JULY 2022

Market Insights

PALISADES

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2022 ushered in the end of a roller coaster ride that has been ongoing for several years leading up to, and following, the 2020 COVID pandemic. And like many roller coasters, its conclusion is creating discomfort for many of the riders. In financial markets, this 'discomfort' has many investors recovering from drawdowns and searching for safety.

Mania Induced Price Risk

Manias in financial markets often do not seem irrational at the time. Even if they do seem irrational, the profits being made by those riding the wave often lead to a fear of missing out for even the most disciplined investor. Often, it is only in hindsight when the fog wears off that investors realize the conditions were unsustainable. Manias tend to rely on the often referenced 'Greater Fool Theory', as defined below by ***Investopedia:***

> *"The greater fool theory argues that prices go up because people are able to sell overpriced securities to a "greater fool," whether or not they are overvalued. That is, of course, until there are no greater fools left.*
>
> *Investing, according to the greater fool theory, means ignoring valuations, earnings reports, and all the other data. Ignoring the fundamentals is, of course, risky; and so people subscribing to the greater fool theory could be left holding the bag after a correction."*

At any point in time, sectors that produce mania-like characteristics are not necessarily indicative of bad assets, often they are just poorly priced. Markets as a whole take on mania-like behavior when liquidity, confidence, and sentiment are high. Manias often feed on themselves as investors are proven right for being risk-takers (or early adopters of innovation), then valuations rise, and as more capital is allocated to the sector it creates a 'virtuous cycle.'

In practice, many investors, especially large institutional investors, do not have the luxury of stepping away from markets during times of mania induced price risk, which feeds the fervor.

As the virtuous cycle extends beyond rational valuation metrics, bubbles burst that often lead to 'vicious cycles' of value destruction. **However, these are often the best times to buy for well positioned investors.**

A few select sectors that exhibited signs of exuberance leading up to 2022, include but certainly not limited to:

- Special Purpose Acquisition Companies ("SPACS")
- Venture Capital
- Cryptocurrency
- Non-Fungible Tokens
- Public Equity Markets
- Corporate Credit
- Housing & Housing Credit

Each of these sectors saw rapid and somewhat irrational increases in prices, but for differing and unique reasons. We will briefly touch on each of these to illustrate the red flags that in hindsight could have alerted investors to unsustainable market trends, before wrapping up with an update on housing credit.

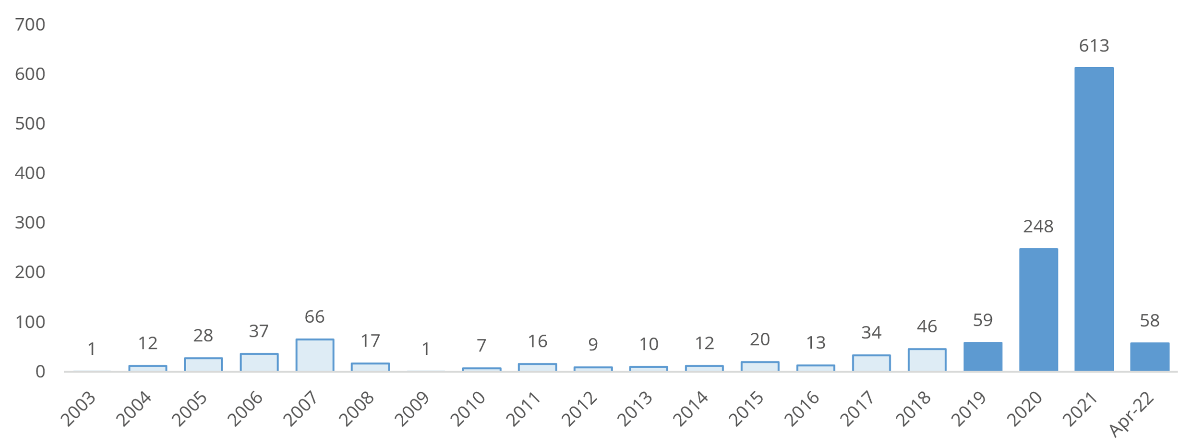
SPECIAL PURPOSE ACQUISITION COMPANIES (SPAC)

According to Statista, in the decade leading up to 2018, there were ***168 SPAC initial public offerings (IPOs).*** In the 3.5 years from 2019 through April 2022, there were ***978 SPAC IPOs,*** 613 in 2021 alone.

This frenzy to launch 'blank check' companies at a pace exceeding any historical precedent could have served as a red flag that this sector was getting overheated.

SPAC IPOS

Source: Statista



Some of the mergers that took private companies public vis-à-vis SPACs had significant valuations and minted nice profits for the early-stage investors. In other cases, investors that stuck around post-merger did not fare as well.

