ELLINGTON
INCOME OPPORTUNITIES FUND

Market Commentary

First Quarter 2020

Report Highlights

- While the turmoil of March was difficult to navigate, it ultimately should present us with a compelling investment landscape for the foreseeable future.
- Far too often in periods of distress in structured credit, the market paints an entire sector with too broad a brush, overlooking structures that are resilient against the economic backdrop.
- There is a major distinction between assets trading at distressed levels due to potential impairment of future cash flows versus assets trading at distressed levels due to technical factors such as liquidity needs. We believe the structured credit markets are presenting us with situations to find investments that fit in the latter category.

Introduction

In what was perhaps the most volatile period in financial history, the markets were rocked by the global outbreak of COVID-19, which shuttered economies across the world. Equity markets plunged while interest rates rallied to all-time lows as investors rushed to safe havens. At its low, the Dow Jones Industrial Average sank 37% in just six weeks. The yield on the ten-year U.S. Treasury note dropped below 0.50% and, at one point, the entire U.S yield curve fell below 1.0%. While no corner of the credit market was spared from widening spreads, structured credit assets underperformed other asset classes in a stretch of time reminiscent of the Global Financial Crisis of 2008. A perfect storm of events led to a liquidity crunch, causing even the highest quality investment grade structured credit assets to trade at double-digit yields.

This liquidity crisis was the result of two related market events – the mass de-leveraging of both mortgage REITs and hedge funds and the forced selling of structured credit assets by daily liquid mutual funds meeting redemptions. REIT de-leveraging came in stages, beginning with agency mortgage-backed securities before moving on to private-label structured credit assets. The sharp interest rate rally of early March drove fears of a refinance wave that would cripple premium-dollar priced agency MBS, causing spreads on those securities to widen substantially. As a result, several mortgage REITs with levered agency MBS strategies were faced with margin calls from repo lenders. However, when these large, levered companies attempted to sell bonds, there simply was no reasonable market bid. Although banks were relatively well-capitalized, they did not want to use balance sheet for these assets in the wake of the pandemic and an uncertain future. Severe price dislocations in the agency mortgage market ensued, which started the downward spiral of more mass selling from the REITs, which drove prices even lower, which led to more margin calls and so on. A return to normalcy in these usually efficient markets did not come until the Federal Reserve stepped in with their latest round of "Quantitative Easing", which included aggressive purchasing of agency MBS on an accelerated schedule in an attempt to inject liquidity into the system.

While the Fed's actions were effective at restoring order to the agency mortgage market, the entire episode shifted the focus of repo lenders onto levered holders of private label structured products. The increased scrutiny of levered funds was occurring at just about the same time as several daily liquid mutual funds were under pressure from significant redemptions. A combination of factors, including investor desire to raise cash as well as to re-allocate from fixed income into stocks, led to these large-scale redemptions. Several of these funds ran structured credit strategies and had strong performance into March, which made them a prime target for redemptions given dislocations elsewhere. These funds began selling assets to meet redemptions just as the REIT and hedge fund de-leveraging cycle was starting, leading to a deluge of supply hitting the market during the week of March 22nd. That Sunday saw four bid lists hit the market as funds scrambled to raise cash, re-setting spreads over 1000 basis points wider.

An influx of capital from private equity firms and hedge funds who had not been involved in the structured credit markets

for quite some time stabilized spreads, which re-traced some of their widening by quarter-end. Although large real money accounts have gradually begun to buy structured credit assets, spreads are still very wide by historical standards, presenting us with one of the greatest opportunities within these markets that we have seen in the post-financial crisis era. While we never expect to see significant NAV erosion in our funds, the events of March made it virtually impossible to avoid given our portfolio composition. As we move forward, we are extremely excited about the opportunity set within our targeted asset classes. We are able to source structured credit securities, many of which we view as fundamentally sound given the broader macro environment, at spreads that are several hundred basis points wider than where they have historically traded. While the turmoil of March was difficult to navigate, it ultimately should present us with a compelling investment landscape for the foreseeable future.

U.S. Non-Agency RMBS

Perhaps no structured credit sector experienced as much actual distressed trading volume as legacy RMBS during the quarter. Entering the year, many large money managers had excess cash, much of which went toward purchases of these pre-crisis residential securities. Given the sector had lagged corporate credit over 2019 and continues to be supported by strong underlying fundamentals, performance was very strong through February. While assets remained well-bid even through early March, the sector was at the epicenter of the structured credit liquidity crisis. Many of the assets that were ultimately sold by mutual funds, REITs, and hedge funds were legacy non-agency RMBS.

