Market Commentary

First Quarter 2022

Introduction

Ellington Income Opportunities (EIO) suffered in the first quarter with strong headwinds from interest rate and credit spread volatility. Rates sold off throughout the quarter as the market priced in a more aggressive Fed hiking cycle. The yield curve bear-flattened with 2-year Treasury rates up 160 basis points (bps) while 10-year rates were up 82 bps. Credit indices also suffered as a result of the rate move in conjunction with the Russian invasion of Ukraine.

The fund's interest rate hedging helped mitigate the impact of one of the most volatile rate environments in recent history.

Market Environment

Within residential assets, redemption-driven selling across various structured credit funds in March pushed residential mortgage-backed security spreads wider as supply weighed on the market. While spread widening was particularly acute in the fund's single-family rental (SFR) assets, home price appreciation has allowed for significant delivering/cushion—for instance, the fund added an attractive 2020-vintage SFR asset with a current loan-to-value of approximately 67% versus 95% at issuance.

The commercial portfolio was relatively flat on the month with carry outpacing modest mark-to-market losses.

Corporate-backed investments saw mark-to-market losses outweigh carry. While not immune to price movement on a mark-to-market basis, we see these positions, much of which are de-levered mezzanine tranches, as very attractive from a risk-reward standpoint and especially versus their ratings.

In asset-backed investments, aircraft-backed securities detracted as the sector experienced a significant shock in the aftermath of Russia's invasion of Ukraine. Russia ordered more than 500 western owned planes to remain in their country, many of which are owned by asset-backed security deals. While our Russia exposure was limited, the entire sector repriced significantly wider after many investors cut their exposure to the sector after experiencing significant losses. With some ABS securities trading 50+ points lower due to fundamental credit concerns, our holdings repriced wider in sympathy despite being unlikely to take losses.

Fund Outlook

The fund's ability to weather credit and interest rate movements in the first quarter has placed it in an excellent position to benefit from current price dislocations across structured product markets. In many ways, this current market is one of the best trading environments for the fund's assets since the volatility of 2020. Forced selling from certain poor performing funds has driven levels on structured credit assets, specifically RMBS, to very attractive spreads, especially when taking into account the previous 24 months of home price growth. Other larger fund complexes seem to have cash to deploy for these profiles, which should place a floor on prices. Such a market dynamic has created the potential for high trading gains for the fund, especially as the dealer community has shown limited appetite to position risk and capture bid-offer spread.

The fund also will look to diversify its RMBS holdings in the coming months, as other parts of the private label mortgage market now appear to offer compelling value. For example, the Credit Risk Transfer (CRT) market has experienced extreme widening in the first quarter on the heels of high supply. Certain parts of the CRT capital structure have widened several hundred basis points over the period despite consistent fundamentals. While there could continue to be spread volatility in the shorter term in these markets, we believe that they could produce significant long-term returns.

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