EASTERLY
ORANGE INVESTMENT ADVISORS

Economic Fundamentals

We believe that US economic growth will moderate to near zero in 2023, with unemployment climbing toward 5% by late 2023 or early 2024. US consumers, who already have reduced their savings rate from 9% in 2019 to 2.3% in mid-2022 amidst the worst inflationary outburst in 40 years, could continue to pare back their expenditures in 2023. Consumer spending retrenchment has the potential to exacerbate the impending economic slowdown in 2023 and beyond. The New York Fed's statistical model, which relies on the spread between the 3-month T-Bill and 10-year Treasury note, estimates the probability of recession over the next 12 months at 45%.

Inflationary Expectations

After peaking at 9.1% in Q2 2022, CPI has declined to 6.5% due to a combination of factors including lower energy costs, a reduction in used car prices, and loosening of supply related bottlenecks. Fed chairman, Jerome Powell, has repeatedly insisted that he does not want inflationary expectations to become entrenched in the public's minds as it did during the 1970s. He reiterated the Fed's absolute commitment to reduce inflation to 2% and ruled out any leeway on that target. After misjudging earlier inflationary pressures as transitory, Powell will want to prevent another policy mistake and thus will be hesitant to cease tightening too early or to revert to an easing stance upon the first sight of disinflation or economic slowdown. We expect the fed funds target rate to top out at 5.00% by the middle of 2023 and stay there until the end of the year. We don't expect the Fed to start easing rates upon the first sign of recessionary pressure, but we think it will be under consideration by the end of the year if the economy is recessionary at that point. We expect the yield curve to remain inverted for at least the first half of the year, with the 2-year ranging between 3.75% and 4.50% and the 10-year between 3.25% and 4.00%.

Credit Markets

2022 was one of the most difficult years for fixed income markets ever. Lower credits widened more than higher credits, resulting in credit curve steepening across rating categories. The Investment Grade (IG) Corporate Index saw 48bp of spread widening, while the High Yield (HY) Corporate Index widened by 189bp. Given our view of a slowdown in corporate earnings growth in 2023, we expect spreads on both IG Corporates and HY bonds to widen from current levels, with further credit curve steepening across rating categories. As default levels potentially increase from current historically low levels, we believe IG Corporates could widen as much as 50bp while HY bonds could widen another 100-150bp. However, we do believe that high overall yields, limited supply, and a light maturity schedule in 2023 will mitigate further corporate spread widening. Leveraged loans, which make up the collateral for CLO securities, could experience greater headwinds from rising rates due to their floating rate exposure in 2023, which will result in wider spreads by 150-175bp.

On a credit spread basis, Structured Credit sectors underperformed Corporate securities across all rating categories in 2022. AAA Structured Credit bonds underperformed the Barclays IG Corporate index, which has an average rating of A/BBB. Also, BBB Structured Credit securities underperformed the Barclays HY Corporate Index, which has an average rating of BB/B. RMBS AAA Non-QM front-pays widened by 120bp while BBB Non-QM RMBS tranches saw 375bp of spread widening. In CMBS, AAA AS mezzanine bonds widened by 115bp while BBB CMBS tranches experienced 350bp of spread widening. In the ABS sector, AAA Subprime Auto front-pays widened by 110bp, while BBB Subprime Auto subordinate tranches finished the year 355bp wider. Finally, in the CLO sector, AAA floating-rate tranches widened by 100bp while BBB mezzanine bonds suffered 250bp of spread widening.

Structured Credit Outlook for 2023

In 2022, Structured Credit sectors generally still outperformed Corporates of similar credit quality on a total return basis, due to higher yield and lower duration. Entering 2023, given higher yields resulting from 2022's spread widening, Structured Credit sectors are even better positioned than last year to outperform Corporates, particularly on a duration-adjusted basis. The table below shows the change in credit spreads for Corporates and Structured Credit sectors from the beginning of 2022 to the beginning of 2023. Note that every Structured Credit sector has widened more over the past year than Corporates of the same rating.

