Angel Oak's Triick Says Mortgages Are In A Fixed-Income Sweet Spot Now

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Clayton Triick, head of portfolio management public strategies at Angel Oak Capital Advisors, part of the team running the Angel Oak Strategic Credit Fund. Read the Q&A below as Clayton says that fundamentals and valuations seldom get aligned the way they have right now for the US housing market and American homeowners. He notes that valuations are "cheaper than they should be" given the strength of the market and mortgage holders, creating opportunity. Triick says homeowners "did a really good job of locking in low mortgage rates", making them the big winners of the rising-rate environment and making mortgages look more attractive than other bond types, particularly corporates, where valuations have gotten rich relative to the economy's strong fundamentals.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

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CHUCK JAFFE: Clayton Triick, head of portfolio management at Angel Oak Capital Advisors, a manager on the team for the Angel Oak Strategic Credit Fund is here, we're talking interest rates, mortgages, consumers and more now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization representing all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we're pointing in the direction of strategic credit investing with Clayton Triick, head of portfolio management public strategies at Angel Oak Capital Advisors. He's part of the team that runs the Angel Oak Strategic Credit Fund, an interval fund trading under the ticker symbol ASCIX, and you can learn more about the firm and the fund at AngelOakCapital.com. And to learn more about interval funds, closed-end funds, and business-development companies generally, check out AICAlliance.org, the website for the Active Investment Company Alliance. Clayton Triick, welcome to The NAVigator.

CLAYTON TRIICK: Hey Chuck, great to be here with you today. Really excited for this conversation.

CHUCK JAFFE: So let's jump in first, because when we're talking strategic credit, well, there's a lot of directions that we can go in, but it's particularly important to know not only the directions you can go in but the directions you want to go in in a market where the credit markets haven't really been doing what everybody expected. I mean, after all, we entered this year pretty certain that there would be not one, not two, but multiple rate cuts, and now most people are thinking maybe one, if any, this year.

CLAYTON TRIICK: Yeah, from our perspective, we came into really the market a year ago, it was quite interesting because if I walked into a client meeting 12 to 18 months ago and said the US would potential for a soft landing, I would have got thrown out of the office, now soft landing has really become consensus in the market. This has been a massive raise in interest rates from the Federal Reserve, which is typically coincided with a big slowdown in the economy. This is very different, the slowdown is taking much longer to happen. We still think a slowdown is very possible for later this year and in 2025, but the US economy, the corporate credit market, the US consumer, and housing market has been extremely resilient,

and that's been the biggest driver of performance over the last 12 months. Year to date, it's really been an interest rate story, and that's really what's been driving returns. And so in our strategies we look across all areas of credit, we have a particular expertise and we're a leader in housing and home owner credit, and so we tend to take a large exposure in those markets from our expertise, but we see lots of opportunities. Fixed-income investors can really get a lot more yield now in the market than they really have in the prior decade.

CHUCK JAFFE: I want to dig in a bit more on that in a moment. I want to stick with the mortgage side of things, because about two thirds of the portfolio of Angel Oak Strategic Credit is in agency and non-agency mortgage-backed residential securities. And there's been a lot of talk about, "Okay, interest rates have been higher for longer," but it hasn't hurt the homeowner, because the homeowner, well, maybe has golden handcuffs to their house, but it's been more effective on the home buyer because, hey, if you're trying to buy a house, you're paying a lot more. So for you as an investor in mortgages, has this actually made the mortgage market more secure? In other words, people are locked in? Do golden handcuffs on consumers become a nice thing for you to be investing in?

CLAYTON TRIICK: Yeah, absolutely. Really what's happened in the housing market the last 12 to 18 months has been brewing really since the Great Financial Crisis. The Great Financial Crisis was really a symptom of the excesses in the housing market, and when you have a crunch in the US economy and you have the Fed drop interest rates, money goes into areas that are doing well and leaves areas that's not doing well. Housing did not do well, so money left housing, at the same time the millennial generation was getting older and getting into that prime age to be forming households and wanting to lever up and buy homes, and so the demand side was rising at the same time that the supply of US homes was shrinking, that created an environment where eventually you would expect home prices to do quite well. Simultaneously, with Covid you had a couple other factors. You had a drop in mortgage rates to extremely attractive levels for individuals buy homes, and/or refinance, and you also had the shelter-in-place component, where people looked to buy a home, the demand for homes went up across all generations including the millennial generation, and so that really pushed home prices higher very rapidly. What the homeowner did an excellent job of after Covid was taking advantage of low mortgage rates, so either they bought a home at that point or they refinanced their mortgage, and you can say almost half of America re-fied at low

