Angel Oak
CAPITAL ADVISORS

Angel Oak's Views on 2020 U.S. Presidential Election

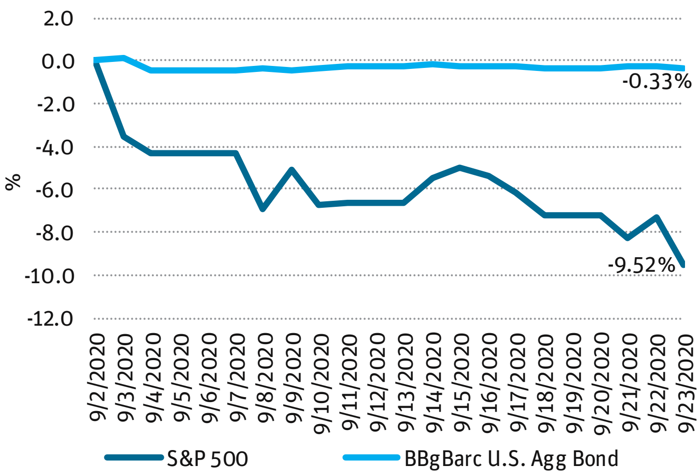
11/2/20

While there are a number of uncertainties relating to tomorrow's election outcome, we predict a couple of likely scenarios regardless of who wins. In either case, we predict Congress will pass a large fiscal stimulus bill that will be beneficial from an economic and risk asset perspective. The amount and the structure of the bill will differ based on who wins, but the next round of fiscal stimulus will finally enter the economy after months of delay. Perhaps more importantly, the Fed will remain dovish and hyper-focused on liquidity. In the following paragraphs, we discuss in more detail the various outcomes and their impacts on risk assets.

If we get a blue wave, the Democrats will execute a huge fiscal stimulus bill followed by an increase in taxes within a year or two. A tax increase amid current local, state, and federal economic shutdowns would not sit well initially. If Trump wins and keeps the Senate, he will also execute a fiscal stimulus bill but without raising taxes. If Biden wins and the Republicans keep the Senate, the results will be fiscal restraint and no tax increases. The first two scenarios, a blue wave and a Trump win/GOP Senate, are the most likely in our view. This would also result in robust fiscal stimulus, which will initially be supportive for economic activity and risk markets, but bearish for the long end of the yield curve. Therefore, we are cautious toward long-duration fixed income and continue to focus on short-duration areas of U.S. structured credit, predominantly residential mortgage and consumer credit, due to their high current income and robust credit fundamentals being in place long before the election and the COVID-19 crisis. We also see opportunities in specific areas of high yield corporate credit with exposure to segments of the economy that would be expected to benefit from a fiscal stimulus bill such as infrastructure and building material-related issuers. Finally, corporate credit issued by financials, particularly regional and community banks, should stand to benefit from renewed economic expansion and the steepening yield curve in our election scenarios.

Despite the recent risk-off environment heading into the election, long-duration fixed income has actually been under pressure. For example, the Bloomberg Barclays U.S. Aggregate Bond Index (Agg) was down 0.45% in October and the S&P 500 was down 2.66%. These are not the moves one hopes for if employing the traditional 60/40 fund allocation. This was particularly evident in the recent equity rout in September, when the S&P was down 9.52% and the Agg was down 0.33% (Figure 1). We think this price action will continue to pose a challenge for investors after the election in either of our likely election outcomes (a blue wave or a Trump/GOP Senate win).

FIGURE 1: PERFORMANCE DURING SEPTEMBER'S SELLOFF

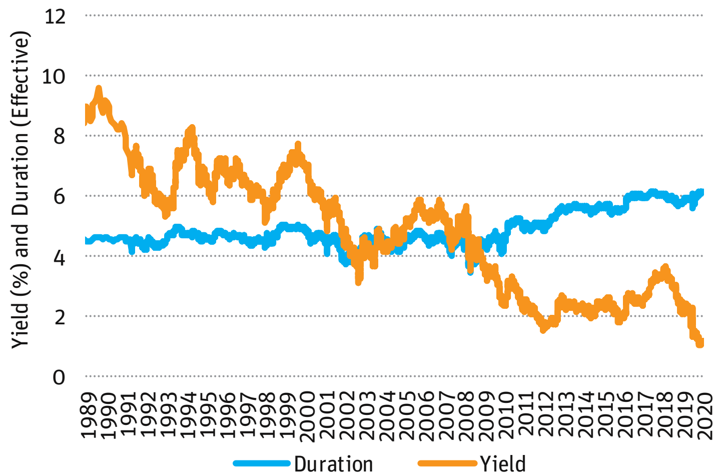


Short-term performance is not indicative of fund performance. Past performance does not guarantee future results.
Source: Morningstar as of 9/23/20.

