Q2 2021 MARKET COMMENTARY

Macro: Fueled by record fiscal and monetary stimuli along with a successful vaccination program, risk assets had another strong quarter with credit spreads and absolute yields in some asset classes reaching historical record lows. US GDP posted an impressive +6.4% growth for Q1 2021, essentially erasing all economic losses from the COVID-19 related recession and restoring US GDP back to its all time high. Over $5 trillion of fiscal stimulus played a large role in sharp economic recovery. However, it wasn't just the 26% of GDP spent by the Treasury and various government agencies that accounted for the astonishing economic recovery from the worst global pandemic in 100 years. A successful vaccine has enabled quicker than expected economic recovery in the first half of 2021. A consequence, however, of the sudden surge in demand against a backdrop of lingering supply chain bottlenecks has been a rapid rise in inflation, with the US CPI at 5% YoY, the highest level since 2008.

Despite elevated inflationary data, the Federal Reserve continued to add at least $120 billion in Treasuries and MBS securities per month, with US M2 monetary supply expanding an unprecedented 33% since the beginning of 2020. However, at their last meeting, Fed officials moved the start of the rate-tightening cycle from 2024 to 2023, as the economy has been performing better than expected. Coincidentally, the 10-year yield reached its highest reading at the end of Q1 and dropped 27 bp by the end of 2nd quarter. As counterintuitive as it might appear given current inflationary readings, the market has been mildly disappointed by underwhelming gains in employment with the unemployment rate at 5.9% in June. That, combined with high short interest in the long-end of the curve and anxiety related to the emergence of the Delta variant of COVID-19, pushed the long end of the curve down. Including the rise in short term interest rates in Q2, the yield curve flattened by 35 bp.

Macro (continued): With markets awash with liquidity, credit markets posted strong returns with spreads tightening across Investment Grade (IG) and high yield markets. The Barclays IG Corporate index had a 3.55% return in Q2 with yield declining to 2.01% and OAS tightening to 85 bp at the end of Q2. The Barclays High Yield index (a bit of oxymoron these days) posted a 2.75% return in Q2, as its yield dropped to 3.75% and its OAS tightened to 264 bp, both record historical lows. Even the CCC component of Barclays High Yield index saw its yield decline to 5.64% and OAS tighten to 455bp, both historical lows.

RMBS: Continuing improvements in fundamentals along with a reach for yield across risk assets were once again dominant themes in the RMBS market. Robust home price appreciation (HPA) gains driven by limited housing inventory pushed COVID-19 forbearance cure rates to 50-70% across collateral types in Q2. The MBA 30+ day delinquency rate has declined to 6.3% from a high of 8.2% in Q2 2020. More credit sensitive sectors such as Non-Qualified Mortgage saw even greater percentage improvements in delinquency rates with 30+ day delinquencies falling below 10% in Q2 2021 from a high of 23% in May 2020. Borrowers have enough equity in their homes to get a modification or sell the property without resorting to default options. As expected, the credit curve continued to flatten across RMBS sectors. Record low mortgage rates have driven prepayment speeds higher over the last few months and caused investors to be more cautious about higher priced callable fixed-rate tranches. Spread tightening and the decline in Treasury rates caused a substantial reduction in Legacy RMBS trading volumes with spreads continuing to tighten inside 150-160 dm for money good non-IG floaters. Discount pricing across many Legacy RMBS sectors continues to present decent optionality due to a pick-up in prepayment speeds and possible optional redemption activity.

Post-crisis tight spread levels are expected to induce a record amount of RMBS new issuance, according to Cantor, who expects 2021 RMBS issuance to exceed 2019's level by almost 20%.

CMBS: CMBS spreads also tightened across the credit spectrum, with the credit curve continuing to flatten as lower credits outperformed higher credits on a spread basis. Last Cashflow (LCF) AAAs tightened by 15 bp to 65 bp spread to swaps while new issue Conduit BBBs tightened 35 bp to 280 bp spread to swaps. New issue Conduit AA and A spreads have hovered around 100 bp and 135 bp, respectively. Floating-rate Single Asset Single Borrower (SABS) issuance saw a significant pick-up in 2021 with $27 billion issued YTD and projected issuance of $32-38 billion total in 2021, according to Cantor. Pricing on SASB deals has varied across borrower and asset property types, but in general AAAs have cleared between 70-100 bp while BBB SASB spreads have ranged between 175 bp and 250 bp. Investor "reach for yield" is evident, with a subset of seasoned SASB subordinate tranches from 2012-2016 vintages moving from the 60s and 70s at the start of the year to the 90s, reflecting the most favorable set of outcomes at loan maturity. According to Trepp, the CMBS conduit special servicing rate has declined for the 9th consecutive month in June to 7.6% from a peak of 9%. Lodging and retail led the decline and end the quarter with 18.5% and 13% of collateral in special servicing, respectively. 2013 and 2014 conduit vintages continue to have the most problematic collateral with over 9% of loans 30+ days delinquent. Agency Freddie K spreads have tightened to all time low levels in Q2 with Bs at 70 bp and Cs at 140 bp over swaps, respectively, as the 90+ day delinquency rate has declined to just 0.07% on fixed-rate Freddie K collateral. Credit performance continued to improve in the Small Balance Commercial (SBC) sector, with Bayview reporting declines in 90+ day seriously delinquent collateral for its legacy BAYC shelf.

