EJF Capital LLC
2107 Wilson Boulevard, Suite 410
Arlington, VA 22201
Ofc 703 875 9121
Fax 703 875 0566

EJF Capital's 2023 Thematic Outlook

Executive Summary

EJF Capital LLC ("EJF" or "we") believes that 2022 revealed several thematic trends about the future in financial services:

- The U.S. Federal Reserve's fight against inflation requires investors to reorient their mindset toward accepting a higher plateau level of rates. Investors should begin consideration of all investments with the understanding that for the foreseeable future borrowing rates will be higher and weigh on corporate profits, and that there are less risky and volatile alternatives to many equity market investments. *(Page 2)*

- Within the financial services sector, the most attractive risk/return investment opportunities lie in the areas of regulatory debt issued by U.S. and European banks and insurance companies and in U.S. agency mortgage-backed securities. More opportunistically and tactically, investment opportunities exist in the debt of challenged specialty finance companies, capital risk transfer transactions and bridge lending to non-startup technology companies. *(Pages 4 - 5)*

- The FTX scandal and the resetting of the digital currency market does not undermine the revolutions taking place in fintech and blockchain technologies. Distributed ledger technologies will continue to evolve and become adopted within the financial services sector. EJF also maintains its strongly held view that the regulatory machinery of the federal government will begin to regulate blockchain technology, if not in 2023 then within the next few years. *(Page 6)*

- Finally, we believe that the transferable tax incentives contained in the Inflation Reduction Act of 2022 ("IRA") will provide compelling investment opportunities in the renewable energy space, including opportunities to finance such projects and creating structured pieces. These opportunities will largely turn on the upcoming regulations interpreting the broadly worded IRA. *(Pages 6 to 7)*

Dear Investor:

At EJF, we have reflected on 2022 to make several thematic projections. We focus our 2023 outlook on our areas of expertise: regulatory direction and its impact on the ever-evolving financial services sector.

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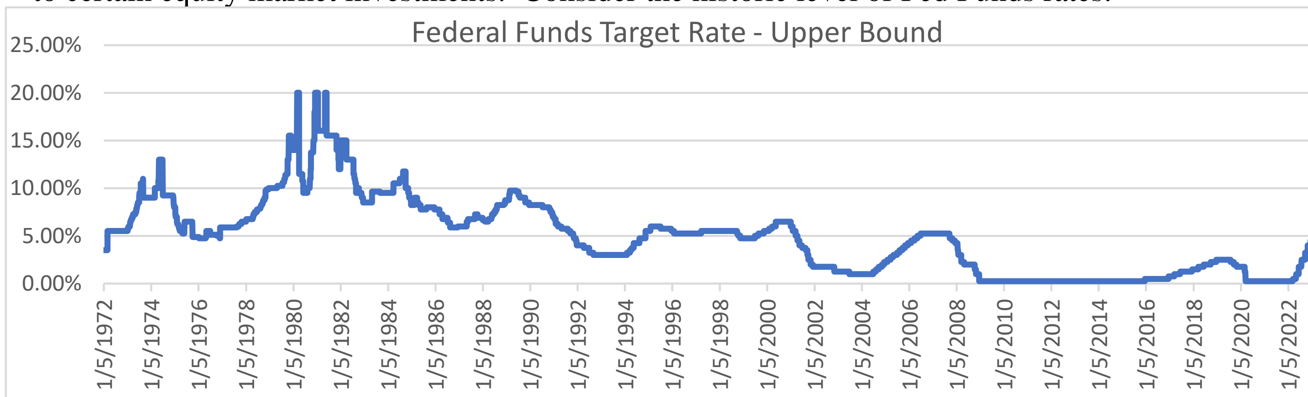
In his book, *The Bomber Mafia*, Malcolm Gladwell examines the development of a revolutionary new idea prior to World War II regarding how to bomb an enemy.[1] Challenging the conventional wisdom of what was then known as "area bombing" – the tactic the Germans used to bomb indiscriminately civilian populations during the Battle of Britain – several American military leaders argued instead for "precision bombing". The theory was that the lives of civilian populations could largely be spared, and wars ended earlier, if critical military targets, such as ball bearings and munition factories, could be precisely wiped out. Although the technology for precision bombing was nascent, the Americans experimented with the tactic in the European theatre of World War II, with little tangible success. Area bombing sadly prevailed as the preferred bombing method during the war with tragic humanitarian consequences: Cologne and Dresden in Germany and Tokyo in Japan, to name but a few. The atomic bombs dropped on Nagasaki and Hiroshima were a more draconian version of area bombing tactics. And as we now know all too well, Russia has been utilizing area bombing in its unprovoked war against Ukraine.

