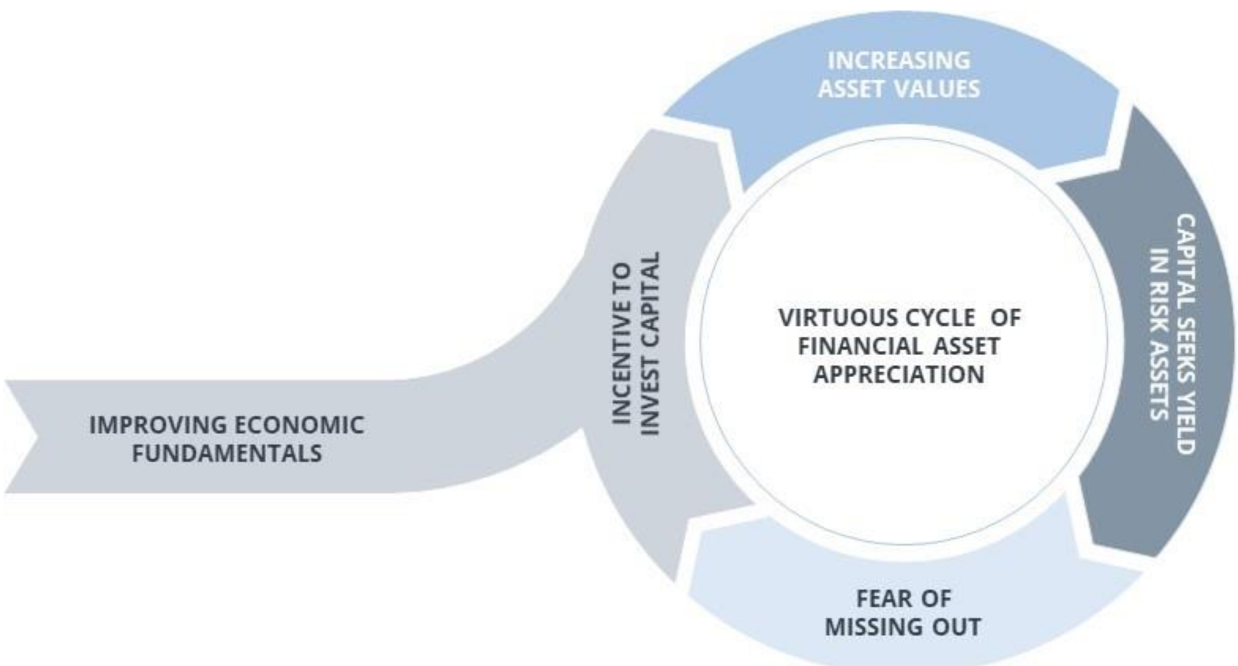
Market Commentary

May 2021

It is a fascinating time to be a participant in the financial markets as an investor and risk manager. Individuals around the globe are becoming vaccinated, and day-to-day life is seemingly returning to some state of normalcy. Many individuals, businesses, industries, and markets are enjoying economic tailwinds because of fiscal stimulus. ~$1.6 trillion in consumer excess savings during the COVID crisis[1] has accumulated and there has been considerable wealth creation from increases in financial asset and real estate values. S&P Global estimates 2021 U.S. real gross domestic product to be 6.5%.

Retail and institutional investors with fresh capital continue to be emboldened as COVID-related risks fade. A year ago, we were writing about a 'vicious cycle' of declining financial asset prices as COVID was setting in. Today, we are witnessing what we consider to be a 'virtuous cycle', as economies emerge from 2020, capital is in search of yield and asset values are increasing. The rise in financial asset values contributes to a 'fear of missing out' mentality and has the tendency to drive capital into risk assets – in further support of rising values.