IPOX SPAC INDEX

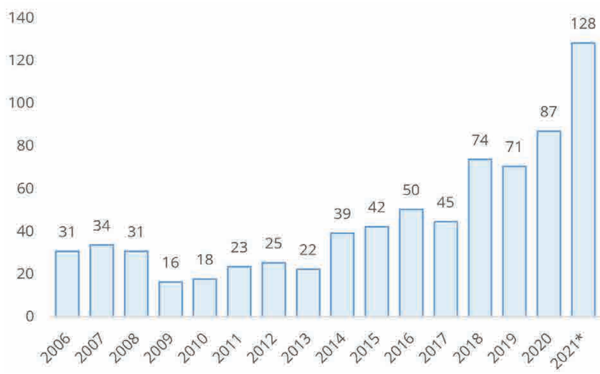
Source: Bloomberg

VENTURE CAPITAL

Allocations to VC funds hit an all-time high in 2021 surpassing the prior peak (in 2020) by 47.6%.

VENTURE CAPITAL FUNDRAISING

$ in billions

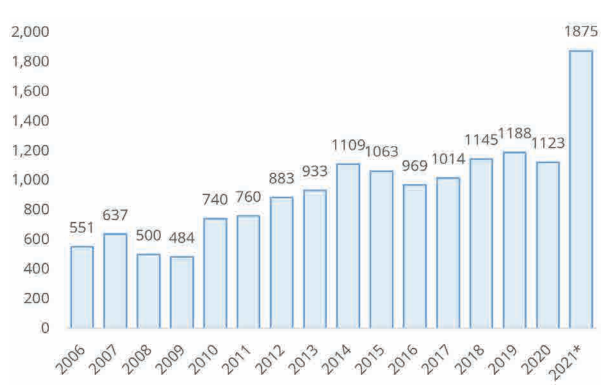


Source: Pitchbook

Venture Capital Exit Activity

Venture funds often find their investment exit through the successful IPO of portfolio companies. Given the strength in the equity IPO market, 2021 reported the largest number of VC exits -- coming in 58% higher than any prior year on record. In cases of successful exits, venture funds were able to memorialize gains.

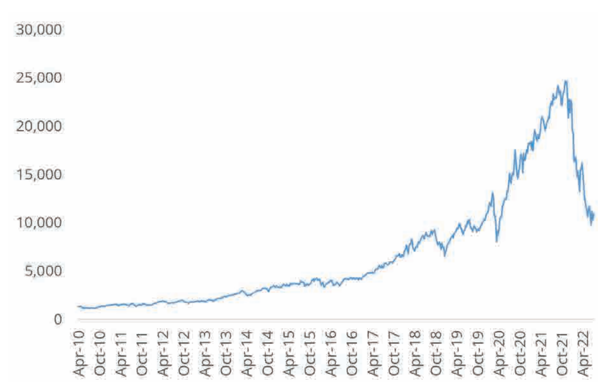
VENTURE CAPITAL EXIT ACTIVITY



Source: Pitchbook

As the market value of public companies soared, so too did the private valuation rounds for many venture-backed companies. Excess liquidity and the allure of outsized gains steered substantial capital to riskier early-stage technology companies. Thomson Reuters Venture Capital Index (shown below as the Refinitiv VC Index) measures the value of the U.S.-based venture capital **private company universe** in which venture capital funds invest.

REFINITIV VENTURE CAPITAL INDEX



Source: Bloomberg

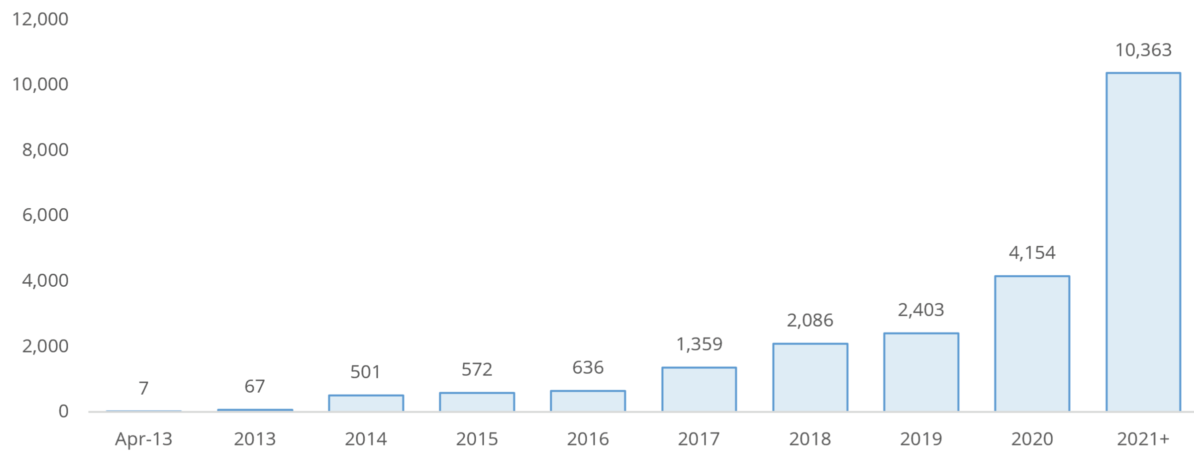
The amount of capital flowing to VC funds combined with the extreme growth in valuation rounds, in hindsight, could have served as red flags that the gains were likely unsustainable.