Current Spreads:

Category	Corporate	Structured Credit	ABS	CLO	CMBS	RMBS
IG (>=BBB)	132	283	254	322	389	279
HY (<=BB)	459	616	621	989		700
AAA	60	121	99	183	217	105
AA	78	267	239	253	330	268
A	115	311	265	341	428	314
BBB	173	448	413	510	581	429
BB	300	558	476	989		550
B	500					

1Y Ago Spreads:

Category	Corporate	Structured Credit	ABS	CLO	CMBS	RMBS
IG (>=BBB)	93	130	95	202	178	133
HY (<=BB)	278	407	277	676		512
AAA	53	51	35	108	94	49
AA	62	140	70	164	150	145
A	77	149	112	211	190	142
BBB	120	209	163	325	280	194
BB	206	358	277	676		322
B	348					

Difference:

Category	Corporate	Structured Credit	ABS	CLO	CMBS	RMBS
IG (>=BBB)	39	153	159	120	211	147
HY (<=BB)	181	209	344	313		188
AAA	7	70	65	75	123	57
AA	16	128	169	89	180	123
A	38	162	153	130	239	171
BBB	53	240	251	185	301	235
BB	94	199	199	313		228
B	152					

RMBS fundamentals remain strong in spite of the impending recession. The combination of significant home price appreciation and low leverage has pushed housing equity to the highest percentage as a share of housing assets since the early 1980s. High homeowner equity will discourage borrowers from voluntarily defaulting in the event of home price declines, as was the case in 2008. In the longer run, a limited supply of homes, exacerbated by building restrictions, higher input costs and inadequate financing, will cause the supply-demand imbalance to continue to exert upward pressure on home prices. Another positive factor is that mortgage underwriting standards have tightened considerably since 2008. We like Non-QM A2, A3 and M1 tranches (rated AA, A and BBB) trading at 7%, 7.5% and 9.5% yields, as well as subordinate AA and A rated Prime 2.0 securities trading at 7-8% yields. Another part of the RMBS market that is attractive are Legacy RMBS fixed-rate and floating rate securities trading at 7% to 9% yields and AAA-A rated Private Reverse Mortgage RMBS securities trading at 8-13% yields.

ABS fundamentals are likely to deteriorate, but we believe a recession is largely priced into current spread levels. Consumer ABS fundamentals are expected to weaken as consumption continues to outpace wage gains due to high inflation, rising interest rates and softening labor markets. While consumer credit card balances are rising at the fastest pace in 11 years (8.1% YOY as of October 2022), the consumer's credit is relatively healthy as US household debt as a percentage of personal income and household debt service ratios are well below long-term averages. We expect a continuation of the credit deterioration in both subprime auto and unsecured consumer lending securitizations in terms of higher defaults, delinquencies, and lower recoveries. Consequently, we prefer more seasoned vintages across ABS consumer sectors such as subprime auto and unsecured consumer lending, as these vintages (2019-2021) have de-levered more and benefit from significant structural support compared to new issue on-the-run securities. Examples include 2020 vintage BBB rated Subprime Auto ABS subordinate tranches trading at 8.5% yield, and seasoned A-rated senior unsecured Consumer ABS tranches trading at 8% yield. Commercial ABS sectors such as aircraft, music royalties, and sales receivables tend to be less correlated to economic cycles and benefit from greater diversification of their collateral.

CMBS fundamentals are at the highest risk among Structured Credit sectors in 2023. Higher rates and high inflation have caused repricing across commercial real estate assets due to higher cap rates, higher expenses and uncertainties related to rental income. Office properties have the highest risk for asset repricing due to the longer-term work-from-home trend that has raised vacancy rates to the highest level (18.4%) since 2007 (REIS data), while rents have stayed relative flat since 2019. 2013-2014 vintages that are coming due in 2023 & 2024 have coupon rates from 4.5% to 5%, while the current conduit CMBS coupon rate is above 6%. Hence, refinancing risks are taking center stage and we might see increased maturity extensions, loan modifications (coupon and principal forbearance) and maturity defaults across the CMBS universe. We expect increased bifurcation between top tier properties, with strong sponsors that will not have any issues refinancing their loans, and lower tier properties, with weaker sponsors who are less likely to contribute equity to properties faced with higher financing costs. In CMBS, we like AA and BBB rated Small Balance Commercial CMBS tranches trading at 7.5% and 8.5% yields.