ABS: After compressing to post-crisis tight levels there is limited room for further spread tightening in on-the-run ABS sectors such as auto and credit cards. Subprime Auto ABS AAA-BBB spreads are between 10 bp and 85 bp with BBs in the low 200s. Dealer forecasts put 2021 ABS gross supply between $240-300 billion but net supply is likely to be negative, which should be further supportive of ABS spreads going forward. From a technical standpoint the demand for short duration paper will continue to be robust in light of uncertainties associated with the Fed's continued liquidity provisions and eventual tapering. There has been significant credit spread tightening between on-the-run sectors (Auto/Credit Cards) and some of the more esoteric ABS collateral types (student loans, unsecured consumer loans, aircraft ABS, small business loans, containers) and that is expected to continue as investors "reach for yield". Due to record fiscal stimulus along with various federal debt relief programs, consumer credit performance has improved beyond pre-COVID levels and credit fundamentals remain supportive of continuing spread tightening among ABS sectors.

CLO: CLOs continued to benefit from the rapid ascent of leveraged loan prices as the S&P Leveraged Loan index closes in on its post-crisis high at the end of Q2. Similar to High Yield, Leveraged Loans have seen significant credit curve flattening with prices of the riskiest CCC loans rising the most. This significant increase in collateral prices has substantially improved Market Value of Collateral (MVOC) coverage ratios for lower tier CLO manager with high CCC buckets. As a result, a number of tranches that were originally rated BBB and had been downgraded to BB or B because they had stopped paying interest when declining MVOC ratios tripped Over-Collateralization (OC) triggers are once again paying interest as OC triggers are back to passing due to MVOC price increases. AAA spreads have tightened marginally from 110 DM to 103 DM. BofA projects a total of $140 billion in new issue supply in 2021, along with $220 billion in refinancing and resets.

The CLO credit curve continues to flatten with BBB CLOs tightening 30 bp to 315 DM while single A rated tranches tightened 10 bp to 200 DM. At 650 DM BB CLOs offer significant relative value compared to Corporate High Yield bonds, as just 5% of Global CLOs have suffered impairment compared to 11% of High Yield bonds, according to BofA Research.

Structured Notes: The end of Q1 marked the highest level on both the 10 year and 30 year Treasury notes. With the 30 to 2 year swap rate differential shrinking by around 45 bp from yield curve flattening, projected coupons on lower multiple (4x-7x) Corporate Structured Notes (CSN) have declined significantly during Q2. This has caused their prices to decline 6-7 points from the high 90s to the low/mid 90s.

The price of higher multiple Morgan Stanley and Credit Suisse CSNs has held up better as their projected coupons are still higher (still above the cap in some cases) making them attractive to yield buyers. 10x and 20x Morgan Stanley CSNs dropped around 2-3 points in price in Q2.

2Q 2021 PORTFOLIO ATTRIBUTION

SECTOR	RETURN	PORT	ATTRIBUTION
RMBS	1.2%	36.6%	0.4%
CMBS	2.2%	12.8%	0.3%
ABS	1.9%	2.6%	0.05%
CLO/CDO	1.9%	15.1%	0.3%
CORP	0.8%	16.9%	0.1%
GOVT	1.1%	8.1%	0.1%
Cash	0.0%	7.9%	0.0%
TOTAL		**100.0%**	**1.3%**

PORTFOLIO OUTLOOK

We believe the Federal Reserve is unlikely to taper before 2022. The Fed's abundant liquidity along with lingering doubts regarding the continuation of the frenetic pace of economic growth, new COVID strains and prevailing views on the transient nature of inflation are applying downward pressure on long term rates. Inflation could surprise to the upside. A rise in long term rates to 1.8-2% cannot be ruled out. We believe credit spreads will be range bound to slightly tighter in sectors that have yet to retrace all of their post-crisis widening.

This quarter, most returns came from carry income rather than spread tightening. Given the current environment of historically low yields and post-crisis tight spreads we have reduced spread duration as we have sought higher-carry return profiles with less price volatility. In RMBS, we like Legacy fixed-rate callable bonds that offer significant carry at limited call risk, mitigated by lower premium prices. We continue to like seasoned Non-QM/RPL/Prime 2.0 subordinate tranches that that are BB or B rated and, due de-leveraging, will soon be eligible for a rating upgrade. These non-IG tranches could potentially tighten 60-75 bp once they de-lever and clean out their delinquency pipeline, which should make them eligible for a rating upgrade. Premium Prime/Non-QM subordinate tranches can benefit from slowing down/burnout in prepayment speeds. In CMBS, we like select SBC Non-IG subordinate tranches that have de-levered and could get upgraded after their delinquency pipeline cleans up. We also like money-good select Conduit 2012-2014 B & C tranches originally rated AA and A that are currently trading at a discount. In ABS, we see value in off-the-run Private Student Loan ABS Senior and Subordinate tranches that trade 50-100 bp wider relative to more generic shelves. In CLOs, we like downgraded BB tranches that have similar credit risk to BBB tranches (CE and MVOC) where credit performance has improved due to higher loan prices and collateral ratings upgrades. These below IG tranches can provide 100-150 bp of spread relative to BBBs.

Finally, in Corporate Structured Notes, we prefer higher multiple Morgan Stanley and Credit Suisse 10x and 20x coupons, where carry can offset any immediate price declines that result from curve flattening. We also like lower-multiple coupons in the low $90s and below, as they provide cheap optionality on further curve steepening.

We enter Q3 with effective duration of 2.0 years, spread duration of 3.5 years, and portfolio yield of 4.5%. Given the historically low yield environment, we are emphasizing higher-carry return profiles with low credit risk and price volatility, as we feel the market is not adequately compensating investors for those risks at this time. We believe there will be a better time to add riskier assets, possibly this quarter, and we maintain dry powder in the event those opportunities materialize.

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