CRYPTOCURRENCY

According to CoinMarketCap, the number of cryptocurrencies ***grew from 7 coins in April 2013, to over 10,300 coins in March 2022.*** The source indicates that there are actually over 18,000 cryptocurrencies in circulation, but many are ***"inactive or completely worthless."*** The mere growth of the crypto market, driven by the allure of quick profits, could have been an indication that the sector was rife with risk.

CRYPTOCURRENCY COUNT HISTORY

Source: CoinMarketCap

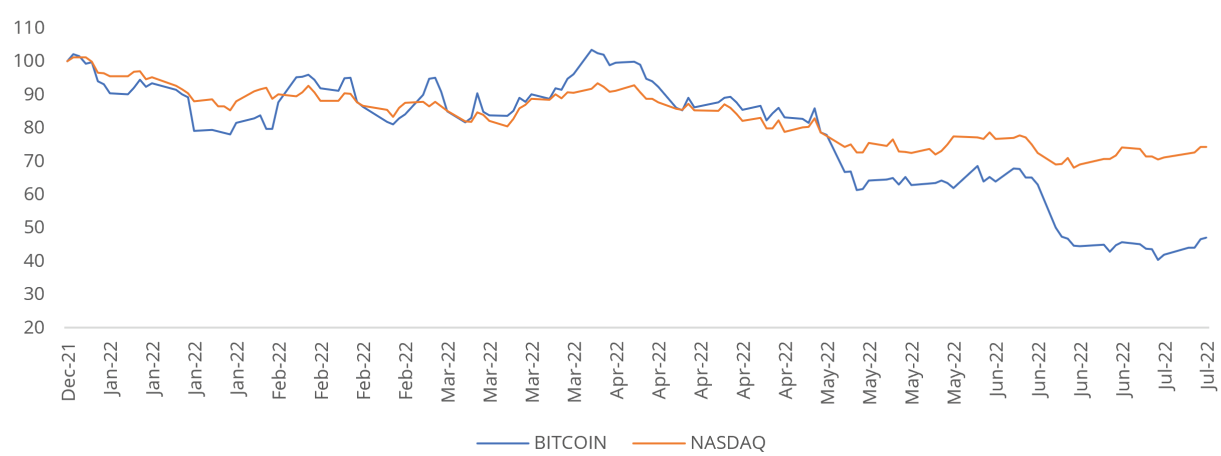


Bitcoin, which is the most prolific of the cryptocurrencies and largest by market cap has been highly correlated with equity markets in 2022 with drawdowns eclipsing 56% (compared to the NASDAQ which is down approximately 26%). Bitfreedom Research stated in a Seeking Alpha blog, ***"...Bitcoin's only actual use case is to convince others to buy it."***

BITCOIN VERSUS NASDAQ

Normalized Year-to-Date

Source: Bloomberg



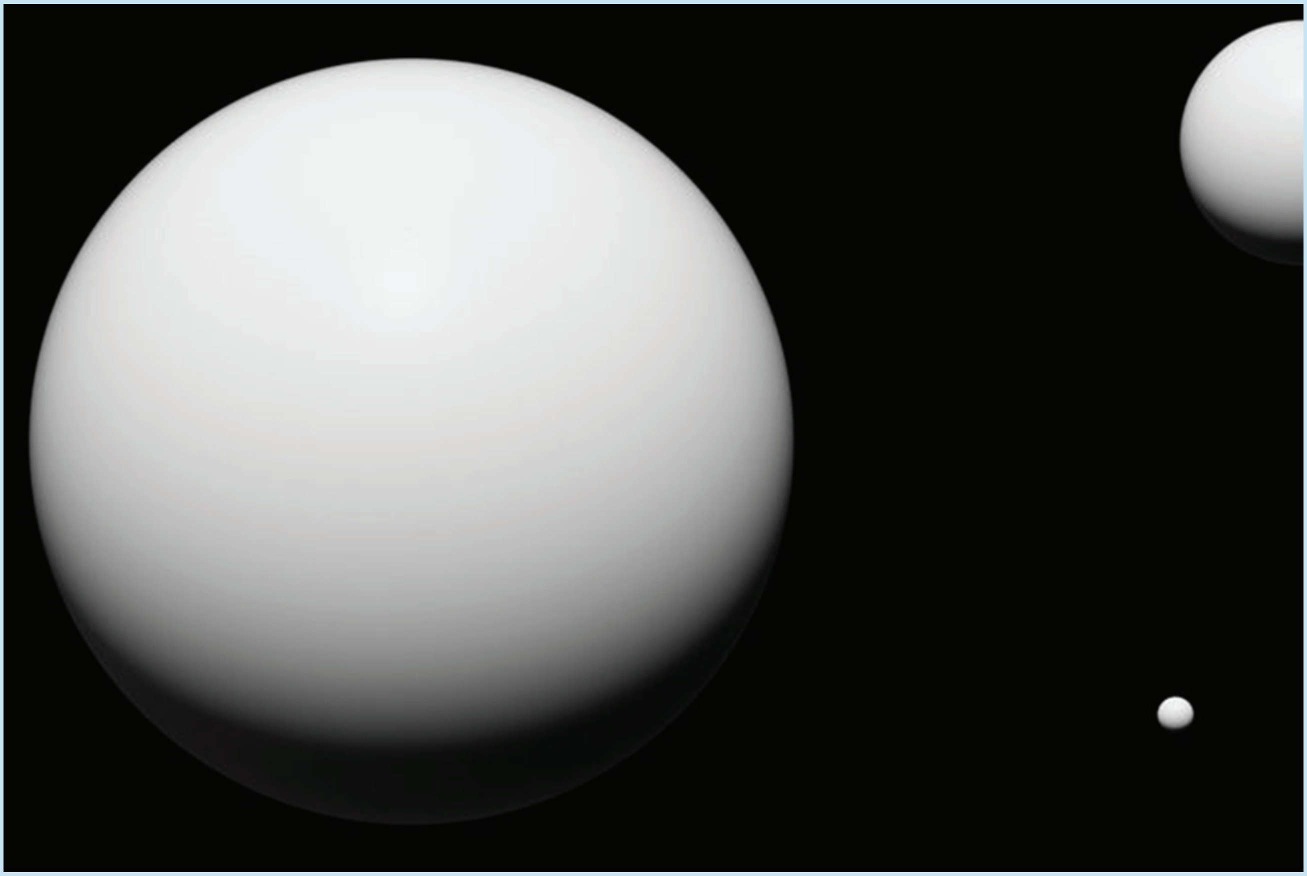
NON-FUNGIBLE TOKENS (NFTs)