What relevance does Gladwell's book have to today and to investing? Gladwell's lesson is that a mindset reorientation was required for the U.S. Air Force to develop precision bombing – a tactic that ultimately prevailed in the U.S. military once the Air Force shifted its focus and the technology was perfected. Although today we find it strange that precision bombing was a revolutionary idea, Gladwell convincingly argues that it was. The indiscriminate method of area bombing is akin to what some technology and leveraged buyouts using historically cheap borrowed money have been in the era after the Great Financial Crisis. Instead of precisely targeting investments, investors carpeted the field in areas that benefitted from historically low interest rates with broadly successful results.

As we begin 2023, a mindset reorientation is required. With the tricky current environment of persistent inflation, impending recession and heightened geopolitical risk, investor mindset must shift back to a reality of higher risk-free yields. In EJF's view, investors should begin consideration of all investments with the understanding that (barring another GFC) borrowing rates will be higher and weigh on corporate profits, and that there are less risky and volatile alternatives to certain equity market investments. Consider the historic level of Fed Funds rates:



[1] Malcolm Gladwell, *The Bomber Mafia* (Little, Brown & Co.: New York 2021)

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As the chart[2] shows, the historic average of the Fed Funds rate has been 5.42% from 1971 to 2022, with a high of 20% in March 1980 and a low of 0.25% in 2008. Consensus estimates are that the current level, 4.5%, is expected to increase to at least 5% over the next two FOMC meetings thus approaching the historic average.[3] We believe that the Fed will stick at that level for some time, consistent with Chairman Powell's recent public statements: "It is likely that restoring price stability will require holding policy at a restrictive level for some time. History cautions strongly against prematurely loosening policy. We will stay the course until the job is done."4 We believe this because it takes time to bring soaring inflation down through FOMC rate hikes, as the resiliency in the labor market demonstrates. Although the housing market is reacting to the rate increases, it can take 18 months or more for broad inflation to begin to recede, as it took the Fed under Chairman Paul Volcker in 1980.[5] Our view is not universal as many market observers believe that the Fed will ease in the latter part of 2023 once unemployment increases amid a slowing economy. But we believe that rates, which have gone up like a rocket – the fastest pace since 1980 – will instead come down more like a feather. [6] A higher plateau of interest rates may be the new normal.

So what should investors focus on after adopting this mindset reorientation? We believe there are several precise areas of investment opportunity in financial services that offer the potential of attractive risk-adjusted returns.

Attractive Risk-adjusted Debt Opportunities

- Floating rate "regulatory" debt issued by entities that benefit from higher rate environment: banks and insurance companies. Another sea change since the GFC has been historic levels of regulatory capital at banks and the ratcheting up of lending standards. With the exception of sub-prime borrowers, we have not seen elevated levels of loan defaults or deferrals, although one would expect them to increase as recessionary pressures come to bear. We are also seeing the beginning of pressure on banks to increase deposit rates, thus potentially squeezing net interest margins in the future, although many of these issuers benefit from strong balance sheets that provide a material buffer. Overall, selective debt issued by regulated entities of this nature has minimal default risk, in our opinion, and present compelling opportunities in the current environment.

