-Frank Act. Following the GFC, numerous regulatory measures were put in place with an aim of increasing transparency and accountability in the mortgage origination process, along with promoting responsible lending. One key part of the Dodd-Frank Act was the ability-to-repay (ATR) provision. For the first time, federal law required lenders to consider certain underwriting criteria and to make a good faith determination that borrowers would have the ability to repay their home loans. The ATR rules require lenders to consider and verify several different underwriting factors, such as a mortgage applicant's assets or income, debt load, and credit history. A creditor must make a reasonable determination that a borrower will be able to pay back the loan. These rules did not exist prior to the GFC, and we expect they will improve credit performance for both the non-agency as well as agency-eligible collateral after COVID-19.

We are optimistic about the significant strides in technology that are reshaping the prospects for mortgage credit performance looking ahead. In recent years, the mortgage business has started to see a more rapid adoption of technology. The trend is simultaneously driven by two forces:

- Pressure on lenders by a new class of technology-savvy borrowers to digitize the mortgage experience and thereby improve the efficiency of the mortgage process.
- The paramount importance of a digitized loan audit trail resulting from a new wave of costly regulatory oversight and compliance standards.

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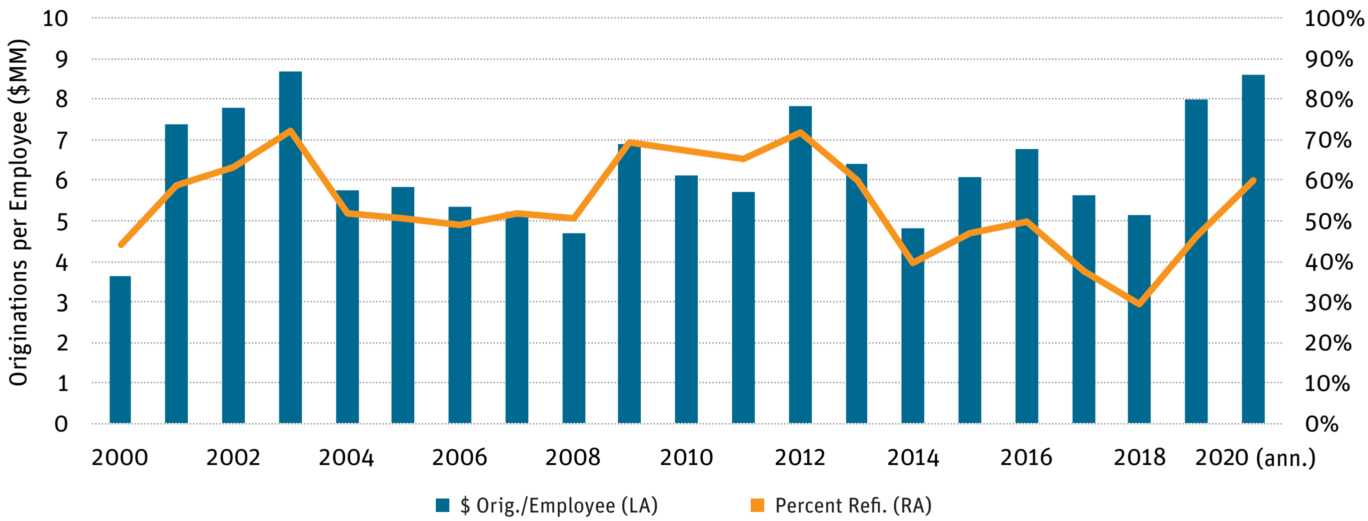
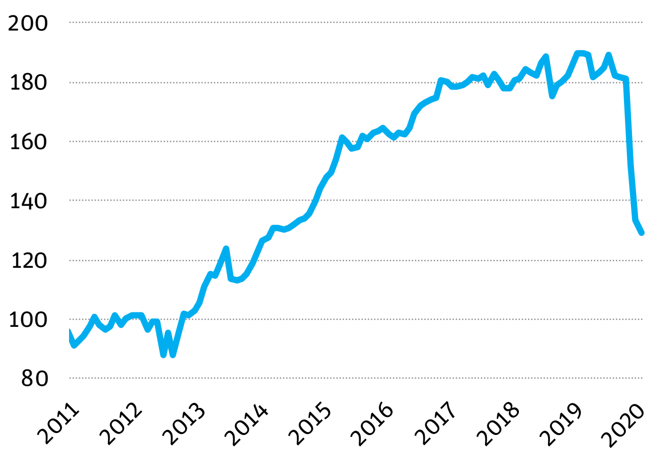
FIGURE 15: MORTGAGE PRODUCTION RUNNING AT 2003 CAPACITY