NFTs are digital 'assets' that are given unique codes that prove authenticity. According to DappRadar, NFT sales volume totaled roughly **$24.9 billion in 2021, up from $94.9 million in 2020.**

The most expensive NFT ever sold eclipsed **$91.8 million in 2021**, according to findstack.com. The artist, named Pak, titled the image ***The Merge***. It is believed to be the highest price for artwork sold by a living artist.

The red flags of risk in the NFT market likely do not require further explanation.

THE MERGE
Pak (Digital Artist)



PUBLIC EQUITY & DEBT MARKETS

Manias are not confined to technology companies or esoteric sectors within the financial markets. When liquidity is plentiful and rates are low, investors and consumers are willing to accept prices beyond what seems rational, at least in hindsight.

For example, was a 30+ price-earnings multiple on S&P companies justified by historical trends, or a sign that price risk had emerged in the late stages of a cycle?

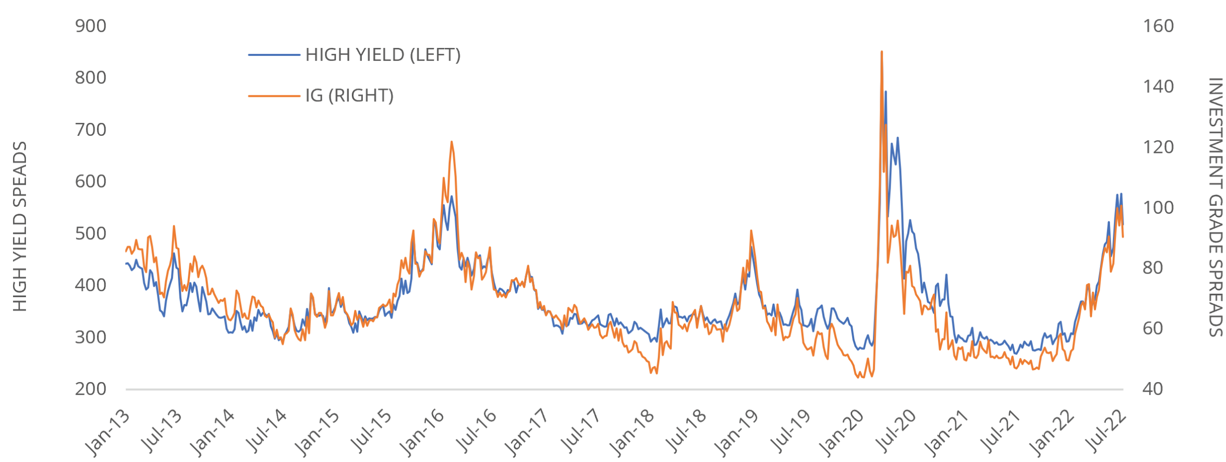
EQUITIES – S&P PRICE/EARNINGS RATIO

Source: Bloomberg

Similarly, investment grade and high yield credit spreads breached ~50 and ~300 basis point thresholds in 2021, respectively, which has historically signaled a peak in fixed income prices. This too was a red flag that a potential correction was forthcoming.