In many ways, the strong fundamentals of the sector were responsible for the large volumes of distressed sales. In order to maximize proceeds, funds needing cash sold assets that were perceived to have minimal impact from the effects of the pandemic. Although the economic fallout caused by the virus is expected to dampen the housing market, the extreme seasoning of the legacy sector make it somewhat resilient to a recession, especially relative to other parts of the credit markets.

We believe this for several reasons. For one, the individuals most impacted economically so far skew more towards being renters. Homeowners tend to be salaried professionals with minimal income disruption as a result of the virus. We'd expect this relationship to be even more pronounced in very seasoned deals, where borrowers have been living in their homes for as many as fifteen years. Second, the borrowers remaining in these securities have already weathered economic storms in the past, showing the ability to pay their loan through the depths of the 2008 Global Financial Crisis. The Federal government has been clear about its desire to keep borrowers in their homes despite any potential financial hardship that they face. Everything is on the table, including many of the programs that were used in the aftermath of the 2008 housing crisis, including loan forbearance and modification plans as well as a foreclosure moratorium. Lastly, the average borrowers in a legacy non-agency RMBS deal have built significant equity in their homes. Given the age of these loans, borrowers have amortized down their loans, which ultimately leads to protection for the bondholder in case there eventually is a default.

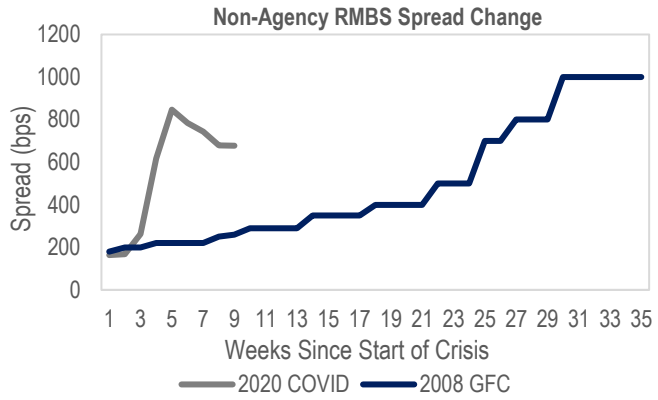

Figure 1: Spread widening as a result of the pandemic was extreme; it took approximately two weeks for spreads to widen over 600 basis points. The same magnitude of spread widening took over 30 weeks during the 2008 GFC.

For these reasons, we are extremely optimistic about the future return profiles of these securities. In order to generate a negative return on many of these securities at current market prices, we'd have to experience a housing event several magnitudes worse than 2008. As we approach a future with many economic unknowns as a result of the virus, we believe that the legacy RMBS sector offers some of the best risk-adjusted return, especially compared to sectors of credit that may have more binary outcomes. With sound bonds currently trading in the high single-digits, it is realistic to expect a mid-teens unlevered return over the next several months if spreads retrace only a portion of the technical widening of March.

CLO

Although the CLO market experienced extreme spread widening as well, we did not see the same levels of trade volume as within the RMBS market. This was most likely due to the fact that the market perceives the credit risk of the

leveraged loan market as a result of the virus to be more severe than other areas such as RMBS. Investors who needed to raise cash were hesitant to sell CLOs as bids for these assets were extremely distressed regardless of an individual security's rating or structure. At one point, AAA-rated CLOs traded as wide as 700 basis points during March.

In addition to the economic shock from COVID-19 that directly affected virtually every sector of the corporate world, plunging oil prices added an additional layer of complication for energy companies, which make up a large portion of high yield debt. We are already starting to see mass downgrades of leveraged loans, which is likely to lead to downgrades of CLO tranches. April's remittance reports showed a large amount of deals fail certain overcollateralization tests, with multiple deals even failing their overcollateralization test at the AAA-level. As a result, Moody's placed over 800 CLO tranches, totaling $22 billion, on downgrade watch.

The inclusion of AAA-rated static CLOs in the Federal Reserve's Term Asset Liability Funding (TALF) program gave prices a brief reprieve although non-AAA securities have continued to lag overall. As we enter uncharted economic territory, it is extremely difficult to have an informed credit view on every loan in every industry. Historically, our position has always been to focus on strong structures that are able to withstand extreme corporate credit shocks, the likes of which we have not experienced in previous periods of economic turmoil. That strategy has paid dividends in these markets. Although our positions have experienced spread widening like any other sector of structured credit, they continue to demonstrate minimal fundamental credit risk, especially relative to other CLO tranches in the market. We have run shocks on our portfolio meant to mimic an extremely rapid global recessionary event, whereby almost one-third of leveraged loans default in the next twelve months with recoveries lower than any point in history. As expected, our CLO positions are able to withstand such a stress. In many ways, a short-term recessionary event benefits holders of investment grade, de-leveraging tranches such as ours. As overcollateralization tests begin to fail sooner, all cash flow is diverted from the lower-rated bonds and equity tranche to the top of the capital structure, causing accelerated de-leveraging of the deal.