- Floating rate Residential Mortgage-backed Securities ("RMBS") debt issued by US Government Sponsored Entities ("GSE"), particularly Fannie Mae and Freddie Mac. There have been historic spreads available in RMBS tranches of structured debt collateralized by US

[2] Source: Bloomberg FFTR Index
[3] *U.S. Macro Latest: Thoughts on Powell*, Greenmantle (Dec. 14, 2022)
[4] "*Inflation and the Labor Market",* Chair Jerome H. Powell Speech at the Hutchins Center on Fiscal and Monetary Policy, Brookings Institution, Washington, D.C. (Nov. 30, 2022)
[5] *U.S. Macro Update: The Great Disinflation Part I: Volcker's Failure*. Greenmantle (Oct. 6, 2022)
[6] *Fed Minutes Show Officials Feared Markets' Rallies Could Hinder Inflation Fight*, Wall Street Journal (Jan. 4, 2023)

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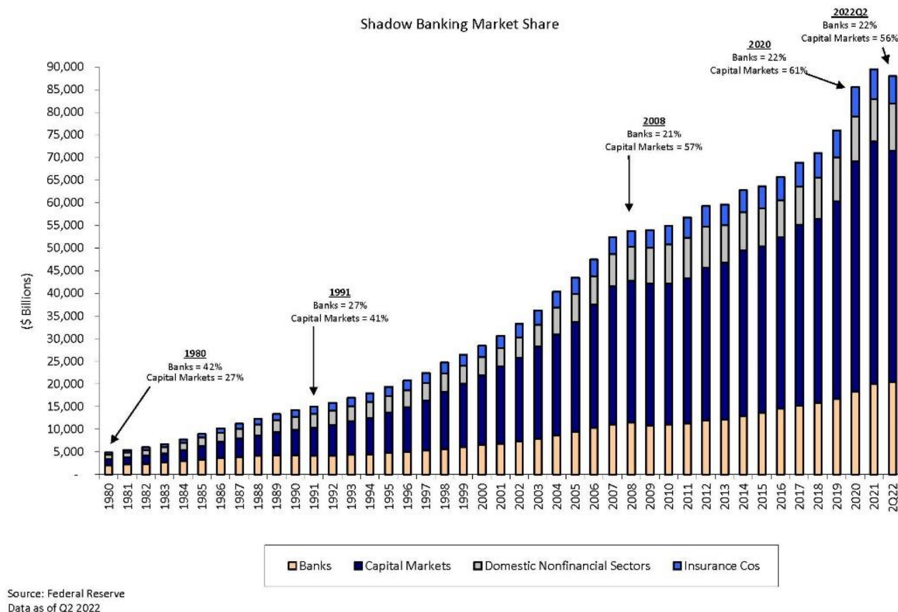
mortgages. Although mortgage rates have leveled off and even decreased over the past few months, in 2022 rates went from approximately 3% at the beginning of the year to a high of approximately 7% in October. The disruptions in the housing and RMBS markets have impacted and enhanced returns for investors of the investment grade tranches of RMBS. In October, the spread of an investment grade tranche over a 10-year Treasury hit the historic level of 2.9% versus the historic average of 1.7%.[7] In part, these disruptions are the result of the Federal government no longer actively purchasing RMBS. We believe the investment grade tranches of RMBS presents attractive risk/reward characteristics that should persist into 2023 as mortgage rates remain elevated.

<u>Opportunistic and Tactical Investments</u>

- Unlike banks, agency mortgage REITS depend upon funding sources other than insured deposits, whether it be the securitization markets or dedicated financing vehicles. When rates rise, the cost of such funding typically increases dramatically and with greater magnitude than do insured deposits. Such companies may thus have their spread profits squeezed or even eliminated and face the prospect of refinancing embedded low-cost debt. This can create opportunities that can be compelling. The broader opportunity set in specialty finance companies is displayed in the follow chart showing the steady evolution of "shadow" banking.



[7] *A Look at the Relationship Between the 10-Year Treasury and 30-Year Mortgage Rate*, Builder (Nov. 14, 2022)

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- Capital relief trades ("CRT") are transactions in which a regulated bank seeks to reduce its capital charges on a basket of loans it voluntarily wants to keep on its balance sheet. The bank does this by selling off some of the risk to outside investors, using tools such as first loss structures (often referred to as "credit-linked notes") and paying attractive interest rates that offset the risk. In times of stress, banks want to reduce their capital charges to free up capital for other purposes.