CORPORATE CREDIT SPREADS

Source: Markit

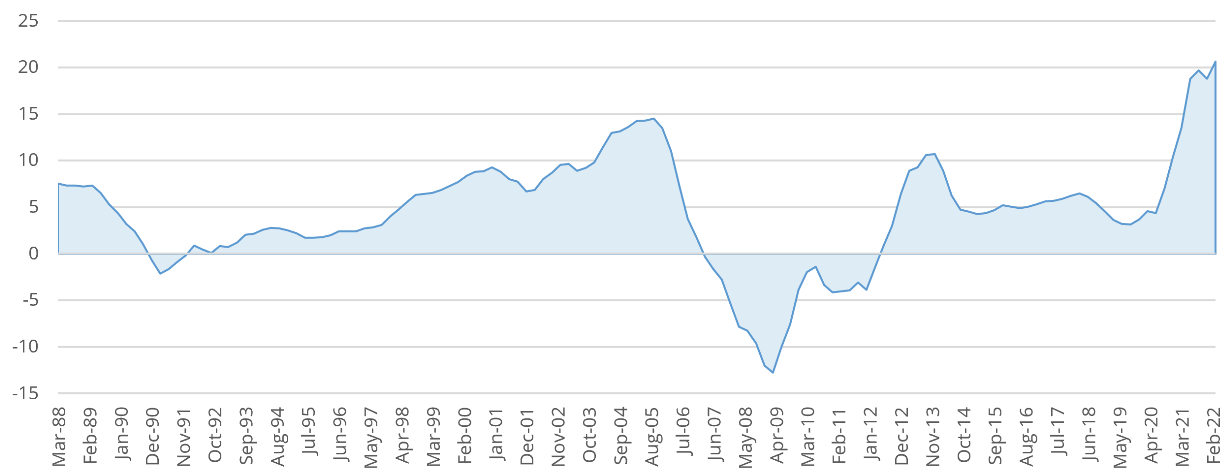


HOUSING & RESIDENTIAL CREDIT

Price risk can be seen in housing as well, however, that is in part due to underdevelopment of housing post-2008 financial crisis and the fact that people will always require shelter. According to the U.S. Census Bureau, for the 10 years prior to the 2006 peak, the U.S. built about 16.9 million units. Over the past 10 years, we have built about 10.8 million. So, we attribute the current house price phenomenon less to irrational exuberance and more to a supply-demand imbalance; with elevated demand driven in part by the opportunity to lock in historically low 30-year mortage rates.

The imbalance in supply and demand for housing resulted in home price growth of 38.7% since December 2019, or 15.7% annualized, according to the S&P CoreLogic Case-Shiller national home price index. The latest report showed year-over-year home price appreciation of 20.39% as of April 2022.

CASE SHILLER NATIONAL HOME PRICE APPRECIATION INDEX
Year-over-Year



So let us take a look at where we were in housing just a few months ago and contrast that to today's environment.

Mortgage Lending was Setting Records.

Prior to 2022, the U.S. residential lending market was operating on overdrive. The 30-year fixed rate mortgage was below 3% and both the purchase and refinance markets were delivering record origination volume for lenders across the country (over $4 trillion of originations in 2021).

Mortgage Lending Talent was in High Demand.

Mortgage industry employment peaked and specialty skills such as underwriting were in high demand, short supply, and lenders were willing to pay up to attract underwriting personnel necessary to close loans.

The New Non-Agency Sector Flourished – No pre-2008 Subprime Loans.

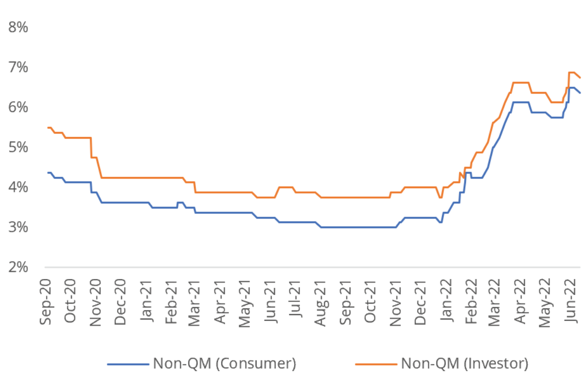
Unlike the loans originated pre-2008, this iteration of mortgages was made to seemingly creditworthy consumers. No concerns of appraisal fraud, broker fraud, stated income underwriting, and no down payment loans. The Dodd Frank Act's Ability to Repay Rule required lenders to verify borrower's ability to repay by documenting income, assets, and employment which makes for a much more stable housing credit market relative to the pre-2008 subprime cohort. Combined with housing tailwinds, rising home values, and increasing homeowner equity, the mortgage market was generally considered to be on sound footing (certainly from a credit and default risk perspective).

Loan Prices Rose, and Yields Declined.

In the non-agency mortgage space, known as non-QM, lenders were eager to capture market share and there was no shortage of capital ready to compete for loans.

Funding costs were low and demand for loans became so elevated that investors were willing to buy at ~3% yields (see chart below sourced from aggregator rate sheets).

NON-QM WHOLE LOANS Par Coupon Loans



Liquidity in the Securitization Market Drove Down Funding Costs.

In the securitization capital markets where many of these loans are ultimately financed, bond investors had an insatiable appetite for rated and unrated bonds which drove in credit spreads. New issue 2-year triple AAA rated RMBS priced below 2.0% yields, while 2-year unrated bonds were pricing in the mid-2.0% area.