Source: Citi Research as of 3/31/20.

FIGURE 16: MORTGAGE CREDIT AVAILABILITY INDEX



Source: Bloomberg as of 5/31/20.

FIGURE 17: WTI CRUDE OIL FUTURES

Source: Bloomberg as of 5/31/20.

Demand for better technology has created higher barriers to entry for new originators. Also, established mortgage companies have been forced by the market to improve their existing systems and to create technological solutions. Meanwhile, many web-based services, which were uncommon just a few years ago, expedite the mortgage origination process. This is fueling prepayment activity, as evidenced by increased origination activity per employee, even during a government-imposed shutdown (Figure 15). What makes the jump in production even more remarkable is the fact that it is coming at a time when credit conditions are tightening. Residential mortgage credit conditions were slowly expanding and on an escalator ride up, but they took the elevator down during COVID-19. While they are a temporary headwind for housing, as credit investors, we see better-quality production looking ahead (Figure 16).

Not only is technology fueling prepayment activity during a pandemic, but technology has also revolutionized appraisal integrity, once a questionable area of residential mortgage underwriting. Before the crisis, loan officers were incentivized to close loans to generate volume and were able to influence the appraisal process. After the crisis, lenders are required to use independent appraisal management companies to maintain appraiser independence by serving as a wall between the appraisers and the loan officers.

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Prior to the GFC, Fannie Mae collected only two data points on each appraisal; today, it collects over 600. It also created a uniform appraisal dataset (UAD) "to improve the quality and consistency of appraisal data for loans delivered to the GSEs." Before the GFC, Fannie Mae had zero appraisals in its UAD. Now it has over 36 million.[4] Other widely available web applications, such as Google Maps, Zillow, Redfin, and centralized public real estate records, also help with collateral verification.

Another incredible sea change caused by COVID-19 that should bolster consumer credit performance despite the increases in unemployment is the collapse in energy prices, with secular lows in prices at the pump (Figure 17).

We think this should do several things to help mortgage and consumer credit performance:

1. Lower monthly payments for transportation, helping consumers stay current on their mortgages, credit cards, and car payments
2. Increase the incentive to move to the suburbs amid the threat of lockdowns
3. Reduce the demand for public transportation and ride sharing because of fear of the virus
4. Increase the demand for driving as opposed to flying or riding the train because of fear of the virus

This further enhances our post-COVID-19 bias for owning short-duration, high-quality, high-yielding, consumer-backed ABS. We think the credit performance will surprise to the upside and steep term structure spreads will continue to narrow, potentially enhancing total return. One example of this opportunity is in automotive ABS. A rise in delinquencies, coupled with the fear of a collapse in used auto prices due to the pandemic, roiled areas of auto ABS. While spreads have retraced approximately 75% of their COVID-19 widening, we see potential for more tightening because of used car valuations surprising to the upside. Used car prices have been the biggest headwind for attractive areas of automotive ABS because they are the collateral that backs bondholders in the event the borrower defaults. Given the positive current trends for automobiles mentioned above, we are starting to see a brisk recovery of used car prices, which is critical for fundamental credit improvement of automotive ABS, an area we see as attractive looking ahead because of its high income, short duration, and total return potential (Figure 18).