mortgage rates when they could. That was also benefited from technology, so the ability to originate loans and mortgage origination from large originators, technology really enabled us to be very efficient in refinancing America. And so borrowers did a really good job of locking in low mortgage rates when they were low, and they also did a very good job of locking in low fixed rates. If you go back to the Great Financial Crisis, almost 40% of mortgages in the US were floating rate, now over 90% are fixed rate, and so as the Fed increased interest rates, that really did not affect current homeowners. They were locked in at low rates, they could actually take the capital that they would have had to spend on a higher mortgage cost and use that to generate attractive yields in their money market accounts for example. And so the homeowner did a really good job, most of them in some cases, to lock in low mortgage rates, and have been a big winner out of the rise in rates overall and been able to not have an increased cost on their home. So they've done a really good job, and it's definitely providing a lot of opportunities for us as bond investors.

CHUCK JAFFE: Do you expect that consumers can continue to ride this out? I mean, there's been a lot of talk about how stretched the consumer is getting, and while it hasn't necessarily shown up in the economic activity thing, eventually if those numbers keep going up, it shows up some place, doesn't it?

CLAYTON TRIICK: It does, and we definitely have seen it across different cohorts of the US consumer, and so we have seen an increase in stress in some income cohorts. We've seen a rise in delinquency rates, for example, in the subprime auto market, we've seen a rise in delinquency rates in charge-offs in some areas of the credit card receivables and unsecured consumer loans from fintech companies, so you have started to see a rise in delinquencies across some areas of consumer credit. Now that being said, a lot of bond investors were kind of aware that you would tend to see this. If you see a big rise in interest rates from the Federal Reserve to slow down demand and put the brakes on the economy, you'd expect an increase in delinquencies or potentially defaults if you have a rising unemployment rate. But we haven't seen that rise in unemployment rate, so you've seen some stress, but overall most of the consumer market has performed well. The unemployment rate as of this last month is still below 4%, which is an extremely low level, jobs are plentiful, and so for now overall the US consumer's doing extremely well. I would bifurcate and say the US homeowner is definitely doing much better than the US renter in the current environment.

CHUCK JAFFE: Let's talk about how companies are doing, because as I look at the composition of your fund, the bulk of your assets are in B to BBB-rated securities, that's investment grade. But for the longest time as we watched interest rates go, there was a lot of talk about we would see a wave of defaults, we would see more companies getting into trouble, yet we really haven't seen that. Investing in that space, have you seen much where stuff maybe hasn't crossed the line to get to where it's junk, but has there been any sort of steady move down towards that, like the pre-junking stage? Or no, it really hasn't been an issue and we don't really expect much change?

CLAYTON TRIICK: You know, Chuck, it's an excellent point. Most strategists expected this rise in defaults to happen across the corporate credit space in the last six to 12 months after the Fed raised rates, it's traditionally what happens, but we've seen the US corporate market also be pretty resilient. That being said, we have seen more capital over the last decade move into areas like commercial real estate and corporate credit and away from the homeowner, and so we do feel that the corporate market is more cyclically sensitive to a change in the economy. So if we do see growth slow down later this year and in 2025, if the Fed has to hike rates because of the resurgence of inflation, we do think the US corporate market is much more sensitive, and we've been positioning for that. Like you mentioned earlier, almost two thirds of the portfolio is in mortgage-backed securities, so those are assets that are backed by US homes and the US homeowner. Within this portfolio, we do find tactical opportunities in the corporate market, but we've very underweight in the corporate credit space because it's so cyclically sensitive, and because you've seen valuations really tighten much more in the corporate space. We actually see better valuations, so cheaper assets, undervalued assets, more in the mortgage space versus in the corporate space. So while we do think that companies have done well so far, if there is a shock to the economy, they're more cyclically sensitive versus the homeowner. What's really fascinating right now, we'll be talking about this a lot with our clients, is that it's very rare when fundamentals and valuations line up as an investment opportunity. Typically if the fundamentals are very, very strong in a certain sector, valuations aren't as attractive because the market's relatively efficient. In today's market we see that the fundamentals of the US's housing market and the US homeowner are quite attractive, but the valuations are actually cheaper than they should be, so that's a very interesting dynamic in the market. The corporate space is kind of the other side, where

fundamentals are still pretty strong but valuations are pretty rich, especially at this point in 2024. I wouldn't have said the same thing 12 months ago, but you've seen a lot of valuation improvement in the corporate space because of the surprise that the overall economy's done well, the soft landing so far has held steady and has won out so far and that's been consensus, but we do think US companies are definitely more sensitive to a change in the economy, economic outlook, than we're seeing in the mortgage market.

CHUCK JAFFE: Clayton, thanks so much for giving me that perspective, I appreciate it. Look forward to chatting with you again down the line here on The NAVigator.

CLAYTON TRIICK: Thanks Chuck, looking forward to the next one as well.

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