We believe that CLOs should present some of the most compelling trading opportunities in the coming months as forced sellers, who have exhausted all options in other portions of their portfolio, turn to their CLO investments in order to raise cash. Far too often, in these situations, the market paints the entire CLO sector with too broad of a brush, overlooking structures that are very resilient against the economic backdrop. We have seen instances of such securities trading at yields approaching 20% over the last several weeks. While we currently have not seen large amounts of volume trading at these levels, we are confident that such supply will come out in due time.

CMBS

In many ways, the CMBS market experienced a similar theme to what we witnessed in CLOs over the quarter. Trading volume was limited compared to RMBS, as the market perceived additional fundamental credit risk within the sector. Distressed selling was concentrated at the top of the capital structure, mainly in AAA-rated securities, which traded at double-digit yields at one point.

Many areas of the commercial real estate market face significant risks as a result of the COVID-19 pandemic. While some sectors may experience only temporary impairments, others may be fundamentally altered forever. Retail, which had been struggling even before the latest pandemic, may face an accelerated demise as consumers rely almost exclusively on online shopping during the quarantine. Student housing, which is dependent on strong college enrollment, could be at risk if higher education permanently shifts toward online learning. Many students may question the costs and need associated with attending a physical location after a successful experience with remote learning. Excess office space can be viewed as unnecessary as companies are successfully navigating the work-from-home model. The hotel sector could see a major reduction in valuations if the current shutdown in global travel persists long beyond the initial stages of the virus. In the last six weeks, the world has been forced to embrace a new order, reliant on technology for shopping, education, and business meetings. For the most part, people are adjusting quite well, leading to a potential paradigm shift in our society, without a need for as many physical properties.

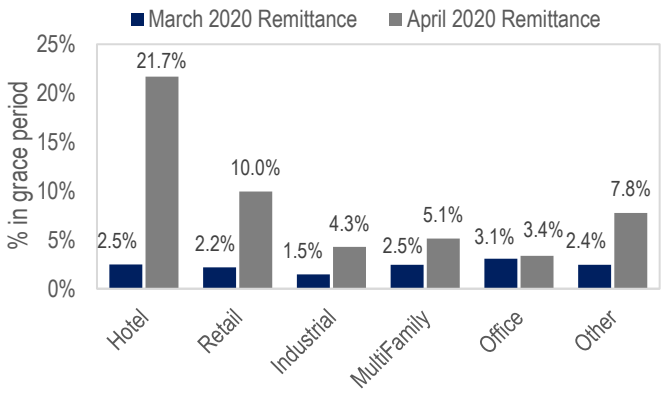

Figure 2: Hotel and retail had the largest increase in the share of loans entering grace periods in April.

The end result could be devastating for particular segments of the commercial real estate universe. However, there will almost certainly be tremendous opportunities as a result of the fallout. Similar to our views on CLOs, we believe that the market will not differentiate enough between bonds with limited risk due to their structures and collateral types. The fund's CMBS holdings, all investment grade tranches with large amounts of credit enhancement, contain large allocations to multifamily properties as deal collateral. Even before these recent events, we had a bias against property types such as hotels and student housing. Although multifamily properties may face temporary cash flow interruptions from delinquent rent, there should continue to be a fundamental need for multifamily housing, where demand has been strong in the years since the 2008 financial crisis. The ability to differentiate between property types that may face temporary setbacks versus those that may become functionally obsolete, should be a tremendous source of alpha within this sector going forward.

While a large supply of RMBS was already flushed through the system in March, we believe that significant amounts of CMBS still has to work its way out of distressed accounts. We are extremely excited about the opportunities that lay ahead, as we can utilize many of the firm's credit tools and analytics, developed to model first-loss tranches, in order to sufficiently analyze a sector that is likely to face increased delinquencies and defaults in the near future. This modeling edge should allow the fund to add safe structures at distressed prices to the benefit of our investors.

Outlook

In many ways, the current environment offers the most compelling investment opportunity in the structured credit market over the last decade. The last time spreads were this wide was in 2011 in the midst of the European credit crisis. What makes the current situation much more appealing, however, is the improved quality of the assets. Legacy non-agency RMBS, for example, have nine more years of seasoning, a period where lower quality borrowers were liquidated and current borrowers have amortized their loans, resulting in low loan-to-value ratios. There is a major distinction between assets trading at distressed levels due to potential impairment of future cash flows versus assets trading at distressed levels due to technical factors such as liquidity needs. We believe the structured credit markets are presenting us with situations to find investments that fit in the latter category. With many hedge funds facing redemptions in the coming months, the forced selling should continue allowing us to source attractive assets and generate robust returns in the near future.

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