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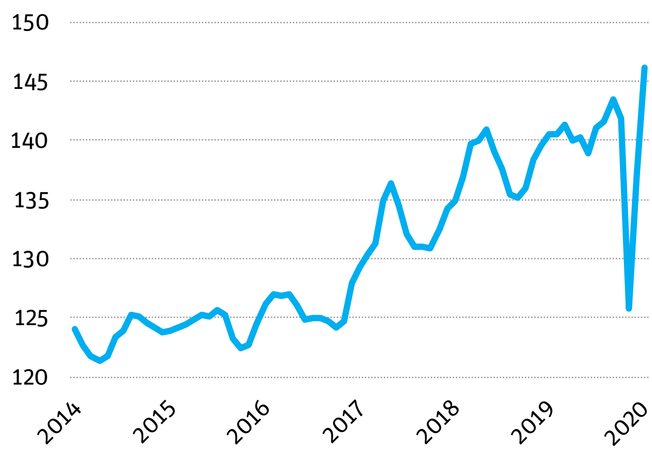
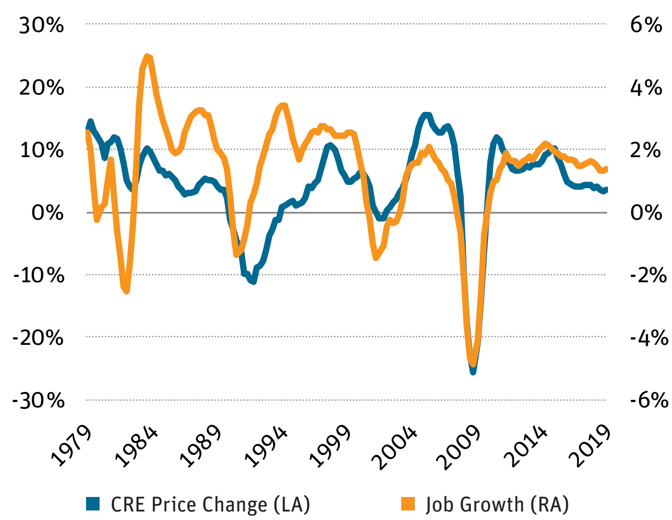
FIGURE 18: MANHEIM U.S. USED VEHICLE VALUE INDEX



Source: Bloomberg as of 6/30/20.

FIGURE 19: YOY CRE PRICE CHANGE VS. JOB GROWTH

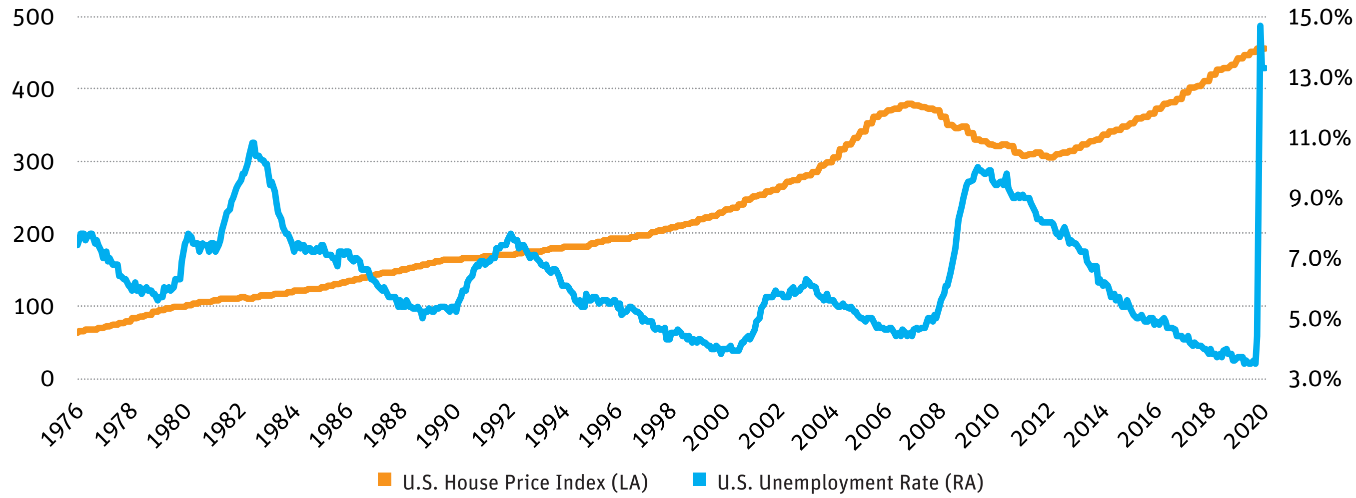


Source: Morgan Stanley Research as of 12/31/19.