Expansionary Phase Reached a Peak.

Given the growth in the Fed's balance sheet during COVID, supply chain challenges, and demand factors, it seemed intuitive that inflation would eventually emerge, even though predictions of inflation over the past decade related to the quantitative easing experiment never came to fruition.

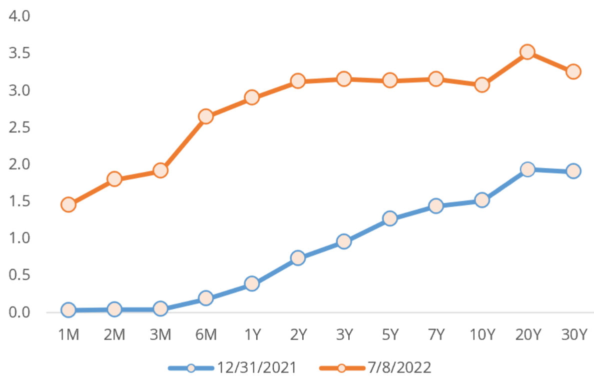
2022 Inflation – and here we are.

Inflation has hit the ground running in 2022 with CPI prints at levels not seen since the early 1980s (9.1% year-over-year in June 2022). Reasons for inflation are well attributed to COVID-induced personal savings, supply chain disruptions, the Russia/Ukraine conflict, monetary policy, and abnormally low policy rates.

As inflation has taken hold, the Fed has abandoned its "transitory" stance and begun to aggressively raise short-term interest rates. Through June 30, 2022, the Fed Funds target rate increased 1.50% and rates across the curve gapped out significantly.

U.S. TREASURY ACTIVE YIELD CURVE

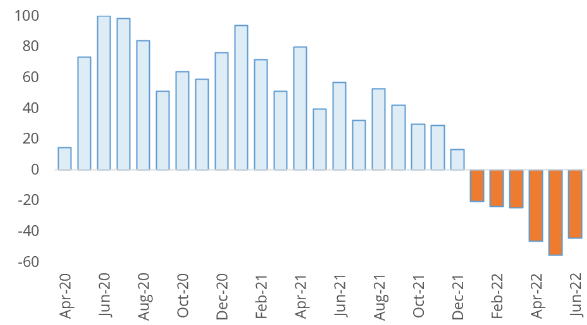
December 31st vs JULY 8th, 2022 (%)



Source: Bloomberg

US FIXED INCOME MUTUAL FUND AND ETF FLOWS

$ in Billions



Source: Investment Company Institute

The Unraveling of Price Risk.

As duration has been rapidly re-priced in 2022 with inflation and the Fed's inflation fighting policies, 30-year mortgage loan prices have plummeted (mortgage rates increasing) along with all duration-based fixed income products. Those left holding unhedged inventory (both originators and mortgage credit investors) have seen portfolio values decline and many have been forced into 'distressed' transactions.

Two prominent lenders have announced business closures presumably due to (i) declining loan prices of held for sale inventory, (ii) margin calls from warehouse lenders, and (iii) funding drying up from institutional loan buyers. As loan demand declines (especially in the refinance market), layoffs have been announced by virtually all mortage lenders.

Retail investors exited fixed income mutual funds in droves as it became clear inflation was taking hold. These mutual funds have historically been the cornerstone of many new issue securitization bond offerings.

What was recently strong demand for new issue paper has since dried up and funding costs soared for mortgage credit investors seeking to securitize. In many cases, the cost of financing is currently above the underlying asset yields. **See diagram on next page.**

CHANGE IN *non-QM* SECURITIZATION FUNDING COSTS
2-YEAR *Single-A rated bond* ANALYSIS

2008 Housing Crisis Similarities, Not So Much.

There are well documented differences in today's housing market versus that of the 2008 crisis.

During the years leading up to the 2008 housing crisis, factors such as relaxed lending standards, high credit risk borrowers, and excessive financial engineering created a cocktail of risk that boiled over. When the bubble burst, homeowners began to default en masse, foreclosures led to a glut of distressed homes hitting the market, home prices tumbled, and a major credit crisis and recession ensued.

While we believe that home price growth will normalize, prices are determined in large part by supply. Blackrock's Joe Zidle said:

> *"[The 2008 housing crisis was created in part due to] oversupply, lower lending standards, and excess leverage that contributed to broad price declines in housing. Conditions appear almost the exact opposite today: secular undersupply, exceptionally high lending standards, and record homeowner equity."*

Distressed Sellers, not Distressed Assets.

While we are not seeing the emergence of 'distressed' and/or defaulted loans, we are seeing 'distressed' situations where those holding mortgage loan portfolios need liquidity – and loan prices are backing up to levels that start to make sense from a risk-reward standpoint.

