Market Commentary

Second Quarter 2022

Introduction

Ellington Income Opportunities (EIO) generated negative performance in the second quarter with extreme volatility across capital markets. From interest rates to credit, a large repricing of risk has occurred across markets as the prospect of a less supportive Federal Reserve and potential for a recessionary environment quickly shifted market attitudes towards defensive posture. Intra-quarter, the S&P was down over 16%, investment grade corporate spreads widened 34 basis points (bps), high yield spreads widened 203 bps, and the 10-year Treasury note sold off 68 bps.

Market Environment

Within residential assets, the fund's focus on seasoned residential assets has helped to minimize return volatility as these assets have traded with a much lower beta to general credit spreads.

The fund's commercial holdings saw mark-to-market losses in Q2. Widening in the commercial sector was particularly acute at the top of the capital structure, and securities in this sector now trade to substantially wider spreads despite stable credit profiles. Within the commercial sector, we continue to focus on deals backed by multifamily residential properties.

Corporate-backed investments were the most significant detractor on the quarter, with collateralized loan obligation (CLO) exposure driving those mark-to-market-driven losses. After outperforming for much of 2022, CLOs weakened further in June after capitulating in May.

In asset-backed investments, aircraft-backed securities detracted. These positions were already trading at distressed levels from events in Ukraine/Russia and have not moved significantly since. The fund entered into a supply chain financing arrangement, adding a new satellite strategy which should provide strong risk-adjusted returns.

The fund's interest rate hedges contributed to the fund's total return in Q2. Although the fund invests in many floating rate assets, interest rate hedges were in place to protect against the duration of the fixed rate components of the portfolio.

Fund Outlook

Having reached the second half of 2022, it is notable in retrospect how quickly market narratives flipped from a "reach for yield" to one of more defensive positioning. In our view, the current market is one of the most attractive entry points for structured products in quite some time. Assets with little to no credit risk, even in the face of harsh economic shocks, now trade at some of the widest levels in product history. However, the current trading environment is extremely challenging as spreads have steadily widened this year without a clear catalyst for reversal. Although spread volatility may persist, the carry profile on the fund's assets have improved as well, creating a strong entry point with significant upside.

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