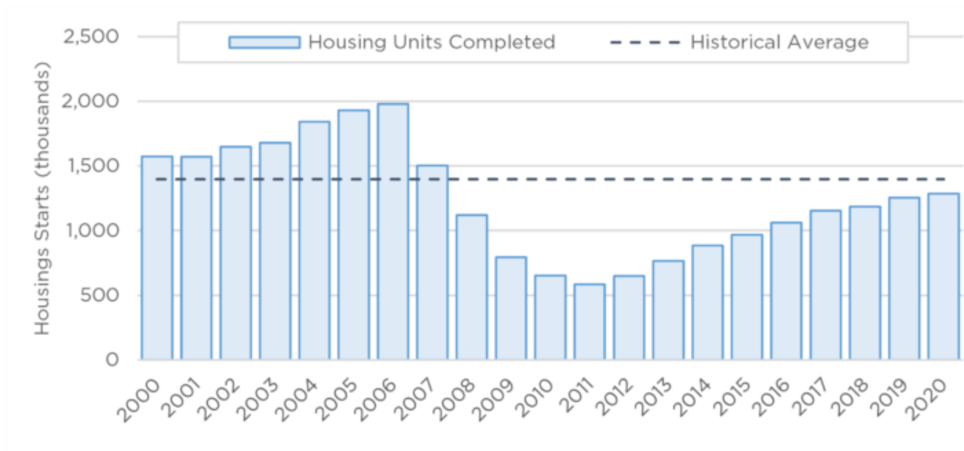
The profits earned in good times often provide investors with a false sense of competency and tends to encourage risky behavior. In Nassim Taleb's book, *Fooled by Randomness*, he postulates that during periods of favorable market conditions, investors often mistake luck for acumen. As investors increasingly believe in their skill, the need for disciplined risk management is diluted and for a time asset values continue to rise.

> *"When things go our way we reject the lack of certainty." — Nassim Nicholas Taleb, Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*

With that said, it is an exciting time to be an investor in residential credit and in particular, the whole loan sector. **Fundamental tailwinds have created a 'goldilocks' environment with low inventory and high demand for housing**.

Structural deficit of housing inventory attributable to decade of under-development

U.S. NEW PRIVATELY OWNED HOUSING UNITS COMPLETED



3.2MM

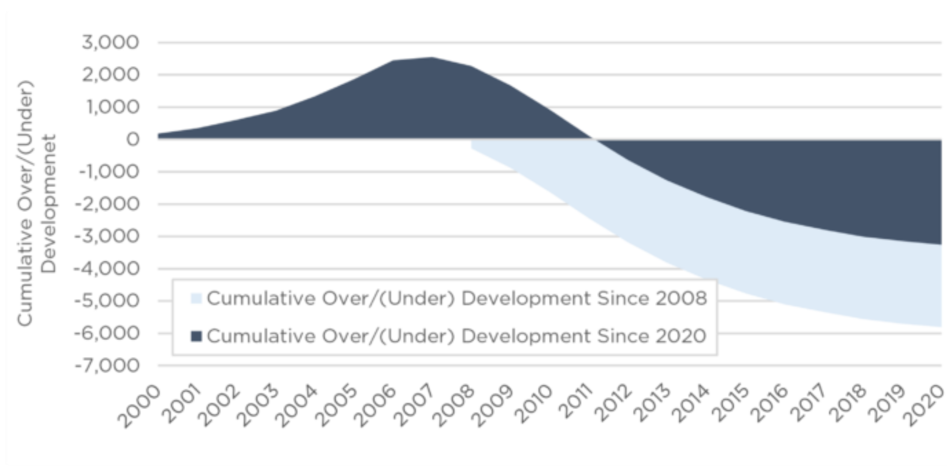
cumulative units

under-developed since 2020

5.8MM

cumulative units

under-developed since 2008



Source: U.S. Census Bureau, Palisades

According to a May 7th note from Freddie Mac:

> *"As of the fourth quarter of 2020, the U.S. had a housing supply deficit of 3.8 million units. These 3.8 million units are needed to not only meet the demand from the growing number of households but also to maintain a target vacancy rate of 13%.* ***Between 2018 and 2020, the housing stock deficit increased by approximately 52%****."*

New completed housing units are rebounding and approaching the historical average, however, assuming production runs at peak levels not realized since 2006, it will still take years to make up for the lost decade of underdevelopment. As such, we believe this will continue to support home values.