Unlike RMBS and ABS, CMBS faces credit headwinds we believe will take some time to work through, even in a V-shaped recovery for growth. First, even if we have a brisk recovery of growth, unemployment may remain stubbornly high, and as Morgan Stanley recently noted, commercial real estate (CRE) prices are highly correlated with unemployment in the U.S. (Figure 19). Conversely, single-family home prices, aside from the GFC, are less correlated with job loss (Figure 20).

[4]Fannie Mae.

FIGURE 20: UNEMPLOYMENT VS. HOUSE PRICE INDEX



Source: Bloomberg as of 6/30/20.

Second, there are some real questions surrounding the post-COVID-19 integrity of cash flow for some sectors of CRE. Retail, an area we have been concerned about for some time because of Amazon, is now under even greater pressure because of COVID-19. The increased use of and familiarity with e-commerce after COVID-19 may be even more intense and could lead to further destruction of big box retailers and regional malls. Another area historically sensitive to economic downturns and other exogenous events, such as 9/11, is hospitality. Business travelers' pace and need for travel going forward are in question. There is a significant amount of post-GFC investment and leverage in hospitality, and it could face immense pressure in the months ahead as income from these properties has collapsed and may not come back for an extended period. Finally, office, once a stalwart, faces some serious headwinds. The service sector has performed quite well in light of the implementation of a nationwide disaster recovery plan, and we think all CEOs are asking themselves the same question Morgan Stanley's CEO James Gorman did on Bloomberg Television: "we've proven we can operate with no footprint. Can I see a future where part of every week, certainly part of every month, a lot of our employees will be at home? Absolutely." These major shifts in retail, hospitality, and office call into question the fundamental aspect of structured credit investing: the certainty of the underlying cash flow and the value of the underlying collateral for a significant portion of the CRE market. Given the difficulty of underwriting CRE in this environment, we will continue to reduce our exposure in areas that have recently recovered from the COVID-19 crisis but face further headwinds going forward. We prefer to target areas in RMBS and ABS with improving fundamentals and the ability to pay us over the long-run credit cycle.

> The increased use of and familiarity with e-commerce after COVID-19 may be even more intense and could lead to further destruction of big box retailers and regional malls.

CLOs also suffer from some well-known credit fundamentals. It's not necessarily questioning the timing of the default cycle that is now upon us but rather its severity and length. CLO structures are sound, but the ultimate recovery of leveraged loans that were arguably the weakest link in the economy heading into the COVID-19 crisis is still in question. They were the source of most of the leverage concern leading up to the current downturn, but the good news is that going forward, we are seeing some improving credit trends that should benefit future CLOs. Unfortunately, though, market participants will be sifting through the default cycle on some damaged deals that hold some of the post-GFC excesses in the collateral. While we are cautious about the uncertain months ahead for CLO performance, we still are of the view that BBB-rated CLOs will not take a loss from here, and that even most CLOs rated BB will make it. However, we don't believe BBB- and BB-rated CLOs offer sufficiently attractive risk-adjusted returns in the mid-high single-digit yields to compensate us for the uncertainty ahead. We are maintaining positions we feel can further recover from March's downdraft because of their structural protection. However, we are broadly reducing exposure upon recovery, as the sector will continue to face credit headwinds as the default cycle materializes.

Investment Grade Corporate Credit

U.S. FINANCIALS

The financial debt sector, one of our highest-conviction ideas in investment-grade corporate credit, was not immune to spread widening in March, but we remain confident in the overall health and soundness of U.S. financials and the banking system in particular, and see it as an area with improving credit fundamentals and opportunities for not only high current income but also potential total return as spreads potentially narrow to pre-COVID-19 levels. The capital, liquidity, and funding profiles of banks have improved vastly in the past decade on the back of increased regulations, and we believe they will allow banks not only to weather COVID-19 defaults but also potentially to thrive after COVID-19.