Special situations across mortgage credit products are creating attractive entry points for assets that just months ago exhibited extreme price risk. Areas where we saw no value (i.e. non-QM at ~3% yields) are now trading at discounts and/or ~7% base case asset yields. We believe the time to add duration tactically is approaching. This is in stark contrast to how we have viewed risk from 2018 through 2021 (as stated in our quarterly investor letters).

It is estimated that there is anywhere from $4 to $7 billion of non-QM loans on Street warehouse lines that need to be sold or refinanced in short order. Some holders are tapping the securitization market where funding costs exceed the asset yields on the underlying collateral, making the financing dilutive to equity returns. We expect this phenomenon to create special situations and attractive investment opportunities throughout 2022.

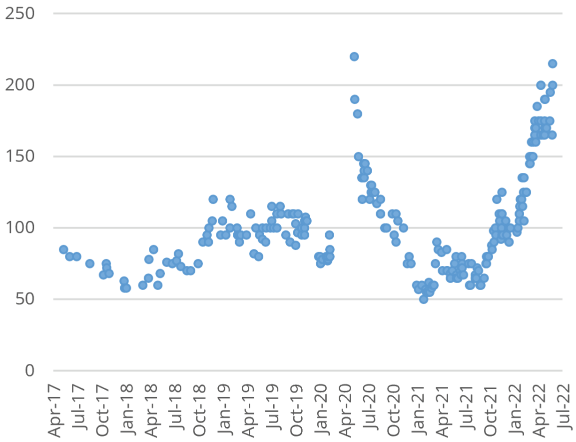
Who has been Skinny Dipping in the Rehab & Construction Loan Space.

In the last several years, investing in property rehab and construction loans has been a great strategy with significantly better relative value as compared to non-QM, jumbo, non-performing, and re-performing loans. Set in a backdrop of low housing inventory, high demand, rising home values, and high absorption of rent increases, rehab and construction lending on single family and multi-family housing has enjoyed significant tailwinds and high absolute asset yields. These tailwinds have attracted investors with limited, if any, default management and loss mitigation capabilities and it will be interesting to see how firms manage to the extent there is a spike in delinquent loans that require workout expertise.

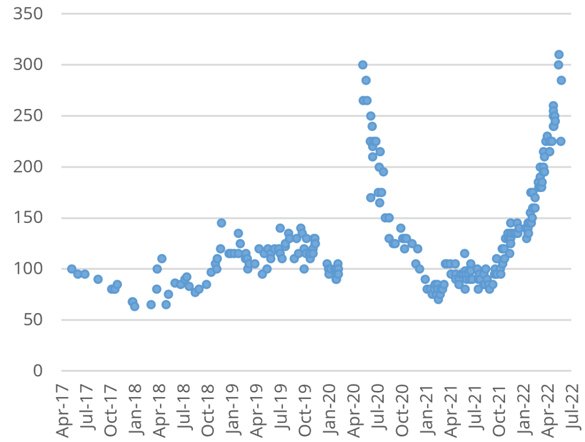
New Issue RMBS.

From a relative value standpoint, new issue RMBS is looking attractive at current price levels. Over the last decade, trying to compete with mutual funds, money managers, hedge funds, insurance companies, and other large pockets of capital for RMBS did not make sense for many value investors. Today's environment is different due to a lack of liquidity and reduced price risk. Triple-A (AAA) credit spreads have widened such that 2-year bonds with ~30%+ credit enhancement are pricing with fixed yields over 5%. Similar tenor double-A (AA) bonds with ~25%+ credit support have yields in the mid-6% area, and single-A (A) at or around 7%. As a result of the dislocation, an investor can decide between buying the entire loan for 7%, or a shorter duration single-A security with 20% credit support at a similar yield.