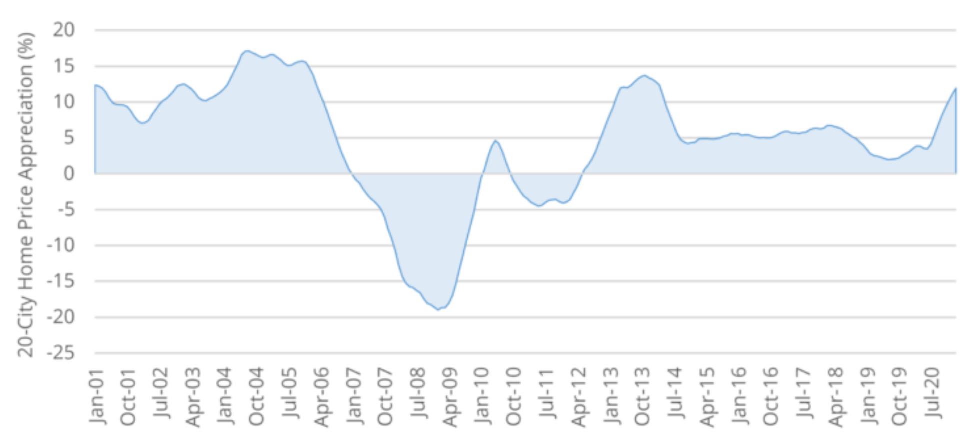
The supply/demand imbalance has resulted in 11.9% year-over-year home price appreciation according to the S&P Case Shiller Home Price Index, and counterintuitively, low interest rates have kept housing affordability levels approximately 20.3% above the historical average.

A competitive home buying market has elevated prices

11.9%

Year-over-year home price appreciation in February 2021

S&P CASE SHILLER 20-CITY HOME PRICE INDEX (YEAR-OVER-YEAR)



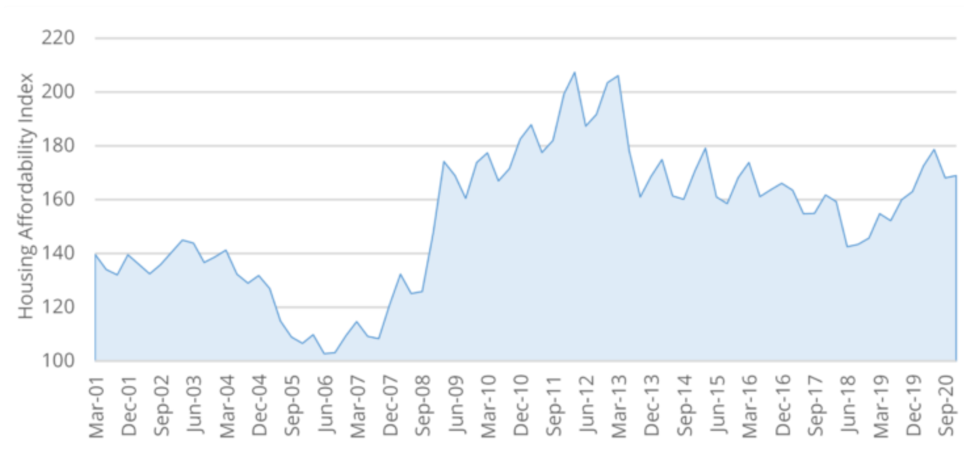
Source: S&P Case Shiller

Low interest rates are keeping homes affordable for many households

20.3%

Above average. Affordability is well above the historical average dating back to 1986

HOUSING AFFORDABILITY INDEX



Source: National Association of Realtors

These fundamental tailwinds in housing have created significant interest in on-the-run residential whole loan sectors. Prices have climbed resulting in traditional loan products such as non-qualified mortgages (non-QM), re-performing loans and non-performing loans (e.g. Ginnie Mae early buyouts) trading at yields ranging between 2.5% and 4.0%. Capital markets investors are buying new issue residential and asset-backed securities at historically tight all-in yields further supporting higher asset prices. Howard Marks once said (along with others):

> *"For a value investor, price has to be the starting point. It has been demonstrated time and time again that no asset is so good that it can't become a bad investment if bought at too high a price. And there are few assets so bad that they can't be a good investment when bought cheap enough." – Howard Marks, Oaktree Capital Management*

As we observe the strong tailwinds supporting residential credit and real estate fundamentals, investors must also consider the price of admission required to participate across the spectrum of investable loan and real estate products. In times when prices are high, we find certain sectors with operational complexities to exhibit less competitive pressures and more attractive risk-adjusted returns.

[1] Source: Consultancy Oxford Economics.