ELLINGTON
INCOME OPPORTUNITIES FUND

Market Commentary

Second Quarter 2020

Introduction

Financial markets rebounded sharply as the Federal Reserve continued its stabilization efforts. The Fed's swift and aggressive response, a multi-pronged stimulus effort involving both asset purchases and lending facilities, drove most asset prices higher. Initially concentrated in sectors directly targeted by the Fed's intervention, the recovery eventually seeped into adjacent markets as investors were forced to extend out on the risk spectrum in a search for yield. As a result, we observed one of the most astounding market recoveries in history, with the S&P 500 Index gaining 20.54% and the Bloomberg Barclays U.S. Corporate High Yield Index returning 10.18% in the second quarter, all while the COVID pandemic continued to actively reshape the global economy.

In a year when U.S. interest rates have rallied to all-time lows, a significant portion of headline return in various credit indices, such as the Bloomberg Barclays U.S. Corporate High Yield Index, has been driven by duration whereas the Fund has always been managed as a duration-neutral vehicle.

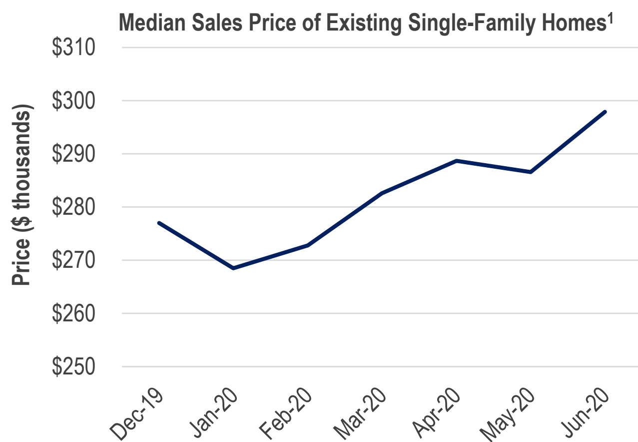
This is not to suggest we aren't surprised by the price moves of the fund's underlying assets. In many ways, the price performance of these assets so far in 2020 has been the opposite of what would have been anticipated based on prior periods of market distress. For example, in the fourth quarter of 2018, structured credit assets exhibited moderate price declines while broader global credit markets sold off significantly. However, in this more recent crisis, technical factors such as mass de-leveraging of REITs and elevated redemptions from daily liquid mutual funds, caused the fund's assets to sharply fall in price early on in the cycle.

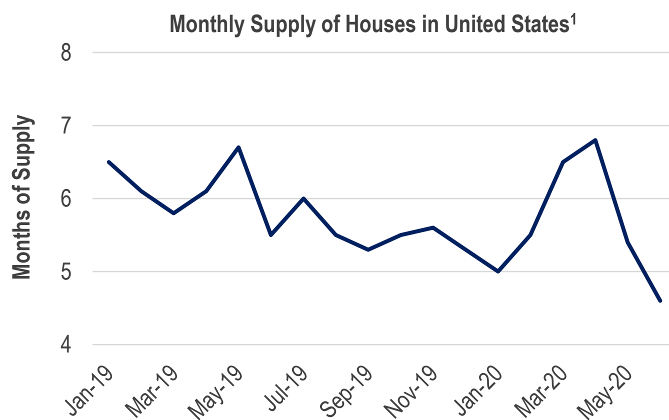
Historically, the fund has found value in fundamentally-sound portions of the structured credit markets that are overlooked by market participants for various reasons. Perhaps the securities have been downgraded to below investment grade or are not part of an index or ETF with broad retail appeal. It is precisely these features, though, which kept the fund's assets off the radar of the Federal Reserve and retail investors, who drove a significant portion of the second quarter's recovery, especially in sectors where asset prices currently appear overvalued. Ultimately, we believe that the strong fundamentals of the fund's securities, whether in the form of low loan-to-value ratios of its RMBS holdings or structural protections of its CLO and CMBS holdings, will be too hard for the market to ignore. The asset price inflation observed in markets around the world has left many investors asking where opportunities remain for capital allocation. We believe that structured credit is one of the most compelling investment opportunities in the current market climate.

U.S. Non-Agency RMBS

Although non-agency RMBS was one of the most heavily distressed asset classes in the depths of March's volatility, the sector now has strong fundamental tailwinds at its back. In many ways, as far as housing is concerned, the COVID crisis has been the opposite of the 2008 Global Financial Crisis (GFC). Demand-side pressure has been one of the strongest drivers of home prices during the pandemic. With people working from home and spending much more time indoors, many Americans are looking to upgrade or increase the size of their primary residence. Many more that are renters are looking to become owners. Homeowners are placing heavy premiums on home offices, gyms, and rooms to accommodate remote learning. Where new inventory cannot be found, homeowners are looking to improve their existing residence, potentially boosting home valuations.

These demand-side dynamics have already shown evidence of boosting real housing prices. According to the Zillow single-family time series, home prices increased 4.4% year-over-year in June. In certain areas, such as those outside major cities, the effect is even stronger. For example, the median sale price in Fairfield County, a Connecticut suburban area outside of New York City, is up 26% year-over-year. With regard to the fund's holdings, the aggregate effect of housing demand will be to drive already low loan-to-value (LTV) ratios on legacy RMBS even lower.





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.