- With the technology valuation readjustments of 2022, private companies in the space will be squeezed if the capital markets remain closed and the appetite for investors to make equity investments wanes. For the stronger technology companies that have a great product and/or technology and just need time and capital to expand, management teams will not want to be diluted by investors at greatly reduced valuations. This dynamic can create opportunities to lend to strong private technology companies at attractive rates and with potential equity upside participation if certain metrics are achieved. We have seen a dramatic increase in such opportunities and expect that to continue through 2023.

Distributed Ledger Technologies

One of the bubbles that the interest rate hikes in 2022 exposed was in digital currencies, or so-called cryptocurrencies. We believe that the lasting legacy of the FTX scandal will be regulation and regulatory scrutiny. We believe FTX and other fallen icons of the industry will act as cautionary tales rather than a condemnation on blockchain technology itself. We believe that evolution and adoption of such technology will continue despite the cryptocurrency bubble bursting.

Blockchain technology is a specific implementation of distributed ledger technology that enables participants, or nodes, to manage, share, and synchronize data across a decentralized network. Data is entered onto the ledger only when consensus is reached, ensuring the accuracy of all incremental data. Blockchains relay data via "blocks", each of which has a unique, immutable cryptographic signature. Similar to traditional distributed ledgers, blockchains rely on consensus which guarantees that encrypted information has not or will not be manipulated. As data can be a representation of value, the use cases for this technology are numerous and broad reaching. Blockchain technology brings three notable improvements relative to traditional data transfer protocols: near instant settlement, significantly lower processing costs, and greater security and permissioned transparency. In simple terms, this technology is cheaper, faster, and safer.

Lastly, blockchains have the capacity to layer on additional technological innovations, such as smart contracts. Smart contracts allow for multi-step transactions to occur under specific, immutable, conditions independent of human intervention. An example of this technology would be disbursement of funds to contracted recipients immediately following receipt of funds by an operating account (think payments to mortgage-backed security holders – the waterfall of payments can be codified at the bond level, disintermediating the servicers of the bond).

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We believe that three areas of blockchain technology/blockchain infrastructure have specific application to financial services: financial infrastructure, payments, and crypto-enablement. We believe that digital assets will remain an investment class going forward, whether that be "legacy" digital assets such as Bitcoin, stablecoins (digital assets backed by liquid, fiat instruments like U.S. Treasury bills), or Central Bank Backed Digital Currencies ("CBDCs"). Any digitized "bearer instrument", in our estimation, will require financial infrastructure for compliance, risk management, accounting, and distribution.

Inflation Reduction Act of 2022 and Renewable Energy Projects

The transferable tax incentives contained in the Inflation Reduction Act of 2022 ("IRA") will provide compelling investment opportunities in the renewable energy space, including opportunities to finance such projects. These opportunities will largely turn on the upcoming regulations interpreting the broadly worded IRA.

In our opinion, the IRA is a meaningful development for the U.S. solar and energy storage sectors as it increased the solar investment tax credit ("ITC") from 26% to 30% and extended the credits for at least 10 years. Additionally, it provides this runway for projects ranging from small residential to large utility-scale markets. The IRA is also powerful for energy storage as it extends the 30% ITC to storage-only installations for the first time. U.S. Solar installations are forecasted to grow 18% annually through 2026 while US energy installations are expected to grow 16% annually through 2040.8

At EJF, we pride ourselves on seeking every day to provide our clients with not only attractive financial performance, but actionable intellectual capital. We hope that you have found this 2023 Thematic Outlook a thoughtful consideration of broad regulatory and investment trends we anticipate in the future.

We wish you and your families a happy and healthy New Year.

Neal J. Wilson
Co-Founder and Co-CEO

[8] Goldman Sachs Research, 'Inflation Reduction Act: From Theme to Tailwind' (January 2, 2023).

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