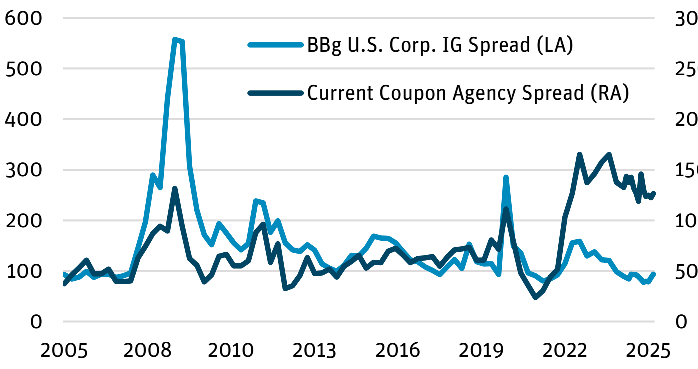
Opportunities in Agency and Non-Agency RMBS

Angel Oak believes that the strength of housing valuations, shortages in housing stock inventory, and the buildup of homeowner's equity relative to mortgage debt are strong tailwinds for mortgages and have created an opportunity for investors in both Agency and Non-Agency residential mortgage-backed securities (RMBS), especially relative to corporate credit. This opportunity is made even more attractive by market technicals that have made RMBS relatively cheap. Angel Oak recommends rotating out of corporate credit allocations and into RMBS.

Agency RMBS trade at a spread to government securities to compensate investors for the prepayment risk in the underlying mortgage loan collateral. Spreads on both Agency RMBS and corporate bonds rose dramatically during the Great Financial Crisis (Figure 1), after which both asset classes experienced spread normalization. Spreads on Agency RMBS widened again as the Fed began increasing rates in March 2022, causing banks to sell off this asset class, while corporate bond spreads over government securities were relatively static (Figure 1). This dynamic has created a significant relative value opportunity in Agency RMBS compared with corporate credit.

Figure 1: Current Coupon Agency Nominal Spread Wider Than IG Corp. Index Spread

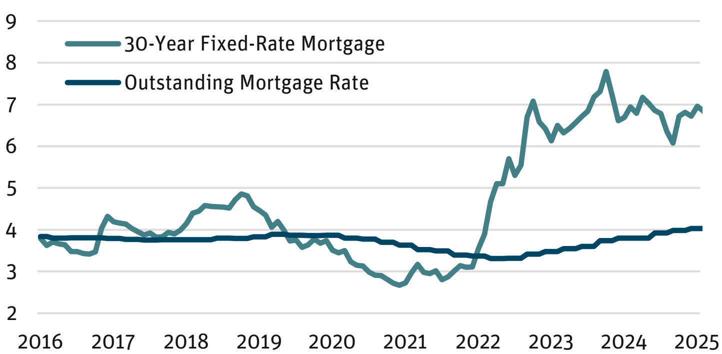
Basis Points



Source: Bloomberg, Morgan Stanley Research as of 3/31/25.

Figure 2: Current vs. Effective Mortgage Rates

Mortgage Rate (%)



Source: Bloomberg as of 3/31/25.

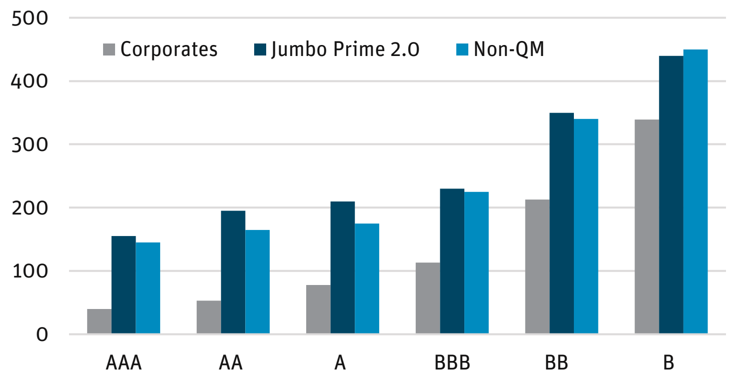
This relative value is even more attractive given the minimal incentive that most borrowers have to refinance their mortgages, which is the primary driver of prepayments in Agency RMBS. Current rates on newly originated Agency-qualifying mortgages are near 7.00%, which is much higher than the average rate of about 4.00% on all outstanding mortgages (Figure 2). The result is that investors in Agency RMBS are getting compensated by a spread that reflects greater prepayment risk than appears to be warranted. The Fed's most recent internal forecast[1] indicates its expectation of a 50-bps decline in the Fed Funds rate throughout 2025, a signal that rates are unlikely to decline substantially enough to create significant refinancing incentives in the residential mortgage space.

Non-Agency RMBS currently offer significantly higher yield spreads versus similarly rated corporates (Figure 3). We believe current spread levels offer a very attractive entry point into this asset class relative to corporate credit.

In summary, fundamental economic strengths in housing combined with market dislocations in the RMBS space and a favorable rate outlook have created a historic opportunity for investors in both Agency and Non-Agency bonds relative to corporate credit.

Figure 3: Non-Agency vs. Corporate Spreads

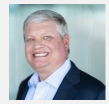
Basis Points



Source: Bloomberg as of 3/31/25.

[1]Source: Federal Reserve Summary of Economic Projections, March 19, 2024.

Agency Mortgage-Backed Securities (AMBS): Securities issued or guaranteed by the U.S. government or a GSE.
Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
Delinquencies: Represent a neglect in making required payments on a debt.
Mortgage-Backed Security (MBS): A type of asset-backed security which is secured by a mortgage or collection of mortgages.
Mortgage Credit Availability Index (MCAI): The MCAI is a barometer of the availability of mortgage credit using guidelines from institutional investors who purchase loans through the broker and/or correspondent channels.
Spread: The difference in yield between two bonds of similar maturity but different credit quality.



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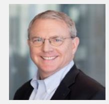

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