1. Capital ratios are at multi-decade highs for U.S. commercial banks, with common equity tier 1 (CET1) regulatory capital ratios up approximately 40% (to 13%, from a low of 9%). Tangible capital (tangible common equity/tangible assets) has doubled over the same time frame (Figure 21).

2. Liquidity at banks has increased, helped by stronger regulatory requirements. We also note that from 2008 to 2011, total deposits grew in each annual period. Additionally, banks increased the quality of their funding: term deposit funding (i.e., certificates of deposit) declined from a peak of 30% to just 12% today, while low-cost core deposits (checking and savings accounts) have increased. Additionally, low-cost deposits surged in March (Figure 22).

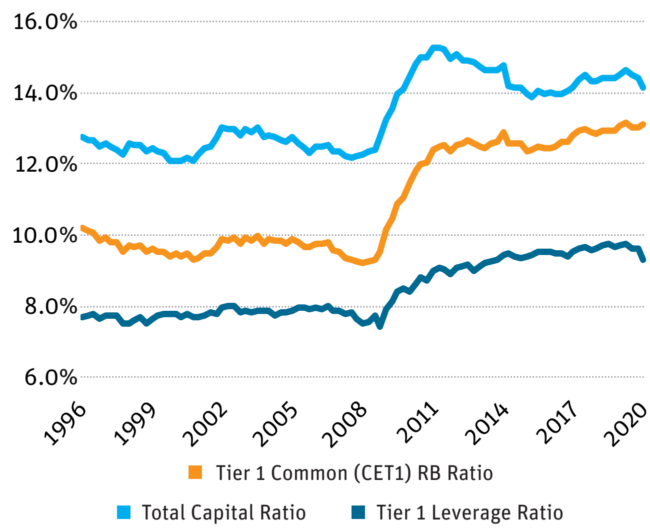
3. Credit quality: While it is difficult to determine the severity of this recession, we expect the impact on banks will be less severe than in the prior cycle, as banks have de-risked and deleveraged over the past decade. Loan underwriting standards are stricter, and capital levels are higher.

4. Low default rates: Bank failure rates are low, with most failures coming in smaller, private banks. Nearly 60% of bank failures are of banks with less than $100 million in assets, and nearly 90% of all bank failures are of banks with under $500 million in assets. Since 1980, the average annual default rate for the entire banking sector is 0.66%. Going back to 1935, the bank failure rate is just 0.36% (Figure 23).

Additionally, with robust capital ratios and liquidity, we believe community-oriented banks are likely prepared to proactively assist small businesses and local consumers throughout this uncertain economic environment, aligning well with the environmental, social, and governance factors incorporated in our investment process.

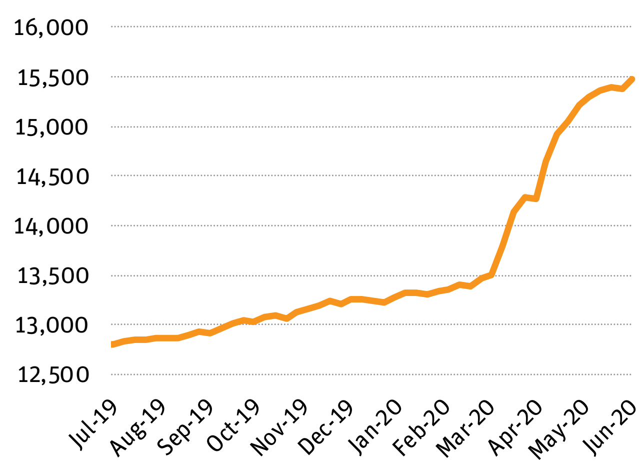
We remain confident in the overall health and soundness of U.S. financials and the banking system in particular, and see it as an area with improving credit fundamentals.