The secular shift by the Federal Open Market Committee (FOMC) regarding inflation is perhaps more important for the long end of the yield curve following the election. The FOMC confirmed in an August press conference that it will no longer manage to a hard annual inflation target of 2%, but rather aim for an average inflation rate of 2% over several years' time. The policy decision to allow inflation to exceed the 2% target has many important consequences, and confirms that the next recovery won't end prematurely due to fears of pending inflation. This became even clearer through Fed Chairman Powell's subsequent speeches during the COVID-19 crisis and rising social unrest. Tight labor markets drive social mobility and reduce inequality. This is what we were beginning to see in the last recovery—historically low unemployment, increasing wages, encouraging promotions, and improving social mobility. At the National Association for Business Economics Virtual Meeting, Chairman Powell noted, "we have seen that the economy can sustain historically high levels of employment, bringing significant societal benefits and without causing a troubling rise in inflation. The new consensus statement acknowledges these developments and makes appropriate changes in our monetary policy framework to position the FOMC to best achieve its statutory goals." This is a very important shift. The Fed of old would have tightened until it rolled the economy over, blown up some area of finance while it was at it, and created significant job losses and structural unemployment—all for the greater good of not running the economy too hot. In effect, the Fed would initiate, or cause recessions, sacrificing the social mobility gains of a tighter labor market. Thankfully, sending the economy into recession in order to reduce wage pressure in a tight labor market has gone the way of the buggy whip.

Robust fiscal stimulus in either of our most likely election outcomes, historically accommodative monetary policy, and a secular shift on inflation will have some interesting consequences that will most likely show up shortly after the election on the long end of the U.S. yield curve. This will be particularly challenging for traditional fixed income, with one of the most asymmetric return profiles in financial market history (Figure 2). According to Bank of America Merrill Lynch (BAML), we are at 5,000-year lows in interest rates, and even a slight scare on the long end could have serious consequences for long-duration fixed income. For example, a 100 basis point move higher in rates, which some market participants view as likely in 2021 with a blue wave and new Fed regime, would eliminate all of the 2020 year-to-date gains in most long-duration fixed income indices.

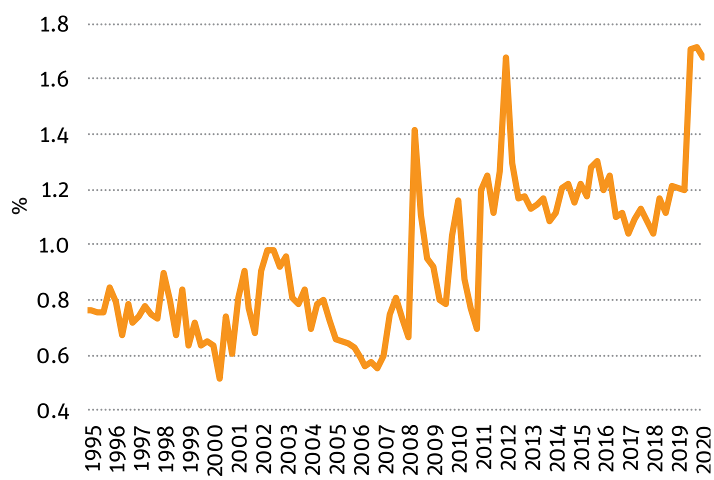
FIGURE 2: HISTORICAL YIELD/DURATION OF THE BBGBARC U.S. AGG. BOND INDEX



Source: Bloomberg as of 9/30/20.
Past performance does not guarantee future results.

In all of our election scenarios—a blue wave, a Trump win/GOP Senate, or a Biden win/GOP Senate—mortgage rates will remain near historic lows even amid the rising long end of the yield curve as the primary/secondary mortgage spread continues to narrow in the months ahead (Figure 3). The case for low mortgage rates and low interest rate volatility in the near term is the Fed's unwavering commitment to the zero bound until 2023 and QE4. Adding to this, the Fed recently announced that it will begin buying UMBS 1.5s, further compressing mortgage rates over the near term. This should be very supportive for the short-duration areas of U.S. structured credit we currently favor, especially residential mortgage and consumer credit. Easy monetary policy and rising inflation is also positive for corporate credit fundamentals, leading to rising revenue and cash flow generation, and ultimately tighter credit spreads.

FIGURE 3: PRIMARY-SECONDARY MORTGAGE SPREAD



Source: Bloomberg as of 9/30/20.

We think high-quality, short-duration income at the zero bound in areas with improving credit fundamentals will perform well in the weeks ahead in any of our likely election outcomes. Not only will income be a critical driver of total return going forward, but less sensitivity to long-term interest rates will be a key differentiating factor for fixed income investors. The impact of decisions at the local, state, and federal levels to shut economies down will be more than offset with more fiscal and monetary bazookas in the months ahead.

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DEFINITIONS

UMBS: Uniform mortgage-backed securities.
Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
Bloomberg Barclays U.S. Aggregate Bond Index: An unmanaged index that measures the performance of the investment-grade universe of bonds issued in the United States. The index includes institutionally traded U.S. Treasury, government sponsored, mortgage and corporate securities.
Effective Duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the effective duration, the greater the price change relative to interest rate movements.
S&P 500 Total Return Index: An American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
Spread: The difference in yield between LIBOR and a debt security with the same maturity but of lesser quality.
Yield-to-Worst (YTW): The lowest potential yield that can be received on a bond without the issuer actually defaulting.

Past performance does not guarantee future results.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Angel Oak Funds. This and other important information about each Fund is contained in the Prospectus or Summary Prospectus for each Fund, which can be obtained by calling Shareholder Services at 855-751-4324. The Prospectus or Summary Prospectus should be read and carefully considered before a decision to invest.

All investing involves risk; principal loss is possible. Investments in debt securities typically decreases when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and non-rated securities present a greater risk of loss to principal and interest than higher rated securities. Investments in asset-backed and mortgage-backed securities include additional risks that investors should be aware of including credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. For more information on these risks and other risks, please see the Funds' Prospectus.

Index performance is not indicative of fund performance. Fund performance can be obtained by calling 855-751-4324 or by visiting www.angeloakcapital.com.

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