CLO fundamentals at the top of the capital structure should hold up well, but increased defaults and ratings downgrades will impact lower rated mezzanine tranches in 2023. Lower corporate profits will put a stress on interest rate coverage ratios as Libor/SOFR rates rise to 5%. Lower collateral prices, particularly hitting B and CCC-rated leveraged loans, will cause interest to be diverted from equity and potentially BB/B mezzanine tranches. Higher rated mezzanine tranches (AA through BBB) should be able to withstand recession-triggered higher defaults and lower recoveries due to superior structural advantages: interest diversion from OC (overcollateralization) Coverage Test failure, OC and excess spread. Based on our outlook, we prefer AA and A rated BSL CLO tranches from 3rd and 4th tier managers trading at 7.5% and 8.5% yields respectively.

Structured Credit Value Strategy

Our Structured Credit Value strategy is designed to capitalize on, and outperform during, stressed markets. It is an active, security-selection-focused strategy that seeks to acquire undervalued bonds in all market environments. In addition, we manage portfolio risk tactically. We de-risk the portfolio by going up in credit, reducing spread duration, and building liquidity when volatility is low and spreads are tight, rather than be fully invested or go down in credit to seek higher returns. During these periods we rely on opportunistic, active trading, featuring our ability to source, analyze, and acquire undervalued bonds at favorable prices. This positions the portfolio to navigate and ultimately capitalize on market dislocations in Structured Credit.

In 2023, we expect rates to remain range bound and credit spreads to remain volatile as the Fed completes its tightening cycle, which will likely bring on a recessionary environment. Potential additional headwinds in 2023, which do not make up our base case scenario but must be considered, include: 1) a continuation of outflows from fixed income mutual funds that began in 2022 ($400 billion in net outflows from fixed income), 2) a worse than expected recession that derails investor confidence and causes liquidity to dry up, 3) persistent inflation which forces the Fed to raise rates higher than the market anticipates, 4) a continuation and possible acceleration of Quantitative Tightening which could drive long term rates higher and 5) further inversion of the yield curve.

As a result of our outlook, we will maintain limited interest rate exposure and will concentrate our holdings in the highest rating tiers across all Structured Credit sectors, with very limited exposure to lower rated tranches in the CMBS and CLO market. We are able to take advantage of credit market dislocations very effectively due to our size and our active trading approach.

Ticker	Name	Yield	Duration	Rating	1Y Vol	3Y Vol
	Orange Structured Credit Value	**8.6**	**1.7**	**A/A**	**1.7**	**5.9**
LUATTRUU	US Treasury Index	3.9	6.3	AAA/AAA	6.7	5.5
LBUSTRUU	US Aggregate Index	4.4	6.3	AA1/AA2	7.4	5.9
LUACTRUU	US IG Corp Index	5.2	7.3	A3/BAA1	9.1	9.5
LF98TRUU	US HY Corp Index	8.4	3.8	BA3/B1	9.6	11.1
LMBITR	US Muni Index	3.4	6.2	AA2/AA3	6.6	6.5
LUMSTRUU	US Mortgage Index	4.4	5.7	AAA/AAA	8.4	5.7

**Source: Bloomberg as of 1/8/2023. 1Y and 3Y Vol refer to Return Volatility which is the standard deviation from the average of returns of defined granularity over time frame. It measures how widely spread the values in a period are. The larger it is, the riskier the security.*

We expect outflows from fixed income funds to reverse in 2023 as the yield and liquidity of fixed income securities now presents relative value versus other asset classes, such as equities and private credit. We expect asset allocators to shift assets to fixed income in 2023 as fixed income, and Structured Credit markets in particular, offer investors 7-9% returns for investment grade cashflows, something not seen in a generation. We believe that, as demand for fixed income increases, particularly in the absence of new issue supply due to higher yields, spreads will tighten, resulting in price return on top of higher yields. Finally, given where spreads are in Structured Credit relative to Corporates of similar credit quality, we believe Structured Credit has significantly more potential for price upside than Corporates.