NON-QM AAA-RATED CREDIT SPREADS
Basis Points

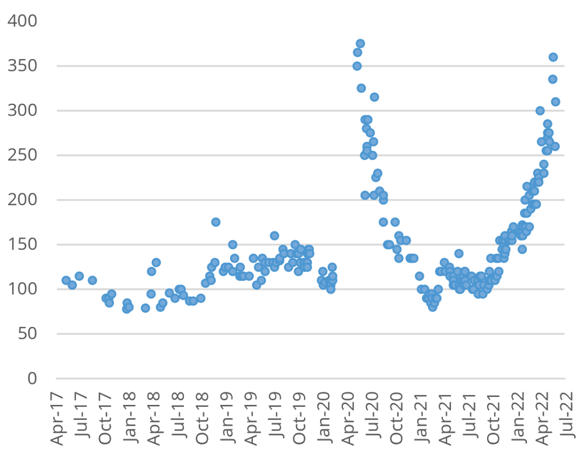


NON-QM AA-RATED CREDIT SPREADS
Basis Points

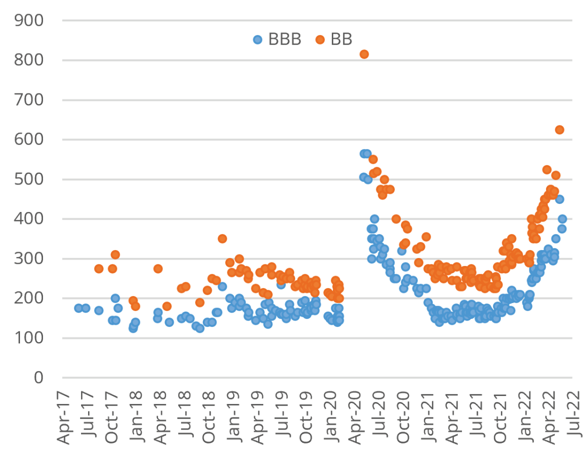


Source: Nomura, Palisades

NON-QM A-RATED CREDIT SPREADS
Basis Points

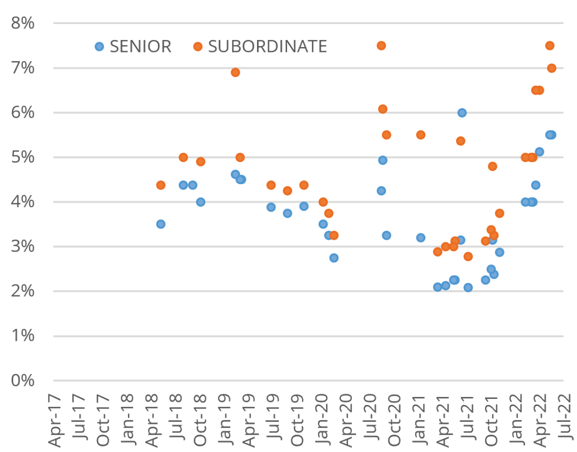


NON-QM BBB & BB-RATED CREDIT SPREADS
Basis Points

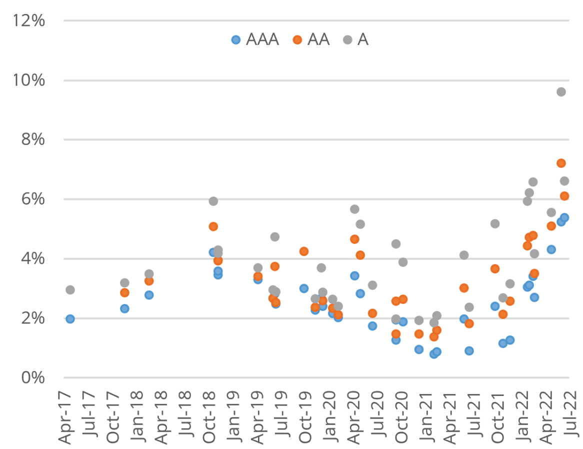


Source: Nomura, Palisades

NON-RATED REHAB & CONSTRUCTION LOAN PRICING YIELDS



REVERSE MORTGAGE PRICING YIELDS



Source: Nomura, Palisades

RMBS FINANCING TERMS

	CLASS	HAIRCUT	3m L+
Non-QM	A-1	10-15%	75
	A-2	15-20%	85
	A-3	20-25%	95
	M-1	25-30%	105
	B-1	30-35%	130
	B-2	35-40%	150
RTL	A-1	15%	130
	A-2	25%	140
	M	30-35%	160

IMPLIED LEVERED YIELDS*

	CLASS	WAL (yrs)	CREDIT SUPPORT	BOND YIELD	FINANCING %	SPREAD	2YR AVG COF	GROSS LEVERED RETURN
Non-QM	A1	2.0	32.0%	5.4%	87.5%	0.75%	3.8%	16.7%
	A2	2.0	24.0%	6.5%	82.5%	0.85%	3.9%	18.9%
	A3	2.0	14.0%	7.0%	77.5%	0.95%	4.0%	17.4%
	M1	4.0	9.0%	8.3%	72.5%	1.05%	4.1%	19.4%
RTL	A1	2.4	20.0%	6.7%	85.0%	1.30%	4.3%	19.9%
	A2	2.5	10.0%	8.4%	75.0%	1.40%	4.4%	20.3%
	M	2.5	5.0%	12.0%	67.5%	1.60%	4.6%	27.3%

** 2-year average cost of funds uses the average forward LIBOR curve over 2-years.*

Shopping for Bargains in Credit.

Credit has been challenged in recent years competing with returns posted in private equity and venture. However, 2022 is changing the tide for credit strategies where mid- to high-teens net returns with strong credit protections are starting to look pretty good.

It is important to note that unlike the 2008 financial crisis, prices in residential credit are not dropping because of credit/default risk or because the underlying assets are bad. Prices have fallen because long duration assets have been simultaneously exposed to **widening benchmark yields** and **widening credit spreads.**

The Fed's monetary policy actions have been telegraphed and followed through upon in 2022. We believe that in large part residential credit markets have priced in the policy risk and there are finally good assets with some duration whose prices make for good investments. That is true across the spectrum of residential credit, including non-QM loans, rehab/construction loans, scratch-n-dent loans, and traditionally more liquid RMBS.

In drawdown funds, we believe it is a better time to tactically provide liquidity in distressed special situations as opposed to engaging in long-term flow commitments with originators at the moment. For income-oriented credit hedge fund structures, credit enhanced RMBS provides attractive entry points.

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