FIGURE 21: BANK CAPITAL RATIOS



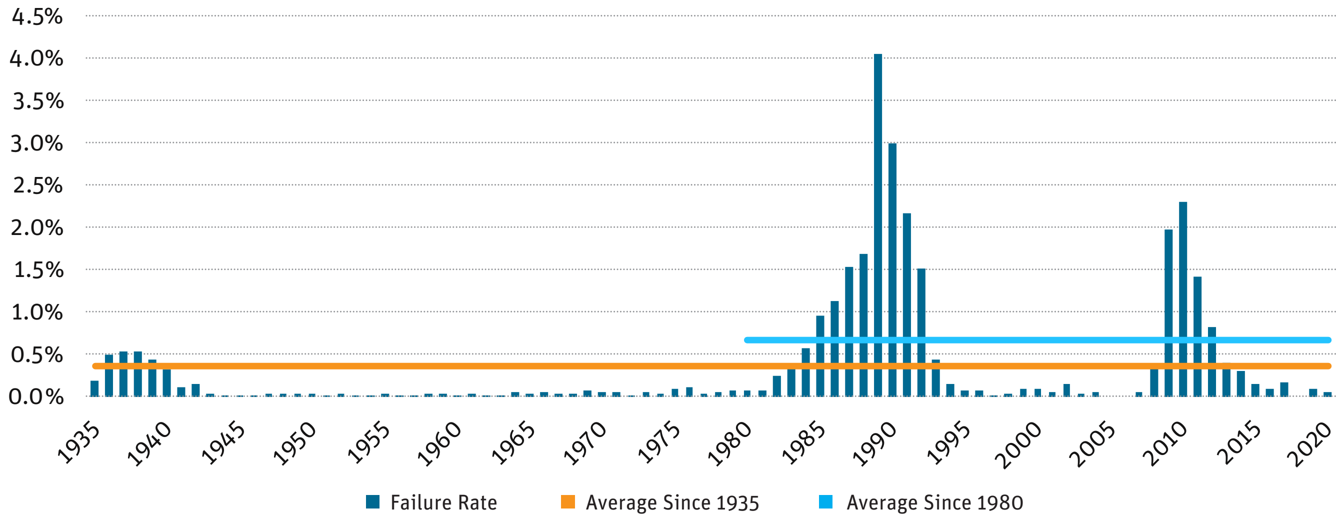
Source: S&P Global Market Intelligence as of 3/31/20.

FIGURE 22: U.S. COMMERCIAL BANK LIABILITIES DEPOSITS



Source: Bloomberg as of 6/10/20.

FIGURE 23: COMMERCIAL BANK FAILURE RATE



Source: FDIC as of 3/31/20.

High Yield

AREAS OF FOCUS

We entered 2020 with a strategy to position the portfolio more defensively, given our view that while the economy was on a slower but steady growth trajectory, high-yield valuation levels were approaching full value. The primary drivers of our view were supportive rate cuts by the Fed, the recent trade agreement between the U.S. and China, and stable trends in corporate fundamentals and default levels. Our favorable views of the economy and corporate fundamentals were balanced by high-yield valuations that were approaching post-crisis tights and that had little cushion to absorb negative developments.

High-yield spreads have recovered about 70% of the widening because of extensive fiscal and monetary support, improving virus trends, and partial reopening of the economy.

As we progressed through February and into March, concerns about the impact of the pandemic accelerated dramatically, and the economy was shut down to help contain the spread of the virus. The unprecedented economic shutdown caused a material deterioration in expectations for corporate earnings and default levels, followed by significant outflows and selling pressure in high-yield corporates. The spread on the Bloomberg Barclays U.S. High Yield Index widened out from 341 basis points in mid-February to 1,100 basis points in late March. To help offset the economic impact of the pandemic and the severe deterioration in financial conditions, Congress passed a significant fiscal package and the Fed announced a number of programs that were aimed at improving financial confidence, including (for the first time) facilities to buy corporate bonds and fixed-income ETFs in both the primary and the secondary markets. Since the wide levels of late March, high-yield spreads have recovered about 70% of the widening because of extensive fiscal and monetary support, improving virus trends, and partial reopening of the economy.