[1]*Source: St. Louis Federal Reserve*

In addition to this fundamental demand shift, fiscal and monetary policy has also played a significant part in supporting the housing market. Fiscal policy has been aimed directly at keeping homeowners and renters in their place of residence. Generous mortgage forbearance terms and "Paycheck Protection Program" (PPP) loans have helped homeowners and renters keep current with their monthly housing expenses or defer payment obligations, which has constrained housing supply. The Fed's monetary stimulus, which has produced the lowest mortgage rates in history, has increased housing affordability. In combination, these factors have pushed home prices higher with no end in sight.

Although spreads within the non-agency RMBS market have tightened substantially since March, there is still value within the sector. Many opportunistic buyers who stepped in during the depths of the pandemic to purchase securities at extremely distressed levels are now looking to take profits at spreads that are anywhere from 100-200 basis points wider than January's levels. There is also greater potential today for trading gains through portfolio turnover than there was prior to the onset of COVID. Many levered, "fast money" accounts have either left the sector or have been forced to play defense as a result of March's price action, leaving the Fund with fewer competitors for bonds. We believe that that Fund's footprint will expand within this market going forward.

CLO

The recovery in CLOs lagged other sectors of structured credit during the second quarter. The recovery was particularly muted within the fund's target profiles, which consists of static, de-levering deals. New capital that entered the CLO market in recent months has been more focused on deals still in their re-investment period, with the belief that strong CLO managers could add significant value to deals during a prolonged period of loan price dislocation. These deals saw greater spread widening in March, but offer more potential upside assuming managers are able to eventually outperform the market.

While we do not disagree with the benefits of a strong manager during a deal's reinvestment period, the fund's strategy has always been to focus on known loan portfolios and strong structures, which we believe can be modeled with a higher degree of certainty. Predicting a manager's future behavior introduces an element of complexity to modeling a deal's future cash flows. The fund's goal, not only within CLOs but among all sectors, is to assemble a portfolio of assets with predictable cash flows that can absorb harsh shocks in downside scenarios. In our view, static deals with managers who may be currently out of favor in the market are the best way to accomplish this over the long run.

Rating downgrades have also weighed on CLO performance across the market this quarter. A high proportion of CLO tranches previously put on negative watch by Moody's experienced downgrades upon further review by the agency. Nearly 45% of Baa-rated bonds reviewed were downgraded to below investment grade while 86% of B-rated bonds were downgraded to Caa or lower, signifying substantial risk. Not surprisingly, a similar story has played out in the loans that back these deals. Of the $18 billion in loans put on negative rating watch by S&P, 35% were downgraded in recent months. Of these, 75% of B-rated loans on negative watch were downgraded to CCC, which could potentially impact CLO tests. Approximately $35 billion of loans in CLOs remain on the S&P negative watch list, which makes up around 6.5% of the overall balance of these deals.

CLO Rating Changes						
Initial Rating	**A**	**Baa**	**Ba**	**B**	**Caa1/Lower**	**Total Bal ($mm)**
A	100%					**$66**
Baa		55%	45%			**$439**
Ba			8%	87%	5%	**$363**
B				14%	86%	**$50**

Source: Nomura

Although the sector has dragged down fund performance this year, we see tremendous upside from here. As of quarter-end, the fund held its CLO positions at a weighted-average spread of 855 basis points, a sizeable pickup for assets we view as structurally sound. We will selectively look to add CLOs to the fund if they continue to lag while being mindful of the sector's liquidity.

CMBS

CMBS spreads tightened substantially in the second quarter. The sector still underperformed RMBS, though, as concerns regarding fundamental performance continue to mount. Delinquencies in CMBS conduit deals grew to approximately 9%, a level not seen since the GFC. Hotel loans were the worst-performing property type with a 33% late payment rate as of July versus a 16% late payment rate in retail and only a 5% delinquency rate for multi-family properties. Performance on hotel-backed loans has been highly correlated with both LTV ratios as well as geography, with higher LTV loans in states such as Illinois and New York performing the worst. Several large retailers declared bankruptcy as the COVID-19 pandemic accelerated the demise of many brick and mortar retailers. Store closures have been a common element in reorganization plans, with Brooks Brothers closing 51 of its 250 stores, while another major chain, Bed, Bath, & Beyond, announced they will be closing approximately 200 locations.

Although the overall picture for CMBS looks fairly bleak, the current situation differs from the GFC in several key ways. For one, many of the delinquent loans today are actually in a state of forbearance, indicating a negotiated effort to cure deferred debt service payments over time. Second, the new issuance market has opened up, as several new deals have been absorbed by the market, albeit with notably reduced hotel and retail exposure. The fact that the new issuance market is functioning in some form is a positive sign for the sector.

Outlook

Looking ahead, we are optimistic regarding the Fund's return potential over the next six to twelve months. We feel confident that the extraordinary spread widening of March and April was driven mainly by technical factors, such as the unwinding of several levered REITs and hedge funds. In fact, we believe that the unwind of these players has acted as a form of "reset", creating a safer market on a going-forward basis and offering relative outperformance of the fund's asset classes if the pandemic were to worsen. There are many indications, such as robust demand for recent investment-grade new issue RMBS and CMBS deals, that point to the fact that significant cash remains on the sidelines in the current market environment. With interest rates near zero, these asset classes provide an obvious home for investors looking to pick up yield without substantially increasing risk. Finally, we own the current portfolio at what we see as extremely attractive levels that offer the potential for outsized total return as we move forward.

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