Looking forward, in the context of an improving economy, low rates, significant support from the Federal Reserve, and a general lack of appealing income-oriented assets, high yield remains an attractive asset class despite an uncertain outlook regarding the length and trajectory of the economic recovery, fears over a potential second wave of the pandemic, and expected higher corporate default levels. The current Bloomberg Barclays U.S. High Yield Index spread of 577 basis points compares favorably to the historical average of 550 basis points and post-crisis tights of 300 basis points. We remain focused on risk/reward, and we prefer issuers that are leveraged to a recovery but can also navigate a more challenging environment. We prioritize issuers that have access to funding markets, are proactive on addressing costs, have sufficient liquidity, and will be able to generate positive cash flow. Since March, we have added positions in certain sectors that were most impacted by the economic shutdown but offered favorable structures and attractive valuations, including select leisure, retail, aerospace, and automotive issuers. We are also opportunistically focused on issuers with potential direct support from the Fed, including fallen angels.

AREAS TO AVOID

We are avoiding issuers and sectors that have significant exposure to a potential second wave of the pandemic or that rely on high concentrations of people and gatherings. In an elevated corporate default environment, we also avoid issuers with limited access to capital markets, stressed balance sheets, limited visibility of cash flow generation, or poor structures. Examples include independent oil producers, theaters, gaming, and airlines. We also are underweight in certain sectors that do not currently offer attractive relative value, such as technology, wireless, and cable.

While the ultimate outcome of the COVID-19 fallout is very difficult to ascertain, we remain confident in our philosophy and process of identifying the best risk-adjusted returns in U.S. structured and corporate credit.

Looking Forward

While the ultimate outcome of the COVID-19 fallout is very difficult to ascertain, we remain confident in our philosophy and process of identifying the best risk-adjusted returns in U.S. structured and corporate credit. Winners and losers will continue to emerge, and we believe NA RMBS and consumer ABS provide the best risk-adjusted opportunities for our structured credit strategies over the long-run credit cycle. Their ability to withstand harsh economic outcomes as well as offer attractive income and upside potential as we potentially return to pre-COVID-19 levels continues to stand out to us. While a V-shaped recovery is looking more likely, we will remain biased toward high-quality income with short-duration characteristics that can protect us on the downside but still have room for upside. Moreover, the high current income and short-duration profile our strategies offer potentially pays investors to wait while the Fed reflates. NA RMBS and ABS are still cheap on a spread and yield basis, especially compared with other traditional areas of fixed-income exposure, with a fraction of the interest rate risk. While CMBS and CLOs will continue to provide tactical opportunity sets for our strategies, they are currently challenged from a fundamental perspective by COVID-19. Financials present a compelling opportunity set after COVID-19. Similar to NA RMBS and ABS, financials were one of our areas of highest conviction before COVID-19. However, after COVID-19, we remain bullish on their ability to not only withstand the coming default cycle but also potentially thrive in a V-shaped recovery as the Fed's preferred transmission mechanism of credit expansion. Finally, we view the winners emerging from the list of epicenter names in high yield as presenting excellent opportunities for very attractive income and total return opportunities as the world normalizes in the years ahead.

DEFINITIONS

Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
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.
Cash Flow: The net amount of cash and cash-equivalents being transferred into and out of a business, especially as affecting liquidity.
Correlation: A statistical measure of how two securities move in relation to another.
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.
ICE BofA MOVE Index: A yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. (weighted average of 1m2y, 1m5y, 1m10y and 1m30y Treasury implied vols with weights 0.2/0.2/0.4/0.2, respectively).
S&P 500 Total Return Index: The index is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Tangible Assets: Assets with a physical form and that hold value.
Tangible Capital: An outstanding stock plus retained earnings.
Tangible Common Equity: The common equity listed on the balance sheet minus preferred stock and intangible assets.
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.

It is not possible to invest directly in an index.

As of 6/30/20, 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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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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